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## *Transparency and Disclosure*

**The Role of the Board in Overseeing Disclosure**

**by**

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## 1. Introduction

As pointed out in the Preamble of the OECD Principles of Corporate Governance, there is no single corporate governance model that fits all situations in different countries. However, financial reporting and disclosure are the keys to good corporate governance in every country and there may be common features of good disclosure system.

In section 2, I make a brief review of the discussions on the role and significance of accounting and disclosure as well as auditing. I turn to the role of Board and other corporate organs in accounting and disclosure in section 3. In section 4, I mention to the experience and recent development in Japan, which might be a lesson not only to Japan but also to Eurasian countries.

## 2. Accounting, Disclosure and Audit

### A. Corporate governance

Though it does not seem to me that the notion of corporate governance has not been well defined yet, emphasis has been laid on a mechanism for decisions in companies or a mechanism having influence on corporate decisions. Corporate governance seems important with respect to prevention of misbehavior by directors or officers of corporation as well as improvement of corporate performance.

### B. Transparency and fairness as the “global standard”

Less attention has been paid to transparency of corporate governance in some European countries than in the United States. It has been common in Japan and some European countries to regulate companies with mandatory and relatively detailed provisions protecting creditors and minority shareholders of the companies. In my opinion, such way of regulation has worked and protected interested parties to some extent in spite of less transparency partly because financial institutions have played a great role in monitoring the corporate sector in some countries such as Germany and Japan. However, such type of regulation has some problems: (1) companies tend to raise their fund in financial market both international and domestic; (2) companies tend to comply with the letter of the regulation but not the substance; and (3) the regulation might be an obstacle for companies to take an appropriate structure for better corporate performance. Especially, company law provisions may sometimes fall behind the time.

On the other hand, if the company law should provide less substantial regulation on companies, market discipline would be essential. It seems to me that the United States has adopted this approach and the market for corporate control has been expected to function as effective measures for good corporate governance. Where market discipline is emphasized, interested parties should take action for protecting their own interests to some extent, but they could not take appropriate measures without sufficient information. For this purpose, corporate disclosure is an indispensable precondition for deregulation in company law. In other words, there would be more need for transparency. In order to maintain transparency, disclosure accompanied by appropriate audit plays a central role.

At the same time, corporate governance codes lay stress on fairness. It has become quite important recent years to provide information to market participants equally as possible because the value of information has become more and more important and critical for interested parties. For example, American Securities Exchange Commission amended their rules on selective disclosure last year. From this point of view, appropriate disclosure is required to achieve fairness in financial activities.

### C. Accounting and Disclosure

Though there are several works that companies have an incentive to disclose voluntarily, we can find legal and/or regulatory settings for accounting and disclosure in almost all the countries. This implies that the legislators have thought that market mechanism may be insufficient to induce a company to disclose its corporate information at least in some cases. For example, a company may have an incentive not to disclose “bad news” for the short-term benefits for the company. Anyway, the legislators recognize the value of disclosure for sound corporate system.

First, disclosure helps interested parties such as shareholders, creditors and investors to make proper decisions in investment or lending.

Secondly, shareholders can evaluate the performance and have influence over the management based on the disclosed information. They can appoint others as the management. They can vote down the proposals of the management.

Thirdly, disclosure may motivate the management to act properly. As a famous U.S. Supreme Court Justice Brandeis said, "Sunlight is said to be the best disinfectant" (Louis Brandeis, *Other People's Money* 67 (1933)). A person usually decides how he acts, taking the expected reaction by others to his act into consideration. In this respect, disclosure might prevent fraud.

Therefore, entities must provide information that stakeholders need in order to make rational, informed decisions in a free market system, and to protect themselves from negative consequences of the actions of the entities. Disclosure must be complete, accurate, timely, objective and understandable. To some extent, stakeholders' "right to know" takes precedence over cost, inconvenience, or risk to the entity.

#### D. Audit

The value of disclosure depends much on the audit system. Even if a vast amount of information is available for interested parties or other market participants, if the information users do not rely on the information, the disclosure does not function well. Inaccurate information will lead interested parties to improper decisions. It may cause damages not only to such interested parties but also the national economy.

Accordingly, disclosed information should be examined in advance by other than those who prepare the information.

#### E. Costs for Disclosure and Audit

For all the benefits of disclosure and audit, it costs for the reporting company to disclose audited information. In addition, it may cost for the national economy to prepare accounting standards, auditing standards or auditing professions.

Accordingly, cost-benefit analysis may be necessary with respect to disclosure and audit system. Whenever one is going to introduce or improve disclosure system, one should consider (1) what kind of information should be disclosed, (2) what kind of entities should disclose and to what extent. It is equally important to decide (3) what kind of information should be audited, especially by auditing professions.

It should be noted that the value of disclosure and audit depends on the type of an entity. For example, whether the securities of the entity are listed, publicly traded or not; whether the entity is small or larger; whether the ownership of shares in the entity is concentrated or not; whether the member or partner of the entity is liable jointly and severally to the entity's creditors or not.

If the securities of an entity are publicly traded, the benefits of disclosure and audit will be more for the interested parties and the national economy, and the more costs will pay. The larger an entity is, the more interested parties exist and the value of disclosure will be higher in principle. The value of disclosure will be higher as well in entities where ownership of shares is dispersed than concentrated. On the other hand, where members or partners of an entity are liable unlimitedly to the entity's creditors, the value of disclosure and external audit might be lower.

### 3. The Role of Board and Other Organs in Disclosure and Audit

#### A. General View

With respect to disclosure and accounting, the main function of the board of directors (hereinafter, mentioned as the Board) or a supervisory organ of a company is oversight. The Board itself directly prepares neither accounts nor disclosure materials in general. The Board supervises, oversees or monitors the activities of officers or managers in this respect. In order to carry out oversight function effectively, the responsible organ should meet at least two conditions: independence and sufficient information. On one hand, an essential precondition for creditworthy oversight over accounting and disclosure is independence from those who prepare the information, that is, the management. On the other hand, sufficient information is necessary for the overseeing organ to oversee effectively. Without adequate information in quality and

quantity, the overseeing organ cannot make proper judgements. It is not very easy, however, to meet these two requirements because independence from information source often leads to isolation from information source. There may be a trade-off relationship between independence and ability to obtain sufficient information. Accordingly, there may be some difficulties in reality in designing an oversight scheme and the structure of company's organ.

As the corporate governance structure is a product of the culture, history and economic conditions of the country or jurisdiction, the structure varies from country to country. However, roughly speaking, legal setting for corporate governance can be divided into two types: (1) one-tier system and (2) two-tier system. In addition, external accounting auditors are appointed under both systems.

#### B. One-tier system

One-tier system is common among Anglo-Saxon countries and there has been no separation between a supervisory organ and a management organ. Though Board is a management organ and supervisory organ at the same time formally, its role as an overseeing and supervisory organ is given priority recently. Accordingly, the Board is responsible for oversee financial reporting and disclosure.

Some have pointed out that this system has functioned well as performance enhancing mechanism. In addition, where all or some of the Board members are officers or managers of the company, this system may be effective in obtaining appropriate information. On the other hand, independence might be threatened. In this respect, audit committees have become more and more popular under this system. For example, U.S. public companies are required to have the audit committee by stock exchange rules. Canadian Business Corporation Act requires listed companies to have one as well (Article 171, paragraph 1).

The audit committee is usually comprised of independent directors or non-executive directors and the requirement for independence is becoming more stringent (for example, Recommendation by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees to NYSE and NASD; Toronto Stock Exchange Company Manual, section 474). The main role of the audit committee is to ensure reliable audits by external auditors (certified public accountants, public accountants, chartered accountants or accounting firms). The audit committee plays an important role in making sure of external auditor's independence on one hand. For example, securities regulation in Anglo-Saxon countries requires the audit committee to review the process in case of the change of external auditors. In addition, the Blue Ribbon Committee in the United States has recommended that the audit committee should be responsible for evaluation and proposal for appointment or change of external auditors. The regulation or recommendations regarding the audit committee in the Commonwealth countries are in the same line. Independence of the members of the audit committee is essential in order to ensure external auditor's independence from the management of the audited company. On the other hand, the audit committee has to ensure effective audits by external auditors. The audit committee reviews the audit plan and exchanges views and information with external auditors.

#### C. Two-tier system

In some European countries such as Germany and the Netherlands, the two-tier system has been adopted. Under such system, the supervisory organ is clearly separated from the management organ. The members of the supervisory organ are appointed by the Shareholders' meeting and sometimes by the workers of the company. The supervisory organ appoints the members of the management organ.

Accordingly, it is easier to maintain independence of the supervisory organ from the managers or officers of the company. In this respect, the two-tier system is more suitable in theory for overseeing disclosure and accounting activities by the management. The role of the audit committee in the U.S. is usually included in the role of the supervisory organ.

It must be noted, however, that an oversight structure is accompanied by the costs. At the same time, we should build a corporate governance mechanism so that the mechanism is useful as well for enhancing the performance of the company. The separation of corporate organs might strengthen the oversight function at the cost of efficiency of corporate decisions. Moreover, the Shareholders' meeting cannot have direct influence on the management organ under this system.

#### 4. A Lesson from Japanese Experience

## A. Accounting and Disclosure

### Present Situation and Problems

Japan has adopted a dual system of accounting, disclosure and auditing under the Commercial Code and the Securities and Exchange Act. This might be a burden for companies subject to the Securities and Exchange Act because they should prepare two types of financial statements.

It is well known that company law provides detailed rules on accounting in the EU member states. In the same way, Japanese Commercial Code stipulates accounting rules, mainly on the measurement of the assets of joint stock companies. Generally speaking, historic cost accounting has been adopted but joint stock companies have been required to give market value where the market value is substantially lower than the acquisition or production cost, unless such market value is likely to rise to a level equivalent to that of the acquisition or production cost. Though this valuation rule has been considered as an example of “conservative accounting”, it has become clear that the rules are not always conservative and effective for creditors’ protection. This is because companies need not give market value lower than book value if the market value is not substantially lower. This made possible for Japanese companies to hide unrealized losses in inventory and securities, or to ignore unrealized losses in calculation of distributable profits at least. However, financial assets may be measured at the market value from a business year beginning on or after April 1, 2000 and it is the widely accepted interpretation that most of the public companies should measure their financial assets and derivative obligations at the market value.

The Commercial Code requires a joint stock company to publish the balance sheet or its summary (and, for larger companies, the income statement as well) on the Official Gazette or the dairy newspaper designated in the Article of Incorporation. However, it is said that 99% of the joint stock companies do not publish their balance sheets because there have been no effective measures against the disobedience.

Companies are required to make disclosure annually under the Commercial Code and, in addition, public companies are required to make disclosure semi-annually under the Securities and Exchange Act. This periodic reporting system has some problems. First, there is a time lag between the last day of the reporting period and the day when the financial statements is published. This makes the published information a little bit out-of-date. Secondly, there is no requirement under the Commercial Code for companies to disclose important events after the publication of financial statements while the Securities and Exchange Act requires disclosing certain important events in a special report.

### Lessons from Japanese Experience

The dual system is an outcome of the history of Japanese law. The Commercial Code was strongly influenced by German law while the Securities and Exchange Act was introduced under the influence of American law. Accordingly, the legislators have made efforts to harmonize these two regulations. In addition, it might take a long time to amend the Commercial Code, which might be an obstacle to catch up with international developments in accounting standards. As the result, the preliminary draft for the amendments to the Commercial Code (April 18,2001) proposes that the Commercial Code will no longer provides detailed accounting rules. From this experience, one should take the cost of accounting and disclosure into consideration when one is going to improve an accounting and disclosure system. At the same time, it will be more and more important to build a system or mechanism to be reviewed and improved timely and easily. The draft also proposes that all the joint stock companies should deposit their financial statements at the Commercial Registry for public inspection, which will enable the authority to find infringements. This shows us the importance of the effective enforcement and sanction mechanism.

On the other hand, disclosure mandated by the law is not a cure-all. With respect to timely disclosure, the legal disclosure system must be supplemented by the regulation by stock exchanges and self-regulatory organizations. In fact, the Tokyo Stock Exchange, for example, has played an important role in timely disclosure.

## B. Oversight Structure

### Present Situation

The model found in Japan is different from those two systems. It is a variation of the two-tier system but the members of supervisory organ are appointed by the shareholders’ meeting.

The Board of Directors is responsible for the management of the company as well as the supervision over representative or management directors. Naturally, the Board is responsible for overseeing corporate accounting and disclosure.

Though the Board system was introduced under the influence of American law in 1950, there has been another supervisory organ in joint stock companies since the enactment of the Commercial Code in 1899. A joint stock company should appoint an internal statutory auditor who audits the activities of directors, while an auditor in small company audits only books and accounts. Moreover, the Law regarding the Exceptions to the Commercial Code with respect to Audit etc. (hereinafter mentioned as “the Audit Act”) requires a “large companies” to have a board of auditors consist of 3 or more auditors, including at least one full-time auditor and one “outside auditor”. “Outside auditor” is defined as an auditor who had not been a director or employee of the company or its affiliates within 5 years before he is appointed as an auditor.

In addition, the Audit Act has required a “large” company to appoint one or more external professional accounting auditors, who is a certified public accountant or an authorized audit corporation since 1974. This requirement was introduced because a lot of window dressing were open to public eyes in the mid-60s when some enterprises went into bankruptcy and the legislators recognized a need for introducing a better audit system into joint stock companies. The board of auditors is responsible for approval of the proposal concerning external accounting auditors and, in specific cases, dismissal of external auditors.

In addition, the financial statements of public companies are subject to audits by public accountants or audit corporation under the Securities and Exchange Act.

#### Some Problems and Lessons from Japanese Experience

However, it has been pointed out that the present system has some problems.

First, the Board has played little role in accounting, disclosure and audit in general. This is because most of the members have sufficient knowledge and experience in sales, research or administration but accounting and disclosure on one hand. On the other hand, this is because most of the directors are executive directors and they are too busy in handling the affairs of their department to pay attention to accounting and disclosure.

Secondly, internal statutory auditors do not always function well. This is partly because independence of internal statutory auditors from managing directors seems to be insufficient. Internal statutory auditors tend to stay in harmony with the President not only because the Japanese prefer to seek an amicable settlement but also because directors and internal statutory auditors are friends or colleagues of long standing in general. In addition, their terms of office are about three years and the President of a company has a de facto authority to make a proposal for reappointing auditors. Even “outside auditors” are not always independent from managing directors, especially from the President because most of the “outside auditors” are former directors or employees of the company, legal advisors or tax consultants for the company. Moreover, internal statutory auditors are not given a power to fire or make proposal to fire managing directors or managers. They can request managing directors to cease illegal or extremely unreasonable activities out of the court or apply for injunction. As for enforcement, this system has a problem. In addition, the Commercial Code does not require special qualification for auditors in general. This may lead to ineffective audits.

Thirdly, recent corporate failures have indicated that some of external accounting auditors were not independent from the management of the audited company in reality. It might be true that these audit failures resulted from the tendency of the Japanese people. The Japanese tend to let sleeping dog lie. Or the accounting auditors might be too optimistic to believe that the time will be good again for the client. At the same time, the relationship between the engagement partner and the audited company has been too close. The auditors hesitated to give an unfavorable opinion for the audited company because they would not like to lose the client, especially a large and celebrated client such as a renowned financial institution. Their terms of office are one business year. The Board of the client has an authority to make a proposal for appointing other accounting auditors though approval by the board of Auditors is required under the Audit Act. Though the accounting auditors are appointed by the Shareholders’ Meeting, the Shareholders’ Meeting will rarely vote down the proposal of the Board (in fact, the President). Accordingly, independence of accounting auditors very much depends on independence of the board of auditors from the Board of Directors and managing directors.

What can we learn from this Japanese experience?

First, oversight mechanism without appropriate enforcement mechanism cannot function well. Where such overseeing organ is not given sufficient power of enforcement under company law, other legal or regulatory mechanism should be considered in order to ensure effective oversight.

Secondly, it is not always easy to ensure independence of oversight organ from the management but independence is critical for oversight mechanism. Without independence in fact, the oversight mechanism never functions properly. At the same time, independence in appearance is very important as well with respect to accounting and disclosure. If the interested parties and the public perceived that the oversight organ is not independent, they could not rely on the disclosed information.

Thirdly, legal provisions or written regulations regarding disclosure may not be enough. Market force may drive the Board strongly to oversee disclosure more appropriate. In my opinion, the Japanese directors are becoming more interested in disclosure and accounting than before because the market requires transparency. In this respect, the Board will be responsible not only for financial disclosure but also for non-financial disclosure such as corporate governance disclosure, which might make market discipline more effective.

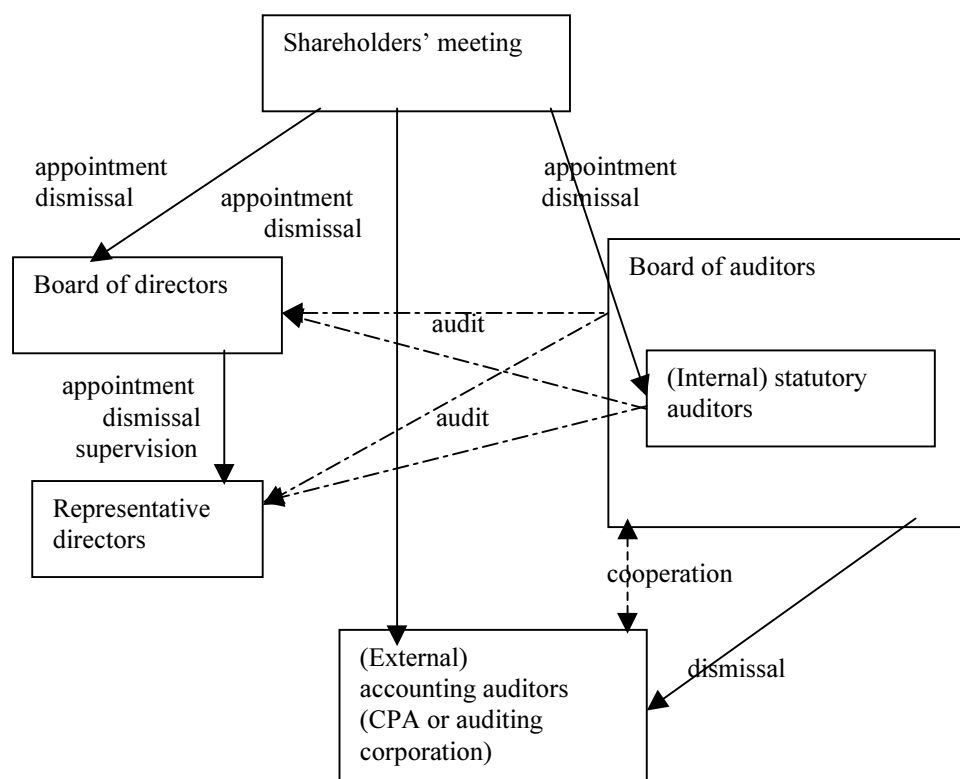
## 5. Conclusion

It is the widely accepted idea that transparency and fairness are essential features required for a good corporate governance system. Eurasia is no exception.

The main role of the Board in accounting, disclosure and auditing has been overseeing. The keys to effective oversight are independence and adequate information. For this purpose, the measures to ensure the independence of the Board or other supervisory organ have been matched with the external professional auditors. Judging from the experience in several countries including Japan, it might be most critical to ensure the independence of the Board or other corporate organ responsible for overseeing disclosure or auditing in order to build a good corporate governance system. It might not be very important to choose Anglo-Saxon-type audit committee, German-type board of auditors or other equivalent supervisory organ. The critical point is that it is necessary to have independent and experienced members in such oversight organs and to make them well informed. It is equally important to provide carefully the qualification of the members of the overseeing and supervisory organ. At the same time, other legal and economic infrastructures are also important. For example, it seems that American audit committees would not function so well without the market for corporate control, the market for directors and executives as well as their court system and liability regime. Efficiency of a model of corporate governance largely depends on the countries' culture and other factors.

It should also be noted that the Board has become responsible for disclose on corporate governance. This is partly because the Board itself should satisfy transparency. Disclosure coupled with market mechanism can improve corporate governance. Moreover, investors have recognized the importance of the structure and composition of the Board. They consider the presence of non-executive directors, and especially independent directors, as the most important corporate governance factors. They have become more interested in the rational of director and executive remuneration package and the component. In this respect, the Board should not only oversee but also make disclosure actively.

Appendix 1: Board of Directors, Board of Auditors and Accounting Auditor



[Figure 1]

1. Board of Directors

The Board of Directors is responsible for the management of the company as well as the supervision over representative or management directors. The board of directors consists of three or more directors as provided in the Articles of Incorporation.

The Commercial Code requires the Board of Directors to decide important managerial matters by itself and prohibit it to entrust decisions to one or more directors: acquisition and disposal of important property, a large amount borrowing (loan), appointment and dismissal of important employees, establishment, alternation and dissolution of important organizations and other important matters. In addition, share split, interim dividend, bond issue, convening the general meeting and some important decisions are entrusted exclusively to the Board of Directors.

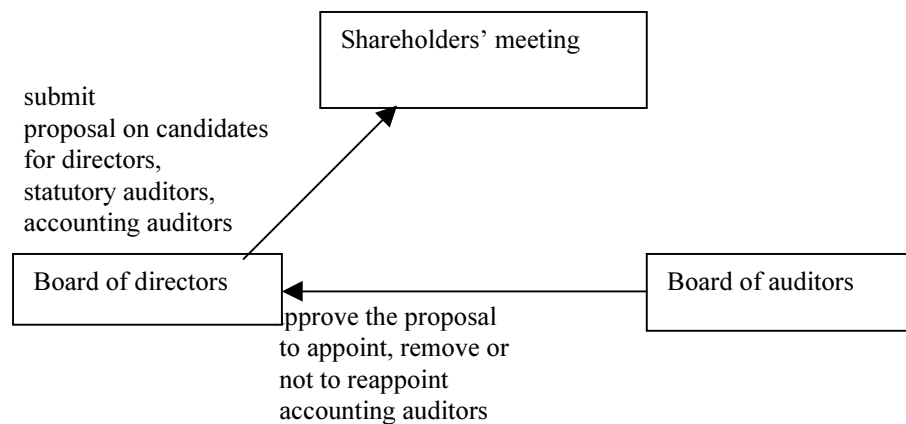
However, it is common among Japanese companies to have an unofficial committee for discussion over managerial and administrative matters. Executive committee (*jomukai*) or management committee (*keiei kaigi*) plays an important role in decisions of the company. Such a committee is an advisory committee for the president and makes pre-decisions, which will then be submitted, if necessary, to the board of directors in which final decisions are vested. The approval by the Board is normally expected because such executive committees consist of higher-ranking directors, who have more knowledge and experience in the company's affairs. In addition, directors tend to stay in harmony with the president because directors' terms of office are not longer than two years and the president of a company has a *de facto* authority to make a proposal for reappointing directors and auditors.

## 2. Representative Director

A company must have at one representative director appointed by the board of directors. The board of directors may provide that two or more representative directors may represent the company only jointly and the company might prevail the restriction against the third party if the restriction has been registered. Representative directors have the authority to represent with regard to all the business of the company. The president (*shacho*) of the company is usually a representative director and the chairman (*kaicho*) – in fact, he seldom is a chairman of board of directors and is usually a former president – is often a representative director as well, vice-presidents are not necessarily representative directors. As the name and address of representative directors should be registered, it is safe to check the commercial registry before concluding contracts. However, non-representative directors are usually granted the power to conclude contracts on behalf of the company to the limited extent, but the scope of their power is not always clear.

## 3. Auditors and Board of Auditors

A joint stock company should appoint an (internal) statutory auditor who audits the activities of directors, while an auditor in small company audits only books and accounts. The Commercial Code does not require special qualification for auditors in general. In addition, a large companies (a company whose stated capital is not less than 500 million yen or total liability on its recent balance sheet is not less than 2000 million yen) should have a board of auditors consist of 3 or more auditors, including at least one full-time auditor and one outside auditor under the Law regarding the Exceptions to the Commercial Code with respect to Audit etc. (Audit Act). Outside auditor is defined as an auditor who had not been a director or employee of the company or its affiliates within 5 years before he appointed as an auditor. The Audit Act does not give the definition of a full-time auditor, but it is interpreted that a full-time auditor should be present during ordinary office hours as far as it is necessary for the audit.



[Figure 2]

## 4. (External) Accounting Auditor

The Audit Act requires a large company to appoint one or more external professional accounting auditors, who are certified public accountants or authorized audit corporations. An accounting auditor is appointed at the shareholders' meeting. The board of auditors must approve the proposal to appoint or remove accounting auditors in advance. While the term of office of an accounting auditor is one year, the accounting auditor is deemed as reappointed unless the shareholders' meeting decides otherwise.

## Appendix 2: Forthcoming Amendments

In September 2000, the Civil Affairs Bureau of the Ministry of Justice announced that the Company Law Committee of the Legal Council would make an over-all review on company law in order to amend the Commercial Code in 2002. For this purpose, the Company Law Committee published a preliminary draft for amendments to the Commercial Code on April 18, 2001 and is calling for opinions.

The draft covers a lot of important areas of company law and makes a little bit drastic proposals.

For instance,

- (1) a company may appoint officers who are not directors;
- (2) a large company will be required to have at least one outside directors;
- (3) disposal of profits will be decided by the Board of directors in a “large” company where both the accounting auditors and the board of auditors are the opinion that the financial statements are in conformity with the Commercial Code, other statutes and the Articles of Incorporation unless the board of directors is the opinion that the proposal for profit disposition is unreasonable;
- (4) in “large” companies, the Board may establish a management committee;
- (5) in “large” companies, the Board may establish, in accordance with the Articles of Incorporation, some committees such as audit committee, nomination committee and remuneration committee;
- (6) shareholders may start a representative suit on behalf of the company with respect to the accounting auditors’ liability to the company.

Moreover, companies may issue warrants or grant stock options in general.

Furthermore, companies should disclose their financial statements at the Commercial Registry.

Public companies are required to prepare consolidated accounts under the Commercial Code. Not the Commercial Code but a MOJ ordinance should provide detailed accounting regulation.