After Toshiba scandal, Japan to float new code for auditors by year-end - Reuters News

Thu, 10 Nov 2016 22:00:00 GMT

- Regulators to propose code by year end - official
- Code likely to give outside voices say in audit oversight
- Enforcement, shareholder pressure needed for change -investors

By Thomas Wilson and Emi Emoto

TOKYO, Nov 11 (Reuters) - Regulators in Japan are planning new rules to improve standards in the auditing profession in a bid to avert scandals like last year's $1.3 billion overstatement of profit by Toshiba Corp. 6502.T, which went unnoticed by the country's biggest auditor for years.

Improving corporate governance in Japan has been a key theme of Prime Minister Shinzo Abe's government, which has introduced a voluntary code for listed companies to challenge a business culture that values unquestioning loyalty to senior bosses over transparency and full disclosure.

Now the Financial Services Agency wants the country's audit firms, which critics say operate under a similar culture of deference and earn relatively low fees for audit work, to raise their game to help clean up corporate Japan.

The FSA will by year-end propose a governance code likely to give outside voices a say in oversight of audits, according to Kazutoshi Harada, the agency's director for enforcement of corporate disclosure.

"Auditors are essential infrastructure for Japan's capital markets," he said. "And their listening to third-party opinions is crucial for them to function as that infrastructure."

The details are still being hammered out, Harada said, but corporate governance experts say the code could ask auditors to appoint independent non-executive directors to oversight boards with a public interest mandate.

No decision has yet been taken on whether the code would be binding or enforced by penalties, Harada added, which some investors say is necessary to change the culture.

"There has to be teeth to a policy for it to be effective," said Soren Aandahl, director of research at U.S.-based Glaucus Research. "There has to be a way to deter an auditor from signing off on what should be obviously inappropriate accounting or fraud."

Fuelled by doubts over the quality of governance and accounting standards in the country, Glaucus was one of a wave of short-sellers to attack Japanese firms in the wake of Toshiba's fall from grace and a similar scandal at camera and medical equipment maker Olympus 7733.T in 2011. (Full Story)

Glaucus accused trading firm Itochu Corp 8001.T of inflating its profits and called for a third-party panel to find an independent auditor to probe its financial statements. Itochu denied any accounting irregularities. (Full Story) (Full Story)

DRIVING CHANGE

Japan's audit quality is already overseen by a professional body, and in 2004 an FSA oversight board was launched to watch over quality reviews and punish auditors in cases of wrongdoing, but that failed to prevent a string of scandals.

The FSA board's fine against the Toshiba auditor, Ernst and Young (EY) ShinNihon, was its first ever against an audit firm.

The Japan Institute of Certified Public Accountants professional body has also stepped up reviews of audit quality, and Japan's four major audit firms - EY ShinNihon, PricewaterhouseCoopers Aarata, Deloitte Touche Tohmatsu and KPMG Azsa - say they have also taken steps to boost quality control and management.

The changes include PwC bolstering outside oversight of audits, to EY ShinNihon telling staff that those who are told to improve, but don't, face "recommended retirement".

But top-down pressure can only do so much to effect real change, said Jamie Allen, secretary general of the Hong Kong-based Asian Corporate Governance Association.

"You need the bottom-up push," he said. "It's really the shareholders and the other stakeholders that drive the culture change in companies."

Boosting the role of shareholders is part of Abe's corporate governance reforms, launched last year.

As well as asking listed firms to appoint outside directors and set rules on disclosure, his code upholds shareholders' rights to information and urges them to vote, while a separate stewardship code encourages unhappy shareholders to speak out.

Although the rules are not legally binding - the Tokyo bourse asks listed firms to comply or explain why they haven't - there are signs they are having an impact.

Over 60 percent of listed companies now have two or more outside directors, up from 32 percent in 2015, according to the Japan Exchange Group.

More can be done, says David Smith, head of corporate governance at Aberdeen Asset Management Asia in Singapore, including greater protection against related-party transactions, and private share issuance that dilutes others' holdings.

But change is happening.

"After decades of moving at a very slow pace on corporate governance reform, Japan over the last few years has moved incredibly fast," he said.

"What we want to see now are the changes and ethos bed down."

(Reporting by Thomas Wilson and Emi Emoto; additional reporting by Michelle Price in Hong Kong; Editing by Will Waterman)

(T.Wilson@thomsonreuters.com ; 81-3-6441-1598; Reuters Messaging: t.wilson.thomsonreuters.com@reuters.net)