April 9, 2016

"Issues Regarding Companies with an Audit Committee"

Summary

Many public companies in Japan have adopted a new corporate governance structure spurred by enforcement of the revised Business Law. The new structure may be difficult to understand due to the difference from structure in many other countries. The real purpose of the amendment of the law should be improvement in corporate governance, but this phenomenon may in fact be something of a setback. According to research, many companies that changed structure merely switched from corporate auditors to directors. Also, many companies have adopted a delegation provision that enables an inside director to assign important business operations without decision by the full board of directors.

Background

Japan's corporate governance structure is different from that of other countries which may create misunderstanding about the actual application of such differences. Since Japan's corporate governance code was enforced in 2015, few companies have employed western style of governance structure, namely a company with committees. Indeed, many public companies continue to maintain the conventional structure, i.e. a company with corporate auditors. It should be noted that in many cases, corporate auditors are persons from finance department or even marketing department of the company but not qualified accountant. It is true there have been discussions on this shortcoming and the need to improve role of 'auditors.'

Meanwhile, partial amendment of Business Law was enforced on 20th June 2015. Based on this act, many companies that hold their AGM at the end of June were able to enact a change to their Articles of Incorporation to comply with the new act. The new act enables a company to employ the structure of "a company with an audit committee" in addition to the two previous structures, ie. a company with corporate auditors and a company with committees. The third structure aims to (a) mitigate load of hiring outside auditors and election of corporate auditors in addition to outside directors for a company with corporate auditors, and (b) move corporate governance forward in a new scheme as many companies are unlikely to move to a company with committees structure in which majority of outside directors decide nomination and compensation issues.

Features of New Structure

A member of an Audit Committee must be a member of the board of directors and the majority must be outside directors (revised Business Law 331-6). One advantage is that a member of the committee is also a director who has voting rights on company matters such as appointing business executive officers and stating opinions including nomination of directors at shareholders' meetings, whereas a corporate auditor does not. A disadvantage is the committee assumes systematic auditing based on internal control but a full-time member of the committee is not necessarily elected, whereas a corporate auditor has more auditing rights as an independent agent. Each company that employs an Audit Committee should design a scheme for ensuring systematic auditing functions. Another purpose is to enrich supervisory function of board of directors that should focuses on supervision, as important operating matters can be consigned to an executive officer, in companies where the board consists of majority of outside directors, or as specified by the article (revised Business Law 399-13-5/6). This should encourage separating supervision and execution of a company.

Research of Companies moved to New Structure

As of April 8th 2016 only 69 companies have changed to a company with committees (including nomination, compensation and audit), but 317 companies moved to a company with an Audit Committee, according to the database of the Tokyo Stock Exchange. Of those 317 companies, 175 companies employ 2 outside directors, 125 companies have 3 outside directors, 15 companies have 4 outsiders and 2 companies have 5 or more outside directors. The companies with 2 outside directors are very likely to switch from corporate auditors to directors. Companies listed in Tokyo Stock Exchange are required to employ corporate

auditors (Tokyo Stock Exchange Rule 437), and those corporate auditors must consist of more than 3 persons, majority of them outsiders (Business Law 335-3). Therefore, in case of 2 outside directors-company that moved to a company with an Audit Committee, they are very likely to slip in directors. 55% (175 of 317 companies) of companies changed to new structure are suspected of switching from corporate auditors. The likely reasoning behind companies moving to the new structure may be as follows: The revised act requires that a company with no outside director disclose appropriate reason of not hiring outside directors in its business report (revised Business Law 327-2) and explain the reason at AGM as its accountability. Corporate Governance Code also requires the company to elect more than 2 independent directors (Corporate Governance Code Principle 4-8). Thus, a company that is not accordance with these rules is more likely to be motivated to adopt the new structure prior to AGM most companies hold in June.

Issues

(a) In order to enrich the supervision capacity of company boards, their members should consist of many of outside directors or independent directors. As mentioned above, more than half companies moved to the new structure are suspected of just switching to directors from corporate auditors. Of course, increase in outside directors should be a good thing, but a well-balanced board of directors must be also a vital point. According to Corporate Governance Code Principle 4-11, “Board of directors should consist of well-balanced members who own knowledge, experience and ability for playing its role and duty, and achieve diversity and appropriate size.” Therefore, simple switching from an auditor to a director should be suspected if these other factors such as balance, diversity and size are considered.

(b) Revised Business Law specifies the role of directors for a company with an Audit Committee as decisions on matters of business execution, supervision of duty of directors and appointment/dismissal of a representative director (revised Business Law 399-13-1). Of these statutory roles, decisions about business execution should be selectively discussed in the board meeting in a given time, as the meeting should focus more on supervision and decision-making for more important agenda that is unable to assign to an executive officer. Due to restriction of time for outside directors, limited number of agenda items should be prioritized in board meetings. However, role of outside directors would be weakened if important matters that must be determined by board of directors were assigned to an executive officer. According to survey by Deloitte Touche Tohmatsu[1], of 172 companies that moved to the new structure 145 companies changed articles that enable to assign an executive officer for important business operation. Only 2 companies have more outsiders than insiders in the board. Thus, 84% of employing the new structure has applied the delegation provision.

(c) Each corporate auditor of a company with corporate auditors owns a right of investigating as an independent agent (revised Business Law 381), whereas the Audit Committee assumes systematic auditing as a council but each member has no such investigation right and only a pre-determined member have the right (revised Business Law 399-13-5/6). Also, systematic auditing is based on internal control system and does not necessarily require full-time audit member. In case the committee has no full-time member, it is important that internal staff of corporate audit department should support the committee. For outside directors, it is also important to assess credibility of information gathered by internal staff. Shareholders/Investors should watch how the committee improves cooperation between the committee and the related parties such as Audit Corporation and internal audit department.

Conclusion

Not all the companies that adopt a company with an Audit Committee abuse the structure or the revised new law. However, a number of companies have already changed their Articles of Incorporation at AGM last year (2015). This would results in weakening role of outside directors, as many of the companies that changed articles have minority of outside directors. Research shows many of them are suspected of just switching to directors from corporate directors without considering improvement in board of directors. We should watch the improvement in corporate governance for the company adopting the new structure, as the structure has pros and cons as mentioned above and is not the goal. Other issues such as appointing and compensation of directors must be solved for better corporate governance.

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[1] “Kaikei Joho” Vol 475/2016.3