The Corporate Governance Debate

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Over the past decade, corporate governance has come to replace industrial policy and Japanese-style management as the key factor to explain Japanese business performance.

From the 1960s through the early 1990s, many observers focused on the close and cooperative relationship between Japan’s economic ministries—especially MOF (Ministry of Finance) and MITI (Ministry of International Trade and Industry)—and the companies under their jurisdiction to explain Japan’s economic success. As a student at the Harvard Business School in the 1970s, I remember taking the required first-year MBA course on BGIE (Business, Government, and the International Economy), where nearly half of the country cases focused on the success produced by Japan’s industrial policy.

Those who felt uncomfortable giving government so much credit for Japan’s economic success focused their attention on what they viewed to be the strengths of Japanese-style management, which included long-term employment, promotion and wages based on seniority, enterprise unions, low labor mobility, patient capital, and keiretsu ties centered on main banks.

The bursting of the bubble economy in Japan in the early 1990s and the ensuing lost decade of economic stagnation have forced all but the staunchest advocates of the Japanese system to concede that changes are necessary to revive the economy. In recognition of the rise of market forces and the power of globalization, most now look to the government primarily to provide the macroeconomic environment for growth and see the enhancement of Japanese corporate competitiveness to be up to the private sector. This has led to the debate over corporate governance as a key to Japanese economic revival.

On one side of the debate are those who contend that Japanese corporate performance will improve only if Japanese companies adopt Western (primarily U.S.) forms of corporate governance. This includes greater emphasis than at present on shareholder rights, information disclosure, transparency, profitability, and management accountability.

Advocates argue that without reform, Japanese firms will continue to lose in global competition. According to the Tokyo Stock Exchange, major Japanese companies’ return on equity declined from 8.46 percent in 1983 to 1.2 percent in 1999. Corresponding figures for U.S. companies rose from 12.36 percent to 17.88 percent during the same period. A survey of 450 companies listed on the first section of the Tokyo Stock Exchange conducted last year by Keio University and the Japan Corporate Governance...
Forum revealed that companies in which outside directors participate in corporate decisionmaking reported higher growth in sales and pretax profit over the past four years than those that did not.

Sony Corp. has been a frontrunner among Japanese companies in adopting certain aspects of U.S. corporate governance. In 1997, the company reduced the number of board members from 38 to 10 and reinforced the role of outside board members. Sony's board now consists of three outside members and nine inside members. In 1998, Sony also established a nominating committee (consisting of one outside and five inside board members) responsible for selecting executives and a compensation committee (consisting of two outside board members and a Sony counselor) to determine executive compensation.

Although Sony is often cited as an example of change in Japanese corporate governance practices, it is atypical. Since 1996, Davis Global Advisors has conducted an annual survey of leading corporate governance indicators. Among the seven countries surveyed (Britain, United States, France, Germany, Belgium, Netherlands, and Japan), Japan consistently ranks at the bottom. On board independence, Britain and the U.S. usually lead with a score in the 5-6 range (10 representing the highest independence), France and Germany come next in the 3-4 range, and Japan usually receives a score of 0.

This is because, unlike the United States, where the average board size of Fortune 500 companies is 12, of whom 9 are outside board members, the typical large Japanese company maintains a board three to five times that size, with few or no outside board members. Even those companies that have opened their boards to outsiders usually invite individuals who are from companies that are corporate partners, creditors, customers, suppliers, etc.i.e., not independent.

The arguments offered by those on the other side of the debate provide interesting insights into the Japanese zeitgeist. First, they argue that the purpose of a corporation in Japan differs from that in the West. Whereas the latter is aimed primarily to provide profits for shareholders, Japanese corporations exist fundamentally to produce economic value to Japan as a nation, which means that providing employment to the Japanese people is the highest priority.

Second, the argument goes, given this difference in corporate purpose, Western notions of corporate governance have limited applicability in Japan. Whereas the West emphasizes the relationship between shareholders, management, and the board of directors, Japanese corporations are beholden to their stakeholders, which includes most importantly the employees, customers, suppliers, creditors, and community.

Third, the opponents of change question whether conformity to Western corporate governance practices will lead to better economic performance. Here they cite the case of Toyota Motor Corp., one of Japan's strongest and most successful companies and the first Japanese company to record annual group pretax profits exceeding one trillion yen. Toyota's board of directors consists of nearly 60 members, every single one a Toyota executive, who have consistently refuted the need to adopt Western modes of corporate governance.
Fourth, even if adopting Western practices were to improve profitability in the short term, the skeptics believe that such practices could have the corrosive effect of encouraging short-term profit-seeking at the expense of long-term investment, creating massive inequalities of income and wealth among employees, and weakening commitment to the company as an institution because the market might dictate that greater short-term value can accrue to shareholders if a company is sold off to the highest bidder. And such mergers and acquisitions may result in corporate restructuring that would almost certainly lead to unemployment.

Finally, the critics like to cite Enron Corp. as a showcase of Western corporate governance at work. The erstwhile darling of Wall Street ended up as one of the biggest bankruptcies in history despite the U.S. rules and regulations aimed at information disclosure, transparency, board independence, rigorous financial accounting and audits, legal and regulatory oversight, management accountability, and investor protection. If what is touted as be the best corporate governance system in the world could not prevent the Enron debacle, the argument goes, why should Japan be so foolish as to adopt the U.S. system?

As a board member of several American and Japanese organizations (corporate boards of directors, corporate advisory boards, and foundation boards), I am fascinated by the differences in the role, composition, and function of these boards compared to their U.S. counterparts. From this vantage point, I would offer three observations.

First, any U.S.-Japan comparisons should take into account the time dimension. It was only in the 1960s and 1970s that the voice of shareholders started to gain prominence in corporate governance in the United States. For instance, most U.S. boards of 30 or 40 years ago looked rather similar to what Japanese boards look like now in terms of independent outside directors.

Second, it is important to keep in mind the diversity of corporate governance practices among U.S. companies. Some adhere to practices that are radical by Japanese standards (e.g., IBM Corp. and Dell Computer Corp., whose boards comprise all outside members except for one), whereas some do not look too dissimilar to the typical Japanese pattern. By the same token, there is increasing diversity of corporate governance practices among Japanese companies, so that the most progressive Japanese companies may be more open than the most conservative U.S. companies.

Third, it is likely that there will be a certain amount of convergence of Japanese corporate governance practices to the U.S. model as globalization proceeds. However, given the deeply rooted differences in the role, behavior, and function of corporations in the two countries, it is likely to be many years, if ever, before corporate governance in Japan truly resembles that in the United States.

This not something to be lamented, but rather accepted as an indication that there are indeed different forms of capitalism and that in many ways the U.S. and Japanese forms lie at the polar extremes among the advanced industrialized countries.

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