March 13, 2015

Corporate Governance Survey Report 2014

Japan Corporate Governance Network
Japan Corporate Governance Research Institute
Takaaki Wakasugi（Professor Emeritus, University of Tokyo; Co-Director, Mitsui Life Financial Research Center, University of Michigan）
Christina L. Ahmadjian (Professor, Graduate School of Commerce and Management, Hitotsubashi University)
Shusai Nagai (Professor, Faculty of Business Administration, Toyo Gakuen University)
Mamoru Obayashi（Professor, School of Commerce, Senshu University）

This report outlines the results of the 13th annual Corporate Governance Survey (JCGIndex) 2014 of the Japan Corporate Governance Research Institute（JCGR）. We are grateful to all companies that responded to this survey.

1. Scope/period of this survey, and number of companies that responded

From December 2014 to February 2015, we surveyed all companies listed on the First Section of the Tokyo Stock Exchange (1,835, as of November 27, 2014), of which 118 responded to the survey.

We have received responses from 895 distinct companies (and a cumulative total of 2,812) throughout the surveys. The numbers of companies that responded to our survey for each year are as follows: 159 (2002）, 201(2003）, 341(2004), 405 (2005), 312 (2006), 311（2007), 252（2008), 215（2009）, 127（2010), 120（2011）, 131（2012）, 120（2013）, and 118（2014）.

2. Contents and categorization of questions

2.1 Governance model for current companies

Companies have social responsibility of serving for the benefits of all stakeholders—employees, managers, customers, suppliers, creditors, shareholders, governments, and local communities to name some— because the support from these stakeholders are necessary for the companies' existence. In the framework of joint-stock company, however, companies are in reality (not by law) treated as private property of shareholders, who contribute money to the company and in turn exercise the control over the company as owners. Moreover, they take responsibility for the consequences of the business by sharing retained earnings. Retained earnings is equal to the sales minus various expenses, and therefore risky (i.e. not predetermined at all). It is shareholders who bear this risk of business.

The Corporate Governance Survey has been funded by the University of Michigan Ross School of Business Mitsui Life Financial Research Center since 2008.

However, shareholders do not directly participate in management, because joint-stock companies adopt separation of ownership and management. They instead elect directors at the shareholders' meeting and entrust the management to the board of directors. In the form of electing directors who realize business execution (in another word, management) in line with shareholders' interests, shareholders control companies. That is what governance by shareholders means. Meanwhile, board of directors selects representative directors (in companies with board of corporate auditors) or executive officers (in companies with committees) to entrust business execution. In doing so, directors steer executive officers (or representative directors) to the management in line with shareholders' interests. That is governance by board of directors, a substitution for governance by shareholders.

To ensure the effective governance by board of directors, those who are independent from executive officers and other stakeholders are selected as independent directors, who are the sole constituent of nominating committee, compensation committee and audit and supervisory committee. The nominating committee chooses the competent directors, who as members of board of directors select competent executive officers. The compensation committee sets up performance-linked incentives to provide an incentive for good management to executive officers. The audit and supervisory committee monitor the management to ensure impartial and effective management.

This best practice of separating governance and management by promoting good use of independent directors has spread to the world in the last quarter century. Although directors used to simultaneously serve as executive officers all over the world, it is now the global understanding that directors should be separate from executive officers against the backdrop of fierce competitive environments of globalization and innovation. Under this model of separation, board of directors should be centered on independent directors and focus on governance to bring about good management from executive officers, who are selected by board of directors and entrusted with management.

Here, the board of directors is tasked with nomination, compensation, and audit functions for the effective governance. It selects competent executives through its nomination function. It exercises the compensation function of providing an incentive for goal-oriented management to executive officers in the form of performance-linked compensation system. Furthermore, the function of auditing the management's business execution is indispensable to fulfill the current needs of compliance. Executives establish the management system under the governance by board of directors to pursue profit through business operations and then distribute the profit to shareholders.

2.2 Contents and categorization of questions

Based on the model described above, JCGIndex Survey's questions are comprised of the following 7 parts:

Part Ⅰ	Performance targets, leadership of CEO	7 questions
Part Ⅱ	Efforts on corporate governance	4 questions
Part Ⅲ	Board of directors	34 questions
Part Ⅳ	Management system	10 questions
Part Ⅴ	Evaluation of management, compensation system	3 questions
Part Ⅵ	Management of consolidated subsidiaries	2 questions
Part Ⅶ	Communication with shareholders	8 questions

These 68 questions in total are recategorized into 4 categories to calculate sub-scores for each category. Each category represents the following perspective:

Category Ⅰ Performance targets and structure of responsibilities of management
Based on Part Ⅰ and Part Ⅱ

Category Ⅱ Functions and composition of board of directors
Based on Part Ⅲ

Category Ⅲ Executive management structure of top management
Based om Part Ⅳ, Part Ⅴ and Part Ⅵ

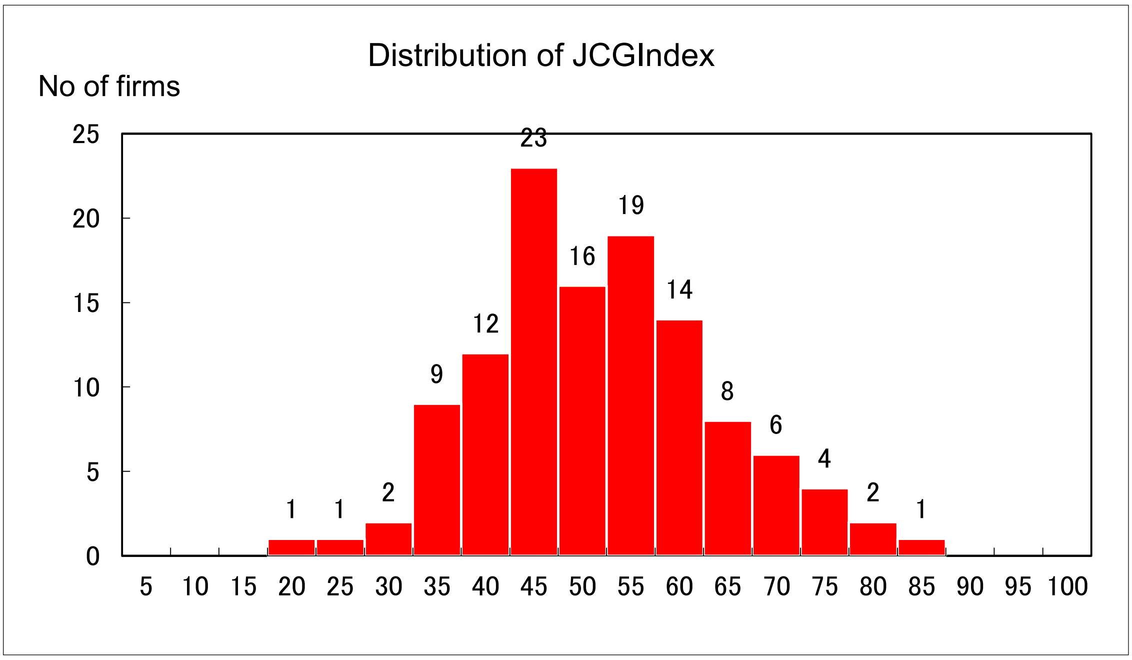
Category Ⅳ Communication with shareholders and transparency
Based on Part Ⅶ

Categories Ⅰ and Ⅱ are related to corporate governance system, and Ⅲ and Ⅳ are about corporate management system. Although it is possible to value the corporate governance through Categories Ⅰ and Ⅱ alone, Categories Ⅲ and Ⅳ are incorporated into JCGIndex, based on the belief that good management system is established under the good governance system.

3. Distribution of JCGIndex

The results of JCGIndex for the 118 companies that responded to our survey in 2014 turned out as the graph in the below shows. This time, we made major changes to take the recent developments in corporate governance into account, for example by adding a large number of questions on board of directors. Therefore, each category's weight is different from 2013.

The mean JCGIndex increased to 49.66 from 49.01 of 2013, while the standard deviation decreased to 12.30 from the previous 15.00. The maximum JCGIndex in 2014 saw an increase to 83 from 78 in 2013, and the minimum also increased to 17 from 14.



Mean：49.66 Standard deviation：12.30

4. Category scores and achievement rates

To clarify the companies' performance for each category having different weight, the table below converts the mean figure into achievement rate in percentage. The table also contains JCGIndex and the previous year's results (in parentheses) just for reference。

Just as the same as the previous surveys, the achievement rates of Categories Ⅰ and Ⅱ for corporate governance remain still low. This clearly implies the overall inadequacy of Japanese corporate governance but could be also interpreted that management reforms are preceding in Japanese companies. Nonetheless, the achievement rates for Categories Ⅲ and Ⅳ are still not sufficient (both around 61%), which might attest "no good governance, no good management."

As corporate governance reforms in the framework of Abenomics are raising awareness toward outside directors' roles in the board of directors, we increased the questions in Category Ⅱ from the previous survey. As a result, the weight of Category Ⅱ doubled from 2013, while the weight of Category Ⅲ halved.

Sub-scores and achievement rates by category

Category		Weight (A)	Mean (B)	Achievement rate (B) / (A)
I	Performance targets and structure of responsibilities of management	22 (29)	10.00 (13.00)	45.5% (44.8%)
II	Functions and composition of board of directors	46 (26)	20.2 (8.45)	43.9% (32.5%)
III	Executive management structure of top management	24 (25)	14.6 (14.09)	60.8% (56.4%)
IV	Communication with shareholders and transparency	8 (20)	4.9 (13.48)	61.3% (67.4%)
JCGIndex		100 (100)	49.7 (49.01)	

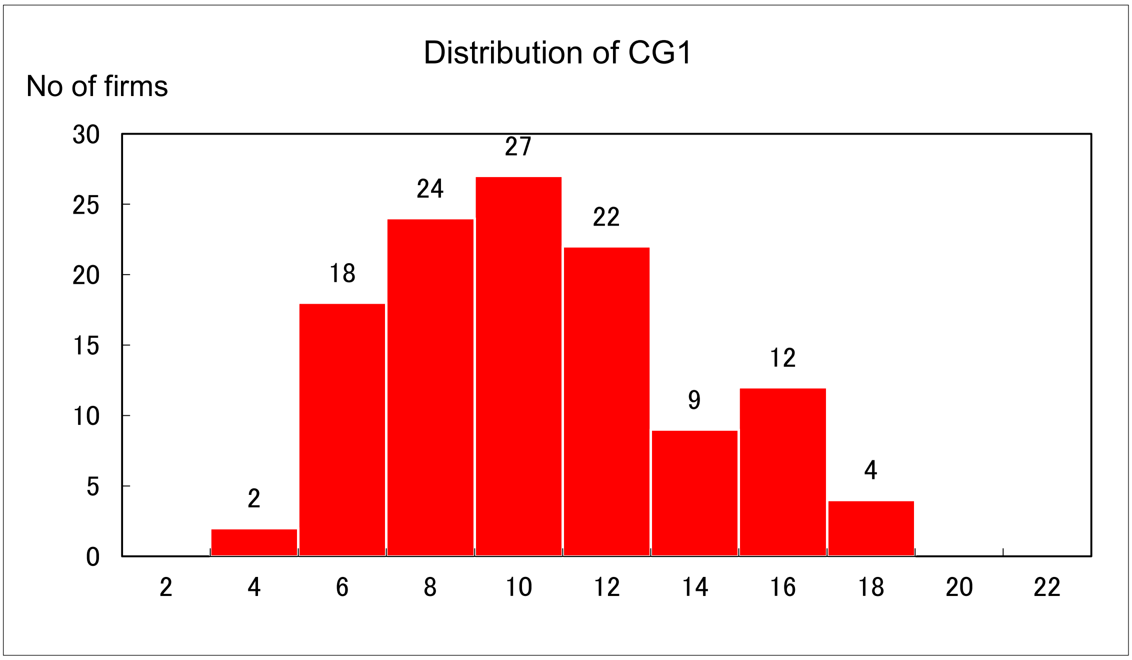
*Results in 2013 are in parentheses.

5. Distribution of category scores

Below are tables for distribution of sub-scores by category. CG1, CG2, CG3 and CG4 stand for sub-scores for each category. These four constitute the JCGIndex.

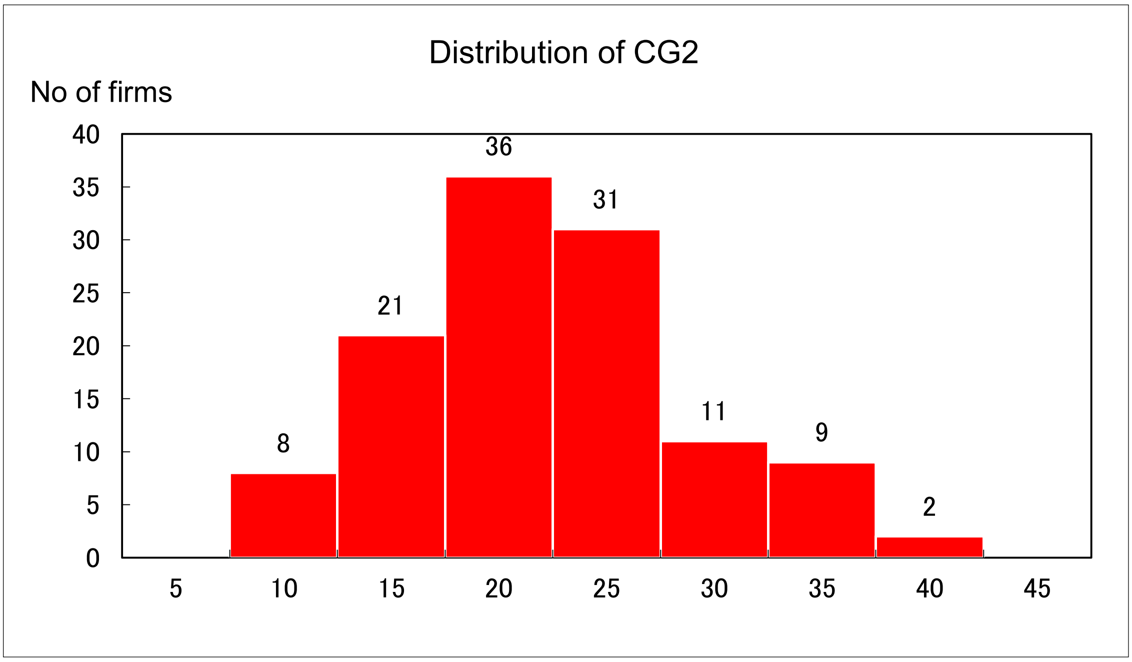
Although the distribution of the JCGIndex forms more like a bell curve, those of the sub-scores do not. That is probably because the number of samples is small. In past surveys with larger numbers of respondents, the distributions of the sub-scores were closer to bell curves than this time. Here, the empirical fact that a variable influenced by various factors forms a standard distribution is verified.

Category Ⅰ Performance targets and structure of responsibilities of management



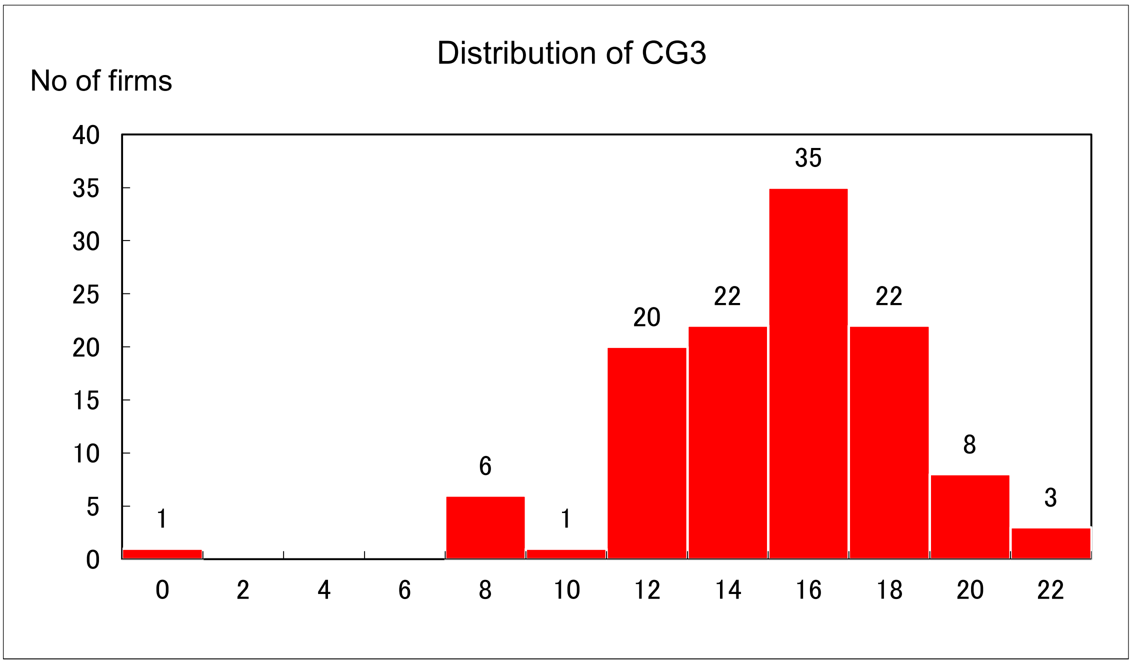
Mean：10.00　Standard deviation：3.38

Category Ⅱ Functions and composition of board of directors



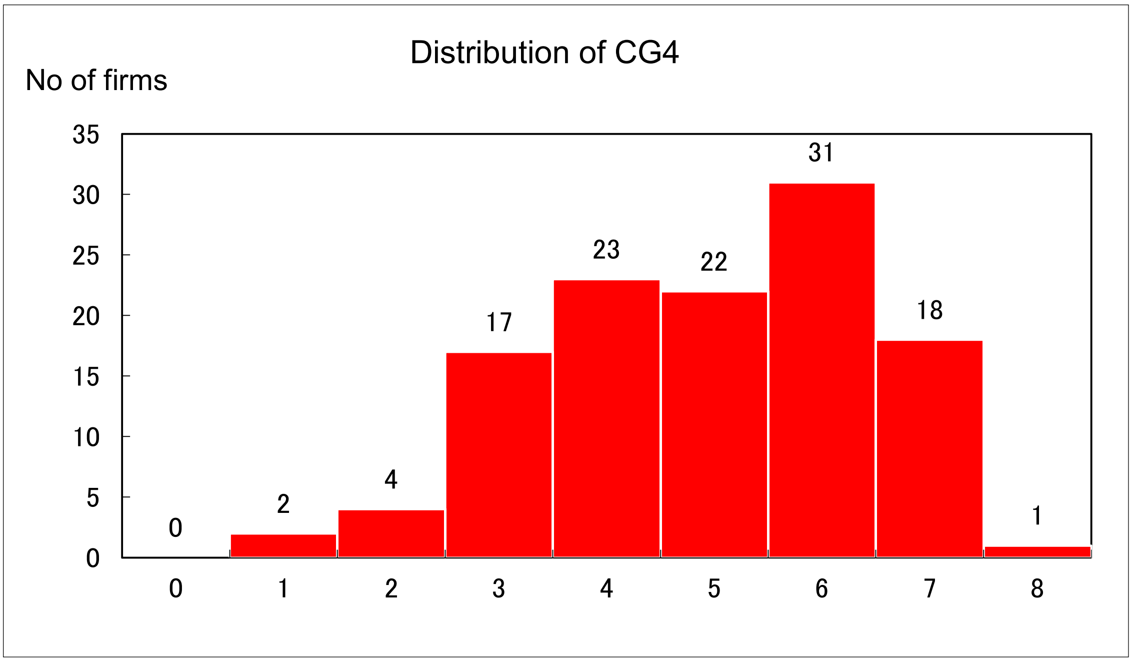
Mean：20.2　Standard deviation：6.68

Category Ⅲ Executive management structure of top management



Mean：14.6 Standard deviation：3.34

Category Ⅳ Communication with shareholders and transparency



mean：4.9 Standard deviation：1.52

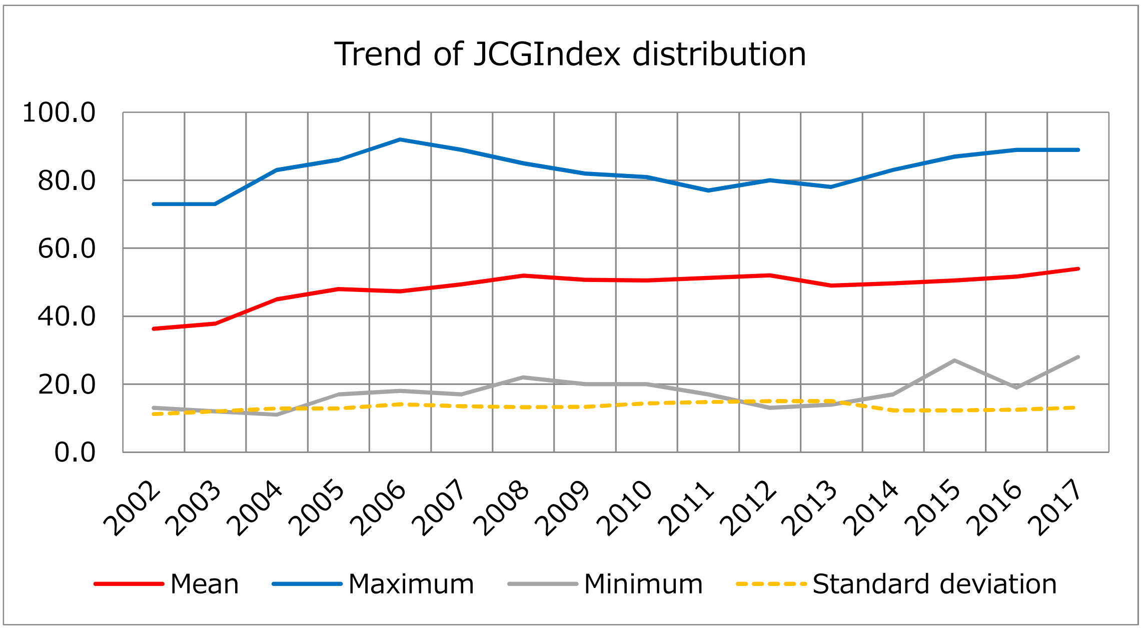
6. Descriptive statistics values JCGIndex and sub-scores

Descriptive statistics of JCGIndex and Category scores are as follows.

	mean	Standard error	median	Mode	Standard deviation	Min	Max
JCGIndex	49.66	1.1	49.5	58	12.30	17	83
Category Ⅰ	9.96	0.3	10	10	3.38	4	17
Category Ⅱ	20.15	0.6	20	18	6.68	7	39
Category Ⅲ	14.61	0.3	15	15	3.34	0	22
Category Ⅳ	4.94	0.1	5	6	1.52	1	8

7. Trend of the distribution of JCGIndex

The trends of mean, maximum and minimum in the past 13 surveys for JCGIndex are presented in the table below.



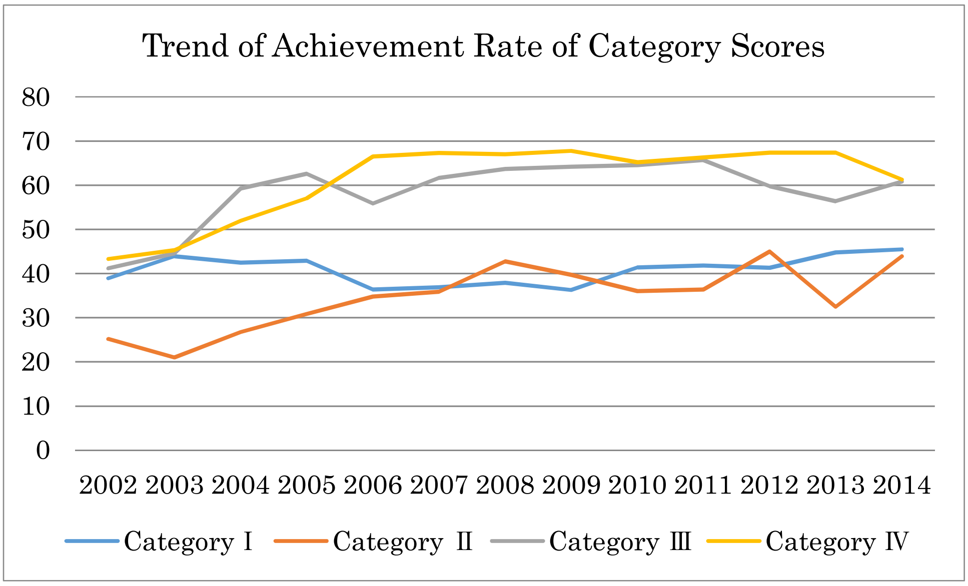
It should be noted that the figures for each year cannot be simply compared to those for another, because the samples change year by year. Furthermore, questions and proportions were modified in 2006 and 2013, and proportions alone moderately changed in 2009. Major changes were even made in 2014 as explained above. Still, very gradual increase in JCGIndex is observed.

Even if only a couple of companies achieve JCGIndex of the maximum or near level, the maximum decreased in the period from 2006 to 2011 and then has been on the upward trend, which can be largely attributable to the changes in questions and proportions.

8. Trend of Achievement Rate of Category Scores

Achievement rates by category show a similar trend with JCGIndex. While the rates for Category Ⅰ are flat for 13 years, the other categories see the rate increase until 2006 and remain flat afterward. Fluctuation within some ranges should be as a result of the change in questions and proportions.

It is significant that the achievement rates for the management categories of Ⅲ and Ⅳ (around 60%) constantly exceed those for the governance categories of Ⅰ and Ⅱ (around 40%) throughout the surveys. That is a clear indication that governance systems are far less developed than managements systems.



9. Correlations among sub-scores and JCGIndex

The table below shows correlation coefficients between categories and between a category and JCGIndex. Not only are the correlations among categories just around 0.5 but also every category shows higher correlation with JCGIndex than with any other category, which means that each category does not overlap with others greatly and rather covers distinctive factors. It is therefore meaningful to calculate JCGIndex with these four categories by setting two separate categories for both governance and management as the result of governance.

With the highest figure for correlation with JCGIndex, Category Ⅱ contributes to JCGIndex the best among the four categories, which may be because the category occupies the most weight. Similarly, Category Ⅳ having the lowest figure for correlation with JCGIndex could be as a result of its smallest weight in the survey.

Correlation Coefficients between JCGIndex and Category Scores

	Category Ⅰ	Category Ⅱ	Category Ⅲ	Category Ⅳ	JCGIndex
Category Ⅰ	1.0000				
Category Ⅱ	0.5744	1.0000			
Category Ⅲ	0.5010	0.5513	1.0000		
Category Ⅳ	0.4741	0.4845	0.5295	1.0000	
JCGIndex	0.7808	0.9102	0.7735	0.6604	1.0000

10. High JCGIndex companies and low JCGIndex companies

The mean of JCGIndex is 49.66, and the standard deviation of JCGIndex is 12.30 for 2014. Mean plus a standard deviation equals to 61.96 and mean minus a standard deviation equals to 37.36. From these calculations, we define JCGIndex of 62 or more to be high JCGIndex, and JCGIndex of 37 or less to be low JCGIndex. With the actual number of high JCGIndex companies being 18 and low JCGIndex companies 18, the distribution of JCGIndex is close to normal distribution (in a normal distribution, companies above/below a standard deviation would constitute approximately 15.9% for each, so the number would be 19 for each).

The table below exhibits the sub-scores by category and JCGIndex of the high and low JCGIndex companies.

High JCGIndex companies achieve twice as much JCGIndex as low JCGIndex companies. In addition, the sub-scores for High JCGIndex companies are far better than those for low JCGIndex companies in every category. This indicates that every category function as a condition for high JCGIndex companies.

JCGIndex and Category Scores of High and low JCGIndex companies

	Category				JCGIndex
	Ⅰ	Ⅱ	Ⅲ	Ⅳ	
High **JCGIndex** companies	14.1	31.1	18.1	6.4	69.9
Low **JCGIndex** companies	6.4	11.6	10.2	3.6	31.8

The table above presents, however, that the difference between high and low JCGIndex companies is relatively small in Categories Ⅲ and Ⅳ for management evaluation and significantly large in Categories Ⅰ and Ⅱ for governance evaluation. The difference is especially remarkable in Category Ⅱ for functions and composition of board of directors, clearly implying that high JCGIndex companies and low JCGIndex companies are differentiated with board of directors as the center of corporate governance system. As for management system, the companies see larger difference in Category Ⅳ for disclosure and transparency.

11. Companies with high JCGIndex

The list of 22 companies that marked the JCGIndex of 60 or higher is attached to this report.

12. 2014 survey as compared to the past ones

2014 marks the 13th JCGIndex Survey, which began in 2002. Even though we once had more than 400 respondents, we have had just around 120 in the past five years. With all major changes made in the questions this time, the JCGIndex and the four sub-scores in this survey present very similar patterns to those in the past surveys.

The changes were made especially in Category Ⅱ, whose weight significantly rose from 26 to 46. This made the correlation coefficient between CG2 and the JCGIndex 0.91. Below are correlation coefficients between categories and between a category and JCGIndex in the last survey.

	Category Ⅰ	Category Ⅱ	Category Ⅲ	Category Ⅳ	JCGIndex
Category Ⅰ	1.0000				
Category Ⅱ	0.5581	1.0000			
Category Ⅲ	0.5508	0.6046	1.0000		
Category Ⅳ	0.5032	0.6042	0.6647	1.0000	
JCGIndex	0.7974	0.8458	0.8386	0.8289	1.0000

In the previous survey, each category showed a very similar level of correlation with the JCGIndex. This time, however, Category Ⅱ correlates with the JCGIndex more than the other categories do. Hence, CG2 can serve as a substitution for the JCGIndex.

Among the categories in the JCGIndex Survey, only Categories Ⅰ and Ⅱ are directly related to governance. Categories Ⅲ and Ⅳ for management are incorporated into the survey because the management system of a company represents its governance. However, the scores on management system might contain some noises because the management system could be influenced by other factors than governance. That concludes that the JCGIndex should be best made up of only Category Ⅰ and Category Ⅱ.

With governance by board of directors being current corporate best practice, this time's JCGIndex Survey that assigns the score for Category Ⅱ crucial weight to determine the JCGIndex would fairly gain further importance.

13. Closing remarks

According to Table 5, the overall trends of the JCGIndex have seen little changes since around 2007. Even though several reforms had been implemented, starting from the introduction of company with committees, etc. (currently company with committees under the Companies Act) through the revised Act on Special Provisions on the Commercial Code Concerning Audits, etc. of Stock Companies in April 2003, the corporate governance in Japan has hardly improved.

After shooting the “arrows” of monetary and fiscal policies, Abenomics formulated the Japan Revitalization Strategy as the third and the last arrow of the growth strategy. The growth strategy expects the companies to draw up their own growth strategies and aims at putting the country’s economy back on track. Since it requires the companies to actively engage in capital investment, executives should be incentivized to maximize shareholder value. Corporate governance is that incentive. Hence, board of directors tasked with the governance is essential for growth.

Recognizing the importance of corporate governance, Abenomics started to push forward corporate governance reforms last year. In February 2014, Japan’s Stewardship Code was formulated as “Principles for Responsible Institutional Investor.” Effective May 1, 2015, the revised Companies Act introduces company with audit and supervisory committee. Furthermore, the Financial Services Agency and the Tokyo Stock Exchange are working on establishing the Corporate Governance Code. It is questionable if just copying the Stewardship Code in the UK and the American corporate governance code could work in Japan, where the behaviors of investors and companies are different from what is assumed by the original codes. Nevertheless, the ongoing corporate governance reforms are concrete unlike those in the past, and worth trusting. Unless securing the effectivity of the corporate governance reforms, the growth strategy will not succeed and there will be no future for Japan.

JCGR continues to watch the developments of corporate governance in Japan and plans to conduct the 14th JCGIndex Survey in 2015, when the revised Companies Act and the Corporate Governance Code are to be enforced. We ask for your continuous understanding and cooperation.

【Appendix】

Companies with 60 or higher JCGIndex in 2014（22 companies）

Rank	JCGIndex	Company
1	83	Sony Corporation
2	78	Ichiyoshi Securities Co., Ltd.
2	78	Sompo Japan Nipponkoa Holdings, Inc.
4	75	Sumida Corporation
5	74	Omron Corporation
5	74	Nissen Holdings Co., Ltd.
7	72	*（1 company）
8	70	Eisai Co., Ltd.
8	70	Konica Minolta Japan, Inc.
10	69	Resona Holdings, Inc.
11	68	NSK Ltd.
12	66	Shiseido Company, Limited
12	66	Mitsubishi Electric Corporation
14	64	*（1 company）
15	63	Terumo Corporation
15	63	Nippon Sheet Glass Co., Ltd.
15	63	Yamaha Corporation
15	63	*（1 company）
19	61	Lawson, Inc.
19	61	Toshiba Corporation
19	61	NEC Corporation
22	60	*（1 company）

An asterisk represents a company that declined to disclose its name.