Corporate Governance / Stewardship update

Japanese companies need to open up or shut down

Alicia Ogawa
Center on Japanese Economy and Business
Columbia Business School

July 2017, #1

Abstract

Corporate Governance has become a key initiative in Prime Minister Abe's program to revitalize the Japanese economy. Investors are demanding better returns on their equity investments, given the environment of global low rates. In addition, Japanese firms continue to fall behind their global competitors in terms of profitability. One of the key challenges for management of Japanese firms is to develop a more dynamic dialogue with shareholders. Failure to have done so accounts for many of the current problems at Toshiba.

Corporate governance has long been a hot topic for investors worldwide, but it is still a new concept in Japan. The increasing number of Japanese corporate scandals points to the need for a new approach to management. Many once-prominent companies seem to be unable to adapt to the pace of global change. The domestic market no longer offers much growth potential, so Japanese firms need to actively engage with the world or perish.

There is strong global interest in Japanese corporate governance for two key reasons.

First, from the point of view of investors, the fact that rates have been low or negative in virtually all major developed economies has encouraged a sharper focus on equity markets for real returns, and Japanese companies fall woefully behind their global competitors in terms of profitability.

Second, as the pace of global competition accelerates, management is under constant pressure to react quickly to changing opportunities, such as the development of new technologies or the consolidation of capacity in maturing industries. Dialogue with outsiders, from shareholders to independent directors, is a prerequisite to navigating this terrain safely.

Japanese companies are at a distinct disadvantage in this new world because of key features of their organizational structures that served them very well in the past, such as lifetime

employment. Decision-making is slow and dominated by consensus-seeking groups of senior men who have never worked outside their own firms, who rarely have specialized expertise and whose loyalties are first and foremost to each other.

The first of the major traumas at Toshiba, which came to light in 2015, involved the 152 billion yen (US$1.33 billion) deliberate overstatement of earnings between 2008–2014. This scandal illuminated the unspoken trade-off inherent in a lifetime employment contract: staff must not question decisions made by top management.

An independent investigation into Toshiba's overstatement of earnings revealed that no CEO during that period directly instructed anyone to falsify the accounts. Rather, there was a long-standing corporate culture which mandated that managers 'couldn't refuse' the profit targets set by the CEOs, no matter how unrealistic. Nevertheless, after the first accounting scandal, Toshiba chose Shigenori Shiga as the new chairman after his predecessor resigned in disgrace. Not only was Shiga yet another lifetime company man, but a former head of Toshiba's subsidiary Westinghouse — which is now in the process of Chapter 11 bankruptcy in the United States.

Many Japanese companies have raced to create better governance on paper — Toshiba was in fact a trailblazer in this respect, having chosen to replace a traditional Japanese system of governance with US-style executive committees, including independent directors on the board. But despite appearances, an inability to encourage and respect independent thinking has led to the collapse of the former world leader in high-tech products.

Failure by Japan's corporations to embrace both the letter and the spirit of Prime Minster Abe's new governance reforms will jeopardize Japan's future prosperity. CEOs must encourage challenges by their subordinates and aggressive supervision by their independent directors.

Investors are the other key class of outsiders who need to be welcomed into the discussion. The traditional silence of friendly shareholders is yet another wall that insulates management from outside competition.

Much attention has been paid to the unwinding of friendly cross-shareholdings by banks. But most of these shares have been transferred from friendly banks to friendly corporations, who will likely never vote against management; to the Government Pension Investment Fund (GPIF), whose size makes it ill-equipped to exercise any positive influence; and to the Bank of Japan, who cannot be a force for better governance. The protection afforded by acquiescent shareholders does not seem to have changed very much.

A survey undertaken by GPIF indicated that 21 per cent of executives regarded investors' increasing scrutiny of capital efficiency to be a positive development, while 32 per cent regarded this as a very negative trend. Clearly, Japanese managers are a long way away from being comfortable discussing fundamental strategies with investors who own shares in their firms, or with their junior staff. But they had better hurry up.

In the case of Toshiba, lawsuits have been brought by several foreign investors, the world's largest public pension fund GPIF, and several of the largest domestic banks. Refusing dialogue with your outside stakeholders can carry a devastating price when mistakes are made. It's better to choose an openness to new ideas and critiques from your independent board directors and your investors, and thereby reap the benefits of dynamism and sustainability.

This essay was originally published by East Asia Forum on May 16, 2017
http://www.eastasiaforum.org/2017/05/16/japanese-companies-need-to-open-up-or-shut-down/