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Toru YOSHIKAWA
Singapore Management University, toru@smu.edu.sg

Phillip H. PHAN
Rensselaer Polytechnic Institute, pphan@smu.edu.sg
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Alternative Corporate Governance Systems in Japanese Firms: Implications for a Shift to Stockholder-Centered Corporate Governance

TORU YOSHIKAWA ToruYoshik@aol.com
College of Commerce, Nihon University, 5-2-1 Kinuta, Setagaya-ku, Tokyo, 157-8570 Japan

PHILLIP H. PHAN Pphan@RPI.edu
Lally School of Management and Technology, Rensselaer Polytechnic Institute, 110 8th St., Troy, New York, 12180-3590 USA

Abstract. In Asia, the recent catastrophic decline in regional stock markets, continuing currency crisis and failures of major financial institutions and industrial corporations have increased domestic and international interest in corporate governance. Nowhere is this greater than in Japan where financial institution reform has catapulted this to the fore. In this paper, we use agency theory and institutional theory, together with comparative case examples, to derive some propositions on the dynamics of changing corporate governance systems in Japanese firms. We argue for the co-existence of stakeholder and shareholder-centered corporate governance systems in Japan. This argument has an important implication for corporate governance research and agency theory. Namely, changes in ownership structure and institutional expectations would force firms to focus on maximizing shareholder value even where the interests of stakeholders are more emphasized. It suggests an environmental selection mechanism to ensure the emergence of appropriate corporate governance mechanisms to solve the agency problem. Further, the loss of competitiveness and the prolonged poor performance of firms can change the institutional norms to emphasize asset efficiency and transparency rather than stability and business ties.

Keywords:

1. Introduction

The recent economic catastrophes in Asia, continued volatility of the Japanese stock markets, and failures of major Japanese financial institutions and industrial corporations have increased national interest in corporate governance issues. In North America, the lingering effects of the U.S. Savings and Loan crisis, the sudden spate of corporate losses from derivative trading in the early 1990s, the failures of several large Canadian financial institutions in the late 1990s, and the collapse of Long Term Credit Corporation most recently have also led to increased attention on the roles and processes of the board of directors. The Toronto Stock Exchange report on Corporate Governance, the Professional Conduct guidelines issued by the National Association of Corporate Directors, the OECD Guidelines on Corporate Governance and the Hampel report (a follow-up to the Cadbury report) illustrate the serious energy accorded to this issue on a global scale. In this paper, we hope to contribute to the growing body of theoretical and empirical literature on corporate governance by suggesting a market selection process for governance mechanisms. Specifically,

we attempt to argue that there are two forms of corporate governance systems in Japan and that the change in ownership structure and poor performance of a firm operating under one system would trigger the emergence of the other. We suggest that under certain conditions, the failure of traditional Japanese stakeholder-centered (i.e., network-based) corporate governance leads to a stockholder-centered (or market-based) monitoring system. We argue that this process is part of an evolutionary global trend, driven by the globalization of financial markets and intensified product market competition, toward the agency relationship between managers and shareholders rather than managers and stakeholders in corporate governance.

A main characteristic of the Japanese industrial system has been its tight network of supplier and buyer companies (*keiretsu*), which are known for their extensive cross-shareholdings among members and their banks (Abegglen and Stalk, 1985; Gerlach, 1992; Sheard, 1994). Gerlach (1992) reports that 70 to 75 percent of shares owned in Japan belong to the ‘affiliated stable investors’ category, defined as long-term, *keiretsu*-affiliated holders of shares. These investors do not own the stocks of affiliate companies for investment purposes (Abegglen and Stalk, 1985). Rather, Japanese institutional shareholders are often also a company’s business partners, so that cross-shareholdings are expressions of business goodwill, information exchange, mutual monitoring, and provides the foundation for formalizing long-term, open-ended business relationships (Clark, 1979). Given this, Japanese institutional investors usually have other priorities than the maximization of returns on their shareholdings in *keiretsu* member firms (Gerlach, 1992). Consequently, the boards of directors of many Japanese firms have not given much attention to the interests of non-*keiretsu* shareholders. Indeed, their implicit mandate has been to arbitrate the claims of competing stakeholders (employees, suppliers, banks, etc.), sometimes by expropriating from non-network members, rather than to focus exclusively on shareholder returns (Aoki, 1988). Such an arrangement worked as long as shareholders were silent and had other interests to pursue, and firms were able to fund their growth needs from internally generated cash flows and from friendly banks. This situation began to change in the early 1990s as the Japanese domestic consumer market went into recession and competition from the newly restructured U.S. and European as well as Asian corporations increased.

Some observers have noted that the traditional emphasis on stakeholders and the resulting lack of priority given to shareholders’ investment returns have recently given way to a more market-driven approach to corporate governance, which has led to a greater emphasis on shareholders’ interests (Watanabe, 1994; Kikuchi, 1999). Since the late 1990s, Japanese firms have become increasingly exposed to foreign capital markets as foreign institutional investors increased their holdings of Japanese stocks and foreign multinationals acquired large equity stakes in some Japanese firms such as Mazda, Nissan and Mitsubishi Motors. These changes have led to the increased demand for disclosure and transparency by foreign investors (Kikuchi, 1999). In addition, global competition has escalated in sectors that were traditional Japanese strongholds such as consumer electronics (from Taiwanese, Korean and European firms), automobiles (from German and American firms), and chemicals (from European and American firms). Furthermore, prolonged poor corporate performance in Japan has made the institutional environment friendlier toward corporate governance reform.

This has been viewed positively in the capital markets and media, which have generated more legitimacy for further reforms. This phenomenon provides a useful backdrop for studying the evolution of corporate governance in Japanese firms, particularly the way one system of governance is selected over another.

Using agency theory, institutional theory and comparative case studies, we derive propositions on the dynamics of changing corporate governance systems in Japanese firms. Specifically, the focus of this paper is to explore the links between firm-specific factors and governance systems to better understand the changing structure of Japanese corporate governance. In the next section, we discuss the general principles underlying the stakeholder-centered or network-based Japanese corporate governance system. Then, we examine a series of comparative cases to illustrate two types of corporate governance systems (stakeholder-centered and stockholder-centered) and develop a series of propositions from the resulting model. We conclude with some future research suggestions.

2. Agency theory and the Japanese firm

Agency theory attempts to deal with problems that arise in bilateral relationships when the goals of a principal and an agent conflict, and when it is difficult or expensive for the principal to verify the agent's actions (Eisenhardt, 1989). According to Eisenhardt (1989), the large modern corporation, wherein professional managers operate the firm as the agent for a large group of shareholders, presents a classic situation in which the agency problem arises. However, the notion of agency is broadly applicable to situations in which incomplete information and monitoring do not allow the principal to write complete contingent claims contracts and is therefore exposed to potential expropriation by the agent. In Asia the use of two classes of equity allows controlling shareholders who do not own a majority of the equity to co-opt the boardroom so as to expropriate minority shareholder claims. The theory posits a number of monitoring mechanisms that attenuate the agency problem between managers and shareholders. These include the external managerial labor market, performance-based compensation, the presence of outside members on the board, and the takeover market (Fama, 1980; Jensen, 1986). The theory predicts that these mechanisms can solve the agency problem by narrowing the divergence of interests between shareholders and management.

While there is some empirical evidence to support the view that these mechanisms reduce agency problems in the Anglo-American context, where the basis for economic exchange is the written contract, it is unclear whether these mechanisms can work in the Japanese context, where the basis for economic exchange is often the relationship (Dore, 1983; Sako, 1992). In fact, extensive cross-shareholdings between large firms and their banks effectively insulate management from any interference by outside investors including hostile acquirers (Charkham, 1994; Kester, 1991). In Japan, the Japanese main banks take on the responsibilities for corporate governance by acting as active principals in the agency relationship (Aoki, 1990; Sheard, 1989). The main banks, as the largest lender to its corporate clients, have a long-term stake in the viability of these corporations. The main banks, together with other major lenders also control large blocks of their client companies' equity.

Using their legal rights as block shareholders, and their access to information as debtors, the main banks monitor the business decisions of their client firms with a view to long-term viability, so as to safeguard their debt holdings and equity investments (Sheard, 1989). This dual role as major credit supplier and large equity holder places the main banks, at least in principle, in the critical role of monitoring and disciplining the Japanese corporate sector (Aoki, 1990; Aoki, Patrick and Sheard, 1994; Sheard, 1989).

Another type of corporate monitoring mechanism prevalent in Japanese firms is the informal mutual monitoring carried on by member firms of corporate groups or horizontal *keiretsu* (Gilson and Roe, 1993). Many Japanese firms belong to such horizontal *keiretsu*, including the former *zaibatsu*-based and bank-centered networks of large firms (Sheard, 1994; Gerlach, 1992). Member firms in this type of grouping are formally related through cross-shareholding arrangements. The vertical *keiretsu*, on the other hand, is usually formed with a large hub firm (e.g., Toyota, Hitachi, Matsushita, etc.) and its suppliers, subcontractors, and other firms in its value chain. In this type of grouping, the hub firm often holds minority and sometimes majority shares in member firms. Because of the close relations among member firms within the same group, vertical and horizontal *keiretsu* also play a critical role in the governance of corporate Japan (Gilson and Roe, 1993; Sheard, 1994).

Although the exact nature of such meetings are not publicly disclosed, it is the practice of top Japanese *keiretsu* executives to meet regularly to discuss general business trends or exchange corporate information (Abegglen and Stalk, 1985; Gerlach, 1992). Here, in the Presidents' Council, they gather information on member firms' activities and if necessary, discipline deviant firms by moral suasion if they engage in business conduct seen to be detrimental to member firms. This type of discipline mechanism inevitably favors the interests of *keiretsu* members rather than those of non-affiliated shareholders whose main aim is to maximize returns on investments. The minority cross share ownership by member firms provides the legal and moral basis for their claims. While each member firm usually controls only a small share of each other's equity, the collective weight of all the members is large enough to impose control over individual member firms (Berglof and Perotti, 1994; Gilson and Roe, 1993).

Some have said that the board of directors in Japan exists as a token of the law. It comprises almost exclusively of retired company executives, other insiders, and former government officials (Abbeglen and Stalk, 1985; Charkham, 1994). Typical of many Asian corporate boards, appointments are based on loyalty, and long service; the boardroom is seen as a place to cap off a distinguished career in the firm. Although Gerlach (1992) argues that the Presidents' Council performs the active monitoring functions typical of a board of directors, one result of such monitoring arrangements is that strategic decisions are often defensive rather than offensive. The *keiretsu* disciplines its members for deviant behavior, but is not structured to encourage strategic innovation and risk taking (Charkham, 1994). Therefore, organizational change is often impeded and needed restructuring forestalled, especially when the economic interests of supplier and customer *keiretsu* members are at stake.

The hub company of a vertical *keiretsu* is usually the largest shareholder in its affiliate firms and often represents their largest single customer. Through the boardroom and in the trading relationship, the hub firm exerts direct and unilateral oversight of its *keiretsu* member

firms (Orru, Hamilton, and Suzuki, 1989; Gilson and Roe, 1993). Thus, the effectiveness of the disciplinary mechanism in vertical *keiretsu* is directly related to the extent of the business and stockholding linkages between member firms in the network (Gilson and Roe, 1993). Again, this type of governance system favors a stakeholder approach to corporate decision making because a firm's trading relationships with network partners is multilateral, which may require the sub-optimization of particular bilateral ties in order to optimize the entire network.

The important point in this discussion is that the objectives of monitoring by the Japanese main banks or corporate group hub firms do not necessarily coincide with those of other shareholders who hold shares primarily for investment purposes. The tight relationships engendered by the *keiretsu* or corporate group ensure that all companies in the system feel the shocks (drastic declines in sales, resignation of key employees, etc.) experienced by one company (Nakatani, 1984). This implies that the result of monitoring is not always an enhancement of a firm's profitability or stock price, but rather an insurance of stability in earnings and sales to protect the interests of other stakeholders such as suppliers, management and employees. In an empirical study, Nakatani (1984) found that corporate group firms were more interested in maintaining stable profits and attenuating risk among member firms than on achieving high profits. Other studies found that *keiretsu* firms and main bank client firms tend to have lower profits (Caves and Uekusa, 1976; Weinstein and Yafeh, 1995; Kong and Shivdasani, 1999). Weinstein and Yafeh (1998) argue that one of the reasons for the lower profits of main bank clients is that, due to their loan exposures, banks are more risk averse than other types of equity investors, which leads to more conservatism in the boardroom. The upshot of this is that a stakeholder-centered corporate governance system is not designed to promote the interests of a shareholder whose main aim is to earn higher returns on his investment.

We have argued that in the Japanese firm, *keiretsu* shareholders are interested in protecting the interests of stakeholders by stabilizing cash flows and lowering operating risks. Theoretically, however, a stakeholder-oriented firm can achieve superior profitability and shareholder returns. Such examples as Hewlett-Packard, Johnson & Johnson, and 3M attest to this possibility. Generous job benefits and security or guaranteed orders can motivate a firm's employees or suppliers to strive for better services and products; consequently delivering higher profits. Such a result, however, is not a natural consequence of the stakeholder model of corporate governance. Instead, if we accept that individuals maximize their utility functions, a strategic focus on stakeholder satisfaction *necessarily* precludes a focus on maximizing profitability. When the interests of principals collide, the resolution of these interests depends on the structure of the ownership of the firm. Specifically, when there are no controlling interests, managers have de facto control over corporate resources and therefore will assign them to maximize their utilities (Hill and Phan, 1997). However, if there is a controlling interest, then the utility function of the controlling shareholder is maximized, which may mean the sub-optimization of other shareholders' goals (Leighton and Thain, 1998).

In contrast to the stakeholder-centered governance system, there also exists in Japan a stockholder-centered governance form. Here, independent Japanese firms that do not belong to any corporate group or *keiretsu* or have only weak affiliations with them often depend

on the external capital markets for financing and growth (Hoshi, Kashyap, and Scharfstein, 1990). In such cases, the dictates of arms length investors appear to have a stronger influence on their behaviors, leading to a corporate form and governance philosophy similar to that of American corporations. From the agency theory perspective, these independent Japanese firms present a case in which the agency problem between managers and shareholders is more clearly highlighted.

Because of this feature, independent Japanese firms tend to focus on maximizing shareholder value, which may include taking risky business decisions that can potentially generate high earnings, but also increase the unpredictability of their cash flows. The unpredictability of cash flows makes it difficult for such firms to offer stable commitments to stakeholders such as life-time employment for employees and fixed purchase order quantities for suppliers, which necessarily subordinates their residual value claims to the shareholders who want higher investment returns (Hoshi, Kashyap, and Scharfstein, 1991).

It should be noted here that in both corporate governance systems, the interests of shareholders that also happen to be business partners and lenders are still served. Even in the stockholder-centered system, a large portion of shares is still held by business partners whose interests are not solely focused on maximizing investment returns. Many Japanese firms have the characteristics of both systems. Therefore, we are not arguing for the merits of one system over another. Instead we are suggesting that firms in a predominantly stockholder-oriented system experience a higher degree of capital market pressure, which leads to different strategic choices. We further develop this idea by exploring the institutional context, using institutional theory. Since the legal and social environment of an economic system has a direct impact on the system of corporate governance, our model will be incomplete without reference to this important variable.

3. Institutional theory and Japanese corporate governance

The institutional theory framework for modeling firm behaviors asserts that organizations attempt to incorporate norms in their institutional environments so that they can gain legitimacy, resources, stability, and enhanced survival prospects (DiMaggio and Powell, 1983; Meyer and Rowan, 1977). These organizational behaviors can be described as a process of isomorphism, which is caused by institutional pressures and expectations. Isomorphism is defined as a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions (DiMaggio and Powell, 1983). The theory suggests that such pressures and expectations force organizations to show conformity, because organizations compete not only for economic resources but also for political power and institutional legitimacy (Dacin, 1997; Suchman, 1995). Thus, institutional theorists argue that organizations conform to certain norms, both structural and procedural, because it is expected of them to do so and that the breach of such an expectation would destroy legitimacy, thus denying the organization access to resources needed for survival.

In the original conception of the theory, this perspective rejects rational choice as the motivator of firm behaviors but instead puts a greater emphasis on the *appearance* of rationality as a path to legitimacy. Managerial actions are thus dictated by existing rules, belief systems, and examples (DiMaggio and Powell, 1983; Meyer and Rowan, 1977).

Since organizational success is achieved by conformity to exogenously created norms, the management of legitimacy is the most important task for managers.

This view of organizational behavior flies in the face of standard economic theory and thus later developments have attempted to combine the institutional and rational perspectives for a more plausible mid-range theory (Oliver, 1991, 1997). This is due to the observation that legitimizing institutional pressures often conflict with each other, so that organizations can gain legitimacy from some, but not from all sources of legitimacy (D'Aunno, Sutton, and Price, 1991). Oliver (1991) presented a model in which social legitimacy, perceived economic gain, external dependence, and the consistency of institutional norms are causal factors of isomorphism. In her model, a firm's response to institutional pressures can accommodate its rational economic objectives as well as non-rational acquiescence to institutions. Practically, this means that a firm's motive to response to institutional norms and its rational choice to gain economic benefits cannot always be clearly separated.

Applying institutional theory to the recent shifts in Japanese corporate governance, one cannot help but acknowledge that such behaviors are simply isomorphic in nature. Attempts to reform corporate governance can be seen simply as another way for Japanese firms to gain legitimacy under a shifting global economic rationale. We observe that Japanese public sentiments on corporate governance practices changed after the collapse of stock prices in 1990 and the continued poor showing of large Japanese *keiretsu* throughout the 1990s. During this period, there have been demands for greater transparency of corporate practices and more attention paid to the interests of shareholders from such groups as investment associations, shareholders' rights groups, the stock market regulators, and the Ministry of Finance (Watanabe, 1994). Because of this emerging sentiment, pressure on Japanese firms to reform their corporate governance has also risen in recent years (Kikuchi, 1999).

The rising institutional pressures to improve corporate governance can be seen in various places. For example, the Japan Investor Relations Association (JIRA) was established in 1993 to promote better information disclosure by Japanese firms to investors and shareholders. In 1995, *Keidanren* or the Japan Federation of Economic Organizations, a powerful lobbying group, issued a statement emphasizing the importance of improving information disclosure by Japanese firms to stimulate the growth of equity transactions in the domestic stock markets (Keidanren, 1995). To promote a stockholder-oriented corporate governance system in Japan, the Corporate Governance Forum of Japan was established in 1994. The Japanese government, in its turn, was the first OECD country to adopt the recommendations of the latest OECD Corporate Governance Best Practices Guidelines promulgated in March of 2000. Newspaper articles on corporate governance abuses and reforms are now commonplace, where barely 5 years ago they were unheard of. Indeed the *Nihon Keizai Shimbun* has begun to publish Economic Value Added (EVA) measures on large Japanese firms, as a way of emphasizing the importance of efficient capital use.

An institutional theory perspective therefore suggests that Japanese firms have started to pay more attention to their corporate governance practices because of the increased public expectations for corporations to deal with this issue. Under such an environment, Japanese firms, especially those that are still performing poorly, have come under increased pressure to implement stockholder friendly corporate governance practices. Thus, in addition to the agency problem, institutional pressure has become another factor that

could prompt Japanese firms to shift toward a stockholder-centered corporate governance system.

4. Comparative case examples

Data and method

This section examines two pairs of comparative case examples, Sony and Mitsubishi Electric and Honda and Nissan, to illustrate the differences and implications for the stakeholder and stockholder-centered corporate governance systems discussed in the previous section. Data and information for these cases were collected from their annual reports, articles in business journals such as *Nikkei Business* and *Toyo Keizai, Nikkei Kaisha Joho* (a databook published by *Nikkei*), the publications of the Security Analysts Association of Japan, and other publications on the cases.

Firms in the Japanese automobile and electronics industries were chosen because they represent industries most exposed to the competitive global product and capital markets and hence have had to respond more quickly than firms in other industries. Because of global competition, they are the least protected of domestic industries and therefore represent the purest form of freely competitive markets in the Japanese corporate sector. Their relatively greater exposure to global capital markets mean that they are under pressure to respond to the needs of arm length market investors, whose main interests are to maximize returns on investments. We chose these pairs of firms as they provided the best contrast between independent and the *keiretsu*-affiliated firms in terms of their corporate governance practices. They were also similar in size and therefore made comparisons valid (see Table 1).

We examined their historical backgrounds, ownership structure, information disclosure practices, recent corporate governance reforms, and historical performance. Ownership structure was chosen because agency theory suggests that it will determine firm behavior and performance (Hill and Snell, 1988, 1989). Information disclosure practices function to mitigate information asymmetry between management and capital market participants, which allows for better monitoring of managerial decisions (Diamond and Verrecchia, 1991; Baldwin, 1984). The agency theory perspective thus suggests that ownership structure and information disclosure practices are important factors mitigating the agency problem.

As Table 1 suggests, Sony and Honda, latecomers to their respective industries, are independent firms with little affiliations to the major corporate group (or horizontal *keiretsu*). Mitsubishi Electric and Nissan are old-line corporate group firms that hail from the *zaibatsu* family business groupings that predate World War II. In order to keep the discussion clear, we do not consider the vertical or main bank *keiretsu*, although we suspect that the same phenomenon can be seen in those types of networks.

Case examples

a. Sony and Mitsubishi electric. Sony is a relative latecomer in the Japanese consumer electronics industry. It was established in 1946 by Masaru Ibuka as a venture firm in Tokyo and did not belong to any major corporate groups. Although independent, it mirrors most

Table 1. Sales and employment figures of Sony, Mitsubishi electric, Honda, and Nissan (March 1994–March 2000).

	Sony	Mitsubishi electric	Honda	Nissan
1994.3	3,733,721	3,105,431	3,862,716	5,800,857
	23,209	49,571	30,961	50,611
1995.3	3,983,438	3,250,876	3,966,164	5,834,123
	22,685	48,452	29,587	47,431
1996.3	4,592,565	3,511,359	4,252,250	6,039,107
	22,411	48,208	28,626	41,897
1997.3	5,663,134	3,725,192	5,293,302	6,658,875
	21,639	47,521	28,284	40,690
1998.3	6,755,490	3,801,344	5,999,738	6,564,637
	21,296	46,450	28,774	40,153
1999.3	6,794,619	3,794,063	6,231,041	6,580,001
	21,645	44,535	29,110	35,106
2000.3	6,686,661	3,774,230	6,098,840	5,977,075
	19,187	42,989	28,840	32,707

Upper line: consolidated sales figures (in million yen).
Lower line: domestic employee numbers.
Source: *Japan Kaisha Joho,* 1993–2000.

Japanese companies in that it has a close working relationship with a major bank, in this case Sakura Bank (formerly Mitsui Bank). Despite its latecomer status in the industry, Sony is often regarded as one of the more globally successful Japanese firms. However, this was not always the case. In the 1950s and 1960s the company found it difficult to obtain bank loans because it lacked the close ties with the pre-war *zaibatsu* groups, which were the bases for raising capital in post-war Japan (Morita, Reingold, and Shimomura, 1986). The company had no choice but to use the foreign capital markets to raise the funds for innovation and growth.

In 1961, Sony issued its first American Depository Receipts (ADR) in the U.S. market. By 1970, it had already listed common shares on stock exchanges in New York, London, and Amsterdam, among the first Japanese firm to do so. This was novel to most large Japanese corporations (Sanwa Sogo Kenkyujo, 1995), which still depended on debt capital through bank borrowings, fed by extremely high household savings rates. This early reliance on capital from the foreign capital markets, rather than on *keiretsu* financing or bank borrowing, had a great impact on the way the company conducted itself and was governed at the top (Morita, Reingold, and Shimomura, 1986).

Since the 1961 issuance of ADRs, Sony has actively disclosed corporate operations and performance information to American investors according to strict Securities Exchange Commission (SEC) requirements (Sato, 2000). Till recently, such disclosure practices are unheard of in Japan (Sanwa Sogo Kenkyujo, 1995). As Sony expanded its foreign operations and established its brand name in foreign markets, the company's strategies came under the increasingly close scrutiny by foreign investors and analysts. This has allowed the company

to develop a sophisticated investor relations (IR) protocol, which has created a shareholder friendly reputation for the company (Sato, 2000). For example, the Japan Investor Relations Association (JIRA) conferred its first excellent IR Company Award to Sony in 1995. The Securities Analysts Association of Japan also chose Sony as the best company for corporate disclosures in the electronics field in Japan in 1995, 1996, and 1999. Therefore, even though the disclosure requirements are American, Sony has been able to institutionalize such practices throughout the organization, so that in Japan, even though they did not have to, such practices continued to be used. These achievements suggest that the company is paying close attention to the interests of investors and capital market participants.

A notable characteristic of Sony's ownership structure is the large portion held by foreign investors. In 1998, foreign investors held 43.6 percent of the company's shares as compared to 20.3 percent of Matsushita's, 11.8 percent of Sharp's, and 6.1 percent of Sanyo Electric's, all of which are Sony's competitors. Another characteristic of Sony's ownership structure is the relatively small fraction of equity controlled by stable shareholders and cross-shareholdings with supplier firms. Sony's stable shareholdings comprised only 43.4 percent of total equity in 1998,[1] while the majority of Nikkei listed Japanese firms claim stable shareholdings of over 60 percent (Gerlach, 1992, *Nihon Keizai Shimbun*, July 26, 1996). International retail and institutional shareholders with no ties to Sony hold shares primarily to enjoy higher returns on their investment, which is indicative of the extent to which Sony emphasizes share value maximization as a performance goal.

As the result of its emphasis on investor relations, Sony has also built a reputation for taking corporate governance seriously in the Japanese market (Teramoto, 1997; Sato, 2000). In June 1997, the company completely restructured its board of directors by reducing the number of directors from 38 to 10,[2] and constitutionally defined and separated the roles of directors and executive officers. Again, in the context of Japanese corporate life, this was seen as a drastic step because board membership is a form of reward given to loyal employees,[3] (Abbeglen and Stalk, 1985). Going even further than any independent Japanese corporation, three of the ten directors were outsiders or non-former employees. They were the Chairman of Blackstone Group, an active U.S. based institutional investor, Chairman of Sakura Bank, and Chairman of Goldman Sachs Securities Japan.

Contrasting Sony's board restructuring to the highly publicized failed attempt by T. Boone Pickens, a well known corporate raider with more than 15 percent ownership share, to obtain a board seat on Koito Corporation, a Toyota corporate group affiliate, one gets the idea that Sony was breaking new ground with the appointment of a foreigner on the board. Sony is also the first large Japanese firm in 1998 to implement a remuneration package that is linked to stock price for its senior executives and non-Japanese managers in foreign subsidiaries (Sato, 2000). While this is not new to many American corporations, in Japan, such practices were unheard of at the time because many Japanese firms did not see the enhancement of shareholder value as their prime objective.

Mitsubishi Electric's pedigree is very different from that of Sony. The company was created as a spin-off of Mitsubishi Shipbuilding in 1921 and is currently one of 29 Mitsubishi corporate group's Presidents' Council member firms. Its membership on the Council requires the heavy equity participation of other Mitsubishi group companies. In 1998, three of the top ten shareholders of the company were Mitsubishi group companies: Meiji Life

Table 2. Foreign ownership, stable shareholding positions and corporate group affiliations[a] of major Japanese electronics firms (1998).

Company	Foreign ownership (%)	Stable shareholding positions (%)	Corporate group affiliation
Mitsubishi Electric	11.0	61.0	Mitsubishi
Hitachi	27.5	49.3	Fuyo, Sanwa, DKB[b]
Toshiba	9.4	59.1	Mitsui
Matsushita[c]	20.3	60.9	Matsushita
Sony	43.6	43.4	Independent
Sharp	11.8	72.4	Sanwa
Fujitsu	14.5	68.0	DKB
NEC	13.7	67.2	Sumitomo

Source: *Nikkei Kaisha Joho, 1999.*
[a]Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, DKB.
[b]DKB: Dai-Ichi Kangyo Bank group.
[c]Matsushita is the hub firm of the Matsushita *keiretsu* group.

Insurance, the Bank of Tokyo-Mitsubishi, and Mitsubishi Trust. They are the main financial institutions that handled the major corporate finance and treasury needs of the group. Compared to other firms in the same industry, foreign ownership in Mitsubishi Electric, at 11.0 percent in 1998, is relatively low (Table 2). At that time, the firm reported stable ownership of 61.0 percent of total shares. Although this figure is not particularly high when compared to other firms belonging to corporate groups, it is much higher than Sony's. In addition, compared to Sony,Mitsubishi Electric's reliance on bank borrowings is heavy. Bank loans in its total liabilities accounted for 29% in 1998, compared to 0% for Sony.[4] Thus, this relatively low exposure to arms length market investors suggests that Mitsubishi Electric's affiliates are effectively governing the firm.

Compared with the board of directors of Sony, insiders dominate the board at Mitsubishi Electric. In 1997, only two out of thirty three directors were not former employees of the company.[5] Of the two non-former employees, one is a former official of the powerful Ministry of International Trade and Industry and the other is president of Mitsubishi Corporation, the hub firm of the group. On the audit committee, which by law is constituted from a different group of people, only two of the five statutory auditors are non-former employees wherein one is a former chairman of Mitsubishi Bank and the other is a lawyer and former public prosecutor.

Thus, among the 38 directors and statutory auditors, only four are non-employee directors with two from the Mitsubishi group. The number of directors is also four times larger than Sony's suggesting a dispersion of power and high potential for passivity in the boardroom. Further, because the company belongs to one of the largest corporate groups in Japan it is secured by extensive cross-shareholdings and has access to debt capital from the group's financial institutions. The characteristics of its ownership structure and governance system suggest that Mitsubishi Electric has not felt the same pressure as Sony to meet the demands of its investing public for transparency. Among professional investors, Mitsubishi Electric is not known for its information disclosure or investor relations practices. For

Table 3. Return on sales (ROS) and return on equity (ROE) of Sony, Mitsubishi Electric, Toshiba, and Matsushita (March 1996–March 2000).

		Sony	Mitsubishi	Toshiba	Matsushita
1996	ROS	**1.2**	**1.7**	**1.8**	**−0.8**
	ROE	5.0	7.1	7.8	−1.7
1997	ROS	**2.5**	**0.2**	**1.2**	**1.8**
	ROE	10.6	1.1	5.4	3.9
1998	ROS	**3.3**	**−2.8**	**0.1**	**1.2**
	ROE	13.6	−15.0	0.6	2.5
1999	ROS	**2.6**	**−1.2**	**−0.3**	**0.2**
	ROE	9.8	−7.6	−1.2	0.4
2000	ROS	**1.8**	**0.7**	**−0.5**	**1.4**
	ROE	6.1	4.4	−2.8	2.8

Source: *Nikkei Kaisha Joho, 2000.*

Table 4. Percentage changes (%) in stock price of Sony and Mitsubishi electric.

	1993	1994	1995	1996	1997	1998	1999	93–99
Sony	−3	+29	+8	+9	+52	−31	+274	+611
Mitsubishi	+11	+33	+5	−12	−51	+7	+89	+36

Source: *Nikkei Kaisha Joho, 2000.*

example, recent rankings on corporate disclosure by the Security Analysts Association of Japan rated the company the worst among nineteen major Japanese electronics firms in 1999.[6]

The contrasts in the corporate performances of Sony, Mitsubishi Electric, Toshiba, and Matsushita, all direct competitors, in terms of return on sales (ROS) and return on equity (ROE) are stark. Table 3 reports ROS and ROE in the 1996–2000 period. Table 4 shows the percentage changes in stock price of Sony and Mitsubishi Electric between 1993 and 1999. During the period between March 1996 and March 2000, Sony recorded significantly better performance than the other three electronics firms. Sony's stock also demonstrated significantly better performance than Mitsubishi Electric's, growing over 600% during the 7-year period, while Mitsubishi's stock price improved only 36%.

These performance figures suggest that Mitsubishi Electric, as a member of a major *keiretsu*, is less focused on shareholder value, while Sony appears to have an unambiguous view on what is important to its economic performance. In fact, Sony's senior managers have often made the statement that the enhancement of shareholder value is a critical corporate objective.[7] To achieve this objective, the company implemented various shareholder friendly governance-related practices in the last several years. Sony's substantially better performance since 1997 seems to suggest the effectiveness of such practices. It would appear that Sony under the stockholder-centered corporate governance system and

Mitsubishi Electric under the stakeholder-centered system pursued different performance objectives and thus adopted different corporate governance policies.

b. Honda and Nissan. Soichiro Honda founded Honda Motor in 1947 to produce motors for bicycles. In the years that followed, the company grew rapidly as a motorcycle manufacturer, successfully penetrating the U.S. market and eventually entering the automobile manufacturing industry in 1963. As a latecomer to the Japanese automobile industry, which was dominated by Toyota and Nissan at that time, Honda Motor was forced to grow its business outside of Japan (Sato, 1995). It thus adopted an international expansion strategy in the U.S. auto market at the start of its inception to the automobile industry. In order to succeed in this market, the company decided that it had to rapidly localize its operations, which included input sourcing, local production, and product design (Sato, 1995). In an early move to localize its financing needs, Honda Motor issued ADRs in the U.S. in 1962, following the example set by Sony just a year earlier. The localization of Honda continued with a program to list its stock on the New York Stock Exchange in 1977. This helped the company surmount protectionism sentiments during a time of rising trade deficits the U.S. had with Japan in the late 70s and early 80s (Sato, 1995). Due to its early exposure to the U.S. investment environment, Honda learned the skills of good investor relations and rapidly obtained the early support of the American financial community (IR-COM, 1995). As a result of this competency, the Securities Analysts Association of Japan ranked Honda as the best company on disclosure in the automobile sector in 1995, 1996, 1997, and 1998.

Honda reports the highest percentage of foreign ownership in its shares than any other Japanese automobile manufacturer. In 1998, foreign ownership reported by Honda Motor was 17.8 percent, while that of Toyota, Nissan, and Mitsubishi Motors were 8.1 percent, 10.6 percent, and 7.3 percent, respectively. Honda also reports lower stable ownership shares than any other major Japanese automobile manufacturer. In 1998, the stable shareholding content of Honda Motor was 74.3 percent of total equity, while that of Toyota, Nissan, and Mitsubishi Motors were 85.4 percent, 79.4 percent, and 80.0 percent respectively (Table 5). Compared to its industry peers, arms length market investors have larger ownership positions in Honda Motor, implying that Honda Motor is under a greater pressure to respond to the needs of foreign and domestic market investors for disclosure and transparency.

Table 5. Foreign ownership, stable shareholding positions and corporate group affiliations[a] of the major Japanese automobile manufacturing firms (1998).

Company	Foreign ownership (%)	Stable shareholding positions (%)	Corporate group affiliation
Honda motor	17.8	74.3	Independent
Toyota motor	8.1	85.4	Mitsui[b]
Nissan motor	10.6	79.4	Fuyo
Mitsubishi motors	7.3	84.0	Mitsubishi

Source: *Nikkei Kaisha Joho, 1999.*
[a]Mitsui, Mitsubishi, Sumitomo, Fuyo, Sanwa, DKB.
[b]Toyota Motor has observer status in the Mitsui group.

Nissan Motor was established in 1933 as part of the Nissan *zaibatsu* group and thus boasts a longer history than Honda Motor. The Nissan *zaibatsu* was dissolved after World War II and Nissan Motor became part of the Fuyo corporate group in the 1950s, which put it on its current trajectory of growth. Nissan Motor and the Industrial Bank of Japan (IBJ) are also closely tied, partly as a result of IBJ being designated the fund provider to Nissan for its military industrial operations during wartime Japan (Cusumano, 1985).

Due to the company's close relationships with financial institutions of the Fuyo group such as Fuji Bank and Yasuda Trust and with the IBJ, Nissan Motor has traditionally had easy access to bank loan capital for expansion (Nikkei Business, 2000). Where there is equity ownership, these are mostly cross-held by the Fuyo group of firms and the Nissan Motor's own *keiretsu* member firms. In 1998, foreign ownership in Nissan Motor was 10.6 percent while stable ownership comprised almost 80 percent of total shares. This compares to Honda Motor's 17.8 percent and 74.3 percent, respectively. Nissan's shares are listed only in Japan and Frankfurt, where disclosure requirements are less stringent than those of the U.S. Thus, the company is less exposed to the pressures for transparency and corporate accountability than Honda, and consequently has not felt the need to actively engage in investor relations activities. This is demonstrated in a recent report by the Security Analysts Association of Japan, which ranked Nissan seventh among the ten major Japanese automobile manufacturers in disclosure quality and corporate transparency.

As Tables 6 and 7 demonstrate, Honda and Nissan's economic performance, together with those of its peer companies in the automobile industry, are markedly different. Here, we note that Honda has consistently reported higher profitability in terms of ROS and ROE than its competitors except in 1996 when Toyota's ROS was higher. Table 7 shows the percentage changes in the stock prices of Honda and Nissan. In terms of stock performance, the pattern is very similar to the Sony-Mitsubishi Electric comparison. Honda substantially beats Nissan in stock price performance during the 1993–2000 period. It would appear that greater exposure to foreign capital markets motivated the company to maintain higher

Table 6. Return on sales (ROS) and return on equity (ROE) of Honda, Nissan, Mitsubishi motors, and Toyota (March 1996–March 2000).

		Honda	Nissan	Mitsubishi	Toyota
1996	ROS	**1.7**	**−1.5**	**0.4**	**2.4**
	ROE	6.5	−6.3	2.6	5.0
1997	ROS	**4.2**	**1.2**	**0.3**	**3.2**
	ROE	17.5	5.7	2.4	7.0
1998	ROS	**4.3**	**−0.2**	**−2.7**	**3.9**
	ROE	17.4	−1.1	−24.4	7.8
1999	ROS	**4.9**	**−0.4**	**0.2**	**3.6**
	ROE	18.1	−2.2	1.6	5.8
2000	ROS	**4.3**	**−11.4**	**−0.7**	**3.2**
	ROE	14.2	−62.7	−6.7	6.3

Source: *Nikkei Kaisha Joho, 2000.*

Table 7. Percentage changes (%) in stock price of Honda and Nissan.

	1993	1994	1995	1996	1997	1998	1999	93–99
Honda	+15	+15	+19	+45	+43	−23	+5	+188
Nissan	+35	+10	−4	−17	−21	−36	+15	−39

Source: *Nikkei Kaisha Joho, 2000.*

profits than its peers. These figures suggest that Nissan's performance objectives are not focused exclusively on profitability or shareholder value whereas Honda seems to put more emphasis on those areas, in part, we argue from the differences in its ownership structure.

Differences in two types of corporate governance system

The comparative case analyses, admittedly cursory, seem to suggest that companies in the same industry can differ in the ways they are strategically focused because of differences in ownership patterns and network affiliations. The attitudes toward investor relations also differ with ownership pattern, driving some firms to become more stockholder-centered and others to be more stakeholder-centered in their approaches to corporate governance. Those firms with greater exposures to the external capital market, particularly those that are foreign, tend to put more emphasis on investor relations, information disclosure and transparency. Those firms that are protected by easy access to internal sources of financing and credit behave accordingly to maintain the stability of their network relationships. We have also tried to illustrate how economic performance differs between stockholder centered and stakeholder-centered firms. Driven by who controls the boardroom agenda, firms that are more stockholder-centered in their corporate governance seem to emphasize asset efficiency and stock performance, whereas those that are more stakeholder-centered tend to emphasize stability. In short, while we have no way of knowing from the data whether Japanese companies in either type of governance forms differed in terms of *operational* efficiency, we do know that they markedly differed in how they used cash flows; whether the cash was redistributed back to investors or to other stakeholders. From these observations, we draw the following propositions for future research:

Proposition 1. *Japanese companies that belong to corporate groups or* keiretsu *use a stakeholder-centered corporate governance system whereas those that do not belong to any groupings* (*i.e.*, *are independent*) *use a stockholder-centered corporate governance system.*

Proposition 2. *The objective of managerial monitoring in the stakeholder-centered corporate governance system is relationship stability whereas that of the stockholder-centered corporate governance system is asset efficiency.*

Propositions 1 and 2 refer to a static situation. However, we know that corporate governance in Japan is far from static. In fact, in response to changes in ownership structure and institutional environment, many companies are already changing the way they are governed. In the next section, we develop further propositions that incorporate the changing

ownership structure and institutional expectations. These propositions aim to examine the future direction of Japanese corporate governance under a dynamic environment.

5. Ownership and institutional changes and corporate governance in Japan

There is anecdotal evidence that an increasing number of firms within the corporate groups under the stakeholder-centered governance system are slowly adopting one or more elements of the stockholder-centered governance system (see Table 8). One of the key factors that drive these firms to contemplate more shareholder friendly practices appears to be a shift in ownership structure. Since the mid-1990s, the foreign ownership of Japanese firms has been rising, reaching over 14% of all listed Japanese shares in 1999.[8] At the same time, cross-shareholdings among affiliated firms have steadily declined. This is largely attributed to the upcoming accounting change that forces Japanese firms to use market value rather than book value when disclosing the extent of their stockholdings (*Nihon Keizai Shimbun*, September 22, 2000). In order to mitigate the impact of stock price movement on their profits, many Japanese firms and banks have started to reduce their stockholdings in other firms. It is reported that cross-shareholdings among large listed Japanese firms declined 2.7% in 1999 from 10.5% in 1998, which in turn was a large drop from about 18% in 1987 (*Nihon Keizai Shimbun*, September 22, 2000). Although this figure does not include holdings by life insurance companies and by other unilateral stable shareholders, it does suggest that the practice of cross-shareholding among Japanese firms is declining.

The importance of the pattern in the rise of foreign ownership and the decline in cross-shareholdings is that it is not evenly distributed. The impact of the change in ownership pattern is greater in some firms than in others. In part, this has been due to the rise in acquisition activity by the foreign competitors of Japanese firms. For example, after Renault, a French automobile manufacturer, acquired a large portion of Nissan's shares in 1999, Nissan's ownership structure changed dramatically. In March 2000, foreign

Table 8. Recent moves to improve corporate governance by Japanese firms affiliated with corporate groups.

Company (affiliation)	Recent moves	Foreign ownership (1995–2000)
Orix (Sanwa)	Board restructuring (21 to 18) Stock option plans NYSE listing	27.9 → 36.7
Toshiba (Mitsui)	Board restructuring (33 to 12)	11.5 → 26.6
Nissan Diesel (Nissan)	Board restructuring (21 to 10)	2.8 → 24.1
Fujitsu (DKB)	Stock option plans Greater information disclosure	13.4 → 27.6
NEC (Sumitomo)	Board restructuring (37 to 17) Greater information disclosure	16.5 → 29.8
Mitsui & Co. (Mitsui)	Stock option plans	11.8 → 19.0
Mitsubishi motors (Mitsubishi)	Greater information disclosure	9.6 → 17.4

Source: *Nikkei Business, Nihon Keizai Shimbun, Nikkei Kaisha Joho*, various issues.

ownership, including the 36.8% by Renault, reached 53.3%.[9] As a result, well over 60% of Nissan's shares are now in the hands of foreign and market investors. Together with this change in ownership, Nissan is attempting to reduce its cross-shareholdings. After Carlos Ghosn, who is President of Nissan, was sent from Renault as Chief Operating Officer, he immediately announced a plan to sell most of Nissan's stockholdings in its *keiretsu* firms (Nikkei Business, 2000).

These ownership changes have led Nissan to reform its corporate governance practices, including the board structure and its relationships with its major financial institutions. The number of board members was reduced from 42 to 13, of which three represent its major shareholder, Renault. Nissan redefined its dealings with its financial institutions purely on the basis of prices and economic benefits, implying that its banking relationships are now based on arms-length transactions rather than relationship (Nikkei Business, 2000). The net result is that Nissan can longer expect its financial backers to rescue it and therefore has to rely on the external market for funds, increasing its exposure to capital market discipline.

While Nissan represents an extreme case of ownership change, many Japanese firms are experiencing the rising pressure of non-*keiretsu*, especially foreign, shareholders to reform their corporate governance structures and practices. This trend appears to be accelerating, suggesting that it is not a temporary phenomenon. In a less dramatic example, NEC, a Sumitomo group firm, experienced a rise in foreign ownership from 16.5% in 1995 to 29.8% in 2000.[10] In response to this change and to improve its performance, the company decided to separate the roles of executive officers and directors in April 2000. The roles of executive officers and directors are often kept ambiguous in Japanese firms because top management usually appoints the directors (Abbeglen and Stalk, 1985). NEC's decision to define the roles and to separate them makes the directors accountable for their monitoring role. In addition, NEC reduced the number of the board of directors from 37 to 17 to make decision-making in the boardroom more effective and efficient. When faced with a change in ownership structures even *keiretsu* firms will implement stockholder friendly governance practices.

Proposition 3. *The increase in non-*keiretsu *and foreign share ownership in Japanese corporate group and* keiretsu *firms will result in the adoption of stockholder-centered corporate governance practices by such firms.*

The institutional pressures on corporations to reform their corporate governance are also increasing. Domestic sentiment toward corporate governance is changing in Japan because of poor corporate and stock performances during the 1990s (Kikuchi, 1999; Watanabe, 1994). Japanese firms are under increasing public pressure to disclose more corporate information and to improve the accountability of the board and top executives. The Corporate Governance Forum of Japan in 1998 released a report calling for Japanese firms to adopt more stockholder-oriented practices. Business journals have also started to pay greater attention to this issue often highlighting firms that have implemented corporate governance reform plans, in part because of the relative novelty. There is even an increasingly popular view that the current problems faced by many Japanese firms stem from the

lack of effective corporate governance; a radical idea given the traditionally closed nature of the Japanese boardroom (Wakasugi and Yanai, 2000).

While this institutional pressure is a plausible explanation for a general shift from the stakeholder-centered to stockholder-centered corporate governance system, it does not fully explain why some corporate group firms are implementing the new practices but others are not. An institutional theory perspective may shed some light on this. Accordingly, *keiretsu* firms that implement shareholder friendly practices are probably doing so to regain social legitimacy. Based on Oliver's (1991) theoretical reasoning, such firms are making a rational choice to conform to the emerging institutional norms of stockholder–centered corporate governance because doing so could help them regain social legitimacy, not because they believe that such practices necessarily improve asset efficiency or can even deliver better shareholder value.

A number of things may cause firms to lose legitimacy. Prolonged poor corporate performance, drastic declines in profits, and ethics scandals have been commonplace in Japanese corporate life, particularly during the Asian crisis period of 1997–1999. Firms that have experienced such events would feel a greater pressure to follow publicly endorsed governance reform plans, such as the reduction of the board members, separation of the role of executive officers and directors, and better information disclosure practices, regardless of the effects of such practices on corporate performance. Thus, *keiretsu* firms may be able to resist the

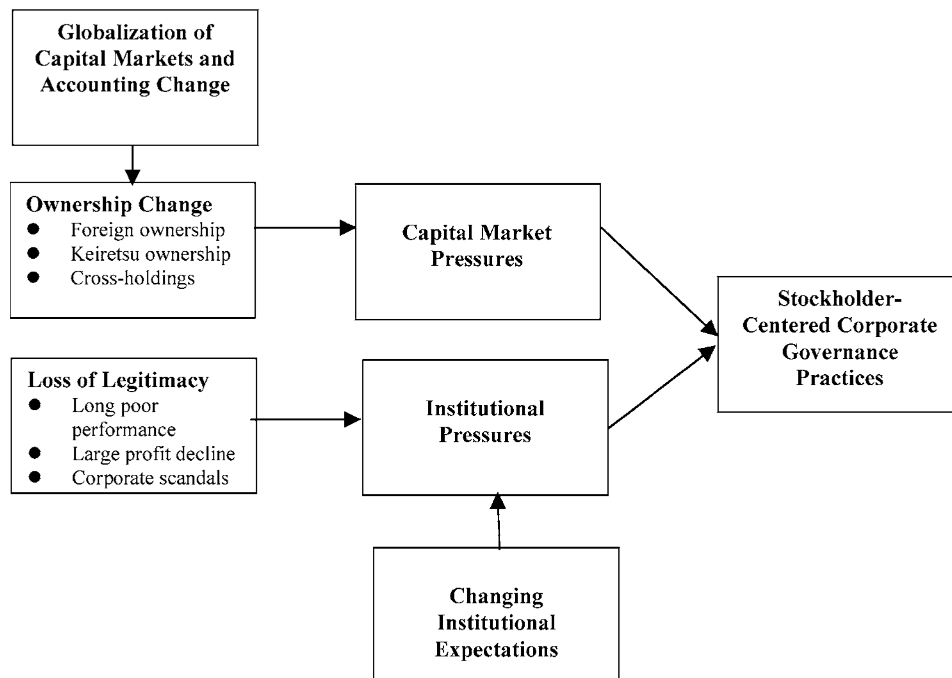

Figure 1. The Transition from Stakeholder-Centered to Stockholder-Centered Corporate Governance System in Japanese Firms.

institutional pressures for reform if they can achieve superior economic performance or if they continue to enjoy good social reputations.

Proposition 4. *Japanese corporate group and* keiretsu *firms that have experienced a loss of social legitimacy are more likely to adopt stockholder-oriented corporate governance practices.*

Taken together, the 4 propositions suggest a future research model shown in figure 1. Here, the model suggests the effects of institutional and capital market pressures on the adoption of stockholder-centered corporate governance practices. Such a model easily lends itself to further empirical testing, which we will discuss in the next section.

6. Conclusions and future research

Prior research on the corporate governance of Japanese firms has largely focused on the monitoring role of main banks and affiliated companies in *keiretsu* (Sheard, 1989; Aoki, 1990). An important assumption in such studies has been that while monitoring mechanisms common to U.S. firms do not exist in the Japanese context, other mechanisms are in place to mitigate the agency problem. The main bank and *keiretsu* relationships, cemented through cross-shareholdings, were seen as the basis of such mechanisms. We take a different tack in this paper because it is now clear that monitoring by the main banks and *keiretsu* firms did not always result in enhanced profitability or good corporate performance (Natakatani, 1984; Kang and Shvdasani, 1999). In fact, because they were more sensitive to the needs of other stakeholders, monitoring by these institutions often resulted in lower asset efficiencies, but higher security for stakeholders. Using their access to management through the boardroom, the main banks and *keiretsu* firms attempted to secure their interests by emphasizing a strategy focused on stable earnings and revenue rather than higher profitability and asset performance (Weinstein and Yafeh, 1998; Nakatani, 1984). Thus, the agency problem for the controlling shareholder was attenuated in post-war industrial Japan by expropriating the claims of minority shareholders. However, because of extremely rapid economic growth and a lack of boardroom transparency, it was not apparent to outsiders that anything was amiss in corporate Japan. Shareholders gained only to the extent that the industry in which the firm competed continued to grow, so that their stock holdings appreciated with the rate of industry growth. Corporate and institutional shareholders did not care since they had other objectives for ownership, and retail investors were largely unsophisticated, made ignorant by a lack of transparency. This situation changed rapidly in the late 1980s and 1990s. The lack of focus on asset efficiency and shareholder value took its toll as a globalized capital market and product market competition led to the changes in ownership structure and institutional expectations. The weaknesses of the stakeholder-centered, network-based corporate governance system were quickly exposed, as this form of governance was not designed to enhance corporate profitability and shareholder value.

In this paper, we have attempted to illustrate two corporate governance systems in Japan, the stakeholder-centered system for firms belonging to the corporate groups or *keiretsu* and the stockholder-centered one for independent firms. These two corporate governance systems were able to co-exist because prevailing institutional and financial environments

allowed it. During a period of economic growth the stakeholder-centered corporate governance system, which aims to secure business ties rather than shareholder value, worked adequately because the existence of slack attenuated the need for more market-driven mechanisms.

We believe our paper has important implications for future corporate governance research. Namely, that in spite of institutional constraints such as traditional business practices and legal regimes, intensifying global competition and the resulting lower price/cost margins will force firms to focus on maximizing asset efficiency and shareholder value if they want to access funds to fuel growth opportunities. The loss of national competitiveness and the prolonged poor performance of firms can change a society's institutional norms to emphasize asset efficiency and transparency rather than operational stability and business ties. The relationship between the change in ownership structure and the change in corporate governance practices suggests a dynamic selection mechanism that ensures the emergence of appropriate corporate governance mechanisms to mitigate the agency problem.

The case examples we presented in this paper reveal large performance differences between independent firms and *keiretsu*-affiliated firms. Does this mean that corporate governance can make a difference to firm performance? While the anecdotal evidence suggests the possibility, we think it is premature to make a conclusive statement. This is an area that needs to be further explored. Theoretically, if a firm changes its corporate governance practices to better align the interests of management and shareholders, we would expect such reform to lead to better firm performance. However, if a firm is simply conforming to institutional norms, no such performance improvements are expected. This is really an empirical question and therefore best answered with large-scale empirical data in a future research program.

It would also be instructive to explore other firm-specific factors that can trigger a shift toward the stockholder-centered corporate governance system. We have suggested ownership structure and the loss of legitimacy. Further study could be directed at the role of top management in Japanese corporate governance. Specific research on the different responses by corporate group firms to the current institutional and economic environment may provide insights on the nature of the inter-organizational cohesiveness of the industrial groups. Why, for example, do firms in some corporate groups implement stockholder-centered practices more readily than firms in other groups? We suspect that the receptiveness of individual top managers may have something to do with this. The results of such a study will shed light on the organizational antecedents of the effectiveness of various discipline mechanisms in the stakeholder-centered network-based corporate governance system. Finally, the perspective developed in this paper can be used as a template to examine similar phenomenon in other nations in Asia and Europe that have traditionally relied on a stakeholder model of corporate governance such as Germany, France, and other South East Asian nations.

Notes

1. Calculated as follows: total shares—(foreign ownership + investment trust holdings + floating shares).
2. Many scholars are of the opinion that large boards are often created by CEOs because it disperses power in the boardroom and reduces the potential for coordinated action by directors, leaving the CEO with de

facto control. Reducing board size, thus enhancing member participation, is seen as positively associated with increased CEO monitoring (Hackman, 1990; Jensen, 1993; Leighton and Thain, 1997).

3. This accounts for its large size, and the ambiguity of directors' roles.
4. *Kigyo keiretsu Soran*, Toyo Keizai, 1998.
5. *Yuka Shoken Hokokusho*, 1998.
6. Security Analysts Association of Japan, 1999.
7. For example, at the annual conference of the Corporate Governance Forum of Japan in 1999, Sony's senior manager stated that enhancement of shareholder value is critical not only from the perspective of shareholders' interests but also in terms of the protection from hostile takeovers.
8. *Kabushiki Bunpu Chosa, 2000.*
9. *Nikkei Kaisha Joho, 2000.*
10. *Nikkei Kaisha Joho, 1997, 2000*.

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