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Abstract

This paper explores the performance impact of recent changes in foreign shareholdings and boardroom reforms in Japan. Empirical research on the impact of reform on the Japanese corporate governance system could provide useful lessons for their European counterparts who are themselves facing similar pressures to reform. We found that although participation of outside directors in strategic decision-making was associated with positive stock returns, the increase in the ratio of outside directors, the separation of the board members and executive officers, and the reduction of board size were not related to firm performance.

Corporate governance, Stakeholder governance, Agency theory, Board of directors, Ownership structure

1. Introduction

Similar to many French and German firms, the post-war Japanese industrial system has been characterized by a stakeholder-orientation based on stock ownership by stable investors and extensive cross-shareholdings (e.g. the 'noyaux durs' in France is similar to the 'keiretsu' in Japan) among its corporations and banks. For such shareholders, equity ownership represents the status of existing commercial trading relationships with partner firms (Clark, 1979, Gerlach, 1992). As a consequence, the role of a Japanese board of directors has been less about maximizing shareholder wealth than about managing the complex business networks between the firm and its stakeholders (Gilson and Roe, 1993, Heftel, 1983).

This changed in the post-bubble economy of the 1990s, as increased foreign ownership combined with regulatory reforms in corporate disclosure and derivative lawsuits led to a rising focus on the shareholder in corporate Japan. These changes are part of a worldwide movement driven by the privatization of government-owned companies, the transition of family businesses into publicly owned corporations, and the rise of shareholder activism by large institutional investors (McCarthy and Puffer, 2002, Peck and Ruigrok, 2000). It has been argued that this convergence of global corporate governance systems toward an agent–principal model is worldwide (Useem, 1998, Davis and Useem, 2002).

This paper explores the performance impact of recent changes in foreign shareholdings and boardroom reforms in Japan. We were motivated to do this study in order to see if convergence toward the agent–principal model of corporate governance is indeed occurring. Agency theory is parsimonious, straightforward and represents an attractive platform for structuring corporate governance systems. However, it has been criticized as Anglo-American centric and insensitive to the non-economic forces that drive managerial choices in mixed (i.e. socialist/capitalist) economies. If the data do not fit the agent–principal model, then we must conclude that corporate governance systems are not converging and that institutional and historical contexts must be considered when we study this issue outside the Anglo-American context (Ahmadjia, 2002, McCarthy and Puffer, 2002).

2. Literature Review

The literature cites various reasons for the perceived convergence of governance practices. They include: (1) the competition for global capital, (2) the competition for equity listings among stock markets, (3) the globalization of consulting and investment banking services, (4) the globalization of US firms and the homogenizing influences of business practices, and (5) the globalization of institutional investing (c.f. Useem, 1998, Davis and Useem, 2002, Yoshikawa and Phan, 2001). Because of these reasons, non-Anglo-American firms including those in Europe and Japan that employ a more stakeholder-oriented approach to corporate governance might believe that unless they move their governance practices to be in line with Anglo-American capital market practices, they cannot be competitive in the market for capital.

In order to find out how non-Anglo-American firms might respond to such challenges, we should examine firms that have traditionally operated further along on the stakeholder end of the stakeholder–stockholder continuum. Given their strongly collectivist culture and social network-based business systems in the post-war period, Japanese firms face greater pressures for change because their business practices are even further removed than many European firms from the stockholder-oriented Anglo-American system. Therefore, examining the factors that drive how Japanese firms have reformed their corporate governance practices and the impact of this on performance can provide a stark example for the kinds of isomorphic forces that European, particularly German and French, firms potentially face.

First, we look at the extant studies and find that a number of them have already examined the effects of ownership structure and concentration on firm strategies and performance (e.g. Amihud and Lev, 1981, Baysinger et al., 1991, David and Kochhar, 1996, Hill and Snell, 1989, Kochhar and David, 1996). These US-based studies generally support the view that concentrated institutional ownership leads to more shareholder-oriented strategies. Other studies have also examined the relationships between shareholdings by banks, partner firms and foreign investors and the performance of Japanese firms (e.g. Aoki, 2002, Gedajlovic and Shapiro, 2002, Kang and Shivdasani, 1995, Nitta, 2000, Prowse, 1990). Generally, they find that foreign ownership correlates with higher performance and while these results have been interpreted to mean that foreign shareholders are more effective in driving firm performance, they do not discount the possibility that foreign owners are just good stock pickers (Nitta, 2000, Sheard, 1997).

2.1. Stakeholder-oriented Corporate Governance

Similar to many European firms, the network-oriented corporate governance system of Japan (Gerlach, 1992) is characterized by long-term relationships among different stakeholders who have substantial influence on firm policy. As with German firms, among those stakeholders, employees are often seen as one of the most important stakeholders. For example, Aoki (1988) presents the Japanese firm as a nexus of coalitions of employees and of shareholders, and management plays a mediating role to strike a balance between the interests of both parties.

Major industrial sectors in Japan are also organized as networks of firms that are characterized by extensive cross-shareholdings (Clark, 1979). These corporate networks, known as *keiretsu*, usually revolve around a main bank. In many ways, this system is similar to the German corporate governance system in which a main bank owns a large portion of the network's equity and serves as lead lender to its client firms. As a large debt holder, the main bank often acts as an advisor and agent to the firm's cash management and financial planning activities (Aoki, 1990, Sheard, 1989). As a large equity holder, the main bank also has an incentive to protect the long-term value of the firm's equity. However, Japanese banks often hold shares in their client firms not to earn investment returns but to cement business relationships (Morck and Nakamura, 1999, Weinstein and Yafeh, 1998). In addition to the banks, many non-financial firms also hold stocks of other firms, often on a reciprocal basis. These corporate shareholders, like bank shareholders, hold shares not necessarily to earn investment returns but to stabilize trading relationships and cement long-term alliances (Abegglen and Stalk, 1985, Kester, 1991). Thus, it is often argued that Japanese firms behave to satisfy the long-term interests of those stakeholders that include employees, their banks, and corporate business partners.

2.2. Corporate Governance Reform in the Japanese Firm

In Japan, as in Europe, the board of directors is legally responsible for the management of the corporation. However, the Japanese board does not delegate its management duties to executive officers (Heftel, 1983). In part, this is because Japanese boards are usually composed of executives and former employees (Abegglen and Stalk, 1985, Charkham, 1994). As a consequence, unlike an American or British board, the Japanese board does not define its primary role as that of monitoring top management (Charkham, 1994, Heftel, 1983).

In recent years, however, there has been a rising view that a more shareholder-oriented approach to corporate governance should be adopted in Japan (Kikuchi, 1999, Watanabe, 1994). Failing profits and rising public pressure from interest groups such as domestic institutional investors and the Japan Investor Relations Association focused Japanese boards on the question of management quality (Nihon Keizai Shimbun, Nikkei Business, Watanabe, 1994). In 1994, the Corporate Governance Forum of Japan was established by business people, scholars, and the media to promote a stockholder-oriented corporate governance system in Japan. In 1995, *Keidanren* or the Japan Federation of Economic Organizations issued a statement that stressed the importance of improving information disclosure by Japanese firms to stimulate the growth of equity transactions in the domestic stock markets (Keidanren, 1995). Such pressures continued to increase after the 1997 Asian economic crisis and the formal introduction of the euro, which increased global competition for financial capital. From March 2003, the Tokyo Stock Exchange required all listed firms to disclose their policies on corporate governance (*Nihon Keizai Shimbun*, November 19, 2002). Newspaper and journal articles calling for corporate governance reforms are now commonplace. To alleviate cash flow problems, some Japanese firms are seeking foreign investors and partners to inject their capital (Kikuchi, 1999, Nitta, 2000). Examples include the near-takeover of Nissan by Renault, and the control of Mitsubishi Motors by DaimlerChrysler.

An agency theory perspective suggests that increases in foreign ownership would lead to realignment in Japanese corporate governance practices (Kikuchi, 1999, Nikkei Business, Yoshikawa and Phan, 2001). According to the evidence, the boardroom changes by Sony in 1997, including reductions in board size and the appointment of outside directors, have been copied by other Japanese firms. For example, a recent survey by *Nihon Keizai Shimbun* reported that over 38% of Japanese firms now have outsiders on their boards even though they are not yet legally required to do so (*Nihon Keizai Shimbun*, June 16, 2001). Thirty-six percent of the respondents in the same survey have separated the roles of the board members and executive officers. Finally, the separation of directors and executive officers often results in the reduction of the board size since many directors are also executive officers (*Nihon Keizai Shimbun*, June 13, 1999). While these changes may show the increased emphasis on corporate governance in the Japanese boardroom, less clear is their impact on shareholder wealth creation, which we try to answer in this paper with the following research model.

3. Research Model

In accordance with the agent–principal notion of the separation of decision management and control, our model suggests that the participation of outside directors in strategic decision-making, increase in the number of outside directors, decrease in board size, separation of the board members and executive officers, and increase in foreign ownership should be positively associated with firm performance.

3.1. Involvement of Outside Directors

Outside directors are deemed to be independent because they do not depend on the firm (and its managers) for compensation. This puts outside directors in the position of acting as managerial monitors (Fama, 1980). Being from the outside, they are supposed to bring objective and diverse perspectives to the boardroom table and thus provide a source of valuable advice for senior management (Chaganti et al., 1985). Studies on the role of outside directors in board decisions such as greenmail payments (Kosnik, 1987), golden parachute contracts (Singh and Harianto, 1989), and dividend policies (Schellenger et al., 1989) argue that they perform a critical function in crafting the structure of CEO compensation, preventing the misuse of corporate resources, and encouraging the allocation of free cash flow to the shareholder (Dalton et al., 1999, Pfeffer and Salancik, 1978). Thus,

H1

Increase in the ratio of outside directors to total number of directors is positively associated with firm performance.

Critics of agency theory have often observed that outside directors have power *de jure* but do not have power *de facto* (Phan, 2001). Partly, this is because outside directors are not always privy to detailed company operating data, which are controlled by senior managers, unless such information is volunteered. More importantly, even if they had the data, outside directors, because they meet infrequently, are not sufficiently sensitized to the operating characteristics of the firm. Such data are critical for assessing managerial performance. Therefore, unless outside directors are also actively involved in the strategic decision-making process, which requires detailed operating data, they cannot perform their managerial monitoring function effectively. Thus,

H2

Outside directors' involvement in strategic decision-making is positively associated with firm performance.

3.2. Separation of Board Members and Executive Officers

In addition to the participation of outside directors in strategic decision-making and the increase in the ratio of outside directors, the separation of the board members and executive officers, one of the more widely adopted reforms among Japanese firms in recent years, can theoretically enhance board effectiveness in the following way. Information processing theory suggests that everything else being equal, an increase in informational complexity will be associated with lower processing capacity. Thus, a board that is focused on the key strategic questions rather than just the day-to-day operations of the firm will be able to allocate its resources more efficiently and thus make better decisions. Thus,

H3

The separation of the board members and executive officers is associated positively with firm performance.

The reduction in the board size, another board reform measure widely adopted by Japanese firms, can also have an important impact on firm performance. There are disadvantages associated with large boards. They tend to be less cohesive and more difficult to coordinate because of the large number of potential interactions and conflict among group members (Forbes and Milliken, 1999, Lipton and Lorsch, 1992). Large boards are less likely to be active, particularly in strategic decision-making (Judge and Zeithaml, 1992). There is also a view that large boards are often created by CEOs because they disperse power in the boardroom and reduce the potential for coordinated action by directors, leaving the CEO as the predominant figure (Leighton and Thain, 1997). In sum, smaller boards are more conducive to board member participation and thus would result in a positive impact on the monitoring function and the strategic decision-making capability of the board.

H4

Reduction of the board size is positively associated with firm performance.

3.3. Foreign Ownership

Similar to German firms, the ownership structure of Japanese firms can be broadly categorized into two classes of shareholders, market investor and stable investor. Stable investors, including Japanese financial institutions and affiliated corporate firms, tend to have on-going business ties with the firms in which they invest. Japanese banks and insurance companies usually have lending, corporate insurance, and other financial transactions with the firms in which they hold shares (Charkham, 1994, Gerlach, 1992). Affiliated corporate shareholders are usually the Japanese business partners, suppliers or customers in which the firm has cross-shareholdings. The domestic shareholders are more interested in stabilizing their business relationships than in the return on investment since the relative cash flows from the former exceed those of the latter (Abegglen and Stalk, 1985, Clark, 1979).

Market investors, who are mostly American and European institutional investors such as pension funds and mutual funds, buy, sell, and hold stocks primarily for investment purposes. At the end of March 2001, these foreign investors controlled 18.8% of outstanding stocks of listed Japanese firms. Foreign shareholders have little commercial relationship with their investee firms, and thus are only interested in the maximization of returns as the objective of their investment decisions (Kikuchi, 1999, Sheard, 1997). Thus,

H5

Increase in foreign ownership ratio is positively associated with firm performance.

4. Data and Variables

4.1. Sample

Our sample consists of 262 listed manufacturing firms in Japan. We chose to focus on manufacturing firms to eliminate industry-level fixed effects. The sample was chosen from the respondents of a survey conducted by the first author with the Japan Corporate Governance Forum (JCGF) in 2000. JCGF sent a mail questionnaire to all listed Japanese firms (2459 firms) and received valid responses from 541 firms, of which 283 firms are manufacturing firms. Twenty-one manufacturing firms were removed from the sample of this study either because their response to the survey was incomplete or there were no complete data for other variables. The 262 sample firms are classified into eight industry groups: foods (12%), textiles (5%), chemicals (21%), steel and metal (12%), machinery (14%), electric and electronics (20%), automotives and parts (7%), other light manufacturing (10%). This breakdown is similar to that of the manufacturing sectors in Nikkei 500 index, implying that selection bias is unlikely to be a problem. The data source for the financial and ownership variables was the *Nikkei Kaisha Joho* (a data book published by Nikkei). Other data were collected from the JCGF survey results and the *Yakuin Shikiho* (*The Board of Director Handbook*).

4.2. Dependent Variables

We used two measures of firm performance: net income to total assets (ROA) and the change in stock return index (RI). ROA was calculated as the mean ROA from 1999 to 2000 (the end of March 2000 and the end of March 2001[1]). We used mean ROA to attenuate year to year variations, because it is less likely to be manipulated, and is the most widely used measure of Japanese firm performance (e.g. Nitta, 2000, Prowse, 1992, Suzuki and Sho, 2000). Change in stock return index is calculated on the basis of total shareholder returns, which include capital appreciation plus dividends, stock buybacks, and adjusted for splits and reverse splits. We used this measure because market investors care primarily about stock returns. To make this measure comparable with the ROA measure, we used the data for the 2-year period between the end of March 1999 and the end of March 2001. The data were collected from *Datastream*.

4.3. Independent Variables

There are five independent variables in this study: foreign ownership change, participation of outside directors in strategic decision-making (director participation), change in ratio of outside directors (outside director change), executive officer system (executive officer), and change in the board size (board size change). *Foreign ownership change* was measured as the change in the ratio of a firm's outstanding shares held by foreign shareholders from the end of the 1997 fiscal year to the end of the 1999 fiscal year. We chose the period from 1999 to 2000 for ROA and from 1999 to 2001 for RI. We lagged the independent variables in order to recognize a temporal relationship between cause and effect and reduce problems due to variable endogeneity. The data were collected from the *Nikkei Kaisha Joho*.

Director participation and *executive officer* are measured as dichotomous variables. Each respondent of the JCGF survey was asked to choose a response from the following five items on the scale of outside directors' involvement in strategic decision-making:

1. Outside directors participate in all strategic decision-making.
2. Outside directors participate in some strategic decision-making.
3. Company has a plan to involve outside directors in strategic decision-making.
4. Company is currently considering outside directors' participation in strategic decision-making.
5. Company has no plan to involve outside directors in strategic decision-making.

Because of potential confusion due to respondent calibration (respondents may interpret the level of participation differently), we changed the interval scale into a dichotomous variable to create a construct valid measure Thus, if a respondent chose either (1) or (2), such a firm was coded as 1 for director participation. 0 was assigned for (3), (4), or (5). If a sample firm has already implemented the executive officer system, it was coded as 1. If not, it was coded as 0. The data were collected from the JCGF survey.

Outside director change was measured as the change in the ratio of outside directors in total number of directors from the end of the 1997 fiscal year to the end of the 1999 fiscal year. Outsiders are defined as those who are not former employees of the firm, directors from main banks, insurance companies, the parent firms, other affiliated firms, and government ministries and agencies. *Board size change* was measured as the change in the number of total size of directors from the end of the 1997 fiscal year to the end of the 1999 fiscal year. The time periods for these variables are consistent with *foreign ownership change*. These data were collected from *Yakuin Shikiho*.

4.4. Control Variables

Firm size and *financial leverage* were included as control variables. Firm size, measured as the log of total sales, was included to account for the effects of scale economies on firm performance. Financial leverage, measured as the ratio of debt to total assets, was also included because high debt levels can significantly impact management behavior and thus firm performance (Jensen, 1986). Stulz (1990), for example, argues that the debt ratio should be positively related to firm efficiency. However, poorly performing firms may also rely on debt financing to compensate for declining cash flows. In the Japanese context where banks have close relationships with their client firms, there might be a negative correlation with financial leverage and firm performance. We used the 1999 fiscal year data for the control variables. In order to account for industry fixed effects, industry variables representing eight of the nine industry sectors in which the sampled firms operated were included in the analyses. The data were gathered from the *Nikkei Kaisha Joho*.

5. Results

Table 1 reports the Pearson correlations of the variables. We note a number of statistically significant relationships, but the data did not suggest multicollinearity problems, which usually require correlations between the independent variables in the order of r=0.80 or more. Table 1 suggests that there are significant relationships between the dependent variables and foreign ownership change and leverage ratios.

Table 1. Pearson Correlations of the Variables

	Mean	S.D.	1	2	3	4	5	6	7	8
ROA	1.575	3.2901	1.000							
Stock return index	10.363	44.1246	0.241*	1.000						
Outside director change	1.7981	9.8907	0.052	0.005	1.000					
Director participation	0.2557	0.4371	−0.109	0.138**	0.153**	1.000				
Executive officer	0.2443	0.4305	−0.013	−0.074	0.035	0.115	1.000			
Board size change	−13.8996	21.1884	0.095	0.093	−0.010	0.007	−0.479*	1.000		
Foreign ownership change	1.3672	4.3443	0.242*	0.270*	0.001	0.138**	−0.025	0.036	1.000	
Sales (log)	11.0198	0.6626	0.061	−0.086	−0.012	0.075	−0.237*	0.290*	0.310*	1.000
Leverage	55.4393	19.2685	−0.443*	−0.175*	−0.069	−144**	−0.151**	0.139**	−0.020	0.303*

*p < 0.01.
**p < 0.05.

The results of the regression are shown in Table 2. We first report the results for ROA. As expected, financial leverage was negatively associated with ROA (t=−8.252, sig.=0.000), which suggests that poorly performing firms are more likely to rely on debt financing. We found that outside director change was not associated with ROA (t=0.428, sig.=0.669), rejecting Hypothesis 1. Director participation was not positively associated with ROA either (t=−1.208, sig.=0.228), rejecting Hypothesis 2. Executive officer was not associated with the firm performance (t=0.931, sig.=0.353), rejecting Hypothesis 3. Board size change was not associated with ROA either, rejecting Hypothesis 4. These results indicate that outside directors, the separation of the board members and executive officers, the reduction of the board size, all of which have been widely promoted for Japanese corporate governance reform, have not had any impact on ROA.

Table 2. Results of Regression Analysis

	ROA			Stock return index		
	Beta	*t*	Sig.	Beta	*t*	Sig.
(Constant)		−0.958	0.339		2.565	0.011
Outside director change	0.023	0.428	0.669	−0.016	−0.273	0.785
Director participation	−0.068	−1.208	0.228	0.135	2.168	0.031
Executive officer	0.060	0.931	0.353	−0.042	−0.588	0.557
Board size change	0.088	1.393	0.165	0.033	0.484	0.629
Foreign ownership change	0.217	3.692	0.000	0.274	4.213	0.000
Sales (log)	0.165	2.564	0.011	−0.147	−2.077	0.039
Leverage ratio	−0.484	−8.252	0.000	−0.150	−2.315	0.021
	$R^2 = 0.305$			$R^2 = 0.165$		
	Adj. $R^2 = 0.265$			Adj. $R^2 = 0.116$		
	$F = 7.665^{***}$			$F = 3.407^{***}$		

Beta and *t*-value for the seven industry variables have been omitted for space considerations.
$^{***}p < 0.001$.

We found that the increase in foreign ownership was positively associated with ROA (*t*=3.692, sig.=0.000). As consistent with Hypothesis 5, rising shareholdings by foreign investors appear to impose a pressure on Japanese managers to focus on profitability. Overall, we only found support for Hypothesis 5.

With regard to the regressions for stock returns (RI), we found that director participation was positively associated with the dependent variable (*t*=2.168, sig.=0.031). This finding supports Hypothesis 2. RI was also highly related to the increase in foreign ownership (*t*=4.213, sig.=0.000), supporting Hypothesis 5. Other hypotheses were not supported. However, we found that financial leverage was negatively associated with RI (*t*=−2.315; sig.=0.021). Thus, the results for RI were similar to those for ROA, which increase the validity of our research model (Table 3).

Table 3. Summary of the Results

	Expected results	**Results**
H1: outside director increase	+	No support
H2: director participation	+	Partial support (RI)
H3: executive officer	+	No support
H4: board size reduction	+	No support
H5: foreign ownership change	+	Support (RI and ROA)

6. Discussion and Managerial Implications

This paper examined the impact of participation of outside directors in strategic decision-making, change in the ratio of directors from outside, separation of the board members and executive officers, change in board size, and foreign ownership change on the performance of Japanese manufacturing firms. We use a lagged temporal model to test our model and found that only the increase in foreign ownership was strongly associated with both ROA and RI, lending more credence to the assertions of Jensen (1993) that only the capital markets are capable of providing appropriate managerial discipline. We found that although the participation of outside directors in strategic decision-making was associated with RI, the increase in the ratio of outside directors, the separation of the board members and executive officers, and the reduction of board size were not related to the firm performance measures. These findings suggest that recent board reforms by Japanese firms have not had much impact on firm performance.

One explanation for these findings is that boardroom reforms are mostly symbolic and represent a response to institutional isomorphism. Institutional theory asserts that organizations attempt to incorporate socially accepted norms from their institutional environments in their behavioral routines 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. 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). Institutional theorists argue that the breach of social expectations would destroy legitimacy, thus denying the organization access to resources needed for survival. Thus, attempts to reform corporate governance may not be driven by considerations of economic performance but a means to gain legitimacy in a shifting environment.

The collapse of stock prices in 1990 and the continued poor performance of large Japanese firms throughout the 1990s led to rising demands for greater corporate transparency and more attention was paid to the interests of shareholders from the media, the stock market regulators, and institutional investors (Kikuchi, 1999). Thus, the political imperative to increase confidence in the domestic economy led to visible and highly publicized window dressing in the form of a government driven boardroom reform movement. We note that these pressures are also felt by American and European firms. In America, the firms have had a longer history of shareholder-oriented corporate governance systems. In Europe, as in Japan, the experience is shorter and therefore, we expect the same types of responses to occur with European firms as we have observed with Japanese ones.

A more serious interpretation of our results may be that outside directors in Japan are not interested in monitoring top management very closely. The term ‘outsider’ was broadly defined in our data so that outside directors included those from affiliated firms and banks that have close business ties with the focal firm. It has been pointed out in past studies that there are many instances where outside directors came from their parent firms, affiliated firms, and business partners (*Nihon Keizai Shimbun*, June 16, 2001). As these ‘outsiders’ are not truly independent, their monitoring activities may not be aggressively affirmative, or even focused exclusively on enhancing profitability, as we might expect of outside directors. With regard to the separation of executive officers and directors, we note that the selection of these individuals is still driven by the chief executive so that the mere separation of their roles may not lead to an improvement of the board’s monitoring capability.

Notwithstanding the previous discussion, we note that the strong positive associations between the increase in foreign ownership and ROA and RI demonstrate the powerful effect of ownership on corporate governance. It suggests that the rising share ownership by market investors is more effective in imposing corporate governance reform.

As with all studies that rely on secondary data and that attempt to measure recent events, there are some limitations on the data. Although we lagged the dependent and independent variables by using data from 1999 to 2000 fiscal years for ROA, 1999–2001 for RI, and 1997–1999 for foreign ownership and the board reform, the lag may be too short. Perhaps, the results may be stronger if we could have used data from a longer time period. However, board reform is a new phenomenon in Japan and so extending the time period is not an option. Having said this, a longer time period would probably have introduced more noise and perhaps even confounding events into the study. Thus, we feel that the lag we used is the most appropriate given the data and phenomenon. Further, given that we found significant relationships, the short lag demonstrates the powerful effect that ownership can have on corporate governance.

7. Conclusions

The shift to a shareholder focus has led to a series of governance reform measures in Japanese firms that include the reduction of board size, separation of monitoring and executive function, and the inclusion of outsider directors. These changes, while familiar to the corporate governance practices of Anglo-American firms, are still largely alien to Japanese and many European family and government-owned corporations, in part because they undermine the social networks on which these firms depend to do business domestically. Therefore, empirical research on the impact of reform on the Japanese corporate governance system could provide useful lessons for their European counterparts who are themselves facing increasing pressures to transition from stakeholder to stockholder centered governance arrangements because of the global competition for capital and the increased participation of foreign owners.

Overall, our findings demonstrate that we should not always expect a positive impact from regulatory reform, which may result in more window dressing than real change. Instead, such a reform should be driven by external forces such as the pressure from market investors who have a clearer motive for profit enhancement. In short, regulatory-induced reforms in the boardroom such as the draconian Sarbanes-Oxley Act of 2002 passed by the United States Congress may prove costly to implement and merely result in window dressing. Such reform measures have been popular in France, Germany, Britain, and Scandinavia following a much publicized OECD recommendation on corporate governance in March of 2001.

Finally, our study found that despite the apparent convergence of corporate governance practices in many Japanese firms, there was little performance impact. Therefore, it may not be appropriate to apply agency theory to studies of corporate governance without reference to the institutional context. This is particularly important for studies of European corporate governance systems. There are strong institutional forces that can slow substantive change. For example, the German constitutional theory of mutual determination guarantees the participation of labor in the governance of the corporation and thus slows the pace of corporate restructuring. In Scandinavia, the strong tradition of communal values and joint decision making means that stakeholders can hold more sway than shareholders in critical corporate decisions. In sum, firms are embedded in a network of responsibilities and social obligations defined by implied social contracts, attitudes toward stakeholders, and traditional values of community. However, to interpret this resistance to change as economically inefficient is to miss the point that in order to compete in the domestic market for suppliers, employees, government support, and social legitimacy, firms need to conform to established institutional norms. Therefore, a firm’s response to social norms and the pressures from global equity investors must be sensitive to the relative degree of domestic and international pressures they face. One size does not fit all.

Note

1. The end of March is the fiscal year for most Japanese firms.

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