Performance Impact at the Board Level: Corporate Governance in Japan

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Abstract

The purpose of this paper is to investigate the performance impact at the board level in the corporate governance of Japanese companies. We investigated the size as well as the composition in the boardroom, like outside directors and outside auditors and applied this to a set of 821 Japanese manufacturing companies.

We found evidence that board size does not matter but a higher ratio of outside directors / outside auditors associates to a better performance of the companies. As a second step, we put Japanese companies into three groups, “traditional companies” (without outside directors), “new Japanese companies” (which appointed outside directors) and as a third group companies who decided to apply to the “US-style system” of committees. Traditional Japanese companies showed the weakest performance and US-style Japanese companies the strongest performance.

This result is highly important as it says that Japanese companies are better off having a high ratio of outside directors and outside auditors. In

addition to this, our second area of research suggests that Japanese companies who might think about getting financed by the capital market should introduce the US-style system, as they clearly outperformed the other categories.

Keywords: Corporate Governance; board room, JUS-style corporate governance, outside ratio, board size

1. Introduction

The boards of large organizations and their role in corporate governance have been investigated already over a very long time span (since Fama and Jensen, 1983). The board plays a key role in monitoring and controlling managers and can be described as a bridge between company management and shareholders (Dalton et al., 1998). There is a long tradition of research arguing to what extent the board of director's composition and size influence their company's performance (Hermalin and Weisbach, 2003; Dalton et al., 1998).

One of the biggest questions concerns the board's composition. There is a worldwide trend toward greater board independence which will be reached through a higher ratio of outside directors. Especially, US-style companies are forerunners in this trend with a board structure having an average of 80% of outside directors (Bhagat and Black, 1999). Among institutional investors as well as pension fund manager and other professionals, it is not unusual to find advocates, who support the so called "supermajority independent

boards" (Bhagat and Black, 1999). The Business Roundtable recommends a "substantial majority" which should consist mainly of independent directors and CalPERS, the Californian Pension fund, even adopted more extreme guidelines (Ahmadjian, 2001). An "ideal" board of directors should only consist of one inside board member, and this person should be the CEO of the company (Bhagat and Black, 1999). There is also clearly a demand towards a more independent boardroom with more outside directors because shareholder activists are increasingly using their power (For an overview of corporate governance and shareholder activism, see Barnard, 1991; Black, 1990, Fligstein, 1990; O'Barr and Conley, 1992). Notably, the prescription of all these studies is that better board governance structure will improve corporate financial performance (e.g. Dalton et al. 1998; Dalton et al. 1999; Millstein and MacAvoy, 1998)

A second phenomenon often seen in the area of corporate governance is how the literature addresses the issue of the board size. Research suggests basically that bigger boards are less effective (Lipton and Lorsch, 1992;

Jensen, 1993). Reducing the board size is popular particularly for troubled companies (Yermack, 1996). We will analyze several papers written in this area and then present our own data.

This paper is one of several contemporaneous papers, studying performance impact at the board level in the corporate governance of Japanese companies as an in-depth country study. A strength of our in-depth study of corporate governance, compared to a multi-country study, is the strong data availability, which lets us use a much more complete set of dependant and control variables. On the one hand, we look at the board size and on the other hand, we look at board composition, to the ratio of outside directors and outside auditors and measure it to the company's performance. As a second step, we divide Japanese companies into three groups and investigate about their performance.

The structure of this paper is outlined as follows. In chapter 2 we discuss agency theory for explaining the board size and the outside ratio. The introduction of the Japanese companies and their groupings will be

introduced as a new approach in chapter 3. In chapter 4 we introduce our research model, chapter 5 is about data and variables and in chapter 6 we present our analysis. Chapter 7 highlights the key concepts of this discussion and in chapter 8 we close our research with a conclusion.

2. Agency Theory for explanation of board size and outside ratio

In finance theory there are two main theoretical models that seek to explain the board size and board composition of companies. On the one hand there is behavioral finance theory (seen in the work of Shleifer), and on the other hand there is agency theory, which is built on the managerial notion of separation of ownership and control. According to agency theory, managers in modern corporations are in the potential conflict of self interest as they gain control in the firm which might benefit themselves, but not the owners (Denis, 2001; Dalton et al. 1998).

Agency theory is in that sense a control-based theory, which can be settled as a frame for argumentation about the board size as well as for

questions concerning the board's composition. In this study we use agency theory as our theoretical foundation in order to explain board size and board composition. The theory's underlying argument applies to board size in the following way: when the board becomes too big, agency problems (like a director free –riding problem) occur, as e.g. directors are more symbolic at the board.

Agency theory can be also grounded in questions about the board composition. Outside directors are independent and this leads to superior control. According to this theory, effective boards should be comprised of more outside directors. The conceptual literature supports this argument. There is near consensus that effective boards will be comprised of greater proportions of outside directors (Dalton et al. 1998; Zahra and Pearce, 1989).

Japanese boards too, came under increasing criticism having insider boards without any kind of separation between monitoring and management. The insider problems were associated with over-investment and delays in restructuring (Miyajima, 2005). Gedajlovic and Shapiro (2002) researched

Japanese ownership structure and firm profitability and found a positive relationship between the ownership concentration and the financial performance. However, when *keiretsu* or banks hold higher ownership, performance was negative. The data of their study was taken from 1986-1991. Especially during this time period for Japan it was difficult to analyze this situation as it was at the end of the Japanese bubble economy.

As agency theory suggests, Japan should follow the same pattern. Small boards and a composition of more outside directors should lead to a better performance. In this line of argumentation, inside directors of Japanese companies have incentives to pursue their own interests at the expense of shareholders. Until now, in Japan there is only some anecdotal evidence that small sized boards and a composition of more outside directors will increase a company's performance.

3. The Japanese Case

3.1 Recent developments

Previously, the Japanese banking-based system was often closely linked to the German system (Sakakibara, 1995; Dore, 2000; Yamamura and Streeck, 2003). Historically, both countries have been bank-dominated by strong stakeholder-orientation. However, in contrast to the German system of co-determination, Japanese law does not require employee participation at the board level. Japanese boards traditionally have been comprised almost exclusively of managers who served their whole career in the same company (Milhaupt and West, 2004).

In recent years, there are indicators that this system has changed in Japan after the bubble economy. Despite past economic success, Japanese companies faced strong pressure to change their corporate governance system. There is evidence that Japan's legal framework of corporate ownership has changed (Egashira, 2001; Kanda, 2001; Wakasugi, 2004, Seki, 2005). The changes covered corporate law and other regulations as well as the role of the banks and the whole financial system. A new stock-swap system and a stock option plan were introduced. Furthermore, companies

have to apply the new market accounting standards (Bebenroth and Tabuchi, 2004). Since April 2002, even US-style corporate governance system is possible for Japanese companies to choose. This was possible because of an amendment of the Commercial Code (Bebenroth, 2004).

Besides these legal changes, several attempts were made to introduce a corporate governance code. In 2001 a Japanese corporate governance code was published and in 2004 the "new principles of a corporate governance for stock listed companies" were released (Internet www.ecgi.org/codes).

In 1997, Sony introduced a new style of Japanese corporate governance, the Executive officer system, the so called *shikko yakuin* system (Seki, 2005). The objective was to separate the board that makes strategic decisions, which were then implemented by the *shikko yakuin* (Executive officer). The May 27 1997 edition of the *Nihon Keizai Shinbun* stated that: "Sony's directors will be reduced from 38 to 10 members and the company will establish a new corporate governance system by introducing a *Shikko yakuin* system so that the business decision-making function is clearly distinguished

from business operations" (International Financial Law Review, 2003, www.iflr.com/includes/supplements/PRINT). Through this, non-executive officers are requested to step down from decision making responsibilities and become board members who instead have monitoring responsibilities (Miyajima, 2005; Ahmadjian, 2001). Moreover, until 1997 there were hardly any outside directors（Miyajima and Aoki, 2002). Sony was not only the first company who introduced the executive officer system, the so called *shikko-yakuin* to separate the monitoring board from the operational functional board, in 1970 it also appointed two outside directors. While in 1976, the CEO system was adopted. After the *shikko yakuin* system was introduced in 1997, the following year saw the Compensation and Nomination system introduced.

Favouring Sony's early introduction of the *shikko yakuin* system, following an amendment of the commercial law, companies could choose to implement a *shikko yaku* system. This is based in commercial law and was comprised out of a statutory auditory board structure. With this system

providing both a separation of executive officers and the introduction of outside directors, many Japanese companies hoped to improve their performances.

Through amendment of the Japanese Commercial Code which became effective on April 1st, 2003, Japanese companies are given the choice in terms of a governance system. Companies can stay with the old traditional corporate auditor system or they may change to company with committee system, here called US-style system if their size allows them to do so. The size of a big company is defined according to the Audit Special Exceptions Law, articles 1-2, paragraph 1 and is viewed as a Kabushiki-Kaisha if it falls under one of the following items: (1) that its capital amount is more than 500 million yen ($4.3 million); (2) that the total amount entered in the part of liabilities of the last balance sheet was 20 million yen or more (International Financial Law Review, 2003, www.iflr.com/includes/supplements/PRINT). If companies choose the US-style system, three committees have to be established, for audit, for remuneration, and for

nomination. On each of the committees the majority of the directors have to be from outside. The three committee governance system functions within the framework of the new commercial law. In this regard, the responsibilities of the board for business decisions becomes clearer and accountability increases. One of the obligations for example, is that reporting of board members increases as they have to report every three months in an individual statement about the status of the company.

According to the revised Code, Japanese companies can either remain with the existing corporate governance structure (with statutory auditor/ board of statutory auditor structure) or adopt the company with committees system, here called US-style system.

In many countries where comply or explain rules exist, there is hope that the market will punish non complying companies (Seki 2005). However, there is no comply or explain rule in Japan. Therefore, it is questionable whether accountability really increases for US-style companies. It could be argued that some companies might only implement the system as a means of

appearing more transparent from the outside, in order to be attractive for investors.

3.2. Segmenting the three groups: Japanese – JUS - US -style

We are already able to segment two groups: traditional companies who remain with the commercial code having statutory auditor system (called *Kansayaku*) without any outside directors and US-style companies. The popular press assumes that companies who continued with the traditional Japanese system of not having any committees and no outside directors might need to explain reasons to the investors. Seki reports that in June 2004 some 43 companies decided to adopt the new system. Our sample only covers manufacturing firms listed on the First Section of the Tokyo Stock Exchange so we have only 24 companies for fiscal year 2003 and 29 for the fiscal year of 2004 who changed to a US-style board system. Needless to say this style is a dramatic and fundamental change from the traditional system.

Showing concern, Sony turned towards a US-style system with nomination committees. Besides that, Hitachi with 19 separate companies has 13 listed companies, from whom 10 decided to implement the US-style company system (with 3 committees and the executive officer system).

Somehow more or less in the middle between the traditional Japanese style and the new US-style board committee system, we come up with a hybrid model that offers some advantages of the American approach of outside directors even though it is still based in the Japanese company system, without the “company with committees” setting. These companies differ from the traditional ones because they have outside directors on their boards. This is segmented as our third group. Outside directors, are seen as increasing the independence of the decision making process. Such a policy change in these companies, in contrast to the traditional Japanese system, is ostensibly a change that might also affect areas that involve foreign investors (though not further investigated).

In 2004, 678 companies listed on the First Section (some 43.5%) appointed at least one executive officer. Here we call this system as sitting between the traditional Japanese-style and the US-style, hereafter called a JUS-style system (Japanese-US-style). In the fiscal year 2003, in the 821 companies we examined 535 traditional Japanese companies (without any outside directors). We found 262 JUS-style companies (with at least one outside director) and 24 US-style companies. This tendency changed in fiscal year 2004 from traditional companies to JUS style and US-style companies. From again 821 companies in fiscal year 2004, we found only 507 companies who remained in the traditional style (minus 28). Therefore, JUS companies saw an increase of 23 to 285, while there was also an increase in numbers of US-style companies by 5 to 29 companies (table 1. board structure variables).

4. Research Model

This study focuses on the board room in Japanese companies and because this research is unprecedented we decided to divide the companies into three blocks. The first are companies who maintain a traditional Japanese board style system without any outside directors. The second group contains Japanese companies who introduced outside directors but remained in the auditor system (to some extent they had a traditional Japanese auditor style and to some extent a US-style, therefore being termed JUS-companies). The third group exists of Japanese companies who completely changed their board to a US-style system which introduced outside directors but no conventional auditor system. In this US-style system a three committee structure is set up (in Japanese: *iinkaito sechi gaisha*).

To explain the meaning of these Japanese words: *Iinkai* refers to the committee style of the board and *to* means virtually as much as others. In this sense here, it means the *shikko yakuin* style of non-executive directors. *Sechi geisha* then leads to the arrangement of a company, or a board system. This new US-style company type, therefore, not only has the three

committees but also separates executive officers and monitoring executive officers.

Using this framework, we first separated our sample of Japanese companies in three groups. Second, we investigated the general performance of all groups. Finally, and measured with two separate variables, we looked at board size and ratio of outside directors/auditors in comparison to performance. We measured performance with the latest financial data using Tobin's Q for the year 2004.

Hypothesis

Board size

A large volume of literature is written about the board size and their influence on financial performance (Jensen, 1993; Dalton et al., 1999; Bonn et al., 2004). Within this literature, only minor studies advise companies to have a big board size (Ferris et al., 2003). According to resource dependence theory, larger boards have a higher level of performance as they have greater

ability to secure critical resources. Furthermore, large boards may be able to create links to other institutions more easily than smaller boards (Pfeffer, 1972; Goodstein et al., 1994). Pfeffer found that the effective external linkage increases with board size. Bigger board sizes also normally insure an increased pool of expertise.

In contrast to this, there are many studies showing a negative relationship in board size to performance (especially for small firms: Eisenberg, et al., 1998). Yermack (1996) researched the board size of US-style companies and found empirical evidence of a negative relationship between board size and company performance. According to Lipton and Lorsch (1992), their research showed that large boards are less cohesive because too many voices are hard to transform into one strategic line. It is hard to take decisions and they are more difficult to coordinate. Therefore, they suggested that large boards are less effective than small boards. If a board is too large, the ability of initiating strategic changes might be reduced (Goodstein, 1994). In the same stream of research Millstein and MacAvoy (1998) as well as Bhagat

and Black (2002) found a negative relationship between the board size and a firm's value. Over this, Lipton and Lorsch (1992) even recommended that board sizes perform best with 10 members.

Historically, Japanese boards were very large in size (Kiel and Nicholson, 2003). In the literature it is reported that some firms have had over 60 directors sitting on the boards (Abegglen and Stalk, 1985; Dalton and Kesner 1987; Yoshikawa and Phan, 2001). Recently, board size in Japanese companies is declining, even if the numbers from other researcher don't seem to be congruent with each other. Bonn, Yoshikawa and Phan (2004) have numbers from 1997 stating an average of 27 directors for Japanese boards. Miwa and Ramseyer (2005) too, report numbers in this range for company data in the 90's. In any case the number of directors seems to be in decline.

To test our hypothesis, we accomplish a regression analysis on all of our sample companies with the performance measure by Tobin's Q for fiscal

year of 2004. For this we measure the board size to the performance of our companies. Our hypothesis is:

1a) A small board size leads to higher performance.

Since JUS-style companies are regarded as a new style and the US-style system is even more timely, we suggest that traditional Japanese companies have bigger board sizes. We prove our hypothesis through a descriptive examination:

1b) Traditional Japanese board system companies have the biggest board size, JUS are in the middle and US-style boards have the smallest number of directors.

Ratio of outside directors and outside auditors

Naturally, a board of directors is composed of inside and outside directors. The composition of boards is exposed in a number of studies (e.g. Lorsch and Maclver, 1989; Bonn et al., 2004).

The majority of the studies in this field support the hypothesis that boards with merely inside directors are less effective than boards with outside directors (Ahmadjian, 2001). According to Ezzamel and Watson (1993) using a sample of UK firms, outside directors were associated positively with profitability. Several other researchers have noted a positive relationship between the numbers of outside directors to the firm's performance (Pearce and Zahra, 1992; Rosenstein and Wyatt, 1990; Schellenger et al., 1989).

Only very few studies have shown mixed results in this area (Baysinger et al., 1991; Chaganti et al., 1985). There is – at least from the US view – a demand for an increase of outside directors so that the board becomes more effective in managerial performance (Fama, 1980; Bonn et al. 2004).

By amendment of the Commercial Code in 2002 the first Japanese definition of an “outside director” was established. An outside director is defined as a person who has not been director, officer or employee of the same company or its subsidiaries. Furthermore, this person does not have the role of executive in the business of the company. However, neither a clear requirement nor independence of an outside director is clearly specified (Seki, 2005). In the Japanese case, this has been so far difficult as many outside directors are in fact not thought to be independent (particularly not to the CEO) as they come from Government, other banks or from other companies with which they have a long-standing-relationship. Hermalin and Weisbach (2003) call these outside directors “affiliated” or “grey” directors. Japan is clearly considered to have insider dominated boards (Charkham, 1994). Although not independent, Japanese outside directors to some extend differ from inside directors in their behavior. Because even if they are sent from certain banks or bureaucracies, they can be considered more independent than in-house directors.

We want to test the ratio of outside directors and outside auditors to the performance in our sample. In 2004, exactly 523 companies from TSE First Section (35% of all listed companies) appointed at least one outside director (Seki, 2005). In our regression analysis we measure the ratio of outside director / auditor to the performance. As traditional companies do not have any outside directors, this argument is therefore applied to two different Japanese boards, to the US-style board companies as well as to JUS-style companies with outside directors. In our measure of the auditor system, however, we analysed only traditional companies and JUS-style companies. Our hypothesis therefore is:

2a) A high outside director /auditor ratio leads to higher performance.

US-style companies have committees which have to be made up of a majority of outside directors. In contrast to this, JUS-style companies might only introduce outside directors to a certain degree. Therefore, we suppose

that the US-style companies have a higher ratio of outside directors to JUS-style companies. We test this again in a descriptive attempt. Our hypothesis is:

2b) US-style companies have a higher outside director ratio to JUS-style companies.

In the final ANOVA analysis we measure performance difference among our three groups. Here we include again all our 821 companies. Our hypothesis is:

3) Traditional Japanese companies have the weakest performance, JUS are in the middle and US-style board companies have the highest performance.

5. Data and Variables

For this study, several sources of data were necessary. Financial Data were collected from NEEDS-databank, an electronic version. Data about board structure were collected from the printed version of Yakuin Shikoho (Board of Directors Handbook).

Our sample consists of 821 companies. All of these companies are from the manufacturing sector to eliminate industry-level fixed effects. The sample consists of Japanese First Stock Exchange listed companies, where we found 834. For 13 companies we could not find data so we filtered our sample finally down to 821 companies for the fiscal year 2003 and 2004.

Board structure variables as independent variables

We used board structure as independent variables. Board structure includes the numbers of inside and outside directors /auditors. We also came up with the ratio for both groups. In our study we focused on the board size as well as the ratio of outside directors / auditors. The ratio of outside directors /auditors was measured as outsiders to the total number of directors /auditors.

We placed a dummy variable for the traditional Japanese board system (without any outside director), for JUS-style companies (which appointed at least one outside director but remained in the statutory auditor system) and for US-style adopted companies (which introduced three committees).

Dependent variables and control variables

There are two major methods of measuring the performance of companies. One method to measure performance is accounting based, where for example Return on Assets (ROA) is a popular measure (MacAvoy et al. 1983; Hermalin and Weisbach, 1991; Bhagat and Black, 2000). The Return could be based on performance, or companies could pay higher dividends for a given level of profits. Another related idea would be that investors could just value the same dividends (or earnings) to a higher level.

A second approach to measure performance can be market based. As suggested by Morck et al. (1988), in a market based approach for measuring the performance Tobin's Q can be used. The reason for using Tobin's Q is

the idea that it reflects the “value added” of intangible factors, e.g. factors of governance (Hermalin and Weisbach, 2003).

Several studies connected to Japan and related to performance use ROA (Prowse, 1992; Nitta 2000; Suzuki and Sho, 2000; Yoshikawa and Phan, 2003). As we divide Japanese companies into three groups with different assets, we measure the firm’s performance using Tobin’s Q as the dependent variable. Tobin’s Q was measured as (Share Price × Outstanding Shares + Debts (long- and short term))/ Total Assets.

We have to consider a time lag. Therefore, we took the fiscal year of 2004 for Tobin’s Q and the fiscal year of 2003 for our independent variables. For our control variable we used five variables. LN (Total Assets), LN (return), fixed asset ratio, growth rate of return (mean for the last 5 years) and growth rate of cash flow (also mean for the last 5 years).

For controlling the firm size, we followed the common practice of using LN (assets) as Durnev and Kim (2003) did. In line with prior research the coefficient on LN (assets) should be negative. These variables can be in

contrast to each other. For example, some companies might focus on high turnover, others might focus on growth rate of return or on a high market share. All the financial data was retrieved from NEEDS Databank.

6. Analysis

We undertook three types of analysis in this paper. First, we analyzed the size of the board room using a descriptive analysis. After that we used regression analyses to look at the board composition and confirmed two hypotheses about outside directors. Finally, we used ANOVA analyses to investigate the statistical significance of our variables in regard to our three groups.

Our descriptive analyses therefore contain: 1. Board structure variables, 2. Control variables and 3. Performance variables. See table 1 down here (and for detailed data see attachments, table I and II).

Table 1

As can be seen from the table above, we tested the board size in the same way Miwa and Ramseyer (2005) did. Furthermore we subtracted auditors from the board so that we came to the real size of the board of directors. The number of directors is smaller than any other study about the board size of Japanese companies so far. From the table above, we find evidence that the average board size based on the Japanese companies we investigated is 10.16 in fiscal year 2003, which decreased to 9.81 directors in fiscal year 2004. If auditors too are included in the board size, the director number increases in average to 13.87 in the year 2003 and to 13.55 in the year 2004.

Looking at the number of the board sizes in 2003, traditional Japanese companies have 13.71, JUS companies have 14.61 and US-style companies have 9.25. In fiscal year 2004 quite similar results appear. Again, traditional Japanese companies' board sizes with 13.48 are smaller than JUS companies with 14.15 directors. US-style companies once more have the smallest size with only 8.97 directors. Therefore, our hypothesis 1b failed.

When dividing the number of outside directors into three groups, we can see that JUS-style companies in 2003 have on average 1.57 outside directors and US-style companies on average 3.71. For the year 2004 the numbers change only to a small degree. JUS companies have 1.69 outside directors on average and US-style companies 3.52. In 2003, JUS-style companies have an outside ratio of 17% in contrast to US-style companies who have an outside ratio of 42%. In 2004, JUS companies have an outside director ratio of 19% and US-style companies of 41% Therefore, our hypothesis 2b is supported.

In addition to this, we looked at the number of outside auditors. For 2003 we measured 1.37 for traditional Japanese style companies and 1.65 for JUS companies. In 2004 this number changes again only to a small degree. For traditional Japanese style companies to 1.46 and for JUS-style companies to 1.67. Interestingly, the gap of outside auditors between traditional and JUS companies is only small. From table 2 we can see Tobin's Q for all companies in 2003 and 2004.

Table 2

Looking at the table above, Tobin's Q for all companies in 2003 is on average 1.23. As our hypothesis suggested, traditional Japanese style companies have the lowest value with 1.18, JUS-style companies are in the middle with 1.30 and US-style companies have the highest score with 1.61. For 2004, Tobin's Q increased to 1.30 for all companies. After our segmentation, in 2004 we see the same picture. Traditional Japanese companies have the lowest value with 1.25, JUS-style companies 1.36 and US-style companies the highest value with 1.77 on average.

Next we undertook a pearson correlation analysis for 2003 and 2004 (see attachment pearson correlation, table III and IV). There is a strong correlation between the ratio of outside directors and Tobin's Q for both years with 1% significance. The ratio of outside auditors to Tobin's Q is significant for two years on a 1% and 10% level. In the next step we did regression analyses (See table 3 and attachments).

Table 3

Looking at the table above, our ratio of outside directors shows a strong positive influence for Tobin's Q in the year 2004 with a significance of 0.025. We see almost the same results with our ratio of outside auditors (0.023). The $R^{2'}$ of our model is 0.126, which means that our sample at the regression analysis can be explained by 12.6%. Other figures, F=10.120, P=0.000 mean that our model is as a whole significant (regression models of traditional Japanese companies and JUS-style companies see attached in tables VI and VII).

According to our ANOVA analysis, traditional Japanese companies have the weakest performance, JUS-style companies are in the middle and US-style companies have the strongest performance as measured by Tobin's Q. The significance level of differences for each group is under 1% what means these results are highly significant (Attachment ANOVA, table VIII).

The results of our hypothesis are written in the table 4 below.

Table 4

7. Discussion

First, we were quite surprised that the number of board members in our study was much lower than described in almost all other previous studies about Japanese board rooms. Naturally, the board size has changed dramatically to what was reported earlier by Abegglen(1985) who stated that board size numbers were around 60 members for some Japanese boards. What is more surprising is that Bonn, Yoshikawa and Phan (2004) as well as Miwa and Ramseyer (2005) also found sizes of more than 20 members on average boards in the 90's.

Unexpectedly therefore, the board size numbers in our research covering the fiscal years 2003 and 2004 comes to only 14 members in average. In fact,

the written number for the board size according to the *Yakuin Shikiho* includes auditors too. It is fair to assume that several previous studies in this field took the written board size number as stated in the *Yakuin Shikiho* for granted, even when the auditors were included. Therefore, for obtaining another independent variable (or pure directors) we subtracted the number of auditors from the whole board size and came then to our real board size of directors. This board size was in 2003 on average 10.16, and decreased for 2004 to only 9.81 directors on an average Japanese board. It is also prudent to mention that in Japan the power of directors might differ from the board size. Thus, to be on a board does not automatically mean that a member will have a wide range of powers. This might be quite different to boards in other countries.

Second, it is interesting for us to see that the ratio of outside directors and the ratio of outside auditors had an impact on the performance, measured by Tobin's Q. As outlined above, in Japanese companies many outside directors could be described as "grey" directors and not independent, but

from the government, another bank or from a cross-shareholding company. In the field of outside directors our results are in line with Bhagat and Black (1999) and Ezzamel and Watson (1993) for UK-firms. Concerning the Japanese results, Yoshikawa and Phan (2003) and Miyajima (2005) are in contrast to our finding. One explanation for this could be that they used an accounting measure, other years and other company sizes.

Third, in our segmentation part of our analysis, we find again interesting results. Traditional Japanese companies showed the weakest performance and US-style companies the strongest; JUS-style companies (with outside directors but remained in the statutory auditor system) were located somewhere in the middle (Hypothesis 3). For the board sizes of the three groups; however, we did not find the result we were looking for. The JUS-style companies' board size was not smaller than traditional Japanese company boards. As JUS-style companies were obviously going new ways through appointing outside directors, we thought that the size of the board

could be effected by this development. US-style companies were – as we supposed – much smaller than both the other groups.

This study has also some shortcomings. In Japan it is argued that not the whole board takes decisions but some groups from the upper level in the board will do so. This upper level is comprised of "Representative Directors" which can exist as a Managing Director (*jomu*), Executive Director (*senmu*), Vice President (*fuku shacho*), President (*shacho*), Vice Chairman (*fuku kaicho*) and Chairman (*kaicho*). Future research could be done about representative directors, in Japanese language called *Jomu-kai*. All the other officers on the board might not influence the actual decision making process to a significant extent. Knowing this, our result that a smaller board size did not lead to a better performance for our sample of Japanese companies is not of a surprise. If Japanese companies remain in the bank based system, our performance measure with Tobin's Q might not be appropriate. Furthermore, we measured the performance by ANOVA test only by Tobin's Q and only for the year 2004. It would be interesting to see

if the results would be robust using other measures for performances in other years. Finally, we did not test in this study whether there is a reverse causality effect in board size and board composition. This could be tested by behavioral finance theory as investors might become attracted by good performing companies, not the other way around.

Future research should cover the link from company board size and composition to the foreign shareholder relationship (as discussed by Ahmadjian, 2001). As pointed out by one of the referees of this paper, there might be a strong relationship between foreign investors and the size and composition of the Japanese companies. This phenomenon is certainly visible at companies like Sony, Orix, Omron and in Fuji Xerox.

8. Conclusion

The board room has played an outstanding role in the area of corporate governance research since Fama and Jensen (1983). There are many studies covering different countries about corporate governance and board room

impact with mixed results. The most popular research focuses on the size of the board and their composition. The theory goes like this: the smaller the board room, the better the performance of the company.

We investigated the size as well as the ratio of outside directors and outside auditors and applied them to all Japanese manufacturing companies which are listed on the First Section of Tokyo Stock Exchange, a set of 821 companies. We obtained the newest data for two years, 2003 and 2004. Our performance was measured by Tobin's Q for the year 2004. We found that the board size did not matter. There was no performance gap between bigger board size and smaller board size companies. However, the ratio of outside directors and outside auditors mattered. Companies having a high ratio of outside directors as well as a high ratio of outside auditors outperformed the other companies.

In the next stage, we divided the Japanese companies into three groups. The first group contained traditional companies (without outside directors). The second group consisted of new-style Japanese companies which

appointed at least one outside director but remained in the statutory auditor system (called JUS companies). The third group, only small in number, was of companies who decided to follow the US-style company system. In this case companies establish 3 committees in the board and an executive officer system. Traditional Japanese companies showed the weakest performance, US-style Japanese companies showed the strongest. JUS-style companies (who appointed at least one outside director) were found somewhere in the middle.

Our results are important for academics and in practice too. If these results can be verified through future research, it would mean that Japanese companies are advised to introduce more outside directors into their boards as well as having more outside auditors. In contrast to this, board reduction through adoption of the *shikko yakuin* system does not correlate to higher levels of performance, as hoped by many Japanese experts. Furthermore, capital market based Japanese companies might think about introducing a

US-style system. In our test with a small sample, clearly US-style companies performed much better than the others.

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Tables:

Table1 Board Structure Variables

Number or Ratio	2003				2004			
	ALL	JPN	JUS	US	ALL	JPN	JUS	US
Directors and Auditors	13.87	13.71	14.61	9.25	13.55	13.48	14.15	8.97
Directors	10.16	9.91	10.77	9.25	9.81	9.61	10.25	8.97
Outside Directors	.61	0	1.57	3.71	.71	0	1.69	3.52
Ratio of Outside Directors	.07	0	.17	.42	.08	0	.19	.41
Auditors	3.71	3.81	3.85	0	3.74	3.87	3.91	0
Outside Auditors	1.42	1.37	1.65	0	1.48	1.46	1.67	0
Ratio of Outside Auditors	.38	.36	.42	0	.39	.38	.43	0
Companies	821	535	262	24	821	507	285	29

Source: Own data

Table 2 Dependant variable (Performance, Tobin's Q)

	2003				2004			
	ALL	JPN	JUS	US	ALL	JPN	JUS	US
Tobin's Q	1.2307	1.1788	1.3030	1.6070	1.3027	1.2460	1.3558	1.7646
Companies N.	815	533	258	24	800	495	276	29

Source: Own data

Table 3 Regression analysis for all Companies

Coefficient [a]

Model		NSPRC		SPRC		
		B	SE	Beta	t	Significance
1	C	.363	.234		1.550	.122
	03Number of Director Size	-5.109E-03	.005	-.044	-.972	.331
	03Ratio of Outside Director	.567	.252	.089	2.254	.025
	03Number of Auditor Size	3.439E-02	.044	.036	.779	.436
	03Ratio of Outside Auditor	.249	.110	.091	2.274	.023
	LN(Total Asstes03)	1.753E-03	.036	.004	.049	.961
	LN(Return03)	9.000E-02	.032	.198	2.852	.005
	Fixed Assets Ratio03	-1.915E-03	.000	-.204	-4.870	.000
	Growth Rate of Return03	2.825E-03	.001	.108	2.499	.013
	Growth of Rate of Cash Flow03	5.214E-03	.002	.143	3.299	.001

a. Dependent: Tobin's Q 2004

$R^{2'}$=0.126, F=10.120, p=0.000.

Valid data of 569 companies.

Table 4 Results

Board size analysis
1a) A smaller board size does not lead to a better performance.
1b) The board size of JUS-style companies is not smaller than the size of traditional Japanese companies.
Board composition analysis
2a) The higher the ratio of outside directors /auditors the better the performance.
2b) US-style companies have a higher ratio of outside directors than JUS companies.
Three-group performance analysis (ANOVA)
3) Traditional Japanese companies show the weakest performance. JUS

Source: Own Data

Attachments

Table I Detailed Board Structure in 2003

03Corporate Governance STYLE: JAN=1, JUS=2, US =3		03Total Board Size	03Number of Director Size	03Number of Outside Director	03Ratio of Outside Director	03Number of Auditor Size	03Number of Outside Auditor	03Ratio of Outside Auditor
1	Mean	13.7140	9.91	.00	.0000	3.81	1.37	.3591
	Frequence	535	535	535	535	535	535	535
	Min.	6.00	3	0	.00	3	0	.00
	Max.	42.00	36	0	.00	7	4	1.00
	SD	4.6747	4.42	.00	.0000	.60	.84	.2159
2	Mean	14.6145	10.77	1.57	.1668	3.85	1.65	.4290
	Frequence	262	262	262	262	262	262	262
	Min.	7.00	4	1	.03	3	0	.00
	Max.	41.00	36	7	1.00	6	5	1.00
	SD	5.1603	4.96	.96	.1150	.56	.89	.2199
3	Mean	9.2500	9.25	3.71	.4172	.00	.00	
	Frequence	24	24	24	24	24	24	
	Min.	5.00	5	2	.21	0	0	
	Max.	16.00	16	8	.67	0	0	
	SD	2.8476	2.85	1.37	.1358	.00	.00	
Total	Mean	13.8709	10.16	.61	6.541E-02	3.71	1.42	.3821
	Frequence	821	821	821	821	821	821	797
	Min.	5.00	3	0	.00	0	0	.00
	Max.	42.00	36	8	1.00	7	5	1.00
	SD	4.8736	4.58	1.08	.1201	.86	.89	.2196

Table II Detailed Board Structure in 2004

04Corporate Governance STYLE: JAN=1, JUS=2, US =3.		04Total Board Size	04Number of Director Size 050731	04Number of Outside Director	04Ratio of OUTSIDE Director	04Number of Auditor Size	04Number of Outside Auditor	04Ratio of OUTSIDE AUDITOR
1	Mean	13.4773	9.61	.00	.0000	3.87	1.46	.3757
	Frequnce	507	507	507	507	507	507	507
	Min.	7.00	4	0	.00	3	0	.00
	Max.	43.00	37	0	.00	7	4	1.00
	SD	4.5298	4.29	.00	.0000	.61	.90	.2261
2	Mean	14.1509	10.25	1.69	.1860	3.91	1.67	.4278
	Frequnce	285	285	285	285	285	285	285
	Min.	6.00	3	1	.03	3	0	.00
	Max.	35.00	31	8	1.00	6	4	1.00
	SD	4.6378	4.37	1.12	.1344	.63	.87	.2167
3	Mean	8.9655	8.97	3.52	.4122	.00	.00	
	Frequnce	29	29	29	29	29	29	
	Min.	5.00	5	1	.07	0	0	
	Max.	14.00	14	8	.75	0	0	
	SD	2.4854	2.49	1.50	.1664	.00	.00	
Total	Mean	13.5518	9.81	.71	7.914E-02	3.74	1.48	.3944
	Frequnce	821	821	821	821	821	821	792
	Min.	5.00	3	0	.00	0	0	.00
	Max.	43.00	37	8	1.00	7	4	1.00
	SD	4.6037	4.27	1.20	.1377	.94	.92	.2241

Table III Control Variables

1000 Yen/%	2003				2004			
	ALL	JPN	JUS	US	ALL	JPN	JUS	US
Total Assets	227714	203547	237497	658653	237107	195996	276945	559311
Turnover	41125	37065	45950	79173	42545	36792	49887	70984
Fixed Asset Ratio	128.17	123.49	138.99	115.78	131.81	114.79	163.85	114.60
Growth Rate of Return (for 5 years)	8.46	8.16	9.09	8.76	9.48	10.47	7.17	14.39
Growth Rate of Cash Flow (for 5 years)	5.17	5.64	4.29	3.42	5.73	6.45	4.37	6.27

Table IV Pearson Correlation in 2003

		Tobin's Q2003	Tobin's Q2004	03Total Board Size	03N. of Director Size	03Ratio of Outside Director	03N. of Auditor Size	03Ratio of Outside Auditor
Tobin's Q2003	Coefficient	1.000	.797**	.007	.012	.219**	-.028	.093**
	Significance	.	.000	.853	.726	.000	.418	.009
	N	815	795	815	815	815	815	791
Tobin's Q2004	Coefficient	.797**	1.000	.020	.032	.171**	-.056	.135**
	Significance	.000	.	.575	.369	.000	.112	.000
	N	795	800	800	800	800	800	776
03Total Board Size	Coefficient	.007	.020	1.000	.985**	-.164**	.415**	-.003
	Significance	.853	.575	.	.000	.000	.000	.929
	N	815	800	821	821	821	821	797
03N. of Director Size	Coefficient	.012	.032	.985**	1.000	-.101**	.252**	-.007
	Significance	.726	.369	.000	.	.004	.000	.853
	N	815	800	821	821	821	821	797
03Ratio of Outside Director	Coefficient	.219**	.171**	-.164**	-.101**	1.000	-.385**	.142**
	Significance	.000	.000	.000	.004	.	.000	.000
	N	815	800	821	821	821	821	797
03N. of Auditor Size	Coefficient	-.028	-.056	.415**	.252**	-.385**	1.000	.026
	Significance	.418	.112	.000	.000	.000	.	.471
	N	815	800	821	821	821	821	797
03Ratio of Outside Audit	Coefficient	.093**	.135**	-.003	-.007	.142**	.026	1.000
	Significance	.009	.000	.929	.853	.000	.471	.
	N	791	776	797	797	797	797	797

**. Statistically significant at 1% level.

Table V Pearson Correlation in 2004

		Tobin's Q2003	Tobin's Q2004	04Total Board Size	04N. of Director Size	04Ratio of Outside Director	04Number of Auditor Size	04Ratio of Outside Auditor
Tobin's Q2003	Coefficient	1.000	.797**	-.011	.003	.196**	-.070*	.064
	Significance	.	.000	.744	.930	.000	.045	.074
	N	815	795	815	815	815	815	786
Tobin's Q2004	Coefficient	.797**	1.000	-.001	.018	.167**	-.087*	.069
	Significance	.000	.	.979	.608	.000	.014	.055
	N	795	800	800	800	800	800	771
04Total Board Size	Coefficient	-.011	-.001	1.000	.980**	-.175**	.441**	-.018
	Significance	.744	.979	.	.000	.000	.000	.607
	N	815	800	821	821	821	821	792
04N. of Director Size	Coefficient	.003	.018	.980**	1.000	-.108**	.256**	-.020
	Significance	.930	.608	.000	.	.002	.000	.573
	N	815	800	821	821	821	821	792
04Ratio of Outside Director	Coefficient	.196**	.167**	-.175**	-.108**	1.000	-.369**	.108*
	Significance	.000	.000	.000	.002	.	.000	.002
	N	815	800	821	821	821	821	792
04N. of Auditor Size	Coefficient	-.070*	-.087*	.441**	.256**	-.369**	1.000	.005
	Significance	.045	.014	.000	.000	.000	.	.892
	N	815	800	821	821	821	821	792
04Ratio of Outside Auditor	Coefficient	.064	.069	-.018	-.020	.108**	.005	1.000
	Significance	.074	.055	.607	.573	.002	.892	.
	N	786	771	792	792	792	792	792

**. Statistically significant at 1% level.

*. Statistically significant at 5% level.

Table VI Regression analysis for Japanese style companies

Coefficient [a]

Model		NSPRC		SPRC		
		B	SE	Beta	t	Significance
1	C	.189	.267		.709	.479
	03Number of Director Size	-2.286E-03	.006	-.020	-.354	.723
	03Number of Auditor Size	4.437E-02	.051	.050	.876	.381
	03Ratio of Outside Auditor	.130	.125	.050	1.041	.298
	LN(Total Asstes03)	1.222E-02	.040	.027	.303	.762
	LN(Return03)	9.195E-02	.035	.209	2.628	.009
	Fixed Assets Ratio03	-1.857E-03	.000	-.206	-4.090	.000
	Growth Rate of Return03	3.536E-03	.001	.139	2.590	.010
	Growth of Rate of Cash Flow03	3.851E-03	.002	.110	2.083	.038

a. Dependent: Tobin's Q2004

$R^{2'}$=0.121, F=7.787, p=0.000.

Table VII Regression analysis for JUS-style companies

Coefficient [a]

Model		NSPRC		SPRC		
		B	SE	Beta	t	Significance
1	C	.720	.491		1.468	.144
	03Number of Director Size	-1.510E-02	.010	-.132	-1.452	.149
	03Ratio of Outside Director	.129	.525	.020	.246	.806
	03Number of Auditor Size	-1.018E-02	.089	-.009	-.114	.909
	03Ratio of Outside Auditor	.530	.233	.171	2.273	.024
	LN(Total Asstes03)	6.874E-03	.076	.014	.091	.928
	LN(Return03)	7.636E-02	.069	.159	1.111	.268
	Fixed Assets Ratio03	-2.112E-03	.001	-.210	-2.728	.007
	Growth Rate of Return03	7.787E-04	.002	.029	.369	.713
	Growth of Rate of Cash Flow03	7.601E-03	.003	.193	2.434	.016

a. Dependent: Tobin's Q2004

$R^{2'}$=0.116, F=3.516, p=0.001.

Table VIII ANOVA analysis for 3 groups

LSD Dependent: Tobin's Q2004

(I) 04Corporate Governance STYLE: JAN=1,JUS=2,US=3	(J) 04Corporate Governance STYLE: JAN=1,JUS=2,US=3	Average's Difference (I-J)	SE	Significance	95% Confidence Interval	
					Min.	Max.
1	2	-0.1098*	0.0441	.013	-.1963	-.0233
	3	-0.5186*	0.1121	.000	-.7386	-.2986
2	1	0.1098*	0.0441	.013	.0233	.1963
	3	-0.4088*	0.1145	.000	-.6336	-.1840
3	1	0.5186*	0.1121	.000	.2986	.7386
	2	0.4088*	0.1145	.000	.1840	.6336

*. Statistically significant at .05 level

This work contains 8,221 words

This article is not under consideration for other journals.

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