DIALOGUE 01

Approach to Transcending Dichotomy between ROE and ESG by Harnessing the Power of Business

The following is a discussion between Professor Kunio Ito, who advocates ROESG, a new integrated indicator for achieving high levels of ROE and ESG in the pursuit of sustainable improvements in corporate value, and MARUI GROUP President Aoi on the topic of co-creation sustainability management for transcending dichotomies.

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Poison Contained in ROE and ESG

Aoi: MARUI GROUP's 2050 Vision is "Harnessing the power of business to build a world that transcends dichotomies." Professor Ito, today, I would like to ask you about how we can transcend the dichotomy between ROE and ESG.

Ito: That is a task that must be addressed through a practical approach at the management level. In 2014, I published the *Ito Report*, which cast light on the low emphasis placed on capital productivity by Japanese companies and encouraged companies to target ROE of at least 8%. Today, the average ROE of all companies listed on the First Section of the Tokyo Stock Exchange is on the cusp of reaching this level. However, the focus on ROE can poison other areas. There are those managers who truly understand the essence of ROE and practice management accordingly. However, this emphasis on ROE threatens to give rise to those managers who focus only on short-term numbers and sometimes look to inappropriately adjust profits based on this limited perspective. An emphasis on ESG also carries such poison in its potential to become an excuse for low capital productivity. I think it is best to harmonize ROE and ESG through a company's core business activities. Dialogue is a powerful tool for overcoming this dichotomy. President Aoi, I understand that you are advocating the power of dialogue to drive co-creation. Dialogue presumes differences of value, seeking to bridge the gap caused by these differences through extensive and ongoing communication aimed at determining from where these differences arise. With this belief, I find that various parts of the management stance of MARUI GROUP and of you yourself resonate with me.

Dichotomies Arising from Differences in Timeframes

Aoi: MARUI GROUP is generally evaluated by investors from the perspective of the traditional retail sector, resulting in many questioning our actual industry and how we should be evaluated. However, there are in fact many other companies for which the industry is unclear.

Ito: It is currently impossible to box companies into a single industry or sector. Given this reality, companies should stress in dialogue the fact that they have a large staff of talented individuals capable of creating new businesses and business models that do not conform to conventional industry boundaries. Effective dialogue is thus about how best to communicate that, fundamentally, employees are acting as the value creators in their companies.

Aoi: It is common practice for personnel expenses and human resource investments to be recorded as costs instead of as assets for accounting purposes. I think that this practice represents another textbook example

Kunio Ito

Graduating from Hitotsubashi University in 1975, Kunio Ito later became a specially appointed professor at this university. Professor Ito has been chairman of the Ministry of Economy, Trade and Industry's "Competitiveness and Incentives for Sustainable Growth: Building Favorable Relationships between Companies and Investors" project. In addition, the *Ito Report* integrated report published in 2014 garnered a great amount of attention, even overseas, elevating Professor Ito to the position of a leading figure in corporate governance reforms in Japan. He has written various works on topics including management for overcoming crises, new corporate value evaluation methods, and accounting of intangible assets.

Ito Report 2.0 (Japanese only)
www.meti.go.jp/press/2017/10/20171026001/20171026001-1.pdf

It is important to recognize that transcending dichotomies is not the same as compromising. Rather, transcending the dichotomy between Vector A and Vector B requires the establishment of a third Vector C.

Kunio Ito

of a dichotomy. The more investments a company makes, the more it seems that their profits decline. At the same time, the more a company invests, the more it will be able to generate value over the long term.
Ito: Baruch Lev, one of the writers of *The End of Accounting and the Path Forward for Investors and Managers*, criticizes our current accounting practices for how they record R&D expenditures and other investments in intangible assets as expenses, inviting bearish economies by encouraging managers to limit such investments. I believe that differences in timeframes, between short-term and medium-to-long-term perspectives in this case, are a source of dichotomies. There is no clear answer on how to transcend this dichotomy, but I think that a good start lies in being able to effectively explain how one's company is prefacing management on a medium-to-long-term perspective while doing their utmost to achieve success in the short term.

Selection of Managers as First Step in Effective Corporate Governance

Ito: If a manager who will only hold their position for four years attempts to postulate on their company's medium-to-long-term outlook, investors will perceive it merely as idealism or as an official stance. This is why the first step to effective governance lies in the selection of a company's manager.
Aoi: I think it is crucial for Japan to develop corporate governance frameworks based on timeframes that enable managers to commit to fulfilling their duties over the long term.
Ito: You are exactly right. To add to this point, managers need to have experienced setbacks in the past if they are to hold their positions over the long term. A person that has never experienced setbacks will crack under pressure should a crisis occur. Of course, governance systems will also need built-in frameworks for dismissing managers that do not exhibit satisfactory performance. What is perhaps most important of all is the degree to which a manager is self-driven. In other words, governance should involve others monitoring the extent to which a manager can exercise a self-driven approach.
Aoi: I am the eldest son of the eldest son of our founder. When I took up the mantle of president, I thus assumed that I would be in this position for around 20 years. This assumed tenure has greatly influenced my actions as president. Faced with a management crisis that had lasted seven years, a commitment to moving forward welled up inside me when I realized that I still had more than a decade to go. Whenever I would visit the founder's grave during this period of adversity, I could not help but think that, if I were to bring about the end of the Company, my ancestors would haunt me. The pressure was enormous.
Ito: When a manager inherits a business from a family member, it is common for them to be able to effectively micromanage, being aware of the subtle inner workings of the company, while also acting based on exceptionally long timeframes. In this manner, these managers are often able to singlehandedly overcome dichotomies. My research organization is currently performing pilot tests on ROA and ROIC. On average, these metrics peak when managers have a term of 10 to 11 years. If a manager recognizes that they will not be around to reap the benefits of structural reforms, they will simply refrain from those reforms.
Aoi: This is why it is important for presidents to be appointed when they are relatively young. A president appointed in their 30s or 40s will have time to fail when they are still new and to learn from and overcome this failure to succeed.
Ito: A president appointed while younger will have time to build a track record of success that they can take with them to other companies. This will also create an ecosystem in which such individuals are able to become investors that nurture the growth of start-up companies. Conversely, presidents that assumed their positions when older will have limited options for after they leave that position, which may lead them to become complacent. In this manner, age is important. However, this also presents another dichotomy, making it difficult to determine the appropriate weight to place on age in the selection criteria for managers.

ROESG Indicator Integrating ROE and ESG

Aoi: You yourself lauded 2019 as the first year of initiatives based on the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). Hoping to adopt these recommendations, we decided to conduct a scenario analysis based on the TCFD recommendations. Do you think that the TCFD will serve as a catalyst for the integration of financial and non-financial information?
Ito: Scenario analyses based on the TCFD recommendations include both quantitative and qualitative perspectives. As the qualitative perspective pertains to non-financial information, these analyses will naturally lead to information disclosure that incorporates both financial and non-financial information. I am currently researching management based on ROESG, an indicator that integrates ROE and ESG. However, even if we understand this concept, it will be a difficult and unprecedented undertaking to actually incorporate this concept into management. It is important to recognize that transcending dichotomies is not the same as compromising. Rather, transcending the dichotomy between Vector A and Vector B requires the establishment of a third Vector C.
Aoi: That is why sustainability is a field that allows us to exercise the greatest creativity and is therefore among the most motivating and interesting fields.
Ito: The underlying principle of sustainability is a desire to evolve, whereas being a going concern only means continuing to exist. These two concepts are therefore completely different. Japan places too much importance on the simple continuation of companies. Sustainability, meanwhile, entails continuing to existing while evolving, and it is corporate governance that underpins this pursuit.

This assumed tenure has greatly influenced my actions as president. Faced with a management crisis that had lasted seven years, a commitment to moving forward welled up inside me when I realized that I still had more than a decade to go.

Hiroshi Aoi