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Corporate Governance Survey Report 2017

Japan Corporate Governance Network
Japan Corporate Governance Research Institute
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This report outlines the results of the 16th annual Corporate Governance Survey (JCGIndex) 2017 of the Japan Corporate Governance Research Institute（JCGR）. We are grateful to all companies that responded to this survey. *)

0. Background and results of this survey

Within a short period, corporate governance reforms have been implemented in an unprecedent scale under the second Abe administration's new Growth Strategy. The Financial Services Agency formulated Japan's Stewardship Code in 2014 (revised in 2017); the amendment of the Companies Act in 2015 introduced company with audit and supervisory committee; and the Tokyo Stock Exchange made the Corporate Governance Code part of its Securities Listing Regulations in 2015. The reforms expect institutional investors to enhance the investee companies' corporate value and sustainable growth through "purposeful dialog" as shareholders for the sake of mid- to long-term investment return for the clients and beneficiaries. For companies, five principles are proposed based on OECD's Principles of Corporate Governance, in expectation of rational and fair corporate governance under independent directors and internationally competitive management: Securing the Rights and Equal Treatment of Shareholders, Appropriate Cooperation with Stakeholders Other Than Shareholders, Ensuring Appropriate Information Disclosure and Transparency, Responsibilities of the Board, and Dialogue with Shareholders.

These reforms apply in fact a soft-law approach of "Comply or Explain", assuming an Anglo-Saxon rational stock market. It is questionable that the Japanese stock market is rational enough, but at any rate, corporate governance reforms are indispensable to regain Japan's international competitiveness, and worth public interests. Looking into the JCGIndex Survey for 2017 from this perspective, the results presented in this paper give us an impression that the corporate governance reforms are still yet to bear fruit. We hope that governance reforms will bring about management reforms, but it is hard to achieve the change in a short period since both governance and management are deeply tied to the society and history. Yet we have no other choice but to speedily address the drastic change the world is experiencing.

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*This survey is funded by the University of Michigan Ross Business School Mitsui Life Financial Research Center. Without this financial aid this survey was not conducted since 2008. I express my deepest gratitude.

The fact that hasty actions are undesirable cannot justify slowing down the reform. Investors, executives and all members of the public need to make a commitment to corporate governance.

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

In December 2017, we surveyed all companies listed on the First Section of the Tokyo Stock Exchange (2,053, as of December 18, 2017), of which 151 responded to the survey.

We have received responses from 986 distinct companies (and a cumulative total of 3,260) 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), 118（2014), 147（2015), 150（2016） and 151（2017).

2. Contents and classification of question items

2.1 Governance model of modern corporations

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.

Joint-stock companies that operate large-scale business with money contribution from a large number of shareholders assume separation of ownership and management. Although shareholders do not directly participate in 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. In most countries under such a system, board of directors makes important decisions on business, and selects CEO and other executive officers (as for Japan, representative directors are selected in companies with corporate auditors and companies with audit and supervisory committee, and executive officers in companies with nominating committee, etc.) to entrust business execution. In doing so, directors steer executive officers 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 determines candidates of directors to submit to the shareholders' meeting. It plays an important role of choosing the competent directors, who as members of board of directors select (and dismiss) 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 check the independence of internal and external auditors 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, fierce competitive environments of globalization and innovation have enhanced the role of directors as monitors. It is now the global understanding that directors should be separate from executive officers. 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. 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 Seven parts and four categories

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 plan	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:

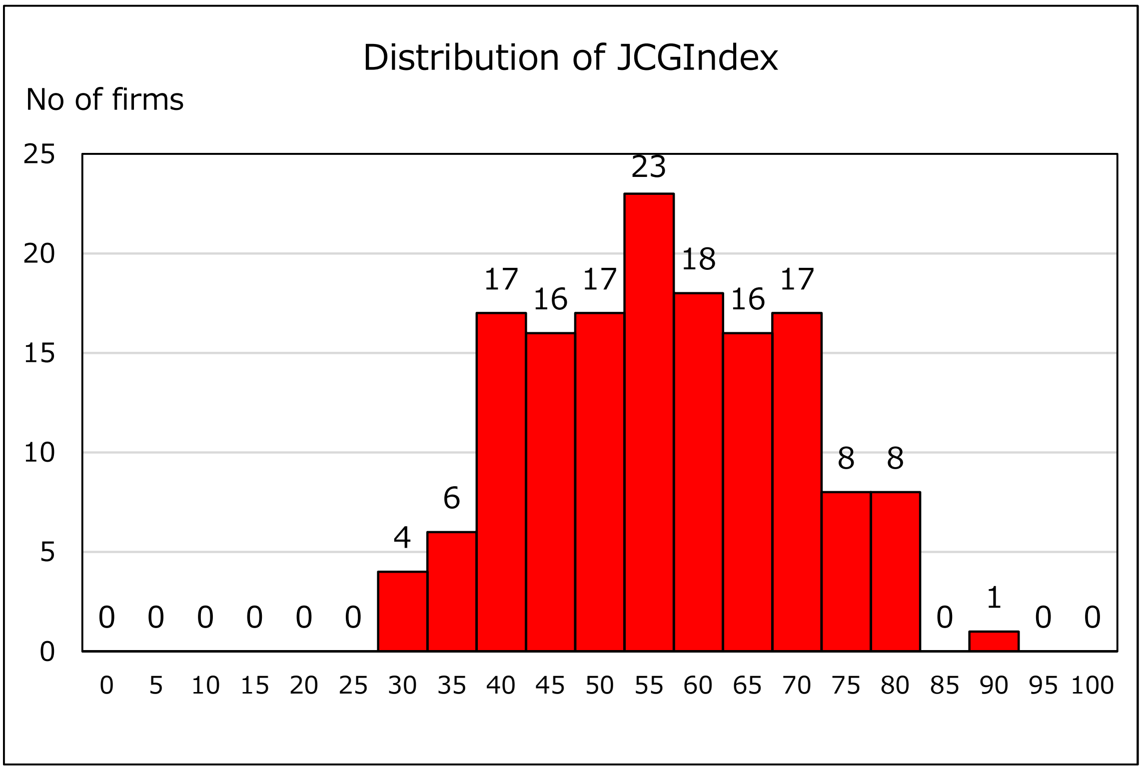
Category Ⅰ Corporate objectives and CEO responsibility
Based on Part Ⅰ and Part Ⅱ
Category Ⅱ Structure and function of board of directors
Based on Part Ⅲ
Category Ⅲ Management system
Based om Part Ⅳ, Part Ⅴ and Part Ⅵ
Category Ⅳ Transparency and communication to shareholders
Based on Part Ⅶ

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 151 companies that responded to our survey in 2017 turned out as the graph in the below shows. We made major changes from 2014 to take the recent developments in corporate governance into account, for example by adding a large number of questions on board of directors. However, we have made no changes for the survey since 2016.

The mean JCGIndex increased to 53.99 from 51.63 of 2016, but the standard deviation also rose to 13.16 from the previous 12.47. While the maximum JCGIndex in 2017 was exactly same as 89 in 2016, the minimum saw an increase to 28 from 19, which is in fact statistically insignificant. It would be fair to conclude that the results indicate little improvement in the situation of corporate governance in Japan.



Mean：53.99 Standard Deviation：13.16

4. Sub-scores and achievement rates by category

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, despite an increase from last survey. On the other hand, the rates of Categories Ⅲ and Ⅳ for corporate management are about 20％ higher throughout the overall surveys. Our JCGIndex surveys for more than 15 years clearly imply the overall inadequacy of Japanese corporate governance, but that could be also interpreted that management reforms are preceding in Japanese companies. This time again sustains the trend with better improvement of achievement rates for Categories Ⅲ and Ⅳ as compared to Categories Ⅰ and Ⅱ.

Sub-scores and achievement rates by category

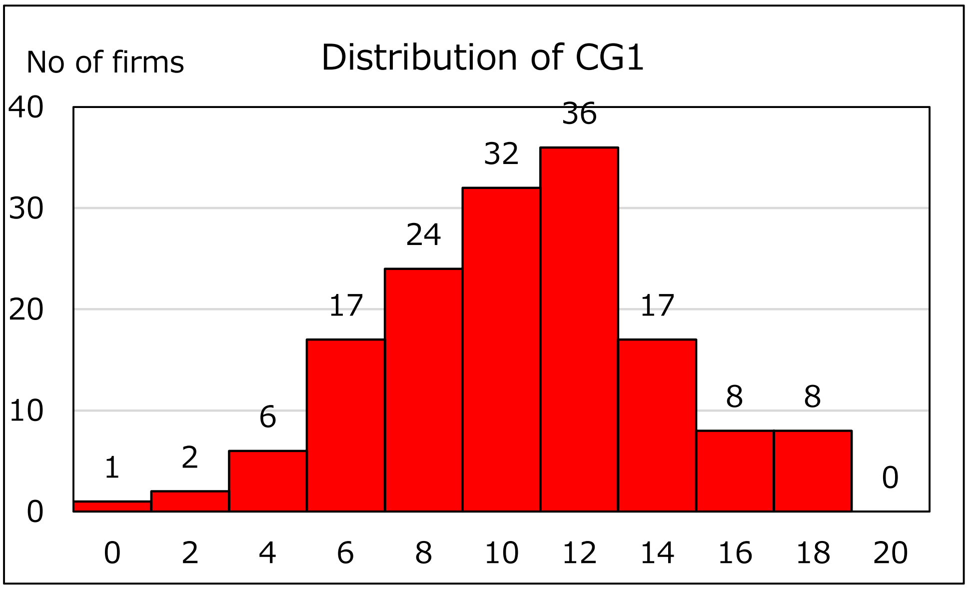
Category		Weight (A)	Mean (B)	Achievement rate (B) / (A)
I	Performance targets and structure of responsibilities of management	22 (22)	9.9 (9.6)	45.2% (43.8%)
II	Functions and composition of board of directors	42 (42)	19.4 (18.9)	46.2% (45.0%)
III	Executive management structure of top management	28 (28)	18.8 (17.9)	67.2% (63.7%)
IV	Communication with shareholders and transparency	8 (8)	5.8 (5.2)	72.8% (65.3%)
JCGIndex		100 (100)	54 (51.6)	

*Results in 2016 are in parentheses.

5. Distribution of sub-scores by category

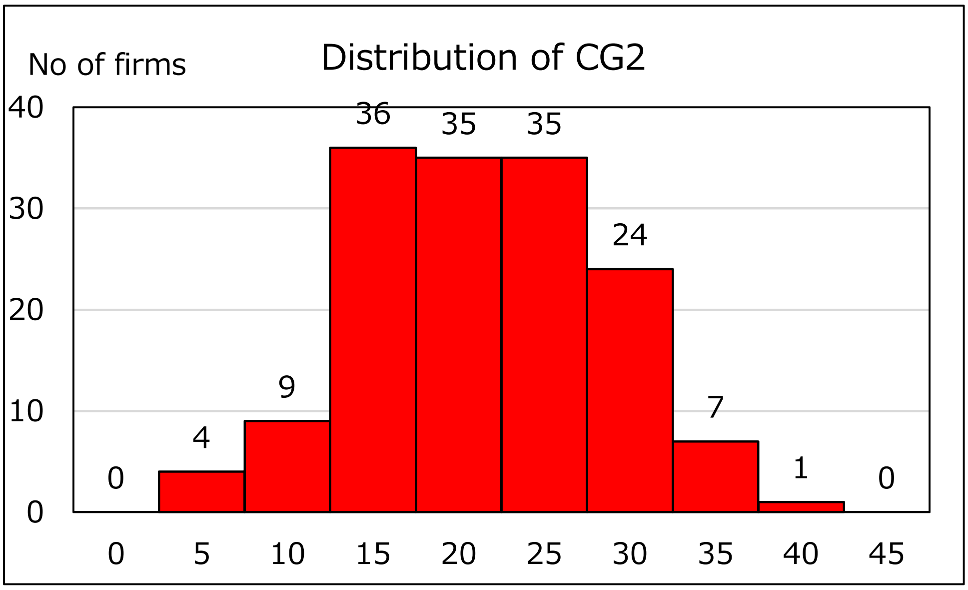
Below are tables for distribution of sub-scores by category. CG1, CG2, CG3 and CG4 stand for sub-scores for each category. These four constitute the JCGIndex.

Category Ⅰ Performance targets and structure of responsibilities of management



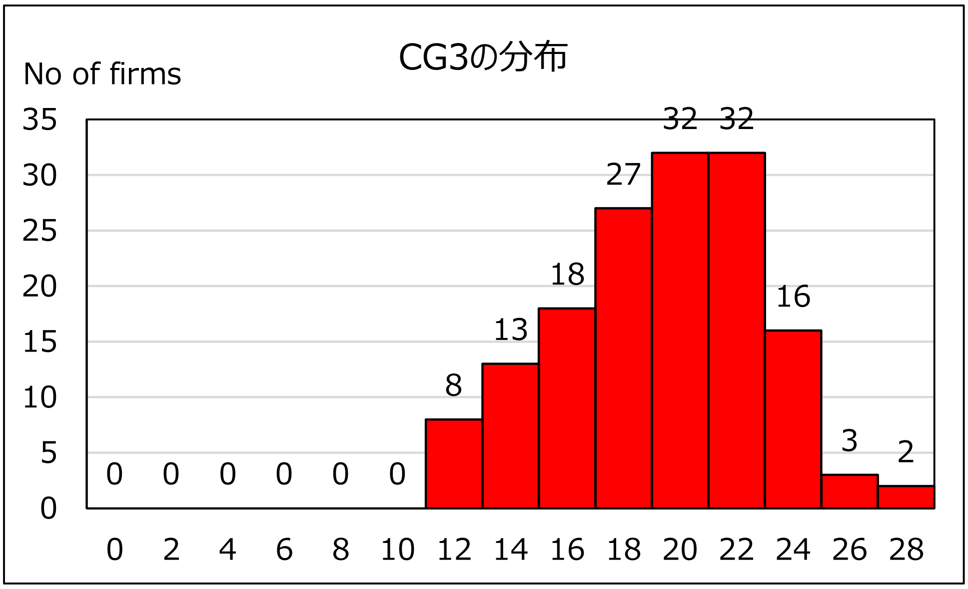
Mean：9.95 Standard deviation：3.63

Category Ⅱ Functions and composition of board of directors



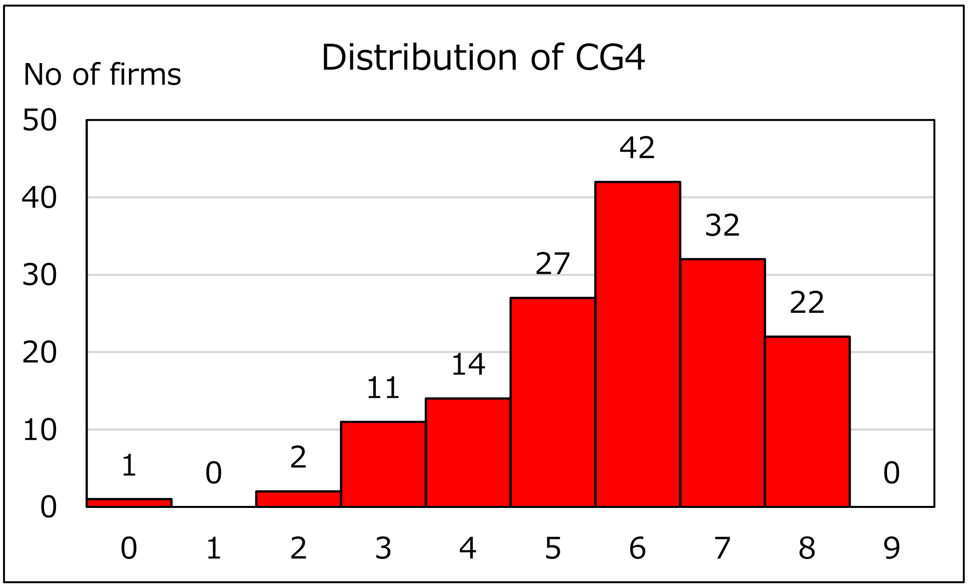
Mean：19.39 Standard Deviation：7.02

Category Ⅲ Executive management structure of top management



Mean：18.83 Standard Deviation：3.54

Category Ⅳ Communication with shareholders and transparency



Mean：5.82 Standard Deviation：1.59

5.1 Descriptive statistics of JCGIndex and sub-scores

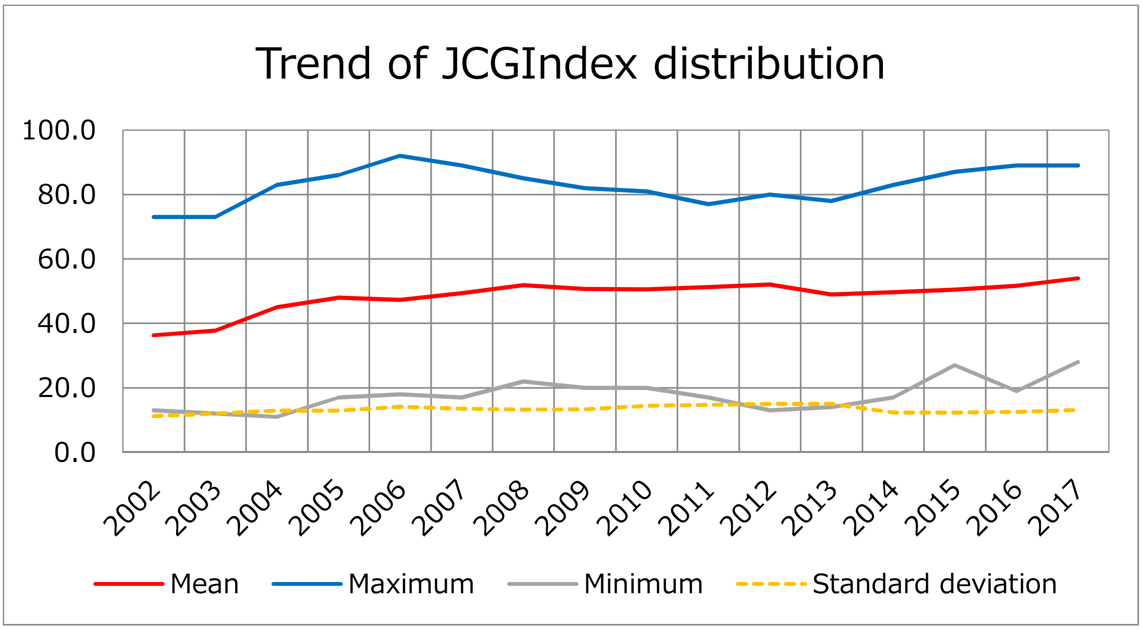
Descriptive statistics of above distributions are as follows.

Descriptive statistics of JCGIndex and category scores

	mean	Standard error	median	mode	Standard deviation	minimum	maximum
JCGIndex	53.99	1.1	54	51	13.16	28	89
Category Ⅰ	9.95	0.3	10	12	3.63	0	18
Category Ⅱ	19.39	0.6	19	14	7.02	1	37
Category Ⅲ	18.83	0.3	19	22	3.54	10.5	27
Category Ⅳ	5.82	0.1	6	6	1.59	-1	8

6. Trend of the distribution of JCGIndex

The trends of mean, maximum and minimum in the past 16 surveys for JCGIndex are summarized in the figure below.



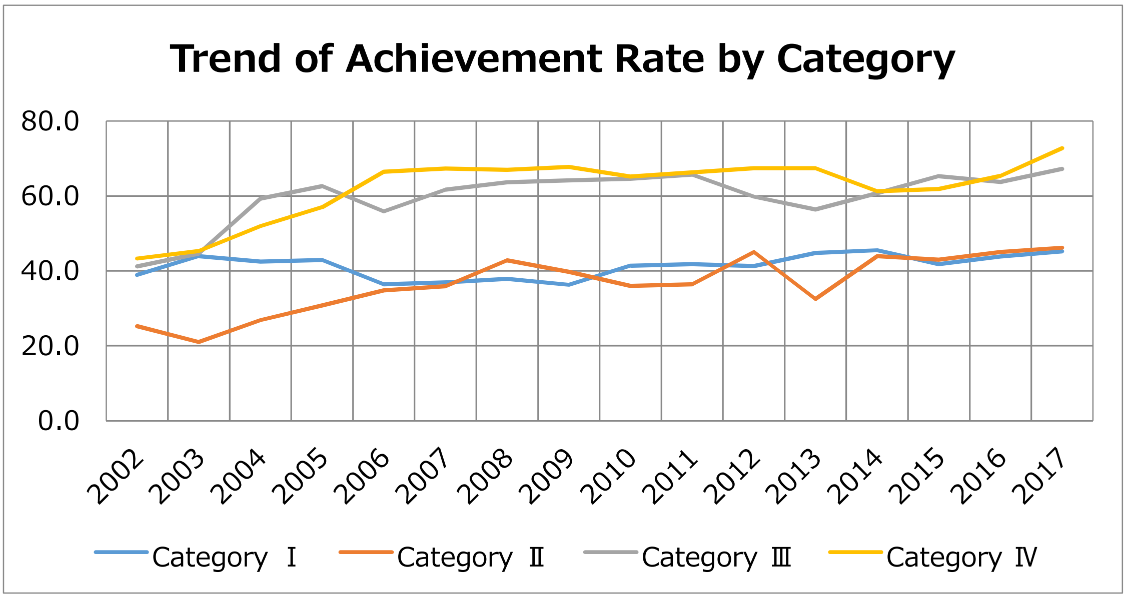
It should be noted that the figures for each year cannot be simply compared to those for another, because the samples change year by year. Furthermore, questions and proportions were modified in 2006 and 2013, and proportions alone moderately changed in 2009. Major changes were even made in 2014 for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

Even though 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.

7. 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（within the range from 60％ to 70％）constantly exceed those for the governance categories of Ⅰ and Ⅱ（from 40% to 50%）throughout the surveys. That is a clear indication that governance systems are far less developed that managements systems.



8. Correlations between JCGIndex and category scores

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 (except for the correlation between Category Ⅰ and Category Ⅱ) 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 is best described as most representative of JCGIndex, which indicates that Category Ⅱ contributes to JCGIndex the best among the four categories, which may be because the category occupies the most weight.

Correlation coefficients between JCGIndex and category scores

	Category Ⅰ	Category Ⅱ	Category Ⅲ	Category Ⅳ	JCGIndex
Category Ⅰ	1				
Category Ⅱ	0.6454 (0.7047)	1			
Category Ⅲ	0.5012 (0.4988)	0.6088 (0.5710)	1		
Category Ⅳ	0.3591 (0.3257)	0.4198 (0.4646)	0.5427 (0.4502)	1	
JCGIndex	0.7984 (0.8288)	0.9259 (0.9361)	0.7977 (0.7605)	0.5898 (0.5734)	1

*Results in 2016 are in parentheses.

9. High JCGIndex companies and low JCGIndex companies

The mean of JCGIndex is 53.99, and the standard deviation of JCGIndex is 13.15 for 2017. Mean plus a standard deviation equals to 67.1 and mean minus a standard deviation equals to 40.8. From these calculations, we define JCGIndex of 68 or more to be high JCGIndex, and JCGIndex of 40 or less to be low JCGIndex. With the actual number of high JCGIndex companies being 26 and low JCGIndex companies 27, 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 24 for each).

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

JCGIndex and category scores of High and Low JCGIndex companies

	Category				JCGIndex
	Ⅰ	Ⅱ	Ⅲ	Ⅳ	
High JCGIndex companies	14.5	29.4	22.8	7.1	73.8
Low JCGIndex companies	5.9	10.2	14.8	4.5	35.4

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.

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.

Top Companies

Companies with 60 or higher JCGIndex in 2017（51 companies）

Rank	JCGIndex	Company
1	89	Sony Corporation
2	80	Ichiyoshi Securities Co., Ltd.
3	79	Eisai Co., Ltd.
3	79	Hitachi, Ltd.
5	78	Konica Minolta Japan, Inc.
5	78	Omron Corporation
5	78	Sumida Corporation
8	76	**（2 companies）
10	74	Ichigo Inc.
11	73	Yokogawa Electric Corporation
11	73	**（2 companies）
14	72	Aeon Co., Ltd
14	72	Resona Holdings, Inc.
16	71	Nomura Research Institute, Ltd.
16	71	MOS Food Services, Inc.
18	70	Lawson, Inc.
18	70	NSK Ltd.
18	70	Tamura Corporation
18	70	*（1 company）
22	69	Daiwa House Industry Co., Ltd.
23	68	Terumo Corporation
23	68	**（2 companies）
26	67	Daito Trust Construction Co., Ltd.
26	67	ASKUL Corporation
26	67	Japan Airlines Co., Ltd.
26	67	*（1 company）
30	66	Santen Pharmaceutical Co., Ltd.
30	66	Mitsubishi Electric Corporation
30	66	CASIO Computer Co., Ltd.
30	66	Hitachi High-Technologies Corporation
30	66	*（1 company）
35	65	Mitsubishi Heavy Industries, Ltd.
35	65	Leopalace21 Corporation
35	65	*（1 company）
38	63	Nichirei Corporation
38	63	Mitsui Engineering & Shipbuilding Co., Ltd.
38	63	Michinoku Bank Ltd.
38	63	**（2 companies）
43	62	Totetsu Kogyo Co., Ltd.

43	62	Mitsubishi Paper Mills Limited
43	62	Mitsui Chemicals, Inc.
43	62	Shionogi & Co., Ltd.
43	62	Shiseido Company, Limited
48	61	Avex Inc.
48	61	Tokyo Electron Limited
48	61	*（1 company）
51	60	NTT Data Corporation

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