"The Roles and Functions of *Kansayaku* Boards Compared to Audit Committees"

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1. Introduction

The aim of this paper is to compare the roles and functions of Japanese *Kansayaku* (statutory auditor)[1] Boards and, secondarily, three-committee system audit committees (3C audit committees) in Japan with Audit Committees as they operate in other developed markets in Asia and the West. After several years of advocacy work in Japan, it has become clear that the *Kansayaku* system is not fully understood outside Japan, nor how it differs from the 3C audit committee system. Conversely, there appears to be some misunderstanding in Japan as to what non-Japanese mean by an "Audit Committee" (which we capitalise in this paper to avoid confusion with the 3C audit committee). The argument is often put forward that *Kansayaku* are a substitute for an Audit Committee—a view we do not share because the powers and functions of the two entities, although overlapping to some extent, are quite different in important respects.

Our conclusion from assessing the evidence is that a genuinely independent and well-run Audit Committee has the potential to strengthen board governance and oversight of management more effectively than the *Kansayaku* system. Audit Committees are usually composed of all or a majority of independent directors and chaired by one (something that is often not the case at Japanese companies with 3C audit committees). Being directors with the right to vote, Audit Committee members have the ability to exert direct influence on board decisions. Because of this, they have greater authority and ability than *Kansayaku* to influence the integrity of financial reporting, the independence of the external accounting auditor, and the robustness of a company's internal controls, internal audit practices, and risk management systems. In recent years, some Audit Committees have taken on additional tasks such as reviewing the implementation of whistleblowing systems.

In contrast, *Kansayaku* are not fully part of the board's formal decision-making and approval process, and do not have the authority of directors (although they do sit in on board meetings and in some companies act as trusted advisers to the president/CEO). Much of the work of the full-time *Kansayaku* is taken up with "business audits", which in many respects task him or her to act more like a quasi-compliance officer who makes sure the company is adhering to laws and regulations. While *Kansayaku* also carry out "accounting audits", this role largely involves setting audit policy, overseeing the work of the external accounting auditor, listening to reports by the full time *Kansayaku*, and mechanically checking the company's financial position.

We acknowledge that in recent years Japanese regulators have worked to strengthen the *Kansayaku* system, and that truly independent and strong-minded *Kansayaku* can make a valuable contribution to the corporate governance of Japanese companies. We also acknowledge that some practices of *Kansayaku* could be usefully adopted by Audit Committees. We also acknowledge that Audit Committees often fail to live up to their potential and that the system is far from perfect.

On balance, however, we believe that both in terms of structure and actual practice, the powers of *Kansayaku* Boards are weaker than those of Audit Committees, which are an integral part of the board and their members full participants in board decisions. If one were designing a system of board governance and management oversight from scratch in a modern capital market, we do not believe that the *Kansayaku* system would be the outcome. Paradoxically, in one way the weakness of the system derives from the fact that most of the formal powers given to individual *Kansayaku* are so strong and confrontational in nature—for

[1] Recently, the Japan Audit and Supervisory Board Members Association (formerly the Japan Corporate Auditors Association) made a decision to translate "*Kansayaku*" in English as "audit and supervisory board members", to stress the fact that *Kansayaku* also have certain oversight roles. Here, for simplicity, we will generally use the terms "*Kansayaku*" and "*Kansayaku* Board".

example, the right to conduct independent investigations, to command directors to cease actions or to sue directors—that, in reality, they are almost never exercised.

In this paper, we elaborate on our views by comparing the formal, expected and actual roles of *Kansayaku* and Audit Committees. We also provide short histories of the two systems as they have evolved in Japan and the West, and offer some suggestions for moving forward.

We would like to make explicit at the outset that the purpose of this paper is primarily to shed light on a complex subject and, we hope, enhance mutual understanding between Japanese companies and foreign investors. While we believe that Japanese companies would be better served by well-functioning Audit Committees than *Kansayaku* Boards, we are not at this stage calling for the mandatory implementation of Audit Committees in Japan. To do so would require, at the very least, a significant change in Japan's Companies Act—something we elaborate on in Part 7 (and which would be no easy task, unless there is a dramatic change in government thinking and behaviour). It would also necessitate the introduction of robust rules on independent directors, since Audit Committees cannot function without properly independent directors. (While progress is being made in this area in Japan, it remains slow and minimal.) In other words, the vast majority of listed companies in Japan, which are statutory auditor-type companies, lack the institutional and legal basis for forming Audit Committees. Other changes need to take place first before such a system could work effectively.

We hope this paper provides food for thought for companies, investors, regulators and others involved and interested in corporate governance reform in Japan. We also hope that it is read in the context of other papers that we have written on Japan in recent years, namely our 2008 White Paper, 2009 Statement and other advocacy submissions on independent directors and company law reform. For all these documents, see our website: www.acga-asia.org. The papers can be found under "ACGA Archive / Reports".

2. Historical Background

Kansayaku

The *Kansayaku* system has its origins in the Commercial Code of 1899, Japan's first integrated and systematic law regarding corporate and commercial matters. The 1899 Code was based in large part on German corporate law in force at that time. A *Kansayaku* was mandatory, was required to be a shareholder, could call shareholder meetings, and was required not only to conduct accounting audits, but also the equivalent of today's "business audit" to confirm legal compliance and the proper execution of fiduciary duties by directors. Like directors, *Kansayaku* could be terminated by shareholders at any time.

The 1899 Code further required *Kansayaku* to approve conflict-of-interest transactions (a rule no longer in place), and granted the power to sue directors on behalf of the company and the authority to pursue internal investigations at any time, including demanding reports from directors or management (both rules are still in place). Only one *Kansayaku* serving for a one-year term was required, but more were allowed if shareholders deemed it necessary. The concept of a separate *Kansayaku* "Board" (KB) did not yet exist.

In 1938, after prolonged debate by an advisory council, the Code was comprehensively revised of in the wake of the long economic depression in Japan that had predated the 1929 crash in the US. The new law removed the requirement that *Kansayaku* be shareholders of the company and clarified procedures for matters such as lawsuits against *Kansayaku* and demands for lawsuits by shareholders.

After World War II, the US occupation authorities attempted to change the system to make it more like the American corporate governance model. Accordingly, the1950 amendment of the Code stripped all oversight functions except accounting audits from the *Kansayaku*, and placed full responsibility for oversight and supervision of management in the hands of the board of directors. Initially, *Kansayaku* were kept in place only as a temporary measure—the plan being to move to a CPA-based external auditor system as soon as enough qualified CPAs could be trained and certified. However, over time regulatory changes restored or strengthened various powers of *Kansayaku*.

In 1974, the duty to conduct business audits, as well as the right of *Kansayaku* to sue directors, was restored. In 1981, large companies were required to appoint more than one *Kansayaku*, with at least one serving full-time at the company; the minimum rule was expanded again in 1993 to at least three, with the stipulation that one must be an "outside" *Kansayaku*. At the same time, the establishment of a separate *Kansayaku* Board was mandated, and the terms of members extended to three years to prevent quick replacement. Then in 2001, half or more of the members of the KB were required to be outside *Kansayaku*, with a mandatory four-year term for every member. As a duty, they were required to attend all board meetings and express their opinions as necessary.

Audit Committees

The concept of the Audit Committee originated in the US following the McKesson & Robbins fraud of 1938. This case, which involved the creation of fake sales documentation and the payment of commissions to a shell distribution company set up by the company's owner, led to the New York Stock Exchange (NYSE) and the Securities and Exchange Commission (SEC) recommending that listed companies adopt audit committees.

In the early 1970s, a spate of corporate scandals exposed misconduct by executives of listed companies and shortcomings in their boards regarding oversight of management. One case in particular catalysed the forging of a regulatory consensus to reform the existing board structure. In 1970, Penn Central, the country's No. 1 railroad company, went bankrupt, becoming the biggest US corporation to collapse in history at the time. The company's downfall was largely attributed to a failed merger and accounting irregularities, but the SEC also found in its investigation a "formalistic" and "somnolent" board that did a woeful job of monitoring Penn Central's management[2].

Following other similar cases of corporate wrongdoing, US regulators concluded that more active and independent boards were needed to redress the situation. In 1977, the SEC and the NYSE issued a new rule requiring all companies listed on the Exchange to set up "an Audit Committee comprised solely of directors independent of management" no later than June 30, 1978[3]. Soon after, Nasdaq and the American Stock Exchange also made Audit Committees mandatory.

Then in 1992, the "*Report of the Committee on The Financial Aspects of Corporate Governance"*—known as the Cadbury Report—was published in the UK in response to a series of scandals that rocked Britain (namely, the collapse of Robert Maxwell's Mirror Group, and Bank of Credit and Commerce International, or BCCI). Taking cues from the US experience, the Cadbury Report recommended that all UK-listed companies set up an Audit Committee, with at least three members who were all non-executive directors. It said "the appointment of properly constituted Audit Committees" was "an important step in raising standards of corporate governance". A year later, the London Stock Exchange adopted the Code of Best Practice contained in the Report as a "comply-or-explain" obligation for companies to stay listed on the bourse. Soon after the Cadbury Report came out, many listed companies in other Commonwealth jurisdictions, such as Australia, began adopting Audit Committees in larger numbers after they became subject to similar "comply-or-explain" listing rules. (Note: Audit Committees first appeared in Australia from the mid-1970s.[4])

In the mid-1990s, the idea to establish Audit Committees spread via various national corporate governance committees to other European countries, starting with France, the Netherlands, Belgium, and followed by Germany, Greece and Portugal. In Asia, many markets, including Hong Kong, Korea and Singapore, adopted the Audit Committee system in the aftermath of the 1997-98 Asian Financial Crisis. Today, among the 11 major Asian markets that ACGA covers, Japan and Taiwan are the only countries where the Audit Committee (and independent directors) is not yet mandatory for all listed companies—although in January 2013 Taiwan announced it would move towards making them mandatory for certain large listed companies.

In the US, another big push for a major reform of the Audit Committee system came in the early 2000s in the wake of the huge accounting frauds that triggered the downfall of several high-profile companies such as Enron, WorldCom and Tyco. In response, the US Congress passed the Sarbanes-Oxley Act (SOX) of 2002, introducing a sweeping overhaul of corporate governance standards. Among the key SOX provisions related to Audit Committees were[5]:

- A requirement to include at least one financial expert on the Audit Committee, a higher standard than the "financial literacy" required by the NYSE of all members of the Audit Committee;

[2] "The Evolution of Corporate Governance in the United States: Remarks of Ira M. Millstein", World Economic Forum, Davos, Switzerland, February 2, 1998, pp. 13-14.

[3] Ibid., p. 14.

[4] See "Audit committee regulation in Australia: How far have we come?", Lois A. Munro & Sherrena Buckby, Queensland University of Technology, 2008.

[5] See www.sec.gov/rules/final/33-8220.htm#back.

- A stipulation making the Audit Committee's role as the primary overseer of the external auditor; and

- An obligation to receive complaints from whistleblowers through a dedicated channel.

3C Audit Committees

In 2003, a revision of Japan's Commercial Code enabled companies to choose a new corporate governance framework ostensibly modelled on the Anglo-American board system—the so-called "committee-style company" system. For this system of governance, the revision clearly delineated the board's primary functions as: taking certain very fundamental decisions and setting basic company policy; and appointing and monitoring executive officers, a separate group whose role and duties were legally defined. It also required three separate committees (3C system) to specialise in nomination, compensation and audit, with each committee required to have a majority of outside directors in lieu of *Kansayaku*.

The role and duties of 3C audit committee members are different from *Kansayaku* in that:

- 3C audit committee members are board directors and can vote. The 3C audit committee audits the legal duties and compliance of directors and executive officers, and the financial statements of the company;

- Whereas the *Kansayaku* Board only gives its permission or has a veto right with regard to the selection of the outside auditor, the 3C audit committee takes direct charge of hiring or firing it; and

- Unlike KB members, 3C audit committee members do not automatically enjoy an individual right to investigate. The committee can demand information but, if something needs to be investigated further, it must agree to assign one of its members to play the role of the lead inspector or investigator.

Like *Kansayaku*, the 3C audit committee must report to the board about past or likely violations by directors or executive officers (who bear fiduciary duties), and can demand a court injunction to force them to cease actions. Overall, the 3C audit committee of a Japanese company functions more like the Audit Committee of a US company. However, it does not determine the exact fee and terms of the contract with the outside audit firm, as that is considered an "execution" matter for management.

It is also important to note that while the 3C audit committee is comprised of directors, only a majority need be outside directors. This means that one or more inside directors[6] may serve on the 3C audit committee as long as they do not number half or more of its members. And at some leading Japanese companies, an inside director even chairs the committee—a major weakness with the 3C audit committee system, in our opinion. (In such cases, the person is a former executive director who stayed on the board but no longer has any managerial role—hence, an "insider" but not "executive".)

At the time of the introduction of the committee-style board structure, there were many calls to impose a mandatory requirement for outside directors. However, the idea encountered stiff resistance from domestic industry groups. As a compromise, the Ministry of Economy, Trade and Industry and the Ministry of Justice (MOJ) proposed that companies could choose

[6] However, inside directors who concurrently serve as executive officers, are ineligible. In effect, this means that even a director who until recently was the CEO could be appointed to the 3C audit committee.

the committee system as an *option*. Early adopters included Hitachi, Orix, Toshiba, and Sony. But, to date, fewer than 2% of all listed companies have switched to this format.

Audit and Supervisory Committees

In this context, it is necessary to mention briefly a third possible system of board governance being considered in Japan—the Audit and Supervisory Committee company. This was an idea put forward by the MOJ in its 2012 proposed amendments to the company law—amendments that have yet to pass. This new committee would replace the *Kansayaku* Board and, in theory, establish a stronger system of supervision over management.

ACGA has expressed doubts about this proposal in other documents, primarily our submission in January 2012 to the Ministry in response to its "Interim Proposal concerning Revision of Companies Act". Our main concerns are as follows:

- The authorities and composition of the Audit and Supervisory Committee would be similar to that of the 3C audit committee, which we believe has fundamental weaknesses—namely, the fact that it does not have to be chaired by an independent director and that inside directors (eg, a senior manager who has recently stepped down) can sit on it;

- The Audit and Supervisory Committee system is essentially being proposed in order to *avoid* requiring a completely independent nomination committee (a reform we believe is necessary in Japan); and

- Proposing a third form of governance for listed companies without addressing problems in the existing two seems counterproductive. It may also be even harder for foreign investors to understand Japanese corporate governance, with many interpreting the Audit and Supervisory Committee as just a different type of *Kansayaku* Board.

3. Legal Position and Formal Roles

Kansayaku

Kansayaku are formally elected by shareholders—usually after being nominated by the company (ie, the president), but they can also be directly nominated by shareholders. They are not required to have any legal or accounting knowledge[7]. Legally, the position of *Kansayaku* is that of an "entrustment contract" (a fiduciary relationship), rather than an employment contract governed by the Labour Law. Therefore, *Kansayaku* can be sued by shareholders or the board (on behalf of the company) for not executing their duties to the company. In such cases, the *Kansayaku* would have to pay damages to the company in the amount equal to the losses that their actions have caused.

According to the company law in Japan, *Kansayaku* have the following main legal duties:

- They must form a *Kansayaku* Board to determine audit policy, and methods for monitoring and investigating the status of operations and the company's financial position. They must also hold a KB meeting after the end of the fiscal year to check that the financial statements are accurate and to agree on the KB's "audit report" that is sent to shareholders prior to the AGM, including any reservations or qualifications; and to give assent to the annual Business Report that is prepared by management and sent to shareholders. Therefore, the KB must meet at least twice a year.

- They must attend all board meetings. They have the right to express their opinions on any matter at board meetings, but cannot cast a vote in any decision. (Non-attendance by all *Kansayaku*, however, does not invalidate a board meeting.);

- They must conduct accounting audits *(kaikei kansa*), which review periodic financial reports and describe the conclusions of the external accounting auditor, and business audits (*gyomu kansa*), which confirm that all board decisions and the execution of duties by directors comply with the law and are "appropriate" (*datosei*) from a fiduciary standpoint. The business audit duty also requires the *Kansayaku* to confirm the internal control system is adequate;

- They must give their consent with respect to the selection and hiring of the external audit firm[8], and monitor its work; and

- If a *Kansayaku* notices a violation of the law, or of a director's duties, he/she must report it to the board and the external auditor. When such a violation cannot be prevented or rectified by demands to the board or the director(s) in question, he/she may obtain a court order or sue the director(s) in the name of the company. If disclosure on it at the shareholders meeting is inadequate, the *Kansayaku* must state his/her opinion at the meeting.

[7] Article 121 of the Company Law Enforcement Regulations requires that *if* the *Kansayaku* has "considerable knowledge about finance and accounting", that fact must be disclosed in the annual report of operations made to shareholders. However, this is a judgment matter; the regulations give no clear definition of what constitutes "considerable knowledge".

[8] This is a "veto right". Note that the current proposed revisions of the Company Act would require the KB to select the external audit firm at its own discretion.

Audit Committees

The following is the US SEC's definition of the Audit Committee:

> *"The Audit Committee, composed of members of the board of directors, plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system. The Audit Committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns. By effectively carrying out its functions and responsibilities, the Audit Committee helps to ensure that management properly develops and adheres to a sound system of internal controls, that procedures are in place to objectively assess management's practices and internal controls, and that the outside auditors, through their own review, objectively assess the company's financial reporting practices."*[9]

It is the responsibility of the board of a listed company to set up the Audit Committee as an internal sub-organ (although the Audit Committee would also be useful for larger, unlisted companies, they have not been a focus for regulators). It usually has at least three members, though smaller companies sometimes only have two. In the US and UK all members of the committee must be independent directors. However in most Asian markets, including Hong Kong and Singapore, independents only have to be a majority. The Audit Committee should be chaired by an independent director. (As noted earlier, Japan is an exception in allowing inside directors to chair the 3C audit committee).

Depending on the jurisdiction, the detailed roles of the Audit Committee are spelled out either in listing rules, best-practice codes or company law. For the US, see Section 303A.07 of the *NYSE Listed Company Manual*; for the UK, see Section C.3 of the Financial Reporting Council's *UK Corporate Governance Code*; in Hong Kong, Section C.3 of the Stock Exchange of Hong Kong's *Corporate Governance Code and Corporate Governance Report*; and for Singapore, Section 201B of the *Companies Act* (see the appendix for the full texts).

Across different jurisdictions, the most common duties of the Audit Committee are:

- To review all formal announcements related to the company's financial performance, including annual and quarterly financial statements. Committee members should discuss these with both management and the external auditor;
- To review the company's internal control procedures, as well as its risk management policy and system. Committee members should discuss with management key financial risks the company faces and how management is dealing with them;
- To monitor the performance of the company's internal auditors;
- To recommend the appointment and dismissal of the external auditor. The committee should assess the auditor's qualifications, independence and performance; and
- To set up a whistleblower procedure, and confidentially receive and review complaints from staff concerning accounting, financial or other matters.

But the Audit Committee cannot do its job alone or assume the full responsibility of the entire board to supervise management. To do its job properly and be effective, Audit Committees need the cooperation of senior management, particularly in gaining access to pertinent

[9] See www.sec.gov/rules/final/33-8220.htm#back.

information and necessary resources. Ensuring such access is one reason why many institutional investors prefer governance systems which require a majority of independent outside directors on the board. Finally, an Audit Committee can be only as good as its members and how seriously they take their responsibilities. This is why many jurisdictions recommend annual self-evaluation exercises and regular training sessions for Audit Committee members (as well as for all board directors). It is also why many stock exchanges require at least one member to have financial expertise.

Key Aspects of the *Kansayaku* and Audit Committee Systems

	KANSAYAKU	**AUDIT COMMITTEE**
How nominated	By company or shareholders	Usually by nomination committee
How elected	By shareholders	By shareholders
Independence	At least half must be "outsiders"	Usually required for all members
Full time?	At least one	No
Board member?	No	Yes
Board meetings	Must try to attend	Must try to attend
Board resolutions	Cannot cast vote	Can cast vote
Regular monitoring of internal auditors & controls?	Yes	Yes
Knowledge of accounting	Not required	At least one must be "financial expert"
Role in hiring of external auditors	Consent	Recommendation
Run whistleblower procedure?	No	Yes
Right to undertake independent investigations?	Yes	No
Can sue directors?	Yes	No
Can be sued by shareholders?	Yes	Yes

Source: ACGA research

4. Expected Roles and "Best Practices"

Kansayaku

In a well-managed Japanese company, the *de facto* role of *Kansayaku* is to serve as an adviser to senior management on what is happening deep within the organisation and how to improve management. The KB, and especially the full-time *Kansayaku,* are expected to act as the "moral compass" of the company and, if necessary, as its "brakes" on the CEO's overwhelming power. In well-managed companies, the members of the KB do not hesitate to speak their minds at board meetings, and to engage in discussions with management about sensitive topics. When they agree, *Kansayaku* may do so as a united KB. But, even if they disagree, individual *Kansayaku* should not shirk from taking necessary action, including writing internal memos "for the record" to the entire board and making statements at shareholders meetings.

It is generally considered best practice for companies to use a "nomination committee" formed by the board to put forward candidates with relevant knowledge, an appropriate career background and mental attitude for the role of *Kansayaku* (ie, someone who is unafraid to speak out). Regardless of who is appointed, all *Kansayaku* should be business-savvy, able to read financial statements[10] and able to spend sufficient time in the role. Best practice would be for the full-time *Kansayaku* to have accounting knowledge or credentials, and not hold more than one such position at a time (except perhaps at a subsidiary). They should also not work for the company or a subsidiary in any other capacity.

Japan has no agreed document setting forth detailed best practices for *Kansayaku* activities, just as it has no "Corporate Governance Code" in general. But proper conduct expected of them would generally include the following:

- The KB should meet regularly on a monthly basis to set policies for audit and monitoring, receive detailed reports from the full-time *Kansayaku* as well as opinions and suggestions from the outside *Kansayaku*, and discuss any current issues or concerns. All *Kansayaku* should attend every board meeting and stamp the minutes. It is best to hold the regular KB meeting immediately after the monthly board meeting, so that the *Kansayaku* can attend both meetings conveniently and that management can elaborate on any issue requiring more explanation;

- As part of their business audits, the full-time *Kansayaku* should make regular on-site visits to all significant consolidated subsidiaries, plants/offices and branch offices around the world to meet with management and accounting/administration staff, and ask questions about ongoing issues. The full-time *Kansayaku* should report findings each month in the regular KB meeting;

- The full-time *Kansayaku* should conduct inspections and investigations at the head office, meeting with the staff of all relevant departments, such as accounting, internal audit, internal control, risk management and legal. He/she should report on all significant topics arising from these meetings at the KB meeting. The KB itself should periodically meet with the external auditor and the head of internal control in order to update each other and exchange information;

- The full-time *Kansayaku* should regularly meet with senior management (ie, the president and/or the chairman) to give them any useful information and advice arising from the on-site inspections to improve management, production efficiency, internal communication, the use of resources, and so on;

[10] On the other hand, a direct "promotion" from the accounting department may not be optimal.

- The full-time *Kansayaku* should review most of the numbers that go into the financial statements, as well as confirm the methods used by internal audit. In the process, the full-time *Kansayaku* should ask for periodic reports from the internal accountants and internal audit, especially for large transactions or new types of transactions;

- The full-time *Kansayaku* should consult early with the external auditors to exchange information and coordinate audit activities. If disagreement arises between the audit firm and company accountants, the full-time *Kansayaku* should mediate;

- All *Kansayaku* should regularly take training courses in key areas such as accounting, audit procedure, risk management, internal control, corporate and securities law; and

- The KB should implement a sufficient orientation and transition process to ensure that new *Kansayaku* receive a full update about the company's status and its audit, control, and risk-management procedures.

Audit Committees

The various regulatory responses to the Global Financial Crisis have highlighted the importance of maintaining robust and well-functioning Audit Committees. Beyond the legal obligations, market expectations regarding the Audit Committee's informal roles have also risen accordingly. Shareholders now look to the Audit Committee as the internal guardian of financial integrity at a company, while the board and management rely on Audit Committee members to be informed of constantly changing regulatory and compliance requirements and to offer expert advice on how best to navigate them.

Such informal expectations are fleshed out in CG codes and best-practices guidelines, which a number of markets have moved to update over the past year. The Financial Reporting Council (FRC) in the UK has been a leader in this effort, and many observers see its *Guidance on Audit Committees*, published in September 2012, as setting a benchmark[11]. The main recommendations in the *Guidance* include:

- The committee should meet as frequently as needed, but ideally around the dates for key financial reporting and auditing. The attendance is for committee members only, and that of a non-member should be strictly at the committee's discretion. All committee members, but especially the chair, should meet informally on a continual basis with "the key people involved in the company's governance, including the board chairman, the chief executive, the finance director, the external audit lead partner and the head of internal audit";

- The committee should report to the board its discussions and opinions on matters considered. It should make recommendations where action is needed. However, if there is unresolved disagreement between the committee and the rest of the board on any issue, it should be reported to shareholders in the annual report;

- The committee should consider the appropriateness of the company's accounting policies, any changes to them and the proper context of disclosures in financial statements. It should review first, whenever practicable, all statements containing financial information that require board approval;

- The committee should review and approve the internal audit function's mandate and

[11] See www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx.

ensure that the unit has the resources to fulfil its responsibilities. It should have the authority to hire and fire the head of internal audit, who should have direct access to the committee and board chairman. It should meet with the head of internal audit without management at least once a year, and monitor management's responsiveness to the internal auditor's findings and recommendations;

- The committee should assess annually the qualifications and independence of the external auditors and report to the board. It should ask the audit firm for its policies and processes for maintaining independence, including requirements for the rotation of audit partners and staff. If the external auditor resigns, it is the responsibility of the committee to investigate the reason and recommend any necessary action. The committee should approve the external auditor's terms of engagement and fees;

- The committee should examine the external auditor's plans and preparation for the annual audit, including the expertise and experience of the audit team;

- The committee should review the external auditor's findings from the annual audit, paying particular attention to major issues (both resolved and unresolved) and key accounting and audit judgements. For any errors identified, the committee should obtain explanations from management. At the end of the audit cycle, the committee should evaluate its overall effectiveness and report this to the board;

- The committee should develop the company's policy for non-audit services provided by the external auditor, taking into consideration the need to safeguard the auditor's objectivity and independence;

- The committee should communicate to shareholders in a separate section of the annual report its formal roles and authority at the company and how it discharged those. The section should contain such things as the names and qualifications of all committee members and the number of meetings;

- The committee should also report to shareholders on significant issues related to financial statements that were discussed and how these were addressed, as well as comments on the effectiveness of the external audit process, the approach to the appointment (or reappointment) of auditors, the length of tenure of auditors (and when a tender was last conducted), any contractual limitations on the committee's choice of auditor, and how independence is safeguarded when the auditor provides non-audit services; and

- The committee chair should attend the AGM and answer shareholder questions.

In addition to these FRC guidelines, best practices widely recommended by other bodies (such as the Big Four accounting firms) also include:

- Cooperating with the remuneration committee to set appropriate compensation levels for management, as well as to help structure incentives to minimise self-interested risk-taking at the expense of shareholders;

- Taking part in a continuing education programme to update the committee members' knowledge of the latest regulations and trends in best practices, to meet peers from other companies and to share experiences; and

- Conducting thorough self-evaluation on a regular basis, and analysing the outcome to improve the workings of the committee.

5. How They Function in Practice

Kansayaku

There is great variance as to how the *Kansayaku* system functions in practice and in the quality and dedication of those appointed to this role. Many well-managed Japanese companies have become successful by building on the collectivist nature of their organisations and the custom of lifetime employment that naturally encourages employees to think and care about the long-term sustainability and growth of their company. In such companies, where there is a high-level of rigour in decision-making and management, the full-time *Kansayaku* brings that mindset to his job, carrying out his role in a serious manner. However, in companies with less managerial rigour, a less dependable corporate culture or a domineering owner/president (CEO), adherence to many of the best practices can be limited. And as noted earlier, although their principal duties are "accounting audits" and "business audits" (often called "legality audits"), *Kansayaku* are not required, or even formally encouraged by soft law, to know anything about accounting or law.

Even in leading companies, appointments of most *Kansayaku* are primarily decided by the president. This is usually the case even if a nomination committee advises the board. As a result, *Kansayaku* often feel loyalty to the president, and even many outside *Kansayaku* cannot be considered truly "independent". This is especially so in the case of the full-time *Kansayaku*, who may feel that he/she was "promoted" to the position as a sort of consolation prize for not getting a board seat.[12] And knowledgeable observers say there are many outside *Kansayaku* who view their appointments as a comfortable side job and make little effort to keep up with the latest developments in audit practices and law in order to do their jobs properly.

Because of the reality of the appointment process and because they cannot vote, *Kansayaku* are generally considered to have a lower status than directors. Particularly in Japan, where perceived hierarchy and the need to avoid confrontation is so important, the fact that *Kansayaku* cannot vote has deeper consequences. Having no effective formal mechanisms for adding topics to the board's agenda[13], they cannot easily propose a larger budget for staff or for their own outside advisers (especially legal advisers) when necessary.[14] As a result, *Kansayaku* are often inadequately supported and must depend on internal resources or employees who are beholden to the company's senior managers.

In contrast to the board of directors, since there is no formal legal requirement for the KB to meet at regular intervals, and since few decisions have to be made by it except at the start and end of each fiscal year, it is possible for the KB to meet infrequently or to meet without a full quorum.

Most tellingly, and because Japanese would consider it provocative and confrontational, many *Kansayaku* rarely exercise some of their strongest powers, such as the right to undertake independent investigations, to deny giving consent to the appointment of the

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[12] This is offset in part by the fact that the *Kansayaku* posting is the last major position in the person's career, so in that sense there is little to prevent him from speaking his mind. The "loyalty" problem is also offset in part by the risk of shareholder derivative lawsuit. But even so, he/she may wish to be assigned next as a part-time "adviser" (*komon* or *sodanyaku)* to the company for a year or two after his retirement, a very comfortable job that requires almost no work.

[13] If a *Kansayaku* believes there is a major problem that needs to be discussed, he or she has the right to convene a board meeting. But this is extremely rare.

[14] In normal practice, *Kansayaku* do not directly hire advisers or staff at their sole discretion, even though technically they have the right to do so and ask for reimbursement later. They would almost always ask management before hiring lawyers to conduct an investigation.

external auditor, to ask a director to cease action or to initiate litigation against directors. Before such actions could be considered, the members of most KB would feel the need to unanimously agree, but this is likely only in extreme situations.

Knowing the above, boards at companies with relatively less competent or dedicated *Kansayaku* may simply avoid giving them important information before board meetings. In such cases, the board meeting itself becomes the main source of information for *Kansayaku*. Naturally, this does not give them sufficient time to digest the information in order to make intelligent comments about it—undermining a crucial function of *Kansayaku*.

A number of corporate scandals in Japan in the past decade attest to the wholly inadequate (or worse) job performed by *Kansayaku* at certain companies. Most recently, in 2011, a massive accounting fraud came to light at Olympus Corp where top executives were found to have been cooking the books for nearly two decades to hide investment losses. Far from keeping them honest, the firm's full-time *Kansayaku* turned out to be one of the accomplices in the cover-up.

Similarly, other *Kansayaku* either turned a blind eye or were asleep at the wheel when scandals engulfed Livedoor (securities fraud, 2006), Kanebo (overstating profits, 2005), Seibu Railway (falsifying financial statements, 2004) and Duskin (unsafe dumplings, 2002). Of course, it may not be fair to lay all the blame for the problems at these companies on their *Kansayaku.* But if the system had worked as it was intended, these companies might have been able to at least avoid the worst, if not prevent them.

Audit Committees

The way an Audit Committee functions will vary depending on the company, its culture, the quality of its directors, and the extent of board independence and leadership. Indeed, the UK FRC guidelines acknowledge this, stating that "best practice requires that every board should consider in detail what arrangements for its Audit Committee are best suited for its particular circumstances. Audit Committee arrangements need to be proportionate to the task, and will vary according to the size, complexity and risk profile of the company"[15].

That said, the most effective Audit Committees are likely to be found in companies that have embraced the spirit of corporate governance, in contrast to those that treat it as merely a compliance matter. If an Audit Committee is doing its job properly, the classic maxim that no news is good news should hold. Quarter after quarter, year after year, the company should deliver accurate, complete and reliable financial information that allows investors and other market players to gauge its performance transparently. The company will have a low risk profile and generate few negative headlines.

However, if a company has a compliance-only mentality, it is likely to lead to an Audit Committee that serves only a perfunctory role. For example: holding scripted or relatively short meetings; allowing some members to call in by telephone (which inherently limits the depth of discussion); holding meetings infrequently (eg, once every 4-6 months, rather than quarterly at a minimum); and timing meetings for just before the board meets to approve periodic financial reports, thus leaving no time for any problems in the accounts to be resolved.

In the annals of Audit Committee failure, probably no company proved more spectacular than Enron. Once a highly admired energy trading firm, Enron collapsed in December 2001 in a pile of dubious accounts. While the chief culprits were Enron executives who had perpetrated a massive accounting fraud, Enron's board also could not escape criticism. In

[15] See www.frc.org.uk/getattachment/6ec23196-28ee-406e-8f56-89ab9d1dc06d/Guidance-on-Audit-Committees-September-2012.aspx, p. 1.

particular, its Audit Committee comprised independent directors who seemed stellar on paper, but were anything but in practice. None apparently thought it necessary to challenge management even after the company's external auditor told them the company's accounting practices were extremely loose.

Asia, too, has seen its share of failures by Audit Committees. For example, their mere presence has proven to be a poor deterrent for major corporate scandals in Korea, which was one of the first markets in the region to mandate the establishment of Audit Committees for large listed companies. In the past few years, no less than four heads of top *chaebol* (conglomerates or *zaibatsu*)—Samsung, Hyundai Motor, SK and Hanwha—have been convicted of financial or accounting crimes. What is more, the Audit Committee has been unable even to prevent repeat offences as in the case of Chey Tae-won, chairman and CEO of SK Corp, the holding company of the third-largest Korean business group that his father founded. In January 2013, Chey was convicted of embezzling billions of won in company funds for private use and was sentenced to four years in prison. This was the second time since 2003 that he has spent time behind bars for financial fraud.

Elsewhere, scandals at several mainland Chinese companies listed in Hong Kong have exposed shortcomings in the Audit Committee system. A spate of accounting irregularities since 2011 at companies such as Ports Design, Shirble Department Store, Boshiwa and Daqing Dairy has led to their shares being suspended on the Hong Kong Stock Exchange. In some cases, as with the latter two, the suspensions were prompted by the resignation of the external auditor. Since companies must set up an Audit Committee to be listed in Hong Kong, such episodes inevitably raise questions about what these committees actually do.

If an Audit Committee fails to do its job, part of the problem may be that its members are not putting in the effort required to actively monitor management. But if management is engaged in fraud, the Audit Committee may simply have had no chance or lacked the technical knowledge to detect and foil it.

The Sarbanes-Oxley Act, which the US Congress passed in the wake of the Enron scandal, was a regulatory response that sought to redress precisely these kinds of failings by the Audit Committee. Since then, one of the key measures of an effective Audit Committee has become how promptly and vigorously it responds to information from whistleblowers about possible wrongdoing or fraud by the company. Ideally, there should already be an internal process in place that will direct the committee's action to get to the bottom of any such allegations. Such readiness to investigate possible corporate malfeasance is not only a fundamental best practice, it is also a legal requirement in some countries (eg, the US and Australia).

Still, problems with the system remain. One of the most intractable is that the independence of Audit Committee members is compromised by the fact that they are appointed by management or a controlling owner-manager and may be closely connected to them (either through business, family, school or village connections). The rules governing who can be considered an "independent" director are inherently flawed in most Asian markets. For instance, the rules tend to be artificially prescriptive and permit "cooling-off periods" of two to three years between employment by a company and appointment as one of its independent directors—an idea that is of particularly limited value when applied to corporate structures characterised primarily by concentrated ownership and to corporate cultures that place a high value on lifelong loyalty to the same employer.

6. Enforcement

For both the *Kansayaku* and Audit Committee, the extent of "enforcement" or encouragement by government or shareholders to ensure these systems work as intended is limited. Regulators in most jurisdictions expect shareholders to perform the tasks of frontline checking and disciplining. But few investors have the time, resources or know-how to do this work effectively. Theoretically, shareholders can vote to oust both *Kansayaku* and Audit Committee members, but board nominees losing elections at AGMs are rare events in most markets around the world.

In Japan, there is essentially no enforcement by "soft law", nor the setting of aspirational targets on corporate governance for companies. There remains no "corporate governance code" setting forth a commonly accepted set of best practices that could be made subject to "comply-or-explain" enforcement or prompt greater disclosure of actual practices. As a result, there is no effective preventive mechanism for failures or abuses of the *Kansayaku*'s duty, with any action largely left up to shareholders to pursue at their own cost.

The situation is not much better in the Audit Committee system. True, many markets regulate Audit Committees through a "comply-or-explain" corporate governance code. But short of a major scandal erupting, there are few practical consequences for Audit Committees that fail to live up to best practices. In reality, the integrity and effectiveness of the Audit Committee system relies largely on the commitment of the directors who comprise it and the good faith of the company to support the committee's work.

When things do go wrong, direct enforcement occurs mainly by means of criminal prosecution and shareholder lawsuits under both systems. For example, at Olympus, the company's full-time *Kansayaku* was one of the three executives arrested for accounting fraud. He pleaded guilty and was given a three-year suspended jail sentence. In the case of Enron, no Audit Committee members were prosecuted, but shareholders in 2004 reached a US$7.2 billion settlement in a class-action lawsuit against the company, including all six members of its Audit Committee. (Three of the committee members made contributions to the settlement from their personal assets.)

As for legal action by shareholders in Japan, after the filing fees for derivative lawsuits were reduced in 1993 (it is now a flat ¥13,000), the number of such lawsuits rose dramatically to around 70 a year. However, most are filed against directors. Fewer *Kansayaku* are sued and end up paying damages. One reason for this is that the principal "act" for which most shareholders sue directors is a vote to approve a certain board resolution. But *Kansayaku* do not vote, and so it can be difficult to prove that a he or she did not undertake sufficient oversight actions. *Kansayaku* are usually held liable only in cases where they were grossly negligent, or where it is clear that they should have strongly suspected that malfeasance was taking place.

7. Conclusion & Recommendations

As this paper shows, there are strengths and weaknesses with both the *Kansayaku* and Audit Committee systems. In many ways, the best and worst aspects of the two systems are mirror images of each other.

We acknowledge that the *Kansayaku* system has certain strong points. First, it allows the presence of a full-time non-executive person who knows the company well with legally prescribed and audit-related duties on the premises. Second, it grants each *Kansayaku* the right to pursue his or her own investigations, with full rights to any and all information, and to take strong actions that are legally sanctioned. As with any system of corporate governance, the most effective *Kansayaku* will be those who embrace the spirit, not merely the formal requirements, of their role.

However, the system also has significant gaps in design, which permit a marked variance between intended and actual outcomes. For instance, many of the powers granted to *Kansayaku* are confrontational in nature (such as obtaining a court order) and are therefore extremely unlikely to be exercised in a corporate culture that prizes consensus—especially by a *Kansayaku* acting alone. And in the absence of detailed disclosure, it is difficult for investors to assess how effectively *Kansayaku* are fulfilling their duties at different firms.

As for Audit Committees, their greatest weakness is that their members often rely (or are forced to rely) too much on management to keep them informed of major corporate developments. Hence, they may not know as much about the goings-on inside the company as they should. Unlike full-time *Kansayaku*, Audit Committee members only work part-time and will likely have other competing commitments, such as their own careers. The effectiveness of an Audit Committee is therefore highly dependent on the variable and undeterminable commitment of busy people—as well as the board culture of the company on which they serve.

Conversely, the greatest potential strength of Audit Committees derives from the fact that their members are mostly independent directors who wield voting power in the board, who can meet without management present, and who have a direct line to both the internal and external auditors. This allows them to have input into board decision-making and places them, in principle, on an equal footing with executive directors and other non-executive directors. As a system of supervision, this clearly offers the potential for more robust outcomes—and can better ensure that problems in financial reporting and internal controls come to the fore more quickly.

We believe that corporate governance in Japan would be best served over the long-term if companies moved towards adopting Audit Committees. It would be ideal if this could be done in a way that incorporated the best aspects of the *Kansayaku* function. We recognise this would not be easy and could not be achieved overnight. However, we believe the following steps offer a constructive way forward:

1. Companies are encouraged to take note of the growing official support for independent directors and the practice of many leading companies, including those with *Kansayaku* Boards, to appoint such directors to their board of directors voluntarily. This trend picked up pace in 2013.

2. Companies with *Kansayaku* Boards should create a completely independent Nomination Committee under the board of directors for the selection and nomination of *Kansayaku* (as well as directors, of course). The members of this committee would all be

independent outside directors, pursuant to voluntary corporate governance guidelines disclosed by the company.

Shining the spotlight of accountability for *Kansayaku* selection on the members of this committee would make it less likely that *Kansayaku* appointments were as heavily influenced by CEOs as they are at present, and more likely that knowledge regarding accounting and law were considered essential qualifications for *Kansayaku* appointments.

Where companies have not established a Nomination Committee, the board should provide a clear explanation of their nomination process and the job criteria for *Kansayaku*.

3. Over the medium term, and when permitted by changes in the company law, companies should consider moving towards a more independent board able to create legally valid board committees of all types, in particular Audit Committees and Nomination Committees.

Such a transition would be more advisable than adopting the new “Company with Audit and Supervisory Committee” board structure. Although the Audit and Supervisory Committee would replace the *Kansayaku* Board and the majority of its members would be outside directors, we believe it would not be as robust as the two-step Nomination and Audit Committee system we are describing above.

The lynchpin of our recommended reforms would be an amendment of the Companies Act. We strongly recommend that the Government of Japan amend the company law to permit all companies to form board committees (a) for any purpose; and (b) which are legally valid and recognised, including, in particular, Audit Committees and Nomination Committees. Companies that choose to form an Audit Committee which is composed of only independent directors should not be required to appoint *Kansayaku* or have a *Kansayaku* Board, if they also form a similarly independent nominations committee.

End.

8. Appendix

Legal authorities of Kansayaku[16]

Under the principle of "autonomy" (*dokuninsei*), except for those decisions that are required to be made by the *Kansayaku* Board (KB) as a group, each *Kansayaku* may use the following "rights" to conduct their duties without the consent or agreement of the other *Kansayaku*:

1. Each *Kansayaku* may at any time demand reports from the directors, managers, or accounting advisers (or from a subsidiary of the company), or otherwise investigate the status of operations, assets and financial position of the company.[17](In the extreme case, a *Kansayaku* can simply go to the relevant file cabinet and make copies of all needed documents. This is something that outside directors cannot autonomously do, because individual directors cannot take actions that a board meeting has not agreed to take.)

2. Each *Kansayaku* can state his opinion on any matter in the board meeting, and refuse to stamp the minutes of the board meeting unless his comments are included.

3. If a *Kansayaku* notices a violation of the articles of incorporation, the law or a director's duties, he or she may convene a meeting of the board to discuss the matter. If a *Kansayaku* believes a director is taking action (or likely to take action) that is outside the permitted scope of the company, in violation of law or the articles, or likely to cause substantial detriment to the company, he may demand that the director cease that action. If necessary, the *Kansayaku* may obtain a court injunction to do so.

4. Unless it can be shown to be unnecessary to carry out his or her duties, each *Kansayaku* may request and the company must provide advancement or reimbursement of expenses, costs or debts incurred in the course of carrying out *Kansayaku* activities.

5. Any *Kansayaku* may call for a meeting of the KB at any time.

6. The KB must give its consent before the external audit firm which has been selected by the board of directors can be hired on the proposed terms. The consent of the KB is also required with respect to all new *Kansayaku* that the board intends to nominate for election at the shareholders meeting. In addition, the KB can suggest that the board nominate specific persons as new *Kansayaku*.

7. At the shareholders meeting, any *Kansayaku* may give his or her opinion about the appointment or termination of any *Kansayaku*. If a *Kansayaku* resigns (or is asked to resign, for example, for unjust reasons), he or she is entitled to make a statement at the next shareholders meeting.[18]

[16] Company Law, Articles 381-395.

[17] A subsidiary can refuse only if there are "justifiable grounds".

[18] This is intended to reduce "forced resignations", especially in cases of malfeasance or cover-ups.

NYSE Listed Company Manual

303A.07 Audit Committee Additional Requirements

(a) The audit committee must have a minimum of three members. All audit committee members must satisfy the requirements for independence set out in Section 303A.02 and, in the absence of an applicable exemption, Rule 10A-3(b)(1).

Commentary: Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 407(d)(5)(ii) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment.

Disclosure Requirement: If an audit committee member simultaneously serves on the audit committees of more than three public companies, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company's audit committee and must disclose such determination either on or through the listed company's website or in its annual proxy statement or, if the listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC. If this disclosure is made on or through the listed company's website, the listed company must disclose that fact in its annual proxy statement or annual report, as applicable, and provide the website address.

(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose - which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors; and

(B) prepare the disclosure required by Item 407(d)(3)(i) of Regulation S-K;

(ii) an annual performance evaluation of the audit committee; and

(iii) the duties and responsibilities of the audit committee - which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act , as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;

Commentary: After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the listed company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";

Commentary: Meetings may be telephonic if permitted under applicable corporate law; polling of audit committee members, however, is not permitted in lieu of meetings.

With respect to closed-end funds, Section 303A.07(b)(iii)(B) requires that the Audit Committee meet to review and discuss the fund's annual audited financial statements and semi-annual financial statements. In addition, if a closed-end fund chooses to voluntarily include the section "Management's Discussion of Fund Performance" in its Form N-CSR, then the audit committee is required to meet to review and discuss it.

(C) discuss the listed company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

Commentary: The audit committee's responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a listed company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;

Commentary: While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

Commentary: To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention.

(F) review with the independent auditor any audit problems or difficulties and management's response;

Commentary: The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the listed company. The review should also include discussion of the responsibilities, budget and staffing of the listed company's internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

Commentary: Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the listed company they audit.

(H) report regularly to the board of directors.

Commentary: The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the listed company's financial statements, the listed company's compliance with legal or regulatory requirements, the performance and independence of the listed company's independent auditors, or the performance of the internal audit function.

General Commentary to Section 303A.07(b): While the fundamental responsibility for the listed company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the listed company's selection or application of accounting principles, and major issues as to the adequacy of the listed company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the listed company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

Website Posting Requirement: A listed company must make its audit committee charter available on or through its website. A closed-end fund is not required to comply with this website posting requirement.

Disclosure Requirements: A listed company must disclose in its annual proxy statement or, if it does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC that its audit committee charter is available on or through its website and provide the website address.

(c) Each listed company must have an internal audit function.

Commentary: Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the listed company's risk management processes and system of internal control. A listed company may choose to outsource this function to a third party service provider other than its independent auditor.

General Commentary to Section 303A.07: To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

UK Corporate Governance Code

C.3: Audit Committee and Auditors

Main Principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code Provisions

C.3.1. The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

C.3.2. The main role and responsibilities of the audit committee should be set out in written terms of reference[19] and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities.

C.3.3. The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.

[19] This provision overlaps with FSR Rules DTR 7.2.3 R (see Schedule B).

C.3.4. Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

C.3.5. The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.6. The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.7. The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.8. A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded**.**

Hong Kong Corporate Governance Code and Corporate Governance Report

(Appendix 14 of HKEx's Listing Rules)

C.3 Audit Committee

Principle

The board should establish formal and transparent arrangements to consider how it will apply financial reporting and internal control principles and maintain an appropriate relationship with the issuer's auditors. The audit committee established under the Listing Rules should have clear terms of reference.

Code Provisions

C.3.1 Full minutes of audit committee meetings should be kept by a duly appointed secretary of the meeting (who should normally be the company secretary). Draft and final versions of minutes of the meetings should be sent to all committee members for their comment and records, within a reasonable time after the meeting.

C.3.2 A former partner of the issuer's existing auditing firm should be prohibited from acting as a member of its audit committee for a period of 1 year from the date of his ceasing:

(a) to be a partner of the firm; or

(b) to have any financial interest in the firm,

whichever is later.

C.3.3 The audit committee's terms of reference should include at least:-

Relationship with the issuer's auditors

(a) to be primarily responsible for making recommendations to the board on the appointment, reappointment and removal of the external auditor, and to approve the remuneration and terms of engagement of the external auditor, and any questions of its resignation or dismissal;

(b) to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process in accordance with applicable standards. The Audit Committee should discuss with the auditor the nature and scope of the audit and reporting obligations before the audit commences;

(c) to develop and implement policy on engaging an external auditor to supply non-audit services. For this purpose, "external auditor" includes any entity that is under common control, ownership or management with the audit firm or any entity that a reasonable and informed third party knowing all relevant information would reasonably conclude to be part of the audit firm nationally or internationally. The audit committee should report to the board, identifying and making recommendations on any matters where action or improvement is needed;

Review of the issuer's financial information

(d) to monitor integrity of the issuer's financial statements and annual report and accounts, half-year report and, if prepared for publication, quarterly reports, and to review significant financial reporting judgements contained in them. In reviewing these reports before submission to the board, the committee should focus particularly on:-

(i) any changes in accounting policies and practices;

(ii) major judgmental areas;

(iii) significant adjustments resulting from audit;

(iv) the going concern assumptions and any qualifications;

(v) compliance with accounting standards; and

(vi) compliance with the Listing Rules and legal requirements in relation to financial reporting;

(e) Regarding (d) above:-

(i) members of the committee should liaise with the board and senior management and the committee must meet, at least twice a year, with the issuer's auditors; and

(ii) the committee should consider any significant or unusual items that are, or may need to be, reflected in the report and accounts, it should give due consideration to any matters that have been raised by the issuer's staff responsible for the accounting and financial reporting function, compliance officer or auditors;

Oversight of the issuer's financial reporting system and internal control procedures

(f) to review the issuer's financial controls, internal control and risk management systems;

(g) to discuss the internal control system with management to ensure that management has performed its duty to have an effective internal control system. This discussion should include the adequacy of resources, staff qualifications and experience, training programmes and budget of the issuer's accounting and financial reporting function;

(h) to consider major investigation findings on internal control matters as delegated by the board or on its own initiative and management's response to these findings;

(i) where an internal audit function exists, to ensure co-ordination between the internal and external auditors, and to ensure that the internal audit function is adequately resourced and has appropriate standing within the issuer, and to review and monitor its effectiveness;

(j) to review the group's financial and accounting policies and practices;

(k) to review the external auditor's management letter, any material queries raised by the auditor to management about accounting records, financial accounts or systems of control and management's response;

(l) to ensure that the board will provide a timely response to the issues raised in the external auditor's management letter;

(m) to report to the board on the matters in this code provision; and

(n) to consider other topics, as defined by the board.

Notes: These are only intended to be suggestions on how compliance with this code provision may be achieved and do not form part of it.

1 The audit committee may wish to consider establishing the following procedure to review and monitor the independence of external auditors: -

(i) consider all relationships between the issuer and the audit firm (including non-audit services);

(ii) obtain from the audit firm annually, information about policies and processes for maintaining independence and monitoring compliance with relevant requirements, including those for rotation of audit partners and staff; and

(iii) meet with the auditor, at least annually, in the absence of management, to discuss matters relating to its audit fees, any issues arising from the audit and any other matters the auditor may wish to raise.

2 The audit committee may wish to consider agreeing with the board the issuer's policies on hiring employees or former employees of the external auditors and monitoring the application of these policies. The Audit Committee should then be in a position to consider whether there has been or appears to be any impairment of the auditor's judgement or independence for the audit.

3 The audit committee should ensure that an external auditor's provision of non-audit services does not impair its independence or objectivity. When assessing the external auditor's independence or objectivity in relation to non-audit services, the audit committee may wish to consider:

(i) whether the skills and experience of the audit firm make it a suitable supplier of non-audit services;

(ii) whether there are safeguards in place to ensure that there is no threat to the objectivity and independence of the audit because the external auditor provides non-audit services;

(iii) the nature of the non-audit services, the related fee levels and fee levels individually and in total relative to the audit firm; and

(iv) criteria for compensation of the individuals performing the audit.

4 For further guidance, issuers may refer to the “Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor’s Independence” issued by the Technical Committee of the International Organization of Securities Commissions in October 2002 and “A Guide for Effective Audit Committees” published by the Hong Kong Institute of Certified Public Accountants in February 2002. Issuers may also adopt the terms of reference in those guides, or any other comparable terms of reference for establishing an Audit Committee.

C.3.4 The audit committee should make available its terms of reference, explaining its role and the authority delegated to it by the board by including them on the Exchange’s website and the issuer’s website.

C.3.5 Where the board disagrees with the audit committee’s view on the selection, appointment, resignation or dismissal of the external auditors, the issuer should include in the Corporate Governance Report a statement from the audit committee explaining its recommendation and also the reason(s) why the board has taken a different view.

C.3.6 The audit committee should be provided with sufficient resources to perform its duties.

C.3.7 The terms of reference of the audit committee should also require it:

(a) to review arrangements employees of the issuer can use, in confidence, to raise concerns about possible improprieties in financial reporting, internal control or other matters. The audit committee should ensure that proper arrangements are in place for fair and independent investigation of these matters and for appropriate follow-up action; and

(b) to act as the key representative body for overseeing the issuer’s relations with the external auditor.

Recommended Best Practice

C.3.8 The audit committee should establish a whistleblowing policy and system for employees and those who deal with the issuer (e.g. customers and suppliers) to raise concerns, in confidence, with the audit committee about possible improprieties in any matter related to the issuer.

Singapore Companies Act

Audit Committees

201B.

(1) Every listed company shall have an audit committee.

(2) An audit committee shall be appointed by the directors from among their number (pursuant to a resolution of the board of directors) and shall be composed of 3 or more members of whom a majority shall not be —

(a) executive directors of the company or any related corporation;

(b) a spouse, parent, brother, sister, son or adopted son or daughter or adopted daughter of an executive director of the company or of any related corporation; or

(c) any person having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the functions of an Audit Committee.

(3) The members of an audit committee shall elect a chairman from among their number who is not an executive director or employee of the company or any related corporation.

(4) If a member of an audit committee resigns, dies or for any other reason ceases to be a member with the result that the number of members is reduced below 3, the board of directors shall, within 3 months of that event, appoint such number of new members as may be required to make up the minimum number of 3 members.

(5) The functions of an audit committee shall be —

(a) to review —

(i) with the auditor, the audit plan;

(ii) with the auditor, his evaluation of the system of internal accounting controls;

(iii) with the auditor, his audit report;

(iv) the assistance given by the company's officers to the auditor;

(v) the scope and results of the internal audit procedures; and

(vi) the balance-sheet and profit and loss account of the company and, if it is a holding company, the consolidated balance-sheet and profit and loss account, submitted to it by the company or the holding company, and thereafter to submit them to the directors of the company or the holding company; and *(b)* to nominate a person or persons as auditor, notwithstanding anything contained in the articles or under section 205, together with such other functions as may be agreed to by the Audit Committee and the board of directors.

(6) The auditor has the right to appear and be heard at any meeting of the audit committee and shall appear before the committee when required to do so by the committee.

(7) Upon the request of the auditor, the chairman of the audit committee shall convene a meeting of the committee to consider any matters the auditor believes should be brought to the attention of the directors or shareholders.

(8) Each audit committee may regulate its own procedure and in particular the calling of meetings, the notice to be given of such meetings, the voting and proceedings thereat, the keeping of minutes and the custody, production and inspection of such minutes.

(9) Where the directors of a company or of a holding company are required to make a report under section 201(5) or section 201(6A) and the company is a listed company, the directors shall describe in the report the nature and extent of the functions performed by the audit committee pursuant to subsection (5).

(10) In this section, "listed company" means a company that is incorporated in Singapore and has been admitted to the official list of a securities exchange in Singapore and has not been removed from the official list.

(11) Any reference in this section to a director who is not an executive director of a company is a reference to a director who is not an employee of, and does not hold any other office of profit in, the company or in any related corporation of that company in conjunction with his office of director and his membership of any audit committee, and any reference to an executive director shall be read accordingly.