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The Role of the Board in Overseeing Financial Reporting and Disclosure

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1. Introduction

While financial reporting and disclosure are the keys to enhancing and maintaining transparency, and thus the keys to good corporate governance, how to design the role of the board in corporate governance as such is a difficult question. In my opinion, there is no single model that fits all situations, and therefore, each country should be free to choose the system that fits it best. In this paper, I begin with a brief review of recent discussion on corporate governance and describe the importance of disclosure, accounting and auditing (Section 2). In Section 3, I turn to the question of how the board or other corporate organs can play an effective oversight role in disclosure, accounting and auditing. I also briefly describe the legal system in Japan on overseeing financial reporting and disclosure. In Section 4, I make prescriptive suggestions for Asian countries. Section 5 is my preliminary conclusion.

I have limited my discussion to publicly held business corporations. Also, by "disclosure," I mean disclosure required by law (known as mandatory disclosure), unless I note otherwise.

2. Corporate Governance and the Importance of Disclosure and Accounting

A. What is Corporate Governance? Does It Matter?

Today, the notion of corporate governance is used in two different contexts: (1) a system or mechanism for stopping fraud or stealing money by managers of the corporation ("misbehavior control mechanism"); and (2) a system or mechanism for enhancing corporate prosperity and performance, and thus economic growth (or economic recovery), in any given country ("performance enhancing mechanism"). While corporate governance in the former sense is important, today, we tend to put more emphasis on the latter notion of corporate governance.

A well-written report that shows this trend is "Committee on Corporate Governance, Final Report (January 1998, in the U.K.)", popularly known as the Hampel Committee Report. The recommendations in this report were

incorporated with slight changes into the "Combined Code of Corporate Governance" of the London Stock Exchange in June 1998. Needless to say, the OECD published "Principles of Corporate Governance" in April 1999, which addresses both aspects of corporate governance mentioned above.

B. Two Puzzling Linkages or Causalities

There are two logically possible linkages or casualties that will make laws (including laws requiring accounting, disclosure and auditing) on corporate governance important for the economy. One is the linkage between corporate governance and economic performance, and the other is that between laws and corporate governance.

laws => corporate governance => economic performance

The existence or strength of each of these two linkages or causalities is not entirely clear, as the results of empirical studies are split. For example, an empirical study about US public companies by Sanjai Bhagat and Bernard S. Black, "Board Independence and Long-Term Firm Performance" (revised version, February 2000), reports evidence that firms suffering from low profitability respond by increasing the independence of their board of directors but find no evidence that this strategy actually works -- that firms with more independent boards achieve improved profitability. Thus, their study does not support the conventional wisdom that greater board independence improves firm performance.

Under the circumstances, however, we believe today that corporate governance appears to affect economic performance, and laws appear to affect corporate governance. If so, corporate governance is important, and laws are important.

C. Common Prescriptions for Effective Corporate Governance: Transparency and Fairness

On the basis of my understanding of past empirical studies and debates on corporate governance, I wish to be blunt and suggest prescriptions that should be common for all Asian countries and those that are not common and should differ among countries. The most important common prescription is that any corporate system must have transparency and fairness. With respect to my different prescriptions, two determinants of corporate governance are important. One is the form of finance and the other is ownership structure. I do not discuss different prescriptions in this paper. (For detailed prescriptions, see Hideki Kanda, Legal and Regulatory Reforms for Effective Corporate Governance, a draft presented at the ADBI's Training Workshop on May 16, 2000.)

Today, any corporate governance system must be accompanied by both transparency and fairness, this being the "global standard." Why? There is no logical reason. For instance, if a firm is owned by a family, there is no need for transparency unless they need finance from outside -- the family knows everything and controls the firm. That's it. I think that the reason why transparency and fairness are required as a common standard for corporate governance today is just the fact of globalization. People act today across countries' borders (as technology has made this possible and easy), and it is easier for different people to interact when transparency and fairness exist.

For legal and regulatory settings, to maintain and enhance transparency, disclosure and external audit by independent auditors are the key. In contrast, fairness is a vague notion, but I think that strong enforcement is the key to maintaining a legal and regulatory environment supporting fairness.

D. Disclosure, Accounting and Audit

In a paper that I presented last time at this roundtable (see Hideki Kanda, Disclosure and Corporate Governance, March 4, 1999), I emphasized three points, and I think that these points are important still today. First, it is easy to say that disclosure is a good thing. In fact, I am an advocate of disclosure. Disclosure enhances transparency. Disclosure helps "stakeholders" of the firm or other market participants act properly. With adequate information, investors can buy or sell stock, "voice" to the management, or even acquire control of the company. Also, disclosure might prevent fraud. Despite these benefits, however, disclosure is accompanied by costs. The costs are placed on the firm which is required to make disclosure and thus on the national economy. Therefore, when one attempts to improve a disclosure system, one must have a clear idea of exactly what sort of disclosure system to aim at. Indeed, it is extremely important to be aware of what information should be disclosed. Information being disclosed must be "useful," that is, understandable and verifiable. In this sense, it is particularly important to determine what accounting rules should be adopted. And auditing by accounting professionals must be reliable.

Second, disclosure does not have an absolute value in isolation. The value, or the effectiveness, of disclosure depends very much on other (often non-legal or loosely legal) conditions, such as the style of finance and ownership structure. The value of disclosure is higher where there is a well-functioning capital market. It is also higher where investor ownership is dispersed rather than concentrated.

Third, from a corporate governance perspective, disclosure alone may not be enough, and other legal infrastructures are equally important. For instance, even if a vast amount of information on public companies is available in the market place, if there are restrictive legal rules on corporate takeovers, the "market for corporate control" does not function as an effective corporate

governance device. Therefore, when one considers the improvement of the disclosure system, one must also prepare a comprehensive regime of securities regulation to take full advantage of the disclosure regime.

3. Oversight in Disclosure, Accounting and Audit

In general, there are a couple of conditions for the system of disclosure, accounting and audit to work properly. First, disclosure should be meaningful. Second, the major content of disclosure should be accounting information (usually shown on the company's financial statements), and therefore accounting standards must be the right ones. What is the right accounting standard is a difficult question. But today it is generally agreed that accounting must show the true and fair status of a company. Third, to assure this, the role of external auditors, particularly professional accountants, is important, because such professionals are probably the best able to check whether the prepared numbers on the company's financial statements are accurate and comply with existing accounting standards.

The question of oversight means how to make sure that the above mentioned three matters function properly enough to obtain investor reliance and confidence, and how the company builds a system, within the board or otherwise, that ensures this. I think that the key to the effective oversight is independence, adequate information, and power of enforcement.

A. Disclosure

Disclosure mandated by law has inevitable weaknesses. For instance, the most typical mandatory disclosure system is to require public companies (known as "reporting companies") to make disclosure periodically. Disclosure is made quarterly in the U.S., and twice a year in Japan. The scope of information being disclosed is carefully delineated by law, and the key information being disclosed is accounting and financial data. Such periodic disclosure, however, has at least two flaws. First, there is a time lag between the date when disclosure documents (typically the firm's financial statements) are prepared and when they are actually disclosed. In Japan, the legal rule is that periodic disclosure is made semi-annually, and the financial statements must be prepared and become public within three months of the cut-off date. For instance, an annual report must be prepared and become public after the closing of the company's fiscal year. Thus, there is a three-month lag. Second, there is no obligation for the company to update the information supplied in the financial statements even if something happens after they are prepared and become public. There is an exception that certain important events must be disclosed in a special report (known as an "8-K" report in the U.S.), but this exception is not comprehensive.

Therefore, to rectify these two flaws, there must be a supplemental scheme. In this vein, stock exchanges and other self-regulatory organizations

usually require "timely disclosure," by which the company is required to disclose pertinent information more often (and sometimes in more detail) than is required by law. For instance, the Tokyo Stock Exchange requires listed companies to file summary financial statements within two months from the closing of the fiscal year and to file special reports for events that would materially affect investor decision-making.

Another problem with legal rules is that any legal rule must be enforced, and enforcement is rarely costless. Fortunately, disclosure and accounting rules, particularly those for "hard" information such as data in the firm's financial statements, are often enforceable at low costs. For example, if a publicly held company keeps supplying false numbers in its financial statements, it will likely be uncovered and penalized in the market place. Thus, contrary to the rule on insider trading, for instance, rules on disclosure and accounting are often self-enforcing. This implies that it is the value of the substantive rule that matters, and not so much the cost or level of enforcement. In such situations, there is reason to expect that various jurisdictions' disclosure and accounting rules converge in a more efficient direction. (For details, see Gerard Hertig and Hideki Kanda, Rules, Enforcement, and Corporate Governance, draft, 1998.)

It might be added that there might be disclosure rules that are not self-enforcing. Typically, rules on "soft" information, particularly non-financial or forward looking information, tend to be litigated. For example, claims concerning misleading projections about the firm's future profits were often filed in U.S. courts, and this led to a legislative response constraining such litigation. This means that, for that kind of disclosure, enforcement matters. And the value of any disclosure rule must be evaluated with its enforcement cost.

B. Accounting

The value of disclosure depends on the value of information being disclosed. In general, information being disclosed comprises of two kinds: accounting and non-accounting information. For accounting information to be useful, it must be based on proper accounting treatment. What is proper accounting, however, is not entirely clear and is much debated today.

Historically, there are two types of accounting. Under traditional German and Japanese company law, the major purpose of accounting is to protect creditors. This creditor-oriented accounting is sometimes called "conservative accounting," and permits hidden reserves, because creditors want to be paid back. In contrast, investor-oriented accounting should not be conservative, and it should rather show the "truth" of the firm, because investors want to know the truth in making investment decisions.

The global trend is toward investor-oriented accounting, and in recent years, the importance of market-value accounting is being recognized more and more. Two champions for such investor-oriented accounting standards are the

U.S. "GAAP" (Generally Accepted Accounting Principles) and the International Accounting Standards prepared by the International Accounting Standards Committee ("IASC") (note that the exact requirements of these two accounting standards are not identical). The IOSCO recently endorsed the International Accounting Standards, and their role for guiding world accounting standards will be even more important in the future.

C. Audit

Auditing is a method by which someone other than managers who prepare financial statements checks whether the financial statements are correctly prepared, that is, whether they comply with the applicable accounting standards. There are both internal and external audits.

An internal audit is a system within a company, usually developed by managers for the purpose of their knowing the company's business well and sometimes protecting themselves from possible challenges by outsiders. Historically, this system emerged voluntarily by the efforts of managers and not by the requirement of law. However, in certain countries, the establishment of a proper internal audit system is required by law. For instance, since 1978 the U.S. securities law (and stock exchange rules) has required "reporting companies" to have a proper internal audit system.

In contrast, an external audit usually means an audit by outsiders, particularly by professional accountants, often known as CPAs (certified public accountants). And while some companies, especially small to medium-size ones, are not required by law to have such external audits yet sometimes voluntarily hire CPAs for external audits, publicly held companies are usually required to have a CPA audit by law. CPAs undertake an audit in accordance with proper auditing standards, and the method of auditing in industrialized countries today is quite scientific and systematic. Among other things, CPAs check whether the company has a proper internal audit or control system, rather than directly investigate the business operations of the company themselves. Thus, for a CPA audit to be successful, the existence and proper functioning of the internal audit system in the company is the key. Needless to say, the quality and capability of CPAs are also very important. That is, each country must have a good CPA system, and CPAs must be professionals and independent from the firms they audit.

D. Oversight

As noted above, generally speaking, past empirical studies do not necessarily show that the independent board contributes to good firm performance. Nevertheless, again as noted above, we believe today that the role of the board of directors in corporate governance is important.

If one limits discussion to oversight of disclosure, accounting and audit,

there is probably no doubt that the existence of an oversight function helps enhance the credibility of the company's disclosure, accounting and auditing. It must be noted, however, that building an oversight mechanism cannot be done without costs. Therefore, what is the best oversight system must be carefully examined by considering the costs and benefits associated with designing such a system.

It may be obvious, but it must be noted that oversight means overseeing or monitoring others' activities and not doing things directly. The purpose of oversight is to let others do things properly. With this in mind, three fundamental conditions must be satisfied: independence, information and enforcement. First, an important prerequisite for effective oversight of disclosure, accounting and auditing is independence from managers. Second, those who undertake oversight must have adequate information and make informed judgments in making others do things properly. Third, when those who undertake oversight find something wrong, they must effectively act to correct it or take other appropriate actions.

The above paragraph shows the functional conditions for oversight to work properly. In reality, however, what should be the design of an oversight system? Should the law require the establishment of an oversight system? These are very difficult questions. In my opinion, there is no single model that fits all situations, and each country should be free to choose the system that fits it best. Also, I think that whether the law should require such oversight can vary from country to country. It is quite possible that local stock exchange rules require it, making national requirements unnecessary.

The most popular structure we observe today in many countries is the audit committee. U.S. public companies have been required to have it by stock exchange rules, but very recently the SEC promulgated a new rule for enhancing disclosure through the audit committee and CPA auditing (see "Audit Committee Disclosure" Release No. 34-42266, 64 Federal Register 73389, effective on January 31, 2000). The audit committee is usually located within the board of directors and comprised of independent directors or non-executive directors only. They do not meet often -- usually four or five times a year -- because as noted above, the committee's role is not to undertake an audit itself but to ensure CPAs make proper audits. For this system to work, in addition to independence, the members of the committee must have adequate information to make informed judgments and also must be equipped with enforcement weapons to act when they find something wrong. In the U.S., most members of the audit committee are executives of other companies. Their expertise in their own companies ensures informed judgment. As for enforcement, the audit committee sometimes is given power to fire external auditors and sometimes not. They can always report to the board and/or shareholders' meetings.

Another model, not popular around the world, is found in the Japanese Commercial Code (Law No. 48 of 1899, as amended) (the major statute

providing legal rules of company law). This system is described below and in the Appendix.

E. Japanese Situation

Japan adopts a dual system of disclosure, accounting and audit: one by the Commercial Code and the other by the Securities and Exchange Law (Law No. 25 of 1948, as amended) ("SEL").

Accounting

Among major industrial countries, Germany and Japan are distinct in that company law provides detailed rules on accounting. In Japan, the Commercial Code provides accounting rules on the recognition, measurement, and reporting of the assets and liabilities of a joint-stock company (kabushikigaisha) -- a counterpart of a U.S. business corporation, a U.K. public limited company, a German Aktiengesellschaft and a French société anonyme. For most assets, the Commercial Code adopts the principle of historical cost accounting, but when the market value declines below the historical cost, the company must adjust booking to the market value (known as the conservative accounting principle). From a fiscal year beginning on or after April 1, 2000, a new rule is applied: financial assets may be (and for most public companies, must be) recognized and measured at their fair market value.

The purpose of "company law accounting" is for the most part creditor protection. Company law regulates accounting for the measurement of the company's annual "profits" in connection with the Code's dividend regulation: dividend may only be paid out of the company's (accumulated) profits. Under the new rule, the amount of unrealized gain (i.e., the difference between fair market value and historical cost calculated on a total net basis) cannot be distributed as dividends. Large companies must have their annual financial documents audited by an accounting auditor (see below) before submission to the annual shareholders' meeting. So to be precise, company law accounting itself has dual purposes: protection of creditors and protection of shareholders.

In addition, the SEL requires all "reporting companies" to prepare financial statements (both consolidated and unconsolidated ones) twice a year. "Reporting companies" are (1) companies whose securities are listed on a stock exchange, traded "over the counter," or the number of whose registered shareholders is 500 or more and (2) companies which filed a registration statement with the regulator when it issued securities. Their financial statements must be audited by CPAs. Accounting rules (for recognition, measurement, and reporting of assets and liabilities) are promulgated under the SEL. Accounting rules for recognition and measurement are known as the "Japanese GAAP".

This dual accounting system of company law and securities law comes

from Japanese history: company law comes from the 19th century German law and securities law was imported from the U.S. after World War II. But accounting standards between these two accounting systems have been harmonized over the decades, and today, the existence of this dual system does not put much burden on the companies subject to both.

Japan is currently in the midst of three important changes in accounting and disclosure requirements under the SEL: enhanced scope of consolidation, market-value accounting, and pension liability. First, the scope of consolidation of financial statements has been expanded. The old rule was to consolidate subsidiaries where the parent owns more than half of the total issued shares of them. The new rule is that the parent must consolidate subsidiaries when it "controls" them even if its stockholding does not amount to more than 50 percent. This consolidation standard of "control" is well-known in the U.S. Second, the new rule is that financial assets must be measured at their fair market value, rather than at historical cost. This is consistent with the current rule in the U.S. GAAP and the position of the IASC. Finally, the new rule requires public companies to recognize pension liability on its balance sheet. This too is already recognized in the U.S. GAAP.

Disclosure

Accounting documents prepared in accordance with the rules in company law must be submitted to the company's shareholders before the annual shareholders' meeting. The Commercial Code requires "large companies" to make public the summaries of their annual balance sheet and profit and loss statement. A "large company" is defined under the statute as a joint-stock company having either capital in the amount of 500 million yen or more, or total (on balance sheet) debt in the amount of 20 billion yen or more. Under the SEL, all "reporting companies" must have their financial statements disclosed to the public at the regulator's, stock exchange's and the company's principal office twice a year. In addition, reporting companies must file a disclosure statement when an unusual matter, such as a merger, happens. Also, as noted above, stock exchanges require the "timely disclosure" of certain information by listed firms.

Auditing

The SEL requires that the annual financial statements of a reporting company must be audited by a certified public accountant or certified auditing firm. This external auditor may be elected by the company, which means that the managers of the company may have influence over selecting this external auditor.

In addition to the SEL, the Commercial Code provides a complex audit system (see Appendix for details). Under the Commercial Code, a joint-stock company must have a kansayaku, often (somewhat misleadingly) translated as

statutory auditor. Statutory auditors are elected at the shareholders' meeting and do not have to be accountants or other professionals. A "large company" must have at least three statutory auditors, and at least one of them must be an "outside" statutory auditor. An auditor is "outside" when he did not serve as a director or employee of the company or its subsidiary for at least five years preceding his appointment as auditor. In a large company, there must be at least one full-time auditor. Statutory auditors constitute the board of auditors.

In addition, a "large company" must have an accounting auditor ("kaikeikansanin"), who must be a certified public accountant or certified auditing firm. An accounting auditor is elected at the shareholders' meeting and is responsible for auditing the company's financial documents annually before they are submitted to the annual shareholders' meeting. In contrast, a statutory auditor is mainly responsible for the oversight of management activities. This is understood to mean confirming the legality of managers and directors' activities.

For financial audits, the Code provides complex rules. But essentially the board of auditors corresponds to the audit committee. As far as financial accounting is concerned, the role of the board of auditors is oversight, that is, to make external auditors do things properly. To do so, the statutory auditors usually check the internal audit or control mechanism as well. The statute requires collaboration between accounting auditors and statutory auditors by providing complex rules. As noted above, statutory auditors have independence from management and are supposed to obtain adequate information and make informed judgments (the Code empowers them with the right to investigate). As for enforcement, statutory auditors are given the power to file an injunctive action before the court when an illegal action is being taken, to sue directors, and to do other things. Although they do not have power to fire managers or directors, they can (and should) report to the shareholders' meeting, so that in theory their view should be considered at the shareholders' meeting when shareholders elect (or even fire) directors.

4. Prescriptions for Asia: What Should We Do?

With all of the above-mentioned analyses, what should we prescribe for oversight over proper disclosure, accounting and auditing? Generally speaking, as noted before, the importance of the two linkages has not entirely been proven: the linkage between corporate governance and economic growth, and the linkage between laws and corporate governance. Even if we have good descriptions of oversight systems, they do not necessarily suggest good prescriptions. Presenting good prescriptions is even harder.

Nevertheless, as noted before, transparency and fairness are the key to good corporate governance today in any country, and for transparency, key components are disclosure, accounting and auditing. If so, proper oversight to ensure properness in disclosure, accounting and auditing should be important and should be given more attention.

I described two models for oversight: the audit committee (adopted in many countries including the U.S.) and the board of auditors (adopted in Japan). Both models make sense, but recent experiences in Korea show an indication that Korea is moving from the statutory auditor system to the audit committee (or non-executive directors) system. Thus, while logically the board of statutory auditors system may be superior because this board is legally separate from the board of directors, and thus managers, I must admit that the burden of proof is now on Japan to show that the board of statutory auditors system plays a proper oversight role as well. A related important point is how we should think about the role of the board of directors itself. If its role is oversight rather than making (important) decisions for running the company, the board of directors is understood as the top-tier oversight place below which the audit committee and other committees are located. Thus, the real question is how the board of directors system should be designed. As noted before, empirical evidence is split about the effectiveness of the board of directors. Under the circumstances, one possible way may be to offer the choice between the audit committee system and the board of statutory auditors system or the like. The important point is that in whatever form, we need an effective oversight system within the company to enhance corporate governance in the areas of disclosure, accounting and auditing in all countries in Asia. And such an oversight system itself must also satisfy transparency and fairness. In that sense, there might be other models to serve the purpose, and it is worthwhile exploring such other models.

Finally, establishing a proper liability regime for financial auditors is also important. The existence of ex post judicial review of a financial audit would help maintain the quality of financial auditing and prevent possible collusion between financial auditors and their client firm's managers. Those who oversee financial auditing also must also be liable if they fail to play a proper oversight function or fail to sue the financial auditors when necessary.

5. Conclusion

Today, for whatever reason, every corporate governance system must be accompanied by both transparency and fairness. Asia is no exception. One key element of transparency in corporate governance is proper disclosure, proper accounting and proper audit. To ensure such properness, the existence of an oversight system is important. Three functional conditions for effective oversight are independence from managers, adequate information, and power of enforcement. While we need further empirical studies about whether the audit committee or the like in fact contribute to good corporate governance, firm performance, and even a country's economic growth, countries in Asia or elsewhere that do not have such oversight systems should seriously consider introducing the audit committee or an alternative mechanism.

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APPENDIX: The Auditor System in Japan

Overview

Under the Commercial Code of Japan ("the Code"), an auditor (kansayaku) is a mandatory organ of a joint-stock company. The auditor system existed before World War II, but the amendments to the Code in 1950 reduced the power and responsibility of auditors. The system took its current form by the amendments to the Code in 1974, 1981, and 1993, which strengthened the power and independence of auditors.

Auditors are elected at the shareholders' meeting, and their role is to "audit" the activities of directors. This audit includes both a "business audit" and a "financial audit." A business audit is a check on whether or not the directors are observing laws, regulations and the company's charter provisions in managing the company and is commonly called a "compliance audit." It is generally understood that this does not include a check on the appropriateness of a director's decision-making or activities (sometimes referred to as an "appropriateness audit"). However, since the Code imposes a duty of care upon directors, a business audit must include a check on whether or not there are any breaches of this duty of care, and therefore, the auditor must look at directors' business judgments from this perspective.

A financial audit is conducted before financial statements are submitted to a shareholders' annual meeting, and the audit report, which contains the results of the financial and business audits, must accompany the notice of the shareholders' meeting.

The auditor system is stricter in "large companies." A large company is defined in the statute as a joint-stock company having legal capital of ¥500 million or more or total balance-sheet liabilities of ¥20 billion or more, and there are approximately 9,000 large companies today. For such large companies, there must be at least three auditors, at least one of whom must be full-time, and there must be at least one "outside" auditor. A board of auditors must be formed. In view of the function it plays in large companies, a board of auditors can be viewed as similar to an audit committee in the United States. However, the board of auditors must be a separate body from the board of directors, and an auditor may not serve concurrently as a director. The Code's qualifications for outside auditors require even greater independence.

Election, Duty and Liability of Auditors

Election of Auditors

Auditors are elected at the shareholders' meeting. A quorum may not be reduced to less than one third of the total number of issued shares (the same as for the election of directors). The Code provides disqualification reasons for auditors and directors, and an auditor may not serve concurrently as a director or employee of the company or its subsidiaries.

An auditor has the right to express opinions at the shareholders' meeting regarding the appointment of other auditors.

Each auditor serves a three-year term, as compared to two years for directors. This term cannot be shortened by the charter. Compensation must be set in the charter or by a resolution at the shareholders' meeting, separately from the compensation for directors.

A large company must have a minimum of three auditors, and they must elect among themselves at least one full-time auditor. Also, at least one of them (termed the "outside" auditor) must not have been a director or employee of the company or its subsidiaries within the past five years prior to appointment. A board of auditors must be formed. Thus, in large companies, the Japanese board system is two-tiered, but it differs considerably from the German system. Rather, the Japanese board of auditors can be viewed as similar to the U.S. audit committee.

Duty of Auditors

The legal relationship between an auditor and the company is entrustment (inin). Consequently, an auditor owes a duty of care to the company. Under the Code, the legal duty of an auditor is to "audit" the activities of directors, through a business audit and a financial audit. (The audit is limited to the latter in "small companies," but the situation for small companies is omitted in this memorandum.)

A business audit is a check on whether or not the directors are observing laws, regulations and the company's charter provisions in managing the company and is commonly called a "compliance audit." It is generally understood that this does not include a check on the appropriateness of a director's decision-making or activities (sometimes referred to as an "appropriateness audit"). However, since the Code imposes a duty of care upon directors, a business audit must include a check on whether or not there are any breaches of this duty of care, and therefore, the auditor must look at directors' business judgments from this perspective.

A financial audit is an audit of financial statements and, unlike an audit required under the Securities and Exchange Law, it must be conducted before the annual shareholders' meeting. The audit report, which contains the results of the financial and business audits, must accompany the notice of the annual

shareholders' meeting and be sent to shareholders before two weeks prior to the meeting.

Auditors are given various powers and legal rights in order to carry out their duties.

Right to obtain reports and conduct examinations

An auditor has the right to ask a director or employee to provide a report on the company's operations and the right to examine the operations and assets of the company at any time. If a director notices the possibility of significant damage occurring to the company, he or she must report this to the auditor even without being asked to do so. The auditor also has the legal right, under prescribed conditions, to ask for a report and examine the operations and assets of any of the company's subsidiaries. The company bears the expense of the audit (including examination).

Prevention of directors' illegal action

An auditor has the right to attend board of directors' meetings and express opinions in order to prevent the board of directors from making illegal or significantly inappropriate decisions for the company. If an auditor notices a violation, or the possibility thereof, of law or the company's charter provisions by a director, he or she must report it to the board of directors. If necessary the auditor may ask for a meeting of the board of directors to be called, or the auditor has the right to call a meeting him/herself. When such a decision or action violating law or the company's charter provisions cannot be prevented or rectified, if there is illegality or significant inappropriateness in the proposals or documents submitted by a director to the shareholders' meeting, the auditor must report his or her opinion at the shareholders' meeting. Moreover, if the auditor finds out an inappropriate act or a significant violation of law or the company's charter provisions, this must be written in the audit report. If there is a possibility that the director's action in violation of law or the charter provisions will cause considerable damage to the company, the auditor has the right to ask the director to stop the action. Also, the auditor has standing to sue for the nullification of a shareholders' meeting.

Litigation between the company and its directors

In litigation between a company and its director, the auditor represents the company. Accordingly, it is the auditor who makes the decision about whether the company will sue a director. It is also the auditor to whom a "demand" is submitted in a shareholder derivative action.

Financial audit

A financial audit is an audit of financial statements and their appendices. A large

company must appoint a CPA or auditing firm as an external financial auditor. The external financial auditor is elected at the shareholders' meeting, and the election proposal must be approved by the auditors in advance. Accordingly, a financial audit in large companies is undertaken primarily by the external financial auditor, and this financial auditor's report is submitted to the board of auditors and the board of directors. The auditors check the appropriateness of a summary of the process and of the results of the financial auditor's auditing. If the auditor believes that either is inappropriate, he or she must state so with reasons in the audit report and undertake an audit by him/herself and describe a summary of the process and the result of such audit in the audit report. If the financial auditor uncovers an inappropriate act or a violation of law or the company's charter provisions in connection with directors' activities, it must report it to the board of auditors. An auditor also has the right to ask the financial auditor for a report if necessary. With all of the above, in large companies, the auditors are responsible for monitoring and managing the external financial audit, as is the case with the audit committee in the United States. The audit report accompanies the notice of the annual shareholders' meeting and includes the results of the financial and business audits. In large companies, this audit report is prepared by the board of auditors, but each auditor has the right to write his or her own opinion.

Liability of Auditors

Under the Code, if there is a breach of an auditor's duty of care owed to the company, the auditor is liable to the company for damages. In addition, if there is bad faith or gross negligence in the audit activity, or if the audit report contains a false statement, the auditor may be liable directly to a third party for damages.