Meiji Institute for Global Affairs

MIGA COLUMN GLOBAL DIAGNOSIS

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Short Curriculum Vitae - Sumitaka Fujita

Joined C. Itoh & Co. (the current ITOCHU Corporation) in 1965.

Appointed Director of the Board in charge of Business Development in 1995, Managing Executive Director in 1997, Senior Managing Executive Director and CFO in 1999, Executive Vice President and CFO in 2001, Executive Vice President, CAO, CFO, and CCO in 2003, Vice Chairman in 2006, Senior Corporate Advisor in 2008, and Advisory Member in 2011 (current position).

Other Positions:

Appointed Outside Director of Orient Corporation in 2007, Outside Director of Furukawa Electric Co., Ltd. in 2008 (current position), Outside Director of Nippon Sheet Glass Co., Ltd. in 2009, Outside Director of NKSJ Holdings in 2010, Chairman of Japan Association for Chief Financial Officers (JACFO) in 2011 (current position), and Outside Director of Olympus Corporation in 2012 (current position).

Corporate Governance Reform

- Subsequent Trends, Accounting Fraud, and Auditing –

1. Corporate governance reform among Japanese companies from 2014 to 2017

Formed in 2012, the second administration of Prime Minister Shinzo Abe formulated the Japan Revitalization Strategy (2013, 2014) under a monetary and fiscal policy aimed at an exit from the protracted trend of deflation that had lasted for 20 years and revival

of the Japanese economy. The aim of reinforcing corporate governance under the banner of “aggressive governance” was posted in the context of the government’s basic policy to “recover Japan’s earning power.” The type of governance-related reform profiled below has been promoted ever since.

(Figure-1)

Major Trends in Reform Since 2014

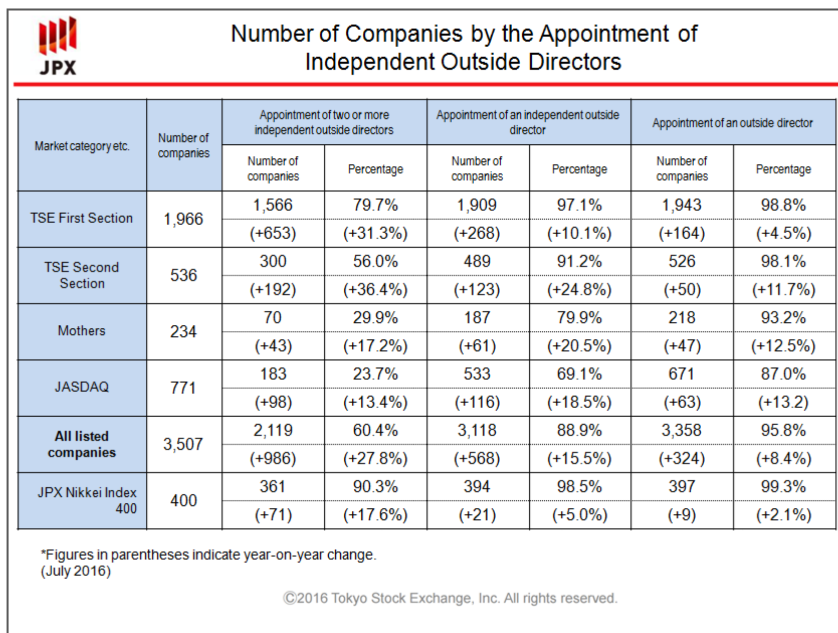
Item		Date
• 2014 Revision of the “Japan Revitalization Strategy”		June 2014
• JPX Nikkei Index 400		January 2014
• Japanese version of the Stewardship Code “Principles for Responsible Institutional Investors”		February 2014
• Amended Companies Act	Promulgation	June 2014
	Effectuation	May 2015
• “Ito Report” METI Project “Competitiveness and Incentive for Sustained Growth”		August 2014
• Revision of advisory standards for execution of ISS voting rights		November 2014
• Corporate Governance Code		June 2015
• Audit Firm Governance Code		March 2017
• Stewardship Code (revised version)		May 2017

Within the flow of recent years noted above, reforms were promoted with the aim of sustainable growth of corporate value against the backdrop of issues related to the performance of Japanese companies, in particular, low levels of capital efficiency and profitability. The following may be cited as the main goals of governance reform between 2014 and 2016: improvement and sustainable growth of corporate value, including improvement of capital efficiency; “aggressive governance,” in other words, promotion of the exercise of a sound entrepreneurial spirit without undue emphasis on risk avoidance; collaboration and dialogue between companies and investors (in the investment chain); and bolstering of the effectiveness of boards of directors, including the selection and appointment of outside directors, for attainment of these ends.

In the reforms that have taken place over the last two to three years, big strides have been made in the appointment of outside directors, which may even be the key to reform promotion. As shown in detail below (Figure-2), as of July 2016, 98.9 percent of the companies listed on the First Section of the Tokyo Stock Exchange (TSE) had already appointed an outside director, and approximately 80 percent had two or more

independent outside directors.

(Figure-2)



Number of Companies by the Appointment of Independent Outside Directors

Market category etc.	Number of companies	Appointment of two or more independent outside directors		Appointment of an independent outside director		Appointment of an outside director	
		Number of companies	Percentage	Number of companies	Percentage	Number of companies	Percentage
TSE First Section	1,966	1,566	79.7%	1,909	97.1%	1,943	98.8%
		(+653)	(+31.3%)	(+268)	(+10.1%)	(+164)	(+4.5%)
TSE Second Section	536	300	56.0%	489	91.2%	526	98.1%
		(+192)	(+36.4%)	(+123)	(+24.8%)	(+50)	(+11.7%)
Mothers	234	70	29.9%	187	79.9%	218	93.2%
		(+43)	(+17.2%)	(+61)	(+20.5%)	(+47)	(+12.5%)
JASDAQ	771	183	23.7%	533	69.1%	671	87.0%
		(+98)	(+13.4%)	(+116)	(+18.5%)	(+63)	(+13.2)
All listed companies	3,507	2,119	60.4%	3,118	88.9%	3,358	95.8%
		(+986)	(+27.8%)	(+568)	(+15.5%)	(+324)	(+8.4%)
JPX Nikkei Index 400	400	361	90.3%	394	98.5%	397	99.3%
		(+71)	(+17.6%)	(+21)	(+5.0%)	(+9)	(+2.1%)

*Figures in parentheses indicate year-on-year change.
(July 2016)

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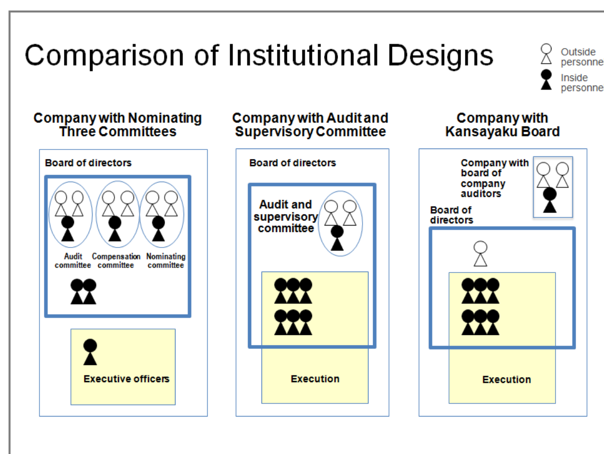
Meanwhile, as shown in (Figure-4), among the companies listed on the TSE as of December 2016, those that adopted organization as a “company with audit and supervisory committee,” which was instated as a third option upon amendment of the Companies Act in 2015 (Figure-3), numbered 676. Moreover, this number is expected to increase further. Like the conventional organization as a company with three committees, an organization as a company with audit and supervisory committee characteristically expands the range of transfer of decision-making authority for business execution to the business execution side. It also acts to expedite decision-making by the board of directors and to encourage a “separation between monitoring and management.” The majority of companies that have adopted this organizational structure cite this point as the reason for their adoption of it. In contrast, a fairly large share are also reluctant, citing the reason for this as “it would be a burden to appoint an outside director in addition to an outside auditor.”

(Figure-3)



(Figure-4)

Number of Companies by Type of Institutional Design and by Market

Market category	Company with Kansayaku Board	Company with three committees	Company with audit and supervisory committee	Total
TSE First Section	1,556	60	373	1,989
TSE Second Section	407	2	127	536
Mothers	195	2	28	225
JASDAQ	606	4	148	758
Total	2,764	68	676	3,508

(As of December 4, 2016) (TSE)

Furthermore, as shown in (Figure-1), the Audit Firm Governance Code, as mentioned below, was introduced in March 2017, partly with a view to improving the quality of accounting audits. As can be seen from the increase in appointment of outside directors and adoption of new institutional designs, the movement to reform corporate governance in Japan has made substantial progress, at least in form. This change is not confined to individual companies; it can definitely be perceived as a change in Japanese companies as a whole.

Nevertheless, the most important matter is to see that these reforms are not held to the level of “appearance” or “external framework”; they must be tenaciously promoted going forward, so that they are reforms that are of “substance,” meaning “effective.” If the reforms up to and including 2016 can be termed the “first act,” the coming “second act” must continue with the task of effective system enhancement.

2. The “second act” of corporate governance reform

The tasks in the “second act” of corporate governance reform include the following: reinforcement of the management and monitoring functions of the board of directors (especially the formulation and promotion of medium- and long-term management strategies and succession plans for the top management layer as well as definition and transfer of business execution determined by the board for this purpose), measures to strengthen the functions of outside directors, ideal arrangements for management team nomination and compensation (e.g., selection of capable presidents/CEOs and

management team members, provision of proper incentives, encouragement of risk-taking, checking of results as well as utilization of the committee mechanism overseen by outside directors for such checking), creation of an environment needed to strengthen leadership of the management team, more extensive information disclosure, actions for engagement with investors, and assurance of sustainable growth in corporate value through these steps. Of the numerous issues involved, I will comment in 3. below on the latest cases and trends in Europe and the United States with a focus on improving the quality of accounting audits and audit transparency in relation to the recent cases of accounting fraud at certain companies.

3. Corporate accounting fraud and the role of accounting auditors – "toward improvement of audit quality"

Properly speaking, corporate governance arose in response to the questions "for whom should companies be managed?" and "how should companies be managed?" It was viewed as a scheme for regulation in these aspects by outside parties (heteronomy) and autonomous control by internal parties. It determined the setup for the checking of managers and their operation of the organization (internal controls). As such, prevention of accounting fraud was not the whole intended purpose. The discussion of corporate governance reform has changed with the times in the United States as well. Against the backdrop of increased instances of hostile takeovers in the 1980s, there was also a need for reinforcement of the role of outside directors. The Enron scandal in 2001, however, was caused by corporate accounting fraud, and raised serious questions indicating the need to strengthen corporate governance reform in the United States. This led to enactment of the Sarbanes-Oxley (SOX) Act, which incorporated tough penalties for corporate improprieties, in 2002. Worldwide financial crises, including the Lehman Brothers failure in 2008, also underscored various issues in corporate governance.

In Japan, corporate governance ineffectiveness in various respects has long been pointed out mainly by overseas institutional investors. Since 2000, various reforms have been made (such as imposition of an obligation to appoint an outside auditor in 2001, introduction of a committee-based corporate organization in 2003, and the requirement for appointment of at least one independent director and/or auditor in 2011). This was

the situation when authorities uncovered the accounting fraud at Olympus (2011) and Toshiba (2015). Toshiba had previously been considered a model of good corporate governance. As of 2011, Olympus had already appointed three outside directors. Toshiba was one of the few companies in Japan that had adopted a Western-style organization with a nominating committee (company with three committees) and was regarded as a practitioner of excellent corporate governance. Nevertheless, in spite of their outward arrangements of the appointment of outside directors, operation of committees whose members were mostly outside directors and strengthening of auditing functions while separating monitoring and management, both of these companies had problems when it came to substance. In short, even the internal corporate organization, not to mention the inside executive officers, were unable to refuse the illicit instructions of the president. Furthermore, the outside directors sitting on the board and audit committee overlooked these wrongs. This indicates that the monitoring and management functions in the aspect of corporate governance that the board of directors are supposed to have, did not work. At the same time, the unique "corporate community" characteristic of Japanese companies which I have long pointed out undoubtedly is a potential factor behind these problems.

Even in the wake of the Toshiba scandal, other incidents have occurred this year as well. For one, Japan Post had an enormous sum of impairment at its Australian logistics subsidiary (it posted impairment of about 400 billion yen in its fiscal 2016 financial statement, owing to a merger and acquisition project in which it invested 620 billion yen in 2015). For another, Fujifilm Holdings announced a revision of its financial statement to post a loss totaling 37.5 billion yen due to fraudulent accounting in several preceding years at Fuji Xerox. Of these cases, that of Japan Post is not a problem of accounting fraud, but of mistaken estimates by the executive team of the future cash flow in the purchase. The board of directors and the corporate auditors were also unable to provide proper supervision.

For the Olympus, Toshiba, and Fujifilm cases, it naturally goes without saying that the responsibility for accounting fraud lies with the leaders of the executive team who deliberately committed the act. Accounting auditors, however, attached their opinions to the consolidated financial statements of these companies every year, and their opinions

were always “true and fair” until the improprieties came to light.

What are the purposes of audit reports prepared by accounting auditors in the first place? When considering who the beneficiaries are, the beneficiaries of the audit reports are not just the audited companies but they should also be society as a whole, meaning the public. In other words investors, financial institutions, transaction partners, employees, and other members of society.

Investors, financial institutions, and transaction partners in particular execute investment, financing, and transactions using disclosed documents such as financial statements and securities reports given a “true and fair” opinion in audit reports as important grounds for their decisions.

In the Olympus, Toshiba, and Fujifilm cases as well, the auditor’s opinion on the consolidated statements every year was “true and fair.” In contrast, in the 2001 Enron scandal, the accounting auditor was also found to have colluded with the company’s executive team in window dressing. As a result, Arthur Andersen, its audit firm, was forced into dissolution.

It is well known that the auditing firms involved in the aforementioned Olympus, Toshiba, and Fujifilm cases in Japan are being exposed to harsh criticism for the nature and quality of their audits. In addition, these cases have prompted calls for a further improvement of audit quality and reinforcement of governance at audit firms. In the next section, I would like to touch on the switch to “longer audit reports,” which has already been written into rules in Europe and begun to be considered in Japan as well, as a part of this trend.

4. Improvement of audit quality and the switch to longer audit reports (extended audit report)

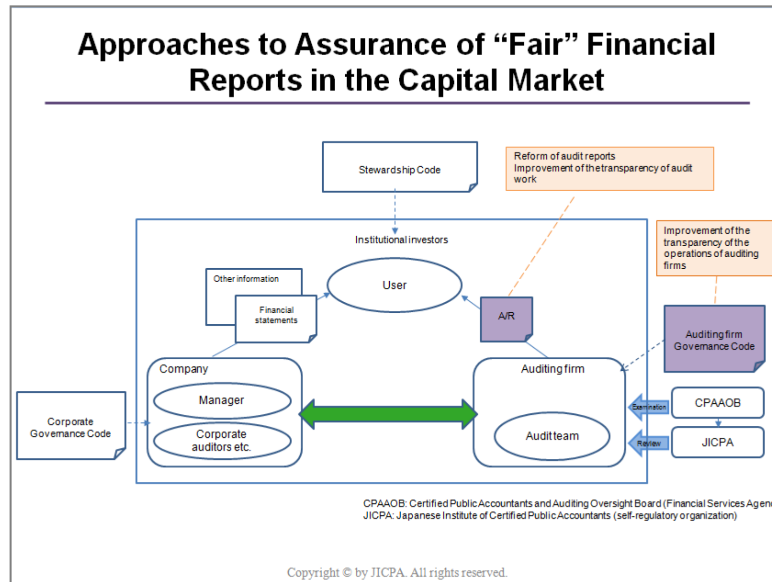
In 1991, Japan’s auditing standards underwent a major revision for the first time in 25 years. There have also been numerous other revisions since then based on trends in international auditing standards. In a sense, the history of auditing is also a story of the fight against fraudulent financial reports. In this process, a great influence is being

exerted by the US Statements on Auditing Standards (SAS), the International Standards on Auditing (ISA) established by the International Auditing and Assurance Standards Board (IAASB), and the auditing standards of the US Public Company Accounting Oversight Board (PCAOB). The biggest issue in regards to the auditing of financial statements was also "how can the auditor heighten their capability for action against fraudulent reports, especially those that management were involved in?"

In the autumn of 2015, the Financial Services Agency held a discussion on the advisable approach to accounting audits for "Ensuring Confidence in Audit" and prepared a related recommendation. This recommendation identified the following five items as the backbone of reform: 1) reinforcing management of audit firms, 2) enhancing provision of information regarding audits to shareholders and others, 3) strengthening ability to detect corporate fraud, 4) assessing audit quality from viewpoints of third parties, and 5) improving environment for high-quality audit.

Within this larger trend, the Audit Firm Governance Code was introduced in March of this year to help preserve public trust in auditing over the medium and long terms. This is to be done through the maintenance and ongoing improvement of audit quality, maintenance of the reputation of auditing firms as a whole as well as improvement in their trustworthiness, and fulfillment of accountability to shareholders and other stakeholders by auditors and other persons responsible for governance at the companies being audited. The approaches shown in (Figure-5) are being taken to ensure that financial reports are true and fair.

(Figure-5)



In (Figure-5) above, the parties preparing financial statements in the capital market are corporate managers. The corporate auditors (the board of auditors and audit committee), as the personnel responsible for governance, have the function of supervising the managers. The Corporate Governance Code is applied to these parties. While the Stewardship Code is applied to institutional investors, who are users of the statement, it is the audit firms that express an independent opinion on the reliability of the financial statements prepared by the company. They therefore play an important role in the capital market. The Audit Firm Governance Code was instated for application to these auditing firms.

As noted above, audit reports play a vital role. Historically speaking, however, there was a time when auditors freely wrote various opinions in the audit reports. Because this could make it unclear whether the financial statements in question could really be trusted, the process was standardized and the practice of writing down a single overall opinion at the end became established about 70 years ago. In short, all audit reports came to use “true and fair” as a standard term for their opinion. The audit opinion is a so-called “pass/fail” type of opinion. The problem with this approach was that what the auditors considered in making their judgment in the audit for the term as experts was completely invisible to investors and other external stakeholders.

This situation led to the idea of having auditors not merely write down whether or not the financial statements are true and fair, but also select and disclose the matters they considered important in the auditing process in their communication with corporate managers, corporate auditors/audit committees, and other persons responsible for governance. This is the substance of the switch to "longer audit reports" that are longer due to notation of Key Audit Matters (KAM). In Japanese, the term "chobunka" (text lengthening) is used in reference to this switch to longer audit reports. With this approach, audit transparency clearly increases, benefiting the users of audit reports. In Japan, too, there has been criticism that "audits are a black box" and provide no footing for making judgments on what auditors are thinking.

"Longer audit reports" therefore make the contents of the audit work more transparent. The figures contained in current financial statements, rather than being an accumulation of past transactions, there is an increasing element of estimation by managers based on future forecasts, on items such as goodwill (intangible assets), and the recoverability of deferred tax assets. This likewise means a commensurate increase in risks and serves as the backdrop for the demands for disclosure of the audit process.

"Longer audit reports" have already been incorporated into the rules in the European Union, including the United Kingdom. In the United States as well, the PCAOB determined and announced Critical Audit Matters (CAM) as the final standard related to audit reports on June 1, 2017. In Japan, the matter is still at the consideration stage, but such a standard should be regarded as an important agenda for increasing the transparency of audit reports and introduced as early as possible.

End