Interview with Atsushi Doi, General Manager, Legal Division, Hitachi, Ltd.

Corporate Governance Reform in a Large Japanese Company

How Has Hitachi Achieved Change?

By *Japan SPOTLIGHT*

Hitachi, Ltd. is currently seeing the restoration of its business performance after chalking up large deficits since 2009 *(Charts 1 & 2)*. It has been engaged in reforming its management system for a decade as a frontrunner in Japanese corporate governance reform. The following interview with Mr. Atsushi Doi, general manager of Hitachi's legal division, gives some insights into the real story of corporate governance reform in a large Japanese company.

Ahead of Other Japanese Electric Equipment Giants

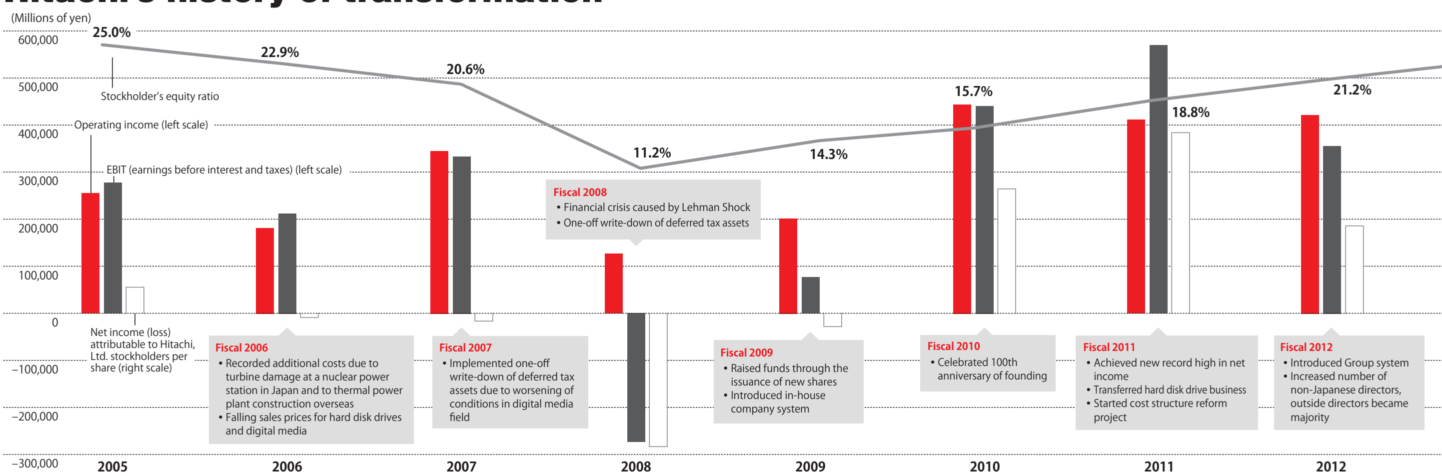
JS: Reform of corporate governance is now considered one of the measures to promote the growth strategy of "Abenomics", since new guidelines putting ROE as the key feature of corporate performance for the interest of shareholders are expected to improve Japanese firms' competitiveness. The pursuit of "diversity" among management as well as employees is considered another reform for encouraging innovation through a synergy among people from different backgrounds. In the light of enhanced competition in a globalized world, these reforms should be an absolute necessity for a global company like Hitachi. Could you tell us what you think about these reforms?

Atsushi Doi, General Manager, Legal Division, Hitachi, Ltd.

Doi: We started separation of business execution from oversight in 2003. Since then, we have been seriously trying to maximize the merits of such a management system in practice. As you said, global competition has changed the nature of corporate governance. Our board of directors, now dedicated to oversight that includes guidance to some extent, needs to think about a global strategy to beat our international rivals rather than a strategy to win domestic competition against our Japanese rivals. So our board directors' discussions include the issue of global competition, which happens to coincide with a current national policy-level discussion. The separation of the board of executives from supervisory functions will enable it to focus on

CHART 1

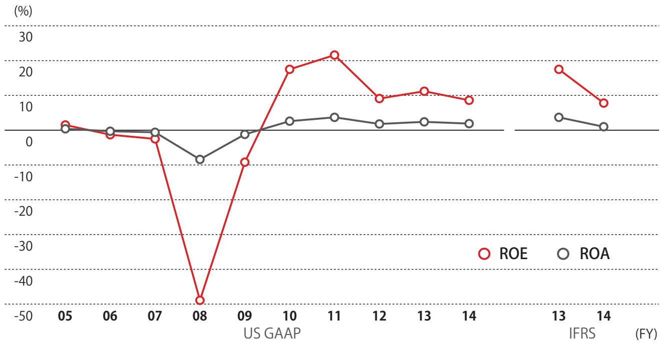
Hitachi's history of transformation



Notes: EBIT is presented as income before taxes less interest income plus interest charges. All figures are based on US GAAP.
Source: Hitachi, Ltd. Annual Report 2015, p. 2-3

CHART 2

Return on equity (ROE)/Return on assets (ROA)



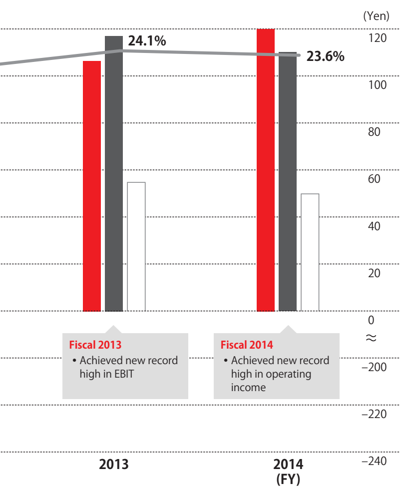
Source: Hitachi, Ltd. Annual Report 2015, p. 32

such global strategic discussions rather than routine business discussions. We have recently been trying to enhance the number of independent directors as the new code of corporate governance recommends and also the proportion of those independent directors of foreign nationality.

Certainly, I understand that "Abenomics" is encouraging such a movement on the business side to enhance Japanese industrial competitiveness. However, we are promoting this for our own business interests.

JS: We had an interview with your colleague on management of "diversity". According to him, though the level of "diversity" is rather low in terms of the ratio to total employees or board members, your company seems to be actively engaged in leaving a number of key posts to people from a variety of backgrounds.

Doi: Yes. We started to nominate local staff who had been working for some overseas offices or factories for a long time as executive directors there instead of sending our Japanese staff from the headquarters office. Among board members as well, we have someone from Singapore, someone from the United Kingdom and someone from the United States, as well as Japanese. We have also female board members. In terms of the expertise of the board members, in addition to ex-CEOs of global business, some are experts on financial accounting and some are legal experts. Thus we have a diversified board of directors.



I guess it is also notable in the case of Hitachi that our non-Japanese executives are mostly our colleagues who have been working for us for a long time and have performed with distinction, rather than being recruited for the current position from outside. Our PR section clearly sent a message to the media that we would conduct our business from a global perspective by introducing these efforts. This global business strategy is also clearly mentioned in our mid-term business plan. Thus our employees are now getting used to such management based upon "diversity".

JS: Your company started to introduce "diversity" at an early stage, didn't you?

Doi: In our industry, the electric device and equipment business, we may have started it earlier than the others. But in other business areas, such as financial business, there should be some who started it earlier than us. We are now providing products and services suited to each market overseas and not selling mass high-technology products made in Japan for overseas markets generally, which used to be our business model in the past. This change in business model seems to have changed our employment system too and now we are utilizing global human resources as much as possible in pursuing our new business model.

JS: Apart from the introduction of "diversity", on the issue of corporate governance reform I guess Hitachi introduced independent directors at an early stage before the new guideline on corporate governance was adopted in Japan. In addition, whereas the guideline proposes that more than one independent director be introduced to enhance the transparency of the management, in your case there are eight independent directors among the 12 on the board. How do you assess the result of this reform?

Doi: As the number of independent directors increases, our board of directors could spend more time and energy discussing the mid- or long-term business strategy issues instead of our routine business details. I believe this is a meaningful outcome. In the old governance system our board members would have to make a decision on too many issues, many of which could have been dealt with well by our company's experts on those issues. However, with the separation of execution of business from oversight functions that was implemented in 2003 in our company, the board could focus on more strategic long-term issues. Above all, with the introduction of diversified independent directors as well, the board can discuss issues from a wide variety of angles and perspectives. The quality of discussions has thus been improved. Of course, we need to have proof to show this in our business performance indicators.

ROE as Almighty Business Indicator

JS: With the introduction of independent directors, the performance of management will be assessed by Return on Equity (ROE), an objective indicator, by third persons. The management team could have a stronger incentive to enhance ROE as their performance would be judged by this single objective criterion rather than by human relations among management members, rather an ambiguous concept, which used to be a kind of criterion in the old governance system. Do you think this would be a positive outcome of the new corporate governance?

Doi: I would say under the new system our executive officers would feel more obliged to convince our independent directors of the relevancy of their business decisions at board meetings where they could be elected or dismissed. That would be a positive outcome of the new system. Transparency in business performance could also be achieved well in our old governance system where execution was not separated from oversight, if appropriate controlling and reporting mechanisms were in place. An informal and friendly atmosphere at board meetings is still very important in achieving a good performance under the new system. I believe that the best performance cannot be achieved in an atmosphere where you are judged by a single mechanical criterion and criticized or pushed by a mechanical process. We are anyway all human beings and not machines. Our 12-member board is much smaller than in the past. I think such a small group can have much more interactive and friendly discussions that could be more fruitful.

JS: It seems, then, that in your company the new corporate governance rule harmonizes well with the existing old Japanese management system, a human relations-oriented one that keeps face-to-face communication as it is.

Doi: Whether we call it Japanese management or not, our company is run according to Japanese law. However, our executive board is engaged in dealing with not only domestic issues but also global issues and we have started adapting ourselves to what we call globalization. We are still in the process of trial and error.

JS: Your directors must be very knowledgeable about financial accounting, since anyway ROE should be the crucial criterion for judging a company's performance. Do you think they have a good knowledge already or will you need to nurture such directors?

Doi: I do not think that all the directors are necessarily equipped with such expertise and knowledge of accounting, but they will need to respond to global business needs appropriately. But anyway we need relevant internal controls for the financial reporting system in our company to work well and avoid any waste of expenditure. Our Audit Committee responsible for supervising such a financial reporting process, in collaboration with our Internal Auditing Office and independent auditors, consists of such experts in financial accounting.

JS: ROE may not necessarily be the only target pursued by the management team, but rather more long-term strategic goals could be as important as ROE. What do you think about this?

Doi: ROE is definitely a useful target for shareholders, of course. Once you have the balance sheets of two companies, you can easily calculate their ROEs and compare one with the other. You can also compare your company's ROE with the average ROE of your industry. But what can we do to enhance ROE? We need to think about the specific factors, such as profitability, asset turnover and equity capital ratio to total liability. For example, what strategy shall we take to raise profitability? How large a liability shall we have? Or how much shall we keep in internal reserves? These questions must also be important goals for the management and discussion of these goals would eventually lead to decisions on how to enhance ROE. In this regard, ROE is a key feature of our business goals. However, as I have said, we are not treating ROE as our absolute deciding factor, but discussing some key factors of ROE such as profitability. We do not have any specific figure for ROE as a goal announced to our shareholders, but we have a numerical target as an internal goal.

JS: ROE-oriented corporate governance is not necessarily inconsistent with other long-term management goals such as maximizing benefits for employees or corporate social responsibility (CSR), is it?

Doi: No, it is not. This is a perfectly understandable indicator for shareholders, since ROE is a return on the equity they own. Not only in the short term but also in the long term, we would naturally need to raise our ROE, which could resolve many long-term issues. Anybody would agree that the highest ROE ever achieved in a certain year should not always be understood as the best performance, since that could be achieved by a decline in the denominator of ROE, the capital amount. We should look at ROE over the long term to find out correctly how well the company is doing.

JS: Shareholders must be interested not only in ROE but also in various other indicators of business performance, mustn't they?

Doi: Yes, certainly. Many shareholders are interested in our long-term business strategy and performance as well as our quarterly performance of ROE. Above all, many of them have been holding our company's shares for a long time.

JS: Window dressing must be checked internally. In the case of your company, you have eight independent directors among the 12 board directors. Will this work well to stop window dressing?

Doi: Yes and no. Independent directors cannot detect window dressing just by checking books and records, but they also cannot be tamed by a CEO who has done something wrong once they know it.

Dealing with Increasing Global Risks

JS: My last question. We see now a variety of global risks increasing. Terrorism, natural disasters, geopolitical risks, economic risks etc. are spreading all over the world. You will need to cope with these in a timely and flexible manner. As you said, your board could specialize in strategic issues after this corporate governance reform by putting priority on mitigation and solutions for such global risks in its decision-making process. Is this right?

Doi: Yes. Our long-term strategic issues include, of course, how to mitigate these risks. Our current governance system has made it possible to discuss the issue of these risks from a broader perspective rather than with regard to only a specific project, which is different from the old system where the board was always supposed to make a decision on a specific project. We can now take into account these global risks in general in formulating our mid-term business strategy. So you will be able to see exactly what global risks we consider crucial for our business. It will remain to be seen in our future business performance how effectively this new governance has worked in coping with these increasing global risks. JS