December 1, 2006

JCGR Corporate Governance Survey 2006
－Summary and Recommendations－

Japan Corporate Governance Research Institute (JCGR)
Corporate Governance Index Research Group

Takaaki Wakasugi (Tokyo University of Economics), Christina Ahmadjian (Hitotsubashi University)
Shusai Nagai (Ritsumeikan Asia Pacific University), Keiji Inoue (former, Kao Pension Fund)
Kazuo Fukui (Fujitsu Research Institute)
For questions regarding this survey, please contact: mailto:webmaster@JCGR.org

Outline of the Survey

The objective of corporate governance is to assure long-term corporate performance by establishing a system that makes management accountable for achieving corporate goals. A good corporate governance system leads to excellent corporate performance because it brings out superior management.

The framework of joint-stock company requires shareholders to take responsibility for the companies in the form of exercising their voting right. In the face of the business environment of the 21st century, with its intensifying global competition and rapid technological change, shareholders have made efforts to enhance the ability of the board of directors to monitor the management by electing independent directors at the shareholders' meeting in the past decade. Hence, a corporate governance system that separates execution by managers (management) and monitoring by the board of directors (governance) has been spreading around the world. Even in Japan, the Commercial Code was revised to allow firms beginning in April 2003 to either introduce a new corporate governance system, called the Board with Committees, or maintain the existing system of statutory corporate auditors. In May 2005, the Companies Act was newly established and took effect with the aim to strengthen corporate governance.

Since 2002, the Corporate Governance Index Group of the Japanese Corporate Governance Research Institute has conducted an annual survey of corporate governance of all firms listed on the First Section of the Tokyo Stock Exchange. This survey assesses how close a firm’s corporate governance adheres to this desirable state of separation between management and governance and reports the results for each firm in terms of the JCGIndex.

Between August and October 2006, we surveyed Tokyo Stock Exchange First Section Firms. While the number of the respondents had steadily increased before, it decreased to 312 firms (18.4% of the total) this year from 405 firms (24.6%) last year. Nonetheless, 70 firms responded to our survey for the first time, this year, reflecting a solid interest in corporate governance. This report covers 302 firms that had responded to the survey by the deadline (October 20). The results of our analyses of the relationship between the JCGIndex and performance were generally similar to results of previous years: high JCGIndex companies enjoy superior performance, as measured by higher ROA and ROE; however, unlike in the past results, low JCGIndex firms present higher return on common stock than high JCGIndex firms. This negative correlation is especially apparent this year.

We had assumed that analyzing the relationship between the past corporate performances and the present JCGIndex alone is sufficient. However, it turns out that several high JCGIndex firms have experienced poor performance; they started to reform the governance recently in the aftermath of the poor performance. For such companies, a negative correlation should be observed between the past performance and the JCGIndex. The existence of such high JCGIndex firms presumably has become apparent since last year. As we already expressed, corporate governance reform aims at improving future performance. Considering the fact that the corporate governance reform has just got started in Japan, that makes it reasonable to trace the relationship between the JCGIndex and performance after these firms start the governance reform. As of now, however, we are unable to conduct analysis from this perspective because the history of our survey is just four years and the size of the samples is too small. Now that we have five-year-data, we will be able to analyze the relationship between the JCGIndex and the future performance next time.

Anyway, the findings of the past JCGIndex surveys demonstrate that there is a positive correlation between the JCGIndex and corporate performance, implying that a corporate governance system that separates governance and management is the best model in today's business environment. We hope that the JCGIndex and the results of our analyses will be used by both investors and managers and will be useful in promoting continued corporate governance reform in Japan. We are very grateful to the companies that responded to this survey.

Since we started the survey, the environment surrounding the Japanese companies has been drastically changing: the new Companies Act, frequent takeover bids, etc. To address these changes, this time too, we modified questions, options, and proportions. Knowing that making changes every year is undesirable with regard to the survey's consistency, we strongly believe that handling with the perpetually changing environment is much more important. Therefore, a company's JCGIndex may increase or decrease by about 10 points. We would appreciate your understanding.

7 Important Results

1. Response rate indicates a continued increase in interest in corporate governance

From August to October 2006, the Japan Corporate Governance Research Institute surveyed all firms listed on the First Section of the Tokyo Stock Exchange (1,696 firms as of July 13, 2006), and received responses from 312 firms. Survey questions were based on the "JCGR Corporate Governance Principles." The JCGIndex is based on these questions.

This is the fifth consecutive year that we have carried out the survey. In 2002, we received responses from 159 firms. In 2003, 201 firms responded, 129 for the first time. In 2004, 341 firms responded, 189 for the first time. In 2005, 405 firms responded, 112 for the first time. In 2006, 70 firms responded for the first time. Over the past five years, we have received responses from 660 firms. This report analyses the results for 302 firms that had responded to the survey by the deadline of October 20.

2. Characteristics of the responding firms: Large firms with high performance

Firms that responded to the survey tended to be very large. The average size of assets, sales, and number of employees of responding firms (averaged over 2001-2005) was more than twice the size of the average listed firm. ROA of responding firms was 5.74%, compared to 5.45% for all listed firms: ROE was 5.03% versus 3.26%. Like in the previous year, however, the return on common stock for responding firms was slightly lower than all listed firms (12.72% versus 12.74%).

3. Distribution of the JCGIndex: Increased average score but wide range

This year, the average JCGIndex for the 302 responding firms is 47.3 (standard deviation 14.1), compared to an average of 48.0 (standard deviation 12.9) for last year. We believe that this decrease in average is due to the changes made in the questions and proportions this year and does not imply a worsening corporate governance in Japan.

Now that matters concerning takeover bids are discussed from the viewpoint of interest of shareholders, it is fair to say that the state of corporate governance in Japan continues to advance. However, 47.3 points is lower than one half of the total of 100 possible points, and from this it can be concluded that the state of corporate governance in most Japanese firms is far from the ideal state of our governance model.

The range between the highest and lowest JCGIndex firms is quite large, as in the previous years. This year, the highest JCGIndex was 92 and the lowest was 18. Last year, the highest JCGIndex was 86 and the lowest 12. The standard deviation increased to 14.1 from the previous 12.9.

4. Average points by category: Governance reform is unbalanced

The JCGIndex is the sum of the points in 4 separate categories (Cg1, Cg2, Cg3, Cg4). Categories Ⅰ and Ⅱ are related to corporate governance system, and Ⅲ and Ⅳ are about corporate management system.

The following table reports the average points in each category for the 302 responding firms. In Categories III and IV, firms on average achieved over 50% of all possible points. The achievement rates for Categories I and II were far lower. In particular, average points for Category II, the structure and function of board of directors, were particularly low, indicating that the separation of monitoring by the board of directors (governance) and execution by managers (management) has yet to spread widely.

For all of the four categories, the average points significantly changed from last year. We assume reasons of the changes to be as follows: The achievement rate for Category I fell from last year because changes in proportions were made to emphasize the difference between good governance and bad governance. The average for Category II increased because even companies adopting the system of statutory corporate auditors reinforced the function of monitoring the management by clarifying the nomination and compensation functions or accepting outside directors. The lower average point for Category III is due to the addition of questions on internal control and anti-takeover measures. The remarkable increase in the average of Category IV reflects the management's serious efforts to meet with the public demand for transparency.

These results suggest that in corporate governance reform, firms have focused on corporate restructuring, and have improved management systems and disclosure. In contrast, reform in the essence of governance, which is CEO accountability and board function, has not progressed as far.

Category	Mean/Total possible points	Achievement rate* (mean/total possible points)
I Corporate objectives and CEO responsibility	10.2/28	36.4% (42.9%)
II Structure and function of board of directors	8.7/25	34.8% (30.8%)
III Management system	15.1/27	55.9% (62.6%)
IV Transparency and communication with shareholders	13.3/20	66.5% (57.0%)

(Note) Results from last year's survey are in parentheses

5. Characteristics of high and low JCGIndex firms

To compare the characteristics of high and low JCGIndex firms and to examine the relationship between the JCGIndex and corporate performance, we constructed two groups: high and low JCGIndex firms. The high JCGIndex group consists of the 51 firms with a JCGIndex of 62 or more points (over one standard deviation above the mean) and the low JCGIndex group consists of the 54 firms with a JCGIndex of 33 or less (over one standard deviation below the mean).

(1) Characteristics of high and low JCGIndex firms: The percentage of foreign ownership is higher

The average percentage of shares held by foreigners in the high JCGIndex group is 30.3%, while the average for responding firms is 18.9%, and the average for low JCGIndex firms is even lower at 10.9%. Every year, our survey has illustrated that companies with good governance generally enjoy strong performance. It is not certain whether good governance defines high foreign ownership or vice versa.

There is no statistically significant difference in the average age of the CEO betwenn high JCGIndex firms (60.3) and low JCGIndex firms (60.0). In the previous survey, the average age for high JCGIndex firms was three years younger than the average for low JCGIndex firms.

(2) High JCGIndex firms are bigger

The total assets, sales, and number of employees are over 10 times greater in the high JCGIndex firms than the low JCGIndex firms.

(3) High JCGIndex firms are strong in all aspects of corporate governance

High JCGIndex firms have achieved high points in all four categories, indicating that a high JCGIndex cannot be achieved with high scores in only one or two categories. In Category I, high JCGIndex firms achieved on average 16.5 points (versus 5.4 points for low JCGIndex firms). In Category II, this was 16.4 versus 4.3, in Category III, 19.9 versus 10.0, and in Category IV, 17.6 versus 8.9. The JCGIndex captures the complete picture of a company's corporate governance capabilities and is not determined by single category.

6. JCGIndex and firm performance: A clear relationship

The objective of corporate governance is to assure excellent corporate performance. Is there really a relationship between corporate governance and corporate performance? In the 2006 JCGIndex survey, as well as in surveys for previous years, we found a close relationship between the two. However, just as last year, return on common stock was lower in the high JCGIndex firms than in the low JCGIndex firms.

(1) High JCGIndex firms enjoy superior performance on most dimensions

Based on 5-year averages, ROA (5.97% versus 5.63%) is higher in the high JCGIndex firms than in the low JCGIndex firms. However, this year, ROE (4.79% versus 5.48%) and return on common stock (10.42% versus 15.33%) were lower in the high JCGIndex firms than in the low JCGIndex firms. In the first three years, all of the three were higher in the high JCGIndex firms, but the trend has changed since last year.

This reversal can be attributable to the fact that several companies that reformed the governance in the aftermath of the poor performance have now scored high JCGIndex, as we explained in the outline. Further analysis is required to verify this assumption.

(2) The rate of growth in employment is higher in the high JCGIndex firms

Based on the 3-year average (2003-2005) of growth of employment, high JCGIndex firms have a higher growth rate than low JCGIndex firms (4.57% versus 2.85%). While it is often said that in order to increase profits it is necessary to sacrifice employment, our result suggests that high JCGIndex companies are establishing high performance without cutting costs through reducing employment.

7. Relationship between each category and performance: Strongest for structure and function of the board of directors and transparency and communication with shareholders

To determine whether or not there was a similar relationship between performance and each of the categories of the JCGIndex, we constructed high and low JCGIndex groups in each of the 4 categories, choosing the firms with points of one standard deviation above the mean or one standard deviation below the mean for each of the categories. In the surveys for previous years, the groups with high points in each category had higher performance (averaged over the past 5 years) than firms with low points. This year, however, we found no clear differences across categories in the relationship to performance. The generally positive relationship between the JCGIndex as a whole and performance explained above indicates that corporate governance is not a question of a single category, but rather, of all the categories taken together.

Conclusion: Corporate governance reform is key to the revival of the Japanese economy

The JCGR surveys over the past 5 years have demonstrated that corporate governance is strongly related to corporate performance. Although the response rate of the survey has not been high in any given year, we have received 1,418 responses for 660 distinct firms, and each year shows a similar relationship between JCGIndex and performance (although there are a few abnormalities). Based on this, we feel that it is appropriate to conclude that corporate governance reform is a necessary condition for Japanese firms to compete in the 21st century business environment. We hope that investors and managers will use the JCGIndex to promote corporate governance reform.

Investors are particularly important to governance reform. From the perspective of managers, there is not much incentive to promote corporate governance, as corporate governance reform makes them more accountable for corporate performance. For investors, on the other hand, corporate governance reform has a close relationship to the improvement of the performance of their investment, and therefore, they have a strong incentive to push for reform. This is especially true for institutional investors, who manage such a large share of investment capital today.

As investors become more aware of the importance of corporate governance reform, shareholder activism, including exercise of voting rights and establishment of governance funds, will increase. We hope that the JCGIndex will be used as an important weapon in these activities. For this reason, in 2004, we started to ask all responding companies to disclose their JCGIndex results. As part of the survey, we ask firms to give us permission to disclose their name if they were in the top 50% of the JCGIndex. Fortunately, most of the companies have answered "yes." Thus, we have been able to report a list of the top 50% JCGIndex firms, as well as a list of all responding companies. We are very impressed by the courage of firms that permitted the disclosure of their names and are very grateful to them. We hope that firms and investors will find many uses for the JCGIndex.

【Appendix】The top 50 JCGIndex firms and their JCGIndex results (tentative)

（see [Firms in the Top 50% of the JCGIndex]）

Nomura Holdings, Inc. (*)	92	Toshiba Corp. (*)	86
Nikko Cordial Corp. (*)	84	Daiwa Securities Group Inc. (*)	83
Sumida Corp. (*)	81	Omron Corp.	80
Eisai Co., Ltd. (*)	79	Shinsei Bank, Ltd. (*)	79
Teijin Ltd.	78	Sony Corp. (*)	78
Meitec Corp.	77	Millea Holdings, Inc.	76
Asahi Glass Co., Ltd.	75	Mitsubishi Electric Corp. (*)	74
Anritsu Corp.	74	Konica Minolta Holdings, Inc. (*)	73
Aeon Co., Ltd. (*)	73	Resona Holdings, Inc. (*)	73
Hitachi, Ltd. (*)	72	Hitachi Information Systems, Ltd. (*)	71
Benesse Corp.	71	**************	71
Mitsui & Co., Ltd.	70	Ube Industries, Ltd.	70
Tokyo Gas Co., Ltd.	70	Isetan Co. Ltd.	69
Asahi Breweries, Ltd.	69	Aisin Seiki Co., Ltd.	68
Terumo Corp.	68	Orix Corp. (*)	67
Marubeni Corp.	67	**************	67
Kao Corp.	66	Sojitz Corp.	66
Yamato Holdings Co., Ltd.	66	Parco Co., Ltd. (*)	66
Japan Airlines Corp.	65	**************	65
Tokyo Theatres Co., Inc.	64	Showa Denko K. K.	64
Nomura Research Institute, Ltd.	64	Yamaha Motor Co., Ltd.	64
TDK Corp.	63	Ricoh Co., Ltd.	62
Tokyo Electron Ltd.	62	Showa Shell Sekiyu K.K.	62
Yokogawa Electric Corp.	62	Hitachi Maxell, Ltd. (*)	62
The Fuji Fire and Marine Insurance Co., Ltd. (*)	62	Transcosmos Inc.	62

(note) (*) firms adopting board with committees