

## Japan's Audit & Supervisory Board Member System

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Under Japan's Companies Act, which consolidated corporate law regulations in Japan, an Audit & Supervisory Board Member ("kansayaku") is a mandatory organ of a joint-stock company, with the exception of unlisted companies and non-large corporations as defined in the Act, as well as corporations adopting a Company with an Audit and Supervisory Committee or a Company with Three Committees (Nomination, Audit and Remuneration) governance structure. The Audit & Supervisory Board Member 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 Audit & Supervisory Board Members. These various provisions in the Commercial Code were consolidated under the Companies Act of 2005. The following is a discussion of large, publicly-held companies that are required to have an Audit & Supervisory Board ("kansayaku-kai") under the Companies Act.

Audit & Supervisory Board Members must be elected at a shareholders' meeting, and their role is to "audit" the execution of duties by directors and to prepare related audit reports. 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 articles of incorporation 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 Audit & Supervisory Board Members, and the results of the audit must be reported at the annual shareholders' meeting.

For large companies (defined in the statute as a joint-stock company having (on its balance sheet) legal capital of 500 million yen or more or total balance-sheet liabilities of 20 billion yen or more), the Audit & Supervisory Board Member system has been strengthened. In other words, for large, publicly-held companies, there must be at least three Audit & Supervisory Board Members, at least one of whom is required to be full-time, and at least half of whom must be "outside" Audit & Supervisory Board Members (definition described later). In such companies, a board of Audit & Supervisory Board Members (Audit & Supervisory Board) must be formed.

Audit & Supervisory Board 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 Audit & Supervisory Board Members and directors, such as not permitting an Audit & Supervisory Board Member to serve concurrently as a director, manager or employee of the company or its subsidiaries, or as an executive officer of its subsidiaries.

Audit & Supervisory Board Members have the right to express opinions at the shareholders' meeting regarding the election of other Audit & Supervisory Board Members. Audit & Supervisory Board Members who have resigned are entitled to attend the first shareholders' meeting that is convened after their resignation and express their views. Other Audit & Supervisory Board Members have the same right. The Audit & Supervisory Board also has the right to give consent and the right to make suggestions regarding the board of directors' proposals on the candidates of Audit & Supervisory Board Members that are submitted to a shareholders' meeting for election. The Audit & Supervisory

Board also decides the election proposal (appointment, dismissal, and non-reappointment) of the external financial auditor, and has the right to give consent when the directors determine the remuneration of the external financial auditor.

Each Audit & Supervisory Board Member serves a four-year term, as compared to two years for directors.

Remuneration must be set in the articles of incorporation or by a resolution at the shareholders' meeting, separately from the remuneration for directors. If there is no provision in the articles of incorporation or resolution by the shareholders' meeting with respect to the remuneration of individual Audit & Supervisory Board Members, the remuneration of individual Audit & Supervisory Board Members is determined through consultation among Audit & Supervisory Board Members, within the scope of the resolution passed at the shareholders' meeting. Audit & Supervisory Board Members may express their opinion on the remuneration of Audit & Supervisory Board Members at the shareholders' meeting.

Large, publicly-held companies must have a minimum of three Audit & Supervisory Board Members, at least one of whom is required to be full-time. Also, at least half of them must meet the statutory requirements for "outside" Audit & Supervisory Board Members, and this means that in the ten-year period before being appointed to the role they must not have formerly been a director, executive officer, manager or other employee of the company or its subsidiaries, nor a director, Audit & Supervisory Board Member, executive officer, manager or other employee of the parent company, nor a spouse or relative within the second degree of a director, manager or other key employee of the company. An Audit & Supervisory Board must be formed. Thus, in such large, publicly-held companies, while the Japanese board system is two-tiered, it differs considerably from the German two-tier board system.

The legal relationship between Audit & Supervisory Board Members and the company is entrustment "*inin*." Consequently, Audit & Supervisory Board Members owe a duty of care to the company. Under the Companies Act, the legal duty of Audit & Supervisory Board Members 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 articles of incorporation 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, Audit & Supervisory Board Members must examine the directors' business judgments from this perspective. A financial audit is an audit of financial statements and their appendices and, unlike an audit required under the Financial Instruments 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 Financial Instruments and Exchange Act must prepare consolidated financial statements under both the Financial Instruments and Exchange Act and the Companies Act, and they are also subject to auditing by Audit & Supervisory Board Members, the results of which are reported to the annual shareholders' meeting.

Audit & Supervisory Board Members are given various powers and legal rights under the Companies Act in order to carry out their duties.

#### (1) Right of Investigations

Audit & Supervisory Board Members have 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, they

must report this to the Audit & Supervisory Board even without being asked by Audit & Supervisory Board Members. Each Audit & Supervisory Board Member 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) Prevention of Directors' Illegal Action

All Audit & Supervisory Board Members must attend all board of directors' meetings and each Audit & Supervisory Board Member is entitled to express opinions as necessary with a view to preventing the board of directors from making illegal or significantly inappropriate resolutions affecting the company. Even outside the realm of board of directors' meetings, if Audit & Supervisory Board Members notice a violation, or the possibility thereof, of a law or the company's articles of incorporation by a director, they must report it to the board of directors without delay. If necessary, Audit & Supervisory Board Members may ask for a board of directors meeting to be called, or Audit & Supervisory Board Members have the right to call a meeting themselves. When a resolution or action violating a law or the company's articles of incorporation 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, Audit & Supervisory Board Members must report their judgment on this point at the shareholders' meeting. If there is a possibility that the director's action in violation of law or the articles of incorporation will cause considerable damage to the company, Audit & Supervisory Board Members have the right to ask the director to stop the action. Finally, Audit & Supervisory Board Members have standing to sue for the nullification of a resolution of a shareholders' meeting.

#### (3) Litigation Between the Company and Its Directors

In litigation between a company and its director, Audit & Supervisory Board Members represent the company. Accordingly, it is Audit & Supervisory Board Members who make decisions about whether the company will sue a director. It is also Audit & Supervisory Board Members to whom a "demand" is submitted in a shareholder derivative action. In the event that a shareholder derivative action is filed before the court, Audit & Supervisory Board Members have the right to consent to the company if the company assists the defendant directors in the lawsuit, and also have the right to consent to the company if the company permits the reduction (partial discharge) of directors' liability.

#### (4) Financial Audit

A financial audit is an audit of financial statements and their appendices. Although large, publicly-held companies must appoint a CPA or auditing firm as their external financial auditor at a shareholders' meeting, the Audit & Supervisory Board has the authority to determine the election proposal of an external financial auditor. 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 the Audit & Supervisory Board and the board of directors. Audit & Supervisory Board Members check the appropriateness of a summary of the process and of the results of the external financial auditor's auditing. If Audit & Supervisory Board Members believe that either is inappropriate, they usually must state this along with their reasons in the audit report. Audit & Supervisory Board Members will then undertake an audit by themselves and describe a summary of the process and the results of such audit in the audit report. If the external financial auditor uncovers an inappropriate act or a violation of the law or the company's articles of incorporation in connection with the directors' activities, the external financial auditor must report it to the Audit & Supervisory Board without delay. Audit & Supervisory Board Members also have the right to ask the external financial auditor for a report if necessary. Along with all of the above, in large, publicly-held companies, Audit & Supervisory Board Members are 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 the Audit & Supervisory Board, but each Audit & Supervisory Board Member has the right to write their own opinion. Consolidated financial statements are also subject to auditing by Audit & Supervisory Board Members, and an audit report is prepared by the Audit &

Supervisory Board.

Under the Companies Act, if there is a breach of an Audit & Supervisory Board Member's duty of care owed to the company, such Audit & Supervisory Board Member 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 Audit & Supervisory Board Member may be liable directly to a third party for damages.

#### **Appendix: Supervisory Committee Members and Audit Committee Members**

Under the Companies Act, large, publicly-held companies may adopt one of three governance structures: a Company with an Audit & Supervisory Board, a Company with an Audit and Supervisory Committee, or a Company with Three Committees (Nomination, Audit and Remuneration) (the organizational structure selected is recorded in the company registry). The Companies Act allows such a choice of organizational structure because it considers each of the multiple frameworks to be a reasonable system, and leaves the selection to the discretion of individual companies.

#### **Companies with an Audit and Supervisory Committee and Supervisory Committee Members**

The Company with an Audit and Supervisory Committee system was introduced in the 2014 revision of the Companies Act. A company with a board of directors and an external financial auditor may choose to become a Company with an Audit and Supervisory Committee by stipulating so in its articles of incorporation (such a company may also choose to become a Company with Three Committees [Nomination, Audit and Remuneration] as described below). In a Company with an Audit and Supervisory Committee, while there are no Audit & Supervisory Board Members (*kansayaku*), a Supervisory Committee is appointed, and the majority of the Supervisory Committee members must be outside directors. In a Company with an Audit and Supervisory Board, all of the roles of Audit and Supervisory Board Members and the Audit and Supervisory Board (auditing) and some of the roles of the board of directors (supervision) in a Company with an Audit & Supervisory Board are given to the Supervisory Committee (the term of directors who are not Supervisory Committee members is one year, and the term of directors who are Supervisory Committee members is two years). On the other hand, under certain conditions (where the board of directors is composed of a majority of outside directors, or where the articles of incorporation stipulate otherwise), a significant amount of authority to make decisions regarding the execution of business operations may be delegated from the board of directors to individual directors (the matters that may be delegated are identical to those that may be delegated from the board of directors to the executive officers in a Company with Three Committees [Nomination, Audit and Remuneration], as described below).

The Supervisory Committee is composed of all directors elected as Supervisory Committee members at the shareholders' meeting (the majority of whom must be outside directors), and its primary responsibilities are to audit the execution of duties by directors and to prepare related audit reports, to determine the content of proposals for the appointment, dismissal, and non-reappointment of the external financial auditor to be submitted to the shareholders' meeting, to consent to the remuneration of the financial auditor, and to express opinions regarding the appointment, etc. of directors who are not Supervisory Committee members and the remuneration of directors who are not Supervisory Committee members. If there is no provision in the articles of incorporation or resolution by the shareholders' meeting with respect to the remuneration of individual directors who are members of the Supervisory Committee, the remuneration of each director is determined through consultation among directors who are members of the Supervisory Committee, within the scope of the resolution passed at the shareholders' meeting. Directors who are members of the Supervisory Committee may express their opinion on the remuneration of directors who are members of the Supervisory Committee at the shareholders' meeting. The authority of the Supervisory Committee may not be delegated to the board of directors.

The Supervisory Committee has authority equivalent to that of Audit & Supervisory Board Members and the Audit & Supervisory Board of a Company with an Audit & Supervisory Board, as well as the authority to conduct so-called "appropriateness audits." Accordingly, the Companies Act stipulates detailed provisions (e.g., the right to claim expenses from the company, the right to conduct investigations, the obligation to report to the board of directors, the obligation to report to the shareholders' meeting, the right to demand an injunction against the actions of directors, and the right to represent the company in litigation between directors and the company). Regarding the preparation and auditing of financial statements, the Supervisory Committee audits financial statements in place of the Audit & Supervisory Board Members and the Audit & Supervisory Board of a Company with an Audit & Supervisory Board (the same applies to consolidated financial statements). Additionally, in a Company with an Audit and Supervisory Committee, if a director who is not a Supervisory Committee member engages in a conflict-of-interest transaction (a transaction between the company and a director) and the transaction in question is approved by the Supervisory Committee, there is no presumption that directors breached their duties.

In a Company with an Audit and Supervisory Committee, audits are expected to be conducted by the Supervisory Committee, in contrast to a Company with an Audit & Supervisory Board, where Audit & Supervisory Board Members are entitled to execute their duties independently, as described above. Accordingly, a Company with an Audit and Supervisory Committee is subject to different rules compared to a Company with an Audit & Supervisory Board (e.g., unlike a Company with an Audit & Supervisory Board, it is the Supervisory Committee, not individual Supervisory Committee members, that is responsible for auditing the execution of duties by directors, and a Company with an Audit and Supervisory Committee is not required to appoint full-time Supervisory Committee members). In addition, the Supervisory Committee is designated as a meeting body (e.g., unlike the Audit & Supervisory Board, it has quorum rules). However, on the other hand, there are many rules that appear to have been adopted from a Company with an Audit & Supervisory Board (e.g., Directors do not have the right to view and copy the minutes of Supervisory Committee meetings, and the shortening of the convocation period for Supervisory Committee meetings is not based on a resolution by the board of directors but rather on provisions in the articles of incorporation. In addition, the status of execution of duties by the Supervisory Committee does not have to be reported to the board of directors.). These aspects differ from the Audit Committee of a Company with Three Committees (Nomination, Audit and Remuneration), which is discussed below.

### **Companies with Three Committees (Nomination, Audit and Remuneration) and Audit Committee Members**

The "Company with Three Committees (Nomination, Audit and Remuneration)" system was introduced in the 2002 revision of Japan's Commercial Code. The 2005 Companies Act changed the name from "Company with Committees, etc." to "Company with Committees," while the 2014 amendment to the Companies Act further modified the name from "Company with Committees" to "Company with Three Committees (Nomination, Audit and Remuneration)." A Company with a board of directors and an external financial auditor may choose to become a Company with Three Committees (Nomination, Audit and Remuneration) by stipulating so in the company's registry. In a Company with Three Committees (Nomination, Audit and Remuneration), the role of the board of directors is primarily to make decisions on fundamental matters and to serve a supervisory role, including the selection and appointment of committee members and executive officers, while its three committees, the Nomination Committee, the Audit Committee and the Remuneration Committee (each of which must be comprised of a majority of outside directors), serve an audit and supervisory role (there are no Audit & Supervisory Board Members or Audit & Supervisory Board; this role is instead performed by the Audit Committee). The company's supervisory and executive functions are separated systematically, with the executive officers in charge of business execution (in principle, directors may not engage in business execution), persons with authority to legally represent the company serving as representative executive officers, and decision-making regarding the execution of business operations being largely delegated to the executive officers (with the exception of basic

statutory matters, decision-making authority for business execution may be delegated to executive officers). Directors may concurrently serve as executive directors. The term of office for directors is always one year, and that for executive officers is also one year. In addition, unlike a Company with an Audit & Supervisory Board or a Company with a Supervisory Committee, in a Company with Three Committees (Nomination, Audit and Remuneration), the details of individual remuneration for directors and executive officers are determined by the Remuneration Committee.

Each of three committees has at least three members (who are also directors) selected by resolution of the board of directors, and the majority of the members of each committee must be outside directors. The same director (including outside directors) may concurrently serve as a member of multiple committees. Members of the Audit Committee (Audit Committee members) may not concurrently serve as executive officers or executive directors of the company or its subsidiaries, or as a manager or other employee of its subsidiaries. The authority of each committee may not be delegated to the board of directors.

The duties of the Audit Committee are to audit the execution of duties by executive officers and directors, to prepare audit reports, to determine the content of proposals for the appointment, dismissal, and non-reappointment of the external financial auditor to be submitted to the shareholders' meeting, and to agree on the remuneration of the external financial auditor. The Audit Committee has powers equivalent to those of the Audit & Supervisory Board Members and the Audit & Supervisory Board of a Company with an Audit & Supervisory Board, as well as the authority to conduct so-called "appropriateness audits." The Companies Act stipulates detailed provisions accordingly. Regarding the auditing of financial statements, the Audit Committee audits financial statements in place of the Audit & Supervisory Board Members and the Audit & Supervisory Board of a Company with an Audit & Supervisory Board. The audit is assumed to be an organizational audit by the Audit Committee, and while this point is the same as that of the Supervisory Committee of a Company with Supervisory Committee, as described above, the provisions of the Companies Act regarding the Audit Committee of a Company with Three Committees (Nomination, Audit and Remuneration) differ in some regards from those of the Supervisory Committee of a Company with Supervisory Committee.