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Auditor committee formation and corporate governance mechanisms: Evidence from Japan[*]

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Abstract

This paper presents examination of the relation between the role of outside auditors and corporate governance mechanisms in Japan in the early 1990s. Under Japanese commercial law before 1994, the establishment of an audit committee was required, but not appointment of outside auditors. Consequently, firms came to coexist with and without outside auditors. The empirical question arises of whether outside auditors in Japan are effective monitors or not. We find the following three points in this paper. First, managerial entrenchment effects exist for the appointment of outside auditors. Second, we can find a negative relation between Japanese bank ownership and firms with outside auditors. Finally, financial keiretsu memberships are not significantly effective for the appointment of outside auditors.

Keywords: auditors, bank ownership, corporate governance, financial keiretsu memberships, Japan

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1. Introduction

The importance of corporate governance mechanisms has been increasingly emphasized worldwide. An audit committee (AC) is an important monitoring mechanism of corporate governance. Klein (2002) points out that the AC is a subset of the board of directors and has the responsibility of monitoring the firm's financial-reporting process. In Japan, however, few analyses explore the relation between corporate governance mechanisms and formations of ACs. The purpose of this paper is to analyze the relation between audit committees (ACs) and the features of Japanese corporate governance mechanisms such as managerial ownership, bank ownership, and financial keiretsu memberships.

The relations between corporate ownership and formations of ACs are empirically investigated worldwide from the view of separation of ownership and control (Chau and Leung (2006), Collier and Gregory (1999), Deli et al. (2000), Menon and Williams (1994), and Pincus et al. (1989) etc.). These studies are based on the characteristics of corporate ownership in each country, different from Japanese corporate governance structures.

Japanese corporate governance mechanisms are regarded as "relation-oriented" or bank-centered" systems and differ from western market-oriented systems (Aoki (1990)). We attempt to provide new evidence to analyze these relations in Japan.

This paper presents examination of the relation between Japanese corporate ownership structure and the existence of outside auditors. Therefore, we make three hypotheses about the relation between Japanese corporate governance mechanisms and the effectiveness of ACs. To analyze the differences of monitoring activities between firms with and without outside auditors, we use the sample period before Japanese regulation was altered to include outside auditors in the audit committee.

The salient conclusions of this paper can be summarized as the following three points. First, managerial entrenchment effects arise from the appointment of outside auditors, but this effect is diminishing. Second, a negative relation exists between Japanese bank ownership and firms with outside auditors. Finally, financial keiretsu memberships are not significantly supported.

The remainder of this paper is summarized into the following five sections. Section 2 discusses the related studies of the literature and audit committees in Japan. In section 3, we describe development of our hypotheses. Section 4 presents a description of data and empirical models. Section 5 presents empirical results. In section 6, we summarize the conclusions of this paper.

2. Related Literature and Audit Committees in Japan

Fama (1980) and Fama and Jensen (1983) discuss that the incentives of outside directors help to monitor managers effectively. Results of prior studies imply that independent auditors used in the US are helpful to monitor firms' financial accounting processes better. Nevertheless, few studies analyze

whether Japanese audit committees help to monitor their firms' processes effectively or not. In this section, we introduce the role of Japanese audit committees and compare them with those of the US.

In the US, the audit committee must include a majority of independent auditors, which are determined by the listing regulations of NYSE and NASDAQ based on their *Reports and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Auditor Committee*. They state that the audit committee is the "ultimate monitor" of the financial accounting system. Carcello and Neal (2000), for example, show that the dependent audit committee tends to send a going concern report when a firm experiences financial distress.

In Japan, auditors are elected at shareholders' meetings and thereafter belong to the auditor committee (AC) of their company. Japanese ACs differ from those of the US. In Japan, auditors need not attend the board meeting. In large companies, Japanese commercial law gives them the right to attend the board meeting and express their opinions. Therefore, auditors participate in the process of decision without the right to vote.

Before 1994, Japanese commercial law required establishment of auditor committees for all firms but did not mandate the appointment of outside auditors. Especially, in the early 1990s, nearly 40% of Japanese companies listed at the First Section of the Tokyo Stock Exchange (TSE) had not appointed outside auditors in their auditor committees[1]. Thereafter, Japanese law came to require "large" companies to maintain audit committees with outside auditors for enhancing the independence of auditors. Japanese commercial law classified a "large" company as a company of ¥500 million in paid-in capital or ¥20 billion in liabilities. These "large" companies must establish audit committees (ACs) whose members include more than three auditors and include at least one outside auditor.

Aoki (1990) points out that Japanese corporate governance mechanisms are "relation-oriented" or bank-centered systems whose features consist of two points. First, Japanese corporations were believed to adopt lifetime employment systems; directors were often elected from among the senior management of the company, which is regarded as "*internal*" promotion. Auditors were also elected from among senior managers who could not be promoted to be directors of their firms. Second, Japanese bank-centered systems represent commercial banks' ties and financial keiretsu memberships.

Some scholars point out the lack of monitoring devices of auditors or audit committees in Japan. Miyamata (2006) argues the case of a lawsuit of Daiwa Bank (the jurisdiction of the Osaka District Court) and evaluates this as a lack of their monitoring mechanisms. He concludes that this lawsuit served as the foundation, the origin, of the commercial law's amendments in 2003.

Comparison of the US and Japan raises an empirical question related to the effectiveness of Japanese auditor committee's monitoring role because regulations about auditor committees in US

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[1] See the descriptive statistics of Table 1

strictly determine the auditor committee's composition. To analyze the effectiveness of Japanese auditor committee, we present three hypotheses in the next section.

3. Hypotheses Development

This paper presents examination of the relation between Japanese corporate ownership structure and the existence of outside auditors. In Japan, the role of outside auditors is expected to be independent of managers and a monitor of them. Therefore, we can predict that outside auditors tend to be appointed in firms with effective monitors. Japanese corporate governance mechanisms are so-called bank-centered systems, and are featured as managerial and bank ownership and financial keiretsu memberships (Aoki (1990), Morck and Nakamura (1999), and Morck et al. (2000)). We construct three hypotheses and examine the relation between Japanese corporate governance mechanisms and the existence of auditors in the following sub-section.

3.1. Relation between Japanese managerial ownership and outside auditors

Jensen and Meckling (1976) show that managerial ownership serves to align the interests of managers with those of shareholders and therefore increases firm value. In contrast, Stulz (1988) points out that stronger managerial ownership contributes to the entrenchment of managers by reducing the threats of takeovers. Morck et al. (1988) and McConnell and Servaes (1990, 1995) empirically support the view of the managerial entrenchment hypothesis over certain ranges of managerial ownership in the US.

In Japan, Morck et al. (2000) find that managerial ownership increases monotonically with firm value, which implies that the managerial entrenchment hypothesis proposed by Stulz (1998) is less important in Japan than that in US because cross-shareholding and bank-ownership limit hostile takeovers. Basu et al. (2007) and Sakawa and Watanabel (2008) report that high degrees of managerial ownership increased levels of compensation. These results imply that the managerial entrenchment hypothesis applies also in Japan.

The relation between outside auditors and managerial ownership in Japan is explainable according to two views, which are the convergence-of-interest hypothesis and managerial entrenchment hypothesis (Morck et al. (1988)). We construct two hypotheses.

H1a: Considering the 'aligning interests of managers' hypothesis, we expect that a positive relation exists between the existence of outside auditors and managerial ownership.
H1b: Considering the 'managerial entrenchment' hypothesis, we expect that a non-positive relation exists between the existence of outside auditors and managerial ownership.

Moreover, the possibility remains that the effect of 'managerial entrenchment' or 'aligning

interests of managers' effect is not monotonic for the level of managerial ownership. Therefore, we also analyze additional estimation, following Morck et al. (1988) and Morck et al. (2000).

3.2. Relation between Japanese bank ownership and outside auditors

Numerous previous studies point out that Japanese banks take a monitoring role under the bank-centered corporate governance mechanism (Aoki (1990)). Kaplan and Minton (1994) find that bank-appointed directors increase with poor performance and that turnover of top executives is active when bank-appointed directors are newly appointed to the board. They conclude that commercial banks serve important disciplinary or monitoring roles in Japan.

Some scholars raise questions about the monitoring roles of commercial banks in Japan (Morck and Nakamura (1999), Morck et al. (2000), and Hiraki et al. (2003)). Hiraki et al. (2003) find that both main bank borrowing and the cross shareholdings between the main bank and its client's business corporation are negatively related to Tobin's Q. Furthermore, Morck et al. (2000) find that Japanese bank ownership decreases with a firm's value from the lower to modest range of Tobin's Q because a bank's ownership is insufficient to align the interests of bank with other stakeholders. In this case, banks are not expected to take a role of appointing outside auditors. Therefore, we construct the following hypotheses.

H2a: A positive relation exists between the existence of outside auditors and bank ownership.
H2b: A non-positive or negative relation exists between the existence of outside auditors and bank ownership.

We also analyze additional estimation to check whether a 'positive' or 'negative' relation is not monotonic for the level of managerial ownership.

3.3. Relation between Japanese business group and outside auditors

Some scholars point out that one important characteristic of the Japanese corporate governance mechanism is their business group memberships: so-called financial keiretsu. Berglof and Perotti (1994) argue that the financial keiretsu system plays a role in monitoring and controlling managers effectively. Kato (1997) finds that top executives of firms with financial keiretsu ties earn less than those without keiretsu ties.

In contrast, Gurati and Singh (1998) argue that coordination costs among keiretsu memberships reduce profits of firms with financial keiretsu ties. Moreover, Miwa and Ramseyer (2002) point out that financial keiretsus serve only a ceremonial role. In other words, we cannot predict the monitoring role of financial keiretsu.

We can construct two predictions about the relation between financial keiretsu memberships and

outside auditors. They tend to appoint outside auditors in the firms belonging to their memberships if the financial keiretsu takes a monitoring role. However, no significant relation exists when financial keiretsu memberships do not take a monitoring role, as suggested by Miwa and Ramseyer (2002). These two predictions are summarized as the following two hypotheses.

H3a: A positive relation exists between keiretsu memberships and outside directors.
H3b: A non-positive relation exists between keiretsu memberships and outside directors.

4. Data, Descriptive Statistics, and Empirical Model

4.1. Data Source and Data Selection

For this study, we choose the sample period 1991–1993 when Japanese regulation did not require inclusion of more than one outside auditor in the audit committee. Therefore, we can analyze the differences of monitoring activities between firms with and without outside auditors.

The sample comprises 1566 observations acquired during 1991–1993 for 522 Japanese manufacturing firms listed in the First Section of the Tokyo Stock Exchange. Financial data were obtained from the Nikkei NEEDS database. Data related to characteristics and the numbers of auditor members were collected manually from *Yakuin Shiki Ho*. The financial keiretsu ties data were collected from *Kigyo Keiretsu Souran* (1991). We constructed the financial keiretsu dummy, which denotes whether or not each firm belongs to an executive gathering known as *Shachokai* (presidents' club) following Hoshi and Kashyap (2001).

4.2. Descriptive Statistics Analysis

We provide definitions of the variables (Outside Auditor, Managerial Ownership, Bank Ownership, Financial keiretsu memberships, logarithm of asset, MTB, and D/A) and their descriptive statistics in Table 1.

Table 2 shows that the average ratio of outside auditor is about 33.2%, indicating that a substantial share of firms do not appoint an outside auditor. The managerial ownership has a mean of 2.1%. It is apparently too low to exist with the convergence of interest hypothesis. The mean of bank ownership is about 40%, which is consistent with Morck et al. (2000). Sample firms include about 11.3% of firms with financial keiretsu ties.

The average of firm size is about 11.4 billion yen. That of the firm's market to book ratio (MTB) is about 2.21. The debt to asset ratio (D/A) is about 0.56, signifying that long-term debt is vital for the capital structure of sample firms.

Table 1 Descriptive Statistics (n = 1566)

Variable	Mean	Std.Dev.
p	0.619	0.486
Outside Auditor Ratio (%)	33.225	31.628
Number of Outside Auditors	0.964	0.919
Managerial Own	0.021	0.041
Bank Own	0.410	0.130
Keiretsu	0.113	0.317
Firm Size	11.483	1.085
MTB	2.217	1.260
D/A (%)	0.560	0.174

Note: The variables are defined as follows:

P= probability that outside auditors are included in ACs of the firms 1 and 0 otherwise

Outside Auditor Ratio =Percentage of outside auditors in the AC

Number of Outside Auditors=Number of outside auditors in the firm

Managerial Own=Percentage of common shares held by board members of firm

Bank Own= Percentage of common shares held by commercial bank

Keiretsu =1 if firms belong to financial keiretsu, 0 otherwise

Firm Size= Legalism of firm's asset

MTB=Market to book ratio (%)

D/A = Debt to Asset Ratio (%)

Table 2 Mean Differences Test

Variables			Wilcoxon rank-sum	
	P=0	P=1	Z-value	p-value
Outside Auditor Ratio (%)	0.000	53.695	-34.757	0.000
Number of Outside Auditors	0.000	1.557	-35.163	0.000
Managerial Own	0.027	0.018	4.575	0.000
Bank Own	0.444	0.388	8.299	0.000
Keiretsu	0.124	0.106	1.072	0.284
Firm Size	241137	173903	4.494	0.000
MTB	2.183	2.237	0.104	0.917
D/ A	0.537	0.574	-4.463	0.000
observations	597	969	-	-

Note: We divide sample firms whether *p* equals to 1 or 0. In column 2 and 3, the mean variables of each group are reported. We also test the mean differences of each variable by wilcoxon rank-sum test. The Z value and p value of the test is reported in column 4 and 5.

Table 2 reports that the mean differences test results between firms with and without outside auditors. Managerial ownership is significantly lower—about 0.9%—in a firm with outside auditors, supporting hypothesis H1b. Regarding bank ownership, the degree of bank ownership is significantly lower in the firms with outside auditors, which is consistent with H2b. No significant difference was found between firms with and without financial keiretsu ties.

Firms without outside auditors are significantly larger, but the debt to asset ratio (D/A) is significantly larger for firms with outside auditors. Klein (2002) points out that creditors' demands for independent ACs increase with a high debt-to-asset ratio. This result is consistent with Klein (2002) and suggests that firms which depend more on debt tend to hire outside auditors.

4.3. Empirical Models

Because of the binomial nature of the dependent variable, we select a logit model to test three hypotheses. The dependent variable (Outside Auditor) is 1 if outside auditors are included in the AC and 0 otherwise. The logit model used for estimation is the following:

$$\begin{aligned} Logit(p) = \beta_0 + \beta_1 ManagerialOwn + \beta_2 BankOwn + \beta_3 Keiretsu \\ + \beta_4 \ln(asset) + \beta_5 MTB + \beta_6 (D/A) + u_t \end{aligned} \quad (1)$$

In eq. (1), p is the probability that an outside auditor exists. We use ownership variables (Ownership) to examine the relation between ownership structure and the existence of outside auditors. To control for the firm size, we adopt the logarithm of firm assets (ln(*asset*)). Klein (2002) shows that firms with high growth opportunities do not demand independent auditor committees. To control for firms' high growth opportunities, we also adopt the market-to-book ratio (*MTB*). Finally, the debt-to-asset ratio (D/A) is adopted to control for firms' risk-taking behavior.

We adopt three independent variables to examine three hypotheses: managerial ownership (*Managerial Own*), bank ownership (*BankOwn*), and financial keiretsu memberships (*Keiretsu*).

We construct the following eq. (2) adding the squared terms of managerial ownership to identify which of hypotheses 1a and 1b is supported.

$$\begin{aligned} Logit(p) = \beta_0 + \beta_1 ManagerialOwn + \beta_2 (ManagerialOwn)^\wedge 2 + \beta_3 BankOwn + \beta_4 Keiretsu \\ + \beta_5 \ln(asset) + \beta_6 MTB + \beta_7 (D/A) + u_t \end{aligned} \quad (2)$$

Furthermore, to analyze hypotheses 2a and 2b, we construct the following eq. (3), adding the squared terms of managerial ownership and bank ownership.

$$Logit(p) = \beta_0 + \beta_1 ManagerialOwn + \beta_2 (ManagerialOwn)^\wedge 2 + \beta_3 BankOwn + \beta_4 (BankOwn)^\wedge 2 + \beta_5 Keiretsu + \beta_6 \ln(asset) + \beta_7 MTB + \beta_8 (D/A) + u_t \quad (3)$$

5. Empirical Results

Results of eqs. (1), (2), and (3) are presented in Table 3. The predicted signs of logistic estimations are reported in the second columns of Table 3. Logistic regression results of eq. (1) are also described in the second column of Table 3. The model's χ^2 is 114.82; it is significant at the 1% level. The pseudo-R^2 is 0.055. In the third and fourth column, the estimated results of eq. (2) and (3) are reported, respectively. These models' χ^2 are 134.19 and 134.46, which are significant at the 1% level. Both the pseudo-R^2 of eq. (2) and that of eq. (3) are about 0.065.

Table 3 Estimation Results

Variables	Equation(1)	Equation(2)	Equation(3)
Managerial Own	-6.941 ***	-18.566 ***	-18.311 ***
	(-4.79)	(-5.86)	(-5.71)
Square of Managerial Own		56.582 ***	55.537 ***
		(3.79)	(3.68)
Bank Own	-3.603 ***	-3.575 ***	-4.876 *
	(-7.18)	(-7.06)	(-1.91)
Square of Bank Own			1.588
			(0.52)
Keiretsu	0.093	0.021	0.016
	(0.49)	(0.11)	(0.09)
Firm Size	-0.129 **	-0.157 **	-0.157 **
	(-2.10)	(-2.52)	(-2.52)
MTB	-0.065	-0.072	-0.074
	(-1.33)	(-1.48)	(-1.52)
D/ A	0.928 **	0.695 *	0.712 *
	(2.56)	(-1.88)	(1.92)
Constant Terms	3.246 ***	3.852 ***	4.089 ***
	(4.73)	(5.44)	(4.85)
Pseudo R^2	0.0552	0.0645	0.0646
Chi Square test	114.82 ***	134.19 ***	134.46 ***

Note: We report the estimated results of each logit model (1), (2), and (3) in this table.
Each of ***, **, and * indicates the statistical significance at 1, 5, and 10 %.

The estimated coefficient of managerial ownership in the second column of eq. (1) is about -6.94, which is significant at the 1% level. This is consistent with H1b and the managerial entrenchment effect exists for Japanese ACs. The possibility remains that the managerial entrenchment effect is not monotonic for the level of managerial ownership.

In the third and fourth columns, we report results of eqs. (2) and (3), including the squared terms of ownership variables. The estimated coefficients of managerial ownership are -18.57 and -18.31; both the estimated coefficients are significant at the 1% level. The squared term of eqs. (2) and (3) are 56.58 and 55.54; they are significant at the 1% level. These results can be interpreted that managerial entrenchment effects for ACs exist, but they are marginally diminishing.

Regarding bank ownership, the second and third columns show that the coefficients of eqs. (1) and (2) are about -3.60 and -3.58 and significant at the 1% level. This result is consistent with H2b, suggesting that bank ownership does not converge with the interests of stakeholders and appointed outside auditors. To analyze whether a monotonic relation exists for the level of bank ownership, we also report the estimated result of its squared term.

The estimated coefficient of bank ownership in the fourth column is -4.876, which is significant at the 10% level and consistent with H2b. The estimated result of its squared term is positive, but not significant. This result can be interpreted similarly to the results of eqs. (1) and (2) because the estimated result of the squared term is not significant. These results imply that bank ownership does not support effective monitoring from the viewpoint of appointing outside auditors.

The coefficient for financial keiretsu is positive, but not significant, for three equations. These results do not support either hypothesis 3a or 3b. In other words, we can find no role of the financial keiretsu for appointing outside auditors.

The coefficients of firm size of three equations are negative and significant and consistent with Klein (2002). Regarding the debt-to-asset ratio (D/A), the coefficient of eq. (1) is positive and significant at the 5% level and those on eqs. (2) and (3) are also positive and significant at the 10% level. This result is also consistent with Klein (2002). The coefficients for MTB are not statistically significant.

6. Conclusions

This paper presented examinations of the relation between outside auditors and corporate governance mechanisms in Japan. Japanese bank-centered corporate governance features are not consistent with market-oriented corporate governance mechanisms as they are in Western countries such as the US and UK. For this study, we choose the sample period 1991–1993 before the commercial law's amendment. We then make three hypotheses about the relation between the effectiveness of ACs and Japanese corporate governance mechanisms such as managerial ownership, bank ownership, and keiretsu.

Our results demonstrate that managerial ownership is negatively related to the effectiveness of ACs in Japan. We infer that the managerial entrenchment hypothesis is adequate for the appointment of outside auditors in Japanese firms. Moreover, the estimated result of the squared term of managerial ownership is positively related to the effectiveness of ACs, which implies that managerial entrenchment effects are diminishing.

Results show a negative relation between Japanese bank ownership and firms with outside auditors. The estimated result of its squared term is positive, but not significant. These results imply that bank ownership does not facilitate effective monitoring from the perspective of appointing outside auditors. Although results of previous studies imply that Japanese banks tend to appoint their employees as directors for the monitoring role (Kaplan and Minton (1994)), our results can be interpreted as showing that Japanese banks have no interest in the effective monitoring role of outside auditors.

Our results show that financial keiretsu are positively related to the effectiveness of ACs, but the coefficient is not significant for three equations. Therefore, financial keiretsu ties do not relate to the appointment of outside auditors; our hypotheses related to financial keiretsu memberships are not significantly supported.

These findings about Japanese ACs in the 1990s suggest that Japanese corporate governance mechanisms are not well functioning for forming effective ACs. From the perspective of effective ACs, we cannot expect a monitoring role of commercial bank and financial keiretsu. Japanese policymakers and stock exchanges face challenges for enhancing effective ACs fit for the Japanese corporate governance structure and fit to protect the investors' interests. These are important requirements for Japanese markets, in which effective ACs have not formed.

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