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# Performance Sensitivity of Executive Pay: The Role of Foreign Investors and Affiliated Directors in Japan

Asli M. Colpan and Toru Yoshikawa

**ABSTRACT**

**Manuscript Type:** Empirical
**Research Question/Issue:** This study investigates the effects of corporate governance factors on the firm performance and executive compensation linkage. Specifically, we examine how domestic corporate-appointed directors, bank-appointed directors and foreign ownership moderate the relationship between firm profitability, sales growth, and executive bonus pay in Japanese firms.
**Research Findings/Insights:** Using a sample of the largest Japanese manufacturing companies from 1997 to 2007, we find that corporate-appointed directors positively moderate the relationship between firm growth and bonus pay, while foreign shareholders exhibit a positive moderating effect on the relationship between firm profitability and bonus pay. Bank-appointed directors are straddled between their profitability orientation and relational role: They link firm profitability and bonus pay, but also show positive influence on the firm growth and bonus pay relationship.
**Theoretical/Academic Implications:** This study makes a contribution to research on ownership heterogeneity and executive compensation by empirically showing that different owners and directors affiliated with certain ownership groups have varied implications on the firm performance–executive pay relationship. It also makes a contribution to research on corporate governance change by providing insights on how different actors facilitate shifts in the linkage between performance and pay.
**Practitioner/Policy Implications:** Our findings offer insights to stakeholders to pay attention to ownership structure and board composition in acknowledging the varied financial motivation of executives to pursue growth and/or profitability.

**Keywords: Corporate Governance, Executive Compensation, Ownership, Board of Directors, Japan**

## INTRODUCTION

Since executive compensation is one of the important governance mechanisms to monitor, motivate, and discipline CEOs and senior managers, a large number of studies examine its determinants and performance effects. Among many topics related to this issue, one of the most researched aspects is the linkage between firm performance and executive compensation (Barkema & Gomez-Mejia, 1998). As prior studies on the relationship between performance and pay yield mixed results, researchers have been investigating other factors that might influence the firm performance and executive compensation linkage including ownership characteristics (Finkelstein & Hambrick, 1989; Hill & Phan, 1991). Although previous research has been insightful on the relationships between ownership concentration and performance sensitivity of managerial compensation (Conyon, 1997; Hartzell & Starks, 2003), it is less comprehensive regarding the effects of the *nature* of the ownership (David, Kochhar, & Levitas, 1998). Further, many of those studies are conducted in the US context, and there have been relatively fewer studies that examine this linkage issue in other geographical contexts such as Europe and Japan.[1]

Prior work that examined the relationship between the nature of ownership and executive compensation has followed Brickley, Lease, and Smith's (1988) categorization of institutional investors in US firms, and argued that institutional investors differed in terms of their influence on executive pay depending on the existence of business relationships those investors have with their invested firms (David et al., 1998). Those studies that looked at performance sensitivity often focused on the relationship between a firm's stock

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performance and profitability, and executive pay (Almazan, Hartzell, & Starks, 2005; Shin & Seo, 2011).

Recent studies have argued that institutional owners are more heterogeneous than was originally assumed by Brickley et al. (1988), and that a more rigorous investigation of the impact of ownership heterogeneity on executive pay and its performance sensitivity is necessary (Davis & Kim, 2007; Shin & Seo, 2011). The past research that distinguished owners with and without business relationships with their invested firms, however, only focused on the extent of their influence on pay-for-performance sensitivity and level of executive compensation, and not on the relationship between different performance measures and executive pay. Nevertheless, not all institutional owners necessarily pursue higher profitability in their invested firms, as their investment goals vary. Our study addresses this issue by arguing that although institutional owners may generally seek to link executive pay with performance, they may prefer to use different measures of performance due to their different objectives. The present study thus attempts to investigate the impact of ownership heterogeneity on the firm performance–executive compensation relationship in Japan to address this gap in research.

Japan is an appropriate context to examine how ownership heterogeneity affects the performance–pay relationship because it represents an interesting contrast among different types of shareholders. Since the mid-1990s there has been an increase in the number of investors who are mostly foreign, predominantly institutional ones from the US and the UK, and more financially oriented. It is expected that those investors seek to strengthen the linkage between firm profitability and executive compensation to provide financial incentives to managers so that investors can improve their investment returns. On the other hand, Japanese domestic shareholders such as banks and non-financial firms are largely business partners who have retained long-standing relationships, and thus are likely to have different incentives as they benefit more from sales growth of their partner firms (David, O'Brien, Yoshikawa, & Delios, 2010). Hence, while both foreign financially-oriented investors and domestic business partner investors likely care about the performance of their invested firms, the sources of their economic gain may be different.

While our main interest is to compare the impact of these different types of shareholders on the performance–pay sensitivity, we choose to focus on the role of "affiliated directors" transferred from domestic shareholders because we expect that such directors are sent by domestic institutions to directly monitor and even influence the management of their invested firms (Kaplan & Minton, 1994). Hence, they likely have a more direct effect on corporate practices. We predict that foreign owners exhibit a strong preference for linking executive pay with firm profitability, while corporate-appointed directors prefer to link executive pay with firm growth. Domestic banks represented by their appointee directors, by contrast, are straddled between the two different objectives because of their role as a business partner of their corporate clients, and their increasing focus on profitability as a financial investor. Bank-appointed directors should thus be linked with both growth- and profit-oriented compensation policies. We, therefore, argue that the interests of the different types of shareholders and directors who represent them would influence executive compensation in dissimilar directions.

This study makes its core contribution to research on ownership heterogeneity and executive compensation by empirically showing that different types of owners and directors affiliated with some ownership group have varied implications on the firm performance–executive pay relationship. We therefore extend prior research by considering the performance goals (growth vs. profit) of different shareholders with or without business relationships in their invested firms, and show how those different owners prefer to link executive compensation with different measures of performance due to their different objectives. Our study further provides insights for the influence of institutional shifts on the performance–pay linkage, when certain elements of domestic institutional settings started to move toward a global standard in investor behavior and governance practices (Colpan, Yoshikawa, Hikino, & Miyoshi, 2007). In this context, the tighter linkage of profitability and pay to motivate executives brought by foreign investors as well as bank-appointed directors may signal a shift of Japanese firms' pay-for-performance schemes more toward market-oriented governance practices.

## CONCEPTUAL BACKGROUND

Executive compensation is a mechanism that is designed to align the interests of senior managers with those of shareholders (Tosi & Gomez-Mejia, 1989, 1994). By using the outcome-control discipline, the agency problems can be solved or at least mitigated if a board of directors designs a compensation package that links executive pay to the firm's performance (Hill & Snell, 1988, 1989; Jensen & Meckling, 1976). Thus, it can be argued that the difficulty of direct observation of managerial behavior by principals is partially solved by performance-based pay. In this line of study, empirical research often examines the relationship between the firm's stock returns or other performance measures and incentive-ridden compensation for the CEO. The objective of such research is to determine the degree of sensitivity of executive compensation to firm performance measures. It is argued that the higher the degree of sensitivity, the smaller the agency problem between shareholders and management.

As the results of prior studies on performance–pay sensitivity are largely mixed (cf. Barkema & Gomez-Mejia, 1998; Benston, 1985; Coughlan & Schmidt, 1985; Jensen & Murphy, 1990; Kerr & Bettis, 1987; Mace, 1971; Riahi-Belkaoui, 1992), researchers have been investigating contingent factors that have to be considered in examining a link between performance measures and executive pay (Finkelstein & Hambrick, 1989; Hill & Phan, 1991). For example, such factors as firm size, peer compensation, ownership structure, and board vigilance are cited by Barkema and Gomez-Mejia (1998). Among these factors, the present study focuses on the corporate governance factors of ownership structure and their representation on the board of directors.

The active influence of shareholders on executive compensation of their invested firms, mainly in the US and, to a

lesser extent, in other industrialized nations, has largely emerged as a result of growing concerns over the past 20 years that executives' pay was not adequately linked to firm profitability and that executives were overpaid (Shin & Seo, 2011). Without the effective involvement of strong shareholders, senior executives may exercise their power in setting their pay at a higher level than that legitimized in the market. Earlier work has mostly supported this argument, for instance by showing that CEOs of owner-controlled firms command compensation packages that are lower than those of firms with more diffuse ownership (David et al., 1998). As institutional investors have emerged as a significant group of shareholders that have the incentives and capabilities to check managerial power, as evidenced by the increase in their aggregate weight in terms of shareholding of listed companies from 16 percent in 1965 to 57 percent in 1994 in the US, it has been pointed out that those investors began to exercise their influence on the executive compensation schemes of their invested firms (David et al., 1998; Useem, 1996).

Previous work that presumed a homogeneous view of institutional investors has shown that firms that have block owners tend to have higher levels of alignment between the interests of CEOs and shareholders through CEO pay policies in US firms (Shin & Seo, 2011; Tosi & Gomez-Mejia, 1989). Hartzell and Starks (2003) also found that the concentration of institutional ownership is positively associated with the performance sensitivity of managerial compensation. In other words, arms' length institutional investors could affect the CEO pay policies in their invested firms. These studies suggest that major shareholders who own block positions and institutional investors can influence executive compensation in the US context.

Another line of work, however, has argued that institutional investors are a diverse set of organizations, and that those investors may have different inclinations to influence executive pay policies (David et al., 1998; Shin & Seo, 2011). Brickley et al. (1988) have classified investors in terms of the extent of their business relationships with their invested firms, which can reduce the ability of those investors to effectively influence firm policies. Banks, insurance companies, and nonbank trusts have been classified as "pressure-sensitive" institutional investors, because they may also have business relations with firms they invest in. It has been argued that business relationships will create conflicts of interest, and thus the investors will become susceptible to influence from firm managers. Public pension funds, mutual funds, endowments, and foundations have been classified as "pressure-resistant" institutional investors, as they do not have any ongoing business relationships with their invested firms.

Using this classification in executive compensation studies, David et al. (1998) found that large ownership by institutional investors was associated with lower CEO pay and stronger long-term incentives when such investors did not depend on business ties with their invested firms. A study by Almazan et al. (2005) suggests that pressure-resistant investors will more likely influence CEO pay in line with shareholder preferences when compared to pressure-sensitive shareholders. More recent studies have called for a more rigorous investigation of institutional investor heterogeneity, and have shown that mutual funds and public pension funds exert different effects on the executive pay plans of their portfolio firms (Davis & Kim, 2007; Shin & Seo, 2011).

Because those studies took the market-oriented institutional shareholders as their sample, they concentrated on the extent to which these shareholders linked compensation with shareholder wealth (Almazan et al., 2005; Shin & Seo, 2011). These studies thus focused on the sensitivity of executive pay with a firm's stock performance and/or profitability. However, the different investment orientations and interests of heterogeneous types of shareholders imply that different types of owners may prefer to link executive pay with firm performance, but with different measures of performance due to their different objectives. The implicit assumption that all powerful shareholders will seek to link firm profits to executive pay does therefore not hold in all situations. Recent work has indeed found that different types of owners may actually have divergent performance goals (David et al., 2010). Therefore, not only do different owners employ varied levels of influence over pay-for-performance sensitivity in their invested firm, but the outcomes that they seek from those pay policies may differ. In the next sections, we discuss the dissimilar performance goals (i.e., profits vs. growth) that different institutional shareholders emphasize in the Japanese context. We then develop a set of hypotheses that predict how these differences can influence the types of sensitivity that different types of investors have in their invested firms' pay-for-performance policies.

## THE EMPIRICAL CONTEXT

### Ownership Structure and Board Representation in Japanese Firms

Many large Japanese firms are linked through extensive cross-shareholding arrangements with their business partners and client firms, and a large portion of Japanese stocks are also often owned by "stable" investors (Gerlach, 1992; Sheard, 1994a). It is frequently argued that stable investors own shares primarily to cement and enhance long-term business relationships rather than to earn an immediate return on their stock investments (Charkham, 1994; Kester, 1991). It is also suggested that they own shares in other firms to ensure stability in sales and earnings so that they can mutually protect the interests of important stakeholders including employees, management, and business partners that are often members of the same *keiretsu* group (Caves & Uekusa, 1976; Nakatani, 1984). Therefore, research on Japanese corporate governance has suggested that capital markets or shareholders do not function as an effective monitoring mechanism to protect and promote the interests of investors who seek financial returns (Kaplan & Minton, 1994; Sheard, 1989).

The top management of large Japanese corporations has conventionally set growth, in contrast to profitability, as the primary goal of their strategic formulation and implementation (Okumura, 2000). Two interrelated factors concerning the historical consequence of economic "democratization"

after World War II should be singled out for the growth orientation. First, senior managers within large Japanese firms have mostly been professional and salaried employees without any substantial ownership of corporate shares of the company they manage. At the same time, a large portion of Japanese shares have been owned by other domestic institutions including banks and non-financial firms that are not financial portfolio investors. Consequently professional and salaried managers who were protected from capital market forces due to this ownership structure have dominated the decision making of many large firms in Japan. These characteristics of postwar Japanese firms resulted in the classic example of managerial enterprises that incorporate the principle of growth, rather than profitability (Baumol, 1959; Marris, 1964; Okumura, 2000).

Second, these managerial enterprises which developed in the post-World War II decades encouraged the stable mutual commitment called "lifetime employment" to nurture and promote the interests of employees as well as executives. As a result of this implicit agreement between employees and management, large Japanese firms had to set growth goals in order to secure employment opportunities within the company. Being employed in the firm that they manage, senior managers shared a strong sense of unity with their employees. The top executives thus set their managerial priority in the growth of their firm, which enhances opportunities for employment in general and guarantees executive prospects for junior managers in particular (Kubo, 2010; Shirai, 1983).

The basic dynamics of growth orientation targeted by Japanese firms, however, have been seriously challenged by the shift in ownership structure since the early 1990s when the Japanese economy entered a severe recession (Jackson & Miyajima, 2007). A notable shift has been the rise of foreign portfolio investors, who are predominantly institutional investors from the US and the UK. Since the mid-1990s, foreign ownership of Japanese stocks by market value has risen from 4.7 percent in 1990, climbing to 22 percent in 2007 (Tokyo Stock Exchange, 2008). Since these foreign investors only have arm's-length relationships with the firms in which they invest, they look for higher investment returns and a more shareholder-oriented corporate governance model (Jackson & Moerke, 2005). In fact, several studies found a positive association between foreign ownership and firm profitability, which is congruent with the stronger profit orientation of foreign owners (Miyajima & Kuroki, 2005; Nitta, 2000).

Another important shift in shareholder profiles resulted from the change in the composition and behavior of domestic investors. Financial institutions, especially commercial banks, suffered from the vast amount of non-performing loans, after the bubble economy abruptly burst in the early 1990s. In order to strengthen their own financial condition, commercial banks had to curtail their conventional ties to their *keiretsu* associates (Gedajlovic, Yoshikawa, & Hashimoto, 2005; Inoue, 1999; Yasui, 1999). Simultaneously, given the strong pressure to recover their financial health, commercial banks gradually started to prioritize market return-oriented principles of investment and lending (Colpan, Yoshikawa, Hikino, & Del Brio, 2011; Kikuchi, 1999; Yasui, 1999).

Non-financial firms that had long-term relationships of transactions and dealings with the companies in which they invested, by contrast, continued to hold on to their stockholdings in those firms for relational transaction reasons, because their equity ties symbolize the long-term security between the two firms (Arikawa & Miyajima, 2007). For those firms, immediate financial returns from equity investments still remained secondary, relative to income generated by business transactions with their invested firms. As such, these corporate investors continuously aim to maximize the growth and expansion of their invested firms (Colpan et al., 2011).

Despite the fact that domestic corporate, domestic financial, and foreign owners influence the management of their invested firms, they differ in how they can do so. Domestic corporations and banks often have representation on the boards of other Japanese corporations. For example, firms that have close business ties sometimes appoint directors on other firms' boards. Domestic banks also often send their current or retired senior executives and managers to the boards of other firms that are usually the banks' corporate clients. We expect that those directors are sent to other firms because relational owners have incentives to directly observe and even influence the decision making of the management of their invested firms (Kaplan & Minton, 1994). While the roles of these "affiliated directors" are expected to be different from independent outside directors because of their specific affiliations with other non-financial firms or commercial banks, it is likely that they play a direct role to represent those firms and banks that own shares and have business or financial transactions (Yoshikawa & Phan, 2005).

Foreign investors, by contrast, do not possess direct instruments or agents (including independent directors to represent them) to exercise influence on corporate decisions, as they are usually not represented on the board.[2] The exit threat of selling shares provides them with indirect but considerable influence, however. After all, foreign investors actually accounted for more than 50 percent of all stock trading volumes in 2007 (Tokyo Stock Exchange, 2008). Furthermore, foreign shareholders sometimes engage in herd behavior (Kamesaka, Nofsinger, & Kawakita, 2002), which creates a snowball effect that can significantly damage the market value of stocks. Initial sell-offs of shares can be interpreted in the capital market as a signal that a firm is poorly managed and/or experiencing financial difficulties. Ultimately, the threat of default can increase and the cost of capital gets higher (Bhojraj & Sengupta, 2003; Brennan & Tamarowski, 2000). Besides this *exit* option, foreign shareholders can use *voice* to influence Japanese managers through direct communications and meetings with them (Ahmadjian & Robbins, 2005). Japanese management has thus become more receptive to the expectations that foreign shareholders set about maximizing profits (David et al., 2010).

Based on the above arguments, in sum, we contend that foreign portfolio investors function as a prime agent of change for Japanese firms to move toward profit-oriented corporate practices, while domestic corporate investors, through their appointed directors, play a role to preserve continuity in supporting growth-oriented corporate practices. Domestic banks fall somewhere in the middle as they

have gradually begun to embrace market-oriented profit maximization as their investment goal, although they still hold on to the conventional principle of stable relational shareholding with their corporate clients.

### Executive Compensation in Large Japanese Firms

Executive compensation in large Japanese firms usually consists of a base payment that is paid monthly and cash bonuses that are awarded semi-annually. The base pay component of executive compensation has usually been determined by the rank and seniority of each executive, and changes in executive base pay have broadly been linked to general movements in employee wages and salaries (Kubo, 2005). Earlier studies actually found evidence of only very weak relationships between firm performance and executive base pay (Kubo, 2010; Kubo & Saito, 2008). These imply that a scheme of a stable base payment has long been predominant in Japan.[3]

On the other hand, executive bonus payments of Japanese firms, which are determined by the board, have conventionally varied by fluctuations in firm performance. The bonus payment amount of executives' compensation is usually about 10 to 30 percent of their total compensation, while it differs by individual firms (Kubo, 2005). When a company enjoys increasing sales and rising profits (customarily termed *zoshu zoeiki* in Japanese), the bonus pay for that particular accounting year should be increased. Executives' bonuses are often reduced when firm performance declines and stagnates (Kubo, 2010; Xu, 1997). In the recessionary 1990s, for example, Kubo (2010) found that executive bonuses actually decreased, while the base payment remained relatively stable.[4] This suggests that executive pay has not been completely shielded from the performance fluctuation of the firm they manage even in the Japanese context. The focus of this study is thus how different governance mechanisms affect the degree of sensitivity between firm performance and executive pay, specifically the bonus payments.

The combination of the long-term stability of the base payment and the short-term fluctuation of bonus payments linked to the performance of Japanese firms implies that the bonus component of executive compensation constitutes the focal point for empirical research, such as the present study that aims to examine the influence of various governance factors on the dynamic relationships between corporate performance and executive compensation. Especially since the mid-1990s when economic and institutional environments have changed, these relationships should be of critical importance to the theoretical as well as empirical understanding of the continuing and shifting mechanisms of corporate governance and executive compensation.

The institutional environment of corporate governance in Japan has long been characterized as stakeholder oriented (Ahmadjian & Robbins, 2005) and also as egalitarian in terms of pay structure (Shirai, 1983). Colpan et al. (2007) show that the average amount of a director's base pay and bonus per year was 23.5 million and 5.8 million yen, respectively, in major Japanese firms in 2004. Those amounts remained significantly lower than their counterparts in average sized US firms. According to the latest estimates, the level of executive salary in the US sometimes is almost ten times higher than that in Japan (Kubo, 2010).

Furthermore, the amendment of the Commercial Code in 1997 created the choice of stock options pay mostly for senior executives. While shareholders naturally welcomed the linking mechanism of their interest in stock performance with the long-term maximization of executive salary, stock option provisions do not undermine executives' interest, either, as the stock option scheme was provided on top of their regular base pay and bonus (Kubo, 2010). In reality, Japanese big business executives did not oppose this new long-term incentive practice, as was symbolized by the positive attitude of *Keidanren*, the business association representing the interests of large firms that pressed for the legalization of stock options (Ahmadjian, 2003). Hence, we look at short-term bonus payments in this paper as the focal and sensitive element of executive pay that reflects the differing interests among various groups of shareholders and corporate executives.

## HYPOTHESES

Our main argument is that while institutional owners universally seek to link executive pay with performance, they may prefer to use different measures of performance due to their different investment objectives. Below we explain how the divergence in performance goals of different owners leads to dissimilar pay-for-performance schemes. While we choose the three different types of owners (domestic corporate, domestic bank, and foreign portfolio shareholders) in terms of their impact on the performance–pay sensitivity, we focus on the role of affiliated directors in the case of domestic owners in Japan. This is because we hypothesize that such directors, corporate-appointed ones and bank-appointed ones, are sent by those domestic institutions to monitor and even influence the management of their invested firms (Kaplan & Minton, 1994). Hence, they likely have a direct impact on corporate practices of those firms. By contrast, foreign investors are usually not represented on the boards of Japanese firms. Nevertheless, they exercise influence on corporate decisions through exit and voice options, thanks to their escalating levels of ownership stakes since the early 1990s, as explained above.

### Governance and Performance Sensitivity of Executive Compensation

Ownership of large Japanese firms has long been dominated by stable domestic investors, not by institutional investors who seek immediate financial returns. These holdings by domestic shareholders, especially other corporate shareholders, in Japan often reflect long-standing business relationships with business partners. Relations among such shareholders are often characterized by reciprocal share ownership, which is seen as an expression of goodwill (Clark, 1979) and helps cement transactional and institutional ties (Gerlach, 1992). In short, these corporate investors are relational (David et al., 2010) or strategic (Aguilera & Jackson, 2003) investors. Further, as discussed earlier, some of these domestic owners appoint directors on the boards of

the firms with which they have business relationships. Therefore, they often have a direct means to influence the managerial decision making, including that related to executive compensation, through their board representations.

These domestic corporations are stakeholders as well as shareholders whose goals are not necessarily to gain direct and immediate financial returns from their shareholdings. Their commitment to long-standing business relationships thus will likely mitigate the importance of current profits (David et al., 2010). Sales growth, however, can significantly benefit the relational corporate shareholders. As corporate partners increase their sales and grow, other corporate shareholders should benefit because they can expect to increase their businesses such as product and service transactions (Colpan et al., 2011). David et al. (2010) also argue that benefits gained through business relationships rather than from dividend income or capital appreciation is advantageous to such investors due to the added advantage of reduced tax payments in financial gains. Due to their preference for stable growth over current profitability, directors on the board who are appointed by such shareholders are not likely to be interested in directly linking executive pay to current profitability. Rather, corporate-appointed directors will likely facilitate linking executive bonus pay with firm growth. As discussed earlier, such directors can directly influence managerial decision making, including executive compensation in the boardroom. Hence, we propose,

> *Hypothesis 1. Directors appointed by domestic corporations have a significant positive moderating effect on the relationship between firm growth and executive bonus payments.*

Another possible governance mechanism exercised by the domestic actors in Japan is bank-appointed directors. The Japanese corporate governance system has often been characterized as a bank-centered system, which is conventionally defined as a long-term relationship between a firm and a bank from which the firm takes the largest share of its loans (Aoki, 1994; Dore, 2000). The main bank relationship is also characterized by shareholdings by banks and also by bank-appointed directors on the boards of their client firms. Due to the close ties with their client firms, it has been argued that the main bank plays a monitoring role in Japanese corporations (Aoki, 1994; Sheard, 1989). While the main bank can monitor its clients through various channels, one method is through the directors appointed to the boards of its borrower firms.

As discussed earlier, banks are also relational investors because they not only own shares in their client firms but also have major financial transactions with those firms. However, the pressures that the two types of domestic relational shareholders, corporate investors and banking institutions, faced were critically different since the 1990s. Banks generally felt more significant performance pressures relative to corporate owners due to their mounting bad loans, which resulted in the banking crisis in the late 1990s (Jackson & Miyajima, 2007). After those banking institutions started experiencing financial difficulty, they were forced to pay attention not only to their relationship with their corporate clients, but also to the efficient use of their invested capital and the ultimate profitability of their investment (Colpan et al., 2011). Hence, we contend that the focal interests of corporate-appointed directors and bank-appointed directors are different.

Banks would conventionally promote growth strategies, as sales growth would lead to more financial business such as loans for the banks. Similar to corporate owners, banks can also exert direct influence on managerial decision making through their appointed directors on the boards of their invested firms. Hence, as banks would prefer stable growth over current profitability, it is likely that bank-appointed directors will likely attempt to link sales growth to executive bonus compensation, in the same way we predicted for the corporate-appointed directors. However, because of their increasing focus on financial performance and return, it is also likely that the banks' interests would be served by higher profitability of their client firms which leads to increased security of loaned money and higher stock prices of those firms. The bank-appointed directors should thus be motivated to strengthen the relationship between sales growth and executive bonus payments, as well as firm profitability and executive bonus payments. Hence,

> *Hypothesis 2a. Directors appointed by domestic banks have a significant positive moderating effect on the relationship between firm growth and executive bonus payments.*

> *Hypothesis 2b. Directors appointed by domestic banks have a significant positive moderating effect on the relationship between firm profitability and executive bonus payments.*

While a large portion of shares in Japanese firms are still owned by those domestic shareholders, there has been a rising presence of foreign portfolio investors in Japanese capital markets, as discussed earlier. Foreign portfolio investors are predominantly institutional investors from the US, the UK, as well as other European countries (Bank of Japan, 2004), and seek financial returns from their investments, as they are usually arm's-length investors and therefore do not benefit from any commercial transactions with their invested firms (Ahmadjian & Robbins, 2005; Okabe, 2002).[5]

Foreign investors hold shares in Japanese firms as part of their global portfolio to earn higher financial returns and also to diversify investment risk. Hence, their invested firms will be theoretically pressured to pursue higher returns on their capital (Jackson & Moerke, 2005). Foreign shareholders tend to trade shares more frequently than domestic investors, which substantially affects the share price of Japanese firms. Therefore, although those investors own a relatively small block of shares compared to domestic strategic owners, they can affect the strategic decisions of their invested firms (David, Yoshikawa, Chari, & Rasheed, 2006; Nitta, 2000). Because of their financial objectives, these foreign investors are motivated to link executive compensation to firm profitability, thereby providing strong incentives to executives. Although foreign investors usually do not have their representative on the boards of their invested firms, they could still exert direct and indirect influences on the board and the senior management of the invested firms, e.g., through direct meetings with executives or a threat of sell-off of their holdings when they are not satisfied with

firm policy. Using such influence, foreign investors are likely to attempt to link executive compensation to firm profitability. As they do not directly benefit from any commercial transactions with their invested firms, they have little incentive to link sales growth and bonus payments as firm growth does not necessarily lead to higher profitability. Hence, we expect that foreign ownership will link executive bonus payments to firm profitability.

*Hypothesis 3. Foreign ownership has a significant positive moderating effect on the relationship between firm profitability and executive bonus payments.*

## METHODS

### Sample

The sample was chosen from the 200 largest publicly traded manufacturing firms in terms of sales in Japan in 1996. The data were collected for each year for the period 1997–2007. We chose this period as it encompasses the institutionalization of several shareholder-oriented measures in Japan, in which foreign investors increased their presence with "active" or more demanding attitudes. We combined data from five sources to construct our sample. The majority of our statistical data was collected from the *Yakuin Shikiho* (Board of Directors Annual Reports), *Nikkei Needs* database and *Kaisha Shikiho* (Japan Company Handbook). We supplemented these data with information from the *Yuka Shoken Hokokusho* (Report on Securities and Stocks), which are the semiannual reports that listed companies are required to file with the Ministry of Finance, and *Nihon no Kigyo Gurupu* (Japanese Corporate Groups). Whenever any substantial data were missing for particular firms, those firms were removed from the sample. Hence, our original sample of 200 was reduced to 153 firms in our final analysis.

### Dependent Variable

As Japanese firms are not legally required to disclose the pay of individual executives and hence most of them do not report such data, previous research (Abe, Gaston, & Kubo, 2005; Kubo, 2005; Sakawa & Watanabel, 2008; Xu, 1997; Yoshikawa, Rasheed, & Del Brio, 2010) on Japanese executive compensation employed the director bonus payments that have conventionally varied by fluctuations in firm performance as a measure of performance-linked executive compensation in Japan. These studies treated the director bonus as a part of executive compensation, as the majority of directors of Japanese firms are insiders, that is to say they are corporate executives.

In Japan, as in many other countries, the board of directors is legally responsible for the monitoring of managerial execution exercised by top management. However, the Japanese board has not traditionally defined its primary role as that of monitoring top management (Gilson & Milhaupt, 2004; Heftel, 1983). In part, this is because Japanese boards are mainly composed of full-time salaried executives and a number of affiliated or related outsiders (Kaplan & Minton, 1994; Sheard, 1994b).[6] Since inside directors are viewed as a representative of employees, researchers suggest that they lack incentives and the capability to monitor top executives to improve shareholder value (Kubo, 2005). Therefore, except for a small number of outsiders, most Japanese directors are members of the top management team and have roles as senior executives (Aoki, 1988).

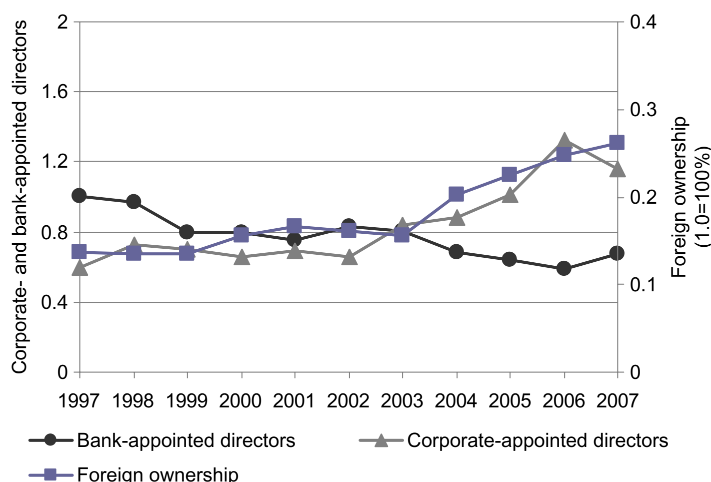
We followed prior research (Kubo, 2005; Yoshikawa et al., 2010) and used the total bonus payments disbursed to all directors divided by the number of directors. This measure was calculated employing the independent data on total bonus payments (separated from their base salary) that is compiled in *Nikkei Needs*. The figures in this database are derived from the data that individual companies publish in *Yuka Shoken Hokokusho*, Japan's equivalent to 10-K reports. The total director figures came from *Yakuin Shikiho*, an annual publication that lists the directors of all the listed companies in Japan.

### Independent Variables

Japanese corporate and financial owners can gain representation on the board of the owned firm by nominating their own employees as directors (Lincoln & Gerlach, 2004). Domestic *corporate-appointed directors* were the total number of directors that were full-time employees in other Japanese firms that are business partners and also held ownership stakes in the firm in question. Because a small number of Japanese firms began including outside independent corporate directors within the time span of our sample, all directors were individually checked for the ownership and transactional ties of the two firms. When the firms do not have ownership and transactional linkages, the directors in question are regarded as independent outside directors. Those who were identified as outside independent directors were excluded from our variable. We used three directories, namely *Yakuin Shikiho*, *Yuka Shoken Hokokusho*, and *Nihon no Kigyo Gurupu*, to individually identify the corporate-appointed directors. The first two sources list the concurrent positions of directors inside and outside the firm, while the last two identify the major firms that have equity holdings, and with which the company has business transactions. *Bank-appointed directors* were the total number of directors on the board who were nominated from commercial banks to their associated companies. We used *Yakuin Shikiho* to identify the bank-appointed directors; and those directors that came from banks that held the ownership of the company in question and had financial transactions as a main bank are considered as a bank-appointed director. Connections with banks are identified in two sources: *Yuka Shoken Hokokusho* and *Nihon no Kigyo Gurupu*. *Foreign ownership* is the percentage of shares held by foreign investors in a firm's total outstanding shares. While foreign ownership includes both institutional and individual investors, it is safe to assume that most of the shares were held by institutions as global equity investments have largely been made by institutional investors in most major countries (Useem, 1998).[7] This data was collected from the *Nikkei Needs*. Figure 1 illustrates the changes in foreign ownership and corporate- and bank-appointed directors of firms employed in this study.

*Sales growth* was calculated as the percentage of year-to-year change in total sales. We used return on total equity (*ROE*) as a measure of profitability, while Robins and

**FIGURE 1**
**Time Trends of Major Independent Variables**[a]




[a]The numbers on the vertical axes represent the average figures for our sample firms from 1997 to 2007.

Wiersema (1995) suggest that various measures of profitability are typically correlated. These data came from the *Nikkei Needs* database.

We controlled for a number of other variables that might impact executive compensation. *Size* was the logarithm of the total firm assets. *Leverage* was total debt (long-term debt and short-term debt) divided by total assets. *Executive tenure* was the average number of years that current directors in a given year had served on the board. *CEO age* is the age of the present CEO serving on the board in the given year. *Succession* is the number of times the relevant firm installed new CEOs during our sample period. *Independent directors* are the number of outside directors without any financial or transaction-related connections with the firms they serve. This category included academics, retired bureaucrats, accountants, lawyers, and others as well as the independent institutional directors that we identified from *Yakuin Shikiho* and *Yuka Shoken Hokokusho*. *Stock option* is a dummy variable denoting the installation of stock option plans in the given year in the sample companies. This variable took the value 1 when a company held a stock option plan, and 0 otherwise.[8] The data for control variables were collected from the *Yakuin Shikiho*, *Nikkei Needs*, *Kaisha Shikiho*, and *Yuko Shoken Hokokusho*.

### Analysis

A panel dataset is employed for the analysis. First, to address the concern of unobserved heterogeneity, we incorporated firm fixed-effects into the models. The employment of fixed-effects rather than random-effects was supported because a Hausman test indicated significant systematic differences in the coefficients produced by the two types of models. Second, to reduce the potential endogeneity problem, a one-year lag between dependent and independent variables was incorporated to facilitate causality. The employment of firm fixed-effects could also reduce endogeneity by controlling any omitted variables invariant over time (David et al., 2010).

We further performed a Durbin–Wu–Hausman test to see whether endogeneity exists that could lead to biased coefficients.[9] That is, the potentially endogenous variables of profitability, foreign ownership, and corporate-appointed directors along with their respective instruments (industry growth, foreign sales ratio, and firm age, respectively, that served as relevant instruments) were regressed separately on all exogenous variables in the model.[10] After obtaining the residual values from each equation, we then incorporated them as additional regressors into the original regression model. The results of the F-test (of the Durbin–Wu–Hausman test) on the null hypothesis that the residuals are equal to zero were not rejected, as the F-statistics in all cases were insignificant ($p > .10$). This meant that there is no likelihood of an endogeneity problem among the variables in the model and our estimation methodology is robust (Cameron & Trivedi, 2010; Davidson & MacKinnon, 1993; Wooldridge, 2002).

Finally, we centered the values of the explanatory variables by subtracting the means, to reduce potential multicollinearity in our tests of the interaction effects (Aiken & West, 1991). We examined variance inflation factors (VIF) to check for multicollinearity and found that the values were less than 4, well below the cutoff value of 10 that indicates excessive multicollinearity (Greene, 2003).[11]

## RESULTS

Table 1 presents the descriptive statistics and correlation coefficients for the variables. Table 2 illustrates the results of the regression analyses for the hypotheses. Model 1 shows the coefficients and their significance values for control variables and independent variables, while Models 2 and 3 add the interactions with firm growth and firm profitability, respectively. From the main-effects model in Table 2, we can see that size, CEO age, succession, stock option, and ROE are all positively related to bonus pay.

The results suggest that, holding other variables fixed, a 1 per cent point change in ROE will lead to an approximate 90,000 yen increase in bonus.[12] Since the mean executive bonus is 5.16 million yen (in Table 1), a 90,000 yen increase means an average 1.8 per cent increase in bonus pay. While these figures may not look to be intense incentives, they establish the fact that bonus pay for senior executives in Japan is sensitive to firm profitability. The outcomes, on the other hand, do not show any significant relationship between sales growth and bonus pay.

Foreign ownership and corporate-appointed directors illustrate positive and significant main effects. One possible reason for the positive main effect of foreign ownership on the bonus pay level is that as foreign investors are largely from the US and the UK, where executive pay tends to be much higher than in Japan and also large proportions of pay for executives are linked to current financial performance of firms in those countries, those shareholders are receptive to large bonus payments. As for the main effects of affiliated directors, our results show that the presence of corporate-appointed directors is positively related to the amount of

**TABLE 1**
**Descriptive Statistics and Correlation Coefficients[a]**

| Variable | Mean | s.d. | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 | 11 | 12 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1. Executive bonus pay (million yen) | 5.16 | 3.69 | 1.00 | | | | | | | | | | | |
| 2. Corporate-appointed directors | .83 | 1.04 | .09 | 1.00 | | | | | | | | | | |
| 3. Bank-appointed directors | .78 | .94 | –.02 | –.08 | 1.00 | | | | | | | | | |
| 4. Foreign ownership | .17 | .11 | .39 | –.01 | –.04 | 1.00 | | | | | | | | |
| 5. Sales growth (%) | 1.65 | 19.12 | .05 | –.01 | .02 | .07 | 1.00 | | | | | | | |
| 6. ROE (%) | 7.88 | 15.55 | .11 | –.07 | –.05 | .07 | .12 | 1.00 | | | | | | |
| 7. Size (log) | 13.25 | .85 | .42 | .01 | .01 | .37 | .05 | .04 | 1.00 | | | | | |
| 8. Leverage | .16 | .12 | –.01 | –.03 | .17 | –.35 | –.06 | .02 | –.23 | 1.00 | | | | |
| 9. Executive tenure | 5.42 | 2.15 | .07 | –.02 | –.11 | .09 | .02 | .03 | –.04 | –.16 | 1.00 | | | |
| 10. CEO age | 62.51 | 4.68 | –.07 | –.04 | .04 | –.11 | –.01 | .07 | .04 | .06 | .01 | 1.00 | | |
| 11. Succession | 2.86 | 1.04 | .31 | .13 | .10 | .10 | .02 | –.04 | .21 | .12 | –.37 | –.16 | 1.00 | |
| 12. Independent directors | .93 | 1.00 | .17 | –.18 | –.19 | .28 | –.02 | –.01 | .27 | –.11 | .07 | –.05 | .05 | 1.00 |
| 13. Stock option | .25 | .43 | .32 | .20 | –.01 | .34 | .03 | –.01 | .18 | –.16 | .09 | –.04 | .18 | .13 |

[a]Pearson correlations greater than .049 are significant at .05.

**TABLE 2**
**Results of Panel Data Analysis of Executive Bonus Pay[a]**

| Variables | Model 1 | | Model 2 | | Model 3 | | Model 4 | |
|---|---|---|---|---|---|---|---|---|
| Size | 2.56** | .82 | 2.24** | 1.14 | 3.21** | .78 | 1.60 | 1.51 |
| Leverage | 2.39 | 3.29 | 2.20 | 2.33 | 3.48 | 3.34 | 2.38† | 1.34 |
| Executive tenure | .07 | .09 | .07 | .08 | .09 | .06 | .09 | .06 |
| CEO age | .14** | .04 | .18** | .03 | .17** | .03 | .15** | .03 |
| Succession | 1.63** | .31 | 1.59** | .20 | 1.93** | .21 | 1.48** | .19 |
| Independent directors | .19 | .17 | .28† | .17 | .10 | .12 | .21* | .09 |
| Stockoption | .90* | .35 | .95** | .36 | .60† | .35 | 1.04** | .29 |
| Sales growth | .00 | .00 | –.01† | .01 | .00 | .00 | –.00 | .00 |
| ROE | .09** | .03 | .07** | .02 | –.02 | .05 | | |
| ROA | | | | | | | –.03 | .03 |
| Corporate-appointed directors | .60** | .28 | .45† | .25 | .45** | .17 | –.03 | .20 |
| Bank-appointed directors | .19 | .25 | .27 | .17 | –.10 | .19 | –.07 | .13 |
| Foreign ownership | 6.61** | 2.22 | 6.44** | 1.48 | 3.92** | 1.09 | 3.05* | 1.45 |
| Sales growth × corporate-appointed directors | | | .01* | .00 | | | | |
| Sales growth × bank-appointed directors | | | .01* | .00 | | | | |
| Sales growth × foreign ownership | | | .04 | .07 | | | | |
| ROE × corporate-appointed directors | | | | | .02 | .02 | | |
| ROE × bank-appointed directors | | | | | .03* | .01 | | |
| ROE × foreign ownership | | | | | .31* | .15 | | |
| ROA × corporate-appointed directors | | | | | | | .12 | .09 |
| ROA × bank-appointed directors | | | | | | | .08** | .03 |
| ROA × foreign ownership | | | | | | | .48* | .19 |
| F | 17.47** | | 16.00** | | 17.35** | | 17.48** | |
| $R^2$ | .39 | | .40 | | .39 | | .41 | |

[a]N = 936. Coefficients and standard errors are shown in the table for each model.
**, *, † indicate significance at the 1%, 5%, and 10% level, respectively.

bonus pay while bank-appointed directors exhibit no effects. These findings suggest that corporate-appointed directors remain tolerant to a relatively high executive bonus paid to the corporate directors of invested firms with business connections. Bank-appointed directors, by contrast, are not that lenient to executive bonuses, while their presence is not quite firm or strong enough to suppress the bonuses, either. These results are consistent with our argument that the objectives of corporate owners and bank owners are not identical.

The results reveal that the interaction between firm growth and directors appointed by domestic corporations is positive and significant ($\beta = .01$, $p < .05$). In order to provide a more thorough analysis, we also checked whether these directors appointed by domestic corporations have any moderating effects on the relationship between firm profitability and executive bonus payments. As expected, the results (in Model 3) did not show any significant signs. These results strongly support Hypothesis 1 that directors appointed by domestic corporations have a significant positive moderating effect on the relationship between firm growth and executive bonus payments.

The interaction of firm growth and directors appointed by domestic banks show a positive sign ($\beta = .01$, $p < .05$). Hypothesis 2a is thus supported. We also find that directors appointed by domestic banks positively and significantly ($\beta = .03$, $p < .05$) moderate the relationship between firm profitability and executive bonus payments. This finding supports Hypothesis 2b. The outcome for Hypotheses 2a and 2b seems to suggest that Japanese banks are straddled between two oft-conflicting forces: a conventional relational principle and an emerging profitability-oriented philosophy.[13]

Finally, as expected, foreign ownership moderates the relationship between firm profitability and executive bonus payments positively with a high level of significance ($\beta = .31$, $p < .05$), supporting Hypothesis 3.[14] We also checked the interaction of firm growth and foreign ownership for a more comprehensive analysis. The results (in Model 2) as projected showed that the interaction term is not significantly related to executive bonus pay. As such, these outcomes provided strong support for Hypothesis 3 that foreign ownership has a significant positive moderating effect on the relationship between firm profitability and executive bonus payments.

A number of additional tests are conducted to examine the robustness of our results. First, we used return on assets (ROA) instead of ROE as an alternative measure of performance. We show in Model 4 of Table 2 that the main findings were qualitatively unchanged, except that bank-appointed directors showed a higher significance ($\beta = .08$, $p < .01$). We also used percentage of corporate ownership, instead of corporate-appointed directors, and the results remained qualitatively the same. Percentage of bank ownership is, however, not available in any major Japanese database.[15] We further statistically tested the moderating effects of independent directors on how growth versus ROE (and ROA) influence bonus, and we could not find any significant effects. This verifies our earlier point that independent directors do not represent any single identifiable ownership group, including foreign investors, and those foreign investors do not possess direct agents to influence decision making on Japanese boards.

Furthermore, we made additional analyses employing random-effects regressions for all our models. The outcomes for the hypotheses did not alter (except that the significance of the interaction term ROE * bank-appointed directors changed from $p < .05$ in our original model to $p < .10$ in the new model, ROA * bank-appointed directors changed from $p < .01$ in our original model to $p < .05$ in the new model, and ROA * foreign ownership changed from $p < .05$ in the original model to $p < .01$ in the new model), thus confirming the robustness of our conclusions.[16]

## DISCUSSION

In this paper, we have examined the moderating effects of corporate governance on the linkage between firm performance and executive compensation in Japanese firms. We found that corporate-appointed directors positively moderate the linkage between sales growth and executive bonus payments. This suggests that when a firm has corporate-appointed directors on its board, senior executives are financially motivated to pursue growth rather than profitability. Our results on its interactions of profitability and bank-appointed directors as well as foreign ownership confirm our view that more return-oriented investors, such as bank owners represented by their appointed directors and especially foreign portfolio investors, play a monitoring role in Japanese firms by linking firm profitability to executive bonus pay.[17] These findings are consistent with the agency theory argument that certain types of investors and directors attempt to narrow the agency gap. Interestingly, however, domestic banks also appear to hold on to their relational role as our results indicate that bank-appointed directors positively moderate the relationship between sales growth and executive bonus pay. This suggests that Japanese banks still maintain their preference for the growth of their corporate clients; and they have not completely shifted to become financial return-oriented investors.

This study makes contributions to research on ownership heterogeneity and executive compensation by providing evidence that, given different types of investors with dissimilar investment objectives, their influence on the linkage between performance (profitability and growth in our study) and bonus pay varies. Although it is still not clear whether a strong performance–pay linkage will improve firm performance in Japan (Kubo, 2005), we show that foreign investors prefer to link executive bonus with profitability and domestic corporate partners with sales growth. Our results suggest that the performance–pay linkage is a monitoring mechanism that is favored by large investors in a governance context that is quite different from the US context. In the Japanese environment, where the internal managerial labor market is still firmly kept, it appears that profitability-based compensation has been supported by foreign portfolio and domestic bank investors. This study thus extends prior studies on ownership heterogeneity by showing that diverse interests of different types of owners (and their representatives on the board) affect the sensitivity of executive bonus pay to the different performance measures in Japan.

These findings add to the past research that distinguishes institutional owners with and without business relationships with their invested firms, which focused on the extent of those owners' influence on executive compensation policies. While previous work concentrated on the extent to which these shareholders linked compensation with shareholder wealth, we suggested that different types of owners with and without business relationships and the directors affiliated with some ownership group prefer to link executive pay with different measures of performance due to their varied investment objectives. Our results demonstrated that heterogeneous owners exert not only varied levels of influence over pay-for-performance sensitivity in their invested firms, but they also seek different goals (e.g., growth vs. profits) reflected in their firms' pay schemes. Hence, one needs to pay close attention to the performance goals of different institutional investors to have a comprehensive understanding of their influence on firms' executive compensation policies.

Our study also makes a contribution to research on corporate governance change. Prior research has focused on external forces such as the pressures from global institutional investors as important agents that foster the change of corporate governance practices (Khanna, Kogan, & Palepu, 2006). The results of our study are consistent with this argument and findings of other studies that have examined the impact of market-oriented foreign investors on Japanese firms in pushing to adopt reformed corporate practices (Ahmadjian & Robbins, 2005; David et al., 2010), such as tighter linkage of profitability and pay to motivate executives that we investigate in our study. This study goes further to suggest that some domestic actors who have conventionally behaved to maintain the existing practices can reconsider their growth-oriented practices and promote change towards profit orientation. Our findings show that while domestic corporate partners still adhere to their traditional preference of growth, banking institutions, through their appointed directors, pursue different goals to embrace profit-enhancing practices. This suggests that not only international forces but also domestic actors who are faced with financial performance pressure play a role in facilitating a shift of corporate governance practices in a given economic and institutional setting. The heterogeneous shareholders with their different orientations in Japan further imply that institutional change is usually dynamic with change in the form of profit orientation and continuity in the form of growth orientation played out by different institutional actors.

This study also contributes to research on the functioning of boards of directors. Previous research has largely focused on the effects of independent board members on firm performance and strategies (Daily & Dalton, 1994; Dalton, Daily, Ellstrand, & Johnson, 1998). Instead, our study focuses on the moderating effects of related or affiliated directors. In the conventional agency theory argument, such directors cannot play an effective monitoring role, although they may be more inclined to provide resources to the management (Hillman & Dalziel, 2003). We have shown that those affiliated directors do play an important role because they attempt to promote the interests of the firms or banks from which they are transferred. This suggests that they not only play a resource provision role but also a monitoring role for the specific interests of relational shareholders.

### Future Research Directions

There are some limitations in this study, which lead to future research directions. First, we have only focused on the 1997–2007 period, which can be characterized as a period of significant change in Japanese corporate governance, and hence what we have captured may be a phenomenon that was still in transition. Nonetheless, as Japanese firms have faced strong pressure to link executive compensation with firm performance since the mid-1990s (Colpan et al., 2007), we believe our study captures the trend during this period of important institutional change. Future research can further extend the study period to examine the relationship between performance and executive compensation including base pay and stock options, which became legally enforced to be systematically disclosed in 2006.

Second, we only used foreign investors as a financially-oriented investor category. There are, however, Japan-based investors that seek financial returns such as investment trust companies (Suto & Toshino, 2005) and their influence or propensity to influence management of their invested firms may be different from that of foreign institutional investors. Even though such domestic investors seek financial returns, they may be under strong influence of the domestic institutional norms and hence may act more passively toward their invested firms' management. Future research can use more fine-grained investor categories.

Furthermore, while our research examined the effects of affiliated directors' influence on the pay-for-performance schemes of their invested firms, it will also be worthwhile to investigate how those affiliated directors' presence in affiliated companies affect the performance as well as pay schemes of their "home" firms.

Another research direction is to conduct more studies in different national contexts, as research that examines the ownership heterogeneity and performance–pay relationship is still relatively limited. One of the reasons for this neglect may be that performance-based executive pay is still not as widespread or systematic as in US firms. Another reason may be that, because data on executive compensation are not fully disclosed in many countries, it is difficult for researchers to investigate this issue. Nevertheless, this is an area which is still under-explored in different institutional and economic contexts and therefore, presents vast research opportunities.

## CONCLUSION

Our study has provided strong indication that different types of owners and the directors affiliated with those ownership groups have varied implications for the firm performance–executive pay relationship. While institutional investors in general seek to link executive pay with performance, different types of institutional investors prefer to use dissimilar performance measures that are consistent with their own investment objectives. This suggests that ownership heterogeneity matters in how specific governance mechanisms are employed to the maximization of dissimilar goals that different owners set. Furthermore, the study provides insights into how different actors (e.g., foreign investors and bank-appointed directors in our study) facilitate to

change corporate governance practices toward more market-orientated strategies, such as tightening the linkage of profitability with executive compensation, and also how those practices may be used differently by different actors in specific institutional contexts. Future research should build on these findings to better understand the impact of ownership heterogeneity on performance-based pay schemes.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## NOTES

1. A limited number of studies on Japanese firms have examined the effects of such determinants as firm performance (Kaplan, 1994; Kato & Kubo, 2006; Mitsudome, Weintrop, & Hwang, 2008), *keiretsu* affiliation (Kato, 1997), characteristics of top executives (Kato & Rockel, 1992), and main bank relationships (Sakawa & Watanabel, 2008) on executive compensation. On the performance implication of pay-performance sensitivity, a study by Kubo (2005) found that greater sensitivity is not related to better firm performance. However, few studies have examined how corporate governance affects firm performance–executive pay linkage in Japan.
2. Independent directors do not represent any single identifiable ownership group, including foreign investors and Japanese individual shareholders. Prior research suggests that Japanese firms superficially adopt some of the Anglo-American style of corporate governance practices such as independent directors on boards. In Japan, in most cases it is the insider corporate executives who select these independent directors. As such they usually select their close associates, and foreigners have little influence on this selection due to their limited shareholdings and knowledge (Colpan et al., 2007; Kubo, 2010). Further, only since the Tokyo Stock Exchange began to ask listed firms to have independent directors on the board in January 2010 have large foreign investors started to cast negative votes on some nominations for directors, as nominated by the management at the General Shareholders Meeting, as not sufficiently independent (Nitta, 2009). The fact therefore still remains that Japanese firms are not officially required to have independent directors. Hence, there is no incentive for management to have "independent" directors who represent foreign investors on the board. In our sample, we also find that independent directors are not highly correlated with foreign ownership (.28 as shown in the correlation matrix in Table 1).
3. A number of firms, however, slowly began shifting towards linking individual performance to base pay after 2002 when the Commercial Code was amended to allow companies to decide executive salary without setting upper limits on the total compensation (Colpan et al., 2007; Miyamoto & Higuchi, 2007).
4. Kubo (2010: 146) showed that base pay did not quite go down even in the 1990s, when many companies experienced severe financial difficulties and stock prices considerably declined in the Heisei recession.
5. In addition to those foreign portfolio investors, there are domestic institutional investors such as investments trusts, similar to mutual funds in North America, which are less concerned about the relationship with their invested firms and tend to pursue financial returns (Suto & Toshino, 2005).
6. A limited number of Japanese firms have also begun to incorporate "independent" outside directors that have no financial or transaction-related connections with the relevant firm to their boards since the late 1990s. However, the number of those firms implementing such schemes and the number of independent directors they have on their boards is relatively small.
7. We excluded the three firms that had the majority of foreign share ownership from our analysis, as those investors may have different objectives from their investments.
8. In Japan companies became legally enforced to systematically disclose the amount of stock option grants in 2006. Furthermore, even after 2006 the most detailed data on stock option grants (in *Yuka Shoken Hokokusho*, Japan's equivalent to10-K reports) do not systematically separate stock options for board members and employees. As such, we used dummy variables for stock option adoption.
9. We tested whether any of our critical variables caused an endogeneity problem, because even if a variable can be theoretically endogenous, it has been suggested that it is preferable not to model it as endogenous unless tests indicate that it induces a statistical problem. This is because two-stage least squares regression is less efficient when the explanatory variables are not endogenous, as it can produce larger standard errors than the OLS (Wooldridge, 2002; David et al., 2010). In their study on institutional ownership and CEO pay, Shin and Seo (2011) also suggest that in some circumstances instrumental variable estimates may be more biased and thus likely to generate incorrect statistical inference relative to simple OLS estimates. Therefore, we performed the Durbin–Wu–Hausman test of exogeneity to check for any potential endogeneity problems.
10. We aimed to check whether foreign owners are not randomly assigned to the sample; i.e., they may be drawn to firms with higher profitability or with fewer corporate-appointed directors who will not prioritize profitability. Prior research gives mixed results on firm profitability and foreign ownership, while no causality is suggested between foreign owners and corporate-appointed directors. We measured industry growth as the average of compound growth rate of industry shipments; foreign sales ratio as foreign sales divided by total sales; and firm age as the age of a firm. These instruments were strongly related to the endogenous variables but weakly related to the dependent variable.
11. The max VIF value was 3.62 for the ROE * bank-appointed directors variable.
12. The figure 90,000 yen is calculated by multiplying .09 (the coefficient of ROE in Model 1) by the unit of bonus pay, which is 1 million yen.
13. The idea that banks may behave differently toward client firms with different growth levels, growth orientation of early-phase firms vs. profit-orientation of mature firms, is not likely in our sample where the youngest firm was established in 1962.
14. We conducted F-tests based on the null hypothesis that the coefficient of ROE and its interaction terms with foreign ownership and bank-appointed directors are different from zero. We could reject this null hypothesis at the 5 per cent significance level. Therefore we conclude that the coefficient for ROE + interactions are significantly different from zero ($F = 2.97$; $Prob > F = .0315$). We also made similar tests for ROA and its interactions with foreign ownership and bank-appointed directors, and found similar results. We thus concluded that the coefficients for ROA + interactions are significantly different from zero ($F = 2.86$; $Prob > F = .0368$).
15. None of the major Japanese databases single out the percentage of bank ownership of individual companies, while they list the ownership by all financial institutions including insurance companies and non-bank financial institutions.

16. While our results were robust to the employment of ROA, PBR (price-book ratio) yielded insignificant estimates for our interaction terms. PBR itself was also not significantly linked to bonus pay either. Because a firm's stock may perform well without large profits when investors have high future expectations, we believe long-term stock option plans rather than cash bonus pay may be more appropriate in this context. On the other hand, because bonus payments come out of current profits, even the profit-oriented foreign investors may not want to link stock performance with cash bonus.
17. See Abe et al. (2005) and Sakawa and Watanabel (2008) for different outcomes and interpretations in the case of bank-appointed directors in earlier time periods.

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