The Role of Outside Directors

in Improving Japanese Corporate Governance

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1. Introduction

1.1 Research Questions

"Outside directors" is one of the hottest buzz phrases in Japan. According to Nikkei Telcom's archive search, the number of articles using this phrase in the *Nikkei Shimbun* reached 430 in the period between 31 May 2012 and 31 May 2014. In other words, the most famous financial newspaper in Japan recently covered "outside directors" at least every two days for two years. This coverage was sparked by three events and related arguments, such as the revision of the Companies Act, the Tokyo Stock Exchange's revised listing regulations, and the new stock price index, the JPX Nikkei Index 400 (see 7.4.1).

However, there has been little substantial and practical discussion about outside directors. Most arguments in newspapers and popular business media have focused on formalities, such as whether or not to appoint outside directors, the trend of the ratios of outside directors in listed firms, which firms will appoint outside directors, and so on. Furthermore, in the academic literature, most studies have focused on exploring links between outside directors and firm performance (Aguilera, Filatotchev, Gospel, & Jackson, 2008), whereas few have developed practical discussions, such as the reasons that outside directors are needed, the kinds of situations that are outside the directors' arena, or whether outside directors have roles in addition to the monitoring and provision of resources.

Without understanding all the reasons for needing outside directors, how to work effectively with them, and the ability of outside directors to contribute to a firm, how are we to best manage them and take advantage of their ability to contribute a firm? My dissertation discusses all these issues, suggests solutions based on the findings of empirical research, and provides recommendations about managing outside directors to business practitioners. Hence, three research questions are posed:

RQ1: Why do Japanese listed firms need outside directors?

RQ2: In what situations do outside directors contribute to a firm?

RQ3: What role do outside directors contribute to a firm?

These questions will be explored in depth in two types of empirical studies that use the quantitative and qualitative approach, respectively.

1.2 Awareness of the Problems

Before proceeding with this dissertation, I have to ensure that Japanese corporate governance functions well. If it works effectively, exploring the role of outside directors in depth will have less value. Because the outside director is just one of many characters underpinning corporate governance, effective corporate governance, in theory, can be achieved by complementing the activities of outside directors with other functions.

Given that "corporate governance deals with the ways in which suppliers of finance to corporations assure that are getting a return on their investment" (Shleifer & Vishny, 1997), it would be meaningful to examine the outcomes of economic value added (EVA), return on equity (ROE), as well as compare the trends of the index market cap among advanced countries. This is because each can be an indicator of how the suppliers of finance to corporations assure themselves of getting a return on their investment, if the corporate governance works.

I will summarize the results of the examination of the three measures (see the details in Appendix 1). With respect to EVA, about half of listed firms in Japan have failed to provide positive EVA, meaning that a significant number of firms may have failed to deliver the expected return to stockholders. In addition, Japan has not only the lowest in average ROE but also the lowest volatility of ROE among ten advanced economies (Nakano, 2009). This means that many Japanese listed firms are likely to take low risks and generate low returns, even though the shareholders expect higher returns. Moreover, among the indexes of other advanced markets, only TOPIX failed to increase the market cap for 30 years. This may also mean that these firms cannot assure the expected return to stockholders. Consequently, based on the definition of corporate governance by Shleifer and Vishny

(1997), these findings cast doubt on the assumption that corporate governance mechanisms work well in Japan.

1.3 Research Approach

The evidence thus indicates that Japanese corporate governance among listed firms does not work well. In order to solidify this argument, I need to confirm this assumption through the lens of theory, which could also serve to answer RQ1. In respect to the relevant theories, researchers traditionally study corporate governance within the framework of agency theory (Aguilera & Jackson, 2003), which dominates corporate governance research (Darton, Dairy, Certo, & Roengpitya, 2003). However, in addition to agency theory, I will make extensive use of multiple theories of corporate governance, such as stewardship theory, governance bundle theory, and resource dependence theory. A multitheoretic approach to corporate governance will enable an in-depth examination of the mechanisms and structures that might reasonably enhance organizational functioning in Japan. This unique view of Japanese corporate governance throughout the lenses of multiple theories is one of the contributions to corporate governance research made by this dissertation.

Regarding the methodology, I first use inductive research for the case studies and then deductive research for the regressions. Although issues of relationship between governance mechanisms and firm performance have dominated the previous research, there is scant evidence of strong linkages and the relationship between these factors is still unclear. Hence, alternative theories and models are needed to uncover the promise and potential of corporate governance (Daily, Dalton, & Cannella,Jr., 2003). Therefore, I take theory-building approach through multiple case studies first and then a theory-testing approach by testing two hypotheses that emerge from the theory and findings of the case studies in large samples. With respect to the hypotheses, one is based on agency theory and resource dependence theory, and links to RQ1, whereas the other is based on the theory of governance bundle and agency theory, and links to RQ2 and proposition 1, which I draw from the qualitative research.

The goal of this dissertation is to bridge academics and practical business in managing outside directors by applying the results of my research to practical situations. Based on these results, I will provide recommendations that can assist business practitioners.

1.4 Outline

This dissertation is divided into seven chapters. In order to understand the drawbacks of Japanese corporate governance, an awareness of how they developed is necessary. In this context, Chapter 2 provides the major trends in Japanese corporate governance during the past 30 years. The past three decades have particular meaning for

Japanese corporate governance because it has been in the process of transformation since the mid 1980s, at the peak of the bubble economy. Understanding previous trends will assist in the understanding of present issues and the development of insights that I will refer to in this dissertation. Chapter 3 explains the multiple theories applied in this dissertation: agency theory, stewardship theory, governance bundle theory, and resource dependence theory. By viewing the current landscape of Japanese corporate governance through these different theoretical lenses, the issue will become clear. At the end of this chapter, I suggest the measures that Japan needs to take in order improve the current issue of corporate governance.

After reviewing the relevant literature, Chapters 4 and 6 attempt two types of empirical studies: the qualitative approach is used in the multiple case studies and the quantitative and deductive approach is used in the regression models. The results of both approaches revealed new findings regarding the outside director's role, which is a main contribution of my dissertation. Chapter 5 highlights constructive interaction, which is closely related to the new role of the outside director. Through multiple case studies, I explain this concept, how it developed, and how it applies to qualitative research. In the last chapter, I provide an overview of the empirical results, a discussion of areas for future research, implications for practitioners, and an outline of recent movements in corporate governance in Japan.

2. Corporate Governance in Japan

This chapter outlines the major trends in Japanese corporate governance over the past several decades.

2.1 Two stages in the Recent History

Corporate governance in Japan has been described by various words, such as bank-based, relationship-oriented, network, insider, stakeholder, as well as a coordinated model of corporate governance (Jackson & Miyajima, 2007), none of which is fully definitive. The bursting of the bubble economy in Japan is a watershed in the history of its corporate governance because various changes were observed after the bubble. In this context, the recent history of corporate governance in Japan is divided broadly into two stages: before the bubble economy and after the bubble economy.

2.2 Before the Bubble Economy

Bank-oriented model. In this model, the Japanese main bank plays a central role in monitoring management (Miyajima & Aoki, 2002). Under bank monitoring, when a firm's performance drops below a certain threshold, the main bank steps in to manage the firm on behalf of stockholders and other banks. Actually, Kaplan & Minton (1994) investigate the determinants of appointments of outside directors who previously employed by banks to the large corporations in Japan and find such appointments increased with poor firm performance. Creditors with only a small stake often take seats on corporate boards and important managerial positions and are active in the corporate rescue (the so-called "contingent governance"), whereas management retains significant discretion and autonomy in matters, such as dominating insiders on the board as long as the performance is not seriously negative (Jackson & Miyajima, 2007).

In this bank-oriented model, shareholders are likely to have other interests than return on investment (Ahmadjian & Robbins, 2005). These shareholders, including main banks, the main source of corporate finance, and the main suppliers capitalize on their status to maintain long-term relationships and to assist ongoing business transactions, such as commercial banking relationships or the supply of parts and materials (Gilson & Roe, 1993). In order to maintain the relationships, corporate ownership in Japan consists of "stable shareholders" with reciprocally cross-shareholdings among corporations and banks (Jackson & Miyajima, 2007). Because of these extensive cross-shareholdings, the capital market is relatively illiquid, the voice of external shareholders is limited, and domestic institutional investors, such as trust banks and insurance companies, are passive (Sheard, 1994). Given these conditions in Japan, not only were there few outside directors but also the stockholders were mainly silent and takeover threats were rare because of the lack powerful mechanisms for internal and external monitoring, as in the Anglo-American model.

Although the main bank system in Japan solved, to some extent, issues in external monitoring, such as takeover threats, but the system could also reject demands for the development of other monitoring mechanisms (Aoki, Patrick, & Sheard, 2005). In addition, the bank tends to be concerned only about the likelihood of repayment and thus must be risk-averse because it has no upside return, whereas it has downside risks, such as irrecoverable debt. It is therefore natural that under a conservative business plan, the bank prefers steady growth towards high profitability by making aggressive investments in the behavior of its borrowers. In this context, it seems to make sense that at that time in Japan, a typical listed firm was not shareholder-oriented but creditor-oriented.

Lifetime employment system. Japan is well known as having a stakeholder model of corporate governance, where employee interests play a predominant role (Dore, 2000). Although the lifetime employment system ensures strong legal constraints on dismissals (Jackson & Miyajima, 2007), it develops internal labor markets, firm-specific skills, and an emphasis on growth over profitability, whereas the Anglo-American employment system is characterized by liquid labor markets, external markets for skills, and an emphasis on profitability over growth (Ahmadjian & Robbins, 2005).

This lifetime employment system is supported by a strong internal promotion system, which is composed of distinctive policies, such as job rotation training and seniority-related wages for core employees. Insiders dominate the board structure, which is thought to be in accordance with the lifetime employment system. In this extension of the internal promotion system, the president is considered a “top employee” instead of a representative of the shareholders (Jackson & Miyajima, 2007). This structure also contributes to the centripetal force of Japanese companies in acquiring and maintaining the lifetime employment system.

Legal framework. In the bank-oriented model, there is little difference in the basic legal structures from those prevailing in most other developed economies, except in a few distinctive respects, such as the corporate auditors system, which is based on the auditors of the German supervisory board (Deakin & Whittaker, 2009). Because the corporate auditor has a legal duty only to monitor the illegal behavior of the management team, and has the right to attend board meetings but has no power to appoint or dismiss the CEO, Japanese boards have a low degree of sufficient separation between monitoring and management roles (Jackson & Miyajima, 2007). The most striking feature of this Japanese corporate governance model is that its main elements—bank-led monitoring, reciprocal cross-shareholdings, lifetime employment, insider-dominated boards, and strong orientation to the interest of core employees—are in no sense legally mandated, while the legal structure of the Japanese firm is based on the principal of shareholder orientation (Deakin &

Whittaker, 2009). Japanese corporate governance practices therefore are shaped by the interaction of a number of complementary mechanisms operating beyond the legal framework (Deakin & Whittaker, 2009).

Every characteristic of the bank-oriented model described above is linked to, directed at, and justified by catching up to the economies of advanced countries. Indeed, the model works well during periods of rapid economic growth. Viewed from another side, the rapid growth before the bubble economy might have concealed the need to improve Japanese corporate governance.

2.3 After the Bubble Economy: First Lost Decade

Two new and growing trends. In the so-called "lost decade" of the 1990s, there were two new and growing trends in the economy of Japan. One concerned foreign investors and the other involved the banks. Since the early 1990s, massive amounts of investment were made in Japan by foreign investors who wanted to diversify their portfolios by adding international stocks (Ahmadjian & Robbins, 2005). Simultaneously, monitoring by the main bank as a substitute for monitoring by outsiders, such as stockholders, began to be discredited because the banks could not easily roll over loans to cover the financial distress of borrowers and the banks themselves (Deakin & Whittaker, 2009). These two trends, the rise of foreign investment and the banking crisis, had a far-reaching impact on corporate governance practices in Japan. Moreover, both trends became the impetus for the later reform of corporate governance (Ahmadjian & Okamura, 2011).

Prior to the banking crisis in 1995 and especially since 1997, the existing form of corporate ownership, which was underpinned by “stable shareholders” with reciprocal cross-shareholdings among Japanese corporations and banks, began to change its role under the influence of the two trends described above. Domestic shareholders were being replaced by foreign institutional investors who cared more about return on investments than maintaining ongoing business relationships (Ahmadjian & Robbins, 2005) and who questioned the significance of cross-shareholding. In addition, although less profitable companies (LPCs), which relied on loans as a means of external finance, tended to maintain cross-shareholdings, more profitable companies (MPCs), which were financed through capital markets and tended to have larger foreign investor ratios, began to unwind their cross-shareholdings because they had to listen to the voice of their foreign shareholders, and they found little need to maintain the former close relationships with the banks (Miyajima & Kuroki, 2007).

Polarization of the responses to cross-shareholding. After the escalation of the banking crisis, the unwinding of cross-shareholdings accelerated only partially in Japan. MPCs facilitated moves to sell bank shares that became risky and fell to the brink of default, whereas banks sold their holding stocks to increase loan-loss reserves and to maintain capital ratios to meet Bank for International Settlements (BIS) regulations (Miyajima & Kuroki, 2007). Because cross-shareholding might work as a premise for keeping insider control and preventing strategic changes to Japanese companies (Jackson & Miyajima, 2007), MPCs that tended to unwind their cross-shareholdings had the chance to improve conditions for changing their conventional governance practices.

In fact, the polarized response to cross-shareholdings by MPCs and LPCs was transformed into a polarization of corporate governance practices. Foreign portfolio investors preferred MPCs that were relatively larger and export-oriented over LPCs in buying stocks in Japan. In addition, the investors had a much larger influence than their actual level of shareholdings because their frequent trading was more significance in terms of its impact on the up-and-down motion of share prices (Ahmadjian, 2007). Thus, some MPCs that were targeted by foreign portfolio investors had to respond to strong pressure from the foreign shareholders and thus changed their corporate governance practices gradually, but not perfectly, in the increasing unwinding of cross-shareholdings. For instance, in the late 1990s, the MPC group adopted the downsizing and divestiture of assets, which was inconsistent with the post-war Japanese stakeholder-oriented system (Ahmadjian & Robbins, 2005).

On the other hand, the undermining of bank monitoring was likely to make borrowers, mainly less-profitable and bank-oriented companies (nearly LPCs), to maintain stable cross-shareholdings to avoid downsizing and to preserve the lifetime employment system under the low-growth economy (Arikawa & Miyajima, 2007). Because the LPC group rarely had foreign shareholders, they did not have to change their governance practices and actually kept most of them such as cross-shareholdings, which allowed keeping insider control. Consequently, LPCs could enjoy their discretion under the situation of undermining of bank's monitoring. Hence, environmental change, such as a bank crisis, may provide unintentional discretion to the management of LPCs. Thus, the two new trends—the rise of foreign investors and the banking crisis—stimulated some Japanese firms to unwind their cross-shareholdings, which enhanced the polarization of governance practices.

2.4 After the Bubble Economy: Second Lost Decade to the Present

New Legal frameworks for corporate governance. Late in the first lost decade, the Hampel Report (1998) and the OECD Principles of Corporate Governance (1999) were made in public and contributed to a distinct, global paradigm shift in the discussion of the goals of corporate governance from mere prevention from scandal to both the prevention and the improvement of business performance (Kanda, 2010). Kanda explained that the Japanese government received a massive boost from this global trend. Consequently, in the late 1990s and early 2000s, new types of legal frameworks were launched, which were in line with the paradigm shift, such as the holding company structure, the committee system, stock options and acquisitions through share exchange. In this context, the formal legal system gradually came to play an increasingly significant role in Japanese corporate governance.

Under this condition, the case of the Daiwa Bank dramatically enhanced this trend in Japan. In a derivative lawsuit concerning the bank's famous trading loss scandal of 1995 in the U.S., the Osaka District Court ordered 11 current and former directors of Daiwa Bank to pay a total of $775 million. Two reasons were given: one was the directors' failure to establish a proper internal control system, and the other was the breach of the directors' duty to comply with United States law to report criminal activity promptly. One of the most significant aspects of this case that the court did not consider traditional practice concerning the bank's informal consultations with the Ministry of Finance, which was widely known as "administrative guidance" and which the bank did well before reporting to U.S. authorities (Aronson, 2003). The Japanese business community was shocked because the court sharply criticized the bank's informal consultation with bureaucrats and emphasized the significance of directors' independent judgment to meet their fiduciary duties (Aronson, 2003). This decision meant that the Japanese business community had to accept that the commonly held view no longer applied and that it would now be necessary to comply with laws and regulations. This could be a step forward for corporate governance in Japan. It successfully acquired a system of after-the-fact monitoring of judgments by management through derivative lawsuits, whereas the Japanese business community might have felt uncomfortable in revising the traditional system (Kobayashi, 2012).

In a series of launches of new types of legal framework to enhance Japanese corporate governance, a highlight was the introduction in 2003 of the company committee system. Unlike the conventional auditor system, this system has a clear legal separation between monitoring and execution and provides better transparency (Chizema & Shinozawa, 2012). Chizema and Shinozawa found that two types of companies are more likely to adopt the committee system: companies that are exposed through global cross listing; companies that are more experienced and keep high levels of cross-shareholdings with larger proportions of foreign ownership. These companies correspond approximately to the MPCs discussed above. The adoption therefore might also exacerbate the polarization of corporate governance practices between MPCs and LPCs. However, the impact was limited because only two percent of the listed companies in Japan adopted this system, partly because it was not mandatory and because this optional corporate structure was strongly protested by the part of the Japanese business community dominated by Keidanren, a leading economic organization with a membership of approximately 1,300 representative firms of Japan. In any case, these legal reforms stimulated both LPCs and MPCs, but mainly MPCs, to change their internal governance structures by selectively adopting practices, such as the executive officer system, stock-based incentive scheme, outside director, and enhanced transparency and disclosure. However, both groups tended to maintain other elements of internal governance structures, such as lifetime employment for core employees (Jackson & Miyajima, 2007) and an insider-dominated board. Moreover, even among leaders of the MPCs, some openly opposed the move to adopt Anglo-American corporate governance practices. Most prominently, Okuda, then Chairman of Toyota, Mitarai, then Chariman of Canon, and the two top executives at Keidanren, insisted that Japanese firms should keep the unique Japanese system, such as the lifetime employment system and insider-dominated boards (Ahmadjian & Okamura, 2011).

Hedge fund activism and hostile takeovers in Japan. The rise of hedge fund activism in Japan is one of the most influential events in in changing the corporate governance practices of Japanese listed companies, such as MPCs, to the Anglo American model (Buchanan, Chai, & Deakin, 2012). Although these firms are not always targets for hedge funds, they are naturally sensitive to the concept of hedge funds and might defensively alter part of their corporate governance practices to accommodate these funds.

In the period from the first activist visits in the early 2000s to the influx in Japan of the global financial crisis in 2008, a variety of hedge funds were introduced, ranging from a few confrontational funds that used public engagement with target firms to strengthen their return on investment, to greater non-confrontational funds that used informal dialogue with the targets (Buchanan, Chai, & Deakin, 2012). Among them, two confrontational cases, the Steel Partners' intervention in Bull-Dog Sauce and TCI's intervention in J-Power, are important because the two cases definitively created the common view that hedge fund activism is a sordid practice. Hence, the firms that were targeted did not necessary reconsider their corporate governance practices even though hedge fund activism has positive aspects, such as an external monitoring function, which Japan traditionally lacks (Buchanan, Chai, & Deakin, 2012).

In addition to the rise of hedge fund activism, the incidence of hostile takeovers was also remarkable turn of events at that time. Almost all takeover bids, such as Livedoor's bid to the Nippon Broadcasting System, Rakuten's bid to the Tokyo Broadcasting System, and Oji paper's bid to Hokuetsu papers, failed. Consequently, the positive aspect of these takeover threats was never recognized in Japan. The waves of takeovers diminished in the wake of the global financial crisis, and Japan lost the opportunity to create a corporate control market, which is one of the most important external monitoring functions.

After the global financial crisis. In addition to the failures of hedge fund activism and hostile takeovers, the global financial crisis emboldened the opposition supporters of the Anglo-American style of corporate governance (Ahmadjian & Okamura, 2011). However, it was a transient reversal. The government and the capital market have reignited discussions on corporate governance reform in Japan. Recently, the discussions have been based on closing the gap between the "global standard" and the "Japanese standard" and have focused on two issues, the establishment of the outside director system and the enhancement of the auditors' monitoring function (Kanda, 2010). However, the mandatory outside director in Japan's listed firms was passed over in the revision of Company Act, although serious corporate scandals, such as the cases of Olympus and Daio paper, demonstrated the weakness of the internal control system in Japanese corporate governance. On the other hand, the Tokyo Stock Exchange (TSE) decided to require at least one outside director on the boards of listed firms and to establish the "comply or explain" rule on this issue. The enhancement of the auditor system was in the form of the newly created Kansa-kantoku Iinkai (audit and supervisory committee), which is a kind of intermediate system between companies with an auditor and companies with a committee system.

3. Japanese Corporate Governance from Diverse Theoretical Perspectives

Although corporate governance research is in the unique position of having direct influence on corporate governance practices through the careful drawing of implications from theory and empirical studies, the fact is that the practices employed by corporations are not always consistent with the guidance provided in the extant literature (Daily, Dalton, & Cannella,Jr., 2003). Especially in Japan, the gap between practices and guidance that stems from theories and empirical studies seems relatively wide. In other words, it may be easier to explore the gap, observe the mechanism, and determine the reasons. Hence, Japanese firms may be better samples in the investigation of governance mechanisms.

With respect to the theories, although studies of corporate governance have been dominated by agency theory (Darton, Dairy, Certo, & Roengpitya, 2003), some governance studies have been based on a wide range of theoretical perspectives (Daily, Dalton, & Cannella,Jr., 2003). Eisenhardt (1989) insisted that while agency theory can present a valid view, additional perspectives could help to capture the complexity of organizations. I therefore take a multitheoretic approach, using the perspectives of agency theory, stewardship theory, bundle theory, and resource dependence theory to explore the gap between practices and guidance and to determine how governance mechanisms work in

Japan. Each of the following sub-sections describes one of the above theories. In each sub-section, a brief explanation of the theory and its main points is followed by the analysis of the present state of Japan through the lens of that theory.

3.1 Understanding Japanese Corporate Governance from an Agency Theory Perspective

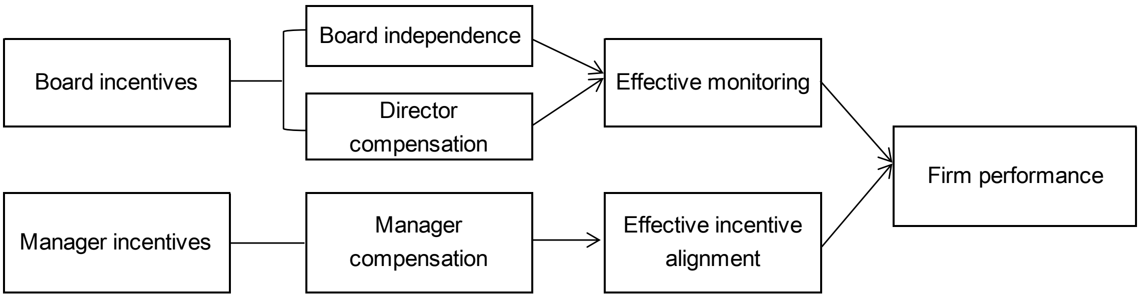
3.1.1 Agency theory

The empirical research on corporate governance has been predominantly based on agency theory, which assumes that humans are rational actors that seek to maximize his or her individual utility (Jensen & Meckling, 1976). The modern corporation is viewed as a nexus of contacts between principals (risk-bearing shareholders) and agents (managers with specialized expertise) (Aguilera & Jackson, 2003). According to agency theory, firms will operate more efficiently and perform better by managing the principal–agency issue between shareholders and managers. Because not only principals but also agents are motivated by the opportunities for their personal gain in the modern corporation, which typically has multiple owners, agents will rationally maximize their own utility at the expense of their principals when the interests of the principals and the agents diverge (Davis, Schoorman, & Donaldson, 1997). Because it is difficult for principals to predict the agents' self-serving behaviors in advance, it is realistic and sensible for principals to limit the potential losses to their utility (Williamson, 1985). Therefore, the goal of agency theory is to reduce the agency costs that are incurred by principals when the interests of the principals and the agents diverge, by imposing internal controls to hold the agents' self-interested behavior in check (Jensen & Meckling, 1976).

Although external control mechanisms, such as buyouts and divestitures will appear to control self-serving managers in cases where the internal control mechanisms have failed, internal mechanisms are generally preferred because they are cheaper than the external mechanisms (Walsh & Seward, 1990). In order to minimize agency costs incurred by addressing conflicts of interest between the principal and the agent, agency theorists emphasize the board's monitoring function, which monitors the managers on behalf of the shareholders (Fama & Jensen, 1983) such that it improves the firm's performance (Fama, 1980).

In addition, agency theorists understand that boards vary in their incentives to monitor managers and suggest that if the incentives are aligned with shareholders' interests, boards could be more effective in monitoring management teams to improve firm performance (Fama, 1980; Jensen & Meckling, 1976). What are the main drivers for the board's incentives? Agency theory research has determined two factors as board incentives: board independence and director compensation (Hillman & Dalziel, 2003).

Agency theorists also regard managerial incentive as another important pillar in addressing agency problems in the internal control mechanism. This is a reward system for the alignment of incentives with shareholders, which will directly influence firm performance. Therefore, in addition to monitoring by the board, managerial incentives that are aligned with the interests of the shareholders are needed as an internal control mechanism to address agency issues (Fama & Jensen, 1983).



The author made this model by partially reference to Hillman & Dalziel (2003).

Figure 1. Model of board and manager incentives from the perspective of agency theory

In the following sections, I will discuss three important factors—board independence, director compensation, and manager compensation—which support monitoring and incentive alignment effectively and analyze them in the context of the current state of Japan.

3.1.2 Board independence

Agency theorists consider that boards composed mainly of insiders or dependent outside directors who have business or personal relationships with members of the management are less effective in monitoring (Lynall, Golden, & Hillman, 2003) because dependence on relationship may compromise the inside and dependent outside directors of the management. Directors must act on the behalf of shareholders when the shareholders' interests oppose those of the management (Hillman & Dalziel, 2003). That is, dependence on a CEO or organization can be a disincentive for directors to act in the interests of shareholders.

On the other hand, independent boards consisting primarily of independent outside directors are the most effective at monitoring because they do not have the disincentive described above, and they do not have to compromise the CEO or organization (Lynall, Golden, & Hillman, 2003). Instead, independent outside directors have incentives not to compromise the CEO or organization because they are concerned about their reputations as experts in corporate governance (Fama & Jensen, 1983). As I discuss below, according to agency theory, Japanese corporate boards are not constructed to encourage independent board monitoring.

3.1.3 Japanese corporate boards

There are two types of listed firms in Japan—companies with auditors and companies with committee. The former comprises 98 % of all publically owned companies in Japan. It is unique situation because board plays both an execution and a monitoring role. Moreover, it simultaneously places management in a monitoring role not only of the board but also of the company’s auditors. Self-monitoring is ineffective, which is the reason that auditors also have a monitoring role under this system. For whatever reason, in the Japanese system, corporate auditors also have a monitoring role. However, under this systems, as monitors, these two players, director and auditor, might not properly act in the shareholders’ interests for the reasons that I outline below.

Director: Distinctive insider-dominated and dependent board. Almost all other advanced economies require firms to have a certain independence from the outside director on the board, either by law or by listing rule. In Japan, however, the Companies Act does not require firms, except companies with a committee system, to have a mandatory outside director, whereas the Cadbury Code requires at least three independent directors per firm in the UK, and the NYSE mandates a majority of independent outside directors among the members of a board. In addition, Companies Act of Japan does not restrict the appointment of outside directors who are former directors and managers of the parent companies, close members of the families of directors and managers, and concerned personnel of an important business partner, despite they are not suitable as monitors on behalf of all shareholders. Thus, in Japan, there remains a lax standard for the independence of outside directors. The listing rules of the TSE also do not have a rigid standard of the independence of outside directors although the US does in the form of the Sarbanes-Oxley Act (2002). Actually, the average number of outside directors per company is only 1.02 for all TSE listed firms (TSE, Inc., 2013). In addition to the few outside directors per firm, Japan generally maintains the low independence of outside directors. Institutional Shareholder Services (ISS), a leading proxy advisor, reported the ratio of independent outside directors to board from 2011 to 2012 was 72% in the US and 68% in Germany, whereas it was only 15% in Japan even if independent outside auditor included (Nikkei Shimbun, 2014). According to a report by Legal and General Investment Management (Omi, 2013), one of Europe's largest institutional asset managers and a global investor, compared to non-Western Asian countries, such as Korea, Singapore, and Hong Kong, Japan maintains a distinctive, highly homogenous board composition, which is dominated by insiders and dependent outsiders. It reports that insiders and dependent outside directors account for more than 90 % of board members of listed firms in Japan, whereas they account for approximately 40 % in Korea, less than 50 % in Singapore, and approximately 65 % in Hong Kong, respectively.

In addition to little pressure from outside directors, it is very typical in Japan that some directors are responsible for a particular division of the firm (Kubo & Saito, 2008). Consequently, boards that have few or no independent directors are likely to become the place where the CEO adjusts conflicts of interests among divisions, which may foster the board dependence on the CEO. Moreover, as a matter of practice, the top executive decides who becomes a director, including outside directors, so it is natural that the board becomes dependent on the CEO (Saito, 2011). This dominant role of CEOs in selecting directors raises suspicions of about the ability of directors to make independent judgments in managing the firm (Rosenstein & Wyatt, 1990). Although some companies with committees have an independent appointing committee, but these firms are less than 2% among all listed firms in Japan. Finally, because of its dependence among most listed firms in Japan, the board of directors may improperly monitor the firm's CEO.

From the agency theory perspective, this low degree of separation between monitoring and management can cause insider control problems, such as over-investment, delays in restructuring (Miyajima, 2007) and entrenched managers. The low degree of separation may also be a remote cause of the distinctive low ROE of Japanese firms. Agency theorists consider that the more independent on management the outside director is and the more outside directors there are on the board, the higher the degree of separation. Without a high degree of separation, it is very hard for the board to function according to agency theory, which assumes that the board keeps the agents' self-interested behavior in check. Thus, in Japan there is considerable room to improve board independence, which is a crucial precondition for effective monitoring, according to agency theory.

Corporate auditors. In Japan, some people insist that the Japanese postwar board system, that is, the "company with auditors" system, works well enough in monitoring management (Keidanren, 2009; Nikkei Shimbun, 2005). In addition, many firms claim that the adoption of independent outside auditors would increase independent oversight (Ahmadjian & Okumura, 2011). However, from the perspective of agency theory, this claim is not valid for the following four reasons.

First, corporate auditors are only in charge of monitoring the illegal behavior by management (Shishido, 2007), which means that if they overlook management's inappropriate business decisions, such as over-investment and delays in restructuring, and these decisions are against the interests of stockholders (principals), their responsibility would not be questioned under this system. Hence, auditors do not have enough incentive to act in the interests of shareholders when they diverge from the interests of management (agents).

Second, corporate auditors have the right to attend board meetings but no power to appoint or dismiss the CEO because they have no vote (Jackson & Miyajima, 2007), which means that even though some highly-motivated auditors warn against or challenge management’s business decisions beyond his/her legal duty, management would have a very weak incentive to listen to the voice of the corporate auditors, even if the interests of shareholders (principals) were at stake.

Third, because corporate auditors are nominated by the board, it is unclear that they represent shareholders or even other stakeholders (Chizema & Shinozawa, 2012). Instead, it can be reasonable for the corporate auditor, whose position was developed as a kind of honorary post for former employees who could not reach management position (Jackson & Miyajima, 2007), not to confront the board and to keep to his/her legal duty of monitoring the board’s compliance with law and reviewing the financial statements.

Finally, based on the above arguments, it is rational that monitoring by corporate auditor only complements the board’s monitoring function. Therefore, the situation would remain the same no matter how independent and outside the corporate auditors were, even if the firm retained outside corporate auditors according to the amendment to the Commercial Code in 2002, which requires a certain number of qualified outside auditors.

To conclude, it is difficult to say that corporate auditors can play a sufficient role in monitoring the management on behalf of the shareholders (principals). Despite these skepticisms, 98 % of publically owned companies in Japan operate according to the corporate auditor system. The remaining two percent have the “company with committees” system, which is the US type. It is a matter of critical importance to stockholders that almost all CEOs in listed Japanese firms support the corporate auditor system.

Nash equilibrium*.* A possible reason that, since 2002, 98 % of publically owned companies have retained the corporate auditor system is that it functions according to the Nash equilibrium. The Nash equilibrium is "a set of actions (or strategies) such that each player is doing the best it can *given what its competitors are doing"* (Pindyck & Rubinfeld, 1995). According to the Nash equilibrium, each player has no incentive to deviate from its Nash action (strategy), which is stable. In brief, almost all CEOs of Japanese listed firms have no incentive to abandon the auditor system and adopt the committee system. In other words, they have no incentive to deviate from their stable Nash strategies, maintaining auditor system in this case. They may consider that by the transformation to a committee system, they have little to gain and much to lose. What do they lose? Certainly, in abandoning the auditor system and adopting the committee system, there may be some switching costs, such as time to establish the new procedures for managing three committees and the budget to search for and compensate outside directors. However, it is logical that the main loss would be discretion in managing the firm without outsiders. Issues of cost can be managed if a firm is serious about transforming to the committee system.

Actually some firms paid the cost and made the transformation successfully. A relevant sample will be introduced in the case study provided in a later chapter.

Divergence from agency theory. The Japanese Companies Act (formerly the Commercial Code) differs from that of Britain and the United States in that it gives the dominant power to shareholders, although the practice is very divergent from the legal prescriptions (Dore, 2000).

Legally, in a company with corporate auditors, the CEO is to be triply monitored by stockholders, directors, and corporate auditors. In addition, stockholders in Japanese listed firms have sufficient formal authority to govern the management team. This is because, based on a resolution at the shareholders' meeting, stockholders can appoint directors who hold supervisory duties over other directors, including the CEO and the corporate auditors who examine financial or operational procedures at the corporation.

In reality, however, the CEO has strong control over at least two parties, the other directors and the corporate auditors, who are expected to monitor the CEO in the Japanese Companies Act. A company with auditors seldom has independent committees for nomination and compensation. It is common that most directors and corporate auditors are insiders who are promoted within the corporation, and a CEO decides their nomination and compensation. Therefore, they have little incentive to correct the CEO's judgments, which may be morally hazardous or against the interests of shareholders. Although the directors and the corporate auditors risk potential lawsuits by stockholders when they fail to prevent the CEO from undermining the shareholder's value, but the risk is insignificant because the CEO's problematic behavior is veiled by the asymmetry of information between the stockholders (principals) and the management team (agents). Moreover, monitoring the CEO's behavior is legally beyond the duties of corporate auditors, as I mentioned earlier. Therefore, the risk to the CEO is relatively small, compared with the other risk of being squeezed out by the CEO.

After the financial crisis in the late 1990s, the main bank, which had been at the center of the corporate governance system, did not enough power to monitor firms, especially large firms that have easily access to capital markets. Under these circumstances, CEOs enjoy discretion in a vacuum of corporate governance (Ahmadjian & Okumura, 2011).

In recent years, the rate of firms' appointing at least one outside director in the first section of TSE has increased by 60% (Ii, 2014). However, the situation that governance mechanisms do not work well has not changed because the average number of outside directors is only 1.02 per one TSE listed firm (Tokyo Stock Exchange, Inc., 2013). Thus, the CEO continues to decide the nomination and compensation of directors and auditors in most firms. As long as the management team is not monitored effectively, that is, the CEO can control directors and corporate auditors through appointment and compensation, the principal-agent problem will not be solved and the suspicion of moral hazard remains. Thus, in Japan most directors, including outsiders, do not play the role assumed by principal-agency theory.

Corporate executive officer (Shikko yakuin) system. The corporate executive officer (Shikko yakuin) system was first launched by Sony in 1997. This system was said to be good for separation of daily management and monitoring. However, it had a hidden agenda. At that time, the size of boards had increased in order to provide senior employees with board appointments, so board meetings tended to lose substance (Buchanan & Deakin, 2009). In this system, firms could demote relatively younger directors to corporate executive officers and reduce the size of the board (Shishido, 2007). Thus, Sony's reforms attracted a number of Japanese firms partly because they could reduce the number of their board members and appear to improve corporate governance through the separation of the executive and monitoring functions (Buchanan & Deakin, 2009). However, the corporate executive officer system has rarely been associated with an increase in the oversight of independent outside directors. Moreover, this system is the same as the previous Japanese board system, in which insiders monitored other insiders (Ahmadjian & Okumura, 2011).

Therefore, not only agency theorists but also most researchers now do not believe that this system can improve corporate governance through the separation of the executive and monitoring functions. In fact, statistics about this system, such as the ratio of the number of firms adopting it, are absent from the latest White paper on corporate governance (Tokyo Stock Exchange, Inc., 2013), although these statistics were regularly included in the white paper only a few years ago.

Companies with the committee system. In 2002, the Corporate Code reform offered another choice of board structure to Japanese firms. The “company with committees” system, which was comparable to the US “company with auditors” system, was a modified traditional system (Aoki, 2007). The introduction of this Anglo-American style governance structure requires three committees responsible for nomination, compensation, and auditing. In addition, outside directors must be in the majority on each committee. Therefore, this structure was expected to make highly separation of monitoring and management in a firm which adopted it and to be one of the most significant reforms in Japanese corporate governance. However, only two percent of the listed firms adopted it, and the reality is that these firms are not very different from firms with the auditor system (Inagami, 2009). Why has the Anglo-American style governance structure not taken hold in Japan?

Compared to companies that use the auditor system, companies using the committee system theoretically have a higher degree of separation between monitoring and management through three mechanisms: three independent committees, a majority of outside directors on each committee, and the board's ability concentration on major policy decisions because it delegates daily management decisions to the management (officers) (Shishido, 2007). However, at the firm level, a very limited number of firms that have adopted the committee system have the degree of separation between monitoring and management that agency theory assumes. For instance, agency theorists assume that both compensation and nomination committees do not have a CEO because the CEO has the heaviest responsibility in managing a firm and is the most important person who is evaluated, which means that the committees have a conflict of interests with the CEO. Nevertheless, in many firms that have adopted the committee system the CEO is a member of the nomination and compensation committees.

Table 1 provides a list of the composition of the boards and committees of all listed companies with committee in Japan. This table is based on a list of companies with committee as of 31 October 2013 provided by Japan Audit and Supervisory Board Members Association (See Table 1). The list includes 57 firms. I look into the degree of independence of each director through external information.

Table 1. Japanese companies using a committee system (as of 31 October 2013)

Name	Year of adoption	Outside director ratio	Independent director ratio of outside directors	Committee		
				Outside director rario of nomination committee	Outside director rario of compensation committee	Outside director rario of audit committee
Hitachi Chemical	2003	5/8	3/5	4/5	2/3	3/4
Konica Minolta	2003	4/11	4/4	3/5	3/5	3/5
Hitachi Metals	2003	3/8	2/3	2/3	2/3	3/4
Hitachi Construction Machiner	2003	3/10	1/3	3/5	2/3	2/3
Hitachi	2003	8/14	8/8	3/4	3/4	3/5
Toshiba	2003	4/16	4/4	2/3	3/5	3/5
Mitsubishi Electric	2003	5/12	5/5	3/5	3/5	3/5
Hitachi Kokusai Electric	2003	3/5	1/3	3/4	3/4	2/3
Sony Corporation	2003	10/13	10/10	5/8	2/3	3/3
Sumida Corporation	2003	8/9	8/8	4/4	3/3	4/4
Hitachi Medical	2003	3/7	1/3	3/4	3/4	2/3
Shizuki Electric	2003	3/7	3/3	2/3	2/3	2/3
Nojima	2003	8/17	1/8	3/5	3/5	3/3
Hoya	2003	6/7	6/6	6/6	6/6	6/6
People	2003	4/6	1/4	2/3	2/3	4/4
Hitachi High-technologies	2003	4/6	2/4	4/5	2/3	2/3
Parco	2003	6/8	4/6	4/5	4/5	4/4
Aeon	2003	5/9	5/5	3/4	3/4	4/4
Risona Holdings	2003	6/10	6/6	3/3	3/3	2/3
Hitachi Capital	2003	3/6	1/3	2/3	2/3	2/3
Orix	2003	6/13	6/6	5/5	5/5	4/4
Nomura Holdings	2003	6/11	6/6	2/3	2/3	2/3
Ichiyoshi Securities	2003	4/7	4/4	2/3	2/3	3/3
Hitachi Transport System	2003	3/7	1/3	2/3	2/3	2/3
Gakkyusha	2003	3/5	1/3	3/4	3/4	3/3
Eisai	2004	7/11	7/7	3/3	3/3	3/5
S.T. Corporation	2004	5/9	2/5	3/5	2/3	4/4
Nihon Seiko	2004	4/12	4/4	2/3	2/3	2/3
Fuji Seal International	2004	3/9	1/3	3/4	3/4	3/3
Shaklee Global Group	2004	6/8	1/6	2/3	3/3	3/3
Daiwa Securities Group	2004	5/12	5/5	4/6	3/5	3/4
Miraka Holdings	2005	6/9	5/6	3/4	5/6	5/5
Eiken Chemical	2005	3/7	3/3	3/5	3/5	3/4
Sosei Group Corporation	2005	4/5	1/4	2/3	3/3	3/3
Ota Floriculture Auction	2005	5/7	1/5	4/5	4/5	2/3
Mani	2005	4/7	4/4	2/3	3/3	3/3
Kabu.com	2005	5/7	2/5	3/3	3/3	4/4
Daikyo	2005	4/8	3/4	4/6	4/6	4/4
Ichigo Holdings	2006	7/10	7/7	3/5	3/5	3/3
MontaRO	2006	5/7	4/5	3/3	2/3	3/3
Gaiax	2006	3/5	2/3	2/3	3/3	3/3
Kuroda Electric	2006	3/5	1/3	3/4	3/4	3/3
Fukui Bank	2007	3/9	3/3	2/3	2/3	2/3
Eighteenth Bank	2007	2/7	2/2	2/3	2/3	2/3
Oracle Japan	2008	6/8	2/6	3/4	3/4	6/6
NSG Group	2008	4/8	4/4	4/5	4/5	4/4
Cookpad	2009	4/7	4/4	4/5	4/5	4/4
Showa Holdings	2009	3/8	1/3	2/3	2/3	3/3
CCS	2009	4/6	1/4	2/3	3/4	3/3
Tasaki	2009	6/9	1/6	2/3	3/3	3/3
Fidea Holdings	2009	5/11	5/5	2/3	2/3	2/3
GNI	2010	4/7	1/4	2/3	2/3	2/3
Carchs Holdings	2010	4/9	1/4	3/3	3/3	3/3
LIXIL Group	2011	4/10	4/4	2/3	2/3	2/3
Tokyo Electlic Power	2012	6/11	6/6	3/5	3/3	2/3
Japan Exchange Group	2013	8/14	8/8	3/5	2/3	2/3
Monex Group	2013	5/10	5/5	2/3	2/3	2/3

…A majority of outside directors

…All are outside directors

From the perspective of agency theory, board independence is strengthened in cases where a firm has compensation and nomination committees that are entirely comprised of outsiders. It is desirable that these two committees do not include the CEO as a member (Mir & Seboui, 2008). However, there are only three firms in which all outside directors and all members of the three committees are independent. In two of these firms all outside directors and all members of two committees, nomination and compensation, are independent. With respect to board composition, 34 firms have the majority of outsiders. Only eight companies have all outsiders on their committees although the members of the nomination committee are not always independent. Moreover, outsiders make up the compensation committees of only 13 firms. The CEO of the large remaining number of firms is a member of the nomination and compensation committees. In short, these observations indicate that even among companies that use the committee system, a very limited number of firms maintains a high degree of separation between monitoring and management. Hence, it would be very hard to eliminate the influence of a top executive in corporate governance systems in Japan. This may be one of the reasons why few firms have adopted the committee system which does not theoretically allow managerial discretion in Japan.

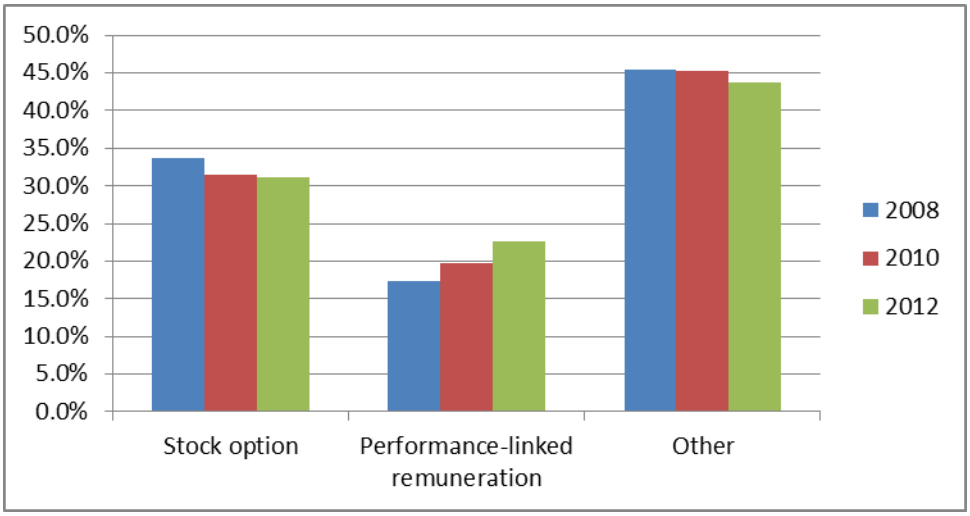
3.1.4 Director compensation

As discussed in section 3.1.1, directors could function as effective monitors of the management team if the incentives were aligned with shareholders' interests. Agency theory assumes that when board members, especially insiders, hold a substantial equity stake in the firm, they are more likely to act on behalf of the shareholders. On the contrary, if they do not have equity holdings in the firm that they serve, they are more likely to act opportunistically, such as supporting projects that ensure their own interests and job security at the shareholders' expense (Himmerlberg, Hubbard, & Palia, 1999). Therefore, director compensation is important for the effective monitoring of management. In the next section, I will outline the actions taken by Japanese firms.

3.1.5 Japanese director compensation

Most Japanese listed firms may fail to align with the incentives of the directors and the shareholders through its compensation systems, based on the following observations.

Weak incentives. According to the TSE-Listed Companies White Paper on Corporate Governance 2013 (See Figure 2), firms adopting a stock-based or performance-based compensation system for directors remain minority in TSE-listed firms. Although companies implementing any initiative to offer incentives to their directors account for 87.2% of TSE-listed firms, stock option plans and performance-linked remuneration are introduced in just 31.1% and 22.7%, respectively, of the firms. "Other" means that firms consider business performance and officer's contributions when deciding the annual bonuses of officers. However, it is common in Japan to regard this annual bonus as a kind of fixed pay. For instance, in Japan, it is usual to apply the annual bonus to the mortgage repayment. In addition, this annual bonus is usually sensitive to a firm's annual performance but insensitive to individual annual performance. These facts demonstrate that the annual bonus is a part of fixed pay. Accordingly, in Figure 2, "Other" is not the incentive to contribute to proactively monitoring the alignment of the interests of shareholders and managers. Thus, the incentive alignment system of board members in Japan is weak.



TSE-Listed Comapnies White Paper on Corporate Gvernance 2013

Figure 2. Implementation of initiatives to offer incentives

Bank's influence. In firms that depend on debt finance, it is possible that the risk-averse tendency of the directors is exacerbated by the influence of banks because both have the same interests. Banks are likely to wish that borrowers would avoid risky projects and achieve a better status quo as long as the repayment goes as planned. Not only banks but also directors cannot benefit from higher profits by taking on high risk projects under their current compensation design that I reviewed above. The historic fact that banks used to influence corporations in postwar Japan could also contribute to enforcing the risk-averse tendency to firms. For instance, banks used to be the main supplier of outside directors when the latter were uncommon. They also were the largest stockholder of approximately one-sixth of listed firms in the first section of the TSE (Hoshi & Kashyap, 2001). Even now, in firms that depend on debt finance, it is typical that the directors, especially those at the top, could serve their term as long as the main banks were satisfied. This risk-sharing issue arises when the principal and agent have different attitudes to risk (Eisenhardt, 1989). The problem here is that the principal and the agent may prefer different actions because of their different risk preferences, which may be attributes to the bank's strong influence. In summary, most director compensation systems in Japan do not effectively work for monitoring on behalf of shareholders.

3.1.6 Manager compensation

Agency theory provides the rationale that firms will operate more efficiently and perform better when managers' interests are aligned with those of shareholders, through managerial equity holdings (Darton, Dairy, Certo, & Roengpitya, 2003). In particular, managerial equity holdings, combined with stock options, are often considered the most direct financial incentive to align managerial interests with those of shareholders (Kubo & Saito, 2008). In fact, agency theorists support that granting options is consistent with firm value maximization (Core & Guay, 1999; Rajgopal & Shevlin, 2002). However, stock-based executive compensation requires attention to the risk of the side effects. Hanlon, Rajgopal, and Shevlin (2003) found that executive stock options were associated with increased performance outcomes and with increased stock return volatility, which means increased risk-taking. Linking management compensation to stock prices may have ill effects that lead managers to abuse their position by manipulating the stock prices of their firms by financial window-dressing (Bergstressera & Philippon, 2006). Indeed, many recent studies have shown that a higher extent of stock-based compensation induces more earnings management (Bergstressera & Philippon, 2006; Cheng & Guay, 2005). Louis (2000) suggested that when CEOs are given too much compensation in stock options, they concentrate too much on stock prices, resulting in a perverse incentive to raise the stock prices, particularly when the CEO wants to exercise his/her options. This, however, does not mean that stock-based compensation generally results in a perverse effect, but it does mean that careful consideration of the potential risk is always required to apply high-powered incentives, such as stock-based compensation (Bergstressera & Philippon, 2006).

3.1.7 Japanese manager compensation

According to the results of the survey described below, it is likely that most Japanese listed firms have never aligned with the incentives of managers and the shareholders to mitigate the agency problem through its compensation systems.

Negative incentive. In 2013, the Japan Association of Corporate Directors (JACD) released a comparative report of the compensation of the CEOs of major companies, which sold more than trillion yen annually in the United States, Britain, and Japan. Although this report is about the compensation of CEOs, it may prove useful in the evaluation of other managers because their compensation is similar to that of CEOs. In brief, the results of the survey showed that the compensation of Japanese CEOs is characterized by an extremely low and outstandingly high ratio of fixed pay. It is surprising that the total volume of compensation for Japanese CEOs is just 11 % and 21 % of that in the US and Britain, respectively. Moreover, it is also astonishing that the fixed pay of Japanese CEOs accounts for 64 % of the total amount of the compensation although that of the US and Britain is just

11% and 22%, respectively. In particular, the composition ratios of other factors in the compensation are a 20 % performance-based bonus and a 16 % long-term incentive, such as stock options in Japan, whereas the ratios are 22% and 67% in the US, and 30% and 48% in Britain (See Figure 3).

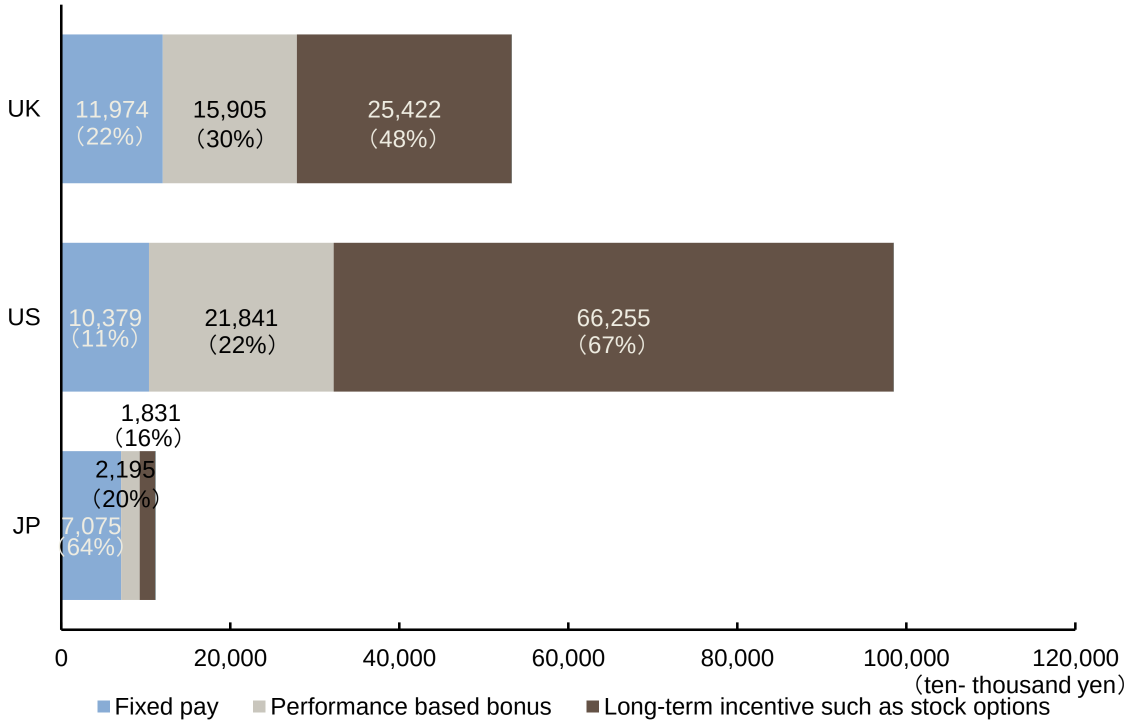


Figure 3. Comparison of the compensation of the CEOs major companies selling more than trillion yen annually in the United States, Britain, and Japan

According to the data, if a CEO of Japanese firm improves performance, he/she could gain a bonus as a CEO on the US or Britain, but it would be smaller in comparison. Kubo (2010) analyzed this topic in detail. He showed how the improvement of a firm's performance affected the increases in top managements' compensation among major companies in Japan and the US. If a CEO improved the rank of the firm he/she served from the 50th to the 70^{th} percentile, the CEO's compensation would increase by approximately USD 200,000 in Japan, whereas, in the US, it would increase approximately by USD 4,000,000, which is twentyfold. That is, the CEO of a Japanese firm is paid far less than a CEO of a US or a British firm as a whole compensation and has a much lower bonus, even when he/she has improved the firm's position in the industry. Under this situation, it is logical that the CEO of a Japanese firm becomes risk averse because the "upside" potential in this compensation system is extremely limited because of the low percentage of performance- and stock-based bonus, whereas the "downside" potential of risk is that a CEO may resign when the performance of a company falls or when a scandal breaks. Even without resigning, in Japan, a CEO often has to reduce the fixed pay by 10% or 30% in the case of a drop in performance or the revelation of a corporate scandal. In addition, the total volume of the CEO's compensation is so small that he/she would become eager to augment his/her terms even by a small annual salary. This could motivate a CEO to hold onto his/her position as long as possible. It could also strengthen the Japanese CEO's tendency to be risk averse, which could even lead him/her to cover a corporate scandal, in the worst scenario.

Hence, logically, a Japanese CEO has the incentive to be risk averse because of the compensation design. Consequently, this design diminishes the incentive to mitigate the conflict of interests between managers and stockholders from the perspective of agency theory. On the other hand, stockholders naturally have an interest in taking on more risk than the managers do. Thus, the compensation system in Japan may encourage CEOs to be risk averse, and the potential conflict of interest between the CEOs and stockholders, that is, the problem of risk sharing, remains.

3.1.8 Conclusion: Japanese corporate governance from an agency theory perspective

From the perspective of agency theory, in most Japanese listed firms, monitoring management may not work well enough for shareholders because the two main drivers of effective monitoring, board independence and director compensation, are not designed and controlled adequately. Hence, in most listed firms in Japan, the board is dependent on the executives, and the compensation system is not designed to work as an incentive. For example, in firms with the corporate auditor system, which comprise 98 % of publically owned companies in Japan, insider-dominated boards have a low degree of separation between the monitoring and management functions, and the directors are compensated by a lower volume of fixed salaries as a larger portion of total income and smaller equity-based incentives. This compensation is less sensitive to firm performance than the compensation paid to their global competitors (Miyajima, 2007). In addition, incentive alignment through the managerial compensation system does not function in Japan. Even in firms with the US-style committee system, the situation differs little from firms with auditors system. A very limited number of firms maintain a high degree of separation between monitoring and management even among companies with committees.

In conclusion, both systems of monitoring and incentive alignment do not fulfil their original functions, as assumed by agency theorists. They do not adhere to the three important factors of the agency theory perspective: board independence, director compensation for monitoring, and manager compensation for incentive alignment.

3.2 Understanding Japanese Corporate Governance from a Stewardship Theory perspective

3.2.1 Stewardship theory

Some researchers have criticized the model of the human in agency theory as individualistic and self-serving, and they have considered that this assumption determines the limits and boundaries of agency theory (Davis, Schoorman, & Donaldson, 1997). For example, according to Jensen and Meckling (1994), the assumptions of agency theory were too simple to describe human behavior, and Doucouliagos (1994) pointed out that categorizing all motivation of managers as self-serving and economic does not cover the complexity of human action. Therefore, a theory developed in areas other than economics and finance is required to explain other aspects of human behavior. In this context, stewardship theory was developed (Davis, Schoorman, & Donaldson, 1997), and it has garnered researchers' interests, not as a substitute but as both a complement and a contrast to agency theory (Daily, Dalton, & Cannella,Jr., 2003). The following sub-section compares agency theory with stewardship theory.

3.2.2 Agency theory vs. stewardship theory

Influenced by sociology and psychology, stewardship theory takes a collaborative approach that is based on the model of an intrinsically motivated, "self-actualizing man." The roots of this model are in the early work of McGregor (1960) and the later work of Maslow (1970) (Davis, Schoorman, & Donaldson, 1997). On the other hand, agency theorists believe that principals (shareholders) have to control agents (managers) because the latter may cause a moral hazard by not being able to diversify their own resources and risks. As a model of man, agency theory assumes that management is self-serving and opportunistic, whereas stewardship theory supposes that stewards can maximize their utility when they achieve organizational goals (Davis, Schoorman, & Donaldson, 1997). That is not to say, however, that stewardship theorists view management as altruistic. Instead, they conclude that managers serve their own interests through serving the interests of organizations and shareholders (Lane, Cannella, & Lubatkin, 1998). While agency theorists deem it necessary to maintain discipline between management and shareholders by monitoring and incentive alignment, stewardship theorists stress service, in which the board advises and delegates management because both sides have relatively strong social ties that foster trust (Sundaramurthy & Lewis, 2003).

Table 2. Comparison of agency theory and stewardship theory

	Agency theory	Stewardship theory
Approach	Control	Collaboration
Theoretical basis	Economics and finance	Sociology and psychology
Model of man and the behavior	Economic man Self-serving	Self-actualizing man Collective-serving
Motivation	Extrinsic	Intrinsic
Management-shareholder relations	Goal conflict Distrust	Goal alignment Trust
Board primary role	Discipline Monitor Incentive alignment	Service Advise Empowerment

The author touched in some details to Sundaramurthy & Lewis (2003).

The choice between agency theory and stewardship theory. As I mentioned above, some researchers have criticized the model of man in agency theory, and there may be “steward-wise” intrinsically motivated managers who are self-actualizing and work toward improving firm performance without monitoring and financial incentives. Should we design corporate governance structure based on stewardship theory or on agency theory? What determines the choice between agency theory and stewardship theory?

Davis, Schoorman, and Donaldson (1997) examined a model (see Figure 4) based on manager–principal choice rather than determinism. They showed that each manager or principal chose to create an agency or stewardship relationship. According to the model, managers choose to act as agents or stewards, based on their psychological motivations and their understandings of the situation, whereas principals choose to create an agency or stewardship relationship, depending on the manager and their perceptions of the situation. When both sides choose a principal–agent relationship, they can meet each expectation and are likely to achieve the expected goal by minimizing the potential costs of the firm. When both sides choose a stewardship relationship, they can maximize the potential performance of the group without cost to the control managers, such as monitoring and incentive alignment. Both combinations of managers and principals (see cells 1 and 4 in Figure 4) can create value for the firm. In particular, when both sides select a stewardship relationship, they are both psychologically satisfied by gaining utility from fulfilling the purposes and goals of the organization. Therefore, the total gains from this combination (Cell 4) are the highest.

However, if a manager and a principal choose different relationships, the side choosing the agency relationship is either disappointed or opportunistic, and the side selecting stewardship is betrayed. For instance, in the case that the principal chooses an agency relationship and the manager selects a stewardship relationship, the manager will be frustrated and feel betrayed by the principal because he/she cannot enjoy the internal rewards, such as self-actualization and personal growth. When, conversely, the principal chooses a stewardship relationship and the manager chooses an agency relationship, the manager will seek his/her own interest at the expense of the principal because the principal will trust the manager and boldly empower him/her without any monitoring. Consequently, the principal is likely to feel betrayed and may increase control or attempt to remove the manager.

Manager's choice	Principal's choice: Agent	Principal's choice: Steward
Agent	Minimize potential costs Mutual agency relationship 1	2 Manager acts opportunistically Principal is angry and betrayed
Steward	3 Principal acts opportunistically Manager is frustrated and betrayed	4 Maximize potential performance Mutual stewardship relationship

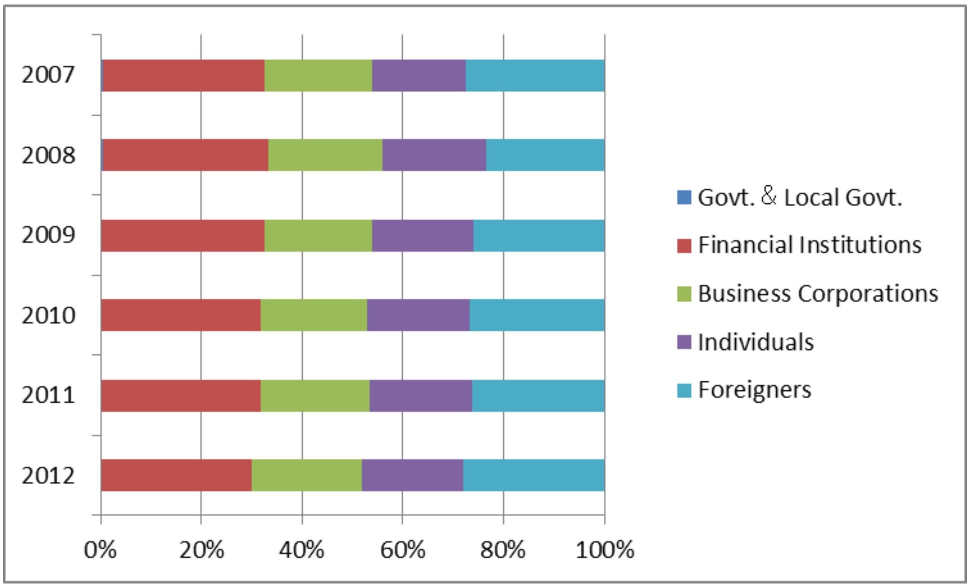
Figure 4. Principal–manager choice model (Davis, Schoorman, & Donaldson, 1997)

Nash equilibrium. Nash (1951) proves that two-person, non-cooperative games always have at least one equilibrium. The highest joint utility (Figure 4, cell 4), shows a mutual stewardship relationship, while the least risk in the betrayal of expectations (Figure 4, cell 1) determines a mutual agency relationship (Davis, Schoorman, & Donaldson, 1997). Although Davis, Schoorman, and Donaldson (1997) did not clearly describe it, the mutual agency relationship (cell 1) represents the Nash equilibrium and is the best choice for both parties. In other words, this choice can minimize the risk of betrayal by the other side, regardless of the choice of the other party. Hence, this is the best and the most realistic choice for both parties under a situation in which the choice by the other party is unknown.

3.2.3 Japanese firms from the stewardship theory perspective

Based on the above analysis, which uses a model of game theory, it is unreasonable to adopt stewardship theory in designing a system of the corporate governance of Japanese listed firms, particularly because the majority of the shareholders of the listed firms in Japan may adopt an agency theoretic stance, as I will explain below.

Ruling idea among stockholders in Japan. A block of shareholders, which is calculated by adding financial institutions and foreign investors, is has the majority of stock ownership of all listed firms in Japan (Figure 5). Their standards of behavior to the issuers are considered influenced by agency theory. It may might be unrealistic to assume that all investors would choose stewardship theory, based on the following evidence. Therefore, it is best that issuers in Japan design a corporate governance system based on agency theory, even if some are unwilling to do so.



(TSE)

Figure 5. Stock ownership ratio by investors' category

Foreign investors. Foreign investors account for more than one quarter of all listed stocks in Japan, and they are obviously the main players in Japanese stock exchange markets (Figure 5). As Ahmadjian and Robbins (2005) pointed out, foreign investors sold and bought stocks so frequently that they influenced the market and the issuers more than Japanese institutional investors (i.e., nearly equal to "Financial Institutions" as shown in Figure 5) did. They took advantage of this position to increase their presence, and thus they have exerted influence over Japanese listed firms (Ahmadjian & Robbins, 2005). Consequently, foreign investors have a distinctive presence in Japan.

It is obvious that their principles are based on agency theory. Their proxy voting for Japanese firms was examined through "N-PX" filings, which are annual reports of proxy voting records for mutual funds and other registered management investment companies issued by the U.S. Securities and Exchange Commission. As previously discussed, agency theorists consider two main points: board independence and director compensation as board incentives (Hillman & Dalziel, 2003).

Some data in N-PX suggests that foreign investors in Japan are interested in board independence and compensation strucure. According to N-PX, in 2013 they opposed the independence of outside directors, outside corporate auditors, and spare outside corporate auditors in the ratios of 8.8%, 41.6%, and 15.6%, respectively. Fujimoto (2013) showed that some foreign investors have much stricter standards of independence in approving outside directors and corporate auditors than famous proxy voting advisors such as Glass,. Lewis and Co. (GL) and ISS do. GL announced an advising policy to vote against the proposal to appoint a CEO of firms that do not have at least two independent outside directors (Stroud, 2012). ISS released a recommendation to oppose the proposal to appoint a CEO of a firm that does not have any outside directors (Ishida, 2013). However, foreign investors in Japan seem to welcome compensation as a mean of incentive alignment. According to N-PX, concerning adopting a stock option, they approved the proposal of the stock option which is designed the market price as its exercise price[1], at 89.5%.

Institutional investors. On the other hand, Japanese institutional investors (nearly equal to "Financial Institutions" as shown in Figure 5 have become driven to comply with agency theoretic ideas about proxy voting because of the build-up of external expectations and pressure. For example, the Japanese government compiled principles (i.e., the Japanese version of the UK stewardship code) by which institutional investors can fulfill their fiduciary responsibilities.

These facts demonstrate that a major block of the principles in Japanese listed equity market, foreign investors, and Japanese institutional investors is based on or will be based on agency theory, not stewardship theory.

3.2.4 Conclusion: Japanese corporate governance from a stewardship theory perspective

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[1] There are two types of stock options recently in Japan. One is a traditional type which is set market price as its exercise price. The other is called one yen stock option which is set 1 yen as its exercise price, meaning that this has almost the same effect as giving new stocks freely. In most cases, the latter options replace retirement benefits for officers and directors (Nikkei Shimbun, 2013). According to N-PX, the foreign investors approved the proposal of adopting the former at 89.5%, whereas they did that of the latter at 79.9%.

The mutual agency relationship between shareholders and managers is represented by the Nash equilibrium (sub-section 3.2.2) and is the best choice for the both parties. This means that agency theory is preferred over stewardship theory in designing a corporate governance system. In addition, the majority of shareholders of listed firms in Japan are likely to choose agency theory (sub-section 3.2.3). Therefore, I conclude that it is reasonable to take agency theory in designing the corporate governance system in Japan.

3.2.5 Implications

Although some advocate that Japan should not comply with the Anglo-American form of corporate governance, which is based on agency theory, but create and adopt a Japanese style of corporate governance. According to Lee and O'Neill (2003), culturally Japan may fit stewardship theory. Itami (2000) insisted that Japan should create a Japanese style of corporate governance that is adopted to Japanese social and economic conditions and is accepted by Japanese society. These views do not account for the fact that a quarter of the listed stocks are owned by foreign investors who buy and sell the stocks without any regard for stewardship theory or a unique Japanese style of corporate governance.

However, there remains the credible concept that mutual stewardship can provide the highest joint utility between shareholders and managers. In addition, “steward-wise” managers who are self-actualizing contribute to improving firm performance without being monitored and receiving financial incentives may exist. Therefore, it would be possible to create another stock exchange market exclusively for shareholders and managers who are stewardship adherents. In this market, theoretically there would be no opportunistic managers and betrayed stockholders and vice versa. However, even if shareholders and managers who are stewardship theorists have a mutual trustworthy relationship, managers could fail to fulfil their duties and shareholders could lose money, as could occur in a firm based on the mutual agency relationship. Hence, it is possible that shareholders would feel betrayed even in the stewardship market. This feeling may have a negative effect on maintaining the trusting relationship between the shareholders and the managers. Therefore, it is doubtful that stockholders would stay in this market.

3.3 Understanding Japanese Corporate Governance from a Bundle Theory Perspective

3.3.1 Theory of bundles of corporate governance mechanisms

Agency theory predicts that when managerial equity holdings are low and particularly when equity holdings are dispersed, the demand for monitoring by outside directors will be high (Jensen & Meckling, 1976) (Fama & Jensen, 1983) (Jensen, 1993). On the other hand, as managerial equity holdings increase, the effects of the incentive alignment between managers and shareholders will reduce the demand for monitoring by outside directors (Peasnell, Pope, & Young, 2003).

Rediker and Seth (1995) incorporated this idea and introduced the concept of a bundles of corporate governance mechanism in which firm performance depends on the effectiveness of the bundle of corporate governance mechanisms, such as incentive alignment and monitoring management, instead of on the effectiveness of any single mechanism. They also verified the effects of substitution on incentive alignment and board monitoring. If incentive alignment works well such that the best interest for managers is synchronized with that of shareholders, the need for board monitoring will be reduced and vice versa. In other words, the two corporate governance mechanisms are substitutable (Figure 6).

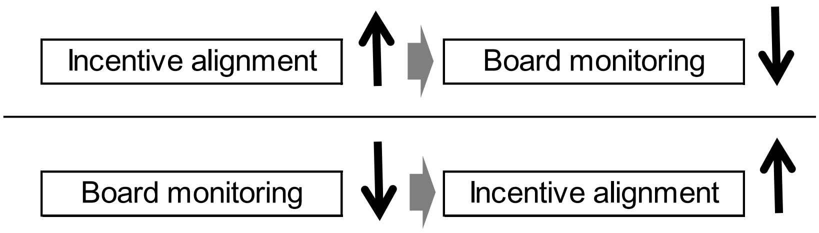


Figure 6. The substitution effect

Ward, Brown, and Rodriguez (2009), however, proposed that adding one mechanism would enhance the other and lead to more effective governance because one plus one equals more than two. That is, incentive alignment and board monitoring do not always carry out substitution functions, but in certain environments work in a mutually complementary manner to solve the agency problem (Figure 7).

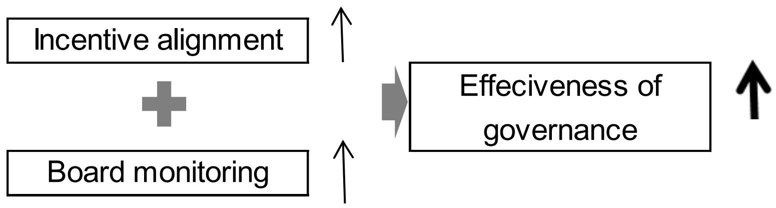


Figure 7. The complementary effect

For instance, as a collective representative of shareholder interests, independent and active boards can be expected to work well in monitoring managerial business decisions. However, the board can also function to prohibit managers from re-pricing stock options when business performance worsening or to modify performance targets that trigger performance-based bonuses. In other words, adding or strengthening monitoring facilitates the improvement of incentive alignment, thus avoiding moral hazard behaviors by managers. Alternatively, adding or enhancing incentive alignment can improve the effectiveness of monitoring because an independent board can focus on core areas, such as the feasibility of business plans, without worrying about moral hazard issues. Thus, the addition of one mechanism strengthens the other and leads to more effective governance; one plus one equals more than two. Will the two corporate governance mechanisms, incentive alignment and monitoring, act as substitutes or complements? What stimulates the mechanisms?

Based on bundle theory, Ward, Brown, and Rodriguez (2009) identified the relationship between incentive alignment and monitoring the effectiveness of corporate governance. They used four propositions to show how firm performance is an important contingency in determining when these mechanisms will act in a substitutable or complementary fashion. They applied indifference curve analysis to explain the substitutability and complementability of corporate governance mechanisms. However, for the sake of simplicity, I will explain them without using indifference curve techniques. Instead, I will describe their work in greater detail by using indifference curve analysis to explain the mechanisms that they used (see Appendix 2).

Firm performance as a determinant of governance bundles. As cited above, Ward, Brown, and Rodriguez (2009) proposed that firm performance affects the provision of governance mechanisms within the governance bundle and determines whether the mechanisms within the bundle work as substitutes or complements. They proposed four propositions about structures, based on scenarios of performance. I will explain these four propositions and apply three of them to analyze the present state of Japanese corporate governance.

Proposition 1. “In firms with good corporate performance, the internal governance mechanisms of monitoring and incentive alignment will act as substitutes in maintaining an effective governance bundle” (Ward, Brown, & Rodriguez, 2009).

For example, when the firm’s stock prices is rising because of good performance, the firm may substitute more stock options (incentive alignment) for less monitoring because the relative cost of stock options is decreasing. The firm can then maintain or potentially reduce overall costs while maintaining the same level of effective governance. Peasnell, Pope, and Young (2003) claimed that as managerial stock holding increases, its incentive alignment effect would reduce the need for monitoring by outside directors. Zajac and Westphal (1994) also provided evidence of a negative relationship between managerial stock holding and the proportion of outside directors.

The same mechanism works according to Proposition 1. For instance, firms decrease the number of independent directors to substitute less monitoring for more stock options (incentive alignment) in the above situation.

Proposition 2. “The lower the performance of the firm, the greater the proportion of monitoring relative to incentive alignment used to achieve an equally effective governance bundle” (Ward, Brown, & Rodriguez, 2009).

For instance, when a firm's stock prices are falling because of poor performance, the firm may substitute more monitoring for fewer stock options (incentive alignment) because poor performance makes incentive alignment less efficient and more expensive to maintain the same level of effectiveness. If the firm can then decrease monitoring costs and simultaneously increase monitoring activity by adding new independent outside directors, for example, the firm can maintain the same level of effectiveness of governance.

However, if the cost of monitoring remains constant and the firm cannot increase its monitoring activity, it must reduce the overall effectiveness of the governance bundle, and the firm is limited to staying at a lower level of effective governance.

Proposition 3. "In firms with poor corporate performance, external monitoring by shareholders can prompt the internal governance mechanisms of monitoring and incentive alignment to act as complements for a more effective governance bundle" (Ward, Brown, & Rodriguez, 2009).

For example, when shareholders worry about poor firm performance, they can facilitate external monitoring to enhance the effectiveness of the board not only in internal monitoring but also in redesigning and improving incentive alignment. This external pressure by concerned shareholders serves to increase the efficiency of the mechanisms in a governance bundle, thus reducing the unit costs of the both mechanisms. Therefore, the activist approach through external monitoring, which can have a complementary effect on the firm's governance bundle, could be a more efficient option for investors than selling the stocks of the firm when its performance is poor. It seems obvious that boards should judge whether the actual request by the concerned shareholders is consistent with the shareholder's common interests.

Proposition 4. "In firms heading towards bankruptcy and under managerial entrenchment, the internal governance mechanisms of monitoring and incentive alignment will not act as complements, and the effectiveness of the firm's governance is likely to decline" (Ward, Brown, & Rodriguez, 2009).

The results of an empirical study by Walsh and Seward (1990) suggested that firms heading toward bankruptcy are disturbed by a downward spiral of their governance mechanisms, with an increase in managerial entrenchment and a decrease in the potential intervention through the market for corporate control. Under such conditions, even external pressure by concerned shareholders, which as stated in proposition 3 can successfully increase the efficiency of mechanisms in a governance bundle, is less likely to have a positive complementary effect because boards become not only less diligent as monitors but also less independent. Moreover, outside directors tend to leave the firm without being replaced (Hambrick & D'Aveni, 1992), which entrenches the management further and reduces its receptivity to external pressure (Ward, Brown, & Rodriguez, 2009).

When the firm is under poor performance and managerial entrenchment, both the unit costs of monitoring and incentive alignment are likely to increase. If the firm cannot maintain effective monitoring at the existing cost (e.g.,, the independent directors leave the board without being replaced.), the effectiveness of governance would be beyond the minimum governance level.

3.3.2 Japanese firms from perspective of governance bundles

I applied the above propositions in governance bundle theory to analyze the situation of Japanese corporate governance. The results showed that from perspective of the governance bundle theory, Japan might be in a serious condition regarding the effectiveness of governance.

Through the lens of Proposition 2. Proposition 2 states that "The lower the performance of the firm, the greater the proportion of monitoring relative to incentive alignment used to achieve an equally effective governance bundle" (Ward, Brown, & Rodriguez, 2009).

Because the stock prices of Japanese listed companies are generally in a slump (see Figure 8), it is likely that the unit cost of incentive alignment has hovered at a relatively high level.

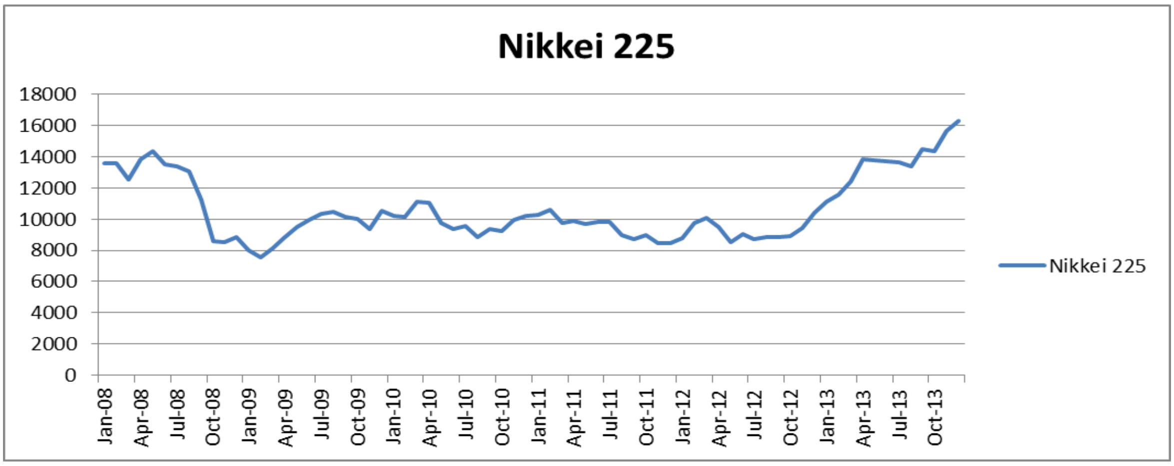


Figure 8. Prices of Nikkei 225 (2008–2013)

(Bloomberg)

Accordingly, the firm may substitute more monitoring for fewer stock options (incentive alignment). Then if the cost of monitoring is consistent and the firm cannot increase its monitoring activity, it has no choice but to reduce the overall effectiveness of the bundle, and the firm is limited to remain at a lower level of effective governance. According to the TSE-Listed Companies White Paper on Corporate Governance (2013), although in 2010 the TSE required that each listed firm appoints one independent director or at least one auditor, the number of independent directors and auditors did not dramatically increase in all TSE-listed firms in 2012 (see Figure 9), which means almost all firms in the

TSE have not increased their monitoring activity by appointing independent directors and auditors to offset the decrease in value of incentive alignment, which I discuss above.

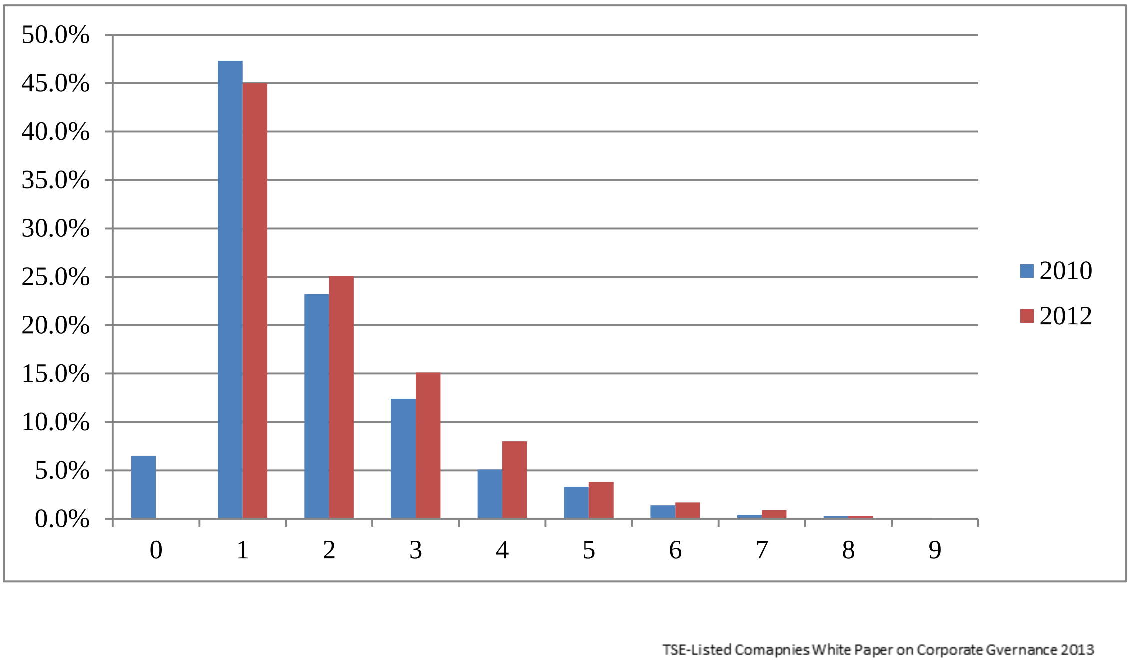


Figure 9 Number of independent directors and auditors (2010/2013)

Through the lens of Proposition 3. Proposition 3 states that "In firms with poor corporate performance, external monitoring by shareholders can prompt the internal governance mechanisms of monitoring and incentive alignment to act as complements for a more effective governance bundle" (Ward, Brown, & Rodriguez, 2009).

As I discussed above, external pressure by concerned shareholders induces firm discipline and increases the efficiency of mechanisms in a governance bundle, thus reducing unit costs of the both mechanisms, or at least reducing the unit cost of monitoring.

Therefore, the activist approach through external monitoring can have a complementary effect on the firm's governance bundle.

Weak external mechanisms. However, in the Japanese context, external pressure by shareholders is rarely applied. A wave of takeover threats occurred in Japan in the mid-2000s, but the global financial crisis of 2008–2009 and the famous failed buy-out deals by hedge funds, such as Steel Partners and M & A Consulting, reduced the influence of foreign investors who had keenly advocated governance reform (Ahmadjian & Okumura, 2011). It follows, according to a N-PX report disclosed by The Securities Exchange Commission, more than 599 US investment funds, one of the main foreign investor groups in Japan, voted in favor of the proposals by Nikkei 225 firms at 92.4% and 92%, respectively, in 2013 and 2012. Japanese institutional investors also have still maintained a low-key attitude toward the corporate governance of the firms in which they invested (Ahmadjian & Okumura, 2011). In the result, Japanese listed firms are rarely confronted by their shareholders.

Previous research has investigated managerial labor markets as an external pressure on management, in addition to threat of takeover and monitoring by large outside shareholders (Fama, 1980). However, Japanese listed firms rarely determine the positions of the management or the board, regardless of seniority.

Because there are few external pressures on the listed firms in Japan, as I described above, it is unreasonable to expect that external pressure would have a complementary effect on increasing the efficiency of governance mechanisms in a governance bundle.

Through the lens of Proposition 4. Proposition 4 states that "In firms heading towards bankruptcy and under managerial entrenchment, the internal governance mechanisms of monitoring and incentive alignment will not act as complements, and the effectiveness of the firm's governance is likely to decline" (Ward, Brown, & Rodriguez, 2009).

As discussed in the previous chapter, the boards of almost all Japanese listed firm that are dominated by insiders have a low degree of separation between the monitoring and management functions, and they are compensated by a lower volume of fixed salaries as larger portion of total income and smaller equity-based incentives, which are less sensitive to firm performance. Therefore, the value of two internal governance mechanisms, monitoring and incentive alignment, may remain at the same low level as firms heading towards bankruptcy do. It is, therefore, small wonder that many Japanese listed firms head for decline and under managerial entrenchment.

3.3.3 Conclusion: Japanese corporate governance from a bundle theory perspective

Ward, Brown, and Rodriguez (2009) expanded the governance bundle theory to identify the relationship between incentive alignment and monitoring in effective corporate governance. They proposed that firms should consider the two internal governance mechanisms, monitoring and incentive alignment, as a bundle of mechanisms to protect shareholder wealth, and by using indifference curve analysis, they showed that firm performance is a key determinant of the composition of this bundle. Consequently, they created some propositions to explain the mechanisms. According to the propositions, a certain portion of listed firms in Japan may not reach an acceptable level of effective corporate governance, which may be difficult to improve under current circumstance for the following three reasons.

First, it is difficult to use stock-based compensation for incentive alignment because most stock prices have slumped since the collapse of bubble economy. Second, Japan lacks important external pressures, such as takeover threats and the strong voices of concerned investors, which could have a complementary effect on firms' governance bundles. In contrast, the voices of foreign investors have facilitated the enhancement of effectiveness (Ahmadjian & Robbins, 2005), but they are not so large as to fill the vacuum of takeover threats. Third, small managerial labor markets cannot substitute for takeover threats and the strong voices. Although the lack of these measures in Japan is a weak point, Japanese firms cannot create and control these external mechanisms. Therefore, currently, it is realistic to focus on enhancing internal governance mechanisms, such as adopting performance-based (not equity-based) compensation to promote incentive alignment and appointing independent outside directors for monitoring.

3.3.4 Implications

The propositions discussed above have some implications for practitioners and policy-makers. First, although it may make no sense to discuss incentive alignment and monitoring separately, regarding the enhancement of corporate governance, such discussions often occur. For example, in the context of strengthening the corporate governance of firms, some have stressed only the importance of adopting performance-based bonuses or stock options, whereas others have insisted on increasing the independence of outside directors. However, the two main internal governance mechanisms, incentive alignment and monitoring, should be treated as a bundle. As I have pointed out, the effectiveness of the bundle of governance mechanisms depends on firm performance.

Second, by applying governance bundle theory, local governments may revive firms that remain caught in a downward spiral of governance. For example, temporary subsidies to the compensation of independent outside directors are effective in firms that fail to have a sufficient number of independent outside directors (or enough monitoring) because of increased unit costs of monitoring. The policy of subsidizing these firms could decrease the unit cost of monitoring and increase the efficiency of monitoring, even under poor performance. In order to address the moral hazard issue, subsidies to independent directors must be temporary, and the criteria for the subsidies must be rigid and be limited to once only per firm.

3.4 Understanding Japanese Corporate Governance from a Resource Dependence Theory Perspective

3.4.1 Resource dependence theory

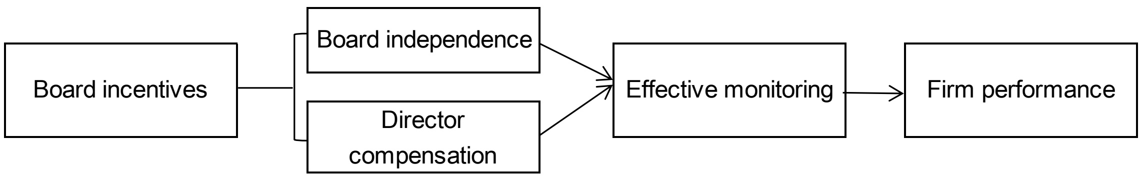
The resource dependence theory is a theory of organization(s) that try to demonstrate organizational and inter-organizational behavior regarding the critical resources that an organization must acquire to survive and function. This theory has sought to explain how organizations reduce environmental interdependence and uncertainty (Hillman, Withers, & Collins, 2009) by using outside directors. Pfeffer and Salamcik (1978) assumed that outside directors provide critical resources under complex business environments. That is, resource dependence theorists regard outside directors not only as monitors of management but also as a relay channel that provides access to resources that are indispensable for the firm's survival and functioning (Daily, Dalton, & Cannella,Jr., 2003). Instead, resource dependence theorists do not emphasize the director's monitoring function, but tend to believe that directors will be selected to maximize the volume of inflow of important resources to the firm and that they may bring different networks and resources to the firm (Lynall, Golden, & Hillman, 2003). In the provision of resources, the board has a wide range of activities, including ensuring legitimacy, providing expertise (including the inside directors' internal knowledge of the firm) (Baysinger, Kosnik, & Turk, 1991), and linking the firm to important stakeholders (Hillman & Dalziel, 2003).

Specifically, resource dependence theorists have examined the relationship between board capital, which consists of both human capital, such as experience, expertise, and reputation, and relational capital, such as networks of important resources, and firm performance (Hillman & Dalziel, 2003). However, the results have been mixed and the relationship remains unclear.

However, aside from the lack of clarity, resource dependence theory is helpful in understanding the relationships among organizations and firms. Nevertheless, this theory underestimates the monitoring function of board, which is deemed significant in agency theory. Thus, resource dependence theory may have limited application in comprehending internal matters, such as the corporate governance of a firm and the relationship between board functions and firm performance. However, the combination of resource dependence theory and agency theory could be very powerful in understanding the function of the firm's board.

3.4.2 Hybrid of agency theory and resource dependence theory

Hillman and Dalziel (2003) proposed that integrating agency and resource dependence theories could provide a better understanding of the factors that contribute to effective monitoring and the provision of resources that lead to good firm performance. As I explain in 3.1.1, agency theory assumes that the board's incentive which has two main components, board independence and director compensation, has a direct relationship with monitoring, whereas Hillman and Dalziel (2003) contended that the relationship between board incentive and monitoring and the provision of resources is indirect (see Figure 10).



Note: This figure is also shown as part of Figure 1.

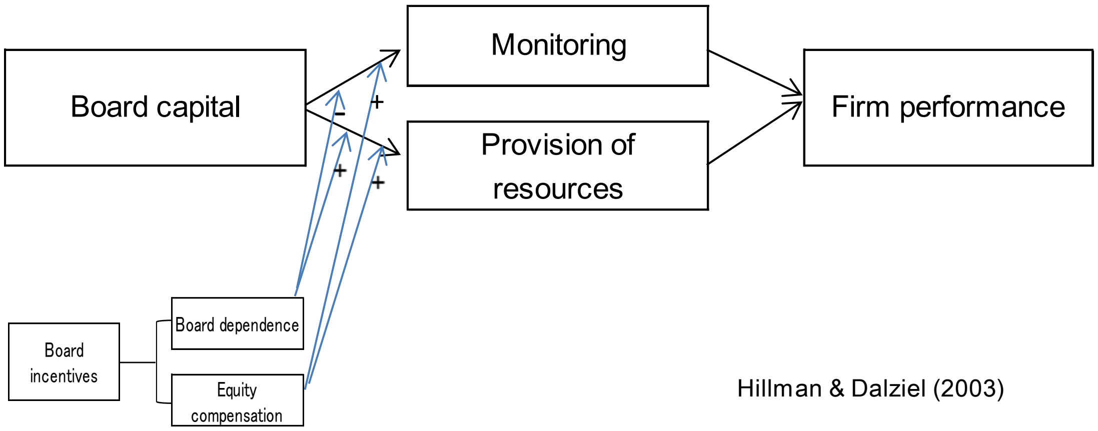


Figure 10. Integrated model of board functions from both perspectives of agency and resource dependence theories (Hillman & Dalziel; 2003)

Hillman and Dalziel (2003) also suggested that board dependence might have a positive effect on the provision of resources. Westphal (1999) found that social ties between the board and the CEO, which can lead to board dependence, increase the frequency of the exchanges of advice and counseling, which improves the firm's performance. However, Hillman and Dalziel (2003) pointed out that from the agency perspective, board dependence may be potentially harmful to monitoring. On the other hand, Hillman and Dalziel (2003) admitted that equity compensation might be beneficial for both monitoring and the provision of resources. Based on these contrasting effects of board dependence on monitoring and the provision of resources, they suggested that the negative effect of board dependence on monitoring might offset the positive effect of board dependence on the provision of resources. They contended that board independence is not a panacea for the effectiveness of corporate governance, in that board independence might have a negative effect on the provision of resources, despite its positive effects on monitoring.

3.4.3 Japanese firms from the perspective of the hybrid of agency theory and resource dependence theory

The opinions of several Japanese firms regarding outside directors may be less from an agency theorist's point of view and more from a resource dependence theorist's point of view. Miyajima, Saito, Peng, Tanaka, and Ogawa (2012) conducted a questionnaire survey of 419 Japanese listed firms. The results showed that 229 firms that already had outside directors answered questions about the actual contributions of the outside director. As Figure 11 shows, their responses indicated that they greatly appreciated the provision of resources by their outside directors, whereas they did not appreciate the monitoring by their outside directors. Only 6.3% of these firms appreciated the function of the outside director as a monitor of management.

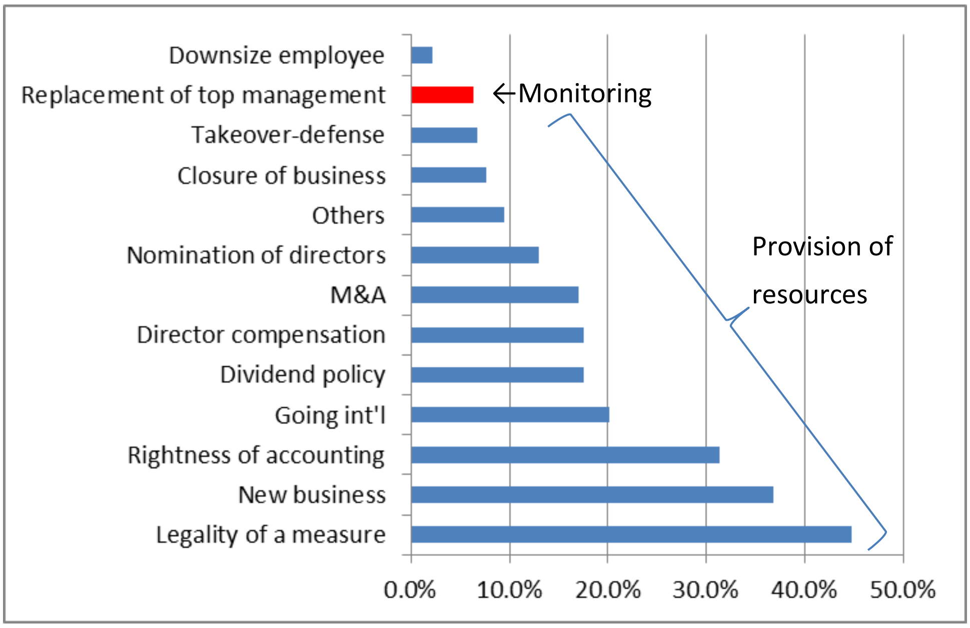


Figure 11. What are the contributions of the outside directors in your firm? (Adapted from Miyajima, Saito, Peng, Tanaka, & Ogawa, 2012).

I apply Hillman and Dalziel's concept of resource dependence theory, which I explained above, to analyze the situation in Japanese corporate governance（See Figure 12）. As I mentioned in sub-section 3.1.3, the level of board dependence was very high, and the director's compensation, such as equity-based compensation, had not been adopted by the majority of the Japanese listed firms. Therefore, in Japan, the board dependence has a strong negative effect on monitoring, whereas it has a strong positive effect on the provision of resources. On the other hand, the low level of equity compensation had a weak effect on both monitoring and the provision of resources. Consequently, while monitoring is weakened, the provision of resources is strengthened, which dominates the board's capital. This strengthened provision of resources may reinforce the tendency toward more board dependence because board members will welcome the increased provision of resources. Hence, the outside directors will intentionally place much weight to the provision of resources but less on monitoring. The re-strengthened board dependence then may have the same influence on monitoring and the provision of resources. In other words, according to this model, a high level of board dependence may create a downward spiral in the monitoring function of the board, and simultaneously induce an upward spiral in the provision of resources.

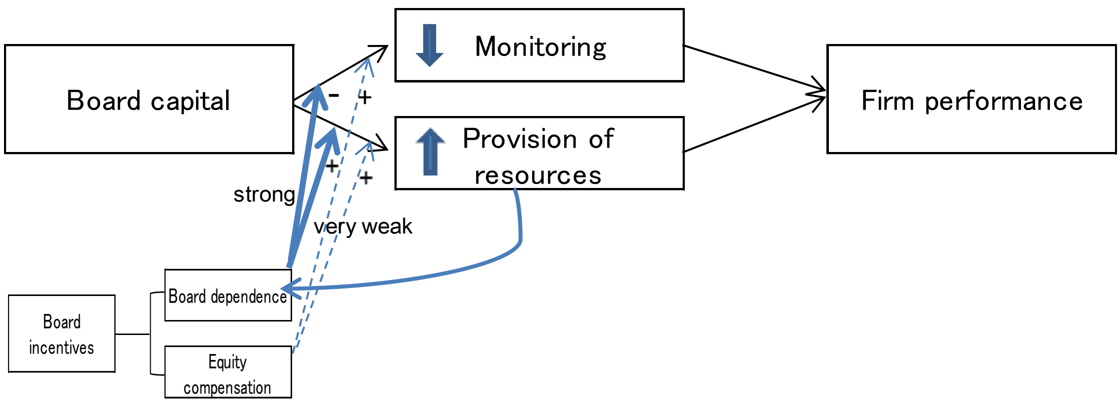


Figure 12. Integrated model (Hillman & Dalziel, 2003) applied to the Japanese case

3.4.4 Conclusion: Japanese corporate governance from a resource-dependence theory perspective

Most boards of Japanese listed firms are dependent on the firm's executives, and there are few extensive internal and external governance functions, such as equity-based compensation, takeover threats, corporate control market, and a managerial labor market.

Thus, the board may place a disproportionate amount of weight on the provision of resources, but no on monitoring. In other words, based on the integrated model, most boards of Japanese listed firms may have a structurally lowered monitoring function and a structurally strengthened provision of resources. This may be one of the reasons why many Japanese listed firms prefer provision of resources as role of outside directors.

3.4.5 Implications

Industry expert/advisor vs. industry inexpert/facilitator. Some people have advocated that outside directors cannot contribute to the board and the firm when they lack knowledge about its business (Ishida, 2010). However, Hillman and Dalziel (2003) showed that the industry expert/advisor type of outside director may foster board dependence and harm monitoring function, which generally remains a low level in Japanese listed firms. From this perspective, therefore, Japanese listed firms should not appoint advisor type of outside directors who place much weight on providing resources, but they should appoint monitors and catalysts type of outside directors who could monitor management properly and facilitate sound discussions in determining the issues in management, even if the person is not familiar with the industry to which the firm belongs.

3.5 Conclusion: Japanese Corporate Governance from Diverse Theoretic Perspectives

Does Japanese corporate governance work well or not? Logically, agency theory is better than stewardship theory in designing the corporate governance system in Japan because when viewed in light of the compatibility between shareholders and managers, the mutual agency relationship represents the Nash equilibrium, which presents the best choice for both parties.

Next, from the perspective of agency theory, I confirm that monitoring management may not work sufficiently in most Japanese listed firms because the two main drivers of effective monitoring, board independence and director compensation are not designed and controlled adequately in Japan. In addition, the alignment of incentives by managerial compensation is also not realistic in the case of Japanese firms.

Given that monitoring and incentive alignment do not function well in Japan, the bundle theory predicts that a considerable portion of listed firms in Japan may not reach a minimum level of effective corporate governance. This is consistent with what I referred in 1.2. In addition, this theory stresses the need for the monitoring function in firms, especially those that are failing.

Moreover, it may be structurally difficult to improve the effectiveness of corporate governance in Japan by the propositions of the bundle theory and the hybrid of resource dependence theory and agency theory. With regard to bundle theory, Japanese firms lack important internal and external governance functions that could have complementary effects on the monitoring function. Regarding resource dependence theory, given the high level of board dependence in Japanese listed firms, the board's role, especially the outside director's role, may place a disproportionate amount of weight on the provision of resources, not on monitoring. It would be difficult to recover the monitoring function under the current situation because the strengthened provision of resource will repeatedly enhance this function.

Therefore, I conclude that the corporate governance of Japanese listed firms would not work well based on a multitheoretic approach.

What does Japan need to do to improve corporate governance? The above argument is that because monitoring is the most important function of the boards of Japanese firms, it should be improved first. Because directors have an important role in monitoring but most Japanese boards are dependent as I discussed in 3.1.1, independent outside directors should be included on the boards of Japanese listed firms. Hence, RQ1 is answered. The following three reasons apply.

First, the monitoring function is important for Japanese firms, relative to other advanced economies, because in Japan there are few other extensive internal and external governance functions, such as equity-based compensation, takeover threats, corporate control market, and managerial labor markets. If these functions substitute for the monitoring function, the functions could cut off the downward spiral, which may weaken monitoring function continuously, and recover the discipline of the board according governance bundle theory. However, based on the observations discussed in the previous chapter, these alternative functions do not work well in Japan. Hence, Japanese firms must strengthen the monitoring function itself to improve the effectiveness of corporate governance. While firms cannot create important external governance functions, such as a good stock market environment, takeover threats, corporate control market, and managerial labor market, they can strengthen their internal functions, such as monitoring, by appointing independent outside directors by themselves.

Second, according to the governance bundle theory, effective monitoring could prevent the bankruptcy managerial entrenchment of poorly performing firms. When firm’s performance is poor, the firm’s unit costs of monitoring and incentive alignment are likely to increase. In particular, the cost of incentive alignment will increase more rapidly than that of monitoring. Hence, the firm has no choice but to depend on the monitoring function to maintain effective governance because Japan lacks other effective governance mechanisms. If the firm cannot maintain effective monitoring, such as by adding independent directors to the board, it is liable to bankruptcy. Conversely, effective monitoring could prevent bankruptcy. Hence, effective monitoring could be a kind of insurance, even for profitable firms, considering that economic uncertainty and the pullback of the whole market are current economic realities.

Resource dependent theorists are likely to place much value on the provision of resources as on the outside director’s role as on the role of monitoring. However, effective monitoring can hardly substitute for the non-director’s tasks, whereas the effective provision of resources can substitute temporary advice by professionals. Therefore, although Japanese firms tend to require experts as outside directors, it is better for them to focus on the monitoring as the role of outside directors to improve corporate governance.

4. Empirical Research: Case Study

4.1 Frame of Research

The previous chapters have shown that the corporate governance of Japanese listed firms does not work well. Therefore, I will explore Japanese corporate governance in depth to provide a better understanding of it and to suggest solutions of business issue to business practitioners. To accomplish this goal, I will conduct two types of empirical studies, qualitative and quantitative, in the following chapters.

First, I investigate the role of the outside director through a qualitative analysis. I provide three case studies, Firm X, Firm Y, and Firm Z, through the analysis of the responses to interviews and relevant articles in the business literature. The case studies highlight the rich, real-world context in which the phenomena actually occur (Eisenhardt & Graebner, 2007). The case studies show the true contributions of outside directors, as well as the complexity of the process of receiving contributions from the outside directors, which have not been explored in previous research. From the results of the case studies, I create two propositions about the outside director's contributions to a firm. They are linked to RQ2, "In what situations do outside directors contribute to a firm?" and RQ3, "What role do outside directors contribute to a firm?"

Next, I will explain the concept that I apply to understand the mechanism of the outside director’s contribution to a firm and show how this concept is new in the corporate governance research.

I will then quantitatively test some propositions using the large sample data. In particular, I will compute five regression models, including the OLS, the fixed effect, and the random effect model, to determine the contributions of outside directors to firms. The data set consists of 9,308 observations made from 2010 to 2013.

4.2 Case Study

As I mentioned earlier, in order to understand the relationship between independent outside directors and firm performance in depth, it is necessary to look at the mechanisms and verification of the effects on the relationship at the firm level; while these may not be expressible in statistical analysis, they may be crucial for understanding. In other words, even though in some previous researches the statistical analyses provided positive results regarding the relationship between independent outside directors and firm performance, this does not guarantee that the mere existence of independent outside directors boosts the firm's performance. The question still remains: "How does the ability of outside directors contribute to a firm?" The mechanism of the process by which outside directors contribute to a firm is still unclear. In order to understand this, I take an inductive approach through a case study at the firm level.

5.4.1 Methodology

My case study methodology is to search for similarity in seemingly different multiple cases, because multiple cases, unlike a single case, enable comparisons that clarify whether a finding is just idiosyncratic to the single case or consistently replicated among several cases (Eisenhardt, 1991). In addition, this juxtaposition of seemingly different cases by a researcher looking for similarities can break the simplistic frame of a case study and lead to a more sophisticated understanding (Eisenhardt, 1989). The subject of my case study is combined with on-site interviews, which are one of the most important sources of case studies (Yin, 2009), and analysis of articles in the business media. The on-site interviews were conducted in 2011 with key persons for designing and managing the board including independent outside directors in Firm X, Firm Y, and Firm Z. The three main reasons why I selected these firms for my interviews are described below.

First, samples for a case study should be chosen on the likelihood that the cases will offer theoretical insight (Eisenhardt & Graebner, 2007). The same is true of scientific laboratory experiments, which are also not randomly sampled. In this context, these three cases meet the criteria based on the following two reasons. One is that these three firms are top-ranked in the Japan Corporate Governance Index (JCG Index) survey and have excellent reputations in managing outside directors through the company with a committee system, which requires three committees, each of which must have a majority of outside directors, to be responsible for nomination, compensation, and audit. The other is that such companies that have chosen independent directors are more likely to use them effectively and they, at least, by adopting the committee system voluntarily, are likely to be more committed.

Second, they are seemingly different firms in business type, size, positioning in each sector, sector, scheme of the firm, and so on (Table 3). This also fits my case study methodology.

Finally, for these three firms, I was able to interview the right persons in consistence with the aim of my case study. All the interviewees have extensive career involvement with designing board structures, including a majority of outside directors and inspiring the greatest efficiency in outside directors.

Table 3. Seemingly different three firms for case study

Name	Index	Unit	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010	FY2011	FY2012
Firm X	Market Cap*	mil¥	275,393	292,431	335,293	790,270	575,544	797,320	821,562	718,445	444,386	578,448	369,569	383,394	364,859
-Business merger in 2003	Sales	mil¥	543,719	539,571	559,041	860,420	1,067,447	1,068,390	1,027,630	1,071,568	947,843	804,465	777,953	767,879	813,073
-No.4 in the domestic office automation equipment market	EBITDA	mil¥	56,483	55,828	71,352	104,785	131,833	142,569	163,174	187,220	135,348	114,395	103,552	98,389	96,521
	ROE	%	4.0%	6.7%	9.3%	4.9%	2.2%	-17.1%	21.9%	17.5%	3.7%	4.1%	6.1%	4.7%	3.4%
	TobinQ	x	1.3	1.3	1.5	1.8	1.4	2.0	1.8	1.5	1.0	1.3	0.9	0.9	0.9
	D/E ratio	x	1.14	1.03	0.84	0.80	0.73	0.81	0.62	0.54	0.57	0.48	0.46	0.54	0.49
Firm Y	Market Cap	mil¥	924,918	918,924	637,562	811,532	1,040,260	1,466,538	1,605,332	968,666	820,530	950,267	850,317	937,587	1,197,403
-Establised in 1941	Sales	mil¥	361,712	431,673	466,613	500,164	533,011	601,252	674,111	734,286	781,743	803,152	768,914	647,976	573,658
-No.5 in the domestic pharmaceutical market	EBITDA	mil¥	73,949	87,955	93,767	101,477	109,166	120,689	132,065	52,308	150,439	143,776	164,381	144,442	121,555
	ROE	%	6.9%	10.3%	10.9%	12.4%	12.6%	13.0%	13.2%	-3.4%	10.9%	9.5%	16.4%	14.2%	10.9%
	TobinQ	x	2.6	2.6	1.7	2.0	2.3	2.9	3.0	1.6	1.5	1.7	1.6	1.7	2.0
	D/E ratio	x	0.07	0.02	0.00	0.00	0.00	0.00	0.00	0.92	0.99	0.99	0.94	0.83	0.67
Firm Z	Market Cap	mil¥	2,356,319	1,815,404	1,006,845	1,518,331	1,440,530	2,198,785	2,529,016	2,154,902	821,866	2,045,718	1,723,678	1,541,528	1,998,831
-Establised in 1904	Sales	mil¥	5,951,357	5,394,033	5,655,778	5,579,506	5,836,139	6,343,506	7,116,350	7,668,076	6,654,518	6,381,599	6,398,505	6,100,262	5,800,281
-No.1 in the domestic heavy electric machinery market	EBITDA	mil¥	571,949	212,664	376,377	423,417	396,169	494,827	551,239	618,259	99,578	416,189	499,877	453,619	412,068
	ROE	%	9.5%	-29.0%	2.9%	4.3%	5.9%	8.6%	13.0%	12.0%	-46.8%	-3.2%	16.6%	8.5%	8.2%
	TobinQ	x	1.5	1.4	1.2	1.4	1.3	1.6	1.6	1.5	1.2	1.6	1.4	1.3	1.4
	D/E ratio	x	1.71	2.58	2.90	1.59	1.36	0.92	1.05	1.23	4.05	1.53	1.25	1.42	1.42

* own shares adjusted

…FY of adoption

The author made this table based on data from SPEEDA.

Each interview was planned ahead so that approximately 1.5−2 hours would be spent with senior managers in the division that designs and manages the board systems, such as the board of directors' office and management audit department. Due to the time limitations, each interview was inevitably of the focused type (Merton, Fiske, & Kendall, 1990), in which the interviewer is more likely to follow a specific set of questions to increase the efficiency (Yin, 2009). Thus, I created questions that would ask a pattern of findings across multiple cases (Table 4). I added a rival claim about outside directors to question 5, because the consideration of rival propositions creates value for discussion on a case study (Yin, 2009). I also surveyed the related articles of the three firms, as complementary to the interviews, through Japanese business media, such as newspaper and business journals.

Table 4. Set of questions in my interviews

1	Why did your firm adopt a company with a committee system that requires three committees that are responsible for the nomination, compensation, and auditing and for which outside directors must be in the majority for each?
2	What triggered the interest in the adoption of this system?
3	Who brought up the idea to adopt this system for your firm?
4	Was there any opposition to this idea within your firm?
5	I believe that to create a system is not enough to make it functional. A system will not function unless it is operated well. In this context, do you have any key to how this system functions, especially as regards the managing of outside directors?
6	Did your firm achieve the goal that it expected initially?
7	What changed after appointing outside directors? Did the performance of your firm improve after this?
8	What are the obstacles to maintaining this system?
9	Why do you think only 2% of listed firms in Japan have adopted this system?
10	What are the drawbacks regarding the effectiveness of this system and outside directors in your firm?

Moreover, I conducted a brief interview with an outside director of the three firms and surveyed business articles about Hitachi (Doi & Sawada, 2014), as an additional case study. I will provide important excerpts of the interviews in addition to insights gained through the comparison of the multiple cases. The interview questions and responses are provided in Appendix 3.

4.3 Interviewees

In Firm X, I interviewed two officers, a general manager and a manager of the board of director's office at the same time. They had been engaged in nominating outside director candidates and in managing board meetings and committees for about a decade. In Firm Y, I interviewed a member of the board and the audit committee (not an outside director) and a general manager of the management audit department at the same time. They also had been engaged in nominating outside director candidates and in managing board meetings and committees for about a decade. In Firm Z, I interviewed an ex-member of the board and the audit committee (not an outside director). He had engaged in nominating outside director candidates and managing board meetings and committees before and after Firm Z adopted the committee system. In addition to the three interviews and related articles, I conducted a brief interview with an outside director of the three firms above and reviewed article in which two members of the legal department of Hitachi answered a question about their expected roles as outside directors (Doi & Sawada, 2014).

4.4 Findings of the Multiple Case Studies

Although my selection of case studies was based on the likelihood that they would offer insight, I was surprised that I found several similarities in seemingly different multiple cases, in which the firms have different conditions, such as history, capability, market environment, and shareholders (Table 3). Consequently, the findings of these empirical cases highlighted important three important similarities in the adoption of the committee system and the appointment of outside directors: *motivation*, *design,* and *performance*. In particular, the similarities in performance were closely related to the research questions, RQ2, "In what situations do outside directors contribute to a firm?" and RQ3, "What role do outside directors contribute to a firm?"

4.4.1 Motivation

The three cases have similar triggers in using outside directors and committees to improve corporate governance.

> *Firm X*: Before the integration of management between Firm X1 and Firm X2, each firm had independently considered the necessity of strengthening corporate governance, especially by the separation of execution and monitoring, to make decisions faster …. Then the integration of both firms was planned, which gave us additional reasons to improve our governance system. In particular, we had to secure the transparency of the decision-making process because both parties were

worried about the competition between Firm X1 and Firm X2. Actually, we shared the understanding that we had no time for internal tugs of war because of the uncertainty of our business environment. So we needed a system and a third party to take part in the system to monitor our management efficiently. They are the committee system and independent outside directors.

Firm Y: We had repeated corporate scandals, such as a violation of the anti-trust law in 1991, the medication scandal of Sorivudine in 1994, and an international cartel with other Japanese pharmaceutical firms in the US market in 1999. We wanted to make sure that it didn't happen again. Thus, we adopted a company with committees system to establish effective monitoring and checking functions.

Firm Z: And, concerning a trigger, although the then president was very familiar with the US style of management, and this might have been a great driver of the adoption, another reason for starting to engage seriously in corporate governance, a kind of trigger to adopt this system, was the so-called case of the violation of COCOM by Firm Z's affiliate firm. We paid a huge price for it.

Although it did not lead directly to the survival of the firm, each trigger event was a potential risk. The top of the three firms realized the risk so strongly that the firm was motivated to improve its corporate governance system. Thus, their motivation was truly spontaneous, even though the trigger was extrinsic. Without the sufficiently strong motivation of the firm's top executive, the outside directors and committees may fail to function. Therefore, spontaneous motivation is a key to implementing the governance system properly. In this sense, the mandatory implementation may not have created the intended effect, but it produced many boards that were window-dressing.

4.4.2 Design

I found a similar pattern of thought among the firms when they considered how they adopted the company with a committee system and managed the outside directors.

This pattern was elicited by the three following questions:

1) What do you expect of outside directors?

2) To what extent should the board delegate authority to management?

3) To what extent should we give business information to outside directors?

In answering these questions, the firms that I interviewed indicated their deep understanding of this system and that they had designed the role of the outside directors appropriately. Hence, the answer to question (1) determined the answer to question (2), and the answer to question (2) determined the answer to question (3), which means that these questions are linked in a chain. Therefore, how a firm answered question (1) was important. Because the three firms provided almost the same answer to question (1), their answers to questions (2) and (3) were almost the same.

Question (1) What do you expect of outside directors? This is a fundamental question. In theory, the answer will divide the role of the outside director into two roles, monitoring and the provision of resources. However, as I discussed in section 3.5, Hillman and Dalziel (2003) showed that the industry expert/advisor type of outside director may foster board dependence and may be harmful to monitoring. Hence, it is very hard to require outsider directors to fulfil both functions, monitoring and the provision of resources and give expert advice at the same time. Therefore, the answer should be either monitoring or the provision of resources. The actual answers to this question by the three firms are as follows:

> *Firm X:* [W]e believe that experience as a CEO can improve the quality of discussion and monitoring. Although we know this criterion contains the risk of homogeneous board members, we consider that the strength more than makes up for the risk.
>
> Insiders must persuade outsiders logically. Our outside directors are very tough. It's time-consuming to prepare, but this process can be one of monitoring management. To secure the effectiveness of this process, it is

crucial to maintain the independence of the outside directors. Our outside directors don’t mince words because of their independence from our firm.

Mr. O, an ex-chairman of board meetings and the CEO of Firm X, said in a newspaper, “A firm should separate its functions of managing a firm and monitoring management, because it’s extremely difficult that a single person promotes a business, stepping on the brake” (Nikkei Shimbun, 2012).

Mr. U, an ex-chairman of board meetings and an outside director of Firm X, answered a question about the effectiveness of outside directors considering their lack of knowledge of the business: “The roles of executives and directors differ considerably. It makes no sense to place responsibility of short-term profit on outside directors. Their roles are to monitor effectively, to prevent misjudgments by management and to stabilize managing the firm in mid-term” (Nikkei Shimbun, 2005).

Firm Y: [O]ur chairman of the board is an outside director, though it is an insider in almost all the listed firms in Japan. Our board consists of seven outsiders and four insiders, including the CEO. The CEO is the only manager who concurrently holds a director position. This means that our board can adequately monitor the management team, including the CEO .… We simultaneously

> encourage management to establish and manage our internal control system on an autonomous basis. Our board also monitors their internal control activity…. We need sound, suspicious minds for monitoring.
>
> *Firm Z:* Is their role to provide advice to management that is free of constraints and internal political ties, or is it to offer expert advice as a lawyer, accountant, or scholar? These roles seem to be not as reasonable as we expected. [This is] because their business experiences and expertise may not always fit our arguments in board meetings even though they accomplished good results in their business …. Now, how about monitoring management? This seems to be correct, because, in this [committee] system, management has to explain their plan, decision, and the reasons to outsiders who wouldn't know our internal practice, which can be a great monitoring function.

The three firms clearly stated that they asked their outside directors to play a monitoring role. Although Firm X seems to place a very high premium on the adviser's role of outside directors because of their criterion of experience in top management, it is a superficial view. They just regard the career as a top manager as a specific and favorable experience that suits the monitoring of management. Regarding the independence of outside directors, all three firms required their outside directors to be independent from management. Considering that a high level of board dependence may create a downward spiral in the monitoring function of the board and a simultaneous, upward spiral in the provision of resources (Hillman & Dalziel, 2003), their answers are logical and consistent with agency theory. On the other hand, Mitarai, the president and CEO of Canon, clearly stated that the roles of its first two outside directors are as advisors for legal and tax matters, respectively (Nikkei Shimbun, 2014). Although another role of the outside director is not problematic, theoretically it may be difficult for the outside directors of Canon to play a monitor's role.

Question (2) How far should board delegate authority to management? In theory, because the answers to question (1) focus on monitoring as the outside director's role, it would make sense to delegate authority to management as much as possible in order to separate monitoring and execution as much as possible. However, it depends on board's capability of monitoring. Such capability depends on how outside directors gain necessary information in a timely manner. Hence, it is closely related to the third question, "How far should we give business information to outside directors?" The answers to question (2) by the firms and Hitachi are as follows:

> *Firm Y:* [W]e make the highest separation between executions and monitoring, as stated in the Companies Act, meaning that the board delegates the authority to

executives whatever possible. This improves the flexibility of management decision made on a daily basis.

Firm Z: If you decide their [outside directors] role, it would be almost automatically fixed how far the board should empower management. But you also should carefully examine it. It may depend on the whole board's capability of monitoring.

If a board is overly dominated by outsiders, monitoring management wouldn't work well in our firm, which has a variety of business lines.

Hitachi: We delegate authority to the management team as much as possible, so we expect that our outside directors contribute to discussions about our overall direction (Doi & Sawada, 2014).

These firms delegate authority to management as much as possible because they clearly want to separate the monitoring and executive functions, which is in line with agency theory.

Question (3) How far should we input business information to outside directors? Regarding maintaining the effectiveness of the board in monitoring management, all firms pointed out that it is indispensable to provide enough information to outside directors before the board meeting. This includes introducing channels for direct access to sources of information, such as factory and division heads. The answers to this question by the three firms and Hitachi are as follows:

> *Firm X:* [F]irst of all, it is very important to provide the necessary information and knowledge to outside directors. We set lots of briefing sessions between outside directors and the top of each division, as well as site visits to our factories and labs. This is because outside directors naturally do not know our business well. But of course this lack of knowledge can't deny their existence and effectiveness. Those people who take a skeptical view of the effectiveness of outside directors may confuse not only the role of the outsiders but also a lack of knowledge with a lack of intelligence.
>
> *Firm Y:* It is very important to deliver the necessary information to outside directors in adequate time prior to board meetings. To ensure this, we have a team that positively supports our outside directors in learning about our firm. In addition, we have an annual self-evaluation survey of the board members and an annual meeting of outside directors only.
>
> [Mr. K, an ex-chairman of board meeting and outside director of Firm Y, said] We have a supporting team that can efficiently provide our outside directors with the essential information for monitoring in a restricted time. The

compensation of the team members is decided by our compensation committee all of which are outside directors. We greatly need this provision of information (Nikkei Shimbun, 2008).

Firm Z: With enough the information provided in a timely manner, the outside directors are able to judge and prevent problems. So it is very important how much business information we should give outside directors. Firm Z's board delegates the power to executives as much as possible. So we have to provide all necessary business information to discuss and judge in board meetings to our outside directors before the meetings, which ensures the effectiveness of outside directors. We made a great effort to do it.

Hitachi: [W]e make a great effort to deliver the necessary information to our outside directors in enough time before the discussion. Some live overseas, so we provide them with tablet computers for efficiency (Doi & Sawada, 2014).

The proper provision of information makes the maximum delegation from board to management possible, and the maximum delegation makes the separation of monitoring and execution possible. Therefore, providing necessary information in a timely manner is a key factor in allowing outside directors to play the monitor's role well. Therefore, as all three firms did, it may be necessary best practice to have a team that is responsible for providing timely, adequate information to board members, including outside directors, and for that team to be evaluated by board members.

4.4.3 Performance

All interviewee–representatives of the firms admitted that their independent outsiders contributed to the firms in the long run, but they failed to realize the immediate positive relation between adopting the committee system, appointing outside directors, and their firm performance. For instance:

> *Firm X:* I'm not sure about the immediate effect, but I am sure about the positive effect in the mid-term.… But the influence of outside directors is not simple in the first place.
>
> *Firm Y:* We don't see outside directors and the committee system as a direct driver for our firm performance, though they must be positive in the long run.
>
> *Firm Z:* I'm not sure it immediately works for improving the results in accounting. Maybe not.

I realized that the interviewees commonly and unconsciously spoke about the contribution in a special kind of situation. In interpreting their responses, I discovered the implication that the outside director can move a firm in a better direction, especially when it faces difficulty in choosing a path to follow and this contribution consequently improve the firm performance in the long run.

It is not a coincidence that all three companies, Firm X, Firm Y, and Firm Z, revealed in the interviews that the reasons for adopting committee system or appointing outside directors to improve governance were a corporate scandal or M&A. These events also might make the firms indecisive about whether they should choose a drastic solution for a challenging issue or not. Perhaps they understood that appointing insiders only was not the best way to control or prevent risks, so they took advantage of outside directors to solve difficulties.

The firms gave other examples of the contribution that an outside director can move a firm in a better direction, especially when it stands at a crossroads and consequently improve the firm performance in the long term:

> *Example 1, Firm X:* In our case, for instance, without our outside directors, we couldn’t decide, in appropriate timing, to terminate the photo imaging business, which was formerly the main business for Firm X1 and Firm X2. We’re frightened by their asking why we had to keep this unprofitable photo imaging business. They didn’t have any sanctuary. This was one of the greatest contributions of our outside directors.

Firm X stood at a crossroads regarding whether it should terminate the original, unprofitable business or not. The outside directors then cast doubt on the chances of the survival of the photo-imaging business, which was the original business of Firm X.

> *Example 2, Firm X:* Another sobering output from the outside directors, which impressed us, was the question of why we would make a medium-term management plan for three years when we're facing economic uncertainty triggered by the global financial crisis. It was 2008. We're going to make a 09-11 management plan. But we're still making urgent cost-reductions at that time. They asked why not made it for two years because it made no sense to decide the three-year plan under this global economic uncertainty, which we couldn't see how long it would last. For insiders, that is, us, there was no doubt about making a medium-term management plan every three years. So then we're focusing on how we made a three-year-management plan. In the process of answering this naïve but pithy question by the outside directors, we, however, reflected on ourselves and concluded that we made a two-year-management plan and instead of growth, made the improvement of corporate quality as a central agenda item over the two years. We avoided making a three-year midterm-management plan, which might have been a pie in the sky.

Firm X also stood at a crossroads regarding whether it should keep the customary three-year medium-term management plan, even under the economic uncertainty that nobody could foresee even the next six months. Although the insiders focused on making a three-year management plan as they had done before, the outside directors simply proposed shortening the term of the plan. They could do so because they did not have the insiders' bias and customs.

> *Example 3, an outside director of the three firms:* [The] important thing that we [outside directors] can do is getting the CEO to work on a succession plan. It seems obvious, but he wouldn't have done it without pressure and tension caused by the outside director. This tension made the planning process much clearer and more transparent.

This firm also stood at a crossroads regarding whether the CEO would put a succession plan on the table or not. The board encouraged the CEO to discuss the succession plan. The outsiders put pressure on the CEO and encouraged him to start discussing the succession plan.

> *Example 4, Hitachi:* For instance, we make our medium-term management plan every three years. We feel that the quality of the discussion in the process of the planning has been improved by the outside directors. Our outside

> directors have never made rubber-stamping agreements to the management plan. Our management team takes enough time to explain their plan to the outside directors.

Hitachi stood at a crossroads regarding whether it maintained rubber-stamping in discussions of medium-term management plan, which was the firm's most important plan. The outside directors ignored rubber-stamping and built agreements with the management plan through intensive discussions with insiders and management. It became standard that the management team took enough time to explain and discuss their plan with the outside directors.

> *Example 5, Hitachi:* Another example of our outside directors' contribution is that they made the discussion about an M&A deal constructive by providing their insights to the board meeting. The deal could change the direction of our firm. So I felt that they made a valuable contribution to us.

Hitachi also stood at a crossroads regarding whether it made an important M&A, which might affect the future of Hitachi. Some outside directors asked questions and made suggestions from perspectives that the insiders did not expect. Consequently, the insiders felt that the outside directors made an invaluable contribution to the firm.

Every example shows that the independent outside directors contributed to decision making by actively joining discussions about an issue that could seriously influence the future of a firm. Consequently, they moved the firm in a better direction. It follows this contribution improves the firm performance in the long run. Finally, I derive a proposition from the analyses of the above interviews and articles as follows:

Proposition 1: Independent outside directors can move the firm in a better direction, especially when the firm stands at a crossroads and consequently improve the firm performance in the long run.

This proposition answers one of my research questions, RQ2: "In what situations do outside directors contribute to a firm?"

4.4.4 The mechanism of moving a firm in a better direction by the outside director

Another research question, RQ3: "What role do outside directors contribute to a firm?" remains to be answered. However, the answer may be drawn from the mechanism of how outside directors move a firm in a better direction and consequently improve the firm performance in the long run. Hence, in this section I will explore the mechanism in depth.

Tension. Through my interviews and review of related business articles, the interviewees pointed out that their outside directors injected tension into the relationship between the board and the management team:

> *Firm X:* Insiders must persuade outsiders logically. Our outside directors are very tough.
>
> Firm Y: Tension in our board meeting has built up soundly [by appointing outside directors].
>
> *Firm Z:* The management team has gained a sense of alertness to the outside directors.… Such discipline will work to improve the management of a firm.
>
> *An outside director of the three firms:* [The] important thing that we [outside directors] can do is getting the CEO to work on a succession plan. It seems obvious, but he wouldn't have done it without the pressure and tension provided by the outside director. This tension makes the planning process much clearer and more transparent.

In interpreting the interviewees' responses, I realized that they wanted to suggest the following:

1) The independence of outside directors guarantees that they put pressure on the management.

2) This pressure provided by outside directors brings about tension and discipline in the relationship between the outside directors and the management.
3) Under such tension and discipline, they both collaborate to deepen discussions about issues.

Although there also may be tension and discipline in the relationship between an insider-dominated board and the management, but it differs from the tension and discipline created by outsiders. The tension and discipline among insiders may derive from a balance of authority and political power, whereas the tension and discipline that I refer to stems mainly from the outside director's independence from the firm and its management. Independent outside directors can speak out and bring about tension and discipline because they do not have to care about the balance of authority and political power balance that is likely to concern insiders. Therefore, outside directors can contribute more deeply to the board's discussions about issues. The comments of the firms regarding this point are as follows:

> *Firm Y:* Thanks to them [outside directors] we can have quality discussions in board meetings.

> *Firm Z:* [The] management team has gained a sense of alertness because of the outside directors.… Such discipline will work for the general improvement in managing a firm.
>
> *Hitachi:* We delegate authority to the management team as much as possible, so we expect that our outside directors contribute to discussions about our overall direction…. For instance, we make our medium-term management plan every three years. We feel that the quality of the discussion in the process of the planning has been improved by the outside directors.

Constructive interaction. However, a gap remains between the tension and discipline brought about by the presence of independent outside directors and improving quality of discussions among the board members. Logically, tension and discipline alone cannot be enough to improve the quality of the discussions by the board although they can be important conditions for it. Certainly, the existence of independent outside directors who can provide pressure and bring about tension and discipline may be positive for improving the quality of discussion among board, but the question concerns whether the independent outside directors directly assist in improving the quality of discussion and move a firm in a better direction by keeping quiet or by asserting themselves. The independent outside directors who contribute to improve their firm’s discussions are expected to contribute actively, not just attend the board meetings. There must be a bridge between the existence of independent outside directors and improving the quality of discussion. Through the intensive analysis of the case studies and applying the findings to other fields (I will explain this application in later chapter.), I will determine the bridge. It is characterized by the constructive interaction between the independent outside directors and the insiders, including management.

Examples 1 to 5 in subsection 4.4.3 can also serve as examples for constructive interaction. The insiders could accelerate to selling only if the outside directors of Firm X cast doubt on the chances of the survival of the photo imaging business. An interviewee in Firm X said “We’re frightened by their asking why we had to keep this unprofitable photo imaging business. They didn’t have any sanctuary. This was one of the greatest contributions by our outside directors.” Through answering many questions, which may be naïve for insiders but necessary for outsiders, the insiders reflected on their reactions and came to the appropriate solution. This interplay is the constructive interaction between insiders and outsiders, which enabled the insiders of Firm X to realize that it was not reasonable to maintain their original but unprofitable business in example 1 and their customary medium-term management plan for three years under that economic uncertainty that no one could predict the situation six months in advance in example 2. In example 3, under pressure from outside directors, the CEO might have realized that the time was right to make his succession plan, which he would not initiate for the first time after responding adequately to the demand from the independent outside directors to make the plan. In this situation, the constructive interaction initiated by the independent outside directors also improved the quality of discussion and advanced the process for going forward with the succession plan. In example 4, Hitachi started discussions of the medium-term management plan only after the outside directors' rejected rubber-stamping and asked for an explanation and discussion of the plan. This devaluation of rubber-stamping by the outside directors might have caused the insiders to realize that it was better for the board to have intensive discussions about the plan, which was nothing special but they had failed to do it. In another example, in Hitachi, "They [outside directors] discussed an M&A deal constructively by contributing insights to the board meeting. The deal changed the direction of our firm." According to this interviewee, the outside directors who made the discussion constructive were not experts in M&A. Therefore, in theory the role of outside directors might not be the provision of resources. In the both cases, constructive interaction between the independent outside directors and the insiders, including management, improved the quality of discussion and led this firm in a better direction.

Finally, I understand the mechanism how outside directors move a firm in a better direction and consequently improve the firm performance in the long run. Under the tension and discipline provided by the independent outside directors, constructive interaction between the sound skepticism of independent outsiders and the responses of the insiders caused the insiders to self- reflect and realize that better solution was possible. In a later chapter, I will explain the details of this mechanism by applying a concept in cognitive science. The interviewees did not articulate a clear understanding of this constructive interaction although they expressed it as tacit knowledge in their responses.

Therefore, I derive another proposition from the above discussion as follows:

Proposition 2: Independent outside directors can promote constructive interaction with insiders in discussions, which moves the firm in a better direction and consequently improves the firm performance in the long run.

4.5 Conclusion of the Case Studies

My empirical cases highlighted three important similarities, *motivation, design,* and *performance*, in adopting the committee system and appointing outside directors, which is helpful in understanding the detailed mechanism of how outside directors contribute to firm performance.

Motivation. Spontaneous motivation is key in the functioning of governance systems, including using outside directors properly. Without sufficiently strong motivation from the top executive of a firm, the outside directors and committees may fail to function because the design and management a governance system that takes advantage of outside directors is complicated and resource-consuming.

Design. There are three important considerations in designing a governance system that takes advantage of outside directors: independence; as much empowerment as possible; and the adequate provision of information. In theory, without independence, outside directors could not monitor management. Hence, the independence of outside directors is important for the monitoring function. If a firm can acquire an effective monitoring function by using independent outside directors, it would make sense to delegate as much authority to management as possible because it would clarify the separation of monitoring and execution. However, it depends on the board's ability to monitor. The ability depends on how the outside directors gain the necessary information in a timely manner. Without enough timely information, outside directors cannot take part in discussions in board meetings. Thus, these three factors are closely linked in the design of a governance system that takes advantage of outside directors.

Performance. I derive two propositions from my case studies as follows:

Proposition 1: Independent outside director can move a firm for better direction especially when a firm stands at a crossroad and consequently improve the firm performance in the long run.

This proposition answers one of my research questions, RQ2: "In what situations do outside directors contribute to a firm?"

Proposition 2: Independent outside directors can promote constructive interactions with insiders in discussions, which moves the firm in a better direction and consequently improves the firm performance in the long run.

This proposition answers my remaining research question, RQ3: What role do outside directors contribute to a firm? That is, the outside director's ability to promote constructive interaction with insiders may be a key contribution to the firm.

This constructive interaction makes insiders realize that they are biased in discussing the issues and that they can reach the better solution without the biases. Then the constructive interaction leads the board, especially the insiders, to different levels of understanding and solving the issues. As this suggests, the constructive interaction does not directly link to the firm performance. Although the interviewees did not express a strong negative opinion about the linkage between the tension created by outside directors' monitoring and firm performance, but they were not convinced a link existed.

Before and after adopting the system and appointing several outside directors, their firm performances had not deteriorated, excluding the financial crisis of 2008, but they had not greatly improved in accounting results and market valuation (see Table 3). However, it does not mean that the constructive interaction created by independent outside directors has no positive effect on firm performance. The results of the case study just suggest that, especially a firm with good practices, the positive effect of outside directors on immediate firm performance might not be apparent. My findings showed that the constructive interaction created by independent outside directors caused the insiders to reflect on their biases toward an issue and lead the board, especially the insiders, to different levels of understanding and solving the issue. Consequently, independent outside director can move a firm in a better direction. This improves the firm performance in the long run.

5. Constructive Interaction: The Third Role of Outside Directors

5.1 The Third Role of Outside Directors

The empirical results of the case studies suggest that independent outside directors can positively contribute to a firm's direction and the firm performance in the long run by promoting constructive interaction with insiders in discussions, based on the tension provided by outside directors. The creation of constructive interaction seems both similar to and different from the two roles of outside director in theory: monitoring and the provision of resources. The board's function is to monitor managers on behalf of shareholders (Fama & Jensen, 1983), which is similar to the creation of constructive interaction in that both are valuable for shareholders. However, monitoring is a kind of static check on management. In contrast, the creation of constructive interaction involves dynamic, proactive, and collaborative action. In addition, it is also similar to the advisory function in that both provide new ideas to insiders. However, the advisory function is expected to provide expert advice in tax and legal affairs or networks, whereas the constructive interaction promotes self-reflection, awareness-raising, and discussion-deepening. Because this function cannot be classified in the monitoring management and provision of resources, it may be the third role of the outside director (Figure 13).

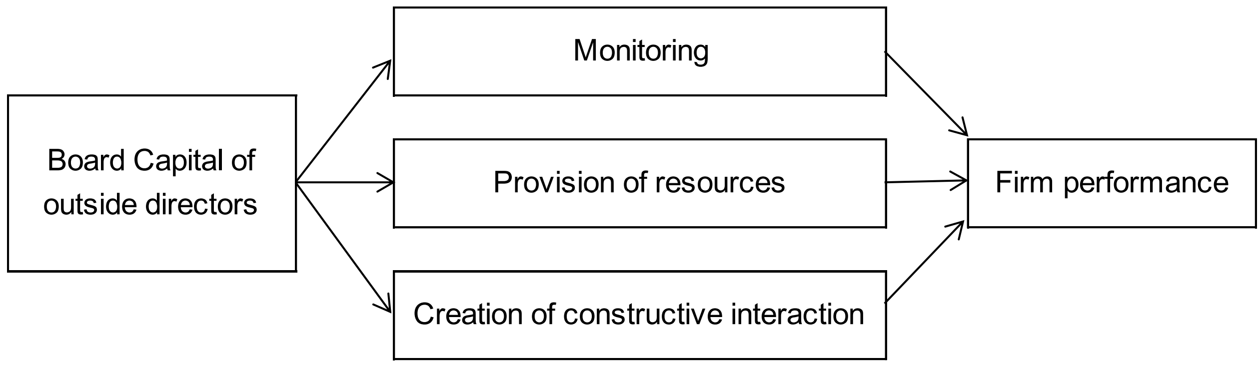


Figure 13. The three roles of outside directors

The results of my qualitative analysis showed that although the creation of constructive interaction is weakly linked to immediate firm performance and is hard to observe, it does exist and is created by outside directors. My point is that this weak linkage between outside directors and immediate firm performance may be a reason that the academic discussion about linkage between independent outside directors and performance is in a mixed state.

5.2 Summarizing the Basic Idea and Mechanism behind "Constructive Interaction" and the Application to a Third Outside Director's Role

5.2.1 Background

"Constructive interaction" is not technical term in corporate governance. It was created in cognitive science, which is a cross-discipline between psychology and artificial intelligence. However, this concept helps in deepening the understanding of the third role of the outside director.

Given that outside directors can move firms, especially those standing at a crossroads, in better direction through constructive interaction with insiders, my primary questions are as follows: What is the mechanism that causes constructive interaction? This question is linked to my third research question: “What role do outside directors contribute to a firm?”

Miyake (1986), a cognitive scientist, explained a potential answer to the above questions. As I conducted interviews with sample firms, analyzed the results, and generalized them, she conducted laboratory experiments, observed the processes, and generalized them. I will briefly outline her study.

5.2.2 Summary of Miyake (1986)

Experiment. She used sewing machines as experimental devices. It is very hard for most people to understand the mechanism in which two pieces of fabric are joined on a sewing machine (see Appendix 4). In Miyake’s experiment, three groups of two people collaborated with each other to figure out how a sewing machine made stitches, in order to identify the conditions that made the verbal interactions between the two people constructive in achieving their goal. In the experiment, three groups of two people were encouraged to cooperate to understand how the two threads, which had invisible ends, were twisted together.

Cycling between understanding and non-understanding. Although each group went through several stages in which they believed they "understood" the mechanism, each stage was one of non-understanding and thus made the group proceed in further steps towards the understanding. Consequently, they approached the complete understanding of the mechanism by cycling between understanding and non-understanding.

Roles and motion. It is interesting that close observations revealed that the two people came to distinguish between the roles and the motions. While the person who knew the sewing machine better tended to be the leader, the other was likely to be an observer. While the leaders spent their time solving the issues at hand with a local focus, the observers had a more global focus without self-tuning control to the leaders. Although the leaders' attitudes were very effective regarding the local problems, they usually did not change the course of interactions. In contrast, the observers were likely to suggest a new way to approach the problem. For example, an observer suggested removing the bottom panel of the sewing machine, which was all but unthinkable for a leader focusing on the stiches so that they could get a better view of the backside of the bobbin and understand the mechanism more deeply. This suggestion “moved” them toward their goal. Miyake (1986) called this “topic-divergent motion” and pointed out that this motion was the most frequently initiated by the observers because the global focus was not easily available to the leaders. She illustrated the “topic-related motion” with an example, such as suggesting examining the needle more closely. The results showed that it was not surprising that the leaders made the most topic-related motions because they were directly engaged in initiating solutions.

Roles and criticisms. Miyake (1986) also made similar observations in the criticisms. The one who understands less (observer) contributed to figuring out complex issues by criticizing the other (leader). The results of this experiment suggest that even when the two people are at different levels of understanding, criticism by a person who understands less can contribute to the best solutions.

Thus, the results of Miyake’s study showed that in two-person constructive interactions, the observer can contribute by giving topic-divergent motions and providing criticism, which are not the primary roles of the leader or the job-doer.

5.2.3 Application to the outside director’s role

If a leader is replaced with an insider and an observer is replaced with an outside director, the mechanism by which the outside director can move the firm in a better direction can be understood.

Although insiders' solutions are very effective for local problems, they usually do not change the course of the business because they have a local focus that is biased. In contrast, outside directors are likely to suggest different approaches to the problem because they have a global focus. This collaboration or tension between insiders and outsiders sometimes may create a cycle between understanding and non-understanding, making them reach higher levels of understanding a business issue. Miyake's findings suggest that, even when outside directors understand the business of the firm less than insiders do, they can contribute to discussions about significant business issues by making topic-divergent motions and providing criticism. In 2014, I interviewed Miyake to probe her understanding of the mechanism. At this time, she gave permission to refer to her study and provided the following additional explanation:

> [Outside directors, even when they have little understanding of the business of a firm, can contribute to discussions with insiders about firm issues.] This is because constructive interaction does not create new ideas about solving an issue between a leader and a monitor (observer). Constructive interaction makes a

> leader, in this case an insider, self-reflect without the insider's bias. The insider then becomes better able to figure out the best solution to the issue via the reflection. [It means that] the insider has upgraded the level of understanding of the issue within him/herself through the interaction created with an outside director, and thus finally reaches the best solution. So you can say that the insider has the potential answer in the first place but cannot figure it out by him/herself. This is human nature. Cognitive science, my experiment, could unravel the mechanism because this science determines mechanisms that make one more intelligent.

She clearly suggested that the mechanism by which the leaders realized how a sewing machine works with monitors in her experiments is identical to the mechanism that insiders can realize a better solution to business issue through the input of outside directors. In the both cases, constructive interaction makes the leaders/insiders upgrade their understanding of the issue and reach better solutions.

Miyake also referred to the relationship between the independence of a leader (insider) and a monitor (outsider) and their constructive interaction:

> Independence is definitely important. Without independence, constructive interaction couldn't occur effectively. I carefully made a combination of

examinees of my experiments independent and being able to speak out each other. If the relation among them is dependent, their collaboration may lead them in a bad direction. It's like the Flash Airlines flight 604 case. The investigation of this serious airline crash suggested that the co-pilot realized the abnormal tilt of the airframe before the crash but didn't point it out to the captain because the latter was his superior. There is a strict hierarchy in a cramped cockpit. So the co-pilot couldn't speak out. This prevented constructive interaction.

Viewing my case study through the lens of the constructive interaction found in Miyake (1986), I observe how constructive interactions occur in firms when outside directors contribute topic-divergent motions and provide criticism. This observation supports the results of my qualitative research. In Firm X, the outside directors cast doubt on the survival of the photo-imaging business, which was the original business for Firm X. This was a topic-divergent motion. Firm X also stood at a crossroads regarding whether it should maintain the customary three-year, medium-term management plan. Although the insiders were focused locally on retaining the three-year management plan, the outside directors offered the idea of shortening the term of the plan because of the global economic uncertainty. This is also an example of topic-divergent motion made by outside directors. An outside director that I interviewed put pressure on the CEO and made him start to discuss the succession plan. This is an example of criticism by outside directors. In Hitachi, the outside directors ignored the customary rubber-stamping function and built agreement with the management plan through intensive discussion with the insiders and management. This is also an example a topic-divergent motion by outside directors. Moreover, in Hitachi, outside directors asked questions and gave suggestions regarding an important M&A from perspectives that the insiders did not expect. This is an example of a topic-divergent motion. In all cases, I observed that constructive interactions created by the outside directors' topic-divergent motions or criticism moved the firm in a better direction.

5.3 Conclusion: A "new" outside director's role

The insiders of all firms acted as follows:

1) self-reflected and upgraded their understanding of issues through constructive interactions with the outside directors, which were promoted by their topic-divergent motions or criticism
2) Determined the best solution by upgrading their level of understanding of the issue
3) Finally moved the firms in a better direction based on the solution that they devised

This may be the dominant explanation about the mechanism by which outside directors can move the firm, especially those at a crossroads, in a better direction and improve the firm performance in the long run. It also answers the following research questions: “In what situations do outside directors contribute to a firm?” and “What role do outside directors contribute to a firm?”

As previously mentioned, this function cannot be classified as monitoring management and providing expert advice. Therefore, the creation of constructive interaction is the third role of the outside director, which no previous study has investigated.

While issues of control over management and independence of oversight have dominated research and practice, there is scant evidence that these approaches have been productive for a firm. Daily, Dalton, and Cannella, Jr. (2003) pointed out that these results suggest that alternative theories and models are needed to uncover the promise and potential of corporate governance. In this context, it may be valuable to unite the basic theories of corporate governance with the realities posed by other field of science, such as cognitive science, in the same manner as insiders unite with outsiders to increase a firm’s value. My finding that constructive interaction as the third role of outside directors contributes to the field of corporate governance and practice. Although my research focused on Japanese firms, I believe that this new finding and the above discussion can be applied to firms in other countries.

6. Empirical Research: Regression Analysis

6.1 Previous studies

Despite the large body of empirical studies, findings of the linkage between governance mechanisms and firm performances continued to be mixed and unclear (Dalton, Hitt, Certo, & Dalton, 2007). Regarding the relationship between firm performance and independent outside directors, Daily and Darton (1992) suggested that the ratio of independent directors is associated with good firm performance in small and medium firms. Rosenstein and Wyatt (1990) found in their empirical study that appointing outside directors had a significantly positive relationship with excess returns, even when most boards were dominated by outside directors. In contrast, Yermack (1996) concluded that the ratio of outside directors on the board is not positively associated with firm performance. Klein (1998) showed that inside directors have a better effect on firm performance than outside directors do. Beiner, Drobetz, Schmid, and Zimmermann (2004) found no relationship between the fraction of outside board members and Tobin's Q in their sample of Swiss firms. Duchin, Matsusaka, and Ozbas (2010) insisted that the presence of outside directors mandated by Sarbanes-Oxley Act of 2002 in the US worsened the performance of some firms. Regarding Japanese firms, although the majority of previous research also focused on the relationship between firm performance and particular governance mechanisms, the results were also mixed (Kang & Shivadasani, 1995; Kaplan & Minton, 1994; Kato & Kubo, 2006), The relationship between firm performance and independent outside directors is more “positive” than “negative.” Miwa (2006) showed that the ratio of outside directors to the board was associated with Tobin’s Q. Miyajima & Nitta (2006) showed that appointing outside directors had a positive impact on firm performance. In addition, the presence of outside directors on boards contributed to increasing ROA (Saito, 2011). On the other hand, Miwa and Ramseyer (2005) found no significant relation between the ratio of outside directors who were ex-bankers or ex-bureaucrats to firm performance. Miyajima and Ogawa (2012) found that independent outside directors were not only significantly associated with firm performance but also negatively associated with firm performance when it was the outside directors had difficulty in accessing the internal information of the firm. They took the ratio of R&D expenses to total assets, book-to-market ratio, standard deviation of price earnings ratio over the last 36 months, and the ratio of intangible asset as proxies for the difficulty of gaining access to internal information in order to provide advice or monitor by independent outside directors. Although Miwa and Ramseyer (2005) showed that the independence of outside directors is a key link to firm performance, Miyajima and Ogawa (2012) showed that the effectiveness of outside directors in relation to firm performance was not affected by the difficulty of accessing information. However, in Miyajima and

Ogawa (2012), how the above proxies were related to the availability of a firm's unique information was unexplained. In addition, it was unclear why outside directors could not monitor the management of a firm where internal information was hard to access.

The results of previous research are mixed and do not clarified the link between outside directors and firm performance. However, a detailed examination of the relevant literature indicates that the effects of outside directors depend on the situation of the firm and the country. Although the relationships between outside directors and firm performance were found to be negative in Switzerland (Beiner, Drobetz, Schmid, & Zimmermann, 2004) and the US (Duchin, Matsusaka, & Ozbas, 2010), in the situation that the outside director is ex-banker or ex-bureaucrat (Miwa & Ramseyer, 2005), or when it is hard for the outside directors to access internal information of the firm (Miyajima & Ogawa, 2012), the relationship in many literatures, especially literatures intended for Japanese firms, is positively concluded (Miwa, 2006; Miyajima & Nitta, 2006; Saito, 2011). In addition, scholars may assign differing degrees of independence to outside directors. For instance, Miwa and Ramseyer (2005) did not exploit the concept of the independence of outside directors but included dependent outside directors, such as the directors of affiliate firms.

In other words, it is likely to find positive relationship between outside directors and firm performance in Japan, whereas there are few researches to test the relationship under a particular situation. Moreover, previous researches have not given much weight to degree of independence of outside directors.

Therefore, in my regression models, I used the ratio of independent outside directors for Japanese listed firms with relatively strict standards for the independence of outside directors in Nikkei NEEDS database to examine the relationship between independent outside directors and firm performance. In addition, I set up a situation where firm performance is poor and examined how the relationship changed, particularly with regard to whether the importance of independent outside director varied in degrees of firm performance, which no previous study has examined. The goal is to test the following:

Proposition 1: Independent outside director can move a firm for better direction especially when a firm stands at a crossroad and consequently improve the firm performance in the long run.

6.2 Hypotheses

I have argued that Japanese firms need the governance mechanism of monitoring. What does Japan require to achieve monitoring? According to agency theory, the most significant requirement for the effectiveness of an outside director as a monitor of management is to maintain independence from management. The monitors have to play a central role in evaluating management and make decisions to keep hire or fire them. Under this condition, the question of the effectiveness of monitoring arises among shareholders of firms without independent outside directors. From the perspective of agency theory, boards dominated by insiders, including current or former managers/employees of the firm, or dependent outside directors, including directors who have business relationships with the firm and/or family or social ties with the CEO, are considered less effective in monitoring because of their dependence on the organization (Lynall, Golden, & Hillman, 2003). In other words, inside dependent directors cannot always solve serious conflicts of interest between managers and shareholders. Resource dependence theory also suggests that the board's dependence on a firm has a negative effect on monitoring management.

Theoretically, since shareholders (principal) are interested in improving firm performance, if effective monitoring by independent outside directors can reduce agency costs, which are incurred by the principals and successfully align the interests between shareholders and management, firm performance would improve. As I previously discussed, in the situation that the corporate governance of Japanese listed firms does not work well, the monitoring function is relatively important. Agency theory holds that the monitoring function cannot be effective without the independence of the board. These points suggest that the sensitivity of effect of monitoring by "independent" outside directors to improve firm performance may be relatively high in Japan, comparing other advanced economies which have other internal and external governance functions. Therefore, I predict that monitoring by independent outside directors is a key in the performance of firms in Japan.

In addition, independent outside directors may add value to discussions about relationships between governance mechanisms and firm performance to determine the kinds of firms that tend to benefit from monitoring. As I mentioned above, Ward, Brown, and Rodriguez (2009) proposed, based on bundle theory, that “the lower the performance of the firm, the greater the proportion of monitoring relative to incentive alignment used to achieve equally effective governance bundle.” If it is true then monitoring by independent outside directors could gain importance in situations of poor firm performance. Specifically, when the unit of cost for incentive alignment increases because of poor firm performance, the incentive alignment effect will decrease or will not exist. Consequently, the importance of monitoring by independent outside directors must increase, according to bundle theory.

However, the results of my qualitative research showed that it is not accurate to limit monitoring as the contribution of outside directors. Although admitting that outside directors are central in monitoring, my qualitative research suggests that this role is not their only contribution. I found that outside directors have another contribution, creation of constructive interaction, especially when the firm faces difficulty and stands at a crossroads. In addition, this role also requires independence of outside directors. Therefore, I finally predict that the degree of independence of outside directors is a key in the performance of firms in Japan. Also I predict that the worse that firm performance is, the more important is the degree of independence of the outside directors, which is supported by governance bundle theory. Hence, I state the following hypotheses:

> *Hypothesis 1: The degree of independence of outside directors will be positively associated with firm performance.*
>
> *Hypothesis 2: When corporate performance is poor, the importance of the degree of independence of the outside directors will increase.*

6.3 Data and Methods

The data set consisted of 9,308 observations of nonfinancial listed firms in Japan and spanned the years from 2010 to 2013. I did not eliminate any firms from the data as outliers for the following two reasons. First, although some firms have abnormal numbers, they are not errors but actual data. For instance, three firms indicated negative Tobin's Q because their shareholder's equities were negative. Second, the number of firms that have abnormal numbers is limited. In addition, I tried to make two regressions with or without numbers that appeared abnormal. The results were similar.

The data set was composed of two streams. The governance data, such as independent outside director ratios and foreign investor ratios, were collected from the Nikkei NEEDS database. The financial data, such as Tobin's Q and total assets, was obtained from SPEEDA, which provides financial information on all listed firms.

6.4 Dependent Variables

I adopted Tobin's Q as a proxy for firm performance. Tobin's Q is widely accepted as an index used to measure firm's performance and growth opportunity (Coles, Lemmon, & Meschke, 2011; Miwa, 2006; Beiner, Drobetz, Schmid, & Zimmermann, 2004). For the purpose of this study, it is suitable for exploring the impact of independent outside directors on the performance of listed firms because independent outside directors do not have rapid effect on accounting performance; instead, it has relatively slow-acting effect on valuation of whole firm. I calculate the Tobin's Q (2011-2013) of all listed firms in Japan, based on financial data collected from the SPEEDA database. The formula (below) used to obtain Tobin's Q has been used in the previous literature on Japanese firms (Kimura, 2013; Miyajima, Arikawa, & Saito, 2001; Yonezawa & Sasaki, 2001):

Tobin's Q = (Market cap + Interest-bearing debt) / (Book value of shareholder's equity + Interest-bearing debt)

6.5 Independent Variables

I take a grading of the ratio of independent outside director as the variable, which is based on the strictest standard of independence in Nikkei NEEDS. The independent outside director has no experience in banking, as a large shareholder with more than a 15% stake, in an affiliate company, counter company in cross-shareholdings, and is not current senior executive of another listed firm. The ratio of independent outside directors can be sorted into five grades among whole listed firms in Japan. Moreover, as an independent variable, I add the interaction of the ratio of the independent outside director and the dummy of a firm with two consecutive periods of negative profits as the proxy of a firm with a seriously poor performance in order to explore whether the worse the firm performance is, the more important the degree of independent outside directors is.

6.6 Control Variables

In order to control the influences of the dependent and independent variables, I adopted the following control variables:

Block-shareholders. Agency theory predicts that blockholders will actively monitor the management of the company in which they invested to confirm its commitment to operate the firm in the best interests of the shareholders (Darton, Dairy, Certo, & Roengpitya, 2003). McConnell and Servaes (1990) found a positive relationship between institutional ownership and Tobin’s Q. This finding is evidence for the monitoring function of managers by outside blockholders. Among the outside blockholders, foreign investors in particular have diligently monitored firms and deeply influenced firms' improvement. From the perspective of agency theory, this applies to corporate governance mechanisms not only in Japan but around the world, including South Korea, France, and Germany (Ahmadjian, 2007).

Therefore, I predict that foreign investors may have positive effects on corporate performance.

Cross-shareholdings. On the other hand, the crossholding of shares in Japan may lead to the lack of close external monitoring of management, thus weakening the ability of managers to discipline themselves (Watanabe & Yamamoto, 1993). Cross-shareholding may also diminish the efficiency of firm management, because one holder is not always the most suitable partner for another in businesses where both are tied by cross-shareholdings. Moreover, as another benefit the management teams of both firms can enjoy reduced pressure from their shareholders. The remaining shareholders, however, may sustain damage from the resulting inefficiencies. Although cross-shareholdings clearly decreased from over 30 % of outstanding in the early 1990s to 11 % by 2005, they are currently increasing to 12.3 % and are expected to rise further (Araki, 2009; Hayakawa & Whittaker, 2009). Nomura Securities' survey results that the cross-shareholding ratio remained 10.9 %

at the end of March, 2012 was reported on the website of Board Director Training Institute of Japan (http://bdti.or.jp/node/593). This figure is far from negligible.

Hence, I predict that cross-shareholdings may have negative effects on corporate performance.

Stock options. Many previous studies supported supported the effectiveness of granting stock options as an incentive alignment. Hanlon, Rajgopal, and Shevlin (2003) showed that executive stock options were associated with increased performance outcomes (i.e., increased operating income). Perry and Zenner (2000) concluded that the increased reliance on equity-based forms of executive compensation resulted in a stronger alignment between executives and shareholders, driven largely by stock options. Agency theorists underpinned granting options as consistent with firm value maximization (Core & Guay, 1999; Rajgopal & Shevlin, 2002).

Bad performance. Because Japanese managers regard repeated negative profitability as a strong signal of poor performance (Ahmadjian & Robbins, 2005), I included the dummy variable of a firm with two consecutive periods of negative profit.

Others. In order to control the influences of company size and capital structure, I included the log of total assets and debt equity ratio, respectively. Cash holding is defined by the equation: Cash holding = (Cash + Cash equivalents) / {Total asset – (Cash + Cash equivalents)}. I include this index because it may have both positive and negative influences on market evaluation. While some have appreciated it as an expedient source of money for strategic investment or as a buffer for the shrinkage of the financial market, others have devalued it because of the free cash flow issue (Jensen C. M., 1986). I included dummy variables for each 10 industries, based on the TSE Industry Classification (Large Classification) and year dummy.

6.7 Analytical Approach

Issue of endogeneity. The study of governance-performance relationships includes the potential issue of endogeneity (Klapper & Love, 2004). For instance, a growing firm that needs more money from the capital market may adopt better governance, which could attract the attention of investors and facilitate financing easier. This reverse causality is an issue in research on the governance-performance relationship. On the other hand, there is a limit to addressing the problem of endogeneity. In their study of the endogeneity issue, Coles, Lemmon, and Meschke (2011) applied standard econometric approaches to panel data on the relationship between Tobin's Q and managerial ownership, but they failed to find that these remedies solved the simultaneity bias perfectly. Nevertheless, I adopted mainly three measures to address this issue. First, I used panel data, which Himmelberg, Hubbard, and Palia (1999) used to address this issue in their research on ownership and performance. Second, I include a one-year lag between performance and governance practices. Third, I add total assets as a control variable for firm size because the effect of firm size is ambiguous (Klapper & Love, 2004). While large firms may have greater agency problems because of the breadth and complexity of their businesses and the need to offset them with stricter governance practices, small growing firms may adopt better governance practices for the primary purpose of external financing, as I noted above. As a proxy of firm size, I use the natural log of total asset.

Model. In order to confirm the robustness of this quantitative approach, I used two types of regression models: one type of model did not consider the individual effect of a firm and the other models considered this effect. The former are OLS regression models, and the latter are a fixed effect model and a random effect model.

6.8 Findings and Conclusion of the regression analyses

Findings. Table 5 reports my set of results. All models use Tobin's Q as the dependent variable.

In Model 1 of the pooled OLS regression, the independent outsider director ratio was significantly positive at the 0.1% level, which supports Hypothesis 1: The *Degree of independence of the outside directors will be positively associated with firm performance*.

Other variables, except debt-equity ratio, also aligned with my prediction with statistical significant at 0.01% to 5%.

In Model 2 of the pooled OLS regression, the interaction between the ratio of independent outside director and the dummy of a firm with two consecutive periods of negative profits were positive and significant at the 1% level. The independent outsider director ratio was also significantly positive at the 0.1% level. The coefficient estimates of the interaction and the ratio of independent outside directors were 0.200 and 0.039, respectively. Thus, the impact of independent outside directors was 0.239(=0.200+0.039) when a firm made two consecutive periods of negative profits, whereas the impact when a firm did not make two consecutive periods of negative profits was 0.039. The coefficient estimate of the former was approximately six times larger, which meant that independent outside directors become more important when firm performance is poor, which supports Hypothesis 2: *When corporate performance is poor, the importance of the degree of the independence of outside directors will increase.*

All other variables, including debt-equity ratio, were the same as predicted, with statistical significance of 0.1% to 5%.

In Model 3 of the OLS regression with robust standard errors, clustering on firms, the results were similar to the results of Model 2, which supports Hypotheses 1 and 2.

In Model 4 of the fixed effects regression, the results were entirely different from those of the other models. Only the interaction was consistent with my prediction and significant at the 0.01% level. A possible reason is that my sample data covered the short period of only three years.

In Model 5 of the random effects regression, the results were similar to those of Model 2 and Model 3, which supports Hypotheses 1 and 2.

Table 5. Corporate governance and firm performance, 2011 to 2013

Dependent Variable	Tobin's Q				
Variables	Model 1	Model 2	Model 3	Model 4	Model 5
	OLS	OLS	OLS	Fixed effect	Random effect
Independent outside director ratio	0.056 ***	0.039 ***	0.039 ***	-0.033	0.034 **
	(0.011)	(0.010)	(0.011)	(0.022)	(0.012)
Independent outside director ratio ×		0.200 **	0.200 *	0.153 ***	0.186 ***
Negative profits in two consecutive periods(dummy)		(0.076)	(0.078)	(0.045)	(0.034)
Foreign investors ratio	0.135 ***	0.133 ***	0.133 ***	-0.141 ***	0.118 ***
	(0.023)	(0.023)	(0.028)	(0.041)	(0.020)
Cross-shareholding ratio	-0.082 ***	-0.080 ***	-0.080 ***	0.008	-0.090 ***
	(0.010)	(0.010)	(0.012)	(0.045)	(0.017)
Negative profits in two consecutive periods(dummy)	0.237 *	-0.273 *	-0.273 *	-0.259	-0.226 *
	(0.108)	(0.124)	(0.127)	(0.145)	(0.110)
Stock option (dummy)	0.328 ***	0.321 ***	0.321 ***	-0.029	0.234 ***
	(0.039)	(0.039)	(0.043)	(0.063)	(0.043)
Log total asset	-0.113 ***	-0.109 ***	-0.109 ***	-0.339 *	-0.123 ***
	(0.023)	(0.023)	(0.027)	(0.136)	(0.018)
Cash holding	0.002 **	0.002 **	0.002 **	-0.002 **	0.001 ***
	(0.001)	(0.001)	(0.001)	(0.001)	(0.000)
Debt-equity ratio	0.004	0.005 *	0.005	0.000	0.002
	(0.002)	(0.002)	(0.002)	(0.004)	(0.003)
Industry Dummy	YES	YES	YES	NO	YES
Year Dummy	YES	YES	YES	YES	YES
Constant	1.712 ***	1.684 ***	1.684 ***	5.313 ***	2.809 ***
	(0.215)	(0.210)	(0.243)	(1.418)	(0.176)
Number of obsevations	9,308	9,308	9,308	9,308	9,308
Number of groups				3,285	3,285
R-squared	0.1024	0.1064	0.1064	0.0056	0.1044

Note: Coefficients are in upper. Standard errors shown in parentheses. 10 dummy variables for sector and 4 dummy variables for year are not reported.
OLS of Model3 is with robust standard errors, clustering on firm.
* p < 0.05; ** p < 0.01;*** p < 0.001(two-tailed tests).

Summary. Four of five models supported both Hypothesis 1, *The degree of independence of the outside directors will be positively associated with firm performance,* and Hypothesis 2, *When corporate performance is poor, the importance of the degree of independence of outside directors will increase.*

Regarding Hypothesis 1, my result is consistent with agency theory and resource dependence theory, even under the situation that corporate governance did not work effectively. This result supports the robustness of agency theory. The result is also consistent with some previous studies (Daily & Darton, 1992; Rosenstein & Wyatt, 1990; Miwa, 2006; Miyajima & Nitta, 2006). In addition, this result answers my research question, RQ1: Why do Japanese listed firms need outside directors?

Regarding Hypothesis 2, no study has investigated that the importance of independent outside directors varies in degrees of firm performance for several years. The positive result of my empirical study is consistent with agency theory and may be the first to support a part of governance bundle theory. This also supports my Proposition 1, *Independent outside directors can move a firm in a better direction, especially when a firm stands at a crossroads and consequently improve the firm performance in the long run* which is drawn from my case study. Moreover, the confirmation of this hypothesis provides clear answers to my research question, RQ2: “In what situation do outside directors contribute to a firm? Under the condition of the independence of a firm and its management, outside directors contribute to firm performance, especially in the situation of poor firm performance.

7. Discussion and Conclusion

7.1 Overview of the Empirical Results

Although there have been several recent discussions about outside directors in Japanese firms, few substantial and practical discussions have focused on outside directors. Most arguments have been superficial and simple. I believe that without understanding all reasons for needing outside directions, the conditions necessary to work effectively, and the ability of outside directors to contribute to a firm, it is hard for a firm to manage outside directors and take advantage of their ability to contribute the firm. My dissertation discusses all these issues, answers them through empirical research, and makes some suggestions about managing the relationship between outside directors and business practitioners, based on three research questions:

RQ1. Why do Japanese listed firms need outside directors?

RQ2. In what situations do outside directors contribute to a firm?

RQ3. What role do outside directors contribute to a firm?

Based on the multitheoretic approach presented in Chapter 3, I conclude that the corporate governance of Japanese listed firms does not work well and that the monitoring function is the most important and should be improved first. Because outside directors have an important role in monitoring, I assert that Japanese listed firms need outside directors, which answers RQ1. On the other hand, the remaining two research questions will be explored in depth in two empirical studies that use the quantitative and qualitative approach, respectively.

Qualitative approach. My empirical case studies highlighted three important similarities—motivation, design, and performance—in adopting the committee system and appointing outside directors, which is helpful in understanding the mechanism of how outside directors contribute to firm performance. I will briefly explain each.

Spontaneous motivation is key in the function of governance systems, including the appropriate use of outside directors. Without sufficient motivation by the top executive of a firm, outside directors and committees may fail to function because the design and management of a governance system that takes advantage of outside directors is complicated and resource consuming.

There are three important considerations in designing a governance system that takes advantage of outside directors. First, it is crucial to maintain the independence of the outside directors. The second consideration is the degree of empowerment given to management. If a firm can acquire a sufficient monitoring function by independent outside directors, it will make sense to delegate as much authority to management as possible because it clarifies the separation of monitoring and execution. However, it depends on the board's ability to monitor. This ability depends on how the outside directors gain the necessary information in a timely manner, which is the third consideration. Without enough timely information, the outside directors cannot take part in the discussions in board meetings. Thus, these three factors are closely linked in the design of a governance system that takes advantage of outside directors.

Concerning performance, I derive two propositions from my case study as follows:

> *Proposition 1: Independent outside directors can move a firm in a better direction, especially when the firm is at a crossroads and consequently improve the firm performance in the long run.*

This proposition answers RQ 2, "In what situations do outside directors contribute to a firm?"

> *Proposition 2: Independent outside directors can promote constructive interactions with insiders in discussions, which moves the firm in a better direction and consequently improves the firm performance in the long run.*

This proposition covers RQ3, "What kind of roles do outside directors contribute to a firm?" Based on a concept in cognitive science, the results of my case study supported that constructive interactions promoted by independent outside directors cause insiders to reflect on their bias towards an issue and leads the board, especially insiders, to different levels of understanding and solutions to the issue. Consequently, independent outside directors can move a firm in a better direction. Because the creation of constructive interaction is not categorized among the monitoring and provision of resources as roles of outside directors in the existing theory, I conclude that this is the new, third role of outside directors. Because there have been few discussions about new roles of outside directors in the academic and business world, this finding has great potential to further the understanding of the relationship between outside directors and a firm.

Quantitative approach. According to the theory, monitoring does not function effectively without the independence of the board. In addition, the monitoring function has become relatively important in Japanese firms, compared to firms in advanced economies, because there are few other extensive internal and external governance functions, and the overall effectiveness of corporate governance in Japan is weak. These points suggest that the sensitivity of effect of monitoring by “independent” outside directors to improve firm performance may be relatively high in Japan. Therefore, I predicted that the independence of the board is a key factor in firm performance in Japan, as expressed in *Hypothesis 1: The degree of independence of the outside directors will be positively associated with firm performance.*

I then predicted that the worse the firm performance, the greater the importance monitoring, based on governance bundle theory and *Proposition 1: Independent outside directors can move a firm in a better direction, especially when a firm is at a crossroads and consequently improve the firm performance in the long run.* Consequently, I formulated *Hypothesis 2: When corporate performance is poor, the degree of independence of outside directors will increase in importance.* This was linked to RQ2. Table 6 shows the relationships of the research questions, propositions, and hypotheses:

Table 6. The relationships among my research questions, propositions, and hypotheses

	Research Question		**Propositions from qualitative study**		**Hypotheses for quantitative study**
R1:	Why do Japanese listed firms need outside directors?		(Chapter 3)	H1:	The degree of independence of outside directors will be positively associated with firm performance.
R2:	In what situations do outside directors contribute to a firm?	P1:	Independent outside director can move a firm for better direction especially when a firm stands at a crossroad and consequently improve the firm performance in the long run.	H2:	When corporate performance is poor, the importance of the degree of independence of the outside directors will increase.
R3:	What role do outside directors contribute to a firm?	P2:	Independent outside directors can promote constructive interactions with insiders in discussions, which moves the firm in a better direction and consequently improves the firm performance in the long run.		

Finally, four of five models supported both Hypothesis 1 and Hypothesis 2. Regarding Hypothesis 1, my result was consistent with previous studies (Daily & Darton, 1992; Rosenstein & Wyatt, 1990; Miwa, 2006; Miyajima & Nitta, 2006). It is important that the result of Hypothesis 1 is consistent with agency theory, even under the situation that corporate governance does not work effectively.

The confirmation of Hypothesis 2 supports Proposition 1: *Independent outside directors can move a firm in a better direction, especially when a firm is at a crossroads and consequently improve the firm performance in the long run.* The present empirical study is the first to support a part of governance bundle theory. No recent previous study has examined that the importance of independent outside directors according to degrees of firm performance. Moreover, this result of Hypothesis clearly answers RQ2: "In what situation do outside directors contribute to a firm? Hence, under the condition of the high independence from a firm and its management, outside directors contribute to firm performance, especially when firm performance is poor.

Similar to my finding of the third role of outside directors, these results may contribute to not only the corporate governance research, but also to all business practitioners who have connections to outside directors.

7.2 Future Research

Based on the findings of my research, I concluded that the creation constructive interaction is a new, third role of outside directors. However, future research should examine and clarify this role. For example, the constructive interaction between the outside directors and insiders of a firm could be observed in the detailed minutes of board meetings. However, it may be relatively hard to find a proxy variable for constructive interaction in a qualitative research. This remains an area for future research, given the potential complexity of this role of outside directors.

7.3 Recommendations for Practitioners

Based on the findings of this study, I develop some recommendations for managing corporate governance, which practitioners and policy makers could apply.

Theoretical foundation. Agency theory should be placed at the core of designing a corporate governance system because, like capitalism, agency theory is the second best and has no strong rivals. In addition, it is a fact that most shareholders expect and even demand that the firm in which they invested bases its governance system on agency theory. No management can be removed from the expectations and demands of the shareholders. It is understandable that firms may be tempted to consider cultural fitness and tradition in designing a corporate governance system. However, this system benefits not only the firm but also its shareholders. Therefore, introspective logic will not work.

The most important function. First, monitoring is the most important function because it not only disciplines management but also theoretically, it is much more important to maintain effective governance when a firm lowers its performance. Incentive alignment, which is another pillar in addressing the agency problem, can substitute monitoring to some extent under a certain conditions, but it will not work in a firm which has poor performance. In order that monitoring functions well, it is indispensable to provide independent outside directors with information that is necessary to discuss business issues in a timely manner. The best practice is that it is effective to appoint a team that takes charge of providing timely information to outside directors and facilitating their access to it.

The most important player. Independent outside directors are the most important players in corporate governance. They not only monitor management but also promote constructive interactions between the board and management. In addition, the results of my empirical study showed that outside directors can gain in importance when a firm lowers its performance. This suggests that a failing firm should strengthen monitoring by adding independent outside directors, even it requires reducing other costs, such as the manager’s compensation.

What kind of person suits the role of outside director? Rosenstein and Wyatt (1990) found no clear evidence regarding the occupations that the best for outside directors. According the theory used in this research, outside directors who are industry expert/advisors may foster board dependence and may be harmful for monitoring, which is the most important function of the board. Therefore, advisors should not be appointed as outside directors because they place too much emphasis on providing resources. However, people who are monitors and catalysts person could be outside directors that monitor management properly, facilitate constructive interactions in discussions, and support insiders in determining the best solutions to business issues. In addition, Miyake (1986) supported the effectiveness of outside directors who are not familiar with the business of the firms, as long as they are independent and have differing, broad and visions and provide sound criticism. Their expected role is to monitor and create constructive interaction with insiders, not to provide advice based on deep industrial knowledge. Outside directors should be able to maintain independence during their term, resisting the temptation to become dependent on management. No one can speak to insiders and management without independence. Without speaking out, outside directors cannot create tension and a constructive interaction between the board and management. Therefore, it is crucial, not for outside directors, but for the firm and its shareholders that the outside directors maintain independence. Hence, it is preferable that outside directors have both spontaneous motivation and extrinsic incentives, such as maintaining his/her reputation or having an income.

What kinds of situation increase the need for outside directors? The results of the present research are also relevant for practitioners and policy makers. For instance, local governments may revive failing local firms that remain caught in a downward spiral of governance and that do not have a sufficient number of independent directors (or enough monitoring) by the temporary subsidies to compensate independent directors. This may stop the downward spiral because monitoring becomes more important when firm performance is poor, according to bundle theory. In addition, according to the results of the present research, independent outside director can move a firm in a better direction, especially when it faces difficulties and is at a crossroads.

7.4 A New Movement in Japan

In addition to those mentioned in the introduction, new movements could change corporate governance in Japan. They can be divided into two categories of control mechanisms: internal and external.

7.4.1 Internal control mechanisms

The emergence of the third option in board structure. In November 2013, a cabinet resolution was made to pass a bill to revise the Companies Act. In the revision, the enhancement of the existing auditor system was in the form of newly creating the Kansa-kantoku Iinkai (audit and supervisory committee), which is a kind of intermediate system for companies with auditors and companies with the committee system. It would be easy for corporate management to adopt this governance system, which has an audit committee that does not include the nomination committee and the compensation committee. While some appreciate the positive side of the built-in auditor governance system as a new option, it could lead to a less disciplined governance system in companies with committees, because it would be too easy for management to keep appreciable governance.

Basically, companies with the committee system are allowed only when they establish a nomination committee and compensation committee. However, because it is too troublesome for the management to keep such committees, many companies are hesitant to adopt this option. If such committees were set up, the important rights "to determine compensation for individual cases" and "to nominate the forthcoming members of board," which are deemed to be the source of the power of the president or CEO, must be handed to the respective committees, in which the majority of the members are outside directors.

Hence, because the president or CEO would be reluctant to lose this source of power, they would not consider committee option. Consequently, staying with the corporate auditor system is on Nash equilibrium. This is the current picture surrounding the corporate governance system of Japanese companies. Actually, they have not shifted to the option of company with committees despite the alleged merits of this option: much authority could be delegated to executive officers, the corporate decision-making processes could be speedier and more efficient, foreign portfolio investors would appreciate this option, and so on.

On the other hand, in the auditor system, because each auditor is granted the right of investigation, they can exercise it at their own will. It occurs rarely, but it could happen, which is potentially troublesome for management. On the contrary, in the audit committee of the new audit and supervisory committee system, because each committee member is not given any individual discretionary right, each must obey the resolutions made by the committee, and the investigative right of each member is allowed only within the scope determined by the committee. If management drew a majority of voters in the audit committee, they would enjoy discretion, even when one member of the committee discovered cheating by the management. From this viewpoint, I confirm that adopting the new audit and supervisory committee system might increase managers’ discretion and weaken the overall governance, at least in terms of checking the behavior of management.

Thus, putting aside the real merits accrued through introducing the new option, it could happen that companies involving more governance problems might be more motivated to change to the new audit and supervisory committee because this transition would bring about a very flexible and convenient situation for the management.

Growing attention to outside directors. The same revision to the Company Act did not obligate a company to appoint outside directors, but it did include the obligation to explain "why appointing outside directors is not reasonable" at the regular shareholders meeting (Article 327-2 of the Companies Act after revision). This is to be newly imposed on companies with auditors which do not employ any outside director as of the fiscal year end (the target is limited to listed and large companies, as well as companies that are obliged to submit MOF securities report concerning their shares outstanding). In addition, the revision provides a stricter standard for selecting outside directors, compared to the current Act. For instance, those involved in the operation of the parent company or affiliated company are not eligible for the position of outside director (Article 2-15 of the Companies Act after revision).

Furthermore, in the requirements expressed by Stock Exchange, they made it clear as their policy since 2010 that it is desirable for a listed company to have an independent outside director or auditor. In February 2014, they revised the securities listing regulations, by introducing the new stipulation that “A listed company must endeavor to secure one or more independent directors.” Hence, they clarified the obligation for management to appoint at least one independent director. In January 2014, a new stock price index was introduced, the “JPX Nikkei Index 400.” The Index consists of companies that are attractive for investors. In selecting the issuer, “Two or more independent outside directors are appointed” are included in the criteria for judgment.

Therefore, the number of outside directors is expected to increase dramatically but they will not be in the majority on each board. In the near future, the quality of outside directors and their utilization by a firm will become a major topic of discussion. The above recommendations will be helpful.

7.4.2 External control mechanisms

Possibility of becoming loud voices from domestic investors. On 27 February 2014, a paper on the “Principles for ‘Responsible Institutional Investors” or Japanese Version of the Stewardship Code” was announced by the Council of Advisers on the Japanese Version of the Stewardship Code through the Financial Service Agency’s website (http://www.fsa.go.jp). The principles that institutional investors deem useful in fulfilling “stewardship responsibilities” are set in the Japanese Version of the Stewardship Code. “Stewardship responsibilities” are described as “those responsibilities to increase the medium to long-terms return on investment on behalf of clientele/beneficiaries, through constructive dialogue (engagement) between institutional investors and target investees, based on the former's deep understanding about the business and environment of the latter and on, having a vision to enhance the target company's enterprise value and to encourage their sustainable growth" (The Council of Experts Concerning the Japanese Version of the Stewardship Code, 2014). The Japanese Version of the Stewardship Code is a set of rules structured for the benefit of institutional investors, not issuers. Although the rules are not legally binding, it is expected that institutional investors in Japan will comply with it or explain why the investors do not have to comply with it.

As explained above, institutional investors are expected to fulfil "stewardship responsibilities." The activities are not confined to exercising voting rights. Proactive discussions with the target company are of primary importance. This matter is not particular to handling general shareholders meetings. In the Japanese Version of the Stewardship Code, in the "dialogue (engagement)" to be pursued by institutional investors, nothing is specifically stipulated, and so it depends on the attitude of each institutional investor. Thus, uncertainties will remain regarding the action pattern of institutional investors, in addition to how they do or do not change.

It will be crucial for institutional investors to address their conflicts of interest. A person involved said, “Insurance companies have exercised their voting rights as a marketing weapon. They have rarely made dissenting votes to the bills proposed by the investees” (Nikkei Shimbun, 2014). A high point will be how institutional investors, especially insurance companies, exercise their voting rights for important bills, such as the appointment of outside directors, which the investees but their customers simultaneously proposed at regular general shareholders meeting of 2015. At first, it is likely that some will be creative in the disclosure of the voting results. However, this attitude will become a target of criticism and will gradually inhibit the creativity. Hence, even the voices of domestic investors may increase dramatically. This movement may accelerate the improvement of governance mechanisms by adopting outside directors and performance-based bonuses.

Possibility of the emergence of a rising star in external monitoring. Japan’s Government Pension Investment Fund (GPIF) is going to become a giant in stock markets. The GPIF, the world's biggest institutional investors, manages 120 trillion yen ($1.15 trillion) in assets, which is a mix of domestic assets: 60% bonds and 12% equities. The Japanese government established a panel of distinguished citizens to discuss GPIF’s reform of the policy of investment and the organizational structure for the operation. According to the *Nikkei Asian Review* (January 23, 2014), Japan's ruling Liberal Democratic Party is going to try to pressure the Welfare Ministry to realign the GPIF's bond-heavy portfolio through recommendations made by the government-commissioned panel. Actually, Takatoshi Ito, a prominent University of Tokyo economist who chairs the panel, suggested on November, 2013, that GPIF's domestic portfolio should be a mix of 35% bonds and 20% equities, which means that GPIF would need to buy 4.6 trillion yen worth of shares to reach this level, according to the estimate by Daiwa Securities. In addition to this huge amount of money, if the GPIF and its outsourcing investors comply with the Stewardship Code, the impact of changing its course would be notable, not only on domestic capital market, but also on improving the level of corporate governance in Japan. According to Ward, Brown, and Rodriguez (2009), GPIF could be a leading star as a concerned external shareholder in prompting the internal governance mechanisms of monitoring and incentive alignment complement an effective governance bundle.

7.4.3 Threat or opportunity?

Although, among new trends above, the new audit and supervisory committee system could have a negative impact to improve level of corporate governance in Japan, the rest may accelerate the changes in a better direction. It is, therefore, highly possible that the improvement of corporate governance in Japan has made progress. External control mechanisms may precede internal control mechanisms. Instead, the former may trigger the latter. Even in this case, especially concerning the appointment outside directors, the soft law of "comply or explain" may be preferable because it is better to have some flexibility in appointing outside directors, for the following three reasons:

First, if it is made mandatory by law, several firms might appoint "window-dressing" outside directors, which make no sense at all. Similarly, some companies with committees might form a nomination committee led by a current CEO. There could be a loophole in the laws. It is hard to change laws quickly to amend such loophole, whereas it is easy to fine tune rules of organizations, such as the stock exchange market, and to lead firms without outside directors towards appointing outside directors by increasing explanations in the soft law approach.

Second, the results of my case studies showed that it is difficult and costly for a firm to search for, appoint, and manage outside directors both monetarily and technically. Hence, some firms could not commit to managing outside directors. Thus, flexibility is needed in requiring firms to adopt this system.

In addition, the hard-law approach may cause difficulties in the future. Once outside directors are mandatory by law, a solid definition of the outside director is required because government punishes a firm that violates the law. For example, among the firms, some would not intentionally violate the standard of the outside director. If the violation of law was discovered several years after, all decisions made by the board of this firm during the period of violation could become invalid because the board has lacked legitimacy. However, in a soft-law approach, not by the government but by stock exchange market, difficulties could be avoided because the issue would be under the rules of the stock exchange market, not the law. In this case, therefore, flexibility would be both important and useful in practice.

Although differences remain in the corporate governance system of the world's advanced economies, simultaneously there is a deeper tendency toward convergence with the shareholder-oriented model (Hansman & Kraakman, 2001). Although appointing some outside directors may be a painful process for the current management, it may benefit all stakeholders, such as shareholders, employees, and even the current management. A serious attitude toward increasing the number of outside directors would send the message to global investors that Japan is earnest about corporate governance and cares about adopting global standards.

Some management and corporate auditors claimed that some firms make great efforts to improve their corporate governance under the current framework and that the improved system works well (Hamabe, 2012). While it is valuable to improve a governance system at the individual firm level under the current situation, it may not sufficiently increase the reputation of Japan's capital market. For example, financial investors, including foreign portfolio investors, cannot set an investment strategy at the firm level until they establish a policy for global asset allocation. Hence, the investors do not have enough time to look into every business and governance structure of a firm in which they will invest. The unfortunate reality is that a firm improves its corporate governance system through its own actions. Considering the fact that among indexes of other advanced markets, only TOPIX has failed to increase the market cap since the late 1980s (Figure C in Appendix 1), it is very important that Japan send this message by using a holistic approach and actually improve its level of corporate governance. This will create an opportunity to boost the market cap in Japan.

7.5 Conclusion

I will state my conclusion and contribution in brief through answering my research questions.

RQ1: Why do Japanese listed firms need outside directors?

Through the lens of multiple theories, I conclude that the corporate governance of Japanese listed firms does not work well and that the monitoring function is the most important and should be improved first. Because outside directors have an important role in monitoring, I draw a conclusion that Japanese listed firms need outside directors.

RQ2: In what situations do outside directors contribute to a firm?

From my qualitative analysis through case study, I found that independent outside directors can move a firm in a better direction, especially when a firm is at a crossroads. In particular, they contribute to firm performance, especially when firm performance is poor. I tested this in my regression models and the results positively support it, which is one of my contributions. Since every firm may face a crossroads under competitive business environment and economic uncertainty, I logically reached a conclusion that it is better for a firm to appoint outside directors.

RQ3: What role do outside directors contribute to a firm?

I also found through my case study that independent outside directors have another new important role which is creation of constructive interaction with insiders in discussions. By their promoting this role, they also can move the firm in a better direction, especially when a firm stands at a crossroads. It will expand understandings of outside directors to look them from the standpoint of this new role. The deeper understandings will suggest who firms should choose as the outside directors and how firms take advantage of their abilities to contribute the firms. This has important implication for corporate boards, officers and staffs. Therefore, this finding is my primary contribution to corporate world.

Beyond the compliance

As I discussed above, recent trends will put pressure on appointing or increasing outside directors to the listed firms in Japan. How will the firms respond to the pressure? One thing I can say is it would be better off not just complying with the rule or generally accepted standard in appointing outside directors. Effective use of outside directors can be ‘corporate governance differentiation’ which is one of means to ensure sustainable growth of corporations and economies. Although most Japanese firms have been said to just imitate and emulate one another and rarely develop distinct strategic positions (Porter, 2002), they could built their strategic position through enhancing corporate governance differentiation by effective utilization of independent outside directors. The above findings can be of assistance to do so.

Appendix 1

Economic Value Added (EVA) in Japan

EVA, a trademark of Stern Stewart Management Services, is a performance measurement that focuses on value creation for stockholders. It is based on the concept that a firm must earn more than its cost of capital and debt (Mir & Seboui, 2008). When firms calculate net income, they deduct costs from revenue. The costs generally cover wages, raw material costs, overhead, taxes, and so on. However, cost of capital is not usually deducted. To determine whether a firm creates added value for its shareholders, it needs to deduct the cost of capital that is contributed by the shareholders. For example, suppose shareholders' equity is 1,000, net income is 150 and the cost of capital is 8 %, the net gain for shareholders is 150 – (1,000 x 0 .08) = 70. This addition to shareholder wealth is contributed by the firm's hard work or good luck (Brealey & Myers, 2003). Net income after deducting the required return by shareholders is called EVA. The formula is

EVA= Income earned – Income required

= NOPAT [2]– (Debt + Shareholder's equity) x WACC[3]

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[2] Net operating profit after tax

[3] Weighted average cost of capital. The capital means a firm's source of financing, debt and equity. WACC is calculated using a following formula: WACC = E/V * Re + D/V * Rd *(1-Tax). Where (My method of calculation): E = market value of the firm's equity (market value at account closing date); D = market value of the firm's debt (book value at account closing date); V = E+D; Re = cost of equity = risk-free rate + β (market risk premium – risk-free rate) (Risk-free rate are 0.824% :2013; 0.775% :2012; 1.081%: 2011.

A negative EVA could be a sign that a firm has failed to achieve the outcome that suppliers of finance expected and to manage corporate governance. That is, EVA can be an indicator of corporate governance. Of course, like other measurements, EVA has limitations. For instance, it does not involve estimated future cash flows. Instead, it is based on current levels of earnings. It, therefore, may not fit firms that require long terms of R&D or are start-ups. However, it can provide the entire picture of a market because the number of such firms is limited.

Outcome of EVA in Japan

Actually, one data set suggests that a certain portion of listed firms in Japan may not reach an acceptable level in shareholders' expectations of corporate governance.

I examined the EVAs of all listed firms in Japan for three consecutive year. Because all firms are listed, the limitation of EVA is unlikely to have a significant impact on this analysis. As Figure A shows, the stake of the firms with negative EVA has been around 50 % of all listed firms in Japan. This means that a substantial number of listed firms (almost half) in Japan have failed to provide the return that stockholders expected. This

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Source: http://www.mof.go.jp/jgbs/reference/interest_rate/jgbcm.htm. β : Latest 5 year. Source: SPEEDA. Risk premiums are 8.9 %:2013; 8.2%:2012; 8.0 %:2011. Source : ibbotson's Japanese Equity Risk Premia Report 2014.); Rd = cost of debt (Interest and discount expense at t divided by average of interest-bearing debt t-1 to t); Tax rate is 35.64%

could suggest that the effectiveness of corporate governance in a certain portion of listed firms in Japan may NOT reach an acceptable level.

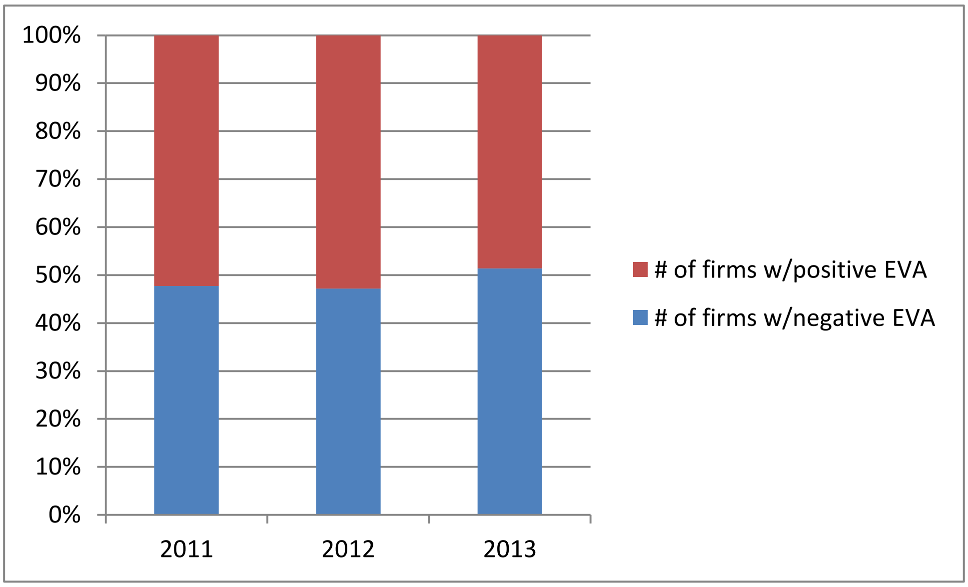


Figure A. Ratio of firms with negative EVA

Return on equity (ROE) in Japan

ROE is definitely an important index for the profitability of a firm. On the one hand, it is not panacea. For investors, ROE is a useful measure to compare roughly their expected return to the profitability of a firm and the expected returns between different divisions of a firm, firms, industries, and economies. For firms, ROE may seem myopic because it can be improved by not only increasing profitability of business but also increasing debt or tentative downsizing. However a block of shareholders that is calculated by adding financial institutions and foreign investors is the majority of stock ownership of all listed firms in

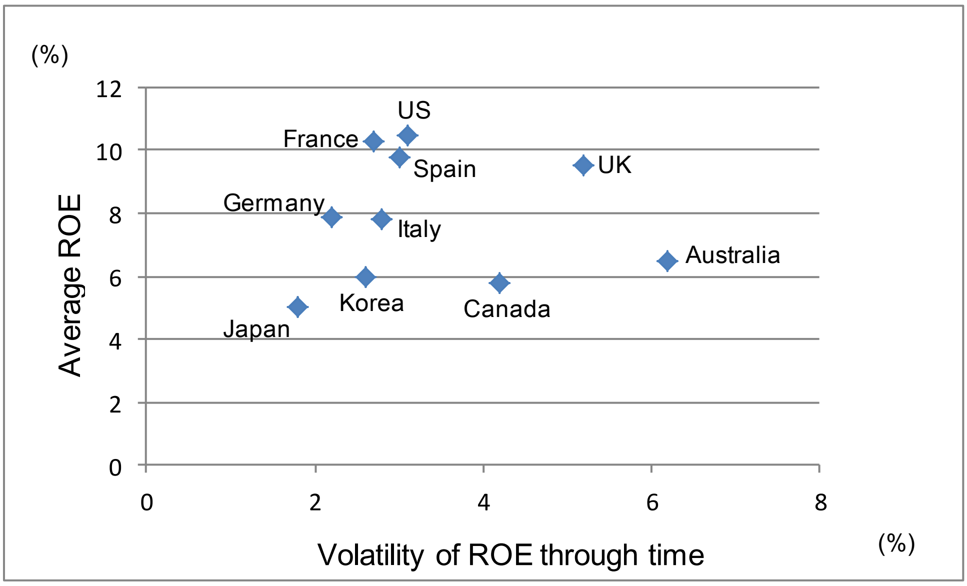
Japan (See Figure 5). Most are institutional portfolio fund managers, such as pension-fund managers. Every portfolio investment manager must estimate future stock-market performance worldwide to measure the funding requirements and to fix investment policy. Retirees face a similar issue (Cornell, 1999). Investors, however, are concerned about whether they can gain their expected returns from the firm in which they invested because every firm becomes a source of the profit that the investors promised to principals. Most have a fiduciary duty to their grantors, who are ultimately funded privately. This means that earning profits through portfolio investments are suitable for not only direct investors, such as institutional investors, but also indirectly for ordinary people, such as current and future pensioners. Hence, it is anticipated that the investors' profit is distributed to people. In this context, a listed firm requires a certain rate of return on external investments in economies (Gordon & Shapiro, 1956).

Investors frequently measure the ROE of each firm and each market, as well as the expected returns. ROE is most popular index to measure profitability, even for Japanese institutional investors (The Life Insurance Association of Japan, 2013). A new stock index in Japan, the JPX-Nikkei 400 was launched at the beginning of 2014. One of the selection criteria is a three-year average ROE ranking among the candidates of the 400 firms (Japan Exchange Group & Nikkei, 2013). Taking account of these situations, very few listed firms can ignore ROE as a measure to evaluate its corporate governance, thus assuring financers of getting a return on their investment.

In addition, some disagree that ROE is a measure of firm profitability because executives manage a firm based on a perspective that is longer term than that of the shareholders, which does not fit the evaluation by annual ROE. However, there is doubt about this angle. At least, it is not suitable in every case. Executives are likely to have a shorter time line than shareholders do because managers are the most interested in the firm performance for the period that can be directly associated with their compensation (Walsh & Seward, 1990).

Outcome of ROE in Japan

Nakano (2009) pointed out that Japanese listed firms generally take lower risk and provide lower returns, compared to the economies of ten major countries by analyzing ROE. He plotted the volatility of ROE during last 22 years to 2006 on a horizontal axis and the average ROE during the same period on a vertical axis (see Figure B). The horizontal axis shows risk, whereas the vertical represents return. Although the average ROEs are 10.5% in the US, 10.3% in France, 9.5% in UK, in Japan they are 5.0%.



The author made this figure based on Nakano (2009).

Figure B. Risks and returns in economies of 10 major countries (Nakano, 2009)

Figure B indicates that Japanese firms are characterized by very low returns. On the other hand, Japan also has the lowest volatility of ROE among ten advanced economies. Nakano (2009) suggested that Japan's very low ROE might be because firms are managed at very low risk. It is seemingly not a problem because it is natural that the lower the risk, the higher return. However, it is a problem. As I show in Figure 1, in Japan the risk-free rate and equity-risk premium are approximately 1% and 8%, respectively, which means that the expected return of shareholders will be 9% on the assumption that β is 1, although the actual average of ROE is around 5%. This may also mean that firms cannot ensure an expected return to stockholders.

Market cap of index in Japan

From the perspective of corporate finance, a firm's market value will decrease when ROE is lower than the expected returns by shareholders, and vice versa. Based on this perspective, around 5% of ROE in Japan may have decreased market caps. Among the indexes of other advanced markets, only TOPIX has failed to increase the market cap since the late 1980s (Figure C). This may also mean that the management of Japanese firms has failed to manage corporate governance, assuring financers of getting a return on their investment.

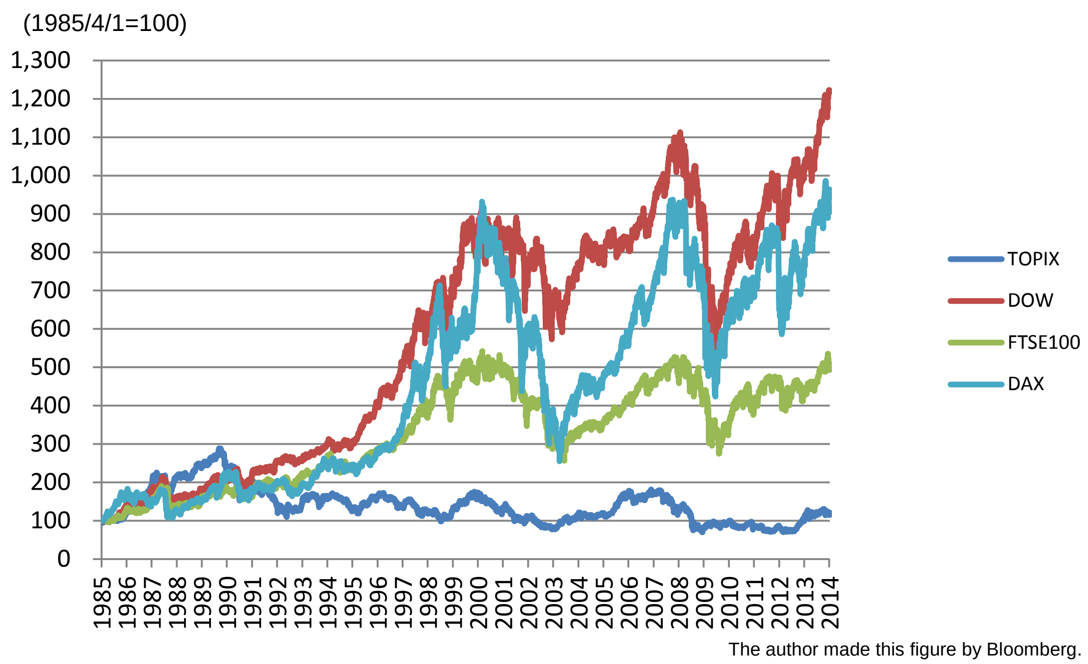


Figure C. Index changes in four advanced markets

Appendix 2

I will explain the four propositions (Ward, Brown, & Rodriguez, 2009) and the situation of Japanese firms from the lens of the propositions by applying indifference curve analysis, supplemented by my ideas.

Indifference curve analysis. On a coordinate that has value of incentive alignment as the vertical axis and that of monitoring as the horizontal axis in Figure D(a), the difference curve represents all governance bundles that combine incentive alignment and monitoring and that yield the same level of governance effectiveness. That is, a firm (or board, or shareholders) is indifferent to any combination (or any point, or any bundle) of incentive alignment and monitoring on the same indifference curve. In addition, there are an infinite number of nonintersecting indifference curves for every possible level of effectiveness of corporate governance, as shown by the coordinate of Figure D(a). The curves will shift away from (towards) the origin if the overall effectiveness of the firms' corporate governance improves (decreases).

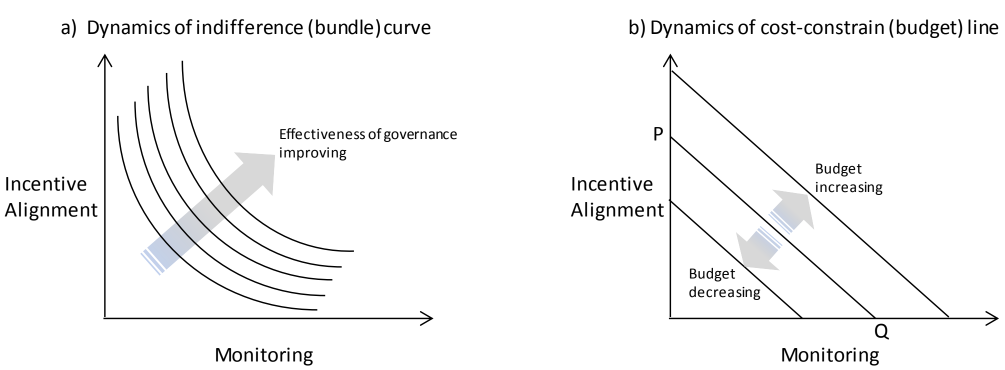


Figure D. Dynamics of indifference curve and cost-constraint line

On the other hand, the cost-constraint line PQ represents the constraint that firms face because of limited budgets. Let us consider a situation in which a firm has a limited budget such that directors pay for the cost of governance mechanisms, *B*, which can be spent on monitoring and incentive alignment. Let *M* be the amount of monitoring and *I* be the amount of incentive alignment. I will denote the unit costs of the two *Cm* and *Ci*. In this case, *Cm M* is the amount of money spent on monitoring, and *Ci I* the amount of money spent on incentive alignment. The cost-constrain line PQ indicates all combinations of *M* and I, for which the total amount of money spent is equal to the limited budget for governance mechanisms. Consequently, the combinations of monitoring and incentive alignment that the firm can pay for all lie on this line:

$$Cm\ M + Ci\ I = B \qquad (1)$$

Using equation (1), I can see how much of *I* must be given up to use more of *M*. I divide both side of the equation by *Ci* and then solve for *I*:

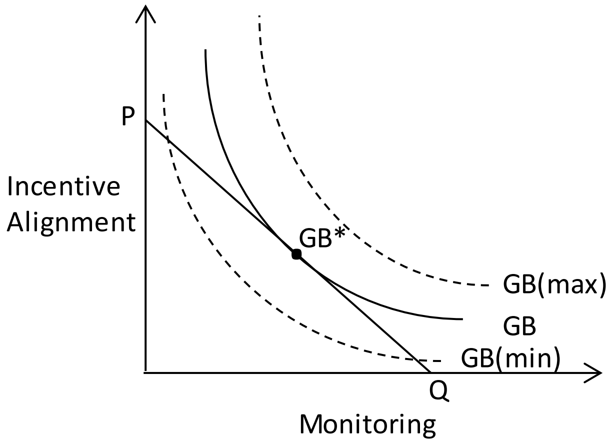
$$I = (B / Ci) - (Cm / Ci)\ M \qquad (2)$$

Equation (2), representing a straight line, has a Y-intercept of *B / Ci* and a slope of – *(Cm / Ci)*. This slope shows the rate at which the two governance mechanisms can substitute each other, keeping the total amount of money spent. The vertical, Y-intercept B / Ci (=P) represents the maximum amount of I that can be paid within the limited budget. The X-intercept B / Cm (=Q) shows how many units of cost of M can be paid if the budget were spent on M.

The cost-constrain line PQ depends both on the budget that directors can pay for the cost of governance mechanisms(B) and on units of cost of monitoring(Cm) and incentive alignment (Ci). From the equation for the straight line (2) above, a change in B alters the Y-intercept of cost-constrain line PQ but does not change the slope of – (Cm / Ci) because the units of cost of monitoring (Cm) and incentive alignment (Ci) remain. Figure D (b) shows that if the budget increases the cost-constrain line PQ shifts outward, whereas if the budget is cut, the line PQ shifts inward (The angle of the units of cost will be discussed later).

The optimal combination, within the budget, of monitoring and incentive alignment in a governance bundle is represented by the point of tangency between the cost-constraint line PQ and an indifference curve or the governance bundle curve GB, which the point GB* in Figure H. The slope of cost-constraint line PQ is determined by the relative costs of providing each governance mechanism, as the slope, – (Cm / Ci), in the equation (2) shows.

The intercepts are determined by the unit costs of providing the respective governance mechanisms, as the intercepts, B / Ci (=P) and B / Cm (=Q), in the equation (2) show.



The author touched up Ward, Brown, and Rodriguez (2009)

Figure E. Governance bundle curve and cost-constraint line

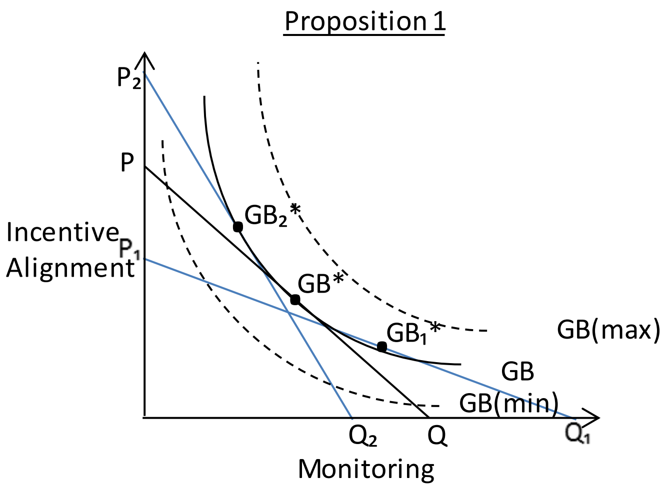
In addition, Ward, Brown, and Rodriguez (2009) proposed that there are both maximum and minimum boundary conditions for governance bundles to remain effective. That is, there is an upper limit beyond which adding governance mechanisms does not improve governance effectiveness, denoted GB(max) in Figure E, whereas there is a lower limit below which shareholders lose controlling power to protect their interests and prevent entrenchment behavior by agents, which is denoted as GB(min). It is therefore crucial for firms to maintain the effectiveness of their governance bundles between GB (max) and GB (min), as shown in Figure E.

Firm performance as a determinant of governance bundles. As noted above, Ward, Brown, and Rodriguez (2009) proposed that firm performance affects the provision of governance mechanisms within the governance bundle and determining whether the mechanisms within the bundle work as substitutes or complements. They explain four propositions about the detailed structures, based on scenarios of performance. I will explain their four propositions and apply some of them to analyze the present state of Japanese corporate governance.

Proposition 1

"In firms with good corporate performance, the internal governance mechanisms of monitoring and incentive alignment will act as substitutes in maintaining an effective governance bundle. (Ward, Brown, & Rodriguez, 2009)"

For example, when the stock prices of the firm are rising because of good firm performance, it may substitute more stock options (incentive alignment) for less monitoring because the relative cost of stock options decreases ($P \rightarrow P_2$). Then the governance bundle curve tilts to P_2Q_2, and the firm can maintain or potentially reduce overall costs while maintaining the same level of governance effectiveness, shown as GB_2* on governance bundle curve GB in Figure F. Peasnell, Pope, and Young (2003) claimed that as managerial stock holding increases, its incentive alignment effect will reduce the need for monitoring by outside directors. Zajac and Westphal (1994) also provided evidence of a negative relationship between managerial stock holding and the proportion of outside directors.



The author touched up Ward, Brown, and Rodriguez (2009)

Figure F. The substitution effect under conditions of good firm performance

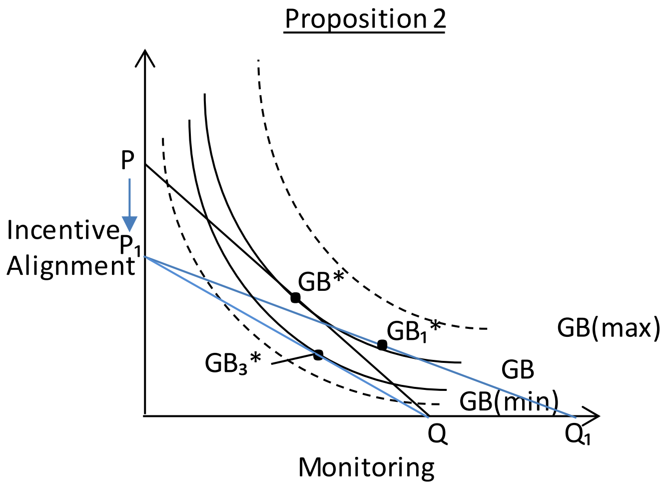
The same mechanism works such that the bundle curve tilts to P_1Q_1 when, for instance, firms add some independent directors to substitute more monitoring for less stock options (incentive alignment).

Proposition 2

"The lower the performance of the firm, the greater the proportion of monitoring relative to incentive alignment used to achieve an equally effective governance bundle. (Ward, Brown, & Rodriguez, 2009)"

For instance, when the stock prices of a firm are falling because of poor firm performance, the firm may substitute more monitoring for fewer stock options (incentive alignment) because poor performance makes incentive alignment less efficient and more expensive to maintain the same level of effectiveness, which means that the relative cost of stock options increases, and P shifts to P_1 because *Ci*, unit cost of incentive alignment, of Y-intercept *B / Ci* (=P) on the equation (2) increases. Then if the firm can decrease monitoring costs and simultaneously increase monitoring activity adding new, independent outside directors, the governance bundle curve tilts to P_1Q_1, and the firm can maintain the same level of governance effectiveness at GB_1, as shown on the governance bundle curve GB in Figure G.

However, if the relative cost of monitoring stays constant and the firm cannot increase monitoring activity, the firm needs to reduce the overall effectiveness of the bundle such that the cost-constraint line moves from PQ to P_1Q, not P_1Q_1 and the firm is limited to stay at a lower level of governance effectiveness, as shown at point of GB_3* in Figure G.



The author touched up Ward, Brown, and Rodriguez (2009)

Figure G. Governance bundles under conditions of poor firm performance

Proposition 3

“In firms with poor corporate performance, external monitoring by shareholders can prompt the internal governance mechanisms of monitoring and incentive alignment to act as complements for a more effective governance bundle. (Ward, Brown, & Rodriguez, 2009)”

For example, when shareholders worry about poor firm performance, external monitoring by them can facilitate the enhancement of the boards effectiveness, not only in internal monitoring but also in redesigning and improving incentive alignment. This external pressure by concerned shareholders increases the efficiency of the mechanisms in a governance bundle, reducing the unit costs of both mechanisms and pushing the cost-constraint line away from the origin (from PQ to P_4Q_4 in Figure H), or at least reducing the unit cost of monitoring (from PQ to PQ_4). The point of optimal governance bundle will shift to GB_4* or GB_5*, respectively, as shown in Figure H. In equation (2) above, the dynamics of the cost-constrain line (from PQ to P_4Q_4) can be translated such that the Y-intercept B / Ci (=P) shifts outward when Ci, unit cost of incentive alignment, is decreased by pressure from the shareholders, whereas the X-intercept B / Cm (=Q) moves outward if Cm, the unit cost of monitoring, is decreased by extensive external monitoring of the shareholders. Therefore, the activist approach through external monitoring, which can have a complementary effect on the firm's governance bundle, could be a more efficient option for investors than selling the stocks of the firm when the firm performance is poor. Thus, obviously the boards should judge whether the actual request by the concerned shareholders is consistent with their common interests.

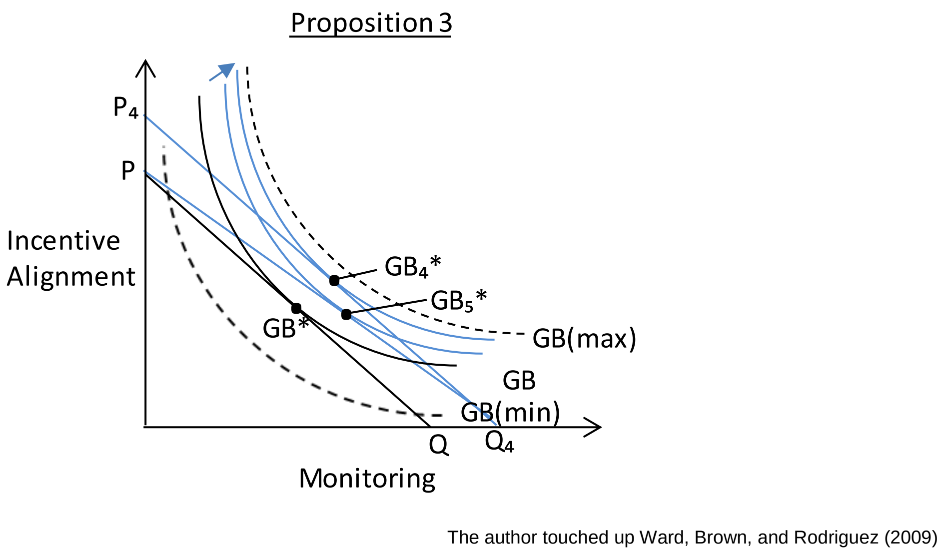


Figure H. Complementary effect produced by external monitoring

Proposition 4

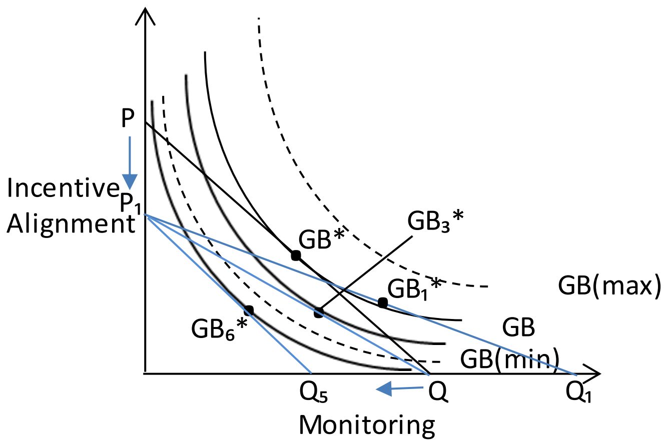
"In firms heading towards bankruptcy and under managerial entrenchment, the internal governance mechanisms of monitoring and incentive alignment will not act as complements, and the effectiveness of the firm's governance is likely to decline. (Ward, Brown, & Rodriguez, 2009)"

An empirical study by Walsh and Seward (1990) suggested that firms heading toward bankruptcy are disturbed by a downward spiral of their governance mechanisms, in addition to increased managerial entrenchment and decreased potential for the market for corporate control to intervene. Under such conditions, even the external pressure of concerned shareholders, which can successfully increase the efficiency of mechanisms in a governance bundle (proposition 3) is less likely to have a positive complementary effect because boards do not remain diligent monitors but become less independent, and outside directors tend to leave the firm without being replaced (Hambrick & D'Aveni, 1992), which entrenches management further and makes it less receptive to external pressure (Ward, Brown, & Rodriguez, 2009).

When the firm is under poor performance and management is entrenched, both the unit costs of monitoring and incentive alignment are likely to increase, pushing the cost-constraint line PQ towards the origin. In doing so, the line PQ is likely to shift to P_1Q

(flatter) because the cost of incentive alignment will increase more rapidly than that of monitoring (See Figure I). Then if the firms cannot maintain effective monitoring at the existing cost (e.g., independent directors leave the board without being replaced), the cost-constraint line P_1Q, in an extreme case, will shift to P_1Q_5 and GB_3* to GB_6*, which is beyond the minimum governance bundle (GB min), as shown in Figure I.

Proposition 4



The author touched up Ward, Brown, and Rodriguez (2009)

Figure I. Governance bundles in firms heading towards bankruptcy and under managerial entrenchment

Japanese firms from perspective of governance bundles. I applied the propositions in governance bundle theory to the analysis of the situation in Japanese corporate governance. The findings indicated that Japan may be in a serious condition regarding the effectiveness of governance, from the perspective of governance bundle theory.

Through the lens of Proposition 2

Proposition 2

"The lower the performance of the firm, the greater the proportion of monitoring relative to incentive alignment used to achieve an equally effective governance bundle" (Ward, Brown, & Rodriguez, 2009).

Because the stock prices of Japanese listed companies generally slump (see Figure 8), it is likely that the unit cost of incentive alignment hovers at a relatively high level (Figure G: $P \rightarrow P_1$).

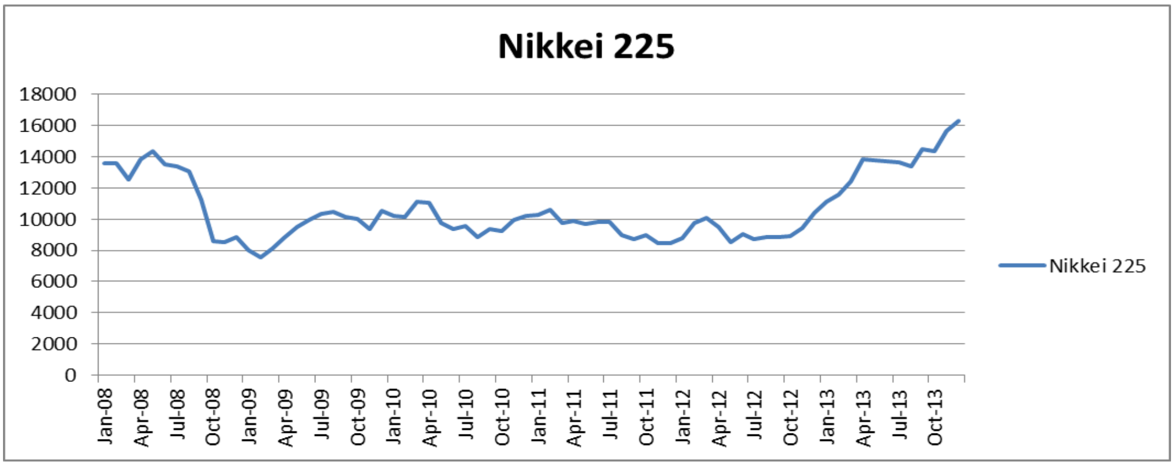
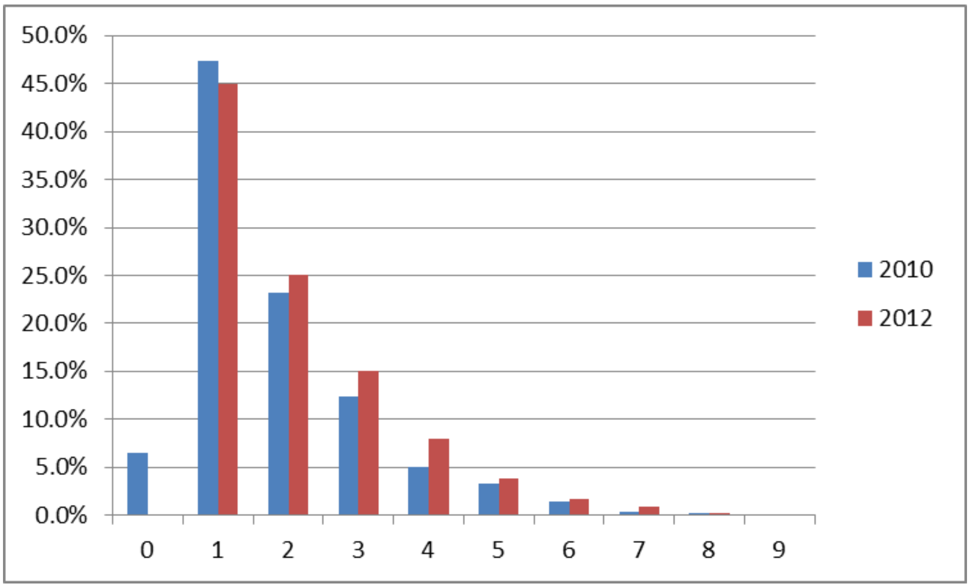


Figure 8. Price of Nikkei 225 (2008-2013)

Accordingly, the firm may substitute more monitoring for fewer stock options (incentive alignment). Then if the relative cost of monitoring remains constant and the firm cannot increase its monitoring activity, it has no choice but to reduce the overall effectiveness of the bundle such that the cost-constraint line moves from PQ to P_1Q, not P_1

Q_1, and the firm is limited to staying at a lower level of governance effectiveness, as at point of GB_5* in Figure J. According to the TSE-Listed Companies White Paper on Corporate Governance (2013) although in 2010 the TSE required that each listed firm appoint at least one independent director or auditor, the number of independent directors and auditors did not dramatically improve in all TSE-listed firms in 2012 (see Figure 9), which means that almost all firms in the TSE failed to increase their monitoring activity by appointing independent directors and auditors to offset the decrease in the value of incentive alignment.



TSE-Listed Comapnies White Paper on Corporate Gvernance 2013

Figure 9. Number of independent directors and auditors (2010/2013)

Through the lens of Proposition 3

Proposition 3

"In firms with poor corporate performance, external monitoring by shareholders can prompt the internal governance mechanisms of monitoring and incentive alignment to act as complements for a more effective governance bundle (Ward, Brown, & Rodriguez, 2009).

As previously explained, external pressure by concerned shareholders creates discipline in the firm and increases the efficiency of mechanisms in the governance bundle, reducing the unit costs of the both mechanisms and pushing the cost-constraint line away from the origin, that is, from PQ to P_4Q_4, as shown in in Figure H, or at least reducing the unit cost of monitoring (from PQ to PQ_4). Consequently, the point of optimal governance bundle will shift to GB_4* or GB_5* , respectively, as shown in Figure H. The activist approach to external monitoring, therefore, can be a complementary effect on the firm's governance bundle.

Weak external mechanisms. However, in Japan, the external pressure is weak. A wave of takeover threats emerged in Japan in the mid-2000s, but the global financial crisis of 2008-2009 and the famous failed buy-out deals by hedge funds, such as Steel Partners and M&A consulting, reduced the influence of foreign investors, who had keenly advocated governance reform (Ahmadjian & Okumura, 2011). It is very rare that the firms are confronted by the shareholders although some exceptional examples are the recent Cerberus-Seibu dispute and Third Point-Sony public discussion.

In addition, according to a N-PX report disclosed by The Securities Exchange Commission, more than five hundred US investment funds, one of the main foreign investors groups in Japan, voted in favor of the proposals by Nikkei 225 firms at 92.4% and 92%, in 2013 and 2012, respectively. Japanese institutional investors also have maintained a low-key attitude toward the corporate governance of firms in which they invested (Ahmadjian & Okumura, 2011).

Regarding external pressure on management beside the threat of takeover and monitoring by large outside shareholders, previous research pointed to managerial labor markets (Fama E. , 1980). However, it is rare that Japanese listed firms determine the appointment of management or board members, regardless of seniority. Because there is little external pressure on the listed firms in Japan, it is unreasonable to expect that external pressure has a complementary effect on increasing the efficiency of governance mechanisms in a governance bundle, as shown in Figure H.

Through the lens of Proposition 4

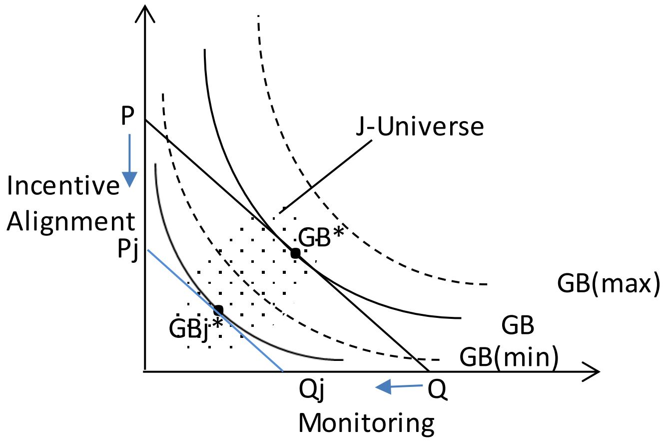
Proposition 4

“In firms heading towards bankruptcy and under managerial entrenchment, the internal governance mechanisms of monitoring and incentive alignment will not act as complements, and the effectiveness of the firm’s governance is likely to decline (Ward, Brown, & Rodriguez, 2009).

Almost all boards of Japanese listed firm that are dominated by insiders have a low degree of separation between the monitoring and management functions, and they are compensated by a lower volume of fixed salaries as larger portions of total income and smaller equity-based incentives that are less sensitive to firm performance. Therefore, the values of two governance mechanisms, monitoring and incentive alignment, may remain at a lower level. Hence, the cost-constraint line PQ will shift to P_jQ_j and GB* to GB_j*, which is beyond the minimum governance bundle (GB min), as shown in Figure J. As shown in Figure I, the cost-constraint line P_1Q_5 is near the origin, and the governance bundle curve may be beyond the minimum governance bundle (GB min). This means that the effectiveness of corporate governance in a certain portion of listed firms in Japan may NOT reach an acceptable level for shareholders. The positioning of Japanese firms (J-Universe) is illustrated in Figure J. Some firms may stay between GB(max) and GB(min), while others may be beyond GB(min).

Figure J. Japanese firms’ positions according to the indifference curve analysis

Figure J. Japanese firms' positions according to the indifference curve analysis



Appendix 3

The responses of the interviewees

1. Firm X

I interviewed two officers, a general manager and a manager of board of directors, at the same time. They had been engaged in nominating outside director candidates and managing board meetings and committees for about a decade. Their responses and related articles to my questions are provided below.

Q1. Why did your firm adopt a company with a committee system that requires three committees that are responsible for the nomination, compensation, and auditing and for which outside directors must be in the majority for each?

Q2. What triggered the interest in the adoption of this system?

We don't want to depend on an outstanding top management like a charismatic leader. We want to depend on a system to manage a firm. That is our principle for managing a firm, including corporate governance. Before the integration of management between Firm X1 and Firm X2, each firm had independently considered the necessity of strengthening corporate governance, especially by the separation of execution and monitoring, to make decisions faster. We believed that this improvement of governance system greatly increased our earning capability, which contributed to the shareholders' wealth. Then the integration of both firms was planned, which gave us additional reasons to improve our governance system. In particular, we had to secure the transparency of the decision-making process because both parties were worried about the competition between Firm X1 and Firm X2. Actually, we shared the understanding that we had no time for internal tugs of war because of the uncertainty of our business environment. So we needed a system and a third party to take part in the system to monitor our management efficiently. They are the committee system and independent outside directors.

Q3. Who brought up the idea to adopt this system for your firm?

Top management who was also a board of director. Without his commitment, we couldn't adopt the committee system and appoint outside directors.

Q4. Was there any opposition to this idea within your firm?

Corporate auditors objected to or showed negative concerns about lowering the level of audit. We had repeated discussions about their concerns.

Q5. I believe that to create a system is not enough to make it functional. A system will not function unless it is operated well. In this context, do you have any key to how this system functions, especially as regards the managing of outside directors?

I agree with your idea that we need to be creative to making the outside directors function. We have shaped so many tips to do it. For example, first of all, it is very important to provide the necessary information and knowledge to outside directors. We set lots of briefing sessions between outside directors and the top of each division, as well as site visits to our factories and labs. This is because outside directors naturally do not know our business well. But of course this lack of knowledge can't deny their existence and effectiveness. Those people who take a skeptical view of the effectiveness of outside directors may confuse not only the role of the outsiders but also a lack of knowledge with a lack of intelligence.

In our case, for instance, without our outside directors, we couldn't decide, in appropriate timing, to terminate the photo imaging business, which was formerly the main business for Firm X1 and Firm X2. We're frightened by their asking why we had to keep this unprofitable photo imaging business. They didn't have any sanctuary. This was one of the greatest contributions by our outside directors.

Another sobering output from the outside directors, which impressed us, was the question of why we would make a medium-term management plan for three years when we're facing economic uncertainty triggered by the global financial crisis. It was 2008. We're going to make a 09-11 management plan. But we're still making urgent cost-reductions at that time. They asked why not made it for two years because it made no sense to decide the three-year plan under this global economic uncertainty, which we couldn’t see how long it would last. For insiders, that is, us, there was no doubt about making a medium-term management plan every three years. So then we’re focusing on how we made a three-year-management plan. In the process of answering this naïve but pithy question by the outside directors, we, however, reflected on ourselves and concluded that we made a two-year-management plan and instead of growth, made the improvement of corporate quality as a central agenda item over the two years. We avoided making a three-year midterm-management plan, which might have been a pie in the sky.

Following other tips, we accelerated the communication among directors, including the outsiders to improve the quality of the discussion in board meetings. For example, our chairman of board meetings makes an active effort to call on outside directors. We changed the layout of the seats of directors at every board meeting, in order to promote mutual understanding through chatting with neighbors.

> In addition, we are still developing new tips for better practice. We conduct a self-evaluation survey among board every year, and accept suggestions and reflect on our operation.

Mr. O, an ex-chairman of board meetings and the CEO of Firm X, said in a newspaper, “A firm should separate its functions of managing a firm and monitoring management, because it’s extremely difficult that a single person promotes a business, stepping on the brake properly by outside directors, a firm must provide necessary information to them. Without this, discussion and voting in board meeting become the bauble, which can’t contribute shareholders’ wealth at all” (Nikkei Shimbun, 2012).

Mr. U, an ex-chairman of board meetings and an outside director of Firm X, answered a question about the effectiveness of outside directors considering their lack of knowledge of the business: “The roles of executives and directors differ considerably. It makes no sense to place responsibility of short-term profit on outside directors. Their roles are to monitor effectively, to prevent misjudgments by management and to stabilize managing the firm in mid-term” (Nikkei Shimbun, 2005).

Mr. K, an ex-CEO of Komatsu and outside director of Firm X, said “ Although we outside directors may not understand the details of business and technical issues after all, we can point out not a few important notes for managing a firm, such as ways to improve management efficiency, the degree of importance placed on each strategy, etc., based on our management experience (Nikkei Shimbun, 2003).

Q6. Did your firm achieve the goal that it expected initially?

Yes. We achieved not only the separation of management and monitoring, but also the improvement of the decision-making process in speed and quality.

Q7. What changed after appointing outside directors? Did the performance of your firm improve after this?

Insiders must persuade outsiders logically. Our outside directors are very tough. It's time-consuming to prepare, but this process can be one of monitoring management. To secure the effectiveness of this process, it is crucial to maintain the independence of the outside directors. Our outside directors don't mince words because of their independence from our firm. About firm performance, I'm not sure about the immediate effect, but I am sure about the positive effect in the mid-term. But it depends on the definition of performance. Decisions about downsizing may be negative for the immediate firm performance in accounting but positive for the stock price because it may create future cash flow for the shareholders. But the influence of outside directors is not simple in the first place.

Q8. What are the obstacles to maintaining this system?

It is becoming harder to find candidates for outside directors. We have some criteria. Two most important points are strict independence from our group and extensive experience as the CEO of a firm with a similar size of business. So it is often the case that a candidate first replies to our offer, “Why me? I don’t have any relationship with your firm and am unfamiliar with your business.” We always answer, “That’s why you are!” Concerning another criterion, we believe that experience as a CEO can improve the quality of discussion and monitoring. Although we know this criterion contains the risk of homogeneous board members, we consider that the strength more than makes up for the risk.

Q9. Why do you think only 2% of listed firms in Japan have adopted this system?

As you know, the company with committees system requires three committees responsible for nomination, compensation, and audit, and outside directors must have a majority on each committee. This means that a CEO, the top of the insiders, can’t only decide his successor, other important positions, and compensations but also has to accept unsatisfactory personnel transfers and compensations including his/her own. Many CEOs might feel it is risky and uncomfortable. In this context, only the audit committee, which is even dominated by outside directors, may function.

Q10. What are the drawbacks regarding the effectiveness of this system and outside directors in your firm?

Not at all. It is possible to increase the number and the diversity of outside directors, which was pointed out in a self-evaluation survey by our board members.

2. Firm Y

I interviewed a member of the board and audit committee (not an outside director) and a general manager of management audit department at the same time. They also had been engaged in nominating outside director candidates and in managing board meetings and committees for about a decade. Their responses and related articles are provided below:

Q1. Why did your firm adopt a company with a committee system that requires three committees that are responsible for the nomination, compensation, and auditing and for which outside directors must be in the majority for each?

Q2. What triggered the interest in the adoption of this system?

We had repeated corporate scandals, such as a violation of the anti-trust law in 1991, the medication scandal of Sorivudine in 1994, and an international cartel with other Japanese pharmaceutical firms in the US market in 1999. We wanted to make sure that it didn't happen again. Thus, we adopted a company with committees system to establish effective monitoring and checking functions.

Q3. Who brought up the idea to adopt this system for your firm?

Our CEO. Without his commitment, we couldn't have adopted the committee system or appointed outside directors.

Q4. Was there any opposition to this idea within your firm?

No. Actually, there was a moment's hesitation among board, but we needed to establish a system to assure effective monitoring and checking functions. In addition, our CEO had a strong commitment to adopt the system. We had no choice but to do it ourselves.

Q5. I believe that to create a system is not enough to make it functional. A system will not function unless it is operated well. In this context, do you have any key to how this system functions, especially as regards the managing of outside directors?

Exactly. We should not leave the body without the soul. We have strived to make the committee system and outside directors function well. To do so, we needed to elaborate the system and the operation. For example, our chairman of the board is an outside director, though it is an insider in almost all the listed firms in Japan. Our board consists of seven outsiders and four insiders, including the CEO. The CEO is the only manager who concurrently holds a director position. This means that our board can adequately monitor the management team, including the CEO. Also we make the highest separation between executions and monitoring, as stated in the Companies Act, meaning that the board delegates the authority to executives whatever possible. This improves the flexibility of management decision made on a daily basis. We simultaneously encourage management to establish and manage our internal control system on an autonomous basis. Our board also monitors their internal control activity. We believe that it is irresponsible to just transfer authority and leave them to themselves. That’s a bad let-alone policy without limitation under the assumption that humans are inherently good. We need sound, suspicious minds for monitoring. Concerning skeptical views about outside directors being unfamiliar with the business, it is an irrelevant argument. The roles are different. While inside directors are essential for monitoring the detailed operation of a firm with their rich and extensive knowledge, outside directors are also mandatory to make sure whether our own company standards and practices are mirrored by those of society at large, through their monitoring.

But we never said that outside directors were fine “as is” in the knowledge of our business. It is very important to deliver the necessary information to outside directors in adequate time prior to board meetings. To ensure this, we have a team that positively supports our outside directors in learning about our firm. In addition, we have an annual self-evaluation survey of the board members and an annual meeting of outside directors only.

Kurachi, an ex-chairman of board meeting and outside director of Firm Y, said, “We have a supporting team that can efficiently provide our outside directors with the essential information for monitoring in a restricted time. The compensation of the team members is decided by our compensation committee all of which are outside directors. We greatly need this provision of information.” (Nikkei Shimbun, 2008).

Q6. Did your firm achieve the goal that it expected initially?

Yes. Absolutely. The committee system and our outside directors contribute a lot to our firm. They not only ensure fairness and transparency in management, and impart vitality to our management.

Q7. What changed after appointing outside directors? Did the performance of your firm improve after this?

Tension in our board meeting has built up soundly [by appointing outside directors]. I think it is because outside directors can vote. Corporate auditors don’t have the right to vote in board meetings. Under this condition, the quality of monitoring by

> corporate auditors depends on his/her quality. Some may monitor management strictly, but some may compromise easily. It's not good thing for the firm and our shareholders.

Naito, a CEO and director of Firm Y, commented, "After adopting the committee system, we added some talented directors. Thanks to them [outside directors] we can have quality discussions in board meetings. So it takes twice as long to reach a conclusion in board meetings than previously, but I think it's good sign" (Nikkan Kogyo Shimbun, 2004).

> We don't see outside directors and the committee system as a direct driver for our firm performance, though they must be positive in the long run.

Q8. What are obstacles to maintaining this system?

> That takes a great deal of time and labor. But it's necessary. No other way. And it is difficult to find candidates for outside directors. In order to maintain the good culture and chemistry among our outside directors, we adopted a so-called classified board in which a portion of the outside directors serve for different lengths of term. Towards the close of the term, we ask the outside director to recommend a candidate. Because of the classified board, we're searching for the next outside director almost every two years. It's not easy but I disagree with the

argument that it's hard to appoint outside directors because of the low representation of candidates. Is it true that we have few candidates? Aren't the criteria too many and too rigid? Ultimately, I can say that your candidate would accept your offer if the governance system of your firm was sound and reasonable. After all, it depends on you.

Q9. Why do you think only 2% of listed firms in Japan have adopted this system?

People like to change themselves by themselves, not by others. We changed our governance system to the committee system in which outsiders have a major role to play by ourselves. So we can make great effort to maintain and improve this system.

Q10. What are the drawbacks regarding the effectiveness of this system and outside directors in your firm?

No. We are going to improve this system and manage outside directors for years to come. We have a sense that they function and contribute to Firm Y.

3. Firm Z

I interviewed an ex-member of the board and audit committee (not an outside director). He had engaged in nominating outside director candidates and in managing board meetings and committees both before and after Firm Z adopted the committee system. His responses and related articles are provided below.

Q1. Why did your firm adopt a company with a committee system that requires three committees that are responsible for the nomination, compensation, and auditing and for which outside directors must be in the majority for each?

Q2. What triggered the interest in the adoption of this system?

We had faced the difficulty of the company with auditors system. Under this system, it is very common that most executives overlap directors, meaning that functions of execution and monitoring are not separated. This could make monitoring a mere facade. We also were concerned about weaknesses of auditors, such as no voting rights etc.... And a majority decision in a variety of issues in board meetings may lead to slow decision making and result in the confusion of responsibility. You know that Firm Z has a variety of business lines form electric bulbs to atomic power plants. Assuming a director from home appliance division, it is very hard for him, a layperson in power plants, to give business advice or make decisions about right and wrong in the construction of atomic power plants. After all, the inside director has to make unsubstantiated votes on some issues, which makes no sense. Also we felt that we needed to strive for more transparency in nominations and compensation. That was opaque. In order to solve these issues, we reached the inevitable conclusion, adopting the company with committees system.

And, concerning a trigger, although the then president was very familiar with the US style of management, and this might have been a great driver of the adoption, another reason for starting to engage seriously in corporate governance, a kind of trigger to adopt this system, was the so-called case of the violation of COCOM by Firm Z's affiliate firm. We paid a huge price for it.

Q3. Who brought up the idea to adopt this system for your firm?

Our then CEO and president. Without his commitment, we couldn't have adopted the committee system and appointed outside directors."

Okamura, then president of Firm Z, wrote in his autobiography "We often come under heavy attack from foreign investors for the lack of transparency of decision making process in our board meeting. I wanted to do something about this criticism from the angle of future financing from the capital market. … In those days, I decided my compensation by myself. Actually I had the authority to decide my successor. … But Firm Z is not my property, of course. Too much concentration of power on top management leads to lack of transparency and lead to the rigidification of an organization. I thought it was high time that we took drastic measures to reform our corporate governance system" (Nikkei Shimbun, 2014).

Q4. Was there any opposition to this idea within your firm?

No. The board members shared the common recognition that we should improve our corporate governance system.

Q5. I believe that to create a system is not enough to make it functional. A system will not function unless it is operated well. In this context, do you have any key to how this system functions, especially as regards the managing of outside directors?

Yes. We created practical tips to make this system work smoothly, but they are just tips. Anyway, a pro forma transformation from the company with auditors system to the committee system will fail. Before adopting the company with committees system and appointing outside directors, we should consider what our outside directors' role is. [This is] because, in this system, we have to depend largely on outside directors. Is their role to provide advice to management that is free of constraints and internal political ties, or is it to offer expert advice as a lawyer, accountant, or scholar? These roles seem to be not as reasonable as we expected. [This is] because their business experiences and expertise may not always fit our arguments in board meetings even though they accomplished good results in their business …. Now, how about monitoring management? This seems to be correct, because, in this [committee] system, management has to explain their plan, decision, and the reasons to outsiders who wouldn't know our internal practice, which can be a great monitoring function. If you decide their [outside directors] role, it would be almost automatically fixed how far the board should empower management. But you also should carefully examine it. It may depend on the whole board's capability of monitoring. If a board is overly dominated by outsiders, monitoring management wouldn't work well in our firm, which has a variety of business lines. Let me give you a for-instance. It is Japan Post. They had eight outside directors of ten. Although these eight directors were a kind of superstars as managers, all were complete ignoramus in the postal business.

In addition, this company was state-owned, which means that discipline by shareholders is generally weak. Under that situation, they delegated as much power as possible to management, who used to be bureaucrats. Although I think this is not the solitary reason that Japan Post produced some problems [see the details in http://www.soumu.go.jp/yusei/governance/], it may be one of the crucial causes of delegating too much power to management by the board, which is dominated by outsiders in this business. Of course, it might be another reason not to provide to outside directors with enough information to make judgments in discussions. With enough the information provided in a timely manner, the outside directors are able to judge and prevent problems. So it is very important how much business information we should give outside directors. Firm Z's board delegates the power to executives as much as possible. So we have to provide all necessary business information to discuss and judge in board meetings to our outside directors before the meetings, which ensures the effectiveness of outside directors. We made a great effort to do it.

Q6. Did your firm achieve the goal that it expected initially?

Yes. We had two goals, strengthening our corporate governance through improving monitoring function, improving the transparency of decision making process by outside directors, and increasing our speed of decision-making and execution. We thought that these two are simultaneously achievable, and actually we did.

Q7. What changed after appointing outside directors? Did the performance of your firm improve after this?

The management team has gained a sense of alertness to the outside directors. After adopting the committee system, the members of the audit committee who are outside directors can vote in appointing executives. I feel that this may make it smoother for the executives to provide outside directors with necessary business information in a timely manner. Such discipline will work to improve the management of a firm, but I'm not sure it immediately works for improving the results in accounting. Maybe not.

Q8. What are obstacles to maintaining this system?

It may not be obstacles, but, I think, managing a firm with outside directors requires the deep understanding of a variety of things, from each role and responsibility to the whole picture of our corporate governance structure. I think it's not at all easy. Fortunately, our executives, directors, and other staffs are capable of understanding them and actually do well.

Q9. Why do you think only 2% of listed firms in Japan have adopted this system?

As I said, it's more complicated and expensive to manage the committee system and the outside directors in this system than the company with auditors system. Top management must commit to the transformation and everyone concerned must understand the pros and cons and accept the adoption. So I don't think most can transfer. It's natural.

Q10. What are the drawbacks regarding the effectiveness of this system and outside directors in your firm?

No. Instead, we have room to improve. For instance, one of our directors is in charge of the business division. We know we have to avoid it. In addition, we have lots of affiliate groups overseas, but we haven't established enough governance structures to cover them.

4. Others

I add a brief interview and article follows.

Additional interview. I conducted an additional, brief interview with one of the outside directors of the three firms. I asked him to tell me the most significant contribution to a firm by outside directors.

An important thing that we [outside directors] can do is getting the CEO to work on a succession plan. It seems obvious, but he wouldn't have done it without pressure and tension caused by the outside director. This tension made the planning process much clearer and more transparent.

Additional case from an article. Two members of the legal department of Hitachi answered a question about the expected role of outside directors (Doi & Sawada, 2014):

We've appointed not a few outside directors because we adopted the committee system. We delegate authority to the management team as much as possible, so we expect that our outside directors contribute to discussions about our overall direction

For instance, we make our medium-term management plan every three years. We feel that the quality of the discussion in the process of the planning has been improved by the outside directors. Our outside directors have never made rubber-stamping agreements to the management plan. Our management team takes enough time to explain their plan to the outside directors.

Another example of our outside directors' contribution is that they [outside directors] discussed an M&A deal constructively by contributing insights to the board meeting. The deal changed the direction of our firm. So I felt that they made a valuable contribution to us.

It may be natural, but we make a great effort to deliver the necessary information to our outside directors in enough time before the discussion. Some live overseas, so we provide them with tablet computers for efficiency.

Appendix 4

Mechanism of a sewing machine

While there is one thread in hand stitching, there are two different threads, upper and lower, in a sewing machine, which makes it difficult to understand the mechanism (see Figure K).

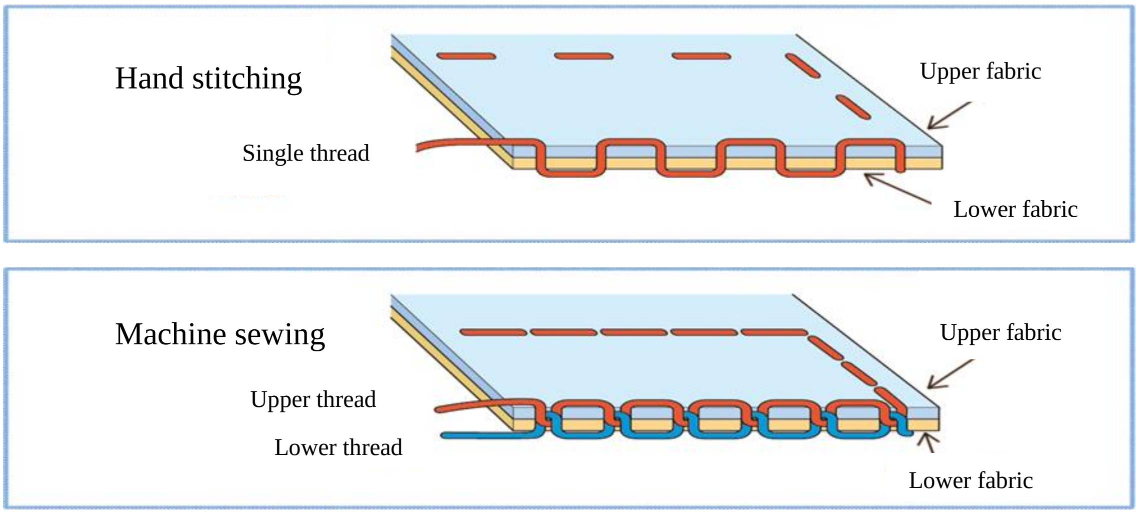


Figure K. Hand stitching and machine sewing (Japan Sewing Machinery Manufacturers Association / www.jasma.or.jp/)

In the process of sewing by machine, while one end of the upper thread is connected to a spool, the other end of the upper thread is sutured into the fabric. One end of the lower thread is linked to a bobbin, and the other end is in the fabric (see Figure L). In the experiment, three groups of two people were encouraged to cooperate in understanding how the two threads, which have invisible ends, twist together.

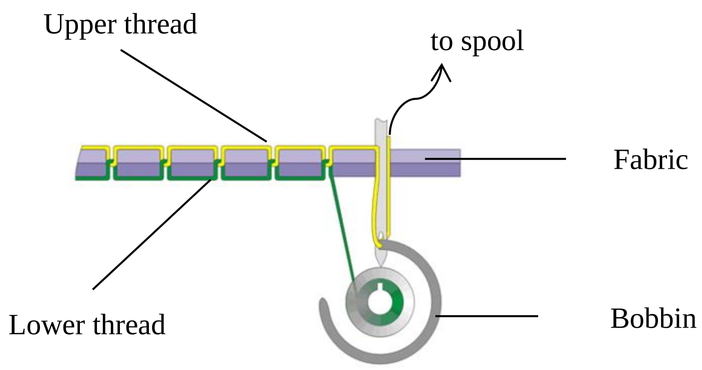


Figure L. Sectional side view of sewing by machine (Wikipedia; Sewing machine/

http://en.wikipedia.org/wili/Sewing_machine)

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