

Corporate Governance at Sony: **Innovations in the Board of Directors**

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Background on Sony's Innovation of Its Board of Directors

Today I would like to describe what Sony Group has done to strengthen its corporate governance. The center of our efforts was an innovation of our Board of Directors, which took place in 1997. This change caused a stir in Japan because moves to strengthen corporate governance there have traditionally paled in comparison to those undertaken in Europe and the United States. Sony's efforts were so progressive that they did more than just lead to a change in my company; they led to calls for enhancement in corporate governance measures throughout Japan.

Sony Group's consolidated revenue for fiscal year 2000 will reach 7 trillion yen. Sony Group is expanding its business on a global scale in such areas as electronics, games, music, movies, finance, and other services. At present, Sony's brand is one of the most recognized in the world. Japan, the U.S., Europe, and other regions each boast a 20 to 30 percent share of sales. Sony is further unique in that 40 percent of our stock is owned by non-Japanese.

Sony has managed to realize substantial growth by sustaining innovation in both the technological and product development aspects of its business AND management structure. We plan to continue this innovation with the hope of achieving even greater growth in the Broadband Network Era of the 21st Century.

Sony currently finds itself dealing with two important business issues:

- 1) how best to use IT, or computer and Network Technology, to revamp our existing management processes and to create a new business model, and
- 2) how best to manage and oversee all of Sony Group so that we can enjoy an increase in shareholder value throughout the Group.

In order to handle these two important issues, Sony has undertaken, over the last few years, various reorganization plans such as an alteration in our business groups and a strengthening of our headquarters function. CEO Idei has made "polarization and integration" the keywords of his vision as to how the Group should be

managed. He has introduced a decentralized management structure in which a wide range of authority is given to the business units, but one in which the headquarters function retains cohesive power. The goal of this structure is to create an environment in which top management can exert strong leadership, mobilize the resources of the entire Group when necessary, advance reform, and increase corporate worth.

I will now outline the primary steps we have taken to achieve these goals in the last few years.

In 1994, we eliminated the Business Group system we had heretofore relied upon, introducing a Divisional Company System instead. This change caused a transfer of operational authority to the Companies that run the electronics business, and it increased the speed at which our business operates, not to mention the level of our competitiveness. Our introduction of the Divisional Company System was our first attempt at achieving the future of decentralized management.

In 1997, Sony moved to innovate our Board of Directors. We defined the purpose of the Board as contributing to an increase in the value of the entire group. We gave the Board power to make important decisions regarding operational policy. And we situated it as the primary body for overseeing the many companies.

In 1999, Sony began to introduce VCM as a way to manage operations. VCM stands for Value Creation Management. Sony announced that business value creation would be the goal of management. In order to achieve this goal, Sony introduced a system of managing operations that used EVA, or Economic Value Added, as a measure of performance. Compared with accounting profit, EVA was considered to be a more accurate measure of the creation of corporate value because it takes into account capital cost, and it is known for its close relationship to share prices. As we speak, EVA is being used to set business plan goals, evaluate the results of these plans, decide whether or not to make investments, and determine the compensation of high-level executives. EVA is applied not only by top management, but also by regular employees as the standard for all types of management decisions and activities.

In January 2001, Sony took private all three of its subsidiaries that had been public. These subsidiaries were Sony Music Entertainment, Sony Chemical, and Sony Precision Technology.

It is often the case in Japan that both a parent company and its subsidiaries are public. In these cases, subsidiaries take full responsibility for their business activities and can expand the value of

the entire group as a result. On the other hand, when a parent company tries to alter management practices throughout its group of companies, or when it tries to raise the value of the entire group, the existence of publicly traded subsidiaries can be an obstacle. By returning these three companies, which each manage important parts of its business, to fully owned companies, Sony was able to increase the sense of unity within other companies in its group. And we have been able to create an environment in which the value of these three companies contribute to the value of the group as a whole.

Now I would like to touch on the historical background that led Sony to implement an innovation of its Board of Directors before any other Japanese company did so.

In the 55 years since its founding in 1946, one of the primary elements that caused Sony's business to flourish was the existence, even when we were a small-scale venture business, of an international spirit that caused us to conduct business with an eye on the world. Beginning with the establishment of Sony Corporation of America in 1960, Sony implemented a strategy of "global localization" by setting up sales companies and factories in numerous countries. We also actively sought out business on a global scale in the entertainment sector, purchasing first CBS Records in 1988, and then Columbia Pictures in 1989.

In regards to capital policy, Sony moved early into the American financial market by issuing ADRs in 1961, compiling consolidated financial statements, and making management of the entire Sony Group the core of our business strategy. In 1970, Sony listed its ADRs on the New York Stock Exchange, and we engaged in reforms such as introducing outside Directors to our Board, disclosing quarterly consolidated reports on performance, and limiting the term of Board members to one year, with election based on approval at the annual meeting of shareholders. Since then, no matter whether results are good or bad, top executives communicate regularly with institutional investors such as those in the U.S., and the utmost effort is made to provide timely disclosure to shareholders.

Because of our experience doing business abroad, Sony has accumulated a wealth of knowledge regarding the way in which companies are managed and corporate governance is regarded in different countries. Our experience led us to implement the innovation of the Board of Directors in 1997.

Before I detail this innovation, I would like to describe how Corporate Boards are comprised in Japan.

According to Japan's Commercial Code, the Board of Directors is the highest management body, responsible for overseeing company business and making decisions on the way business is conducted. Several problems with the actual state of affairs, however, are evident. Because the top of each division in a Japanese company traditionally sits on the Board, the number of Board Members who have an individual interest has increased, and it has become difficult for Boards to debate issues from a detached perspective.

As the last stop on the promotion road, seats on the Board of Directors appointed by the President of a company are numerous, and it is impossible for the individuals who fill these seats to function as independent representatives of the stockholders, or as overseers of the other officers of the company.

Board of Directors Innovation, June 1997

I will now discuss Sony's innovation of its Board of Directors.

The first thing Sony did to change its Board of Directors was to make clear the role that the Board would play in the management of Sony Group. The Board was made into the highest management body at Sony. And Board members were assigned three concrete roles to perform:

- 1) Decide Sony Group's management policy
- 2) Make final decisions regarding significant matters raised by Sony Corporation or by any of the Sony Group subsidiaries
- 3) Oversee Sony Corporation and Sony Group subsidiaries' activities.

Japan's Commercial Code maintains that the role of a company's Board is to oversee and make the final decisions of a single company. In the case of Sony Group, this means Sony Corporation. At Sony, however, we have gone beyond this narrow definition to make the Board the highest management body of the entire group. We are unique in making the role of the Board exceed the role set by Japan's Commercial Code.

The next thing we did when innovating the Board was to consider what kind of people would fit best into this newly defined role for the Board. Before the change, 38 people sat on our Board. Most of these people were executives responsible for individual business divisions. Sony chose to remove these people from the Board, making those who had responsibilities for the actual implementation of business into Executive Officers, and selecting people who could devote exclusive time to the Board as members of that body.

As a result, the number of Board Members decreased to ten. Of those ten, we increased the number of outside Directors by one, bringing the total of non-Sony Directors to three. The Executive Officer system was not adopted by any Japanese companies at that time. Once Sony introduced it, however, it became popular as a way to separate the functions of the Board from the actual operation of the business. The Executive Officer system also gained appeal as a way to reduce the number of people on any given Board.

What is the composition of our Board? Currently, there are twelve Directors, nine of whom are from inside Sony, three of whom are from outside the company. Two of our Directors are U.S. citizens.

Sony's innovation of its Board caused other Japanese companies to pay greater attention to the role of outside Directors. Indeed, selecting outside Directors was an important part of Sony's Board renewal. The purview of Sony Group's business activities has diversified so much, and the range of our business has become so global, that bringing to the Board people who have experience, knowledge, and expertise not found within Sony is, I believe, essential to enhancing the oversight power of the Board. Bringing in such diverse people is also crucial for raising the quality of the Board's internal discussions and management decisions.

As you know, it is common for public companies in the U.S. to have a majority of their Board members come from outside the company. In the case of Sony, our thinking in this regard is a little different from that of the U.S. In the U.S., the primary role of a Board is oversight, and, thus, it is essential to have the Board filled with non-employee Directors so that independence from management and business implementation can be insured. In the case of Japan, however, the Commercial Code requires Boards to make final decisions regarding business implementation. This means that Sony's Board must decide the policy of our entire Group. As a result, I believe there will NOT be an increase in outside Directors to the point where they outnumber inside Directors. When Sony moved to innovate its Board, we learned as much as we could from the U.S., but we eventually introduced a model that takes into account the situation in Japan, and, we believe, is the most appropriate for Sony.

Next I will speak about the actual running of Board meetings.

Board meetings take place for half a day every month. Once every quarter, there is a Full Day Meeting that deliberates important management matters. Once every year, the Board meets somewhere

outside of Japan, and the business strategy and business environment of that locale are discussed. So far meetings have been held in New York, Berlin, Beijing, and, last year, San Jose in Silicon Valley.

At Sony, we are trying to make several improvements in the way Board meetings are run.

First, I will mention changes in the way proposals are handled at Board Meetings. In meetings before the Board was changed, individual items required by law such as the selection of representative directors, the issuance of new stock, and the issuance of corporate debt were raised. The meeting was run as a means of getting formal approval for these items. Since the innovation, other issues are being selected for discussion that require in-depth debate over the management policy of Sony Group. In choosing items for the agenda, the Chairman of the Board of Directors takes the lead. Relying upon advice from other Directors, he decides which of the most important management issues will be raised at each meeting.

Soon after Sony altered the composition of its Board, Executive Officers at the company proposed several projects that had a major impact on the value of the company. They included a large scale restructuring, an advance into the network service business, a large investment in the semiconductor field, and other advances into new areas of business. The Board of Directors was called upon to consider these plans from a variety of angles and to make final decisions. It is expected that matters requiring high-level decision-making by the Board will increase in the future.

We have enhanced the oversight function of the Board by creating a mechanism by which important projects within Sony Group, and the status of operations among its many businesses, can be reported to the Board when necessary. This means that the Board can discover problems by looking out over the entire group, and it can make appropriate suggestions that will lead to a resolution.

I would now like to discuss the establishment of the group of experts that supports the Board of Directors.

In May 1998, Sony created the Compensation Committee and the Nominating Committee. The role of these two committees is to support the Board in certain areas of expertise.

Since the 1997 innovation, advances have been made in the compensation scheme for Corporate Vice Presidents and above, including the CEO, CFO, and Board Members. A compensation plan

that more closely matches corporate performance has been introduced. And, to facilitate the process of determining compensation, the Compensation Committee has been created. Outside Board members comprise this committee and make final decisions regarding compensation.

The Nominating Committee's role is to nominate candidates for Directors and senior executive officers, and to submit these proposals to the Board. It is hoped that this Committee will recommend appropriate Board member candidates from outside of Sony.

Both the Compensation Committee and the Nominating Committee are common features in public companies in the U.S. But in Japan, very few companies have them.

I have just described the innovation of Sony's Board of Directors.

Lastly, I would like to say what the strengthening of corporate governance at companies like Sony means in the context of Japan.

In Japan, among the various stakeholders of a corporation, stockholders have often enjoyed less attention than customers or employees. This is because cross share holding by companies led to an "incorporation" of shareholders, and the financial institutions that held large amounts of company stock acted as "silent shareholders" who hardly questioned management. This system led to a kind of management culture in which shareholders were not high on the list of concerns for managers.

Nevertheless, in the last few years, as the restructuring of Japan's social and economic system has progressed, people are beginning to recognize the importance of a management system that believes in the importance of shareholders. And the innovation of corporate boards, the enhancement of information disclosure, and the decrease of cross-share holding are becoming more prevalent. I will end my speech by saying that this kind of change has begun to take place in Japan.

Thank you for your attention.