

## A CLASH OF GOVERNANCE LOGICS: FOREIGN OWNERSHIP AND BOARD MONITORING

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*We ask whether and when shareholder-oriented foreign owners are likely to change corporate governance logics in a stakeholder-oriented setting by introducing shareholder-oriented governance practices. We focus on board monitoring and claim that because the bundle of practices used in a stakeholder context does not protect shareholder-oriented foreign owners' interests, they seek to introduce their own practices. Our results suggest that board monitoring is only activated when shareholder-oriented foreign ownership is high and that the influence of foreign ownership is especially strong in firms without large domestic owners, with high levels of risk and poor performance. Our findings uncover the possibility of the co-existence of different corporate governance logics within a given country, shaped by the nature and weight of foreign owners* Copyright © 2014 John Wiley & Sons, Ltd.

### INTRODUCTION

Over the past two decades, institutional investors, especially from Anglo-American countries, began to diversify in international equity and entered into stakeholder-oriented systems. As a result, local organizations became increasingly exposed to foreign norms that are often at odds with local norms (Campbell, 2004), raising the need to better understand the influence of foreign investors in shaping governance practices in different business systems. While prior studies have looked at the impact of foreign ownership on firm outcomes (e.g., Ahmadjian

and Robbins, 2005; David *et al.*, 2006), the effect of foreign ownership on organizational processes and changes in corporate governance patterns is still far from known, and has received less attention from scholars, practitioners, and policy makers.

Corporate governance (CG) is an institutional element of a nation's business system and hence reflects economic and social structures and norms of key stakeholders in a society (Aguilera and Jackson, 2003; Fiss and Zajac, 2004). One of the sharpest distinctions among CG systems is between the shareholder-oriented economies of the Anglo-American countries and the stakeholder-oriented economies typified by Germany and Japan (Aguilera *et al.*, 2008; Hall and Soskice, 2001; Streeck, 2001). Our objective is to analyze to what extent and under what conditions shareholder-oriented foreign owners shape corporate governance in a stakeholder-oriented setting

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by introducing governance practices that are shareholder oriented. Specifically, we focus on testing the influence of institutional Anglo-American foreign ownership on board monitoring behavior in Japanese firms. We examine monitoring behavior by independent directors rather than solely looking at board structural characteristics because the latter may turn out to be cosmetic, symbolic, or camouflaged, with the underlying director practices and behavior left unchanged (Fiss and Zajac, 2004).

The general outline of our argument is as follows. Shareholders' interests vary across business systems. In stakeholder systems, shareholders tend to have other interests above and beyond their equity investment, such as maintaining on-going business relationships. When foreign investors from a shareholder system invest in a stakeholder system, their governance logics and interests clash with those of (stakeholder-oriented) domestic shareholders. Because the bundle of governance practices deployed by domestic stakeholders may be unavailable or does not address the agency conflict that foreign owners face, they seek to protect their investment by introducing governance practices that are common in the Anglo-American context. In the shareholder-oriented context, two key governance practices to alleviate the agency problems between shareholders and managers stand out: board monitoring and contingency compensation (Shleifer and Vishny, 1997). However, these practices have traditionally not been emphasized in the stakeholder-oriented model. Instead, main banks, affiliated business partners, as well as senior and retired executives play a significant monitoring role (Deakin, 2010/2011). Then, we focus on board monitoring to test our logic of whether shareholder-oriented foreign investors introduce foreign practices into the stakeholder-oriented context.

In order to examine whether board monitoring behavior is contingent on foreign ownership, we analyze the effect of independent directors on the amount of external audit fees<sup>1</sup> in firms with different levels of foreign ownership. The purpose of the external audit is to obtain reasonable assurance on whether the financial statements as a whole are free from material misstatement. To this end, the

auditor should obtain sufficient appropriate audit evidence, which depends on both qualitative and quantitative considerations. To gain qualitative information, the external auditor generally meets with the board to gather information about the business and the quality of internal control systems. Through these meetings, directors who engage in monitoring can provide information and express concerns about records, documentation, internal control weaknesses, and other matters that are relevant to the preparation and fair presentation of the financial statements (AU section 380; JICPA report 260 (2009)). Moreover, they may also express their desire for a better and more thorough auditing (Aguilera *et al.*, in press). The external auditor considers this qualitative information to plan and conduct the audit, which consecutively determines the audit fee. Board members who seek to protect shareholders' interests (potentially at odds with management), typically independent directors, have incentives to monitor. Hence, they tend to ask for more information and to share with the auditor their concerns regarding internal control weaknesses and other accounting issues as well as the need to enhance overall shareholder protection, leading to a significant effect of independent directors on the level of audit fees (Carcello *et al.*, 2002). In contrast, if independent directors do not play a monitoring role, they will not have relevant information to assist the auditor, nor will they have incentives to demand better and more thorough auditing, leading to an insignificant effect of independent directors on audit fees. Therefore, we believe that an effective way to capture board monitoring behavior is to assess the relationship between board independence and external audit fees, in line with previous studies (e.g., Abbott *et al.*, 2003; Carcello *et al.*, 2002; Cohen, Krishnamoorthy, and Wright, 2007; Desender *et al.*, 2013).

We argue that the monitoring behavior of independent directors will be contingent on the degree of foreign ownership. When foreign ownership is high, we expect that independent directors will have greater incentives to protect shareholders' interests by monitoring. However, we expect such behavior to be absent when foreign ownership is low, as independent directors do not have the same incentives and ability to monitor because domestic shareholders employ a different set of governance mechanisms to protect their interests, of which board monitoring is not a key part. In addition, we contend that the effect of foreign investors is

<sup>1</sup> Audit fees reflect the amount paid by the company for the professional examination and verification of the financial statements for the purpose of assessing their consistency, fairness, and conformation to accepted accounting principles (Simunic, 1980).

unlikely to be homogenous across firms, and we explore how large domestic owners, firm risk, and performance impact foreign investors' influence.

To test our arguments, we focus on Japan, which is a particularly suitable setting for several reasons. First, the Japanese system contrasts sharply with the Anglo-American system, and Japanese firms have been resistant to change their corporate governance model towards the Anglo-American style—i.e., Japan is the only major market in Asia that does not require a minimum number of independent directors. Second, the presence of foreign investors has increased dramatically since the 1990s. While foreign ownership accounted for less than 5 percent in 1990, it rose to 28 percent in 2012—the vast majority being Anglo-American institutional investors (Bank of Japan, 2012). Ahmadjian and Robbins (2005) argue that to assess the influence of these new foreign actors it is necessary to look not only at their direct effect, but also at how they are embedded in the existing governance system. In this sense, the growing presence of shareholder-oriented foreign owners may give rise to hybrid forms of CG (Aguilera and Jackson, 2003). Finally, the fallout from recent Japanese corporate scandals such as Olympus, Daio Paper, Tokyo Electric Power, and Kyushu Electric has revived the debate regarding the monitoring role of the board and the relevance of independent directors in Japan.

Considering the universe of listed Japanese firms in the Tokyo Stock Exchange (TSE) over the period 2006–2012, our results show that board independence and external audit fees are positively related only when foreign ownership is high (above 20%). In addition, we reveal that the influence of foreign ownership is especially strong in firms without large domestic owners and in firms with high levels of risk and poor performance. Our findings are robust to different specifications and to the use of instruments to address endogeneity concerns.

Our study contributes to several lines of research. First, it sheds further light into the literature on corporate governance bundles. In particular, we extend Rediker and Seth's (1995) concept of governance bundles from a single decision-maker perspective to a setting where different types of shareholders influence a (partial) set of practices embedded in an existing system. Furthermore, while research on governance bundles has been mostly conceptual, we hypothesize and empirically test the relevance of foreign ownership as a key contingency in explaining the boards' monitoring function, uncovering a

hybrid governance system. Second, we contribute to the debate on the lack of convergence of CG systems, by investigating the role of foreign investors in shaping board monitoring practices in a system that is radically different. Whereas researchers have emphasized distinctions between governance systems and the patterns through which these systems evolve, there is less evidence on the mechanisms by which systems change. Third, our study also speaks to research on drivers of organizational change. In the context of Japanese CG, studies have looked at the influence of foreign ownership on downsizing (Ahmadjian and Robbins, 2005; Ahmadjian and Robinson, 2001), employee wages (Yoshikawa, Phan, and David, 2005), R&D and capital investment (David *et al.*, 2006), and corporate performance (Gedajlovic, Yoshikawa, and Hashimoto, 2005; Miyajima and Kuroki, 2007). While these studies have mainly focused on outcomes, we examine when and how foreign ownership leads to changes in governance processes and contribute to a better understanding of the mechanisms through which internationalization influences local organizational practices.

## JAPANESE CORPORATE GOVERNANCE CONTEXT

Japan is usually categorized as a network-oriented country, where firms have maintained a strong stakeholder orientation. The Japanese system is characterized by tight networks of vertical and horizontal groupings known for their cross-shareholdings and financial, human, and transactional ties (Lincoln and Gerlach, 2004). Instead of owning stocks primarily as portfolio investments or for financial purposes, domestic investors are often business partners or commercial banks, both of which hold shares for the implicit purpose of business goodwill, information exchange, and mutual monitoring. Japanese investors typically fall under Aguilera and Jackson's (2003) category of investors with strategic interests as opposed to financial interests. In addition, the Japanese system considers employees as key firm stakeholders (Colpan *et al.*, 2011; Yoshimori, 1995).

With stakeholders concerned about long-term relationships, firms develop and implement strategies based on long-term goals, seeking to maximize mostly market share and growth rather than short-term profits or share price. In this respect,

Deakin (2010/2011) argues that most large Japanese firms are run on a variant of the “community firm” system in which executives see themselves as having a commitment to maintain the company as an entity in its own right, and view their obligations to customers and employees, present and future, as taking priority over those owed to shareholders. While shareholders have the power to replace directors with a majority vote and can initiate litigation against directors, in practice, Japanese shareholders rarely exercise these rights.

The Japanese board of directors, like its U.S. counterpart, is vested with authority to make strategic decisions and monitor corporate activity. However, Japanese boards have traditionally put little emphasis on their monitoring role (Aoki, Jackson, and Miyajima, 2007; Gilson and Milhaupt, 2005). In part, this is because Japanese boards are often mainly composed of executives, former employees, and a small number of affiliated or related outsiders (Yoshikawa and McGuire, 2008). Since executive directors are viewed as a representative of employees, they lack incentives and capabilities to monitor top executives to enhance shareholder value (Kubo, 2005). Deakin (2010/2011) compares U.K. with Japanese boards and concludes that, in Japan, there is a belief that absence of deep knowledge of the company’s business makes it inappropriate for independent directors to make informed decisions concerning corporate strategy, justifying their limited monitoring role. Over the past decade, however, independent directors have become more prevalent in Japanese boardrooms. Yoshikawa and McGuire (2008) state that there is a possible evolution in the board’s role, given changing ownership pressures. Directors have a term of two years in firms that use the corporate auditor system, while this is one year for firms that adopted the committee system, but they may serve any number of consecutive terms if re-elected.

The limited presence of independent directors, however, does not equate to monitoring being nonexistent. Instead, main banks, as well as affiliated business partners and product markets, play a significant monitoring role (Aoki and Patrick, 1994; Kaplan and Minton, 1994). In addition to monitoring by these relational stakeholders, there is strong peer-based monitoring, with senior executives monitoring each other throughout their careers. For example, CEOs are typically company insiders whose entire careers have been spent climbing the corporate ladder. Retired executives also bear

a key role in monitoring, often through informal channels (Deakin, 2010/2011). Therefore, the bundle of governance mechanisms used by domestic owners reflects their governance logic where monitoring by independent directors is not fundamental to the protection of their interests.

The audit of financial statements by an external (or accounting) auditor (*kaikeikanshinin*) is mandatory for all listed firms, and is equivalent to external auditors elsewhere. The financial statement audit was formally introduced in Japan in 1957 and is based upon U.S. standards and practice. In Japan, as in most other countries, the board proposes the external auditors, and they are appointed at the general shareholders’ meeting. A series of reforms in early 2000s made it mandatory for external auditors to declare whether a client faces a serious risk of going bankrupt within a year, and, more importantly, auditors could be sued if found to have misled shareholders.

The rising influence of foreign investors in Japan occurred concurrently to a decline in the banking system that supported stakeholder systems, caused by the banking crisis and, to a smaller extent, the 1997 Asian financial crisis. These events led financial institutions to sell off large proportions of their shareholdings (Ahmadjian and Robbins, 2005; Hoshi and Kashyap, 2004). As a result, the presence of foreign shareholders sharply rose in the late 1990s, and foreign investors, with very different incentives, replaced domestic shareholders who were more tightly bound to the stakeholder system. U.S. and U.K. investors, mainly institutional investors, jointly constitute around 70 percent of all foreign equity investments in Japan over the last 15 years (Bank of Japan, 1996–2012). Foreign investors tend to hold small stakes at individual levels, and they rarely appear as strategic investors.

## THEORETICAL FRAMEWORK AND HYPOTHESES

Corporate governance represents an interrelated system in which some practices will be effective and relevant only in certain combinations, leading to different patterns of CG (Aguilera *et al.*, 2008). We establish that the heterogeneity in shareholders’ logic and interests and their relative strength within the organization is important to understand the influence of different types of owners over existing governance arrangements, as well as

the emergence of hybrid bundles of governance practices. Within an organization, there are different groups with diverse interests and value perception, which represent and import into an organization the logics to which they have been primarily exposed (Greenwood *et al.*, 2011). While monitoring and contingency compensation are commonly used in shareholder-oriented systems to alleviate the agency problem, a different set of mechanisms is used by domestic owners in a stakeholder-oriented system, which is specific to their agency problems. As a consequence, the bundle of governance mechanisms employed by domestic shareholders in a stakeholder-oriented setting is unlikely to solve the agency problems faced by shareholder-oriented foreign owners. In this vein, we adopt a contingency approach to examine how shareholder-oriented foreign investors protect their interests in a stakeholder context, focusing on whether (and when) foreign ownership activates board monitoring behavior. Our theoretical arguments draw mainly on agency theory and on the resource dependence notion that boards have distinct incentives and abilities to monitor management.

The monitoring role of boards has been the focus of extensive CG research (e.g., Adams, Hermalin, and Weisbach, 2010). Agency theorists argue that an impartial assessment of managers will occur more readily if directors are independent from management (Hillman and Dalziel, 2003), and as a consequence board independence has often been used as a direct measure of board monitoring (Adams *et al.*, 2010). Since executive directors report to the CEO, they will be less likely to perform comprehensive monitoring tasks. Moreover, because independent directors are not part of the organization's management team, they are less subject to the same potential conflicts of interest that are likely to affect the judgments of executive directors (Kosnik, 1987). Following this line of reasoning, prior research has highlighted the insufficient representation of independent directors as a possible explanation for boards' failure to fulfill their monitoring role (e.g., Finkelstein and Hambrick, 1996). However, critics of the agency theory perspective have pointed out its "under-contextualized" nature and, hence, its inability to explain the diversity of governance arrangements across institutional contexts (Aguilera and Jackson, 2003).

We draw on Hillman and Dalziel (2003) as they push the agency theory logic further by bringing in a resource dependence component to propose

a more comprehensive view of board activities. Specifically, they suggest that, rather than assuming that two boards with an identical proportion of independent directors will grant equal monitoring effectiveness, it is critical to realize that these independent directors might have different incentives as well as abilities to monitor. In addition, some independent directors may focus less on the monitoring role and more on the advisory role, which reduces both their incentives and ability to monitor. Similarly, Deutsch, Keil, and Laamanen (2011) note that independent directors should be understood as agents in their own right, with their own individual motivations as board members. Following this line of research, we argue that the primary role of independent directors is defined by the context in which the company is embedded. While the monitoring role of independent directors is strongly emphasized in shareholder-oriented CG systems, in a stakeholder-oriented setting, like Japan, the monitoring role has traditionally not been stressed, and as a consequence, higher ratios of board independence do not necessarily correspond with higher monitoring effort. To capture board monitoring, and in line with Desender *et al.* (2013), we focus on the effects of independent directors on the amount of external audit fees (a board action) rather than on the level of independent directors (board structure).

Our conceptualization of board monitoring behavior builds on an extensive body of research in the managerial accounting and audit field that discusses the effect of board independence on external audit fees suggesting that, if independent directors engage in monitoring, this effect could be either negative or positive (e.g., Carcello *et al.*, 2002; Cohen *et al.*, 2007; Hay, Knechel, and Ling, 2008). First, a negative relationship is expected if independent directors take an active role in improving the design of internal controls and internal governance in general. To the extent that independent directors share information with the auditor about the board's effort to improve the firm's internal controls and overall reliability of financial reporting, the external auditor's greater reliance on internal controls results in less substantive audit testing and, hence, a lower audit fee (Cohen *et al.*, 2007; Collier and Gregory, 1996). Second, a positive relation is expected if independent directors, instead of actively improving internal controls and overall reliability of financial reporting, ask for more information from management and share their concerns about internal control weaknesses

and other accounting issues as well as their desire for a better and more thorough auditing with the auditor. This information may lead the auditor to increase the amount of audit evidence and hence the audit fees. Furthermore, independent directors' commitment to oversight may also signal to the auditor that the expectations placed on the external audit are high. This second line of reasoning is generally supported by empirical evidence in the Anglo-American context (Abbott *et al.*, 2003; Carcello *et al.*, 2002; Hay *et al.*, 2008).

In a stakeholder-oriented setting, like Japan, the possibility of a negative effect of board independence on audit fees is less likely since the monitoring role of independent directors has, traditionally, not been emphasized, and independent directors have, most likely, limited influence to enforce major changes in the internal organization of accounting controls. However, while one or two independent directors may not have enough power over a board decision that would require majority voting, even a small number of independent directors may have an influence on the auditor's perception regarding the quality of the internal control system and the overall reliability of financial reporting. This makes the information exchange with auditors a feasible and effective mechanism available to independent directors to enhance the protection of shareholder rights. Therefore, in a stakeholder-oriented setting, if independent directors engage in monitoring, we expect to find a positive significant effect of board independence on audit fees, in line with previous literature (e.g., Abbott *et al.*, 2003; Carcello *et al.*, 2002). In contrast, a nonsignificant relationship would suggest no monitoring behavior by independent directors, i.e., they do not strengthen the internal control environment, nor do they provide relevant information about internal control weakness or other accounting issues that would influence the audit scope, and in turn impact the audit fee. To test the occurrence of board monitoring behavior in a stakeholder-oriented setting, we establish our baseline hypothesis as follows:

*Hypothesis 1: Board independence increases external audit fees.*

We contend that the relationship between independent directors and audit fees (i.e., board monitoring) is contingent on the level of foreign ownership. In particular, when foreign ownership is

low, we would not expect the relationship between board independence and the amount of audit fees to be significant, because the monitoring role of independent directors has not been emphasized by domestic owners, as they rely on other mechanisms to protect their interests. Yet, when foreign ownership is high, we argue that the relationship between independent directors and audit fees becomes critical, as foreign investors seek to protect their investment and exert pressure on independent directors to perform a monitoring role. Thus, independent directors in those firms may serve a monitoring role as there is a greater expectation from their monitoring.

There are three factors that explain this activation of the monitoring role of independent directors with the relevant presence of foreign investors. First, the conflict of interest and asymmetry of information between the (Japanese) management and the foreign investors are magnified by geographical distance and cross-national differences (Buckley, 1997). The divergence in objectives and risks between foreign and domestic shareholders, combined with the traditional informal governance practices employed by the domestic stakeholders, may force foreign investors to introduce CG practices that are closer to their own governance logic. Given the importance of board monitoring and active collaboration by independent directors with the external auditors in the shareholder-oriented context, foreign shareholders may put pressure on strengthening both the monitoring role of independent directors and their interaction with the external auditor above other governance practices. In this sense, the bundle of governance practices that works for domestic shareholders is unlikely to address the agency conflict that foreign owners face. In addition, the costs of auditing are shared between all shareholders while the benefits in terms of reduced information asymmetries may be reaped by foreign investors, rather than domestic owners who have access to other channels of information and control.

Second, foreign investors tend to hold, individually, a relatively small stake and rarely appear as strategic investors, which reduces their incentives of direct monitoring and their ability to introduce radical changes, such as the adoption of the board committee system. Moreover, radical governance changes may be met with strong resistance and, consequently, are difficult to implement. As a result, foreign investors need to rely on internal CG practices. Fostering the monitoring role of

independent directors and their interaction with the external auditor to express concerns about certain accounting issues or internal control weaknesses falls within the span of actions that foreign investors can adopt to protect their interests within a stakeholder-oriented governance system like Japan.

Third, foreign shareholders rely on both voice, through direct meetings with management, and exit strategies to make their interests clear (Ahmadjian and Robbins, 2005). For many years, foreign investors have pleaded for the regulatory adoption of a transparent process of external supervision of management through independent directors, in order to protect shareholders' interests (Gilson and Milhaupt, 2005). Hence, when foreign investors are important, there may be a greater expectation regarding the monitoring role of the board. Independent directors in those firms are likely to be aware of foreign shareholders' preferences for their more proactive monitoring role and may feel compelled to take steps to enhance shareholder protection (Colpan *et al.*, 2011). When foreign ownership is high, independent directors may also have higher incentives for monitoring to avoid replacement.

For firms with a low degree of foreign ownership, we do not expect independent directors to exhibit the same monitoring behavior for at least three reasons. First, domestic shareholders employ mainly informal channels to discipline managers and rely less on independent directors for monitoring. Therefore, in the presence of low foreign ownership, independent directors are less likely to feel pressure to exhibit monitoring behavior. In fact, asking more questions and sharing this information and their concerns with the external auditor could represent a shift from existing organizational routines and may receive strong resistance from insiders (Hannan and Freeman, 1984). Second, it is important to note that, unlike in the United States, litigation against directors is very low in Japan (Numato and Takeda, 2010). This further diminishes the independent directors' incentives to reduce their legal liability by monitoring and expressing accounting concerns with the external auditor. Third, while reputation concerns may be linked to monitoring in Anglo-American firms, in a setting where the institutional logic favors an active insider-oriented board and monitoring through relational shareholders and peers, the contribution of independent directors may be more appreciated as providers of resources, such as industry expertise or giving access to finance,

than as monitors overseeing general shareholders' interests. Taking these arguments together, *ex ante*, we would only expect to find a significant relationship between board independence and audit fees for firms in a stakeholder-oriented setting when foreign ownership is high. Therefore, we propose:

*Hypothesis 2: Board independence increases external audit fees more when foreign ownership is high than when foreign ownership is low or not present.*

The adoption of U.S.-inspired governance practices by Japanese firms represents a departure from organizational routines (Han *et al.*, 1998) and may receive strong resistance from inside actors (Hannan and Freeman, 1984), reducing the ability of foreign shareholders to introduce board monitoring behavior. The effect of foreign ownership is unlikely to be homogenous across all firms, and it is likely to be driven by factors that influence the ability and incentives of foreign owners to activate monitoring by independent directors. We first consider the relevance of large domestic owners as a constraining factor. In addition, we examine firm risk and performance, which have been identified as two key firm characteristics shaping board monitoring (Tuggle *et al.*, 2010; Zajac and Westphal, 1994).

Our theoretical framework posits that within an organization there are different groups with diverse interests and value perception, who have access to different governance mechanisms. The ability of foreign owners to introduce changes in board monitoring, therefore, depends upon the extent to which groups have an interest in proposed reforms and their capacity to either support or resist them. We argue that domestic owners in a stakeholder system may not share the interest of (shareholder-oriented) foreign owners as they rely on a governance bundle in which board monitoring does not play a prominent role, and the larger their ownership stake, the more likely that large domestic owners may limit foreign investors' influence over the monitoring role of the board. In this respect, Ahmadjian and Robbins (2005) find evidence that the impact of foreigners with respect to corporate restructuring was weaker in firms more deeply embedded in the local system, measured by the importance of domestic financial blockholders and corporate group ties. Therefore, we expect the influence of foreign ownership on monitoring by independent directors to be less strong in the presence of large domestic owners.

In terms of firm risk, high levels of uncertainty may widen information asymmetries between foreign owners and managers and enable opportunistic behavior. Zajac and Westphal (1994) develop and test a contingency cost/benefit perspective on governance decisions as resource allocation decisions, and identify how and why the observed levels of managerial incentives and monitoring may vary across organizations. Their findings suggest that riskier firms can accrue greater benefits from higher levels of board monitoring (relative to managerial incentives), and thus are likely to rely more on board monitoring. Following their logic, we argue that foreign investors may have greater incentives to monitor more closely their investment for firms with riskier operations, and we expect the influence of foreign ownership on board monitoring behavior to be stronger for riskier firms.

Poor past performance indicates the ineffectiveness of existing organizational practices, and thus provides strong and legitimate reasons for firms to initiate reform (Chizema and Shinozawa, 2011). Previous research suggests that firms with poor performance face less resistance to the adoption of new practices (Miller and Chen, 1994). In our setting, the ability of foreign owners to activate board monitoring behavior is likely to increase, as it represents a justifiable governance alternative that carries the potential for better performance. In addition, Tuggle *et al.* (2010) find that negative deviations from prior performance increase boards' attention to monitoring, while positive deviations from prior performance reduce it (for a sample of US listed firms). Underperformance could therefore affect the incentives and ability of foreign owners to enhance board monitoring. Considering these three contingency factors, we propose:

*Hypothesis 3: The influence of foreign ownership on board monitoring is stronger for firms (a) without large domestic owners, (b) with high risk, and (c) with poor performance.*

## DATA AND METHODS

To test our hypotheses, we consider all listed firms on the TSE for the 2006–2012 period—Japanese firms are only required to disclose external audit fees since March 2004. Financial firms are excluded because their accounts and audit process are significantly different. Our data comes from several

data sources. The governance and ownership structure data was manually collected from the companies' annual corporate governance reports on the TSE website, eliminating any bias related to measurement errors. We gathered audit data as well as all control variables from company financial statements and Thomson Reuters Worldscope. Our final sample contains 2,151 listed firms and 6,823 firm-year observations.

To test our hypotheses, we estimate panel data regressions extending the traditional audit fee model (Abbott *et al.*, 2003; Carcello *et al.*, 2002; Simunic, 1980). The factors activating board monitoring behavior can be modeled as follows:

$$y_{it} = \alpha_1 z_{it-1} + \beta_1 x_{it-1} + v_i, \quad (1)$$

where  $y_{it}$  is the total amount of audit fees,  $z_{it-1}$  is the vector of control variables,  $x_{it-1}$  represents our variables of interest, i.e., board independence and foreign ownership, and  $v_i$  is the vector of heteroskedastic-robust standard errors. All explanatory variables are lagged by one period to mitigate possible simultaneity. For our first hypothesis, we consider the individual effects of board independence on audit fee, while for our second hypothesis, we introduce and focus on the interaction term between board independence and foreign ownership. Finally, to test Hypotheses 3a–c, we split our sample using the median values of domestic owners, risk, and performance and compare the interaction effect between board independence and foreign ownership between the subsamples.

Our dependent variable, *Total audit fees*, is the natural log of audit fees, following prior studies on the relationship between corporate governance and audit services (Carcello *et al.*, 2002; Hay *et al.*, 2008). This variable represents the amount paid by the company for the professional examination and verification of the financial statements for the purpose of assessing their consistency, fairness, and conformation to accepted accounting principles.

We define *Board independence* as the proportion of outside board members (directors who have never served as executive director, executive officer, employee of the company or any of its subsidiaries, as reported in the companies' annual report) over the total board size, similar to previous studies (e.g., Carcello *et al.*, 2002; Hay, Knechel, and Wong, 2006). In addition, we also use a more conservative measure of board independence, taking advantage of the fact that since June 2006 the TSE requires

every listed company to prepare a report on corporate governance in which detailed disclosure of the relationship between an outside director and the company is mandatory. The TSE enumerates five categories (out of nine) of individuals who would not be considered truly independent: (1) directors related to the parent company, (2) directors related to other affiliated companies, (3) directors who are major shareholders, (4) directors who share a compensation relationship, or (5) directors who are relatives of executives. We went through every individual company's annual CG report and calculated the variable *Board independence (narrow)* as the proportion of outsiders who qualify as truly independent directors over the total number of directors.

*Foreign ownership* reflects the percentage of total outstanding shares held by non-Japanese investors. The TSE reports the degree of foreign ownership in four categories: between 0 and 10 percent, between 10 and 20 percent, between 20 and 30 percent, and more than 30 percent. We use two main measures of foreign ownership. First, we employ the four categories as defined by the TSE, which allows us to test for nonlinearity and possible cut-off points. Second, we are able to establish the cut-off point of 20 percent foreign ownership as a critical inflection point, and hence we use a dummy variable taking the value 1 if foreign ownership is at least 20 percent, and 0 otherwise. Moreover, we were able to corroborate that our measure of foreign ownership indeed captures institutional ownership from shareholder-oriented countries (United States and the U.K.).

We start estimating our model (1) using the generalized least squares (GLS) random effect (RE) technique with clustered standard errors by firm to account for within-firm error correlations, following the Baltagi and Wu (1999) procedure. This technique is robust to first-order autoregressive, AR(1), disturbances (if any) within unbalanced panels and to cross-sectional correlation and/or heteroskedasticity across panels. It also has a number of advantages over fixed effects (FE) estimations. First, FE estimation requires significant within-panel variation of the variable values to produce consistent and efficient estimates. Second, FE estimates may aggravate the problem of multicollinearity if solved with least squares dummy variables (Baltagi, 2005).

We were concerned that the issue of endogeneity, including omitted variables and simultaneity, could bias the results. Endogeneity problems related to measurement errors are less of a concern given that

our data is derived directly from the TSE. Our main issue is that foreign owners' investments are not random and could be related to an unobserved or uncontrolled factor. Although it is difficult to completely solve the endogeneity problem, we attempt to address this concern by (1) introducing adequate control variables, (2) estimating fixed effects regressions to account for heterogeneity induced by time-invariant factors and period effects, and (3) using instrumental variable techniques. We discuss each of them in turn below.

### Multiple controls

A commonly used strategy for reducing concerns about endogeneity is to saturate the regression with a large number of firm characteristics to capture as much of the error term as possible (Laeven and Levine, 2009). Following previous auditing literature, we control for a wide range of factors that could bias the relationship between our variables of interest:

#### *Log of total assets*

Larger companies are involved in a greater number of transactions that necessarily require longer hours for an auditor to inspect (Carcello *et al.*, 2002; Hay *et al.*, 2006). We capture firm size as the natural logarithm of total assets. Our results are robust to alternative measures of size based on sales or employees.

#### *Receivables and inventory/total assets*

The evaluation of accounts receivable and inventories is complex and requires more in-depth inspection, and therefore are considered risk categories in an audit. This variable is scaled by total assets and captures, partially, the complexity of the audit process (Hay *et al.*, 2006).

#### *Big 4 auditor*

Higher audit fees are expected when an audit firm is recognized to be of superior quality to other firms (Hay *et al.*, 2006). This variable takes the value 1 if the client firm is working with one of the "Big 4" auditors, i.e., AZSA & Co. (KPMG), Tohmatsu (Deloitte Touche), Aarata (PwC), and ShinNihon (Ernst & Young), and 0 otherwise.

*Long-term debt/total assets*

Total long-term debt divided by total assets is a common measure of firm leverage. Highly leveraged firms are more likely to fail, exposing the auditor to litigation risk, and hence are expected to be associated with higher fees (Simunic, 1980).

*Net income/total assets*

Lack of client profitability is considered a concern for the auditor because it reflects the extent to which the auditor may be exposed to loss in the event that a client is not financially viable (Simunic, 1980). To capture profitability, we focus on the return on assets, measured as net income over total assets.

*Industry and year*

We introduce industry (i.e., the 33 industrial sectors used by the TSE) and year dummy variables to control for industry and time effects.

**Fixed effects**

One limitation of adding control variables is that it is unlikely to effectively control for every relevant factor, in part because some variables are unobserved. Using fixed effects allows us to control for unobserved time-constant firm heterogeneity. In addition, we include dummies for the time periods in our FE estimator to control for endogeneity related to systemic shocks that lead to increases in audit fees in all firms. This approach permits us to assess whether time-constant unobserved heterogeneity or period effects are creating bias.

**Instrumental variables**

To further mitigate reverse causality concerns or potential correlated omitted variables issues and to increase confidence in the directionality of our results, we implement a two-stage feasible efficient generalized method of moments (GMM) estimation with validity-tested instruments. To this end, we define an instrumental variable (IV) that is correlated with foreign ownership, but is uncorrelated with the error term in regression 1. In the spirit of Laeven and Levine (2009), we generate an instrument by calculating the average level of foreign ownership (excluding the contribution of the focal firm) for each industrial sector-size

pair.<sup>2</sup> The intuition is that the level of foreign ownership of other firms within the same sector with a similar size is likely to influence a focal firm's foreign ownership, but is unlikely to affect its audit fees. In fact, previous research has shown that foreign ownership is linked to both industry and size (Kang and Stulz, 1997). Because the contribution to the level of foreign ownership by the focal firm is excluded, the instrument varies across firms.<sup>3</sup> For the interaction term between foreign ownership and board independence, once we verified that board independence can be treated as exogenous, we follow Wooldridge (2002) and multiply our instrument of foreign ownership with board independence to create a second instrument.

To ensure the validity of our instruments, we perform diagnostic checks. First, we check that the instruments are relevant (i.e., they are correlated with the included endogenous variables), using the *F*-statistic for joint significance of the instruments in the first-stage regression of each endogenous regressor on the instruments and on the remaining exogenous regressors. As a second diagnostic, we use the Shea's partial  $R^2$  in the first stage for each endogenous variable. The Shea's partial  $R^2$  records the additional explanatory power of the excluded instruments taking the intercorrelations of the instruments into account. We also test for underidentification and report the Kleibergen-Paap underidentification test (Kleibergen and Paap, 2006). Finally, we report a test of endogeneity (GMM *C*-statistic) for the instrumented variables, in order to check whether the variables presumed to be endogenous in our model could instead be treated as exogenous.

To test our Hypotheses 3a–c, we split our sample using the median values of the ownership stake by the largest domestic shareholder, firm risk, and poor performance, respectively, and estimate our model (using instrumental variables) for both subsamples. Splitting our sample avoids the introduction of new endogeneity problems, while the comparison between the subsamples enables us to contrast the strength of foreign ownership on monitoring

<sup>2</sup> We use 33 industrial sectors (following the TSE industry classification) and four categories of size (using the quartile cut-off points Q1-Q2-Q3), based on total assets.

<sup>3</sup> An additional issue with our data is the presence of heteroskedasticity. To address this issue, we specify a GMM option in our implementation to make efficient estimation, valid inference, and diagnostic testing, allowing for clustering the errors at the firm level.

by independent directors contingent on these key factors, which we measure as:

#### *Largest domestic shareholder*

We define this variable as the total stake of the largest domestic owner.

#### *Firm risk*

In line with Zajac and Westphal (1994) and Laeven and Levine (2009), we calculate firm risk as the annualized standard deviation of weekly equity returns.

#### *Poor performance*

We focus on the deviation from prior performance, captured as the current performance compared with the average of the prior two years' performance, following Tuggle *et al.* (2010) where performance is measured with return on assets.

## RESULTS

In this section, we first provide descriptive statistics of our data and we later test our proposed hypotheses. Table 1 gives an overview of the descriptive statistics for the most important variables used in this study as well as their correlations. The average audit fee for the entire sample is ¥33.8 million (\$400,000). Regarding foreign ownership, more than half of all firms have less than 10 percent foreign ownership, while about one quarter have more than 20 percent. Foreign portfolio investors are predominantly institutional ones from the United States and the U.K. that on average constituted 47.0 and 20.6 percent, respectively, of all foreign equity investments in Japan over the period 2006–2011 (Bank of Japan, 1996–2011). In terms of board composition, about 10 percent of the board members are outsiders (the average board size is 8.5), a finding that is substantially lower compared to Anglo-American or Continental European boards. Board independence grew steadily from 9.87 in 2006 to 11.87 in 2011. About half of all firms in our sample have a board with only insiders, while about 22 percent have one outside director. Regarding the contingency factors that we believe are likely to impact the influence of foreign ownership, the average stake of the largest domestic owner is about

20 percent, while the weekly stock return volatility is around 3 percent and the average change in profitability is around zero.

Both board independence and foreign ownership are positive and significantly correlated with audit fees. Furthermore, the correlation coefficients between audit fees and our control variables show the expected signs. In line with previous literature, the highest correlation coefficient is found for firm size. We test for possible multicollinearity considering our independent and control variables. The variance inflation factor gives a mean value of 1.40 and a maximum value of 1.53, indicating no multicollinearity problems.

Next, we discuss the multivariate analysis to test our three hypotheses. While Tables 2 and 3 test for a general effect of board independence on audit fees (Hypothesis 1) and whether board monitoring is activated in the presence of foreign ownership (Hypothesis 2), Table 4 examines under what conditions the influence of foreign ownership on board monitoring is strongest (Hypothesis 3). Table 2 presents the results obtained from the regression models with total audit fees as the dependent variable, when we consider board independence and the four categories of foreign ownership. Models 1–2 in Table 2 only include our control variables, with and without industry and year dummies, respectively, and explain a large proportion of the audit fee variance, confirming previous studies with Anglo-American data (e.g., Abbott *et al.*, 2003; Carcello *et al.*, 2002). In these models, firm size, receivables and inventory, long-term debt over total assets, and the presence of a Big 4 auditor are significantly associated with higher audit fees, while net income is not significantly related to audit fees, once we account for industry and year effects.

We next discuss Models 3–5 in Table 2, considering the influence of board independence and foreign ownership on audit fees. The specification of Model 3 adds board independence and foreign ownership to our model with controls. On the one hand, the coefficients of foreign ownership reveal that audit fees in firms with more than 30 percent of foreign ownership are significantly larger than audit fees in firms with less than 10 percent of foreign ownership, while intermediate levels are not significantly different from firms with very low levels of foreign ownership. On the other hand, the coefficient of board independence is positive and significant, in line with our Hypothesis 1. However, it is important to understand whether this direct positive effect

Table 1. Descriptive statistics and correlations

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1. Audit fees (Log)	3.860	0.894	1.000														
2. Board independence	0.100	0.140	0.188 <sup>+</sup>	1.000													
3. Foreign ownership: 0–10%	0.511	0.500	-0.309 <sup>+</sup>	-0.109 <sup>+</sup>	1.000												
4. Foreign ownership: 10–20%	0.252	0.434	0.073 <sup>+</sup>	-0.015	-0.498 <sup>+</sup>	1.000											
5. Foreign ownership: 20–30%	0.148	0.355	0.183 <sup>+</sup>	0.057 <sup>+</sup>	-0.346 <sup>+</sup>	-0.159 <sup>+</sup>	1.000										
6. Foreign ownership >30%	0.089	0.285	0.269 <sup>+</sup>	0.156 <sup>+</sup>	-0.281 <sup>+</sup>	-0.129 <sup>+</sup>	-0.090 <sup>+</sup>	1.000									
7. Foreign ownership >20%	0.237	0.425	0.336 <sup>+</sup>	0.152 <sup>+</sup>	-0.466 <sup>+</sup>	-0.214 <sup>+</sup>	0.741 <sup>+</sup>	0.602 <sup>+</sup>	1.000								
8. Foreign ownership >20% × board independence	0.033	0.097	0.278 <sup>+</sup>	0.553 <sup>+</sup>	-0.337 <sup>+</sup>	-0.192 <sup>+</sup>	0.389 <sup>+</sup>	0.399 <sup>+</sup>	0.593 <sup>+</sup>	1.000							
9. Log of total assets	18.394	1.489	0.645 <sup>+</sup>	0.008	-0.368 <sup>+</sup>	0.184 <sup>+</sup>	0.238 <sup>+</sup>	0.358 <sup>+</sup>	0.248 <sup>+</sup>	0.273 <sup>+</sup>	1.000						
10. Receivables and inventory/total assets	0.336	0.170	-0.074 <sup>+</sup>	-0.093 <sup>+</sup>	0.056 <sup>+</sup>	0.014	-0.034 <sup>+</sup>	-0.068 <sup>+</sup>	-0.061 <sup>+</sup>	-0.073 <sup>+</sup>	-0.007	1.000					
11. Big 4 auditor	0.825	0.380	0.227 <sup>+</sup>	0.057 <sup>+</sup>	-0.115 <sup>+</sup>	0.074 <sup>+</sup>	0.062 <sup>+</sup>	0.077 <sup>+</sup>	0.041 <sup>+</sup>	0.095 <sup>+</sup>	0.205 <sup>+</sup>	-0.032 <sup>+</sup>	1.000				
12. Long-term debt/total assets	0.102	0.117	0.244 <sup>+</sup>	0.032 <sup>+</sup>	-0.011	-0.004	0.022 <sup>+</sup>	0.008	-0.014	0.051 <sup>+</sup>	0.182 <sup>+</sup>	-0.275 <sup>+</sup>	-0.024 <sup>+</sup>	1.000			
13. Net income/total assets	0.055	0.064	-0.090 <sup>+</sup>	-0.02 <sup>*</sup>	-0.153 <sup>+</sup>	0.057 <sup>+</sup>	0.052 <sup>+</sup>	0.087 <sup>+</sup>	0.066 <sup>+</sup>	0.111 <sup>+</sup>	-0.032 <sup>+</sup>	-0.030 <sup>+</sup>	0.156 <sup>+</sup>	-0.125 <sup>+</sup>	1.000		
14. Largest domestic owner	0.201	0.157	-0.148 <sup>+</sup>	0.075 <sup>+</sup>	0.089 <sup>+</sup>	-0.026 <sup>*</sup>	-0.063 <sup>+</sup>	-0.035 <sup>+</sup>	-0.077 <sup>+</sup>	-0.038 <sup>+</sup>	-0.235 <sup>+</sup>	-0.061 <sup>+</sup>	-0.012	-0.087 <sup>+</sup>	0.105 <sup>+</sup>	1.000	
15. Firm risk	0.032	0.022	0.221 <sup>+</sup>	0.071 <sup>+</sup>	-0.242 <sup>+</sup>	0.093 <sup>+</sup>	0.110 <sup>+</sup>	0.143 <sup>+</sup>	0.188 <sup>+</sup>	0.135 <sup>+</sup>	0.201 <sup>+</sup>	0.214	0.023	0.093 <sup>+</sup>	0.108 <sup>+</sup>	-0.035 <sup>+</sup>	1.000
16. Poor performance	-0.003	0.068	-0.009	0.034 <sup>+</sup>	0.012	-0.019	-0.001	0.009	0.006	0.007	-0.014	0.040 <sup>+</sup>	-0.018	-0.013	0.365 <sup>+</sup>	0.010	-0.007

N = 6,823

+significant at 0.01 percent; \*significant at 0.05 percent

Table 2. Results of regression analyses considering four levels of foreign ownership

Dependent variable: audit fees	GLS RE Model 1	GLS RE Model 2	GLS RE Model 3	GLS RE Model 4	GLS FE Model 5
Board independence			0.217*** (0.072)	0.098 (0.080)	0.135 (0.114)
Foreign ownership: 10–20%			0.020 (0.020)	0.016 (0.024)	0.018 (0.0247)
Foreign ownership: 20–30%			0.031 (0.031)	−0.0102 (0.039)	−0.011 (0.035)
Foreign ownership >30%			0.086* (0.044)	0.041 (0.048)	−0.002 (0.049)
Foreign ownership 10–20% × board independence				0.035 (0.131)	0.057 (0.136)
Foreign ownership 20–30% × board independence				0.338** (0.163)	0.297** (0.153)
Foreign ownership >30% × board independence				0.398** (0.174)	0.357** (0.181)
Log of total assets	0.363*** (0.009)	0.407*** (0.013)	0.398*** (0.014)	0.398*** (0.014)	0.201*** (0.034)
Receivables and inventory/total assets	0.218*** (0.083)	0.175** (0.087)	0.204** (0.088)	0.205** (0.078)	0.186 (0.126)
Big 4 auditor	0.342*** (0.030)	0.272*** (0.028)	0.271*** (0.028)	0.270*** (0.029)	0.278 (0.192)
Long-term debt/total assets	0.540*** (0.142)	0.421*** (0.119)	0.448*** (0.108)	0.436*** (0.107)	0.369*** (0.129)
Net income/total assets	−1.343*** (0.169)	−0.180 (0.145)	−0.236 (0.148)	−0.229 (0.147)	−0.079 (0.130)
Constant	−3.009*** (0.258)	−5.201*** (0.287)	−5.033*** (0.294)	−5.014*** (0.295)	−0.669 (0.632)
Year dummies	No	Yes	Yes	Yes	Yes
Industry dummies	No	Yes	Yes	Yes	No
Firm dummies	No	No	No	No	Yes
R <sup>2</sup> - within	0.0260	0.4443	0.4392	0.4397	0.4444
R <sup>2</sup> - between	0.6063	0.7173	0.7206	0.7215	0.6163
R <sup>2</sup> - overall	0.4841	0.6686	0.6609	0.6618	0.5446

N = 6,823

\*\*\**p* < 0.01; \*\**p* < 0.05; \**p* < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

holds across all firms, or whether it is driven by the subsample of firms with higher levels of foreign ownership (as suggested by our Hypothesis 2). We explore this issue in Model 4.

Model 4 in Table 2 uncovers whether board monitoring behavior is only present when the level of foreign ownership is high, by introducing the interaction term between board independence and our four categories of foreign ownership. Interestingly, now the coefficient of board independence becomes nonsignificant, suggesting that the general effect of board independence disappears when introducing the interaction terms. Thus, our results demonstrate that adding independent directors does not lead to more monitoring as a general rule. In line

with our Hypothesis 2, the coefficient of the interaction terms is significant only when foreign ownership is relatively high, lending support to the idea that board monitoring behavior is contingent on the level of foreign ownership. Specifically, we find evidence that independent directors play a monitoring role only when the level of foreign ownership is above 20 percent. Our results show that, for firms with low levels of foreign ownership, independent directors do not influence the audit fees. Finally, the coefficients of foreign ownership are not significant, which is consistent with the idea that foreign shareholders do not interact directly with external auditors but, instead, focus on changing board monitoring.

Table 3. Results of regression analyses considering two levels of foreign ownership

Dependent variable: audit fees	GLS RE Model 6	GLS FE Model 7	IV -second stage Model 8
Board independence	0.115 (0.083)	0.109 (0.101)	0.120 (0.084)
Foreign ownership >20%	-0.015 (0.033)	-0.030 (0.027)	0.064 (0.077)
Foreign ownership >20% × board independence	0.328** (0.152)	0.293** (0.128)	1.084*** (0.229)
Log of total assets	0.404*** (0.013)	0.206*** (0.034)	0.414*** (0.062)
Receivables and inventory/total assets	0.198** (0.088)	0.183 (0.126)	0.216*** (0.062)
Big 4 auditor	0.270*** (0.028)	0.285 (0.192)	0.267*** (0.017)
Long-term debt/total assets	0.424*** (0.101)	0.366*** (0.129)	0.489*** (0.082)
Net income/total assets	-0.206 (0.146)	-0.073 (0.130)	-0.311* (0.166)
Constant	-5.111*** (0.288)	-0.669 (0.632)	-5.199*** (0.282)
Year dummies	Yes	Yes	Yes
Industry dummies	Yes	No	Yes
Firm dummies	No	Yes	No
R <sup>2</sup> - within	0.4396	0.4442	
R <sup>2</sup> - between	0.7208	0.6130	
R <sup>2</sup> - overall	0.6612	0.5430	
Centered R <sup>2</sup>			0.6619
Kleibergen-Paap rk Wald <i>F</i> -statistic (weak identification test)			29.764***
<i>F</i> -statistic - foreign ownership >20%			45.763***
<i>F</i> -statistic - foreign ownership >20% × board independence			15.754***
Shea's partial R <sup>2</sup> - foreign ownership >20%			0.1617
Shea's partial R <sup>2</sup> - foreign ownership >20% × board independence			0.3197
Kleibergen-Paap rk <i>LM</i> statistic (underidentification test)			59.488***
Test of endogeneity (GMM <i>C</i> -statistic)			11.542***

$N = 6,823$

\*\*\* $p < 0.01$ ; \*\* $p < 0.05$ ; \* $p < 0.10$ , based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

Model 5 in Table 2 employs a FE estimation with time fixed effects, and yields very similar results, demonstrating that board monitoring only occurs when foreign ownership is above 20 percent, while no such behavior is observed for lower levels of foreign ownership. Our results show a very similar effect of foreign ownership for the two top categories using both random and fixed effects estimations, which justifies a 20 percent cut-off point. For the following analyses, we use below and above 20 percent to account for foreign ownership.

Models 6 and 7 in Table 3 consider only two categories of foreign ownership, and the results for both GLS RE and GLS FE are consistent. In addition, both estimations support our cut-off point at 20 percent. Again, board independence is only

significantly related to audit fees when foreign ownership is high, while the coefficients of board independence and foreign ownership are not significant when foreign ownership is below 20 percent.

To mitigate additional endogeneity concerns or correlated omitted variables issues, and to increase confidence in the directionality of our results, Model 8 in Table 3 presents the results of the second stage regression using instrumental variables. For our data, the model is uniquely identified. The *F*-statistic and Shea's partial *R*-squared, obtained from the first-stage regressions, are high, indicating that the instruments are relevant and strong.<sup>4</sup>

<sup>4</sup> The tables of the first-stage regressions are available upon request.

Table 4. Results of regression analyses considering contingencies (IV second-stage results)

Dependent variable: audit fees	SH1 domestic <sup>a</sup>		SH1 domestic <sup>a</sup>		Firm risk <sup>a</sup>		Performance <sup>a</sup>	
	<median Model 9	>median Model 10	<median Model 11	>median Model 12	<median Model 13	>median Model 14		
Board independence	-0.034 (0.179)	0.147 (0.096)	0.072 (0.152)	0.167 (0.147)	-0.078 (0.137)	0.064 (0.141)		
Foreign ownership >20%	0.026 (0.149)	0.054 (0.074)	0.072 (0.134)	-0.017 (0.107)	-0.058 (0.127)	-0.052 (0.120)		
Foreign ownership >20% × board independence	1.370*** (0.391)	0.645*** (0.217)	1.153*** (0.317)	0.592** (0.277)	1.634*** (0.424)	0.751** (0.361)		
Log of total assets	0.462*** (0.025)	0.348*** (0.013)	0.414*** (0.024)	0.380*** (0.020)	0.418*** (0.020)	0.425*** (0.024)		
Receivables and inventory/total assets	0.250** (0.104)	0.281*** (0.064)	0.358*** (0.112)	0.325*** (0.092)	0.409*** (0.094)	0.303*** (0.105)		
Big 4 auditor	0.267*** (0.023)	0.273*** (0.021)	0.283*** (0.028)	0.251*** (0.021)	0.223*** (0.024)	0.314*** (0.025)		
Long-term debt/total assets	0.438*** (0.155)	0.301*** (0.102)	0.301** (0.142)	0.597*** (0.121)	0.268** (0.102)	0.655*** (0.152)		
Net income/total assets	-0.429 (0.280)	-0.074 (0.190)	-0.221 (0.278)	-0.528** (0.268)	-0.744 (0.457)	-0.091 (0.141)		
Constant	-6.078*** (0.524)	-4.561*** (0.327)	-3.805*** (0.417)	-4.579*** (0.427)	-5.227*** (0.425)	-5.049*** (0.489)		
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes		
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes		
N observations	3,253	3,291	3,155	3,291	3,287	3,257		
Centered R <sup>2</sup>	0.6750	0.6619	0.6790	0.6587	0.46115	0.56205		
Kleibergen-Paap rk Wald F-statistic (weak identification test)	23.147***	29.243***	23.147***	26.854***	27.582***	23.658***		
F-statistic - foreign ownership >20%	44.126***	45.253***	44.289***	44.926***	46.024***	45.475***		
F-statistic - foreign ownership >20% × board independence	14.854***	15.125***	14.712***	14.787***	15.985***	15.689***		
Shea's partial R <sup>2</sup> - foreign ownership >20%	0.1575	0.1421	0.1625	0.1383	0.1720	0.1469		
Shea's partial R <sup>2</sup> - foreign ownership >20% × board independence	0.3298	0.2894	0.3142	0.3159	0.3273	0.3151		
Kleibergen-Paap rk LM (underidentification test)	54.113***	54.256***	54.113***	55.128***	61.345***	53.654***		
Test of endogeneity (GMM C-statistic)	14.452***	15.582***	13.245***	17.125***	14.256***	16.215***		

<sup>a</sup>SH1 domestic is measured as the total shareholdings by the largest domestic shareholder, firm risk is the annualized standard deviation of weekly equity returns, and performance is the deviation from prior performance, captured as the current ROA compared with the average of the prior two years' ROA.

\*\*\*p < 0.01; \*\*p < 0.05; \*p < 0.10, based on two-tailed tests, robust standard errors, clustered at the firm level in parentheses. All independent variables are lagged by one term.

Finally, we also report a test of endogeneity for the instrumented variables, which confirms that the variable presumed to be endogenous in our model cannot be treated as exogenous. From the IV estimates in Model 8, in Table 3, we see that the coefficients of the interaction term are positive and significant at the 1 percent level, with even larger magnitudes than the coefficient estimates from the GLS RE or FE regressions. Thus, the effect of foreign ownership on the board independence-audit fee relationship remains and is, in fact, strengthened after addressing the potential endogeneity problem. These results provide strong evidence to our Hypothesis 2 suggesting that the monitoring role of independent directors is only activated when foreign ownership is high (above 20%). Moreover, such monitoring behavior is absent when foreign ownership is low, as the coefficient of board independence is not significant. In economic terms, an increase in board independence by one standard deviation will lead to a 15 percent higher audit fee when foreign ownership is high, while a similar increase will have no effect on audit fees when foreign ownership is low. Finally, our results reveal no significant effect of foreign ownership on audit fees, which is consistent with the idea that foreign investors change the monitoring dynamics of the board, rather than interacting directly with the external auditor. Overall, our findings give strong support to our argument that foreign owners are likely to change board monitoring in foreign-held firms to resemble those of their home-based CG system.

In Table 4, we test our Hypotheses 3a–c, in which we argue that the influence of foreign ownership on board monitoring is unlikely to be homogenous across firms. We focus on three main firm characteristics providing additional depth to our analysis. First, we examine the influence of domestic ownership concentration as a key potential deterrent of changes in board monitoring. Our results, using instrumental variables, in Table 4 (Models 9 and 10) provide support for our hypothesis that the effect of foreign ownership on board monitoring is lower in firms with large domestic owners. While the overall effect of foreign ownership on board monitoring remains in both subsamples, the effect is stronger in the absence of large domestic owners, compared to when large domestic owners are present. Next, we focus on two key firm characteristics that could impact the incentives or ability of foreign ownership to activate board monitoring: firm risk and performance. Again, we split our sample in two,

i.e., above and below the median value of firm risk (Models 11 and 12) and firm performance (Models 13 and 14), respectively. Our results show that the influence of foreign ownership on monitoring by independent directors is especially strong in firms with above-median risk and below-median performance. These results lend support to the idea that a higher level of risk increases foreign owners' incentive to activate board monitoring, while a low level of performance increases their ability and incentives to introduce changes in the monitoring role of the board.

### Robustness tests

We conduct a series of robustness tests. As a robustness test with respect to our instruments, we use the 1997 Asian crisis as an exogenous event that led, in part, to the fast increase of foreign ownership in Japan. After the banking crisis, and particularly as of 1999, banks offset their losses by realizing capital gains on long-held stocks (Hoshi and Kashyap, 2004), reducing shareholding mainly by selling firms with high market valuations (Miyajima and Kuroki, 2007). In line with these findings, we use the accounting and stock market performance over the period 1997–1998 as alternative instruments that explain the level of foreign ownership, and we find consistent results for both alternative instruments. Our results also hold for longer time periods, to account for both the banking and the 1997 Asian crisis.

We next look for alternative explanations of our results. First, we examine the alternative hypothesis that our results could be driven by higher levels of independent directors in firms with a high level of foreign ownership, i.e., that foreign owners enhance board monitoring by adding independent directors to the board, rather than enhancing monitoring. Using the same control variables to explain audit fees, we have changed our dependent variable to board independence, and we are particularly interested in the effect of foreign ownership. Our results do not reveal a significant relationship between foreign ownership and board independence. In addition, we test for possible endogeneity between board independence and audit fees, and corroborate that board independence is exogenous and that it is not determined by audit fees.

In order to address the potential concern that our results could be driven by a too-broad definition of independent directors, we have constructed

a narrower definition of independent directors. We have gone through every firm's corporate governance report issued for our sample period to identify the proportion of independent directors that may not be truly independent—i.e., we excluded independent directors who fall into one of the five TSE categories not considered truly independent. In line with our previous results, we do not find that foreign ownership explains the level of board independence (narrow), after controlling for other factors. More importantly, our findings corroborate that the monitoring behavior of independent directors, narrowly defined, is only present in firms with a large stake of foreign ownership. This finding holds when using random and fixed effects models and when using instrumental variables.

We have replicated our analyses eliminating all firms that adopted the board committee system (removing 126 observations, out of 6,767). While even for these firms it is not mandatory to have the majority of the board be outside directors, the three committees must have a majority of outside directors, which raises the level of board independence indirectly. Our results are unaffected in all specifications when removing these observations.

Finally, our results on the relative influence of foreign ownership on board monitoring are robust to alternative cut-off points and alternative definitions of domestic ownership concentration, firm risk, and performance.

## DISCUSSION

This paper espouses the view that the effectiveness of corporate governance practices must be examined in light of the institutional context, as well as the ownership composition of the firm. Drawing on a contingency approach, which conceptualizes corporate governance as a system of interrelated elements having strategic and institutional complementarities, we explore how CG dynamics change, when shareholder-oriented foreign owners, with distinct objectives and preferred governance practices, coexist with (stakeholder-oriented) domestic shareholders, who rely on a different set of governance practices. We contend that board monitoring depends on the composition of shareholders as well as the heterogeneity of the shareholders' objectives and influence over governance practices.

When investors from a shareholder system invest in a stakeholder system, we argue that their

interests clash with the stakeholder logic. Because monitoring channels used by domestic stakeholders may be unavailable or insufficient for foreign investors, they seek to protect their investment by introducing corporate governance practices common in the Anglo-American context within the existing stakeholder CG context. In particular, we analyze differences in board monitoring behavior, which we capture as the effect of board independence on external audit fees. We claim that the monitoring behavior of independent directors will be contingent on the degree of foreign ownership. When foreign ownership is high, we expect that independent directors will have greater incentives to protect shareholders' interests by monitoring and communicating concerns about internal control weaknesses and other accounting issues to external auditors. This exchange will broaden the audit scope and will result in higher audit fees. In contrast, independent directors in firms with a low proportion of foreign ownership will not show the same monitoring behavior.

Using a large sample of Japanese listed firms, our findings support our claims by demonstrating that monitoring behavior of independent directors is contingent on the level of foreign ownership. We are able to demonstrate that foreign shareholders can change board monitoring dynamics when they reach a critical mass. Our findings also uncover that the influence of foreign ownership on board monitoring is stronger in the absence of large domestic owners, when firm risk is higher, and when firms become less profitable. To deal with endogeneity concerns, we use fixed effects regression and instrumental variables and find consistent results. We also conduct additional tests to rule out alternative explanations.

Our research offers critical insights for the comparative corporate governance and strategic management literature in several ways. First, we extend Rediker and Seth's (1995) concept of governance bundles from a single decision-maker perspective to a setting where multiple shareholders influence a (partial) set of practices embedded in an existing system, demonstrating the relevance of foreign ownership as a key contingency in understanding boards' monitoring role. In this sense, our analysis also expands on Hillman and Dalziel's (2003) framework on monitoring effectiveness, as our findings demonstrate that exploring the nature of ownership allows for a better understanding of both directors' incentives and ability to monitor

top management. We argue that it is important to recognize that the existing bundle of governance mechanisms designed to protect domestic owners' interest is unlikely to be equally effective for foreign investors, and, as a result, they want to introduce additional governance practices. Our findings uncover the possibility of hybrid systems, in which Japanese corporations with a high degree of foreign ownership combine elements common to both the Japanese CG context, e.g., a board with a majority of inside directors, and the Anglo-American context, e.g., monitoring by independent directors. As such, we provide new insights on the substitute/complementary nature of CG practices.

Second, our results make an important contribution to debates on globalization and convergence of CG systems, by showing how foreign investors are a channel through which convergence occurs. Our analysis reveals that convergence happens within the boundaries of the existing corporate governance system, as change in board monitoring behavior is still at work, even when the vast majority of Japanese firms did not make the switch to the committee system common in the shareholder CG model. Our study also adds to the comparative CG literature and the call by Aguilera, Desender, and Kabbach de Castro (2011) to shift our conceptualization of governance systems beyond the dichotomous world of common law/shareholder-oriented system vs. civil law/stakeholder-oriented system. If foreign ownership is able to shape CG bundles, it is difficult to continue to equate firm nationality with governance systems.

Third, prior studies on the influence of foreign ownership have mainly focused on outcomes, rather than processes (e.g., Ahmadjian and Robbins, 2005; Ahmadjian and Robinson, 2001; David *et al.*, 2006; Yoshikawa *et al.*, 2005). Our study contributes to a better understanding of the mechanisms through which foreign ownership influences local organizational practices. Considering Japanese listed firms also allows for an exploration of the external validity of the link between board independence and audit fees in a stakeholder-oriented environment.

Our research also has implications for policymakers and in particular for the CG reforms undertaken following the recent Japanese and worldwide accounting scandals. Our findings speak to the fact that universalistic policy prescriptions merely focusing on enhancing board independence may not lead to better monitoring of management in general. While it may be a necessary condition,

we uncover that it is not a sufficient condition to enhance board monitoring. In practical terms, efforts could focus on greater information access to strengthen monitoring processes and greater emphasis on the role of independent directors and board monitoring, through the establishment of a corporate code of best practice combined with a "comply or explain" requirement for listed companies. Recognizing the diversity of governance needs among Japanese listed companies could enable the development of a "mixed" or "hybrid" model that incorporates a greater element of management supervision into Japan's traditional corporate structure.

Our research also opens interesting venues for future research. First, it would be worthwhile to investigate the influence of foreign ownership on other aspects of corporate governance bundles. For example, since June 2010, Japanese firms are required to disclose compensation details for executives and board members who receive more than ¥100 million (about \$1.1 million). This disclosure requirement opens possibilities to evaluate how foreign ownership might influence the design of compensation packages. In addition, it would be intriguing to examine whether practices introduced by foreign investors create spillover effects, over time, in firms without large levels of foreign ownership. Second, while we study how Anglo-American institutional foreign owners affect board practices in firms in a stakeholder economy, we establish, more generally, that heterogeneity in shareholders' objectives (and logic) and their span of control over governance practices are important to understand the influence of different types of owners over existing governance arrangements.

Our framework is therefore not only useful to analyze the influence of shareholder-oriented foreign ownership on board monitoring in a stakeholder-oriented context, but it may also be used in other contexts. For example, acknowledging differences in shareholder's objectives and preferences for certain governance mechanisms may help explain how the introduction of institutional investors in family-controlled firms may lead to changes in the firm's governance practices. While family owners may have preferences over direct monitoring of managers, institutional investors may want to reinforce board monitoring or link executive compensation more closely to firm performance. Furthermore, we believe that the nature of foreign ownership in terms of type and origin is likely

to affect their influence. Future research could therefore explore whether the effect of foreign ownership on corporate governance is contingent on the type and degree of shareholder/stakeholder orientation of the foreign owner.

Our study has limitations as well. First, we focus on listed companies from a highly stakeholder-oriented context like Japan. Our results may therefore not generalize to non-listed companies or to firms with a two-tier board system as in Germany. We expect our findings to be relevant in those settings where the bundle of governance practices deployed by domestic stakeholders is unavailable or does not address the agency conflict that shareholder-oriented foreign owners face. Given the potential influence of institutions in our setting, future research could benefit from testing our framework in different institutional settings. In addition, while our study highlights the influence of foreign ownership on the behavior of the board of directors with respect to monitoring, we have not discussed other board functions such as advising.

## CONCLUSION

We build on the contingency approach to CG, which proposes that effective CG depends upon the alignment of interdependent organizational and environmental characteristics, rather than on one universal set of relationships that hold across all organizations. Our study suggests that board monitoring must also be examined in light of contingencies related to firms' foreign ownership. Our findings demonstrate that, for a large set of listed Japanese firms, board monitoring behavior is contingent upon the degree of foreign ownership. We uncover that the relationship between board independence and audit fees is positive only for high levels of foreign ownership, while this relationship is not significant for lower levels of foreign ownership. We also show that this relationship is strengthened when domestic ownership concentration is low, firm risk is high, and firm performance is low. Our results highlight the possibility of different patterns of CG within a given country, shaped by the nature and weight of foreign owners.

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