ACG Case Study

November 2017

Kobe and the Japan Codes of Corporate Governance and Stewardship

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1. Introduction

Kobe Steel is one of the pillars of the Japanese industrial establishment. In a few short weeks in October, its share price suffered a disastrous drop of some 40% following revelations by the company that over some years it had routinely produced fake quality control data. The company has issued a succession of apologies and updates to try to reassure customers that it is conducting a full investigation to ascertain all possible safety implications and to put a stop to future transgressions.

When we look at the company's published code of conduct and when we apply the Japanese Corporate Governance Code to Kobe's failings, we ask ourselves how this bad behaviour was allowed for so long when processes were supposed to be in place to prevent it, particularly after the company's attention was drawn to it some time ago. And we suggest measures that should now be taken to stop it happening again.

2. History of Kobe Steel

This is an historic company and a key player in Japan's recent commercial history. To quote its website:

Our history began in September 1905 when Suzuki Shoten, a trading firm, acquired a steel business called Kobayashi Seikosho in Wakinohama, Kobe. That business became Kobe Seikosho, now known as Kobe Steel, Ltd. In 1926, we completed Japan's first cement plant and in 1930 produced Japan's first electric mining shovel………
In 1951…….we were the first in Japan to produce titanium and pioneered the industrial application of this metal. In 1959, the No. 1 Blast Furnace at Kobe Works was fired, turning KOBELCO into an integrated steelmaker. In 1970, the Kakogawa Works was completed, broadening our product line-up to include steel wire rod, bar, plate and sheet.

In 1960, we opened our first overseas location, an office in New York City. In 1962, KOBELCO completed a fertilizer plant in East Pakistan, currently Bangladesh. This was Japan's first plant export. The 1970s saw an acceleration in our global activities with the establishment of companies and offices in Southeast Asia, the Middle East, the United States and China…..

We became Japan's largest wholesale supplier of electricity with the start-up of the No. 1 Power Plant at Shinko Kobe Power Station in 2002 and the No. 2 Power Plant in 2004…..In 2005, we celebrated our 100th anniversary.

And in 1995, its head office was destroyed and other facilities disrupted by the Kobe earthquake, but it recovered and continued to grow. So how has this company, one of the top 10 steel producers in the world, suddenly hit the news with such an impact that its global website now simply features a succession of apologies for its "Improper Conduct"?

3. KOBE's Principles of Good Governance

On the KOBELCO website, Hiroya Kawasaki, who is described as Chairman, President, CEO and Representative Director, sets out his Message about how the Group is pursuing its goals for growth in line with its core values. The Message has six elements, the last of which states:

In order to fulfill the Core Values of KOBELCO, we have newly created the Six Pledges of KOBELCO Men and Women, which are pledges that all employees must observe. The pledges lay out standards of conduct for all employees.

It is worth setting out KOBE's Three Core Values and Six Pledges, since what follows casts a light on the degree to which these fine principles have turned out to be empty words.

Core Values of KOBELCO

1. *We provide technologies, products and services that win the trust and confidence of our customers we serve and the society in which we live.*
2. *We value each employee and support his and her growth on an individual basis, while creating a cooperative and harmonious environment.*
3. *Through continuous and innovative changes, we create new values for the society of which we are a member.*

Six Pledges of KOBELCO Men and Women

1. *Heightened Sense of Ethics and Professionalism*
2. *Providing Superior Products and Services*
3. *Establishing a Comfortable but Challenging Work Environment*
4. *Living in Harmony with Local Community*
5. *Contribution to a Sustainable Environment*
6. *Respect for Each Stakeholder*

Interestingly, the website has a section addressing Corporate Governance, but it opens with a description of how their CSR Committee (Corporate Social Responsibility) has a key role in fulfilling their CRS responsibilities and reporting to the Board on these matters. It also has a Compliance Committee to advise the Board. Most of the

Corporate Governance detail is about the composition of the Board and its sub-committees, but the first sub-section says

The Company believes it is impossible to pursue technical development and innovations, which form the foundation for the Company's continued growth, without integrating discussions with the shop floor.

So the Board presumably believed until recently that it was in close touch with what was going on at the operational level in its sprawling empire.

4. The recent scandal

The events of October 2017, which resulted in an almost daily series of apologies, were reported to have arisen from new quality processes that were put in place earlier and have resulted in the exposure of a widespread breakdown in quality assurance.

Specifically, at the time of writing, there have been 15 announcements of what is described as “improper conduct”.

October 8 2017
Improper conduct concerning a portion of the aluminium and copper products manufactured by Kobe Steel

October 11, 2017
Report on improper conduct: the case of steel powder and an inspection company

October 13, 2017
Report on improper conduct concerning Kobe Steel and its group companies

October 17, 2017
The receipt of a request for document production from the U.S. judicial administrative authority

October 20, 2017 (twice)
Improper conduct concerning products with JIS marks
New improper conduct confirmed in self-investigation

October 26 (twice)
Improper conduct in the Kobe Steel Group
Cancellation of JIS mark display at Kobe Steel subsidiary Kobelco & Materials Copper Tube Co., Ltd.

...

Oct 31
Update on safety verification status concerning improper conduct in the Kobe Steel Group

Nov 2
Correction to October 11 news release "Report on improper conduct: the case of steel powder and an inspection company"

Nov 7
Update on safety verification status concerning improper conduct in the Kobe Steel Group

Nov 10 (twice)
Update on safety verification status concerning improper conduct in the Kobe Steel Group
Report on investigation into the causes of the Kobe Steel Group's inappropriate conducts and on measures to prevent recurrence

Nov 15
Additional cancellation of JIS certification at Kobe Steel subsidiary Kobelco & Materials Copper Tube Co., Ltd.

Nov 17
Update on safety verification status concerning improper conduct in the Kobe Steel Group

The details have been widely published but, in summary, hundreds of customers have been affected, ranging from aircraft and automobile makers to high speed train manufacturers, and tens of thousands of tons of steel and other products have been incorrectly certified. To be fair, no one has so far reported any safety concerns, but these are early days.

The US authorities are investigating, as has the Japan Quality Assurance Organisation, and it was reported on 26 October that Kobe Steel is losing Japan's quality seal for copper products.

Kobe's announcements make it clear that they have no idea how big will be the adverse impact on the company.

5. Stakeholders affected

Considering the key stakeholder groups:

Customers: Kobe correctly aims its apologies primarily at the hundreds of customers for whom it has created considerable worries. The safety of travellers in aircraft, cars and trains, to name but one group, will be a nightmare for those of Kobe's customers which have built their products to transport these people. Until they have satisfied themselves that the fake certifications will not affect the manufactured goods of which they are a part, either because they aren't critical to safety or because they pass the required quality criteria anyway, they carry the responsibility for thousands of lives.

Shareholders: in the past few weeks, they have seen the value of their investment in Kobe fall by up to 40%, and while the share price has recovered to a mere 25% loss at the time of writing, this may not be the end. Any brand premium in the share price will have been eliminated by the reputational loss which the CEO acknowledges when he says that trust in Kobe is now at zero.

Employees: the immediate livelihoods of thousands of staff may not be affected, but who would want to work for a company with this hanging over them?

Suppliers and lenders: the medium term financial situation of Kobe must be a worry, even if the group has adequate resources for the short term.

6. Kobe's response

From the first release of the devastating news at the beginning of October, Kobe has issued a succession of humble apologies, directed primarily at its customers, which is correct and understandable. These are summarised above, and an example is shown below:

At this time, we sincerely and deeply apologize for the enormous amount of worry and trouble we have caused many of you in respect to the improper conduct concerning a portion of our products made by our company and group companies.

The Kobe Steel Group, together with its suppliers, is quickly working to determine how its products have affected safety and other factors. We are thoroughly analyzing the cause and are engaged in developing countermeasures to prevent a reoccurrence from happening. We are making sincere efforts to eliminate the burden on all parties concerned and to resolve these problems as quickly as possible.

Kobe immediately appointed an outside firm of lawyers to oversee an investigation to give comfort to customers worried about their recent purchases.

But what about the other stakeholder groups, and what about the Core Values and Six Pledges referred to above? What does it say about Kobe's ability to control its operations and deliver on its promises about corporate behaviour?

It is reported that the current scandal came to light following tests on certification at a subsidiary in 2016, which prompted more detailed investigation. However, the Financial Times reports that it has been found guilty on past occasions of falsifying pollution data and quality data on steel. So why were bad practices ("improper conduct") not thoroughly investigated and rooted out at a much earlier stage when there was ample evidence, for those who chose to see, of a cancer spreading silently through the operational side of the business?

As of the end of October, Kobe had abandoned the relatively optimistic trading forecast which it had made earlier this year, saying that it couldn't make any predictions at the present time, and its lenders were gathering to discuss any necessary financial support.

7. The Japan Code of Corporate Governance and Stewardship Code

What does the Japan Code of Corporate Governance have to say, and is the Japan Stewardship Code relevant?

The Corporate Governance Code has five general principles, which we list below:

Principle 1	*Securing the rights & equal treatment of shareholders. This has 7 sub principles*
Principle 2	*Appropriate cooperation with stakeholders other than shareholders: 5 sub principles*
Principle 3	*Ensuring appropriate information disclosure and transparency: 2 sub principles*
Principle 4	*Responsibilities of the board: 14 sub principles*
Principle 5	*Dialogue with shareholders: 2 sub principles*

There is a clear orientation towards shareholders, but, to be fair, the Code does take pains to emphasise other stakeholders and wider corporate governance considerations than compliance, referring particularly to ESG. However, the relevant Principle for us in this consideration of Kobe is Principle 2.

In the fuller definition of General Principle 2, it states that

"The board and the management should exercise their leadership in establishing a corporate culture where the rights and positions of stakeholders are respected and sound business ethics are ensured".

Read: What is ESG? Can it really unlock Brand Value?

The sub-principles, which focus the directors' attention on the interests of stakeholders generally, cover the following areas:

Principle 2.1 *Business Principles as the Foundation of Corporate Value Creation Over the Mid- to Long-Term*
Principle 2.2 *Code of Conduct*
Principle 2.3 *Sustainability Issues, Including Social and Environmental Matters*
Principle 2.4 *Ensuring Diversity, Including Active Participation of Women*
Principle 2.5 *Whistleblowing*

So the Board is expected to give due regard to the interests of the wider group of stakeholders in the long term interests of the business. This is clearly relevant to the loss of reputation, and customers, resulting from the dishonest product certifications.

And it is also worth noting the Supplementary Principle to Principle 2.2, regarding Conduct, which gives additional guidance:

The board should review regularly (or where appropriate) whether or not the code of conduct is being widely implemented. The review should focus on the substantive assessment of whether the company's corporate culture truly embraces the intent and spirit of the code of conduct, and not solely on the form of implementation and compliance

The Board seems to have been tardy, to say the least, in its review process.

The Stewardship Code complements the Governance Code. What does it say about the responsibility of the institutional owners of Kobe shares? The Code has seven principles whose purpose is:

"….to promote sustainable growth of the investee company and enhance the medium-and long-term investment return of clients and beneficiaries…"

Two principles seem relevant to our consideration of this scandal:

Principle 3 states that

"Institutional investors should monitor investee companies so that they can appropriately fulfil their stewardship responsibilities with an orientation towards the sustainable growth of the companies".

And Guidance note 3.2 says:

"Institutional investors should monitor investee companies continuously and review as appropriate the effectiveness of the monitoring".

Guidance note 3.3 says:

"When investors monitor investee companies, a variety of factors, including non-financial ones, may be considered as relevant. Factors may include, for example, governance, strategy, performance, capital structure, and risk management…."

Principle 7 states that

"To contribute positively to the sustainable growth of investee companies, institutional investors should have in-depth knowledge of the investee companies and their business environment and skills and resources needed to appropriately engage with the companies and make proper judgments in fulfilling their stewardship activities."

Guidance note 7.1 says:

"To make dialogue with investee companies constructive and beneficial, and to contribute to the sustainable growth of the companies, institutional investors should develop skills and resources needed to appropriately engage with the companies and to make proper judgments based on in-depth knowledge of the companies and their business environment".

These Principles and the related Guidelines make clear the intention of the regulatory authorities regarding the responsibilities of the big investing institutions. What were the Kobe's big shareholders doing to keep their ears to the ground and safeguard the value of their investments as demanded by the regulator?

8. The ACG Holistic Approach

Our Five Golden Rules of good corporate governance would clearly address these breeches under the heading of ethical conduct and corporate culture, and Kobe's chairman would equally clearly agree. Furthermore, the Corporate Governance Code specifically mentions Conduct as one of its General Principles, and provides safety for whistleblowers through another. But still the scandal happened, leading to Kobe's multiple apologies for misconduct.

What we emphasise is that setting up Rules is not enough. There has to be a system of regular monitoring and feedback, via an independent channel, to the chairman and the Board. It should not be necessary to rely on whistleblowers to bring attention to misconduct. And, as we have pointed out in an earlier article, whistleblowing is dangerous for the whistleblower and often happens too late to prevent disaster. Ask the Board of Wells Fargo.

Read: How safe is whistleblowing?

What is needed is a Stakeholder Engagement channel to provide dynamic feedback to the office of the Chairman on the current feelings and perceptions of the key stakeholders in regard to how the company's policies and operations are impacting them. And in relation to the Kobe scandal, two things stand out:

- assuming that the wrong certification was widespread and lasting many years, it seems inconceivable that the knowledge of this was not pretty widespread. An efficient communication channel with the operational workforce should have picked this up.
- on the basis that the apparently under-specified steel and other products had been supplied to customers for years, without complaint from customers about product failure or failure in customer inspections, the conclusion must be that much of the product was over-specified, which itself would lead to questions about operational efficiency.

With today's easy availability of social media, it should not be difficult for Kobe to put in place a Stakeholder Engagement process to reduce, if not eliminate, the chance of something like this happening again. Then the Board would have fulfilled its commitment to "integrating discussions with the shop floor" and the Chairman could be confident that the three Core Values and Six Pledges were being implemented.

Golden Rules

The Key to Good Corporate Governance

9. About Applied Corporate Governance

Applied Corporate Governance was founded to provide corporate governance training, advice and consultancy for organisations around the world and in both private and public sectors. Our website, www.applied-corporate-governance.com was originally set up to reproduce and update our work in this field developed over more than two decades. It is now recognised as a leading global resource in its sector, with readers and subscribers from almost every country on the planet. From this base we continue to expand the range of content, including analysis and comment on current issues, as well as more substantial articles and white papers such as this with greater longevity, which address the challenges of designing and implementing corporate governance programmes. We have also recently launched The Leadership Zone, which aims to foster strong, ethical leadership through dedicated content and training.

We are primarily a father and son team, based in the UK and Spain, who share a commitment to improving standards of governance and a passionate belief that our approach has the potential to prevent massive corporate failure and improve the lives of millions through transforming transparency, accountability and responsibility of companies and countries alike. We believe our family connection and age difference, combined with a long history of working together, give us a unique set of strengths in helping people and organisations, from providing different perspectives to allowing for robust debate on the best course of action. We also have a wide network of friends, colleagues and contacts on all five continents to aid us in our pursuit of good corporate governance.

Below are links to a few of the web pages most relevant to the subject of long-term strategy and corporate governance:

http://www.applied-corporate-governance.com/importance-of-corporate-governance.html

http://www.applied-corporate-governance.com/best-corporate-governance-practice.html

http://www.applied-corporate-governance.com/importance-of-strategic-management.html

http://www.applied-corporate-governance.com/what-is-stewardship.html

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