JCGR Corporate Governance Survey 2008

－Summary and Recommendations－

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I. 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 by introducing two types of basic governance system for large public companies (companies with committees and companies with board of corporate auditors).

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 2008, we surveyed Tokyo Stock Exchange First Section Firms. While the number of the respondents had steadily increased before, it decreased to 252 firms (14.7% of the total) this year from 311 firms (18.0%) of the last year. Nonetheless, 45 firms responded to our survey for the first time, this year, reflecting a solid interest in corporate governance. One firm is omitted for analysis because it was downgraded to the Second Section of the Tokyo Stock Exchange during the analysis. 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.

Still, it would be fair to conclude from the findings of the JCGIndex surveys from 2002 to 2008 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: Revision of the Companies Act and Financial Instruments and Exchange Act, ever more globalization, 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.

II. Seven Important Results

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

From August to November 2008, the Japan Corporate Governance Research Institute surveyed all firms listed on the First Section of the Tokyo Stock Exchange (1,719 firms as of July 29, 2008), and received responses from 252 firms. Survey questions were based on the "JCGR Corporate Governance Principles." The JCGIndex is based on these questions.

This is the seventh consecutive year that we have carried out the survey, to which a cumulative total of 1981 companies have responded. 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, 312 firms responded, 70 for the first time. In 2007, 311 firms responded, 71 for the first time. In 2008, 45 firms responded for the first time. Over the past seven years, we have received responses from 778 firms (equal to 44% of the firms currently listed on the First Section). Of the 252 firms that responded to the survey this year, one is omitted for analysis because it was downgraded to the Second Section of the Tokyo Stock Exchange during the analysis.

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 2003-2007) was more than twice the size of the average listed firm. The performance of responding firms was also higher than the average for listed firms. ROA of responding firms was 6.80%, compared to 6.42% for all listed firms: ROE was 7.66% versus 7.26%, and return on common stock was 16.09% versus 14.99%.

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

This year, the average JCGIndex for the 251 responding firms is 51.9 (standard deviation 13.2), compared to an average of 49.4 (standard deviation 13.5) for last year.

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, the average JCGIndex is 51.9 points, only slightly greater 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 85 and the lowest was 22. Last year, the highest JCGIndex was 89 and the lowest 17. The standard deviation slightly decreased to 13.2 from the previous 13.5.

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 251 responding firms. The better results in Categories I to III than last year pushed up the average of the JCGIndex. However, while 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.

As a whole, firms have focused on corporate management reform after 'the Decade Lost', 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/point allocated (A)	Percent expression of (A)
I Corporate objectives and CEO responsibility	10.6/28	37.9% (36.9%)
II Structure and function of board of directors	10.7/25	42.8% (35.9%)
III Management system	17.2/27	63.7% (61.7%)
IV Transparency and communication with shareholders	13.4/20	67.0% (67.3%)

(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 38 firms with a JCGIndex of 66 or more points (over one standard deviation above the mean) and the low JCGIndex group consists of the 39 firms with a JCGIndex of 38 or less (over one standard deviation below the mean). JCGR regards companies in the high JCGIndex group as companies with good governance.

(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 30.9%, while the average for responding firms is 21.7%, and the average for low JCGIndex firms is even lower at 12.7%. 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 between high JCGIndex firms (61.7) and low JCGIndex firms (61.6).

(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.

	Category I	Category II	CategoryIII	CategoryIV
High JCGIndex firms	16.1	19.8	20.8	16.9
Low JCGIndex firms	6.5	5.6	12.3	9.0

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 2008 JCGIndex survey, as well as in surveys for previous years, we found a close relationship between the two.

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

Based on 5-year averages, ROA (7.20% versus 7.00%) and ROE (8.91% versus 7.12%) are higher in the high JCGIndex firms than in the low JCGIndex firms. However, return on common stock was lower in the high JCGIndex firms than in the low JCGIndex firms, both the 3-year average (15.02% versus 15.76%) and the 5-year average (14.17% versus 20.01%).

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

Based on the 3-year average (2005-2007) of growth of employment, high JCGIndex firms have a lower growth rate than low JCGIndex firms (5.68% versus 5.98%). In the past 6 surveys, high JCGIndex firms had a higher growth rate than low JCGIndex firms. We need to examine each company's employment growth rate to identify the reason of this reversal.

While it is often said that in order to increase profits it is necessary to sacrifice employment, our past results suggest 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. Still, points in Categories II (board of directors) and IV (transparency) seem to be relevant for 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.

III. Recommendation

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

The JCGR surveys over the past 7 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 1,981 responses for 778 distinct firms, and each year shows a similar relationship between JCGIndex and performance (although there are a few exceptions). 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.