Corporate Fraud in Japan

Corporate Fraud in Japan:

Risk Management and Governance

By

Takashi Yasuoka

Cambridge Scholars Publishing

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FOREWORD

YB DR. MASZLEE BIN MALIK

MINISTER OF EDUCATION, MALAYSIA

I recall the moments of my talk to a group of Malaysian students in Tokyo, Japan during the Golden Weeks of 2002. In the discourse, my advice to these "young hearts" was to strive for the pinnacle of academic excellence whilst not neglecting the importance of mingling with locals and assimilating the positive features of the Japanese culture, spirit of competitiveness and nation-building. As the privileged few who were fortunate enough to study abroad, it was also their duty to bring home enabling value systems as well as the varsity scroll. Where better than Japan, an exemplar in rising from the ashes following Hiroshima and Nagasaki to developed-nation status and a global superpower—largely due to enormous amounts of best practice, discipline and *kaizen*.

It is indeed a pleasant surprise that those very "students" have come back to me recently. This time around, it is to write a foreword on this superb piece of work entitled *Corporate Fraud in Japan: Risk Management and Corporate Governance*, a Japanese-to-English translation project with their sensei, Professor Takashi Yasuoka of the Shibaura Institute of Technology.

Alhamdulillah, my advice had yielded fruition 15 years later in no better a time than in Malaysia Baru, which further emphasizes and revisits the "Look East Policy" initiated by our current prime minister, Tun Dr. Mahathir Mohamad, back in 1981.

The book is unique since the contents highlight the lessons learned from the fraud cases of Japan's big corporations, such as Toshiba, Olympus and Mitsubishi, presenting invaluable knowledge and inputs for readers worldwide about business management, risk management and corporate governance. Malaysians are constantly reminded of the dire consequences—to taxpayers' pockets—of money laundering and serious governance issues. Academic-wise, I have a keen interest in governance and have had a fair chance to publish a few books on the subject; namely from the perspectives of religion.

Last but not least, I hope this constructive collaboration between a professor and students of two different countries will further foster and enhance bilateral ties between Japan and Malaysia. I also hope and pray that readers find this work beneficial.

EDUCATION IS HAPPINESS, LOVE AND MUTUAL RESPECT

YB Dr. Maszlee Bin Malik

PREFACE

In recent years, numerous incidents of corporate fraud have been reported in Japan, with many of these incidents occurring at world-famous Japanese companies, including Toshiba, Olympus, Kobe Steel, Nissan and Toyo Rubber. Needless to say, risk management systems were already incorporated into these companies. The question is why the risk management systems did not function there. The risk management system might be only a formality in these corporations.

On this issue, I published a book in Japanese for businesspeople, entitled *Study of Corporate Fraud*.[1] This book introduces how enterprise risk management should be. For case studies, the book investigates eight scandals from 2011 to 2017 based on the reports of third-party investigations of the incidents, and it studies the causes and measures for preventing the recurrence of these types of fraud from the viewpoint of risk management.

These observations are also valuable for readers worldwide who study business management, risk management and corporate governance. However, these companies published their investigation reports in Japanese. People worldwide, including investors and stakeholders, cannot easily understand the content of these reports or the details of the incidents of fraud.

For this reason, this book is written as a new English-language book based on the previous Japanese book. For this English book, I have revised the Japanese text for readers in Western countries by:

(1) providing additional explanation of the management style and its associated problems in Japanese corporations
(2) revising the book to take an academic perspective
(3) changing the chapter structure of the book to facilitate the objectives above

Accordingly, this book will allow these readers to know what happened, and it will show weaknesses in corporate governance and

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[1] Takashi Yasuoka, *Study of Corporate Fraud*, [in Japanese], Tokyo: Nikkei BP, 2018.

internal control in Japanese corporations.

Finally, it should be noted that the Japanese manuscript for this book—specifically Chapters 2 to 9—was translated into English by eight Malaysian collaborators. They all were students staying in Japan who graduated from Japanese universities. We call this work “Project MJ”. It is my pleasure to publish this book to the world within the friendly relation between Malaysia and Japan.

Takashi Yasuoka
Tokyo
October 2018

List of Contributors

Takashi Yasuoka: Original author and translation supervisor.

He has been a Professor in the Graduate School of Engineering Management at the Shibaura Institute of Technology (Japan) since 2009. He is working in the field of financial engineering and risk management.

He is the author of *Study of Corporate Fraud* (Nikkei BP, 2018, in Japanese), *Interest Rate Modeling for Risk Management: Market Price of Interest Rate Risk* (Bentham Science, 2018) and several other books.

From 1986–2009, he worked at the Mizuho Information & Research Institute.

He holds a B.S. in Mathematics from Osaka University, an M.S. in Mathematics from Kobe University and a Ph.D. in Mathematical Science from Kyushu University.

Alirnus Che Mat: Translator of Chapter 2

He is a General Manager at Standard Energy Solutions Sdn Bhd (Malaysia). He has 12 years' experience in Project Management and Design Engineering for Engineering, Procurement, Construction, Installation and Commissioning (EPCIC) projects for oil and gas facilities and marine and infrastructure works.

He holds a B.Eng. in Mechanical System Engineering from Takushoku University. He was one of the JSME Hatakeyama Award recipients nominated by Takushoku University for the year 2005 batch.

Azizul Helmi B. Sofian: Translator of Chapter 3

He has been a Senior Lecturer at the Universiti (Malaysia) Pahang since 2014. He worked at Polymatech Co. Ltd. from 2008 to 2011 and at Sunaga Polymer from 2007 to 2008.

He holds a B.S. in Materials Science Engineering from Gunma University, an M.S. in Materials Science Engineering from Gunma University and a Ph.D. in Regional Environment Systems from the Shibaura Institute of Technology.

Muhammad Zulfahmi Bin Samsudin: Translator of Chapter 4

He has been a Mechanical Engineering Lecturer for the Malaysia Japan Higher Education Program under Yayasan Pelajaran MARA since 2012. He also became an AutoCAD instructor at Mirai Techno Enterprise in 2015.

Before being a lecturer, he worked as a Steam Turbine Design Engineer at Fuji Electric Co. Ltd. in the Kawasaki Factory in Kanagawa, Japan during the period of 2008 to 2012.

He has a first degree and Master in Mechanical Engineering from Waseda University, Tokyo, Japan.

Muhammad Zaimi Bin Zainal Abidin: Translator of Chapter 5

He has been a Senior Lecturer in the Faculty of Manufacturing Engineering at Universiti Teknikal Malaysia Melaka (UTeM) since 2013. He worked at the PETRONAS Refinery from 2015 to 2016 and Showa Denko HD (Malaysia) in 2006.

He has a Bachelor in Advanced Materials Engineering from Yamaguchi University, a Master of Engineering in Materials Science and Engineering from the Shibaura Institute of Technology and a Ph.D. in Regional Environment Systems from the Shibaura Institute of Technology.

His recent publications include (with Kok-Tee Lau and Cheng-Guan Ong) “Investigation of Lead-free Solder Strength on Different Nickel Phosphorous-plated Nickel’s Roughness,” *International Journal of Applied Engineering Research* (2018).

Halim Bin Ghafar: Translator of Chapter 6

Halim Bin Ghafar is a Lecturer at Universiti Teknologi MARA (Malaysia). His work experience includes roles at Nissan Shatai Co. (Japan), Toyota Autobody (Malaysia) and the Malaysian Institute of Road Safety Research (MIROS).

He holds a Bachelor in Mechanical Engineering from Keio University and a Master of Science in Mechanical Engineering from UiTM Shah Alam. His recent publications include “The Influence of Oxygen in the Carbonization of Oil Palm Shell on Bio-Char Yield and Properties,” *Applied Mechanics and Materials* (2013).

Muhammad Ibrohim B. Mazalan: Translator of Chapter 7

He has been a Manager at Koperasi Ummah Sejahtera Pahang Berhad (Malaysia) since 2016. He was a Lecturer at IKIP International College in 2015. He worked at the Islamic Center (Japan) from 2013 to 2014 and at JGC Plant Solutions Co. Ltd. from 2009 to 2012.

He holds a Bachelor Degree in Mechanical Information Engineering from Meiji University (Japan).

Nasrul Hakim bin Ghazali: Translator of Chapter 8

Nasrul Hakim bin Ghazali is currently a Senior Assistant Director for the Public Service Department of Malaysia.

He was previously a Senior Assistant Secretary in the Ministry of Science, Technology and Innovation (Malaysia), an Engineer in NEC Semiconductors and a Research Engineer in Telekom Malaysia (TM).

He holds a Bachelor Degree in Electrical & Electronic Engineering from Tokyo University of Agriculture and Technology, and a Master's Degree in Management of Technology (Professional) from the Shibaura Institute of Technology.

Muhammad Yassir Bin Salehuddin: Translator of Chapter 9

Muhammad Yassir is currently a General Manager at CRI Sdn Bhd, and he was formerly a manager at GTI Sdn Bhd, Malaysia. He was also a Product Design Engineer at Sony Corporation, Japan.

He holds a Bachelor Degree in Electrical & Electronic System Engineering from Saitama University, and a Master's Degree in the same field.

ACKNOWLEDGMENTS

A preliminary version of this book called *Study of Corporate Fraud*, in Japanese, was published by Nikkei BP. I am very grateful to Nikkei BP, who allowed me to translate the original book into an English version.

In order to write this English book, eight collaborators were compiled by Mr. Nasrul Hakim bin Ghazali while he was a graduate student at the Shibaura Institute of Technology, Tokyo. It is due to their cooperation and translation to English that I could make this English book.

Additionally, I am grateful to many graduate students of the university, with whom I could practically discuss and study the actual cases of corporate fraud.

Conflict of Interest

The author declares no conflict of interest, financial or otherwise.

INTRODUCTION

This book introduces recent incidents of Japanese corporate fraud from 2011 to 2017 and investigates the reports of third-party investigations of the incidents. Specifically, we investigate the causes of fraud from the viewpoint of risk management and examine the effectiveness of measures to prevent recurrence. For this study, we work with the Three Lines of Defense model. This analysis also shows weaknesses in corporate governance and internal control in Japanese corporations.

This book is composed of 10 chapters. Chapter 1 summarizes the state of corporate governance and risk management needed for analyzing incidents of fraud in Japanese corporations. Chapter 2 studies the data falsification scandal of Toyo Tire & Rubber, and Chapter 3 studies misrepresentation at the Fukumusume Sake Brewery.

Chapter 4 deals with the data fabrication scandal of Kobe Steel. When I was writing the manuscript for the Japanese-version book, Kobe Steel had not yet published the investment report. After reading the investment report, which was published in March 2018, I drastically revised the content of the previous manuscript for this book.

Chapter 5 studies falsified inspection records at JXTG Energy's Mizushima Refinery. Chapter 6 studies fabricated fuel efficiency data at Mitsubishi Motors. Chapter 7 studies circular transactions at Tsubakimoto Kogyo. Chapter 8 studies accounting fraud at Olympus, and Chapter 9 studies the accounting scandal at Toshiba.

Finally, Chapter 10 summarizes these incidents from the viewpoint of the Three Lines of Defense model.

The author hopes that this book will allow readers worldwide to know what happened at Japanese enterprises and to make use of this study for enterprise risk management.

CHAPTER ONE

CORPORATE GOVERNANCE AND RISK MANAGEMENT IN JAPAN

This chapter summarizes the state of corporate governance and risk management needed for analyzing incidents of fraud in Japanese corporations. First, it explains risk management as carried out under Japan's Corporate Governance Code. Next, it touches upon corporate risk management from the perspective of preventing corporate fraud. Finally, it explains the limitations of risk management in protecting against corporate fraud.

1.1 Japanese companies' corporate governance

Japan's Corporate Governance Code

An appendix to the Tokyo Stock Exchange's listing rules sets out Japan's Corporate Governance Code, which has been in force since June 2015. We provide an overview using extracts from the English version (Japan's Corporate Governance Code 2018).

> In this code, "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.

Next, Japan's Corporate Governance Code discusses five general principles for listed companies as follows:

General Principle 1. Securing the Rights and Equal Treatment of Shareholders
General Principle 2. Appropriate Cooperation with Stakeholders Other Than Shareholders
General Principle 3. Ensuring Appropriate Information Disclosure and Transparency
General Principle 4. Responsibilities of the Board
General Principle 5. Dialogue with Shareholders

General Principle 1 and General Principle 2 are related to risk management, as explained below.

General Principle 1.
Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively.

General Principle 2.
Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought about as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities.

The thinking behind these principles is in line with basic risk management.

Furthermore, among the responsibilities of the Board of Directors (BOD) (shown below), are six points—principles regarding risk management and corporate fraud—as shown below.

Principle 2.5 Whistle-blowing
Companies should establish an appropriate framework for whistle-blowing such that employees can report illegal or inappropriate behavior, disclosures, or any other serious concerns without fear of suffering from disadvantageous treatment.

Principle 3.2 External Auditors
3.2.1 The *kansayaku* [auditor] board should, at minimum, ensure the following:
i) Establish standards for the appropriate selection of external auditor candidates and proper evaluation of external auditors; and
ii) Verify whether external auditors possess necessary independence and expertise to fulfill their responsibilities.

Principle 4.1 Roles and Responsibilities of the Board (1)
The board should view the establishment of corporate goals (business principles, etc.) and the setting of strategic direction as one major aspect of its roles and responsibilities.

Principle 4.3 Roles and Responsibilities of the Board (3)
The board should engage in oversight activities in order to ensure timely and accurate information disclosure, and should establish appropriate internal control and risk management systems.

Principle 4.4 Roles and Responsibilities of *Kansayaku* and the *Kansayaku* Board
Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of *kansayaku* and the *kansayaku* board, in order to fully perform their duties, it would not be appropriate for *kansayaku* and the *kansayaku* board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management.

Principle 4.8 Effective Use of Independent Directors
Companies should therefore appoint at least two independent directors that sufficiently have such qualities.

Japan's Corporate Governance Code is self-regulation without legally binding force, so listed companies are not required to follow it. However, they must explain their reasoning when they choose not to follow it (Comply or Explain).

Corporate governance and organizational design

Japanese companies employ various organizational design formats (governance formats). Japan's Companies Act (2005) provides for the following three types of large listed companies (stock companies that have had a public offering of shares and have at least JPY 500 million or total liabilities of at least JPY 20 billion). The explanation focuses mainly on the function of auditors (committee members).

(1) Board of directors + board of auditors + accounting auditors = (Company with a Board of Directors)

This type is called a Company with a Board of Directors, and it has auditors. Due to differences between this type and types 2) and 3), it is also known as a Company with a Board of Auditors. At least half of the auditors must be outside auditors (Article 335 of Japan's Companies Act).

The auditors monitor the directors and investigate the business and company finances themselves. They do not have the authority to use members of the Internal Audit Department to conduct investigations, so there is a limit to the work they can do. The Company with a Board of Auditors company type is peculiar to Japan, and it has a number of problems.

(2) Board of directors + three committees (nominating, audit and compensation) + accounting auditors = (Company with Committees)

This is called a Company with Committees, and it follows a US-style governance model. In this case, there is no Board of Auditors, but there is instead an Audit Committee. The Audit Committee is within the BOD, and the members monitor directors and executive officers. Because directors serve on the Audit Committee, they can instruct members of the Internal Audit Department to carry out investigations. Due to this fact, Audit Committee members have more authority than auditors.

To ensure effective oversight by the Audit Committee, Japan's Companies Act (Article 400) places restrictions on this format, including the stipulation that the majority of Audit Committee members must be outside directors. In this sense, this scheme is more effective in management oversight than the use of traditional auditors, and overseas investors appear to view this format favorably.

Toshiba adopted this organizational format long ago, but the management team was still involved in an instance of major corporate accounting fraud. This was due to issues with the appropriateness of the outside directors and the selection of personnel for the Audit Committee. The key to an effective governance structure lies in the authority of the Nominating Committee and the makeup of the Audit Committee.

(3) Board of directors + Audit Committee + accounting auditor = (Company with Audit and Supervisory Committees)

This format fits between (1) and (2), and it is known as a Company with Audit and Supervisory Committees. In this format, as in (2), the Audit Committee is within the BOD, and directors serve as Audit Committee members. Under this format, supervision by Audit Committee members looks promising. However, Kobe Steel employed this format and was still involved in a major quality-related fraud. Even when a governance format is employed, it may be difficult for it to function well.

Japanese corporate governance formats

Table 1.1 shows the number of companies listed on the First Section of the Tokyo Stock Exchange grouped by organizational format, as well as representative examples of each. This shows that 75% of companies employ the Company with a Board of Auditors format peculiar to Japan.

Table 1.1 Companies listed on TSE First Section by governance format

Source: eol,[2] 2017

	Company with a Board of Auditors	Company with Audit and Supervisory Committees	Company with Committees
Number of companies	1548	453	65
Share (%)	75	22	3
Notable companies	KDDI, Kyocera, JAL, Fuji Film HD, Shin Etsu Chemical, Komatsu, Ricoh, Subaru, SoftBank, Seven & I HD, Panasonic, Kao, JR West, Fujitsu, Suzuki Motors, Isuzu Motors	Takeda Pharmaceutical, Murata Mfg., Seiko Epson, Honda Motor, Cosmo Energy HD	Lixil Group, Mitsubishi Chemical HD, Mitsubishi Estate, Sony, Kobe Steel, Hitachi, Toshiba, Mitsubishi Electric

Japanese corporate employment formats and directors

From the year 2000 onward, Japanese companies restructured as they globalized, and lifetime employment is no longer guaranteed. This change has resulted in increased diversity of employment formats and an increase in fixed-term contracts. However, workers are almost never fired once they have been hired as regular employees. The proportion of persons switching companies has increased since 2000, but lifetime employment is still a basic format.

Employees are promoted to managerial positions, outstanding managers become executive officers, and selected individuals move up to become directors. As a result, the bulk of the management team is made up of employees from within the company.

Also, to gain promotions, employees have to be rated highly by their superiors. To become a director, they need to be looked upon favorably by

[2] eol is a corporate information database developed by Pronexus inc. in Japan.

other directors or by the company president. The president can build the management team with a coalition of internally promoted yes-men.

This is the background to the Japanese corporate management style. As a result, one issue is that management tends to become closed and opaque. Under Principle 4.8 of Japan's Corporate Governance Code, there should be at least two outside directors as a rule, but many companies have one or even none.

Table 1.2 shows the number of directors for 2,050 Tokyo Stock Exchange First Section listed companies in 2017. There is an average of 9.3 directors (2.4 independent) per company. Of all included companies, 229, or over 10% of the total, have fewer than two independent outside directors. These data also show that promoting directors from within is a common pattern.

Table 1.2 Number of directors at 2,050 TSE1 listed companies

Source: eol, 2017

Number of directors	Number of companies
3–4	20
5–6	288
7–8	579
9–10	599
11–12	308
13+	256
Average	9.3

Number of independent outside directors	Number of companies
0	14
1	215
2	1184
3	434
4+	201
N/A	2
Average	2.4

1.2 Japanese corporate risk management and corporate fraud

Under Japan's Companies Act, internal control (including risk management) is the exclusive responsibility of the BOD (Japan's Companies Act: Article 362, among others). Large companies (defined as those with capital of at least JPY 500 million or total liabilities of at least JPY 20 billion), in particular, must exercise internal control. This is hard to interpret for those not familiar with the law, but for the sake of simplicity we assume the board is responsible for preparing risk management and internal control measures.

Enterprise risk management

Enterprise risk management (ERM) refers to corporate risk management. However, this does not entail individual divisions managing their own risks. Instead, it involves integrated strategic risk management across the whole company.

Among ERM frameworks, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the United States is well-known. International risk management guidelines (ISO31000) were established along these lines. Almost all Japanese companies are believed to have risk management structures that comply with ISO31000.

The ISO31000 standard was translated and became part of Japan's Industrial Standards as JISQ31000. Although JIS rules are called "standards", JISQ31000 is not legally binding.

Internal control and compliance

Internal control refers to regulations and other arrangements which make internal monitoring systems and financial reporting reliable. In other words, it is explained as arrangements that enable risk management to function.

The mere presence of a Risk Management Department (or Committee) is not sufficient for risk management. Internal regulations or the internal organizational structure shown in Figure 1.1 enable risk control.

In addition to having structures and regulations, it is important that a company abides by laws and regulations and that each individual employee obeys laws and rules (compliance). In this sense, it is said that "risk management functions with internal control and compliance in tandem".

Risk management and independence between departments

For the sake of simplicity, we consider the case of a Company with a Board of Auditors in Sections 1.2 and 1.3. If we replace "auditors" with "audit committee," the situation is basically the same, except for the differences mentioned in the previous section.

For the of sake convenience, Figure 1.1 shows the organizational structure of a company (specifically, a manufacturer). Let us describe the thinking behind the risk management structure in this case. First, the BOD decides on risk management policies. For a Company with a Board of

Auditors, the auditors are in a position to supervise the BOD. For the case in Figure 1.1, there is no Risk Management Department, and the Risk Management Committee is placed below the BOD, which is responsible for overall company-wide risk management.

The departments inside the box bordered by the dotted line are responsible for conducting company business and are known as Operating Departments. The Internal Audit Department is independent from the Operating Department. It is responsible for carrying out risk management under the direct control of the president, and it checks on the Operating Department's risk management. The Internal Audit Department is also independent from the auditors. It is important to note that this point differentiates a Company with Auditors from a Company with an Audit Committee.

In the Olympus incident, the directors involved in the fraud were in charge of the Internal Audit Department. In this situation, internal audit does not work.

When the Internal Audit Department is made up of members originally from a certain division, checks of that division become looser. To prevent this, it is better to have the department made up of members from various departments and to conduct regular personnel rotations.

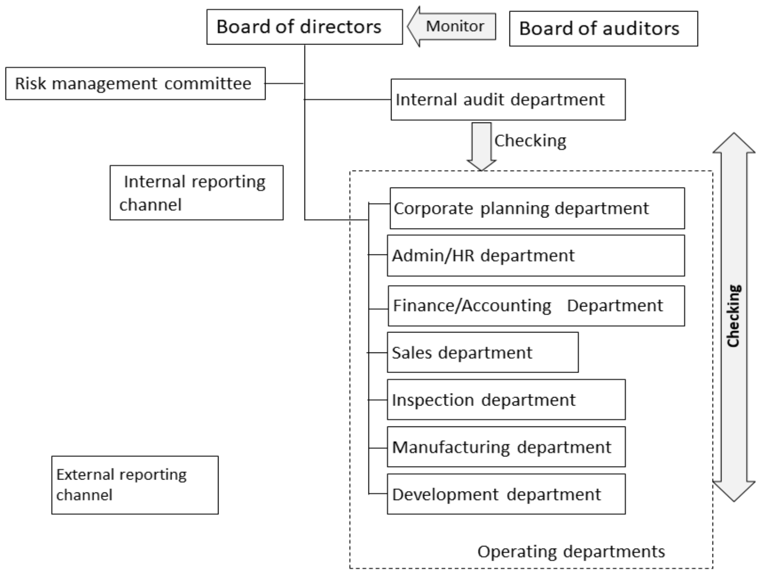

Figure 1.1 Internal organizations for risk management

It is important that departments be both independent of each other and able to check on each other. For example, the Inspection Department must conduct quality inspections from a position independent of the Development and Manufacturing Departments. It is also necessary to ensure that mistakes made or fraud committed by members of one department do not continue, the chance of which can be reduced by regular personnel rotation between departments and divisions.

In the examples in this book, quality issues and fraud occurred because these fundamentals were not in place. In such cases, the Development Department may only be able to produce substandard products due to lack of technological capability, or it may be unable to develop technology by the scheduled date. In some cases of fraud, the Sales Department may conspire with the Inspection and Manufacturing Departments to sign off on defective products in order to win orders. It is vital to ensure independence for each department and clearly apportion authority and responsibility to prevent such incidents.

Three lines of defense

When checking a company's internal control and risk management structures, one way of thinking employs the "Three Lines of Defense model". In simple terms, this is three-step risk management as follows:

(1) Risk management in the workplace
(2) Risk management in the Finance Department, Risk Management Department, Inspection Department, and similar
(3) Risk management by the Internal Audit Department

This way of thinking applies to a company with an Audit Committee, but it may also be applied to a Company with a Board of Auditors.

First defense line

The first defense line refers to risk management in the workplace. For example, the ordering system employed by a company can be thought of as a mechanism to prevent the Sales Department from placing fraudulent orders. Schemes to enforce safety checks on a construction site or factory are first defense lines. Product inspections carried out by the person in charge in the Manufacturing Department and checks from those in charge of software development are also first defense lines. I also think that, in many cases, internal regulations are part of the first defense line.

Second defense line

The second defense line carries out risk management from a position independent of the workplace. Financial institutions have what are called Risk Management Departments, but it is common for ordinary companies not to have one; this role is instead carried out by an Inspection Department or Quality Control Department.

For example, the quality and performance of a product made in a factory is typically investigated by an Inspection Department independent from the Manufacturing Department. However, in reality, this is sometimes not the case. In the Toyo Rubber incident described in this book, the Manufacturing Department was more powerful than the Inspection Department, and the inability of the Inspection Department to carry out independent inspections was said to be a major factor in the fraud.

The difference between the first and second lines of defense is whether business risk is involved. For example, the Manufacturing Department takes business risk with respect to its products' quality and performance as well as sales. The Inspection Department will not pass defective products in order to boost productivity. That is, the Inspection Department does not bear any business risk. However, when the Manufacturing and Inspection Departments are in the same business unit, both departments share the same earnings targets, and this erodes the independence of the Inspection Department. In this case, the Inspection Department is part of the first defense line.

Regarding accounting, the person who orders something to be procured and the person who does the actual purchasing (procurement) should be in different departments. This is because when the ordering department has authority to purchase and accept orders, it is easier for frauds such as fictitious orders to occur.

Third defense line

The third defense line can be considered the work of the Internal Audit Department. In some companies, this department is named the Business Audit Department. The differences between these departments and the Inspection Department and Risk Management Department depend on whether the department is part of the Operating Departments.

The Internal Audit Department is supposed to conduct audits of business processes—mainly those relating to contracts, as well as approvals and settlements. For companies like manufacturers, technology-heavy audits of manufacturing and inspection are not straightforward.