

## Background and Goals

### New Recommended English translation of “Kansayaku” and “Kansayaku-kai”

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#### 1. Announcement of the new English translation

Japan Corporate Auditors Association (the “Association”, currently Japan Audit & Supervisory Board Members Association) published a new recommended English translation for “Kansayaku” and “Kansayaku-kai” on September 4<sup>th</sup>, 2012 as below, after they received a recommendation from the advisory committee on the English translation of “Kansayaku” and “Kansayaku-kai” (the “advisory committee”, members of which are as below) . <sup>1</sup>

|               |                                  |
|---------------|----------------------------------|
| Kansayaku     | Audit & Supervisory Board Member |
| Kansayaku-kai | Audit & Supervisory Board        |

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| The members of the advisory committee<br>on the English translation of “Kansayaku” and “Kansayaku-kai” |   |
| Chairperson  | Kazuhiro Takei, Attorney at Nishimura & Asahi.  |
| member   | Hiroyuki Kansaku, Professor of University of Tokyo Graduate Schools for<br>Law and Politics |
| member   | Takaya Seki, Managing Director, Corporate Practice Partners, Inc.                           |
| member   | Riyo Ihara, Member of Audit Committee of Japan Broadcasting Corporation                     |
| member   | Yoichiro Ichimaru, Full-time Kansayaku of Toyota Motor Corporation                          |
| member   | Teruo Miyamoto, Secretary-general of Japan Audit & Supervisory Board<br>Members Association |

We are the members of the advisory committee and will introduce the discussion about the new recommended English translation. It must be emphasized that this new recommended English translation is based on a philosophy concerning the fundamental role of “Kansayaku” and “Kansayaku-kai” in corporate governance. We reviewed the English translation for “Kansayaku” and “Kansayaku-kai”, taking into account many opinions from various experts in corporate governance.

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<sup>1</sup> This is only a recommended translation, as before. The other translation won't be prohibited from use.

## 2. History and Background

### a “KANSAYAKU”, “Statutory Auditor” and “Corporate Auditor”

The Association had reviewed the English translation for “Kansayaku” and “Kansayaku-kai” several times. According to the Association, the English translation of “Kansayaku” was first examined on March 1989. The association adopted “KANSAYAKU” as the primary English translation and “Statutory Auditor” as the supplementary explanation. After that, the Association examined the English translation for “Kansayaku-kai” since the “Kansayaku” system was reinforced and the “Kansayaku-kai” system was introduced in the revised Japanese Commercial Code in 1994. The Association recommended a new English translation, “Corporate Auditor” for “Kansayaku” and “Board of Corporate Auditors” for “Kansayaku-kai”.

### b Background - the drawback of the term “Auditor”

“KANSAYAKU”, “Statutory Auditor”, and “Corporate Auditor” etc. were not incorrect translations and many Japanese corporations often used these translations. However, over twenty years has passed since the last review and foreign investors’ holding ratios in listed companies in Japan has dramatically increased. Indeed, some institutional investors and influential proxy advisors have pointed out that reviewing the English translation might relieve unfamiliarity with the “Kansayaku” system.<sup>2</sup>

The term “Statutory Auditor” or “Corporate Auditor” has a serious problem; It is hard to understand the difference between a “Kansayaku” and an internal auditor or an external auditor. The mission of “Kansayaku”, including monitoring and supervising management, was totally different from the mission of an internal auditor or an external auditor.<sup>3</sup>

More important, there are two corporate organizations other than a company with a “Kansayaku-kai” in Japan; A “Company with committees” (linkai secchi gaisha) and a “Company with Audit and Supervisory committee” (Kansa-kantoku i-inakai secchi gaisha)<sup>4</sup>. Whichever organization a listed company adopts, substantially the same standard of soundness and effectiveness of the management would be demanded of the company. A review of the English translation was expected to clearly explain the missions of

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<sup>2</sup> An example which was published, Takeyuki Ishida, *Looking back the ordinary general meeting of shareholders in June, 2012*, No.730, Tokyo Kabushiki Konwakai Bulletin, 7 (2012)

<sup>3</sup> An important indication regarding the meaning of “Kansa”, Yoshiki Nishiyama, *Lecture series for new Kansayakus - What is Kansayaku -*, No.587, Monthly Kansayaku, 46 ff (2011)

<sup>4</sup> “Company with audit & supervisory committee” was proposed as a new corporate organization in the decision of Legislative Council of the Ministry of Justice, *the draft outline of amendments to the Companies Act*, September 7th, 2012. The advisory committee took into account that a “Company with audit & supervisory committee” is likely to be legislated into existence.

“Kansayaku” and “Kansayaku-kai” and to demonstrate the equivalence of the soundness and effectiveness standards for companies with “Kansayaku-kai” and for the other corporate organizations.

In addition, Japanese corporations have found a larger market abroad and more Japanese corporations have foreign subsidiaries, and as a consequence, the “Kansayaku” of a Japanese parent corporation increasingly takes on the “Kansa” function of the foreign subsidiaries. Therefore, to explain Japanese corporate governance’s rationale, there has been an increasing need for a clear English translation for “Kansayaku”.

### **3. “Audit & Supervisory Board Member”**

#### **a Review principle**

We understood that a perfect English equivalent for “Kansayaku” might not exist. Therefore, Our principle was to clarify the purpose of reviewing a translation and to find the most appropriate translation to meet the purpose. We selected the translation from the perspective of enhancing the global understanding of a “Kansayaku” and a “Kansayaku-kai” as described at 2-b.

It was not beneficial to understand that there was large difference between the missions of a “Kansayaku”, a “audit committee member”, and a “supervisory & audit committee member”, since they were all non-executive directors and were in charge of monitoring and supervising management. We made its review considering the compatibility between the systems of a “company with a Kansayaku-kai”, a “company with committees” and a “company with a supervisory & audit committee”.

#### **b Supervisory function of “KANSAYAKU” and “KANSAYAKU-KAI” in a corporation with Board of Directors**

The limited liability company is a popular organization in the world and a large scale limited liability company, including a listed company, is generally supposed to have a management supervisory function. A supervisory function is necessary because executive directors might manage the company against shareholders’ and other stakeholders’ interests, using the company’s personnel, assets and money.<sup>5</sup>

Non-executive directors are expected to be in charge of the supervisory function since the supervisory target is executive directors’ management. The Japanese Companies Act requires non-executive directors, including a “Kansayaku”. A “Kansayaku” is a non-

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<sup>5</sup> Shareholders might be negligent of corporate management since their liabilities are limited, although limited liability companies can run risks and exert an influence on society. Therefore it is also important to supervise a limited company’s action in which managers and shareholders both might be negligent. In this case, stakeholders exercise supplemental supervision in addition to non-executive officers’ supervision.

executive director by statutory definition. When we tried to explain the functions and the benefits of a “Kansayaku” and a “Kansayaku-kai”, it was most natural to understand that a “Kansayaku” and a “Kansayaku-kai” are in charge of the supervisory function in a broad sense<sup>6</sup>, considering the global understanding of a limited liability company’s governance.

The supervisory function is globally emphasized in a limited liability company, especially a listed company. It is not too much to say that the supervisory function is an indicator of corporate governance.

Regarding the supervisory function in a Japanese limited liability company, K.K., in a “Company with committees” and a “Company with a supervisory & audit committee”, the board of directors are in charge of the supervisory function. On the other hand, in a “Company with a Kansayaku-kai”, which is the most popular form in Japan, the board of directors, the “Kansayaku” and the “Kansayaku-kai” are jointly and cooperatively in charge of the supervisory function (see the chart below. The supervisory board is boxed with a broken line). The Board of directors appoints and dismisses executive directors, and the “Kansayaku” and the “Kansayaku-kai” check whether the executive directors perform their duty of care and fiduciary duty. The “Kansayaku” is obliged to attend directors’ meetings and to report various circumstances. The Japanese Companies Act describes the function of the Board of directors as “Kantoku” (supervisory) (Article 381(1)) and the function of a “Kansayaku” as “Kansa” (Article 362(2)(ii)), but the understanding that “Kansa” of a “Kansayaku” and a “Kansayakukai” was a part of a supervisory function (a supervisory function in a broad sense) in a limited liability company is the most natural explanation as to why the Act requires a “Kansayaku” and a “Kansayakukai” to be non-executive directors. The “Kansa” function of a “Kansayaku” and a “Kansayaku-kai” mainly consists of (a) information gathering<sup>7</sup>, (b) various actions including reporting, advice, and proposals for the board of directors, (c) reconciliation of conflicts of interests between executive directors and the external auditor (an Audit committee is generally in charge of this function outside of Japan), and so on.

We have reasoned that one reason why the “Kansayaku” system is difficult for foreigners to understand is a lack of awareness that a “Kansayaku” and a “Kansayaku-kai” are in charge of the supervisory function, cooperating with the board of directors.

### **c Audit & Supervisory Board**

Considering the above, We finally recommended “Audit & Supervisory Board Member”

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<sup>6</sup> the supervisory function in a narrow sense is a board of directors’ supervisory function in Article 362 of Japanese Companies Act.

<sup>7</sup> Information gathering by outside directors or board of directors is not stipulated in the Japanese Companies Act and is a matter of statutory construction. One of the reasons for this was that the Legislator took for granted that a Kansayaku is in charge of information gathering for supervision as per the Japanese Companies Act.

for “Kansayaku” and “Audit & Supervisory Board” for “Kansayaku-kai” as the new translation.<sup>8</sup> This translation has the advantage that it clearly illustrates the point that a “Kansayaku” plays a part in the supervisory board. Our majority comment was that using the term “board” would make this more easy for foreign people to understand.

We were aware that people might misunderstand that (a) a “Kansayaku-kai” was the only supervisory organ, ignoring the board of directors, and (b) a “Kansayaku-kai” had the right to appoint and dismiss executive directors like a German supervisory board (Aufsichtsrat). We felt that adding the term “audit” was appropriate, since a “Kansayaku” was in charge of important functions that audit committees generally have outside of Japan, including the reconciliation of conflicts of interests between executive directors and the external auditor and the monitoring of internal controls. We believed the term “audit” would prevent people from misunderstanding that a “Kansayaku-kai” is the only supervisory organ, ignoring the board of directors. Moreover, the term “audit” would clarify that “Kansayaku-kai” carries out an audit function as a part of its supervisory function.

#### **d Compatibility of “Kansayaku-kai”, “Audit Committee” and “Audit & Supervisory Committee”**

Once an audit by a “Kansayaku” or a “Kansayaku-kai” is considered as an effective way of supervising, it becomes clear that a “Kansayaku” and a “Kansayaku-kai” are compatible with an audit committee of a company with committees and an audit & supervisory committee of a company with an audit & supervisory committee<sup>9</sup>, that is, that there is no substantial difference between these corporate organizations at a governance level<sup>10</sup>.

### **4 Other possible translations**

#### **a Non-executive Director**

From the perspective of foreign investors’ familiarity, “Non-executive Director” (NED) was one possible translation, which is an ordinary term in UK. This translation would not

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<sup>8</sup> Even if a company had a “Kansayaku” but did not have a “Kansayaku-kai”, the advisory committee recommends the translation, “Audit & Supervisory Board Member” for “Kansayaku”. The Supervisory Board consists of a board of directors and a Kansayaku.

<sup>9</sup> It was the intent of the Legislator to give the Audit & Supervisory Board new supervisory authorities, such as (a) statement of opinions on appointments, dismissals and remuneration, etc., of directors who are not audit & supervisory board members, and (b) the power to pass resolutions approving such transactions that give rise to a conflict of interest between the company and the directors, to rebut a presumption of breach of the directors’ duties (1(4)(vii)(viii)(ix), Chapter 1, Part I, the draft outline of amendments to the Companies Act).

<sup>10</sup> Although “Kansaku” is a single-person organ, it was possible to understand “Kansa” as a part of a supervisory function in a broad sense.

have been entirely incorrect. However, we felt (a) that there was a nuance of outside officers in the translation, while a “Kansayaku” is non-executive but not necessarily outside, and (b) that the term “director” has been already established as the translation for “Torishimariyaku”. Therefore, we did not adopt the translation “Non-executive Director”.

#### **b Statutory Supervisor**

Eastern Asian countries have similar “Kansayaku” systems which are nonetheless somewhat different from each other, and the most common translations were “Supervisor” for an individual and “Supervisory Board” for an organization. Since Korea and Taiwan have imported the Japanese corporate system, their systems are very close to the “Kansayaku” system. Therefore another possible translation was “Supervisor” or “Statutory Supervisor”. However, we felt (a) that the term “Supervisor” did not have global familiarity since the term was used only in some Asian countries, and (b) that there was a slight nuance of only a supervisor for the rank and file of the company. Therefore, we did not adopt the translation “Statutory Supervisor”.

#### **c Oversight Board**

The other possible translation was “Oversight Board”, since the functions of a “Kansayaku” and a “Kansayaku-kai” were often regarded as overseeing. However, there seemed to be no examples of using “Oversight Board”, and we did not adopt this translation.<sup>11</sup>

### **5 Conclusion**

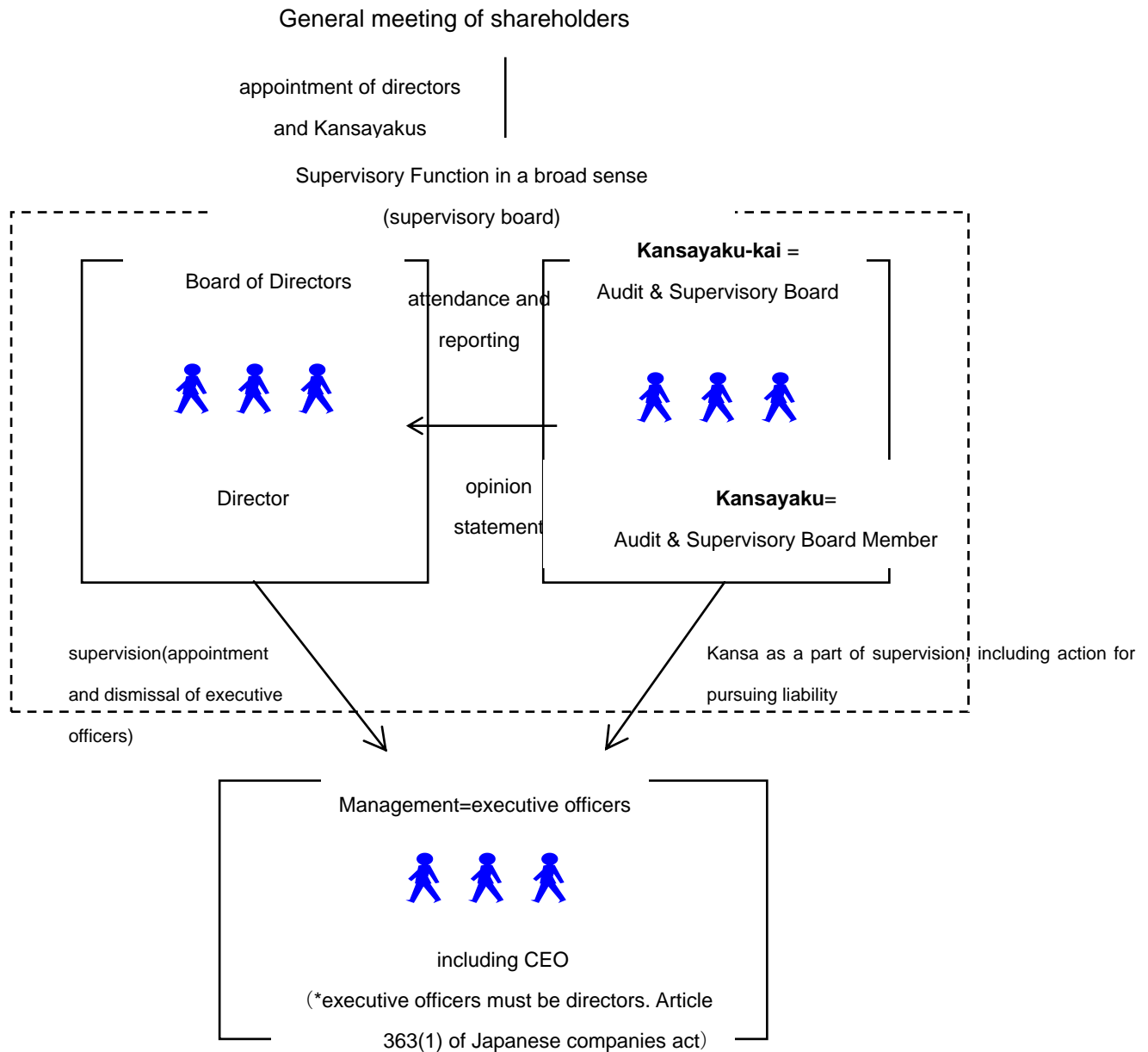
We wanted to ensure that any new translation would endure the passage of time. If a company is comfortable using the previous translation of “Corporate Auditor”, it won’t be compelled to use the new translation. However, we believe that the new translation will help to explain the “Kansayaku” system with greater accuracy and depth to investors and other interested parties outside of Japan.

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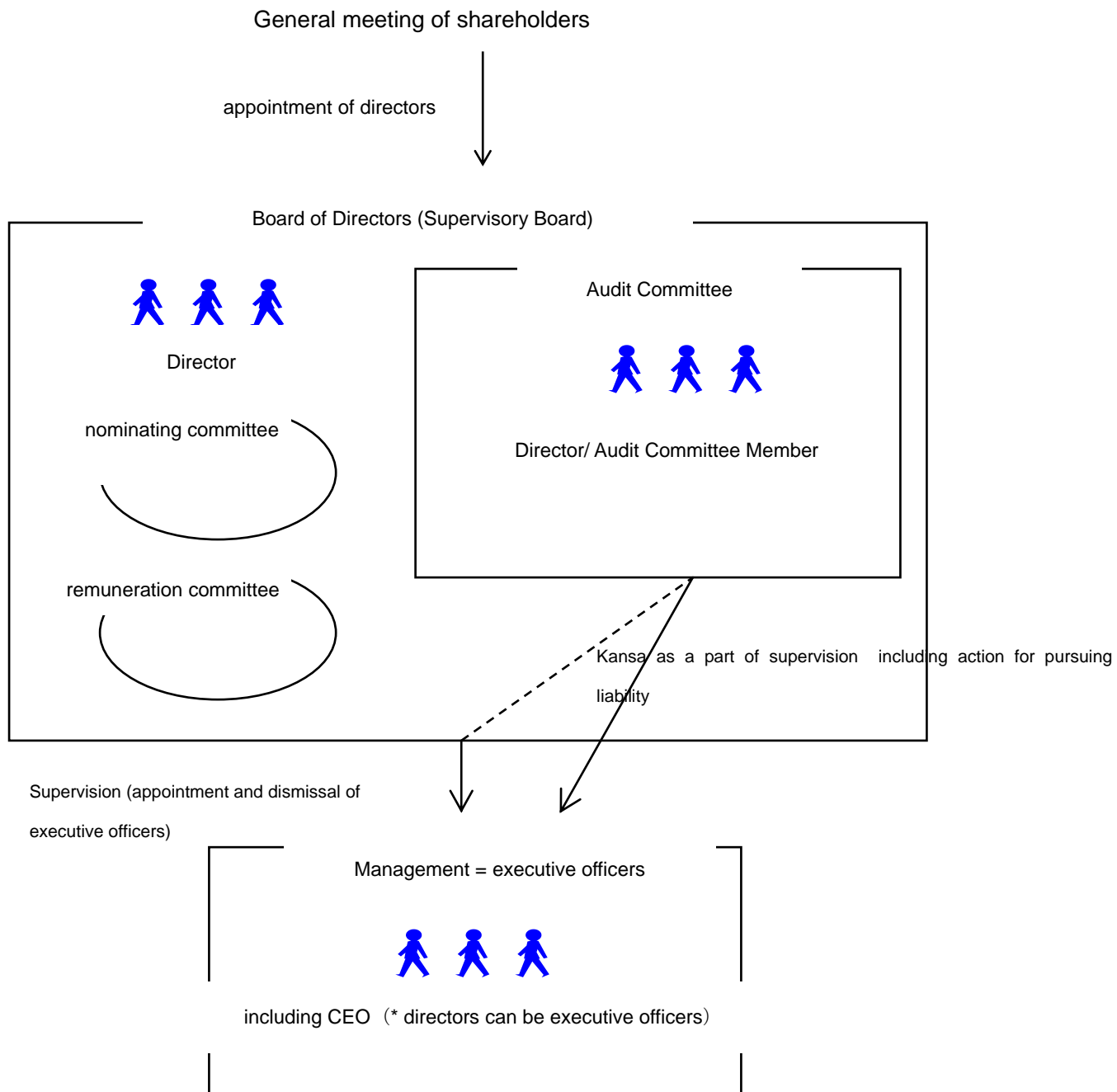
<sup>11</sup> In addition, the advisory board discussed the translations, “Governance Committee” and some other possible translations with the term “Monitoring”, but did not adopt them.

**Chart: Variations on corporate governance systems and on the organs responsible for the supervisory function in a broad sense**

**1. Company with a "Kansayaku-kai"**



2. Company with committees (I-inkai secchi gaisha)





3. Company with an Audit & Supervisory Committee (Kansa-kantoku i-inkai secchi gaisya)

