

About Corporate Auditor

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1. Overview

Under Japan's Companies Act of 2005, which consolidated corporate law regulations in Japan, a corporate auditor ("*kansayaku*") is a mandatory organ of a joint-stock company with two exceptional situations. Specifically, a small-scale closely-held company is not required to have *kansayaku*, and a "committee" company is required to have three committees (the audit committee, the nominating committee and the compensation committee) but not *kansayaku*. All other joint-stock companies must have *kansayaku*. This memorandum focuses on large-scale, publicly held companies, which must set up a board of *kansayaku* ("*kansayaku-kai*") under the Companies Act.

The *kansayaku* system existed before World War II, but the amendments to the Commercial Code in 1950 reduced its power and responsibility. The system took on its current form through Commercial Code amendments in 1974, 1981, 1993, and 2001; all of which extensively strengthened the power and independence of *kansayaku*. These various provisions in the Commercial Code were consolidated under the Companies Act of 2005.

Kansayaku must be elected at a shareholders' meeting, and his/her role is to "audit" the activities of directors. This audit includes both a "business audit" and a "financial audit." A business audit is an assessment of whether or not the directors are correctly observing applicable laws and the company's charter provisions while managing the company, and is commonly referred to as a "compliance audit."

A financial audit is conducted before the financial statements are submitted to a shareholders' annual meeting. The audit report, which contains the results of both the financial and business audits, must accompany the notice of the shareholders' meeting. Consolidated financial statements are also subject to auditing by *kansayaku*, and the results of the audit must be reported at the annual shareholders' meeting.

The *kansayaku* system is stricter in "large companies." A large company is defined in the statute as a joint-stock company having legal capital of 500 million yen or more or total balance-sheet liabilities of 20 billion yen or more, and there are approximately 12,000 large companies today. For such a large company, if it is a publicly-held company (which is defined under the statute as a company

where the transfer of shares is not restricted by its charter), there must be at least three *kansayaku* members, at least one of whom is required to be full-time, and at least half of whom must be "outside" *kansayaku*. *Kansayaku-kai* must be formed. In view of the function it plays in large companies, *kansayaku-kai* can be seen as similar to an audit committee in the United States. However, the Japanese *kansayaku-kai* must be a separate body from the board of directors, and must include at least one full-time *kansayaku*. In addition, *kansayaku* may not serve concurrently as a director. The Companies Act requires even greater independence for outside *kansayaku*.

2. Election, Duty and Liability of *Kansayaku*

2.1. Election of *Kansayaku*

Kansayaku members are elected at the shareholders' meeting with a quorum that may not be reduced to less than one-third of the total number of voting shares (the same as for the election of directors). The Companies Act provides grounds for the disqualification of *kansayaku* and directors, such as not permitting an auditor to serve concurrently as a director, officer or employee of the company or its subsidiaries.

Kansayaku has the right to express opinions at the shareholders' meeting regarding the election of other *kansayaku*. *Kansayaku* who has resigned is entitled to attend the first shareholders' meeting that is convened after his resignation and express his/her views. Other *kansayaku* members have the same right.

Kansayaku-kai also has the right to give consent and the right to make suggestions regarding the board of directors' proposals on the candidates of *kansayaku* that are submitted to a shareholders' meeting for election.

Each *kansayaku* serves a four-year term, as compared to two years for directors. This term cannot be shortened by the charter. Compensation must be set in the charter or by a resolution at the shareholders' meeting, separately from the compensation for directors.

As mentioned earlier, large publicly-held company must have a minimum of three *kansayaku* members. Also, at least half of them must be "outside" *kansayaku*, and this means that they must not have formerly been a director, officer, or employee of the company or its subsidiaries. A board of *kansayaku* (*kansayaku-kai*) must be formed, and the board must elect at least one full-time

kansayaku. Thus, in such large companies, while the Japanese board system is two-tiered, it differs considerably from the German two-tier corporate governance system.

2.2 Duty of *Kansayaku*

The legal relationship between *kansayaku* and the company is entrustment "inin". Consequently, *kansayaku* owes a duty of care to the company. Under the Companies Act, the legal duty of *kansayaku* is to "audit" the activities of directors, through a business and financial audit. (The audit may be limited to the latter in "small-scale closely-held companies," but the situation concerning such small companies is omitted in this memorandum.)

A business audit is a check on whether or not the directors are observing laws, regulations and the company's charter provisions in managing the company and is commonly called a "compliance audit." It is generally understood that this does not include a check on the appropriateness of a director's decision-making or activities (sometimes referred to as an "appropriateness audit"). However, since the Companies Act imposes a duty of care upon its directors, a business audit must include a check on whether or not there have been any breaches of this duty of care, and therefore, *kansayaku* must examine the directors' business judgments from this perspective.

A financial audit is an audit of financial statements and, unlike an audit required under the Securities and Exchange Act, it must be conducted before the annual shareholders' meeting. The audit report, which contains the results of the financial and business audits, must accompany the notice of the annual shareholders' meeting and be sent to shareholders two weeks prior to the meeting. Reporting companies under the Securities and Exchange Act must prepare consolidated financial statements under both the Securities and Exchange Act and the Companies Act, and they are also subject to auditing by *kansayaku*, the results of which are reported to the annual shareholders' meeting.

Kansayaku is given various powers and legal rights in order to carry out their duties.

2.3 Right of Investigations

Kansayaku has the right to ask a director or employee to provide a report on the company's operations and the right to examine the operations and assets of the company at any time. If a director is aware of the possibility of significant damage occurring to the company, he or she must

report this to *kansayaku-kai* even without being asked by *kansayaku*. Each *kansayaku* also has the legal right, under prescribed conditions, to ask for a report and examine the operations and assets of any of the company's subsidiaries. The company bears the expenses of this audit (including the examination).

2.4. Prevention of Director's Illegal Action

All *kansayaku* members must attend all board of directors' meetings and each auditor is entitled to express opinions as necessary with a view to preventing the board of directors from making illegal or significantly inappropriate decisions affecting the company. Even outside the realm of board of directors' meetings, if *kansayaku* notices a violation, or the possibility thereof, of a law or the company's charter provisions by a director, he or she must report it to the board of directors. If necessary, *kansayaku* may ask for a board of directors meeting to be called, or *kansayaku* has the right to call a meeting him/herself. When a decision or action violating a law or the company's charter provisions cannot be prevented or rectified, and the proposals or documents submitted by a director addressing this violation to a shareholders' meeting contain illegal statements or significant inappropriateness, *kansayaku* must report his/her judgment on this point at the shareholders' meeting. If there is a possibility that the director's action in violation of law or the charter provisions will cause considerable damage to the company, *kansayaku* has the right to ask the director to stop the action. Finally, *kansayaku* has standing to sue for the nullification of a shareholders' meeting.

2.5. Litigation Between the Company and Its Directors

In litigation between a company and its director, *kansayaku* represents the company. Accordingly, it is *kansayaku* who makes decisions about whether the company will sue a director. It is also *kansayaku* to whom a "demand" is submitted in a shareholder derivative action. When a shareholder derivative action is filed before the court, the company may "participate" in the litigation on behalf of the defendants only if all *kansayaku* members give their consent. In addition, more generally, consent of all *kansayaku* members is required for the liability of directors to be discharged in accordance with the procedures and limitations provided by the Companies Act.

2.6. Financial Audit

A financial audit is an audit of financial statements and their appendices. A large company must appoint a CPA or auditing firm as an external financial auditor. The external financial auditor is elected at the shareholders' meeting, and the election proposal must be approved by *kansayaku-kai* in advance. Accordingly, a financial audit in large companies is undertaken primarily by the external financial auditor, and this financial auditor's report is submitted to both *kansayaku-kai* and the board of directors. *Kansayaku* checks the appropriateness of a summary of the process and of the results of the financial auditor's auditing. If *kansayaku* believes that either is inappropriate, he or she usually must state this along with his/her reasons in the audit report. *Kansayaku* will then undertake an audit by him/herself and describe a summary of the process and the results of such audit in the audit report. If the financial auditor uncovers an inappropriate act or a violation of the law or the company's charter provisions in connection with the directors' activities, the financial auditor must report it to *kansayaku-kai*. *Kansayaku* also has the right to ask the financial auditor for a report if necessary. Along with all of the above, in large companies, *kansayaku* is responsible for monitoring and managing the external financial audit, as is the case with an audit committee in the United States. The audit report accompanies the notice of the annual shareholders' meeting and includes the results of the financial and business audits. This audit report is prepared by *kansayaku-kai*, but each *kansayaku* has the right to write his or her own opinion. As noted above, consolidated financial statements are also subject to auditing by *kansayaku*.

2.7. Liability of *Kansayaku*

Under the Companies Act, if there is a breach of *kansayaku's* duty of care owed to the company, such *kansayaku* is liable to the company for damages. In addition, if there is bad faith or gross negligence in the audit activity, or if the audit report contains a false statement, such *kansayaku* may be liable directly to a third party for damages.