



# Corporate Governance Overview 2017

**Taking Corporate Governance to New Levels and its future  
outlook**

November 2017

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# On the Publication of *Corporate Governance Overview 2017*

The governance of Japanese companies has changed significantly in recent periods after a series of corporate governance reforms. We believe it is vital that these changes do not end as a temporary boom solely aimed at complying with the Corporate Governance Code. Rather, Japanese companies should be open to gaining new insights in constructive dialogue with institutional investors, and join the ranks of US and European companies in bold risk-taking. In addition, they must invest and reorganize their businesses and continue to take their corporate governance to new levels so that they can improve profitability and achieve sustainable growth.

KPMG Japan issued the *Corporate Governance Overview* summarizing the trends in corporate governance in Japan for the first time in 2016. Three years after Japan's Stewardship Code (the "Stewardship Code") was established and two years after the Corporate Governance Code was introduced, KPMG is now releasing the 2017 edition of this report.

When preparing for the 2017 edition, we surveyed the directors/officers responsible for corporate governance at listed companies and the chief investment officers (CIO) of the institutional investors to identify changes at listed companies and among the institutional investors. The questionnaires covered areas relating to the Corporate Governance Code, the Stewardship Code and also the dialogue between companies and institutional investors. The results showed that both companies and institutional investors feel that the Corporate Governance Code reforms have resulted in changes. However, there were clear differences in the perspectives of companies and institutional investors.

The differences between companies and institutional investors highlighted the issues that emerge when these two parties engage in dialogue. Accordingly, KPMG Japan's experts in corporate governance analyzed and considered these issues in particular in this 2017 edition. We hope that these analyses and observation will be a useful reference for initiatives to raise the corporate value of Japanese companies.

November 2017

KPMG Japan CEO  
**Hiroyuki Sakai**



# Executive Summary

## Outline

I

First, we will provide an overview of the corporate governance reforms carried out in 2016 and 2017 and the improvements in capital efficiency. We then look into how the approach to the “comply or explain” concept introduced in the Corporate Governance Code is changing on the ground and examine the changes in Japanese companies brought about by the introduction of the Corporate Governance Code.

II

In light of the appointment of external directors and changes in organizational design, we examine issues experienced by companies in board evaluation and succession planning, such as for the replacement of CEO, with a focus on the institutional aspects of companies’ corporate governance.

III

Given the changes among companies that set KPIs using capital efficiency indicators, we focus on the discrepancies between the way how companies and investors perceive corporate value. We identify issues on the corporate side related to awareness of cost of capital and restructuring of business portfolio and we also put emphasis on the importance of dialogue.

IV

In light of the trend in dialogue between companies and investors toward a focus on the medium- to long-term timeframe, we consider approaches to such dialogue as a means of raising corporate value, focusing on changes in the role of disclosure documents as well as the growing importance of non-financial information, including such as environmental, social and governance (ESG) factors.

V

We lay out the issues facing institutional investors as they strive for more constructive dialogue. This section focuses on changes from the perspective of institutional investors, such as the opportunities for dialogue, the increase in time spent for considering the agenda for shareholder meetings and the potential for making the most of group engagement as a result of the introduction of the Stewardship Code.

The KPMG opinion survey cited in this report was conducted by KPMG Japan by way of a questionnaire given to listed companies and institutional investors in August to September 2017.

# Key Findings

Differences in awareness and perspectives on corporate governance reforms and progress made, as revealed by the KPMG opinion survey for listed companies and institutional investors

1

## Differences in perceptions of progress made on dialogue between companies and investors

Institutional investors believe that more progress has been made in “dialogue with investors” and “management taking shareholder value into account” than companies do.

Companies have emphasized “augmenting board operations” and “strengthening the governance system” most in their initiatives. Institutional investors also recognize “strengthening the governance system”, but the percentage of institutional investors responding with “strengthening dialogue with investors” and “management oriented around shareholder value and capital efficiency” was higher than for companies. The result indicates that institutional investors believe that companies are involved in management oriented to shareholders more than what the companies expected.

⇒ Page 18 (Chapter I)

### Initiatives which were strengthened or perceived to have been strengthened as a result of the introduction of the Corporate Governance Code

Companies



Augmenting board operations 75%

Strengthening the governance system 72%

Strengthening dialogue with investors 34%

Institutional investors



Strengthening the governance system 91%

Strengthening dialogue with investors 73%

Shareholder value oriented management 42%

2

## Differences in perception of issues related to board evaluation

While both companies and institutional investors strongly feel that augmenting disclosures is important for board evaluation, companies feel that the objectivity of the effectiveness evaluations and standards for the evaluation are the issues.

Both companies and institutional investors ranked strengthening “board evaluation” as the most important issue for corporate governance disclosure. Institutional investors expect explanations about the effectiveness of the boards and their relationship to a higher corporate value. On the other hand, companies tend to view the objectivity of effectiveness of the evaluations and evaluation standards as problems, and many companies seem to see issues with the methods for disclosing the evaluation results.

⇒ Pages 26, 27 (Chapter II), 54 (Chapter IV)

### Issues with the board evaluation

Self-evaluations are not objective 52%

I do not understand the evaluation standards/  
I am not satisfied with the standards 40%

# 3

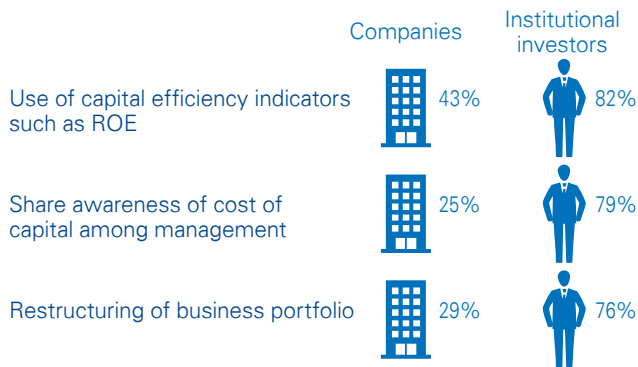
## Inadequate awareness of cost of capital at companies

While 79% of institutional investors expect management to share an awareness of cost of capital as part of the efforts to improve capital efficiency, only 25% of companies stated that management shares this awareness. As such, it appears that institutional investors are identifying a lack of companies' understanding of cost of capital.

Both companies and institutional investors put the use of capital efficiency indicators such as ROE (return on equity) and ROIC (return on invested capital) as the first priority among initiatives to improve capital efficiency, but 43% of companies responded with this, compared to 82% of institutional investors, pointing to a large gap in awareness of the issue. Capital efficiency indicators are metrics that should be used in making comparisons with cost of capital, and this indicates that institutional investors believe that companies should have a strong awareness of cost of capital, as a prerequisite to the use of such indicators.

⇒ Page 35 (Chapter III)

### Initiatives to improve capital efficiency



# 4

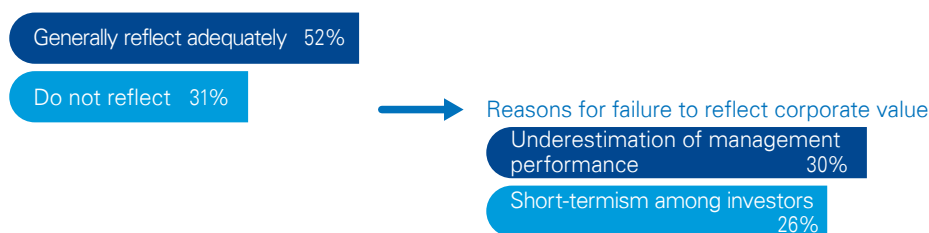
## Differences in perceptions of corporate value

31% of the companies surveyed believe that share prices do not adequately reflect their companies' corporate value in the medium- to long-term, and cite "investors' underestimation of management performance and short-termism" as the reason.

52% of the companies surveyed believe that share prices do adequately reflect corporate value in the medium to long term, but 31% of that the companies surveyed feel that the share price of their company is undervalued relative to corporate value. They attribute this to investors' underestimation of management performance and a lack of understanding about long-term value creation due to short-termism. This reveals a gap in perceptions of corporate value among some companies and investors.

⇒ Page 39 (Chapter III)

### Do share prices adequately reflect corporate value in the medium to long term?



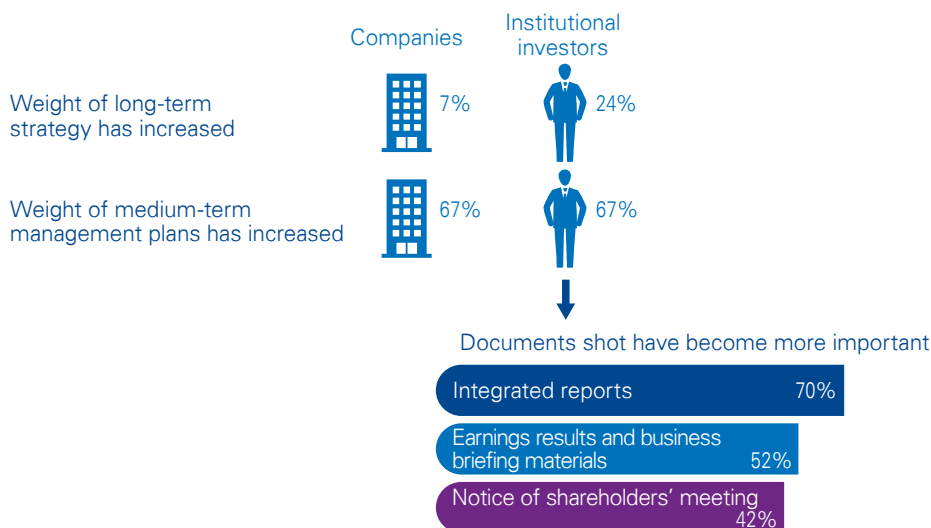
## Longer timeframe for dialogue and growing importance of non-financial information

As the timeframe for dialogue between companies and institutional investors shifts to the medium- to long-term, disclosure documents that include considerable non-financial information such as integrated reports and earnings results and business briefing materials are becoming increasingly important for institutional investors.

Both companies and institutional investors appear to see a medium- to long-term shift in the timeframe for dialogue since the adoption of the two codes, which exceeds the duration of mid-term management plans (3 to 5 years). Given this, there is a growing tendency among institutional investors to prioritize disclosure documents that include considerable non-financial information such as integrated reports, earnings results and business briefing materials. Less than 10% of institutional investors stated that summaries of financial results had become more important, which implies that they are more actively using disclosure documents that include a large amount of non-financial information.

⇒ page 43-45 (Chapter IV)

### Timeframe of dialogue after introduction of the Corporate Governance Code and the Stewardship Code



# 6

## Differences in perspectives on “E” and “S”

While companies hold dialogue on environment (E) and social (S) with an emphasis on revenue opportunities, institutional investors see E and S in terms of the risks they pose to the businesses, as well as revenue opportunities.

While companies are well aware of E and S as revenue opportunities, institutional investors see E and S in terms of the risks they pose to the businesses, and also as revenue opportunities. Institutional investors are aware of the impact of E and S on the supply chain, which indicates that they are trying to determine the impact that E and S would have on the overall businesses. Just as revenue opportunities and risks are the opposite sides of the same coin, companies and institutional investors are observing E and S issues from different perspectives.

⇒ Page 53 (Chapter IV)

### Points considered in dialogue on E(environment) and S(social)

#### Companies



#### Institutional investors



# 7

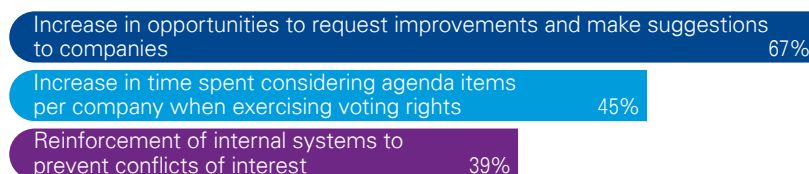
## Increasing momentum for dialogue with institutional investors

The adoption of the Stewardship Code has resulted in an increase in opportunities for institutional investors to make requests and proposals for improvement to companies.

As a result of the introduction of the Stewardship Code, institutional investors do not simply listen at meetings with companies, but have also had more opportunities to request improvements and make suggestions. With the exercise of voting rights and the time spent for thoroughly examining agenda items for each company has increased, institutional investors are working to enhance dialogue as part of their efforts to fulfill stewardship responsibilities.

⇒ Page 60 (Chapter V)

### Points that changed as a result of the adoption of the Stewardship Code by institutional investors



# KPMG's Recommendation

Corporate governance reforms which aimed at achieving sustainable growth and improving medium- to long-term corporate value, as indicated by the coexistence of the Corporate Governance Code and the Stewardship Code. Companies are well aware of the presence of institutional investors in the stock market. We attribute this to the growing role played by institutional investors as suppliers of risk capital in the stock market. Companies need to understand institutional investors' perspective on corporate value in order to develop their business by utilizing the funds provided by institutional investors.

However, the KPMG opinion survey clearly reveals the gap between institutional investors and some companies' perceptions of corporate value. The survey also indicates that institutional investors feel that management has an inadequate awareness of cost of capital. Per the observation in the Ito Review, given that the basis for corporate value from the institutional investors' perspective is the discounted present value of free cash flow, corporate value does not improve unless free cash flow grows sustainably, or cost of capital (discount rate), an indicator for risk, declines. In other words, institutional investors view inadequate awareness of cost of capital among management as a sign that companies are lack of adequate understanding of corporate value.

Not only does today's business environment change quickly, but there are also more uncertainties. As a result, it has become more difficult to direct management. This also indicates that risk has heightened for all aspects of management. Greater risk damages corporate value because the discount rate increases in corporate value assessments. Given such business environment, institutional investors attempt to identify those risks that could harm the sustainability of corporate value from an ESG perspective, and also strive to ascertain the company's revenue opportunities. Companies need to earn the trust of institutional investors by raising their ability to carry out dialogue with investors on their policies for responding to opportunities and risks.

To this end, the approach of the board of directors should be constantly reviewed to ensure that they hold discussions that enable them to accurately identify the company's opportunities and risks and take risks that will improve sustainable growth and medium- to long-term corporate value. A board's effectiveness differs significantly, depending not only on its format, but also on the management style, members (skills) making up the board, and the selection of managers who can lead the next generation. This suggests that corporate governance reforms are expected to bring about change, starting with the board of directors.

Based on an understanding of the problems described above, we provide the following recommendations.

## **(1) In light of the increase in external directors, shift focus from the structure of the board to operational aspects**

With a growing number of companies adopting a Company with Audit and Supervisory Committee system, institutional investors indicate that they are concerned about the appointment of an external corporate auditors to a successive position as external director in a sideways move, and by the relatively low proportion of external directors. While continuing with reforms to issues like these on the structure of the board, such as increasing the number of external directors, companies should also make reforms to operational aspects in order to enhance discussion over the direction of corporate strategies and to reinforce the supervisory function.

## **(2) Strengthen the relationship between the board evaluation and the improvement of corporate value**

Institutional investors are also very interested in board evaluations, but companies see problems due to the limitations of self-evaluations and are not satisfied with the evaluation standards. In addition to using external experts, companies have to set evaluation standards which focus on the correlation with the improvements in the company's corporate value, such as the quality and quantity of discussions (do discussions contribute to raising the company's corporate value?) and the knowledge in the board of directors (does the board of directors have the knowledge required for raising the company's corporate value?). In addition, companies have to ensure that the PDCA (plan-do-check-act) cycle functions systematically. To this end, it is increasingly important that the functions of the board secretariats be reinforced.

## **(3) Do not limit succession to mere planning, but focus on talent reform by incorporating "talent management" techniques**

There is a growing need to view succession plans not just as a mere planning for the next president/CEO, but as a plan for cultivation and selection of candidates for future board members and next-generation management, in order to maintain and improve board effectiveness over the medium- to long-term. This should be seen as talent reform that supports the next generation of managers while incorporating talent management techniques.

#### **(4) Operations of the board of directors which support and encourage risk-taking**

Sustainable growth and medium- to long-term improvements to corporate value require not only managing the risks that the companies are facing, but also the willingness to take on the risks. The board of directors should be operated in a way such that the executive directors, particularly management, are encouraged to take risks, while at the same time risk management is monitored. To this end, it is important to develop a system which visualize and manage the risks as part of the management strategy.

#### **(5) Improve awareness of cost of capital among management**

Institutional investors feel that management should have greater awareness of cost of capital. Capital costs are the expected rate of return on investments, and if a company cannot generate returns that exceed the expected rate of return in the medium- to long-term, from the investor's perspective, corporate value has not increased. More companies have introduced capital efficiency indicators such as ROE and ROIC as KPIs, but these indicators should be utilized in comparison with cost of capital. Cost of capital is the discount rate used in evaluating corporate value, and a company's awareness of cost of capital is essential in ensuring that corporate value reaches institutional investors' target.

#### **(6) Compile and augment non-financial information to encourage the understanding of the value creation story**

In order to encourage the understanding of the value creation story in the medium- to long-term, companies have to organize and enhance their non-financial information in terms of the content that explains the source for creating the company's value and type of documents in which such information will be disclosed. As such, companies could present the revenue opportunities and risks they face, for example, from an ESG perspective.

#### **(7) Strengthen dialogue with investors through external directors**

As both companies and institutional investors are more interested in ensuring board effectiveness, it is increasingly important that external directors, who are independent from management and controlling shareholders, and non-executive board chairperson hold dialogue with institutional investors about the effectiveness of their boards and raising corporate value. Such initiatives lower the perception of risk

among institutional investors, and can help to ensure the acceptance when they exercise their voting rights.

#### **(8) Raise capacity of institutional investors further to fulfill stewardship responsibilities**

In order to contribute to increasing the corporate value in the medium- to long-term for the companies which they invest, investment managers must determine what inquiries to make to a company after assessing the companies' business strategies and risks. This means that investment managers must improve their own capability. In addition, the investment managers should enhance dialogue with asset owners, while the asset owners must share an awareness of the role played in fulfilling stewardship responsibilities as an institutional investor by engaging in stewardship activities.



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# Initiatives for corporate governance reforms and changes among companies

## POINT

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- » There were no changes in the overall corporate governance framework in Japan in 2017, but there was progress on initiatives related to several important topics aimed at enhancing the effectiveness of corporate governance including strengthening institutional investors' stewardship activities, augmenting corporate information disclosure, strengthening incentives through director compensation reform, and carrying out reforms related to appointment of retired presidents/CEOs as advisors and consultants.
- » Over the past year, ROE has recovered to 8% and share prices have been solid as Japanese companies' profitability has improved. We have also seen progress with the content of corporate governance codes among companies.
- » Institutional investors consider that companies are engaging in "dialogue with investors" and "shareholder value oriented management and capital efficiency" more than companies themselves perceive that they are.



# 1 — Initiatives for effective corporate governance reforms

According to the KPMG opinion survey, the introduction of the Stewardship Code in February 2014 and the adoption of the Corporate Governance Code in June 2015 have led to steady changes in the awareness of companies and institutional investors about the corporate governance of Japan's listed companies and institutional investors' stewardship activities. However, compared to US and European companies, Japanese companies still have challenges when it comes to improving profitability, and initiatives to achieve more effective corporate governance reform going forward.

Specifically, from 2016 to 2017, a series of initiatives were made to (1) strengthen institutional investors' stewardship activities, (2) encourage dialogue with investors and augment corporate information disclosure, (3) strengthen incentives through director compensation reform, and (4) carry out reforms related to appointment of retired presidents/CEOs as advisors and consultants.

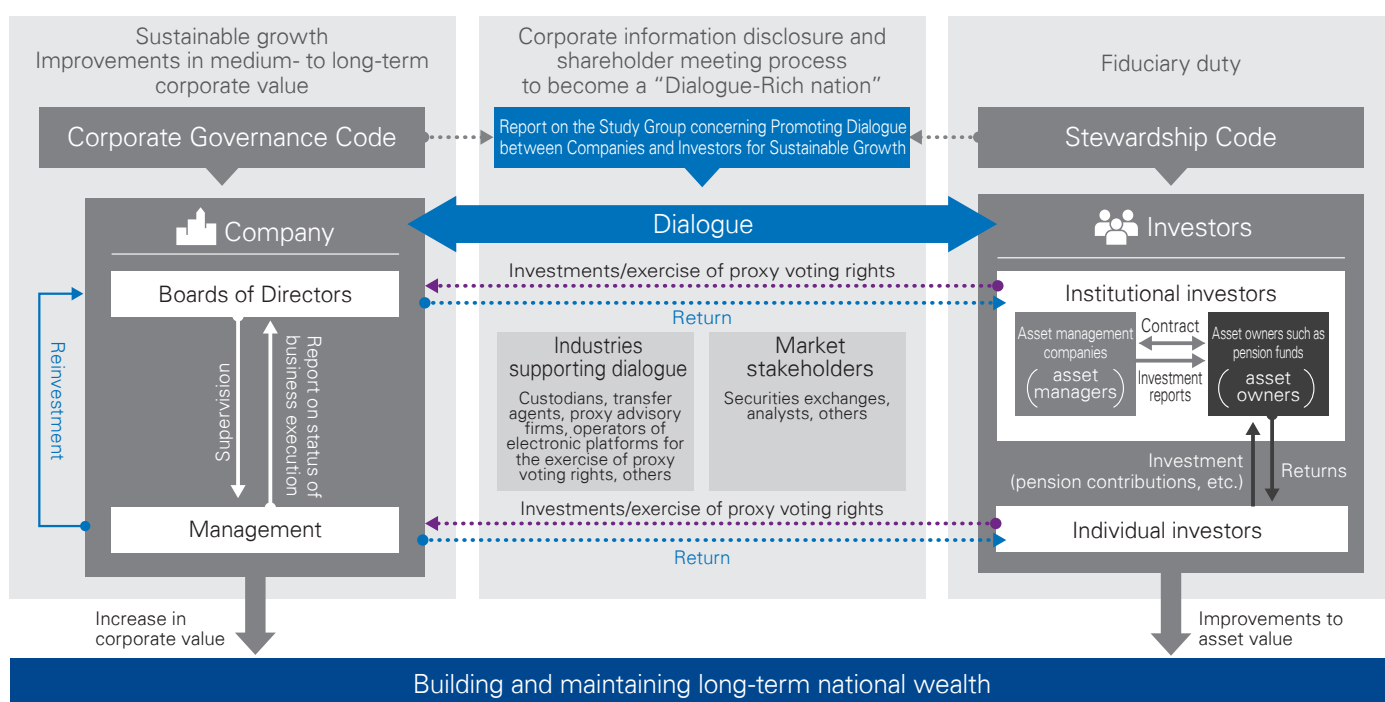
## Strengthening institutional investors' stewardship activities

In May 2017, the Stewardship Code was revised. The revisions clarify the role of the asset owner (institutional investor as the asset owner), such as pension funds, who

are closer to the end beneficiary along the investment chain (a flow in which investors create medium- and long-term value through dialogue with companies, and the resulting returns are ultimately returned to households, maintain and form national wealth; Figure 1). In addition, the revisions encourage stronger management of governance and conflicts of interest at investment managers (institutional investors as asset managers).

Investment managers engage in dialogue directly with companies. It is only natural for these investment managers to consider the interests of asset owners, who are the other party in their investment management contracts. To encourage such action, the revisions state that asset owners should engage in effective stewardship activities themselves and should clarify the actions and principles required of investment managers. Investment managers can engage in constructive dialogue with companies from a medium- and long-term perspective by setting up third-party committees in response to requests from asset owners and strengthening governance and conflict of interest management, for instance by implementing guidelines on conflict of interest management. This can lead to a virtuous cycle in the investment chain.

■ Figure 1. Investment chain



## Organizing and enhancing the disclosure of corporate information as a foundation from which to promote dialogue with investors<sup>1</sup>

On March 31, 2017, the requirement to use the Tokyo Stock Exchange's forms for earnings summaries and quarterly earnings summaries were suspended. This was motivated by the intention that reducing required disclosure as much as possible and raising the degree of freedom available for disclosure would enable companies to tailor their disclosure to their own circumstances, thus enhancing constructive dialogue between companies and shareholders/investors.

There was also progress with initiatives aimed at preventing regular shareholder meetings for companies whose fiscal year ends in March from concentrating in the same period. This was intended to encourage more dialogue with investors. Specifically, practical guidance was released for companies changing their record date, and the fiscal 2017 tax reforms made it possible to extend the filing date for corporate taxes.

A discussion about revisions to the Japanese Companies Act to allow documents attached to the notice of convocation, in principle, to be provided electronically, has also begun with the aim of providing investors with information of agenda items earlier and enhancing the content.

At the same time, when companies and institutional investors hold dialogue, companies can disclose previously unreleased internal information. When this kind of information is important and can affect share prices, market participants no longer have a level playing field, and thus it can potentially damage the expansion of sound capital markets. As a result, in May 2017 the Financial Instruments and Exchange Act was revised to introduce fair disclosure rules requiring that when companies provide undisclosed internal information to a third party, this information must be offered to other investors.

Moreover, non-financial information such as management strategies, business models and risk response is important in enabling investors to assess corporate value. However, some believe that medium- to long-term investment assessments by companies and investors, as well as constructive dialogue among them, is being damaged by the perception that investments in human capital,

R&D, IT, software and other intangible assets as well as environmental, social and governance (ESG) initiatives, which aim to raise corporate value in the medium- to long-term, are costs in the short term, and by a shortage of information disclosure and dialogue on these subjects.

With this understanding of the problem, the Ministry of the Economy, Trade and Industry released its Guidance for Integrated Corporate Disclosure and Company-Investor Dialogues for Collaborative Value Creation on May 29, 2017. This guidance provides (1) guidelines for corporate managers conveying comprehensive information to investors on their management philosophies, business models, strategies and governance and (2) guidelines enabling investors to evaluate companies from a medium- to long-term perspective and helping them make investment decisions and carry out stewardship activities. The *Ito Review 2.0*,<sup>2</sup> released on October 26, 2017, recommended that the Guidance be used as a common language among investors and companies and as a framework for systematically and comprehensively organizing the information that a company should convey to investors. In addition, it recommended that listed companies apply the Guidance by considering their approach to disclosing information, including quarterly disclosure, and creating a system encouraging investment in intangible assets.

## Using executive compensation to strengthen incentives

Fixed compensation accounts for a high percentage of manager compensation at Japan's listed companies, and observers have pointed out that this does not function as an appropriate incentive that would raise corporate earnings in the medium- to long-term. In light of these factors, the Corporate Governance Code requires that the percentage of compensation linked to medium- and long-term earnings and the proportion of cash compensation and compensation in the form of company stock be set at appropriate levels (Principle 4.2, Supplementary Principle 4.2.1).

In Europe and the US, restricted stocks and performance shares are widely used as medium- to long-term incentive compensation for managers of listed companies. In Japan companies can now give their own version of restricted stocks to employees. METI's guidance on the adoption of restricted stocks plans, released on April 28, 2016, had a

1. Related materials include "Corporate Governance: Reforms to Frameworks for Dialogue between Companies and Investors: Issues That Companies Should Address," an excerpt from a seminar entitled "Issues Companies Should Address in Reforms of Framework for Dialogue between Companies and Investors" held by KPMG Japan on April 6, 2017. Refer to <https://assets.kpmg.com/content/dam/kpmg/jp/pdf/jp-corporate-governance-report-20170406.pdf> (in Japanese)

2. METI's "Report of the Study Group on Long-Term Investment (Investment Evaluating ESG Factors and Intangible Assets) toward Sustainable Growth" (October 2017)

Q&A on taxes, the Companies Act and accounting issues when introducing stock compensation and performance-based compensation, as well as examples of a contract for stock compensation and examples of proposals for shareholder meetings. These were updated in 2017 after the tax system was revised.

## **Reforms related to internal advisors and consultants**

The Practical Guidelines for Corporate Governance Systems (CGS Guidelines) released by METI on March 10, 2017 recommended that, in terms of ensuring that current managers play an appropriate leadership role within the company, “in considering whether to appoint its retired president/CEO as an advisor or consultant who has no responsibility to shareholders, a company should consider clarifying what roles it specifically expects him/her to play, should consider establishing benefits (such as compensation) commensurate with those roles, and should consider having external directors join the process through the use of its nominating and compensation committees or other means.” In addition, the Guidelines stated that it is meaningful that a company retaining its retired president/CEO as its advisor or consultant should voluntarily provide information externally on the number of retired presidents/CEOs who serve as its advisors and consultants, their roles and benefits, and requested that companies take such an approach.

In response, on August 2, 2017, the Tokyo Stock Exchange (“TSE”) revised its guidelines for preparing corporate governance reports. Beginning with corporate governance reports submitted from January 1, 2018, companies can voluntarily add information on the status of presidents/CEOs who have retired and the name, job title, position, responsibilities, employment terms, conditions and other information if the company appoints a former president/CEO as advisor or consultant.

# 2 — How have Japanese companies changed?

## Improvements in capital efficiency

We note improvements in capital efficiency, which is important in raising corporate value.

If we look at fluctuations in corporate earnings from fiscal 2015 to fiscal 2016 (all industries excluding finance), we find that ROE in fiscal 2016 was 8.53%, a significant improvement on the 7.54% in the previous fiscal year. During the same period, the yen appreciated overall, but operating profit margin increased from 6.24% to 6.40% and the capital adequacy ratio was almost unchanged, which indicates that the improvement in ROE was not due to leveraging but to improved profitability. Moreover, dividend on equity (DOE) is also rising, which shows that companies are not simply building up their capital but making efforts to return profits to shareholders (Figure 2). The *Ito Review*<sup>3</sup> indicated that when engaging in dialogue with global institutional investors, companies should view 8% as the minimum acceptable level of ROE. In this sense, the capital efficiency of Japanese companies is reaching the level that would satisfy institutional investors that invests globally.

## Evaluation of the stock market

As the ROE has improved over the past year, share prices have remained solid. Since April 2016, TOPIX has outperformed Dow Jones and MSCI World (Figure 3).

3. Final Report of the Ito Review, "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" Project (August 2014)

■ Figure 2. Changes in main financial indicators of Japanese companies (excluding the financial sector) (%)

	Profit rate	Capital efficiency	Returns to shareholders	Financial soundness
	Operating profit margin	ROE	DOE Dividend on Equity	Capital adequacy ratio
FY2015	6.24	7.54	2.45	30.27
FY2016	6.40	8.53	2.61	30.99

\*Average exchange rates

Fiscal 2015: USD/JPY 120.17

Fiscal 2016: USD/JPY 108.54

Source: Earnings related—Japan Exchange Group's "Results of Financial Earnings Summary Compilation Fiscal 2016 (April 2016–March 2017)"

Data for fiscal 2015 is data for the companies included in fiscal 2016 totals that have been retroactively aggregated.

Exchange rate – source: SPEEDA, average of weekly exchange rates

Moreover, if we look at the breakdown of shareholders in the fiscal year ended March 2017, we find that the holdings ratio of institutional investors such as foreign investors, trust banks and life insurers increased 1.1% compared to the fiscal year ended March 2016. This shows that holdings by institutional investors who have a higher preference for risk are increasing (Figure 4) and suggests that the stock market's solid performance over the past year was due in part to net buying by institutional investors.

Since share prices are affected by a range of factors, starting with the external environment, improvements in the stock market's performance cannot be completely explained by the independent efforts of companies. However, changes in companies as a result of corporate governance reform could create a positive cycle in which institutional investors' equity stakes increase, leading to gains in share prices. Next, we will outline the initiatives that companies have engaged in since the Corporate Governance Code was introduced.

## Corporate initiatives as seen in corporate governance reports

We see signs of changes in compliance with the Corporate Governance Code.

As of July 2017, 25.9% of all companies had complied with all 73 of the principles in the Corporate Governance Code, up 4.9% compared to July 2016. The percentage of companies complying with less than 90% of the principles decreased 4.4% compared to July 2016 to 11.1% (Figure 5).

There are also signs of changes in the principles with a high percentage of companies opting to "explain."

Five principles had an explanation rate of over 20% as of July 2017, one fewer than in July 2016. The percentage of companies that explained why they did not have two or more independent directors, as stipulated in Principle 4.8, was less than 20%, indicating that the vast majority of companies have appointed several independent directors.

The explanation rate for board evaluations, stipulated in Supplementary Principle 4.11.3, fell significantly from 45.0% to 28.7%. This shows that, over the past year many companies have introduced some kind of mechanism to evaluate the effectiveness of their own board of directors.

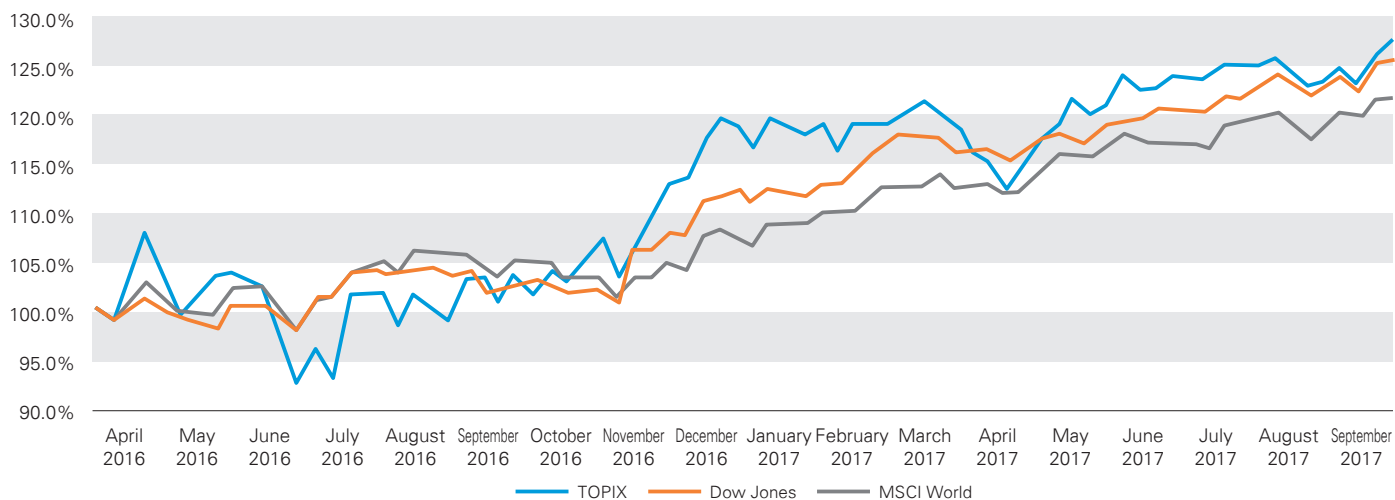
The two principles with the highest explanation rate were "infrastructure allowing for electronic proxy voting and the provision of English translations of the convening notices for general shareholder meetings" and "information disclosure and provision in English." For which there was only a limited

change in the explanation rates compared to the previous year. Electronic proxy voting and information disclosure in English are measures focused on foreign institutional investors, and companies with a relatively low percentage of foreign investors would have little incentive to strengthen these initiatives (Figure 6).

The Corporate Governance Code does not necessarily require compliance with all of the principles. Nevertheless, 88.9% of companies comply with 90% of the principles, and the principles with a high explanation rate include those

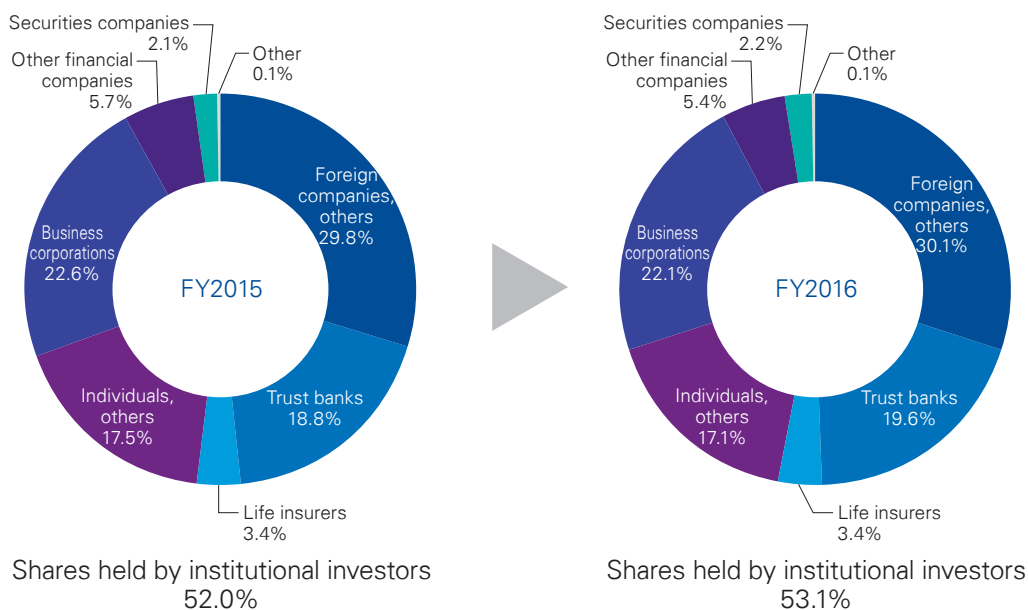
that are closely related to the shareholder composition. This shows that companies are establishing their own corporate governance systems in line with the Code.

■ Figure 3. Stock market performance



Source: Prepared using SPEEDA (indexed with April 1, 2016 as 100).

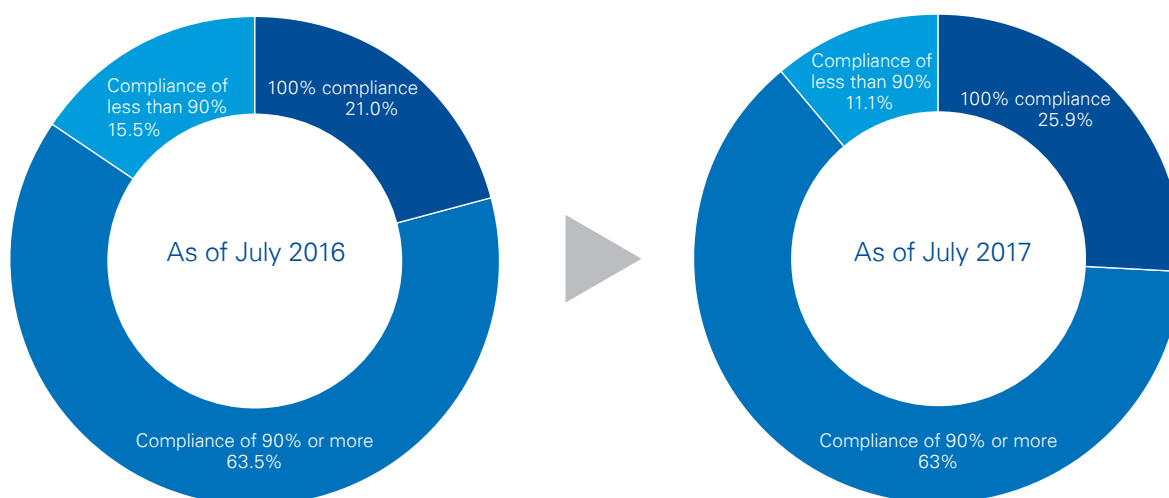
■ Figure 4. Shareholder composition



Source: TSE's Results of Survey on Distribution of Shareholders by Investor Type for Fiscal 2015 and Fiscal 2016

## 2- How have Japanese companies changed?

■ Figure 5. Compliance with Corporate Governance Code (companies listed on the first and second sections of the TSE)



Source: Tokyo Stock Exchange's "How Listed Companies Have Addressed Japan's Corporate Governance Code" for July 2016 (released on September 13, 2016) and as of July 14, 2017 (released on September 5, 2017)

■ Figure 6. Principles with an explanation rate of over 20%

As of July 2016

#	CGC Principles	Content	Explanation rate
1	1.2.4	Infrastructure allowing for electronic proxy voting and the provision of English translation of the convening notices for general shareholder meetings	55.7%
2	4.11.3	Board Evaluation	45.0%
3	4.2.1	Performance-based management remuneration	29.8%
4	3.1.2	Information disclosure and provision in English	28.1%
5	4.10.1	Establishment of optional advisory committees	25.1%
6	4.8	Appointment of at least two independent directors	21.2%

As of July 2017

#	CGC Principles	Content	Explanation rate
1	1.2.4	Infrastructure allowing for electronic proxy voting and the provision of English translation of the convening notices for general shareholder meetings	55.8%
2	3.1.2	Information disclosure and provision in English	29.4%
3	4.2.1	Performance-based management remuneration	29.1%
4	4.11.3	Board Evaluation	28.7%
5	4.10.1	Establishment of optional advisory committees	23.3%

Source: Tokyo Stock Exchange's "How Listed Companies Have Addressed Japan's Corporate Governance Code" for July 2016 (released on September 13, 2016) and as of July 14, 2017 (released on September 5, 2017)

## Initiatives strengthened with the introduction of the Corporate Governance Code, according to the opinion survey

The KPMG opinion survey gave us a clearer idea of the areas in which companies had strengthened their efforts. Many companies stated that they had reinforced initiatives in the areas of “enhancing the operations of the board” and “strengthening the governance system,” but many also seem to have made more efforts with “dialogue with investors” and “management oriented to shareholder value and capital efficiency” (Figure 7).

Institutional investors also sense changes in companies’ initiatives (Figure 7).

Institutional investors stated that they sensed that companies had reinforced their efforts with “governance systems,” followed by “dialogue with investors” and “management oriented to shareholder value and capital efficiency.” In particular, 34% of companies stated that they were focusing more on “dialogue with investors,” but 73% of institutional investors responded that they perceived a change here. Many institutional investors felt that there was more progress with dialogue than companies themselves.

While only 17% of companies stated that they had strengthened their efforts with “management oriented to shareholder value and capital efficiency,” 42% of institutional investors saw renewed efforts. This implies that institutional investors felt that, as more progress has been made in dialogue, management with an eye to shareholder views is gradually expanding (Figure 7).

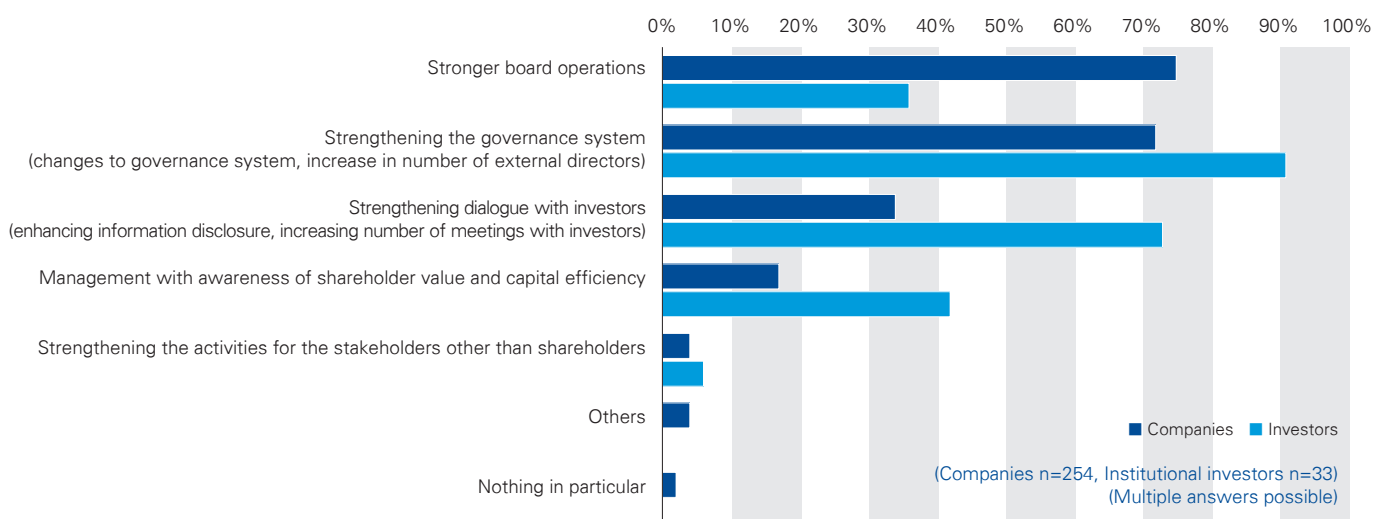
## Results of corporate governance reforms

Thanks to the introduction of the Corporate Governance Code, companies’ approach to governance is changing as they improve board operations and strengthen the governance system. In addition, institutional investors are impressed with companies’ greater efforts to engage in dialogue with investors and their shift to management focused on shareholder value, and that, at the same time, companies’ profitability has improved and ROE has increased. As a result, institutional investors’ holding ratio has increased and share prices have remained solid, which suggests that, at the very least, the results of corporate governance initiatives are bearing fruit.

However, companies have only just begun their corporate governance reforms, and still face many issues.

In the following chapters, based on results of the KPMG opinion survey, we will describe the current status of companies’ efforts, as well as the issues they face, to ensure the effectiveness of corporate governance, management with awareness of shareholder value and dialogue with investors. At the same time, we will consider institutional investors’ compliance with the Stewardship Code.

■ Figure 7. Initiatives which are strengthened or perceived to have strengthened as a result of the introduction of the Corporate Governance Code



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# Trends in and Outlook for Corporate Governance System

## POINT

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- » The structural aspects of corporate governance reforms by companies continue to appear in the form of increasing in the ratio of external directors appointed and adopting of a Company with Audit and Supervisory Committee system. However, if companies wish to truly comply with the Corporate Governance Code, they must shift their focus from structural reforms to operational, such as enhancing the discussion over corporate strategies in the board of directors' meetings and reinforcing the supervisory function, and also to reforms in talent of board members.
- » In fact, a comparison of the operation of board meetings before and after the Corporate Governance Code was introduced shows that companies are endeavoring to enhance the operations of the board of directors in terms of "emphasizing the supervisory function of the external directors" and "emphasizing on shareholders and other stakeholders." On the other hand, it is clear that many companies face issues in areas such as conducting board evaluations and having succession plans.
- » In respect of the reforms to the board of directors going forward, the key issue is whether the board of directors can contribute to raising corporate value by encouraging risk-taking among management and the frontline of their business.

# 1 — Results of two years of corporate governance reforms

It has been over two years since the adoption of the Corporate Governance Code in June 2015. During this period, many companies made progress with corporate governance reforms in line with their corporate policies by using the Corporate Governance Code as the guideline. The progress with these reforms differed among companies, but generally we find that priority has been

■ **Figure 8. Transition from structural reforms to operational and reforms in talent of board members**



given to reforms to the organizational system of the board of directors (structural reforms), while there has been gradual progress with reforms to the operations of the board of directors (operational reform) (Figure 8).

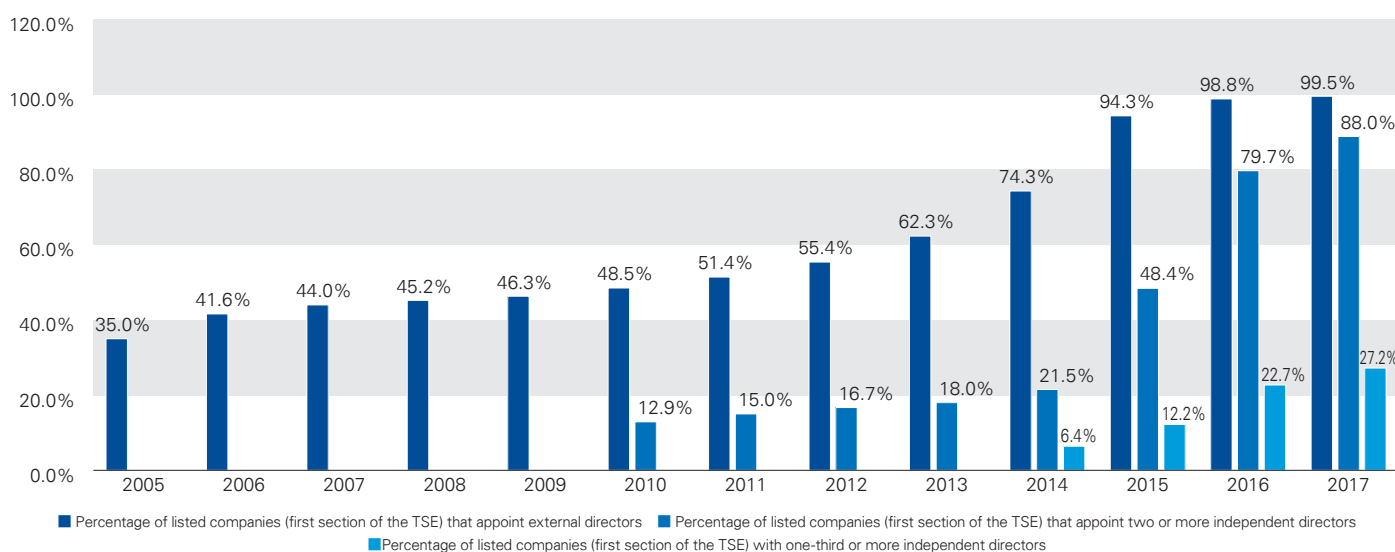
The results of KPMG opinion survey for companies clearly indicate that companies are reinforcing their efforts in regards to both the organizational system and operations (refer to Figure 7 in “I. Initiatives for corporate governance reforms and corporate changes”).

## Increasing the ratio of external directors

Since 2015, the ratio of external directors appointed by companies has increased dramatically to 88.0% of companies having appointed multiple independent directors. The percentage of companies with one-third of the board comprised of independent directors has gradually increased, reaching 27.2% in 2017 (Figure 9).

The direct reason for this is that the 2014 revision of the Companies Act requires companies to provide explanation if they have not appointed external directors, and the Corporate Governance Code requires that several independent directors be appointed (Principle 4-8). However, another reason may be that more companies are highlighting their “emphasis on shareholders and other stakeholders” with their commitment to incorporate the views of the stakeholders including minority shareholders in the board of directors by having multiple external directors.

■ **Figure 9. Appointment of external directors and two or more independent directors**



Source: Prepared by KPMG based on the TSE's “Status of Appointment of Independent Directors and Establishment of Committees by Companies Listed on the TSE” (July 26, 2017)

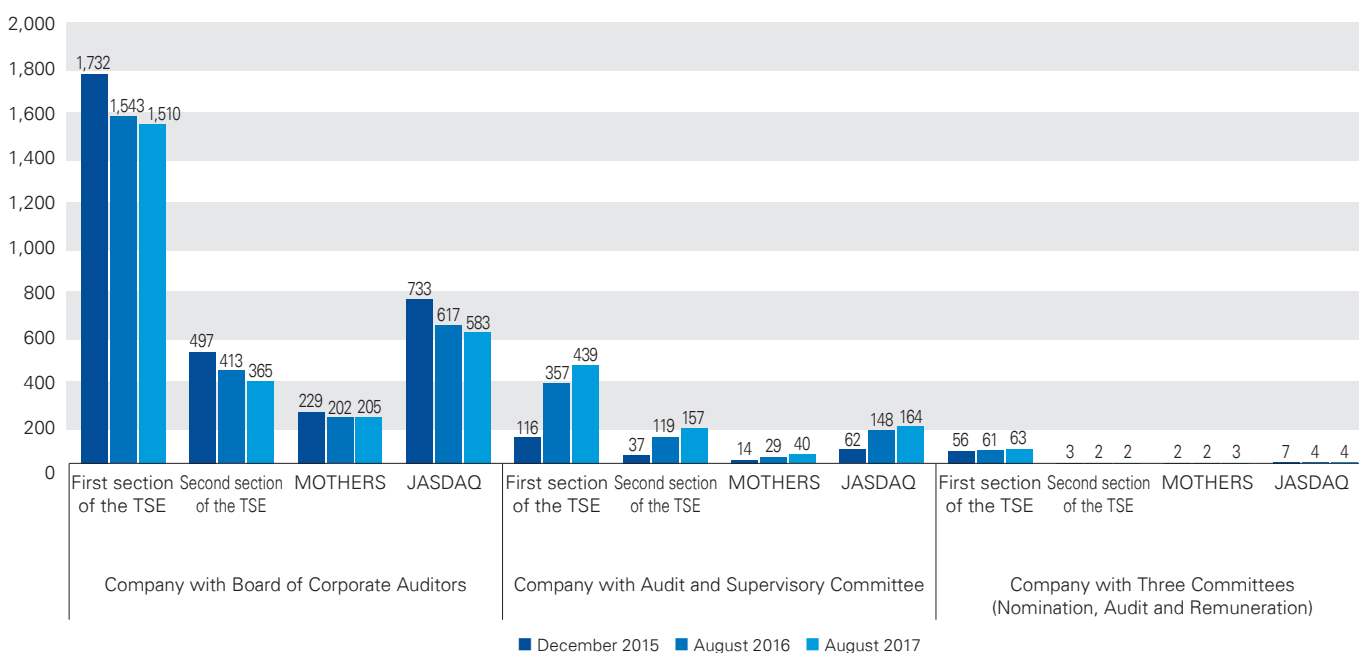
1- Results of two years of corporate governance reforms

We expect that more companies will have the board of directors which consist of one-third or more independent directors, as recommended in the Corporate Governance Code, in order to utilize the roles of the external directors more effectively.

### Changes in institutional design

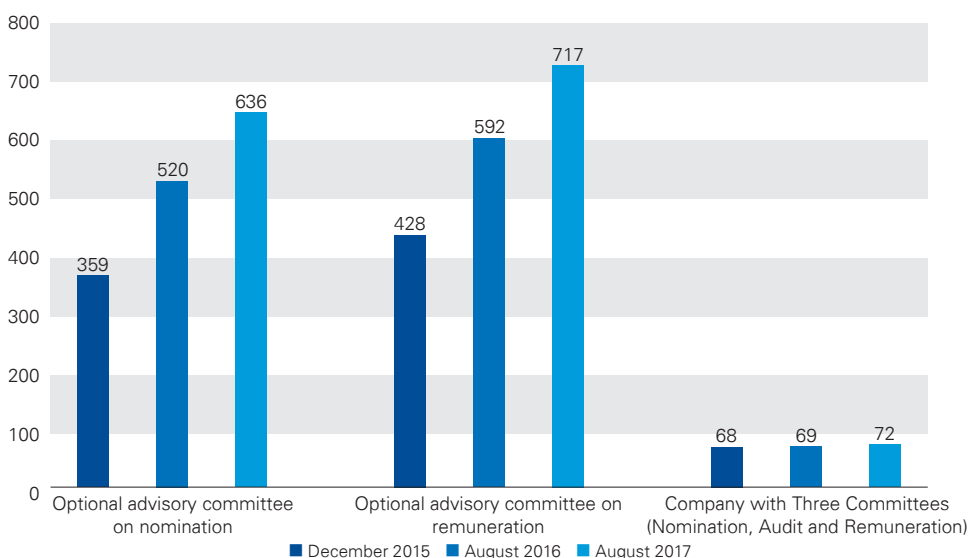
There has been ongoing progress since 2015 in shifting from a Company with Board of Corporate Auditors to a Company with Audit and Supervisory Committee system (Figure 10). There has also been an increase in the number of companies with optional advisory committees on nomination and remuneration (Figure 11). General Principle

■ Figure 10. Selection of organizational system by listed companies (as of end-July 2016)



Source: Compiled by KPMG using KPMG Japan's "Corporate Governance Survey 2016" and JPX Data Cloud "CG Report Data"

■ Figure 11. Establishment of optional advisory committees



Source: Compiled by KPMG based on the TSE's "Corporate Governance Information Service."

4 of the Corporate Governance Code identifies the primary roles and responsibilities of the board of directors as follows.

Setting the broad direction of corporate strategies (Principle 4.1)

Establishing an environment where appropriate risk-taking by the senior management is supported (Principle 4.2)

Carrying out effective oversight of directors and the management (including *shikkoyaku*(executive officers) and so-called *shikkoyakuin*(corporate executives)) from an independent and objective standpoint (Principle 4.3)

This means that companies that wish to truly comply with the Corporate Governance Code's stipulations on

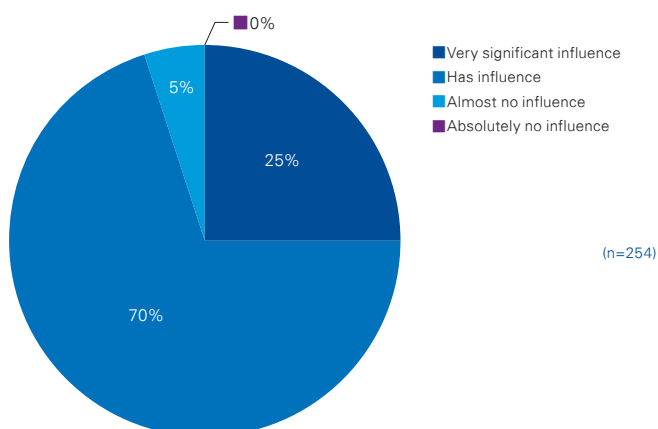
the board's roles and responsibilities must enhance the board's discussion on the directions of corporate strategies and the supervisory function of the board, which is currently inadequate.

If companies shift to a Company with Audit and Supervisory Committee system and have a board of directors with a majority of external directors or have a provision in their Articles of Incorporation, same as a Company with Three Committees (Nomination, Supervisory and Remuneration) system, entrusting the board of directors with the authority to make decisions over operations to some extent and to appoint directors, will enable the board to enhance discussion on the direction of corporate strategies and to shift to a monitoring model.

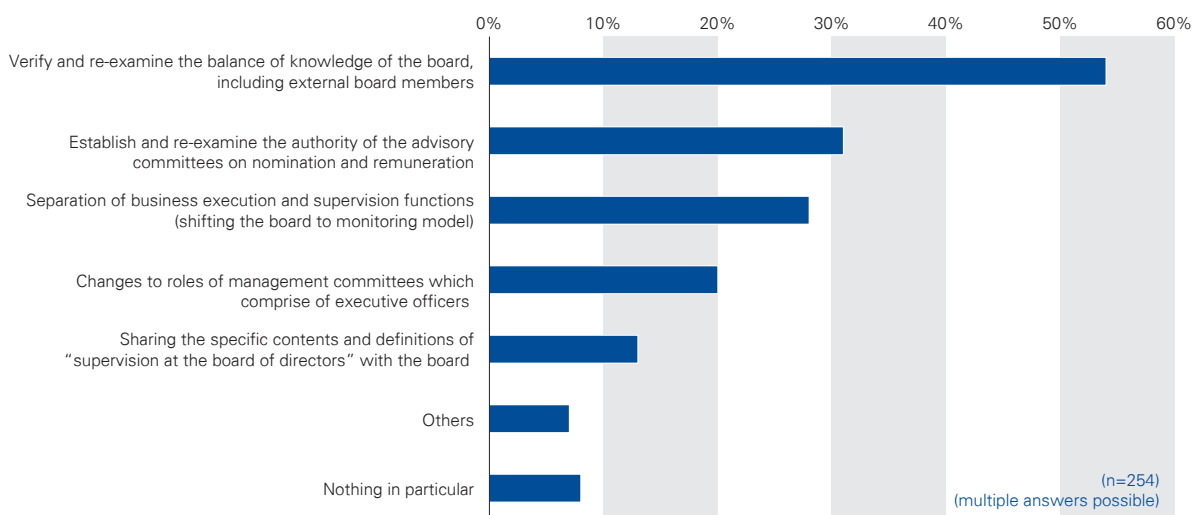
However, in fact, some companies shift to a Company with Audit and Supervisory Committee system in order to alleviate the sense of burden and overlap when two independent directors are appointed. Institutional investors are particularly concerned about "sideways moves" in which an external corporate auditor is appointed as an external director, and also about the relatively low numbers of external officers. In this case, companies should not only take up the structural reforms such as increasing the number of external directors, but also carry out the operational reforms by enhancing the board's discussion on the direction of corporate strategies and strengthening its supervisory function.

Moreover, one of the ways to involve independent directors in enhancing the supervisory function is to

■ Figure 12. [Companies] Extent of influence of external directors' opinions on the board's decision-making



■ Figure 13. [Companies] Initiatives deemed to have been effective in strengthening the board's supervisory function



## 1- Results of two years of corporate governance reforms

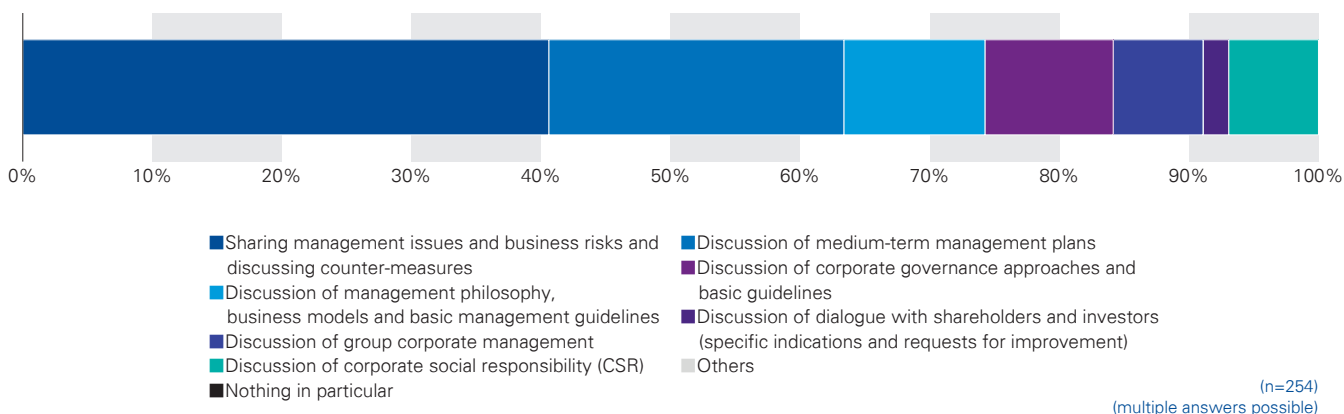
appoint optional advisory committees on nomination and remuneration to get involved in considering issues that are particularly important such as the nomination of and remuneration for management. Optional advisory committees on nomination and remuneration play a wide range of roles, but based on the objective of the Corporate Governance Code, operational reforms such as granting appropriate level of authority, selecting the committee chairperson and members, and devising decision-making methods would be the challenges.

### Changes in the roles of external directors on boards

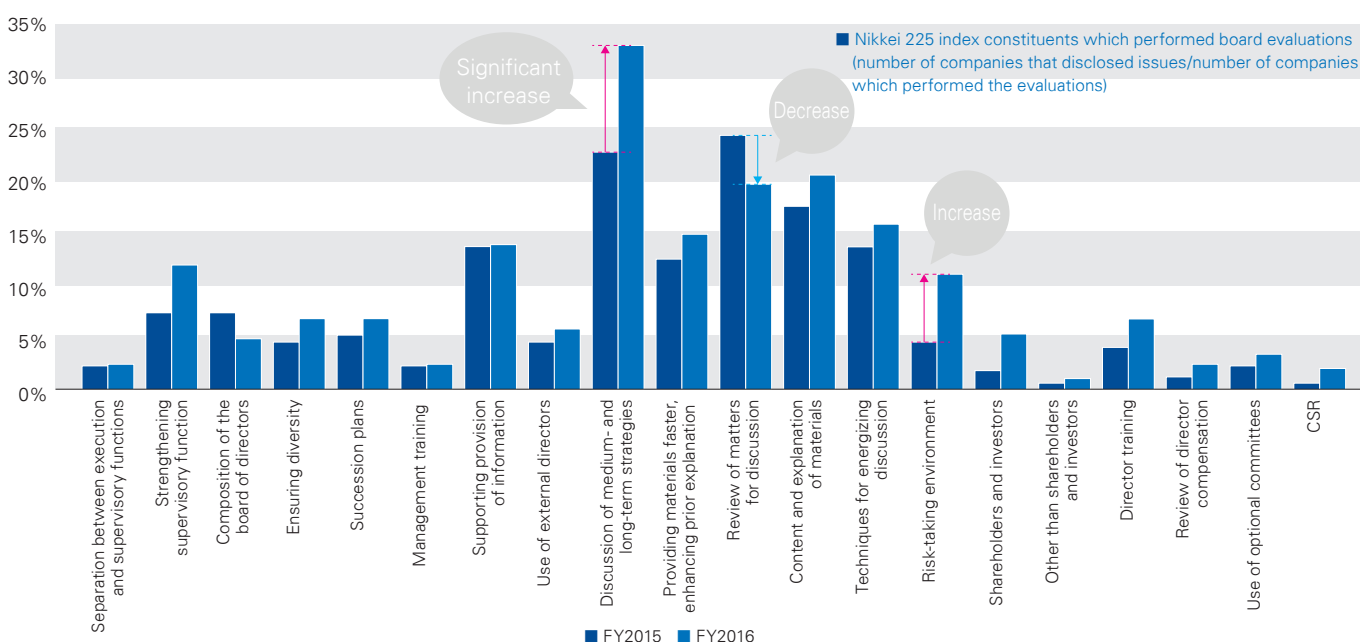
As noted above, the percentage of external directors appointed by companies has increased, and the KPMG opinion survey for companies shows that external directors have a growing sense of presence on the board of director (Figure 12).

In a similar survey that KPMG gave to corporate auditors in 2016<sup>4</sup>, a total of 28% answered that statements made by external directors had “almost no influence” or “absolutely no influence” on the board’s decision-making, but in the

■ Figure 14. [Companies] Issues getting more discussion time at the board meetings



■ Figure 15. Changes in recognition of issues with evaluations of board effectiveness (Nikkei 225 index constituents)



Source: Prepared by KPMG based on the “Overview of results of board evaluations” in the corporate governance reports released by the Nikkei 225 index constituents

recent survey, that percentage had dropped to 5%. Other efforts that are likely to be effective in strengthening the board's supervisory function are "verify and re-examine the balance of knowledge of the board, including the external board members" which over half of companies surveyed considered effective (Figure 13). In addition, many companies stated that they had high expectation for exchanging views with external directors and the information that they could provide.

These responses indicate that companies are running their boards with an emphasis on how they can bring the knowledge and perspectives that cannot be obtained internally within the company.

### Changes in board's agenda

The KPMG opinion survey for companies indicates the changes in the time allocated for the agenda items at the board of directors meetings (Figure 14).

Compared to the previous year, 75% of companies surveyed stated that discussion time had increased for "sharing management issues and business risks and discussing counter-measures," "discussion of medium-term management plans" or "discussion of management philosophy, business models and basic guidelines for management." The result indicates that companies are not simply making decisions on the execution of individual operations and reviewing and checking separate proposals, but are also attempting to manage deliberations with an emphasis on agenda items related to business risks from a medium- and long-term perspective and the

basic management guidelines. The fact that the board of directors has begun to function as a forum for constructive discussions and exchange of views, reflecting the aims of the Corporate Governance Code, is a sign that progress is being made with operational reforms.

The opinion survey shows that these initiatives are yielding results, but many companies still have issues with the agenda that should be discussed by the board. KPMG analyzed the agenda items at the board of directors meetings listed in the "Overview of results of board evaluations" in the corporate governance reports released by the Nikkei 225 index constituents. The result shows that 33% of those companies felt that "discussion of medium- and long-term strategies" was necessary. This is more than 10% higher compared to the 2015 disclosures (Figure 15).

These results indicate that companies are attempting to run their boards with a focus on discussion concerning medium- and long-term strategies, management issues and business risks, but there are still disparities in the degree to which this has been achieved.

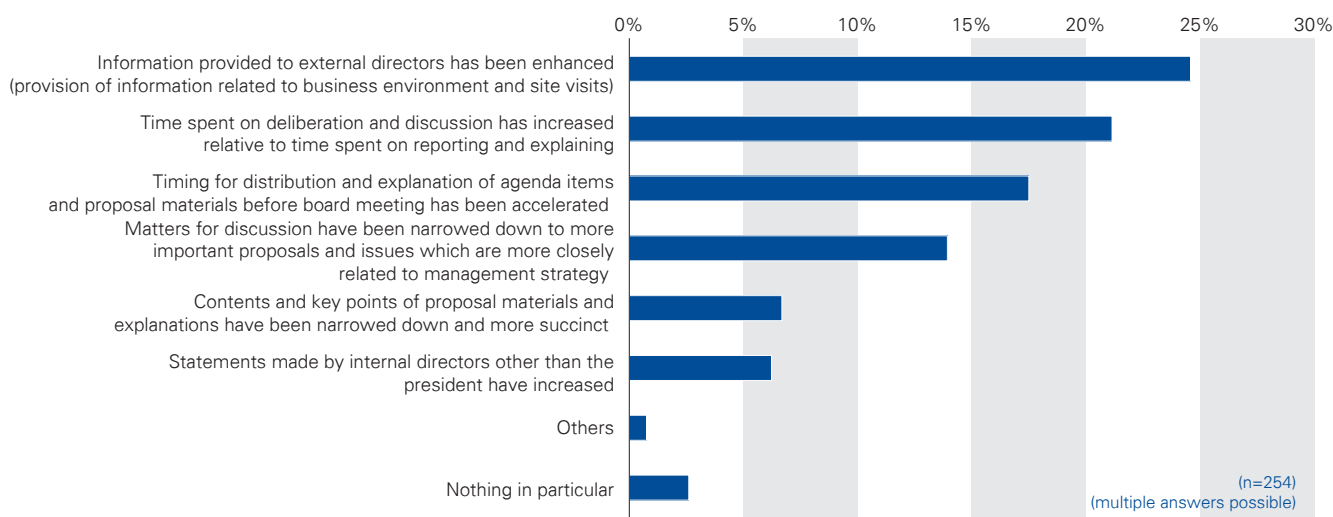
### Changes in deliberation and operations of the board

The KPMG opinion survey shows that companies are taking various measures in the deliberation and operations of their board of directors (Figure 16).

The biggest changes in terms of energizing board discussion over the past year have been "enhancing the information provided to external directors" and "increasing time for deliberation and discussion (reducing time for

4. KPMG Consulting's "Results of 2016 Questionnaire on Current Status of Discussion and Reporting in the Board of Directors," October 2016

■ Figure 16. [Companies] Changes in energizing board discussion over the past year



reporting and explaining).” This also corroborates the aforementioned “changes in the roles of external directors on the board” and “changes in the agenda”.

The aforementioned analysis result in relation to changes in the perception of “evaluations of board effectiveness” (the Nikkei 225 index constituents; Figure 15) shows that the percentage of companies which view the “narrowing down of matters for discussion” decreased in 2016 compared to 2015. Such result suggests that some companies have already finished addressing this issue. We surmise that some companies are already wrapping up the operational reform measures that are easy to undertake.

## 2 — Specific issues facing companies in meeting investors' expectations

As we have stated thus far, structural and operational reforms are yielding results, although the progress differ depending on companies. However, are these reforms proceeding in a way that meet the expectations of institutional investors? The KPMG opinion survey for institutional investors shows that some of the areas in which institutional investors expected improvements (priority areas) were seen as problematic areas by companies. Typical examples are board evaluations and succession plans for top management.

In the section below, we explain the current status of these two problems and clarify the issues faced by companies.

### Expectations of institutional investors for board evaluations and the current status as revealed by the opinion survey

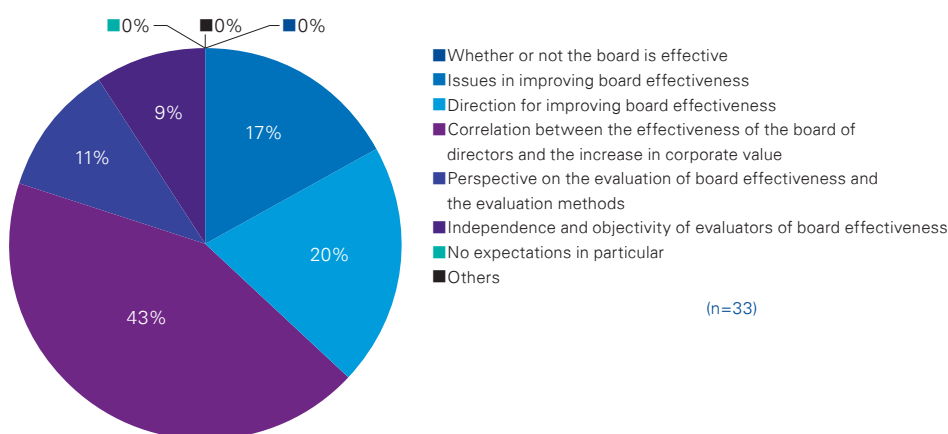
According to the KPMG opinion survey for institutional investors, many institutional investors believe that information on the evaluation of board effectiveness should be enhanced and provided as information on governance (Figure 17).

When asked about the disclosure of board evaluation, the most common response at 43% was that they expected to see "a correlation between the effectiveness of the board of directors and the increase in corporate value" (Figure 18).

■ Figure 17. [Institutional investors] Disclosure on governance information which should be enhanced by companies



■ Figure 18. [Institutional investors] Expectations for disclosure of results of the evaluation of board effectiveness



Institutional investors have high expectations for board evaluation because they are hoping that boards that are run effectively will lead to an increase in the corporate value. However, this is one of the areas that companies are struggling the most with in complying with the Corporate Governance Code.

The KPMG opinion survey for companies shows that there are issues with “limitation to self-evaluation,” “difficulty in setting evaluation standards” and “insufficient utilization of evaluation results” (Figure 19).  
 “Limitation of self-evaluation” refers to the inability to ensure the objectivity of the evaluations, draw out the

■ Figure 19. [Companies] Issues with evaluation of board effectiveness



■ Figure 20. Perspectives and issues in setting evaluation standards for board evaluation

No.	Evaluation perspectives	Key points
I	Roles and responsibilities of the (board of) directors	Establishment of management principles, formulation of management strategies and succession plans, etc., with a view to building a foundation for improving corporate value over the long-term
II	Relationship between board of directors and executives	Appointment and dismissal of executives, risk management and compliance, status of execution, reports and supervision
III	Design and composition of organization including board of directors	Organizational design, use of external directors, establishment and administration of committees
IV	Quality and knowledge of the (board of) directors	Knowledge, capability, experience, independence and diversity of external directors, training
V	Discussions at board of directors	Energizing of discussions at board of directors, system for obtaining information and support, use of external directors
VI	Relationship and dialogue with shareholders	Ensuring rights of shareholders, shareholder response, enhancing information disclosure, constructive dialogue with shareholders
VII	Response to stakeholders other than shareholders	Response to social and environmental issues, ensuring diversity of employees, respect for employees, communication with stakeholders

board's real views, and identify issues. Companies which have performed self-evaluation for two or three times also have the similar frustration. There are limitations in identifying and analyzing the issues of the board of directors in a broad and deep manner by simply using the self-evaluated questionnaire annually.

The "difficulty in setting evaluation standards" refers to the problem of what should be evaluated and from which perspective, as well as the level that has to be reached for a board to be considered "effective". Many companies use a general framework while also setting its own evaluation standards, as shown in Figure 20.

On the other hand, many companies feel that it is difficult to determine how to incorporate a perspective that will contribute to the increase in the company's corporate value, other than simply using the evaluation standards based on the general framework.

Moreover, regarding the issue on "insufficient utilization of evaluation results", METI's "Practical Guidelines for Corporate Governance Systems" states that "It should be noted that in conducting evaluation, scoring or ranking does not necessarily have any meaning. Companies can choose to conduct a plan-do-check-act (PDCA) cycle-based evaluation to consider whether there are any matters for which the board of directors should take corrective actions and what actions it should take, verify the effect(s) of those actions, and plan what further actions should be

taken." It would be ideal if the PDCA cycle could be used well, but there are many issues identified in the actual evaluations which are difficult for companies to resolve in the short term, such as the consideration of training the next generation of managers and the appointment of top management at overseas site as board members. On the other hand, the officers in the operation departments do not always have a sense of ownership, and it is difficult to commence improvements utilizing these evaluation results.

■ Figure 21. Approach to setting the evaluation standards which focused on corporate growth and continuity

		Evaluation perspectives (examples)			
		<u>Roles and responsibilities of the (board of) directors</u>	<u>Credentials and knowledge of the (board of) directors</u>	<u>Discussions by the board of directors</u>	...
Approach to raising corporate value (examples)	<b>Corporate growth</b> <ul style="list-style-type: none"> <li>Improved returns</li> <li>Synergies from acquisitions</li> <li>Avoiding impairment losses, etc.</li> </ul>	<ul style="list-style-type: none"> <li>Does the board discuss adjustments to the business portfolio to improve revenue?</li> <li>Does the board monitor the status of acquisition synergies?</li> </ul>	<ul style="list-style-type: none"> <li>Are board members well-versed in operations such as corporate acquisitions?</li> <li>Is information provided to external directors on business development?</li> </ul>	<ul style="list-style-type: none"> <li>Is information on progress with post-merger integration (PMI) provided in advance before the monthly board meeting and used for the board discussions?</li> </ul>	• ...
	<b>Corporate continuity</b> <ul style="list-style-type: none"> <li>Social trust</li> <li>Compliance</li> <li>Avoiding legal violations, etc.</li> </ul>	<ul style="list-style-type: none"> <li>Does the board supervise company-wide risk management system and compliance system?</li> <li>Does the board supervise the response to important risks?</li> </ul>	<ul style="list-style-type: none"> <li>Does the board provide updates on compliance issues, such as legislative revisions and example of recent scandals?</li> </ul>	<ul style="list-style-type: none"> <li>Does the audit committee or board secretariat confirm the risks included in proposals with the originating division and convey them to board members in advance?</li> </ul>	• ...
		Set evaluation themes related to growth-oriented governance			
		Set evaluation themes related to preventative governance			

## Future developments for evaluations of board effectiveness

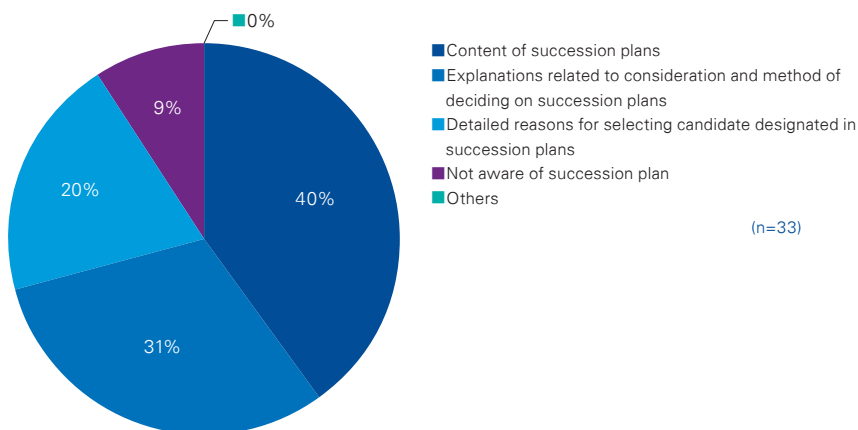
We expect more companies to involve external experts in 2017 to resolve the problem of having limitations in self-evaluations. However, due to the cost constraint, it is unlikely that external experts would be involved every year going forward, but we do expect to see an approach in which external experts are utilized periodically every few years.

We also expect that the evaluation standards could be set so that they do not only cover general corporate governance issues, as described above, but also focus on a correlation to a higher corporate value. We believe that the questions of “the quality and quantity of discussions (is the board holding discussions that raise corporate value?)” and “knowledge of board members (do the board members have the knowledge required to raise corporate value?)” should be proactively incorporated in the evaluation standards (Figure 21).

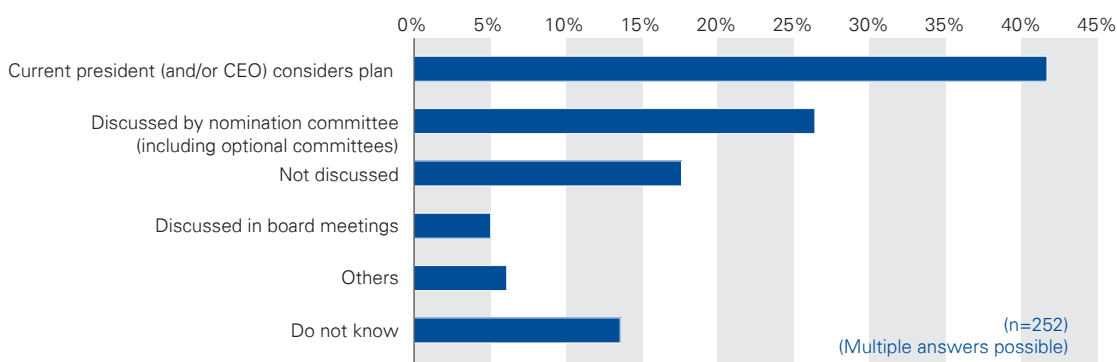
In order to ensure that the PDCA cycle functions systematically for the evaluation of board effectiveness,

roles must be clarified and human resources must be enhanced. For example, in addition to utilizing third-party evaluations effectively, the secretariat of the board of directors, which supports the chairperson of the board, should take responsibility for managing and improving the issues. The role of the board secretariat can be expected to change significantly to further pursue board reforms.

■ Figure 22. [Institutional investors] Expectations for disclosure of succession plans



■ Figure 23. [Companies] Means of discussing succession plan



## Institutional investors' expectations on succession plans and the current status as revealed by the opinion survey

According to the KPMG opinion survey for institutional investors, when asked about their expectations related to the disclosure of succession plans, many institutional investors (40%) responded that they expected disclosure of the content of succession plans (Figure 22). They would like to see greater transparency in the content of succession plans and the decision process, rather than the detailed reasons why the candidates were selected.

### Supplementary principle 4.1.3

The board of directors should provide appropriate supervision of succession planning, based on the company's goals (management philosophy, etc.) and specific management strategies.

The Corporate Governance Code does not require that companies disclose a succession plan. However, institutional investors' own expectations go well beyond the Corporate Governance Code requirements.

The KPMG opinion survey for companies shows that the most common answer (42% of respondents) to the question about succession plans was that the current president (and/or current CEO) was considering the plan (Figure 23).

In the KPMG survey for corporate auditors carried out in 2016, similar responses exceeded 60%, indicating that this tendency to leave the succession plan up to the company's top leader was stronger than in this year's survey. In this year's opinion survey, "discussed in nomination committee (including optional committees)" was the second most common response to this question, which shows that some companies believe that succession plans should be discussed from a more objective perspective.

At the same time, over 30% of companies surveyed responded either that succession plans were "not discussed" or that they "did not know," indicating that many companies are still far from the level of disclosure that institutional investors are expecting.

This survey shows that progress by companies with reforms on considering and discussing succession plans is polarized.

## Outlook for succession plan

Succession plans can be viewed not by the narrow definition of a plan for the next president, but as a plan to select and train board member candidates and candidates for next-generation executives to maintain and improve the board's effectiveness for the medium- to long-term.

In order to secure members for the board with the necessary knowledge, employees must be selected from the executive candidate stage and a career plan prepared to systematically train them to become executives. Systematically selecting and training candidates for the board and candidates for the next generation of executives, while also incorporating "talent management" techniques, should become a common-sense tactic in Japanese companies' succession plans going forward. Succession plans should not stop at selecting the next president, but must also consider "talent reforms" to support next-generation management.

# 3 — Reforms to create a board that supports risk-taking and future outlook

As we have noted thus far, solid progress has been made on board structural reforms, but there are still discrepancies between companies in the progress they have made with operational reforms, and with talent reforms such as succession plans.

At the same time, companies that proactively engage with corporate governance are taking their reforms to the next stage so that the boards can help raise their company's corporate value. In the section below, we consider future developments for board reforms beyond structural reforms, operational reforms, and talent reforms.

## Meaning of board's contributions to raising corporate value

As noted in General Principle 4 of the Corporate Governance Code, "in order to promote sustainable corporate growth and the increase of corporate value over the mid- to long-term and enhance earnings power and capital efficiency" the board is responsible for "establishing an environment where appropriate risk-taking by the senior management is supported."

"Sustainable corporate growth and the increase of corporate value over the mid- to long-term" is premised on the company's continuity and growth. In terms of risk, a company's continuity is equivalent to risk management and a company's growth involves risk-taking. Companies must prevent risks that have significant negative impact in order to sustain their companies, and they must take risks through investments so that they can generate returns and grow as a company.

Japanese companies tend to focus on methodical and systematic initiatives addressing the former (risk management), but they leave the latter (risk-taking) up to the instincts of the managers leading the business. We surmise that, coupled with a tendency toward a demerit system approach to human resource evaluations, conditions in Japanese companies have long remained hostile to making decisions that take a positive stance on risk-taking. Given these conditions at Japanese companies, the aforementioned General Principle 4 in the Corporate Governance Code requires that the board "establish an environment where appropriate risk-taking by the senior management is supported."

## Challenges for risk-taking

If the objective of board reforms is to create a board that contributes to raising corporate value, then the key word for future board reforms will be "risk-taking." To this end, the executives who execute business in particular will be encouraged to take risks, and the board will have to monitor their risk-taking and risk management.

One way of encouraging risk-taking is to enhance executives' compensation by linking it to their performance in the medium- to long-term. However, the effect is diminished unless the risk-taking target and achievement are visualized to incentivize risk-taking behavior with compensation. Companies must clarify the kind and extent of risk they should take as a company and a business and whether they have actually succeeded in taking risk, and then share this with the board and management.

The board should take the following specific initiatives.

- (1) When deciding on the medium- and long-term business strategies, the board should consider and discuss the kind of risk that should be taken in relation to the strategy, and what risks should not be taken together with setting a visualized and objective revenue target. Sometimes the target is set as an indicator such as "hurdle rate of X% or more in overseas business investment" but qualitative expressions can also be used, such as "replacing existing low-profit products with new high-profit products in carrying out the sales plan" (taking the risk of failing to change the product portfolio).
- (2) When monitoring the status of strategy implementation, the board also monitors the response to risks visualized in (1).

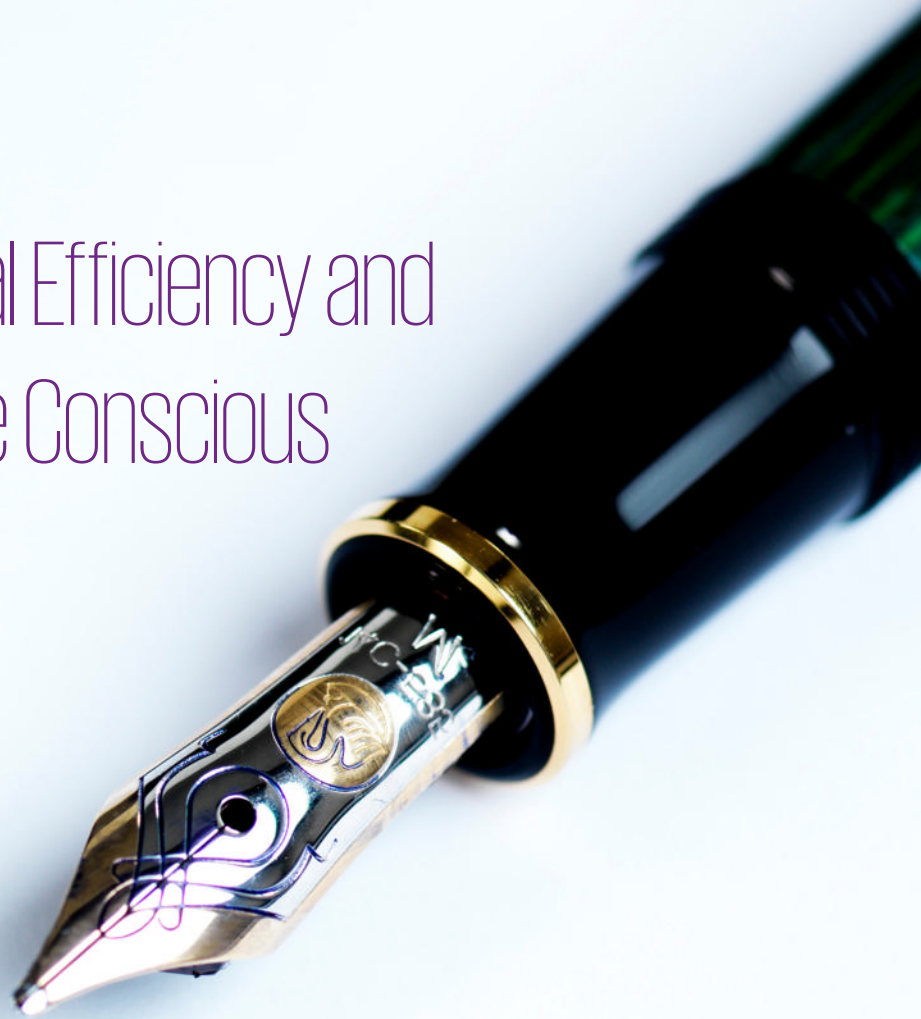
By managing risks clearly related to strategies, the board can methodically and systematically encourage risk-taking. Taking those risks that represent strategic advantages is called "risk appetite," and increasing number of companies are introducing schemes to visualize and manage risk appetite (appendix on page 64).

The ability to build a system which encourages risk-taking is important so that the boards can contribute to raising corporate value in the medium- and long- term. We believe that those companies that achieve this through board reforms will build a strong foundation of competitiveness.



III .

# Situation of Capital Efficiency and Shareholder Value Conscious Management



## POINT

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- » While corporate governance reforms encourage improvement of capital efficiency to enhance corporate value, more and more companies set KPIs using capital efficiency indicators such as ROE and ROIC.
- » On the other hand, only 40% of the companies surveyed have a clear idea about their own cost of capital. Institutional investors strongly request management to raise their awareness of cost of capital.
- » As much as 30% of the companies surveyed believe that corporate value is not adequately reflected in the stock price which indicates a gap between institutional investors and companies in terms of their perception of corporate value in various respects. This also demonstrates that dialogue between institutional investors and companies on corporate value is essential.

# 1 — Initiatives to improve capital efficiency and institutional investors' expectations

## Relationship between capital efficiency and corporate value

The Corporate Governance Code states that the board is responsible for “promoting sustainable corporate growth, increasing corporate value over the medium- to long-term and to enhance earnings power and capital efficiency” (General Principle 4). Moreover, the board is required to engage in constructive dialogue with shareholders to this end (General Principle 5).

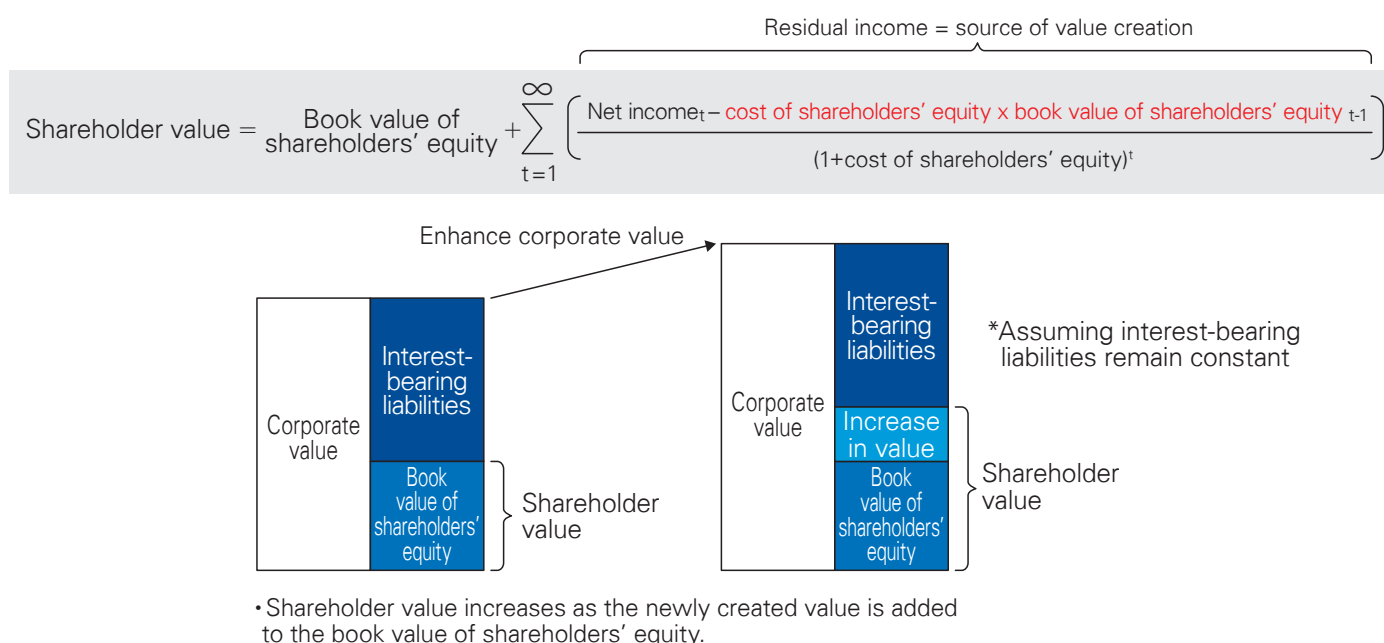
Moreover, the Stewardship Code requires institutional investors which signed the code to “fulfill their stewardship responsibility with the aim of enhancing the mid- to long-term corporate value and capital efficiency and supporting the sustainable growth of companies” (Guidance 3-1). Both codes call for enhancing corporate value by improving and raising capital efficiency.

ROA (return on assets), ROIC (return on invested capital) and ROE (return on equity) are typical indicators used in measuring capital efficiency. These indicators are ratios in which capital is the denominator and, depending on the indicator, the numerator is a type of profit. These indicators only illustrate a result. Each of these indicators has a corresponding cost of capital, and if returns do not exceed cost of capital, value has not been created.

The relationship between capital efficiency and corporate value can be explained by using the residual income model. In this model, if the residual income, calculated

as net income less fund-raising costs from shareholders (cost of shareholders' equity x book value of shareholders' equity), is positive, it means that value has been created. The increased shareholder value can be shown by adding the present value of the newly created value to the book value of shareholders' equity. Corporate value is the sum of shareholder value and interest-bearing liabilities, thus raising shareholder value is extremely important in enhancing corporate value (Figure 24).

■ Figure 24. Enhancement of corporate value from the residual income model

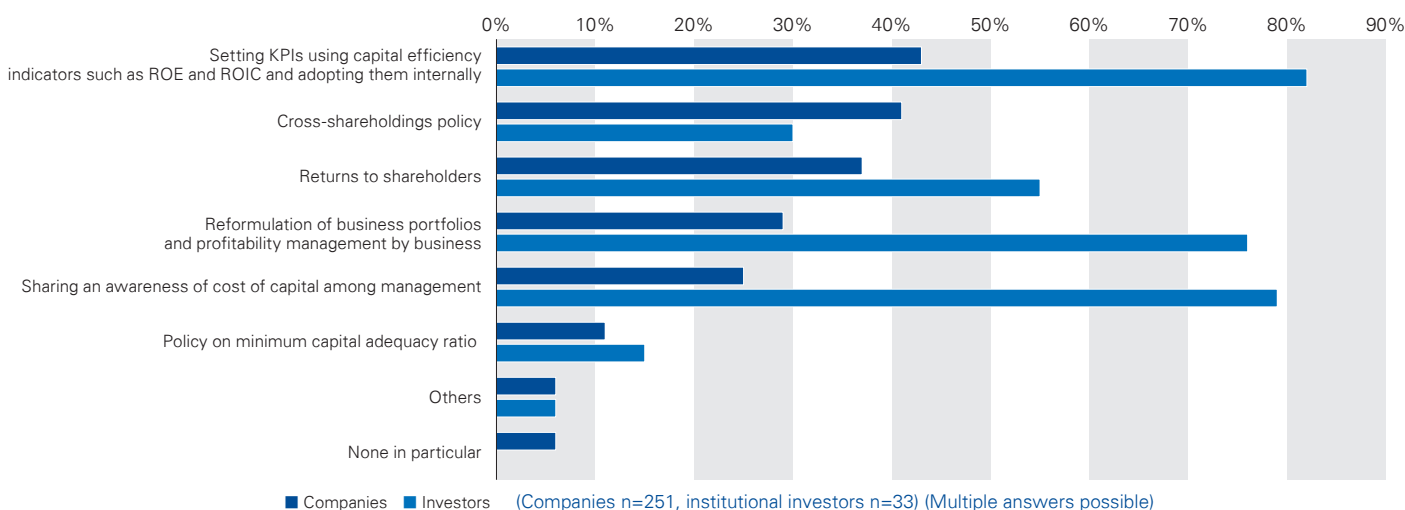


## Japanese companies' perception of cost of capital

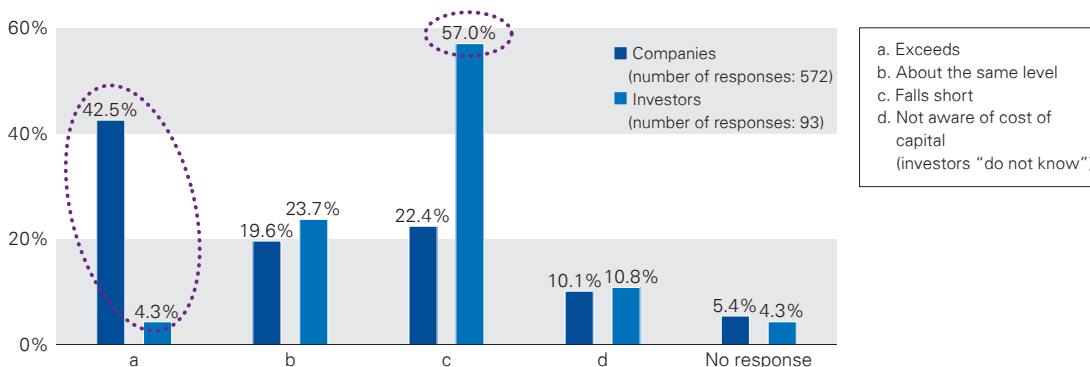
KPMG surveyed companies on the areas in which they have strengthened their initiatives and which they plan to strengthen with the aim of raising capital efficiency. As the most common response, 43% responded "setting KPIs using capital productivity indicators such as ROE and ROIC and adopting internally"; followed by 41% responded "cross-shareholdings policy" and 37% responded "returns to shareholders". This shows that capital efficiency indicators such as ROE and ROIC are gradually making headway among management as performance management indicators.

In comparison, when the KPMG opinion survey asked institutional investors about the areas which should be strengthened to improve capital efficiency, 82% responded "setting KPIs using capital productivity indicators such as ROE and ROIC and adopting internally"; followed by "sharing an awareness of cost of capital among management" (79%) and "reformulation of business portfolios and profitability management by business" (76%). "Setting KPIs using capital productivity indicators such as ROE and ROIC and adopting internally" was the most common response for both companies and institutional investors. However, 43% of the companies surveyed gave this response, as compared to 82% of the institutional investors surveyed. This highlights the significant difference in awareness of this area (Figure 25).

**Figure 25. Initiatives to raise capital efficiency**  
 [Companies] Initiatives that have been strengthened to improve capital efficiency after the introduction of the Corporate Governance Code / Areas that companies plan to improve  
 [Institutional investors] Areas which should be improved to raise capital efficiency



**Figure 26. Views on ROE level relative to cost of capital**



We also see the gap in awareness when comparing the responses to “sharing an awareness of cost of capital among management,” which 79% of the institutional investors surveyed selected as compared to only 25% of companies surveyed. Since capital efficiency indicators such as ROE and ROIC are indicators that should be assessed with respect to cost of capital, they cannot be used to evaluate performance if there is no awareness of cost of capital. The results of the survey given to institutional investors indicate that the prerequisite for using capital efficiency indicators is a strong awareness of cost of capital (investors’ expected rate of return) among management.

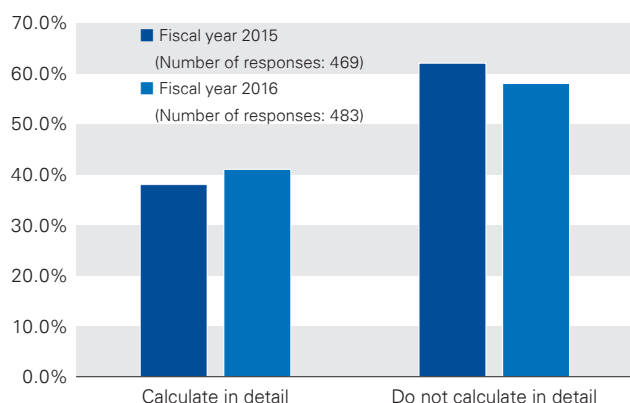
According to a survey given to both companies and institutional investors conducted by the Life Insurance Association of Japan, 42.5% of the companies surveyed responded that their company’s ROE exceeds cost of capital, while only 4.3% of the institutional investors surveyed felt that Japanese companies’ ROE typically exceeds cost of capital. Conversely, 57% of the institutional investors surveyed responded that Japanese companies’ ROE falls short of cost of capital as compared to 22.4% of the companies surveyed. Moreover, 10.1% of the companies surveyed responded that they did not know their cost of capital (Figure 26).

Of those companies who responded “exceeds,” “about the same” or “falls short” to the question on “views on ROE level relative to cost of capital” (Figure 26), 40.8% responded that they calculate a detailed figure for cost of capital, while 58.4% of the companies surveyed responded that they do not calculate a detailed figure. While the number of companies that have precise

knowledge of their cost of capital increased compared to the previous fiscal year, 58.4% of companies still have not ascertained their company’s cost of capital in detail (Figure 27).

Awareness of cost of capital at Japanese companies has certainly increased. However, as the results of these surveys show, there is a major gap in the awareness of capital efficiency between companies and institutional investors. The management of many companies does not have an adequate awareness of cost of capital, while institutional investors believe that companies are not adequately utilizing capital efficiency indicators.

■ **Figure 27. Japanese companies’ awareness of cost of capital**



Source: Life Insurance Association of Japan  
Prepared by KPMG based on “Life Insurance Association of Japan’s Fiscal 2016 Report on Initiatives to Raise Shareholder Value”

### Expectation for reformulation of business portfolio and subsidiaries' governance

As shown in Figure 25, when asked which initiatives companies should reinforce to improve capital efficiency, institutional investors listed "reformulation of business portfolios and profitability management by business" after "use of capital efficiency indicators" and "sharing an awareness of cost of capital among management."

One reason that institutional investors believe Japanese companies' capital efficiency is low is that they have unprofitable businesses that are unrelated to their main operations. These unprofitable businesses are not simply businesses with losses or low profits, but businesses that are not consistent with the company's management philosophy and vision, and whose profit potential falls short of cost of capital.

Using the portfolio concept of diversifying business risk to manage businesses is consistent with the thoughts of institutional investors, but when expanding and developing their businesses, companies must appropriately invest capital in line with risk. Specific businesses with low profitability that are not aligned with the company's management philosophy and vision not only prevent the investment of necessary capital in businesses that are in fact aligned with the company's management philosophy and vision, but can also lower the company's overall profitability. Institutional investors assess companies in terms of how effectively they utilize their limited resources in running businesses to raise their capital productivity (Figure 28).

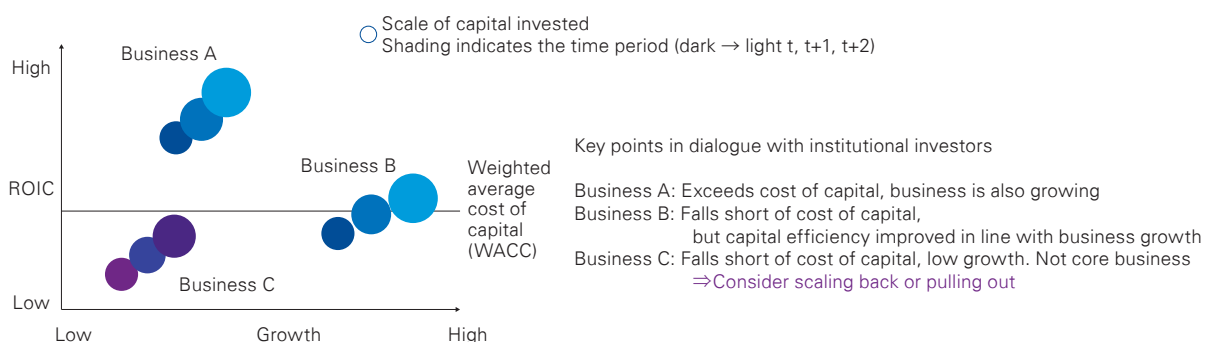
In terms of management of profitability by businesses, institutional investors are concerned about how companies are going to exercise governance of their subsidiaries. Subsidiaries as well as parent companies play an important role in raising corporate value, and in recent years Japanese companies have increasingly turned to

cross-border M&A to grow in global markets. Exercising PMI (post-merger integration, the integration process after M&A are carried out) and synergies with acquired subsidiaries is extremely important in raising profitability by business.

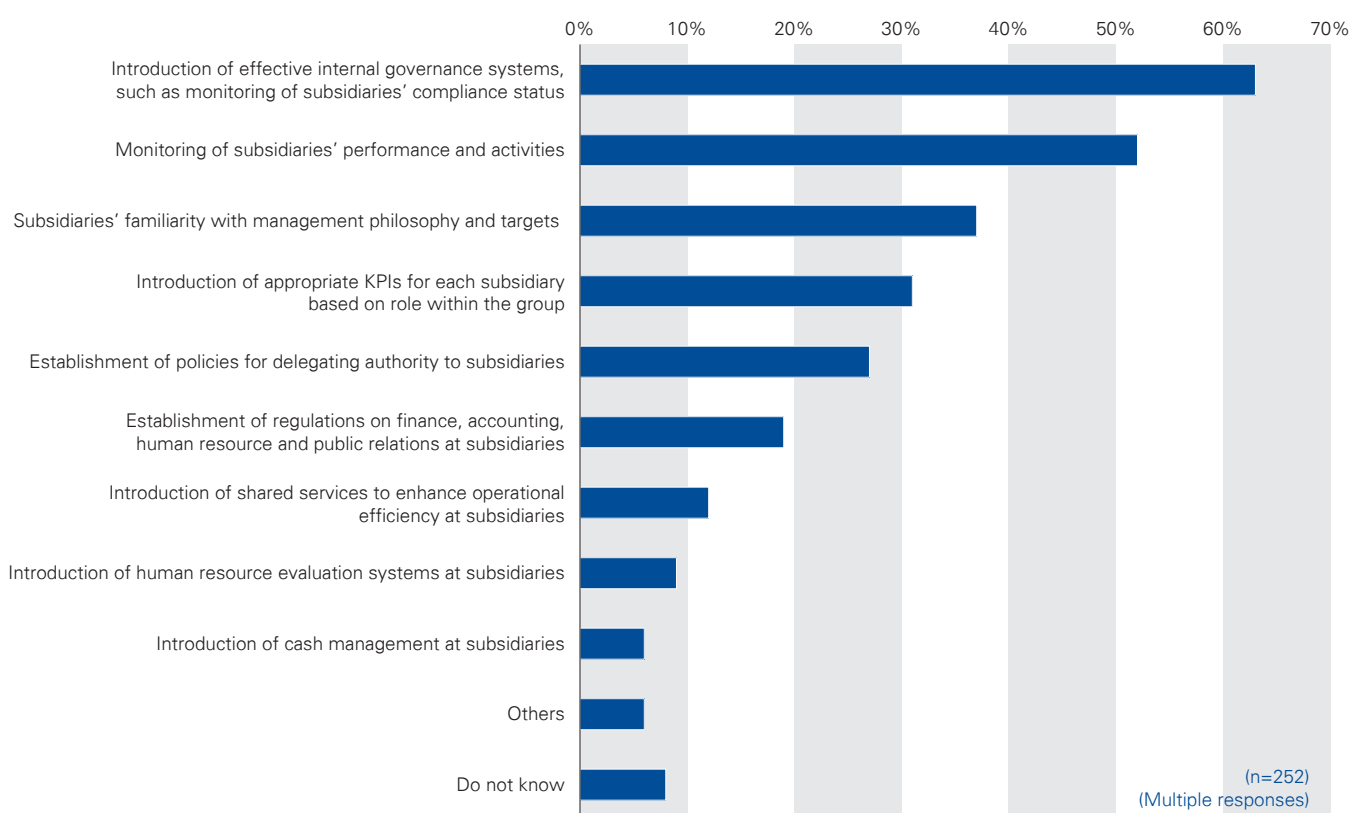
According to the KPMG opinion survey, the most important issue in governance of subsidiaries for both companies (63% of responses) and institutional investors (73%) was "introducing effective internal governance systems, such as monitoring compliance conditions at subsidiaries" (Figures 29, 30).

There were also discrepancies in the other areas that companies and institutional investors view as important. 52% of companies identified "monitoring of subsidiaries' earnings and activities" as the second most important area, and there were significant differences in the third most important areas and below. At the same time, "introduction of appropriate KPIs for each subsidiary based on role within the Group," "monitoring of subsidiaries' performance and activities" and "spread of management philosophy and targets in subsidiaries" had response rates of 48% to 55%, among institutional investors. Institutional investors clearly prioritize monitoring by the parent company of the subsidiaries' earnings progress and activities, including introduction of internal governance systems and KPIs, based on familiarity with the management philosophy (Figure 30).

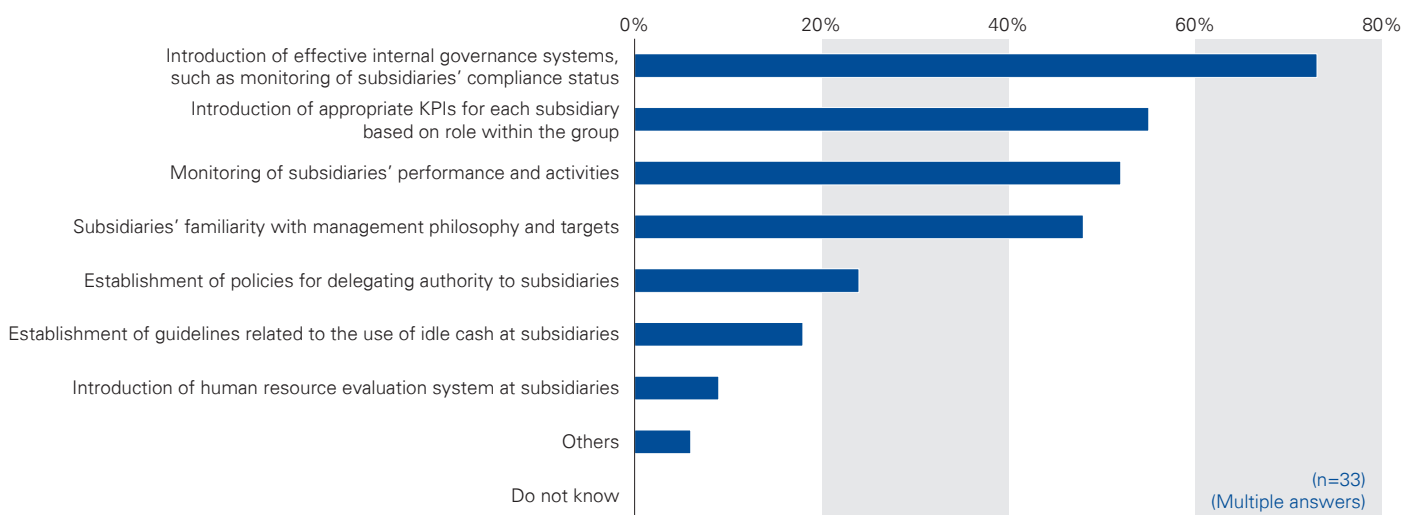
■ Figure 28. Approach to business portfolios (example)



■ Figure 29. [Companies] Issues with governance of subsidiaries



■ Figure 30. [Institutional investors] Issues with governance of subsidiaries



## 2 — Differences in perceptions of corporate value between companies and institutional investors

### Awareness of corporate value and share price

Do companies think their corporate value is appropriately reflected in the share price? According to the KPMG opinion survey for companies, 52% of the companies surveyed believe that their corporate value is “appropriately reflected from a mid- to long-term perspective,” while 31% stated that it is “not reflected (share price is undervalued relative to corporate value)” (Figure 31).

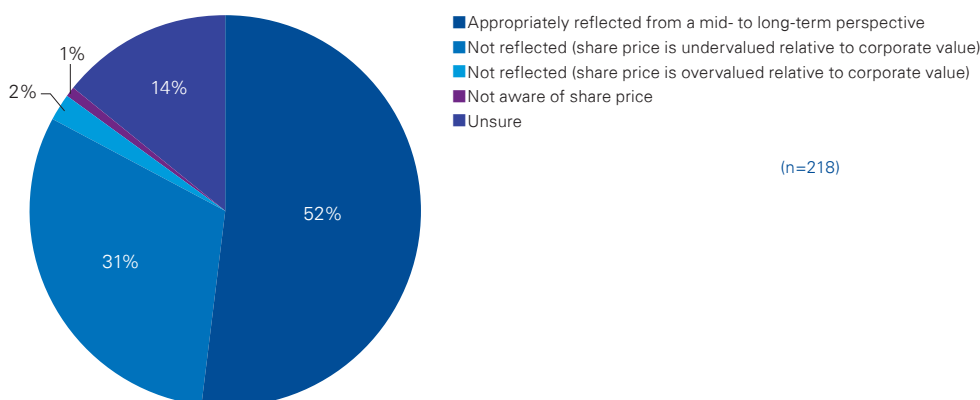
Of the 31% of the companies which feel that their corporate value is not appropriately reflected in the share price, 30% say that “investors under-evaluate the company’s management performance” and 26% state that “investors practice short-termism and do not have an adequate understanding of the company’s long-term value creation” (Figure 32). This indicates that a majority of companies feel that investors do not understand their company’s process for creating corporate value. Related to this, “others” had a high response rate of 19%, but most

were medium- and small-cap companies which investors may not be aware.

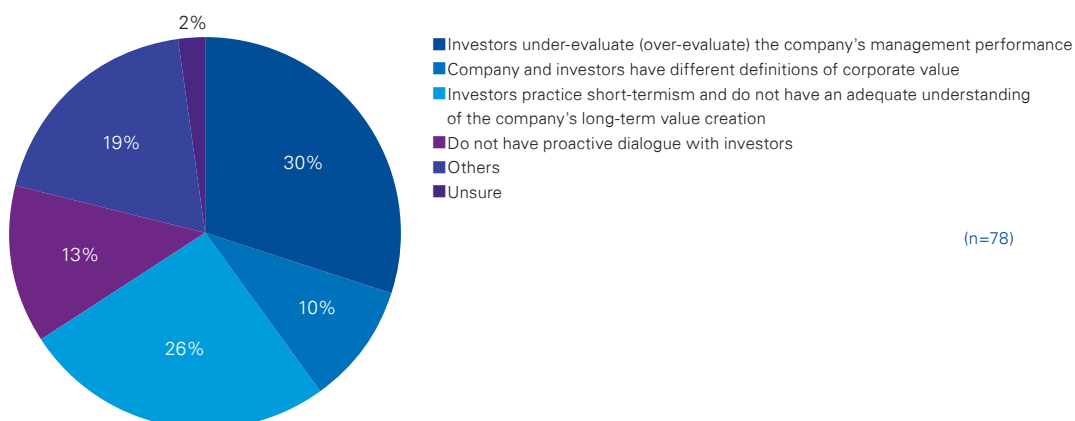
Moreover, 10% of the companies surveyed feel that “company and investors have different definitions of corporate value.” Since shareholders are not the only stakeholder of the company, some companies define corporate value as the sum of all the value they provided to various stakeholders. Although we would not attempt to refute this, this concept is difficult to quantify, and in some cases it may not be consistent with the perspective of investors who prioritize shareholder value.

As noted above, there are discrepancies between companies and institutional investors in their perception of initiatives to raise corporate value and capital productivity. It is important that companies and institutional investors align their views of corporate value so that this gap can be bridged. Dialogue between companies and investors is the way for this to happen, and dialogue is the starting point for improving corporate value in the mid- to long- term.

■ Figure 31. [Companies] Does the share price accurately reflect your company’s corporate value from a medium- to long-term perspective?



■ Figure 32. [Companies] Reasons that companies feel that their corporate value is not appropriately reflected in the share price





# IV.

## Dialogue between Companies and Investors

### POINT

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- » The awareness of promoting the understanding of the medium- and long-term value creation story in dialogue with investors has been increasing among companies. As a result, the focus of their dialogue with institutional investors is shifting from short term to medium-and long-term gradually.
- » Corporate governance reports and integrated reports are becoming ever more useful, and institutional investors are putting a much greater emphasis on non-financial information, such as ESG. Although some issues remain, information disclosure by companies is being enhanced to meet the information needs of investors.
- » When external directors and non-executive chairperson of the board discuss the effectiveness of the board and the enhancement of corporate value with institutional investors, it reduces institutional investors' risk perception, and ensures the confidence of institutional investors in exercising their voting rights.

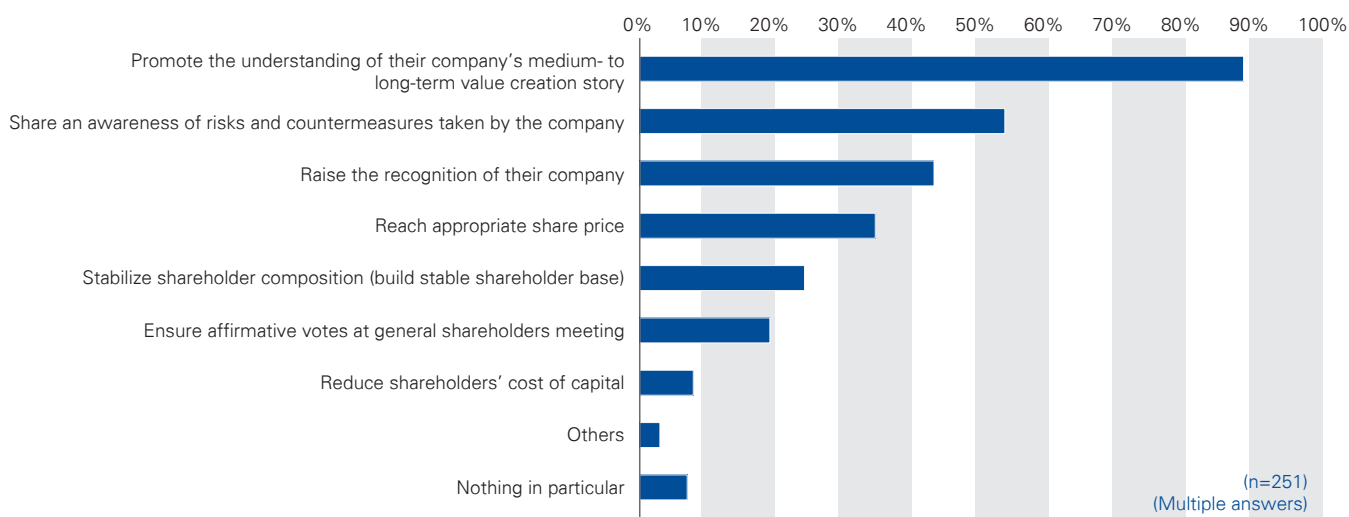
# 1 — Changes in timeframe covered in dialogue between companies and investors

In the previous chapter, we noted that there is a gap between companies and institutional investors regarding companies' efforts to enhance corporate value and to improve capital efficiency, and recommended that this gap be eliminated gradually through dialogue focused on corporate value. With more than two years since the introduction of the Corporate Governance Code, changes have been seen in the quality of the dialogue between companies and investors.

## Awareness of medium to long-term focused dialogues

According to the KPMG opinion survey for companies, almost 90% of the companies surveyed are particularly aware of the need to "promote the understanding of their company's medium- to long-term value creation story" in dialogue with investors (Figure 33).

■ Figure 33. [Companies] Matters which companies are particularly aware of in dialogue with investors

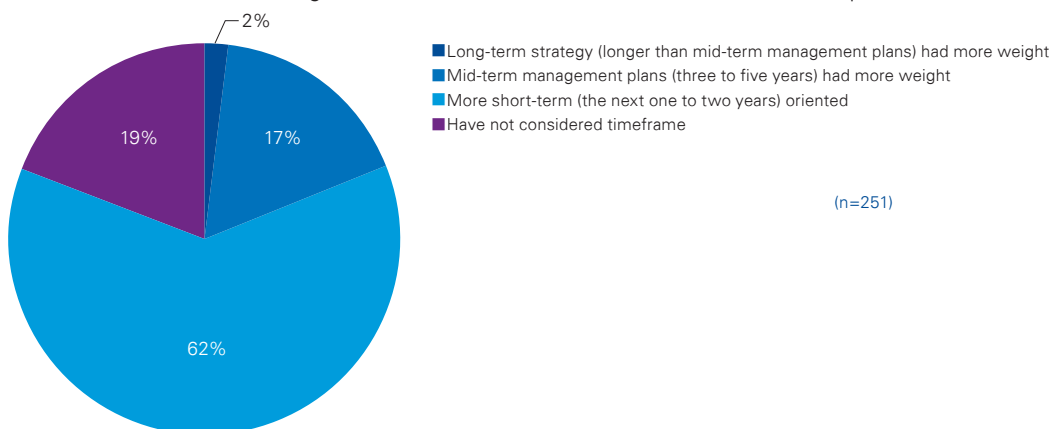


The result of this can be seen in changes in the timeframe covered in dialogue with institutional investors. When asked about the timeframe covered in their dialogue with investors before and after the introduction of the Corporate Governance Code, 62% of the companies surveyed responded that, before the introduction, "more short-term (the next one to two years) oriented". Most of the companies surveyed, at 67%, responded that, after the introduction, "weight of mid-term management plans (three to five years) has increased" (Figure 34).

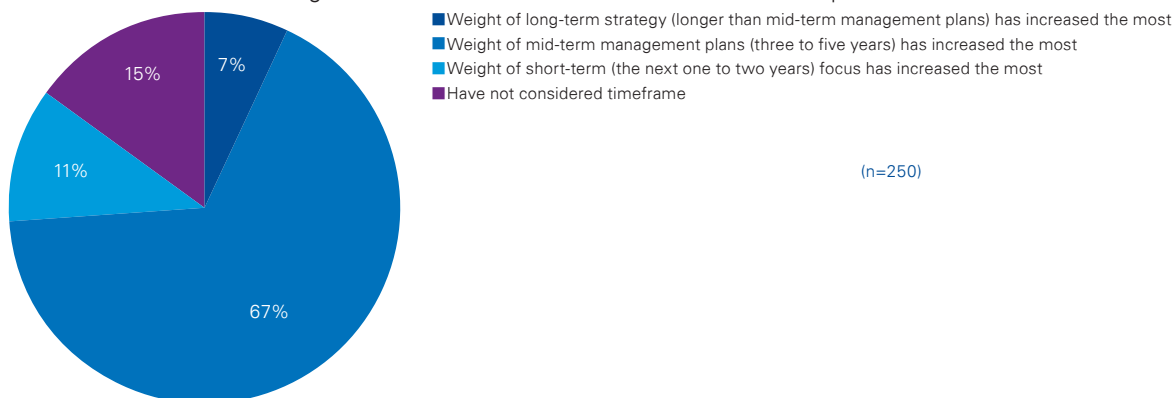
On the other hand, when institutional investors were asked about the timeframe covered in their dialogue with companies before and after the introduction of the Stewardship Code, a total of 53% of the investors surveyed responded that, before the introduction, "mid-term management plans (three to five years)" and "long-term strategy (longer than mid-term management plans)" had more weight, while the response for "after the introduction" was significant higher at 91% (Figure 35).

■ Figure 34. [Companies] Timeframe covered in dialogue with investors before and after the introduction of the Corporate Governance Code

<Timeframe covered in dialogue with investors before the introduction of the Corporate Governance Code>



<Timeframe covered in dialogue with investors after the introduction of the Corporate Governance Code>

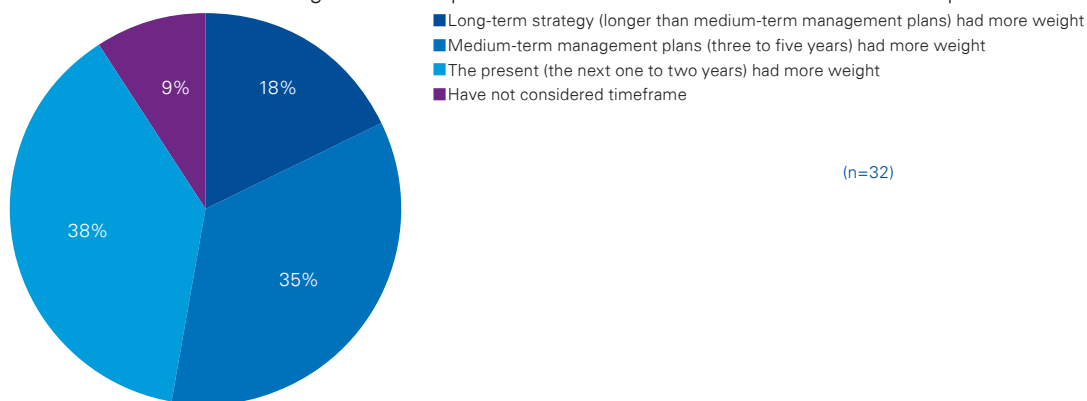


These results show that, since companies are more aware of the need to promote the understanding of their medium- and long-term value creation story, they match the timeframe covered in dialogue between companies and institutional investors.

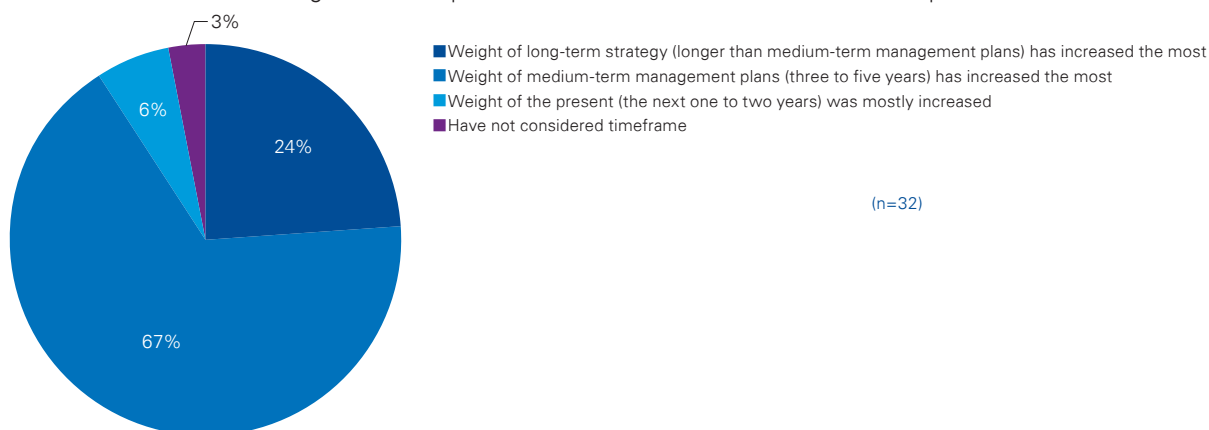
As a result of the change in the timeframe covered in dialogue, we presume that companies will be less affected by short-termism when formulating their business strategies, and that institutional investors will also assess investments from a medium- to long-term perspective. We expect that this will, through dialogue, enhance the medium- and long-term corporate value.

■ **Figure 35. [Institutional investors] Timeframe covered in dialogue with companies before and after the introduction of the Stewardship Code**

<Timeframe covered in dialogue with companies before the introduction of the Stewardship Code>



<Timeframe covered in dialogue with companies after the introduction of the Stewardship Code>



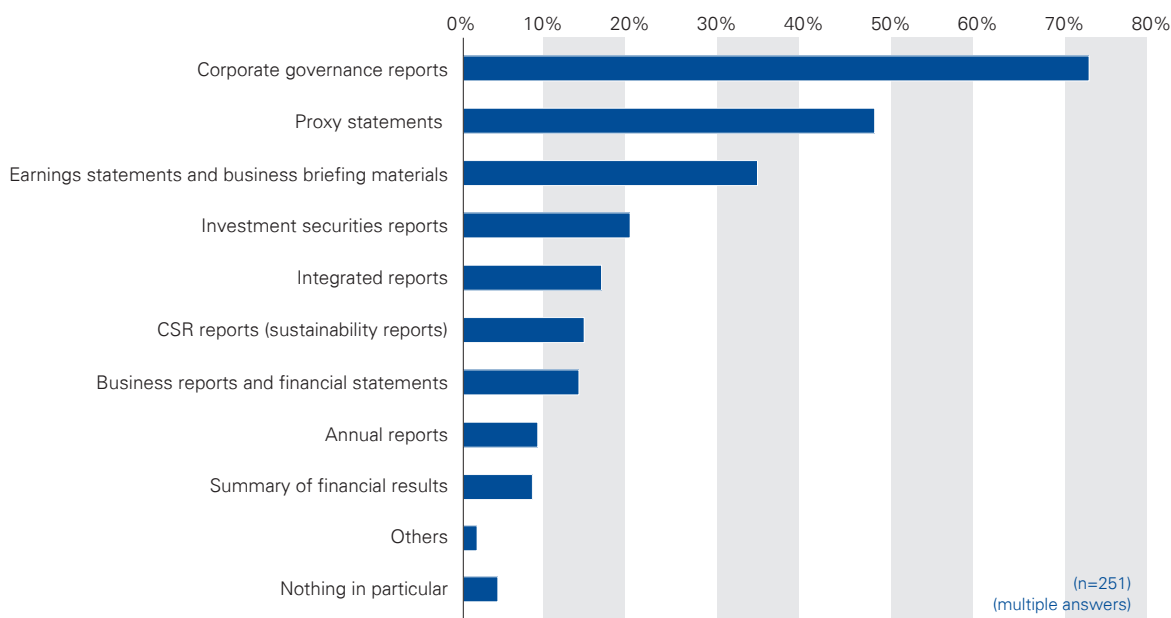
## 2 — Changes in the role of disclosure documents due to corporate governance reforms

Disclosing high-quality information so that investors can understand the company in advance is an important part of making a constructive dialogue more effective. The type of documents disclosed varies, but we believe it is important to identify the perception gap between the companies which prepare the disclosure

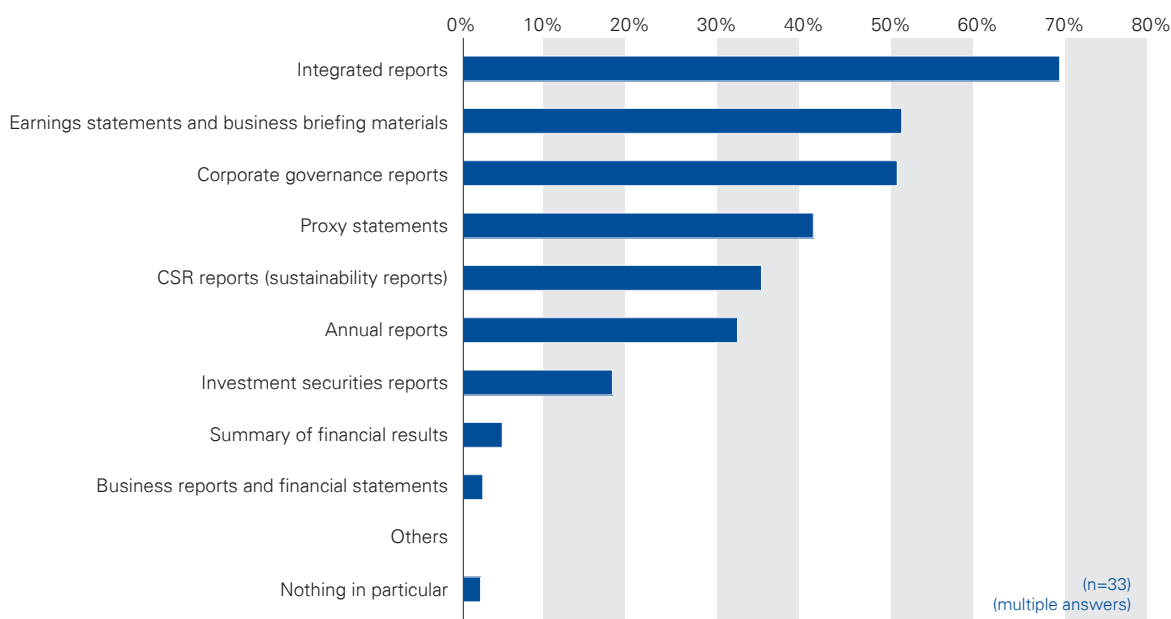
documents and the institutional investors which use the documents so that dialogue can be elevated to the next level.

**Figure 36. Disclosure documents which became more important after the introduction of the Corporate Governance Code**

### [Companies]



### [Institutional investors]



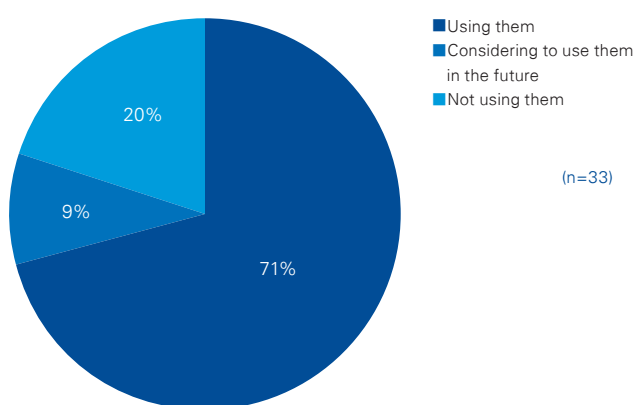
## Disclosure documents which are increasingly important

According to the KPMG opinion survey for companies, corporate governance reports followed by proxy statements became increasingly important after the Corporate Governance Code was introduced (Figure 36). It is obvious that the most common answer among companies was that corporate governance reports are important because of the requirement to disclose the new corporate governance reports due to the introduction of the Corporate Governance Code; but at the same time, it proves that companies understand the importance of stating and explaining their “comply or explain” status. On the other hand, following the Corporate Governance Code, proxy statements are becoming more important given the increasing significance of including the explanation of the agenda items to be resolved at the general shareholders meeting in the proxy statements. For example, more companies are reinforcing their efforts to comply with the principle of “Full Disclosure” stipulated in the Corporate Governance Code (Principle 3.1). As a result, they are including “reasons for appointing internal directors,” “management philosophy, management strategies and management plans,” “basic approach to

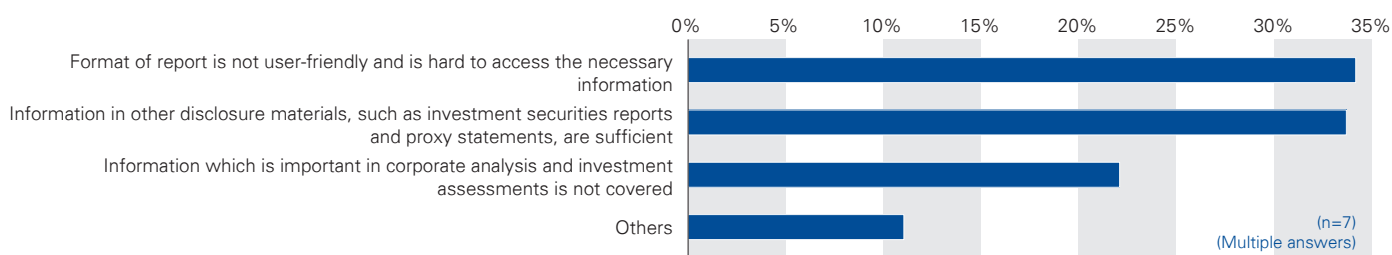
and basic guidelines on corporate governance,” “method and process for determining director compensation” , “method and process for selecting and nominating directors” and “Independence Standards for, and Qualifications of Independent Directors” (Principle 4.9) in the reference materials for general shareholders meetings. Companies are also putting more effort into increasing voluntary disclosures in the materials related to the general shareholders meeting in order to enhance dialogue with shareholders. In addition, more companies are including photographs of candidates for directors and providing English translation of the proxy statements. This indicates that proxy statements are now more aligned with investors’ information needs.

The KPMG opinion survey for institutional investors shows that institutional investors place emphasis on disclosure materials such as integrated reports and corporate governance reports which contain a considerable amount of non-financial information (Figure 36). This indicates that, as the timeframe covered in dialogue shifts to the medium-and long-term, institutional investors feel that it is important to grasp non-financial information as well as financial information in order to hold constructive dialogue with companies.

■ Figure 37. [Institutional investors] Status of using corporate governance reports



■ Figure 38. [Institutional investors] Reasons for not using corporate governance reports

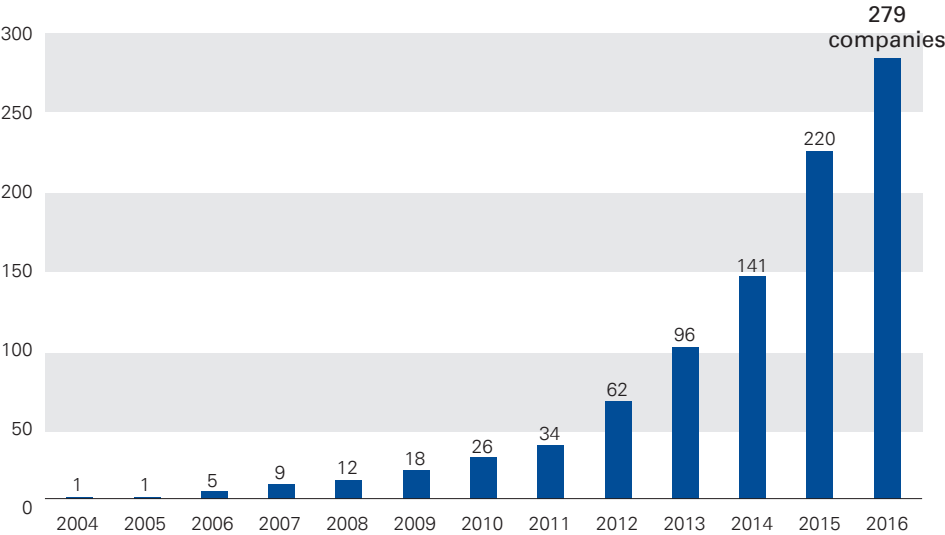


Status of using corporate governance reports by institutional investors

With corporate governance reports becoming increasingly important for companies, institutional investors are utilizing them more and more. The KPMG opinion survey for institutional investors showed that 71% of the institutional investors surveyed use corporate governance reports, and the percentage increases to 80% when including “considering to use in the future.” However, 20% of institutional investors surveyed indicated that they are not

using the corporate governance reports (Figure 37). The reasons that institutional investors gave for not using the corporate governance reports were due to the difficulties in identifying the necessary information and the duplication of information disclosed in the investment securities report and other disclosure materials. When information which should be disclosed in corporate governance reports is disclosed through a medium that is widely available, such as investment securities reports, annual reports, or the company’s website, the companies

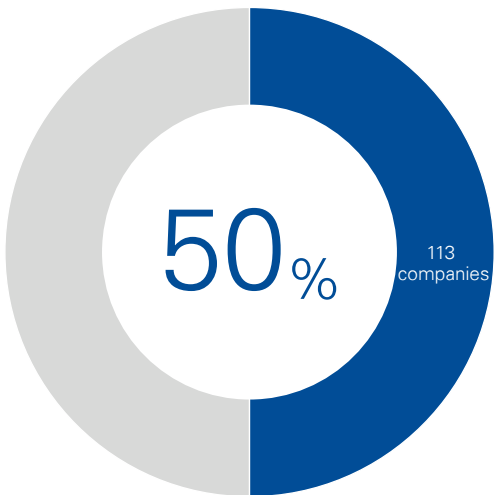
Figure 39. Number of companies issuing integrated reports



Source: The KPMG Japan Integrated Report Advisory Group’s “Survey of Integrated Reports in Japan 2016”

Figure 40. Number of companies issuing integrated reports among Nikkei 225 index constituents

Percentage of companies within Nikkei 225 index constituents



Source: The KPMG Japan Integrated Report Advisory Group’s “Survey of Integrated Reports in Japan 2016”

are permitted to ask the readers to refer to such medium by indicating where the information can be accessed (website URL, for example). If the companies adopt this approach, it is not necessary to include all information within the corporate governance reports, otherwise, there might be duplication of information with other disclosure materials.

Moreover, some institutional investors questioned the effectiveness of corporate governance reports stating that the corporate governance reports do not cover information which is important for conducting corporate analyses and making investment decisions (Figure 38).

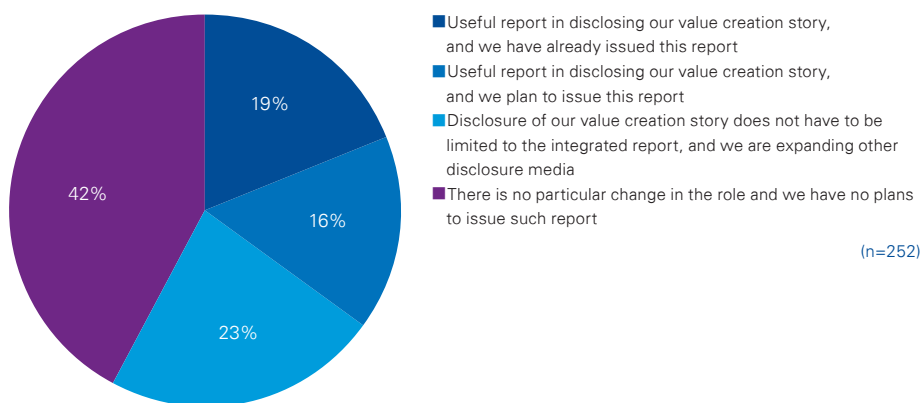
### Changes in the role of integrated reports

Integrated reports have recently attracted more attention as a means of conveying companies medium- and long-term value creation story. In 2016, 279 companies issued integrated reports (Figure 39), and 113 companies, a majority of the Nikkei 225 index constituents, issued integrated reports. This indicates that blue-chip companies, in particular, issue integrated reports (Figure 40).

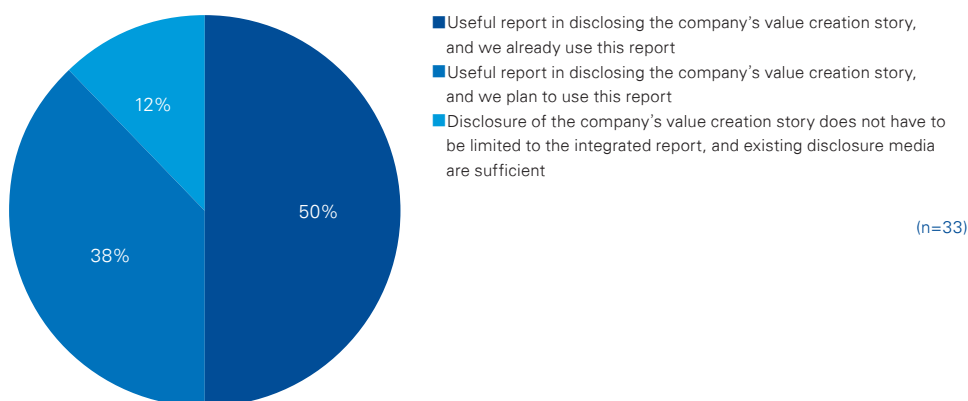
According to the KPMG opinion survey for companies, when asked about the role of integrated reports after corporate governance reforms, the most common response (42%) was that “there was no particular change in the role and we have no plans to prepare such reports”. In addition, 23% of the companies surveyed answered that “disclosure of our value creation story does not have to be limited to the integrated report, and we are expanding other disclosure media”.

5. In the “Survey of Integrated Reports in Japan 2016,” the KPMG Japan Integrated Report Advisory Group surveys and analyzes integrated reports issued by Japanese companies from various perspectives.  
<https://assets.kpmg.com/content/dam/kpmg/jp/pdf/jp-e-integrated-reporting-20170324.pdf>

■ Figure 41. [Companies] Changes in the role of integrated reports after corporate governance reforms



■ Figure 42. [Institutional investors] Changes in the role of integrated reports after corporate governance reforms



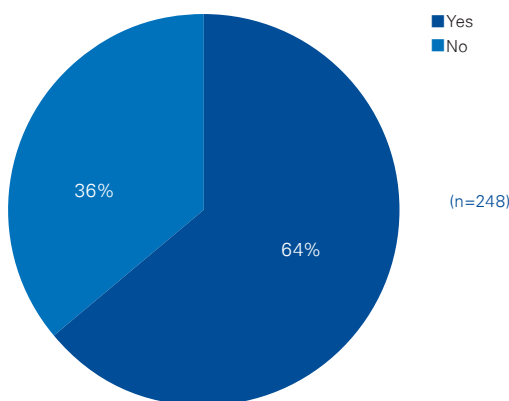
Given promoting the understanding of the medium- to long-term value creation story is what companies are most aware of in their dialogue with investors, it seems that many companies believe that the existing disclosure media are sufficient in achieving this objective (Figure 41).

On the other hand, with more institutional investors are placing emphasize on non-financial information, we note a trend towards the active use of integrated reports. According to the KPMG opinion survey for institutional investors, almost 90% of the institutional investors surveyed indicated that they have already used integrated reports or plan to do so in the future (Figure 42).

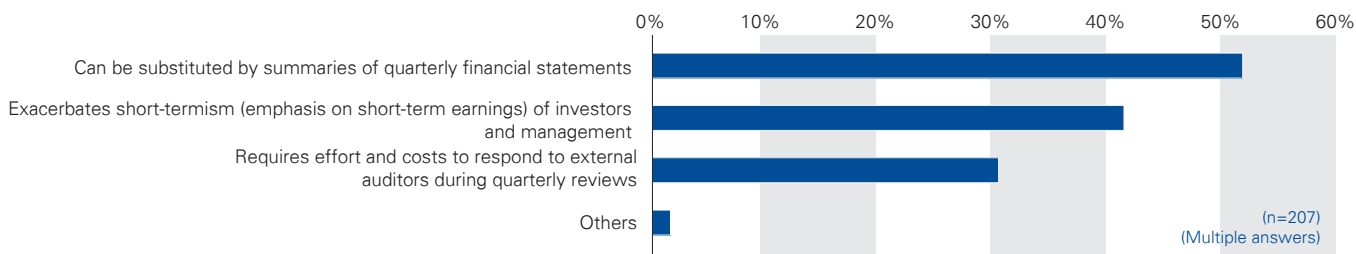
As noted above, institutional investors tend to consider integrated reports as an important source of non-financial information. We expect the companies will be more

motivated to prepare integrated reports if institutional investors will utilize these reports more actively in their investment assessments.

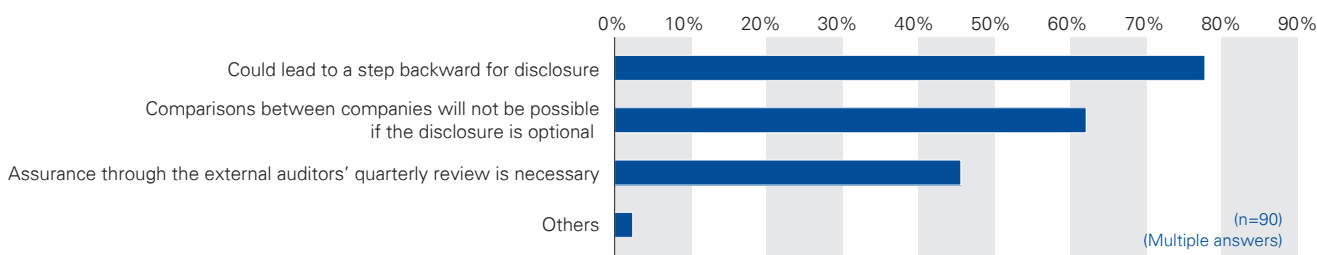
■ Figure 43. [Companies] Should the quarterly reports required under the Financial Instruments and Exchange Act be abolished?



■ Figure 44. [Companies] Reasons why it should be abolished



■ Figure 45. [Companies] Reasons it should not be abolished



## Approach to quarterly earnings reports

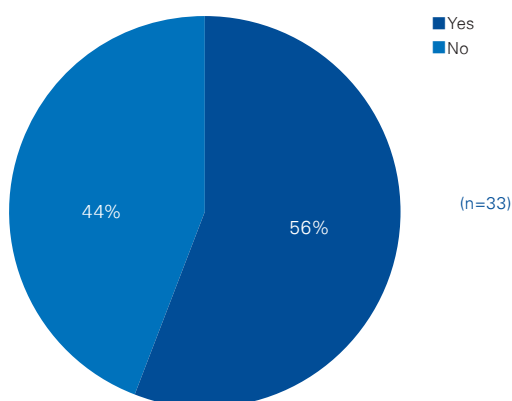
Duplication of Japanese companies' information disclosure has become an issue due to the double-layered disclosure regulations for the mandatory disclosures under the Companies Act and the Financial Instruments and Exchange Act, together with the timely disclosure of summaries of financial statements and other documents required for the listed companies. In addition, it is pointed out that quarterly disclosure could lead to short-termism. As such, the approach to quarterly disclosure has become an issue for information disclosure.

The KPMG opinion survey for companies showed that 64% of companies surveyed believed that the quarterly reports required under the Financial Instruments and

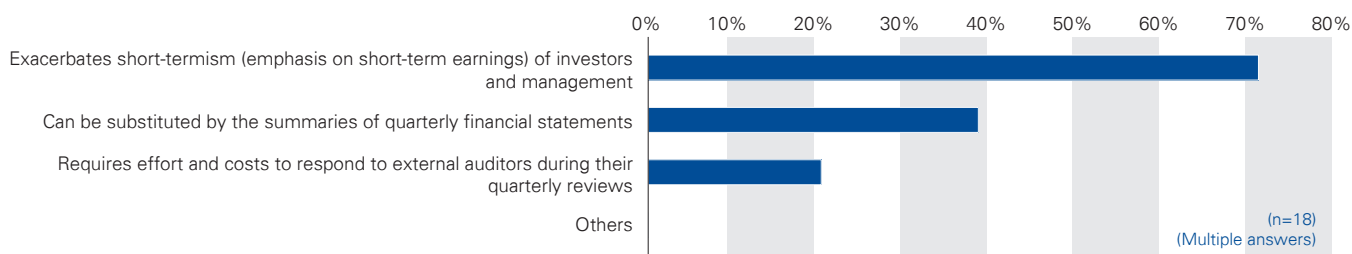
Exchange Act should be abolished (Figure 43).

The most common reason was "it can be substituted by the summaries of quarterly financial statements" which is likely because companies find the duplication of information disclosed to be burdensome (Figure 44). On the other hand, companies which felt that the quarterly reports should not be abolished typically cited as their reason that it could lead to a step backward for disclosures. This indicates that some companies do see the need for the quarterly reports required under the Financial Instruments and Exchange Act (Figure 48).

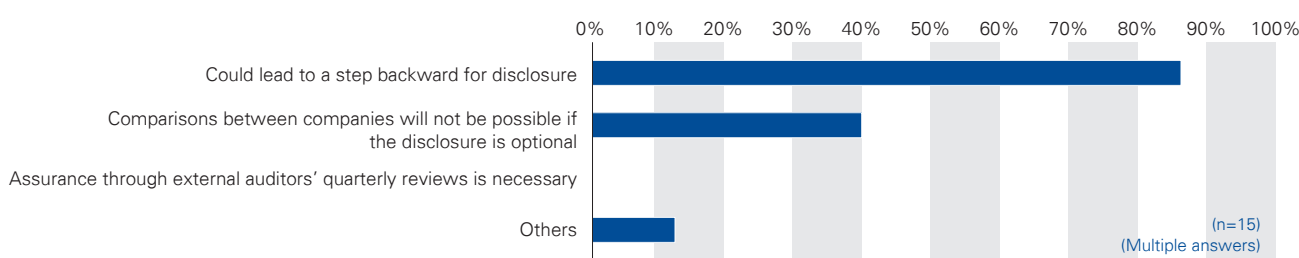
■ Figure 46. [Institutional investors] Should the quarterly reports required under the Financial Instruments and Exchange Act be abolished?



■ Figure 47. [Institutional Investors] Reasons why it should be abolished



■ Figure 48. [Institutional Investors] Reasons why it should not be abolished



When institutional investors were asked the same question, 56% stated that the requirement should be abolished (Figure 46).

The most common reason they gave was that the disclosure of the quarterly reports “exacerbates short-termism (emphasis on short-term earnings) of investors and management”. Many institutional investors appear to expect the abolishment of quarterly reports would prevent this kind of short-termism and could contribute to the enhancement of corporate value in the medium to long-term (Figure 47). However, the most common reason given for “should not be abolished” was “it could be a step backward for disclosure”. This indicates that, same as the companies, some institutional investors do see the need for the quarterly reports required under the Financial Instruments and Exchange Act (Figure 48).

Quarterly earnings reports are considered to be a necessary source of information about a company’s recent earnings, but given the burden of duplicating disclosure, it is time to reconsider the approach to quarterly earnings reporting. In June 2017, the government released *Growth Strategy 2017* which considers the approach to quarterly earnings reporting, and also proposes that by Spring 2018, a conclusion will be reached about how to resolve the duplication of disclosure and to improve efficiency. Given this, we anticipate that this issue will be more thoroughly considered.

# 3 — Increasing importance of ESG and other non-financial information

As noted above, disclosure media which include non-financial information, such as integrated reports, are increasingly becoming important for institutional investors. We attribute this to the issue of how non-financial information, such as a company's sustainability and environmental, social and governance (ESG) performance, can be incorporated into making investment decisions. Non-financial information has become more important for companies in explaining the source of their value creation.

## Role of sustainability and ESG

The adoption of the Sustainable Development Goals (SDGs; [Figure 49](#)) by the United Nations in September 2015 encourages initiatives which aim at realizing a sustainable world. This global trend has begun to affect Japan's capital market.

Companies and investors beginning to recognize that their initiatives in addressing environmental and social issues can lead to improvement in their companies' sustainability and medium- and long-term growth and enhancement in investment performance for investors. This has given momentum to efforts with SDGs through companies' business activities, and has expanded ESG investments by investors. This trend is also reflected in the Corporate Governance Code and the Stewardship Code.

Principle 2.3 of the Corporate Governance Code states that "companies should take appropriate measures to address sustainability issues, including social and environmental matters."

Principle 3-2 of the Stewardship Code states that "institutional investors should monitor investee companies continuously and review as appropriate the effectiveness of the monitoring." Principle 3-3 addresses the areas that institutional investors should assess, stating that "when investors monitor investee companies, a variety of factors, including non-financial ones, may be considered as relevant. Factors may include, for example, the investee companies' governance, strategy, performance, capital structure, business risks and opportunities (including risks and opportunities arising from social and environmental matters)"

In a related move, the Government Pension Investment Fund (GPIF) signed the Principles for Responsible Investment (PRI) in September 2015. The PRI's objective is to "understand the investment implications of environmental, social and governance (ESG) factors and to support its international network of investor signatories in incorporating these factors into their investment and ownership decisions." The PRI has set six principles, the first of which states, "We will incorporate ESG issues into investment analysis and decision-making processes"

■ Figure 49. Sustainable Development Goals: 17 Goals to Transform Our World



Source: United Nations Information Centre

The GPIF became a signatory to the PRI because these investment principles aim to “expand medium- and long-term investment returns from stock investment for the insured persons through the various activities carried out to fulfill stewardship responsibilities.” When the investee companies appropriately consider ESG, the improved return after adjusting for risk “contributes to improved corporate value and sustainable growth, which can become the foundation for expanded returns in the medium- and long-term”.

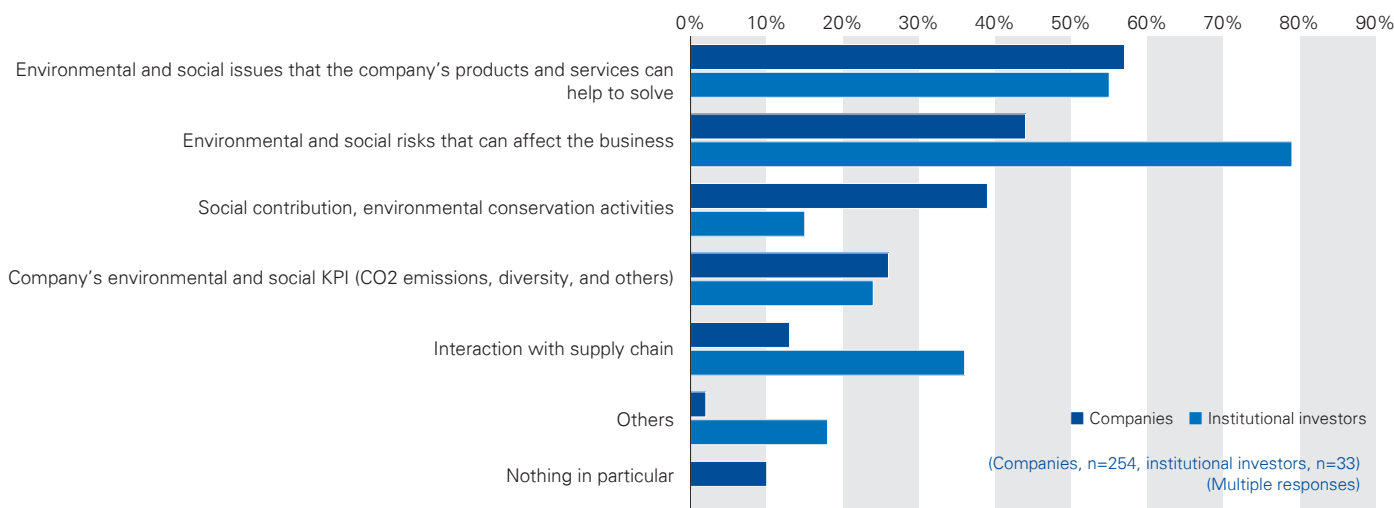
The Stewardship Principles established by the GPIF on June 1, 2017 requires its asset managers to sign the PRI and to “proactively engage with investee companies on critical ESG issues”.

In July 2017, the GPIF selected three ESG indices for Japanese stocks, and began passive investing in conjunction with these indices. The GPIF selected the FTSE Blossom Japan Index and MSCI Japan ESG Select Leaders Index as its comprehensive indices, which included 151 and 251 stocks, respectively, as of June 2017. In addition, the MSCI Japan Empowering Women Index, which is a more focused index and included 212 stocks, was selected.

## Opportunities and risks in E and S

Companies and institutional investors have a different perception about E (environmental) and S (social) issues. The KPMG opinion survey for companies and institutional investors showed that, in their dialogue on E and S issues, companies are most concern about “environmental and social issues that company’s products and services can help to solve”, whereas institutional investors are most concern about “environmental and social risks that can affect the business” (Figure 50). About the same percentage of companies and institutional investors surveyed responded with “environmental and social issues that company’s products and services can help to solve”, which indicates that both companies and institutional investors view E and S issues as opportunities to generate revenue. However, institutional investors are more aware of E and S issues as risks that companies should address. Since risks and returns are opposite sides of the same coin, companies and institutional investors are essentially looking at different aspects of the same E and S issues. As such, companies and institutional investors are not necessarily taking a different approach, but engaging dialogue on E and S issues based on the fact that there are differences in the point of view.

■ Figure 50. Areas of focus in dialogue on E (environmental) and S (social) issues



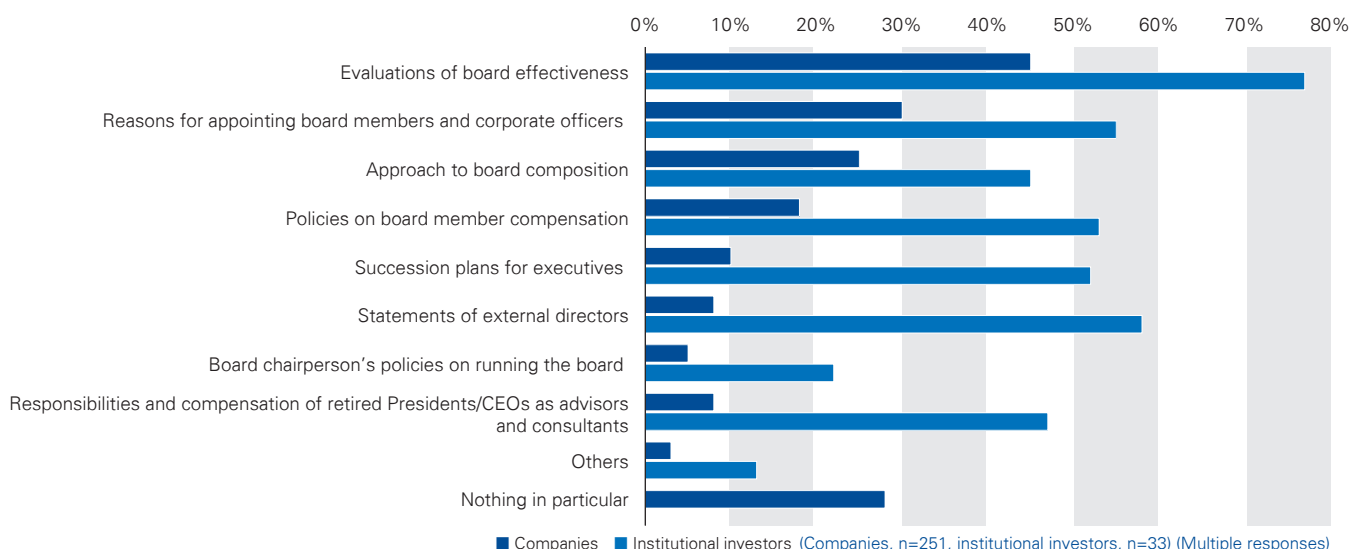
## Awareness of enhanced information disclosure on governance

In “II. Trends and Outlook in Corporate Governance System,” we pointed out that disclosure on evaluation of board effectiveness is the governance related information institutional investors feel companies should enhance (Figures 17 and 51). Institutional investors are expecting an explanation of the relationship between board effectiveness and higher corporate value (Figure 18), so they focus on the role that which the board plays in raising corporate value.

According to the KPMG opinion survey for companies, as with institutional investors, companies cited “board evaluations” as the most important information regarding governance whose disclosure should be enhanced. However, as seen in “II. Trends and Outlook in Corporate Governance System,” many companies see problems with the objectivity of the evaluations and the approach of how the evaluations are disclosed.

Moreover, over 25% of the companies surveyed stated “nothing in particular” when asked about for which disclosure should be enhanced, indicating that some companies feel that the current disclosure is adequate. No institutional investors gave such response, which indicates a gap in awareness between companies and institutional investors, and symbolizes the difficulties in their dialogue (Figure 51).

■ Figure 51. Governance related information for which disclosure should be enhanced



Reliability of non-financial information

While non-financial information plays an important part in dialogue, ensuring the reliability of non-financial information has become a problem. According to the KPMG opinion survey for companies, 45% of the companies surveyed responded that they are “not sure” about the need to ensure the reliability of non-financial information, while 38% responded that “management’s commitment to the reliability of information is essential”. This indicates that some companies find it necessary for management to make a commitment, while not feeling that assurance by third party is necessary (Figure 52). However, 54% of the institutional investors surveyed responded that “management’s commitment to the reliability of information is essential”. In addition, 23% responded that third-party assurance of the “the process of gathering non-financial information” and “the content of non-financial information” is necessary. This indicates that there is a major difference in the perception of companies and institutional investors (Figure 53). Companies might

begin to consider getting third-party assurance of non-financial information if the requests from institutional investors for such assurance increase.

Figure 52. [Companies] Necessity to ensure the reliability of non-financial information

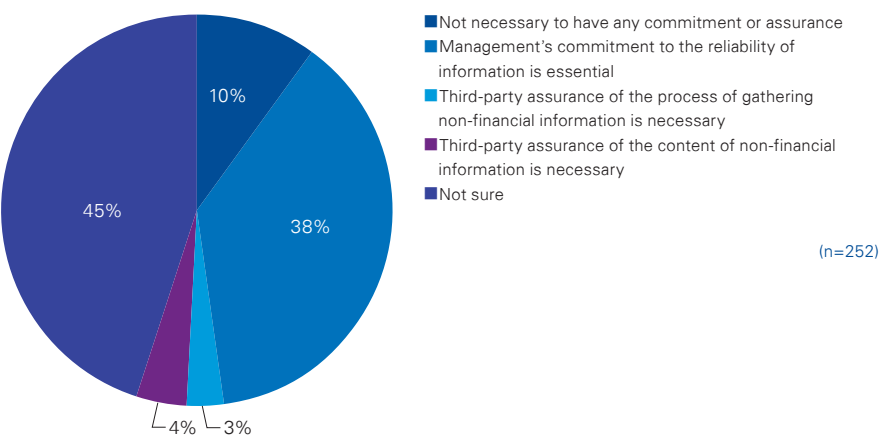
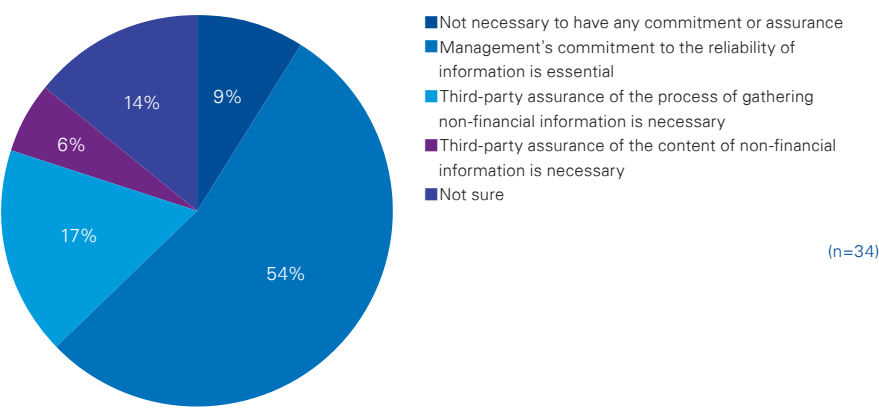


Figure 53. [Institutional investors] Necessity to ensure the reliability of non-financial information



# 4 Approaches to dialogue between companies and investors

## Individual disclosure of the results of exercise of voting results

The revision of the Stewardship Code has led to the progress in the disclosure of individual institutional investor's voting results. According to the KPMG opinion survey for companies, 41 % of the companies surveyed reported that individual disclosure helped to promote dialogue with investors and contributed to the reviews of the design of the proposals (Figure 54).

If institutional investors are shareholders, their shareholdings are noted in the shareholder registry via trust and custody services banks and custodian banks, which means that companies do not have the information whether the institutional investors they are engaging in dialogue with are their shareholders or not. Same as with the exercise of voting rights, even if institutional investors vote against a proposal, the vote is communicated via trust and custody services banks or other intermediary. It

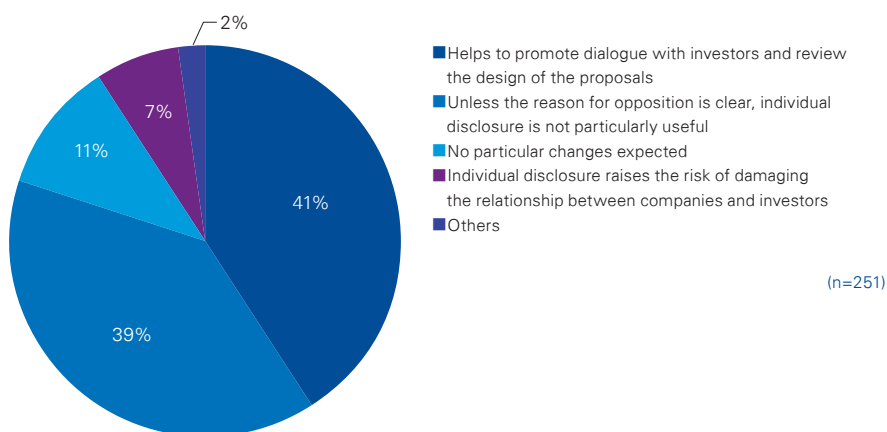
has been an issue for many years that companies' effort to discuss the results of the shareholders meeting are hindered by their inability to know who had actually voted against the proposals.

As many institutional investors are now disclosing their individual results of the exercise of their voting rights, companies are having a clear understanding of what institutional investors have opposed. As such, it raises the expectation for promoting dialogue and contributing to reviews of the design of the proposals.

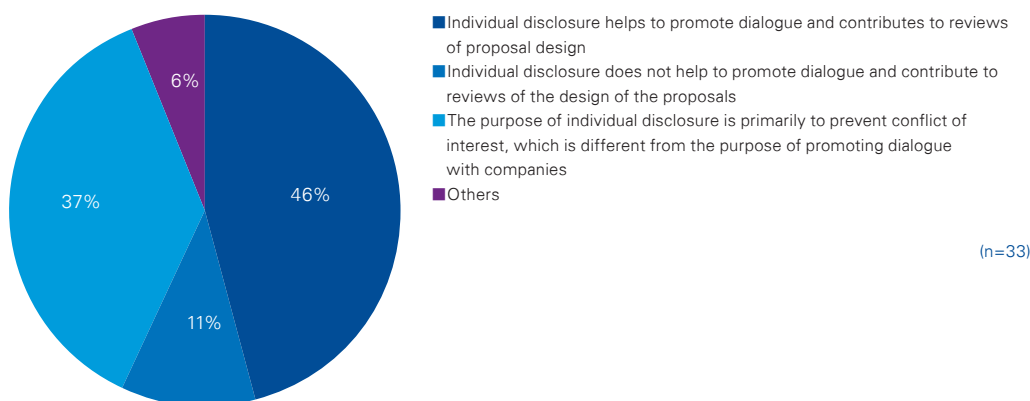
On the other hand, 39% of the companies surveyed responded that "unless the reasons for opposition is clear, individual disclosure is not particularly useful". Some companies find that unless the reasons for institutional investors to vote against the proposals are known, it does not help with dialogue.

According to the KPMG opinion survey for institutional investors, 11 % responded that "individual disclosure did

■ Figure 54. [Companies] Contributions of individual disclosures of the results of exercise of voting rights to dialogue with investors



■ Figure 55. [Institutional investors] Contributions of individual disclosure of results of exercise of voting results to dialogue with companies



not help to promote dialogue and contribute to reviews of the design of the proposals.” Coupled with 37% responded that “the purpose of individual disclosure is primarily to prevent conflict of interest, which is different from the purpose of promoting dialogue with companies”, 48% of the institutional investors surveyed responded that it did not contribute to dialogue.

In the process of debating the revisions to the Stewardship Code, institutional investors pointed out that individual disclosure of exercise of voting rights could actually result in overplaying the results for and against the proposals by the mass media. It would only focus on the results and could reinforce a sense of confrontation with companies and eventually curtail incentives to engage in dialogue.

Conversely, at 46%, roughly similar number of institutional investors responded that “individual disclosure of exercise of voting rights helps to promote dialogue and contributes to reviews of the design of the proposals,” and expect to utilize the disclosure beyond the initial purpose of the system. This shows that there are different views on this topic among institutional investors (Figure 55).

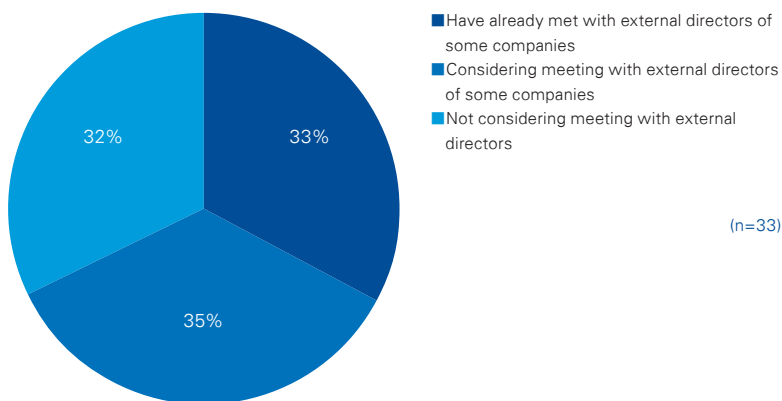
A significant number of institutional investors believe that individual disclosure of results of the exercise of the voting rights has a different purpose than promoting dialogue, but given the corporate sector’s views, it could help to promote dialogue if the reason that an institutional investor voted against a proposal is disclosed as well.

### Dialogue with external directors and board chairperson (non-executive)

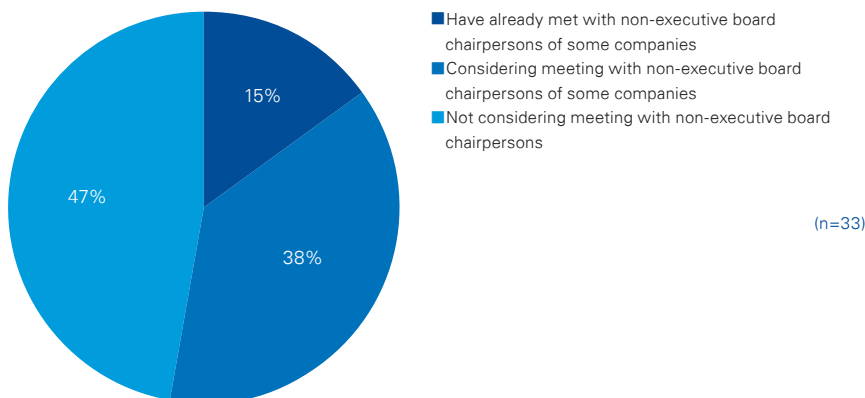
Given the growing momentum in dialogue between companies and investors, the question of “which representative of the company the investors should talk to” is becoming more important. Before the adoption of the Corporate Governance Code, dialogue between companies and investors was often carried out with the company’s executive officers, such as the CEO, CFO, or IR officer.

The Corporate Governance Code states that the senior management and directors, including external directors, should basically be positioned to engage in dialogue (Supplementary Principle 5.1.1). The inclusion of external

■ Figure 56. [Institutional investors] Dialogue with external directors



■ Figure 57. [Institutional investors] Dialogue with non-executive board chairpersons



directors reflects that appropriately representing the views of minority shareholders and other stakeholders in the boardroom from a standpoint independent from management and controlling shareholders is one of the roles and responsibilities of independent directors (Principle 4.7).

According to the KPMG opinion survey for institutional investors, 33% of the institutional investors surveyed had met with external directors, which increases to almost 70% when including those who are currently considering to do so (Figure 56).

However, given the role of non-executive board chairpersons in corporate governance, dialogue with non-executive board chairperson would be useful, but only 15% of the institutional investors surveyed indicated that they have already had meetings with them. The progress is slow compared to dialogue with external directors. Nevertheless, 38% of the institutional investors surveyed are considering meeting with non-executive board chairpersons, which indicates that a majority of institutional investors are interested in dialogue with non-executive board chairpersons as well as external directors (Figure 57).

## Future direction of dialogue between companies and investors

There has been a dramatic change in the quality of dialogue between companies and institutional investors before and after the adoption of the Corporate Governance Code. Many companies are aware of the importance of dialogue with investors in promoting the understanding of their medium- and long-term value creation story. As such, the shift from the short term to the medium- and long-term timeframe covered in dialogue between investors and companies is important when considering the approach to dialogue going forward.

As discussed in “III. Management Focused on Capital Efficiency and Shareholder Value,” companies and institutional investors have different perceptions in respective of their assessment of corporate value and approaches to enhance it. Investors’ short-termism is considered to be one of the reasons why corporate value is underestimated, and the shift to the medium- to long-term timeframe covered in dialogues could potentially bridge the gap in perception between companies and institutional investors.

In order to encourage the understanding of the medium- to long-term value creation story, companies need to clarify the role of non-financial information. In particular, they have to consider the content to ensure that it conveys the source of their company’s value creation and choose a medium for their disclosure documents that conveys this content. To this end, it would be helpful to take another look at the company’s revenue opportunities and risks—for example, reviewing ESG aspects.

Moreover, given that exercising voting rights is one means by which shareholders express their trust in the directors as a result of dialogue, individual disclosure of the results of exercise of voting rights, including the reason for opposition, could clarify institutional investors’ thoughts on their votes and deepen dialogue. Moreover, with both companies and institutional investors increasingly interested in ensuring the effectiveness of board meetings, discussions between external directors or non-executive board chairpersons and institutional investors on the effectiveness of their company’s boards and increasing corporate value could reduce institutional investors’ perceptions of risk. This could result in greater trust in the company when it comes to time to vote.

We expect progress in the content and methods used in dialogue between companies and institutional investors.

V.

# Institutional Investors' Response to the Stewardship Code

## POINT

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- » With the adoption of the Stewardship Code, institutional investors have had more opportunities to give advice on addressing the challenges faced by the companies in which they invest. This has led to changes in constructive dialogue with companies.
- » Many institutional investors consider collective engagement if they have the opportunity, and they may see this as an option that would make their dialogue with companies more effective.
- » Many institutional investors believe that their capacity to effectively fulfill their stewardship responsibilities is inadequate. As a result, building up an adequate capacity as an organization is an issue for the industry.

# 1 — Changes due to the introduction of the Stewardship Code (including revisions)

In the previous chapters, we discussed the changes caused by the adoption of the Corporate Governance Code and compared how companies and institutional investors have been affected. In this chapter, we focus on how the introduction of the Stewardship Code has affected institutional investors, and outline the points that may be highlighted in their dialogue with companies going forward.

## Growing interest in dialogue among institutional investors

The Stewardship Code was established in February 2014, but it was revised in May 2017, only after three years.

In the KPMG opinion survey for institutional investors, almost 70% of the institutional investors surveyed responded that the adoption of the Stewardship Code “increased opportunities to discuss the possibility of improvements and give advice to companies during meetings, instead of being limited to interviews” (Figure 58). The Stewardship Code is expected to contribute to enhancement in corporate value through day-to-day constructive dialogue between asset managers (institutional investors as asset managers) and investee companies. Institutional investors do not simply listen to the companies in which they invest; they have more opportunities to give them advice on how to address challenges, and this change may have resulted in the kind of constructive dialogue that leads to sustainable growth for companies.

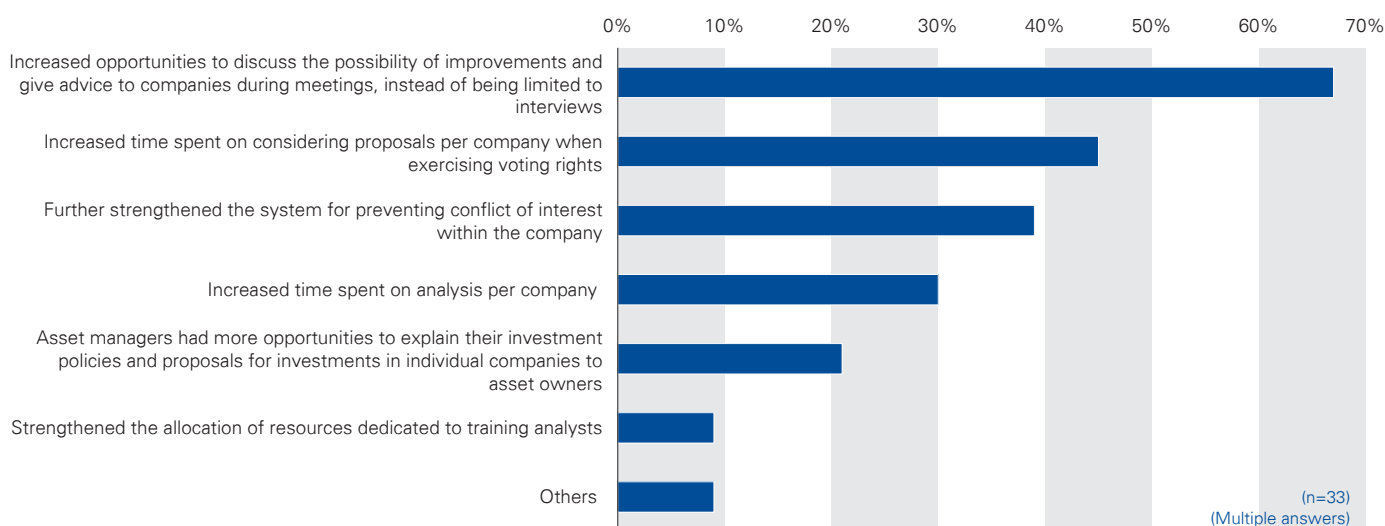
About half of the institutional investors surveyed responded to a question on their voting that “the time spent on considering the proposals per company increased”. Given that companies had previously indicated that institutional investors exercised their voting rights in a standardized way in line with guidelines and had little time to consider individual proposals, we believe that this change should be able to help promoting dialogue at general shareholders’ meetings.

## Asset managers’ need for dialogue with asset owners

While there have been some changes promoting constructive dialogue between asset management institutions and companies, we do not see any marked change in their relationship with asset owners (institutional investors as asset owners). In the KPMG opinion survey for institutional investors, only about 20% responded that “asset managers had more opportunities to explain their investment policies and proposals for investments in individual companies to asset owners”. Asset owners are expected to disclose their policies on fulfilling their stewardship responsibilities in the investment chain and contribute to improvements in the corporate value of investee companies through their own actions as well as the actions of the asset managers to which they outsource their asset management activities.

The stewardship responsibilities that institutional investors are asked to fulfill refers to the “responsibilities of institutional investors to enhance the medium- to long-

■ Figure 58. [Institutional investors] Changes due to the introduction of the Stewardship Code (including revisions)



term investment return for their clients and beneficiaries (including ultimate beneficiaries) by improving and fostering the investee companies' corporate value and sustainable growth through constructive engagement, or purposeful dialogue, based on in-depth knowledge of the companies and their business environment". Asset managers must strive to attain a proper understanding of the intentions of asset owners in order to fulfill their stewardship responsibilities.

Asset managers' dialogue with asset owners must also improve in the interest of optimizing the overall investment chain.

### Current status of collective engagement

When the Stewardship Code was revised in 2017, the inclusion of dialogue between a company and multiple investors (collective engagement) was discussed, and as a result, the revised Code clarified that collective engagement was effective in some cases. In the UK's Stewardship Code, collective engagement is recommended as an action to be taken in collaboration with other institutional investors when appropriate.

The KPMG opinion survey found that 62% of the institutional investors surveyed "do not participate in collective engagement but would consider doing so if given the opportunity" (Figure 59).

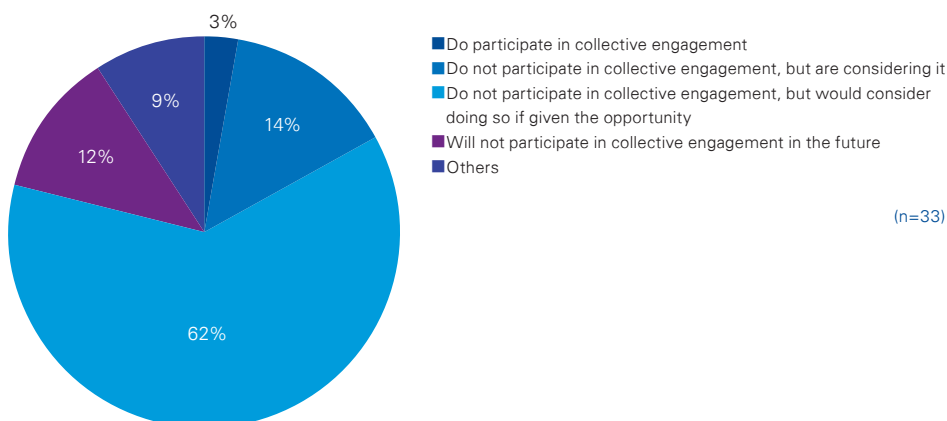
Combined with the institutional investors who responded that they "do participate" and those that "do not participate, but are considering it", these results show that about 80% of the institutional investors surveyed are actively aware of collective engagement.

The Corporate Governance Code and the Stewardship Code are the pillars of Japan's corporate governance reform, and they represent reforms that prioritize companies' relationship with institutional investors, one of their shareholders. In part due to concern over a spate of hostile takeovers and shareholder activism around 2000, there were no clear provisions about collective engagement in the initial Stewardship Code. The UK's Stewardship Code recommends collective engagement for institutional investors, and also lists shareholder proposals and, in some circumstances, calls for board member replacements as examples of ways to strengthen engagement.

The Stewardship Code stresses the importance of dialogue with companies from a long-term perspective, but collective engagement is a valid means of achieving effective results. As a result, this approach may be considered in Japan going forward.

6. Situation in which multiple institutional investors collaborate in holding dialogue with a company.

■ Figure 59. [Institutional investors] Current status of and approach to collective engagement



## 2 — Institutional investors' future approach to promoting constructive dialogue

### Do institutional investors have enough capacity to fulfill their stewardship responsibilities?

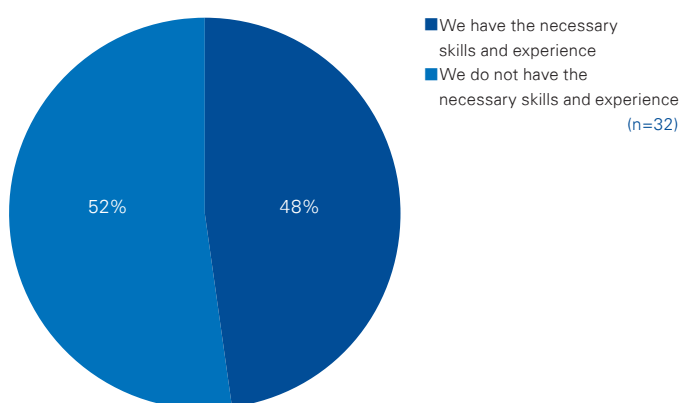
Principle 7 of the Stewardship Code states that institutional investors should have the capacity needed to fulfill their stewardship activities.

#### Principle 7

To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgements in fulfilling their stewardship activities.

Institutional investors should go beyond merely formal dialogue with investee companies and instead pursue

■ **Figure 60**  
[Institutional investors] Do you have the capacity needed to carry out stewardship activities appropriately?



constructive dialogue, after considering things for themselves, in order to help companies come to new insights. Accordingly, institutional investors must have the skills and experience needed to effectively fulfill these stewardship responsibilities.

When the Stewardship Code was revised in 2017, "the management of institutional investors should have appropriate capability and experience to effectively fulfill their stewardship responsibilities" and "the management of institutional investors should also recognize that they themselves have important roles and responsibilities in carrying out stewardship activities such as enhancing dialogue, structuring their organizations and developing human resources, and take action on these issues" were added to the code (Guidance 7-2). Institutional investors are the subject of this guidance, which stresses that it is important for not only the asset managers, but also the asset owners, to recognize their capacity, experience, roles and responsibilities.

According to the KPMG opinion survey for institutional investors, 48% replied that they have the necessary capacity to engage in dialogue with investee companies and make appropriate decisions resulting from stewardship activities (Figure 60). Conversely, 52% of institutional investors surveyed believed that such capacity is "inadequate", which indicates that many institutional investors believe there is room for improvement in their capacity.

This raises the question of where those institutional investors who replied that their capacity to effectively carry out stewardship activities is inadequate (lack of appropriate skills and experience) see room for improvement.

■ **Figure 61. [Institutional investors] Stewardship activities with room for improvement**



About half of those institutional investors who responded that their capacity is inadequate stated that "some staff have the necessary skills and experience, but this has not spread to the entire company" (Figure 61). Many institutional investors believe that ensuring the appropriate capacity is an issue for their organization, such as utilizing staff with the right skills and experience and spreading stewardship activities company-wide. Moreover, some institutional investors replied that "the internal structure needed to have appropriate engagement and make proper judgments is not in place" and that "we do not have staff with the right skills and experience". This indicates that the capacity of institutional investors must be recognized as a major issue facing the industry.

The revisions to the Stewardship Code were intended to ensure the effectiveness of stewardship activities, based on the voluntary initiatives of institutional investors. The Stewardship Code states that "asset managers should regularly conduct self-evaluations with respect to the status of their implementation of each principle, including guidance, and disclose the results" (Guidance 7-4) to ensure that they have the capacity to fulfill their stewardship responsibilities and to ensure the effectiveness of their stewardship activities.

### **Dialogue based on an in-depth understanding of investee companies from a medium- to long-term perspective**

In the three years since the Stewardship Code was established, institutional investors have made progress in setting up and strengthening the systems needed to fulfill stewardship responsibilities, such as reinforcing internal governance and conflict-of-interest management. There have been changes in terms of dialogue with companies, including an increase in opportunities to addressing challenges with investee companies. In addition, revisions to the Stewardship Code are expected to lead to new developments in improving the effectiveness of stewardship activities, including the inclusion of collective engagement as a means of effective dialogue.

As such, while the environment is becoming more conducive to constructive dialogue with investee companies, many institutional investors see room for improvement in their capacity to make appropriate judgments based on dialogue and stewardship activities.

The Stewardship Code notes that ESG factors be accurately ascertained when engaging in dialogue with investee companies to understand a company's

circumstances. Institutional investors are also expected to understand a wide range of information, including non-financial factors. As discussed in "IV. Dialogue between Companies and Investors," institutional investors tend to emphasize non-financial information as a result of changes in the timeframe covered in their dialogues, and have more opportunities to make investment decisions based on a medium- to long-term perspective.

To ensure that dialogue with companies improves their medium- to long-term corporate value, institutional investors, in their role as long-term investors with a deep understanding of companies, must also take into account non-financial information since this is a source of economic benefit. Moreover, institutional investors should determine the areas they want to focus on in dialogue after assessing the investee company's business strategies and risks.

As experts in asset management, institutional investors' capacity to make investment decisions based on a deep understanding of the company and analysis of a wide range of information, including non-financial information, is being called into question.

We must also not forget that asset owners also play an important role as "responsible investors" in the investment chain.

The stewardship responsibilities of asset owners were one of the focus areas in the revision of the Stewardship Code. Similar to a company's board of directors, as trustees handling the money received from clients and beneficiaries, they are responsible for supervising the performance of asset managers. This is crucial in ensuring that the final beneficiary receives an appropriate return on investments.

Based on their own position and role in the investment chain, asset owners carry out stewardship activities independently with the aim of fulfilling their stewardship responsibilities.

With the basic understanding that they can affect capital markets, institutional investors can not only enhance their dialogue with companies, but also share a medium- and long-term investment timeframe, by enhancing dialogue between asset owners and asset managers. In addition, by understanding their own roles and fulfilling their responsibilities, institutional investors can be expected to help optimize the investment chain.



# About KPMG Japan Corporate Governance Center of Excellence (CoE)

KPMG Japan's Corporate Governance Center of Excellence (CoE) was formed with the aim of studying, analyzing and providing information on corporate governance trends in Japan.

KPMG Japan's Corporate Governance CoE comprises KPMG Japan's experts on the Companies Act, boards of directors and risk management, financial strategies, dialogue with investors (engagement), integrated reporting, information disclosure and shareholder meetings. The organization compiles knowledge and best practices related to corporate governance by utilizing KPMG's global network and affiliated external institutions, and gives advice.

The Corporate Governance CoE will continue to provide information on the latest trends in corporate governance by holding seminars and issuing reports, among other endeavors.



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