

Japan's Corporate Auditor System

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I. RECENT DEVELOPMENTS AFFECTING AUDITORS

Professor Egashira's presentation introduced the governance structure for large companies that he called the "T-type company" (*kansayaku setchi kaisha*). I am from such a typical "T-type company," the *Nippon Steel Corporation (Shin Nihon Seitetsu Kabushiki Kaisha)*, where I serve as one of six statutory corporate auditors (*kansayaku*). It is my pleasure to have the opportunity to talk about the evolving Japanese auditing system at this symposium, before an audience of scholars and other participants from overseas.

In 2001 and 2002, there were very important amendments to the Commercial Code. In 2001, the corporate auditing system was revised, and the authority and responsibility of auditors were been strengthened. Corporate auditors have obtained a particular responsibility to prevent illegal and inappropriate acts. In the earlier symposium discussion about outside directors, the criticism was made that their responsibility has not been fully pursued. But corporate auditors like myself bear a heavy responsibility, and have accepted it.

To describe the outcome of the 2002 reform I would like to make use of *Professor Egashira's* abbreviation. This Code reform primarily recognised two company models, the "T-type company (a traditional company)" and the "C-type company (a company with committees inside the board)". Large companies now have an option to choose between these structural alternatives. This can be characterized as a new era. For Japanese corporations the reform has brought about an important stimulus for reconsidering company structures. The executives and managers of most companies have begun to think about this subject seriously. The process of evaluation of the reform has just begun, as the "C-type company" has been just introduced and this company model differs somewhat from the U.S. corporate model.

* This summary was prepared by *Dr Luke Nottage* (University of Sydney) and *Marc Dernaue* (MPI Hamburg) based on materials provided at the Dôshisha symposium, as well as *Mr Yoshii's* article „*Nihon no kansayaku seido*“ subsequently published in: *Shôji Homu* 1694 (2004) 7-15.

Professors Kanda and Egashira presented slightly different figures, but my research shows that about 70 companies have already reorganized as C-type companies, including non-public companies. Excluding companies in the same corporate groups, there are now about thirty “C-type companies”. Most are very large companies, especially electrical goods companies.

The Japan Corporate Auditors Association changed its Articles of Association in 2002, to allow members of C-type company audit committees to become members. About 50 of the 70 C-type companies have remained part of the Association. The aim is to incorporate the knowledge gained so far about the auditing process into the design and implementation of auditing functions in these C-type companies as well. Our premise is that the essence of auditing does not change even if such new corporate forms become available, because that does not necessarily mean a revolution in the way companies are constituted or operate.

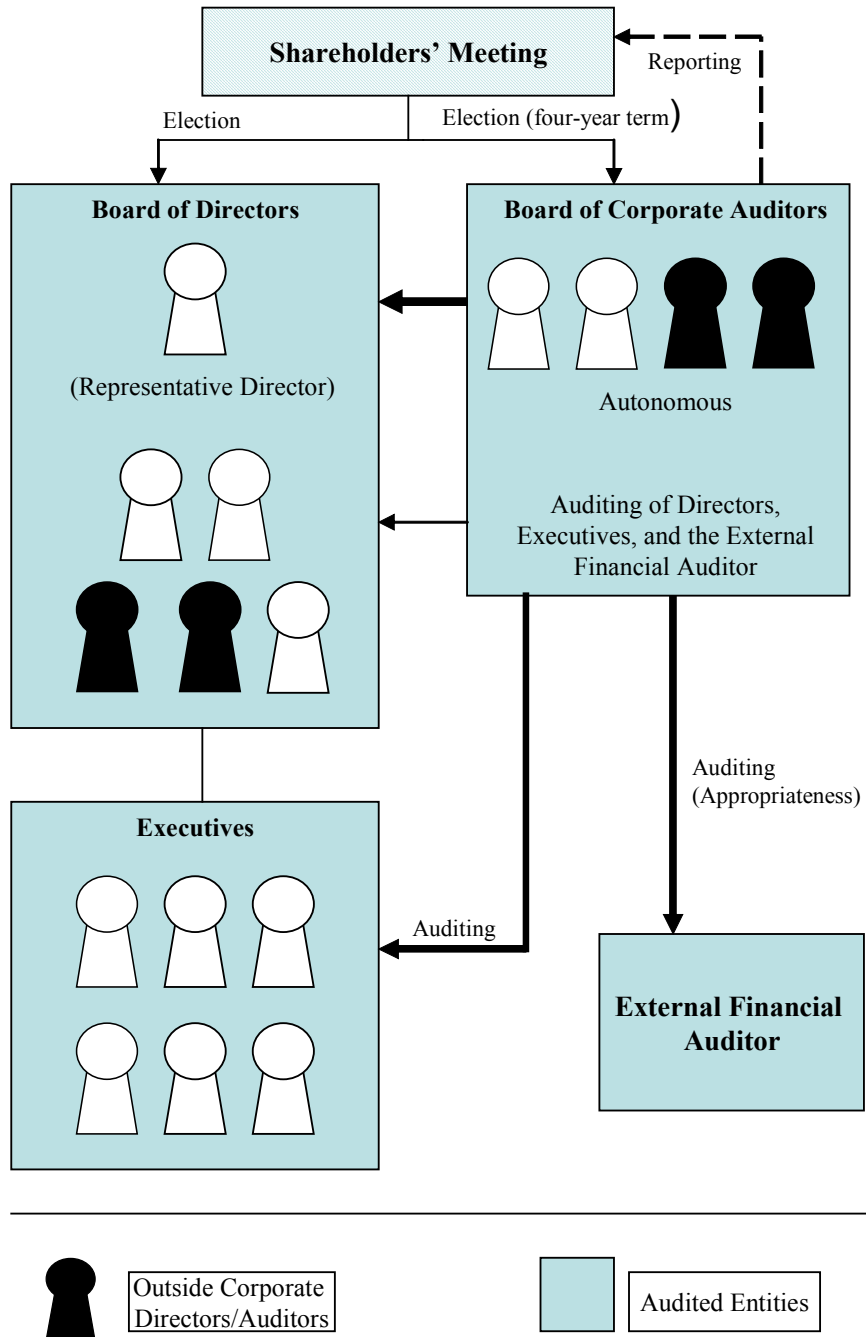
In fact, many corporate scandals have occurred both in Japan and the US over the last few years. But those in the US appear to differ in character and content. The scandals in the US mostly involve window-dressing of financial statements encouraged by senior executives, who moreover have lined their pockets as a result. By contrast, out of about 100 significant scandals in Japan each year over the last three years, which were reported in the media (over several days), 46 involve bid-rigging, followed by cases involving bribery. Such cases implicate the entire culture of the firm, or its industry. On the other hand, the background to scandals in both countries is that almost all involve intentional misconduct. Preventing such misconduct is a major task for auditors.

The image of auditing in Japan has been of *ex post* monitoring, but actually the focus is on pro-active or preventive measures. *Ex ante* monitoring functions guide best practice, and evaluation of the legal framework for auditing. The attitudes of corporate auditors have changed significantly in the last few years, and most do now venture into the realm of checking also the appropriateness of directors’ decision-making or activities („appropriateness audits“). This goes beyond traditional roles involving reviews of financial affairs for the regular financial statements („financial audits“), and whether directors are observing rules contained in corporate law and the company’s Articles of Association („business audits“ or „compliance audits“), on the understanding that the latter must include checking whether directors have breached the duty of care they owe to the company. Times are changing quickly, for corporate auditors too.

II. JAPAN’S CORPORATE AUDITOR SYSTEM

Japan’s corporate auditor system was built into the Commercial Code enacted in 1899, based on French and especially German models. However, unlike Germany where the supervisory board is superimposed on top of the Board of Directors, corporate auditors and directors in Japan exist in parallel (see Figure 1).

Figure 1: Japan's Corporate Auditor System (*kansayaku seido*)



Both are elected by the shareholders, and monitor the actions of each other. Further, at least half of the auditors comprising the Board of Auditors must be outsiders to the company, and monitoring powers are mostly accorded to each auditor individually and cannot be usurped by that Board. Thus, considerable independence is built into Japan's corporate auditor system. In addition, since amendments to the Code in 1981, in large companies at least one auditor must be full-time, which strengthens the ability to prevent corporate misconduct. (Incidentally, a similar requirement has been imposed on members of audit committees in the new C-type companies.) Some have suggested that auditors, especially full-time auditors, may be compromised by the fact that their remuneration comes from the company. But auditors' sense of responsibility towards the company as a whole tends to be extremely strong. Indeed, one issue is whether the outside auditors can develop such a sense, and not be dominated by the CEO or chairperson. Ultimately, the public will judge whether the auditing systems in both T-type and C-type companies is sufficient, in preventing corporate scandals.

Essential for more effective corporate auditing is „access to information“. The Code sets out various ways to achieve this. But these provisions must be transformed into practical channels for obtaining timely and accurate information from within the company, and also for disclosing information to the public. There is a danger that information will be hidden when misconduct occurs, and a big problem lies in uncovering such intentional misbehaviour. In Japan, those who have come through the company ranks to become auditors will have been trained and involved in all aspects of its affairs, including preparation of financial statements. Accordingly, I believe that window-dressing (as occurred in US scandals) can be detected and stopped. This is made easier by the practice of having outside corporate auditors also review the information obtained, pursuant to their powers (and duties) of autonomous action. Another key difference is that auditors in Japan attend all top meetings within the company.

A further very important issue is whether or not people may be ignoring the detailed internal control structures added by the CEO and departments within the company, especially given the pressure to maximise profits. One rule of thumb is that for every serious accident, say involving loss of life, there are probably around 300 situations where another accident was only just avoided. Managers do profess to put safety first, but they also emphasise productivity. So I think many at the coal-face do believe that pursuing profits is more important. Even with compliance programs, this is particularly likely when there are incentives due to remuneration being closely linked to performance, through evaluation of the departments' results, salary bonuses (especially if short-term), or stock options. Thus, to avoid serious accidents, we must insist on machinery being stopped for full repairs even if it might be repaired while in operation, for example; and emphasise that it is alright to miss out on an order if that might involve bid-rigging, because other business opportunities should be available. This helps counter the risk of people just following what they think the CEO or others would want. But the best solution is to have the CEO fully involved in addressing these sorts of problems

properly. In doing so, he or she should already be the person with the greatest ability within the company, but must not become too biased towards short-term profit maximisation.

Finally, although the combination of full-time auditors accessing information and outside auditors reviewing can be extremely effective in preventing corporate misconduct, good people must be enlisted to serve as outside auditors too.

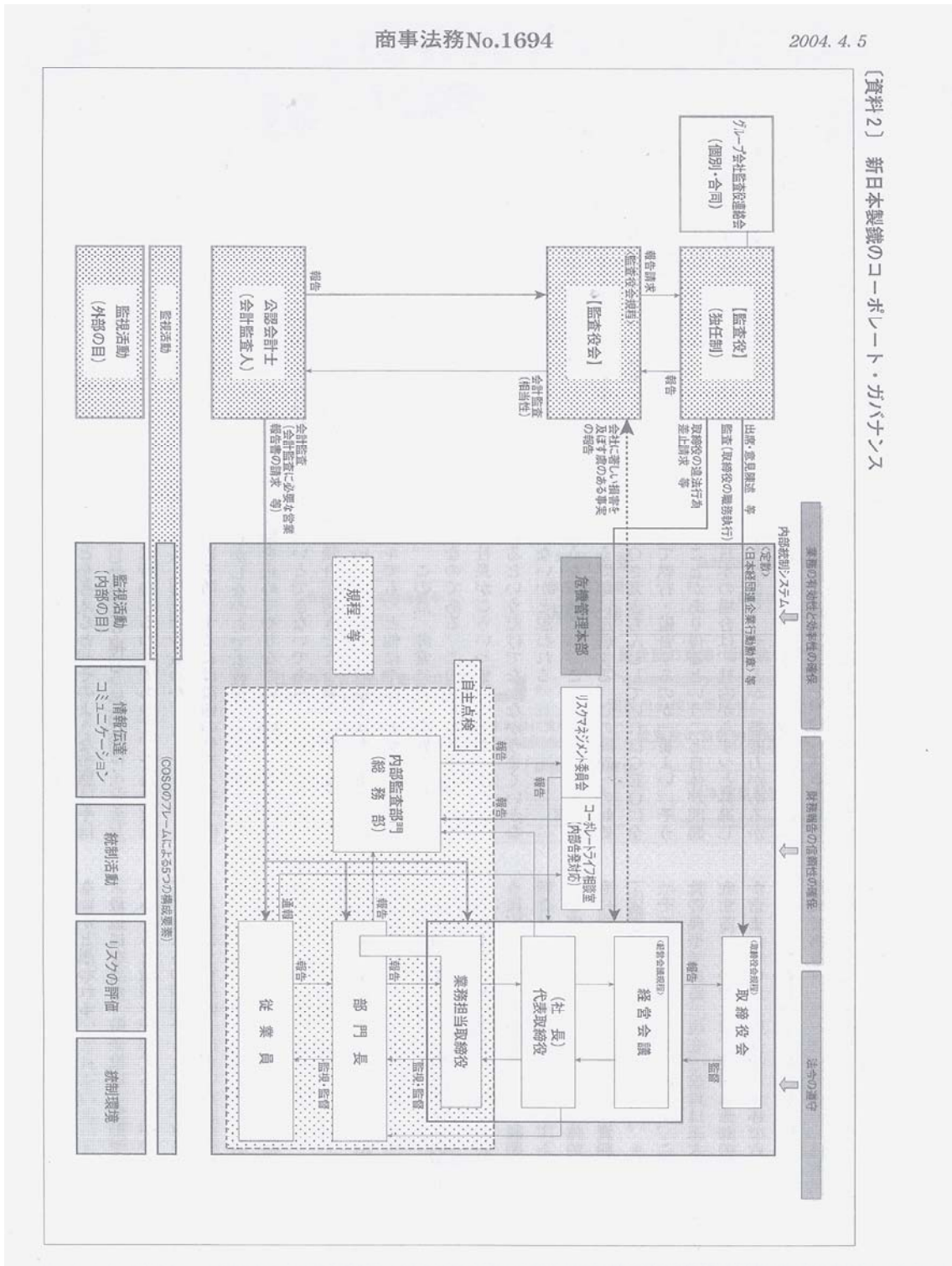
III. ACTIVATING CORPORATE AUDITORS IN *NIPPON STEEL*

My company has tried to address these matters in the following way. *Nippon Steel* has some very traditional features (see Figure 2). It still has 36 directors, including executive directors working in the company. There is some talk of reducing these numbers, but this would mean establishing a system of „executive officers“ (*shikkō yakuin*) whose activities would have to be monitored. Unlike many companies which have adopted the executive officer system, *Nippon Steel* retains a „management meeting“ group of 12 directors who make the important decisions, rather like the top management meetings in the new C-type companies.

In parallel, there are six corporate auditors at present. We are fortunate to have secured three very high-quality outside auditors: the chairman of Japan's largest life insurance company, someone qualified as a practicing attorney, and a professor of electrical engineering from a very well-known university. Of the three others, I am the only one to have „graduated“ (as *Professor Egashira* termed it) from all the main staffing departments of our firm. The other two (with technical or engineering backgrounds) did not serve as directors here, but instead ended up first as directors of affiliated firms. That is quite a common career path. Although there is some debate about this, they have strong commitment and a sense of responsibility to the company as a whole.

In addition, we auditors are supported by four staff (three male, one female). A major challenge is to schedule all our activities. We attend all the directors' meetings, about 20 per annum, which is quite a lot. I also attend the „management group“ meetings. The Board of Auditors itself meets 6-8 times per annum. An auditor also attends meetings of the risk management group, and a full-time auditor attends those (about four times per annum) of the risk management committee. Each outside auditor also conducts on-site audits of business activities about five times per annum. An aim is for them to better understand, and identify closely with, the company. But they can also add a new perspective.

Figure 2: (from Shōji Hōmu No. 1694 (2004) 12)



In addition, a „corporate life room (*sôdanshitsu*)“ was established about a year ago, where any matters of concern can be raised, and the auditors review these every three months. It goes beyond providing a point of contact for „whistleblowing“, a fashionable topic at present. Indeed, the nine cases reviewed so far have not really raised major issues. It seems most matters involve more diffuse concerns such as work-related stress or a wife's sense that her husband does not seem to be in good health. We have clinics and the like for these sorts of matters, so they ought to be transferred to those appropriate channels. So, we will have to watch closely whether and how this „corporate life room“ can be most effectively used.

One special feature of our company is that although the General Affairs Department is responsible for the Internal Audit department, the latter has no separate staff assigned to it, so the work is undertaken by the corporate auditors and their own staff. We can make recommendations, incorporating internal auditing, to the risk management committee, although it is then up to its (executive) members whether or how to follow our advice. In addition, a major task in such a large company is to help develop detailed work rules for employees. However, as mentioned above, making sure these rules are followed is always a concern. The possibility that some bid-rigging related activity is occurring somewhere, for example, cannot be excluded. Achieving perfect compliance will require further refinements.

Another innovation of our company involves setting clear checklists related to compliance or internal auditing for each department, and getting them to conduct self-evaluation reports. Those have to be undersigned by the director(s) in charge of the department, and then become the subject of intense discussion, about once a year. A final distinguishing feature is to hold review meetings in developing interim reports, including staff from each relevant business department, planning or finance department, etc. We auditors can then make various proposals, sometimes quite far-reaching, relating also to business management issues.

In all, these activities add up to between 150-200 hours' work per annum for each outside corporate auditor. This is rather similar to the 200 hours' work that is expected for outside directors in C-type companies. We must seek to integrate properly all these efforts and the new systems, with the aim to prevent corporate misconduct, to gain a positive appraisal on the part of the general public.

ZUSAMMENFASSUNG

Der Autor ist einer von sechs gesellschaftsinternen Prüfern bei dem Großunternehmen „Nippon Steel Corporation“ (Shin Nihon Seitetsu Kabushiki Kaisha). In seinem Artikel berichtet er zum einen allgemein über die Tätigkeit interner Prüfer in japanischen Großunternehmen, zum anderen beschreibt er die Arbeit und die Strukturen in seinem eigenen Unternehmen.

Die jüngsten Reformen des Handelsgesetzes in den Jahren 2001 und 2002 haben bedeutende Veränderungen für die Leitungs- und Kontrollorgane in japanischen Unternehmen mit sich gebracht. Durch die Reform im Jahre 2001 wurde beispielsweise das Prüfsystem in großen Unternehmen reformiert, und den internen Prüfern wurden sowohl weiterreichende Befugnisse verliehen als auch eine größere Verantwortung auferlegt. Durch die Reform im Jahre 2002 wurde insbesondere ein neuer Typus einer Aktiengesellschaft gesetzlich zugelassen, bei dem der Verwaltungsrat bestimmte Ausschüsse bilden und zudem „Geschäftsführer“ bestellen muß. Große Aktiengesellschaften haben seither die Wahl zwischen dem herkömmlichen Modell der japanischen Aktiengesellschaft, bei dem allerdings auch einige Gesetzesänderungen zu beachten sind, und dem neuen Typus der Aktiengesellschaft. Hierdurch haben sich einige wichtige Änderungen auch für die Prüfungs- und Kontrolltätigkeit in japanischen Unternehmen ergeben. Allerdings haben sich deren Grundsätze nicht verändert. Die Statuten der „Vereinigung der Gesellschaftsinternen Prüfer Japans“ wurden kürzlich geändert, um künftig auch Prüfer aus den Prüfungsausschüssen von Unternehmen aufzunehmen, die nach dem neuen Typus der Aktiengesellschaft organisiert sind.

Die Tätigkeit von gesellschaftsinternen Prüfern hat sich in den vergangenen Jahren erheblich verändert. Während vielfach noch das Bild einer Kontrolle der Unternehmensaktivitäten ex post vorherrscht, hat sich tatsächlich der Fokus der Tätigkeit hin auf eine vorbeugende, aktive Kontrolltätigkeit verschoben. Dies liegt auch an einer gewandelten Einstellung und einem gewachsenen Verantwortungsbewußtsein der Prüfer, die nun nicht mehr nur die Bilanzen und Geschäftsberichte überprüfen, sondern ganz selbstverständlich auch die Geschäftstätigkeit der Verwaltungsratsmitglieder überwachen. In den vergangenen Jahren hat es sowohl in den USA als auch in Japan eine Reihe von Unternehmensskandalen gegeben. Es ist insbesondere Aufgabe der Prüfer, zu verhindern, daß es zu solchen Skandalen kommt. Die Art der größten Skandale in den beiden Ländern unterscheidet sich jedoch deutlich und läßt auf eine unterschiedliche Unternehmenskultur schließen. Während es in den USA vor allem um Fälle von „Bilanzverschönerung“ ging, handelte es sich bei den japanischen Skandalen meist um Fälle von Submissionsabsprachen.

Die Grundlagen des japanischen Prüfungs- und Kontrollsystem in Aktiengesellschaften wurden mit der Verabschiedung des Handelsgesetzes im Jahre 1899 gelegt. Es wurde zwar von deutschem Recht beeinflusst, beruht aber nur zum Teil auf dem damaligen deutschen Modell. Bis heute charakteristisch ist die Tatsache, daß der Verwaltungsrat und die gesellschaftsinternen Prüfer praktisch nebeneinander stehen (Schau-

bild 1). Mindestens die Hälfte der Prüfer müssen von außerhalb des Unternehmens stammen, in Großunternehmen muß wenigstens ein interner Prüfer voll angestellt sein. Die Kompetenzen und die Verantwortung von Prüfern sind über die Zeit hinweg ständig erweitert worden. Zwar behaupten einige Stimmen, daß die internen Prüfer in Japan unter einem zu starken Einfluß der Geschäftsführung stünden, weil sie ihr Gehalt von dem Unternehmen beziehen, tatsächlich ist dies aber nicht der Fall. Die Verantwortung gegenüber dem Unternehmen insgesamt scheint sehr stark ausgeprägt.

Viele interne Prüfer in Japan kommen aus dem Unternehmen selbst und sind daher mit den Geschäftsabläufen in der Firma sehr vertraut. Dies macht es für sie leichter, die nötigen Informationen über Vorgänge im Unternehmen zu besorgen, was wichtig ist, um unbillige und rechtswidrige Praktiken von Verwaltungsratsmitgliedern und anderen leitenden Angestellten zu erkennen und zu verhindern; dies gilt insbesondere für die Bilanzfälschung. Zudem besitzen interne Prüfer meist die Möglichkeiten, auf die Verantwortlichen im Unternehmen angemessen einzuwirken, um etwa die Beteiligung an Submissionsabsprachen zu verhindern. Die Kombination von internen Prüfern, die aus dem Unternehmen stammen, und solchen, die von außerhalb des Unternehmens kommen, kann sehr effektiv sein, um mißbräuchliche und rechtswidrige Geschäftspraktiken der Geschäftsleitung zu verhindern.

Nippon Steel versucht, solche Geschäftspraktiken durch entsprechende Strukturen von vorne herein zu unterbinden. Das Unternehmen ist als Aktiengesellschaft des herkömmlichen Typs organisiert (Schaubild 2). Der Verwaltungsrat besteht aus einer vergleichsweise großen Anzahl von 36 Mitgliedern. Im Verwaltungsrat besteht ferner ein Gremium aus zwölf Personen, dem die geschäftsführenden Verwaltungsratsmitglieder angehören und in dem besonders wichtige Entscheidungen getroffen werden. Zu den sechs internen Prüfern des Unternehmens zählen drei hoch qualifizierte Prüfer, die nicht aus dem Unternehmen stammen, unter anderem ein geschäftsführendes Verwaltungsratsmitglied des größten japanischen Versicherungsunternehmens. Die Prüfer werden in ihrer Tätigkeit von vier Angestellten unterstützt. Für die Prüfer ist es schwierig, an allen der zahlreichen und wichtigen Sitzungen und Besprechungen im Unternehmen teilzunehmen. Dennoch nehmen die internen Prüfer bei Nippon Steel nicht nur an den großen Sitzungen, sondern auch an vielen kleineren Besprechungen in den Abteilungen teil, um über die Geschäftsabläufe auf dem laufenden zu bleiben. Um rechtswidrige und schädigende Geschäftspraktiken zu verhindern, wurden darüber hinaus verschiedene weitere Maßnahmen getroffen, die unter anderem eine Pflicht zu regelmäßigen Rechenschaftsberichten der Abteilungsleiter umfaßt. Die Arbeitsbelastung der internen Prüfer bei Nippon Steel ist enorm hoch.

Die Redaktion