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## Report on the 2002 Corporate Governance Survey

Japan Corporate Governance Index Research Group (JCGR)

<http://www.jcgr.org/>

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### Overview

- (1) From March to May 2002, The Japan Corporate Governance Index Research Group surveyed Tokyo Stock Exchange First Section firms (1,504 firms as of March 11, 2002) on their corporate governance practices. We received 159 valid responses. We used these responses to develop the JCGIndex, which measures how closely a firm adheres to a model of corporate governance based on the “Revised Corporate Governance Principles” of the Japan Corporate Governance Forum.
- (2) The average JCGIndex for the 159 firms that responded to our survey was 36.3 (out of 100 possible points). The actual corporate governance practices of most Japanese firms diverge considerably from our model.
- (3) The JCGIndex consists of four categories. In general, firms scored the lowest in category 2, structure and function of board of directors, indicating that developments in this aspect of corporate governance have lagged the others.
- (4) The distribution of the JCGIndex ranged from a maximum of 73 to a minimum of 13, indicating a wide divergence in corporate governance practices across firms.
- (5) We compared the 25 firms with the highest JCGIndex to the 25 firms with the lowest JCGIndex (firms with JCGIndex of greater or less than 1 standard deviation from the mean). ROA, ROE and stock returns were higher for the high JCGIndex group, indicating that firms with the highest JCGIndex had superior capital efficiency and delivered greater returns to shareholders.
- (6) Over the past three years, low JCGIndex firms decreased their number of employees, while high JCGIndex firms added employees. Although it is often said that it is necessary to sacrifice employees to increase shareholder value, our results suggest that both shareholders and employees can benefit simultaneously.
- (7) While the relationship between the JCGIndex and corporate performance reported here is a correlation and we cannot prove causality, it is possible to infer from these results that firms with higher JCGIndex’s are delivering greater value to their shareholders.
- (8) We urge Japanese firms to pay attention to their corporate governance practices, and to speed the pace of corporate governance reform. We believe that the JCGIndex is a useful tool to help firms implement the corporate governance system demanded in today’s global environment.

Our analyses demonstrate that the JCGIndex will be useful not only to firms seeking to reorganize their corporate governance systems, but also to asset managers and other investors seeking to better understand firms. We hope that firms will use the JCGIndex as a means to communicate with their investors and the general public.

## **1. About this survey**

The Japan Corporate Governance Index Research Group (JCGR) sent a mail survey to all firms listed on the first section of the Tokyo Stock Exchange (1,504 firms as of March 11, 2002) between March and May 2002. We received 159 responses. We compiled and analyzed these responses to form the Index of Corporate Governance (JCGIndex). The names and industries of responding firms are attached as an appendix to this report.

## **2. Survey objective**

Our objective in developing the JCGIndex was to gain an accurate understanding of the current state of corporate governance in Japan, and to present this information in index form. We hope that through the JCGIndex, we can help both the Japanese and international business communities to better understand Japanese firms. At the same time, we anticipate that through the process of completing the survey, Japanese managers will develop a deeper understanding of our corporate governance model and the practices and systems that are increasingly demanded in the global business environment. We hope that the JCGIndex will be a useful tool to help firms to realize their desired corporate governance systems.

## **3. Underlying principles of the JCGIndex**

The following principles underlie the JCGIndex. These principles are based on the “Revised Corporate Governance Principles” of the Japan Corporate Governance Forum.

1. governance from the perspective of shareholders
2. clear and measurable corporate objectives
3. a system to assure accountability of CEO and top management team
4. an independent board with capability to monitor and discipline management
5. systems for managerial decision-making, implementation, and risk-management
6. accountability to shareholders
7. provision of appropriate and sufficient information to shareholders through investor relations activities
8. maintenance of transparency through disclosure of information to all stakeholders

The JCGIndex reports the degree to which a firm adheres to these principles, on a scale of 1 to 100 points.

#### 4. Analyses

##### (1) Characteristics of the responding firms

The 159 firms that responded represent about 10% of Tokyo Stock Exchange First Section firms. The following table compares the responding firms with the entire set of listed firms, based on consolidated financial data for the previous three years from 1999 to 2001. (Firms that did not report data for each of the past three years are not included.)

Responding firms tended to be larger than listed firms as a whole. ROA, ROE and stock returns were also greater for firms that responded to the survey.

total assets (consolidated)	firms	average	minimum	maximum	standard deviation
listed firms	1281	452703.77	1044.67	20169014.33	1287032.76
responding firms	138	758445.89	11573.00	17959139.33	1938884.85

(million yen)

sales (consolidated)	firms	average	minimum	maximum	standard deviation
listed firms	1281	375188.37	688.00	13803427.00	1117902.28
responding firms	138	728717.39	9626.67	13803427.00	1996759.48

(million yen)

ROA(consolidated)	firms	average	minimum	maximum	standard deviation
listed firms	1177	4.580	-38.297	51.027	4.739
responding firms	133	5.391	-3.223	18.973	3.943

(%)

ROE(consolidated)	firms	average	minimum	maximum	standard deviation
listed firms	1162	-0.654	-214.957	50.590	16.751
responding firms	133	2.190	-35.023	30.213	8.669

(%)

employees (consolidated)	firms	average	minimum	maximum	standard deviation
listed firms	1228	7613.07	31.67	318237.67	21153.78
responding firms	128	12971.82	262.67	283478.00	34631.21

(number of employees)

stock return	firms	average	minimum	maximum	standard deviation
listed firms	1326	4.022	-44.000	383.867	23.437
responding firms	140	6.887	-24.233	79.400	19.386

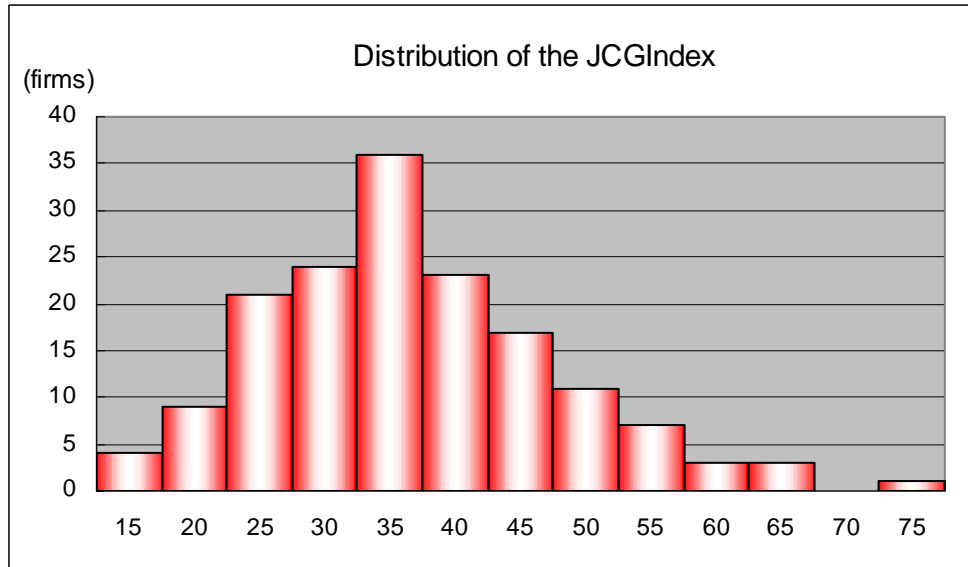
(%)

(about the responding firms)

The firms that responded to our survey tended to be stronger performers than non-responders. Regardless of their individual JCGIndex scores, the firms that responded to our survey are to be applauded for their serious interest in corporate governance and their efforts to understand and improve their own practices.

## (2) Distribution of the JCGIndex

The JCGIndex ranged from a maximum of 73 to a minimum of 13. The mean value was 36.3. There was a near-normal distribution.

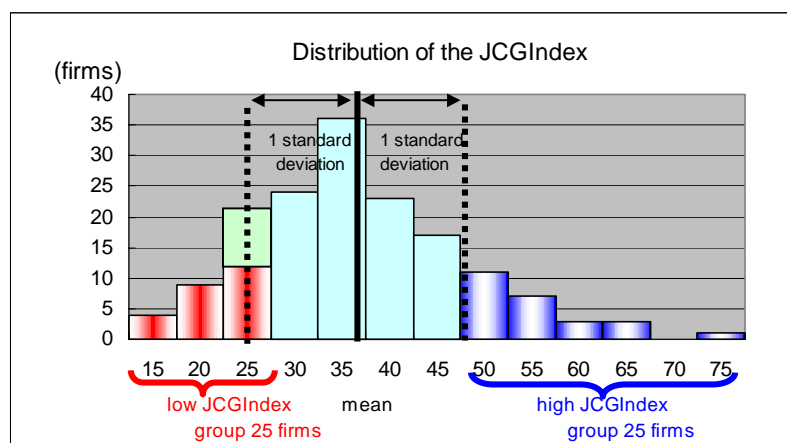


### (Definition of high JCGIndex and low JCGIndex groups)

In order to analyze the relationship of JCGIndex to various firm characteristics, we compared firms with high and low JCGIndex. High JCGIndex firms had JCGIndex of approximately 1 standard deviation (11.2) or greater above than the mean (36.3). Low JCGIndex firms had JCGIndex approximately 1 standard deviation or less below the mean.

High JCGIndex group: 25 Firms with JCGIndex greater than 48.

Low JCGIndex group: 25 Firms with JCGIndex less than 25.



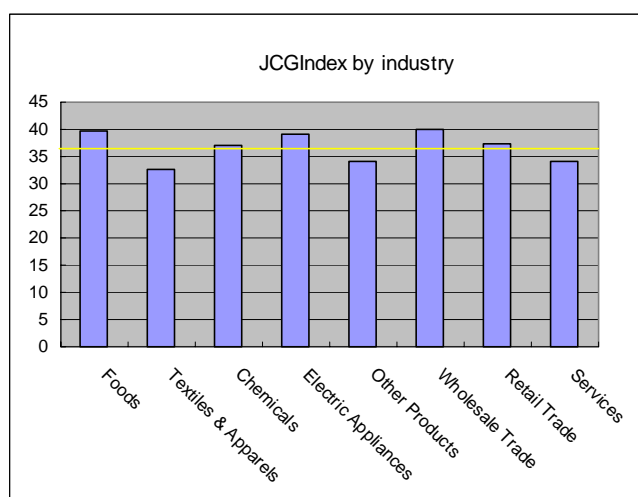
**(3) 4 categories in JCGIndex**

The JCGIndex is made up of four categories. These are: corporate objectives and CEO accountability, structure and function of board of directors, management system, and transparency and disclosure. Firms tended to score the fewest points in Category 2, “structure and function of the board of directors.” On average, firms achieved only 7.3 out of 29 possible points. This indicates that the functions of the board of directors and operating officers have not yet been sufficiently separated, and that independent directors have yet to be fully utilized.

Category	Maximum points <i>a</i>	Mean <i>b</i>	Achievement rate <i>b/a</i>
1. Corporate objectives and CEO accountability	28	10.9	38.9%
2. Structure and function of board of directors	29	7.3	25.2%
3. Management system	25	10.3	41.2%
4. Transparency and disclosure	18	7.8	43.3%

**(4) JCGIndex by industry**

This graph shows JCGIndex by industry, for industries in which there were 8 or more respondents. (We report only scores for industries with 8 or more respondents to preserve the confidentiality of responding firms.)

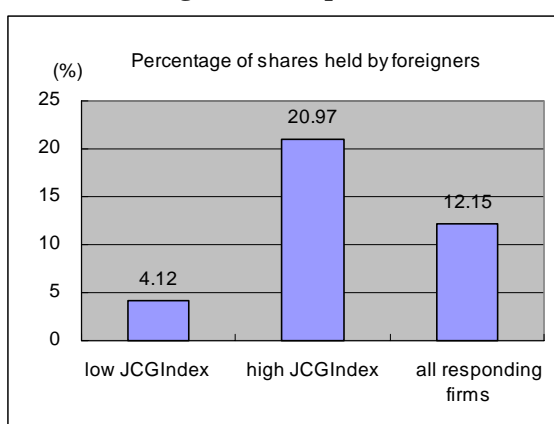


The following graphs, from item (5) to item (9), show characteristics of firms with high and low JCGIndex. The financial data is on a consolidated basis, and is averaged over the previous three (1999-2001) or five (1997-2001) years. Firms that do not report data for all years are omitted.

Performance measures are calculated as follows: ROA is (interest paid + after tax profits) / total assets (average of period beginning and period end). ROE is after tax profits/total shareholders equity (average of period beginning and end). Return on common stock is annual dividends + change in share price (capital gain or capital loss) from the beginning of the year.

**(5) JCGIndex and firm characteristics**

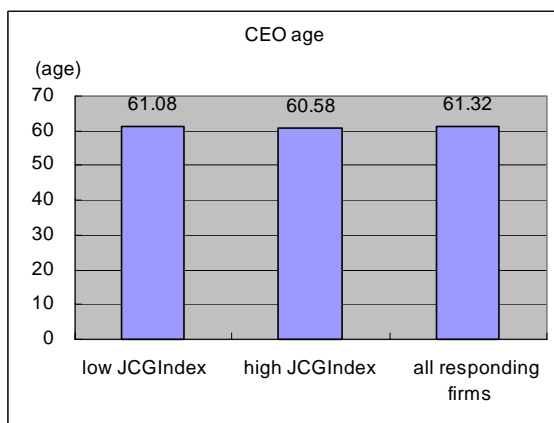
**a) Rate of foreign ownership**



The rate of foreign ownership in the high JCGIndex group was greater than that of the low JCGIndex group.

Total responses:	147
High JCGIndex group:	24
Low JCGIndex group:	25

**b) CEO age**

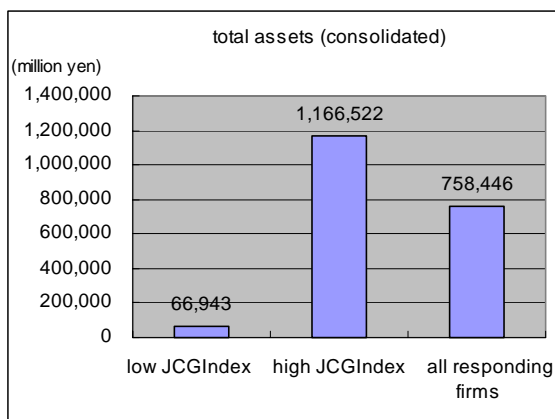


CEO's of firms in the high JCGIndex group tended to be younger than those in the low JCGIndex group. This difference, however, was not statistically significant.

Total responses:	146
High JCGIndex group:	24
Low JCGIndex group :	24

**(6) JCGIndex and firm scale**

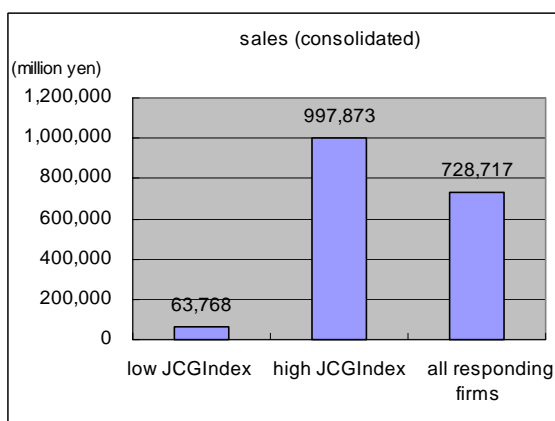
Firms in the high JCGIndex group were significantly larger in assets, sales, and employees than firms in the low JCGIndex group.



Total responses: 138

High JCGIndex group: 24

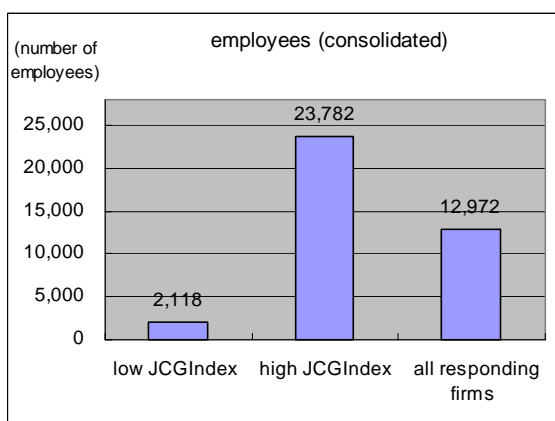
Low JCGIndex group : 18



Total responses: 138

High JCGIndex group: 24

Low JCGIndex group : 18



Total responses: 128

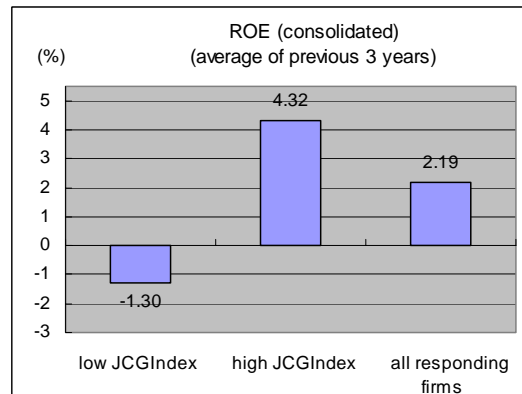
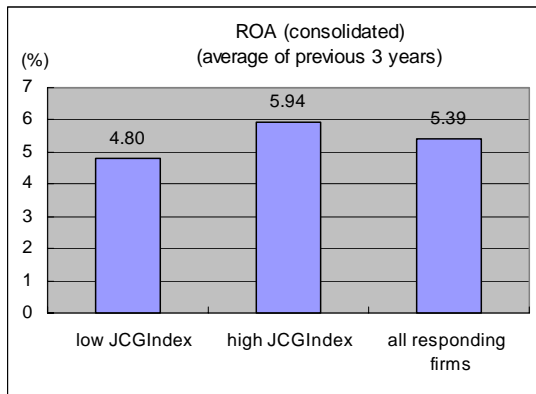
High JCGIndex group: 22

Low JCGIndex group : 18

**(7) JCGIndex and corporate performance**

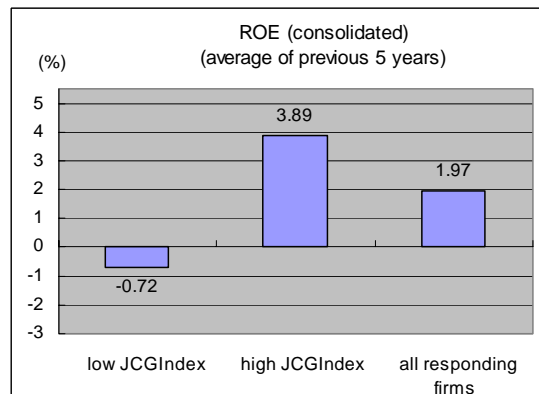
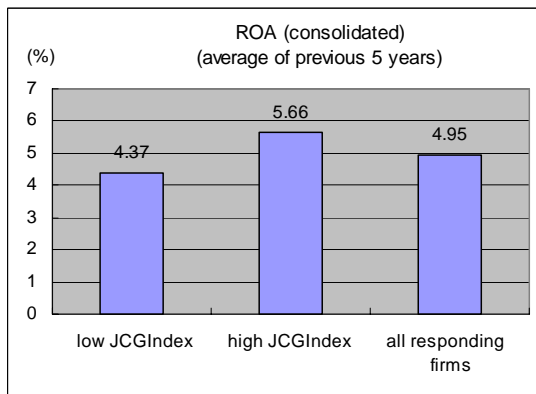
Firms in the high JCGIndex group had higher ROA and ROE than firms in the low JCGIndex group.

(ROA and ROE, average of previous 3 years)



Total responses:133 High JCGIndex group:24 Low JCGIndex group:18

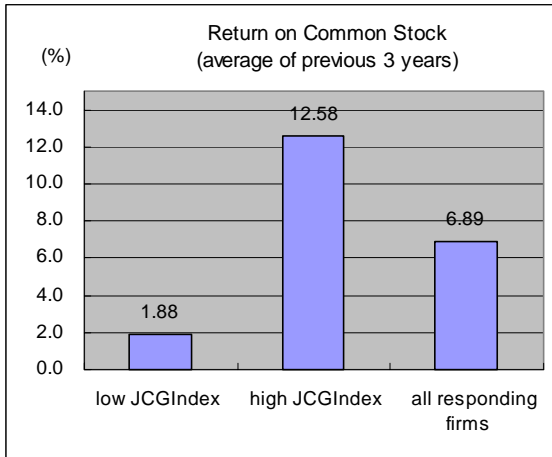
(ROA and ROE, average of previous 5 years)



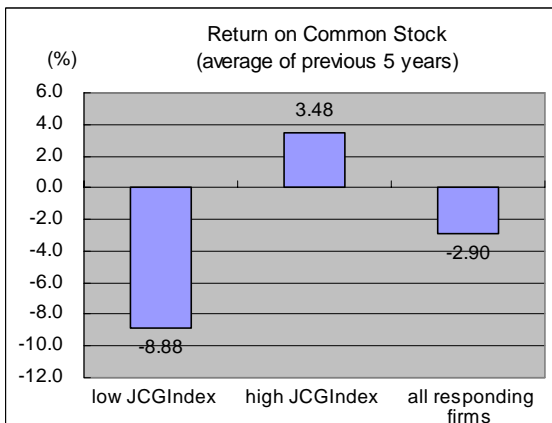
Total responses:124 High JCGIndex group:24 Low JCGIndex group:16

**(8) JCGIndex and stock returns**

High JCGIndex firms had higher returns to common stock over the previous three and five years than low JCGIndex firms. (Because in general, there is a relationship between high risk - high return and low risk - low return, simple comparisons of the size of share returns must be interpreted with caution.)



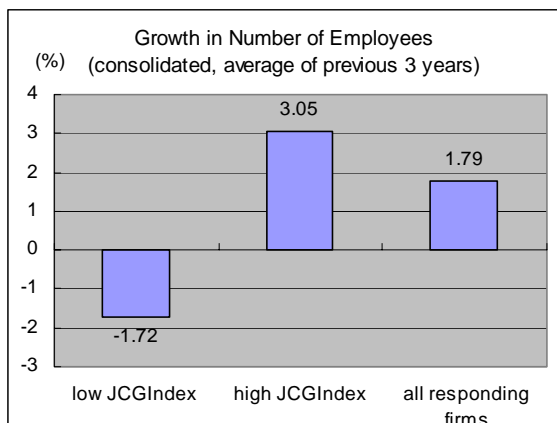
Total responses: 140  
High JCGIndex group: 23  
Low JCGIndex group: 21



Total responses: 134  
High JCGIndex group: 22  
Low JCGIndex group: 21

**(9) JCGIndex and employment growth**

Over the past three years, high JCGIndex firms increased their number of employees while Low JCGIndex firms decreased their number of employees



Total responses:	128
High JCGIndex group:	22
Low JCGIndex group:	18

**(note)**

Above we compared high JCGIndex and low JCGIndex firms. These results should be interpreted with a few cautions in mind.

First, our measures of performance predate the JCGIndex survey. This makes it impossible to establish a causal relationship between the JCGIndex and performance, and we cannot guarantee that these divergences in performance between high and low JCGIndex firms will continue in the future (though we believe that they will). Second, our sample of 159 firms is only a fraction of Tokyo Stock Exchange First Section firms (approximately 1,500 firms). Third, while it is impossible to dispute the relationships between performance and other firm characteristics and the JCGIndex for the firms in our sample, we can only infer that these relationships are the same for all listed firms.

**(Note) Sources of data used in the survey report**

**Industry**

Based on the classification used by the Tokyo Stock Exchange

**“4. (1) Characteristics of the responding firms”,**

**”4. (6) JCGIndex and firm scale” and “4. (7) JCGIndex and corporate performance”**

Items: total assets, sales, employees, ROA, ROE (non-consolidated, consolidated)  
Firms: Tokyo Stock Exchange First Section firms (1,503 firms as of August 24, 2002)  
Period: Most recent 5 years (1997 to 2001)  
Data used: NEEDS (Comprehensive economic data bank of Nihon-Keizai Shinbun- Sha)  
(The last edition updated on August 8, 2002)

**“4. (1) Characteristics of the responding firms” and ”4. (8)JCGIndex and stock returns”**

Items: stock returns  
Firms: Tokyo Stock Exchange First Section firms (1,503 firms as of August 24, 2002)  
Period: Most recent 5 years (1997 to 2001)  
Data used: “Rate of return on stock, 2001”,  
published by the Japan Securities Research Institute