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Absract:

This paper analyzes the institutional and legal changes regarding corporate governance in Japan and their impact on the financial performance of firms since 1997. It attempts to address how much the governance reforms transformed the conventional system of alliance capitalism and managerial control; and what economic outcomes of those governance changes we can detect. Our results show that the influence of new ownership composition and corporate governance apparatus on financial performance has been mixed. We found that only certain measures such as foreign and financial investors functioned positively, while others such as the executive officer system generated unexpected troubles.

Keywords: Corporate governance, Japan, institutional and legal changes,performance impact.

JEL codes: G34, K22, L21

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Introduction

Previous studies on Japanese corporate governance largely attempted to address the agency relationship in the Japanese context in which some institution specific factors such as bank monitoring and *keiretsu* affiliation play an important role. However, Japanese corporate governance model and practices based on such mechanisms have been facing rising pressures from multiple sources since the early 1990s. Indeed, there have been substantial changes in several aspects of corporate governance in Japan. This paper analyzes those institutional and legal changes regarding corporate governance in Japan and their impact on the financial performance of Japanese firms since the second half of the 1990s.

There were two major triggers, one domestic and the other international, that can be counted for such changes in Japanese corporate governance. First, the collapse of the bubble economy at the beginning of the 1990s forced the Japanese firms and government to reexamine the conventional business practices. Due to the prolonged recession into the 2000s Japanese corporate executives and business scholars lost their confidence in the Japanese-style management that they collectively and uncritically praised as the core mechanism of Japan's long-term phenomenal growth since the second half of the 1950s. Instead, some started to support the "global" corporate governance model after the U.S. standard which emphasizes market orientation and shareholder value.

Second, since the 1980s the liberalization of financial and capital markets, besides the privatization and deregulation of economic activities, became the focal issues globally. Between the U.S. and Japan, in particular, underlining concern had been the economic and political pressure from the U.S. businesses and the government as their agent. Despite the rising yen and the gradual opening of Japanese markets to international trade and investment, the unbalance of current accounts between the U.S. and Japan did not improve. The U.S. government then turned its focus to various legal, regulatory and structural issues that were claimed to impede the success of U.S. merchandise and investment in Japanese markets. It was argued that the alterations of Japanese governance mechanism toward the U.S. models should make it easier for American firms to penetrate Japanese product and capital markets.

These two elements seeking governance reforms merged into a single strong tide to bring major legal and institutional changes that would result in formal and informal pressures on Japanese firms and their management to reform corporate governance practices. Such alterations include the adjustments in corporate financing practices; the reexaminations of group relations; the reforms in the boardroom practices such as the implementation of the executive officer system; and the modifications in executive compensation including the introduction of stock option plans,. In addition to these changes, we have also witnessed significant movements in the shareholder composition of Japanese firms, which was caused by the changing macroeconomic and global environments (Hoshi and Kashyap, 2001; Miyajima and Aoki, 2002; Shimotani, 2006).

Although numerous governance reform measures got introduced since the 1990s, we still know little about how these changes actually have altered the inner functioning and ultimate financial outcome of Japanese firms. According to the agency theory framework, ownership by "market" investors who demand shareholder-oriented practices and seek financial returns should narrow the agency gap, and therefore the executive management is pressured and motivated to improve firm profitability rather than try to target other goals in order to satisfy other stakeholder interests. However, from an institutional theory perspective, while a firm, as long as it is a publicly-held one, cannot determine its own shareholder composition (although it may influence as, for example, it can ask affiliated firms to own its stocks), it may be motivated to adopt new governance measures only superficially to appease external pressures (e.g., from arms-length investors) and decouple the actual practices, especially if legitimacy, both functional and social, of those measures has not been firmly established (Oliver, 1991). In other words, a firm may adopt some new governance practices as a strategic or tactical response to external market pressures, yet they may only do so symbolically (Fiss and Zajac, 2004). In this case, the adoption of the new governance practices will have limited effects on firm performance, although ownership preference may still remain as a factor to influence financial outcomes.

These two different perspectives, the agency framework and the institutional theory, will present contrasting implications on the effectiveness of specific corporate governance mechanisms. By employing econometric analyses the second half of the current paper aims to pin down the performance implications of those several governance and managerial changes on firm performance and test the applicability of agency and institutional theories in the Japanese context.

Theory

Agency theory

Agency theory attempts to deal with problems that arise in bilateral relationships when the goals of a principal and an agent conflict, and when it is difficult or expensive for the principal to verify the agent's actions (Eisenhardt, 1989). According to Eisenhardt (1989), the large modern corporation, wherein professional managers operate the firm as the agent for a large group of shareholders, represents a classic situation in which the agency problem arises. The theory posits a number of ownership conditions and monitoring mechanisms that attenuate the agency problem between shareholders and managers. These include shareholding by block owners or institutional investors, the external managerial labor market, performance-based managerial compensation, the presence of outside independent members on the board, and the market for corporate control (Fama, 1980; Jensen, 1986). The theory predicts that these mechanisms can solve or mitigate the agency problem by narrowing the divergence of interests between shareholders and management. If Japanese firms began to implement some of these internal mechanisms such as performance- or stock-based managerial compensation in the form of stock options or more effective board monitoring by shareholders, or their ownership structure has changed to include more performance-oriented shareholders, then the theory predicts that the agency problem can be mitigated, and therefore firm performance should improve to benefit the interests of shareholders.

Institutional theory

Institutional theory posits that firms attempt to incorporate norms in their institutional environments so that they can gain legitimacy, resources, stability, and enhanced survival prospects (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). In other words, firms take actions that enhance their legitimacy in the environment in which they operate. This implies that firms will implement new measures when they can enhance their legitimacy and hence their survival prospect by doing so. Therefore, when social legitimacy (and also economic rationality) of new measures has still not been firmly established, firms tend to resist adopting such measures as they will not gain much from the adoption (Oliver, 1991). This is especially true if new measures are vastly inconsistent with the existing organizational practices.

However, when firms face strong external pressures to implement the new measures, especially from an important constituent who provides key resources such as capital, they may adopt them only partially or adopt them but decouple them from actual practices so that they can appease the key constituent and at the same time, they can maintain internal organizational stability. This argument is also consistent with resource dependence theory (Pfeffer and Salancik, 1978). Therefore, firms may be seemingly complying with the external pressures by implementing new measures but actually concealing non-conformity (Oliver, 1991; Westphal and Zajac, 2001). This suggests that internal measures that a firm implements represent strategic and tactical options available within the institutional constraints, and the performance implications of such measures are often uncertain because firms may choose to decouple them.

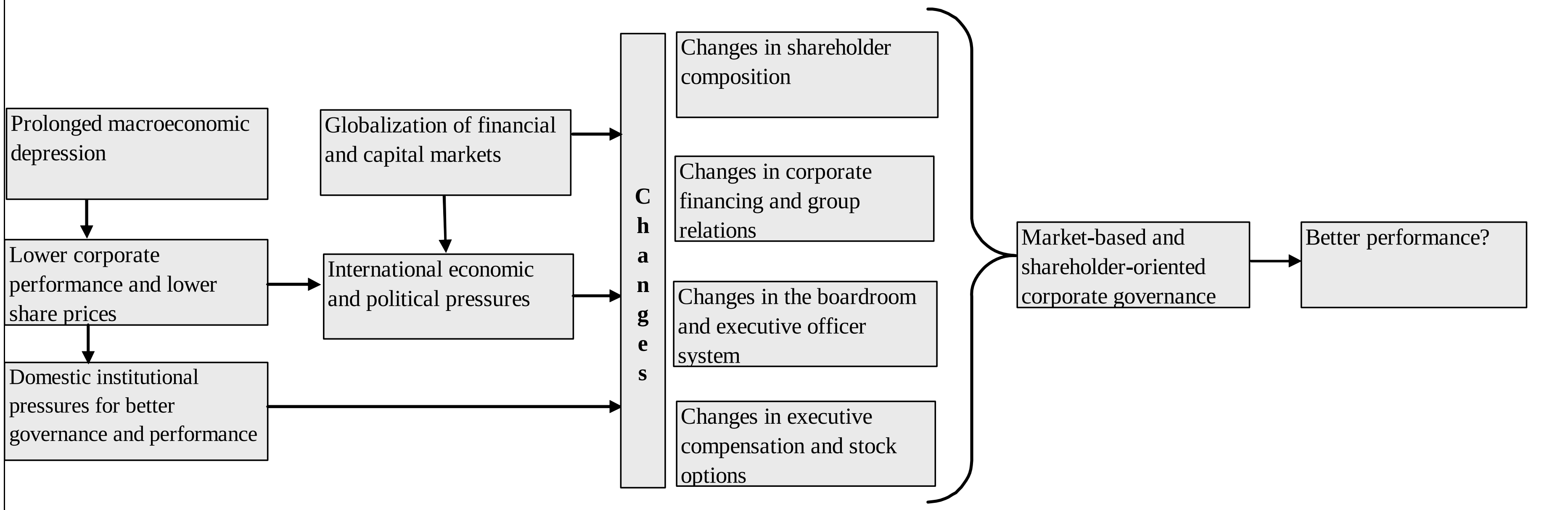
This argument is, however, applicable to ownership structure only to some extent. Facing the rise of investors that seek financial returns, a firm may be able to mitigate their pressure by asking its affiliated firms or close business partners to own its shares. However, a firm cannot completely block the capital market pressure exerted by market-oriented investors, because it does not have complete control over its ownership structure as long as the firm is publicly listed. This means that although a firm that faces capital market pressure through changing ownership composition has strategic choices as to how to respond to such pressures (some of them may be merely symbolic), it cannot block them. This implies that ownership structure may directly or indirectly have stronger performance implications than internal practices that a firm has control over their implementations. Therefore, we have two different perspectives on the performance implications of the adoption of new internal corporate governance measures. The next section discusses the major changes that took place in Japanese corporate governance since the 1990s.

Changes in Japanese Corporate Governance

The post-war corporate governance of Japanese firms has adopted a relationship-centered model based on the combination of stable institutional ownership, main bank debt financing, professional managerial control, and keiretsu transactions. This relational pattern has begun to change since the 1990s due to the two abovementioned conditions: prolonged slump in Japanese business and international economic pressures, mainly from U.S. interest (Hoshi and Kashyap, 2001; Miyajima and Aoki, 2002; Shimotani, 2006). The macroeconomic recession led to the deterioration in corporate performance and thus the decline in paid-out dividends and share prices. Some investors and observers blamed the inadequate corporate governance system of Japanese firms for the significant drop in share prices (Watanabe and Yamamoto, 1992). Because of the rising public and international expectations on Japanese firms to deal with the governance issue for higher profitability, Japanese firms started to pay greater attention to their corporate governance practices. The traditional stable investors, especially commercial banks started to care about higher performance of their invested firms as they themselves were also facing financial troubles due to the large amount of non-performing loans. Foreign and domestic arm's length investors seeking capital and income gains who bought these shares sold by stable investors imposed further pressure to improve corporate governance practices and ultimately financial performance.

The pressure to place more focus on shareholders' interests and firm profitability ultimately implied the shift for Japanese firms from relationship-based, stakeholder-centered governance towards a market-based and shareholder-oriented model. When a firm tries to accommodate various stakeholders' interests that may be in conflict, it may have to choose sub-optimal allocation of resources and hence sacrifice firm profitability. The business relationship-oriented stable investors did not aim at maximizing the investment return on their shareholdings; as such they did not impose much pressure on senior managers to improve firm performance (Charkham, 1994; Kester, 1991). However, because of the changes in stable shareholders interest on the one hand, and the ownership structure towards increasing foreign and market investors that are return-oriented on the other hand, a move toward a market-based shareholder-oriented model of corporate governance became inevitable in Japanese firms (see Figure 1).

Figure 1. Structural change in Japanese corporate governance



In reaction to those pressures in the environment, we have witnessed the major legal reforms introduced by Japanese government and the institutional changes in corporate governance practices of Japanese firms. Below we analyze the resulting four major changes in ownership and management in detail.

Organizational changes in shareholder composition

The ownership of Japanese large corporations has long been dominated by domestic financial institutions and non-financial firms. These holdings often reflect long-standing business relationships with partners who are called "stable" shareholders. Relations among such stable shareholders are sometimes characterized by reciprocal holdings, which are seen as an expression of goodwill (Clark, 1979) and help cement transactional and historical ties (Gerlach, 1992). Because of this feature, the emphasis on the maximization of shareholder interests was less applicable to these domestic shareholdings (Phan and Yoshikawa, 2000; Sheard, 1994).

However, changes in the capital markets and accounting rules have exerted pressures toward change. The prolonged Japanese economic downturn since the 1990s has had deep impacts on traditional stable shareholdings (Shimotani, 2006). Since many Japanese firms needed to avoid reporting losses from their shareholdings, especially during their performance decline, after the new accounting rules, which were implemented by the Hashimoto administration in 1996 to make the Japanese accounting rules closer to the international accounting standards, they started to reduce their shareholdings in affiliated firms. Further, they were put under increasing pressure to pay greater attention to the operational efficiency of their employed capital due to rising capital market pressures. Consequently, the proportion of stable shareholdings and reciprocal holdings has declined significantly over the past decade. According to data from the NLI Research Institute (2004), stable shareholdings have dropped from 45% to 24%, and reciprocal holdings declined from 18% to 7% during the period 1990-2003 (see Table 1).

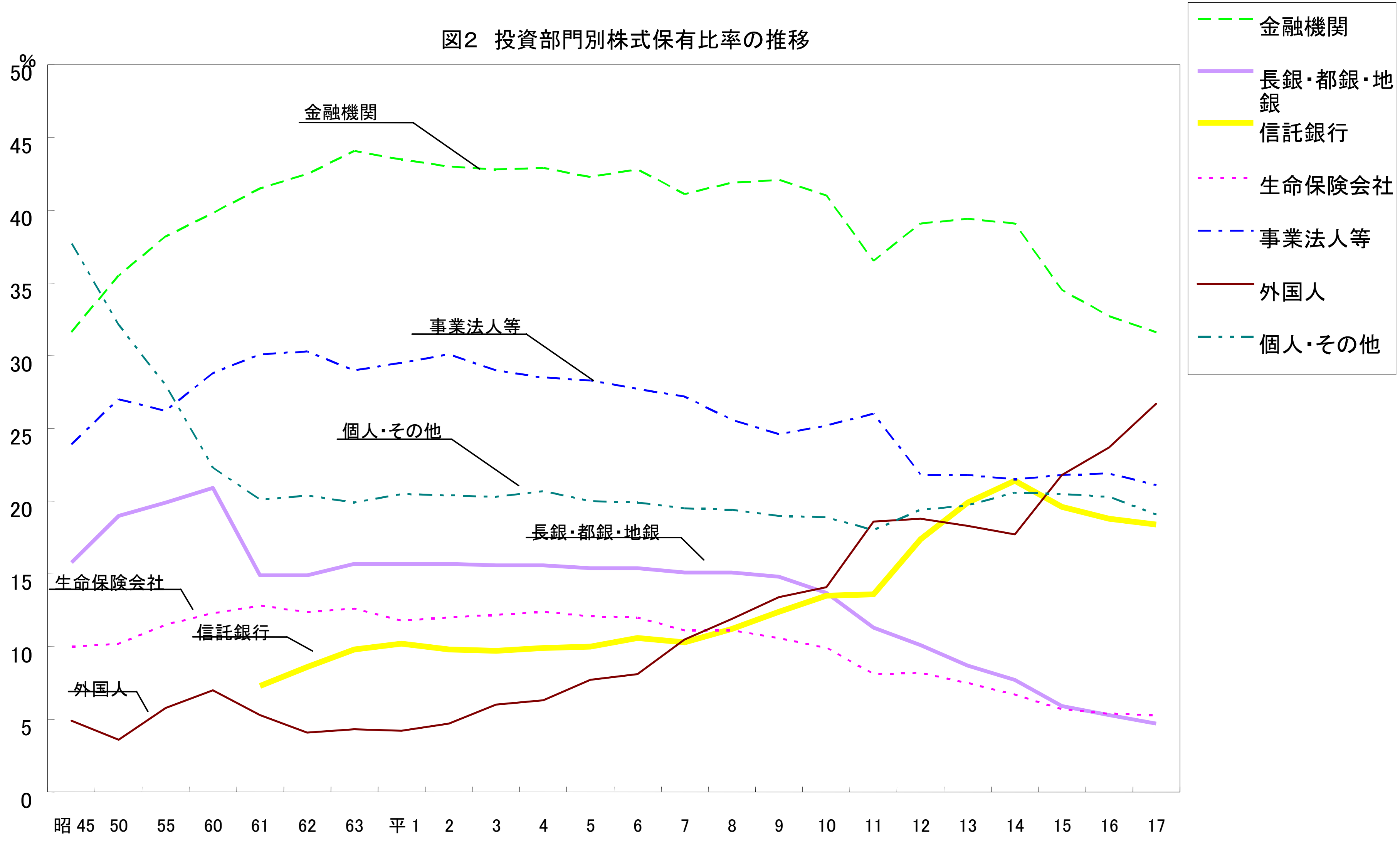
Table 1. Stable and cross shareholdings

	Stable Shareholdings	Cross- Shareholdings
1990	45.60%	18.10%
1991	45.60%	17.90%
1992	45.70%	17.80%
1993	45.20%	17.60%
1994	44.90%	17.40%
1995	43.40%	17.10%
1996	42.20%	16.30%
1997	40.50%	15.10%
1998	39.90%	13.30%
1999	38.00%	10.90%
2000	33.10%	10.40%
2001	30.20%	9.00%
2002	27.20%	7.90%
2003	24.30%	7.60%

Source: *Kabushiki Mochiai Bunpu Chosa 2003*, NLI Research Institute; Kabushiki Bunpu Chosa 2004, Association of Stock Exchanges
Note: Percentage of bank shareholdings includes cross-shareholdings. Percentage of stable shareholdings includes cross-shareholdings.

A large amount of shares sold by these stable relationship-oriented investors has been acquired by foreign and domestic market-oriented investors, especially trust banks. Domestic pension funds as well as investment trusts have been gaining prominence in the Japanese capital markets since the 1990s (Fukao, 1999; Inoue, 1999). Although they are not quite arms-length players, these investors are more performance-oriented and hence seek higher returns on their equity holdings (Suto and Toshino, 2005). On the other hand, globalization of stock investment by international institutional investors, especially from the U.S. and Europe, and relatively lower Japanese stock prices after the burst of the bubble economy led foreign portfolio investors to increase their holdings of Japanese stocks steadily since the 1990s (Nitta, 2000). Since the early 1990s, foreign ownership of Japanese firms has been rising from 4 percent in 1990 to 22 percent of all listed Japanese shares in 2004.[1] Since many of these foreign investors have only arms'-length relationships with the firms in which they invest, they look for higher investment returns based on more shareholder-oriented corporate governance model (Jackson and Moerke, 2005; Yoshikawa and Phan, 2001). Figure 2 illustrates the change in ownership of Japanese firms since 1970 that represents the long-term and short-run trends described above.

図２　投資部門別株式保有比率の推移



These changes in ownership structure suggest that Japanese firms are under greater pressure to accommodate the needs of more return-oriented investors such as foreign portfolio investors and domestic trust banks. As these investors have only performance-based relationships with firms in which they own shares, they look for higher investment returns. Further, especially foreign investors are more likely to demand that Japanese firms disclose more corporate information since they do not have other means to gather such information, unlike stable domestic shareholders (Yoshikawa and Linton, 2000). This means that internationally active institutional investors may pressure Japanese firms to adopt global standards of corporate disclosure (Useem, 1998). Hence, those Japanese firms that have large foreign ownership may have to place greater focus on market shareholders' interests.

One of the consequences of these changes in terms of shareholder composition and managerial principles is the rise of executive shareholding among Japanese firms. Following the theoretical argument of agency theory, the executive share of ownership of the enterprise that they manage is assumed to be instrumental in aligning their interest with that of other shareholders. In other words, the senior managers with shareholdings are assumed to maximize the shareholder value, rather than the size and sales, of the firm they manage, because that value directly result in their own financial gains.

Organizational changes in corporate financing and group relations

Corporate finance practices of Japanese firms after World War II illustrated two structural characteristics: the predominance of debt financing and the intra-group reciprocal shareholding and mutual control. After the war most Japanese firms were cash-starving due to hyperinflation and direct wartime damages to their facilities. Demand for large-scale investments was then immediate for most businesses, while capital markets remained still marginal in size and speculative in nature. The organizational mechanism within these economic constraints was *keiretsu* financing in which commercial banks, particularly large ones designated as *toshi ginko*, or city banks, selected their customers for long-term financial ties. The resulting *keiretsu yushi*, relational lending, became popular as the Japanese economy experienced rapid growth since the middle of the 1950s. The bank coined as the "main bank" repeatedly rolled over their loans to their customers, and the consequential relationships became maintained as a stable source of long-term loan until the 1980s (Hoshi and Kashyap, 2001; Shimotani, 2006).

The *keiretsu yushi* functioned as a monitoring instrument as well as a financing mechanism. Given the relative shortage of loanable money and the abundance of investment demand, banks first scrutinized and screened loan applications coming from *keiretsu* enterprises for the feasibility of investment schemes. Once they decided on and actually committed to funding particular schemes, the banks were forced to monitor the execution of the investments for their implementation. This was a protective mechanism on the part of the bank in order to avoid non-performing loans. On the borrower side this bank supervision worked as a monitoring device through which the effective functioning of project execution be assured (Aoki, 2004).

The commercial banks and industrial operating companies in postwar Japan generated one more organizational and operational structure that is unique to that economy: *kigyo shudan* or the corporate group. Often confused with the *yushi keiretsu* summarized above, *kigyo shudan* illustrated different principles in terms of ownership and control. In addition to a mechanism of debt financing organized by the core commercial bank within the corporate group, *kigyo shudan* functioned primarily as an apparatus of equity ownership and transaction domains. Certainly commercial banks most often at the core of the *kigyo shudan* maintained debt financing relationships with constituent group enterprises, but the banks also owned a small percentage of their shares. Furthermore, within each group member firms mutually owned a small fraction of the share of other enterprises, which resulted in the mechanism called "mutual ownership and mutual control" (Okumura, 2000).

Those two central organizations, *yushi keiretsu* and *kigyo shudan*, gradually became insignificant especially in the 1980s, as the long-term success of those group forms had paradoxically transformed their constituent firms more independent of associations. The firms accumulated enough internal reserve to finance their own investment schemes, while commercial banks started owning abundant cash that should be loaned out to whatever the opportunities the banks could find, inside or beyond the main-bank relationships (Hoshi and Kashyap, 2001).

In the depressed decade of the 1990s, many of those banks were saddled with non-performing loans, which resulted from the expansive lending sprees of the late 1980s. Many of the banks thus had to reorganize their main bank relationships for the sake of their financial health. As the banks became more market and performance oriented, Japanese firms gradually moved away from debt financing toward equity financing. *Kigyo shudan* also became a constraint for further growth, rather than a mechanism for stable development, as individual firms could not uncover significant entry opportunities without invading into the business domains of other members. In a sense individual member firms now had outgrown the entire group (Miyajima and Arikawa, 2001; Shimotani, 2006).

Managerial changes in the boardroom and executive officer system

When Sony announced its changes in management organization toward an executive or executive officer system in 1997, business journalism welcomed the move as an innovation toward the efficient and effective apparatus after U.S. governance models. After all, Japanese economy was still suffering from negative growth and nagging deflation, while Sony then remained a bright success story in global markets (Shimotani, 2006). Sony's *shikko yakuin* system resulted from a classic dilemma of modern corporate management: how to distinguish and divide the distinctive management roles of supervisory control and operational implementation. That inventive firm came up with the organization to separate implementation function as *shikko yakuin*, executive or operating officers, while the board of directors became concentrated on the fundamental decision-making and the supervision of strategic implementation on the part of executive officers. This variety of control, supervision, and implementation was supposed to be modeled after the common institution adopted by U.S. firms. Within a widespread consensus toward shareholder orientation of U.S. corporate management combined with the lost confidence in Japanese governance convention and Sony's innovative reputation, it was not surprising that other Japanese firms followed suit (see Table 2).

Table 2. Number of Firms Implementing the Executive Officer System (EOS)

Year	Number of Firms	Number of firms implementing EOS	Ratio
1997	n.a.	1(Sony)	n.a.
1998	1137	40	3.50%
2000	1310	279	21.30%
2002	1363	466	34.20%
2005	1317	649	49.30%

Source: Tokyo Stock Exchange

While Sony's modification remained voluntary and internal without any broad legal foundations, that system encouraged the reform of the Commercial Code in the spring of 2002. That change institutionalized the executive officer system under the name of *shikko yakuin*. Indeed, the 2002 revision of the Commercial Code offered individual firms with two fundamental choices in terms of the governance structure. Newly introduced was the committee governance system that is modeled after the U.S. institution in which the board establishes three committees, supervisory, nominating, and compensation, that are supposed to monitor the functioning of executive or operating officers. Firms that adopted this model are not required to keep the office of auditors because its function is now supposed to be carried out by supervisory committee.

While the executive officer system as a business practice became popular among many enterprises, the diffusion of the legally-backed committee system in which the operational officer system is integrated is still limited. This discrepancy stems partially from the fact that the separation of supervision and management remains fuzzy, as some executives at top management ranks carry the dual role of the board member and the representative executive officer. This is thus an eventual mechanism of self monitoring in which a single individual plays the role of monitoring and monitored. This is naturally the structural issue still hotly debated even in the United States, but given the weakness of shareholder pressure in Japan, ironically the new organization not simply became symbolic, as the institutional theory suggests, it may actually strengthen the dominance of insider management.

Managerial changes in executive compensation and stock options

One of the most significant corporate governance reforms concerning executive compensation in Japan has been the introduction of stock options and the transition of executives' salary to the performance-based pay system. Both systems have been introduced to promote the stockholder-conscious management by strengthening the link between executive compensation and firm performance.

The amendment of the Japanese Commercial Code in 1997 opened the way for the full-scale introduction of stock options, which is one of the methods that aim to establish the efficient corporate governance by encouraging managers to conduct business in accordance with the interests of shareholders. The Commercial Code originally allowed the granting of stock options only to firms' own management and employees, which would be revised to include all the stakeholders of the relevant firm in 2002. Besides, there was a limit on shares that could be allotted to stock options and the terms of the options were restricted to a time period of 10 years. However, these restrictions have been removed by the amendment of the Commercial Code in 2001 and more than one third of publicly-traded companies have introduced the system by the end of 2004 (Tanaka, 2005).

According to the study of Tanaka (2005), Japanese firms that adopted stock option plans after 1997 allotted 2.03% on average (approximately 506 thousand stocks) of the number of stocks issued. The average number of people receiving stock options was 190 per firm and the average number of stocks received was 2,346 per person. Those who can receive stock options are now not limited to directors or officers. In fact, in more than 90% of firms that have stock option plans, employees are also entitled to receive stock options. Further, younger firms have a stronger tendency to use stock options as a part of the compensation plan for their employees. The prior study also found that Japanese firms that have a substitute monitoring mechanism in place, such as a higher level of ownership by other firms, option plans are less likely to be adopted (Kato *et al*., 2005). Nagaoka (2005) also found that stock option plans are used more widely by fast-growing Japanese firms and less in regulated industries.

Executives' salary, on the other hand, has been traditionally determined by setting limits to total salary amount in the statutes of a corporation or in the resolution in the shareholders' meeting, and then by ratifying the exact amount for each executive in the board meeting. It has thus been pointed out by some studies that the sensitivity of executive compensation to the firms' performance is rather low (Kaplan, 1994; Kubo, 2005). However, the amendment of the Japanese Commercial Code in 2002 enabled firms to determine the amount of executives' salary without setting limits to the total salary, therefore enabling firms to highly link salary to performance. As a result, there are an increasing number of firms that introduce performance-based executive salary system. As of 2006, 59% of companies in the First and Second sections of the Tokyo Stock Exchange have adopted this system[2].

Table 3 shows average amounts of executive compensation including salary and bonus per director and auditor in the largest Japanese firms in 2004. The table illustrates that the average amount of a director's salary and bonus per year was 23.5

million yen and 5.8 million yen, respectively. For auditors, this number is smaller with an average value of 12.1 million yen for salary and 1.5 million yen for bonus. Manufacturing industry in total shows higher amounts of executive compensation in comparison to non-manufacturing industries. Nevertheless, the high standard deviation for both salary and bonus in the manufacturing industry implies that there is a greater discrepancy among firms in the manufacturing industry compared to non-manufacturing industries. The table also illustrates that 28.4% of those large firms introduced stock option plans as of 2004.

Table 3 Composition and Compensation of Executives in Major Japanese Firms in 2004

Variable	All firms		Manufacturing firms		Nonmanufacturing firms	
	Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.
The number of board members						
Directors	14.8	7.5	14.5	7.0	15.3	8.2
(Outside directors)	(0.7)	(1.2)	(0.6)	(0.9)	(0.8)	(1.5)
Auditors	4.3	0.7	4.2	0.6	4.4	0.8
(Outside auditors)	(2.4)	(0.8)	(2.3)	(0.7)	(2.5)	(0.8)
Salary and bonus per person						
Director's salary (in million Yens)	23.5	20.3	25.5	25.4	20.8	9.2
Director's bonus (in million Yens)	5.8	6.6	6.6	7.6	4.8	4.7
Auditor's salary (in million Yens)	12.3	3.9	12.9	3.7	11.5	4.2
Auditor's bonus (in million Yens)	1.5	2.0	1.7	2.3	1.1	1.5
Proportion of firms introducing stock options (%)	28.4		31.96		23.61	

Notes:

1. Numbers of outside directors and outside auditors are included in the numbers of directors and auditors, respectively.
2. Sources of data are as follows: For the number of executives, values in *Yakuin Shikiho* are employed, except for numbers of outside directors and outside auditors, which have been compiled from the financial statement report of each company. The average executive's bonus per person has been calculated by dividing the total of executives' bonus which appears in the section of 'Situation of Corporate Governance' of financial statement report or the

‘Appropriation Statement’, by the number of executives. The average executive’s salary per person was calculated by dividing the total of executives’ salary in the section of ‘Situation of Corporate Governance’ of the financial statement report by the number of executives. *Nikkei Needs* is employed for calculating the proportion of firms introducing stock options.

3. The total amount of pay to executives is composed of the executives’ salary, bonus, retirement benefit and salary and bonus paid as wage payment. However, few companies report them separately in financial statement reports. In the above table, we thus compiled the data of the largest 500 companies in terms of consolidated sales except for financial institutions which had detailed data in their financial reports, and contacted the investor relations departments of the others to clarify the content of total amount of pay to executives described in their financial statement reports. Values in this table have been calculated from the data of 154 companies (87 firms in the manufacturing industry and 67 firms in non-manufacturing industry) from which we could obtain the accurate value of the executives’ salary through the above procedure.

Effectiveness of Corporate Governance Factors

Although many Japanese firms have formally altered many of their corporate governance mechanisms, the performance implications of individual governance factors are still not clear. Following the arguments on the changes in corporate governance at the managerial and organizational levels, we hypothesize their effects on firm performance according to the agency theory reasoning. We then compare the results with the institutional theory logic in the discussion section. Table 4 summarizes the expected effectiveness of several governance variables.

Table 4. Hypothesized relationships between governance factors and profitability from an agency theory perspective

Expected results	Profitability
H1. Foreign ownership	+
H2. Executive ownership	+
H3. Financial ownership	+
H4. Yushi keiretsu membership	Insignificant
H5. Board size	−
H6. Executive officer system (presence)	+
H7. Stock option (presence)	+

The first three hypotheses relate to the effectiveness of key shareholders on firm performance. We suggest the positive effects of foreign ownership, executive ownership and financial ownership. Since the main investment objective of foreign investors is high investment returns, their increasing ratio in a firm shall result in higher financial outcomes. Executive ownership that aligns the interests between shareholders and executives shall also bring higher returns, as the executives will become more profitability-oriented. Financial shareholders shall also have positive impact on profitability. This is because financial institutions have become more motivated to pressure their client firms to place a greater emphasis on profitability in the 1990s, thanks to the banks' own bad debt troubles. Besides, trust banks that increasingly have high proportions of firm shares in that time period are performance-oriented and seek higher returns on their equity investments.

Several studies in the literature to date have shown mixed results. While foreign ownership was positively associated with firm performance in some studies (Miyajima and Kuroki, 2005; Nitta, 2000; Sasaki and Yonezawa, 2000), others (Gedajlovic *et al.*, 2005) did not find any relationship between foreign ownership and profitability in the 1990s. Gedajlovic and Shapiro (2002) found a positive relationship for financial ownership, while Nitta (2000) found a negative relationship. Sasaki and Yonezawa (2000) found a positive relationship between director ownership and Tobin's q, while Gedajlovic *et al*. (2005) found an insignificant relationship between director ownership and firm profitability.

Several studies that examined the effect of main bank monitoring on firm performance argued the positive relationship. Gerlach (1992), for instance, in his study covering the period 1976-1985 showed that borrowing from the main bank was positively associated with profitability of its client firms. Other studies (Kaplan and Minton, 1994; Sheard, 1994; Kang and Shivdasani, 1995) discussed the similar positive effects of *yushi keiretsu* affiliation. Nonetheless, all these studies use the data in the 1970s and 1980s, when the main bank's monitoring power was relatively strong. Hence, we cannot conclude from these past outcomes that the main bank monitoring has still been effective in the 1990s. Indeed, there is some evidence that illustrate that the main bank doesn't play an effective governance function any longer (Morck and Yeung, 2006; Weinstein and Yafeh, 1998). Given the declining role of *yushi keiretsu* linkage, we thus hypothesize here that affiliation to a main bank has no significant effect on firm profitability (Hypothesis 4).

Hypothesis 5 and 6 propose that the boardroom reforms in terms of reduction of board size and introduction of executive officer system shall improve firm performance because the goal of those changes has been to improve the quality of decision-making and the effectiveness of monitoring (Aoki, 2004). Nevertheless, some recent studies in the literature suggest that the recent boardroom reforms initiated by Japanese firms do not seem to have any positive effects on firm performance (Aoki, 2004; Yoshikawa and Phan, 2003).

Firms initiated the employment of stock options to align the interests between shareholders and managers, and the introduction of such system ultimately should have a positive impact on firm performance (Hypothesis 7). Kato *et al*. (2005) have also pointed out that, in comparison to firms which did not adopt stock option plans, ROA of the adopting firms is significantly higher to that of non-adopting firms and these results are in consistence with the view that the option plans improve performances of adopting firms.

The sample, variables and methodology

The sample includes all the electronics companies listed on the First section of Japan's three largest stock exchanges: Tokyo, Osaka and Nagoya. The electronics industry is chosen in this study for three reasons: First, it represents one of the most dynamic and successful industries in Japan. Second, electronics firms embody the wide spectrum of cases in terms of their ownership and governance from the conventional style of managerial dominance to enterprises owned and managed by international investment funds. Third, those electronics enterprises have been the forefront of several important shifts in terms of corporate governance. By 2002, for instance, the 69 listed electronics firms had adopted the executive officer system, which represents by far the most widespread employment of that management organization in manufacturing. The electronics industry, beside finance, has remained one of the most active sectors of international investment, with more than 30% of corporate stocks have been in the hand of foreign shareholders. Further, our selection of one industry allows us to remove the industry-level effects. The time period of this study is from 1997 to 2003, which encompasses the institutionalization of several measures of shareholder orientation in Japan starting with the introduction of stock options, the establishment of executive officer system and the legalization of pure holding companies all in 1997.

The majority of the statistical data was collected from *Yuka Shoken Hokokusho (Report on Securities and Stocks)* that is the semiannual reports that listed companies file with the Ministry of Finance, *Nikkei Needs* Database, and *Yakuin Shikiho (Board of Directors Handbook).* Whenever any substantial data was missing for particular enterprises, however, those firms were removed from the sample. This meant that original sample of 146 firms was reduced to104 companies in our final analysis.

This study employs the return on assets (ROA) to illustrate the profitability of companies. For governance factors, we employ several variables. Foreign ownership is the proportion of total shares held by foreign owners. This measure has been used reliably in past studies (Ahmadjian and Robinson, 2001; Yoshikawa, Phan, and David, 2005). Executive ownership measures a proportion of total shares held by the members of the board and inside auditors. As the majority of Japanese board members are insiders (i.e., senior executives), we treat this as executive ownership. By owning shares of the enterprise they manage, executive ownership will promote shareholder value on the part of the executives. Financial ownership is the proportion of total shares held by Japanese financial institutions that include banks and insurance companies (Gedajlovic and Shapiro, 2002). They are assumed to possess superior monitoring capabilities and higher incentives than operating companies and individual investors. In terms of corporate group relations, we only employ yushi keiretsu affiliation in this study given its high correlation at 0.785 level with kigyoshudan membership. Given the significant changes that all the *kigyo shudan* experienced at the beginning of the 2000s *yushi keiretsu* will give us more consistent measure of performance impact. *Yushi keiretsu* is assessed as the membership to a main bank linkage and is measured by dummies. Board size is measured as the total number of directors on the board of each firm. The other measure for boardroom changes includes the adaptation of executive officer system computed as binary variable. Because there is no accurate and complete data available on executive salary, we could not employ that as an independent variable in this study.3 The introduction of stock option mechanism is measured by dummies for each year.

Several control variables are introduced into the regression models. Firm size is measured by the number of employees. Firm age is the other firm-level control. Leverage is calculated as the percentage of long-term debt to total assets. Strategic investments are computed as R&D intensity (expenditures divided by total sales) and capital intensity (capital expenditures divided by total assets). Average rate of annual growth of industry shipment in 3-digit JSIC sub-industries is employed using data from Kogyo Tokeihyo (Manufacturing Census) published annually by the Ministry of Economy, Trade and Industry (or the Ministry of International Trade and Industry until 2001).

Multiple regression analyses are employed to examine the effectiveness of corporate strategy and governance variables that the Japanese electronic firms have employed. Panel data set is used for the analysis. The estimation technique employed is the general linear squares (GLS) models. As Hausman test indicated that there was a significant systematic difference in the coefficients from fixed effects models to random effects models, we chose to use random effects models (White cross-section standard errors & covariance (d.f. corrected)) in our analysis. We incorporated a one-year lag between dependent and independent variables to facilitate causality.

Statistical results

Table 5 presents descriptive statistics and correlation coefficients for the variables. As the table shows, there were no significant correlations among the variables.

We report the results of the regression analysis in Table 6. Model 2 illustrates the findings on foreign, executive and financial shareholdings. The outcomes show that foreign ownership and financial ownership has positive and significant effects on firm performance, while the impact of executive ownership is insignificant. Hypotheses 1 and 3 are thus supported, while Hypothesis 2 is rejected. Hypothesis 4 proposes that *yushi keiretsu* membership is insignificantly linked to profitability. Model 3 supports that hypothesis. Hypotheses 5 and 6 relate to the boardroom reforms, which predict that reduction of board size is negatively, and the presence of executive officer system is positively, related to corporate performance, respectively. The results in Model 4 show that board size has no significant effects, while executive officer system is negatively related to profitability. Hypotheses 5 and 6 are thus both rejected. Hypothesis 7 proposes the introduction of stock options will align shareholder and management interests and shall thus have positive performance effects. Model 5 shows insignificant coefficient for stock options and the hypothesis is rejected.

Table 5. Pearson correlation coefficients

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
ROA	1.000													
Age	-0.083	1.000												
Employee	-0.037	0.407	1.000											
Leverage	-0.214	0.214	0.230	1.000										
Capital intensity	0.088	0.030	0.008	-0.157	1.000									
R&D intensity	-0.009	-0.144	0.048	-0.038	0.036	1.000								
Industry growth	-0.064	-0.152	-0.100	-0.068	-0.015	-0.017	1.000							
Foreign ownership	0.019	-0.165	0.245	-0.231	0.062	0.087	0.054	1.000						
Executive ownership	0.105	-0.418	-0.162	-0.178	0.009	0.124	0.053	-0.085	1.000					
Financial ownership	0.023	0.238	0.253	0.025	0.043	-0.147	-0.021	0.176	-0.255	1.000				
Yushi keiretsu	-0.067	0.406	0.176	0.340	-0.030	0.006	-0.076	-0.186	-0.332	0.043	1.000			
Board size	-0.052	0.264	0.409	0.223	-0.026	-0.057	-0.009	-0.004	-0.269	0.232	0.198	1.000		
Executive officer systen	-0.024	0.189	0.215	0.005	0.056	0.018	-0.135	0.205	-0.087	0.133	0.073	-0.272	1.000	
Stockoption	0.086	-0.023	0.214	-0.044	0.080	0.182	-0.058	0.256	0.023	0.064	-0.106	0.034	0.258	1.000

Table 6. GLS regression results on ROA[a]

	Dependent variable: ROA					
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Age	-0.037	-0.009	-0.027	-0.022	-0.028	0.021
	(0.032)	0.037	(0.032)	(0.033)	(0.033)	(0.041)
Employee	-2.29E-05	-9.79E-05*	-2.35E-05	2.10E-05	-3.40E-05	-5.75E-05
	(4.46E-05)	(4.65E-05)	(4.44E-05)	(5.34E-05)	(4.29E-05)	(6.06E-05)
Leverage	-1.379*	-1.092*	-1.295*	-1.397*	-1.364*	-0.993*
	(0.539)	-0.491	(0.501)	(0.546)	(0.539)	(0.445)
Capital intensity	0.329	0.320	0.329	0.333	0.326	0.321
	(0.267)	(0.268)	(0.267)	(0.262)	(0.267)	(0.264)
R&D intensity	0.220	0.317	0.223	0.239	0.213	0.360
	(0.246)	(0.261)	(0.248)	(0.254)	(0.266)	(0.286)
Industry growth	-0.009	-0.020	-0.009	-0.024	-0.011	-0.054
	(0.105)	(0.101)	(0.105)	(0.107)	(0.107)	(0.106)
Shareholder composition						
Foreign ownership		0.114†				0.165*
		(0.062)				(0.067)
Executive ownership		0.110				0.008
		(0.074)				(0.112)
Financial ownership		0.106*				0.117*
		(0.045)				(0.046)
Main bank relationship						
Yushi keiretsu			-1.024			-0.171
			(1.270)			(1.387)
Boardroom reforms						
Board size				-2.240		-4.133
				(2.952)		(2.941)
Executive officer system				-4.370†		-7.134**
				(2.380)		(2.494)
Executive compensation						
Stockoption					0.981	1.402
					(1.773)	(1.767)
R^2	0.091	0.106	0.092	0.096	0.091	0.120
Adj. R^2	0.078	0.088	0.078	0.080	0.077	0.093

[a] Unstandardized coefficients are shown, with standard errors next to them (White heteroskedasticity-consistent).
n= 624
† p <0.10; *p <0.05; **p <0.01

Discussion and Conclusion

The current paper has systematically attempted to tackle two critical issues regarding the adaptation of various governance reforms in Japanese corporations: how much the corporate governance of Japanese firms has actually transformed the conventional system of alliance capitalism and managerial control; and what the economic outcomes of those governance reforms have yielded since the second half of the 1990s. The conclusion of our study is that, despite all the hypes regarding the amendments in the Commercial Code and other legal and institutional frameworks and the resulting changes in stock ownership, corporate control, and managerial organizations and practices, the influence of new ownership composition and corporate governance apparatus on financial performance has been somewhat mixed.

Share ownership by such performance-oriented entities as foreign investors and financial institutions, especially trust banks, illustrates a positive and significant influence, as is expected. *Yushi keiretsu*, then, shows no significant impact, positive or negative, as we hypothesized. This provides additional evidence that the main bank monitoring has become less effective and more invisible in recent years. Interestingly, while board size did not affect the financial performance, the introduction of executive officer system negatively influenced profitability. This result challenges the conventional view that the boardroom practice modeled after the U.S. system in which the board function of decision-making and supervision and the operating execution are sharply separated should have positive performance effects. One of the possible reasons for this result is that the functional separation of directors and executive officers was not clearly implemented and thus many boards still had the overlaps of monitoring and execution functions. As such the combination of smaller board size and executive officer system might have unexpectedly sharpened, rather than solved, the agency problem, because the small number of insider top executives now dominate the decision making process that is not effectively monitored by independent directors on the board. Further, executive ownership and stock options remained ineffective as a mechanism to align the interest of senior executives with that of shareholders, as our test illustrates.

These findings are, however, consistent with the institutional theory logic. Generally, firms certainly have an incentive to conform with and implement new practices that are widely viewed as superior and legitimate. However, perceived benefits of such new practices, such as greater economic benefits and enhanced social legitimacy, are still not too clear, firms may adopt such practices only superficially and cosmetically but actually decouple them from the original functional model (Oliver, 1991). Also, when there is a vast inconsistency between the internal organizational logic and the new governance practices, then, firms have an incentive to avoid or decouple such practices. After all, there remain Japanese executives and shareholders who are still skeptical about the U.S. governance model, especially its applicability in the Japanese social and organizational context. For example, the top management of both Toyota and Canon, two of the most successful Japanese companies, argues that outside directors with limited industry knowledge bring little benefits. This is reflected in the fact that there is no consensus among the key corporate governance constituents in Japan regarding the future direction of corporate governance (Gilson and Milhaupt, 2004). Further, economic superiority of the U.S. model of corporate governance based on the monitoring by independent directors has not been empirically established even among U.S. firms (c.f., Dalton, Daily, Ellstrand, and Johnson, 1998; Denis and McConnel, 2003; Johnson, Daily, and Ellstrand, 1996). Therefore, it is not surprising that many Japanese firms only superficially implemented some elements of the U.S. practices presumably to appease the capital market pressures. Only ownership-related variables thus had any positive effects in our study.

Performance implications of various new governance mechanisms in sum have been mixed with some measures functioning positively as have been hypothesized while other instruments creating new and unexpected problems of their own. It seems that there is still no clear consensus on the future direction of the corporate governance system among Japanese firms and key stakeholders. Hence, our findings validate the current transitional state of Japanese corporate governance where some firms are trying to adopt new practices only in form or with modifications to suit the local and firm-specific contexts, which may bring unintended performance consequences from what such practices are originally designed for. However, it is also possible that new governance measures in Japanese firms evolve over time and begin to exhibit more substantive performance effects in coming years.

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Notes:

[1] *Kabushiki Bunpu Chosa* (Stock distribution survey), 2004.

[2] Nomura Research Institute, *News letter*, February 2007.

[3] A close examination of the only readily available data on the executive compensation in terms of salary and bonus that appears as one of expense items of administrative and selling expenses in Nikkei Needs, (which includes not only the executives' salary but also the provision for executives' retirement allowances as well as the executives' bonus treated as administrative and selling expenses) shows that that data is often incomplete and inaccurate.