ResearchGate

See discussions, stats, and author profiles for this publication at: https://www.researchgate.net/publication/312140556

# Effective Corporate Governance and Financial Reporting in Japan

**Article** *in* Asian Academy of Management Journal of Accounting and Finance · January 2016

DOI: 10.21315/aamjaf2016.11.S1.5

CITATION
1

READS
1,620

**2 authors**, including:

Khondaker Mizanur Rahman
Nanzan University

**35** PUBLICATIONS **54** CITATIONS

SEE PROFILE

**Some of the authors of this publication are also working on these related projects:**

Asian Human Resource Management: Theory, Practice, and Culture View project

Population Stabilization Policy and Declining Work-age Population View project

All content following this page was uploaded by Khondaker Mizanur Rahman on 10 January 2017.

The user has requested enhancement of the downloaded file.

ASIAN ACADEMY *of* MANAGEMENT JOURNAL *of* ACCOUNTING *and* FINANCE

*AAMJAF, Vol. 12, Suppl. 1, 93–122, 2016*

# EFFECTIVE CORPORATE GOVERNANCE AND FINANCIAL REPORTING IN JAPAN

**Khondaker Mizanur Rahman and Marc Bremer***

*School of Business Administration, Nanzan University,*
*18 Yamazato-cho, Showa-ku,*
*Nagoya, 466-8673 Japan*

*Corresponding author: bremerm@ic.nanzan-u.ac.jp

## ABSTRACT

*This paper examines corporate governance in Japan since the 1990s. Its focus includes financial reporting, a key part of good governance. It offers an overview of various legal, institutional, and stakeholder aspects of governance, followed by an investigation of Japanese accounting, disclosure, and reporting. The paper presumes that accurate financial reporting is a prerequisite for good corporate governance. Bad governance often follows from fraudulent financial reporting. The paper also considers the status of international financial reporting standards, the nature of fraudulent financial reporting, the all-too-common practice of window dressing in Japan, the liabilities of corporate audit board members and financial auditors. Our findings suggest that the existing high quality laws, codes, guidelines, and institutional arrangements do improve corporate governance. Yet in practice, the quality of corporate governance in Japan has not matched the quality of its codes and regulations. The paper discusses Japan's new corporate governance code. It concludes that this code is excellent, but that more needs to be done to improve financial reporting. Finally, a number of suggestions are offered to enhance corporate governance and reduce fraudulent reporting.*

**Keywords:** corporate governance, financial reporting, Japan, window dressing, Japan's new corporate governance code

Published Online: 31 December 2016

To cite this article: Rahman, K. M., & Bremer, M. (2016). Effective corporate governance and financial reporting in Japan. *Asian Academy of Management Journal of Accounting and Finance, 12*(Suppl. 1), 93–122. http://dx.doi.org/10.21315/aamjaf2016. 12.S1.5

To link to this article: http://dx.doi.org/10.21315/aamjaf2016.12.S1.5

© Asian Academy of Management and Penerbit Universiti Sains Malaysia, 2016

## Introduction

Corporate governance (CG) concerns the very fundamental question of who owns a corporation, in whose interests it is run (Ohtsu & Imanari, 2002), and by whom it is ultimately controlled (Miwa, 2006a). CG is also defined as the mechanisms, processes, and relations by which corporations are controlled (Shailer, 2004). In line with the ideas of Berle and Means (1932) concerning the separation of ownership and control, control of the modern corporation has shifted from stockowners to professional managers. This result is due to the inertia of stockowners, their use of the proxy in annual general meetings (AGM), and the self-perpetuation of management. Autonomy of management and the concern that management is now seeking its own interests at the expense of stockowners and broader society have increased interest in CG. Indeed, CG is now at the very top of the agenda in the broader debate on the role of companies in the world economy.

Accurate financial reporting is the foundation of good corporate governance. All aspects of corporate control require the objective measurement of the firm's assets, liabilities and cash flows. CG is a "framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders (financiers, customers, management, employees, government, and the community)" (*Business Dictionary*, 2015). CG includes the processes through which corporate goals and objectives are determined, measured and pursued in the context of the social, regulatory, and commercial environment. Mechanisms for effective CG include monitoring the actions, policies, and decisions of corporations and their agents. However, another way to improve CG is to align the interests of management and stakeholders (Organisation For Economic Cooperation And Development (OECD), 2004; Tricker, 2009).

Interest in CG practices, particularly in relation to financial reporting, has increased substantially following the high-profile collapses of a number of large corporations in the US (Enron and MCI), Australia (HIH and One.Tel), and Europe (Parmalat) during 2001–2002; all of these involved accounting fraud. CG gained further importance at a different level for business, government, and research after the financial crisis of 2008, which climaxed with the collapse of Lehman Brothers in the US Apart from these, corporate scandals of different forms in both developed and developing nations have increased public and government interest in the regulation of CG. For example, after the Enron crisis, the US government enacted the *Sarbanes-Oxley Act, 2002*, with the aim of improving financial reporting and restoring public confidence in CG (Goergen, 2012).

The structure of effective CG consists of "(a) explicit and implicit contracts between the company and the stakeholders for distribution of responsibilities, rights, and rewards, (b) procedures for reconciling the sometimes conflicting interests of stakeholders in accordance with their duties, privileges, and roles and (c) procedures for proper supervision, control, and information flows to serve as a system of checks-and-balances" (*Business Dictionary*, 2015). CG allocates and assigns responsibilities among different participants: board members, management, stockowners, creditors, auditors, regulators, and other stakeholders, and establishes the rules and procedures for making decisions in corporate affairs (Tricker, 2009).

This paper explores financial reporting in Japan under the presumption that accurate financial reporting is a prerequisite for effective CG. The next section describes the legal basis of corporate governance in Japan. The third section extends this discussion to the disclosure of important financial information. The fourth explores some of the unique aspects of CG in Japan. The fifth section explains Japan's new code of corporate governance; it argues that the code is good in the sense that it is consistent with the OECD's governance principles, yet notes that persistent reporting scandals and poor financial performance mean that these laws and guidelines do not actually deliver good governance. The sixth section offers suggestions to improve financial reporting and governance. The last section offers a conclusion.

## CORPORATE GOVERNANCE IN JAPAN

### The Company Law, the Commercial Code, and Corporate Governance

The legal foundation of CG in Japan derives from the *Commercial Code* (Act No. 48 of 1899; amended by Act No. 57 of 2008). Most of the provisions of this law for public limited liability companies were revised and included in the *Companies Act, 2005*. The *Commercial Code* specifically established that shareholders are the ultimate owners of the company. It grants broad and specific rights to shareholders. The shareholders elect directors in the company's AGM, who in turn select management. Shareholders ultimately elect all statutory auditors, who then monitor the board of directors and ensure that it works in accordance with the provisions of the law. The law grants minority shareholders elaborate rights; the holder of a 1% or greater stake for more than six months is able to make proposals at the AGM; the holder of a 3% or greater stake can demand a board meeting at any time; and the holder of a 10% or greater stake can access confidential documents (Shishido, 2000).

The spirit of the laws establishing Japanese CG articulates the highest principles. Yet as described below, repeated scandals and persistent poor financial performance mean that these laws all too often fail to produce good governance. Management tends to regard CG as a low-priority matter of technical compliance, and in some cases as something to be cynically circumvented when it becomes inconvenient. Historically, shareholder meetings in Japan have been very short and, though far less common now, corporate racketeers (*sokaiya*) occasionally practiced extortion at annual general meetings by asking embarrassing questions. On some occasions companies actually employed racketeers to intimidate legitimate stockowners at these meetings. Even now minority shareholders tend to lack a keen interest in AGM. They frequently cast votes electronically or by proxy rather than actually attend the meetings. Although external auditors are supposed to monitor the activities of board members and management, they are effectively appointed by the president and are typically people who possess a close relationship with the company. Ahmadjian (2002, p. 92) argues that "the shareholders meeting is little more than a rubber stamp" for board appointments, dividend declarations, and other important decisions. Thus, auditors largely fail to play a significant role in establishing effective corporate governance in Japan.

**Board of Directors and Stockowners Governance**

The Japanese *Companies Act No. 86 of July 26, 2005* gives shareholders certain legal rights, which include, (a) a share in the profit if a dividend is declared, (b) inspection of the company's accounts at any time and in any case of need, and (c) the right to vote to elect or remove members of the board of directors. Ohtsu and Imanari (2002) observe that most stockowners look on their stock as an investment; as long as dividends are paid and the stock's price appreciates, they have little interest in the details of management. If they are dissatisfied, they sell their stock rather than make an effort to change the management of the company.

As indicated above, the primary influence of stockowners on CG is exercised through the AGM. This influence has its legal basis in Articles 295–319 of the *Companies Act*. Shareowners can exert their influence by voting in the meeting (Article 310); however, most individual stockowners feel it onerous to attend AGMs to cast their votes. Instead they delegate their vote to a proxy, usually a director or officer of the company, who is a member of the management group. This empowers management to take over the voting rights of a large portion of stockowners (Ohtsu and Imanari, 2002). In effect, this waters down the idea of CG by stockowners, the real owners of the company.

In order to guide the affairs of the company, the stockowners elect a board of directors (*torishimariyaku-kai*), who on their behalf supervise the affairs

of the corporation to achieve its goals and protect stockowners' interests. Usually, this board elects a chairperson who is responsible for overseeing the entire business. The board also selects officers, who are responsible for specific aspects of the company's business. Yet, because of the prevailing system of proxy, management actually selects the directors. The chairman position is traditionally filled by a retired or former president. As Ohtsu and Imanari (2002) observe, virtually all board members are corporate officers appointed by the president or chairman. Board members usually carry out functional responsibilities like the general management of a division, department, or branch. Consequently, the board becomes a *de facto* executive body under the control of the president. The board members are called *yakuin* or officers, and they constitute the top management: president, vice president, senior managing directors (*senmu torishimariyaku*), and managing directors (*jomu torishimariyaku*). As a practical matter, managing directors are the real decision makers in Japanese firms. They often do not consider the interests of stockowners; they themselves may have little actual stock ownership. For this reason, the advocates of strong CG in Japan argue that the board of directors needs to be changed in accordance with the provisions of the *Companies Act*. In recent years, because of directives from the stock exchanges, public pressure, government guidance, and a new code of governance, some companies (Softbank, Orix, Snow Brand Milk Products, and Toyota Motor) have brought in directors who are not selected from internal management.

**Board of Auditors and Governance**

Most large Japanese companies have a board of statutory auditors (*kansayaku*), separate from the board of directors; these auditors are elected at the shareholders meeting (see Figure 1). As many companies belong to a formal *keiretsu* (affiliated company group) and other less formal groups, external directors and auditors are often from other companies in the same group. As a result, many external directors and corporate auditors are actually officers in related companies (Demise, 2006a). The authority and responsibility of the auditors are determined by provisions in the *Companies Act* (Articles 381–384).

The statutory auditor system existed even before World War II, but its authority, responsibility, and independence were transformed through a number of revisions in the *Commercial Code* in 1974, 1981, 1993, 2001, and 2003. Through the revision in 1993, large companies with a registered capital of ¥500 million or more or a total liability of ¥20 billion or more were required to introduce a board of corporate auditors composed of at least three part-time members and at least one full-time member (Demise, 2006a; JASBA, 2007). While many of the corporate auditors are former employees of the companies,

currently it is required that at least half be outsiders. A member of the board of auditors cannot serve on the corporate board of directors at the same time.

According to the *Companies Act* (Article 381), the responsibilities of the auditors are: (a) examining the execution of duties by directors, (b) preparing reports in response to the instructions of government ministries (the Ministry of Justice (MOJ) in particular), (c) requesting reports on the business at any time from the directors, accounting advisors, managers, and other employees, (d) investigating the status of the operations and the financial status of the company, and (e) requesting reports on the business form of a subsidiary and investigating the status of its operations and financial status. Furthermore, in accordance with the provisions of Article 390, the auditor shall prepare audit reports, appoint and remove full-time company auditors, decide audit policy and methods to investigate the status of operations and the financial status of the company, and report on the status of the execution of their duties (Ministry of Justice (MOJ), 2005).

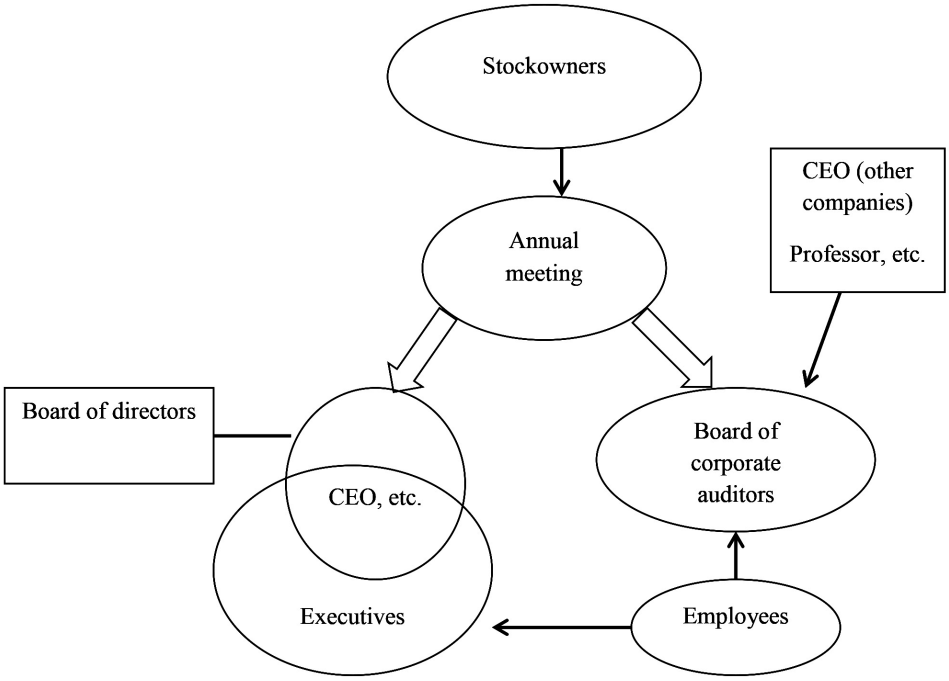


*Figure 1.* Companies with a Board of Corporate Auditors (Demise, 2006a).

The duties of the auditors as stipulated in this law (Articles 382 and 405) are as follows: (a) reporting to the board of directors without delay on the misconduct of any director, or likelihood to engage in misconduct, in violation of

laws and regulations or articles of incorporation, (b) attending the board meetings and stating opinions, if necessary, (c) demanding that the directors call a board meeting, if necessary, and (c) investigating proposals, documents, and other items prescribed by the ordinances of the ministry, which the directors need to submit to stockowner meetings (MOJ, 2005).

Consistent with the provisions of the above act, the Japan Audit and Supervisory Board Members Association (*Nihon kansayaku kyokai*/ JASBA) and the Japan Association of Corporate Directors (*Nihon torishimari kyokai*/ JACD) have developed rules that further clarify the rights, duties, and audit procedures of corporate auditors. JASBA upholds and articulates the provisions of the *Companies Act*. It regards the relationship between an audit board member and the company as an "entrustment" (*inin*), and consequently, the auditor owes a "duty of care" to the company. That legal duty includes checking the activities of directors through audits of financial reports as per the provisions in the *Companies Act* (JASBA, 2007). In so doing, they can create a structure to conduct audits, determine audit policy, prepare audit plans, examine audit methods and initiate actual processes, and write the audit report as well (JASBA, 2007).

The audit done by the statutory auditors is indeed a strong tool to check and ensure whether directors are observing the laws, regulations, and the company charter's provisions in managing the company. This is also called a compliance audit, but this does not include any appropriateness audit of the directors' decision-making and management activities. JASBA emphasizes that, since the *Companies Act* imposes a duty of care upon the directors, a business audit must include a check to determine whether there were any breaches of the duty of care, and therefore, should also examine a director's business judgments (JASBA, 2007). Although Japanese firms report quarterly, generally the audit of the financial statements (called a financial audit) is done annually before the AGM. The audit report usually includes the result of financial and business audits. Together with the notice of the AGM, it is sent to all stockowners two weeks prior to the meeting. In addition to financial statements, under the *Financial Instrument and Exchange Law* as well as the *Companies Act*, a company should also report its consolidated financial statements, which are also subject to audit by the statutory auditors (JASBA, 2007). The auditor's report must clearly certify that the financial statements show a "true and fair view" of the business's results and the financial conditions of the company.

In order to carry out his assigned duties, an auditor has a number of legal powers, such as, (a) to ask any director to provide a report on the operation of the company, (b) to examine the operations and assets of the company at any time, (c) to ask for a report and examine the operation and assets of the company's

subsidiaries, and (d) to obtain the full financial information of all subsidiaries (JASBA, 2007). JASBA's provision requires an auditor to issue notice to a director if he is aware of the possibility of any significant damage occurring to the company due to his actions.

With a view to preventing any illegal action by the directors, the audit board members are entitled to attend all board meetings and an individual auditor is entitled to express opinions to prevent any illegal or inappropriate decision by the board of directors. Moreover, he has the right to call a board of directors meeting and can even call a meeting on his own authority. He can also report his judgment on any point of a director's statement to explain any violation of the law and the company's charter to the shareholders meeting (JASBA, 2007).

The Japan Association of Corporate Directors (JACD) was established in 2001 and framed its Best Practice Code for the board of corporate auditors in 2005, thereby authorizing them to exercise their best judgments, to oversee operations, to report on disclosure, accountability and transparency, to conduct audits, to nominate directors and suggest remuneration, to ensure compliance and prevent malpractice, and to take action to prevent takeover bids (JACD, 2005). This organisation aims to ensure sustained development of the Japanese economy through enhanced efficiency of management by establishing an effective CG system (JACD, 2005). In its mission statement, JASBA has assigned to its members an ambitious responsibility for strengthening corporate governance alongside corporate management and urges them to carry out duties in a principled and professional manner with accountability in all circumstances (JASBA, 2014).

**Board Committees and Governance**

The revised *Commercial Code of 2003* required that companies introduce a board committee system (Figure 2). This matter is included now in Section 10, Articles 400 to 409 in the *Companies Act*. In this system, a board committee is composed of the nominating committee, the compensation committee, and the audit committee (Article 404). These committees are composed of three or more members from among the directors by resolution of the board of directors. The majority of the members of these committees must come from outside the company (Article 400). Also, members of the audit committee cannot concurrently act as an executive officer, executive director, accounting adviser, or manager of an affiliated company or subsidiary firm.

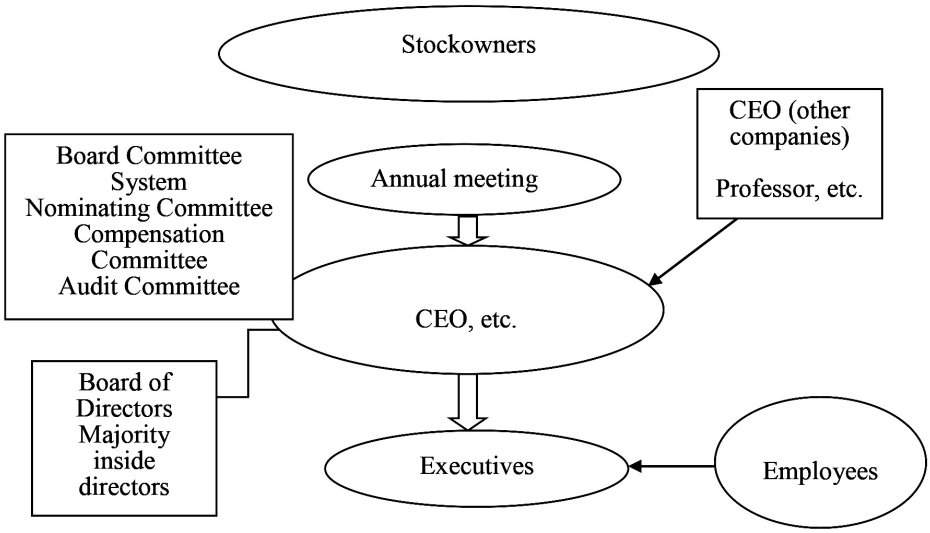


*Figure 2.* Companies with the Board Committee System (Demise, 2006a, adapted).

The authority of these committees is stipulated in Article 404 of the *Companies Act*. The nominating committee determines the contents of proposals concerning the election and dismissal of directors and accounting advisors (in companies with an Accounting Advisors system) for submission to the shareholders meeting. The audit committee examines the execution of duties by the executive officers, namely directors and accounting advisors, and determines the contents of proposals concerning elections, dismissals, and reelections of accounting auditors to the shareholders meeting. The compensation committee determines the remunerations of the executive officers.

Major Japanese electronics companies such as Hitachi, Sony, and Toshiba have adopted this model because it mitigates problems associated with the separation of ownership and control. Through adopting this board committee system, as observed in Demise (2006a), Sony aimed to enhance its group CG by improving management transparency and boosting the role of the board as a monitoring body. Toshiba adopted this system to reinforce supervisory functions and management transparency and to improve operating flexibility. Hitachi, on the other hand, aimed at improving its decision-making speed, ensuring more transparent management practices and improving its global management. In companies with this board committee system, stockowners do not have the right to elect corporate auditors nor to nominate board members (Demise, 2006a).

In addition to these, there are companies that have introduced ethics committees, which are usually chaired by external directors. As the number of

foreign investors has increased, there is a trend to include outside members in these ethics committees with responsibility for communication with foreign investors (Demise, 2006a).

**Institutional Investors and Governance**

In the Japanese corporate environment, institutional investors—mainly banks and other corporate investors—play a significant role in establishing CG. As Miwa (2006a) observes, institutional investors have become more involved in corporate governance by using stockowner proxy votes and promoting socially responsible investment (SRI), which means investing in companies that consider their corporate social responsibility (CSR). Such investors consider not only the gains their investments return but also the full impact of the firm on society.

Institutional investors have gained prominence in Japan since the start of the current century. There are certain historical reasons for this. Holding the stock of other companies is very common in Japan. Banks and other large corporations hold the stock of related and unrelated companies. These companies are monitored by their investors in the context of mutual stock ownership within the cross-shareholding system.[1] CSR gained importance in Japan after the Enron crisis in the US, and also since the 1990s when scandals related to illegal loss compensation by stockbrokers became public. The Japan Federation of Economic Organisations (*Keidanren*) developed a Charter of Good Corporate Behavior for its member companies. In the face of frequent scandals among its member companies, it revised the charter three times. In May 2004 it incorporated social justice and environmental management as part of its model of ideal corporate behavior, with increasing stress on CSR (Miwa, 2006a). The Japan Association of Corporate Executives (*Shacho Kaigi*) issued a Corporate White Paper in 2003, spelling out the importance of CSR. This gained further impetus from a story in the *Nihon Keizai Shimbun* on 1000 major companies published on January 14, 2004, which found nearly 45% of the companies had instituted CSR by 2003 (Miwa, 2006a).

Japanese institutional investors have a friendly attitude to CSR, in that they establish funds to promote investment in companies that consider their social responsibilities. The first such fund, the Eco Fund, was established in August 1999 by Nikko Asset Management. Asahi Life Asset started selling its *Asu no Hane* in September 2000 and promoted several of its CSR aspects, namely consumer responsiveness, employment quality, and social contributions. By December 2003, 18 socially responsible investment funds were established by several different investment trusts (Miwa, 2006a). However, the financial performance of these funds has been mixed. Total fund value reached 200 billion yen in 1999, but plummeted to 60 billion yen in 2003. The number of these funds

increased to 2500 in September 2004 (Miwa, 2006a). Although the number of socially responsible investment funds increased in the first half of the 2000s, their attractiveness has greatly diminished recently.

Socially responsible investment funds have the potential to play a very positive role in CG. Miwa (2006b) found that two prominent funds, the Pension Fund Association and the Pension Fund Association for Local Government Officials, have devised ways to exercise their voting rights in a positive way without any direct corporate influence. They are able to voice their opinions about CSR in all governance issues. There also exist institutions such as trust banks, life insurance companies, and investment advisory firms that invest the assets of employee pension funds. They are given the "necessary authority to carry out investment for customers concerned." Miwa (2006b) found that the pension fund sponsors propose guidelines on voting rights in "basic investment policies" and "management investment policies" to tackle social issues in a positive manner. Even here, the ultimate *decision* making authority on exercising shareholders' voting rights is left with the fiduciary institutions. These institutions need to report their business results, for which quantitative evaluation criteria are available. The investment advisor firms possess self-regulating rules for their investment business and ideally take a leading role in exercising shareholders' voting rights (Miwa, 2006b) to protect stockowners and advance socially responsible causes. Importantly, Japan's recently introduced *Stewardship Code* requires institutional investors to enhance medium- to long-term investment returns for their clients and beneficiaries by improving corporate value and promoting sustainable growth through constructive engagement. The code defines institutional investors as "asset managers" and "asset owners". It requires the former to enhance the corporate value of companies through day-to-day constructive dialogue. Asset owners are requested to fully disclose their stewardship responsibility policies (Council of Experts Concerning the Japanese Version of the Stewardship Code, 2014).

**Stakeholder Governance**

CG in Japan is based on the understanding that a business corporation is accountable to multiple stakeholders including creditors, employees, business partners, and interested parties in society. In addition to the regular stockowners, banks, buyers and suppliers, and other associates invest in the company's shares, but these investors are mostly interested in the long-term growth and prosperity of the firm rather than short-term profits (Ahmadjian, 2002). High dividends and stock prices are less attractive to them; rather they are more interested in seeing an increase in the market share of the company (Ohtsu & Imanari, 2002).

One characteristic feature of Japanese business is the *keiretsu* (affiliated company group) system and business financing from a large bank, usually called

the "main bank". The main bank acts as the nucleus of the financing system, holds shares in the companies, provides bulk loans and extends working capital to companies in the group. Before and after investing in its stock and extending loans, the main bank thoroughly examines a firm's overall position, including its business strategy, technology, business links, and future plans. It is potentially a very powerful monitor of the activities of client firms from the perspective of other creditors and the remaining shareholders.

The main bank provides insurance against financial distress and is a lender of last resort to the firm because other creditors will abandon the firm if it faces problems (Scher, 2002). As the governance and monitoring agent, it supplements the role of the other creditors and shareholders. As a matter of fact, the main bank acts as a watchdog on its client firms by continuously monitoring their creditworthiness and financial viability. Since the *keiretsu* system prevails in the banking sector also, the main banker's related trust bank (*shintaku ginko*), insurance companies, and firms closely related to it may also invest in the firm. This cross-shareholding helps exercise governance for their mutual benefit. It is quite common that the main bank places one or two of its executives on a firm's board of directors. Although the main bank's role was seriously questioned during the collapse of the bubble economy (characterised as excessive speculation in land and the stock market) in the early 1990s and the period of severe crisis (mainly of non-performing loans) in the banking industry in the late 1990s, the system is still in good shape because small and medium-sized Japanese firms remain heavily dependent on bank financing.

Another important part of CG in Japan is the employees in the company. Historically, under the prevalent managerial paternalism, the employing firm has an unwritten but binding obligation to provide continuous and stable employment. Under the lifetime, or permanent employment system large corporations must provide job security and career advancement opportunities to all full-time employees. The Japanese job market encourages vertical mobility within the firm and discourages horizontal movement between firms. As a result, the employing firm and its management possess a *de facto* obligation to sustain the growth of the firm to offer increasing opportunities for career growth to employees (Khondaker, 1997). As their career prospects are linked to the fate of the firm, employees continuously monitor the activities of management. Although Japanese employees are not represented on the board, their concern with management efficiency goes a long way to promoting better corporate governance.

Under Japanese-style management and its supply-chain management, buyers and suppliers also constitute powerful stakeholders and exercise a strong role in consolidating governance. Large-scale final product manufacturers in the

automobile, electric, and machinery industries, which mostly operate just-in-time inventory systems, promote and manage strong tie-ups with parts-makers and ancillary suppliers called *shitauke* (subcontractors). In order to reduce lead times for supply and delivery, such makers build factories in close proximity to their main buyers. Large manufacturers and even their *keiretsu* firms invest in the equity of *shitauke*, place their own representatives on the board to exercise oversight, provide them with technical support, and dispatch experts to support them. Buyers also train suppliers' engineers and core employees in their manufacturing systems. Some supplying firms depend exclusively on these large buyers and do not possess external markets. Thus, a mutual interdependence and unity of interests prevail among them. Ahmadjian (2002) observes that a firm's obligation to its buyers and suppliers and the ability to monitor one another depends mostly on a set of normative understandings concerning its obligations to its trading partners.

The government and society also have a keen interest in the activities of firms and corporations in Japan. To give a few examples, the government urges corporate management to exercise fair and constructive practices and offer stable employment and income, urges corporate responsibility in national economic development, promotes employment for women, and encourages investment in rural districts. Bureaucrats influence management and CG through extralegal methods in the guise of *amakudari.*[2] The consumers' association also keeps a vigilant eye on CG, especially in matters of safeguarding consumers' interests.

## ACCOUNTING, DISCLOSURE, AND FINANCIAL REPORTING IN JAPAN

### Accounting

Articles 431–435 of the *Companies Act* include provisions regarding the use of accounting principles and the types of financial statements to be prepared by a public company. The accounting must be subject to business practices generally accepted as fair, appropriate, and pursuant to the applicable ordinance of the MOJ. And all accounts and important materials regarding business must be retained for ten years from the time of closing and preparation of the financial statements. Any shareholder holding three percent of the voting rights can request at any time to inspect those accounts.

Financial statements in Japan include profit and loss statements, balance sheets, and most other commonly used statements (cash flow statements and consolidated financial statements) prescribed by any applicable ordinance of the ministry. A company is also required to prepare necessary business reports for

each year accompanied by the necessary supplementary statements. A number of ministries and departments, namely MOJ, the Ministry of Finance, and the Financial Services Agency (FSA / *Kinyu-cho*) under the Cabinet Office, exercise control of accounting practices. In order to develop corporate accounting standards, the FSA established a Financial Accounting Standard Foundation or FASF (*Zaimu Kaikei Kijun Kiko*) in July 2001, and the Business Accounting Standard Committee of Japan or ASBJ (*Kigyo Kakei Kijun Iinkai*) was set up within this agency.

Three laws govern financial accounting practices and reporting in Japan. Of these, the *Companies Act* has replaced the provisions of the *Commercial Code*, and it applies to all public corporations. It is primarily concerned with the protection of creditors and shareholders, and defines how assets, liabilities, revenues, expenses, and net income are to be calculated. It also provides guidelines for how financial statements are to be announced to the public and submitted to shareholders meetings, and how any temporary financial statements will be made. The *Financial Instruments and Exchange Act* governs the information disclosure obligations of all listed public companies and helps investors make their decisions. The *Corporate Income Tax Law* governs some accounting measurement issues, such as income appropriation and tax deductions, that are not covered in other laws.

The ASBJ has developed 26 Japanese corporate accounting standards. It takes into account International Financial Reporting Standards (IFRS) and other standards issued by leading national standard setters, especially the Financial Accounting Standards Board in the US These Japanese accounting standards have some elements that differ from international and US standards in the areas of directors' remuneration, audit fees, and business combinations, and are considered less meaningful by foreign investors (Nakoshi, 2006).

**Disclosure**

In accordance with the disclosure concept of accounting, the corporation must transmit all material financial data either in the body of its financial statements or in the attached explanatory notes. Especially, full disclosure is needed with respect to the method of charging depreciation, valuation of inventory and assets, declaration of dividends, directors' remuneration, audit fees, business combinations, bad and doubtful debts, contingent liabilities, acquisitions, and changes in accounting methods. The company must give full disclosure of all material facts necessary for a complete understanding by third parties or that are relevant to decision-making that might be based on the financial statements. The Japanese *Companies Act* and generally agreed accounting principles (GAAP) uphold the spirit of accounting disclosure.

After the *Sarbanes-Oxley Act* of 2002 in the US, the announcements of earnings in financial statements and securities reporting in Japan have conspicuously increased. The contents of such disclosure documents are very similar to those in Europe and the US, and consequently disclosures concerning governance have widened (Nakoshi, 2006). Furthermore, the Tokyo Stock Exchange announced a set of "Basic ideas concerning corporate governance and execution conditions", which reflected the suggestions submitted to it by many listed companies concerning decision-making, execution mechanisms, election of external directors, external auditors, human relations, capital relations, self-dealing relations, and other interests (Tokyo Stock Exchange, 2013). The mechanisms of operating audit, accounting audit, and internal audit were set out in detail. Disclosure on remuneration was divided into two parts, one for directors and the other for auditors. They must report their numbers and the amount of each director's remuneration; and no distinction was made between internal and external directors (Nakoshi, 2006). This practice is now followed by many Japanese companies.

Another important milestone concerning disclosure in Japan and yet another great influence from the *Sarbanes-Oxley Act* is that all listed companies are required to include in their prospectus and securities report an item on the "Situation of the corporate governance". Two additional items, "Risk of business" and "Analysis of the financial position and the management result," are also now required. This has created new obligations for management regarding the disclosure of material facts and significantly raised the quality of Japan's financial reporting (Nakoshi, 2006).

**Financial Reporting**

The situation of financial reporting in Japan is outlined here along the lines described by Singleton and Okazaki (2002). Both the *Companies Act* and the *Financial Instruments and Exchange Act* require companies to submit a business report for every accounting year together with a balance sheet, income statement, statement of appropriations of retained earnings, and supplementary statements to the Ministry of Finance (MOF) and the Securities Exchange Commission. The format, classification, extent of disclosure, and the type of supplementary information differ as required by these two agencies. The *Companies Act* requires the following supplementary information: (a) changes in capital stock and reserves, (b) changes in bonds payable and other debt instruments, (c) changes in fixed assets and accumulated depreciation, (d) the amount of debt guarantees and collateral assets, (e) related party transactions, such as with subsidiaries, directors, and controlling shareholders, and (f) ownership of subsidiaries. Although the *Financial Instruments and Exchange Act* requires similar information to be submitted to the MOF, this ministry requires additional

information: details on pension obligations, marketable securities, and intangible assets. It also requires additional forecasts of capital expenditures, debt requirements, a cash flow statement, and a six-month cash flow forecast. However, these are not required to be audited (Singleton & Okazaki, 2002).

Companies that are listed on the stock markets are subject to the *Financial Instruments and Exchange Act.* They are required to submit consolidated financial statements including a balance sheet, income statement, and cash flow statement. The financial statement of a subsidiary company must be consolidated with those of the parent company when the latter holds more than 50 percent of the stock in the subsidiary. The law precludes some categories of subsidiary from inclusion in the consolidated statement. But the requirement of consolidated financial statements increases the transparency of the corporation, and especially of the operation of unprofitable subsidiaries (Singleton & Okazaki, 2002). Depending on the submission requirements of the specific agency, financial statement formats differ. For the balance sheet, assets, liabilities, and equity must be classified separately. Current assets and current liabilities are distinguished from long-term items. The income statement is required to have an additional section for special gains and losses, which also include prior period adjustments (Singleton & Okazaki, 2002).

The MOF holds the upper hand on all matters in connection with financial reporting by companies in Japan. The MOF requires disclosure of the major segments of a firm's operations, classified into lines of business and geographical sectors in footnotes, and with particular disclosure on each segment's turnover, assets, and operating income. According to Article 496 of the *Companies Act*, the financial statements, business reports, and supplementary schedules must be audited. The auditor's duty is to attest to the authenticity of the financial statements. Companies listed on the stock market and unlisted companies that have share capital exceeding ¥500 million and liabilities of ¥20 billion, are required to have their accounts and financial statements audited by a Certified Public Accountant (CPA). This accountant must certify that financial statements show a true and fair view of the business's performance and the financial position of the company.

**The Status of International Financial Reporting Standards in Japan**

Although the Japanese accounting principles are similar to those in other industrialised countries, especially the US, in fact, many differences remain. Japan has not yet adopted international reporting standards; rather, it has developed its own standards that are broadly in line with those of the International Financial Reporting Standards (IFRS). The standard setting process is complicated and slow. The Business Accounting Council or BAC (*Kigyo*

*Kaikei Shingikai*) of the FSA suggests that it is appropriate for the ASBJ, which is capable of developing accounting standards and authorised to do so, to first examine the contents of the IFRS, so that it can design standards consistent with those used by Japanese GAAP (ASBJ, 2013). Consequently, the ASBJ is trying to harmonise its accounting rules and reporting standards with the global norms. In August 2007 the ASBJ and the International Accounting Standard Board (IASB) signed an agreement intended to accelerate the convergence between Japanese GAAP and IFRS. In accordance with this agreement, some major differences between Japanese GAAP and IFRS were eliminated in the first phase by 2008 and the remaining differences were removed by June 2011. The European Commission (EC) concluded in December 2008 that Japanese GAAP were equivalent to the IFRS adopted by the European Union (JICPA, 2015). According to a report in the *Nihon Keizai Shimbun* dated 4 March 2015, by the end of 2013, 25 large companies had introduced IFRS. This increased to more than 100 companies by 2014. The list includes Hitachi Seisakujo, Toshiba, Honda, Nidec, JX Holdings, Iida Group Holdings, and many other prominent companies. It is likely that many other Japanese companies will soon switch to IFRS. One major motivation of the shift to IFRS is that it will facilitate foreign acquisitions in Europe, North America, and other developed countries (*Nihon Keizai Shimbun*, 2015).

**Window Dressing in Financial Statements**

Fraudulent financial reporting is easy to define. It is simply reporting inaccurate values for assets, liabilities, and cash flows. It includes practices such as reporting sales and expenses in periods when the sales or expenses are not actually incurred. Such activities are a clear violation of accounting principles. As mentioned above, according to the prevailing laws and customs in Japan, financial statements must show a true and fair view of performance and the state of affairs of the company in the most accurate form and understandable way. In contrast to fraudulent financial reporting, window dressing is the process of manipulation of financial information; it intends to give users a more favorable impression of the performance and the position of the company (Khan, 2000). The practice is not necessarily fraudulent, but it is a willful maneuver to show a better performance and state of affairs. In reality, the state of affairs shown is not typical of what prevailed throughout the year. Companies resort to it to show a stronger business position than competitors, influence prices in the stock market, sell a new stock or bond issue, deceive the tax authority, conceal a liquidity crisis, defend against hostile takeovers, hide managerial inefficiency, pay or receive shoddy bonuses, and deceive unsophisticated investors. Griffiths (1986) humorously calls window dressing *creative accounting* whereby, "every company in the country is fiddling its profits. Every set of published accounts is based on books which have been gently cooked or completely roasted. The

figures which are fed twice a year to the investing public have been changed to protect the guilty. It is the biggest con trick since the Trojan Horse." He further argues that although the accounting standard regimes have undergone drastic changes in the 1990s, there still exist a plethora of devices that a company can adopt to show its performance and position in a better light.

Many of the accounting scandals that occurred in Japan in recent years involved the nation's top companies and auditing firms. This, despite the fact that Japan possesses very fine accounting regimes, accounting and auditing standards, and many surveillance authorities. Window dressing went unnoticed and undetected because regulatory regimes and protections are, in practice, lax. The accounting and auditing professions are largely controlled by powerful business elites. The latest scandals include major companies like Kanebo, Livedoor, Daio Seishi, Toshiba, and Akebono Brake. These scandals, especially Olympus's decades-long accounting deceit and Toshiba's enormous markdown, shocked the nation and the business community (Olympus Corporation, Third Party Committee, 2011 and Mochizuki, 2015). Teikoku Data Bank (various years) reported that there were 10 window-dressing cases in 2005, 17 in 2006, 35 in 2007, 44 in 2008, 25 in 2009, 40 in 2010, 59 in 2011, 57 in 2012, 52 in 2013, and 88 in 2014. These show the enormity of the problem in Japan. Most of these scandals were made possible, or were permitted to endure, because of accounting fraud, flexible financial reporting, excessive window dressing, and violations of compliance requirements.

## Auditor's Liability

### *Audit Board Member (Kansayaku)*

Under Articles 429 and 430 of the *Companies Act*, an audit board member is liable to the company if there is any breach of "duty of care" owed to it. Moreover, if there is any bad faith or gross negligence in performing audit activities, or if the audit report contains any false statement, the concerned member will be directly liable to the third party (MOJ, 2005).

### *Accounting Auditors (Kansahojin)*

Theoretically, auditors' offenses in connection with creative accounting practices to window-dress financial statements can be labeled professional negligence, misfeasance (breach of trust or duty imposed by law), and professional misconduct—for which they can be prosecuted under the civil and criminal laws of the country. Most of these offences happen due to non-compliance with professional codes of conduct and ethics, failure to follow accounting and auditing standards, and malicious collusion with clients.

The auditors' responsibility is one of the most debated and controversial topics among auditors, academics, media, regulating authorities, and the public (Gay, Schelluch, & Reid, 1997). The debate has become exacerbated by the collapse of big corporations such as Enron and WorldCom. The debacles of Enron, AIG, WorldCom, and Sunbeam in the US, Parmalat in Italy, Satyam Computer in India, One.Tel in Australia, and several other big frauds in Germany and South Korea prove that accounting scandals are blind to geography (*Financial Week*, 2009), and the national status of companies and audit firms. Financial report users perceive auditors' duties to be detecting and reporting frauds more than looking into compliance with statutes and audit standards (Lee, Md. Ali, & Gloeck, 2008). Auditors must assume both professional and legal duties while examining their clients' financial statements (Ang & Lim, 2008).

In the aftermath of scandals at some prominent companies, including Kanebo and Livedoor, the FSA developed internal control regulations in 2007. In 2006 it took 163 administrative disciplinary actions against financial institutions, which was an increase by 50% over the previous year. The FSA instituted those legal measures to enhance internal controls in the listed companies. These measures are nicknamed J-SOX by the Japanese media (Carozza, 2007) after the nickname for the *Sarbanes-Oxley Act*.

Theoretically, complaints and litigations by any party may give rise to liabilities, which can be categorised as liabilities to clients and liabilities to third parties. The first category arises due to professional negligence in carrying out assigned responsibilities and for committing misfeasance. When sued, the court investigates under *Civil law* or *Criminal law* depending on the nature of the alleged offense. The court may refer to all the principles and rules that regulate the affairs of the accounting and auditing profession in the country. The final verdict of the court, whether it is a financial penalty or a professional penalty, is given with due reference to the precedents and verdicts set in earlier cases.

However, in Japan the penalties for accounting misstatements are less severe than those in the US In accordance with Article 197(2) of the *Financial Instruments and Exchange Law*, the court can imprison an auditor for up to ten years and/or can impose a fine of up to 10 million yen. For any misstatement in the internal control report, the penalty is imprisonment for up to five years and/or a fine of up to 5 million yen (Carozza, 2007). Table 1 shows a summary of the various offenses and liabilities under the jurisdiction of these different laws.

An aggrieved party can also lodge complaints against an auditor, or his affiliated audit firm. It is mandatory on the part of professional auditors in Japan to strictly follow the guidelines of the CPA Law. If they fail to follow any of the rules, charges for professional misconduct can be filed against them. In such

cases, with due investigation into the content of the complaint, the Prime Minister's office may either issue a tough reprimand, or may cancel membership, or may withhold membership for a period of up to two years, which precludes the auditor from undertaking any professional activity. The office may even ask for the dissolution of the audit firm (Yamaura, 2012).

Table 1
*Liabilities for auditors for window dressing of financial statements*

| Type of Offense | Related Law | Liability |
|---|---|---|
| Criminal offense | Financial Instrument and Exchange Law | Maximum of 10 years in prison or fines of 10 million yen (¥) (personal abatement or joint offense) |
| Administrative punishment | Companies Law | Fine of up to ¥ 1 million |
| | Financial Instrument and Exchange Law | Accepted disposal |
| | CPA Law | Individual auditor: Reprimand, withhold from practice for two years, cancellation of membership, surcharge payment<br>Auditing firm: Reprimand, order to improve business management, withhold from practice for two years, dissolution, surcharge payment |
| Civil offense | Companies Act | Liability for damage (audited company, third party) |
| | Financial Instrument and Exchange Law | Liability for damages (investor) |

## SOME OBSERVATIONS ON CG AND REPORTING IN JAPAN

The CG debate in Japan is relatively newer than that in the US and Europe (Aoi, 1997). In part, this is because CG faces somewhat different challenges in Japan's unique business environment. As described above and further explained below, cross-shareholding, the main bank system and stakeholder governance mean that the traditional preeminent focus on shareholder rights and value is diminished in Japan. Nevertheless, CG in Japan is broadly similar to corporate governance in other developed countries; its primary focuses are on the rights and treatment of stockowners, responsibilities of the board, and accurate financial reporting.[3] It was only in the 1990s that the debate got some momentum when corporate earnings, investment, and stock prices declined tremendously. The actual governance at that time was rather lax. The practice of cross-shareholding among companies has prevented shareholders from exerting sufficient influence on management. Corporations can deny shareholders any means of effective oversight of investment policies and retain excess capital instead of returning it to shareholders, which leads to inefficiency (Aoi, 1997) and conflict among stakeholders (Kester, 1997). Due to their close relationship with banks,

management did not feel the presence of capital constraints even during the period of high growth in the 1960s, 1970s, and 1980s. This allowed firms to make long-term investments in facilities and expansive R&D expenditures for product and process development. The negative impact of this was that many Japanese companies embarked on unrelated diversification and expansion. On the whole, these investments were not viable—indeed, these ill-advised investments are one of the reasons that Japan has experienced low economic growth over the last 25 years. It is a painful reminder that poor CG has a broader impact than simply damaging the interests of stockowners.

Since the inclusion of the provisions regarding corporate accounting and auditing into the *Companies Act* from the *Commercial Code* around 2005 or so, some hundreds of companies have adopted the board committee system. Toyota, Matsushita, Sony, and Canon have adopted this system, reduced the size of their boards, and introduced corporate auditors from outside. Many companies have adopted an executive officer system (*shikko yakuin*) to introduce the small board system and to separate execution from decision-making (Ahmadjian 2002; Demise, 2006a).

According to Sherman (1997), main bank and cross-shareholding of stock result in a situation where the inside shareholders hold effective power and the outside shareholders do not. Similarly, inside directors have power, but outside directors do not. This situation has seriously reduced the effectiveness of CG in Japan. Especially in the 1990s, when the bubble economy burst and corporate scandals erupted, there was a collapse of corporate growth and business confidence. To a degree, these were all attributable to lax CG. The stakeholder system was blamed for fostering insular thinking and a lack of accountability (Ahmadjian, 2002). The lifetime and seniority employment system was blamed for breeding deadwood inside firms, which obstructed merit-based reward systems. The long-term buyer-supplier relationship is also blamed because large, powerful corporations precluded firm-specific specialisation by small and medium-sized enterprises. This was done through the large firms placing their own employees on the boards of the small firms. In this way, their boards do not allow them to exercise their own decision-making and management authority in view of their specific circumstances (Chernenko, Foley, & Greenwood, 2012).

From the 1990s onward, foreign investment in the Japanese stock market has increased. Although companies are increasingly interested in incorporating external directors on their boards, both individual and institutional foreign investors are reluctant to take part in high-level management activities. Yet they are pressuring firms to pay more attention to shareholder governance. The recent example of activist foreign investor Daniel Loeb's efforts to encourage Fanuc to

increase its dividend payout shows that Japanese firms can respond positively (McCombs & Clenfield, 2015).

Some other changes have also taken place since the 1990s. After the enactment of the *Sarbanes-Oxley Act*, *2002* in the US, the basic concept of corporate governance and execution was refined and widened in Japan. Prospectuses and securities reports were required to include items on the situation of CG, business risk, financial position, and management result. This has created consciousness both inside and outside the companies. The *Financial Instruments and Exchange Act, 2006* included new punitive measures to prevent fraudulent reporting in listed companies. The FSA, known as the Japanese version of the US Securities and Exchange Commission, has also reinvigorated its surveillance activities. The government has reduced the fee for filing a lawsuit against executives for derivative losses and other premeditated malpractice. This has increased the number of cases against companies for actual and attempted misbehavior in compliance, reporting, and governance. Some companies also have reduced the size of their boards to reduce unscrupulous practices. The Association of Certified Fraud Examiners has launched a Japan branch and started certification of fraud detectors since 2004. Consequently the number of trained and experienced fraud examiners has increased.

## JAPAN'S NEW CORPORATE GOVERNANCE CODE

In June of 2015, Japan adopted a new corporate governance code. The goal of this code is to raise corporate value over the medium and long-term. The code is the work of a council of experts, notably Professor Kunio Ito of Hitotsubashi University, Japan's Financial Services Agency, and the Tokyo Stock Exchange. The code is consistent with the OECD's governance principles. The code is not legally binding; rather, its principles request that all corporations comply, or explain why they do not comply. Much of the code is conventional. It seeks to promote the rights and equal treatment of stockowners. Accurate financial information must be disclosed and decisions should be transparent. Cooperation with all stakeholders in the firm is encouraged.

The new governance code's primary impact will come from three innovations. It calls for all corporations to have at least two outside board directors. These new external directors should be appointed by March 2016. This will be a challenge because most large Japanese firms have only one external director and some have no external directors at all. Although less than the majority of external directors required in some countries, this requirement could reduce the entrenchment of current corporate managements. The code also calls for an explanation for cross-shareholding, with the implicit suggestion that cross-

ownership of shares damages value, hides poor performance, and entrenches management. Further, the code requires that this explanation be meaningful. Cliché, boilerplate explanations such as "… cross-shareholdings are considered investments aimed to strengthen competitiveness among suppliers and partners" will not be acceptable under the new code.[4] This change could have a huge consequence if stable shareholders are replaced by owners who aggressively seek increased corporate value. Finally, the new code calls for companies to welcome greater participation by women in management and the establishment of independent whistleblowing systems. These changes offer perhaps the most significant long-term improvement in governance and performance, as they will reduce the ingrown mentality that dominates many companies.

The arrival of the new governance code has coincided with an increased emphasis on improving profitability. Professor Ito and other governance experts have called on all public firms to achieve a return on equity of at least eight percent. Further, a new stock index has been created that focuses on Japanese firms that meet global investment standards. This JPX-Nikkei Index 400 is composed of Japanese firms with good governance and good performance (Japan Exchange Group, 2015). Performance includes measurement with return on equity and governance specifically requires at least two outside directors and the adoption of (or commitment to adopt) International Financial Reporting Standards.

The new code and other changes may indeed lead to significant improvements in Japanese corporate governance. This certainly would be a very good thing, both for companies themselves and the broader Japanese economy. Yet, a certain amount of skepticism is justified. The new code does not have the force of law; it does not specify punishments or sanctions. Corporate leaders may appoint outside directors who are not qualified to evaluate financial accounts. For example, a major computer maker has recently appointed a former astronaut to its board. The astronaut is undoubtedly intelligent and brave, but has no experience with finance. Similarly, the practice of cross-shareholding could be transformed into another kind of stable, passive ownership by introducing new classes of stock with limited selling rights and different payout claims. A major automaker has created just such a class of stock.

## HOW TO REDUCE FRAUDULENT REPORTING AND REFORM CG

In order to enhance the effectiveness of governance, reducing fraudulent reporting is an essential precondition. In practice much fraudulent reporting arises from the discretion that managers have with respect to reporting revenues and costs. Traditional accounting gives managers a choice in that they can decide

whether to report revenues in the current period or later periods. This choice is based on accounting principles that in theory are clear but in fact can be interpreted in ways that managers find convenient. Internal accountants and independent auditors can limit this discretion in theory, but in practice auditors are often unwilling or unable to challenge managers. A similar situation applies to costs. Managers have an effective choice of whether to recognise expenses in the current period, or to capitalise these costs over later or longer periods. The amortisation of goodwill is an item especially likely to be manipulated.

The motivations of managers differ in the way they use their accounting discretion when they deal with tax collecting agencies, minority firm owners, creditors, and governance issues. Managers use their discretion to minimise reported profits when dealing with tax agencies. Managers usually elect to report better results when dealing with governance-focused groups and creditors (in the hope of qualifying for additional credit). Managers also have mixed fraudulent incentives when dealing with minority owners. In some related party transactions, they deceitfully report lower asset values (for example, when a manager-related party buys the asset from the company). In other cases, they report higher asset values (for cases when the company buys an asset from a party related to the management).

In almost all cases, the problem is related to reporting assets, liabilities, and cash flows at wrong, or non-market, values. The inability of auditors to recognise (or reject) these wrong values makes the fraud successful. Therefore, any change that makes the transactions more likely to be reported at *real* market values, or minimises the discretion of managers to decide how to report revenues and costs reduces misleading reporting and improves governance. Anything that reduces related party transactions (and parallel transactions) will lead to improvements in both reporting and governance. Cash-flow accounting, if fully implemented, might improve financial reporting and governance. In terms of tax collection, anything that forces firms to report transactions at arm's length values will help improve reporting.

Anything that improves the independence of auditors is good for clean financial reporting. Lack of genuine independence is especially detrimental to good CG. High-quality laws, codes, and guidelines will not produce good CG unless internal and external auditors have the genuine power to stand up to management to produce financial reports that accurately describe the assets, liabilities, and cash flows of firms. So, borrowing words from the old Jim Croce song, auditors should be "meaner than a junkyard dog," and not the passive lapdogs they are today. Furthermore, there is a need to adopt the mentality that managers and workers are genuinely responsible for the care of the firm’s assets for the real owners of these assets: stockowners.

As described above, failures of corporate governance are almost always linked to fraudulent or inaccurate financial reporting. High-quality laws and regulations that conform to best-practice, international standards will not contribute to good governance when managers are able to report inaccurate financial statements. This problem is vividly demonstrated by the recent case of Toshiba. Toshiba follows international financial accounting standards and has won numerous awards for social responsibility. Toshiba was in the JPX-Nikkei 400 index of good Japanese firms and, Toshiba had *four* external directors on its board. Yet, Toshiba has experienced a fraudulent financial reporting scandal involving more than one billion dollars that has persisted for years under several management teams. Once the scandal became public knowledge, Toshiba was forced to reorganise its businesses. Chronic underperforming business lines are being sold, closed, or repaired.

Japan's new governance code is a joint product of academics, corporate managers, and financial market administrators. Of necessity it is a compromise. Because the code's adoption by companies is voluntary, the code cannot be excessively radical. Yet, the code could be better. So, in the context of recent scandals, poor corporate performance and with a view to enhancing the new corporate governance code, we suggest the following:

1. Boards
   a) Boards and managers must pay more attention to shareholders' interests in the company. This includes making a dated commitment to earning a minimum return on equity and creating middle- and long-term value in a concrete way.
   b) Companies should make a dated commitment to achieve a certain proportion of their senior management and board being women. This will improve corporate governance and performance by diluting the ingrown mentality that has become common in many companies.
   c) Boards should introduce systems to communicate with the institutional shareholders and encourage them to increase investment in socially responsible projects/companies. Boards should create a new committee alongside the existing committees to address outside shareholder queries, concerns, and suggestions. In this area, institutional investors should commit to follow Japan's Stewardship Code.
   d) The size of the boards is still impractical in many companies; it should be reduced. Boards should have at least two outside members. Ideally, a majority of board members should be external.
   e) Companies should make greater use of external board members in the audit committee.

2. Shareholder Meetings
   a) Companies should initiate a disclosure system for the nominees to board membership and seek the opinions of proxy voters beforehand while casting their proxy votes for any such nominee.
   b) Companies should simplify their registration and voting process and encourage shareholders to participate in the annual general meeting of shareholders.
   c) Companies should refrain from holding their annual shareholder meetings on the same last few days of June.
   d) For foreign shareholders, the board meeting's timing, proxy issues, and linguistic matters should be handled without any cultural bias. Companies should develop adequate and effective communication measures for non-Japanese.
3. Financial Reporting
   a) Companies should change their certified public accountants every three years. A material restatement of financial results should trigger an automatic change in the firm's certified public accountant with the new accountant selected by Japan's Financial Services Agency.
   b) All reporting and CG measures should focus on prevention of malpractice rather than simple compliance with regulations.
   c) Companies should fully disclose all related-party transactions with directors and major shareholders.
   d) All Japanese public firms should adopt International Financial Reporting Standards.
4. Stock Ownership
   a) Current interlocking parent-subsidiary relationships create onerous pressure, especially on the subsidiary companies. This should be mitigated to promote flexibility of management and better governance and allow genuine value-creation by subsidiaries.
   b) Companies should not create classes of stock with different voting rights, different payout rights, and limited selling rights. Preferred stock and debt securities should not have voting rights equivalent to common stock voting rights. In principle, all equity holders should receive equal treatment.
   c) Companies should eliminate cross-shareholding that does not have an economic rationale.
5. Corporate Responsibility to Society
   a) Companies should make a dated commitment to establish an independent system for whistleblowing.
   b) Like most developed nations, Japan should encourage the development of independent shareholder research and proxy voting organisations.

c) The new Japanese Corporate Governance Code is an excellent start. However, the code's ultimate effect on governance will depend on how strongly boards are motivated to implement the code. Firms that fail to comply with the code should be removed from stock indices.

## CONCLUSION

This paper has described the current state of corporate governance and financial reporting in Japan. It has outlined the legal basis of how firms should be managed, and in whose interests firms should be run. Although the legal basis is good in the sense that it conforms to international standards, as a practical matter, the resulting governance is not what it should be. Both in terms of return on investment and in protecting the interests of shareholders, corporate governance in Japan leaves much to be desired. The paper argues that a key to good governance is accurate financial reporting. Fraudulent reporting has played a significant role in many recent examples of governance failure. The paper offers suggestions to enhance governance and improve financial reporting. However, the authors believe that most of the current problems and weaknesses in corporate governance in Japan can be mitigated if the company's annual general meeting functions effectively and auditors produce accurate financial reports. In view of the apparent effectiveness of the *Sarbanes-Oxley Act* in the US, making the chief executive directly responsible for all financial reports might reduce fraudulent reporting and improve governance. Finally, the authors believe that these suggestions are relevant to corporate governance in other countries.

## ACKNOWLEDGEMENTS

We are very grateful to Taslima Khondaker, Edmund Skrzypczak and Eriko Yamamoto for their helpful comments. The authors have no relevant or material interests that relate to the research described in this paper.

## NOTES

1. Mutual cross-shareholding is very common in Japan. For example, Company A will own some of the stock of Company B and Company B will own some of the stock of Company A. Cross-shareholding peaked in 1988 at 51% of shares based on market values. It is still high, at more than 10% on average.
2. *Amakudari* is the practice of retired government bureaucrats being employed in the firms and organisations they formerly supervised. The literal meaning of the term is "descent from heaven."

3. The OECD principles of corporate governance (2004) use the terms "disclosure" and "transparency" to refer to accurate financial reporting. Although much of Japan's corporate governance development is a result of domestic processes, concepts of corporate governance from other developed countries played important roles. In particular the "comply or explain" idea from the London Stock Exchange's principles and some concepts in the Sarbanes-Oxley legislation from the US contributed to Japan's corporate governance. For more on this please see Demise (2006b).
4. And in a similar way concerning external directors, boilerplate that explains the lack of these directors as due to "… the inability of outsiders to understand the business" will not be acceptable.

## REFERENCES

Accounting Standards Board of Japan, Financial Accounting Standards Foundation (ASBJ) (2013). Working group for the endorsement of IFRS. Retrieved 8 April 2015 from http://www.asb.or.jp/asb/ asb_e/endorsement/objective.jsp

Ahmadjian, C. L. (2002). Corporate governance. In A. Bird (Ed.) *Encyclopedia of Japanese business and management* (pp. 92–94). London: Routledge.

Ang, C. H., & Lim, K. T. C. (2008). Who left the gates unlocked? Reconciling the duties of auditors and company directors, *Singapore Academy Of Law Journal, 20*.

Aoi, J. (1997). To whom does the company belong? A new management mission for the information age. In D. H. Chew (Ed.), *Studies in international corporate finance and governance systems—A comparison of the US, Japan, & Europe* (pp. 243–250). New York: Oxford University Press.

Berle, A. A. Jr, & Means, G. C. (1932). *The modern corporation and private property*. New York: Macmillan.

Bird, A. (2002). *Encyclopedia of Japanese business and management*. London: Routledge.

Business Dictionary (2015). Corporate governance. Retrieved 27 March 2015 from http://www.businessdictionary.com/ definition/corporate-governance.html

Carozza, D. (2007). An interview with Prof. Shinji Hatta—The new Japanese internal control framework: Japan works to deter fraud with 'J-SOX'. Retrieved 4 April 2015 from http:www.fraud-magazine.com/

Chernenko, S., Foley, C. F., & Greenwood, R. (2012). Agency costs, mispricing and ownership structure. *Financial Management, 41*(4), 885–914. http://dx.doi.org/10.1111/j.1755-053X.2012.01214.x

Chew D. H. (1997). *Studies in international corporate finance and governance systems—A comparison of the US, Japan, & Europe*. New York: Oxford University Press.

Council of Experts Concerning the Japanese Version of the Stewardship Code (2014). Japan's stewardship code—Principles for responsible institutional investors, 26 February, Tokyo, Japan.

Demise, N. (2006a). Board of directors. In N. Demise, Y. Miwa, M. Nakabayashi, & Y. Nakoshi (Eds.) *Corporate governance in Japan—From the viewpoints of*

*management, accounting, and the market* (pp. 59–66). Tokyo: Springer. http://dx.doi.org/10.1007/978-4-431-30920-8_6

Demise, N. (2006b). OECD principles of corporate governance. In N. Demise, Y. Miwa, M. Nakabayashi, & Y. Nakoshi (Eds.). *Corporate governance in Japan—From the viewpoints of management, accounting and the market* (pp. 109–117). Tokyo: Springer. http://dx.doi.org/10.1007/978-4-431-30920-8_10

Demise, N., Miwa, Y., Nakabayashi, M., & Nakoshi, Y. (2006). *Corporate governance in Japan—From the viewpoints of management, accounting, and the market*. Tokyo: Springer.

*Financial week* (2009). Getting away with it: Accounting scandals blind to geography, research shows, *Financial week*. Retreived 24 December 2009 from http://www.financialweek.com/article/

Gay, G., Schelluch, P., & Reid, I. (1997). Users' perceptions of auditing responsibilities for the prevention, detection and reporting of fraud, other illegal acts and error, *Australian accounting review, 7(1)*, 51–61. http://dx.doi.org/10.1111/j.1835-2561.1997.tb00028.x

Goergen, M. (2012). *International corporate governance*. Englewood Cliffs, NJ: Prentice-Hall.

Griffiths, I. (1986). *Creative accounting—How to make your profits what you want them to be*. London: Sidgwick & Jackson Ltd.

Japan Association of Corporate Directors (JACD). (2005). Retrieved 21 December 2015 from http://www.jacd.jp/report/050801_01report.pdf

Japan Audit and Supervisory Board Members Association (JASBA). (2007, 11 March). About corporate auditors. Retrieved 31 March 2015 from http://www.kansa.or.jp/en/about-corporate-auditor/about.html

JASBA (2014, 31 October). JASBA association brochure. Retrieved 1 March 2015 from http://www.kansa.or.jp/en/JASBA_Brochure.pdf

Japan Exchange Group (2015) JPX-Nikkei index 400. Retrieved 15 June 2015 from http://www.jpx.co.jp/english/markets /indices/jpx-nikkei400/

Japanese Institute of Certified Public Accountants (JICPA). (2015). Accounting standards. Retrived 21 March 2015 from http://www.hp.jicpa.or.jp/

Kester, C. W. (1997). The hidden costs of Japanese success. In D. H. Chew (Ed.) *Studies in international corporate finance and governance systems—A comparison of the US, Japan, & Europe* (pp. 227-242). New York: Oxford University Press.

Khan, M. M. (2000). *Advanced accounting I* (reprinted edition). Dhaka: Ideal Library.

Khondaker, M. R. (1997). *Japanese style management for the Bangladesh public sector—The case of the jute industry*. Dhaka: NSU-NFU.

Lee, T., Md. Ali, A., & Gloeck, J. D. (2008). A study of auditors' responsibility for fraud detection in Malaysia. *South African Journal Of Accountability And Auditing Research*, *8,* 27–34.

McCombs, D., & Clenfield, J. (2015, 28 April). Loeb shows how to get at Japan Inc's $1.9 trillion cash pile. *The Japan Times.* Retrieved from http://www.japantimes.co.jp/news/2015/04/28/business/financial-markets/loeb-shows-get-japan-inc-1-9-trillion-cash-pile/#.V1du7GbesyJ

Miwa, Y. (2006a). Institutional investors and corporate governance. In N. Demise, Y. Miwa, M. Nakabayashi, & Y. Nakoshi (Eds.), *Corporate governance in Japan—From the viewpoints of management, accounting and the market* (pp. 31–38). Tokyo: Springer. http://dx.doi.org/10.1007/978-4-431-30920-8_4

Miwa, Y. (2006b). Institutional investors exercising shareholder voting rights in Japan. In N. Demise, Y. Miwa, M. Nakabayashi, & Y. Nakoshi (Eds.), *Corporate governance in Japan—From the viewpoints of management, accounting and the market* (pp. 41–57). Tokyo: Springer. http://dx.doi.org/10.1007/978-4-431-30920-8_5

Mochizuki, T. (2015). Toshiba profit markdown almost double earlier estimates: Japanese company likely to lower past earnings by more than $800 million due to accounting irregularities. *Wall Street Journal* (July 4), 1.

Ministry of Justice (MOJ). (2005). *Japanese companies act (Part I, Part II, Part III, and Part IV*), *Act No. 86 of July 26, 2005*. Tokyo: Author.

Nakoshi, Y. (2006). Accounting and disclosure in Japan. In N. Demise, Y. Miwa, M. Nakabayashi, & Y. Nakoshi (Eds.), *Corporate governance in Japan—From the viewpoints of management, accounting and the market* (pp. 67–74). Tokyo: Springer. http://dx.doi.org/10.1007/978-4-431-30920-8_7

*Nihon Keizai Shinbun* (2015). International accounting standards increased to more than 100 companies (in Japanese). Tokyo, 4 March.

Ohtsu, M., & Imanari, T. (2002). *Inside Japanese business—A narrative history, 1960-2000*. New York: M.E. Sharpe.

Olympus Corporation The Third Party Committee (2011, 6 December). Investigation report summary. Retrieved from http://www.olympus-global.com/en/info/ 2011b/if111206corpe.pdf

Organisation For Economic Cooperation And Development (OECD) (2004). OECD principles of corporate governance. Retrieved 27 March 2015 from http://www.oecd.org.daf/ca/oecdprinciplesofcorporate governance.htm

Scher, M. (2002). Main bank system. In A. Bird (Ed.) *Encyclopedia of Japanese business and management* (pp. 288–291). London: Routledge.

Shailer, G. (2004). *An introduction to corporate governance in Australia*. Sydney: Pearson Education Australia.

Sherman, H. D. (1997). Redressing structural imbalances in Japanese corporate governance. In D. H. Chew (Ed.), *Studies in international corporate finance and governance systems—A comparison of the US, Japan, & Europe* (pp. 267–277). New York: Oxford University Press.

Shishido, Z. (2000). Japanese corporate governance: The hidden problems of corporate law and their solutions. *The Delaware Journal of Corporate Law*, *25*, 189–233. http://dx.doi.org/10.2139/ssrn.163377

Singleton, R., & Okazaki, K. (2002). Accounting in Japan. In A. Bird (Ed.), *Encyclopedia of Japanese business and management* (pp. 1–4). London: Routledge.

Teikoku Data Bank (various years). Survey of corporate bankruptcies and compliance violations, Retrieved 8 April 2015 from http://zuuonline.com/archives

Tokyo Stock Exchange (2013, February). TSE-listed companies: White paper on corporate governance 2013. Retrieved from http://www.jpx.co.jp/equities/listing/cg/tvdivq0000008jb0-att/b7gje6000003 ukm8.pdf

Tricker, A. (2009). *Essentials for board directors: An A-Z guide*. New York: Bloomberg Press.

Yamaura, H. (2012). *Theory of auditing* (in Japanese). Tokyo: Chuo Keizai.



View publication stats