Interview with Nicholas E. Benes, Representative Director, the Board Director Training Institute of Japan (BDTI)

# How Is Japanese Business Management Taking Advantage of the Corporate Governance Code?

By *Japan SPOTLIGHT*

**Since the adoption of the Code of Corporate Governance in 2014, there have been many discussions about the future evolution of Japanese management and the benefits and possible deficiencies of the Code. The recent case of Toshiba's "window dressing" reminds us of the urgent need to implement it. In the light of such new developments in corporate governance, *Japan SPOTLIGHT* had an interview by e-mail with Mr. Nicholas Benes, representative director of the Board Director Training Institute of Japan, following an earlier one with him in the March/April issue of 2015. He is the person who first proposed and explained the concept of a governance code to leading parliamentarians in the ruling Liberal Democratic Party and has advised key lawmakers and the Financial Services Agency on the content of the new Code.**

**JS: Will the Toshiba incident be a good lesson for Japanese businesses and encourage them to implement the Code as quickly as possible?**

**Benes:** Yes, I think it will. For one thing, it is a very clear example of something I have been teaching in our director training courses for some time now: "Never think it can never happen in your own company." The unfortunate truth is that these sorts of incidents can happen anywhere, unless the board is constantly vigilant about fostering an "open" corporate culture where anyone feels free to report and question *anything*. The recent incident at Volkswagen shows the exact same thing.

Each event like the Toshiba accounting scandal incrementally demonstrates to Japanese executives that they need to constantly keep in mind their legal duties and potential liability, and that the word "hierarchy" has no place on the board. Legally, everyone has only one vote, for a good reason. Governance along these lines can save the company; hierarchy out of control can destroy it.

The Toshiba example also holds several other clear lessons for existing governance at many Japanese companies. First, committees need to be composed solely of independent directors, and should *never* be chaired by an insider or ex-executive. In Toshiba's case, the chair of the audit committee was the former CFO. So in essence, he was presiding over audit review of transactions that he had approved as CFO. Under these conditions, you cannot expect the independent directors on the committee to receive information so that they might smell something funny and ask questions, and you cannot expect employees to blow the whistle to them.

Second, director skills and competencies *matter*. A company should never, ever appoint directors who do not know much about accounting and finance to its audit committee. Of the four persons on Toshiba's audit committee, two were ex-diplomats who were unlikely to know much about accounting and finance, and one was the internal ex-head of the legal department — also an experience base where you do not read a lot of financial reports. Only one person combined the attributes of (a) knowing something about accounting and (b) independence.

Third, whether they think so or not, most directors (or would-be directors) need to humbly acknowledge that constantly updating their knowledge of their role and legal duties is essential, and that third-party, specialist programs should play a role in this. If they did that, they would be more aware of their legal responsibility, and that the most important role of the board is to foster and improve corporate culture, including knowledge about laws that relate to governance.

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Just think: not *one* of the nine inside directors who must have known something about what was going — enough to have questions

and doubts — came to consult with any of the outside directors on the audit committee, so far as we know. But they all had a legal duty to do so, and to raise the matter at the board as well. Did they realize what their legal liability could be? In part, this is simply a knowledge thing.

**JS: Do you think the prevailing international standard of financial accounting will increase arbitrary financial estimates or predictions and thus enlarge "grey zones" in accounting practices? Will it increase the possibility of "window dressing"?**

**Benes:** Yes, perhaps, but there are already many "grey zones" to worry about. At the end of the day the way to address most of these issues is not primarily to focus on the accounting rules, but rather raise the awareness of potential legal liability in the minds of directors and audit firms, and modify incentive structures so that they make such estimates on a "good faith", sincere basis, and review them frequently.

For instance, to help eliminate incentives to misleadingly exploit "grey zones", executive compensation practices need to aggressively employ long-term "claw-backs" of any compensation received based on financial results that arose from fudging the rules or not making honest estimates. In other words, if financial fraud or similar problems are uncovered later on, you will have to pay back a large portion of compensation already received, or it will not be paid to you from a trust that was set up in advance, or you will not be able to exercise your options, etc. Japan needs to introduce more "claw-backs" like this, the way other countries are starting to do and the new OECD Principles encourage. Toshiba had none in place.

**JS: Many successful companies do seem to be adopting ROE or ROIC (return on invested capital) for their corporate reform in the long term, according to METI's research in 2013. (In other words, they are integrating the concept of ROE into their long-term managerial plans.) Do you think this is necessary to prevent business from blindly seeking to increase ROE and pursuing only short-term profits?**

**Benes:** Yes, it goes without saying that realistic ROE or ROIC goals need to be carefully incorporated into long-term management plans and the overall strategy. Unless executives do this, such targets run the risk of not being sustainable or even reducing sustainability. In the worst case, they will just be reducing the denominator without increasing the numerator at all, a form of lazy management that will not impress investors on anything other than a short time frame, if that.

But please note that this is not to say that finding short-term ways to increase ROE and ROIC that do *not* reduce sustainability is a bad thing at all. Eliminating unnecessary expenses, or using cash for stock buybacks if the firm has enough equity cushion to capitalize on all its opportunities, is just good management. There is room for improvement here. Every time I travel in Japan and notice all the unused in-house resort facilities owned by Japanese companies, I am reminded of this.

Second, when firms *do* fully integrate ROIC and cost of capital measures into their strategy, they may find that they need to adjust or improve the strategy. So modify it! This of course is the true benefit of being aware of ROIC and measuring it. For example, managers may be forced to admit that it is time to exit the ABC business soon, because the firm no longer has a competitive advantage, and to shift capital so as to invest more and faster in the XYZ business, where the firm *does* have a competitive advantage. Or they may strive to develop new efficient sales channels, or focus the product line.

It is this sort of dynamic, fast capital allocation that Japanese companies have not done as well or as speedily as many foreign firms over the past several decades. Boards need to realize that one of their most important jobs is to make sure that management is optimally allocating the firm's precious capital, and that delaying necessary decisions is to destroy value. ROIC is a good measure to use in this process, because you can calculate it for each division, and it separates out the amount of capital actually invested in that business, while excluding (and hence shining a flashlight on) excess cash holdings.

Last, not all divisions should necessarily be charged the same cost of capital or expected to generate the same ROIC in a given period. Obviously a new product or business that is in the growth stage and requires investment will often not generate cash returns for several years or longer. The point is, do we have a good basis for thinking it *will* generate good returns in the future, so that our overall return targets will be met? We do not need certainty. We need a very objective viewpoint and a good strategy, one that we constantly improve.

**JS: Long-termism seems to be adopted by US companies as well. Will corporate social responsibility (CSR), human resources development for employees, investor relations (IR) and other factors become important long-term managerial targets? Are they inconsistent with ROE?**

**Benes:** Yes, they will, because the global trend to include environmental, social and governance (ESG) factors in investment decisions on an analytical basis is expanding very rapidly, and soon will no doubt become big in Japan as well. As a result, companies will become increasingly aware that their stock could be excluded or underweighted in portfolios because they have come to be viewed as relatively less sustainable than other companies in their global sector. Moreover, they will become aware that ESG-oriented investors attribute much more credibility — and hence more sustainability — to companies which seek to quantitatively or objectively measure important aspects of E, S and G so that they can set goals to improve them further in the succeeding years.

Personally, I dislike the word "short-termism", which seems to imply that all short-term decisions to improve profits are somehow bad, or "long-termism", which in the Japanese context can all too easily mean that we sweep all management goals under a rug of ambiguity and perpetual non-accountability. I prefer to simply focus on the fact that if a company's absolute profits are not growing and are not sustainable in the long term, that company's value as calculated today will be drastically reduced. This means that the company should want to avoid those short-term decisions that rob from the future, but not those that do not.

Such a view is entirely consistent with maximizing long-term ROIC — true return on invested capital — and ROE, the more general measure which frankly can be more easily manipulated near-term. In the long run, a company cannot achieve high returns under these yardsticks without the support of its internal and external stakeholders, and without avoiding damage to their interests or those of society and the market.

Yet, worldwide and also in Japan, many companies do not yet attempt to actually measure and monitor their environmental or social footprint, so as to actually consider how to improve it. To them, ESG is just old-style CSR in the sense that it is just "PR-like things you do to enhance your brand image". This is not managing for true sustainability.

**JS: ROE-oriented management is expected to increase a firm's productivity and encourage executives to prudently take on reasonable levels of risk in order to achieve a high return on investment and create business value. Do you think a lack of risk-taking business behavior and entrepreneurship are the principal reasons for the stagnant Japanese economy over the past few decades? And could the new Code encourage innovation and entrepreneurship?**

**Benes:** Yes, I generally agree with the economist Paul Krugman when he said that Japan's economy has been "crippled by caution" for the last two decades. There have not been enough risk-taking "animal spirits". Instead, when companies licked their wounds after the bursting of the bubble, corporate cultures became risk averse to the point where many of the executives who rose in the ranks were those who had avoided a single mistake. Executives at the top of companies, without realizing they were doing so, actually acted on a very short-term timeline — the time until they would retire. At the same time, at many of Japan's large companies these trends were aggravated by Japan's failure to create a more mobile labor market and a market for corporate control, both of which might have served as a sort of counterbalance or stimulus.

I do hope that the Corporate Governance Code can help in breaking down these ingrown barriers to entrepreneurial risk-taking. The key hope for this to happen comes from two simple things. First, the government — supported by society at large — has sent a clear message to companies that they do not exist in order that employees can collect paychecks for the meantime and build up a pile of cash; rather, they mainly exist in order to strive for greater profitability and the active reinvestment of those profits so as to contribute to the economy, shareholders, and employees along the way. This message may sound obvious, but given the past mangled rhetoric, it is a breath of fresh air.

Second, the Code stresses the importance of "objectivity" in decision-making, and the vital role played by independent directors in that regard. At the end of the day, successful management must be based on a frank, objective analysis of the facts. This also may sound incredibly obvious, but insider-controlled boards have an amazing ability to invent and perpetuate their own internal logic that would not pass muster anywhere outside their own company. As the practices in the Code take effect, I hope the influx of outside directors, and the expectations of investors for greater objectivity, will speed up analysis-driven decisions, bold strategy shifts, new work practices, greater entrepreneurial thinking, and necessary restructuring.

At the end of the day, this will often mean speeding up the process by which Japanese companies evolve their decision making and work practices. We will need to depart from seniority-based promotional systems, nomination of board members based mainly on loyalty rather than skills and competencies, and "advisor" positions for retired members of the board. In their place "objectivity" needs to insert performance-based promotions; diversity, outsiders and foreigners at senior levels; and performance-linked compensation that has a healthy claw-back feature.

**JS: Greater risk-taking corporate actions could result in failures. In the case of failures, executives will need to be brave enough to exit the business. Will the new Code also work so as to encourage them to take such decisions at the right time, in order to exit smoothly?**

**Benes:** Hopefully so. But the changes I just spoke of will take time, and of the many things that Japanese companies are good at, exiting from business lines early enough to get good value from such divestment (and reinvestment of proceeds) is not one of them. Exiting business lines earlier partly depends on the board — outsiders especially — supporting CEOs who make such bold decisions but are criticized internally for doing so. Often the criticism comes from other board members who are vying for the CEO's job, or retired directors. It also partly depends on investors, including activists, and whether they specifically suggest exiting from those business lines that seem to be non-core. If the company cannot articulate a persuasive plan for restructuring and repositioning the business so that it once again contributes to profits, then investors will have to punish them more than just by selling the stock. Otherwise, it is true, many Japanese companies will move too slowly.

**JS: As product lifecycles are short nowadays, any given product will only be able to maintain its success in the market for a limited time. A firm would need to be flexible in making decisions to exit from business lines in order to maintain its value overall. Can the new Code make a product cycle even shorter by encouraging a smooth exit?**

**Benes:** Yes, it can. This is why a company needs to be constantly extending and building on its product and technology base so as to bring new, high-margin products and services to the market sooner than the competition, as it retires older products that have become "commoditized". Companies need to think "out of the box", not copy what their Japanese rivals do, which is what so many Japanese companies do.

The answer is more complex than simply not tolerating low returns. Companies need to invest more in product development, R&D, M&A, and try out new business models, so as to constantly find ways to add new value and therefore raise margins — or keep them high.

Sometimes this might even mean your total sales shrink but your return on sales improves and you build a better base for the future.

**JS: Do you think it will still take some time for Japanese firms to reform their corporate governance completely in accordance with the new Code? Would this changing process cause economic inequalities among companies — between those that adjust quickly and those that are slower to catch up?**

**Benes:** Yes, for most companies it will take more than five years. But a small number of others are fully in line with the principles and spirit of the Code, and aiming to improve further as we speak. Even at the starting line there is already a huge disparity of governance quality and rigor between these two groups. This disparity will widen even further and faster than before. Those companies that are "leaders" and appear to be successful and respected because of it, sometimes even inventing new practices that go beyond what is in the Code, will serve as a stimulus for the "laggards" to catch up.

It takes a long time to bring about lasting behavioral change at organizations. Corporations develop their own comfortable ways of doing things as part of their "corporate culture". If you think of a director as having a role in a play, , someone who has been playing the role of Henry IV up until Act II has great trouble suddenly shifting into the role of Julius Caesar in Act III. He is used to something else. He does not know those new "lines". So a large part of the true substance and spirit of the behavioral and management practice changes that are needed will inevitably have to wait for the upper echelon of directors to retire.

On the other hand, this process can be drastically sped up if a strong CEO takes firm command and sincerely decides to embrace reform. We will see some examples like that. Also, while true substance and deep understanding take time to develop, to some extent "attitude follows behavior". Many companies that diligently put into place all of the practices that are suggested by the Code will find that their executives and outside directors collectively start to understand the logic of those practices more deeply in the process of implementing them. It is not rocket science. These practices just make good sense.

And as I said before, the speed of change at any company will partly be determined by how assiduous its shareholders are at studying the company's present practices and strategy, and urging modifications. Whether we are talking about gentle engagement, soft activism, or vocal activism, as a general matter the voice of shareholders will now be heeded more than it was, say, 15 years ago.

**JS: The majority of Japanese businessmen seem to be in favor of the new Code. Do you think the Code will dominate Japanese corporate governance much sooner that we think? Will the Toshiba case encourage this?**

**Benes:** I agree with you that the Toshiba incident will, if anything, hasten change, and that at certain companies the Code will have a pronounced impact faster than we might expect. I also think that many Japanese businessmen, on balance, are quietly in favor of the new Code in general — that is, they hope it will encourage useful internal reforms and better governance at their own companies, and improve the economy.

Many of the people who support the Code are what are called "middle management", most of whom are not board members yet, and are the group who will ultimately push through true reform, to the extent it occurs over the next few years. They are the powerhouse and great hope of Japanese companies, the underutilized modern executives who know what needs to be done but feel held back (and often are) by the present system, its customs, and their seniors.

But at a senior level, some executives are not in favor, in their hearts. Some feel "criticized" because there is an implication that since they had not sought to improve their governance practices much up until now, they needed to be "told" to do so. And as I said before, they are comfortable in their ways and do not really want to change in Act III. There are concrete incentives influencing them. They want to be able to protect their "legacy", not have it shown to be partly wrong. And they hope they will not lose the post-retirement "advisor" freebie positions that are part of what they feel they have worked their lives to get — the no-work paid position where they get a chauffeured limousine, and are privy to information so they can kibbitz (complain) about decisions while taking no responsibility. At these companies, significant change will have to wait for the executives to fully retire.

Over the years, I have noticed a significant gap between the former group's sincere desires for rational change — their open-mindedness — and the latter group's lack of true long-term leadership when it comes to any major topic related to strategy or management reform, including governance. The senior executives are metaphorically looking at their watches and saying, "I have only two more years in this position. After that I am on the gravy train. It is easier to delay a decision and make it the next guy's problem rather than be seen to cause a commotion and have to take responsibility for fixing things or taking a new direction. In contrast, the younger managers in their 40s are thinking, "I have to spend the next 20 years in this company. I *need* this place to become a more vibrant, growing organization…or the next 20 years will not be fun at all."

This is why I often tell foreign institutional investors that the best possible proxy for a truly long-term "shareholder value" mindset at each company in Japan is the middle-level managers in their 40s. I often tell them, "Don't confuse what senior executives are doing with what the younger executives are *thinking*."

Related to this, I am disappointed with the lack of constructive national leadership shown by Keidanren in the corporate governance debate. All of us who have been arguing for reform for years — lawyers, private groups, politicians, bureaucrats, investors, journalists — privately mutter about this, but few people publicly point it out. They are afraid of the power of Keidanren — in a word, that they will be ostracized and lose business, support, contributions, advertising, whatever.

I think it is about time that Keidanren publicly accepted the fact that the world has changed, and if they mean what they say about improving Japan it would be better for them to cooperate with nonprofit organizations like the BDTI in helping to build the better boards of the future. After all, we are only doing *training*. It is hard to see what could be bad about that. JS