



Business Risks in Japan

Managing Risk amidst a Changing Governance and Compliance Landscape

Its GDP twice the size of the United Kingdom or France and GDP per capita ten times that of China, Japan remains, despite its public debt burden, low inflation and ageing population, a mighty presence within the world's most dynamic economic region. As it prepares to stage its second Olympics in 2020, and with its corporations currently upgrading their governance and risk practices to meet the ambitious Abenomics economic policies agenda, it is important to reassess Japan's business risks.

Any discussion on business risks in Japan must be rooted in a basic understanding of the country's corporate governance system and Japanese culture and language. It should also be apprehended in the context of the multi-year expansionary economic reform program launched in 2013 by current Japanese prime minister Shinzo Abe and known as "Abenomics". Abenomics aims to tackle two decades of economic stagnation by increasing the nation's money supply, boosting government spending and enacting reforms, including in the realm of corporate governance, to make the economy more competitive.

Corporate Governance

Japan's corporate governance system is a blend of national and international law, voluntary codes and local practices. Board level supervision has traditionally been organized around the "Kansayaku" system having its origin in the Commercial Code of 1899. Kansayaku widely differs from western Audit Committees in that Kansayaku members are not fully part of the board's formal decision making and approval process. Full-time dedicated Kansayaku Board members are usually promoted from within the company. They have no voting rights. Instead Kansayaku Board members, whose number vary with the size of the organization, have veto and investigation rights which they

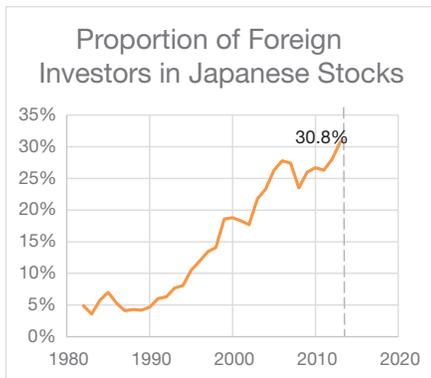
rarely exercise in practice to challenge management or board decisions because, in many cases, they are nominated by their company's CEO and lack independence.

An alternative corporate governance framework modelled on the Anglo-American board system was introduced in 2003 as the three-committee system (3C system) overcoming the inherent limitations of the Kansayaku as three separate committees specialize in nomination, compensation and audit with each committee required to have a majority of outside directors with voting rights. However, fewer than 2% of all listed companies, including Sony, Toshiba and Hitachi had switched to this framework as of 2013, leaving the Kansayaku as the overwhelming dominant corporate governance framework in Japan.

Japanese corporate governance under the current system can be characterized by its conservative risk taking approach. This stems from multiple factors. Japanese companies have traditionally used bank loans as their main source of capital inciting them to conservative risk taking so as to secure low borrowing rates. Many companies have also traditionally been

sheltered from the pressure independent shareholders could apply to raise profits by taking more risks as companies linked to the same Group commonly held each other's publicly traded stocks. Finally, Japan's conservative risk culture is also a consequence of the country's lifetime employment system whereby companies' executive directors are often promoted internally and may not be inclined to taking risks.

Nevertheless the growth and globalization experienced by the country's most successful companies has contributed to attract foreign investors in the Japanese capital markets. The proportion of foreign investors in Japanese stocks has been steadily increasing in the long term, exceeding 30% in 2013. Per comparison the highest share of foreign investors in Europe is currently about 45% in France.



In a context in which the Japanese Government has recently encourage domestic companies to increase their ROE from their current average hovering around 8% to a level closer to American standards above 14%, the Nikkei Stock Index has reached its highest average in 15 years in April 2015. This is in part attributed to foreign investors reacting positively not only to Japanese listed companies business prospects but also to recent official efforts to reinforce local governance.

Company law in Japan has been updated many times but a recent major overhaul was the Companies Act of Japan, enacted in 2005 and closely followed by the local J-SOX programs, with the aim to adapt Japanese companies to 21st century global business standards. However, a string of major corporate scandals including the one that affected Olympus in 2011 casted the corporate governance of Japanese companies in a negative light.

As a response, corporate governance regulations have been evolving. The Companies Act Reform, also known as the new Companies Act, enacted in 2014 and coming into effect in May 2015 introduces audit committees as a new alternative to the traditional Kansayaku or the stronger but not widely adopted 3C system. Furthermore, a new Corporate Governance Code, a soft law formally adopted by the Tokyo Stock Exchange rendering it binding for listed companies on the exchange will come into application in June 2015 and sets new guidelines for companies to nominate at least two independent non-executive directors.

Thus, amid urging from the Government and Abenomics policies to raise ROE and significant regulatory changes materializing in 2015 that are seen to potentially strengthen their corporate governance, Japanese companies are expected to embrace risk taking and adapt their risk management practices accordingly.

Language and Culture

Global organizations face real challenges in reaching their business outcomes in Japan due to the Japanese language and culture. Japan is certainly seen from abroad as a country with safe and clean cities, where dynamic global companies can emerge and thrive. However, Japan is a country with distinctive formal and informal communication rules and strong expectations on product quality and corporate integrity which, when upset, may hurt beyond recovery trust and business prospects.

Although English language capabilities are improving, the average proficiency level among Japanese professionals currently lags far behind that of other Asian countries such as Singapore, India or the Philippines. In addition to difficulties with business communication in English, multinational companies may also struggle with Japanese only official documentations and information systems and may require the help of an interpreter.

Even when language is not a barrier, cultural differences may hinder effective business communications. Doing business in Japan entails engaging internal teams and collaborating with local third parties whose basic expectations may differ from that of Western corporations. For instance, consensus based decision making is very much ingrained in Japanese companies and Western managers may end up frustrated when trying to convey their priorities.

Japan is a country of marked contrast, between tradition and modernity, but also between openness and insularity. As a nation, Japan can also perform remarkable and decisive changes of direction as it proved when it came out of more than 200 years of self-imposed seclusion to the rest of the world through the Sakoku ("Locked Country") policy which remained in effect until 1853 to embrace international trade and becoming the first Asian nation to adopt a Western style Constitution in 1889.

The combined influence of the Abenomics policies and the prospect of stronger corporate standards are boosting Japan's profile as a target for foreign investment and contributing to improve conditions for international business. Understanding some of the background behind what makes Japan unique is a critical first step in better apprehending the following distinctive business risks multinational companies face when conducting business in a country where compliance mistakes can be very costly both in terms of reputation and bottom line.

1. Compliance

Compared to other Asian countries, Japanese regulation is positively regarded as large, transparent and specific. However, then comes the necessity to understand and properly follow it. Navigating between mandatory laws and voluntary recommendations or guidelines laid out in various Codes, not always available in English, can be challenging. Distinguishing between what specifically applies to companies listed on one of the country's Stock Exchanges or to highly regulated industries such as Financial Services or Pharmaceuticals is also necessary.

Global banking and pharmaceutical firms usually have important if not strategic operations in Japan and are not immune to highly public and costly compliance setbacks away from their home base.

- In June 2009, local authorities ordered Citibank's Japan unit to suspend all sales operations at its retail banking arm for one month after it failed to improve anti-money laundering measures that target crime syndicates.
- A series of scandals affected Novartis in 2014 around the manipulation of clinical trials data leading the company to receive a "pre-notification" from Japan's Ministry of Health, Labour and Welfare of a complete business suspension order in the country for up to 15 days, even after it had replaced its local top management and implemented remediation training for its entire workforce. Japan represented 7% of Novartis global sales in 2014.

The Financial Services Agency (FSA) is a government body overseeing banking, securities and exchange, and insurance in the country. It sets rules and guidelines for domestic players that may complement or differ from the principles set in global, voluntary regulatory frameworks such as the Basel committee or foreign law such as the Dodd Frank Act in the United States. Foreign multinational companies looking

to acquire a Japanese target should also remain on top of the latest changes in the Stewardship Code of Japan which sets non binding, yet widely respected rules for investment in the country.

The Pharmaceuticals and Medical Devices Agency (PMDA) is the government agency overseeing local pharmaceutical companies. Its power and influence are very strong making compliance ever more of a priority for Japanese subsidiaries of global pharmaceutical companies. Bribery scandals having recently affected global pharmaceutical companies in Asia is the reflection of the challenge in sorting what constitutes bribery in each market. For instance in Japan, taxi tickets for healthcare practitioners and experts such as doctors and university professors are deemed acceptable but their threshold is not formally regulated. It is thus critical for global companies to implement adequate controls and set up effective audits in their subsidiaries to prevent major reputation and financial damages.

2. Information Security

With the surge in high profile corporate data breaches in 2014, managing information security challenges has become a prevailing concern among top decision makers across the globe. Doing business in Japan going forward entails adapting to strengthening regulatory requirements and addressing stakeholders' increasing expectations pertaining to the prevention of the following three main issues:

- Cybercrime (hacking)
- Privacy Protection
- Third Party Providers

Benesse Corporation, a Japanese company which focuses on correspondence education and publishing and is listed on the Tokyo Stock Exchange has suffered severe reputational damage and loss of customers following a massive leak of customer information to third parties due to the actions of one subcontractor. The matter, which

was widely reported in local media, had an immediate and significant negative impact on revenues and led the company to the first significant layoffs of its history and the restructuring of large parts of its organization.

Japanese regulators have begun tackling privacy protection matters as new regulations are imposing conditions on the safeguard and use of Personally Identifiable Information (PII), and penalties for organizations failing to sufficiently protect it. The topic is all the more urgent as Japanese companies, including the subsidiaries of foreign multinational companies, will need to adapt for the launch on January 1st 2016 of a new social security and tax identity system dubbed "My Number" and strengthen their data security to avoid leaks of concentrated and large amount of personal information. While the launch is expected to have as large an impact on businesses as the introduction of the consumption tax in 1989, a recent online survey by the Nomura Research Institute found that less than 6 percent of the responding companies were making any kind of preparations.

3. Asia Supply Chain

The security of outsourcing goes well beyond the information security realm. Manufacturing and Food companies in Japan are often reliant on suppliers from nearby Asian countries such as China for part of their manufacturing process. Beyond good supply chain management, managing supply chain risks from Asia countries calls for robust monitoring of quality standards and enforcement of related controls to guard against major adverse events.

A recent illustration is the series of food safety scandals that occurred in Japan, the most high profile of which affected Macdonald's Japanese unit after a Chinese supplier was shown on television repackaging expired and soiled meat. The supplier was forced to stop its operations resulting in temporary nationwide

shortages in the company's restaurants. The company is yet to recover from the long lasting reputation damage and related drop in sales as the company's Japanese subsidiary president recently reiterated product safety as being her number one priority.

4. Natural Disasters

Japan is prone to, and has experienced, numerous natural disasters such as:

- Earthquakes
- Tsunamis
- Typhoons
- Volcanic eruptions

Such natural phenomena are frequent occurrence in Japan and Japanese people are taught from a young age how to prepare for them as much as possible. However, no amount of preparation can prevent dire consequences when those phenomena take catastrophic proportions such as the 1995 earthquake in Kobe or the 2011 earthquake and tsunami in Fukushima and the Tohoku region.

In addition to human suffering, natural disasters of such amplitude severely impact an array of corporate activities, from supply chain and production to sales. The potential for damage from natural disasters cannot be completely mitigated, but global companies with operations or suppliers in Japan, should prepare as much as possible with a strong commitment to Safety Regulations, Business Continuity Planning and Third Party Management. Japan is still expecting a major earthquake to hit Tokyo at some point in the future.

5. Organized Crime

Japan is known to be a low crime society and terrorists or violent groups attacks on Japanese soil have historically been rare.

Nevertheless, global corporations should be aware that Japan is home to the largest organized crime group in the world with total members estimated to be slightly above 100,000, commonly known as the Yakuza but referred to as bōryokudan ("violent groups") in Japan.

It can be very difficult for foreign corporations to understand and properly manage the threat posed by Yakuza as there are many kinds of such groups which are engaged in different kinds of activities with some actually regarded as semi-legitimate organizations in Japan. A real danger for foreign companies is therefore not to recognize a Yakuza who may contact them as part of their business activities. Background checks are thus critical before forming alliances.

Global corporations should be aware of Japanese legislation enacted under the Organized Crime Countermeasures Law ("Bōryokudan Taisaku Hō") to combat Yakuza influence by making it illegal for companies to do business with the Yakuza. Japanese securities exchanges routinely review all listed companies and expel those with yakuza ties. A local subsidiary of Mizuho, one of the three Japanese Mega Banks, was recently the subject of a highly mediated inquiry and was ultimately fined for the loans it provided to companies with Yakuza ties. To recover from reputation damage, Mizuho's top management publicly apologized and, as a direct consequence of the scandal, adopted the strongest corporate governance framework available, the 3C audit committees system, similar to those implemented at giant banks in America and Europe. It was soon emulated by fellow Japanese Mega Bank, Mitsubishi UFJ.

Crowe Risk Consulting Japan

Cross boarder GRC engagements involving Japanese subsidiaries strongly benefit from a local perspective. Global companies' decision makers based outside Japan or expatriate executives based locally may be held back in their effort to supervise and manage the risks critical to their organization by the constrained view they may have as to how risks are actually managed in their affiliate. Having an external partner which understand both their needs and the local market can help them deal with the challenges posed by the risks introduced above and beyond them.

Crowe Risk Consulting Tokyo office is engaged in the Japanese market since November 2013 and is composed of a multicultural team with capabilities in Japanese, English and French. The Tokyo office is also working closely with Crowe Horwath International member local statutory audit firm, Yusei Audit & Co, with has close to 200 accounting professionals and a growing network of Japan Desks throughout Asia.

Please contact Philippe Bottgen for any inquiry you may have for the Crowe Risk Consulting's International Desk in Tokyo whose aim is to actively engage in information sharing about international GRC trends and referral opportunities.

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