

THE ROLE OF OUTSIDE STATUTORY AUDITORS IN BANK-DOMINATED CORPORATE GOVERNANCE: EVIDENCE FROM JAPAN

*Naoki Watanabel**, *Hideaki Sakawa***

Abstract

This paper examines whether or not the role of outside statutory auditors are effective post the amendment of commercial law in Japan. By this amendment, Japanese large firms are urged to appoint at least one auditor. Under bank-dominated corporate governance, the monitoring role of outside auditors do not seem to be strongly expected. The empirical question arises of whether outside auditors in Japan are effective monitors or not post the amendment of commercial law. We find managerial entrenchment effects exist for the appointment of larger outside auditors. In addition, we can find a negative relation between bank ownership and firms with more outside auditors. These findings suggest that outside auditors have not still been expected for adequate gatekeeper in Japan.***

Keywords: Bank Ownership; Corporate Governance; Japan; Statutory Auditors

* College of Business Administration, Ritsumeikan University, 1-1-1, Noji-Higashi, Kusatsu, Shiga, 525-8577, Japan

E-mail: n-wata@fc.ritsumei.ac.jp

** Corresponding author, Associate Professor at Graduate School of Economics, Nagoya City University,

1 Yamanohata, Mizuho-cho, Mizuho-ku, Nagoya, Aichi, 467-8501, Japan

E-mail: sakawa@econ.nagoya-cu.ac.jp

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1. Introduction

An internal control is an important topic for corporate governance and an audit committee takes an important monitoring mechanism of internal control. Klein (2002), for example, assert that the audit committee is a subset of the board of directors and has the responsibility of monitoring the firm's financial-reporting process. Many previous studies empirically investigate the role of audit committees or statutory auditors from the view of separation of ownership and control (Chau and Leung, 2006; Collier and Gregory, 1999; Deli and Gillan, 2000; Menon and Williams, 1994; Pincus et al., 1989). However, many countries are not dispersed ownership structure like Anglo-American countries and we might separately consider about different corporate governance structure of concentrated ownership like emerging countries or bank dominated corporate governance structure like Japan (Claessens et al., 2000). Therefore, we do not simply conclude the effectiveness of audit committees or statutory auditors by these studies. Bank-dominated corporate governance has been featured as delegated monitoring of banks instead of block holders or independent internal control mechanisms (Aoki, 1990; Aoki et al., 1994; Morck and Nakamura, 1999).

The purpose of this paper is to analyze the relation between statutory auditors and investigate whether or not they take an effective monitoring role like audit committees in US. In addition, we also examine how Japanese corporate governance features of such as managerial ownership, bank ownership, and financial keiretsu memberships relate to the monitoring roles of auditors in Japan. Most of prior researches are based on the characteristics of corporate ownership in each country, different from Japanese corporate governance structures. In Japan, the introduction of audit committee has not been permitted until the amendment of Commercial Law in 2003 and statutory auditor has taken monitoring roles during 1990s. Watanabel and Sakawa (2013) find that outside statutory auditors do not help to appoint outside auditors when Japanese commercial law do not require to appoint outside auditors before 1993. Previous analyses do not explore the relation between corporate

governance mechanisms and monitoring roles of statutory auditors post 1993 when Japanese commercial law urge to appoint outside auditors.

This paper presents examination of the relation between Japanese corporate ownership structure and the number of outside auditors because they are independent from board of directors and expected for effective internal control mechanisms similar to US. Therefore, we make three hypotheses about the relation between Japanese corporate governance mechanisms and the effectiveness of statutory auditors. To analyze the monitoring strengthens of outside auditors in Japanese internal control mechanisms, we adopt the sample period before Japanese regulation was altered to appoint at least one outside auditors.

The main results of our paper are summarized as following three points. First, managerial entrenchment effects depend on the appointment of outside auditors and smaller size of outside auditors are appointed under firms with larger managerial ownership. Second, a negative relation exists between Japanese bank ownership and the number of outside auditors. Finally, financial keiretsu memberships are not significantly related to the number of outside auditors.

The remainder of this paper is organized into the following five sections. Section 2 discusses the related studies of the literature and Japanese commercial law changes related to internal control system. In section 3, we make development of our hypotheses. Section 4 explains a description of data and empirical models. Section 5 summarizes empirical results. In section 6, we summarize the conclusions of this paper.

2. Related Literature and Japanese Commercial Law

The incentives of outside directors help to monitor managers effectively (Fama, 1980; Fama and Jensen, 1983). 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 statutory audit systems help to monitor their firms' processes effectively or not. In this section, we introduce the role of Japanese statutory auditors and compare them with audit committees of the US.

In the US, the audit committee must include a majority of independent auditors. 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. On the other hand, auditors are elected at shareholders' meetings in Japan and the statutory auditor systems are different from those of Anglo Saxon countries like US. In Japan, auditors do not have a duty of attending 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 statutory auditors for all firms but did not mandate the appointment of outside auditors. Thereafter, Japanese law came to require "large" companies to maintain statutory audit systems 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 statutory auditor systems whose members include more than three auditors and include at least one outside auditor.

This commercial law change might affect the effectiveness of statutory auditor systems in Japan. Watanabel and Sakawa (2013) find that outside auditors do not tend to appoint at large firms with larger managerial ownership and bank ownership during 1991-1993 before the commercial law change. This suggests that Japanese bank-dominated corporate governance mechanisms are functioned as substitutes for the role of outside auditors. These situations might be changed by the commercial law amendment at 1994 because all large firms have at least one outside auditor post 1994. These changes might expect to strengthen monitoring role of outside auditors in Japan like Anglo American countries. This paper compares the pre and post-period of law change and intend to reveal whether or not the role of Japanese outside auditors change. To analyze the effectiveness of Japanese statutory auditors post the commercial law change, we present three hypotheses in the next section.

3. Hypotheses Development

This paper investigates the relation between Japanese corporate ownership structure and the number 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 bank-dominated systems, and are featured as managerial and bank ownership and financial keiretsu memberships (Aoki, 1990; Morck and Nakamura, 1999; 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 takes a role of aligning the interests of managers with those of shareholders and increases firm value. In contrast, Stulz (1988) find that stronger managerial ownership is a source of the entrenchment of managers for protecting the threats of takeovers. Prior studies like Morck et al. (1988) and McConnell and Servaes (1990, 1995) empirically support the view of the managerial entrenchment hypothesis 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 are not satisfied in Japan. On the other hand, Basu et al. (2007) and Sakawa and Watanabel (2008) find that high degrees of managerial ownership increased levels of compensation. These results imply that the managerial entrenchment hypothesis might also be satisfied in Japan.

The relation between the number of 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 following two hypotheses H1a and H1b.

H1a: Considering the ‘aligning interests of managers’ hypothesis, we expect that a positive relation exists between the number of outside auditors and managerial ownership.

H1b: Considering the ‘managerial entrenchment’ hypothesis, we expect that a non-positive relation exists between the number of outside auditors and managerial ownership.

There also remains the possibility 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.

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-dominated corporate governance mechanism (Aoki, 1990). Kaplan and Minton (1994) find that bank-appointed directors are appointed to firms with poor performance and that turnover of top executives is likely to be observed in the case when bank-appointed directors are newly appointed to the board. In addition, Sakawa et al. (2014) find that main-bank lending relationships would function as bonding of healthiness of firms in the financial markets and suggest that main bank would take a substitute role of block shareholders. These studies suggest that main banks serve important disciplinary or monitoring roles in Japan.

There are some studies to raise questions about the monitoring roles of commercial banks in Japan (Morck and Nakamura, 1999; Morck et al., 2000; Hiraki et al., 2003; Sakawa et al., 2012). Hiraki et al. (2003) find that both main bank borrowing and the cross shareholdings between the main bank and its client’s business corporation rather weaken firm performance. Furthermore, Morck et al. (2000) point out that Japanese bank ownership reduces 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 addition, Sakawa et al. (2012) find that bank ties measured as bank ownership and bank-appointed directors are not helpful to adopt adequate incentive for managers and imply that monitoring roles of banks are insufficient in recent Japan. In this case, banks are not expected to take a role of appointing outside auditors. Therefore, we construct the following hypotheses H2a and H2b.

H2a: A positive relation exists between the number of outside auditors and bank ownership.

H2b: A non-positive or negative relation exists between the number 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 bank ownership.

3.3. Relation between Japanese business group and outside auditors

There are many previous studies 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 monitoring role for managers who belong to financial *keiretsu* membership. Kato (1997) finds that top executives of firms with financial keiretsu memberships earn smaller pay than those without keiretsu memberships.

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

We can construct two predictions about a relation between financial keiretsu memberships and the number of outside auditors. They tend to appoint a large number of outside auditors in the firms belonging to their memberships if the financial keiretsu is an effective monitor. However, we cannot predict significant relation 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 and H3b.

H3a: A positive relation exists between keiretsu memberships and the number of outside auditors.

H3b: A non-positive relation exists between keiretsu memberships and the number of outside auditors.

4. Data, Descriptive Statistics, and Empirical Model

4.1. Data Source and Descriptive Statistics

For this study, we choose the sample in 1994 after Japanese regulation change in the statutory auditor system. Therefore, we can analyze the differences of monitoring activities between pre-period at 1993 when the commercial law did not change and post-period at 1994 when the commercial law changes. The sample comprises 522 observations in 1994 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 number of auditor members were collected manually from *Yakuin Shiki Ho*. The financial keiretsu membership's data were collected from *Kigyo Keiretsu Soran* (1991). We constructed the financial keiretsu dummy, which denotes whether or not each firm belongs to an executive gathering known as *Shachokai* (presidents' club)⁴ following Hoshi and Kashyap (2001).

We provide definitions of the variables (The number of Outside Auditor, Managerial Ownership, Bank Ownership, Financial keiretsu memberships, logarithm of asset, debt to asset ratio, and market to book ratio) in Appendix and their descriptive statistics and Pearson correlations in Table 1.

Table 1. Descriptive Statistics and Correlation Matrix (n = 522)

Variable	Mean	Std Dev	1	2	3	4	5	6	7
1. The number of Outside Auditors	1.58	0.94	1.00						
2. Managerial Ownership	0.02	0.04	-0.09	1.00					
3. Bank Ownership	0.41	0.13	-0.25	-0.18	1.00				
4. Keiretsu	0.11	0.32	0.01	-0.16	0.21	1.00			
5. ln (Asset)	11.48	1.09	-0.08	-0.16	0.47	0.45	1.00		
6. D/A	0.55	0.18	0.12	-0.30	-0.10	0.18	0.07	1.00	
7. MTB	2.39	1.90	-0.01	-0.09	-0.12	0.03	-0.08	0.39	1.00

Note: The definition of variables are provided in the Appendix.

Table 2. Mean Differences Test

Variable	Post Law	Pre Law	Difference	t-value
The number of Outside Auditors	1.58	1.00	0.58 ***	(10.04)
Managerial Ownership	0.02	0.02	0.00	(-0.36)
Bank Ownership	0.41	0.41	0.00	(0.45)
Keiretsu	0.11	0.11	0.00	(0.00)
ln (Asset)	11.48	11.47	0.01	(0.09)
D/A	0.55	0.55	0.00	(-0.20)
MTB	2.39	1.96	0.43 ***	(4.70)

Note: In column 2 (Post law) and 3 (Pre Post), the mean variables of each period are reported. We test the mean differences of each variable.

+ $p < 0.1$; * $p < 0.05$; ** $p < 0.01$.

Table 1 shows that the average number of outside auditors are about 1.58. The managerial ownership has a mean of about 2 %. It is apparently too low to exist with the convergence of interest hypothesis. The mean of bank ownership is 41%, which is consistent with Morck et al. (2000). Sample firms include about 11 % of firms with financial keiretsu ties. The debt to asset ratio (D/A) is about 0.55, signifying that long-term debt is vital for the capital structure of sample firms. The average of market to book ratio (MTB) is about 2.39.

Table 2 reports that the mean differences test results between firms of pre-period and post-period. We can find that the number of outside auditors significantly increases post the law. This suggests that many large firms appoint more outside auditors post the change of commercial law. Corporate ownership structure of managerial ownership and bank ownership are stable at post -period. In addition, the average of market to book ratio (MTB) of the sample firms in post-period is significantly higher than that of the firms in pre-period. It implies that the stock price of Japanese market tend to increase during this period.

4.2 Empirical Models

Because of the multinomial nature of the dependent variable, we select an ordered-logit model to test three hypotheses. The ordered-logit model used for estimation is the following estimated equation:

$$\begin{aligned} \text{Outside_Auditors} = & \beta_0 + \beta_1 \text{ManagerialOwn} + \beta_2 (\text{ManagerialOwn})^2 + \beta_3 \text{BankOwn} \\ & + \beta_4 \ln(\text{Asset}) + \beta_5 \text{MTB} + \beta_6 (D/A) + u_t \end{aligned} \quad (1)$$

In equation (1), the dependent variable is the number of outside auditors. We use ownership variables to examine the relation between ownership structure and the number of outside auditors. To control for the firm size, we adopt the logarithm of firm assets ($\ln(\text{Asset})$). Klein (2002) shows that firms with high growth opportunities do not require 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 (*Bank Own*), and financial keiretsu memberships (*Keiretsu*). We construct the following estimated equation (2) adding the squared terms of managerial ownership to identify which of hypotheses 1a and 1b is supported.

$$\begin{aligned} \text{Outside_Auditors} = & \beta_0 + \beta_1 \text{ManagerialOwn} + \beta_2 (\text{ManagerialOwn})^2 + \beta_3 \text{BankOwn} \\ & + \beta_4 \text{Keiretsu} + \beta_5 \ln(\text{Asset}) + \beta_6 \text{MTB} + \beta_7 (D/A) + u_t \end{aligned} \quad (2)$$

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

$$\begin{aligned} \text{Outside_Auditors} = & \beta_0 + \beta_1 \text{ManagerialOwn} + \beta_2 (\text{ManagerialOwn})^2 + \beta_3 \text{BankOwn} \\ & + \beta_4 (\text{BankOwn})^2 + \beta_5 \text{Keiretsu} + \beta_6 \ln(\text{Asset}) + \beta_7 \text{MTB} + \beta_8 (D/A) + u_t \end{aligned} \quad (3)$$

To check the robustness of our estimated results of three equations, we adopt another dependent variables; rank of outside auditors. We predict that the monitoring strength of firms with more than three firms would be slightly different and construct rank of outside auditors. Therefore, the rank of outside auditors is defined as three if more than three outside auditors are included in the statutory auditor system; otherwise it is equal to the number of outside auditors.

5. Empirical Results

Estimation results of ordered logit estimation of equation (1), (2), and (3) are presented in Table 3.

In these estimations, our dependent variables are both of the number of outside auditors and rank of outside auditors. The results of equation (1) are also described in the column (1) of Table 3. In the column (2) and (3), the estimated results of equation (2) and (3) are reported, respectively. As for the rank of outside auditors, the column (4), (5), and (6) show the estimated results of equation (1), (2), and (3).

Table 3. Estimation Results

	<u>Number of Outside Auditors</u>			<u>Rank of Outside Auditors</u>		
	(1)	(2)	(3)	(4)	(5)	(6)
Managerial Ownership	-8.33 ** (-3.25)	-22.09 ** (-4.51)	-21.30 ** (-4.27)	-8.48 ** (-3.32)	-20.53 ** (-4.24)	-19.61 ** (-3.97)
Managerial Ownership ²		73.75 ** (3.58)	70.83 ** (3.39)		61.82 ** (3.10)	58.31 ** (2.88)
Bank Ownership	-4.12 ** (-5.44)	-4.06 ** (-5.34)	-6.52 * (-2.10)	-4.16 ** (-5.44)	-4.12 ** (-5.37)	-7.11 * (-2.22)
Bank Ownership ²			3.11 (0.82)			3.76 (0.96)
Keiretsu	0.15 (0.53)	0.09 (0.30)	0.07 (0.25)	0.14 (0.50)	0.08 (0.29)	0.06 (0.22)
ln (Asset)	-0.04 (-0.38)	-0.06 (-0.65)	-0.06 (-0.60)	-0.03 (-0.35)	-0.06 (-0.58)	-0.05 (-0.52)
D/A (%)	0.95 + (1.72)	0.73 (1.32)	0.76 (1.36)	0.97 + (1.76)	0.77 (1.37)	0.80 (1.43)
MTB	-0.09 * (-2.01)	-0.09 * (-2.07)	-0.10 * (-2.14)	-0.09 * (-2.03)	-0.09 * (-2.07)	-0.10 * (-2.17)
Industry Dummies	Yes	Yes	Yes	Yes	Yes	Yes
Pseudo R2	0.056	0.063	0.064	0.059	0.065	0.066
Log likelihood	-660.1	-655.2	-654.9	-626.9	-622.8	-622.3
LR Chi Square	78.26 **	88.10 **	88.76 **	78.36 **	86.65 **	87.58 **

Note: We report the estimated results of Ordered Logit model in this table. The variables are defined in the Appendix. The dependent variables are the number of Outside Auditors in the column (1)-(3) and Rank of outside Auditors in the column (4)-(6). All specifications include Industry dummies. Z-statistics are presented in parentheses.

+ $p < 0.1$; * $p < 0.05$; ** $p < 0.01$.

The estimated coefficient of managerial ownership in the column (1) and (4) of equation (1) are about -8.33 and -8.48, which are significant at the 1% level. This is consistent with H1b and the managerial entrenchment effect exists for Japanese statutory auditor systems. The possibility remains that the managerial entrenchment effect is not monotonic for the level of managerial ownership. In the column (2) and (3), the estimated coefficients of managerial ownership are also negative and significant at the 1% level. The squared term of equation (2) and (3) are significantly positive at the 1% level. The estimated results in the columns (5) and (6) also show the similar results in the column (2) and (3). We can interpret that these results imply the existence of managerial entrenchment effects for statutory auditor systems, but this effect is marginally diminishing.

As for bank ownership, the column (1) and (4) show that the coefficients of equation (1) are about -4.12 and -4.16 and significant at the 1% level, which is consistent with H2b. The coefficients of equation (2) are also negative and significant in the column (2) and (5). These results suggest that bank ownership does not converge with the interests of stakeholders and appointed outside auditors. To analyze a monotonic relation of bank ownership, we also report the estimated result of its squared term. In the columns (3) and (6), the estimated coefficient of bank ownership are significantly negative. We cannot gain significant results of its squared terms. These results show bank ownership have the monotonic relation with the number of outside auditors. We can interpret that bank ownership does not support effective monitoring from the viewpoint of appointing larger number of outside auditors.

The coefficient for financial keiretsu is not significant for all equations. The coefficients of firm size of three equations are not significant. Regarding the MTB, the coefficient of equation (1), (2), and (3) are significantly negative at the 5% level. These results show that firms with the lower MTB tend to have larger outside auditors than those with higher MTB. Firms with the higher growth opportunity do not need to appoint outside auditors, consistent with U.S evidence of Klein (2002).

As a result, we can find that the appointment of a large number of outside auditors would not be promoted by managerial entrenchment effect and the effect is diminishing with the increase of managerial ownership. In addition, higher bank ownership do not help to enlarge the number of outside auditors. Finally, financial keiretsu ties do not relate to the appointment of outside auditors¹. These results suggest that bank monitoring are expected for substitutes of effective monitoring of outside auditors under Japanese bank-dominated corporate governance.

6. Conclusions

This paper investigates the relationship between the number of outside auditors and corporate governance mechanisms post commercial law amendment in Japan. This law amendment would require Japanese large firms to appoint outside auditors which would expect for effective monitoring in Anglo-American corporate governance countries like US and UK. For this study, we focus on the post-period of commercial law's amendment. We construct three hypotheses about the relation between the effectiveness of statutory auditor systems and Japanese corporate governance mechanisms such as managerial ownership, bank ownership, and financial keiretsu memberships.

Our results show that managerial ownership is negatively related to the effectiveness of the number of outside auditors in Japan. This suggests that the managerial entrenchment hypothesis is adequate for the appointment of outside auditors in Japanese firms. In addition, the estimated result of the squared term of managerial ownership is positively related to the number of outside auditors, which implies that managerial entrenchment effects are diminishing.

We also show a negative relation between Japanese bank ownership and firms with larger number of outside auditors. The estimated result of its squared term is insignificant. These results imply that bank ownership does not facilitate effective monitoring from the perspective of appointing larger number of outside auditors. Our results can be interpreted as showing that Japanese banks have no interest in the effective monitoring role of larger outside auditors post the commercial law change. In other words, bank ties can be functioned as substitutes for monitoring roles of outside auditors. Our results show that financial keiretsu memberships are not significant for three equations. Therefore, financial keiretsu ties do not relate to the appointment of larger number of outside auditors post the commercial law amendment.

These findings about statutory auditor systems in the 1990s suggest that Japanese corporate governance mechanisms are not well functioning for forming effective statutory auditor systems. From the perspective of effective statutory auditor systems, Japanese monitoring role of commercial bank would substitute for outside auditors. This suggests that outside auditors has not still been functioned as adequate gatekeeper post the amendment of commercial law in Japan. This result also provides lessons for the emerging countries which do not form audit committee systems.

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¹ To check the robustness of the estimated results, we also implement other estimation methods of OLS and ordered probit estimations. In un-tabled results, we gain the consistent results.

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Appendix. Variable definition

Variable	Definition and Measure
The Number of Outside Auditors	The number of outside auditors in the firm
Rank of Outside Auditors	We define rank of outside auditors in the firm as followed; 0 if the number of outside auditors=0 1 if the number of outside auditors=1 2 if the number of outside auditors=2

	3 if the number of outside auditors \geq 3
Managerial Ownership	Percentage of common shares held by board members of firm
Bank Ownership	Percentage of common shares held by commercial bank
Keiretsu	Keiretsu equals 1 if firms belong to financial keiretsu; Otherwise it is equal to 0.
Ln(Firm Size)	Legalism of firm's asset
D/A	Debt to Asset Ratio
MTB	Market to book ratio
