

Interview with Tadaaki Sugiyama, Executive Officer, Senior Vice President, Legal & Compliance, Kao Corporation

Kao Corporation Was Awarded Grand Prize for Best Corporate Governance in Japan in 2017

By Japan SPOTLIGHT

Corporate governance reform is considered an engine to promote Japanese business firms' earning capacity. The growth strategy in Abenomics defined this as one of the key structural reforms of Japanese business and industries. The adoption of the Corporate Governance Code by the Tokyo Stock Exchange in 2015 was aimed at enhancing transparency of management and encouraging a company to maximize shareholders' interests through Return on Equity (ROE)-oriented business management. Three years after the adoption of the code, what consequences and changes have Japanese companies seen?

The Japan Association of Corporate Directors, an NGO reviewing the outcome of corporate governance reform by selecting the company with the best corporate governance performance each year in an event titled "Corporate Governance of the Year", awarded Kao Corporation, a Japanese cosmetics and toiletry company, as the "Winner Company" (second best) in 2016 and as the "Grand Prize Company" (best) in 2017.

Tadaaki Sugiyama, executive officer and senior vice president (legal and compliance) of Kao Corporation, kindly responded to our questions as below.

(Interviewed on July 28, 2018)

Introduction

JS: You are now not only heading Kao Corporation's legal and compliance section but also working for the Association of Corporate Legal Departments, an NGO working on corporate legal issues, as chairman. Could you briefly tell us about your involvement in corporate governance-related issues so far?



Tadaaki Sugiyama

Sugiyama: I have been working for Kao for nearly 40 years. When I joined the company, there was no technical term like "corporate governance". My job in the company's legal section then was to administer board meetings and general meetings of shareholders in accordance with the Companies Act, and thus trying to keep good relations with the shareholders. Then, after a number of revisions of the Companies Act in the 1980s and 1990s, in the domain of corporate governance, the function of audit and supervisory board members was strengthened around the year 2000. Then the term of office of the audit and supervisory board members was extended from two years, the same as for directors, to three, then to four years. In the case of large companies, they were obliged to have more than three audit and supervisory board members and more than half are legally required to

be outsiders. Since the beginning of the 2000s after these revisions of the Companies Act, Kao has been discussing how it would recruit outside directors and outside audit and supervisory board members who can be well integrated at the board meetings and how they could realize their maximum potential.

Another big issue of corporate governance is the compensation system for directors. Kao devises its compensation system for the directors working as executive officers and other executive officers to reflect not only the current

business term but also mid- to long-term achievements. Kao introduced Economic Value Added (EVA) as one of its management indicators in 1999. We made EVA be reflected in compensation for executives and at the same time abolished their retirement benefits and introduced stock options to maintain consistency between executive compensation and mid- to long-term shareholder benefits and perspectives. Kao has been working on reform of executives' compensation system since the early days. In this reformed system, we assess the performance of our management team to see if they create sufficient economic value from the capital entrusted by our shareholders and reflect this assessment in their compensation. Reform of corporate governance can be compared to a big tanker unable to make a quick turn. We believe if we want to make a turn 10

kilometers from here, we must start to steer this big ship right now. Kao's two decades' efforts since the 2000s for the reform of corporate governance as a base for its development and continuous efforts even now helped us to receive the Grand Prize Company in 2017, I believe. However, I do not think we should be satisfied with the current corporate governance of our company. Today's business environment will change tomorrow. Even though our governance system was the best when we received the award, it will need reform again in a year's time. We could fall behind the trend if we stay with the same governance next year. In Kao's corporate philosophy which we call "The Kao Way", we have "continuous improvement and innovation" as "value". In the light of "The Kao Way", I believe we will need to catch up with the continuous improvement and innovation in the business environment and adjust ourselves to them. Corporate governance is no exception. Kao's president, Michitaka Sawada, is always saying "We need to transform ourselves to drive change." Kao considers corporate governance as a means to achieving a goal and not as a goal itself. We have a mission to strive for the wholehearted satisfaction and enrichment of the lives of people globally and we believe one of the important means to achieve it is our corporate governance.

What Is "The Kao Way"?

JS: "The Kao Way" (shown in the diagram) seems to contain a long-term business perspective to achieve a long-term business goal. However, I think the majority of Japanese companies are today thinking and behaving only with a short-term perspective. Could you please tell us why Kao is different from the others?

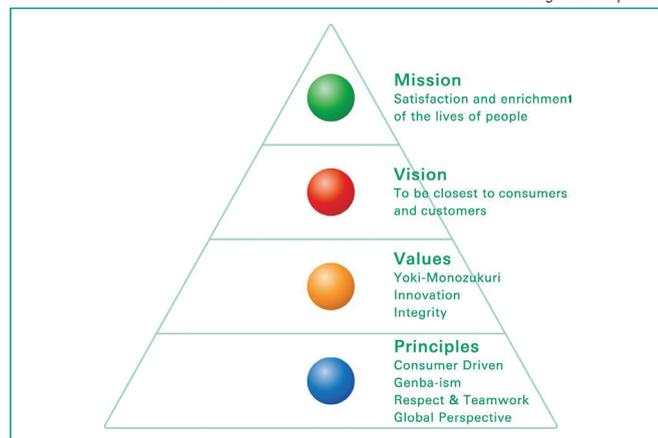
Sugiyama: Tomiro Nagase, the founder of Kao Corporation, came to Tokyo from his home town in a rural area in 1887 with the ambition of achieving success in business, and started a Western sundry goods dealership. At that time, Japanese soap was cheaper than imported soap, was low in quality and when women washed their face it caused them pains. Also, imported soap was very expensive and difficult to get. Nagase decided to produce high-quality soaps as good as imported ones to meet the needs of Japanese women. This was the origin of our company. This spirit to do the best to produce what people need most on every occasion has not changed.

After World War II, while insanitary conditions in civic life continued, under the slogan "Clean lifestyles are the foundation of a prosperous society", Kao restarted production of soaps, shampoos and detergents by using its wisdom of cleanliness and technologies from its pre-war soap production. With the spread of washing machines, our laundry detergents, having matched the development of washing machines, became popular and Kao was successful in achieving explosive sales of these products and established a basis for today's business development.

Kao's functional drinks named "Healthya", a Food for Specific Health Use, were born exactly in the same context. The company's technology to make body fat easy to be burnt inside the human body by using the

The Kao Way (corporate philosophy)

Image: Kao Corporation



"The Kao Way" is the foundation of Kao Group business activities through Yoki-Monozukuri from the consumer/customer's perspective. <https://www.kao.com/global/en/about/policies/kaoway/>

green tea ingredient catechin and prevent it from accumulating in the body was found to be a useful remedy for contemporary diseases caused by accumulated body fat. We are developing to meet people's needs by taking advantage of our existing technologies over time and I believe these efforts are leading to Environmental, Social and Governance (ESG) or Corporate Social Responsibility (CSR).

On Feb. 1, 2018, when Kao announced its business results, President Sawada said, "We are proud of dealing in ESG from the perspective of creating a sustainable society. I had been thinking up to now that investment in ESG from our profits would be at our own cost, which we would think to reduce as much as possible, but now I found that investment in ESG must be nothing other than our investment for Kao's sustainable growth."

JS: Having heard about your founder, I think since its foundation Kao has been pursuing growth by fulfilling CSR. Corporate governance should be the means to achieve this. The spirit of today's corporate governance reform in Japan is to enhance transparency of management and also achieve a wider perspective on business and management by taking account of the views of outside directors. "The Kao Way" seems to share this spirit.

Sugiyama: Yes, you are right. Our ancestors in the Meiji Era (1868-1912) in Japan must have been dreaming about their personal success and promotion, but at the same time they must have been seriously thinking about how they could make a contribution to their nation under development. Kao's founder, Nagase, was one of those businessmen. And that has become the company's philosophy and the management team has been seriously thinking about their contribution to our society and nation through their own resources and capacity. This has been reflected in our selection of outside directors. At certain times, we have asked global business experts to be outside directors who could provide us with advice on how to promote our sales worldwide, but on other occasions we have asked

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experts on maintaining product safety to be outside directors who could provide advice on this. We are always thinking about what we need now or will need in three or five years' time in selecting outside directors.

Role of Outside Directors

JS: Japanese companies today have truly started thinking about fully utilizing outside directors' knowledge and capacity to meet business needs as efficiently as possible, though in 2015 when the Corporate Governance Code was adopted they considered it just as a formal obligation and not as a trigger for management reform.

Sugiyama: I truly believe they are moving in that direction. In the last revision of the Companies Act, there was a suggestion that the introduction of outside directors should be obligatory by law. However, I believe that companies following such an obligation as a formality will not be able to enjoy fully the merits of outside directors and those outside directors in such companies could not perform to their full potential. We proposed at that time that we should adopt a policy of increasing the number of companies inviting people as outside directors who could make an active contribution to their management, rather than just making the introduction of outside directors for each company obligatory by law. That would be far more effective in achieving good business performance.

JS: Kao has six outside directors and audit and supervisory board members in total. They are all communicating and collaborating well with the other board members as well as among themselves. Does the president himself enjoy talking informally with the outside directors and are the board meetings organized in an informal and friendly manner?

Sugiyama: Kao's current board meeting consists of seven directors and five audit and supervisory members — a total of 12 members. Among directors, four are insiders and three are outsiders. Among the

audit and supervisory members, two are insiders and three are outsiders. Thus among the 12 board members, the proportion of outsiders is 50%. Among those outside directors and audit and supervisory members, we have members with a wide range of backgrounds such as a former chairman of a bank, a business executive of a private company, and a business management consultant as outside directors, and a business executive with a certified public accountant qualification and a lawyer as outside audit and supervisory members.

Since Sawada became president, we have further reduced the number of board members, and we have organized our board meetings in an extremely small meeting room where the board members can talk to each other closely across the desk. Seating has recently been changing each time except for the chairman's seat. Thus each time their neighbors at the table are different. So, we are making our meetings and discussions more spontaneous. Though the company does not have to set any particular meeting only for the outside directors, the current outside directors and the former ones spontaneously get together during the lunch break at the board meetings on some occasions or gather at one of the outside director's office. We respect such spontaneous initiatives and we have very active and good discussions among our board members. However, if such spontaneous initiatives would not work in the future, the company might have to set a place for meetings.

JS: Compliance or corporate governance for preserving the quality or safety of products seems to be crucial as well. How do you deal with those issues in Kao?

Sugiyama: One issue is management itself and another is a company's business operations created by the management. Kao has adopted a global matrix management system. On the vertical axis, we have business divisions, and horizontally we have function divisions such as legal, accounting or personnel affairs. The heads of the business divisions are responsible for the business performance and they may have a tendency to just focus on results. We could prevent minimum potential risks in advance by checks by the functional divisions on equal terms with the business divisions.

For example, I am the head of Legal and Compliance and my subordinates would not mind what the heads of the business operation sections think about our views of the business operations when we check them from the legal and compliance perspective. This system would work well in maintaining internal control but the decision-making and its implementation process would be retarded by dual decisions in the business and functional divisions. Retarded decision making would discourage the competitiveness of a company. We would need a balance between internal control and efficiency to beat the competition in this regard.

The other issue is the function of a tripartite auditing framework. They are integrated as our defense line against inappropriate behavior in our matrix management structure, namely auditing in the business divisions, auditing in our functional divisions in charge of internal

control, and finally our internal audit.

JS: It would need strong leadership by the top management to balance the need for internal control and the need for speedy decision making to increase competitiveness, wouldn't it?

Sugiyama: At Kao, we consider internal control including compliance as a base for promoting business operations. You must not balance compliance and business. It needs strong leadership by the top management.

Other Issues Kao Is Pursuing

JS: Good work by the ad hoc committees discussing nominations of directors or their compensation in your company was also referred to as a reason for the Grand Prize in 2017. How well are they functioning?

Sugiyama: The Companies Act defines companies with committee structure governance and those committees are a Nomination Committee, Compensation Committee and Auditing Committee. Kao is not a company with committee structure governance, but a company with an audit and supervisory board. However, we have spontaneously adopted a Committee for the Examination of the Nominees for the directors and a Compensation Advisory Committee as supplementary functions to the board meeting. We have been explaining to our foreign shareholders holding nearly 50% of the company about committee structure governance and thus we do not need to transform into a company with a committee structure. While those two committees meet three or four times a year, the first one or two meetings of the Committee for the Examination of the Nominees for the Members of the Board of Directors are devoted to discussions on the desirable size and structure of the board members, such as the number of the board members, the percentage of men and women, the members' backgrounds etc., to fulfill the board's responsibility and achieve what is expected upon them. After that, they nominate specific candidates. The process works very well, probably thanks to the cooperative leadership of the president and the board chair, an outside director.

JS: A company needs to raise its sales or profit ratio in the short run, while pursuing long-term goals such as social responsibility or long-term contributions to society as mentioned in "The Kao Way". I guess there needs to be consistency between the short-term goals and the long-term goals.

Sugiyama: Yes. We announced a four-year mid-term business plan called "K20" in 2016. This is the plan for 2017-2020 in order to achieve a desirable business performance in 2030. In this plan, we

defined three business commitments: one is to foster a distinctive corporate image; the second is to create profitable growth; and the third is to return benefits to stakeholders, including not only our shareholders but also our employees, customers and society. We are now standing on the threshold of being an authentic global company. We have established a certain business presence in Asia, but not yet in other regions. In order to be a full-fledged global company, we will need to establish our distinctive corporate image anywhere in the world. That is our first goal and this will come first before any numerical target. This is our uniqueness. We have specific numerical targets such as a 5% annual increase (CAGR) in net sales and a 15% operating profit ratio to realize the first goal. The primary strategy for achieving these targets is all the members' commitments to the goal including the management in running the company with "integrity" which shows in "The Kao Way".

JS: Are you also working on promoting health care for the employees, another important stakeholder? What kind of projects are you working on in this regard?

Sugiyama: Yes. One example is that we promote our "GENKI (good health) Project" supporting each employee's health care under the responsibility of the managing executive officer who is in charge of Human Capital Development. This is, I believe, a kind of long-term investment for the future, just like investment in ESG. If our employees are in good health, their work performance will stay high and our health insurance expenditure on our budget would be curbed.

JS: I am impressed by the casual and friendly atmosphere in your company. What about your engagement to promote diversity in your company?

Sugiyama: When we introduced outside directors in 2002, we invited Ms. Sakie T. Fukushima, a personnel affairs consultant, to be one of them. However since then, as there are very few female executives in this country, we have not been able to keep female directors, though we have constantly made them offers. Whether they accept being board members or not is another story. We are not in a situation where we can see a significant increase of female executives. The female employees who joined our company at the time of the implementation of the Equal Employment Opportunity Law are now around the age of 50, but unfortunately they may not necessarily have been well trained as managers. However, in the light of my analogy about a tanker that would need to be steered far in advance in order to make a turn later, I think this is a crucial moment for specific action to achieve truly substantive equal opportunities between men and women in thinking about our future and how we can fully utilize diversified human resources.

JS

Written with the cooperation of Naoko Sakai who is a freelance writer.