# Sustainable Enhancement of Corporate Value and Improvement of Corporate Governance for Japanese Companies

**— Reevaluation of Japanese-Style Corporate Management Focusing on Social Contributions and Long-Term Perspectives, and Use of the Findings —**


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# Introduction

In its Revitalization Strategy, the government of Japan stressed the importance of enhancing corporate governance in a bid to assist Japanese companies in regaining their earning power. Accordingly, in a move to adopt many of the reforms called for by investors, a series of changes have been rapidly implemented, including the establishment of a Japanese version of the Stewardship Code for institutional investors in February 2014 and the Corporate Governance Code for listed companies, which were made applicable in June 2015.

However, carrying out reforms only from the perspective of investors is not enough to bring about discussions that will lead to sustainable enhancement of corporate value. Further intensification of the tendency to determine corporate value based solely on external forms of governance structures or financial indicators emphasized by investors could hinder the continued development of Japanese companies as they tap into their inherent merits (corporate management from a long-term perspective, etc.).

In order to learn from the multifaceted perspectives developed by some companies, it would be necessary to determine what merits Japanese companies need to preserve and seek out ways to achieve sustainable enhancement of corporate value by looking at the cases of enterprises in Kansai, which hosts a number of time-honored businesses.

As such, Kankeiren has examined relevant cases of long-running companies in Kansai, expert views, and other references to compile this report with the aim of defining how to achieve "sustainable enhancement of corporate value" in a way that leverages Japanese companies' strengths and what should be done about corporate governance, which is essential for achieving this goal.

# 1. Recognition of issues based on the present situation

## (1) Corporate governance reforms from the perspective of investors

In the general background behind the recent moves to tighten corporate governance in Japan is a strong demand from foreign investors for governance reforms (appointment of more outside directors, switchover to a "monitoring-type" board of directors, etc.) as a way of preventing wrongdoing by Japanese companies and, more importantly, doing something about low profitability, which affects shareholder profit.

Needless to say, it is meaningful to humbly listen to the opinions of shareholders, who have invested their money in companies, but it is also important to note that corporate activities are conducted with the participation and involvement of not only shareholders, but also various other stakeholders, including customers, employees, business partners, suppliers, and communities.

Legally speaking, the principle of "separation of ownership and management" says that companies belong to shareholders. In Japan, however, "a company is a public entity of society" by tradition, and does not exist for the sake of shareholders alone. Rather, companies exist for a variety of stakeholders.

Therefore, in order for companies to sustainably enhance their corporate value, we believe that it is necessary to not only think from the investors' point of view, but also to pay close attention to the entire group of stakeholders and constantly update corporate governance to cater to everyone involved.

**(2) Excessive emphasis on ROE as an indicator of enterprise valuation**

In recent years, investors and analysts often talk about Return on Equity (ROE) as an indicator of a company's "earning power." It is true that, compared with their counterparts in Europe and North America, Japanese companies' ROE is low on average, yet stable with only small fluctuations on either side.

In Kansai and other regions of Japan, there exist a number of time-honored companies that were founded over 100 years ago. As they managed to survive throughout the years, they have maintained their "earning power" by responding to changes in their operating environments while at the same time moving proactively and flexibly restructuring themselves to offer new products and services designed to create new demands. It is certainly no small feat to keep a business running for as a long period as more than a century, having overcome wars, natural disasters, economic crises, and other emergencies. These companies deserve the highest praise for creating added value, maintaining employment, and contributing to society through tax payments.

In Europe and North America, on the other hand, not a few companies discontinue their business or are delisted, and they often find it difficult to survive if they fail to increase short-term earnings. As such, it may be inferred that their ROE fluctuates greatly.

Companies with a high ROE are rated highly by investors as putting their equity to efficient use; however, ROE cannot assess all aspects of corporate value because it is only a snapshot of short-term business performance.

If, for example, a company begins curbing R&D expenses and capital expenditures and reduces labor costs in exchange for short-term profit, ROE can be boosted at once. At the same time, however, doing so will impair its mid- and long-term growth potential. It must also be considered that ROE may fluctuate significantly due to non-operating factors, such as increased borrowings, dividend hikes, and share buybacks, and that it can change depending on which accounting standards are adopted.

Placing excessive emphasis on ROE for the sake of profit does not mesh well with principles and realities of Japanese companies, which are guided by corporate ethics heavily geared toward social contributions, run from a long-term perspective, and focused on fostering growth potential. Rather, the important thing for such companies is maintaining and improving "earning power" by engaging in human resources development, R&D, and investment for the sake of mid- and long-term benefits for management, rather than pursuing short-term gains. Of course, having a higher ROE as a result of all of these efforts is ideal.

Some companies use key indicators other than ROE to assess their corporate value. Return on Invested Capital (ROIC) is one such indicator that equally measures the performance of any form of business and better represents gains from major businesses. Some companies have already begun using ROIC to manage and evaluate their business objectives or have gone so far as to break it down into individual components that are then used to set targets for each workshop.

Furthermore, with a focus on companies' relationships with diverse stakeholders and their social contributions, it has been proposed to develop a new indicator for corporate value assessment that takes into account fair distribution, business sustainability, margin for improvement, and other factors, and it is hoped that this indicator will replace ROE.

## 2. What is "sustainable enhancement of corporate value?"

### (1) What is corporate value?

Because diverse stakeholders are involved in corporate activities, it can be said that corporate value is the sum of the value created not only for shareholders, but for the entire group of stakeholders, including customers, employees, business partners, suppliers, and communities. Therefore, things that cannot be assigned monetary value, such as corporate philosophy, customer/employee satisfaction, and commitment to corporate social responsibility (CSR), should also be recognized as corporate value along with ROE, share prices, and other financial indicators.

If a business does nothing but seek to maximize shareholder returns based on the most recent short-term earnings results and financial data, then only monetary value is being sought. This does not help to improve overall corporate value, and instead ends up reinforcing a shortsighted approach to business management.

If investors begin to deepen their understanding and recognition of the significance of corporate value in a broader sense that includes consideration to all stakeholders and the creation of value that cannot be assigned monetary worth, it is expected that they will think twice about focusing on corporate value assessment indicators that place excessive emphasis on short-term earnings indicators, such as ROE.

**(2) Reevaluation of Japanese-style corporate management (the merits of Japanese companies)**

One of the traditional management philosophies endorsed by many Japanese companies states that "a company is a public entity of society." This notion holds true particularly among long-running companies based in Kansai. As embodied in the management principle of *sanpō-yoshi* ("three-way satisfaction," or "a win-win-win situation" among the seller, buyer, and society), they have been strongly aware of the need to share profit equally among all stakeholders since the Edo period, which has laid the foundations for their current management. These management principles of considering all stakeholders and performing social contributions are still advocated by many companies, including second-tier companies and small- and medium-sized enterprises.

Other strengths of Japanese companies include human resources development and R&D from a long-term perspective, establishment of customer trust through impeccable quality management and painstaking after-sales service, and fostering of cooperation and collaboration between management and employees through company unions.

These excellent qualities of Japanese-style corporate management, together with social contributions, should be utilized properly to achieve sustainable enhancement of corporate value and, furthermore, to strengthen corporate governance.

### (3) Evaluation of governance reforms in recent years

Some overseas proxy voting services and institutional investors judge Japanese companies' efforts to strengthen governance only by taking note of formalities, such as the number of outside directors or the company's organizational design.

However, nothing can be changed by simply emulating how corporate organizations are designed in Europe and North America (e.g., being a "Company with Committees"). Wrongdoings will not simply disappear just by structuring organizations as they do in the West. There are many instances in which highly independent auditors with strong authority adequately check directors' performance of duties at Japanese companies that adopt the Company with Board of Company Auditors format, which represent the majority of companies in Japan. The point is, we would like foreign services and investors to <u>substantially evaluate Japanese companies on an individual basis</u> by reviewing the philosophies, realities, and track records of each company, <u>rather than evaluating them based solely on formalities</u>.

<u>What needs to be stressed here is that companies should be evaluated based on whether or not they are taking adequate risks and managing their business soundly to enhance corporate value from a long-term perspective, while also maintaining constructive dialogue with the entire group of stakeholders</u>.

## 3. Summary: Toward sustainable corporate value enhancement

### (1) Future solutions Japanese companies should aim for while seeking to achieve sustainable corporate value enhancement

In order to continue sustainably enhancing corporate value amid significant operating environment changes, including intensifying global competition and progress in advanced technological development, <u>business managers need to share long-term visions with the entire stakeholder group while maintaining constructive dialogue with them under solid management principles</u>.

In addition, to enhance their profitability, <u>they must also flexibly restructure their businesses to bring out the best in themselves and continue to take on such challenges as attempting to achieve innovations and develop new markets, while at the same time taking risks appropriately</u>. In so doing, it is <u>important that boards of directors support and back up</u>

risk-taking managers, and this necessitates assembling a board of directors who are sensible enough to make decisions that endorse such risk-taking.

In order to support management that will seek to increase profitability and implement sound management practices, it is necessary to further develop Japanese companies' traditional management philosophies while always bearing in mind the most basic tenet of management: "A company will create added value and, in so doing, contribute to the benefit of society."

To ensure sound management that is free from wrongdoing, it would be effective to revise and reapply the internal check function by, for example, holding constructive dialogue through labor-management negotiations while maintaining positive tension, and to listen to diverse opinions from external sources, including women and non-Japanese, by appointing outside directors who can revitalize board meetings.

In order to ensure that outside directors play their expected roles, it is important to develop an internal support system so that they are given appropriate and timely access to internal information that they need to make decisions. It is also necessary to forge ties with the internal control department, internal audit department, corporate auditors, full-time audit and supervisory committee members, and accounting auditors to prevent dishonest accounting practices and other cases of malpractice.

**(2) Policy measures sought from the government and relevant authorities to improve corporate governance**

Effective corporate governance serves as a framework for achieving sustainable corporate value enhancement and realizing the sound management that supports it. However, there is no optimal solution for this, as companies are all in different situations and growth stages and business environments are becoming increasingly diverse.

The fundamental premise for corporate governance improvement is that business managers, who personally lead the company, bear themselves well to become strongly aware of the importance of corporate ethics and compliance and then take the initiative to share such awareness throughout their organization in an effort to maintain and enhance the trust placed in them by society. When developing a specific system, it is important that they always bear in mind the fact that emphasis should be placed on "substance," rather than "formalities," use their own judgment to determine what is best for the governance of their own company, and make constant efforts to bring about corporate governance reforms.

"Substantial" reform of corporate governance cannot be promoted if, every time a corporate scandal comes to light, the government and relevant authorities are simply allowed to impose pro forma, uniform rules in the form of laws and regulations that treat the only the "symptoms."

While businesses voluntarily work toward constant corporate governance reform, the government and relevant authorities should also strive to foster the understanding that what matters in real corporate governance is "substance" and not "formalities" by disseminating accurate and comprehensible information to foreign investors and others concerned about the brilliant management principles, track records, and social contributions of Japanese companies, many of which boast more than a century of history.

Sustainable corporate value enhancement also requires promotion of constructive dialogue with mid- and long-term shareholders ("shareholders collaborating with companies"), who appreciate their portfolio companies' long-term visions, growth strategies, and philanthropic activities and support them through thick and thin, rather than being overly intent on the short-term movements of financial indicators. Below are some suggestions on how to improve the current system to foster constructive dialogue between companies and shareholders who tend to hold their equities over the mid and long term.

i. Revision of the corporate information disclosure system

In order to avoid excess supply of information and instead provide useful information both effectively and efficiently, it is necessary to simplify, streamline, and reduce redundancy among the three disclosure systems of the stock exchange regulations, the Companies Act, and the Financial Instruments and Exchange Act.

One point that merits special mention here is quarterly disclosure. The current system forces all listed companies to disclose earnings forecasts and other data without giving any regard to individual situations. This pressures companies to seek short-term profit and thus makes it difficult for them to run their businesses from a mid- and long-term perspective. In light of this, companies should not be obliged to make such disclosures. It would be more appropriate to leave individual companies to decide autonomously whether or not they should continue with quarterly disclosure of financial statements, disclose earnings data by other means, or disclose half-year results only.

In order to ensure that Japanese companies receive fair appreciation for their creation of corporate value while giving due regard to their relationships with diverse stakeholders and corporate activities designed to enhance growth potential over the mid and long term, it would be effective to disseminate an integrated set of information on multifaceted corporate activities, which would include not only financial information, but also non-financial information on matters such as management principles, management strategies or policies, and social contributions. It would also be appropriate to leave individual companies to use their own imaginations to decide what non-financial information to disclose voluntarily, rather than demanding that they disclose a standard package of information.

ii. Consideration of a revision of the shareholder's proposal right

It is true that the minority shareholders' proposal right is an effective tool for dialogue between companies and their shareholders, but there have been cases in which this right is used improperly when individual shareholders or certain shareholder groups take the initiative in making proposals.

The next round of discussions on the revision of the Companies Act, which will begin next year, should cover a revision of the current shareholder's proposal right in such a way that promotes constructive dialogue leading to corporate value enhancement.

iii. Leaving decisions on dates of general meetings of shareholders to individual companies

Some argue that the record date for exercising the voting right should be set after the closing date so that, for example, companies closing their books on March 31 may hold general meetings of shareholders in July of the same year, as this would ameliorate the heavy concentration of such meetings during the same period, give shareholders ample time to review agenda items, and make it easier for companies to submit their financial statements (*yū-hō)* to general meetings of shareholders.

Holding general meetings of shareholders in July, however, comes with several disadvantages for both companies and general shareholders. For example, our member companies say that doing so can delay important management decisions, such as appointment/dismissal of officers and drawing up of management strategies, increase the burden on staff members as they must compile financial statements for the first quarter while simultaneously preparing for the general meetings of shareholders, and create difficulty in completing the financial statements and having them audited based on the present disclosure schedule.

Accordingly, it would be appropriate to leave the decision to modify the general meetings of shareholders schedule by setting the record date after the closing date to the discretion of individual companies, rather than uniformly "recommending" or "requesting" them to do so.

It has also been deemed best for companies who strive to enhance their corporate value through such activities as promoting R&D over the mid and long term to proactively consider issuing class shares to reward mid- and long-term shareholders with voting rights and dividends.

**(3) Kankeiren's efforts to educate its member companies and encourage them to reinforce their programs in this regard**

With the aim of realizing the set of programs described above in which companies should seek to achieve sustainable corporate value enhancement and developing a framework for voluntary and effective corporate governance that puts weight on "substance" rather than "formalities," Kankeiren is determined to educate its member companies and help them to reinforce their programs in this regard, disseminate its opinions to institutional investors and analysts both in and outside of Japan, request the government and relevant authorities to improve systems, and make continued efforts to conduct research studies on corporate value assessment indicators, while monitoring the member companies' responses to corporate governance codes.

It is expected that, through these activities, companies in Kansai will earn well-deserved trust and a positive reputation among not only shareholders, but also various other stakeholder groups, and sustain their corporate value enhancement, thus making positive contributions toward creating a virtuous economic cycle.

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