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Comparing Exit Decisions and Corporate Governance

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COLUMBIA UNIVERSITY IN THE CITY OF NEW YORK

COMPARING EXIT DECISIONS AND CORPORATE GOVERNANCE

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ABSTRACT

This study examines how widespread the similarities between U.S. and Japanese corporate governance practices have become. Results suggest that, in spite of convergence in many areas of business practices, Japanese board structures and governance practices still differ greatly from those in the United States – particularly in SEC-mandated reforms such as independent audit and compensation committees. Our results suggest that corporate governance differences between Japanese and U.S. firms may be driven, in part, by differences in directors' recognition of investors' performance expectations. In particular, results indicate that the exit barriers related to employment influence decision-making for Japanese directors more strongly than they affect U.S. directors' decisions. Board independence – particularly with respect to audit and compensation committee membership – reduces the height of perceived exit barriers. Results suggest that, in spite of convergence in many areas of business practices, Japanese board structures and governance practices still differ greatly from those in the United States although it does not conclude that the transition is necessarily desirable.

COMPARING EXIT DECISIONS AND CORPORATE GOVERNANCE

Waning investor confidence in the performance of Japanese corporations has motivated some Japanese firms to embrace corporate governance structures and practices that resemble U.S. board reforms. Western-style CEOs, like Howard Stringer at Sony or Carlos Ghosn at Nissan Motors, were recruited to restructure Japanese firms and introduce western governance practices to improve company performance. But how much progress has actually been made towards the convergence of corporate governance policies in Japan and the United States? Are disparities in Board structure reflected in their decisions to leave unprofitable lines of business?

Ahmadjian & Robbins (2005) argue that the increasing pressure of Japanese shareholder capitalism has made some Japanese managers and corporate boards accept downsizing, divestiture, and other corporate strategy practices that are more characteristic of western-style corporate governance. Does this mean that Japanese board members use performance measures and decision criteria that are similar to U.S. board members, as well? Milhaupt (2001) argues that Japanese social norms opposing downsizing practices do not have a long history and that opposition to them is waning in light of the rise of shareholder-centered ideology in Japan. Pease, *et al* (2006) suggest that greater turnover among Japanese shareholders may result in more corporate governance practices reflecting this change. Since there are conflicting perceptions of how far corporate governance reform has progressed, this study examines how widespread the similarities between U.S. and Japanese corporate governance practices have become – particularly with respect to downsizings and the treatment of distressed lines of business.

Results suggest that in spite of convergence in many areas of business practices, Japanese board structures and governance practices still differ greatly from those in the United States where corporate boards have undergone substantial reforms to regain the confidence of American investors in a post-scandal era. Wu (2004) notes that public opinion has compelled the directors of U.S. firms to improve their corporate governance systems. Most notably, the financial reporting requirements of Sabanes-Oxley legislation and process of 404 internal controls certification have strengthened corporate governance structures and practices in the United States -- making independent audit committees stronger than they were in the era of Enron- and Tyco-related control scandals and making independent compensation committees more cautious about excessive pay schemes in the U.S. In spite of Japanese investor concerns about similar Japanese accounting scandals, our results indicate that reforms such as independent audit and compensation committees are not yet as widespread among Japanese boards as they are among U.S. boards.

The rigorous corporate governance policies imposed in the United States by the oversight of the Securities and Exchange Commission (SEC) are a mixed blessing because – although shareholders can credibly rely on these reforms to expect that troubled businesses will be dealt with efficiently – the corporate managers who implement divestitures are heavily evaluated by expectations of shareholder value maximization in the United States. Their corporate boards are more willing to sell troubled U.S. businesses to owners that can obtain better performances from their assets. Managers typically expect their troubled lines of business to be divested to new owners (or liquidated) if their respective turnarounds are not achieved promptly.

Our results suggest that findings concerning corporate governance differences between Japanese and U.S. firms may be driven, in part, by differences in directors' recognition of investors' performance expectations (Rosenstein & Wyatt, 1990; Gugler *et al*, 2004). Against a backdrop of strongly rising shareholder capitalism, financial considerations shape an increasing number of corporate directors' perceptions concerning what constitutes attractive investment opportunities and which businesses to retain in the corporate family. Pressures to divest unprofitable lines of business now tend to overcome most barriers that could discourage exit decisions in the U.S.

Earlier studies of divestiture found that timely disposals of assets were impeded where exit barriers were perceived to be high by corporate directors and managers (Harrigan, 1981; 1982). Because exit barriers adversely shaped directors' perceptions concerning the ease of divesting underperforming assets (Porter, 1976), high exit barriers kept firms operating within troubled industries even where they earned subnormal returns on their investments. Our results indicate that such exit barriers have largely lost their power over U.S. managers and directors in many situations. Results also suggest that exit barriers related to maintaining employment levels influence Japanese directors more strongly than they affect U.S. directors when contemplating shutdowns and other actions intended to remedy poor business unit performance.

Methodology

We created a 5-point Likert scale questionnaire in order to gather information about Japanese and U.S. firms' governance structures and perceptions of how to deal with their underperforming assets. The questionnaire was translated into Japanese by a native-born colleague. A parallel sample of publicly-traded firms in Japan and the United States was created to represent several industries from each nation's economy. The Japanese questionnaire was mailed to the Presidents of 412 Japanese corporations with annual revenues in excess of ¥1 billion. Many of the sample firms appear in the *Nihon Keizai Shimbun*. Usable responses were received from 45 Japanese firms representing 16 different industry classifications (an 11% response rate). The U.S. questionnaire was mailed to the Chief Executive Officers of 869 United States corporations with market capitalizations in excess of US$1 billion. Usable responses were received from 72 U.S. firms representing 40 different primary industry classifications (a 10.4% response rate).

Results

We tested the effects of corporate governance traits (such as director and committee independence) on three forms of exit barrier using multivariate regressions. We report the specifications that yielded the highest corrected R^2 values. As shown in Table 1, the coefficient of the dummy variable -- which indicated whether the respondent was Japanese – was always negative and statistically significant, which reduced the Likert scale's average value by at least one increment. (In the questionnaire, "Strongly Agree" was coded as 5, while "Strongly Disagree" was coded as 1, and statistically-significant differences between the samples are reported herein.)

Table 1 about here

Independent directors

Director independence is an area of great divergence between the samples -- perhaps because we used a stringent definition of it (that is consistent with the SEC's definition of "independence"). To be considered independent, directors are not (nor have they been) employees of the firm, represent neither supplier nor customer firms, and have no relatives holding key managerial positions within the firm nor other financial ties with it (other than shareholdings). Although 90.3% of the respondents in the U.S. sample agreed that their directors (and the committees that they served on) were independent, none of the Japanese respondents agreed with this statement. This result may seem surprising because results from Kaplan & Minton (1994) suggested that independent outsiders are being appointed with increasing frequency to Japanese boards to monitor firms' performance. But outsider directors on many Japanese boards that are acting as representatives of the firm's corporate and banking institutional investors are scarcely independent (Yoshikawa & Phan, 2005). Moreover, responses from the Japanese sample reflect the reality that most Japanese directors have worked as employees for the same company that they oversee and have worked their way up their firm's hierarchy before being appointed as directors (Cooke & Sawa, 1998).

The Japanese responses to the question concerning the presence of retired corporate officers on company boards are consistent with Miwa & Ramseyer's (2005) findings that independent outside directors are most likely to serve on boards of Japanese firms in a very limited set of industries that may not be represented by this sample. Responses are not consistent with Peng's (2004) observations about outsiders serving on corporate boards nor with Yafeh's (2000) predictions of convergence. Yoshikawa & Phan (2005) would assert that the executives and former employees of Japanese corporate boards do not consider themselves to be active monitors of top management.

In Table 1 the coefficient of the *CEO as only insider* variable is positive but not statistically significant -- weakly suggesting that director independence does not reduce the impact of these exit barriers. The coefficient of the *no retired officer as director* variable is negative and statistically significant -- suggesting that if company officers remain on the board after retirement, exit barriers arise for businesses with a large market share or for concerns about employees losing their jobs if the firm tries to exit from an unprofitable line of business.

Director criticisms and shareholder primacy

Valuing directors' constructive criticism of managerial performance is an area of divergence between our samples. In the statement linking director independence with the value of constructive criticism, 52.3% of the Japanese respondents strongly disagreed with the statement that director *independence* ensured that the company's board of directors would be constructively critical of managerial performance, suggesting that director independence is not yet valued on Japanese boards. Since Klein (1998) found significant positive correlations between firm performance and the number of corporate officers on finance and investment committees, we interpreted our result as suggesting that respondents in the Japanese sample believed that having insider directors on their boards provides valuable information to other board members about their firm's long-term investment decisions. Moreover, as Yoshikawa & Phan (2005) point out, typical Japanese directors do not question executive management and do not delegate their managerial duties to corporate officers. In models testing firms' exit barriers, the coefficient of the *constructive criticism* variable is positive and statistically significant in the first specification (but loses its significance when the nationality variable enters the equation) -- weakly suggesting that having critical independent directors on a board does not ameliorate the impact of exit barriers due to sunk costs and having a large market share.

Responses from the Japanese sample showed lower expectations that the board emphasized shareholder primacy in their decisions -- a contrast, perhaps, of the stakeholder- versus stockholder-oriented models (Abe & Shimizutani, 2007). Although 87.2% of the U.S. respondents agreed with the statement that their firm's board of directors primarily represents shareholders' interests and concerns by ensuring that the firm's activities all create value, the dominant answer in the Japanese sample was disagreement with that statement (51.2%), suggesting that Japanese investors tolerate more deviations in the returns realized from their firm's investment activities. This finding is not surprising if Japanese corporate managers and directors are indeed the same individuals because the lines of control and intervention could easily become blurred -- particularly if no delegation of duties to executive officers occurs (Hirota & Kawamura, 2007).

Independence of audit and compensation committees

U.S. board committees generally follow the NACD's Blue Ribbon Committee' guidelines concerning board structures. The boards in our sample differed in the independence of their committees. Where 90.3% of the U.S. sample strongly agreed with the statement that their firm's audit committee was independent, *all* of the Japanese respondents disagreed with this statement. Audit committee independence is one of the non-negotiable board attributes mandated by SEC reforms and publicly-traded U.S. firms are castigated for failing to satisfy this structural requirement (NACD, 2002). In Japan, it has been proposed that at least half of the audit committee members must be outside directors who cannot serve as executive officers of the company (Takehara & Nihei, 2005), but it is not known how many firms have embraced this recommendation for reform.

Agrawal & Chadha (2005) found that independent directors with financial expertise are valuable in providing oversight of a firm's accounting practices. In a question suggesting that all of the members of a firm's audit committee were financially literate -- i.e., each member fulfilled the minimum regulatory requirements concerning the comprehension and use of financial statements (Report of the NACD, 2004) -- 75% of the U.S. respondents *strongly* agreed with the statement, but 86.4% of the Japanese respondents disagreed with this statement. Results suggest that in the selection of Japanese directors, financial literacy is valued less highly than in the case of U.S. boards. Indeed Cooke & Sawa (1998) report that some Japanese companies have corporate auditors – which are separate from *accounting* auditors – who are often appointed from the firm's employee ranks with no particular financial qualifications.

In the case of compensation committees, 97.2% of the U.S. respondents agreed that their board had an "independent" compensation committee as is required by the SEC (using the same stringent, SEC-inspired language as was used in the questions concerning the firm's audit committee members), but 72.7% of the Japanese respondents disagreed with the statement that their board's compensation committee was independent -- which is consistent with the Japanese principle of internalism whereby companies are controlled by internally-appointed board members

(Buchanan, 2007). Internalism means that Japanese shareholders accept management's recommendations on most governance matters and proxy fights where shareholders reject managerial decisions are rare – even after the proposed takeover of Tokyo Kohtetsu was defeated in 2007 (Morse & Moffett, 2007). [1]

In Table 1, the coefficient of the *independent audit committee* variable in is negative and statistically significant in the sunk cost specification (as it is also in the model testing the impact of employees losing their jobs as an exit barrier) -- suggesting that director independence within its audit committee reduces the firm's exit barriers. (The coefficient of the variable suggesting that an *independent audit committee hires and fires the firm's independent audit firm* also is negative but not statistically significant in the exit barrier model specification where a distressed business unit has large market share.) The *compensation committee determines CEO pay* variable is negative but not statistically significant in the sunk cost exit barrier specification.

Importance of preserving jobs

In Japan frequent adjustment of employment levels during the negative phases of business cycles has been regarded as an irresponsible transfer of business risks to employees (Suzuki, 1999). Kang & Shivdasani (1997) reported that Japanese firms are less likely to downsize or terminate the employment of a large fraction of their workforce when they experience a decline in performance. 82.1% of the U.S. respondents disagreed with the statement suggesting that their firm would not get out of an unprofitable line of business if many employees would lose their jobs,. Although 37.1% of the Japanese responses also disagreed with the statement, the samples are statistically different regarding this deterrent. The reluctance of Japanese respondents to comment on this source of exit barriers may be indicative of the special role that lifetime employment policies play in Japanese society (Gilson & Roe, 1999), although Jacoby (2005) would argue that the two employment systems are slowly converging in their practices.

DISCUSSION

In single-variable regression specifications, the coefficients were all negative and statistically significant (<.0001) for the independence of committee variables (e.g., for compensation and audit committees, respectively), their expertise (e.g., financial literacy of audit committee members) and for the tasks that they performed on behalf of the firm (e.g., hiring and firing auditors, setting CEO compensation, and planning for executive succession). The nationality variable alone explained 35% of the variance in the sunk-cost model, 21% of the variance in the market-share model, and 23% of the variance in the loss of employment model, respectively.

[1] Takehara & Nihei (2005) define an outside director as a non-managing director who does not, and never did, manage the corporate affairs of the company or one of its subsidiaries as a director, executive officer, manager or other employee and who is not an employee of the company or one of its subsidiaries. The 2005 report of the Corporate Governance Forum of Japan recommends that at least half of the firm's compensation committee must be outside directors – assuming that the Japanese firm has committees (instead of corporate auditors as overseers). There are no restrictions about outside directors in Japan representing supplier or customer firms, having relatives holding key managerial positions within the firm, or having other financial ties with it (other than shareholdings) in these recommendations.

In corporate governance practices that maximize shareholder wealth, we expect U.S. directors to support divestiture when a firm’s restructuring efforts are not successful. Results suggest that although downsizings in Japan have become more widespread, many Japanese firms are still resistant to them (Ahmadjian & Robinson, 2001). Indeed, Kang & Shivdasani (1997) report that when they experience a decline in performance, Japanese firms are less likely to downsize or terminate the employment of a large fraction of their workforce.

Results suggest that a relationship exists between having independent outsiders on corporate boards and those boards’ willingness to divest underperforming assets. Results are consistent with the Perry & Shivdasani (2005) study of firms facing material declines in performance which noted that firms having a majority of outsiders on their boards were faster to initiate restructurings leading to performance improvements. Results suggest that the absence of questioning outsiders on Japanese boards increases perceived exit barrier heights in the minds of directors. It appears that although Japanese firms are slowly transitioning towards a greater emphasis on shareholder value creation (Whittaker & Hayakawa, 2007), convergence is occurring slowly for reasons intrinsic to Japanese institutions and their investors.

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Table 1

Regression Results
“This firm will not get out of an unprofitable line of business …

	…. until it has recovered		…. if it holds a large		…. if many employees	
	its investment”		market share in it”		will lose their jobs”	
Intercept	**3.7114**	**2.7700**	**4.2540**	**4.5161**	**3.1922**	**2.7857**
	(10.28)	(15.32)	(8.39)	(9.39)	(17.08)	(21.02)
	<.0001	<.0001	<.0001	<.0001	<.0001	<.0001
Nationality dummy,	--	**-1.3006**	**-0.7832**	--	--	**-0.9648**
where 1 = Japanese firm		(-7.34)	(-3.24)			(-5.71)
		<.0001	0.0016			<.0001
Director "independence"	**0.1238**	**0.0947**	**0.0687**	**0.0722**	--	--
ensures directors are	(2.13)	(1.70)	(0.99)	(1.03)		
critical of management	0.0359	0.0928	0.3268	0.3054		
Only corporate officer who	**0.0447**	--	**0.1211**	**0.1128**	--	--
serves on Board of	(0.85)		(1.90)	(1.78)		
Directors is its CEO	0.3949		0.0600	0.0781		
No retired company officer	--	--	**-0.2502**	**-0.2403**	--	--
on Board after retirement			(-3.27)	(-3.13)		
			0.0015	0.0023		
Audit Committee of firm	**-0.3036**	--	--	**-0.2178**	**-0.2806**	--
is "independent"	(-4.35)			(-3.23)	(5.94)	
	<.0001			0.0017	<.0001	
Audit Committee hires and	--	--	**-0.2315**	**-0.2303**	--	--
fires firm's auditors			(-1.95)	(-1.94)		
			0.0541	0.0559		
Compensation Committee	**-0.2089**	--	--	--	--	--
determines pay of CEO	(-1.98)					
and ratifies other pay	0.0509					
Mean	2.2621	2.2882	2.5742	2.6239	2.1944	2.1927
Corrected-N	102	108	100	96	106	107
R-Square	**0.4166**	**0.3567**	**0.3293**	**0.3588**	**0.2499**	**0.2334**

Coefficient
(t-Value)
Pr > |t|