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JCGR Corporate Governance Survey 2007 Final Report A Summary

Japan Corporate Governance Research Institute (JCGR)

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Outline of the Survey

The objective of corporate governance is to assure long-term corporate performance by establishing a system that makes management accountable for achieving corporate goals. A good corporate governance system leads to excellent corporate performance because it brings out superior management.

In the corporation (*kabushiki gaisha*), shareholders have responsibility for governance and exercise their rights through voting, etc. Over the last 10 years, in the face of the business environment of the 21st century, with its intensifying global competition and rapid technological change, corporations have begun to strengthen the monitoring function of their boards of directors through means such as appointment of independent directors by the annual shareholders' meeting. As a result, a corporate governance system that separates execution by managers (management) and monitoring by the board of directors (governance) has been spreading around the world. Even in Japan, the Commercial Code was revised to allow firms beginning in April 2003 to either introduce a new corporate governance system, called the Board with Committees, or maintain the existing system of statutory corporate auditors. Furthermore, in May 2005, the Company Law, which emphasizes strengthening of corporate governance, was established.

Since 2002, the Japanese Corporate Governance Research Institute has conducted an annual survey of corporate governance of all firms listed on the First Section of the Tokyo Stock Exchange. This survey assesses how close a firm's corporate governance adheres to this desirable state of separation

between management and governance, and reports the results for each firm in terms of the JCGIndex.

Between August and October 2007, we carried out our survey for the sixth time. This year, we received responses from 307 firms, for a response rate of 17.8%, which is less than our response rate of 18.4% (312 firms) for 2006. However, we received responses from 71 firms that have not responded to our survey in the past, which shows that interest in corporate governance continues to spread. In the analyses that follow, we report results for the 306 firms (of the 307 total) that responded by the deadline of November 10. The results of our analyses show that consistent with the previous five years, high JCGIndex firms enjoy higher financial performance as measured by ROA and ROE. Moreover, high JCGIndex firms also returned to shareholders higher returns on their equity investment.

In previous analyses, we found a correlation between the JCGIndex and corporate performance, suggesting that separation between governance and management is the appropriate form of governance for corporations in today's business environment. We hope that the JCGIndex and the results of our analyses will be used by both investors and managers and will be useful in promoting continued corporate governance reform in Japan. Last, but not least, we are very grateful to the companies that responded to this survey and offer them our sincere thanks for their cooperation.

Since we have begun to conduct the JCGIndex survey, the environment faced by companies has changed significantly, with the implementation of the Company Law, and as takeover bids have become an almost daily occurrence. For this reason, we have made some changes in the questions and choices for answers, and have changed some of the point allotments in this year's survey. We realize that this is not desirable in terms of continuity with previous years, but we also believe that it is important to change the index to reflect the changing business environment. Some firms may experience a change in their JCGIndex of up to 10 points, as compared to previous years, as a reflection of these changes in the survey, rather than in their actual governance.

Seven Important Results

1. Response rate indicates a continued increase in interest in corporate governance

From August to October 2007, the Japan Corporate Governance Research Institute surveyed all firms listed on the First Section of the Tokyo Stock Exchange (1,728 firms as of July 26, 2007), and received responses from 307 firms. Survey questions were based on the "JCGR Corporate

Governance Principles.” The JCGIndex is based on responses to these questions.

This is the sixth consecutive year that we have carried out the survey. In 2002, we received responses from 159 firms. In 2003, 201 firms responded, in 2004, 341 firms, in 2005, 405 firms, in 2006, 312 firms. In 2007, this year, 307 firms responded, and of these 71 were for the first time. Over the past six years, we have received responses from 731 firms, which represent about 40% of all firms listed on the First Section of the Tokyo Stock Exchange. The analyses presented in this report are based on results for the 306 firms (of the total of 307 respondents for 2007) that responded by the deadline of November 10.

2. Characteristics of the responding firms: Large firms with high performance

Firms that responded to the survey tended to be very large. The average assets, sales, and number of employees of responding firms (averaged over 2002-2006) were over twice those of the average listed firm. The performance of responding firms was also higher than that of all listed firms. The ROA of responding firms was 6.12%, compared to 6.07% for all listed firms: ROE was 6.91% versus 5.10%. There was no difference in return on common stock between responding and all listed firms (12.85% versus 13.32%). Last year, the return on common stock for responding firms was actually lower than the average.

3. Distribution of the JCGIndex: A wide range, but increased average score

This year, the average JCGIndex for the 306 responding firms is 49.4 (standard deviation 13.5), compared to an average of 47.3 (standard deviation 14.1) for last year.

As takeover bids are increasingly launched from the perspective of improving returns to shareholders, interest in and understanding of corporate governance among Japanese firms has deepened. However, 49.4 points is less than one half of the total of 100 possible points, and from this it can be concluded that the state of corporate governance in most Japanese firms is far from the ideal state of our governance model.

The range between the highest and lowest JCGIndex firms is quite large, as in previous years. This year the highest JCGIndex was 89 and the lowest was 17. Last year the highest JCGIndex was 92 and the lowest 18. This year, the standard deviation, 13.5 was somewhat smaller than last year's of 14.1.

4. Average points by category: Governance reform is unbalanced

The JCGIndex is the sum of the points in 4 separate categories (Cg1, Cg2, Cg3, Cg4). Categories I and II contain items that evaluate the level of governance, while the Categories III and IV evaluate the quality of the management system.

The following table reports the average points in each category for the 306 firms responding by the deadline. In Categories III and IV, firms on average achieved over 50% of all possible points. The achievement rates for Categories I and II were far lower. In particular, despite some improvement over time, average points for Category II, the structure and function of board of directors, has remained low, indicating that the separation of monitoring by the board of directors (governance) and execution by managers (management) has yet to spread widely.

In total, these results suggest that in corporate governance reform in the aftermath of the “lost decade” of the Japanese economy, firms have focused on corporate restructuring and have improved management systems and disclosure. In contrast, progress in reform in the essence of governance, CEO accountability and board function, has been relatively slow. Note that we have included the achievement rate for the previous year in parentheses.

Category	Mean/Total possible points	Achievement rate* (mean/total possible points)
I Corporate objectives and CEO responsibility	10.3/28	36.9% (36.4 %)
II Structure and function of board of directors	9.0/25	35.9% (34.8 %)
III Management system	16.7/27	61.7% (55.9 %)
IV Transparency and communication with shareholders	13.5/20	67.3% (66.5 %)

(Note) results from last year’s survey are in parentheses

5. Characteristics of high and low JCGIndex firms

To compare the characteristics of high and low JCGIndex firms and to examine the relationship between the JCGIndex and corporate performance, we constructed two groups: high and low JCGIndex firms. The high JCGIndex group consists of the 51 firms with a JCGIndex of 63 or more points (over one standard deviation above the mean) and the low JCGIndex group consists of the 47 firms with a JCGIndex of 35 or less (over one standard deviation below the mean).

(1) Characteristics of high and low JCGIndex firms: The percentage of foreign ownership is higher.

The average percentage of shares held by foreigners in the high JCGIndex group is 30.3%, while the average for responding firms is 19.9%, and the average for low JCGIndex firms is even lower at 10.0%. As we will see below, the financial (accounting) performance of well-governed companies is strong. It is not clear if foreigner investors purchase shares of these companies because they are well governed, or if the companies improve their governance because they have a high level of foreign ownership. Whichever direction this relationship runs, we have found a strong positive relationship between governance level and foreign ownership every year that we have conducted this survey.

The average age of the CEO for high JCGIndex firms is 61.5 while the average age for low JCGIndex firms is 60.5. Last year we found that the CEO's of high JCGIndex firms were, on average, 1 year younger than those of low JCGIndex firms.

(2) High JCGIndex firms are bigger

The total assets, sales, and number of employees are over 10 times greater in the high JCGIndex firms than the low JCGIndex firms.

(3) High JCGIndex firms are strong in all aspects of corporate governance

High JCGIndex firms have achieved high points in all four categories, indicating that a high JCGIndex cannot be achieved with high scores in only one or two categories. In Category I, high JCGIndex firms achieved on average 15.8 points (versus 5.5 points for low JCGIndex firms). In Category II, this was 16.9 versus 4.3, in Category III, 20.7 versus 11.2, and in Category IV, 16.9 versus 8.3. The JCGIndex captures the complete picture of a company's corporate governance capabilities and is not determined by single category.

6. JCGIndex and firm financial performance: A clear relationship

The objective of corporate governance is to assure excellent corporate performance. Is there really a relationship between corporate governance and corporate performance? In the 2007 JCGIndex survey, as well as in surveys for previous five years, we found that high JCGIndex companies have superior performance.

(1) High JCGIndex firms enjoy superior performance

Based on 5-year averages, ROA (7.31% versus 5.69 %) and ROE (8.15% versus 5.49 %) are higher in high JCGIndex firms. However, results are slightly different for return on common stock. For the three-year average, return on common stock is higher in high JCGIndex firms than in low JCGIndex firms (27.35% versus 23.48 %). However, for the five-year average, return on common stock is lower in the high JCGIndex firms than in the low JCGIndex firms (11.52% versus 13.42%). We believe that this is because the superior governance in high JCGIndex firms caused a more rapid improvement in performance in high JCGIndex firms.

(2) The rate of growth in employment is higher in the high JCGIndex firms

Based on the 3-year average (2004-2006) of growth of employment, high JCGIndex firms have a higher growth rate than low JCGIndex firms (6.81% versus 5.13 %). While it is often said that in order to increase profits it is necessary to sacrifice employment, this result suggests that high JCGIndex companies are establishing high performance without cutting costs through reducing employment.

7. Relationship between each category and performance: Strongest for structure and function of the board of directors and transparency and communication with shareholders

To determine whether or not there was a similar relationship between performance and each of the categories of the JCGIndex, we constructed high and low JCGIndex groups in each of the 4 categories, choosing the firms one standard deviation above the mean or one standard deviation below the mean for each of the categories. In the surveys for previous years, the groups with high points in each category had higher performance than firms with low points. This year, however, we could not see a clear relationship between points in individual categories and performance. The generally positive relationship between the JCGIndex as a whole and performance indicates that corporate governance is not a question of a single category, but rather, of all the categories taken together.

Corporate governance reform is a key to the revival of the Japanese economy

The JCGR surveys over the past 6 years have demonstrated that corporate governance is related to corporate performance. Although the response rate of the survey has not been high in any given year, over the past five years we have received 1,725 responses for 731 distinct firms. Though in recent years, the negative relationship between the JCGIndex and return on common stock is puzzling, the general picture is that good governance is related to higher performance. Based on this, we feel that it is appropriate to conclude that corporate governance reform is a necessary condition for Japanese firms to compete in the 21st century business environment. We hope that investors and managers will use the JCGIndex to promote corporate governance reform.

Investors are particularly important to governance reform. From the perspective of managers, there is not much incentive to promote corporate governance, as corporate governance reform makes them more accountable for corporate performance. For investors, on the other hand, corporate governance reform has a close relationship to the improvement of the performance of their investment, and therefore, they have a strong incentive to push for reform. This is especially true for institutional investors, who manage such a large share of investment capital today.

As investors become more aware of the importance of corporate governance reform, shareholder activism, including exercise of voting rights and establishment of governance funds, will increase. We hope that the JCGIndex will be used as an important weapon in these activities. For this reason, while we, in principle, did not disclose JCGIndex results for the first two years, from the third time that we conducted the survey, we have asked all responding companies to disclose their JCGIndex results. As part of the survey, we asked firms to give us permission to disclose their name if they were in the top 50% of the JCGIndex. Fortunately, most of the companies answered “yes.” From the third year of the survey, we have disclosed the list of all responding companies, and we have been able to add a list of the top 50% JCGIndex firms. We respect the courage of firms that permitted the disclosure of their names, and are very grateful to them. We hope that firms and investors will find many uses for the JCGIndex.