Corporate Reform in Japan and the United States

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1. Sarbanes-Oxley One Year On

1) Ensuring that investors receive proper information and a fair share of cash flow

It is a year since the Sarbanes-Oxley Act was passed. In these 12 months corporate reform has been carried out vigorously in many different areas. As a result, in the words of William Donaldson, Chairman of the SEC, the fact that corporate scandals in the United States have passed their peak and investor confidence has recovered has been reflected in the recent stock market rally.[1]

In a nutshell, the aim of these reforms is to ensure that investors receive proper information about companies and their fair share of corporate cash flow.

In order to ensure that investors receive proper information, the first thing that was necessary was to restore their confidence in corporate accounting data. It is exactly a year since the controversy surrounding one of the measures designed to achieve this—requiring senior executives to sign off financial documents. Since then, progress has been achieved in reforming audit corporations, audit committees, accounting standards and disclosure requirements.

Nor is corporate accounting data the only problematic area as regards investor information. There has also been progress in reforming the role of analysts and credit-rating agencies in order to ensure that the research and credit-ratings provided to investors are accurate.

Examples of cases where investors have not received their fair share of corporate cash flow include cases of spinning and kickbacks as well as cases where senior managers have sold shares in their company during a "lockdown" (i.e., a blackout period when holders of 401(k) plans are not permitted to cancel their plans). In such

[1] "SEC chief says worst of fraud is likely past," Wall Street Journal, July 23, 2003.

cases, senior managers and special interests lined their pockets with money that rightfully belonged to shareholders. Progress has also been made in these areas.

Stock options are an issue that affects both the accuracy of investor information and the amount of cash flow they receive. Privileged people have made enormous profits by exercising stock options when stock prices have been inflated by profits that have been diluted because companies failed to expense those options. The cost of this has had to be borne by ordinary shareholders. There is no denying that, regardless of whether stock options were expensed or not, they were a potential incentive to senior managers to distort investor information in order to boost stock prices and one of the main factors that contributed to a spate of corporate accounting scandals.

2) Maximizing management value rather than shareholder value

There are those who argue that the Enron and WorldCom scandals illustrate the failure of the US approach to management with its emphasis on the maximization of shareholder value. However, what is clear from these scandals is that senior managers were trying to boost stock prices not out of a sincere desire to maximize returns to investors and shareholders but in order to benefit themselves.

Although stock options should have helped to solve the dilemma that faces agents by striking a balance between the interests of shareholders and management, they actually served as an inducement to management to line their own pockets by providing shareholders and other investors with false or misleading information.

Given that there is bound to be considerable asymmetry of information between shareholders and management, (1) any manipulation of the financial information that investors need in order to judge whether stock prices reflect a company's true worth or (2) any connivance by audit corporations in this manipulation, far from helping to solve the agency dilemma, will only exacerbate it.

The Internet bubble also saw a surge of takeover activity financed by expensive paper. However, it is rare to hear of cases where this has enhanced the value of the acquiring company. A much more common reason for such activity was probably the desire of managers to build empires and entrench their own positions.

This was the age of the "equity standard," where shares were used to reward staff and pay for takeover deals. Far from maximizing shareholder value, however, the equity standard really served only to maximize management value by transferring the wealth of a company from its shareholders to its management. The reforms that are

currently under way are intended to restore the maximization of shareholder value to its proper position in US companies.

Another common misunderstanding with regard to the principle of maximizing shareholder value is that it is supposed to give priority to shareholders over other stakeholders such as employees and business partners.

Companies do business with all sorts of markets, including the labor market and the markets for goods and services. The same is true of the debt and equity markets, to which the stock market belongs. As economic agents companies act as optimizers in all these markets, while the workers and business partners with whom they do business are also seeking to maximize their utility and profit by doing business with those companies on these markets. Similarly, shareholders take it for granted that, when they deal on the stock market, any business they do with a company will maximize shareholder value. This is because, if companies did not do business on these terms, they would lose their shareholders just as they would lose workers if they did not pay them a proper wage.

It is a matter of course that companies should distribute as much as possible of the cash flow they generate through economic activity to providers of capital such as workers, suppliers and shareholders in proportion to what they contribute.

The reason there has been so much emphasis on shareholder value in recent years is that the number of both retail and institutional investors has been rising as share ownership becomes increasingly common. Unlike economic agents which can easily switch business partners or agents which are either protected by trade unions or able to exert direct negotiating pressure on companies by virtue of their size, retail investors are not in a position to negotiate with companies individually, while the fact that institutional investors are increasingly managing their funds passively makes them more reluctant to reshuffle their portfolios.

Therefore, if shareholder value is to be maximized in the true sense of the term, the optimization principle that applies to labor markets and markets for goods and services should also be applied rigorously to the stock market. Likewise, companies should give shareholders a fair share of their cash flow. However, shareholders would only know whether they were earning an adequate return on the risk they were taking if companies conducted proper disclosure. Maximizing shareholder value therefore means that companies need to improve this aspect of their business.

3) What should Japan's priorities be?

As we have seen, the Sarbanes-Oxley Act has given rise to a spate of related rules and regulations over the past 12 months, and these are now coming into effect. During this period the focus in Japan has tended to be on how these will affect Japanese companies.

Similarly, not enough attention will be paid to the details of the corporate reforms in the United States so long as people in Japan see the Enron scandal as a problem peculiar to the way US companies are run (one example of which is the mistaken approach to maximizing shareholder value we saw above) and an opportunity to reconfirm the positive aspects of the way Japanese companies are run.

Given, however, that the heart of the problem is the fact that companies have failed to provide investors with proper information and a fair share of their cash flow, people in Japan should accept the fact that they face many of the same problems and see the corporate reforms in the United States as an example from which they can draw lessons which can be applied to corporate and market reform in Japan.

This is not to deny that stock options are still in the process of development and that senior managers in Japan, where there has never been the same kind of remuneration gap as in the United States, have never consciously maximized management value. However, there have been numerous examples in the corporate failures of recent years where senior Japanese managers have concealed what was really going on in order to keep their company going, even though they were not pursuing personal gain. Similarly, as the widespread practice of cross-shareholding shows, overzealous Japanese managers have sometimes done things which were not in the best interests of ordinary shareholders in a desire to achieve stability.

There are probably many lessons for Japan from the recent corporate reforms in the United States, but one major lesson is that they represent root-and-branch reform in the areas of accounting and corporate governance, where, even after the reforms of the securities markets in the 1930s, loopholes remained. Given that Japan finds itself in a period of major transition, especially in these two areas, it would seem only sensible (as is argued below) to draw as many lessons from the US experience as possible.

2. Resona Bank and Enron: Reforming Audit Corporations and Corporate Governance

1) Issues raised by the crisis at Resona Bank

In May of this year, following the report of its audit corporation on its deferred tax assets, Resona Bank, one of Japan's biggest banks, suffered major impairment of its regulatory capital, leaving the government no choice but to call the first ever meeting of the Financial Crisis Response Committee and sparking a public debate about how disclosure and audit corporations should be regulated.

Whereas the issue at stake in the Enron scandal was the collusion between the company and its audit corporation, in the case of Resona Bank the audit corporation had resisted pressure from the bank and insisted on publishing its own opinion—the reverse opposite.

However, what did resemble the growing accounting scandals in the United States was the fact that other Japanese companies and financial institutions were instantly covered in a blanket of suspicion about the way in which they accounted for their deferred tax assets. Moreover, even before the situation at Resona Bank reached crisis proportions, the fact that the bank had severed its ties with its previous audit corporation because the latter had demanded a more stringent approach aroused suspicions that the bank was simply looking for whichever auditor would express the most favorable opinion.

Indeed, the fact that the bank's then chief executive officer declared that, by voicing its opinion, the audit corporation had destroyed a long-standing relation of trust only increased the suspicion that the two might have been acting in collusion for many years. In particular, the fact that the original auditor's opinion was given just after the director of the Japanese Institute of Certified Public Accountants (JICPA), at the behest of the Financial Services Agency, issued an instruction to the country's main banks in February 2003 to tighten up the way they audited deferred tax assets inevitably made matters seem worse, suggesting that this was simply a first step in the direction of normality.

The focus of attention in the Resona crisis was the disagreement between the bank and its audit corporation.[2] But in the Enron scandal it was not just that the senior managers and the audit corporation were accused: the behavior of the board of directors and the audit committee, which should have safeguarded the interests of the

[2] However, there was also controversy over the alleged involvement of the Financial Services Agency—an important issue that needs to be discussed elsewhere.

shareholders but failed to identify and solve the problems, was also called into question. In contrast, in the controversy surrounding Resona not very much appears to have been said about the failure of the board of directors and the corporate auditors as part of the company to safeguard the interests of the shareholders.

There are, of course, many differences between Japanese and US corporate governance. However, whatever formal differences there may be, the fact that a situation such as that surrounding Resona Bank occurred and the fact that in the wake of the Enron scandal efforts are being made to improve the effectiveness of corporate governance in the United States by carrying out wide-ranging reform suggest that more attention should be paid in Japan to the question of how to ensure that companies are managed in the interest of their shareholders.

Let us now consider in more detail the two issues that formed the focus of the crisis facing Resona Bank: How should audit corporations and corporate governance in Japan be reformed?

2) Reform of audit corporations in Japan and the United States

The recent case of Resona Bank is not the first time that public confidence in auditors has deteriorated. In November 1997, when Sanyo Securities, Hokkaido Takushoku Bank and Yamaichi Securities failed; in October 1998, when Long-Term Credit Bank of Japan failed; and in December 1998, when Nippon Credit Bank failed, an audit corporation had approved the latest set of accounts of the banks and securities companies concerned. Even in the case of a nonfinancial company, Mita Industrial, in October 1998, the role of its auditors was questioned when it was discovered that the company had cooked the books. More recently, in May 2002, an accountant employed by the auditors of Footwork was arrested for having approved the company's embellished accounts.

The fact that the case of Resona Bank was enough in itself to foster doubts about the reliability of the accounts of other companies (both financial and nonfinancial) shows that even after such a large number of corporate failures over so many years public confidence in Japan's auditing profession has yet to improve.

In stark contrast, public confidence in company accounts in the United States has improved dramatically as a result of the radical reforms undertaken in the 12 months since the Enron scandal surfaced. One of the key targets of the reforms has been audit corporations.

The first measure was to set up a new body, the Public Company Accounting Oversight Board (PCAOB), to monitor the activities of audit corporations. This marked the end of self-regulation. Other measures—to ensure that audit corporations are independent—included limiting their other activities, obliging companies to rotate their audit corporations and placing restrictions on the appointment of audit corporation staff involved in an audit to positions as directors with the client company.

As it happens, the most significant reform to auditing in Japan since 1966, an amended version of the Certified Public Accountants Law, was promulgated in June of this year. Inasmuch as one of its main aims is to make auditors less dependent on the companies they audit, some of its objectives can be said to be similar to those of the recent US legislation.

More specifically, similar restrictions to those already in effect in the United States have been adopted in Japan: for example, audit corporations are now prohibited from engaging in certain non-auditing activities; companies are obliged to rotate their accountants, and there are restrictions on the appointment of audit corporation staff involved in an audit to positions as directors with the client company.

Also, whereas in the past accountants and auditors were largely self-regulated by JICPA, regulation by the authorities has been improved and strengthened in order to deal with some of the shortcomings of self-regulation.

More specifically, the job of monitoring JICPA's "quality control audit" is now that of the CPA and Auditing Oversight Board.[3] Also, whereas in the past unannounced inspections of certified public accountants by the authorities could only be carried out if there appeared to be grounds for taking disciplinary action, an unannounced inspection of an audit corporation's audit certification operations can now be carried out, even if there are no grounds for taking disciplinary action, provided the authorities believe that this is necessary or appropriate in order to safeguard the interests of the public or of investors.

There are, however, those who argue strongly that, given the situation in which audit corporations in Japan have to operate, it would be mistaken to simply copy the

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[3] Formerly the Certified Public Accountants Investigation and Examination Board, the function of the organization, which is one of the councils set up by the Financial Services Agency, is to take disciplinary action against certified public accountants where necessary, inspect audit corporations and organize accountancy examinations.

US system.[4] In the United States, as the Enron scandal showed, there have been many cases where audit corporations have benefited financially by using their expertise to help client companies embellish their accounts. In Japan, on the other hand, the fact that audit corporations are in a weak position and therefore vulnerable to pressure from client companies is more of a problem than this sort of collusion. This vulnerability manifests itself, for example, in the fact that audit corporations in Japan tend to be badly paid and are therefore unable to spend enough time on an audit. This is one aspect of the problem of independence that the amended law can hardly be said to have fully addressed.

To begin with, it is only now that the duties and responsibilities of certified public accountants have been laid down in the Certified Public Accountants Law. Moreover, the new law encountered considerable criticism and cynicism in the Diet because the ruling coalition insisted that the words "fair and proper conduct of business" be inserted before the words "protection of investors" ("…seek to ensure the fair and proper conduct of business and the protection of investors") in the section defining the duties of accountants, suggesting, perhaps, that the law was for the benefit of companies rather than investors and that advising clients on how to run their businesses (rather than simply certifying their accounts) was, perhaps, one of an accountant's responsibilities. If anything, the new legislation highlighted just how little consensus there is in Japan on the role of accountants.

3) Reform of corporate governance in Japan and the United States

The stance of the Sarbanes-Oxley Act is that simply imposing stricter regulations on audit corporations will not guarantee their independence. What the Enron scandal demonstrated was that audit committees had failed to perform one of their most important functions—that of monitoring companies on behalf of shareholders to see whether their relations with their auditors were acceptable. Hence the realization that audit committees had to be as independent and professional as possible.

More specifically, the SEC rules adopted in April of this year require not only that all the members of an audit committee be independent, but also that the committee be responsible for appointing audit corporations, deciding their remuneration and supervising them. Similarly, they require the committee to be aware of any issues relating to accounting and auditing within the company.

In response, the New York Stock Exchange, the Nasdaq and other exchanges are revising their listing rules with the aim of producing new rules by the end of this year.

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[4] The issue in question is raised by Kenjiro Kudo in "Konin Kaikeishi Kansa Seido no Kaikaku to Kongo no Kadai" [Reform of Japan's Auditing System and Issues Outstanding], Kigyo Kaikei [Corporate Accounting], Vol. 55 No. 4, 2003.

When the new rules are adopted, any companies that fail to comply with them will be delisted.

In addition, Section 407 of the Act requires companies to state whether they have any financial professionals on their audit committee. In response, the SEC adopted a new rule in January of this year requiring companies to state the number and names of those financial professionals and declare that they are fully independent of senior management.

Japan has also seen a major revision of its Commercial Code (in 2002, with effect from April of this year), and corporate governance in Japan has undergone a major change. More specifically, large companies now have the option of setting up a committee system, consisting of an audit committee, a nomination committee and a remuneration committee. However, unlike the United States, there are no plans to require all the members of the audit committee to be outside directors. Although this option was chosen because of its similarity to the US system of corporate governance, Japan is finally embracing this approach at a time when the US system is in the process of becoming even more rigorous.

Following the injection of taxpayers' money, Resona Bank has accepted the will of the state (as one of its largest shareholders) and agreed to set up a committee system, thereby demonstrating its recognition of the importance of the governance issue in its existing operations and its desire to adopt a radically new approach to the problem.

However, simply setting up an audit committee is not enough—as the situation in the United States goes to show. Nor does it follow that a company with a committee system is better governed than one with a corporate auditor. The corporate auditor system has also undergone changes designed to enable corporate auditors to remain in post longer and to give them greater independence and authority.

The adoption of the committee system and the improvements to the corporate auditor system are a milestone in the history of corporate governance in Japan. However, one of the lessons from the Enron scandal is that, in order to ensure that the system achieves its aims, a more elaborate system is required. Moreover, the system will need to be operated effectively and not simply as a formality.

Finally, in addition to these organizational improvements, investors will also have to commit themselves to corporate governance if the system is to evolve. Here the growing number of investors prepared to exercise their voting rights and make proposals as shareholders is an encouraging sign for Japan's capital markets.

4) Internal controls

If corporate malpractices are to be minimized, it is not enough simply for shareholders and their representatives to exercise more rigorous governance over senior managers. A proper system whereby senior managers can exercise control over the company (i.e., an internal control system) is also needed. The Sarbanes-Oxley Act also calls for such a system in order to restore confidence in financial reporting.

More specifically, US companies are now required to include a report from their chief executive officer on their internal controls for financial reporting. The relevant SEC rule was adopted in May of this year.

In the United States, the Treadway Commission was originally set up to deal with the spate of illegal corporate payments and fraudulent financial reporting that occurred in the 1970s, the most notorious of which was the Watergate scandal. In 1992 the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published a report (the "COSO Report") entitled "Internal Control—Integrated Framework." It proposed a framework of internal control to improve not only the reliability of financial reports but also compliance and operational efficiency. The significance of the Sarbanes-Oxley Act is that it is an attempt to institutionalize the efforts to establish such a framework.

In Japan, the judgment of the Osaka District Court in the case against the rogue trader in Daiwa Bank's New York branch who lost the bank millions of dollars (September 2000) and the views of the Kobe District Court on Kobe Steel's granting of favors to *sokaiya* (gangsters who try to blackmail companies) (April 2002) made it clear that senior managers could be charged with failure to exercise their duty of care if they failed to set up proper internal control systems. These cases marked a turning point in corporate Japan's recognition of the need for such systems.

In January 2002, when the auditing standards for certified public accountants in Japan were revised, it was recognized that better internal control systems were needed (as had been recommended in the COSO Report) if auditing was to be done more effectively and efficiently.

In addition, following the amendments that were made to the Commercial Code in 2002, the boards of directors of companies that adopted the committee system were required to decide what action needed to be taken to enable the audit committee to carry out its duties. Companies were thereby compelled to adopt a system of internal

controls, and the decisions taken by boards of directors had to be disclosed in company reports.

As far as companies with a corporate auditor system are concerned, however, experts differ in their views about whether there is any requirement to set up a system of internal controls, supposedly reflecting the fact that there has never been a consensus in Japan about such systems.

Although the court's judgment about the case concerning Daiwa Bank's rogue trader may have marked a turning point in the adoption of internal control systems by Japanese companies, the fact that the bank that took over Daiwa Bank's business, Resona Bank, was itself the center of an even bigger scandal suggests that, whatever the institutional framework, acceptance of such controls within individual companies is still limited.

3. Accounting and Disclosure Reforms

The Enron scandal also threw up the problem of accounting standards and disclosure. More specifically, the problem of accounting standards involved stock options and special-purpose entities, while the problem of disclosure involved the use of pro forma earnings figures. This section deals with the efforts that have been made in the United States to solve these problems and with the lessons that Japan can perhaps learn from this.

1) Stock options

As was mentioned above, stock options are one of the main factors behind the corporate scandals in the United States. The first response to this has been to argue that companies should be required to treat stock options as an expense. More specifically, the Federal Accounting Standards Board (FASB) began to consider this in March of this year and is due to publish a draft proposal by the end of the year.

In SFAS 123, issued in 1995, the FASB encouraged companies to account for stock options at fair value. Following opposition, mainly from business, however, the FASB permitted companies to continue to use the intrinsic value method, which did not require them to treat stock options as an expense, provided they included in a footnote figures for their net profit and earnings per share (EPS) calculated on the assumption that they did value stock options at fair value. As a result, until recently most companies have failed to treat stock options as an expense.

Since the Enron scandal, however, a growing number of companies—either voluntarily or under pressure from investors—have bitten the bullet and decided to treat stock options as an expense.

Nor is whether to treat them as an expense the only issue concerning stock options. There are some who question whether they really act as an incentive. Now that the bull market in equities is over and has been followed by a bear market, especially in technology stocks, a growing number of people are casting doubt on the value of the system itself.

In response to the various issues surrounding stock options, the New York Stock Exchange, the Nasdaq and other exchanges submitted a proposal to the SEC that their listing rules should be amended to require companies to obtain permission from their shareholders for all stock options and other equity compensation plans. The proposal was approved in June of this year.

In this connection, Microsoft's announcement in July of this year that it would stop granting stock options probably marked a turning point in the use of stock option plans.

Stock option plans were generally introduced in Japan when the Commercial Code was amended in 1997. Since then, the number of companies adopting such plans has, if anything, increased—partly as a result of an amendment to the Commercial Code in 2001 that eased the rules governing who could be granted stock options, how many shares could be granted and when options could be exercised. Currently, more than 1,000 Japanese companies (or one third of those listed) have already adopted stock option plans.

Unlike the United States, however, where companies have been recommended to treat stock options as an expense since 1995, the debate about stock option accounting in Japan only started in June 2002. Indeed, the situation as regards stock options in Japan would appear to be rather like a boom at the very moment when there are growing moves in the United States to reform the present system.

2) Special-purpose entities

One of the problems that came to light in the Enron case was the fact that the company had made frequent use of special-purpose entities, which are not included in the consolidated accounts, in order to disguise both the actual debt it had incurred as a

result of its core, energy-related business activities and the low profit margins (or even losses) it had incurred as a result of its non-core investments.

In response to this, the FASB began an enquiry into the issue of special-purpose entities, which led to the publication of FASB Interpretation No. 46[5] in January of this year. This was where a new consolidation model based on the notion of "variable interests" rather than ownership of an entity's outstanding voting shares was devised. Variable interests are contractual interests that include loans, guarantees, leases, preference shares and residual claims on transferable assets rather than voting interests. The primary holders of such interests in special-purpose entities (referred to in the Interpretation as "variable interest entities") were required to consolidate them. The term "variable interest entities" covers a wide range of entities, including corporations, partnerships, limited liability companies, and trusts.

As far as special-purpose companies established under Japan's Special-Purpose Company Law, which came into effect in September 1998, are concerned, there are special provisions, and in many cases they are not required to be consolidated. Also, the fact that special-purpose companies are a relatively new phenomenon in Japan means that they tend to be managed carefully. As a result, there have been no cases of abuse so far. However, there is no way of knowing the true state of affairs in structured finance entities not covered by the Law (e.g., partnerships, trusts and special-purpose companies registered in another country).

Also, there have been a number of cases in Japan of companies that have used their connections with affiliates and allies either to conceal their true financial condition or to book bad debts and losses elsewhere.

All this indicates that improvements will be needed in the way special-purpose companies and affiliates are consolidated in Japan.

3) Pro forma earnings figures

In the United States many companies have claimed that so-called pro forma earnings figures, which exclude one-off items such as restructuring costs and revaluation losses, make it easier for investors to compare their performance with that of previous years and give a truer picture of their profitability. Similarly, many investors have based their investment decisions on these figures.

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5 FASB Interpretation No.46, Consolidation of Variable Interest Entities—An Interpretation of ARB No.51, January 2003.

The problem, however, has been that some senior managers have taken advantage of this practice by announcing pro forma earnings figures that have been inflated by excluding as many unflattering figures as possible as "one-off items." This has then boosted the company's share price. In the case of Enron, it was the fact that the company announced a pro forma profit and claimed that it was doing well when, in fact, it had made a loss that added fresh fuel to the reform debate when the company finally collapsed.

In response to this, in January of this year, the SEC adopted Regulation G, which made it illegal for companies to announce non-GAAP figures that might give a false picture of their earnings. Also, if companies did announce non-GAAP figures, they were required to report details of expenses and any other excluded items in order to explain the differences between their own figures and those that would have been reported had they used standard accounting principles.

In Japan there is nothing comparable to pro forma earnings figures. However, in recent years there have been many companies that have commented that they have been hampered by their non-core operations—partly because they may have had to face increasing restructuring costs or extraordinary losses as a result, for example, of large revaluation losses on their equity portfolios or write-downs on impairments or pension costs. However, in the case of most listed Japanese companies, such losses have been squeezing profits from their core operations for several years in succession and should therefore be regarded as a serious reflection of the state of corporate Japan rather than as an aberration.

However, the debate that developed in connection with this issue of extraordinary losses was one about such things as allowing Japanese companies to choose whether to value their securities portfolios at market and postponing the introduction of impairment accounting for fixed assets—something that had already been decided.

Unlike the United States, where the Congress was arraigning companies that tried to conceal their true state of affairs from investors and the ground was being laid for the SEC to introduce new regulations, in Japan some politicians were doing their best to bend accounting rules to ensure that the true state of affairs of some companies and financial institutions did not come to light. Furthermore, such efforts were also supported by representatives of some leading Japanese companies and business organizations.

The fact that Japanese politicians and businessmen have been making investors, who are already distrustful and becoming increasingly critical of Japanese corporate accounting practices, even more distrustful shows just how regressive Japan is as far

as accounting issues are concerned. The fact that the Accounting Standards Board of Japan (ASBJ) decided, in the face of political pressure, not to give companies the option of choosing whether or not to value their securities holdings at market and to continue its discussions on whether to postpone the introduction of impairment accounting for fixed assets deserves the highest praise for showing the good judgment one would expect of a group of experts and for succeeding in retaining the confidence of investors.

4. Need for Japanese Politicians and Civil Servants to Recognize the Importance of the Market Function

This report has looked at the progress that has been made in US corporate reform in the 12 months since the Sarbanes-Oxley Act was passed and compared this with some of the related issues that have still to be resolved in Japan.

Given the institutional, legal, social and cultural differences between the two countries, it is only natural that differences of approach should also arise. Nor is the Act free of shortcomings, as has already been acknowledged.[6]

Nevertheless, there is no question that, like the United States, Japan should carry out the reforms needed to ensure that investors receive proper information and a fair share of cash flow. As this report has shown, however, this reform process has, in many ways, barely begun.

Perhaps because they have traditionally relied on private-treaty finance from banks or on the support afforded by cross-shareholdings, Japanese companies have failed to take due account of investors and the capital markets or to carry out the radical reforms needed to overcome their distrust—even in the wake of a spate of corporate scandals.

However, now that banks can no longer be relied on to provide a secure source of capital or to be stable shareholders, Japanese companies find themselves having to face their shareholders head on and to be honest with them to an unprecedented extent. Similarly, the important role that non-Japanese investors now play in Japan's capital markets means that it is becoming increasingly unrealistic for Japanese companies to expect to be able to use their "Japanese-ness" as an excuse for everything.

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6 Compare, for example, "Sarbanes and Oxley agree to disagree on Bill's Impact," Wall Street Journal, July 24, 2003.

It is clear from US experience of corporate reform what will have to happen in Japan if investor confidence is to be restored: politicians and civil servants will have to recognize the importance of the market function and commit themselves to reform.

In the United States, the President, the Congress, the SEC and the judiciary authorities in states such as New York all vied with each other to expedite the reform process. In Japan, on the other hand, it would appear that the priority has been to maintain an illusion of stability in the stock market and banking system, while efforts to restore investor confidence in companies and markets have been half-hearted. Indeed, the Resona Bank affair served only to fuel concern that the authorities were still intervening to conceal the true financial position of one of the country's leading banks.

If, as they claim, Japan's financial authorities really want to revitalize the country's securities markets and foster a fair and effective form of market-based finance rather than just conceal some of the problems facing the banking system, they should make their commitment to restoring confidence in the accounting system clear.