IR Insight

*Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.*

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INVESTOR IMPACT

Investor Relations and Corporate Governance

In this issue of *IR Insight,* we would like to consider the relationship between IR programs and corporate governance.

IR is an activity that promotes corporate growth and improves the conduct of corporate management through reporting on a company's business activities to its shareholders, thereby providing the discipline of exposure to the shareholders' evaluation. Further, corporate governance has the objective of making sure the company is "well managed" and a "good enterprise"; accordingly, corporate governance also has the same fundamental aim as IR, namely, promoting growth and improving management. IR programs and corporate governance activities are closely interlinked. Going forward, IR programs, through their roles in communicating corporate information and supporting dialog with shareholders, are expected to evolve to have a major role in managing the engagement of the company with its shareholders and, more broadly, all its stakeholders.

1. Defining Corporate Governance

Corporate governance centers around exercising discipline on corporate management. In many cases, discussions of corporate governance focus on management compensation, the organizational structure of companies, and IR; considerations cover a number of fields, including organizational theory and corporate finance theory.[1] Core objectives of corporate governance are conducting management to maximize corporate value for a diverse range of stakeholders and avoiding moral hazards, and discussions center

1. Hiroshi Osano, *The Economics of Corporate Governance, Nihon Keizai Shimbun* (July 2001)

around how to impose discipline on corporations.[2] In this *IR Insight*, we will assess corporate governance using the framework set forth in the *Economics of Corporations and Organizations,* by Ronald Coase and Oliver Williamson.[3]

The principal reasons given for the necessity of corporate governance can be summarized as follows. Since contractual relationships do not exist for capital transactions between corporations and investors, corporate managements can avert risk. On the other hand, investors must entrust the running of the corporations they invest in to the management of those companies. This gives rise to the problems that investors (1) are exposed to the risk of moral hazards that may arise because of the opportunistic actions of management and (2) must pay agency costs*. For investors engaging in capital transactions, the issue is how to reduce these agency costs. Therefore, to impose discipline on management, it becomes necessary to consider how to structure capital transaction relationships between investors, who provide finance for the corporation, and management through monitoring and the creation of organizational incentives.[4] The information asymmetries between management and investors must be recognized, and the issue of monitoring and creating organizational incentives for management within the limits of bounded rationality** is difficult. These issues have been addressed by using models that (a) incorporate the concepts of "organizational solutions" (through internal controls) and "market solutions" (through external controls) and (b) introduce corporate governance into the organization.

In other words, organizational solutions draw on a mechanism in which monitoring and incentive creation are carried out by the board of directors and the board has a voice in management. Market solutions draw on a mechanism based on market liquidity to provide resolution. Currently, a major issue is how to incorporate these mechanisms into the organization.

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2. Keiichi Omura, Makot Masuko, Governance Revolution among Japanese Corporations, *Nihon Keizai Shimbun* (May 2013)
3. Coase and Williamson are economists belonging to the new system school of economists. Coase was born in the United Kingdom and became an academic economist in the United States. In 1991, he received the Nobel Memorial Prize in Economic Sciences for his book, *The Nature of the Firm*. Williamson is a noted authority on the economics of transaction costs, and received the Nobel Prize in economics in 2009.
4. Mitsuharu Miyamoto, *Economics of Corporate Systems*, Shinseiki (March 2004)

*Agency costs are borne by shareholders when management (persons delegated to run the company) make decisions that are not in the interests of the shareholders (the owners of the company), and, when management, who have more information than shareholders, use their information advantage to further their own interests (opportunism).

**Bounded rationality refers to the limitations on individual intellectual capacity due to their inability to forecast all future situations and pursue optimal behavior.

2. Who Benefits from Imposing Discipline on Management?

We should note that the composition of economic agents of the corporation include more interests than those of the shareholders. Stakeholders of corporations include shareholders, employees, creditors, transactions partners, organizations, national and local government entities, the local community, and others. Despite this, there is still discussion about "Who controls the corporation?" and "For whom does the corporation exist?" However, for example, adhering to the philosophy that the corporation belongs to the shareholders, objections may arise. If it is established that the correct philosophy is that "the corporation should be run by the management in the interest of the shareholders and operated for the profit of shareholders," this may be construed in practice to mean "the corporation should be governed by the management and run for profit of the management." Taking the argument to the extreme to make our point, the approach that "employees should govern the corporation" and "it should be run for the profit of the employees" would be completely unrealistic.[5] The important thing is that when discipline on management becomes lax and corporate performance deteriorates, discipline should be tightened. At this point, we must first (a) ask what governance measures should be implemented to improve performance and then (b) put them into action.

3. Corporate Governance Framework in Practice

Until a few years ago, the focus of discussions about corporate governance was on whether (a) shareholder-centric corporate governance, which pursues the interest of shareholders, or (b) stakeholder-centric corporate governance, which promotes the interest of employees and customers, could better attain the goals of imposing discipline on management and improving corporate performance. Notwithstanding, a number of incidents suggested that in some instances the shareholder-centric governance model

5. Mitsuharu Miyamoto, *Economics of Corporate Systems,* Shinseiki (March 2004)

was more effective, and, in other instances, it was ineffective. In addition, the same held for the stakeholder-centric governance model. In the case of the United States, these incidents included the discovery of accounting fraud at Enron.

On the other hand, in Japan, issues included the prolonged stagnation in corporate performance in corporate Japan in the 1990s and the recent disclosure of accounting fraud at Olympus Corporation. In the final analysis, the conclusion was that judgments regarding the question of whether corporate governance was effective or not will depend on whether governance bolsters and secures the credibility and competitiveness of corporations. These discussions about governance are consistent with the aims of Japan's much-discussed policy basket generally termed Abenomics. This background situation in Japan is probably why the Japanese government is placing more emphasis on corporate governance.

However, there are those who insist that it is important that corporate management be subject to discipline to protect the interests of shareholders. This view can be summarized as follows:

(1) From the perspective of legal contractual relationships, among stakeholders, the interests of shareholders are the most prone to violation. Stakeholders other than shareholders normally have some kind of transactions relationships with corporations and, therefore, are protected by various legal provisions governing these relationships. In contrast, shareholders have a claim only to the residual value of the corporation, and they will be the last to receive payment in compensation for their investment.

(2) Even though stakeholders other than shareholders have some kind of transactional relationship with corporations, in many cases, such relationships may become questionable, and there is a strong possibility that this will impair transparency. As a result, such transactional relationships may lead to impairment of the interests of other stakeholders. In contrast, if shareholders are not in the position of being creditors, employees, and/or transactions partners, this will remove questionable matters related to the protection of shareholder interests and be useful in securing transparency.

(3) If the objective is to protect the interests of shareholders in the long run, the indicator that best allows us to infer the economic value generated by the corporate organization as a whole is shareholder value. Also, since the corporation's stock price reflects corporate value and is readily observable by everyone, it is a superior

indicator for securing transparency and making clear the objectives of corporate governance activities.

In the final analysis, these arguments and ways of thinking lead to the idea that corporate governance that looks after the interests of shareholders also protects the interests of all stakeholders. It is also clear from these arguments that the function of governance is not to look after the interests of shareholders alone.

4. IR as Part of the Corporate Governance System

Perhaps no one would disagree with the idea that the roles of truly superior corporate management are to use corporate assets and capital efficiently and thereby increase corporate value. When we examine our line of reasoning so far, we can say the roles of shareholders and investors are not to rely exclusively on market solutions, but also to monitor whether management is performing its roles and then work to influence management decision making in right directions through ongoing dialog.

How can we make this dialog a reality? Shareholders and investors monitor corporations by focusing on the information that corporations disclose and on how well management draws on corporate resources (personnel, capital, and natural resources) to create value. However, the value creation that investors aim for is something that must be achieved through management's unceasing drive toward management improvement. It cannot be achieved just through monitoring. Creation of corporate value can only be achieved when corporate management and shareholders work actively to deepen mutual engagement through purposeful dialog and involvement.

This kind of interface between investors and corporations, in fact, can take place on an ongoing basis everyday via IR programs. Moreover, engagement is an activity that has the same objectives as corporate governance, namely, management improvement and efficient allocation of resources.

Therefore, we can say that it is precisely these IR programs that have the mission of providing high-quality information to the market that makes it possible for shareholders to move toward their objective of improving the management of corporations. IR programs make it possible for corporate governance to function effectively by deepening the engagement between corporate management and investors. The outlook is for IR activities to evolve from performing the role of facilitating dialog with shareholders through information disclosure to taking on a major role in promoting the engagement among corporations, shareholders, and other stakeholders.

This strongly suggests that, as Japan's corporate governance revolution proceeds and corporations put governance into practice, IR programs will assume a considerably more important role in increasing corporate value.

The above issues are covered in depth in the Investor Impact 2014 seminar materials on corporate governance.

Prepared by Rika Sumi, Representative Director and Vice President, Investor Impact, Inc.

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Feel free to contact the following with your comments on or questions about IR Insight:

C. Tait Ratcliffe
Tel: +81-3-6417-4932, Email: tait.ratcliffe@investorimpact.com
Thomas R. Zengage
Tel: +81-3-6417-4933, Email: thomas.zengage@investorimpact.com
Rika Sumi
Tel: +81-3-6417-4935, Email: rika.sumi@investorimpact.com

Investor Impact, Inc.
8th Floor, Gotanda KY Building, 2-18-2 Nishi-gotanda, Shinagawa-ku, Tokyo 141-0031,
Tel: +81-3-6417-4930 Fax: +81-3-6417-4931 Email: info@investorimpact.com
URL: www.investorimpact.com