"Audit & Supervisory Board Member, etc.*" expected for Corporate Governance reform

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1. Developments in corporate governance reform (in Japan)

The concept of corporate governance varies from country to country and from position to position. It also varies according to the stage of the corporate enterprise's growth.

Countries worldwide tend to develop their own corporate governance codes with reference to OECD Corporate Governance Principles. Japan's Corporate Governance Code was developed by referring to OECD Principles and the Corporate Governance Code of the UK and other countries.

Corporate governance in Japan is defined as follows.

> "Corporate governance" means a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also customers, employees and local communities." Source: "Corporate Governance Code - Seeking Sustainable Corporate Growth and Increased Corporate Value over the Mid- to Long-Term" (Tokyo Stock Exchange, Inc. on 1 June 2018)

The system of corporate governance in Japan consists of the Companies Act and other legislations called "hard law" and "soft law" that is not compulsory but requires explanations if they do not comply with the code. The Auditing Standards formulated by the Business Accounting Council are also part of hard law because they are mandatory under the Financial Instruments and Exchange Act and related laws and regulations. The code includes the Corporate Governance Code for listed companies, the Stewardship Code for institutional investors, and the Audit Firm's Governance Code for auditing firms. This structure of the codes follows that of the UK precedent. In addition, the Financial Services Agency and the Ministry of Economy, Trade and Industry have released guidance supplementing the Code. (see Chart 1, "Corporate Governance Systems")

Chart 1. Laws and codes related to corporate governance

Category	Examples	Characteristics
Law	• Companies Act • Financial Instruments and Exchange Act	Require to comply
Code	• Corporate Governance Code (TSE) • Stewardship Code (Expert Investigative Commission) • Auditing Firm's Governance Code (Expert Investigative Commission)	Comply or Explain
Guidance	• The Guidelines for Investor and Company Engagement (FSA) • CGS Report (METI)	Code Supplement

* "Audit & Supervisory Board Member etc." includes Audit & Supervisory Board member (KANSAYAKU), Audit Committee Member, and Audit & Supervisory Committee member in Japan

2. Corporate Governance in Japan

(1) Development of the Corporate Governance System

Since the Meiji Restoration, the governance system in Japan has been formulated through the complex process of development

Chart 2. The small history of corporate governance in Japan

1899 Meiji Commercial Code amended (German Corporate Governance system (corporate auditor system) introduced)

1948 Securities and Exchange Act enacted (American Securities Law introduced)

1950 Commercial Code was revised (adoption of the US-type Corporate Governance System ie. Board of Directors System)

1951 "Principles of internal control in Companies" (Ministry of International Trade and Industry)
(Introduction of American style Internal Control)
Commencement of Audit of Securities and Exchange Act (Audit of Certified Public Accountants)

2002 Revision of the Commercial Code (Introduction of a Company with Committees System)

2005 The Companies Act was enacted

2007 "Evaluation and Auditing Standards for Internal control and its Implementation Standards" established

2008 Commencement of Internal Control Audit based on Financial Instruments and Exchange Act

2014 Revision of the Companies Act (Introduction of a Company with Audit and Supervisory Committee, etc.)

2015 Adoption of the Corporate Governance Code (introduction of the UK-type Comply or Explain method)

To summarize, in the Meiji period, Japan introduced a Corporate Governance system centered around the system of KANSAYAKU (Corporate Auditors) from Germany[1]. After World War II, Japan introduced various systems, such as the board system from the US. At that time, there were moves to reduce the system of KANSAYAKU , but the Commercial Code and the Companies Act were repeatedly amended to strengthen the system of KANSAYAKU . In addition, in 2015, the UK style "comply-or-explain" method of Corporate Governance Code was introduced. In this way, institutional reforms are being implemented in such a way that the German, US and UK systems coexist in parallel. This is a characteristic of Japan's Corporate Governance System.

(2) Three types of Corporate Governance

In 2014, after the revision of the Companies Act, "a company with Audit and Supervisory Committee" was introduced, several dozen types of company designs were available, and the degree of freedom of organization design was dramatically increased. However, in the case of a listed company, one of the three types "Company with KANSAYAKU Board", "Company with Audit and Supervisory Committee", and "Company with Nomination Committee, Audit Committee and Remuneration Committee." should be selected according to the regulations of the Companies Act and Listing Rules.

In the event that any of the three types is selected, the audit organization within a company is legally designated as a company organization. They are "KANSAYAKU Board" , "Audit and Supervisory Committee" in the case of a company with Audit and Supervisory committee, and "Audit Committee" in the case of a company with Nomination Committee, etc. The statutory Director/ KANSAYAKU constituting each organization are: KANSAYAKU in the case of KANSAYAKU Board, Director & Audit and Supervisory Committee Members in the case of the Audit and Supervisory Committee, and Director & Audit Committee Member in the case of the Audit Committee. The functions of each organization are designed on the model of the KANSAYAKU Board, However, there are differences in some respects. KANSAYAKU, Audit and Supervisory Committee member, and Audit Committee member are collectively referred to as "Audit & Supervisory Board Member etc.," Refer to Chart 3: Comparison of Audit Organization within a company for the differences of them.

1 Unlike Germany, which has a two-tier governance structure in which the board of Corporate Auditors elects Directors, under the Commercial Code of Japan (the current Companies Act), both Directors and KANSAYAKU are elected at a general meeting of shareholders. Roesler, who was involved in drafting the Meiji Commercial Code, is said to have introduced an innovative KANSAYAKU system in Japan, referring not only to his home country, Germany, but also to commercial laws such as France. ("Birth of KANSAYAKU" by Haruhisa Takada, Monthly KANSAYAKU by Japan Audit and Supervisory Board Members Association, May 2015 editio

Chart 3 Comparison of Audit Organizations within a company

	KANSAYAKU Board (KANSAYAKU)	Audit and Supervisory Committee (Audit and Supervisory Committee member)	Audit Committee (Audit Committee member)
Voting rights at the Board of Directors' meeting	None	Yes	Yes
Composition	3 or more Half or more are outside the company	3 or more Majority outside the company	3 or more Majority outside the company
Full-time member	Required	Not required	Not required
Election and selection	Elected at the general meeting of shareholders	Elected at the general meeting of shareholders (selected separately from the Board members other than the Audit and Supervisory Committee member)	Appointed by the Board of Directors
Term of Office	4 years	2 years	1 year
Removal or dismissal	Special Resolution at the general meeting of shareholders	Special Resolution at the general meeting of shareholders	Board resolution (Dismantling the position of the Audit Committee members) Ordinary resolution of the general meeting of shareholders (Removal of the Status of Directors)
Remuneration	Provision in the articles of incorporation or resolution by a shareholders meeting	Provision in the articles of incorporation or resolution by a shareholders meeting (Resolved separately from the Board members other than the Audit and Supervisory Committee member)	Decision of the Remuneration Committee
Scope of Audit	Execution of duties by Directors	Execution of duties by Directors	Execution of duties by Directors and Executive Officers
Existence of the individual audit system	None	None (Assuming Organizational Audit using internal control System)	None (Assuming Organizational Audit using internal control System)
Audit Reported by	Each KANSAYAKU and KANSAYAKKU Board	Audit and Supervisory Committee	Audit Committee
Right to state opinions on the election and dismissal of other Directors and remuneration of them at the general meeting of shareholders	None	Yes	None

3. Audit & Supervisory Board member etc. in Corporate Governance

(1) Duties of Audit & Supervisory Board member etc.

The Companies Act stipulates the duties of Audit & Supervisory Board member etc. and audit organizations with in a company (KANSAYAKU Board, Audit and Supervisory Committee, and Audit Committee) organized by auditors (KANSAYAKU or Director). Specifically, KANSAYAKU are required to audit the execution of business duties by Directors and prepare Audit Reports. In addition, the KANSAYAKU Board which is composed of all KANSAYAKUs, is also required to prepare Audit Reports. The Audit and Supervisory Committee is required to audit the execution of duties by Directors and prepare Audit Reports. The Audit Committee is required to audit the execution of duties by Directors and Executive Officers and prepare Audit Reports. Of these, the KANSAYAKUs are responsible for auditing as each person even if the person is a member of KANSAYAKU Board, and are therefore the KANSAYAKU system is said to be an " individual audit system."

In this way, "audits" are the basic roles of Audit & Supervisory Board member, etc. In addition, Audit & Supervisory Board member, etc. are required to fulfill the following roles during ordinary times and in times of emergency.

- The roles of Audit & Supervisory Board member, etc. in ordinary times include: auditing and audit reports; attendance at meetings of the Board of Directors and statement of opinions; decision on proposals submitted to the general meeting of shareholders regarding the election, dismissal, and non-reappointment of Accounting Auditors; exercise of the right to consent to the remuneration of Accounting Auditors; duties as "Those Charged with Governance," and monitoring of the financial reporting process.
- The roles of Audit & Supervisory Board member, etc. in emergencies are: deterring illegal acts by Directors, demanding an injunction against illegal acts, representing the company in litigation between the company and Directors, responding

to reports of violations of laws and regulations from External Auditors (Accounting Auditors), and dismissing Accounting Auditors based on certain grounds

(2) Those Charged with Governance

The role of Audit & Supervisory Board member, etc. will increase in significance in the future as "Those Charged with Governance ," which is the role of Audit & Supervisory Board member, etc., during ordinary and emergency times.

"Those Charged with Governance" are defined as "persons or organizations responsible for overseeing the strategic direction and accountability of a company" when incorporating the "Those Charged with Governance" of the International Auditing Standards into Japanese Auditing Standards. A company organization applicable as Those Charged with Governance is the Board of Directors, and a KANSAYAKU, KANSAYAKU Board, Audit and Supervisory Committee or Audit Committee, depending on the type of governance adopted by a company. Among them the communication target of external auditors as Those Charged with Governance is KANSAYAKU, KANSAYAKU Board, Audit or Supervisory Committee or Audit Committee depending on the company's governance structure[2].

(3) Revision of Auditing Standards in 2017

Auditing standards based on which Certified Public Accountants conduct audits were revised in 2017. This revision is the largest revision since the postwar Certified Public Accountant audit system began.

The following two items which have been added to the Audit Report contents have a significant impact on an Audit & Supervisory Board member etc. Both are related to the roles of an Audit & Supervisory Board member etc. and as Those Charged with Governance.

① Responsibilities for Financial Reports by an Audit & Supervisory Board member etc. …"an Audit & Supervisory Board member etc. must be responsible for monitoring the financial reporting process."

② "Key Audit Matters" … "Key Audit Matters (KAM) is selected from among the matters considered by the auditors to be particularly important in the auditing of the financial statements for the current fiscal year, which are discussed with the Audit & Supervisory Board member etc. KAM is to be adopted from the audit of the financial statements for March, 2021 (early adoption is possible), and the companies listed on the 1st. Division of Tokyo Stock Exchange are encouraged to adopt from March 2020.

The purposes of KAM are to enhance the transparency of audit conducted by external auditors, and to raise the value of information in the audit report.

In the U.K., which precedes the introduction of KAM, an Audit Committee Report of how Audit Committee handled KAM presented by auditors is established.

4. International Comparison of Auditing Organizations within a company

What is the state of affairs in Japan's auditing organization within a company, which is composed of an Audit & Supervisory Board member etc., compared to auditing organizations in other countries?

Corporate Governance is diverse, and there is no single model to apply to all companies. Nevertheless, as a result of the history of the economy and society, corporate activities, and laws and regulations in each country, a certain model of Corporate Governance has been developed. A typical example is one-tier governance and two-tier governance.

One-tier governance is a form of governance in which there is only one key governance body in the enterprise organization. It is also called one-tier board governance. A typical example is corporate governance in the UK and the US. In both countries, a Board of Directors, consisting of board members elected by shareholders, acts as a single board.

Two-tier governance is a form of governance of which there are two main governance bodies in the enterprise organization. It is also called two-tier board governance. A typical example is corporate governance in Germany. In Germany, the Board of Corporate Auditors (Supervisory Board), which is composed of corporate auditors elected at the General Meeting of Shareholders, and the Board of Directors, which is composed of directors elected at the Board of Corporate Auditors, have governance functions.

In Japan, a company with a Nomination Committee, etc. is a one-tier type of governance body with the Board of Directors as its governance body. In addition, although the Audit and Supervisory Committee is given strong independence and cannot be simply referred to as an internal body of the Board of Directors, from an international standpoint, a company with an Audit and Supervisory Committee can also be regarded as a one-tier type of governance. In contrast, Companies with a KANSAYAKU Board cannot be regarded as two-tier governance, since Directors are elected at a general meeting of shareholders rather than at a KANSAYAKU Board, and therefore should be regarded as governance with a parallel structure of the Board of Directors and KANSAYAKU and the KANSAYAKU Board.

2 For more information on "Those Charged with Governance," please refer to JICPA Audit Standard Committee Report 260 "Communication with Audit & Supervisory Board member, etc." and the International Standard on Auditing (ISA) 260 "Communications with Those Charged with Governance'."

Let us then compare audit organizations of Japan and the UK/US that have influence over the management and governance of Japanese companies. See Chart 4, "International Comparison of Auditing Organizations."

Chart 4 International Comparison of Auditing Organizations

Item	UK London Premium Listed Company (Note1)	US NYSE listed company	Japan TSE listed company
Auditing Organization	• Audit committee	• Audit committee	• KANSAYAKU Board, Audit and Supervisory Committee or Audit Committee
Composition of Auditing organization	• 3 or more composed of Independent Directors (two or more in the case of companies smaller than FTSE350). • The Chairman of the Board cannot be a member.	• All members of Audit committee shall be independent directors. (SOX Act, Article 301)	• More than half of the KANSAYAKUs shall be outside (in the case of a company with a Nomination Committee etc., the majority of the Audit Committee shall be outside directors. In the case of a company with an Audit and Supervisory committee, majority of the Audit and Supervisory committee shall be outside directors). (Article 335, etc. of the Companies Act) • Requirement to ensure the appointment of one or more independent directors (independent directors or independent KANSAYAKUs) (Article 436-2 of the Securities Listing Regulations of the Tokyo Stock Exchange) • The Corporate Governance Code stipulates that two or more independent External Directors should be selected. (Comply or Explain)
Primary role and responsibilities	• Note 2, which although covers a wide range of issues, does not require an "audit" or an "audit report."	• It is directly responsible for the appointment and dismissal of external auditors, the determination of remuneration, and supervision (SOX Act, Article 301). • Supervision of internal audits (NYSE Listed Company Manual 303A. 07) • No Audit committee "audit" or "audit report" is required.	• Audit and audit reports • Decide on proposals for the appointment, dismissal and non-reappointment of Accounting Auditors. • Exercise Right to consent on remuneration for Accounting Auditors. • Monitoring of the financial reporting process
Activity report	• Report the status of fulfillment of the responsibilities of Audit committee to the Board of Directors. • Audit committee activities are described in the Annual Report. (See Note 3 for specific items)	• The status of Audit committee activities is reported to the Board of Directors and disclosed through Annual Report and Proxy Statement etc.	• Prepare an audit report and report it to the Board of Directors and the general meeting of shareholders. • Inclusion of activities of the KANSAYAKU Board, Audit and Supervisory Committee or Audit Committee in the Annual Securities Report (Yuho)

Relationship between Auditing Organization and External Auditor	• Audit committee is responsible for the bidding, election, reappointment, dismissal, fees, monitoring, review and assessment of external auditors as described above.	• Audit committee is directly responsible for the appointment and dismissal of external auditors, the determination of fees, and oversight, as described above.	• Audit & Supervisory Board member etc. shall have the authority to appoint, dismiss, non-reappointment, and fee for auditing the Accounting Auditors mentioned above. • Audit & Supervisory Board member etc. evaluate External Accounting Auditors to confirm independence and expertise (CG Code Supplementary Principles 3-2 ①) • There are no special provisions for the supervision of External Auditors by Audit & Supervisory Board member etc.
Requirement of internal audits and relationship between auditing organizations and internal auditors	• In principle, the effectiveness of internal audits shall be monitored and reviewed by Audit Committee. If there is no internal audit function, an explanation is required.	• NY listed companies are required to maintain their internal audit functions. • Require Audit Committee oversight of internal audits.	• Internal audit is listed in examination items when IPO. • After listing, there is no provision requiring listed companies to maintain their internal audit functions. • There is no provision for the supervision of internal audits by Audit & Supervisory Board member etc. • Listed companies are required to ensure cooperation between the Internal Audit Department and directors and KANSAYAKU (CG Code Supplementary Principle 4-13③).

Note 1 Principles and Provisions of "The UK Corporate Governance Code 2018"

Note 2 Major roles and responsibilities of Audit committee of UK London Premium Market Listed Companies:

1. monitoring the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, and reviewing significant financial reporting judgements contained in them;
2. providing advice (where requested by the board) on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable, and provides the information necessary for shareholders to assess the company's position and performance, business model and strategy;
3. reviewing the company's internal financial controls and internal control and risk management systems, unless expressly addressed by a separate board risk committee composed of independent non-executive directors, or by the board itself;
4. monitoring and reviewing the effectiveness of the company's internal audit function or, where there is not one, considering annually whether there is a need for one and making a recommendation to the board;
5. conducting the tender process and making recommendations to the board, about the appointment, reappointment and removal of the external auditor, and approving the remuneration and terms of engagement of the external auditor;
6. reviewing and monitoring the external auditor's independence and objectivity;
7. reviewing the effectiveness of the external audit process, taking into consideration relevant UK professional and regulatory requirements;
8. developing and implementing policy on the engagement of the external auditor to supply non-audit services, ensuring there is prior approval of non-audit services, considering the impact this may have on independence, taking into account the relevant regulations and ethical guidance in this regard, and reporting to the board on any improvement or action required; and
9. reporting to the board on how it has discharged its responsibilities.

Note 3 Report on the activities of Audit committee of UK London Premium Listed Companies:

1. the significant issues that the audit committee considered relating to the financial statements, and how these issues were addressed;
2. an explanation of how it has assessed the independence and effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, information on the length of tenure of the current audit firm, when a tender was last conducted and advance notice of any retendering plans;
3. in the case of a board not accepting the audit committee's recommendation on the external auditor appointment, reappointment or removal, a statement from the audit committee explaining its recommendation and the reasons why the board has taken a different position (this should also be supplied in any papers recommending appointment or reappointment);
4. where there is no internal audit function, an explanation for the absence, how internal assurance is achieved, and how this affects the work of external audit; and
5. an explanation of how auditor independence and objectivity are safeguarded, if the external auditor provides non-audit services.

There are two key differences between audit systems of UK/US and Japan. First, existence of "audit" by the auditing organization within a company and the second is the relationship between the auditing organization within a company and internal audits. The main differences will be discussed below.

(1) Existence of "audit" by auditing organization within a company

In Japan, if any of the three types of governance is selected, the Companies Act requires that "audit" and "audit report" be provided by the auditing organization within a company.

① Companies with KANSAYAKU and a KANSAYAKU Board: KANSAYAKU shall audit the execution of duties of Directors and Accounting Advisors and prepare audit reports (Article 381, para.1 of the Companies Act).

Furthermore, if a KANSAYAKKU Board is established, an audit report by the Board shall be prepared based on the audit report of each KANSAYAKU (Article 390, para.2 of the Companies Act).

② A company with a Nomination Committee, etc.: The Audit Committee prepares audit report by auditing the execution of duties by Executive Officers, Directors, and Accounting Advisors (Article 404, para.2 of the Companies Act).

③ Companies with Audit and Supervisory Committee: The Audit and Supervisory Committee shall audit the execution of duties by Directors and Accounting Advisors and prepare audit report (Article 399-2-3 of the Companies Act).

In contrast, Audit Committees in the UK and the US are not required to conduct "audit" as they do in Japanese auditing organization within a company and therefore are not required to report the result of an audit. In the UK, however, an Audit Committee report which describes the activities of Audit Committee including monitoring of external and internal auditors will be prepared and disclosed in an Annual Report. In the US, Audit Committee's activities are briefly described in Annual Report and SEC documents.

Because of these differences, it can be said that the auditing organization in Japan is the organization that conducts audit, while the auditing organization in the UK and US. is the organization that let someone audit.

(2) Relationship between Auditing organization and Internal Audit

Next, what is the relationship between the auditing organization and the internal audit which is responsible for auditing activities within the company? First, I'll give an overview of the position of internal audit in the US, which Japan has regarded as a model for Corporate Governance and Internal Audit after World War II, and the UK, which has had an influence on the US for many years and has increased its influence over Japan today

For the US, we will look at the case of a NYSE listed company. NYSE listed companies are required to maintain internal audit functions by the NYSE Listed Company Manuals (NYSE Listed Company Manual 303A.07(c). Furthermore, NYSE listed companies have a governance system in which the Audit Committee supervises both internal and external audits. Regulations based on the Listed Company Manual can be said to be a soft-law regulation by NYSE, which is SRO= Self-Regulatory Organization. However, it is stipulated by the Securities Exchange Act of 1934 that new or revision rules in the NYSE Listed Company Manual must be approved by the SEC (SECURITIES EXCHANGE ACT OF 1934 Section 19-(b). This can be said to be a regulation that is as enforceable as hard-law as possible.

Now let's look at the UK in the case of the London Premium listed companies which include global companies. London Premium Listing listed companies are required to apply the UK's Corporate Governance Code. The UK's Corporate Governance Code requires strict explanation, such as descriptions in the Annual Report, in the absence of an internal audit function, due to the comply or explain method. As in the US, the maintenance of internal audits is virtually mandatory.

Compared to the US and UK, the position of internal audit in Japan is significantly different.

In Japan, internal audit is stipulated as follows under various standards, etc..

- With regard to the Internal Audit Standards (Japan Internal Audit Association) (1.0.1),

  "Internal audit is an assurance service that evaluates the achievement of governance processes, risk management, and control-related management activities from a fair and independent perspective as well as from the viewpoint of legality and rationality, based on an attitude of discipline observance as an internal auditor, provides objective opinions, advice, and recommendations based on the evaluation, and provides advisory services to support specific management activities," with the aim of helping the organization effectively achieve its management objectives. It is substantially the same as the definitions of internal audit set forth by IIA: Institute of Internal Auditors.

- Implementation Standards for internal control (Business Accounting Council) (5)

  ② Internal audit is stipulated that in general, an internal auditor appointed under the direct supervision of the management shall investigate the status of the development and operation of internal control from an independent standpoint for the execution of business activities and report on any improvements to be made.

- The Corporate Governance Code requires the coordination of the Internal Audit Department with the Directors, KANSAYAKUs, and External Accounting Auditors.

- The status of the internal audit of the applicant company is usually reviewed during the listing application process.

In all the above standards, etc., although existence of an internal audit is recognized, it does not require a listed company to maintain its internal audit function. In addition, while the Japanese Corporate Governance Code employs the comply or explain method as in the UK, unlike the UK, it does not list the maintenance of the internal audit function as a principle of corporate governance and therefore does not require explanations in the absence of internal audit.

Recent developments in other countries have come to emphasize the role of internal audit with emphasis on governance.[3]

In this way, internal audit in Japan are quite different from the positions of internal audit in the US and the UK, and they also diverge from the global trend of emphasizing governance.

5. Enhancement of operations of Audit & Supervisory Board member etc.

In such circumstances, in order to fulfill their roles of the Audit & Supervisory Board member etc., it is necessary to make efforts to enhance the operations of the Audit & Supervisory Board member etc.

The following three measures will be helpful in advancing the sophistication of operations of Audit & Supervisory Board member etc.

(1) Organize the concept of governance, risk management, and internal controls
(2) Utilizing the " Three Lines of Defense "
(3) Coordination of three types of audit

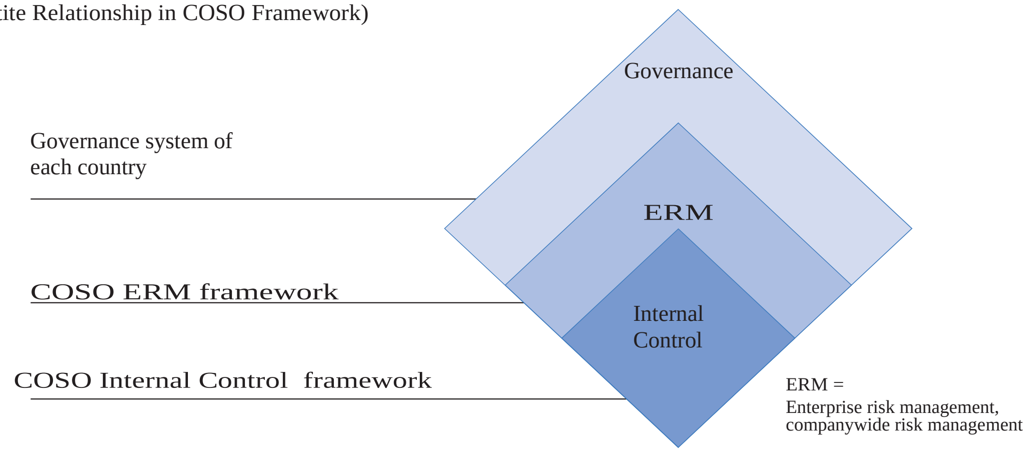
The following is an explanation in order.

(1) Organize the concept of governance, risk management, and internal controls

When examining the enhancement of the operations of Audit & Supervisory Board member etc., it is necessary to organize the relationship of Governance with Risk Management and Internal control, which are important functions to support Corporate Governance.

I think there are many ideas, but here I will introduce the concept on governance, risk management, and internal control of COSO, which has developed a framework of Internal control and Risk Management as global standards. Please see Chart 5.

Chart 5 Governance/Risk Management/Internal Control relationship
(Tripartite Relationship in COSO Framework)



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Source: "COSO internal control-Integrated Framework 2013" (translation led by Shinji Hatta and Junya Hakoda, Japanese Institute of Certified Public Accountants, published in 2014) Framework Volume P. 215, processed and prepared

3 For example, "primary reporting line to the board" description for the reporting line of internal audit in “Leveraging COSO across the Three Lines of Defense” (COSO, July 2015) and "be accountable to the board" and "no dual hatting" (No change in attitude to whom reporting) in “Corporate Governance Principles for Banks” (Basel Committee on Banking Supervision, July 2015),.

COSO regards Governance, risk management, and internal control as one linkage. As a rule of thumb, they define Governance at the top, Risk Management, and Internal control as the foundation.

Among the three parties, COSO shows the ERM (Enterprise risk management = company-wide risk management) framework (COSO ERM Report) for Risk Management, and an entire business group internal control framework (COSO Internal Control Report) for internal control is also presented. However, COSO does not provide a framework for Governance since this is to be subject to system of each country.

COSO's way of thinking will be helpful in organizing the concepts of Governance, Risk Management, and Internal Control.

(2) Utilizing the " Three Lines of Defense "

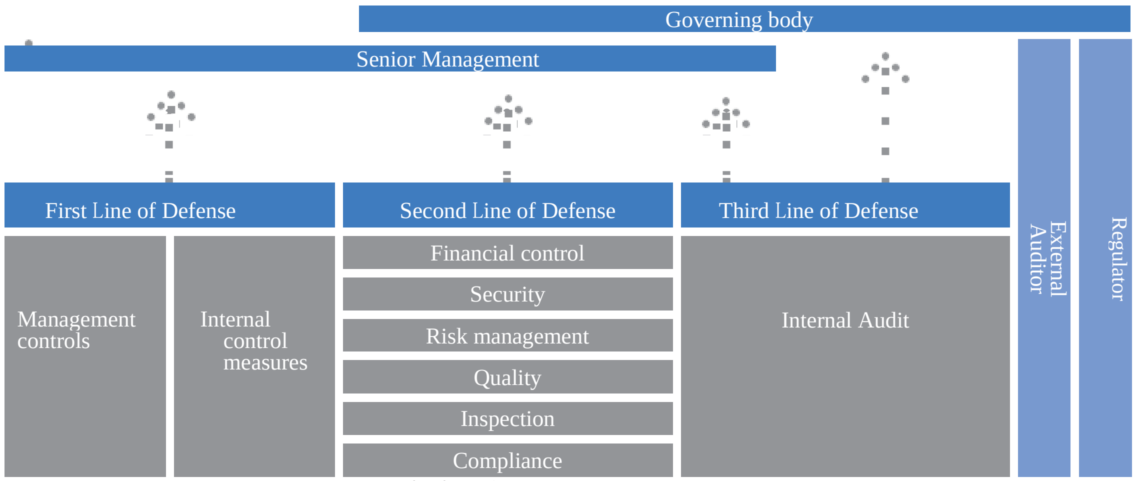
As the next step in organizing the concepts of Governance, Risk management, and Internal Control, Audit & Supervisory Board member etc., as "Those Charged with Governance" need to consider how to ensure the effectiveness of corporate governance based on internal control and risk management. In particular, in the case of large corporations and corporate groups, it is not possible for a small number of Audit & Supervisory Board members etc. to directly monitor the internal control and risk management of the entire organization, so an approach to using the organization is effective.

" Three Lines of Defense " is an effective framework for utilizing organizations from the standpoint of Audit & Supervisory Board member etc. The " Three Lines of Defense " has been developed from the practices of US and European financial institutions as a framework for internal control and risk management that support corporate governance. This is a framework that has been widely used throughout the world through the "Principles for Sound Operational risk management" by the Basel Banking Supervision Committee in 2011 and the "COSO Internal Control- Integrated Framework 2013". In Japan, this framework is referred to by financial institutions and other international corporate groups.

The " Three Lines of Defense " is the framework for building internal control and risk management that support management and governance organizations by combining the three defense lines of the first (management by the business department), the second (management by the indirect department), and the third (internal audit) (see Chart 6 "Three Lines of Defense").

As a governance body, Audit & Supervisory Board member etc. are expected to monitor the functions of the Three Lines of Defense and confirm that internal control and risk management are systematically developed and are operating.

Chart 6 Three Lines of Defense



Materials: "Leveraging COSO Across the Three Lines of Defense" (COSO, 2

(3) Coordination of the three types of audit

In Japan, the term "three types of audit" is used. Three types of audits refer to: external audit, internal audit, and audit by Audit & Supervisory Board member etc. The three types of audit is a unique form of audit in Japan. This is because, unlike in Japan, where it is legally stipulated for an Audit & Supervisory Board member etc. to conduct an audit, in UK and US, while external and internal audits are conducted, Audit Committee, etc., as the auditing organization, dose not conduct an audit, instead, is in a position to supervise the external and internal audits.

The parties involved in the three types audit differ in their positions as follows.

- Audit & Supervisory Board member etc.: Supervise and audit the execution of duties by management as non-executive directors/ KANSAYAKU. Determines the content of proposals for the election and dismissal of accounting auditors.
- Internal auditor: normally reports directly to management.
- External auditor (accounting auditor): An outside party independent from the management.

Collaboration based on understanding of such differences in positions is beneficial for mutual audits. Promoting three types of audit coordination based on the Three Lines of Defense framework contributes to improving Corporate Governance.

In addition, it is useful to have a cooperation of Audit & Supervisory Board member etc. and outside directors (outside directors other than Audit Committee members and Audit & Supervisory Committee members) In particular, in a company with KANSAYAKU, the role of KANSAYAKU is audit and that of outside directors is oversight. Audit of KANSAYAKU will be an important support for the oversight of outside directors and at the same time, KANSAYAKU will be able to obtain useful knowledge from outside directors. The Corporate Governance Code also requires the coordination of KANSAYAKU with outside directors. (Supplementary Principle 4-4①)

6. Expected leadership of Audit & Supervisory Board member etc.

In order to bring Japanese corporate governance to global standards, it is essential to raise the level of Japanese auditing organization within a company to the same level as Audit Committee in UK and US.

The Audit & Supervisory Board member etc. who are responsible for the auditing organization shall play an active role as the promoter of the three types of audit collaboration, thus contribute to society.

At the same time, it is necessary to reform the Corporate Governance system. It is necessary to reconsider the modality of auditing organizations in Japan, taking into account international trends, while considering the historical developments.

Reference Materials

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