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

Good Corporate Governance and Investor Relations (IR)

Investor Impact's principal services include assisting leading Japanese corporations in planning their IR programs and developing their IR disclosure documents, including annual reports and integrated reports. From this perspective, we are well positioned to observe trends in corporate disclosure and frequently are asked by our clients to make comparisons with peer companies in Japan and overseas as well as recommendations on best practices in disclosure. As part of Investor Impact's "IR Insight" series of thought pieces, here we review major recent developments in disclosure and provide our critical assessment and recommendations.

Corporate Governance Disclosure Rising in Importance in Japan

Recently, one of the most-important trends in disclosure in Japan has been the rise in interest and the amount of information made available concerning corporate governance at Japanese companies. Reasons for this rise include the introduction of Japan's *Corporate Governance Code*, influence of foreign shareholders, and so-called Abenomics, which emphasizes the importance of corporate governance in strengthening the earnings power of Japanese corporations. What have been the concrete results so far?

Japan's Corporate Governance Code Sets Tone and Direction

Based on a length period of deliberation by experts and public comments, Japan's *Corporate Governance Code* sets a clear tone and direction:

> "In this Corporate Governance Code, 'corporate governance' means a structure for transparent, fair, timely, and decisive decision making by companies, with due attention to the needs and perspectives of shareholders and also customers,

> employees, and local communities.
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> … It is expected that the Code's appropriate implementation will contribute to the development and success of companies, investors, and the Japanese economy as a whole through individual companies' self-motivated actions so as to achieve sustainable growth and increase corporate value over the medium-to-long term."[1]

In other words, there is now a consensus about the value of corporate governance in Japan.

■ Impact on Corporate Governance Key Performance Indicators

According to corporate governance reports and research conducted by the Japan Association of Corporate Directors (JACD)[2], as of July 2015 the percentage of Tokyo Stock Exchange (TSE) First Section listed companies with at least one outside director rose 20 percentage points to 94.3% and those with at least one fully independent director, as recognized by the TSE, increased some 26 percentage points to 87.7%. The number of outside/independent directors elected also demonstrates the rising tide of corporate governance in Japan: Of 3,464 companies listed on the TSE, between 2014 and 2015 the number of outside directors increased by 1,794 to 5,563 individuals, and the number of independent directors was up 1,837 to 4,155 individuals.

According to interviews by our firm, foreign shareholders in Japanese companies clearly support corporate governance best practices. The impact of foreign shareholders on Japanese corporate governance is noteworthy. In the fiscal year ended March 31, 2015, the percentage of ownership by foreigners in 3,565 publicly traded Japanese companies rose to fully 31.7%. Notably, according to the JACD, of Japanese companies surveyed, 18.3% of companies with less than 10% foreign ownership had no independent directors, whereas only 6.2% of those with over 30% foreign ownership lacked independent directors.

■ How Corporate Governance is Impacting Disclosure in Japan

In prior years, the corporate governance sections of Japanese annual reports and websites were brief. Around 2010, the typical length was only about 2 pages, but by 2015, some companies were devoting as many as 10 pages to explain their corporate governance systems. There is a clear trend toward a more-detailed framework for explaining corporate governance systems in Japan.

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1 http://www.fsa.go.jp/en/refer/councils/corporategovernance/20150306-1/01.pdf

2 http://www.jpx.co.jp/english/equities/listing/ind-executive/tvdivq0000008o74-att/20150729_2.pdf

In 2010, typical governance sections explained only the bare basics. This minimal amount of disclosure included the company's approach to governance (e.g., separation, in principle, of management surveillance and execution of business activities), the structure of the governance framework (Board of Directors, Board of Executive Officers, and governance committees), and the activities of advisory committees.

However, most recently sections on corporate governance provide much more-detailed explanations of the approach to governance, including the roles of various parts of the governance framework. Other information that has been added in recent years includes explanations of the corporate governance system (e.g., corporate auditor or governance committee approaches); detailed introductions to directors, including photographs and career experience history; attendance record at Board meetings; director compensation; explanations as to why specific outside/independent directors were selected; and, perhaps most importantly, interviews with independent/outside directors covering such topics as their views on governance, their contributions, and their recommendations for improvements.

■ Changes in Management Attitudes

Until the introduction of Japan's *Corporate Governance Code* in 2015, especially in the years before about 2010, there was some degree of resistance to electing outside/independent directors and to enhancing corporate disclosure on governance. The grounds for this view included the strong belief that companies could only be managed by persons with extensive backgrounds in the respective company and industry, and that outsiders therefore could not make important contributions to corporate management and might even represent an obstacle to prompt decision making. Speaking of our own IR consulting practice, specific proposals from our firm to our client companies regarding expansion of corporate governance disclosure and questions about the possibility of eventually appointing independent directors were often dismissed as being too difficult to implement. Another idea that was sometimes rejected was concept of expanding discussions of risk management beyond "boilerplate" type explanations found in the financial notes.

The *Corporate Governance Code* and its linkage to restoring the earnings power of Japanese companies under the Japan Revitalization Strategy seem to have accelerated the pace of change. As the chairman of JACD commented in his message for 2015, "The Code states the need to separate oversight and business execution as much as possible, which can be considered a major breakthrough in the attitude toward corporate governance."[3]

■ Drilling Down: Interviews with Independent Directors

Most recently, more Japanese companies are including interviews with their independent directors in their disclosure documents. Reading and helping to prepare these messages suggests to us that they have many functions. One is to encourage independent directors to contribute actively in sharing their views with the rest of the Board and sharing this information with interested parties, particularly shareholders. Another function is to focus their attention on fulfilling their role of introducing outsiders' perspectives to the Board of Directors of Japanese companies. Responding to interview questions also provides an opportunity for independent directors to reflect on their performance as persons responsible for corporate oversight.

One of the issues in preparing interview write-ups to go into corporate governance sections is what questions to ask and the extent to which the company's management and IR officers should have a voice in the content. Some key questions include the following:

- "Now that you have become an independent director, what do you view as your roles to be and what are your thoughts and plans on how you will perform them?"
- "Issues confronting many companies in Japan include how to restore earnings power and globalize the scope of their operations. How will you assist the company in addressing these issues?"
- "How will your background in business and/or other areas contribute to your performing the roles of independent director?"
- "How do you perceive your role in helping to build shareholder value and corporate value in the medium term?"

■ Tasks Ahead

Although progress is being made at a faster pace than previously in moving closer to global standards of governance and management transparency, the goal that JACD expresses as "the mountainous task of ensuring effective functioning of corporate governance" may take some time. Delineating the functions of business execution and oversight by the Board of Directors, along with clarifying the roles of independent directors, audit committees, and oversight, will be major tasks.

This does not mean that we should take it easy along the way. The simplest way to

[3] http://www.jacd.jp/en/works/150619_chairmans-message-2015.html

explain governance is to think of a game in sports. To raise the likelihood of a fair outcome, the players on both sides need an umpire. The players, the executive officers in charge of conducting management, need umpires, the independent directors, to review their performance thoroughly and often from an objective perspective. In most Japanese companies today, independent directors are completely outnumbered on the Board of Directors (in fact, the current data suggests outside directors are outnumbered 9:2), and internal directors in many cases also hold positions as executive officers. In sports terms, the players are calling the shots. If increasing earnings power and winning high appraisal from the market have high priorities, then corporate governance disclosure should also have a high priority.

■ The IR Function and Corporate Governance Disclosure

As the growing attention to corporate governance disclosure indicates, companies in Japan have become aware that the quality of their corporate governance can have a tangible impact on the market value of their shares. One way to achieve continued improvement in corporate value is to keep shareholders and investors aware of your company's progress toward separating the functions of business execution and oversight by the Board of Directors as well as clarifying the roles of independent directors.

■ Implications for Japanese Companies

Based on our analysis, we believe Japanese companies should take action as follows.

- Non-Japanese institutional investors are keenly interested in and watching closely how Japan's Corporate Governance Code is being implemented due to the potentially positive impacts in terms of clarifying corporate strategic focus, boosting corporate value, and easing stock price volatility.
- Companies should maximize the effectiveness of the contributions of outside/independent directors and auditors by encouraging them to unreservedly contribute probing and even critical questions, insights, and recommendations. Evaluations of outside/independent directors and auditors should be undertaken on an ongoing basis - annually, quarterly, or even after each board meeting - so as to encourage ongoing engagement, actionable discussion, and focus on performance.
- Continue to enhance the quality of strategic corporate governance disclosure by going beyond mechanical or rote administrative style statements. Strategic corporate governance disclosure spans provision of convincing information on the roles of various parts of the governance framework, compelling information on why particular outside/independent directors and auditors were nominated, and disclosure of the insightful viewpoints of outside/independent officers in such

forums as annual reports and integrated reports.

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