DIALOG 01

TORU KITAGAWA

After working for a trading company, he has been mainly involved in FP&A at venture companies and foreign companies. He joined Starbucks Coffee Japan K.K. in 2006 and served as CFO for 10 years. Since 2016, in addition to his consultancy work, he has served as an outside director of several publicly traded companies, including as Chairman of the Audit committee, Chairman of the Nomination and Compensation committee, and Audit Committee member

TETSUJI MORIKAWA

Founder, Chairman & Group CEO

What Is Essential to Increasing Corporate Value through Governance?

Tetsuji Morikawa, Group CEO of Avant Group has been pondering this for some time. "Will governance reform really increase the corporate value of Japanese listed companies? Through their boards of directors, will they be able to increase their corporate value?" To find clues to these questions, we sat down with Mr. Toru Kitagawa, who has worked in corporate planning and as a CFO for several companies, and has also served as an outside director of listed companies.

Difficulties in Making the Board of Directors' Function to Enhance Corporate Value

Morikawa ■ Mr. Kitagawa, you have extensive experience as an outside director. Do you see different management colors in each company? Or is there some sort of common denominator?

Kitagawa ■ All companies have a strong management philosophy and business mission, but sectors and history vary, and some companies emphasize internal culture in board discussions, while others are more open. My sense is that there is a disparity in the role of outside directors, their awareness of the executive side, and the way they interact with external stakeholders.

Morikawa ■ Do the expertise and experience of the outside directors who make up the board of directors also vary from company to company?

Kitagawa ■ Yes, the composition varies from company to company.

Morikawa ■ Is there a tendency for the board of directors or management to function or not function according to its composition?

Kitagawa ■ In Japan, many companies have a well-balanced collection of various specialists, and while this can be effective in some cases, I also feel that there is little overlap in knowledge, which makes it difficult to discuss issues in a common language at board meetings. As long as the board's primary function is to oversee the company on behalf of shareholders, make important decisions, and build relationships with stakeholders, I feel that having more than one person with management experience as outside directors works better.

Morikawa ■ I also feel that it would be better to have several outside directors who are not necessarily the president, but have experience as CFO, or head or executive of some description. Even with executive experience, it is still difficult for outside directors to step into the management of a company they do not manage.

Kitagawa ■ Yes, it's like a hard to scratch itch. If you have an idea of how to do this, do not overstate it. If an outside director has experience that the internal management team does not have, of course they will give advice in that area, but too much can spoil the function of the company.

Morikawa ■ I believe that the purpose of governance reform is to give Japanese companies the management capabilities to compete on the global stage, and ultimately this must lead to increased corporate value and company growth strategies, and to this end, it is necessary to acquire an investor perspective. First, increase the number of outside directors. However, in most cases, it is management that selects outside directors, and at present there are still few outside directors who understand management practices and can make top management personnel decisions from the perspective of long-term improvement of corporate value, my impression is that the reforms are only superficial. What do you think, Mr. Kitagawa?

Kitagawa ■ Certainly, there is an opinion that increasing the number of outside directors and imitating Western style boards of directors in form only is not appropriate for Japanese companies. But that may be because the board of directors is not yet functioning well. I also believe that if the board of directors does not discuss growth strategies, the company will not be able to realize its full potential. For example, if a company has

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very strong technological capabilities or has established a solid relationship of trust with its customers, this is the result of its meticulous business execution, but if such value is not fully discovered by the stock market, the P/B ratio may be less than 1x. If the agenda of the board of directors is centered on growth strategies, this will be the engine for effective utilization of management resources, and I think the potential value of the company will be appreciated in the stock market.

Financial Literacy Will Help You Realize “Value”

Morikawa ■ The managers themselves are convinced that raising corporate value makes not only themselves but also those around them happy. I believe that would be the trigger for real governance reform. Publicly listed companies are implementing a value creation cycle by practicing “sampo yoshi,” which means that employees contribute to customers and society through their enthusiastic activities, which in turn increases economic value and corporate value at the end of the cycle. Measuring and improving corporate value, which is the end result of this process, is a way of checking how well the “sampo yoshi” principle has been realized and further expanding it, which I believe is a value that has taken root in Japan since ancient times, but not many companies still see it that way.

Kitagawa ■ As the owner of a construction company that has been in Omi for generations, “sampo yoshi” is a spirit that has been instilled in me since I was a child, but Mr. Morikawa’s modern meaning is very inspiring. Of the three parties, management needs to monitor corporate value as perceived by stakeholders to see if the company has value to customers, who are the “buyers,” and to society and investors, who are the “public”. When we inspect the current situation from this perspective, we find that while many corporate executives are well oriented toward customers, they do not seem to be oriented toward society or investors. CFOs who are serious about the stock market in Japan tend to be lonely within their companies. In this respect, in U.S. companies, perhaps thanks to MBAs, not only CEOs and CFOs but also senior management have a certain level of financial literacy. I feel like we speak the same language within the company and are able to make investment decisions in a common language.

Morikawa ■ Perhaps the reason why Kazuo Inamori’s “Real world learning (Jitsugaku)” was so well read more than 20 years ago was because many managers felt uncomfortable with the gap between accounting figures and actual management. The book stated, “If we don't look at things not only from the perspective of maximizing sales and minimizing costs on the income statement, but also from the perspective of cash, we will end up with a situation where the accounts match but the money is not enough. I remember that the book said, ”Don't just take accounting for granted; understand the essence of accounting and apply it to actual business management.

It's not just about accounting literacy anymore, but financial literacy. Financial literacy that goes beyond accounting is necessary to go beyond looking at past figures, to create a vision for the future and explain it in a way that is easy to understand for people outside the company, such as investors. I feel that if we can organize this vision in a way that it can be communicated to investors, it can be communicated more clearly to employees and enhance the execution of the organization as a whole.

Kitagawa ■ Managers are concerned about stock prices, but price and value are not the same thing. It is important for management itself to talk about how to maximize the value of the company, and this must be a common language with the stock market or it will not be understood by investors.

If you become financially literate and try to think in those terms, you will notice the various values that lie dormant in your company. It would make it easier to add more value and invest in that value.

Morikawa ■ I also feel that management will change if the board of directors can discuss issues in the common language of finance. If there is financial literacy, especially among outside directors, the hurdle for management to be accountable will be raised, and the resolution of the strategy will naturally increase.

How Can Financial Literacy Be Acquired?

Morikawa ■ I feel that in today’s Japan, it would be difficult for corporate executives to acquire financial literacy intrinsically. Mr. Kitagawa, in your experience, what has been most helpful to you in developing your financial literacy?

Kitagawa ■ It was very important for me to learn finance standards and textbook management at Levi Strauss Japan, where I used to work. The basics are still important. It was only with that foundation that I was able to apply it in my later work as CFO of Starbucks Coffee Japan.

Morikawa ■ When I joined a consulting firm as a new graduate, I too was taught frameworks and methodologies so that even someone with no experience could sell complex services, which helped me later in my business. You can’t apply it without understanding its essence, so you can’t easily rely too much on methodologies, but in finance, methods are necessary.

Kitagawa ■ I agree. If you are a young, future business leader, studying in academia, such as an MBA, is a good way to go. However, for experienced managers, the MBA content may be too abstract compared to actual business and difficult to take seriously. So for corporate leaders, it may be an effective move to have someone like Mr. Morikawa coaching them from the standpoint of an outside director. Good leaders will grow quickly with it. While serving as an outside director myself, I intend to work on how to raise the financial literacy of the management team to a certain level in the future.

Morikawa ■ I believe that at present, outside directors are most effective in areas such as strategy, investment, and human resources, and in fact, some companies are beginning to see outside directors functioning well in the succession area. In the future, as you mentioned, it

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could be an important function to increase the awareness and ability of accountability on the executive side through coaching. If we have the perspective of learning from outside directors, we may avoid unnecessary backlash in our discussions.

Kitagawa ■ But coaching also requires tools. For example, I believe that using your AVANT Compass, which you showed us earlier, will raise the level of financial literacy of both internal directors and, more importantly, outside directors.

Morikawa ■ Mr. Kitagawa, you have been in the finance field for a long time, including FP&A. In your experience, with tools, can anyone fill in the gaps?

Kitagawa ■ If you are a manager with some sense of numbers, an excellent tool like AVANT Compass will help you connect the dots of existing information in your head.

Governance Reform Takes Next Step by Creating an Environment Where Management Skills Are Honed

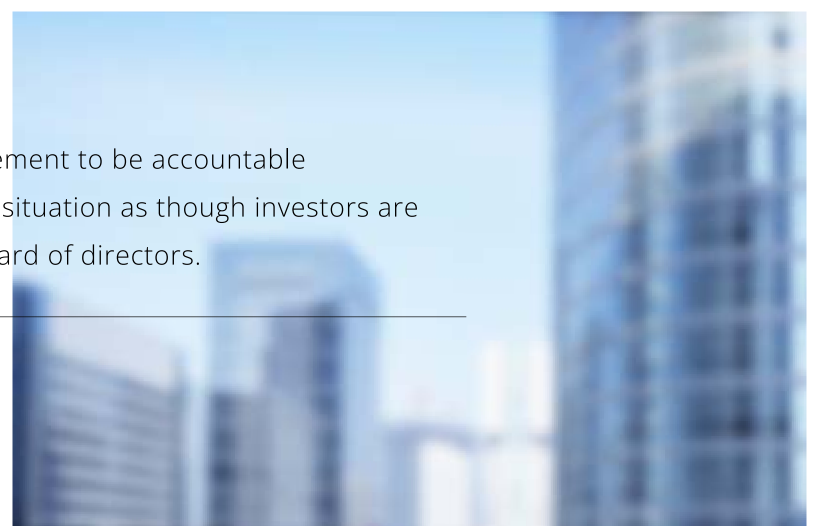
Morikawa ■ So far we have seen that financial literacy seems to be the key to a well-functioning board, but do you think it is possible for outside directors to take the initiative and increase the company's corporate value?

Kitagawa ■ The position of outside director is only a pull rather than a push type, so it will not happen overnight. However, there are things that can be done in a pull-type approach, and I think it is important to increase the number of people on the board of directors who agree on the importance of increasing corporate value. It also depends on whether outside directors have sufficient access to information within the company. Problems are common for outside directors who have no idea where to find information, or if they do get it, it is not up-to-date. In this regard, your TRINITY BOARD will be a powerful support tool. The information you want can be pulled up remotely at any time, allowing you to prepare in advance for board meetings. Only then can the power of the outside directors be demonstrated.

Morikawa ■ Thank you very much. The ultimate form of governance is to reverse the number of internal and outside directors and to appoint a president with an objective viewpoint, in other words, to create an environment in which the top management can be dismissed, but I am not sure that it is easy for the Japanese mentality to actually exercise such power. Rather, what is required in Japan today is for management to have a sense of accountability. I think it would be better suited to Japanese people if managers set their own goals, rather than being told to do so from the outside, and if the board of directors were to create a simulated situation as though investors are always inside the company, so to speak, and train them to fulfill their accountability.

Kitagawa ■ Yes, I think so. In the U.S., there is a sufficient pool of professional management personnel, so it is common to dismiss a top executive and invite a new candidate from the outside. In Japan, however, the external human resource market for management is not so large, so even if a top executive can be dismissed, it is difficult to find the next candidate. From this perspective, rather than the dismissal of top management, I think it is important to first establish the basic function of the board of directors, which is to provide the top management and management team with goals for the next several years and have them agree to them, and then evaluate progress toward achieving those goals in a transparent manner.

Train management to be accountable by creating a situation as though investors are inside the board of directors.



Morikawa ■ I feel that the essence of governance reform in Japan lies in creating an environment that enhances the manager's own management skills. Management skills cannot be acquired overnight, so I think it is essential to have a training process that positions management as a profession, for example, by giving employees a variety of experiences from a long-term perspective. If such an environment can be established, a stronger management team will emerge in Japan, and governance will become more effective.

Kitagawa ■ I agree, at least at this stage. In the future, though, there may be an increase in the number of management personnel in Japan with enhanced literacy, making it easier to invite new top management from outside the company.

Morikawa ■ First, there has been the reform to date of increasing the number of outside directors has been formulaic, and now the second step is for management to increase financial literacy through dialogue with directors and investors in order to enhance the resolution of corporate value improvement. Then, when both internal and external literacy has been sufficiently increased, the third step is to promote more dynamic management innovation.

Kitagawa ■ What's more, if more CEOs and CFOs like Mr. Morikawa, who have acquired financial literacy at a listed company serve as outside directors of other companies, the governance of those companies will evolve, and outside directors will be able to objectify their own knowledge, which will further accelerate governance reform.

Dialogue with the Market Refines Management and Unleashes Buried Strengths

Kitagawa ■ Needless to say, dialogue with investors is very important for a company. I became acutely aware of this when Levi's, which I mentioned earlier, later went through an MBO and management struggled. As U.S. companies began to produce in China in droves in the 1980s to cut costs, the founding family of Levi's was at odds with the stock market when it tried to pull out of China for labor and environmental protection reasons. Then they chose to conduct an MBO, but as a result, I think they lost their competitiveness because they lost the opportunity to interact with the market and fell into a complacent management style.

Morikawa ■ Especially in Japan, there are still many companies that do not have the management capabilities to compete with global companies and institutional investors, so depending on the situation, it may be a strategic decision to choose an MBO to solve the problem after thorough discussions. But unless that is the case, I also believe that management can only be refined in a healthy environment exposed to the stock market.

Kitagawa ■ As you say, I don't feel that MBOs to flee from the stock market are a convincing path for listed companies. In the case of Levi's, the founding family's wishes were well understood, but it is difficult to say whether it was the right choice for a publicly traded company.

Morikawa ■ The TSE's advocacy of promoting "management that is aware of cost of capital and stock price" starting in 2023 is probably aimed at encouraging companies to improve their management capabilities.

Kitagawa ■ Until now, governance reforms have had an atmosphere of just getting the form right, but from now on, we can see the seriousness of the TSE in looking at the substance of the reforms. I think this is a good trend, as it shows a willingness to support companies and frequently disseminate information.

Morikawa ■ With the mechanism for increasing corporate value coming into view, thanks in part to the information being disseminated by the TSE, there is a sense that Japanese corporate managers have been confronted with the fact that, in the end, it all comes down to growth strategies. In many cases, the stagnation of corporate value is purely a matter of perspective, and once the direction of increasing corporate value is set, I believe that the highly capable managers of each of these companies will be able to demonstrate their abilities.

Kitagawa ■ Japanese companies have excellent human resources and great technical and service capabilities. But it feels buried, doesn't it? How do we unlock it and how do we communicate the value we uncover to the stock market? I believe that if we can develop financial literacy, P/B is not merely 1x.

Morikawa ■ Yes, let's unlock it together. Thank you very much for your time today.