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Chapter I

Change and Continuity in Japanese Corporate Governance

1.1 Introduction

Japanese firms began to tackle the two parallel organizational reforms confronted with the critical business situations around 2000, corporate governance reform and human resource (HR) management reform. In contrast to the long-lasting slump of Japanese firms, US firms were being praised for their prosperity. The cause of such a stark contrast in economic performance was attributed to the difference in corporate governance and employment system, two fundamental institutions to consist of corporation; that is, the behavior of prioritizing shareholder interests in corporate governance and boosting labor force mobility by relying on the market-based employment practices in US firms, whereas the behavior of prioritizing stakeholder interests and maintaining the long-term employment (LTE) practice in Japanese firms. Therefore, it seemed almost inevitable that Japanese firms would be reformed, modeled on their US counterparts, in the direction of shareholder-oriented corporate governance and market-based employment system. Such a claim for an overall institutional change of Japanese firms was spread immediately.

However, Japanese firms preserve their fundamental nature despite the persistent calls for radical change. Although many changes—discussed later—have occurred, insider dominance in corporate governance and the LTE practice are continuing accompanied by some incremental changes. This evidence displays the resilience of the Japanese corporate system, suggested by the theory of Variety of Capitalism (VoC; Hall and Soskice 2001), and highlights the continuity along with the institutional change. Nevertheless, radical calls for an overall institutional change are unlikely to abate; rather, they were repeated during the past two decades, as if every failure of reform evoked a more radical call for reform. Now, it is renewed by “Abenomics,” touted by some as the last chance for reform to revive Japanese economy.

Viewing the actual change during the past two decades is likely to be led to the recognition of the fallacy of advocating a radical change, such as from organization-based to market-based corporation and from a Japanese-style corporation to one that is based on the US style. However, VoC approach tends to overemphasize the institutional continuity. Instead of two contrasting perspectives—one insists on the discontinuous change and the other stresses the persistent continuity—Streeck and Thelen (2005) and Mahoney and Thelen (2010) present the perspective of “gradual institutional change” and argue that actual change is incremental and cumulative, whereby the existing institutional framework tends to change gradually. In addition, Aoki (2010) presents the perspective of “evolving diversity in the corporate system,” highlighting that the existing system cannot simply be changed into a US-style one; rather, it will evolve into a hybrid system composed of heterogeneous institutions such as market-based and organization-based components.

From these perspectives, we investigate the ongoing changes in Japanese firms. We discuss the change in two parts—the reform of corporate governance is covered in this chapter, and the reform of HR management in Chap. 2. It should be recognized that the success of reforms will depend on an understanding of the existing system to be reformed, as well as that of the system to be realized. If the two are misunderstood, reform will not succeed; rather, it will bring about an extreme form of confusion. Based on the past reform, it is clear that existing Japanese firms and the targeted US firms might be misunderstood or understood incompletely.

In the following sections, we first present the traditional Japanese firms’ views on corporate governance and employment system. It is necessary to understand exactly the nature of Japanese firms to avoid a one-sided argument for radical reform. Second, we discuss the change in Japanese firms focusing on the corporate governance structure. Apart from the debate on whether the US-style corporate governance structure should be adopted, actual change is advanced gradually and faster than expected. This process is discussed in detail in the following sections. Finally, we will argue about change and continuity in gradual institutional change in corporate governance reform.

1.2 Traditional Japanese Firm: Managerial Autonomy

As is well-known, Japanese firms have been understood as a model of organization-based, stakeholder-oriented corporate governance. Putting it simply, employee-oriented management comprised of organizational HR management on one hand and organizational ownership on the other (Aoki 1988). Although the former has been stylized as “lifelong employment” and “seniority wage” since the study of Abegglen (1958) in the late 1950, understanding it only by this phrase may lead one to understand that Japanese firms fall into rigidity in the sense of not implementing

pay and employment adjustment.¹ Similarly, stylizing the latter as “managerial autonomy” protected by organized shareholdings may lead one to think that Japanese firms fall into mismanagement by losing the discipline to manage. Were this the case, Japanese firms could not be able to compete with US firms that enjoy flexibility in employment and strict monitoring by shareholders. Otherwise, Japanese firms would be understood as a peculiar institution, quite distinct from its western counterparts. In any case, a radical call for the transformation of Japanese firms is inevitable.

However, it is organizational HR management—a combination of LTE, in-house training, and competence-based seniority wages—that has established the competitiveness of Japanese firms. First, continuous employment allowed continuous training to build organizational competence (Koike 1988). Second, wages were determined according to the appraisal of individual competence; thus, wage rose cumulatively with an improvement in the competence rank. Although such a wage rise has been called the seniority wage, as if it corresponds with employees’ tenure, it depends on both continuous in-house training and successive appraisals of individual competence; thus, it is more accurately called the competence-rank wage system (Marsden 1999). Finally, this was sustained on the premise of continuous employment; institutional complementarity was thus forged between wage and employment system in Japanese firms.

These long-term HR practices need to be protected from the short-term fluctuations in profits. Therefore, the so-called Japanese management was first established in the large-scale firms with ability to cope with the short-term fluctuation in their business performance and spread to the relatively smaller firms as a norm of Japanese management through the high economic growth during the 1960s. Furthermore, even the large-scale firms have to be protected from the pursuit of short-term shareholder interests. In particular, the question whether divided or employment should be prioritized becomes critical when corporate performance worsens. In the era of the traditional Japanese firms, before the bursting of the bubble economy, prioritizing employment over dividends was a common practice (Yoshimori 1997). Operating on this premise, employees could have confidence in the practice of LTE.

Here, another institutional complementarity was shaped: between long-term HR management and organized ownership structure based on cross-shareholdings. As argued by Aoki (1994), this not only protected the employee-oriented management from stock market pressure to pursue short-term shareholder interests but also protected managerial autonomy from the intervention by the outside shareholders. In reality, Japanese firms organized a large volume of stable shareholdings in the late 1960s, when they perceived the threat of being acquired by foreign companies, along with the liberalization of international capital movement. The percentage of organizational shareholdings comprised of financial institutions (excluding invest-

¹A symbolic event was that Toyota’s rating was lowered in 1989 when they announced the policy to keep long term employment against shareholder pressure. However, it was soon raised to the highest level on seeing Toyota’s excellent subsequent performance.

Table 1.1 Average rate of annual growth of stock prices

	Nikkei stock average	Dow Jones industrial average
1960–1969	5.5%	3.1%
1970–1979	12.0%	0.3%
1980–1989	15.8%	9.2%
1990–1999	–2.3%	14.5%
2000–2009	–2.7%	–0.3

Source: Nikkei Average: <http://www.indexes.nikkei.co.jp/nkave/archives/data>
 Dow Jones Industrial Average: <http://finance.yahoo.com/q/hp?s=YHOO>

ment and pension funds) and business corporations has increased significantly from 40% during the 1960s to 60% during the 1970s.

Managerial autonomy, per se, was first established in US firms—the so-called “Berle-Means” type of managerial firm—by means of highly dispersed ownership (Berle and Means 1932). As mentioned by Jacoby (2006), US managerial firms could be regarded as behaving like stakeholder orientation. However, they could not avoid shareholder pressure because the dispersed ownership also activated the market for corporate control (Roe 1994). Therefore, US managerial firms had to keep stock prices at a certain level that avoid the possibility to induce a hostile takeover, which enforced short-term employment adjustment in US managerial firms to ensure short-term profits for keeping stock prices.² By contrast, Japanese managerial firms could avoid such pressure by organizing shareholders via financial institutions, who served as patient capital for establishing long-term HR management.

In addition, whereas the manager’s prerogative was paramount in US managerial firms, which have focused on the pursuit of their own interests, employees’ voice has been raised in Japanese firms through the Joint Labor-Management Committees, which promoted cooperative industrial relations via information sharing about corporate purpose and business environment (Kato and Morishima 2002). This has been referred to as a “corporation as a community” (Dore 2000), where managers and employees shared not only their common interests but also their common recognition on their corporation. In this way, Japanese managerial firms have incorporated employees in their organization, whereas US ones have excluded employees, although there were exceptions, like former IBM and Kodak, as like the Japanese-style managerial firms in the USA.

²This was a theory of ‘managerial firm’ in the 1960s and 1970s (Marris 1964). In fact, stock prices remained at the level of 800 dollars during the 1970s. This not only reflected the US firms’ stagnation but also their policy to stock markets. In other words, stock prices were a constrained condition to the corporate behavior; objective was the growth of the firm. US managerial firms pursued conglomerate strategy for the growth. However, as Chandler (1990) mentioned, it failed due to the neglect of the organizational synergy; he addressed it as the degenerate of managerial firm. Thereafter, managerial firms were forced to be transformed to shareholder firms during the 1980s, and established it during the 1990s as seen in the present style, wherein stock prices became an objective for the corporate behavior.

While the nature of “community”—as mentioned by Aoki (1988)—was paramount in Japanese firms, it has not been established by sacrificing shareholder interests. Japanese shareholders enjoyed fairly high rates of return on investment by means of capital gains due to increase in stock market prices during the heyday of managerial firms, from the 1960s to 1980s, compared with the stagnant state of US managerial firms, as shown in Table 1.1. US firms thereafter were forced to transform themselves into shareholder-dominated firms during the 1980s due to the stock market pressure that arose from the extremely stagnant state during the 1970s (Gordon 2007).

Of course, managerial autonomy was not assured in all cases. Aoki (1994) conceptualized it as contingent governance, under which the main banks intervened to rebuild management when loan companies experienced financial crisis. The interventions included changing executives, providing financial support, and conducting a large-scale restructuring of failing businesses. According to Kang and Shivdasani (1997), firms with strong relationships with banks are more likely to make management reforms, such as reducing the number of employees and reducing assets, in the event of a crisis, now accelerated on a larger scale by shareholder pressure instead of main banks. Managerial autonomy was established on this premise, which served to increase management discipline because they wanted to avoid the main banks’ intervention. Although a negative effect of contingent governance—expectation of rescue by main banks weakened discipline—is pointed out, which has been revealed after bursting of the bubble economy, existing HR practice could be continued by the aid of main banks.

Similarly, in the face of such business difficulties, changes in employment security were inevitable. However, even in such cases, employment was not reduced without imposing constraints on such action. Dividends were also cut, either before or during cuts in the labor force (Matsuura 2001), and employment adjustment followed the internal arrangement between the management and unions: reducing working hours, stopping new hiring, transferring redundant workers to other jobs or affiliated companies, and terminating non-regular workers’ hiring. Although these methods were devised to assure the incumbent workers’ employment, early retirement was implemented when redundant workers could not be absorbed in this way. It was not unusual to see early retirements occurring on a large scale in firms facing a severe downturn, due to the oil crises in the 1970s, rapid appreciation of yen value in the mid-1980s, the burst of bubble economy in the early 1990s, and the prolonged depression thereafter. The LTE policy was established on the premise of such an employment adjustment.

1.3 Banking and Managerial Crisis

The economic and business environment surrounding Japanese firms has changed drastically since the burst of the bubble economy in the early 1990s and particularly after the banking and managerial crisis in the late 1990s. Confronted with these

hardships, Japanese firms began to reform in two institutional areas: corporate governance and HR management. Here, we focus on corporate governance reform; the reform of HR management is covered in the next chapter.

First, stock market conditions have deteriorated extremely. The Nikkei stock average fell to the 60% level of the value at the peak of the bubble economy in 1989 and continued declining to reach the level that existed before the economic bubble in the late 1990s. Then the phrase “lost decade,” referring to the poor performance of the Japanese economy, gained currency. Although there was a recovery from 2002 to 2007, it fell again due to the world depression after the shock caused by the Lehman collapse in 2008 and continued declining; after this, the phrase “lost two decades” was used for the Japanese economy.³ As seen earlier in Table 1.1, the average rate of annual growth of stock prices fell drastically: from 15.8% during the 1980s to -2.3% during the 1990s. The rate was -2.7% during the 2000s.

By contrast, the US stock markets continued soaring during the same period. Although the sudden decline in stock prices was found in 2002, and 2008, the stark contrast, reflected in the 14.5% average rate of annual growth in the USA and -2.3% in Japan during the 1990s, was sufficient to assert the primacy of the US-style shareholder-dominated corporate governance. As mentioned by Gordon (2007), the extremely stagnant state of US stock markets during the 1970s—average rate of annual growth of 0.3% in the USA versus 12.0% in Japan—had given rise to the stock market pressure to force the transformation of US managerial firms into shareholder-dominated ones during the 1980s–1990s. Although the difference between US and Japanese managerial firms should be considered, viewing such a stark contrast was enough to lead to the assumption that Japanese firms would follow the path of US managerial firms.

From these perspectives, we can see the two factors that accelerated the corporate governance reform: liquidation in the stock markets due to the dissolution of cross and stable shareholdings on one hand and a managerial crisis due to the precipitously declining profits on the other. The former was triggered by the banking crisis in the late 1990s and was accelerated by the change in accounting rule for valuation—from an acquisition-value to a market-value basis. These two factors forced the main banks to release the stocks they owned, which had been the basis of cross and stable shareholdings, and a large part of the relinquished stock was acquired by foreign investors. Shareholdings by business corporations, the other basis of cross and stable shareholdings, were also forced to release the stocks due to their managerial crisis. On a market-value basis, foreign investors' shareholdings were 4.7% of the Tokyo Stock Exchange (TSE) in 1990; this increased to 18.8% in 2000 and, further, to 30.1% in 2016, whereas commercial banks' shareholdings decreased from 15.1% in 1990 to 10.1% in 2000 and reached 3.5% in 2016; business corporations' shareholdings decreased 31.1% in 1990 to 21.6% in 2000, and 22.1% in 2016, as shown in Table 1.2. Although the stocks owned by nonfinancial business

³Although the phrase of “lost decade” or “lost two decades” embraces Japanese economy in a pessimistic mood, it may be just a return to the original state of Japanese economy before the economic bubble.

Table 1.2 Transition in shareholding ratio by investor category (on a value basis)

	Commercial banks	Institutional investors	Business corporations	Foreigners	Individuals
1990	15.7	25.7	30.1	4.7	20.4
2000	10.1	28.3	21.8	18.8	19.4
2010	4.1	24.6	21.2	26.7	20.3
2016	3.5	24.2	22.1	30.1	17.1

Source: Nikkei Average: <http://indexes.nikkei.co.jp/nkave/archives/data>

Note: institutional investors consist of trust banks including investment and pension funds and life and nonlife insurance corporations. The total does not reach 100% because some negligible sectors are excluded

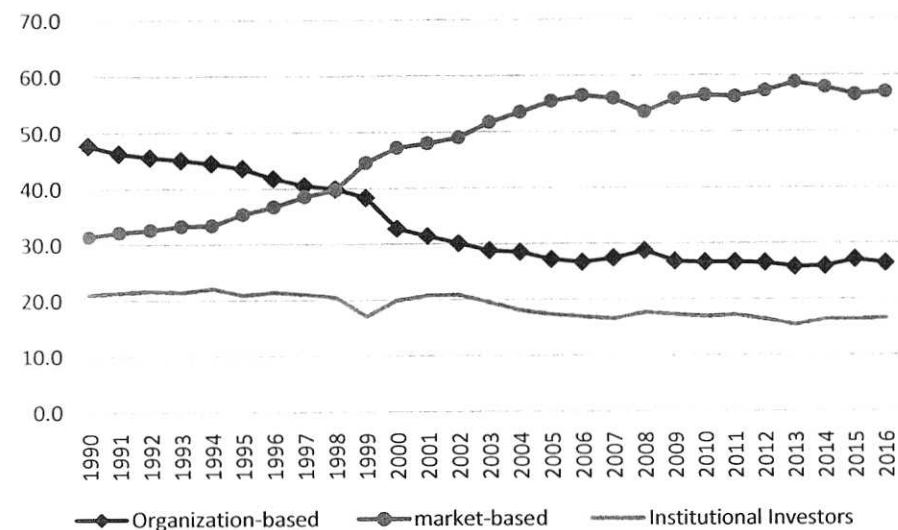


Fig. 1.1 Liquidation in shock market: percentage of shareholdings of two contrasting groups: organization-based and market-based shareholdings

Note: organization-based shareholdings: commercial banks and business corporations.

Market-based shareholdings: foreign investors, pension and investment trusts, and individuals. Institutional investors: life and nonlife insurance corporations and trust banks (except pension and investment trusts)

Source: Tokyo Stock Exchange

corporations still account for about 20% of total shareholdings,⁴ now, foreign investors constitute the largest block of shareholders in “Japan Inc.”

As a result, the percentage of market-based shareholdings at the end of 1990—obtained by summing up those of foreign investors, pension and investment trusts, and individuals—surpassed the organization-based shareholdings, which are the sum of those of commercial banks and business corporations, as shown in Fig. 1.1.

⁴Japanese firms seem not to release these shareholdings, at least try to preserve it, because it serves for the last resort to protect their managerial autonomy.

The former has continued to increase and now exceeds half the shareholdings in stocks trade on the TSE. In contrast, institutional investors in Japan, such as life and insurance companies and trust banks (excluding pension and investment trusts), tend to behave as stable shareholders. If they are included in the organization-based shareholdings, market-based and organization-based shareholdings are almost equal. In other words, if they start to behave as market-based shareholders as like US institutional investors, Japanese stock markets will change drastically. The trends in the stock markets depend on the behavior of Japanese institutional investors.

Although the stock market increases liquidity, a liquid market may develop a Berle-Means type of managerial autonomy if it has only dispersed ownership. In other words, core shareholders are needed to replace managerial autonomy. The foreign institutional investors, particularly the activist or aggressive investors in the US stock markets, were such shareholders. They need not to behave as patient capital; they not only significantly affected the stock prices by undertaking a large number of deals based on quarterly profit (accounting for about 70% of the total trading in the TSE First and Second) results but also raised their voice demanding an increase in dividends, change in corporate strategy, and the adoption of a US-style corporate governance structure.

These concerns were raised not only through a general meeting of shareholders but also through the threat of hostile takeover by some aggressive hedge funds. Hostile takeovers have not yet succeeded because the Japanese institutional investors still behave as stable shareholders and nonfinancial corporations maintain substantial cross-shareholdings, still accounting for 22.1% of all shareholding in 2016, although a large decline from the 30.1% they had in 1990. However, the surge in hostile takeovers in the early 2000s brought a type of shock that Japanese firms had never experienced. Japanese firms realized for the first time that they were surrounded by aggressive shareholders, which forced the existing management to tackle the corporate governance reform required to cope with shareholder pressure.

Another factor that accelerated corporate governance reform was the profitability crisis in Japanese firms around 2000. As shown in Fig. 1.2, which depicts firms with more than one billion yen in capital, corporate profits declined rapidly after the bursting of the economic bubble in the early 1990s. They fell to a critical level during the banking crisis in the late 1990s and declined further in the early 2000s due to the economic downturn caused by the failure of many US dotcoms. Japanese firms faced unprecedented managerial crises, not only the fear of bankruptcy—seen in several large banks and companies—but also the absence of any rescue from the main banks, which had been expected to provide the financial support to rebuild management. In fact, Nissan, Japan's second-largest automobile company, was forced to merge with Renault, and Sogo, Japan's largest department store, was forced to declare bankruptcy.⁵ In both cases, their main bank, the Industrial Bank of

⁵The case of Sogo was caused by the noncooperative behavior by non-main banks. The rebuilding plan initiated by main banks need the cooperation by non-main banks to suspend the repayment of a loan. However, one non-main bank, acquired by a foreign fund, refused to cooperate with the IBJ.

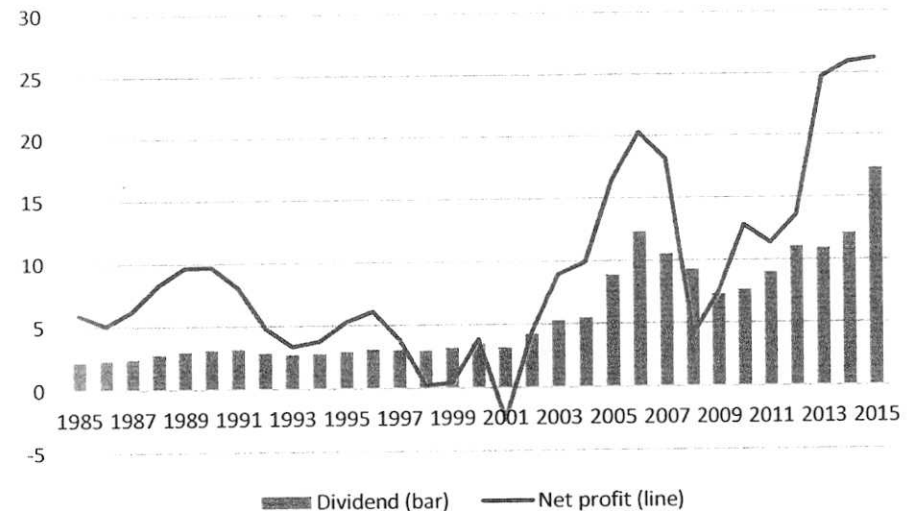


Fig. 1.2 Transition in dividends and net profits (real-term, trillion yen). (Source: Corporate Statistics (Ministry of Finance))

Japan (IBJ), no longer had the financial ability to rescue and rebuild these companies. Rather, the IBJ had itself fallen prey to the financial crisis and had to merge with other banks to survive. As with the stock market pressures, Japanese firms realized for the first time that there would be no rescue in the event of a business crisis, which led to tackling the corporate governance reform to rebuild management by their own efforts.⁶

1.4 Increase in Dividends and Introduction of the Executive Officer System

We can pick out the two factors that led to or enforced the corporate governance reform in Japanese firms. On the one hand, there was shareholder pressure, and on the other, there was worsening business performance. The former immediately led to a rapid growth in dividend payout. As shown in Fig. 1.2 above, it began to increase rapidly in the early 2000s, in contrast to the trend of low and constant dividends before 2000; during the economic bubble in the 1980s, despite increasing profits; and during the “lost decade” of the 1990s, despite decreasing profits. This was called the “stable dividend policy” to avoid shareholder intervention by maintaining

⁶There is no doubt that the appearance of Gone, who succeeded in rebuilding Nissan in a short time, brought a big impact to the existing Japanese firms. Ironically, his success may strengthen the Japanese firm's will to rebuild management by their own effort, that is, to expel the outsider to preserve their managerial autonomy.

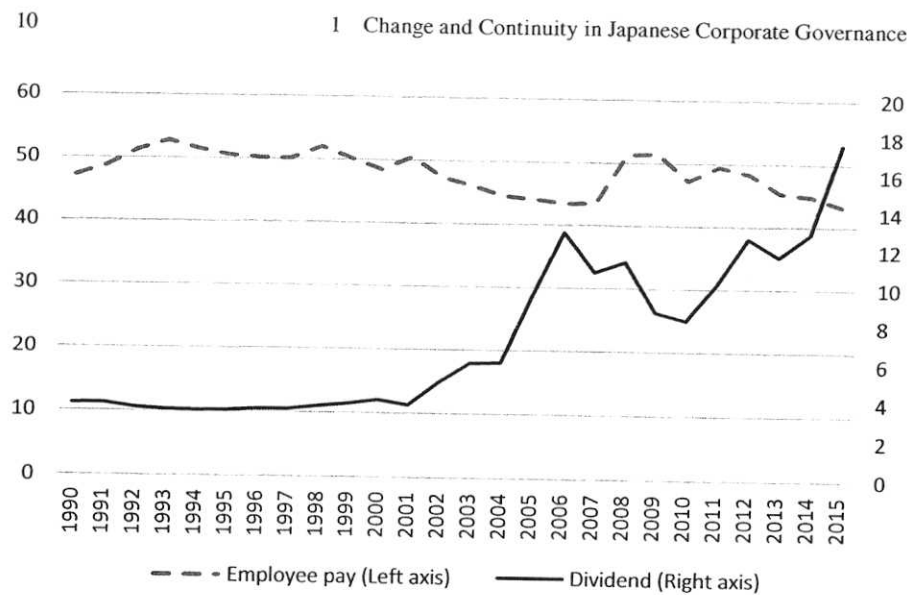


Fig. 1.3 Transition in the distribution of value added: ratio of dividends and employee payment to total value added. (Source: Corporate Statistics (Ministry of Finance))

a certain level of dividends; this was achieved by selling off stockholdings to generate profits during bad periods and keeping profits in reserve during good periods.

However, such a method was not only blamed for profit manipulation but became inapplicable after the change in accounting rule to market-value basis. Dividends became highly correlated with profits; they increased rapidly, along with the recovery in profits that began in 2002. Although they Dividends decreased rapidly, along with the sharp decline in profits during the downturn after the global financial crisis in 2008, ; yet, they it yet remained at a significantly higher level than that the level before 2000. Consequently, as shown in Fig. 1.3—firms with more than one billion yen in capital—the ratio of dividend payout to the total value added rises sharply since 2000, whereas the ratio of employee pay is stagnant, rather continuing to decrease. Considering dividend policy, corporate governance is confirmed to move toward a shareholder orientation.

It is worth noting that executive salary is also correlated with profits with the increase in dividends. As shown in Table 1.3, demonstrating the correlation coefficients among net profits, dividends, executive pay, and employee pay for firms with more than one billion yen in capital, there was no correlation between dividends and profits from 1992 to 2001, that is, before the dividend policy changed, whereas a very strong correlation was found between executive and employee pay, meaning that both shared a common pay system within organization (Kubo 2010). Here, the executive pay excludes bonus payments because the latter value is zero in 2006, seemingly an abnormal value, and employee pay includes bonus payment because these two were not separated before 2007.

In contrast, after the dividend policy changed, a very strong correlation was found between dividend and profits in the period from 2002 to 2011. Moreover the

Table 1.3 Correlation coefficients: net profits, dividend, executive pay, and employee pay

1992–2001	(1)	(2)	(3)	(4)
(1) Net profits	1			
(2) Dividends	-0.2497	1		
(3) Executive pay	0.0594	0.3172	1	
(4) Employee pay	0.2269	0.2688	0.9673 ^a	1
2002–2011	(1)	(2)	(3)	(4)
(1) Net profits	1			
(2) Dividends	0.7088 ^a	1		
(3) Executive pay	0.6485 ^a	0.5118	1	
(4) Employee pay	0.0889	0.4492	-0.3245	1

^aSignificant statistically at 5%

Source: Corporate Statistics (Ministry of Finance)

Note: executive pay excludes bonus payment; employee pay includes bonus payment

correlation between executive pay and profits appeared. However, the correlation between executive and employee pay disappeared. The relationship between management and employees seems to have changed, in parallel with corporate governance reform. This reflects the reform of management organization, by which the executive officer system was introduced. As discussed below, it intended to strengthen managerial function, whereby executive managers were consciously raised from ordinary employee status and made aware of their responsibility for outcomes that generated profits. The evidence presented here above—appearance of correlation between executive pay and profits and disappearance of correlation of pay between managers and employees—shows a change in the employment relationship under corporate governance reform.

However, the correlation between executive pay and profits disappears when the period is extended from 2012 to 2015. Instead, the correlation between executive pay and employee pay reappears. Furthermore, the correlation between dividends and profits disappears. This can be illustrated in Fig. 1.4, in which the transition of net profit, dividends, executive pay, and employee pay are depicted, with the value in 2000 being taken as 100. We can see the correlation trends among profits, dividends, and executive pay in the early 2000s, along with the advancement of corporate governance reform and the economic recovery from 2002 to 2007, whereas employee pay was almost constant. Thereafter, confronted with a sharp decline in profits due to the world economic depression in 2008, both dividends and executive pay declined rapidly. After the hard adjustment, profits recovered immediately. In particular, they increased rapidly due to mainly the depreciation of the yen by the extraordinary money easing policy by Abenomics after 2012. However, executive pay continued to remain stagnant, and the increase in dividends was much lower than that in profits. Ten years after the beginning of corporate governance reform, the upward trend in executive pay seems to be suppressed all over the Japanese firms, when compared with that in the USA. This will be discussed again in the next chapter.

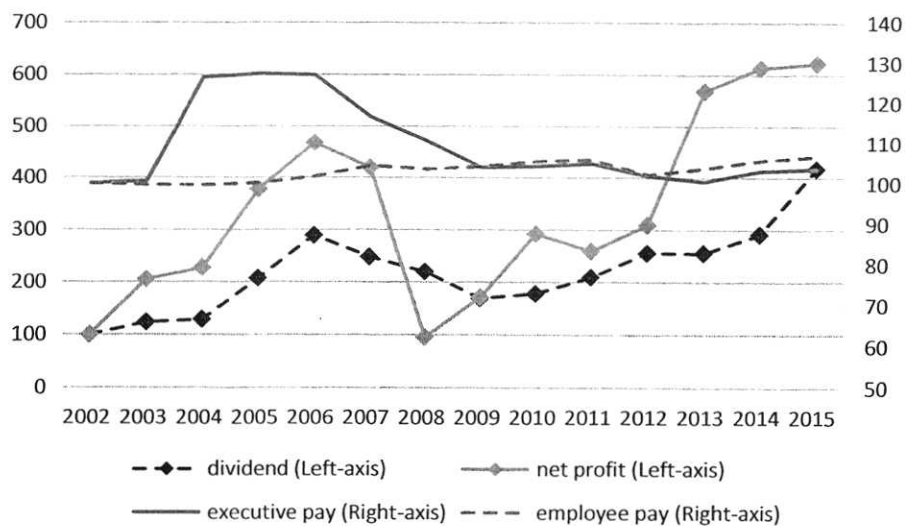


Fig. 1.4 Transition in net profits, dividends, executive pay, and employee pay: 2002 = 100. (Source: Corporate Statistics (Ministry of Finance))

Next, worsening business performance—another factor in corporate governance reform—led to a change in the managerial organization through the introduction of the corporate executive officer system. It is well-known that the board of directors in the traditional Japanese firm had many members because senior managers of business units were also appointed as executive directors. Thus, the function of the board of directors was in effect to approve the business decisions presented by the unit managers. This was referred to as a “bottom-up” style of decision-making and was appreciated because it promoted close coordination between top and middle managers. Nevertheless, strategic decisions such as the restructuring of failing businesses tended to get delayed, and unit managers’ accountability for achieving targets tended to be obscure.

For these reasons, the executive officer system was introduced, in which unit managers were separated from board members, and reappointed as executive officers, with both power and responsibility to achieve unit performance, while being supervised by the board of directors. According to Kubo (2010), among the 189 companies in the Nikkei Stock Average Index, 29 (15.3%) had adopted the corporate executive officer system by 1999, and 122 (64.6%) had done so by 2005. According to the most recent survey (Japan Audit and Supervisory Board Members Association 2017),⁷ 72.3% of the listed firms and 51.5% of the unlisted firms are introducing executive officer system in 2016. Even in the unlisted firms, about half have introduced executive officer system to strengthen the managerial function.

⁷ Sample is 3487 firms joining JASBMA. Seventy-four percent had more than 300 million yen in capital.

Furthermore, the number of directors was reduced drastically—along with the introduction of executive officer system—to strengthen strategic decision-making by streamlined board members. According to Nitta (2008), who surveyed 613 companies, the average number of directors was reduced from 21.4 in 1997 to 12.7 in 2004. Most recently, the number dropped to 8.3 persons in 2016, according to the TSE survey titled “White Paper on Corporate Governance 2017” (Tokyo Stock Exchange 2017). For instance, Toyota Motors had 58 directors in 2003; this was reduced to 27 in 2013 and to 12 persons in 2015. The urgent issue for Japanese firms was to restore corporate performance by reforming managerial organization, especially with regard to strengthening strategic management. For that reason, the executive officer system was introduced, and the board members were reduced. This was the reform for Japanese firm’s own betterment. However, from the view of the advocates of shareholder-dominated corporate governance, a US-style board structure should be adopted. Two views were confused and contested around the corporate governance reform during the past decade.

1.5 Reform of the Board of Directors

Watching the growth in dividends and the introduction of the executive officer system with slimming board members, Japanese firms appeared to shift to the US-style corporate governance structure. Reflecting such trends, a new corporate law was enacted in 2004 to promote the adoption of the US-style board structure, called as the “company with committees” (committee system), whereby management is supervised by the three committees—nominating, compensating, and auditing—on the condition that independent directors have a majority in each committee. Japanese firms were provided with the same institutional apparatus as US firms and expected to adopt the shareholder-oriented corporate governance model.

However, there are very few Japanese firms that have adopted the committee system. According to the aforementioned TSE survey, only 42 firms in the TSE First had adopted it by 2012, roughly 10 years after the new corporate law was introduced, and 70 firms (2%) among all listed firms on TSE had done so by 2016. An overwhelming majority of Japanese firms continued to adopt the traditional structure, called as the “company with audit board” (audit board system), which consists of the board of directors and the board of auditors and is designed to supervise the work of directors by auditors.

It should be noted that the board of directors in the committee system is designed to function as a monitoring board, which supervises the work of management board conducted by senior executive officers; by contrast, the board of directors in the traditional structure is designed to work as a management board to conduct decision-making regarding not only strategic but also ordinary issues (Kanda 2015). Thus, the board of auditors in the traditional structure is regarded as designed as a sort of monitoring board to supervise the board of directors, wherein auditors discuss the company’s financial and operational matters with the directors. The effectiveness of

audit board system to monitor the board has been doubted because auditors are ranked lower than directors in a managerial hierarchy. Therefore, it was stipulated to appoint at least one independent auditor—two independent auditors now—to improve the functioning of the audit board system.

Regarding the function of managerial organization, both the committee and audit board system introduced the executive officer system to strengthen the board's decision-making by the delegation of management issues to the executive officer. However, the audit board system is more burdensome in the operation of managerial organization, because there are not only more tasks for the board of directors but also dual tasks of running both the board of directors and auditors. In contrast, the committee system is enabled to delegate more issues to the executive board. Nevertheless, majority of Japanese firms continue the audit board system despite the clamor to adopt the committee system. The reason for preserving the audit board system or avoiding committee system is apparent; existing managers dislike the control by outsiders to determine the nomination of successors and the compensation of their own payment. Nominating and compensation committees are considered to invade their managerial autonomy.

Interestingly, when the committee system was first adopted by several electronic companies, the actual structure was that shown in Table 1.4.⁸ At the beginning of the committee system, in 2004, it was only Sony that met the criteria of a US-style committee system, while the other firms had made insiders more than outsiders among board members or appointed insiders as the chair of committee. They did not give

Table 1.4 Composition of the board member in company with committees, comparison between 2004 and 2015

	Number of directors		Chair of committee		
	Insider	Outsider	Nominating	Compensation	Auditing
2014					
Sony	3	10	Outsider	Outsider	Outsider
Mitsubishi	7	5	Insider	Insider	Insider
Toshiba	12	4	Outsider	Insider	Outsider
Hitachi	6	8	Insider	Insider	Insider
2015					
Sony	3	9	Outsider	Outsider	Outsider
Mitsubishi	7	5	Insider	Insider	Insider
Toshiba	5	6	Outsider	Outsider	Outsider
Hitachi	4	8	Outsider	Outsider	Outsider

Source: Annual report of each company

⁸These firms suffered from deteriorating business performance at that time. It was said that the Ministry of Economy, Trade, and Industry (METI) strongly persuaded or enforced them to adopt the committee system in exchange for the introduction of consolidated accounting rule, which saved these firms.

Table 1.5 Composition of the board member in company with audit board in 2015

	Number of directors		Number of auditors		Voluntary committees
	Insider	Outsider	Insider	Outsider	
Panasonic	14	3	2	3	Yes
Toyota	9	3	3	3	Yes
Komatsu	7	3	2	3	Yes

Source: annual report of each company

up their managerial autonomy even in the adoption of the committee system. Ten years later, in 2015, the criteria of the committee system were met except by Mitsubishi Electronics; Toshiba was due to the accounting scandal, and Hitachi was due to the initiative by an exceptional top manager. Including Sony, however, there was no case in which institutional investor enforces such transformation, and there was no case in which new president was nominated outside the company. Ironically, Mitsubishi Electronics, the most conservative among them, achieves good performance by restructuring poorly performing businesses, whereas Sony, the closest to the US style, suffered from a long slump. By contrast, several cases of the company with audit board are shown in Table 1.5. These firms, counterparts to the company with committee system, are equivalent in the number of outsiders, sum of both outside directors and auditors, and creating voluntary committee in which outside directors have a role of advisors.

Considering the reality of the committee system, it is not surprising that the adoption of it has not increased thereafter. Even if the adoption is likely to obtain the favorable response from foreign investors as mentioned by Dore (2009), the majority of Japanese firms preserved their own style. However, or therefore, the attack from foreign investors does not abate. There is no doubt that the number of outside directors is very few simply because there are no committees. According to the aforementioned TSE survey, the average number of outside directors in 2014 is 1.04 in the audit board system, whereas it is 4.5 in the committee system. Similarly, the average number of independent directors is 0.6 in the audit board system, whereas 2.14 in the committee system. Approximately, independent directors were completely absent in a half and were one or two in number in the remaining half in average in the traditional Japanese firms.

These observations were considered as a delay or insufficiency in the corporate governance reform in Japan. In particular, the existence of a very small number of independent directors was blamed for their ineffectiveness in supervising management with regard to shareholder interest and regarded as evidence that Japanese firms are persistent in preserving their managerial autonomy against shareholder interests. Therefore, foreign investors' attacks have always been focused on the scarcity of independent directors. Confronted with these increasing pressures, the Financial Service Agency (FSA) and TSE announced in 2014 the Corporate Governance Code, which proposes the appointment of at least two independent directors. Although this was a voluntary code, it was, in effect, compulsory due to the inclusion of the "comply or explain" rule. As a result, many firms rushed to

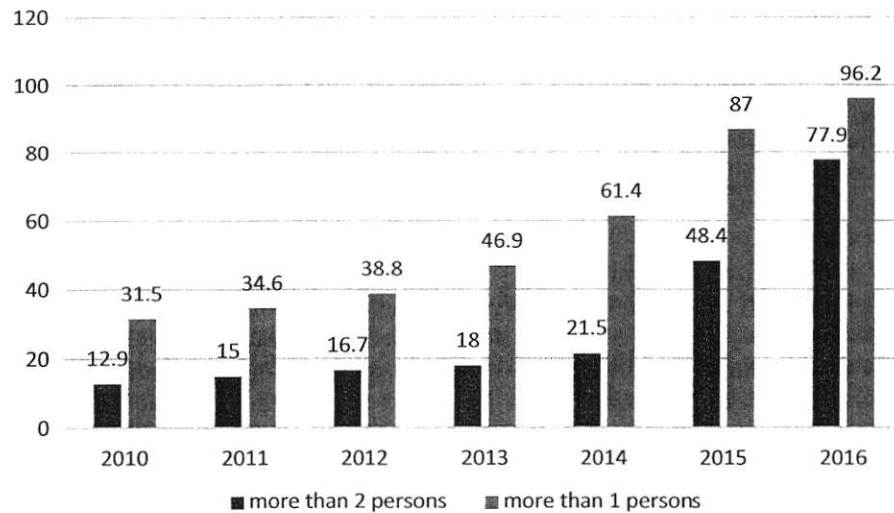


Fig. 1.5 Percentage of firms appointing independent directors. (Source: Tokyo Stock Exchange (2016))

appoint independent directors; as shown in Fig. 1.5, the percentage of the firms having more than two independent directors in the TSE First increased drastically (Tokyo Stock Exchange 2016).

Along with the announcement of the Corporate Governance Code, the corporate law was again amended in such a way as to allow a new board structure: the “company with audit committee.” It has only an audit committee; in other words, it is distinct from the “company with committees” due to the absence of nominating and compensation committees and distinct from the “company with audit board” due to the absence of the board of auditors. The existing “company with committees” is now called the “company with nomination/compensation committee,” despite having an audit committee, to distinguish the two structures. According to the JACD (Japan Association of Corporate Directors) survey, many firms (357 in TSE First) rushed to move to this new board style, as shown in Fig. 1.6 (Japan Association of Corporate Directors 2016). A recent report shows that the number of firms that adopt a new style will increase to about 800, after the general meeting of shareholders in 2017 (Nikkei Newspaper, 24 June 2017).

In short, a new structure was a very convenient way to meet the Corporate Governance Code because it was adequate to redesignate the existing two independent auditors in the original “company with audit board” as new directors of the “company with audit committee.” It can be said that a sort of loophole was created to meet the corporate governance code. In contrast, the majority of Japanese firms continue to be the traditional “company with audit board,” with at least two independent directors and two independent auditors.

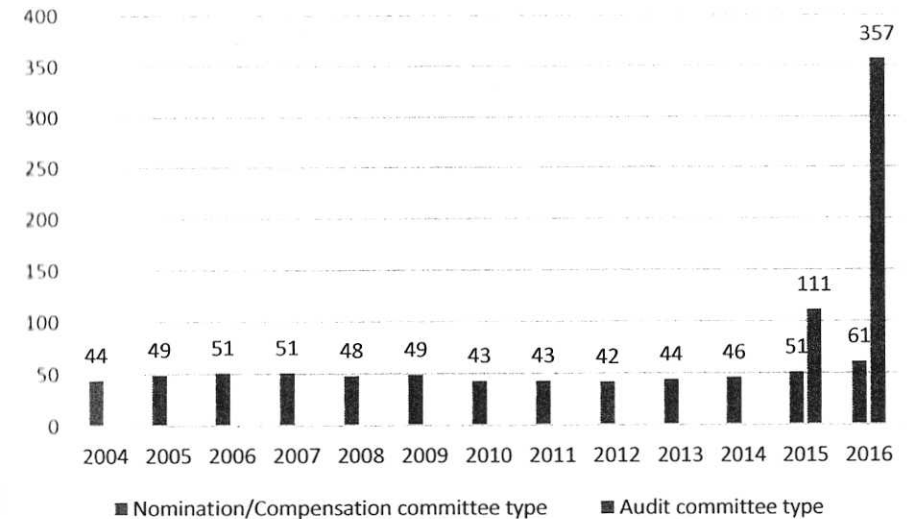


Fig. 1.6 Number of firms with nomination/compensation committees and audit committee. (Source: Japan Association of Corporate Directors (2015))

1.6 Gradual Institutional Change in the Corporate Governance Structure

Now, there are three types of governance structure—audit board, full committee, and audit committee—which correspond to the company with audit board, company with nomination/compensation/audit committee, and company with audit committee, respectively. The new audit committee type is continuously increasing and is found in 23% of the firms listed on the TSE, while the audit board type is still the majority form, found in 75% of the firms; the full committee type is followed by only 2%, according to the most recent data (Nikkei Newspaper, 28 August 2017). Although adopting one of the three types is mandatory under corporate law, which one is adopted is left to the individual firms. Here we see a gradual institutional change in the corporate governance structure.

First, the full committee-type governance structure was advocated as an overall change in corporate governance structure. Despite the enactment of new corporate law to promote such a radical change, there were very few that have adopted the full committee type. Majority have persevered with the traditional audit board type and advanced the reform of the board structure by introducing the executive officer system and reducing the number of directors. Japanese firms have changed internally to reconstruct managerial organization and strengthen strategic management. Therefore, the number of independent directors has remained quite small.

Next, in order to cope with the stock market pressure to demand an increase in independent directors, Corporate Governance Code was announced by TSE to rec-

commend the appointment of at least two independent directors. The effect of the “comply or explain” rule was elaborated; appointing two independent directors progressed immediately as if they follow the Japanese custom to behave in conformity with others, rather explained by sociological model of mimicry and imitation (DiMaggio and Powell 1983). Coincidentally, corporate law was revised again to permit the third type of governance structure—the audit committee type. This was a very convenient measure to meet the code; it was adequate to slide the independent auditors in the original audit board type to the independent directors in the audit committee type.⁹

In this way, the audit committee type increased rapidly, practiced in about one-fourth of TSE companies. Then a question arises; will it increase further and replace the traditional audit board type? There may be several reasons to adopt the audit committee type. One of them is purely financial, because at least four outside officers in total—two independent directors adding to two independent auditors—are needed if the audit board type is to be preserved. It may be too much of a burden for the small-scale firms. Another reason is the foreign investors’ pressure. They demand for more independent directors not only by raising the voice to management but also by organizing veto voting against the appointment of a president at the general meeting of shareholders. These firms have to be wary of foreign investors because of the high ratio of foreign investors. Thus, it is possible to meet the foreign investors’ demand by adopting the audit committee type.

Here we find that the two types—audit board and audit committee type—will compete with each other. Both are similar in their avoidance of nomination and compensation committee controlled by outside independent directors. In other words, both are interested in preserving their managerial autonomy. Even in the case of full committee type, it is doubtful whether these firms abandon their managerial autonomy because there is still no instance of a nomination committee appointing an outsider as a new president. However, as in the case of the comparison between audit board and full committee type, audit board type is more burdensome than audit committee type not only in financial burden but also in organizational burden because it runs a dual structure composed of the board of directors and auditors. For simplifying managerial organization, it seems appropriate to incorporate audit board into the board of directors as audit committee.

However, at least until now, a majority of companies still adopt the audit board type. This may be because audit function is emphasized more. Audit board type has institutionally assured independence of auditors from management. Although the work of audit board was doubted when inside auditors were the subclass directors, it has improved due to the introduction of at least two independent auditors. Furthermore, audit board can access more information on the ordinary issues at

⁹This can be confirmed by the occupation of the independent directors. In the audit committee-type structure, 48% of them are lawyer, accountant, or scholar. The corresponding proportion in audit board type and full committee type is 31% and 32.1%, respectively. Lawyers, accountants, and scholars are mainly appointed as independent auditors. They are likely to be appointed again as an independent director in the audit committee type structure.

workshops than audit committee because the former can more concentrate their duty on auditing; thus, it seems more effective in auditing or monitoring with regard to the internal accounting and compliance issues. For these reasons, main Japanese firms with large and complicated business structure are likely to continue the traditional audit board type. In contrast, it is easy to predict that audit committee type will spread in small-scale and simple structured firms.

In addition, many of these firms have introduced a nominating and compensation committee voluntarily—a total of 546 firms, according to the aforementioned JACD survey (Japan Association of Corporate Directors 2016). Although the decisions of such voluntary committees do not have a compulsory effect—only an advisory one—on management, there is not actually a very large difference between formal and informal committee in terms of the nature of the chair of nomination committee. According to the aforementioned TSE survey, 49% of the audit board type have an inside-chairman in their voluntary nomination committee, while 43% have similarly an inside-chairman even in the full committee type, in contrast, 60% in the audit committee type (Tokyo Stock Exchange 2017). Although the full committee type has a slightly large proportion of outside-chair, the difference from the audit board type is small. In other words, the full committee type is a far cry from the US-type corporate governance structure.

In short, Japanese firms have adopted their own corporate governance structure. Apart from the debate on whether the US-style corporate governance should be adopted or not, what is revealed through the actual reform is that Japanese firms preserve their own governance structure—managerial autonomy—against increasing shareholder pressure. This does not preclude changes occurring. The most important issue for Japanese firms was to rebuild the existing management for restoring corporate performance; in particular, they sought to strengthen strategic management by introducing the executive officer system and slimming the board members. As mentioned by Buchanan and Deakin (2009), corporate governance reform in Japanese firms was to make managerial organization as a whole work more effectively, not reform corporate governance system as a whole by modeling it on their US counterparts. Therefore, independent directors have not been excluded from the outset; rather, they have been introduced as advisors to the management. Corporate governance code has also been accepted without much resistance, and even a nomination as well as compensation committee was introduced voluntarily in the form of advisory committee. In this way, Japanese firms change gradually and discretionally coping with changing environments.

It is sure that managerial autonomy is being preserved in Japan, not only in the firms to make internal directors majority, even in the firms with committees. However, it should be recognized that managerial autonomy per se is indispensable for management. For instance, excellent companies in Silicon Valley never abandon their managerial autonomy even in the initial public offering. They address overtly that only they can manage this company. On the other hand, shareholder’s claim is that although this is true for growing and innovative companies, it does not apply to matured companies having no prospective businesses; thus, the old companies have