Asian Corporate Governance Association (ACGA)

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

Presentation by:

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Topics

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1. Our basic position

We do not believe the *Kansayaku* Board is a substitute for an Audit Committee – contrary to the view often put forward by regulators and some business groups in Japan.

The *Kansayaku* Board concept has certain strengths, but does not fulfil several of the core functions required of a sound system of board governance and management oversight.

On balance, the Audit Committee system as practised in other major markets, while imperfect, offers a stronger basis for a system of board governance – *if* implemented well.

- *By "Audit Committee", we do <u>not</u> mean the three-committee system (3C) audit committee in Japan.*

2. What do we mean by an "Audit Committee"?
Basic differences with the 3C audit committee in Japan

Non-Japanese Audit Committee	**Japanese 3C audit committee**
Chaired by an "independent" director and should comprise all independent directors.	Comprised of directors, a majority of whom should be "outside".
Executive directors cannot be members.	"Inside" directors could be members. In some firms, a former insider chairs the committee.
Definition of "independence" is strict.	Definition of "outside director" not as strict in terms of independence from management.
Has oversight of financial reporting, risk management, internal controls, external auditor, internal auditor, whistleblowing systems.	Audits the legal duties and compliance of directors and executive officers, reviews financial statements, appoints external auditor.

3. Why are we concerned?

Limited rules on board independence in Japan.

Country	Official CG Code(s) on board governance?	Independent directors mandatory?	Minimum # of INEDs	Audit committees mandatory?
China	2002 / ?	Yes	One-third	Yes
Hong Kong	1993/2004/2012	Yes	One-third	Yes
India	1999 / 2009	Yes	33-50%	Yes
Indonesia	2001	Yes	30%	Yes
Japan	Still no consensus	Optional. Now comply / explain.	One INED or ISA[α]	No. Very few.
Korea	1999/2003 / ?	Yes	25-50%	Yes (large firms).
Malaysia	2000/2007/2012	Yes	Majority*	Yes
Philippines	2002/2009	Yes	Two/20%	Yes
Singapore	2001/2005/2012	Yes	One third to majority*	Yes
Taiwan	2002/2011	Yes. Phased in.	Two or 20%.	Yes (from 2014).
Thailand	1999/2006	Yes	Three/one-third	Yes

*Majority suggested only if the chairman is non-independent. Not a mandatory rule.

α "ISA" refers to an independent statutory auditor (kansayaku).

Source: ACGA research

Japan out of step with international standards

- Japan is moving towards a system of outside directors, but slowly. The rest of the world, including most of Asia, did this at least10-20 years ago.

- Japan has no widely-used, high-quality system of Audit Committees, which is a key board committee and essential for good governance and supervision of senior management.

- The Global Financial Crisis (GFC) raised significant and legitimate concerns about board quality, composition, and independence in all advanced economies:

  - Particular focus on the audit committee and its oversight role both of management and external auditors .
  - Recognition of need for serious director training and development, including on financial expertise and financial literacy.

A typical response: 'But Japan is different'

Yes, but mostly No

- It is true that corporate governance (CG) institutions and laws in Japan differ considerably in some respects from other countries.
- Most corporate CG failures in Japan may be different from other markets in terms of intention (ie, less obviously driven by greed), but are little different in terms of outcome (ie, damage to corporate value and reputation).
- Fraud, embezzlement, misleading disclosure, domineering chairmen, poor capital allocation—all have a familiar ring to anyone following CG around the world.
- Non-Japanese ideas and solutions have a role to play in helping to mitigate CG risk. 'A good idea has no nationality.'

4. Why are international investors concerned ?

- Japan is part of the international capital market
- Foreign investors account for a large part of the trading and ownership of Japanese stocks.
- Shareholder returns in Japan are often poor.
- An Audit Committee would help to focus minds on the more efficient use of capital, among other things.

Global institutional investors today also place increased emphasis on:

- Their "fiduciary" responsibilities to beneficiaries (eg, pensioners, ordinary savers).
- "Responsible investment": incorporating governance, environment and social factors into their investment process.
- Comparing and valuing companies against their global peers on governance as much as economic performance.

5. Role of *Kansayaku* Boards

Formal roles

1. Determine audit policy and the monitoring of a company's operations and financial position.
2. Attend all board meetings and have a right to express their opinions. But they cannot cast a vote.
3. Conduct accounting audits *(kaikei kansa),* which include reviews of periodic financial reports and conclusions of the external accounting auditor.
4. Conduct business audits *(gyomu kansa),* which confirm that board decisions and execution of director duties are compliant with law and fiduciary responsibilities.
5. Give consent to the selection/hiring of external auditor. (Note: Revision to Companies Act will allow KB to select the CPA firm.)
6. Must report any violation of the law or director duties to the board and external auditor. Can sue a director if necessary.

6. Pros and cons of *Kansayaku* Boards

The key advantage we see in the Japanese system is the role of the full-time *Kansayaku:*

- A full-time *(jokin) Kansayaku* can play a useful role gathering information inside a company. Makes regular on-site visits to major plants, branch offices and subsidiaries.

- A full-time *Kansayaku* has a *de facto* role to act as an advisor to the President and senior management on what is happening within the company and how to improve management.

Kansayaku Boards – 2

However, we see many disadvantages:

- Some powers on paper are, paradoxically, extremely strong and therefore rarely used. For example, the right to sue directors.
- *Kansayaku* are not directors, hence lack the authorities and responsibilities of directors.
- *Kansayaku* undertake "audits" and monitor what is going on inside a company, but they do not "supervise" the board and senior management.
- Few consequences if *Kansayaku* do not do their job properly.
- Full-time *Kansayaku* are not employees, technically speaking, but are still appointed by the President and often loyal to him.
- They are not required to be experts in accounting or law.

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"Supervision"

- The words "supervision" and "supervisory" have a clear meaning in English: they refer to a hierarchical relationship involving a person(s) overseeing a project/task, directing the work of other people or keeping watch over someone (eg, prisoners).

  (From medieval Latin: supervidere, from super- 'over' + videre 'to see'.)

- In corporate governance terms, supervision refers to the Board of Directors overseeing the strategy and operations of a company, as well as the performance of the executive directors and senior management. If the latter do not perform, then the Board has the power to take corrective action.

- Linking the word "supervise" to the role of the *Kansayaku* is misleading: they do not stand above the inside directors/board in the corporate hierarchy, they cannot decide the fate of the President/CEO and other senior management.

7. Pros and cons of Audit Committees

On balance, we see more advantages than disadvantages to the Audit Committee system:

- Having an independent chair and comprising, at best, only independent directors gives the committee power influence and oversight within the Board.
- Each member has the full authority of a director.
- Each member should have accounting and/or financial management expertise.
- Discusses in-depth a range of critical governance issues: financial statements, accounting systems, internal controls, risk management policies and processes, whistleblowing systems.
- Has close communication with and oversight of the external accounting auditor.
- Internal auditors report directly to the Audit Committee.
- In short, potentially a more powerful oversight mechanism.

Audit Committees – 2

Disadvantages

- Tends to rely on management for information. Has no counterpart to the *Jokin Kansayaku*.
- In the worst cases, meetings can be scripted and formulaic.
- Quite common for many audit committees to meet just before board meetings each quarter—a problem if approval of accounts is on the agenda, since there is no time for any remedial action to be taken by the auditor.

8. Unilever's Audit Committee

- All independent non-executive directors.*
- All have deep business and/or financial management expertise.
- An international group bringing value to a multinational firm.

Byron Grote (Chair)

American

Mary Ma

Chinese

Hixonia Nyasulu

South African

John Rishton

British

**Hixonia Nyasulu worked for Unilever early in her career from 1978 to 1984. She was appointed to the Unilever board in 2007, hence more than 20 years later and more than sufficient to deem her independent.*

Unilever's Audit Committee
Terms of reference

The Audit Committee concerns itself with:

1. The oversight of the integrity of Unilever's financial statements;
2. The oversight of Unilever's risk management and internal control arrangements;
3. The oversight of Unilever's compliance with legal and regulatory requirements;
4. Making recommendations to the Boards on the nomination of and compensation payable to the External Auditors;
5. The oversight of performance, qualifications and independence of the External Auditors;
6. The policy on work that can and cannot be performed by the External Auditors and the compliance thereof;
7. The performance of the internal audit function; and
8. The approval of the Unilever Group trading statements for quarter 1 and quarter 3.

9. Director Ecosystem

- Board reform should be about more than structural change: appointing directors and forming committees.
- All directors, not just independents/outsiders, need some degree of training and development.
- Senior directors may not need basic "training", but could still benefit from knowledge and skills "development", eg, in technology or social media.
- Governments and regulators should ensure that a healthy ecosystem for such director development exists. By mandating some degree of education, and the disclosure of company policies and practices in this area, they can help to encourage the growth of such an ecosystem.
- Stock exchanges should review corporate board practices from time to time, not simply set a rule or best practice and proceed to ignore implementation.

10. Conclusion and Recommendations

1. Appoint independent directors to your board voluntarily and sooner rather than later.
2. Ensure they receive a proper induction and ongoing training and development, as required.
3. Companies with *Kansayaku* Boards should create an independent Nomination Committee under the board of directors for the selection and nomination of *Kansayaku* (as well as directors, of course).
4. 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.

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