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Acronyms

ACRC	Anti Corruption and Civil Rights Commission
ASJB	Accounting Standards Board of Japan
BC	Board Committees
BS	Board Size
CEO	Chief Executive Officer/ CEO Duality (as a variable)
Coef	Coefficient
CG	Corporate Governance
CSR	Corporate Social Responsibility
EVA	Economic-value-added
FKI	Federation of Korean Industries
FP	Firm Performance
FSC	Financial Supervisory Commission
GAAP	Generally Accepted Accounting Principles
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
JFSR	Japan Financial Services Agency
IMF	International Monetary Fund
KASB	Korea Accounting Standards Board
KOREI	Korea Enterprise Institute
KSDA	Korea Securities Dealers Association
KSE	Korea Stock Exchange
KOSDAQ	Korea Securities Dealers Automated Quotations
M&A	Mergers and acquisitions
MOCIE	Ministry of Commerce, Industry and Energy
MOF	Ministry of Finance
NASDAQ	National Association of Security Dealers Automated Quotations
NYSE	New York Stock Exchange
OECD	Organisation of Economic Cooperation and Development
OLS	Ordinary Least Squares
OD	Outside Directors
P	P-value
PCAOB	Public Company Accounting Oversight Board
ROA	Return on Assets
ROE	Return on Equity
ROI	Return on Investment
SEC	U.S. Securities and Exchange Commission
SCAP	Supreme Commander for the Allied Powers
UN	United Nations

1. Introduction

1.1 Background of the Thesis

In 2012 Japan has been assigned the fourth position in Asia by the "Asian Corporate Governance Association" in terms of good corporate governance. It shares this position with Malaysia. This is mainly due to two reasons: Japan does not require its companies to have a certain percentage of outside board directors and it equally does not require any training of directors, unlike its competitors South Korea, India and China. In 2009 the New York Stock Exchange and the NASDAQ introduced the requirement of a majority of independent directors in order to effectively monitor managers.[1] Any firm listed in New York must fill a majority of board seats with outsiders. According to Japanese bosses these rules limit the managers' freedom. But given the current Olympus affair, there are voices being raised that this has a negative effect on firm performance.[2]

A survey conducted by Booz & Company covering the world's biggest companies illustrates how the NYSE requirements have changed corporate governance over the past decade. For example in 2002 in the US about 48 percent of the incoming Chief Executive Officers were also made chairman of the board as opposed to 2009 where this number diminished to 12 percent. Equally now chairmen of corporate boards are held accountable for their performance and in case of failure they are dismissed. The average length of tenure in 2000 was 8.1 years as compared to 6.3 years in 2009. Also these days' directors are sent off to take courses in business schools as according to the new regulations they are personally liable for all the accounts they sign.[3]

Over the past few years there have been new changes and regulations introduced and adapted world wide. Most of these changes focus on board independence and accountability. But some experts ask if these reforms are really as successful. The Financial Crisis of 2008 gave opportunity for possible tests. Bad corporate governance is considered the main reason for this crisis but when examining financial institutions in regard to this matter we get opposing views.[4] For example America's Citigroup and Switzerland's USB made severe losses as opposed to JP Morgan Chase and Credit Suisse. According to corporate reformers banks have always been badly managed. But sceptics claim that the banks which made it through the crisis relatively well were not examples of what is considered to be good corporate governance these days and vice versa. For example Citigroup and Lehman Brothers disposed of strong outside directors.[5]

So even though there has been an apparent trend and shift towards more board independence, separate leadership and disclosure and there seems to be a consensus that this path leads towards good corporate governance and better firm performance, there is still no actual proof that this is true and the reality is giving differing results. Therefore we have to ask ourselves how significant corporate governance really is in terms of firm performance. Is it possible that corporate governance is only secondary in this context? And that firm success is determined by other factors?

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[1] "Corporate Constitutions," *The Economist*, October 28, 2010, http://www.economist.com/node/17359354?zid=294&ah=71830d634a0d9558fe97d778d723011d (accessed October 1, 2013)

[2] "Back to the Drawing Board," *The Economist*, November 4, 2012, http://www.economist.com/news/business/21565660-after-olympus-scandal-japan-inc-wants-less-scrutiny-back-drawing-board (accessed October 1, 2013).

[3] Ibid.

[4] Grant, Kirkpatrick, 2009, *The Corporate Governance Lessons from the Financial Crisis* Working paper, OECD, 1.

[5] Ibid.

According to the Financial Times, publicly traded companies have an incentive problem. "The people who run the company (management) are not the same as the people who own the company (shareholders) and who otherwise have a stake in its success (stakeholders)." [6] Managers have their own self-interests. In order to prevent managers from making decisions only based on their own self-interest, which might harm the company, a system called corporate governance was developed. [7] In general it is difficult to find one complete framework on how corporate governance can affect firm behaviour and economic performance. There are many different and often conflicting views. Therefore in order to be able to extract a framework, it is useful to consider the different analytical backgrounds or approaches that are often employed. There are different models of the company that appear in the debate about corporate governance and firm performance on a regular basis: the shareholder model, which is the narrower theory and the stakeholder model, which applies a broader view.

The purpose of this master thesis is to investigate the relationship between corporate governance and firm performance in Japan and South Korea. First we look at theories of corporate governance. We describe and evaluate theories developed by different authors. We explore the different models as identified by theories on corporate governance such as the two most common models (shareholder model and stakeholder model) but also at other influential models like the resource dependency theory and the stewardship theory. We look at different aspects of corporate governance such as corporate boards and ownership. We develop factors to evaluate and categorize corporate governance in both countries hereby focusing on board structure. In order to evaluate firm performance we find common indicators of firm performance. Subsequently we identify definitions, principles and benefits of corporate governance. We explain the Japanese corporate governance system as well as the system in South Korea. Additionally we analyse thirty companies listed at the stock exchange in Japan and South Korea respectively. We want to determine the relationship between corporate governance practices of board structure and firm performance of listed companies in South Korea and Japan. In order to do so we will apply statistical and econometric means such a descriptive statistics, Spearman's correlation, multiple regression and random effects models.

These calculations let us draw a final conclusion on the relationship between firm performance and corporate governance in Japan and South Korea.

1.2 Objective of the Thesis

The specific objectives of this study are as mentioned before to determine the relationship between corporate governance and firm performance in Japan and South Korea but equally to define all dimensions of corporate governance and how it evolved. Furthermore we aspire to examine the development of corporate governance practices in Japan and South Korea and how they are applied today. We want to explore to which extent practices have been adopted compared to general standards. We will compare both countries to each other and illustrate how their practices differ from each other and what characterises them. Also we want to analyse the board structures of listed companies in Japan and South Korea as well as their corporate reporting practices including corporate social reporting using statistical means.

As a theoretical basis we use theories on corporate governance which allows us to extract a framework of analysis.

1.3 Analytical Framework of the Thesis

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[6] *Financial Times Lexicon*, s.v. "Corporate Governance," http://lexicon.ft.com/Term?term=corporate-governance. (accessed October 1, 2013).

[7] Ibid.

We base our framework on an analysis of relevant literature and the most dominant theories in order to be able to extract relevant factors of corporate governance and firm performance. Regarding corporate governance we focus on the characteristics of the board of directors and corporate reporting including corporate social reporting.
Theoretical basis for this are the agency theory which promotes the separation of ownership and control, shareholder theory, which emphasises the importance of shareholder protection, stewardship theory and parts of the stakeholder theory which promotes accountability of companies to all its stakeholders. Most of the theories have differing views but what they have in common is the fact that they focus strongly on the characteristics of corporate boards of directors, in more detail: the size of the board, its composition (especially the number of outside directors), the separation between chairman of the board and CEO and the question of the committee system. So even though scholars are divided on how these factors influence corporate governance, they are subject of regular analysis and discussion as these factors are supposed to serve as monitoring mechanisms of the board. Therefore they serve as variables for corporate governance in our framework.
Furthermore the question of corporate social responsibility is often discussed. This variable represents accountability towards share- and stakeholders and is based on the stakeholder approach. As the importance of corporate social responsibility has been more and more emphasised over the past years, this factor is added to our framework of analysis.
As we see in the course of this thesis these factors have been very present in past papers worldwide and can be considered relevant for any research on the relationship between corporate governance and firm performance.
Firm performance is measured through accounting-based measures, namely return on equity (ROE) and return on assets (ROA) as they represent two of the most common ratios for financial performance.

1.4 Methodology of the Thesis

In order to analyse the relationship between firm performance and corporate governance in Japan and South Korea quantitative measures are used. These measures are conducted by using Microsoft Excel in order to obtain descriptive statistics, create correlation matrix' and perform multiple regressions. We use Gretl for panel data regressions namely the random effects models.
We present descriptive statistics in order to illustrate corporate governance characteristics and firm performance for each country. We collect data for listed firms on the stock exchange for each country respectively for the years 2008 to 2012. Data is collected from secondary sources such as annual reports and information found on the companies' homepages.
The results of correlation, multiple regression and panel data regression analysis do not show any significant relationship between firm performance and corporate governance in both cases which leads to the conclusion that the highly desired good corporate governance is not one of the main influential factors of firm performance.

1.5 Reasons for Focus on Corporate Boards

Firstly it can be stated that boards of directors are considered to be one of the most important mechanisms in order to monitor, control and also advise management on the hand and protect

shareholder's interests on the other hand (e.g. Fama & Jensen (1983)[8], Adams and Ferreira (2007)[9], Harris and Raviv (2008)[10], Hermanlin and Weisbach (2003)[11]). [12]
The second reason is the fact that after the current financial crisis the failure of corporate boards to review and guide a firm's risk-management policies was seen as one of the main reasons for the crisis. It has been said that boards of financial and non-financial firms did not provide stable risk policies and did not monitor the risk-taking behaviour of companies appropriately. Even if corporate boards were not the main reason for the financial crisis firm could have been better protected given better board governance.[13]
Last but not least there is still a lack of consensus amongst researchers about how corporate boards and firm performance are related, especially in regards to board independence. As our literature review shows, there is a variety of papers devoted to that subject but the results are mixed.

1.6 Outline of the Thesis

This thesis is divided into five chapters.
The first chapter introduces the topic, the research question, the analytical framework and the methodology.
The second chapter provides an analysis of existing literature divided into a general section and a section focusing on board characteristics.
The third chapter explains corporate governance, its theories and development as well as international regulatory frameworks.
The fourth chapter explores corporate governance practices in Japan and South Korea respectively. It provides information on the development of corporate governance and reporting in each country, how it has evolved over time and how it can be characterized today.
The fifth chapter constitutes the empirical part. The analytical framework and methodology are explained in detail. Subsequently quantitative methods are applied and results are presented.
The sixth chapter gives a summary of the results obtained as well as a conclusion.

1.7 Significance of the Thesis

There are a number of scientific papers which deal with corporate governance and firm performance in Japan and South Korea. But these papers mostly examine one single country or decide to focus either on the descriptive or quantitative dimension of this question. Also the theoretical background of corporate governance is usually only presented in a shortened form. This paper provides a quantitative analysis of the relationship between corporate governance and firm performance for companies in both Japan and South Korea for the years 2008 to 2012. It uses recent data for listed companies and performs a variety of quantitative measures.

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[8] Eugene F. Fama and Michael C. Jensen, "Agency Problems and Residual Claims," *Journal of Law and Economics* 26, no. 2 (June, 1983): 327-49.
[9] Renee Adams and Daniel Ferreira, "A Theory of Friendly Boards," *Journal of Finance* 62, no. 1 (February 2007): 217-50.
[10] Milton Harris and Artur Raviv, "A Theory of Board Control and Size," *The Review of Financial Studies* 21, no. 4 (July 2008): 1797-1832.
[11] Michal S. Weisbach and Benjamin E. Hermalin, "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," *FRB New York-- Economic Policy Review* 9 (April 2003): 7-26.
[12] Michal S. Weisbach and Benjamin E. Hermalin, "Endogenously Chosen Boards of Directors and their Monitoring of the CEO," *American Economic Review* 88 (1998): 96-118.
[13] Grant, Kirkpatrick, 2009, *The Corporate Governance Lessons from the Financial Crisis* Working Paper, OECD, 1-2.

In addition to that a descriptive part on the evolution and current practices of corporate governance is given which gives a better understanding of the general conditions in both countries. At the same time it provides an extensive analysis of theoretical background of corporate governance.

1.8 Limitations of the Thesis

This analysis is limited to corporate governance factors that focus on the characteristics of the board of directors and accountability. It does not take into account single behavioural factors such as characters and objectives of board members or relationships betweens these. Also due to availability of data firm performance is limited to accounting based ratios and excludes market-based ones. It is equally limited to 30 companies from South Korea and Japan respectively.

2. Literature Review

In this chapter, we provide a review of the related literature on the relationship between corporate governance and firm performance. We start with a broader review of the literature dealing with corporate governance and firm performance in a general way. This is followed by a presentation of literature dealing with board composition and its relationship with firm performance, which will be further subdivided into two categories dealing with board characteristics, namely board size, and board composition.

2.1 Relationship between Corporate Governance and Firm Performance

General belief says that good corporate governance is responsible for better firm performance. [14] Nevertheless throughout literature on the relationship between corporate governance and firm performance, we can find that opinions on the subject are divided. Many findings claim that there is indeed a positive relationship between corporate governance and firm performance. But there is a large amount of literature which claims that there is no significant relationship between both and that firm performance is more influenced by other factors.

According to Schleifer and Vishy (1997)[15], John and Senbet (1998)[16] and Hermalin and Weisbach (2003),[17] corporate governance results in higher productivity, lower systematic risks and an increase in value of the companies.

There are many studies that have conducted cross-country analysis to highlight the importance of corporate governance related to firm performance but the number of researchers who examined a single country is low. For example in 2001 Mitton conducted an empirical study of 398 firms from five East Asian countries including Korean, Malaysian, Indonesian and Thai firms in order to illustrate the positive effect that corporate governance had on firms during the Asian crisis. He showed that better performance is related to firms that dispose of higher disclosure, greater transparency and higher outside ownership concentration which led to an improved stock price performance during the crisis.[18]

In 2004 Brown and Caylor examined US firms with 51 factors, 8 sub-categories for 2327 firms. Their study was based on the data set obtained from the Institutional Shareholder Service (ISS). They came to the result that good governance leads to more profitability, value and more cash paid to the shareholders.[19]

According to Vishny et al. (1999) investors are more inclined to invest when their protection is stronger therefore a strong legal environment increases a firm's profitability.[20]

Adjaoud et al. (2007) found that there is no significant relationship between the scores and accounting-based variables of performance (e.g. ROI, ROE, market-to-book) but a significant relationship between scores and measure of value created.[21]

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[14] Beth Young, "Corporate Governance and Firm Performance: Is There a Relationship?" *Ivey Business Journal* (September/October 2003), http://iveybusinessjournal.com/topics/governance/corporate-governance-and-firm-performance-is-there-a-relationship#.Unu53uLOTnv (accessed October 3, 2013).

[15] Robert W. Vishny and Andrei Shleifer, "A Survey of Corporate Governance," *The Journal of Finance* 52, no. 2 (1997): 737-83.

[16] Kose John and Lemnia W. Senbet, "Corporate Governance and Board Effectiveness," *Journal of Banking and Finance* 22, no. 4 (May 1998): 371-403.

[17] Michal S. Weisbach, and Benjamin E. Hermalin. "Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature," *FRB New York - Economic Policy Review* 9 (April 2003): 7-26.

[18] Todd Mitton, "A Cross-Firm Analysis of the Impact of Corporate Governance on the East Asian Financial Crisis," *Journal of Financial Economics* 64 (2002): 215-41.

[19] Marcus L. Caylor and Lawrence D. Brown, "Corporate Governance and Firm Operating Performance," *Review of Quantitative Finance and Accounting* 32, no. 2 (2009): 129-44.

[20] Robert Vishny et al., "Law and Finance," *Journal of Political Economy* 106 (1998): 1113-55.

Classens et al. (2002) examined nine East Asian countries and found that higher cash flow rights of shareholders lead to higher market value. However higher voting rights are related to lower market valuation.[22]

Boone et al. (2000) found that a higher Tobin's Q is related to higher shareholder protection. They found that weak legal enforcement of corporate governance practices was one of the reasons for stock market declines during the 1997 East Asian financial crisis. According to them, weak shareholder protection results in capital inflows being much more sensitive to events that could shake shareholders' trust. [23]

Cornett et al (2009) claim that companies with good internal governance experienced higher rates of returns during the recent financial crisis.

Paul MacAvoy and Ira Millstein (1999) found a positive relationship between the measure of independence and a measure of firm value which was related to economic-value-added (EVA). They measured board independence through a survey by the California Public Employees' Retirement System. These responses produced grades which were combined with the authors' own evaluation of board performance. Therefore this study was able to deliver more performance indicators than other studies which may have caused positive correlations.[24]

In 2001 Andrew Gompers et al. conducted a study that found a positive relationship between a company's score in a multi-factor governance index and their long-term corporate success. They have created an equal-weighted governance index including 1,500 companies with 24 variables on shareholder rights.[25]

Black et al. (2006) found that the value of Korean public companies is highly influenced by corporate governance. They used a corporate governance index.[26]

There are studies claiming that corporate governance indexes are especially important in countries with weak legal shareholder protection. For example Black (2001) claims that the positive effects of good corporate governance can be especially seen in countries that are still developing as they often have weaker legal enforcement and a larger gap between corporate governance practices.[27]

Core, Guay and Rusticus (2005) claim that firms with weak shareholder rights tend to dispose of a more negative firm performance. Nevertheless the market is not influenced by negative performances of firms with bad corporate governance.[28]

Lehn, Patro and Zhao (2005) found that in the 1990s there was no significant relationship between the G-Index and valuations multiples after checking valuation multiples for the period from 1980 to 1985.[29]

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[21] Fodil Adjaoud, Daniel Zeghal, and Syed Andaleeb, "The Effect of Board's Quality on Performance: A Study of Canadian Firms," *Corporate Governance: An International Review* 15 (2007): 623-35.

[22] Stijn Claessens et al., "Disentangling the Incentive and Entrenchment Effects of Large Shareholdings," *Journal of Finance* 57 (2002): 2741-71.

[23] Peter Boone et al., "Corporate Governance in the Asian Financial Crisis," *Journal of Financial Economics* 58, no. 1 (2002): 141-86.

[24] Paul MacAvoy and Ira Millstein, "The Active Board of Directors and Its Effect on the Value of the Large Publicly Traded Corporation," *Journal of Applied Corporate Finance* 11 (1999): 8-20.

[25] Paul A. Gompers, Joy L. Ishii, and Andrew Metrick, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118 (2009): 107-55.

[26] B. Black, J. Hasung, and K. Woochan, "Does Corporate Governance Affect Firms' Market Values? Evidence from Korea," *Journal of Law, Economics and Organization* 22 (2006): 366-413.

[27] B Black, "The Corporate Governance Behavior and Market Value of Russian Firms," *Emerging Markets Review* 2 (2001): 89-108.

[28] John E. Core, Wayne R: Guay Rusticus, and Tjomme O., "Does Weak Governance Cause Weak Stock Returns? An Examination of Firm Operating Performance and Investors' Expectations," *Journal of Finance* 61 (2007): 655-87.

[29] Kenneth Lehn, Sukesh Patro, and Mengxin Zhao, "Determinants of the Size and Structure of Corporate Boards," *Working Paper, University of Pittsburgh* (2005): 1935-2000.

Demsetz and Lehn (1985) examined 511 large U.S. companies including financials from 1976-80 by using the Ordinary Least Squares (OLS) model with return on equity ratios and standard-error-of-market model. They performed a regression analysis with the dependent variables firm return and market return and seven independent variables and found that the relationship between accounting return is insignificantly decreasing with ownership by large shareholders but ownership by large shareholders increases significantly by standard error of market return.[30]
McConnell and Servaes (1990) analysed roughly 2.000 U.S. firms in 1976 and about 1.000 U.S. firms in 1986 listed on NYSE or AMEX. They used Tobin's Q and ROA as dependent variables and performed an OLS regression analysis with four independent variables. They found that profitability is significantly increasing with ownership by managers and directors and that profitability increases significantly with institutional ownership.[31]
Leach and Leahy (1991) examined 470 large industrial firms based in the United Kingdom through 1983 to 1985. They used market value, return on sales (ROS) and return on equity (ROE) as dependent variables and regressed them against eight dependent variables by using a multivariate regression. Their results show that ownership control firms are significantly more profitable than management control firms. [32]
David Erkens, Mingyi Hung and Pedro Matos of the University of California analysed the performance of 296 financial institutions in 2007 and 2008 with assets of more than $10 billion. According to this research none of the institutions with good corporate governance performed well. They claim that it does not make a difference if directors are well informed in their area of expertise or if the role of CEO and chairman are separated. Quite to the contrary powerful shareholders and independent directors provided worse shareholder values. The reason for this, the researchers claim, lies in the fact that powerful shareholders are urging firms to take more risks in the run-up to the crisis in order to gain higher returns on investment unlike managers who are more dependent on the company. Equally they claim that independent directors strive to raise more equity capital when share prices are plummeting as they are worried about their own "market worth" or in other words reputation which may be harmed when they are overseeing companies that are unsuccessful. [33]
There is a large and growing amount of literature on governance issues like board composition, leadership structure but the results are not quite clear in regards to firm performance according to Dalton et al. (1999). Many of the studies indeed found a positive relationship between various variables related to that subject and firm performance, nevertheless when these results were analysed meta-analytically they often showed negative relationships and these relationship were not statistically significant at all. They claim that firm size moderates the relationship between board size and firm performance. [34]
Of course it remains a truth universally acknowledged that good corporate governance enhances better firm performance but there is no absolute proof that these two spheres are significantly linked or that factors like director independence have the desired positive effect on firm performance. [35]

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[30] Harold Demsetz and Kenneth Lehn, "The Structure of Corporate Ownership: Causes and Consequences," *Journal of Political Economy* 33 (1985): 3-53.
[31] John J. McConnell and Henri Servaes, "Additional Evidence on Equity Ownership and Corporate Value," *Journal of Financial Economics* 27 (1990): 595-612.
[32] John Leahy and Dennis Leech, "Ownership Structure, Control Type Classifications and the Performance of Large British Companies," *Economic Journal, Royal Economic Society* 101, no. 409 (November 1991): 1418-37.
[33] Ibid.
[34] Dan R. Dalton et al., "Number of Directors and Financial Performance: A Meta-Analysis," *The Academy of Management Journal* 42 (1999): 674-86.
[35] Beth Young, "Corporate Governance and Firm Performance: Is There a Relationship?" *Ivey Business Journal* (September/October 2003): http://iveybusinessjournal.com/topics/governance/corporate-governance-and-firm-performance-is-there-a-relationship#.Unu53uLOTnv (accessed October 1, 2013).

2.2 Relationship between the Board of Directors and Firm Performance

In the following we discuss the relationship of board size and firm performance and board composition and firm performance separately.

2.2.1 Board Size

Eisenberg et al. (1998) explored the relationship between board size and firm performance for small firms and boards in Finland and found a negative correlation. Equally they found a strong correlation between firm size and board size and the relationship to firm performance. They claim that firm size can influence firm performance through ownership structure because in small firms managers and board members often own the firm.[36]

Yermack (1996) argues that usually firms with bigger boards of directors tend to have a lower Tobin's Q ratio. He took a sample of 452 firms from the Forbes 500 list for the years 1984 through 1991 and performed a regression on Tobin's Q with the variable board size and control variables like company size, industry membership and board stock ownership. According to him there is an inverse relationship between the size of the board and a firm's market value.[37]

Ferris, Jaganathan and Pritchard (2003) found a positive relationship between board size and market-to-book ratios by using a large sample of U.S. firms.[38]

2.2.2 Board Composition and Structure

One of the earliest studies on this subject was conducted by Vance (1964) and claims that boards with a larger number of inside directors show better performance than outside boards.[39]

Baysinger and Butler (1985) examined the relationship between the number of independent directors in 1980 and industry-adjusted returns on equity in 1980 and found a positive correlation. But if the relationship is investigated for the same year there is no correlation to be found.[40]

In 1989 Forsberg reports to not have found any significant correlation between board composition and firm performance.[41] Hermalin and Weisbach (1991)[42] and Klein (1998) report similar results. In all three cases different performance measures were used. In the first case it was return on equity, in thee second case Tobin's Q and in the last case one-year raw market returns. Still there was no significant positive correlation in all four cases. Klein found a significant negative relationship between a measure of change in market value of equity and the number of outside directors, as well as a positive relationship between the proportion of inside directors on finance and investment committees and different accounting and market-base measures of performance.[43]

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[36] T. Eisenberg, S. Sundgren, and M.T. Wells, "Larger Board Size and Decreasing Firm Value in Small Firms," *Journal of Financial Economics* 48, no. 1 (1998): 35-54.

[37] David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics* 40 (1996): 185-211.

[38] Stephen P. Ferris, Murali Jagannathan, and A.C. Pritchard, "Too Busy to Mind the Business? Monitoring by Directors with Multiple Board Appointments," *The Journal of Finance* 58 (2003): 1087-12.

[39] S. C. Vance, *Boards of Directors: Structure and Performance.* (Eugene: University of Oregon, 1983).

[40] Barry D. Baysinger, and Henry N. Butler, "The Role of Corporate Law in the Theory of the Firm," *Journal of Law and Economics* 28 (1985): 179-91.

[41] R. H. Fosberg, "Outside Directors and Managerial Monitoring," *Akron Business and Economic Review* (1989).

[42] B.E. Hermalin, and M. S. Weisbach, "The Effect s of Board Composition and Direct Incentives On Firm Performance," *Financial Management* 20 (1991): 101-12.

[43] A. Klein, "Firm Performance and Board Committee Structure," *The Journal of Law and Economics* 41 (April 1998): 275-304.

Another set of studies found evidence that boards with a higher percentage of outside directors may even perform worse. Barhart and Rosenstein (1998)[44] and Yermack (1996)[45] found a significant negative relationship between the performance indicator Tobin's Q and the proportion of outside directors. Agrawal and Knoeber (1996) found similar results using the same variables.[46]

Bhagat and Black (2002) performed a long-term study on the relationship between board independence and firm performance by using a range of different governance variables such as ownership characteristic, firm and board size as well as industry. They measured board composition in 1991 and then examined the effect of composition on performance in lagged years (1988-1990) and in lead years (1991-1993). They also examined if changes in board independence from 1988 to 1991 influenced firm performance in any way in the following years. According to their results firm with bad performance were more likely to enhance the independence of their boards. Nevertheless they did not find any evidence that higher board independence leads to better firm performance.[47]

The empirical evidence that explicitly and directly deals with the relationship between board composition and firm performance is mixed and rather weak.

2.3 Conclusion

Literature shows differing relationships between corporate governance, corporate boards and firm performance. Some results show negative relationships, others show positive relationships between different variables of governance and firm performance and some show no significant relationship at all. But even the ones that show for example a positive relationship between governance and performance variables differ in regards to which variables show this significant relationship and if this relationship is positive or negative. Therefore it is not possible to draw an ultimate conclusion as results differ even within the three categories of results.

[44] S.W. Barnhart and S. Rosenstein, "Board Composition, Managerial Ownership, and Firm Performance: An Empirical Analysis," *Financial Review* 33 (1998).

[45] David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics* 40 (1996): 185-211.

[46] A. Agrawal and C. R. Knoeber, "Do Some Outside Directors Play a Political Role?," *Journal of Law and Economics* 14 (2001): 179-98.

[47] Sanjai Bhagat and Bernard S. Black, "The Non-Correlation between Board Independence and Long-Term Firm Performance," *Journal of Corporation Law* 27 (2002): 231-73.

3. *Corporate Governance*

In this chapter we give an overview of different theories on corporate governance. We explain how corporate governance evolved and look at different definitions in order to be able to tell what in entails. We identify drivers of good corporate governance and problems that often occur. Subsequently we define the different parties and areas of a company involved in corporate governance.

In order to define corporate governance we explore different key ideas that have shaped modern corporate governance practices and regulations. According to research, corporate governance and the work of boards of directors remain largely invisible to outsiders and are often misunderstood. Directors themselves are influenced by their own experience on what constitutes the work of the board whilst investors have to rely on stereotypical ideas on what constitutes good corporate governance.[48] It is often the case, that individuals involved in corporate governance apply what they think is common sense, when in reality they draw sub-consciously on long-established economic theory and assumptions that are challengeable.[49]

Corporate governance has been a subject of discussion in the past years. The question if better corporate governance leads to better firm performance and shareholder protection has been analysed often. But giving an exact definition of this term is a challenge since there are major differences between countries due to different economic, social and political backgrounds. Systems in developing and developed countries differ strongly. There are different schools of thought and theories which we discuss in due course that give an idea of what constitutes corporate governance. But many of these theories disagree in regard what good corporate governance is and how it should look in daily practice. As a consequence a comparison theories and what is actually put into practice can show many differences.

3.1 Definitions of Corporate Governance

In this section we provide general definitions of what corporate governance entails and give a brief overview of changes that have occurred in the immediate past.

In order to define corporate governance we first need to differentiate it from management. During the 20th century business scholars mainly focussed on professional management theory and practices but as the millennium approached this focus shifted more towards corporate governance and today this focus remains more important than ever.[50]

Professional management can be illustrated in the shape of a classical pyramid representing the hierarchy within the management with the chief executive officer at the top and other managers reporting to him. Of course this is a simplified view but it represents the general idea of management from top till bottom of the pyramid with functional departments and assigned responsibilities of line and staff management. [51]

So where does corporate governance fit in? One of the most basic definitions of corporate governance describes a

> "*System of rules, practices and processes by which a company is directed and controlled. Corporate governance essentially involves balancing the interests of the many stakeholders in a company - these include its shareholders, management, customers, suppliers,*

[48]Don Young, "The Theories Behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 6 2013).
[49]Ibid.
[50] Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (New York: Oxford University Press, 2009), 35-6.
[51] Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (New York: Oxford University Press, 2009), 35-6.

financiers, government and the community. Since corporate governance also provides the framework for attaining a company's objectives, it encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure."[52]

According to this definition corporate governance penetrates every level of management since it sets the company's overall objectives. It is described as a system of rules, practices and processes in order to balance the interests of a group of "stakeholders" of the firm.
The OECD also defines corporate governance broadly for both private and public institutions as a set of laws, regulations and accepted business practices which combine the management of the relationship between corporate managers and entrepreneurs and between investors in a market economy. It adds that corporate governance, especially the corporate board of directors is supposed to serve as a monitoring mechanism of the management in order to ensure accountability to the shareholders and the company itself. [53]

"The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."[54]

An older and narrower definition states that corporate governance is a system that manages and monitors companies. The structure of a corporate governance system determines how rights and tasks are divided between all the members of that system, namely board of directors, managers, shareholders and stakeholders. It determines decision making procedures regarding corporate affairs and equally the setting of goals, achieving them and monitoring performance.[55]
Shleifer and Vishny define corporate governance as a set of mechanisms in order to guarantee (potential) shareholders an appropriate return on investment due to the separation of ownership and control.[56]

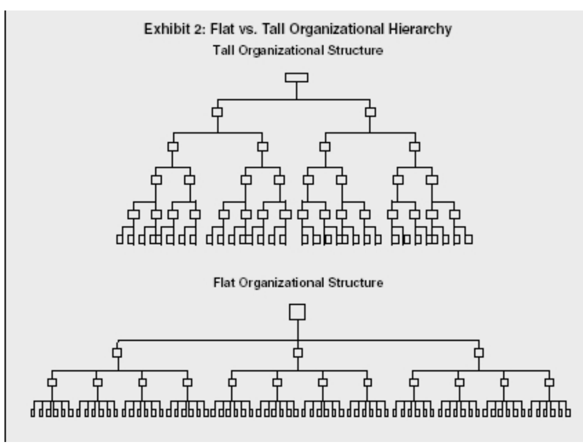

Figure 1: Classical Depiction of Management, Tall vs. Flat Structure[57]

[52] *Investopedia*, s.v., "Definition of Corporate Governance," http://www.investopedia.com/terms/c/corporategovernance.asp (accessed October 9, 2013).
[53] OECD, *Corporate Governance and National Development, Technical Papers No.180,* (Paris: Organisation for Economic Co-operation and Development 2001), 13.
[54] *OECD, Principles of Corporate Governance,* (Paris: Organization for Economic Co-operation and Development, 1999), 24.
[55] *OECD, Principles of Corporate Governance,* (Paris: Organization for Economic Co-operation and Development, 1999), 24.
[56] Robert W. Vishny and Andrei Shleifer, "A Survey of Corporate Governance," *The Journal of Finance* 52, no. 2 (1997): 737.

3.2 Overview of Past Concerns Regarding Corporate Governance

In the course of the Wall Street Crash of 1929 new theories on the role of the modern corporation evolved. Scholars like Adolf Augustus Berle and Gardiner Means claimed that this role is changing and has to be adjusted to the demands of today's society.[58] Ronald Coase developed the idea of transaction costs when trying to answer why firms are founded and how they evolve.[59] Lorsch and MacIver concluded that many firms lack adequate accountability or supervision by their board of directors.[60]

Corporate governance gained a rise in attention in the 1980s' where a wave of takeovers rolled over a large number of U.S. firms. Managers tried to brace themselves against those takeovers through various anti-takeover means (e.g. poison pills, greenmail and golden parachutes) known as management entrenchment which were clearly not in the interest of those companies' shareholders. During this scenario and given the situation then, where managers were facing severe pressure from boards to achieve short-term results, the focus on long-term planning and investment was dwindling. This revived the discussion on corporate governance systems.[61] Around the same time Eugene Fama and Michael Jensen developed the "principal-agent problem" which we be discuss in the following section.[62]

Twenty years later, several corporate frauds and failures (e.g. Maxwell, Polly Peck, the Bank of Credit and Commerce International, Barlow Clowes, Ferranti, Coloroll, British and Commonwealth) occurred. These incidents demonstrated what can happen when corporate control becomes too strong and is concentrated in the wrong hands. At same time the role of the auditors was questioned as they are responsible for a firm's accountability and seemed to have failed to perform their duties. Another problem that became more apparent was the fact the companies involved in the scandals had been distorting financial information. [63]

Excessive salaries of executive directors also became a public issue, when huge raises were given that were not related to actual performance and thus were not justified. One of the most famous examples occurred in 1994 when Cedric Brown of British Gas received a 75 per cent raise to 480,000 pounds. But other even more extreme cases followed, e.g. Sam Chishol of BSkyB who received a 203 percent increase to 2.03 million pounds and Michael Green of Carlton with a 170 percent raise to 1.72 million. This lack of justification between performance and salary became one of the central parts of discussion regarding corporate governance in the following years. What followed where stricter observations and regulations from investor groups, business media and regulators regarding both general corporate governance and the performance of boards. [64]

3.3 Theories on Corporate Governance

[57] *Reference for Business*, s.v. "Management Levels," http://www.referenceforbusiness.com/management/Log-Mar/Management-Levels.html (accessed October 9, 2013).
[58] A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932).
[59] Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (1937): 386-405.
[60] J. W. Lorsch and E. MacIver, *Pawns or Potentates: The Reality of America's Corporate Boards* (Boston: Harvard School Press, 1989).
[61] Philip Stiles and Bernard Taylor, *Boards at Work: How Directors View Their Roles and Responsibilities* (Oxford: Oxford University Press, 2001), 5.
[62] E. Fama and M. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 26 (1983a): 301-25.
[63] Philip Stiles and Bernard Taylor, *Boards at Work: How Directors View Their Roles and Responsibilities* (Oxford: Oxford University Press, 2001), 5.
[64] Ibid.

According to Jensen, one of the central points of debate on corporate governance is a strong disagreement about the original purpose of a corporation.[65] There are two competing views: The shareholder view and the stakeholder view. The shareholder view is the more narrow theory and basically defines a system of accountability of management to shareholders and monitoring of the management in order to maximise shareholder value. The stakeholder view comprises a network of formal and informal relations between the so-called stakeholders and the corporation. This model involves stakeholders that can be involved in long term performance of the company and shareholder value, as well as business ethics that can have an effect on reputation and long term success.[66] But when examined in more detail the difference between both models is not as strong as it may initially seem, it is more a question of emphasis.

3.3.1 The Shareholder Model

Firstly this theory claims that the main purpose of a public corporation is to create long-term value which can be done through a corporate governance framework. Value ought to be created and protected. Thus the main focus still remains on the shareholders as long-term strategies of sustainability are developed The origins of the shareholder view come from Adam Smith's (1776) "The Wealth of Nations", highlighting the importance of "free markets", the "invisible hand of self-regulation" and "enlightened self-interest". The thoughts were further developed by the "Austrian School" and scholars like Schumpeter et al. who strongly supported "laissez-faire" capitalism entailing self-regulation of firms and little government intervention. Current theories were introduced by the "Chicago School" of economics, mainly through Milton Friedman who has been emphasising the maximisation of shareholder wealth as the main purpose of a corporation.[67] He considered anything beyond as a waste of time. According to him social and moral development ought to be managed by non-governmental organisations NGOs and governments. Nevertheless he never encouraged unethical behaviour in firms.[68] One of the most influential theories today that derived from the shareholder view is the agency theory that we discuss further on.

Criticism of this theory usually involves the fact that managers are presented as strong and dominant while shareholders are seen as weak. This theory does not focus on management entrenchment which can be a major problem in the scenario of principal agent theories with dispersed ownership. Most of the ideas related to this theory focus on the role of the board of directors, stock options, executive remuneration, shareholder protection, the role of institutional investors etc. But the idea of a widely held firm as portrayed by Berle and Means is not the rule but more of an exception. It is prominent in the USA but other countries tend to dispose of a concentrated ownership as we explore later on. Usually a firm is controlled by a majority of shareholders or by a group of controlling block holders. In a way it also presents a means to resolve the monitoring problem and make sure shareholders are protected. As a consequence the real problems regarding shareholders are often not the protection of shareholders in general or monitoring of management but issues like cross-shareholding[69] and holding companies etc. Therefore it is more crucial to protect minority shareholders given

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[65] M.C. Jensen, "Value Maximization, Stakeholder Theory, and Corporate Objective Function," *Journal of Applied Corporate Finance* 14, no. 3 (2001): 8.
[66] Ibid., 8-9.
[67] Michael D. Pfarrer, "What Is the Purpose of the Firm? Shareholder and Stakeholder Theories," *Enterprise Ethics* (May 2010): 86-87, http://www.enterpriseethics.org/Portals/0/PDFs/good_business_chapter_07.pdf (accessed October 10, 2013).
[68] Milton Friedman "The Social Responsibility of Business Is to Increase Its Profits," *New York Times Magazine*, September 13, 1970, 122-26.
[69] Cross-shareholding occurs when a publicly listed firm owns stocks of another publicly listed company.

such a scenario. However it is rather difficult to develop a framework which could guarantee this along with other crucial factors.[70]

Basically the shareholder view is simply too narrow as time has shown since shareholders are not the only ones that invest in a firm and a firm’s success does not only dependent on its shareholders but also by a range of other relationships and resources. Hence corporate governance needs to be built in a way that also considers all the parties involved. A need for a broader framework arose. The stakeholder view which we explore in due course was one of the results of these insights.[71]

3.3.2 The Stakeholder Model

The stakeholder view as opposed to the shareholder view takes on a broader perspective by acknowledging the importance of wealth creation as well as the company’s relationships with all its interested parties, namely shareholders, creditors, employees, managers etc.[72]

The stakeholder theory evolved in the 1980s through ideas of Ed Freeman and initially it seems that it opposes the agency theory in regards to shareholder interests. It basically claims that a company should be managed in a way that benefits all of its stakeholders.[73]

Post, Preston and Saks define stakeholders as follows:

> *“The stakeholders in a corporation are the individuals and constituencies that contribute, either voluntarily or involuntarily, to its wealth-creating capacity and activities, and that are therefore its potential beneficiaries and/or risk bearers.”*[74]

According to the Mitsubishi Research Institute the stakeholders can be divided into the following categories with very different interests and therefore with partly different desired management practices:

Stakeholders	Interest	Desired management
Shareholders	Maximize profits Asset protection	Profitable management Sound management
Investors	Efficient investment	Exploitation of profitable investment
Creditors	Protection of receivables	Sound management
Main bank	Corporate growth	Sound management Pursuit of productivity growth
Employees	Pay raise Secure employment relationship Promotion	Profitable management Sound management Sustainable corporate growth
Consumers	High quality goods and services	Pursuit of productivity growth
Suppliers	Business stability Expansion of business	Sound management Sustainable corporate growth

Source: EPA (1998), Mitsubishi Research Institute, Inc.

Figure 2: Constituents of Corporate Governance according to the Stakeholder View [75]

[70] Michael D. Pfarrer, “What Is the Purpose of the Firm? Shareholder and Stakeholder Theories,” *Enterprise Ethics* (May 2010): 86-87, http://www.enterpriseethics.org/Portals/0/PDFs/good_business_chapter_07.pdf (accessed October 10, 2013).

[71] Ibid.

[72] Ibid., 87-8.

[73] Don Young, “The Theories Behind Corporate Governance,” http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 10, 2013).

[74] J. Post, L. Preston, and S. Sachs, *Redefining the Corporation* (Stanford: Stanford Business Books., 2002), 19.

So the interests of a company should not only be focussed on securing the satisfaction of its shareholders, but a company should also consider all of its stakeholders. For example employees can be considered important stakeholders as they invest their expertise into the firm, therefore they should equally dispose of a voice regarding the firm's corporate governance. This theory also considers other groups like suppliers and customers as being dependent on a company's performance not to mention indirect stakeholders like local communities, the environment and society.[76] Literature often presents the shareholder and stakeholder theories as opposing views. Smallmann argues that the stakeholder theory is simply an extension of the agency and shareholder ideas. The traditional focus on shareholders has been extended to a broader interest group and social, environmental and ethical issues.[77]

Criticism of this theory usually involves the argument that the idea of stakeholders is difficult to incorporate into daily practice as it is challenging to determine whose interests weigh more. In addition it is difficult to put executives in a position where they would be answerable to all of the firm's stakeholders. Therefore a "lighter version" of this theory has been developed where it is advised to still focus on shareholders when it comes to accountability but that the board should bear in mind other interests when they are making decisions on the firm's corporate governance.[78]

Nevertheless this theory has made important contributions. The recently growing interest in business ethics originated in the stakeholder theory, as well as the discussion about excessive levels of executive pay especially in times of crisis and negative impacts on employees and local communities. Globalisation also played a role in uncovering problems in corporate governance worldwide which very not transparent before like child labour, environmental damages, and corruption. Through this and the idea of stakeholders the role of the board has somewhat changed with an enhanced set of responsibilities. It has become responsible for introducing corporate ethics codes, social and environmental reporting.[79]

The stakeholder theory is also responsible for the development of the Balanced Scorecard, which was introduced by Kaplan and Norton in 1992 and which is a performance measurement tool not only focussing on the financial spheres. Kaplan and Norton assume that solely focussing on the financial sphere and accounting can lead to distortions and therefore it is crucial to consider other factors as well. Basically the balanced scorecard represents a set of measures that focuses on the interests of crucial stakeholders and links them to financial factors. Therefore it is possible for executives to analyse links between customers' needs and is supposed to provide information as to what a company needs to achieve in order to satisfy stakeholders and remain financially competitive at the same time. The Balanced Scorecard disposes of key areas that need to be observed and constantly improved. In contrast to traditional systems where the focus is on control of individual behaviour, this approach allows to develop a strategy and vision, followed by the development of goals that can be reached through individual, team or cross-functional work. Therefore in this scenario the board and its

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[75] Hirotsugu Akai and Hitoshi Asaoka, "The Japanese Corporate Governance System and Firm Performance: Toward Sustainable Growth" (January 2003), http://www.esri.go.jp/jp/prj-rc/macro/macro14/05mri1_t.pdf (accessed October 11, 2013).

[76] Don Young, "The Theories Behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 10, 2013).

[77] C. Smallman, "Exploring Theoretical Paradigms in Corporate Governance," *International Journal of Business, Governance and Ethics* 1, no. 1 (2004): 78-94.

[78] Don Young, "The Theories Behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 10, 2013).

[79] Ibid.

executives are responsible for establishing a vision and high performance results from the board's capacity to understand key drivers of success and to communicate those in an appropriate manner to staff, customers and financial markets. [80]

Now we explore three other theories that have been prominent in the debate on corporate governance over the last years.

3.3.3 Agency Theory

First signs of discussion about corporate governance can be found in the early 1930s through the release of Berle and Means' "The Modern Corporation and Private Property". There they observed that through a division of ownership and control as well as a wide scatter of ownership, the means of control over executive managers were rather scarce.[81] These ideas were further developed in the 1970s and evolved to the agency theory. This was followed by many other works for example Jensen and Meckling (1976). Their works discussed the dilemma between the "principal" in that case the owner who is employing an "agent" that is supposed to act in his best interest. [82] This theory goes hand in hand with neo-liberal theories characterizing this agent as acting purely in his self-interest, therefore the needs of the principal will be second priority and as a consequence the owner/shareholder has to be prepared for "agency costs". These are costs that are created through the necessity of providing incentives in order to influence the behaviour of executives in their best interest. Time has shown that there are limitations to this theory. There has been a lot of empirical research but this research usually involved the testing of various propositions in relation to large data sets in order to observe the different mechanisms introduced in order to guarantee the fulfilment of shareholder interests. Therefore pure self-interest of executives is taken for granted. The more emotional sphere of corporate governance is not explored any further, for example attitudes, behaviour and relationships between members of the board.[83]
Nevertheless this theory has led to the development of a universal set of techniques and practices in order to maintain control over executive behaviour internally and externally.[84]
Boards are seen as the main control mechanism to minimize problems created by the principal-agency relationship. The main responsibility of boards according to the agency theory is towards shareholders in the shape of shareholder value maximisation. The boards can either lay off non-performing managers or create options for example share-options or long-term incentives. But in order to reach this, directors on the board have to be independent non-executive directors who are capable of supervising management performance. Over the past decades a rise in non-executive directors and a clearer definition of their tasks could be observed throughout the world. For example it is encouraged to separate the chief executive officer from the non-executive chairman of the board. In addition the idea was developed to introduce separate audit, remuneration, and nominations committees which should be filled with independent non-executives only and which are supposed to guarantee a proper use of

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[80]Don Young, "The Theories Behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 10, 2013).
[81] A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932).
[82] M. C. Jensen and W. H. Meckling, "Theory of Firm: Managerial Behaviour, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (1976): 305-50.
[83]Don Young, "The Theories behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 12, 2013).
[84] J. Seward and J. Walsh, "On the Efficiency of Internal and External Corporate Control Mechanisms," *Academy of Management Review* 15, no. 3 (1990): 421-58.

incentives and better supervision of managers and their decisions.[85] Equally there has been a public appeal to provide more transparency and disclosure of the financial, social and environmental performance of companies. [86]

This has led to the development of internal and external controls that can be widely found in Anglo-American companies and are currently considered to be the most effective system. But a number of diverse scandals after 2001 (Enron, Worldcom, Tyco) and the current financial led to further demands of reform and stronger external controls as the effectiveness of the self-regulation of boards and markets was questioned. For example the Sarbanes-Oxley Act was deeply influenced by the scandal around Enron.[87]

The agency theory is also an essential element of the "incomplete contracts" theory that was developed by scholars like Coase (1937)[88], Jensen and Meckling (1976)[89], Fama and Jensen (1983a)[90] etc. The basic assumption is that the agency problem would not even occur if it was possible to create "complete contracts", which would basically determine in advance what a manager is entitled to do with investments, how the returns are divided etc. However signing such contracts is not possible as future developments cannot be foreseen with all certainty. Therefore "residual control rights" have to be bestowed upon managers which give them the right to make decisions in unforeseen situations and regarding areas that may not have been covered by the contract. According to Hart (1995) corporate governance means structures that allow decision making in situations that have not been determined in the contract. [91]

3.3.4 Stewardship Theory

The stewardship theory can be seen as a contrary to the agency theory. The agency theory presented a more pessimistic view on the motivation of senior executives. They are characterized as self-interested and self-serving. The stewardship theory on the other hand claims that there can be pro-organisational motives for executives. It suggests that it is possible for executives to identify themselves with the aims and goals of the company. They can strive to enhance long-term profits. Thus this theory claims that there can be negative consequences due to a separation of the roles between a chairman and chief executive since joint roles provide more executive leadership. At the same time this theory favours a smaller number of board members as it allows better communication and coordination. So unlike the agency theory, this theory states that self-interest of executives is not the problem of corporate governance issues in companies but rather a weakening of the leadership.[92]

3.3.5 Resource Dependency Theory

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85 John Roberts, "Agency Theory, Ethics and Corporate Governance," *Corporate Governance and Ethics Conference* (2004): 3.
86 S. Zadek, *The Civil Corporation: The New Economy of Corporate Citizenship* (London: Earthscan Publications, 2001): 4-5.
87 John Roberts, "Agency Theory, Ethics and Corporate Governance," *Corporate Governance and Ethics Conference* (2004): 3.
88 Ronald H. Coase, "The Nature of the Firm," *Economica* 4 (1937): 386-405.
89 M.C. Jensen, and W. H. Meckling, "Theory of Firm: Managerial Behaviour, Agency Costs and Ownership Structure." *Journal of Financial Economics* 3 (1976): 305-50.
90 E. Fama and M. Jensen, "Separation of Ownership and Control," *Journal of Law and Economics* 26 (1983a): 301-25.
91 Oliver Hart, "Corporate Governance: Some Theory and Implications," *The Economic Journal* 105, no. 430 (May 1995): 679.
92 Don Young, "The Theories behind Corporate Governance," http://www.havingtheircake.com/content/1_Ideas%20that%20shape%20the%20world/fact%20and%20opinion/The%20theories%20behind%20corporate%20governance.lnk (accessed October 13, 2013).

The resource dependency theory evolved in the 1970s through Pfeffer and Salanick (1978). This theory did not develop from original theories like the agency theory but from empirical research. This theory's main assumption is the fact that the corporate board and in particular its non-executive parts can bring crucial resources. Therefore the board is seen as a source of resources for a company and therefore redefines a board's role in creating value and high performance. These resources can come in different shapes but they supposedly add capital to a company. [93] For example non-executive directors provide knowledge and experience and can advise executives when it comes to theory and its implementation. Resources can serve as symbols for the company, for example a person associated with the company can influence its reputation in a positive or a negative way. The theory also assumes that there are different stages of life in a company and as a consequence different needs, e.g. a young, developing company may use non-executive directors as a relatively affordable source of knowledge and experience in regards to legal, financial or operational management that the entrepreneur might still be lacking. With time and growth of the companies, the non-executive directors' main contribution to the company is the provision of a network of contacts as well as access to new markets and sources of finance and reputation. [94]

To sum up, the agency theories views the non-executive directors mainly as a source of monitoring of executives whilst the resource dependency theories sees them as a context specific resource providing vital service to the company and its executives. [95]

3.4 Board of Directors

3.4.1 Definition and Responsibilities

One of the major monitoring and controlling tools of corporate governance are the boards of directors. A basic definition characterizes boards as a

> *"Governing body (called the board) of an incorporated firm. Its members (directors) are elected normally by the subscribers (stockholders) of the firm (generally at an annual general meeting or AGM) to govern the firm and look after the subscribers' interests. The board has the ultimate decision-making authority and, in general, is empowered to (1) set the company's policy, objectives, and overall direction, (2) adopt bylaws, (3) name members of the advisory, executive, finance, and other committees, (4) hire, monitor, evaluate, and fire the managing director and senior executives, (5) determine and pay the dividend, and (6) issue additional shares. Though all its members might not be engaged in the company's day-to-day operations, the entire board is held liable (under the doctrine of collective responsibility) for the consequences of the firm's policies, actions, and failures to act. Members of the board usually include senior-most executives (called 'inside directors' or 'executive directors') as well as experts or respected persons chosen from the wider community (called 'outside directors' or 'non-executive directors').[96]"*

Generally there are two types of boards of directors which can be found in companies worldwide. First there is the single (one) tier board system, also known as the Anglo-Saxon model which has only one board, the board of directors. It is responsible for the supervision of the management. It is elected by the Annual General Meeting (AGM). This system is dominant in the USA, England, Australia and other commonwealth countries. The second model is the dual (two) tier board system or the Continental European model which consists of two boards. The first one is the management board, responsible for the management of the firm and the

[93] Ibid.
[94] Ibid.
[95] Ibid.
[96] *Business Dictionary*, s.v. "Board of Directors," http://www.businessdictionary.com/definition/board-of-directors.html#ixzz2e0iZx8XE (accessed November 1, 2013).

second is the supervisory board which is responsible for the supervision of the management and board.[97] For example, it can be found in Germany. But even if the same system is given, there is still enough room for interpretation. For example French boards usually include a former senior politician as a member, whilst US boards often include members that are somehow related to the CEO.[98]

Directors dispose of a variety of responsibilities that differ from those of executive managers such as the monitoring and supervision of the management, setting overall strategies, appointing executives etc. We explore their tasks in more detail further on. But basically they are responsible for directing the companies and therefore they play a crucial role in corporate governance.[99] The board of directors is not part of the management hierarchy and there should be no hierarchy within the board, every director has equal responsibilities and duties. We can make a distinction between executive or inside directors and non-executive or outside directors. Executive directors dispose of management responsibilities alongside with their tasks as a board member. Executives are considered employees of a corporation and fall under the employment law while board directors are not considered employees and fall under company law. Furthermore a distinction between directors can be made. There are independent non-executive directors and outside non-executive directors who can be somehow linked to the company, for example they have close ties with the chairman, are representing a dominant shareholder to the corporation and therefore could lack objectivity.[100] Independent non-executive directors are not involved in daily management of the company but policy making and planning. Both types of non-executive directors are supposed to monitor executive directors and act in the interest of the company's stakeholders.[101] In addition to inside and outside directors there can be shadow directors who are no listed anywhere, since they are not directors and do not openly take part in a company's governance but still control and direct. Usually these directors are holders of controlling or majority stocks.[102]

OECD Principles of Corporate Governance describe the key responsibilities of the board as follows:

> *"A.Board members should act on a fully informed basis, in good faith, with due diligence and care, and in the best interest of the company and the shareholders.*
> *B.Where board decisions may affect different shareholder groups differently, the board should treat all shareholders fairly.*
> *C.The board should apply high ethical standards. It should take into account the interests of stakeholders.*
> *D.The board should fulfil certain key functions, including:*
>
> - *Reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.*
> - *Monitoring the effectiveness of the company's governance practices and making changes as needed.*

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[97] A. A. Mardiyah and W. Pudjiastuti, "The Influence of Board Structure on Firm Performance," *Simposium Nasional Akuntansi X* (July 2007): 12. http://www.stie-mce.ac.id/~pdf/penelitian/N19990001075802.pdf (accessed November 1, 2013).

[98] "Corporate Governance," *Economist*, September 7, 2009, http://www.economist.com/node/14298774?zid=294&ah=71830d634a0d9558fe97d778d723011d (accessed November 1, 2013).

[99] Bob Tricker, *Corporate Governance: Principles, Policies, and Practices* (New York: Oxford University Press, 2009), 37.

[100] Ibid., 35-6.

[101] *Investopedia*, s.v. "Non-Executive Director," http://www.investopedia.com/terms/n/non-executive-director.asp. (accessed October 14, 2013)

[102] *Business Dictionary*, s.v. "Shadow Director," http://www.businessdictionary.com/definition/shadow-director.html. (accessed October 14, 2013)

- *Selecting, compensating, monitoring and, when necessary, replacing key executives and overseeing succession planning.*
- *Aligning key executive and board remuneration with the longer term interests of*
- *the company and its shareholders.*
- *Ensuring a formal and transparent board nomination and election process.*
- *Monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.*
- *Ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems of control are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards.*
- *Overseeing the process of disclosure and communications.*

E. The board should be able to exercise objective independent judgement on corporate affairs.

- *Boards should consider assigning a sufficient number of non-executive board members capable of exercising independent judgement to tasks where there is a potential for conflict of interest. Examples of such key responsibilities are ensuring the integrity of financial and non-financial reporting, the review of related party transactions, nomination of board members and key executives, and board remuneration.*
- *When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board.*
- *Board members should be able to commit themselves effectively to their responsibilities.*

F. In order to fulfil their responsibilities, board members should have access to accurate, relevant and timely information.[103]"

To conclude we can say corporate boards and directors of this board are responsible for determining major strategies of the corporation, they are supposed to monitor the management and the effectiveness of corporate governance practices, as well as appoint executives and determine board nomination and remuneration. Equally they are expected to ensure proper corporate accounting.

Boards can be built in many different ways in order to meet the needs of an organisation and to fulfil the duties mentioned above. Subsequently we look at different factors that affect board characteristics. Dehaene et al. state that board structure is determined by the proportion of outside directors, in other words board independence, the total number of directors in other words board size and the separation of the roles of chief executive officer and chairman of the board in other words board leadership. [104] As we have explored before theories on corporate governance are divided when it comes to how these factors (number of outside directors, separation of CEO and chairman, size of the board, corporate social responsibility) affect corporate governance and firm performance. In reality most organisations choose frameworks that fall in between those opposing views so that they can exert managerial control on the one hand and outside director monitoring on the other hand. Therefore subsequently we explore these three factors idenftied by Dehaene in more detail.

3.4.2 Board Leadership

One of the most interesting questions is the debate on whether the role of CEO and chairman of the board should be separated. As examined before theories are divided on that subject. Combined leadership means that one person embodies the role of the CEO and chairman. This

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[103] OECD, *OECD Principles of Corporate Governance* (Paris: Organization for Economic Co-operation and Development, 1999), 24-5.

[104] A. Dehaene, V. De Vuvyst, and H. Ooghe, "Corporate Performance and Board Structure in Belgian Companies," *Long Range Planning* 34, no. 3 (2001): 383-98.

kind of leadership is supported by the stewardship theory, whilst the agency theory strongly opposes this view. The agency theory claims that combined leadership leads to ineffective supervision of the management since the CEO will be the most dominant figure which is does not guarantee that shareholders' interest will be taken into account. The stewardship theory on the other hand supports a dominant CEO as management is supposed to be trustworthy and acting in the best interest.
According to Dehaene et al. combined leadership influences ROA. They claim that the CEO due to his involvement in daily firm routine will tend to invest as much as possible to maximise revenues and that he will keep pursuing this as long returns are increasing. [105] Donaldson and Davis claim that combined leadership increases ROE, which supports the stewardship theory.[106]
Still, combining the role of CEO and chairman means that the management is accountable to an instance that is also led by the management. This is why the majority of literature nevertheless supports a separation since it provides a more objective monitoring of management and CEO, as well as more accountability and avoids conflicts of interests.[107] Also it is expected that a chairman usually brings expertise regarding his tasks unlike the CEO who is not as familiar with the responsibilities and daily tasks of a board chairman. [108]
The Cadbury report, which we explore later on, also advises the separation of the chairman and CEO since the latter is responsible for day-to-day business in the company while the chairman is supposed to monitor the work of executive directors and the CEO.[109] Therefore both roles require different additional skills and abilities, apart from leadership skills, as the CEO is responsible for day-to-day business and strategies while the chairman should have some distance form daily matters of the company and remain independent.[110]
Alan Greenspan former chairman of America's Federal Reserve Board claimed that CEOs and their failure to fulfil their tasks properly are mainly to blame for weak corporate governance. But worldwide there a big differences regarding the task and powers of CEOs. For example in the United States, CEOs usually disposed of major influence and power, whilst UK companies usually applied a separation of the CEO and chairman. German CEOs on the other hand are closely monitored by a supervisory board. [111]

3.4.3 Board Size

Board size is discussed on a regular basis in this context however opinions on the subject appear to be divided. Some scholars claim that smaller boards affect firm performances in a positive way (e.g. Lipton and Lorsch (1992)), [112] while others oppose this view (e.g. Pfeffer

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[105] Ibid.
[106] L. Donaldson and J. H. Davis, "Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns," *Australian Journal of Management* 16 (1991): 49-64.
[107] R. Monks and N. Minow, *Corporate Governance* (MA: Blackwell Publishing, 2004).; A. Suryanarayana, *Corporate Governance: The Current Crisis and the Way Out* (Hyderabad: ICFAI University Press, 2005).
[108] E. Banks, *Corporate Governance, Financial Responsibility, Controls and Ethics* (New York: Palgrave Macmillan, 2004).
[109] D. Laing and C. M. Weir, "Governance Structures, Size and Corporate Performance in UK Firms," *Management Decision* 37, no. 5 (2005): 457-64.
[110] A. Cadbury, *Report On the Committee On the Financial Aspects of Corporate Governance* (London: Gee, 1992), 20.
[111] "Corporate Governance," *The Economist*, September 7, 2009. http://www.economist.com/node/14298774?zid=294&ah=71830d634a0d9558fe97d778d723011d (accessed October 15th, 2013).
[112] M. Lipton and J. W. Lorsch, "A Modest Proposal for Improved Corporate Governance," *Business Lawyer* 48 (1992): 59-77.

(1972)).[113] Therefore we present an overview of the leading views on that subject. Lipton and Lorsch (1992)[114] and Jensen (1993)[115] found that a smaller board size leads to higher performance since benefits brought by larger boards through elevated monitoring are outweighed by weaker communication and decision-making due to the group size. Other scholars claim that the number of directors does not matter as opposed to the board composition measured through the percentage of independent outside directors on corporate boards.[116] Jensen claims that smaller boards are to be favoured since they allow for easier coordination and communication between board members. The higher the number of board members the more it deteriorates communication. There have been studies conducted that seem to prove these theories (Yermack (1996)[117], Eisenberg et al. (1998)).[118]
Counter theories on the other hand argue that a larger board size enhances monitoring and guidance to the CEO (Pfeffer (1972)[119]; Coles et al. (2008)).[120] It equally increases a company's capability to manage environmental issues (Pearce and Zahra 1992).[121] This is a view that is supported by the stewardship theory. Dalton (1999) claims that a larger number of directors allows better advising as it usually leads to a higher number of outside directors which leads to more shared knowledge.[122] According to Coles et al. (2005) larger firms tend to have larger boards and are more in need of strong advising. This has a positive influence on the number of outside directors since the CEO and management require specific advice.[123] Goodstein, Gautam and Boeker (1994) explored that larger boards are on average less inclined to introduce different strategies especially during times of economic challenges. Equally companies disposing of a more diverse board composition are less likely to be involved in those changes. So in this case company size appears as an important factor of influence on boards of directors.[124]
Looking at the question from the perspective of the agency theory that has been discussed before, a larger board will lead to better monitoring which automatically reduces CEO domination on the board as desired by this theory while the stewardship theory prefers a smaller size in order to avoid coordination and communication problems.

3.4.4 Board Composition

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[113] J. Pfeffer, "Size and Composition of Corporate Board of Directors: The Organization and its Environment," *Administrative Science Quarterly* 17 (1972): 218-29.

[114] M. Lipton and J. W. Lorsch, "A Modest Proposal for Improved Corporate Governance," *Business Lawyer* 48 (1992): 59-77.

[115] M.C. Jensen, "The Modern Industrial Revolution, Exit and the Failure of Internal Control Systems," *Journal of Finance* 48, no. 3 (1993): 831-80.

[116]S. Abdullah, "Board Composition, CEO Duality and Performance Among Malaysian Listed Companies," *Corporate Governance* 4, no. 4 (2004): 47-61.;
G. Kiel and G. Nicholson, "Board Composition and Corporate Performance: How the Australian Experience Informs Contrasting Theories of Corporate Governance," *Corporate Governance* 11, no. 3 (2003): 189-205.

[117] David Yermack, "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics* 40 (1996): 185-211.

[118] T. Eisenberg, S. Sundgren, and M.T. Wells, "Larger Board Size and Decreasing Firm Value in Small Firms," *Journal of Financial Economics* 48, no. 1 (1998): 35-54.

[119] J. Pfeffer, "Size and Composition of Corporate Board of Directors: The Organization and its Environment," *Administrative Science Quarterly* 17 (1972): 218-29.

[120] Jeffrey L. Coles, Daniel D. Naveen, and Lalitha Naveen, "Boards: Does One Size Fit All?" *Working Paper, Arizona State University* (February 2005): 329-356.

[121] J. A. Pearce and S.A. Zahra, "Board Composition from a Strategic Contingency Perspective," *Journal of Management Studies* 29, no. 4 (1992): 411-38.

[122] Dan R. Dalton et al., "Number of Directors and Financial Performance: A Meta-Analysis," *The Academy of Management Journal* 42 (1999): 674-86.

[123] Jeffrey L. Coles, Daniel D. Naveen, and Lalitha Naveen, "Boards: Does One Size Fit All?" *Working Paper, Arizona State University* (February 2005).

[124] J. Goodstein, K. Gautam, and W. Boecker, "The Effects of Board Size and Diversity on Strategic Change," *Strategic Management Journal* 15 (1994): 241-50.

The structure and composition of boards of directors is a topic that is often discussed in this context. The main point of discussion is the number of outside and inside directors on the board and how this influences the performance of a board and/or the company (e.g. Gillette et al. 2008[125]; Hermalin and Weisbach 1991[126]; Eisenberg et al. 1998[127]). In addition determinants of board composition or structure are discussed on a regular basis (e.g. Lehn et al. 2003[128]; Boone et al. 2007[129]; Linck et al. 2008[130]). According to Yoshimori, board structure is important for corporate success and values, along with culture and strategy.[131]
Boards can be structured in many different ways in order to fulfil their duties. In general there are very mixed views when it comes to the question of how boards should be best structured to be most effective and efficient and at the same time have a positive influence on firm performance. Theories developed by Berle and Means argue that boards should be controlled through management since it improves performance as access to inside information and a better understanding of a firms needs is provided as opposed to a system with more independent non-executive directors.[132] According to the agency theory agency costs should be minimized through the monitoring of managements by outsiders. According to this theory boards should dispose of a majority of non-executive outside directors. But executive directors are necessary as they usually bring expertise in certain fields e.g. finance and marketing and are involved in daily business. At the same time these executives are subordinates of the CEO and therefore dependant they cannot monitor the latter, therefore it is necessary to have a third party involved that can monitor the CEO and executives.[133] For example Weisbach (1988) claims that outside directors have more reason to oversee executives since inside directors are more dependent on the company's CEOs.[134] Farma and Jensen (1983) claim that outside directors are responsible for major decisions in other organizations. For them it is more important to demonstrate control through board decisions to the management and thus a higher number of outside directors would be more effective.[135] According to Fama it is more important for non-executive directors to protect shareholders' rights as they have a reputation to maintain in the market for independent directors.[136]

[125] A. B. Gillette, T. H. Noe, and M. J. Rebello, "Board Structures around the World: An Experimental Investigation," *Review of Finance* 12 (2008): 93-140.
[126] B. E. Hermalin and M. S. Weisbach, "The Effects of Board Composition and Direct Incentives On Firm Performance," *Financial Management* 20 (1991): 101-12.
[127] T. Eisenberg, S. Sundgren, and M.T. Wells, "Larger Board Size and Decreasing Firm Value in Small Firms," *Journal of Financial Economics* 48, no. 1 (1998): 35-54.
[128] Kenneth Lehn, Sukesh Patro, and Mengxin Zhao, "Determinants of the Size and Structure of Corporate Boards," *Working Paper, University of Pittsburgh* (2005): 1935-2000.
[129] Audra L. Boone et al., "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," *Journal of Financial Economics* 85 (2007): 66-101.
[130] J. Linck, J. Netter, and T. Yang, "The Determinants of Board Structure," *Journal of Financial Economics* 87 (2008): 308-28.
[131] M. Yoshimori, "Does Corporate Governance Matter? Why the Corporate Governance Performance of Toyota and Canon Is Superior to Gm and Xerox," *Corporate Governance: An International Review* 13, no. 3 (2005): 447-57.
[132] A. Berle and G. Means, *The Modern Corporation and Private Property* (New York: MacMillan, 1932).
[133] D. Laing and C. M. Weir, "Governance Structures, Size and Corporate Performance in UK Firms," *Management Decision* 37, no. 5 (2005): 457-64.
[134] Michal S. Weisbach and Benjamin E. Hermalin, "Endogenously Chosen Boards of Directors and their Monitoring of the CEO," *American Economic Review* 88 (1998): 96-118.
[135] M. C. Jensen and W. H. Meckling, "Theory of Firm: Managerial Behaviour, Agency Costs and Ownership Structure," *Journal of Financial Economics* 3 (1976): 305-50.
[136] E. F. Fama, "Agency Problem and the Theory of the Firm," *Journal of Political Economy* 88, no. 2 (1980): 288-307.

Pfeffer (1972) claims that board composition is exogenous since it is influenced by the conditions of the external environment. [137]

According to Hermalin and Weisbach (2001) on the other hand board structure is influenced by firm performance and vice versa and therefore it is endogenous. [138]

Lehn, Patro and Zhao (2004) claim that firm size is an important factor for board structure as it is negatively correlated to insider representation.[139] According to Raheja boards have a higher number of inside directors where monitoring costs are higher and private benefits to insiders are lower. [140]

According to Link et al. (2008) boards of directors are structured in a way that is consistent with the costs and advantages of its supervision and advising roles. They claim that boards are usually more independent under a strong CEO influence and inside directors who receive more private benefits. [141] Inside directors have access to more company-related information and have usually a stronger relationship with the CEO as opposed to outside directors who bring more independent monitoring (Raheja 2005). [142] The main functions of boards are monitoring and advising as mentioned above. Board structure is correlated to the costs of these tasks. Link et al. (2008) assume that if the costs of monitoring increase, boards will decrease monitoring which will lead to a lower number of outside directors and vice versa. [143]

Cadbury sees monitoring as the key role played by non-executive directors. Still it is acknowledged that this independence may diminish as their tenure progresses since relationship can be formed.[144]

In 2008 Gillette et al. examined how boards are structured and if board and firm performance are affected by the number of inside and outside directors. Furthermore they identified four different types of board structure. There are single-tiered boards that consist of both inside and outside directors and its tasks are mainly monitoring and advisory. Two-tiered boards on the other hand are strictly divided between an insider managerial board and an outside advisory board, e.g. Germany. The third type are insider-controlled boards which consist of a majority of inside directors and a minority of outside directors. The fourth type called outsider-controlled board disposes of a majority representation of outside directors but also multiple inside directors, e.g. in the USA. According to this study single-tiered boards with a larger number of outside directors are the most successful when it comes to the introduction of “institutionally preferred policies”. Two-tiered boards on the other hand are more efficient than single-tiered boards that dispose of a small number of inside directors. Nevertheless these boards are usually more conservative which can have a negative influence on firm value.[145]

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[137] J. Pfeffer, “Size and Composition of Corporate Board of Directors: The Organization and its Environment,” *Administrative Science Quarterly* 17 (1972): 218-29

[138] B. E. Hermalin and M. S. Weisbach, “The Effect s of Board Composition and Direct Incentives On Firm Performance,” *Financial Management* 20 (1991): 101-12.

[139] Kenneth Lehn, Sukesh Patro, and Mengxin Zhao, “Determinants of the Size and Structure of Corporate Boards,” *Working Paper, University of Pittsburgh* (2005): 1935-2000.

[140] Charu Raheja, “The Interaction of Insiders and Outsiders in Monitoring: A Theory of Corporate Boards,” *Journal of Financial and Quantitative Analysis* 40 (2005): 283-306.

[141] J. Linck, J. Netter, and T. Yang. “The Determinants of Board Structure,” *Journal of Financial Economics* 87 (2008): 308-28.

[142] Charu Raheja, “The Interaction of Insiders and Outsiders in Monitoring: A Theory of Corporate Boards,” *Journal of Financial and Quantitative Analysis* 40 (2005): 283-306.

[143] J. Linck, J. Netter, and T. Yang, “The Determinants of Board Structure,” *Journal of Financial Economics* 87 (2008): 308-28.

[144] Dan R. Dalton et al., “Number of Directors and Financial Performance: A Meta-Analysis” *The Academy of Management Journal* 42 (1999): 674-86. ;

David Yermack, “Higher Market Valuation of Companies with a Small Board of Directors,” *Journal of Financial Economics* 40 (1996): 185-211.

[145] A. B. Gillette, T. H. Noe, and M. J. Rebello. “Board Structures around the World: An Experimental Investigation.” *Review of Finance* 12 (2008): 93-140.

3.4.5 Board Committees

The agency theory supports the separation of monitoring and execution in order to monitor execution functions like audit, remuneration and nomination. The corporate scandals of the past years have led to criticism regarding corporate governance structures. It has been suggested that a board of directors is not enough to monitor these issues.[146] As a result the Cadbury Committee suggested that boards should create sub-committees to take care of three issues: Firstly there should be committees which are responsible for overseeing accounting procedures and external audits. Secondly companies should introduce remuneration committees that determine salaries of corporate executives and thirdly they should equally dispose of nominating committees that are supposed to nominate directors and officers to the board.[147] However these committees will remain useless unless they consist of independent members with financial expertise. Therefore Cadbury suggests that theses committees ought to consist of independent non-executive directors only. [148]

3.5 Corporate Accountability

3.5.1 Definition and International Accounting Standards

Corporate reporting is another important means of exercising control in order to facilitate good corporate governance. It is essential for a company to draw up its accounts and have an outside auditor verify them as boards of directors are considered accountable to shareholders and stakeholders. This provides a means for shareholders to get insight into how their money is invested. Corporate reporting is supposed to provide stakeholders with information about the firm and society with information disclosing if the organization has met its responsibilities. Accountability means the responsibility to provide account of a company's actions.[149] This kind of reporting ought to be responsibility-driven not demand-driven.[150]According to Eccles CR should include financial reporting but also information that goes beyond of what is required through regulations.[151] Corporate reporting is supposed to reduce the risks of losses that may be caused through opportunistic behaviour of managers. [152]

Annual reports became mandatory after the stock market crash in 1929. They usually contained the following sections: Financial Highlights, Letter to the Shareholders, Narrative Text, Graphics and Photos, Management's Discussion and Analysis, Financial Statements, Notes to Financial Statements, Auditor's Report, Summary Financial Data and Corporate Information. [153] According to studies large firms tend to disclose more information in their annual reports than smaller firms since they are exposed to more (international) public

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[146] S. T. Petra, "The Effects of Corporate Governance on the Informativeness of Earnings," *Economics of Corporate Governance* 8, no. 2 (2007): 129-52.

[147] "The Cadbury Report," University of Cambridge, http://www.jbs.cam.ac.uk/cadbury/report/ (accessed November 13, 2013).

[148] Ibid.

[149] A. Cadbury, Report On the Committee On the Financial Aspects of Corporate Governance (London: Gee, 1992), 14.

[150] C. Deegan, *Financial Accounting Theory* (NSW: McGraw-Hill Australia Pty Ltd, 2004).
R. Gary, D. Owen, and K. T. Maunders, "Accountability, Corporate Social Reporting and External Social Audits," *Advances in Public Accounting* 3, no. 4 (1991): 1-21.

[151] R. G. Eccles, "Hopes and Fears for Financial Reporting and Corporate Governance," *Balance Sheet* 12, no. 2 (2004): 8-13.

[152] R. M. Bushman and A. J. Smith, "'Financial Accounting Information and Corporate Governance," *Journal of Accounting and Economics* 32 (2001): 237-333.

[153] *Investopedia*, s.v. "Annual Report," http://www.investopedia.com/terms/a/annualreport.asp (October 20, 2013).

scrutiny.[154] For example large Japanese manufacturers that operate in international markets tend to disclose more information than other firms.[155]

One of the major challenges of corporate reporting is the fact that rules for those practices differ widely throughout the world and even between countries which would appear to dispose of similar system like the United States and the United Kingdom for example. Surprisingly the differences between UK and US accounting rules can make a 50 percent difference regarding a company's net profit. Even within the same country it is possible that two different auditors will come up with different results as regulations and rules still leave enough room for interpretation. As auditing is one of the most crucial elements of corporate governance, critics of the current practices claim that governments or at least government supervised agency ought to take up this task in the future.[156]

Indeed there is a set of international accounting standards. Until 2001 international accounting standards (IAS) were set by the Board of International Accounting Standards Committee (IASC) which was founded in 1973 as a private organisation based in London. However these standards did not receive a lot of attention until 2000, when the European Union decided to adopt them.[157] In 2001 the IASC was replaced by the International Accounting Standards Board (ISAB) which introduced the International Financial Reporting Standards (IFRS).[158] Many of the IAS standards have been absorbed into the new IFRS.[159] Since 2001 roughly 120 countries worldwide have required or permitted the use of IFRS including the European Union, USA and the UK.[160]

The IFRS regulate corporate accounting in much detail. They require an organisation's financial statement to contain the following parts: Statement of Financial Position, Statement of Comprehensive Income, Statement of Changes in Equity, Cash Flow Statement and notes including a summary of significant accounting policies. [161] The objective of a financial statement is to provide information about the financial position, the financial performance, and cash flows of an entity that is useful to a wide range of users in making economic decisions. To meet that objective, financial statements should provide information about an entity's assets, liabilities, equity, income and expenses, including gains and losses, contributions by and distributions to owner, cash flows. [162]

In addition it should contain comparative information in respect of previous periods for all amounts reported in the financial statement, both face of financial statements and notes, unless another Standard requires otherwise. [163]

Such a financial statement ought to be prepared at least annually. If another frequency is used the reasons for that change should be presented along with a warning about problems.[164]

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[154] M. A. Firth, "The Effect of Stock Market Listings, and Auditors on Voluntary Disclosure in Corporate Annual Reports," *Accounting and Business Research* 9, no. 36 (1979): 273-80.

[155] T. E. Cooke, "The Effect of Stock Market Listing and Industry Type on Disclosure in the Annual Reports of Japanese Listed Companies," *Accounting and Business Research* 22, no. 87 (1992): 229-37.

[156] "Corporate Governance," *The Economist*, September 7, 2009, http://www.economist.com/node/14298774?zid=294&ah=71830d634a0d9558fe97d778d723011d (accessed October 18, 2013).

[157] "Was Sind IFRS/ IAS?" IFRS-Portal, http://www.ifrs-portal.com/Grundlagen/Was_sind_IFRS_IAS/Was_sind_IFRS_IAS_01.htm (accessed October 18, 2013).

[158] *Investopedia*, s.v. "International Accounting Standards - IAS," http://www.investopedia.com/terms/i/ias.asp (accessed October 18, 2013).

[159] "Was Sind IFRS/ IAS?" IFRS-Portal, http://www.ifrs-portal.com/Grundlagen/Was_sind_IFRS_IAS/Was_sind_IFRS_IAS_01.htm (accessed October 18, 2013).

[160] "IFRS Foundation International Accounting Standards Board (IASB)," http://www.ifrs.org/The-organisation/Documents/2013/Who-We-Are-English-2013.pdf (accessed October 18, 2013).

[161] "IAS 1 - Presentation of Financial Statements," http://www.iasplus.com/en/standards/ias/ias1#link5 (accessed October 18, 2013).

[162] Ibid.

[163] Ibid

[164] Ibid.

So far the IFRS are not mandatory worldwide. But what are the possible advantages and disadvantages of uniform regulations?
The advantages of mandatory IFRS are that they can provide scales of economies as only one framework worldwide is needed and can be treated like a public good. Therefore the marginal costs of introducing them would be zero. Another advantage would be an elimination of informal externalities caused by a lack of comparability between companies, countries etc. which is something that usually occurs when different systems encounter each other.
A possible disadvantage is that the fact that the introduction of IFRS results in initially very high costs which may be higher than the actual benefits.[165]

3.5.2 Corporate Social Responsibility and Corporate Social Reporting

The idea of corporate social responsibility was introduced through the stakeholder theory as we explored before. As according to this theory corporate governance is about a company's relationship with all its stakeholders, it is supposed to meet the needs of all parties involved. According to Liyanage (2007) corporate social responsibility means achieving economic success in ways that respect ethical values and people, communities and the environment. [166]
There are many opposing views regarding CSR. Milton Friedman for example defines CSR as accountability to shareholders within a framework of rules and ethical habits. [167]

> *"Corporate officials and labour leaders have a social responsibility that goes beyond the interest of their stakeholders or their members. This view shows fundamental misconception of the character and nature of a free economy. There is only one social responsibility of business – to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition, without deception or fraud."*[168]

The neo-classical view of a company sees its social responsibility solely in the shape of employment and tax payment which can be also found in the OECD Principles of Corporate Governance. [169] Tanimoto on the other hand claimed that the

> *"…essential point of CSR is to incorporate social fairness, ethic, environmental and human rights in the management process to make clear their accountabilities to the stakeholders"*[170]

He classified this as business activity paired with social work and philanthropy.[171]
There is a large number of scholars that agree that a business has a responsibility beyond profit maximisation and that it should make a positive contribution to society. It is believed that companies wide range of social obligations apart from meeting regulatory and legal obligations, e.g. philanthropic contributions such as aid for developing countries and underprivileged communities.[172]
According to Carroll,

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[165] "International Financial Reporting Standards," AICPA IFRS Resources, http://www.ifrs.com/updates/aicpa/ifrs_faq.html#q5 (accessed November 1, 2013).
[166] U. Liyanage, "From CSR to SRB," *The Journal of Institute of Chartered Accountants of Sri Lanka* 42 (2007): 28-29.
[167] Milton Friedman, *Capitalism and Freedom* (Chicago: Chicago University of Press, 1962), *133.*
[168] Ibid.
[169] L. Moir, "What Do We Mean by Corporate Social Responsibility," *Corporate Governance* 1, no. 2 (2001): 16-22.
[170] Kanji Tanimoto, "Evaluation of Corporate Social Responsibility (CSR) and the Market," *Hitotsubashi University Repository* (2007): 103.
[171] Ibid.
[172] D. J. Wood, "Corporate Governance Revisited," *Academy of Management Review* 16 (1991): 691-718.

> *"The social responsibility of business encompasses the economic, legal, ethical and discretionary (philantrophic) expectations that society has of organizations at a given point in time."*[173]

He illustrates this in the shape of a pyramid. The first level is the economic sphere since business is supposed to create affordable goods and services needed by society. Secondly laws are to be obeyed. Thirdly companies have ethical responsibilities. Basically laws are the minimum requirement under which companies are supposed to operate but they are expected to rise beyond that and display behaviour that is expected by society and to avoid what is prohibited. [174]

Over the years the demand for accountability to share- and stakeholders that goes beyond the financial sphere has risen. According to Gary (1991) who developed an accountability model, there are two responsibilities. First there is a responsibility to undertake certain actions and then there is the responsibility to deliver an account of those actions that affect the environment.[175] CSR reporting means the voluntary disclosure of a company's actions that regard social and environmental issues and their effectors to particular interest groups within society and society itself.[176]

Rettab et al. suggested that financial performance measures, corporate reputation and employee commitment should be used as potential indicators in order to measure corporate governance.[177] According to McGuire CSR can be measured through expert evaluation, the analysis of the contents of annual reports and similar documents, as well as a company's performance regarding the control of pollution. [178] It involves information on ethical conduct of the company and initiatives undertaken that benefit society and minimize negative effects for all parties involved.[179]

Buhr et al. claim that today there is a larger number of organisations that consider their CSR activities as critical success factors that can create new market opportunities, consumer satisfaction and competitive advantages since it can build a better reputation and a stronger brand name which can attract and motivate employees as well as build goodwill.[180]

As mentioned before, the stakeholder model and a number of large corporate scandals raised concerns for CSR and raised public demands to make it a part of the board's responsibilities. But according to Arora and Dharwadkar the current demand for CSR is bigger than the actual current supply which will lead to managers acting on behalf of the principal which will

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173 Anne K. Buchholtz and Archie B. Carroll, *Business and Society: Ethics and Stakeholder Management* (Mason: Cengage Learning, 2008), 36.

174 Ibid., 35-9.

175 R. Gary, D. Owen, and K. T. Maundres, "Accountability, Corporate Social Reporting and External Social Audits," *Advances in Public Accounting* 3, no. 4 (1991): 1-21.

176 A. E. Neilsen and C. Thomsen, "Reporting CSR - What and How to Say it?" *Corporate Communications: An International Journal* (2007): 25-40.

177 A. B. Brick, K. Mellahi, and B. Rettab, "A Study of Management Perceptions of the Impact of Corporate Social Responsibility On Organisational Performance in Emerging Economies: The Case of Dubai," *Journal of Business Ethics* 89, no. 3 (2009): 371-390.

178 H.J. McGuire, T. Schneeweiss, and A. Sundgren, "Corporate Social Responsibility and Firm Performance," *Academy of Management Journal* 31, no. 4 (1988): 854-72.

179 U. Liyanage, "From CSR to SRB," The Journal of Institute of Chartered Accountants of Sri Lanka 42 (2007): 40.

180 Helena Buhr and Maria Grafström, "The Making of Meaning in the Media: The Case of Corporate Social Responsibility in the Financial Times," *Managing Corporate Social Responsibility in Action* (2007): 15-31.

usually result in a reduction CSR activity.[181] Therefore it is crucial that appropriate governance frameworks are provided so that they contain stakeholder interests.[182]

3.6 Ownership Concentration

One of the major differences between corporate governance systems are the differences in ownership concentration and the identity of shareholders. We can make a distinction between dispersed ownership (outsider systems) and concentrated ownership (insider systems). In dispersed ownership the main conflict appears between controlling managers and outside widely dispersed shareholders. Concentrated ownership on the other hand can be executed by individuals, a family holding, bloc alliance, financial institutions or through cross-shareholding. Here the main source of conflict is the relationship between inside controlling shareholders and outside minority shareholders.[183] The conflict that occurs through dispersed ownership has been much more in the focus of scholars than concentrated ownership which is surprising as concentrated ownership is the dominant form worldwide.[184]

Outsider systems are typically found in the United States and the United Kingdom. Their most typical feature is dispersed ownership and the separation of ownership and control. Rights of shareholders are protected. Since ownership is widely dispersed there is little incentive for outside investors to participate in corporate control as well as a low commitment to long-term strategies of the corporation. The main conflict in this case occurs between the management and shareholders and in this case the question is: How can the rights of shareholders be protected?[185]

In this system financial markets are usually highly sophisticated and diversified and one of the main sources for controlling managerial behaviour, since for example share prices usually fall, when the company fails to maximise shareholder value which can expose the company to hostile takeovers that are costly and antagonistic or the removal of inefficient management.[186]

There is a low debt-to-equity ratio and a low ratio of bank credits-to-total liabilities since debt financing by banks is usually short-term and equities and corporate bonds are the preferred source for long-term financing. Costly and antagonistic takeovers are relatively common. In general this system requires strict trading rules and information disclosure.[187]

Insider systems can usually be found in Europe (with the exception of the UK), Japan and Korea and their main feature is concentrated ownership (which equals stronger voting power) and various inter-firm relationships and corporate holdings. This system differs strongly from the outsider system. Whilst outsider systems use mechanisms on the stock market and the

[181] P. Arora and R. Dharwadkar, "Corporate Governance and Corporate Social Responsibility (CSR): The Moderating Roles of Attainment Discrepancy and Organization Slack," *Corporate Governance: An International Review* 19, no. 2 (2011): 136-52.

[182] M. De Wit, E. Schouten, and M. Wade, "Hardwiring an Softwiring Corporate Responsibility: A Vital Combination," *Corporate Governance* 6, no. 4 (2006): 491-505.

[183] Marco Becht, "Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure" (European Corporate Governance Network, Executive Report, October 27, 1997), http://tcgf.org/research/control_europe/documents/eu.pdf (accessed October 22, 2013), 21-23.; Robert W. Vishny and Andrei Shleifer, "A Survey of Corporate Governance," *The Journal of Finance* 52, no. 2 (1997): 737-83.

[184] Marco Becht, "Strong Blockholders, Weak Owners and the Need for European Mandatory Disclosure" (European Corporate Governance Network, Executive Report, October 27, 1997), http://tcgf.org/research/control_europe/documents/eu.pdf (accessed October 22, 2013), 21. ; Robert W. Vishny and Andrei Shleifer, "A Survey of Corporate Governance," *The Journal of Finance* 52, no. 2 (1997): 737-83.

[185] OECD, *Corporate Governance: Effects on Firm Performance and Economic Growth,* (Paris: Organization for Economic Co-operation and Development, 1999), 18.

[186] Ibid.

[187] Ibid.

board of directors to exercise control over the management, insider system associate ownership with control. Concentrated ownership gives the shareholders an incentive to participate in corporate control and to commit to long-term strategies of the firm. The main conflict in this case is between majority shareholders and outside minority shareholders as majority shareholders may desire to receive private benefits which usually goes at the expense of minority shareholders. Intervention by outside investors is limited to periods of clear financial failure which may encourage collusion.[188] As opposed to outsider systems there are low opportunities for diversification of financial markets and hostile takeovers are usually not the case. Equally relationships with banks and financial institutions tend to be more complex and long-term oriented than in outsider systems. There is a high debt to equity ratio and a high ratio of bank credits to total liabilities. This can be both beneficial and counterproductive. On the one hand a "bank-based" system can allow better screening and monitoring of a company's activities. On the other hand it can also lead to control by interested parties and yet again disadvantage minority shareholders. Hostile takeovers are usually not the case. [189]

3.7 Firm Performance

Throughout literature firm performance is defined as the value of the firm. There is a wide range of measures of firm performance but they can be roughly divided into accounting-based measures and market based measures. The most common accounting based measures are return on assets (ROA), return on equity (ROE) and return on sales (ROS) while the most common market-based measures are market-to-book-value ratio and Tobin's Q. Some experts claim that accounting based measures are not as reliable as they can be easily manipulated as it suffices to change the accounting methods to change results. They do not evaluate risks and investment requirements. In addition it is difficult to compare these measures between industries. Market-based measures on the other hand are usually more influenced by external factors than the management. Still both measures are widely accepted as indicators of firm financial performance. [190]

3.8 Principles, Codes and Guidelines of Corporate Governance

There is a wide range of principles, codes and guidelines of CG worldwide. Usually compliance with them is not mandated by law but a few of them like for example stock exchange listing requirements have a mandatory nature. In this section we will introduce the most important and influential governance guidelines, codes and principles .

3.8.1 OECD Principles

The OECD Principles were introduced in 1999 and have become an international benchmark for corporate governance. They can be see as the most influential set of corporate governance recommendations as they have served as a basis for a variety of reforms in the governmental and private sector. A revision occurred in 2003 in order to consider recent developments and scandals in the private sector. An agreement followed in April 2004. The principles basically involve about six areas of corporate governance as documented below. These principles evolved since integrity of business and markets is seen as crucial in order for economies to remain vital and stable. Recent corporate scandals have laid open certain weaknesses of corporate governance system and the necessity to improve these critical spheres. They are

[188] Ibid., 25.
[189] Ibid., 25.
[190] Richard J. Gentry and Wei Shen, "The Relationship between Accounting and Market Measures of Firm Financial Performance: How Strong Is It?" *Journal of Managerial Issues* 22, no. 4 (2010): 514

supposed to deliver guidance for policymakers, regulators and market participants by revising the frameworks of corporate governance, focussing on publicly traded companies. In addition they give suggestions for stock exchanges, investors, corporations and other parties that are involved in corporate governance. [191]
The main areas of the OECD Principles are:

> ***"I. Ensuring the basis for an effective corporate governance framework***
> *The corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities.*
>
> ***II. The rights of shareholders and key ownership functions***
> *The corporate governance framework should protect and facilitate the exercise of shareholders' rights.*
>
> ***III. The equitable treatment of shareholders***
> *The corporate governance framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights.*
>
> ***IV. The role of stakeholders in corporate governance***
> *The corporate governance framework should recognise the rights of stakeholders established by law or through mutual agreements and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.*
>
> ***V. Disclosure and transparency***
> *The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.*
>
> ***VI. The responsibilities of the board***
> *The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders*" [192]

These principles were adopted by the International Corporate Governance Network (ICGN). Its members should be aware of them and consider also governance criteria and not only financial aspects when making investment decisions. [193]
The United Nations Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) was also founded on the OECD Principles and issued a "Guidance on Good Practices in Corporate Governance Disclosure" which deals with a wide range of disclosure issues.[194]

3.8.2 The Cadbury Report

The Cadbury Report was released in 1992 in the aftermath of a large number of corporate failures in the 1980s. It advises the separation of the roles of CEO and chairman, proposes

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[191] *OECD, Principles of Corporate Governance,* (Paris: Organization for Economic Co-operation and Development, 1999), 183-4.
[192] Ibid., 185.
[193] ICGN, "ICGN Statement on Global Corporate Governance Principles" (Paper presented to Annual Conference in London, London, United Kingdom, 2005).
[194] United Nations, "United Nations Conference On Trade and Development: Corporate Governance Disclosure," http://unctad.org/en/Docs/iteteb20063_en.pdf (accessed October 15th, 2013).

changes to board structures and asks for more accountability to shareholders through more independent directors. It also highlights the importance of board committees and proposes to create sub-committees of the board to deal with certain parts of corporate governance that haven proven challenging in the past, such as financial reporting, the remuneration of the board and senior management as well as the appointment of board members. [195]

3.8.3 Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley act was passed by the U.S. Congress in 2002 as a response of corporate scandals such as Enron, Tyco and WorldCom. It is supposed to protect shareholders from possible fraudulent accounting activities by a company. It serves the purpose of improving financial statements from corporations in order to prevent accounting fraud. [196]
Its two main provisions were:

> *"1. Section 302: A mandate that requires senior management to certify the accuracy of the reported financial statement*
>
> *2. Section 404: A requirement that management and auditors establish internal controls and reporting methods on the adequacy of those controls"* [197]

The establishment and maintaining of the controls required by Section 404 resulted in very high costs for companies which led to strong criticism from many sides. The introduction of the Public Company Accounting Oversight Board (PCAOB) made CEOs and financial officers (FOs) accountable for all financial statements issues as in the past a lack of information was used as an excuse. Furthermore board audit committees need to consist of truly independent directors and one of them needs to be a financial expert.[198]

3.8.4 NYSE Stock Exchange Listing Standards

Companies that are listed on the NYSE are required to fulfil certain conditions in regards to their to corporate governance practices according to Section 303A of the NYSE Listed Company Manual. Nevertheless, listed companies that function as foreign private issuers can rely on home country provisions instead of regulations found under Section 303A. The table below illustrates the differences in corporate governance between U.S. companies and in this case the Japanese company Nomura. The information set forth below is current as of March 31, 2013. [199]

Corporate Governance Practices Followed by NYSE-listed U.S. Companies	***Corporate Governance Practices Followed by Nomura***

[195] A. Cadbury, *Report On the Committee On the Financial Aspects of Corporate* Governance (London: Gee, 1992).
[196] *Investopedia*, s.v. "Sarbanes Oxley Act," http://www.investopedia.com/terms/s/sarbanesoxleyact.asp (accessed October 24 2013).
[197] Ibid.
[198] "Sarbanes-Oxley: Five Years under the Thumb," *The Economist*, July 26, 2007, http://www.economist.com/node/9545905 (accessed November 12, 2013).
[199] Nomura, "Corporate Governance | Difference between Corporate Governance Practices in Japan and in U.S.," http://www.nomuraholdings.com/investor/cg/difference.html (accessed October 17, 2013).

A NYSE-listed U.S. company must have a majority of Directors meeting the independence requirements under Section 303A of the NYSE Listed Company Manual.	*Under the Companies Act, a company which adopts the Committee System is not required to have a majority of outside directors, but is required to have a majority of outside directors on each of the audit, nomination and compensation committee. An outside director is defined under the Companies Act as a non-executive director who does not currently assume, and has never assumed, the position of executive director, executive officer, manager or employee of the company or its subsidiaries.* *Nomura, while meeting the requirements of the Companies Act, has six outside directors among its eleven Directors.*
The non-management directors of a NYSE-listed U.S. company must meet at regularly scheduled executive sessions without management.	*Under the Companies Act, Nomura is not required to hold such executive sessions for its outside directors.*
A NYSE-listed U.S. company must have an audit committee that satisfies the requirements under Section 303A of the NYSE Listed Company Manual, including those imposed by Rule 10A-3 under the U.S. Securities Exchange Act of 1934. The audit committee must be composed entirely of independent directors and have at least three members.	*Nomura has an Audit Committee consisting of three Directors, all of whom are independent directors under Rule 10A-3 under the U.S. Securities Exchange Act of 1934. The Audit Committee is in charge of monitoring the performance of the Directors and Executive Officers of Nomura and to propose the appointment or dismissal of its independent auditors and accounting firm. The Audit Committee satisfies the requirements of Rule 10A-3 under the U.S. Securities Exchange Act of 1934.*
A NYSE-listed U.S. company must have a nominating/ corporate governance committee with responsibilities described under Section 303A of the NYSE Listed Company Manual. The nominating/corporate governance committee must be composed entirely of independent directors.	*Nomura has a Nomination Committee consisting of three Directors, two of whom are outside directors. The Nomination Committee is in charge of proposing to the meeting of shareholders the election or dismissal of Directors of Nomura.*
A NYSE-listed U.S. company must have a compensation committee with responsibilities described under Section 303A of the NYSE Listed Company Manual. The compensation committee must be composed entirely of independent directors.	*Nomura has a Compensation Committee consisting of three Directors, two of whom are outside directors. The Compensation Committee is in charge of determining the compensation of each Director and Executive Officer of Nomura.*
A NYSE-listed U.S. company must generally obtain shareholder approval with respect to any equity compensation plan.	*The Compensation Committee establishes the policy with respect to the determination of the individual compensation of each of our Directors and Executive Officers (including stock options in the form of stock acquisition rights as equity compensation) and makes determinations in accordance with that compensation policy. Under the Companies Act, stock options are deemed to be compensation for the services performed by our Directors and Executive Officers*

Table 1: Comparison of Corporate Governance Practices Followed by NYSE-listed U.S. companies and Japanese company Nomura[200]

This table documents the differences between requirements for U.S. companies and Japanese companies listed on the NYSE

While U.S. companies have to fulfil many requirements in order to be listed on their domestic stock exchange Japanese companies are subject to different regulations. U.S. companies must always dispose of a majority of independent directors, while this is not mandatory for

[200] Ibid.

Japanese companies. Equally they are not required to hold regularly scheduled executive sessions without the management like U.S. companies. Also the audit, nominating and remuneration committees of U.S. companies must be composed entirely of independent directors. This is not the case for Japanese nominating and remuneration committees.

3.9 Benefits and Drivers of Corporate Governance

The main purpose of corporate governance is to create a healthy competitive corporate sector. The Organization for Economic Co-operation and Development (OECD) has introduced factors and drivers of good corporate governance. Firstly corporate governance is supposed to protect the rights of shareholders. Secondly it is supposed to provide equitable treatment of shareholders, as well as minority or foreign shareholders. Thirdly it encourages shareholders to take an active role in corporate governance. Fourthly it demands greater disclosure and transparency of all material matters regarding the firm and last but not least it asks for protection of this framework through monitoring by management boards, which themselves are held accountable to the company and its shareholders. [201]

What comes through here is that the main importance is placed on shareholders' rights. Simply defined shareholders legally own the company and therefore a firm's success means larger revenues for them. But as we explored before there are theories that show a different perspective as they advise to focus on the larger picture and that shareholders' interests are surely important but that there are other agents involved whose interests matter as well for the well being of a firm. Therefore it is crucial to have a wholly ethical strategy that will result in a better reputation and a better reputation of integrity leads to positive results.[202]

As mentioned before, transparency and accountability are equally important in order to secure good corporate governance. Weak governance on the other hand is usually related to financial and managerial information opacity which initially may seem beneficial but in the long run results in moral hazard.[203] Transparency of information can only exist when no agent withholds information between other agents in a system.[204]

Equally the board of directors should be kept separate from a company's owners in order to facilitate transparency and accountability. It is crucial that these boards are impartial towards all the agents since it is their task to monitor a firm's performance and to act in their shareholders' best interest. Having outside directors that are not involved in daily procedures of the company can help to keep the managers in line.[205]

Good corporate governance is beneficial in order to maintain beneficial relationships among companies and its stakeholders. This is important especially since globalisation enhances structural interdependence between companies. [206] It is necessary to develop new political and social structures to encourage cooperation between countries and individuals. If corporate governance is further developed throughout the world, comparative institutional benefits for companies will improve.[207]

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[201] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 108. ; Stephen S. Cohen and Gavin Boyd, *Corporate Governance and Globalization* (Cheltenham: Edward Elgar Publishing, 2000), 65.

[202] A Naciri, *Corporate Governance Around the World* (Abingdon: Routledge, 2008), 246.

[203] *In economic theory, a **moral hazard** is a situation where a party will have a tendency to take risks because the costs that could incur will not be felt by the party taking the risk. In other words, it is a tendency to be more willing to take a risk, knowing that the potential costs or burdens of taking such risk will be borne, in whole or in part, by others. A moral hazard may occur where the actions of one party may change to the detriment of another after a financial transaction has taken place.*

[204] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 108-9.

[205] Ibid.

[206] A Naciri, *Corporate Governance around the World* (Abingdon: Routledge, 2008), 352.

[207] Ibid. 350

3.10 Conclusion

In this chapter we have given an overview of the various dimensions that corporate governance entails. There are basic theories as well as regulatory frameworks that give ideas and advice on how to best perform corporate governance. A lot of thought is given to corporate governance as a crucial factor of long-term success of companies which leads to the conclusion that the relationship between corporate governance and firm performance is considered significant even though views on how exactly they are correlated in practice have shifted over the past few decades. The theories introduced in this chapter disagree on the question of how corporate boards should be best structured in order to secure good corporate governance. Some theories prefer boards to consist of many members and have a higher number of outside directors as this should increase monitoring. Other theories prefer a smaller board size in order to avoid issues of miscommunication and coordination as well as smaller number of outside directors and so on. Also theories have differed widely from the reality in the past. In the last few years a series of corporate scandals and the introduction of frameworks such as Cadbury and the OCED Principles have been the results of these scandals. Mandatory frameworks such as Sarbanes-Oxley have been based on these principles and occurred as a consequence of the crisis as worldwide the need for powerful shareholders and independent directors was expressed and considered possible remedy for inefficient corporate governance.

4. Corporate Governance in Japan and South Korea

This chapter investigates corporate governance practices and reforms in Japan and South Korea and identifies current governance challenges. It focuses on corporate governance issues and is therefore limited to aspects related to these issues. It does not analyse overall reform and competitiveness of the corporate sector, macroeconomic policies and reforms of the financial sector which have been equally important for the development of both countries.

4.1 Corporate Governance in Japan

In this part we explore how the Japanese corporate governance system developed and how it has changed over the years. We look at reforms, practices, corporate boards as well as corporate (social) accounting and corporate social responsibility. Subsequently we do the same for South Korea and conclude an initial comparison and analysis which is followed by the empirical part.

4.1.1 Overview of Past Economic and Political Developments

In the course of the Meiji restoration, Japan started a process of modernization. The country wanted to secure its national independence and avoid the kind of colonization that some of its neighbours had to experience. Its government aspired to become "a rich country with strong soldiers". What followed was a restoration of almost all its institutions: political, social, economic, military, educational etc. shaped by Western and especially European influences. For example in 1899, the first Japanese Commercial Code was enacted and based on a draft by a German scholar, named Hermann Roesler. This German influence is visible until today. For example, Article 261-3 of the current Commercial Code states that the authority of the representative director is to carry out all affairs of business in and out of court which is a direct translation of the German provision in the Aktiengesetz article 78. [208]

The separation of ownership and management in Japan evolved over time. Initially founders were managing their corporation themselves. With time a stock exchange listing of those companies occurred and holdings by founders were gradually reduced. Companies grew and became company groups. Eventually founders and their families gave up their posts. In the early 1900s four large "financial combines" existed, known as zaibatsu in Japan: Mitsui, Mitsubishi, Sumitomo and Yasuda. These companies disposed of a central holding company. The families held control over these and were directors of the main companies. After the end of World War II the General Headquarters of the Allied Powers "broke up" these zaibatsu and forced the owning families to give up all of their company shares. Furthermore the Japanese government was compelled to forbid any holding companies and many Japanese managers who had been involved with Japanese military authorities were driven into leaving public life. As a consequence many founding families left Japanese companies that have been created before the end of World War II.[209]

After 1945 companies like Honda Motors, Sony and Sanyo Electric were founded. It was still a tradition that the family of the founder was expected to take over posts. One exception was, Soichiro Honda, who expressively prevented his son from entering the company since he felt that now that his company had become a listed company, it should be treated like a public institution. Therefore it is exposed to and depending on the business environment. Since this is constantly changing and affected by external and internal factors, he needs top management

[208] M. Yoshimori, "The Japanese National System of Corporate Governance," in *Corporate Governance around the World* (New York: Routledge, 2008), 172.
[209] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 3.

that disposes of the needed abilities, knowledge and experience of business administration. He did not feel that his son would be up for such a task.[210]

In the course of business scandals or bad company performance Japanese founder families would usually give up their posts. Nevertheless it would take a long time or a big scandal until family would actual left their posts in the given companies and be replaced by outsiders. For example, in 2005 a former outside director was appointed chief executive officer (CEO) at Sanyo Electric.[211]

In the 1980s many former large national enterprises were privatized, e.g. Japan National Railway, the Nippon Telegraph and Telephone Public Corporation. Initially these enterprises were made companies with limited liability and shares only owned by the Ministry of Finance (MOF). Eventually many of these companies became listed companies and disposed of a top management which did not consist of public servants. It can be said that the separation of ownership and management in privatized companies did grow to a certain degree.[212]

In the past, the term "shareholder value" has been often used in Japan. There was a change in the structure of ownership in Japanese in the mid-1990s and in the course of this shareholder value orientation increased significantly. At the same time employment has always been an important factor in Japan and the companies in itself represented a certain kind of community. So in a way the stakeholder approach has been much more prominent in Japan than in the west even though the term was not as popular. Employees were integrated into the system of the company with the potential of their career eventually leading them to a post on the board of directors.[213] But only recently the term stakeholder orientation has become more prominent around business even though specialists in business administration have been familiar with the term since the 1980s. Still often enough shareholders have been characterized as interest groups or constituencies. [214]

Something that is very specific to Japan is the fact that its companies, due to their development after World War II, developed specific industrial structures which led to a limited capital market orientation. The dominance of the horizontally organized keiretsu, which are business groups that are connected to each other through cross-shareholding, led to certain isolation from the capital markets.[215] Also directors often belonged to the same business group but were still appointed as independent directors on the other companies' boards.[216] Mergers needed to be authorised by the management and hostile takeovers were almost impossible which disabled one of the most important functions of the capital market. As a consequence supervision between instances of corporations became weaker than it would have been in a system with capital market orientation. Another effect was the pursuit of increasing market shares instead of aspiring an increase in profitability.

Also Japanese banks were an important factor of influence. Since capital market orientation was limited, banks played a more important role. Japanese companies usually disposed of a small amount of equity capital therefore they depended strongly on bank loans. At the same time banks were holding shares of that company. This would lead to Main Banks covering most of the company's loans, overseeing accounting and installing own employee in

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[210] Ibid.

[211] Ibid., 3-4.

[212] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 3-4.

[213] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder Gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 422.

[214] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 8-9.

[215] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder Gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 422-23.

[216] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 60.

management positions. When the company was in crisis or overly indebted, executives and directors of the bank were usually sent to reconstruction the bank.[217] In the 1980s banks held about 40 percent of shares while corporations held only 25 percent.[218] Nevertheless the power of banks has diminished after the burst of the economic bubble.[219]
The Japanese state was an equally strong influence. After the war the Japanese government promoted certain industries more than others. Informal instructions made it possible to influence companies. The practice of amakudari especially in horizontally organized, where former government employees are placed on corporate boards, was very common.[220]

4.1.2 Corporate Governance Reforms

The first major revision of the Commercial Code occurred in 1950 after World War II under Allied Occupation. Five officials of the Supreme Commander for the Allied Powers (SCAP), which was the main governing body of the Allied forces, were responsible for the revision. As a consequence the new code was profoundly similar the US model, namely the Illinois Code as three out of the five officials were trial lawyers from Illinois. Therefore the code can be seen as a creation of US and German influences.[221]
The Commercial Code was revised in 1993 and demanded that companies disposing of a legal capital of 500 million yen or total balance-sheet liabilities of 20 billion yen must introduce a board of corporate auditors with at least three corporate auditors with one out of the three being a full-time auditor.[222]
The latest amendment of the Commercial Code, which came into effect on April 1st, 2003, was one of the first big steps towards a more transparent and effective corporate governance system. This code brings the Japanese system a step closer to the US model and applies to about 10,000 large companies. It allows those companies to choose between the old Japanese corporate governance system which consists of a board of directors and an audit board, and the more Western audit committee system. Before this reform there have been a few voluntary codes of CG, for example the Corporate Governance Principles which were published by the Japan Corporate Governance Forum which consists of top executives, managers, lawyers, consultants and academics. The ones that found most acceptance though, were the French Viénot Reports I and II, and the UK's Combined Codes integrating the foregoing Cadbury Report, Greenbury Report, Hampel Report and Mainers Reports as well as the Cromme Committee's Codes of Best Practices which were sponsored by the German government.[223]

4.1.3 Corporate Governance Practices

As mentioned before the purpose of a company is to make a profit. But profit is only one result of business. According to Post, Preston and Sachs a corporation is supposed to bring long-term benefits to all its stakeholders.[224] When examined closely we realise that profit is only one of the results of business activity. Business activity inevitably creates goods and

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[217] Ibid.
[218] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 9.
[219] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 60.
[220] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel Oder Gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 422.
[221] M. Yoshimori, "The Japanese National System of Corporate Governance," in *Corporate Governance around the World* (New York: Routledge, 2008), 173.
[222] Ibid., 175-6.
[223] Ibid., 175-6.
[224] J. Post, L. Preston, and S. Sachs, *Redefining the Corporation* (Stanford: Stanford Business Books., 2002), 19.

services needed by consumers and society. Therefore business is equally related to society. Japanese companies like Matsushita Electric, Toyota Motors and Honda Motors represent these ideas openly.[225] For example Matsushita Konosuke, the founder of Matsushita Electric made this a part of the Matsushita Basic Management objectives in 1929:

> *"Recognizing our responsibilities as industrialists, we will devote ourselves to the progress and development of society and the well-being of people through our business activities, thereby enhancing the quality of life throughout the world."*[226]

One of the first questions to ask is: Can we compare corporate governance in Japan directly to western standards and practices? Of course there are similarities to the Anglo-Saxon system. But one of the crucial points we must consider is the fact that Japanese democratization was implanted from above through occupational forces. Therefore it is a democracy that remains largely on paper and in contrary to most Western nations where democracy was won through often violent struggles. This is the reason why a large gap remains between law and actual application. For example the statutory auditors are given a lot of power to reject illegal board decisions but they cannot overcome the CEOs and their boards, since they are the ones who appoint auditors which results in the creation of a legal obligation.[227]

The country disposes of vertically integrated, e.g. Toyota and horizontally integrated companies, e.g. the keiretsu. Vertically integrated companies do not use cross-holding of shares. Usually they own a certain amount of shares of their suppliers which allows them to exercise control to a certain extent and results in a more Anglo-Saxon structure.[228]

The companies are subject of the Commercial Code which also compromises questions of corporate governance. There are three main instances responsible for corporate governance in public companies. First there is the shareholders' meeting, then the board of directors and the board of corporate auditors. The board of directors is a one-tier board. Before the reforms of 2003 it only disposed of the Board of Corporate Auditors System. Auditors dispose of the following legal rights:

> *"(1) Right to obtain reports and conduct examinations, (2) Prevention of directors' illegal action, (3) Litigation between the company and its directors, (4) Financial audit)"*[229]

The board is supposed to represent the company's shareholders' interests and therefore members are elected through a shareholders' meeting. Often directors and executives are former employees of the company. The board of corporate auditors, whose members must be outsiders, are also elected at the shareholders' meeting. Directors, who are both responsible for active guidance and monitoring at the same time, appoint one or more representative directors amongst the members of the board. Seen from a legal perspective, the shareholders'

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[225] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 8-9.

[226] Panasonic, "Panasonic Code of Conduct," http://panasonic.net/corporate/philosophy/code/04.html (accessed October 12, 2013).

[227] M. Yoshimori, "The Japanese National System of Corporate Governance," in *Corporate Governance around the World* (New York: Routledge, 2008), 175.

[228] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 423.

See N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 59-61.;

Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 9.

[229] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 62.

meeting is the top-level arbitration but in reality about 70 percent of the meetings were held on the same day and did not last longer than 30 minutes. Also it was difficult for auditors to effectively control and influence due to the hierarchical structure of boards. As there is no actual law requiring independent directors on Japanese boards, boards were usually large and consisted mainly of inside directors with different hierarchical statuses with the company's president on top supported by the chairman who usually was a forerunner of the current president. The required amount (if any at all) of outside directors was usually provided by external directors from linked corporations This structure had the effect that most of the decision making power was concentrated in the hands of the president who was making staff decision regarding the board as well as daily business decisions together with a group of higher ranked directors. So by law boards were supposed to approve management decisions in the best interest of shareholders when in reality Japanese boards had more of a symbolic function and would usually only affirm any decision made by executives. In the Japanese understanding a position on a company's board was a position of status and prestige awarded to managers after many years of service. The position of a statutory auditor worked in a similar way. [230]

The burst of the economic bubble and the following financial crisis of the 1990s illustrated that changes in industrial and corporate governance structures were necessary. The stock market has gone through changes as well. The number of foreign investors rose by 13 percent since 1990 while the share ownership of companies diminished from 30.1 percent to 21.5 percent. This shows that the country has gotten closer to developing a capital market with lower barriers for companies and a larger number of mergers and acquisitions. At the same time the number of cross-shareholdings has diminished significantly. This reduction in cross-shareholding led to a bigger volume of shares available which opened more possibilities for foreign investors and companies. [231]

At the same time big companies are reducing their number of bank loans and shares and access capital through bond issues and equities. Disposing of a larger amount of shares usually opens the possibility of gaining access to the companies' boards. Therefore the number of foreigners on Japanese boards increased. However research has shown that there is no correlation between the number of foreigners on boards and firm performance.[232]

At the same time the habit of amakudari has also diminished. There were strong ties between the government and Japan's companies since they were offering concessions and loans. But with the emergence of more capital market orientation other possibilities of financing have appeared and the failure of governments to deal with the economic problems of the 1990s effectively, made companies less dependent on government loans etc. which automatically reduced the number of ex-bureaucrats on Japanese boards with exception of the keiretsu. [233]

Corporate officers were introduced and report to the directors. They are responsible for operative decisions. After the Japanese Commercial Code was revised companies were allowed to introduce a board committee system instead of the corporate auditor system. As mentioned before this system usually consists of a board of directors, an audit committee, nominating committee and the remuneration committee which must dispose of a majority of outside directors. In 2003, 38 companies chose to switch to the new system but many big

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[230] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 423. ;
N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 59-61.;
Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 9.

[231] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 425-27.

[232] Ibid.

[233] Ibid., 427.

companies e.g. Toyota Motor, Canon etc., chose not to do so and pursued other paths of change. In substance the amendments to the Commercial Code were mostly legal confirmations of a board reform that was introduced by Sony in 1997. The company divided its 38-members-strong board into directors and executive officers: ten directors out of which three are outside directors and 34 Officers which included nine newly appointed ones. Seven former directors became officers. Soon hundreds of listed firms followed this example which reduced the average size of larger Japanese companies and made them more manageable. In 2001 Sony's CEO Noboyuki Idei went even further and created a nominating committee and a compensation committee. This new reform was introduced with the amendments of the Commercial Code which was the first time where an initiative taken by a private company actually found its way into legislation. In many ways this documents that private business in Japan was ahead of its conservative lawmakers. Before this amendment was introduced an average public corporation usually disposed of a board size of 30 to 60 directors which rarely included outside directors and the few that existed were not really independent since they were former managers of the company or sent from other companies that had formed business ties with the current company. The reforms introduced by Sony also influenced many other Japanese companies to introduce changes. For example, Toyota also modified its board in June 2003 and reduced its 58-member-strong board to 27 directors including three non-Japanese (for the first time in the company's history). Prior to this reform its board was probably one of the largest in the whole of Japan and consisted of various hierarchal levels. At the top the was one honorary chairman, one chairman, two vice chairmen, one President and CEO, eight executive vice presidents, five Senmu Senior directors, 14 Yomu directors and at the bottom 26 ordinary directors. In addition there were six statutory auditors monitoring the board.[234] Hitachi decided to reduce its number of directors from 30 to 14 directors and other companies like Sanyo Electric and Orix decided to introduce outside directors for the first time. Hoya introduced a remuneration committee in 2001 which was composed only of external directors. At the same time there were corporate scandals happening which resulted in the decision of introducing changes in these companies. For example the company Snow Brand Milk Products was involved in a corporate scandal at the end of which it decided to introduce outside directors in order to improve its reputation. These directors were responsible for intoducing an ethics committee solely responsible for business ethics.[235]
A survey conducted by the Tokyo Stock Exchange in 2008 which involved 2, 103 listed firms with a 65 percent response quota illustrates these changes. It shows that after the revision of the Commercial Code about 54 percent disposed a board size smaller than ten.[236]

4.1.4 Corporate Reporting Practices

Japanese accounting standards have changed since the 1990s when it started to introduce reforms.[237] In 1996 a series of reforms was introduced to open financial markets. The Financial Services Agency (FSA), created in 1998, was responsible for accounting reforms. By the year 2000 accounting standards for listed were brought closer to international standards.[238] Japan adopted U.S. Generally Accepted Accounting Principles (GAAP) and

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[234] M. Yoshimori, "The Japanese National System of Corporate Governance," in *Corporate Governance around the World* (New York: Routledge, 2008), 175-77.
[235] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 60-61.
[236] Ibid.
[237] Keisuke Yorihiro "Financial Reporting," http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2011_10/Update--IFRS-Developments-in-Japan.aspx#axzz2fcDoky8I (accessed October 17th, 2013).
[238] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 11.

International Accounting Standards (IAS).[239] Firms were required to report any cross-shareholding and shares for investment, as well as report consolidated results for companies where they disposed of de facto control which served the purpose of impeding companies to hide possible losses.[240] In 2005 the Accounting Standards Board of Japan (ASBJ) and the International Accounting Standards Board (ISAB) expressed the need to reform Japanese accounting standards so that they are more similar to the IFRS. In 2007 the "Tokyo Agreement" was established where 26 major differences between Japanese and international standards where identified and supposed to be eliminated until 2008 or 2011 at the latest. In 2008 the European Commission stated the Japanese GAAP corresponded to the IFRS adopted by the EU. In the same year the U.S. Securities and Exchange Commission (SEC) released a draft IFRS roadmap and the Japan Financial Services agency (IFSA) followed by releasing a Japanese IFRS roadmap in its Interim Report. This report allowed listed companies that were operating internationally to start using IFRS if desired from March 31, 2010. At this point it is not clear how many companies will adopt IFRS in the future. For now Nihon Dempa Kogyo, HOYA Corp. and Sumitomo Corp. have adopted IFRS. As a consequence the financial section of Sumitomo's securities report has expanded decisively, while HOYA's report doubled. Sumitomo Mutsui Financial Group, adopted IFRS and listed its stock on the NYSE in 2010.[241]

According to the MOF in 2011, a mandatory application of IFRS will not occur soon as five to seven years will be required for a transition. So for now U.S. GAAP standards can be used beyond March 31, 2016.[242]

4.1.5 Corporate Social Responsibility

The first mentioning of corporate social responsibility (CSR) for companies occurred in 1956 through the Japanese Association of Corporate Executives Keizai Dyukai. It stated that a corporation is a public institution and corporate executives are no stewards of shareholders anymore but more like stewards of the company's stakeholders and society.[243] This resolution is said to have based on Howard R. Bowen's book "Social Responsibility of the Businessmen" which was published in 1953.[244]

Japan's rapid economic growth in the post-war years led to massive environmental pollution in the 1960s. Therefore it was necessary to introduce ideas of corporate social responsibility.[245] But ideas on CSR differed widely. Matsushita Konosuke, founder of Matsushita Electric considered companies to be social institutions and state that companies who "do as they please" would not last. Nevertheless he considered the environmental problems that occurred during these years, as being out of the range of CSR. The chairman of Keizai Doyukai, Hosai Hyuga state in 1966 that the only contribution that companies ought to make is the result of what is produced and profits are the compensation they receive from society. Therefore it is

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[239] Keisuke Yorihiro "Financial Reporting," http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2011_10/Update--IFRS-Developments-in-Japan.aspx#axzz2fcDoky8I (accessed October 17th, 2013).

[240] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 11.

[241] Keisuke Yorihiro "Financial Reporting," http://www.financialexecutives.org/KenticoCMS/Financial-Executive-Magazine/2011_10/Update--IFRS-Developments-in-Japan.aspx#axzz2fcDoky8I (accessed October 17th, 2013).

[242] Ibid.

[243] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 10.

[244] Keidanren, "Charter of Corporate Behavior," http://www.keidanren.or.jp/english/policy/csr/charter2010.html (accessed November 1, 2013), 4.

[245] N. Demise et al., *Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market* (Tokyo: Springer Verlag, 2006), 10.

essential for companies to grow profits before anything else.[246] The concepts were taken mainly from the United States and dealt with the interaction between society and companies. The oil crisis of the 1970s led to economic depression and reduced the interested in CSR. As a consequence of the economic crisis many Japanese companies entered US markets. They were influenced by US practices and took up more CSR activities but these were limited to donations and volunteering and the setting up of foundations. These ideas eventually reached Japan but the consequences of the bubble economy in the 1990s really enforced them as many corporate scandals suddenly became public.[247]

In 1991 Nippon Keidanren[248] the Japan Business Federation introduced the Charter of Corporate Behaviour which was followed by an Implementation Guidance in 1996. They have been revised several times ever since. An excerpt from the foreword of the charter states:[249]

> *"In particular, while the presence of corporations is indispensable for the economic development of society in terms of their capacity to generate income and employment, corporations should realize the great impacts they have on society as well as the environment and take the initiative to discharge their Corporate Social Responsibility (CSR).*
> *Specifically, corporations should seek dialogue with a wide range of their stakeholders, including shareholders, investors, consumers, business counterparts, employees and the local community, and earn their trust by responding to their expectations, such as continuing to pursue greater efforts to ensure consumer safety and promoting eco-friendly activities. Corporations should discharge their social responsibility not only within their corporate groups, but they should also promote socially responsible behaviour within their supply chain. Furthermore, in response to the growing public interest on human rights and poverty, it becomes important for corporations to tackle these issues from a global perspective."* [250]

This Charter was quite influential and many companies decided to introduce codes of ethical conduct. There were a number of top managers that considered business ethics as crucial but their number was relatively low. In reality companies still put more value to profit than to CSR.[251]

4.1.6 Conclusion

Corporate Governance has become one of the most talked about issues in Japan since the economic downturn after the burst of the economic bubble. This was followed by a series of corporate scandals, illegal behaviour of top executives and bankruptcies and laid open severe flaws in the Japanese CG system.[252] In Japan there are several parties involved. On the one hand there are the companies but then there are also the government, banks and the

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[246] Keidanren, "Charter of Corporate Behavior," http://www.keidanren.or.jp/english/policy/csr/charter2010.html (accessed November 1, 2013): 3.

[247] N. Demise et al., Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market (Tokyo: Springer Verlag, 2006), 10.

[248] KEIDANREN (Japan Business Federation) is a comprehensive economic organization with a membership comprised of 1,300 representative companies of Japan, 121 nationwide industrial associations and 47 regional economic organizations (as of July 1, 2013). It is considered the most conversative out of the three major economic organisations in Japan (Japan Chambers of Commerce and Industry, Japan Committee for Economic Development).

[249] Keidanren, "Charter of Corporate Behavior," http://www.keidanren.or.jp/english/policy/csr/charter2010.html (accessed November 1, 2013).

[250] Ibid.

[251] N. Demise et al., Corporate Governance in Japan: From the Viewpoint of Management, Accounting, and the Market (Tokyo: Springer Verlag, 2006): 12.

[252] M. Yoshimori, The Japanese National System of Corporate Governance, in *Corporate Governance around the World* (Routledge New York/Canada 2008): 172.

entrepreneurs association Keidanren and initiatives like the Corporate Governance Forum. Old parties like banks are losing influence, new potential sources of influence are appearing. Corporate boards are diminishing in size and disposing of more outside directors. Anglo-Saxon influences are becoming more visible. Laws have been updated and there was a convergence towards more international standards. The latest amendment of the Commercial Code illustrates this. There have been some changes, the number of mergers and acquisitions rose which is always a sign of stronger capital market orientation. Cross-shareholding has diminished to a certain degree. The influence of banks and the governments is decreasing as the markets are becoming more international. Still the Japanese system is very far away from becoming an eastern pendant of the Anglo-Saxon system.[253] For example many companies only seem to apply those changes and some of the changes barely touch the surface. Japanese companies are still strongly influenced by old practices and habits. Major factors are the kereitsu, cross-shareholding and the appointment of only seemingly independent directors as they often belong to the same business group.

4.2 Corporate Governance in South Korea

In this section we explore how the South Korean corporate governance system developed and how it has changed over the years. We look at reforms, practices, corporate boards as well as corporate accounting and corporate social responsibility. Subsequently we do an initial comparison between Japan and South Korea based on the facts assembled which is followed by the empirical part.

4.2.1 Overview of Past Economic and Political Developments

The development of the South Korean corporate governance system was strongly influenced by the Japanese system that was introduced in the period of colonization and developed further after World War II. [254]

In 1910 Japan officially annexed South Korea. The occupation can be divided into different phases. From 1910 to 1919 Japan's colonial policy consisted mainly of economic exploitation and political suppression. But in the course of the March 1st movement in 1919 by the Koreans against the Japanese occupation, the course was changed in order to avoid any further uprising. Therefore from 1919 on Japan started investing into the Korean economy which in a way triggered the industrialisation of Korea which until this point had been a rural society where farming was the major source of income. The Japanese built factories for light industry production like sugar and textile where many workers were needed and in this way also laid the foundation for South Korea's working class. In 1910 there were less than 10,000 industrial workers, by 1943 they were 1.3 million. At the same time they built roads, railroads, reformed schools and introduced higher education.[255] Koreans were not allowed to obtain high level management positions nor to hold ownership of Japanese firms therefore only a small of number Koreans could learn about Japanese manufacturing methods. This changed after World War II when the Japanese had to leave Korea and Manchuria and left behind everything they had built. A large amount of these factories was located in the north or destroyed in the following Korean War (1950-953) but what had remained in the south gave opportunities to South Korea entrepreneurs. The first businesses that developed were the so

[253] Andreas Moerke, "Corporate Governance in Japan: Paradigmenwechsel oder gradueller Wandel," *JAPAN aktuell - Journal of Current Japanese Affairs* (October 2004): 421.
[254] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 269.
[255] Charles Holcombe, *A History of East Asia - From the Origins of Civilization to the Twenty-First Century* (Cambridge University: Cambridge University Press, 2011), 244-49.

called chaebol.[256] The chaebol had similarities to the Japanese keiretsu but at the same time there were major differences regarding the structure of ownership and control.[257] Chaebol are defined as a group of companies of which more than 30 percent of shares are owned by the group's controlling shareholder and its affiliated companies according to the Korea Fair Trade Commission. These business groups can be found throughout many different industries and they are usually tied to each other through a number of various contracts and business ties. They dispose of pyramidal or multi-layered shareholding agreements and cross-debt guarantees between member firms.[258] Their structure can be circular (where each company own a share in another group company, which results in a circular shape of relationships), cross-ownership where all companies own parts of other companies in a net-like structure), or in a top-down circle (where companies are organised in a formal holding structure holding subsidiaries control the holding company). Theses structures are supposed to assemble absolute control over all businesses in the hands of only a few minority shareholders which are usually the heirs of the founders over generations.[259]

The Synghman Rhee administration of the 1950s which was established in 1948 as the First Republic through elections that were moderated by the United Nations can be characterised as having been fundamentally corrupt. Rhee was was accused of having created many ethically questionable financial agreements with entrepreneurs in the following years. He did not pursue any real industrialization and the country remained heavily dependent on foreign aid.[260] In 1961 the first republic was overthrown through a military coup by Park Chung Hee became President in 1961 through a military coup which also laid the foundation for strong state intervention. He was assassinated in 1979 but remained in power until then and led the state to rapid industrialisation. During his rule South Korea was able to abolish its "Third World" economic status and become a major industrial power. The state was the main engine in this process.[261] Park attended a Japanese military academy in Manchuria during the colonial rule and was a second lieutenant in the Japanese army in Manchuria during World War II. There he could experience the Japanese developmental state model in its most extreme shape. The former Japanese slogan of "enriching the country and strengthening the army" (fukoku kyouhei) became an inspiration for him (puguk kangbyong). He desired a developmental state system that would deliver quick and high results of economic growth even if the conditions for the population were initially exploitative and difficult. The basic foundation had already been laid during the Japanese occupation.[262]

In order to achieve his aims he installed an Economic Planning Board (EPB). This Economic Planning Board developed the first out of six five-year plans for economic development. In the course of its implementation capital movement was coordinated, resources for investment were allocated and prices decreed. The Park government nationalised the banking systems and by 1970 about 96.4 percent of South Korea's financial assets where in state hands. By doing so the government disposed of resources to invest into industrial development as they pleased.[263]

Two major decisions were that the government should chose which markets should be developed by Korean organisations and to only allow access to a small number of firms. They

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[256] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 106.

[257] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 269.

[258] Ibid.

[259] Solability, "Corporate Sustainability 2013 Korea," *Annual ESG Review* 6 (2013): 8-9.

[260] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 106.

[261] J Minns, "Of Miracles and Models: The Rise and Decline of the Developmental State in South Korea," *Third World Quarterly* 22, no. 6 (2001): 1027-28.

[262] Charles Holcombe, *A History of East Asia - From the Origins of Civilization to the Twenty-First Century* (Cambridge University: Cambridge University Press, 2011), 304-5.

[263] Ibid.

offered many incentives such low-interest loans, tax breaks etc. to increase cooperation. The second decision was to focus on market development through export-oriented industrialisation by only producing goods that have a comparative advantage. The development of domestic good was neglected. The products were mainly produced by the chaebol. Therefore South Kores economy depended strongly on export industries and the chaebol and became vulnerable to instabilities of international markets which was one of the major problems in the 1997 Financial Crisis.[264] Nevertheless South Korea economy developed strongly over a very short period of time which makes it the 14th-biggest economy worldwide. The firms that were given entry to markets would grow in size and revenue. They disposed of financial safety-nets thanks to state-run banks and the government so they could expand as they pleased. They would spread into different unrelated markets. When a chaebol became unprofitable in the eyes of the government, it would simply be distributed to other chaebol.[265] In 1998 the chaebol accounted for about 12 percent of the GNP, 48 percent of total corporate assets and 47 percent of total corporate revenues.[266] Nevertheless the chaebol would become strongly indebted over time and living off bank loans which controlled allocation of all foreign investment in Korea. In 1985 the corporate debt-equity ratio was a 348.4 which was about three times that of the USA and Taiwan. Finally the 1997 Asian Financial Crisis illustrated how necessary corporate governance reforms are. [267]

4.2.2 Corporate Governance Reforms

The 1997 Asian financial crisis showed that the Korean governance model is flawed and that reforms are overdue. South Korea received large loans from the International Monetary Fund (IMF) and the World Bank. Both organisations demanded drastic reforms regarding corporate structure and business practices towards a more global standard.[268] Since then the Commercial Code, which applies to all companies, and the Securities Exchange Act, which is only relevant for companies that are traded on the Korea Stock Exchange (KSE) or the Korea Securities Dealers Association Automate Quotation system, have both been revised and amended on various occasions.[269]

In 1998 Kim Dae-Jung was elected as President and he pursued a non-conservative direction. He introduced a number of important reforms that mainly focused on financial and corporate sectors in order to fix the problems encountered during the financial crisis. They were based on IMF guidelines that were given to the government. He aspired to increase managerial transparency (through accounting reforms, independent directors and minority shareholder rights[270]), to force corporations to focus on their core business instead of pursuing unrelated industries, improve financial health, end loan guarantees between related business and increase the accountability of chaebol leaders. In 1999 he added three other goals: prevent industrial capital from dominating finance, discourage investment between chaebol affiliates and prevent nepotistic ownership or management transfer to heirs. This became the “5+3” rule.

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[264]Charlotte Powers, “The Changing Role of Chaebol,” *Stanford Journal of East Asian Affairs* 102 (2010): 106-7.
[265] Ibid.
[266]Jae-Seung Baek, Jun-Koo Kang, and Kyung Suh Park, “Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis,” *Journal of Financial Economics* 71 (2004): 267.
[267] Charlotte Powers, “The Changing Role of Chaebol,” *Stanford Journal of Eas Asian Affairs* 102 (2010): 106-7.
[268] Christina Ahmadjian and Jaeyong Song, “Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization,” *Discussion Paper* 23 (2004): 5.
[269] “Korea,” Global Corporate Governance, http://www.globalcorporategovernance.com/n_ap/292_298.htm (accessed October 22, 2013).
[270] Christina Ahmadjian and Jaeyong Song, “Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization,” *Discussion Paper* 23 (2004): 6.

[271] South Korea increased the allowed percentage for foreign ownership from 26 percent to 55 percent by 1999. Hostile takeovers and inward FDI were liberalized. The IMF demanded more accounting disclosure and transparency in the shape of independent audits, mandated complete disclosure and consolidated financial statements. Corporate dependence on bank-loans was supposed to be diminished and capital market orientation should be increased. [272]
In September 1999 the Korean Committee on Corporate Governance adopted the Code of Best Practice for Corporate Governance, which are informal guidelines for listed companies. But compliance is not mandatory, and there is no 'comply or explain' obligation. The code was revised in 2003 to address concerns raised by corporate scandals worldwide.[273]
The Sarbanes-Oxley Act only affects Korean companies and their accounting that are listed on the NYSE or NASDAQ. But certain parts of the Securities Exchange Act amendments have been influenced by Sarbanes-Oxley. [274]
Those reforms introduced in the past years brought South Korea closer to what are considered international norms. But it is not yet clear if changes in the governance framework will also provide actual improvement as some of the mechanisms have already been established in the 1960s but have not been properly used. In many ways corporate governance in South Korea is still very young in practice. Further and above all stricter reforms regarding accounting and compliance may be necessary given the number of recent corporate accounting scandals.[275]

4.2.3 Corporate Governance Practices

Korean companies dispose of one-tier boards which are responsible for the supervision and discharging of the management. They must have at least three directors if their capital accounts to more than 500 million won.[276] Board members in South Korea quite similarly to Japan were usually former managers who were appointed board members as a kind of reward at the end of their career. The boards often disposed of a hierarchy and tended to become very large. This usually led to weak corporate monitoring due to coordination problems and a lack of efficiency. [277] Two years before the Asian Financial Crisis the government tried to introduce a mandatory 25 percentage of independent directors however this was given up due to strong resistance from large corporations. In March 1998 at least one independent director per company was required. One year later in October the Securities Trading Act was revised and required companies with more than 2 won worth of assets as well as financial institutions to dispose of more than 50 percent of independent directors. It also demanded to establish audit committees where two thirds of the members ought to be independent including the chairman. From 2000 on firms were also expected to create a nominating committee where 50 percent of the members had to be independent. In 2001 this was expanded to large firms listed on KOSDAQ. [278] The board is responsible for the election of the representative director who usually serves as board chairman. Directors are usually elected at the shareholders' meeting.

[271] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 106-7.
[272] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 5.
[273] "Korea," Global Corporate Governance, http://www.globalcorporategovernance.com/n_ap/292_298.htm (accessed October 28, 2013).
[274] Ibid.
[275] Ibid.
[276] Ibid
[277] Byung Min and Robert G. Bowman, "Corporate Governance, Regulation and Globalization: Lessons from Korea," *Asian Finance Association* (June 2012): 6-7.
[278] Christina Ahmadjian and Jaeyong Song, "Corporate Governance Reform in Japan and South Korea: Two Paths of Globalization," *Discussion Paper* 23 (2004): 6-7.

The board is responsible for the nomination of candidates. In larger companies outside director candidates must be nominated by the nomination committee. The maximum term of office is three years or shorter as a director can be removed any time through a special shareholders' resolution. The rights of minority shareholders are protected through the Commercial Code and the Securities Exchange Act.[279] But despite those new regulations for boards to fill 50 percent with outside directors the current regulations do not define the differences between outside and independent directors. Therefore it is often the case that those outside directors are in reality business associates. [280] Even today Korean boards usually approve 99 percent of management decisions, as they do not seem themselves as a controlling mechanism. In addition chaebol provide a structure that allows the companies to replace a disagreeing director anytime.[281] As a consequence leadership in those corporations does not focus on sustainability as public accountability is not enforced. For example in January 2013 a fatal gas leak occurred at one of Samsung's semiconductor plants. This went on for 26 hours until one of the contract workers died of exposure and three others were injured. In the course of this incident it was revealed that Samsung had been outsourcing safety management of the acid to a contractor who in exchange was outsourcing parts of tasks to a spin-off. The leak was not reported immediately as Samsung feared a degradation of its safety rating, which would have resulted in stricter and more frequent safety inspections.[282] In February 2012 Hanwa Group's chairman Kim Seung-yeon was investigated for alleged embezzlement. A month before that Chey Tae-Won, chairman of SK Group, was indicted as 99 billion won had disappeared. These were supposed to cover possible trading losses. Chey who had already been convicted in 2003 for accounting fraud, denied the charges. The Federation of Korean Industries (FDI) has asked for mild prosecution of this case as a punishment would result in harming the "entrepreneurial spirit".[283]

Over time South Korea has also loosened foreign equity ownership restrictions. Foreign equity was limited to only 10 percent per company until the 1990s, now up to 50 percent of the outstanding shares of most public corporations can be owned by foreigners. Hostile Mergers and acquisitions were prohibited, now any type of M&A and hostile takeover by both foreign and domestic shareholders is permitted. According to the United Nations Conference on Trade and Development the number of M&As rose by 17 times in the first half of the 2000s when compared to the pre-crisis numbers. Chaebol debt-equity ratios are far lower than in the 1990s, economic growth rates have improved. Still over the past decade chaebol have developed a system of interaction.[284]

One of the problems encountered today is circular shareholding[285] as it lowers transparency and weakens minority shareholders. It creates room for moral hazard since controlling shareholders may increase personal benefits at the cost of others. Circular shareholding makes it also impossible to remove corrupt managers from positions as seen with ex-Samsung chairman Lee Kun-hee.[286] According to law, directors who violate laws, or do not perform as they should can be held severally and jointly liable for any losses that the firm may

[279] Kap Su Sol, "Korea's Chaebols Are a Corporate Governance Fiasco," Business Insider Australia, http://www.businessinsider.com.au/corporate-sustainability-korea-a-review-of-the-solability-2013-survey-2013-2 (accessed October 29, 2013).

[280] Ibid.

[281] Solability, "Corporate Sustainability 2013 Korea," *Annual ESG Review* 6 (2013): 8-9.

[282] Kap Su Sol, "Korea's Chaebols Are a Corporate Governance Fiasco," Business Insider Australia, http://www.businessinsider.com.au/corporate-sustainability-korea-a-review-of-the-solability-2013-survey-2013-2 (accessed October 29, 2013).

[283] "The Korea Discount: Minority Report," *The Economist*, February 11, 2012, http://www.economist.com/node/21547255 (accessed November 1, 2013)

[284] Byung Min and Robert G. Bowman, "Corporate Governance, Regulation and Globalization: Lessons from Korea," *Asian Finance Association* (June 2012): 9-10.

[285] equals cross-shareholding by three or more companies

[286] Charlotte Powers, "The Changing Role of Chaebol," *Stanford Journal of East Asian Affairs* 102 (2010): 114.

experience. If gross negligence or wilful misconduct this liability may be expanded to third parties. If any of those actions were approved by the board of directors, all the directors involved will be held liable. In general the newly introduced policies and reform have not been enforced as they should as South Korean regulators prefer to control through informal means and avoid suitcases. There was a large number of founding shareholders who were prosecuted for business crimes. Chaebol like Samsung, LG and SK are under investigation for accounting fraud and corruption. According to the Anti-corruption Act and the Securities Exchange Act individuals who report corruption to the Anti-Corruption and Civil Rights Commission or the securities authorities are guaranteed protection and if this report leads to substantial results that individual will even be rewarded. Still it has been observed that Korean courts tend to be lax when it comes to prosecution. It is even possible that a director will get released from liability through an unanimous shareholder resolution.[287] According to empirical research in Europe and the US family-run businesses are more successful than listed companies on the long run. So family ownership does not only have negative consequences. But accumulation of power can lead to corruption. Out of the 10 major South Korean chaebol, 4 chairmen have been arrested for illegal financial transactions, misreporting etc. as a means to increase family control. What is crucial here is the fact that all of them have been pardoned or their sentences overturned. This creates two problems: a two-class legal system where bribes are common and weak corporate governance enforcement which can decrease foreign direct investment in the country.[288]
Ownership structure in Korea can be characterized as having many institutional investors who hold a big proportion of voting rights. They can be affiliated with the companies and be trading partners. Therefore they have an even higher interest in the firm's profitability than large stakeholders who are not affiliated even though they also have a strong financial interest in monitoring the management. However affiliated investors can be prevented from monitoring due to cross-shareholding of the chaebol as controlling shareholders are likely to use equity ownership by affiliated firms in order to secure control.[289] There are two other problems that occur through cross-holding. One of them is tunnelling which means the giving of contracts owned by family members. As chaebol executives usually only own a small portion of the firm but remain in control through cross-holding, tunnelling is a means to increase and exploit this power to a personal benefit. For example in 2007 the Fair Trade Commission fined Hyundai Motor for giving 1.3 trillion won of business to Glovis which is owned by Hyundai's chairman. The second problem is propping which means giving financial support to unviable units of sister companies and is similar to tunnelling and equally damaging to small shareholders.[290]

4.2.4 Corporate Reporting Practices

Accounting practices in South Korea had a bad reputation before the financial crisis. But after the failure of big chaebol like Kia Motors and Daewoo the Financial Supervisory Commission has introduced new tighter standards. Banks, creditors, credit-rating agencies and investors are now studying auditor's reports with a lot more attention.[291]

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[287] "Korea," Global Corporate Governance, http://www.globalcorporategovernance.com/n_ap/292_298.htm (accessed November 1, 2013).
[288] Solability, "Corporate Sustainability 2013 Korea," *Annual ESG Review* 6 (2013): 9.
[289] Jae-Seung Baek, Jun-Koo Kang, and Kyung Suh Park, "Corporate Governance and Firm Value: Evidence from the Korean Financial Crisis," *Journal of Financial Economics* 71 (2004): 267.
[290] "The Korea Discount: Minority Report," *The Economist*, February 11, 2012, http://www.economist.com/node/21547255 (accessed November 1, 2013)
[291] "South Korean Accounting," *The Economist*, May 18, 2000, http://www.economist.com/node/310191 (accessed November 10, 2013).

A company is required to report certain facts regarding material and board resolutions to the Korea Stock Exchange (KSE), Korea Securities Dealers Association (KSDA) and the FSC. It may be asked to confirm or deny market rumours and press reports. If it fails to disclose or provides inaccurate disclosures criminal charges may follow.[292] It must deliver an annual report with the FSC within 90 days at the end of the fiscal year. An audit report by an independent auditor must be included.[293] The chaebol must issue three sets: individual consolidated and combined. The combined statements must include subsidiaries but also more than 100 linked companies that the chaebol do business with. But there still remain many problems as practices lag behind international standards.[294]
As of 2011 IFRS is required for all listed South Korean companies. IFRS are also mandatory for unlisted financial institutions and state-owned companies, unlisted companies are given a choice between IFRS and the Korean Accounting Standards for Non-Public entities which are based on existing Korean GAAP and were published 2009. The Korean Accounting Standards Board (KASB) has absorbed IFRS as Korean IFRS. They are the same as IASB IFRS with the exception of implementation of newly published IFRS. But K-IFRS are kept up to date.[295]
But a number of recent scandals illustrates fraudulent accounting practices continue to be exist in South Korean. One of the reasons is that accountants nevertheless often have long-standing personal relationships with executives. There seem to be no effective remedies for this.[296]

4.2.5 Corporate Social Responsibility

In the 1960s South Korea still belonged to the poorest countries worldwide. Within the last four decades it has grown from an agricultural country to an advanced economy. The huge, export-oriented chaebol contributed strongly to this development. One the one hand society sees them as being special and important to South Korea economy. On the other hand they have been criticised for dividing the economy into the more international large industry and the local small and medium-sized companies which resulted in a unequal division of assets.[297]
It was not until the financial crisis that concept of CSR was introduced into Korean society. After the crisis the number of references to CSR in the Korean Economic Daily increased significantly.[298] Parts of the population regard the chaebol as the source of economic problems and condemn their concentration of assets paired with illegal or ethically questionable practices.[299] A survey by Accenture in 2001 illustrated that Korean CEOs perceive the strongest anti-corporate sentiments worldwide. 70 percent of the CEOs stated that they feel an anti-corporate mood in their country.[300] As a consequence of the post-crisis criticism that occurred, these chaebol have tried to improve their reputation through more

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[292] "Korea," Global Corporate Governance, http://www.globalcorporategovernance.com/n_ap/292_298.htm (accessed November 2, 2013).
[293] Ibid.
[294] "South Korean Accounting," *The Economist*, May 18, 2000, http://www.economist.com/node/310191 (accessed November 3, 2013)
[295] "Korea," Deloitte, http://www.iasplus.com/en/jurisdictions/asia/korea (accessed November 4, 2013).
[296] "Korea," Global Corporate Governance, http://www.globalcorporategovernance.com/n_ap/292_298.htm (accessed November 6, 2013).
[297] "South Korea," CSR Weltweit, http://www.csr-weltweit.de/en/country-profiles/profile/republik-korea/index.html (accessed November 7, 2013).
[298] Christine A. Malin, *Corporate Social Responsibility: A Case Study Approach* (Cheltenham: Edward Elgar Publishing, 2009), 128.
[299] "South Korea," CSR Weltweit, http://www.csr-weltweit.de/en/country-profiles/profile/republik-korea/index.html (accessed November 8, 2013).
[300] Christine A. Malin, *Corporate Social Responsibility: A Case Study Approach* (Cheltenham: Edward Elgar Publishing, 2009), 130.

corporate social activities.[301] Officially they are committed to improving the welfare of stakeholders and society. They have established endowments, built schools, founded charities and hospitals. It has also happened that founders used private assets to save employment and bail out companies. But these actions often served a purpose. Companies would receive better benefits from the government, such as tax breaks and financial favours.[302] Another problem is that usually those social contributions did not exceed donations. There were no further efforts afterwards such as community involvement and social contributions. Donations were seen as an easy way of receiving media attention and improving the company's reputation. The idea of CSR has been somewhat misunderstood. A survey carried out by the Korea Enterprise Institute (KOREI) in 2004 that only 21 percent of the respondents among Korean firms were even familiar with the concept.[303] The concept of CSR has not yet been incorporated into corporate law.[304] In 2005 MOCIE (Ministry of Commerce, Industry and Energy) announced that istplans to develop a CSR reporting system for companies in order to create a more transparent, ethical, and responsible society where corporations fulfil their obligations by making investment that guarantee employment.[305]

One of the Korean pioneers in the field of CSR is the company Yuhan-Kimberly. It is a joint venture between Kimberly-Clark and Yuhan Corporation. In 1984 it introduced a unique social contribution programm named "Keep Korea Green". As South Korea's forest haven been strongly damaged in the phase of economic development, this program aims to restore these forests. This program includes various activities such as the planting of trees in public areas, projects of city forestation and the cultivation of international partnerships and educational programs for younger generations. In 2014 the program is celebrating its 30th anniversary and YK plans to plant 50 million trees which equals the population number of Korea. It is probably one of the most distinguished Korean CSR campaigns as it clearly separates social giving from the company's business strategy.[306]

4.2.6 Conclusion

In the 1960s South Korea's GDP per capita was about the same as in the Congo. But by 1996 the country had become one of the largest economies in the world and was a member of the OECD. In the 1960s it disposed of the fifth highest growth rate of real GNP worldwide, followed by the highest GNP in the 1970 and for some time in the 1980s. In 1986 the Fortune list of the top 500 private, non-oil companies featured ten companies from South Korea and only 10 from all other developing nations combined.[307] As we have seen there has been a

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[301] "South Korea," CSR Weltweit, http://www.csr-weltweit.de/en/country-profiles/profile/republik-korea/index.html (accessed November 8, 2013).

[302] Kap Su Sol, "Korea's Chaebols Are a Corporate Governance Fiasco," Business Insider Australia, http://www.businessinsider.com.au/corporate-sustainability-korea-a-review-of-the-solability-2013-survey-2013-2 (accessed November 9, 2013).

[303] Christine A. Malin, *Corporate Social Responsibility: A Case Study Approach* (Cheltenham: Edward Elgar Publishing, 2009), 130.

[304] Kap Su Sol, "Korea's Chaebols Are a Corporate Governance Fiasco," Business Insider Australia, http://www.businessinsider.com.au/corporate-sustainability-korea-a-review-of-the-solability-2013-survey-2013-2 (accessed November 9, 2013).

[305] "South Korea," CSR Weltweit, http://www.csr-weltweit.de/en/country-profiles/profile/republik-korea/index.html (accessed November 9, 2013). ;
Christine A. Malin, *Corporate Social Responsibility: A Case Study Approach* (Cheltenham: Edward Elgar Publishing, 2009), 129-30.

[306] Mee-Hyoe Koo, "CSR Development Trends and Outlook in Korea - Institute for Industrial Policy Studies," Forbes, April 21, 2013, http://www.forbes.com/sites/meehyoekoo/2013/04/21/csr-development-trends-and-outlook-in-korea-institute-for-industrial-policy-studies/ (accessed November 10, 2013)

[307] J Minns, "Of Miracles and Models: The Rise and Decline of the Developmental State in South Korea," *Third World Quarterly* 22, no. 6 (2001): 1025-43.

number of major reforms and changes regarding corporate governance since the Asian financial crisis. But the latest annual corporate sustainability survey conducted by SolAbility points out that the country's corporate governance framework is filled with loopholes even though it may initially seem comprehensive. The power of the country's family-controlled conglomerates known as chaebol remains strong and influential. According to this survey respondents named CEOs and the upper management as crucial success factors and drivers of sustainability. The role of the corporate boards was not mentioned.[308]

The economic development since the 1960s created an environment where companies were competing without having to worry about revenues. Expansion into unrelated market occurred on a regular basis and often increased debt which resulted in a high reliance on bank-loans which did not need to be paid. Over time this led to the Asian financial crisis. What followed were government-driven reforms that occurred suddenly and over a very short time span. Corporate governance frameworks often evolve over time but in the case of Korea they were more revolutionary. South Korea transformed from an insider model to an outsider model and moved closer towards and Anglo-Saxon system. It became less bank-dominated, introduced a protection of rights of minority stakeholders. But still there is a large gap between the framework and actual application. Law enforcement is relatively weak, the policies have not yet become daily practice. Further reforms are necessary. Still South Korea has made an enormous progress in the course of only a few years. But the concept of sustainability is still in its infancy. The improvement of public accounting would be one of the steps towards achieving better corporate governance and sustainability.

So on paper the corporate governance laws in South Korea look similar to those that can be found in Anglo-Saxon model's where there is a separation of ownership and control. But when looking at reality this separation is only pro forma. The larger groupings of related companies with highly concentrated family or individual control who serve as executive directors, known as chaebol are still the most dominant model. So often enough the corporate boards do not have any actual power even today but still incorporate the role they used to have: serving as nominal organs with no actual executive or monitoring power.

4.3 Comparison of Japan and South Korea

In both countries changes in corporate governance have occurred. Both countries introduced more western facets to the existing systems. Japan and South Korea tried to replace or enhance their current systems with more Anglo-Saxon elements in order to secure more board independence, transparency and more attention to shareholder value. Even though both countries tried to do the same in principle application and outcomes differ somewhat for both countries even on the theoretical basis.

In Korea the changes affected mainly areas like board independence and financial structure. However South Koreas development was also different as its economic development occurred later than in Japan. As the economy developed very quickly over a short period of time, corporate governance frameworks were underdeveloped and weak, which led to a strong dominance of chaebol that practiced circular-shareholding, very highly reliant on banks loans and expanded into unrelated markets without paying much attention to profitability. As a consequence the country was hit very hard by the Asian financial crisis of 1997 and depended on bailouts by the IMF and the World Bank which put them under strong pressure for reforms as opposed to Japan which introduced reforms on a more voluntary basis after these events. Therefore those reforms focussed strongly on board independence and introduced quotas for independent board directors as well as a mandatory introduction of the audit committee

[308] Kap Su Sol, "Korea's Chaebols Are a Corporate Governance Fiasco," Business Insider Australia, http://www.businessinsider.com.au/corporate-sustainability-korea-a-review-of-the-solability-2013-survey-2013-2 (accessed November 10, 2013).

system in for a large number of companies. Also the South Korean population is generally more critical of its companies given the history with the Asian financial crisis of 1997 which was strongly related to bad governance of the chaebol which led to a more antagonistic view of labour. In South Korea corporate governance and corporate social responsibility are still relatively new concepts. Therefore CSR is often limited to donations. In addition there is still a strong dominance of chaebol. Law is often not enforced strongly enough.

Japan on the other hand disposed of more flexibility. The companies could choose their preferred system. Firms exposed to international capital markets would usually chose the Anglo-Saxon system in order to please foreign shareholders. But in total the number of companies that introduced the Anglo-Saxon system remains relatively low. Many companies still dispose of the old system but enhanced it by adding special committees without introducing the audit committees systems. Equally there is no mandatory law that would require companies to fill their boards with a certain number of outside directors.

Still both countries are facing similar problems namely accounting failures, corporate scandal and boards that lack effectiveness and monitoring.

In the following chapter we explore how corporate boards in Japan and South Korea are structured today in terms of size, number of outside directors, CEO duality, the committee system and if corporate social governance has increased by analysing 30 listed companies for each country.

5. Theoretical Framework, Methodology and Results

In this chapter we present our theoretical framework, methodology and results of the analysis of the relationship between corporate governance and firm performance in Japan and South Korea. Initially we present descriptive statistics for both countries from 2008 to 2012. Subsequently we explore the results of Spearman's correlation analysis which gives us an idea about the correlation between our variables. This is followed by multiple regression analysis for each year of data for both countries. It is supposed to inform us about the relationships between firm performance and corporate governance and give information if these relationships are significant. Next we treat the data as panel date and perform panel data regressions. Finally we summarize the results and give a conclusion.

5.1 Theoretical Framework

In chapter three we have analysed theories of corporate governance. Most of these theories focus on the board of directors, its composition and characteristics and how they affect corporate governance and firm performance. The main areas of focus are the board size, the number of independent directors and the question of CEO duality. According to the agency theory leadership ought to be separate and boards should dispose of a higher number of independent directors and be larger in general in order to prevent conflicting views between principals and agents. The stewardship theory on the other hand encourages combined leadership and insider dominated boards. The stakeholder theory takes on a broader view and believes that corporate governance should focus on all stakeholders. Therefore it encourages corporate social responsibility and corporate social reporting. As it is difficult to measure corporate social responsibility, we will focus on corporate social reporting of companies. We also identified the introduction of committees systems, namely audit, remuneration and nomination committees, as a recent factor which is considered an effective means to improve corporate governance. Having identified these factors we want to analyse how these factors of corporate governance affect firm performance and if these relationships are significant at all. In order to do so we apply statistical means namely Spearman's correlation matrix, multiple regressions and random effects models on data collected from Japanese and South Korean companies. The conceptual framework serves as an illustration between our theoretical framework and the following operationalisation of our variables:

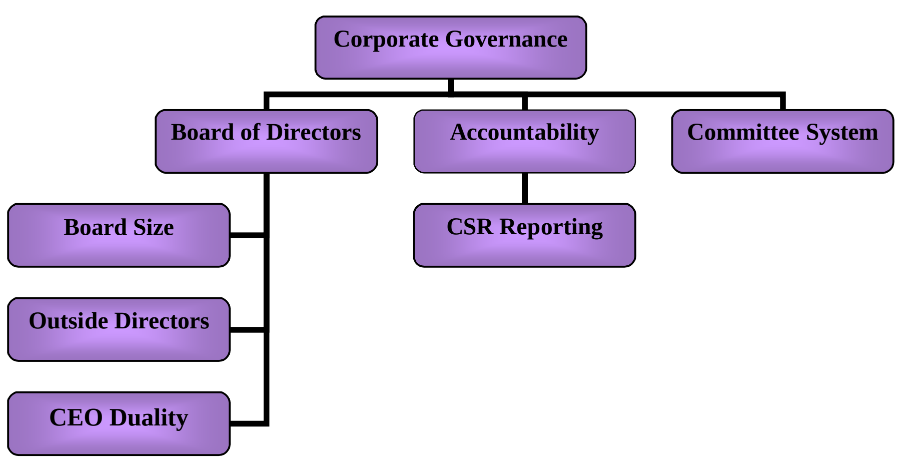

Figure 3: Framework of Analysis

To analyse the relationships between the variables we use Excel and Gretl in order to generate descriptive statistics, Spearman's correlations, multiple regressions and random effects models.

5.2 Design of the Variables: Operationalisation and Measurement

This study does not include all dimension of corporate governance but is limited to the following variables:

	Variables	**Measures**	**Symbols**
Corporate Governance	CEO Duality	Dummy variable 0 for combined leadership, 1 for separate leadership	**CEO**
	Board Composition	Number of independent directors	**BC**
	Board Size	Number of directors on the board	**BS**
	Board Committees	*For South Korea*: Dummy variable 0 if board of auditors and 1 if committee system present *For Japan*: Dummy variable 1 if board of auditors, 1 if 1 or more committees present, 2 if audit committee system was introduced in the case of Japan	**BC**
	CSR Reporting	Dummy variable 0 for financial reporting, 1 for CSR reporting	**CSR**
Firm Performance Measures	Return on Assets	Net Income divided by Total Assets	**ROA**
	Return on Equity	Net Income divided by Shareholders Equity	**ROE**

Figure 4: Measurement of Variables

5.2.1 Independent Variables

We consider board characteristics namely board size (BS), number of outside directors (OD) and separation of leadership (CEO) as well as board committees (BC) and corporate social reporting (CSR) to be our independent variables and we measure them the following way:
We measure board size in terms of the total number of directors.
Board composition is measured as the total number of outside directors on the board.
In order to assess leadership structure on boards we use dummy variables which are common indicator variables in econometrics and especially in regression analysis.[309] If there is no separation of the roles of chairman of the board and CEO it will be coded as '0', if separation of those two roles exists we code it a with '1'.
We apply dummy variables to measure board committees. In the case of South Korea we use '0' if the old system, namely the audit board is still present and '1' if the audit committee

[309] In statistics and econometrics dummy variables are used in order to indicate if a certain effect is present or absent. They usually take the values 0 or 1.

system has been introduced. In the case of Japan we use ‘0’ if the audit board is still present, ‘1’ if there Japanese version of the committee system is present and lastly we use ‘2’ if the audit committee system has been fully introduced.

We also use dummy variables to assess corporate social reporting. We use ‘0’ if there is solely financial reporting and ‘1’ if this is enhanced through corporate social reporting, meaning that the financial report entails information on corporate social responsibility activities or if there is a special annual sustainability/CSR report available instead.

5.2.2 Performance Measures

We consider the performance measures return on equity (ROE) and return on assets (ROA) to be our dependent variables and we asses them as follows:

Return on equity is an accounting-based measure of firm performance and is supposed to show how profitable a company is relative to its shareholders equity. It is measured by dividing net income/profit for the fiscal year by shareholder’s equity for the year. It is estimated in percentage. A positive and high ROE ratio is desirable and indicates good firm performance and vice versa.[310] The formula for the calculation is:

Return on Equity = Net Income/ Shareholder’s Equity[311]

Return on assets (ROA) is also an accounting-based measure to show how profitable a company is relative to its total assets. It is supposed to indicate how efficiently assets are being used by a company’s management in order to generate earnings. ROA is calculated by dividing annual net income/profit by a company’s total assets. It is estimated in percentage. Positive and high ROE is desirable and indicates good firm performance and vice versa. [312]
The formula for the calculation of return on assets is:

Return on Assets = Net Income/ Total Assets [313]

5.2.3 Data Collection

The panel data set covers a 5-year period from 2008 to 2012 with a random sample of 50 Japanese and South Korean listed firms, respectively. The data are collected from the annual reports and company homepages of the firms. All financial data is nominated in terms of the national currencies. The availability of annual reports on the companies’ website plays a determining role for the final list of companies. If annual reports are not available, companies are removed from the sample and the sampling technique is repeated. The data collection technique is mainly manual search and content analysis in the annual reports of companies. In case of unavailability of data, such as director’s profiles and statements on corporate governance, this information will be taken from other official sources such as the company’s homepage.

All companies listed on each country’s stock exchange constitute the population of this study with the exception of the financial services industry and regulated utility companies are excluded from the sample due to special regulatory practices.

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[310] *Investopedia*, s.v. “Return on Assets,” http://www.investopedia.com/terms/r/returnonequity.asp (accessed November 12, 2013).

[311] Ibid.

[312] *Investopedia*, s.v. “Return on Equity,” http://www.investopedia.com/terms/r/returnonassets.asp (accessed November 12, 2013).

[313] Ibid.

In our preliminary analysis of our data for the years 2008 to 2012 we exclude firms which are missing information and therefore our final sample is reduced to 30 listed companies on the Japanese Nikkei 225 Index and the South Korean KOSPI 200 Index respectively. Both indexes are chosen as they entail the "biggest" companies and are more likely to dispose of annual reports.

5.3 Descriptive Statistics Japan

Descriptive Statistics are a common tool in academic research and are a means to measure dispersion and a general tendency of data. Developments over time and between variables can be easily compared. The most common tools of descriptive statistics are mean and median. Therefore in this paper we present median, mean and minimum and maximum of the data for each year. In addition we provide a summary of the years 2008 to 2012 for each country. The maximum presents the highest value and the minimum the lowest value for each variable per year or over the whole time period.[314]
The descriptive statistics help us to see if strong changes in corporate governance structure happened over this period of five years or if the status remained unchanged.

5.3.1 Board Size

In 2008 the average board size consisted of 12 members with a minimum of 7 and a maximum of 25 members. In the following year the results remained the same, while in 2010 the average board consisted of less than 12 members with a minimum of 7 and a maximum of 19 members. In 2011 the average board still disposed of 12 members with a minimum of 7 and a maximum of 20 members. Not much changed in 2012 expect for the maximum number of board members which again went down by 1. In total we can say that in the time between 2008 and 2012 the average board consisted of 12 members with a minimum of 7 and a maximum of 25 directors. In conclusion we can say that the number of directors on the board remained relatively stable on average with the exception that the maximum number of directors went down which confirms what was mentioned in chapter three where we found that Japanese companies have been reducing the overall size of their boards in the recent years as they used to be relatively large.

5.3.2 Outside Directors

In 2008 the average number of outside directors on the board was 2 with a minimum of 0 and a maximum of 14 outside directors. The numbers remain the same for the following year. In 2010 we can see a slight rising tendency in the mean of outside directors to 2.07 but the minimum is still at 0 and the maximum is reduced to 12. In 2011 the average number of outside directors is 2.33 with a maximum of 13 and a minimum of 0 outside directors. In 2012 the average number of outside directors rose to 2.4 but there was still a minimum of 0 and a slightly diminished maximum of 2011. In total for the years 2008 to 2012 we have an average of 2.2 outside directors with a minimum of 0 and a maximum of 14 outside directors.
In conclusion we can say that given the average number of board members in total as we discovered before, which was 12 board members in total, an average number of 2.2 outside directors appears relatively low and very far away from the desired concept of a majority of outside directors. However there is a slight trend visible regarding the rise in the number of outside directors.

[314] *Investopedia*, s.v. "Descriptive Statistics," http://www.investopedia.com/terms/d/descriptive_statistics.asp (accessed November 12, 2013).

5.3.3 CEO Duality

In 2008 about 83 percent of the Japanese companies separated the roles of CEO and chairman of the board. In 2009 and 2010 this was the case in 90 percent of the companies.
The number fell slightly to 83 percent in 2011 as well as to 80 percent in 2012. Over the time span from 2009 to 2012 85 percent of the companies separated the role of the chairman of the board and the CEO which is the majority.

5.3.4 Board Committees

Japanese board which disposed of the Japanese version of the committee system were given a 1 and those who actually adopted the newly introduced audit committee system on a voluntary basis were given a 2. The mean in 2008 was at 0.70 indicating that there were more companies that introduced committees of some kind rather than keeping the old system, still the mean remains below 1 which indicates that the number of companies which actually introduced the new system is still low. The same goes for 2009, 2010, 2011 and 2012 with a mean of 0.7, 0.72, 0.7 and 0.73. The latter indicates only a small change. In total over the period of five years the average number was 0.71. It indicates that Japanese boards are willing to introduce committees of some kind but the newly introduced audit committee system has not spread yet and companies prefer to stick to a board of auditors instead but at the same time introduce other specialised committees.

5.3.5 Corporate Social Reporting

In 2009 and 2010, 93 percent of all the companies in this survey practiced corporate social reporting. Reports on sustainability and corporate social responsibility were included in their annual report or an annual sustainability report was available in addition to the financial report. The number declined to 90 percent in 2010 and 83 percent in 2011. In 2012 there was a slight increase to 89 percent. In total 89 percent of the companies practiced corporate social reporting between 2008 and 2012.

5.3.6 Return on Equity

In 2008 average ROE was at 8.42 percent with a maximum of 26.2 and a minimum of 7.2 percent. In 2009 there was a decline to an average of -3.88 percent with a minimum of 71.20 and a maximum of 22.1. In 2010 the average ROE rose to 0.62 percent with a maximum of 24.4 percent and a minimum of -59 percent. In 2011 the mean remained the same with a slight rise in the maximum to 28.4 percent and a higher minimum of -12.8. In 2012 the average ROE ratio rose to 2.94 percent with a maximum of 29.80 and a minimum of -34.4 percent. In total there average ROE was at 2.82 percent with a minimum of -71.20 and a maximum of 29.80 percent. Over the course of five years average ROE on equity declined into to the negative sphere but managed to rise again even though it did not reach its 2008 levels.

5.3.7 Return on Assets

A similar development can be observed in the case of ROA. Its average ratio measured 3.97 percent with a maximum of 14.10 and a minimum of -3.4 percent. In 2009 its average ratio fell to -0.98 percent with the same maximum as the year before but a much lower minimum of -26.3. In 2010 the average ratio was at 1.09 percent with a lower maximum than the year before (12.20 percent) but a higher minimum of -14.2. Average ROA rose to 2.52 percent in

2011 while its maximum remained similar to the year before (12.4) and its minimum rose to - 3.2 percent. In 2012 average ROA fell again to 1.79 with a minimum of 11.69 percent and a maximum of 12.30. In total average ROA was at 1.68 percent with a maximum of 14.10 and a minimum of - 26.30 percent. This development resembles the one we could observe with ROE. As in both cases the average ratio fell after 2008 and even though it managed to rise in the following years it did not reach its pre 2009 level.

Table 1: Descriptive Statistics Japan 2008 and 2009

Variables	Japan 2008				Japan 2009			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-7.2	26.2	7.7	8.42	-71.20	22.1	1.15	-3.88
ROA (%)	-3.4	14.10	2.98	3.97	-26.3	14.10	0.58	-0.98
BS	7	25	10.5	12	7	25	10.5	12
OD	0	14	2	2	0	14	2	2
CEO	0	1	1	0.83	0	1	1	0.9
BC	0	2	1	0.7	0	2	1	0.7
CSR	0	1	1	0.93	0	1	1	0.93

Table 2: Descriptive Statistics Japan 2010 and 2011

Variables	Japan 2010				Japan 2011			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-59	24.4	2.81	0.62	-12.8	28.4	5.75	0.62
ROA (%)	-14.2	12.20	1.75	1.09	-3.2	12.4	2.5	2.52
BS	7	19	11	11.53	7	20	12	11.93
OD	0	12	2	2.07	0	13	2	2.33
CEO	0	1	1	0.9	0	1	1	0.83
BC	0	2	1	0.72	0	2	1	0.7
CSR	0	1	1	0.9	0	1	1	0.83

Table 3: Descriptive Statistics Japan 2012 and Summary

Variables	Japan 2012				Japan 2008-2012			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-34.4	29.80	4.08	2.94	-71.20	29.80	4.55	2.82
ROA (%)	-11.69	12.30	1.60	1.79	-26.30	14.10	1.92	1.68
BS	7	19	11.5	11.77	7	25	11	11.84
OD	0	11	2	2.4	0	14	2	2.2
CEO	0	1	1	0.8	0	1	1	0.85
BC	0	2	1	0.73	0	2	1	0.71
CSR	0	1	1	0.87	0	1	1	0.89

5.4 Descriptive Statistics South Korea

5.4.1 Board Size

In 2008 there average board consisted of roughly 9 members with a minimum of 4 and a maximum of 15 members. In the following four years minimum and maximum remained the same but a slight decline of board members occurred. From 2009 to 2011 an average board consisted of 8 members. In 2012 the number declined to a bit less than 8 members. On average from 2008 to 2012 boards consisted on 8.25 members with a minimum of 4 and a maximum of 15 members. Similar to Japan a slight decrease can be seen over the course of five years. With an average of 8 members Korean boards are smaller than Japanese board which on average consisted of 12 members and had a higher maximum (25) and minimum (7).

5.4.2 Outside Directors

Unlike Japan which does not have an obligation by law to introduce outside directors this is mandatory for a large number of South Korean companies. Often even a majority of outside directors is mandatory. From 2008 to 2012 companies disposed of an average of roughly four outside directors with a minimum of 1 and a maximum of 8 directors in all five years which results in a total maximum of 8 and a total minimum of 1 as well as an average number of four outside directors. There has not been a significant change over the course of five years. It is striking to see that even though South Korean boards are smaller by four persons on average its average number of four outside directors is still higher than Japan which only has two outside directors on average.

5.4.3 CEO Duality

In 2008 only 40 percent of the Korean companies in our study separated the role of the CEO and the chairman of the board. In 2009 it was only 37 percent. The number rose to 43 percent in 2010 and remained the same in 2011 but it fell again slightly to its 2008 level of 40 percent in 2012. The numbers do not change significantly over the whole time period and on average about 41 percent of the companies separated the role of the chairman and CEO which is about 44 percent lower than the companies in Japan.

5.4.4 Board Committees

After the Asian financial crisis the audit committee system was introduced in South Korea and became mandatory for certain companies depending on their annual revenues. In 2008 already 90 percent of the companies disposed of an audit committees system, the number remained the same over the next five years which results in a total amount of 90 percent of all companies in the survey which already introduced the audit committee system
This is a much higher percentage than in Japan where the western system is not mandatory and companies are hesitant to introduce it on a voluntary basis and choose to add committees to the already existing system.

5.4.5 Corporate Social Reporting

In 2008, 63 percent of the companies provided corporate social reporting in the shape of annual sustainability reports or within their regular annual report by reporting on their corporate social responsibility. This number rose to 67 percent in 2009, 70 percent in 2010, 77 percent in 2011 and finally 79 percent in 2012 which results in a total average on 71 percent. Even though this number is significantly smaller than the Japanese average of 89 percent there was an increase of 15 percent over the last five years.

5.4.6 Return on Equity

In 2008 average ROE was at 9.63 percent with a minimum of -18.54 percent and a maximum of 116.50 percent. Average ROE decreased to 9.06 percent in 2009 with a decrease in maximum to 30.97 percent and a lower minimum of -36.70 percent. In 2010 average ROE rose to 11.69 percent with a low minimum of -99.12 percent and a maximum of 42.90 percent. In 2011 average ROE was at 10.41 percent with a slightly higher minimum of -61.22 percent and a similar maximum as the year before (41.46 percent). In 2012 average ROE fell to 6.43 percent with a very low minimum of -141.76 and a maximum of 61.79 which results in a total average ROE of 9.44 between 2008 and 2012. As opposed to the Japanese companies ROE did not fall after 2008 but kept increasing until 2012 where it suddenly fell below its 2008 average.

5.4.7 Return on Assets

In 2008 average ROA was at 1.45 percent with a minimum of -8.49 and a maximum of 21.63 percent. Just like in the case of ROE it rose to 9.06 percent in 2009 (minimum -6.5 percent and maximum 15.83 percent), it rose to an average of 11.69 percent in 2010 with a minimum of -8.12 and a maximum of 31.40 percent. It fell slightly to 10.41 in 2011 with a minimum of - 7.86 percent and a maximum of 21.20 percent. It was not until 2012 though that average ROE fell decisively to 6.51 with a minimum of -19.70 percent and a maximum of 14.20 percent. Over a period of five years average ROA was at 9.44 percent with a minimum of -23.87 and a maximum of 31.40 percent. On average both ROA and ROE in South Korea were higher than in Japan over the last five years. ROE and ROA did not decrease significantly but often increased until 2012 as opposed to Japan were a strong decrease occurred. Japanese companies seemed to recover in 2012 were both ratios increased again even though they did not reach their 2008 levels. South Korean ratios on the other hand suddenly fell below their 2008 levels.

Table 4: Descriptive Statistics South Korea 2008 and 2009

Variables	South Korea 2008				South Korea 2009			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-18.54	116.50	4.81	9.63	-36.79	30.97	10.27	9.06
ROA (%)	-8.49	21.63	1.45	3.12	-6.5	15.83	5.11	5.60
BS	4	15	8	8.53	4	15	7.50	8.33
OD	1	8	4	4.33	1	8	4	4.00
CEO	0	1	0	0.4	0	1	0	0.37
BC	0	1	1	0.9	0	1	1	0.9
CSR	0	1	1	0.63	0	1	1	0.67

Table 5: Descriptive Statistics South Korea 2010 and 2011

Variables	South Korea 2010				South Korea 2011			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-99.12	42.90	15.65	11.69	-61.22	41.46	10.58	10.41
ROA (%)	-23.87	31.40	6.06	6.51	-7.86	21.20	4.45	5.26
BS	4	15	7	8.17	4	15	7.5	8.27
OD	1	8	4	4.17	1	8	4	4.27
CEO	0	1	0	0.43	0	1	0	0.43
BC	0	1	1	0.9	0	1	1	0.9
CSR	0	1	1	0.7	0	1	1	0.77

Table 6: Descriptive Statistics South Korea 2012 and Summary

Variables	South Korea 2012				South Korea 2008-2012			
	Min	Max	Median	Mean	Min	Max	Median	Mean
ROE (%)	-141.76	61.79	8.31	6.43	-141.76	116.50	9.62	9.44
ROA (%)	-19.70	14.20	3.26	3.96	-23.87	31.40	3.93	4.88
BS	4	15	7	7.93	4	15	7	8.25
OD	1	8	4	4.17	1	8	4	4.25
CEO	0	1	0	0.4	0	1	0	0.41
BC	0	1	1	0.9	0	1	1	0.9
CSR	0	1	1	0.79	0	1	1	0.71

5.5 Correlation Matrix

In this part of our paper we present results of the correlation matrix' for Japan and South Korea from 2008 to 2012 respectively. A correlation matrix is a very useful initial tool of analysis that allows drawing first conclusions easily. The correlation matrix consists of numbers between -1 and +1 and is supposed to indicate how strongly correlated variables are. For example a +1 correlation between two variables indicates that they are both perfectly and positively correlated, in other words they go up and down in a synchronized way. A correlation of -1 means the opposite, in other words as one variable goes up the other one goes down. The closer the value of the correlation to 0 the weaker is the relation between two variables. A correlation between 0.8-9 indicates a strong correlation where nearly all of the variable is affected by the other which can also suggest multicollinearity problems depending on the variable, a ratio of 0.5-79 means a moderate correlation, while 0.3-49 indicates a weak correlation and 0-0.29 indicate a a possible connection ("not completely ruled out", which is probably more random or not existent. [315]
Correlations are independent of scale, it does not matter how the variables are measured. A variable is perfectly correlated to itself with a correlation of 1.00, therefore the matrix can be presented in a reduced from with duplicate numbers taken out.[316]

5.5.1 Correlation Results for Japan 2008-2012

Table 7: Japan Correlation 2008

K	*ROA*	*ROE*	*OD*	*BS*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.5140**	**1.0000**					
OD	**-0.0782**	**-0.0361**	**1.0000**				
BS	**-0.0035**	**0.1141**	**0.2481**	**1.0000**			
CEO	**0.0686**	**0.0688**	**0.1667**	**-0.0696**	**1.0000**		
BC	**0.1862**	**0.3397**	**0.3467**	**0.2091**	**-0.1109**	**1.0000**	
CSR	**0.3039**	**0.2248**	**0.0498**	**0.0347**	**0.2390**	**0.3315**	**1.0000**

In 2008 (Table 7) ROA and ROE are moderately correlated. ROA is negatively correlated with the number of outside directors and board size but these correlations are not significant.

[315] Bud Gerstman, "Correlation" (Lecture, San José State University,), http://www.sjsu.edu/faculty/gerstman/StatPrimer/correlation.pdf (accessed November 13, 2013)
[316] Ibid.

Furthermore it is positively correlated with CEO duality, BC and CSR but the correlation with CEO duality and BC is not significant and its correlation with CSR is relatively weak (.03039). Roe is negatively correlated with the number of outside directors but this correlation is too low to be significant. Furthermore it is positively correlated with BS, CEO, BC, CSR but these correlations are insignificant except for BC which indicates a weak correlation at 0.3397. Furthermore there were weak correlations between CSR and OD (0.3397) and CSR and BC (0.3315) but they are not high enough to cause possible multicollinearity problems which usually can occur at a correlation level of 0.80 or more.

Table 8: Japan Correlation 2009

	ROA	*ROE*	*BS*	*CEO*	*BC*	*CSR*	*OD*
ROA	**1.0000**						
ROE	**0.8414**	**1.0000**					
BS	**0.1408**	**0.1518**	**1.0000**				
CEO	**-0.0894**	**-0.0728**	**-0.2588**	**1.0000**			
BC	**0.3252**	**0.2330**	**0.1444**	**-0.2067**	**1.0000**		
CSR	**-0.0529**	**-0.0542**	**-0.2075**	**-0.0891**	**-0.1657**	**1.0000**	
OD	**-0.0542**	**-0.1092**	**0.1861**	**0.1488**	**0.3691**	**-0.6263**	**1.0000**

In 2009 (Table 8) ROA and ROE were strongly and positively correlated with each other (0.8414). ROA was negatively correlated with CEO, CSR and OD but none of these correlations were significant. It was positively correlated with BC and BS but its correlation with BS was not significant and the one with BC was weak (0.3252).
ROE was negatively correlated with CEO, CSR and OD but these correlations were not significant. It was positively correlated with BS and BC but both correlations were low and not significant.
There was a weak correlation between OD and BC but it was not strong enough to cause mulitcollinearity problems (0.3691).

Table 9: Japan Correlation 2010

	ROA	*ROE*	*BS*	*CEO*	*BC*	*CSR*	*OD*
ROA	**1.0000**						
ROE	**0.8266**	**1.0000**					
BS	**0.2083**	**0.1492**	**1.0000**				
CEO	**-0.0628**	**-0.0400**	**-0.1285**	**1.0000**			
BC	**0.0667**	**-0.0798**	**0.1336**	**0.0000**	**1.0000**		
CSR	**-0.0033**	**-0.0130**	**-0.1285**	**-0.1111**	**0.0000**	**1.0000**	
OD	**-0.0541**	**-0.0523**	**0.2317**	**0.2878**	**0.3541**	**-0.4085**	**1.0000**

In 2010 (Table 9) ROE and ROA were still strongly correlated with each other which makes sense when we look at the descriptive statistics where both ratio went up and down at the same time.
ROA was again positively correlated with BS and BC but its correlation with BS was not significant and the one with BC was weak. It was negatively correlated with CEO, CSR and OD but none of these correlations were significant.
RO was positively correlated with BS and negatively correlated with CEO, BC, CSR and OD but none of these correlations were significant. Again OD and BC were weakly and positively correlated with each other but given the low level of correlation (0.3691) no problems of multicollinearity should occur.

Table 10: Japan Correlation 2011

	ROA	*ROE*	*BS*	*CEO*	*BC*	*CSR*	*OD*
ROA	**1.0000**						
ROE	**0.5993**	**1.0000**					
BS	**0.0791**	**-0.1107**	**1.0000**				
CEO	**0.1715**	**0.1820**	**-0.0092**	**1.0000**			
BC	**0.1055**	**-0.1125**	**0.1603**	**0.0555**	**1.0000**		
CSR	**0.3054**	**0.3312**	**-0.0092**	**0.2800**	**0.2219**	**1.0000**	
OD	**-0.2090**	**-0.3088**	**0.2809**	**0.2794**	**0.3622**	**-0.3402**	**1.0000**

In 2011 (Table 10) ROA and ROE were moderately and positively correlated with each other. ROA was positively correlated with BS, CEO, BC and CSR but except for CSR which indicates weak correlations at 0.3054 the other correlations were not significant. It was furthermore negatively correlated with OD but this correlation was not significant.
ROE was negatively correlated with BS, BC and OD. The correlations with BS and BC were not significant, while the one with OD was weak (-0.3088). It was positively correlated with CEO and CSR. The correlation with CEO was not significant while the one with OD was weakly significant.
Furthermore there was a weak positive correlation between OD and BC but it was not strong enough to cause multicollinearity problems.

Table 11: Japan Correlation 2012

	ROA	*ROE*	*BS*	*CEO*	*BC*	*CSR*	*OD*
ROA	**1.0000**						
ROE	**0.5993**	**1.0000**					
BS	**0.0791**	**-0.1107**	**1.0000**				
CEO	**0.1715**	**0.1820**	**-0.0092**	**1.0000**			
BC	**0.1055**	**-0.1125**	**0.1603**	**0.0555**	**1.0000**		
CSR	**0.3054**	**0.3312**	**-0.0092**	**0.2800**	**0.2219**	**1.0000**	
OD	**-0.2090**	**-0.3088**	**0.2809**	**0.2794**	**0.3622**	**-0.3402**	**1.0000**

Finally in 2012 (Table 11) ROA and ROE were still moderately and positively correlated (0.5993).
ROA was positively correlated with BS, CEO, BC, CSR but ,except for CSR which shows a weak correlation of 0.3054 percent, all the other correlations were not significant. There was a negative correlation between OD and ROA but it was not significant.
ROE was negatively correlated with BS, BC and OD. The correlations with BS and BC were not significant, only the one with OD shows weak correlation (-0.3088). Furthermore it was positively but insignificantly correlated with CEO and it shares a positive but weak correlations with CSR (0.3312)
In addition there is a positive and weak correlation between OD and BC, and a negative, weak correlation between OD and CSR. But none of these correlations are strong enough to cause mulitcollinearity problems.

In conclusion we can say that there has been a moderate correlation between ROA and ROE and over the years a few weaker correlations between variables can be observed but none of them reach moderate or strong levels which would mean that nearly all or all of the changes in one variable are synchronised with the other. In the best case scenario possibly some changes in one variable affect the other one positively or negatively given the fact that all the correlations remained below 0.40.

5.5.2 Correlation Results for South Korea 2008-2012

Table 12: South Korea Correlation 2008

	ROA	*ROE*	*BS*	*OD*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.5825**	**1.0000**					
BS	**-0.0528**	**-0.0506**	**1.0000**				
OD	**0.0265**	**-0.0746**	**0.7497**	**1.0000**			
CEO	**-0.1566**	**-0.1162**	**0.2449**	**0.3029**	**1.0000**		
BC	**0.0241**	**0.1672**	**0.2749**	**0.4593**	**0.2722**	**1.0000**	
CSR	**-0.2029**	**0.1119**	**-0.0408**	**0.0433**	**0.1111**	**0.4082**	**1.0000**

In 2008 (Table 12) ROA and ROE were moderately and positively correlated (0.5825). ROA was furthermore negatively correlated with BS, CEO, CSR but none of the correlations were significant. It was positively correlated with OD and BC but yet again none of these correlations were significant.

ROE was negatively correlated with BS, OD and CEO and positively correlated with BC and CSR but none of these correlations were significant.

There was a moderate correlation between OD and BS (0.5825) and there were weak correlations between BC and OD, CSR and BC, CEO and OD. However none of these correlations were high enough to cause multicollinearity problems.

Table 13: South Korea Correlation 2009

	ROA	*ROE*	*BS*	*OD*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.5116**	**1.0000**					
BS	**-0.4112**	**-0.1636**	**1.0000**				
OD	**-0.4071**	**-0.2017**	**0.8737**	**1.0000**			
CEO	**-0.2616**	**-0.0857**	**0.4583**	**0.4245**	**1.0000**		
BC	**-0.1903**	**-0.2006**	**0.2881**	**0.5408**	**0.0231**	**1.0000**	
CSR	**0.0486**	**-0.1106**	**0.2292**	**0.2098**	**0.0048**	**0.4381**	**1.0000**

In 2009 (Table 13) ROE and ROA were moderately and positively correlated (0.5116). ROA was positively correlated with CSR but the correlation was not significant. In addition it was negatively correlated with BS, OD, CEO and BC. The correlation with CEO and BC were not significant while the other two were weak.

ROE was negatively correlated with BS, OD, CEO, BC and CSR however none of these correlations were significant.

Apart from that CEO was weakly and positively correlated with BS and OD, OD was moderately and positively correlated with BC (0.5408). BC was positively and weakly correlated with CSR. There was a strong and positive correlation between BS and OD (0.8737) which may possibly involve multicollinearity problems when performing a regression analysis.

Table 14: South Korea Correlation 2010

	ROA	*ROE*	*BS*	*OD*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.8769**	**1.0000**					
BS	**-0.3204**	**-0.1556**	**1.0000**				
OD	**-0.4462**	**-0.2673**	**0.8394**	**1.0000**			
CEO	**-0.1169**	**-0.0191**	**0.3484**	**0.2651**	**1.0000**		
BC	**-0.4505**	**-0.2381**	**0.2466**	**0.4166**	**0.0673**	**1.0000**	
CSR	**-0.2584**	**-0.1855**	**0.2473**	**0.2719**	**0.0476**	**0.4714**	**1.0000**

In 2010 (Table 14) ROA and ROE were strongly and positively correlated (0.8769). ROA was negatively correlated with BS, OD, CEO, BC, and CSR. Its correlation with CEO and CSR was not significant while its correlations with BS (-0.3204), OD (-0.4462) and BC (-0.4505) were weak.
ROE was negatively correlated with BS, OD, CEO, BC and CSR but none of these correlations were significant.
There were weak and positively correlations between CEO and BS (0.3484), BC (0.4166) and OD (0.4166) and BC and CSR (0.4714).
In addition there was a strong and positive correlation between OD and BS (0.8394) which could cause multicollinearity problems.

Table 15: South Korea Correlation 2011

	ROA	*ROE*	*BS*	*OD*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.3834**	**1.0000**					
BS	**-0.5353**	**-0.3150**	**1.0000**				
OD	**-0.5703**	**-0.3539**	**0.8571**	**1.0000**			
CEO	**-0.0277**	**0.1072**	**0.3462**	**0.2728**	**1.0000**		
BC	**-0.3807**	**-0.1700**	**0.2647**	**0.4000**	**0.0673**	**1.0000**	
CSR	**-0.2620**	**-0.2512**	**0.2208**	**0.3805**	**0.0710**	**0.5528**	**1.0000**

In 2011 (Table 15) there correlation between ROA and ROE was positive but weak.
Furthermore ROA was negatively correlated with all the remaining variables. The correlations with BS and OD (-0.5353 and -0.5703) were moderate which means that definitely some parts of the variables are synchronised, the correlation with BC was weak and the remaining two not significant.
ROE was negatively correlated with BS, OD, BC and CSR. The correlations with BC and CSR were not significant. The ones with BS and OD were weak**.** Moreover there was a positive but insignificant correlation with CEO.
CEO and BS and BC and OD were positively and weakly correlated. BC and CSR were positively and moderately correlated (0.5528).
Again there was a strong and positive correlation between OD and BS (0.8571).

Table 16: South Korea Correlation 2012

	ROA	*ROE*	*BS*	*OD*	*CEO*	*BC*	*CSR*
ROA	**1.0000**						
ROE	**0.7489**	**1.0000**					
BS	**-0.2219**	**-0.0086**	**1.0000**				
OD	**-0.2609**	**-0.0910**	**0.8933**	**1.0000**			
CEO	**-0.1090**	**0.0954**	**0.3577**	**0.2951**	**1.0000**		
BC	**-0.1755**	**-0.0341**	**0.2190**	**0.3786**	**0.0454**	**1.0000**	
CSR	**-0.3068**	**-0.1831**	**0.2002**	**0.2958**	**0.0308**	**0.5528**	**1.0000**

In 2012 (Table 16) ROA and ROE were positively and strongly correlated (0.7489). ROA was negatively correlated with all the remaining variables but with the exception of a weak correlation with CSR (-0.3068), all the other correlations were insignificant.
ROE was negatively correlated with BS, OD, BC and CSR and positively correlated with CEO but none of the correlations were significant in any way as they did not exceed 0.29.
In addition there were positive but weak correlations between CEO and BS, and BC and OD, (>0.29) and a positive and moderate correlation between CSR and BC (> 0.5).

In conclusion we can say that ROA and ROE have been moderately to strongly correlated with each other which makes sense when looking at the figures between 2008 and 2012.
Apart from that ROE and ROA have not been strongly correlated with any other variable. There were many weak correlations but these only indicated that maybe some parts of the variables are synchronised with each other but not strongly enough to explain one variable through the other. Only in 2011 there were negative and moderate correlations between ROA and BS and OD respectively which indicate that there is definitely some synchronisation between ROA and those two variables which suggests that if there is an increase in BS and OD it can have a negative effect on ROA. From 2009 to 2011 there was a positive and strong correlation between OD and BS. Nevertheless a correlation of 0.80 is required to indicate a truly significant correlation. As this was not the case between our dependent variables and any of the independent variables we have to conclude that there is no truly significant relationship between the variables.

5.6 Multiple Regression Results

5.6.1 Theory

Regression is a statistical tool in order to explore relationships between variables. We have two kinds of regressions. The first one is a linear or simple regression and the second one a multiple regression. Both types of regressions serve the same purpose. They want to explore the relationship between a dependent variable Y and an independent variable X. In addition it takes the values from an already existing set of data which measures the values of the variables X and Y in order to develop a model that will be able to predict how much the value of the dependent variable Y changes in correlation to X. The only difference is that multiple regressions usually dispose of more than one independent variable X.[317] The model for regressions look like follows: [318]

[317] New York University, "Multiple Regression Basics" (Lecture, New York), http://people.stern.nyu.edu/wgreene/Statistics/MultipleRegressionBasicsCollection.pdf (accessed November 13, 2013): 3-4.
[318] Ibid., 5.

Simple regression: Yi = ß0 + ß1xi + ei
Fitted model: Yi = bo + b1x
The equation for a simple regression is: Y= a + bX + e [319]

Multiple regression: Yi = ß0 + ß1 (x1) + ß2 (x2) I + ß3 (x3)I + … + ßk (xK)I + ei
Fitted model = Y bo + b1 (x1) + bs (x2) + b3 (x3) + … + bk (xK)
Equation Y= a + b1X1 + b2X2 + b3X3+ e [320]

The equation for a multiple regression looks similar with the only exception that there are multiple X variables. The ßs are coefficients and are non-random but unknown quantity.[321] A or Alpha is a constant and it equals the value of Y when the value of X=O. B or Beta is the coefficient of X, indicating how much Y changes in correlation to X. E is the error term which indicates the error in predicting the value of Y in correlation to X, though it is often not displayed. [322]
In our case ROA and ROE are dependent variables Y and we want to explore if variable Y is related to any of the X variables. As we have five X variables we are going perform a multiple regression. [323]
The coefficient in a multiple regression indicates the size of the effect that the independent variable has on the dependent variable and if the relationship is positive or negative through the sign on the coefficient. For example if the coefficient is positive (negative) it indicates by how much the dependent variable will increase (decrease) given an increase (decrease) of the independent variable by [324]
R-squared expresses how much of the variation in the dependent variable can be explained by the independent variables. But this indicator is usually of secondary importance unless it is desired to use the regression equation to make detailed and accurate predictions. [325]
The P-value is usually the most important indicator as it tells the significance of the relationship between the dependent variable and each independent variable, which is what we aspire to find out in this thesis. A P-value of 5 percent (or 0.5) indicates that there is only a 5 percent chance that the results we receive are caused by a random distribution. In that case it can be said that with a probability of 95 percent the X variable is significantly correlated with the Y variable. Usually a P-value of 5 percent or less allows us to reject the null hypothesis that there is a significant relationship. We have to keep in mind that the P-value does not describe the size of the effect the X variable has on the Y variable. This can be seen through the coefficient. It is fairly possible to have a highly significant P-value but only a very low effect on the Y variables. [326]

5.6.2 Multiple Regression Japan

Multiple Regression and Board Size

We performed a multiple regression for every single year between 2008 and 2012 in order to find significant relationships between the variables in the case of Japan

[319] Ibid., 3-6.
[320] Ibid.
[321] Ibid
[322] Ibid.
[323] Ibid.
[324] "Data and Statistical Services: Interpreting Regression Output," Princeton Univeristy, http://dss.princeton.edu/online_help/analysis/interpreting_regression.htm (accessed November 13, 2013).
[325] Ibid.
[326] Ibid.

We wanted to analyse the relationship between ROA and ROE our dependent variables and our independent variable Board Size (Table 17). In 2008 ROA was negatively correlated with BS, while ROE was positively correlated. But both correlations are insignificant as their P-values were larger than 5 percent.
In 2009 ROA and ROE were both positively correlated with BS but still both P-values were larger than 5 percent.
In 2010 there were again positive correlations between ROA, ROE and Bs however P-values were higher than 5 percent and therefore insignificant.
In 2011 ROA was positively correlated while ROE was negatively correlated but again P-values were too high to be significant. The same is valid for 2012.
No significant relationship could be found between the dependent variables and the independent variable board size in any of the years.

Table 17: Japan Multiple Regression of ROA and ROE with BS

FP	**CG Variables**	**2008 Coef**	**P**	**2009 Coef**	**P**	**2010 Coef**	**P**	**2011 Coef**	**P**	**2012 Coef**	**P**
ROA	**BS**	-0.227	0.983	0.264	0.528	0.334	0.283	0.141	0.441	0.012	0.962
ROE	**BS**	0.169	0.629	0.808	0.450	0.798	0.417	-0.048	0.916	-0.514	0.497

ROA, ROE and Outside Directors

We tried to analyse the relationship between the dependent variables ROA and ROE and the number of outside directors (Table 18).
In 2008 both dependent variables were negatively correlated with OD but P-values larger than 5 percent make those correlations insignificant.
The relationship between the dependent variables and the independent variable BS remains negative over the next four years but none of the correlations are significant due to a P-value larger than 0.05.

Table 18: Japan Multiple Regression of ROA and ROE with OD

FP Variables	**CG Variables**	**2008 Coef**	**P**	**2009 Coef**	**P**	**2010 Coef**	**P**	**2011 Coef**	**P**	**2012 Coef**	**P**
ROA	**OD**	-0.227	0.477	-1.043	0.191	-0.283	0.538	-0.431	0.191	-0.574	0.193
ROE	**OD**	-0.563	0.301	-3.095	0.132	-0.420	0.772	-0.828	0.315	-1.868	0.160

ROA, ROE and CEO Duality

We tried to investigate the relationship between our dependent variables ROA and ROE and the independent variable CEO Duality for each year (Table 19).

The relationship remained positive in every year for every dependent variable but as P-values were higher than 0.05, the relationship between the dependent variables ROA and ROE and the Y variable CEO Duality did not show any significance.

Table 19: Japan Multiple Regression of ROA and ROE with CEO

FP Variables	CG Variables	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**CEO**	0.572	0.796	1.808	0.742	0.109	0.971	1.914	0.288	1.664	0.508
ROE	**CEO**	2.543	0.501	5.406	0.701	0.067	0.994	4.163	0.357	5.306	0.484

ROA, ROE and Board Committees

We also performed a multiple regression to find the interaction between the dependent variables ROA and ROE and the independent variable BC (Table 20). In 2008 the relationships were positive but the P-value between ROA and BC was higher than 0.05 and therefore not significant. The correlation between ROE and BC disposed of a P-value of 0.090, <0.10 and showed significance on the ten percent level.
In 2009 relationships were again positive and the one between ROA and BC showed significance on the ten percent level (p = 0.05, > 0.10) while there was no significance found between ROE and BC. From 2010 to 2012 there were positive relationships between ROA and BC none of which were significant. The same goes for ROE and BC except that the relationships were negative in 2010 and 2011.

Table 20: Japan Multiple Regression of ROA and ROE with BC

FP Variables	CG Variables	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**BC**	1.210	0.471	6.286	0.055	0.733	0.675	0.991	0.430	2.980	0.101
ROE	**BC**	4.946	0.090	12.902	0.118	-1.920	0.730	-0.932	0.766	6.561	0.224

ROA, ROE and Corporate Social Reporting

We also explored the relationship between both dependent variables and corporate social reporting. In 2008 they were positive but insignificant due to their high P-values. In the following two years the relationships were negative but still insignificant. In 2011 there were positive relationships while they turned negative in 2012 again yet none of the relationships were significant.

Table 21: Japan Multiple Regression of ROA and ROE with CSR

FP	CG	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**CSR**	3.812	0.268	-5.450	0.487	-0.533	0.867	0.610	0.757	-2.219	0.477
ROE	**CSR**	1.940	0.736	-17,495	0.384	-0.938	0.926	3.968	0.427	-2.634	0.778

We performed multiple regression analysis for Japan by analysing data for each year separately in order to find a relationship between the dependent variables return on equity and return on assets and the independent variables board size, number of outside directors, CEO duality, board committees and corporate social reporting. None of the relationships showed significance with a P-value of 0.05. However in 2008 the relationship between ROE and BC showed significance with a P-value of 0.09, <0.10 and in 2009 ROA and BC showed significance due to a P-value of 0.055, <0.10. This means that there is a probability of more than 90 percent that these variables are correlated but there is also a ten percent probability that the results are random. As mentioned before usually a P-value of 0.05 is necessary to accept a correlation there we have to conclude that there is no significant relationship between all the variables.

5.6.3 Multiple Regression South Korea

In this part we performed multiple regression analysis for the annual data also for South Korea.

ROA, ROE and Board Size

We looked at the dependent variables ROA and ROE and their relationship with Board Size from 2008 to 2012 (Table 22). The relationship between ROA and BS was negative in 2008, 2009 and 2011 and positive in 2010 and 2012 but due to the high P-values none of the relationships were significant.
The relationship between ROE and BS was positive in all years but again none of the relationship were significant as their P-values were higher than 0.05.

Table 22: South Korea Multiple Regression of ROA and ROE with BS

FP Variables	CG Variables	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**BS**	-0.402	0.554	-0.884	0.394	0.320	0.782	-0.630	0.364	0.0590	0.961
ROE	**BS**	0.558	0.827	-0.196	0.943	1.857	0.607	-1.387	0.595	4.639	0.456

ROA, ROE and Outside Directors

We also examined the relationships between our dependent variables and the independent variables number of outside directors (Table 23). The relationship between ROA and OD was positive in 2008 and 2009 but negative from 2010 to 2012. As in all years the P-value was higher than 0.05 none of the relationships were significant.
The relationship between ROE and OD was negative in all the years but none of the relationships were significant due to a P-value higher than 0.05.

Table 23: South Korea Multiple Regression of ROA and ROE with OD

FP Variables	CG Variables	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**OD**	0.581	0.644	0.080	0.966	-1.867	0.276	-0.882	0.420	-0.826	0.668
ROE	**OD**	-2.945	0.534	-0.709	0.890	-5.062	0.339	-2.053	0.6185	-8.651	0.384

ROA, ROE and CEO Duality

We further explored the relationship between ROA, ROE and the independent variable CEO Duality (Table 24). The relationship between ROA and CEO was negative in all the years except for 2011. However the P-values remained higher than 0.05 and therefore the relationships were insignificant.
The relationship between ROE and CEO was negative in 2008 and 2009 and became positive from 2010 to 2012. Due to their high P-values no significant relationship was found between the variables.

Table 24: South Korea Multiple Regression of ROA and ROE with CEO

FP Variables	CG Variables	2008 Coef	P	2009 Coef	P	2010 Coef	P	2011 Coef	P	2012 Coef	P
ROA	**CEO**	-2.126	0.411	-1.010	0.664	-0.438	0.889	1.703	0.339	-0.679	0.806
ROE	**CEO**	-6.774	0.487	-0.896	0.885	1.045	0.915	8.121	0.231	0.859	0.648

ROA, ROE and Board Committees

We explored the relationship between ROE and BC for every year (Table 25). The relationship between ROA and BC was positive in 2008 and 2012 and negative from 2009 to 2011 but none of the relationships were significant due to high P-values.
The relationship between ROE and BC was positive in 2008, 2011 and 2012 and negative in 2009 and 2010 but again none of the relationships were significant as indicated by a high P-value.

Table 25: South Korea Multiple Regression of ROA and ROE with BC

FP Variables	CG Variables	2008 Coef	2008 P	2009 Coef	2009 P	2010 Coef	2010 P	2011 Coef	2011 P	2012 Coef	2012 P
ROA	**BC**	3.167	0.527	-3.233	0.522	-8.203	0.184	-3.531	0.303	1.162	0.830
ROE	**BC**	20.402	0.285	-5.868	0.663	-6.795	0.717	2.282	0.859	18.662	0.504

ROA, ROE and Corporate Social Reporting

Finally we explored the relationship between the dependent variables and CSR for each year Table 26). The relationship between ROA and CSR was negative in 2008, 2010 and 2012 but positive in the remaining years. Due to P-values higher than 0.05 none of the relationships were significant.
The same goes for the relationship between ROE and CSR which was negative in all the years except for 2008.

Table 26: South Korea Multiple Regression of ROA and ROE with CSR

FP Variables	CG Variables	2008 Coef	2008 P	2009 Coef	2009 P	2010 Coef	2010 P	2011 Coef	2011 P	2012 Coef	2012 P
ROA	**CSR**	-3.225	0.238	2.347	0.329	-0.660	0.8530	0.163	0.944	-4.138	0.237
ROE	**CSR**	1.332	0.896	-0.710	0.911	-4.498	0.684	-6.473	0.460	-16.568	0.354

In conclusion we can say that the separate multiple regression analysis for each year did not find any significant relationships with the dependent variables return on equity and return on assets and the independent variables board size, number of outside directors, CEO duality, board committees and corporate social reporting.

In this part of the analysis we treated the data for each year separately. Subsequently we analyse the data for each country as panel data and perform regressions that give us results based on data for the whole time period.

5.7 Panel Data Analysis

5.7.1 Theory

In this part we perform regressions with panel data. What exactly is panel data? Panel data is a data set that usually consists of n sets of observations on individuals at different times. We distinguish between balanced and unbalanced panels. In our case all individuals (= companies) have been observed the same amount of times T and therefore it is a balanced panel. An unbalanced panel is a data set where the individuals were observed at different times. A fixed panel is a data set where the same set of individuals is observed for the whole duration of the study whilst a rotation panel is a data set where the individuals change from one period to the

next. As all the companies were observed over the same time period from 2008 to 2012 and regarding the same variables, we do have a balanced, fixed data set.[327]
Panel data cannot be treated the same way as regular data for only one time period. Therefore we cannot perform a multiple regression analysis. There are however different models thant can be applied. Subsequently we introduce three different models for panel data that are the most prominent. [328]
The first model is a pooled regression, and then there are the fixed effects model and the random effects model.
They can be explained as follows:

1. Pooled Regression:
This regression works similar to a regular regression but pools the data in an OLS regression. It is basically assumes that the coefficients as well as the intercept are exactly the same for all the individuals. In other words data cannot be heterogeneous as the model treats all data as exogenous. Heterogeneity can lead to biased and inconsistent OLS estimates. It is estimated that each individual has time-invariant but unique effects on the dependent variable. But in this model those unique effects are all comprised in the error term e. [329]

Yit = ß0 + ß1X1it + … + ßkXkit + eit [330] (t=1, …T and i=1,..., N) [331]

2. The fixed effects model

The fixed effects model claims that the individuals dispose of characteristics that are not observed in the panel but are correlated with the independent variables. Therefore the least squares estimator of ß is biased and inconsistent. As opposed to the pooled regression the model assumes that intercepts of each individual may be different and considers the data to be heterogeneous. So in our case the fixed effects model assumes that apart from the independent variables each firm disposes of different characteristics that are not observed but somehow correlated with the independent variables and have an effect on our results.

Yit = Xitß + ai + uit (t = 1, …, T and i = 1, …, N)[332]

3. The random effects model

The random effects model is similar to the fixed effects models but it assumes that the unobserved characteristics of the individuals are not related to the variables of the data. [333] So as opposed to the fixed effects model, this model assumes that the companies dispose of characteristics that are unobserved but may influence the results however at the same time they are not correlated with the independent variables but rather completely independent from them.

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[327] Greene, "Models for Panel Data" (Lecture, New York University. 2013), http://people.stern.nyu.edu/wgreene/Lugano2013/Greene-Chapter-11.pdf (accessed November 15, 2013).
[328] Ibid.
[329] Hyunchul Kim, "Principles of Econometrics" (Lecture, University of Minnesota, 2012), http://www.econ.umn.edu/~kimx1395/econ4211_fall2012/note4211_8.pdf (accessed November 15, 2013): 2.
[330] Ibid. 3
[331] Hyunchul Kim, "Principles of Econometrics" (Lecture, University of Minnesota, 2012), http://www.econ.umn.edu/~kimx1395/econ4211_fall2012/note4211_8.pdf (accessed November 1, 2013): 2.
[332] http://en.wikipedia.org/wiki/Fixed_effects_model
[333] "Data and Statistical Services: Panel," Princeton University, http://dss.princeton.edu/online_help/analysis/interpreting_regression.htm (accessed November 17, 2013).

In general it is a safe assumption to use the fixed effects model when dealing with panel data as this model usually give consistent results but it is possible that it is not the most efficient model that can be used. The random effects model can deliver better P-values as its estimates are usually more efficient. In order to decide which of the last two models to perform it is common to use the Hausman test. It checks a more efficient model against a less efficient but consistent model in order to check if the more efficient models would also deliver consistent results. Basically it checks the null hypothesis if the coefficients that were estimated by the random effects estimator are equal to the one estimated by the consistent fixed effects estimator. If they are, which is shown through an insignificant P-value (P-value > 0.05) and a Chi2 larger that 0.5, then it is advisable and save to use the random effects model In the case of a significant P-value (not larger than 0.05) the fixed effects models should be used.[334]
After running the Hausman test (Table 27) for all four cases, namely for the fixed and random effects models with ROA and ROE for Japan and South Korea respectively, we get the following results:

Table 27: Hausman Test

Variables	Null hypothesis	Chi2	P
ROA Japan	GLS estimates are consistent	0,768752	0,978983
ROE Japan	GLS estimates are consistent	0,552887	0,990059
ROA South Korea	GLS estimates are consistent	4,6863	0,321024
ROE South Korea	GLS estimates are consistent	2,96374	0,563912

In all four cases the estimates are consistent, we receive a chi2 value higher than 0.5 and a P-value that is insignificant as it is larger than 0.05. Therefore it is advisable to use the random effects model. The Hausman test shows that in all cases a random effects model is preferable to a fixed effects model. Subsequently we perform random effects regressions for each dependent variable and for each country resulting in a total amount of four regressions.

5.7.2 Random Effects Models Japan

In the case of Japan (Table 29) board size has a positive coefficient meaning a positive relationship with both ROA and ROE but the P-value is higher than 0.05 and the relationships are therefore not significant.
The number of outside directors has a negative relationship with both dependent variables. But the P-values in both cases are higher than 0.05 and therefore not significant.
The independent variable CEO duality is positively related to both dependent variables but these relationships are not significant due to a high P-value over 0.05.
Board committees are positively related to ROA and ROE. The relationship with ROA is significant on the 10 percent level due to a P-value below 0.10. The relationship with ROE is insignificant.
The independent variable CSR is positively related to ROA and negatively related to ROE but both relationships are insignificant due P-values over 0.05.

Table 29: Random Effects Model Japan

[334] Ibid.

FP Variables	CG Variables	2008-2012 Coef	P
ROA	**BS**	0.096	0.5871
ROE	**BS**	0.2376	0.5993
ROA	**OD**	-0.4268	0.1616
ROE	**OD**	-1.180	0.1249
ROA	**CEO**	0.5882	0.6900
ROE	**CEO**	1.5048	0.7044
ROA	**BC**	2.374	0.0612*
ROE	**BC**	4.6548	0.1478
ROA	**CSR**	0.0276	0.9877
ROE	**CSR**	-0.8612	0.8575

5.7.3 Random Effects Models South Korea

In the case of South Korea (Table 30) the independent variable board size has a negative relationship with ROA and a positive one with ROE. But as both P-values are higher than 0.05 the relationships are not significant.
The number of outside directors is negatively related with both dependent variables but no significance in the relationships was found.
The independent variable CEO is negatively related to both dependent variables but they are not significant due to their high P-value.
Board committees are related negatively to the variable ROA and positively to the variable ROE. Due to a high P-value the relationships are not significant. The independent variable CSR is negatively related to both dependent variables but these relationships are not significant.

Table 30: Random Effects Model South Korea

FP Variables	CG Variables	2008-2012 Coef	P
ROA	**BS**	-0.3793	0.3522
ROE	**BS**	0.1318	0.9275
ROA	**OD**	-0.0194	0.9754
ROE	**OD**	-2.6400	0.2375
ROA	**CEO**	-1.4344	0.3230
ROE	**CEO**	-0.6801	0.8983
ROA	**BC**	-3.0695	0.3284
ROE	**BC**	1.2830	0.9148
ROA	**CSR**	-1.3506	0.4058
ROE	**CSR**	-1.2036	0.8399

5.8 Conclusion

In this chapter we have presented descriptive statistics for the 30 companies of each country which showed that board characteristics have not changed significantly over the period from 2008 to 2012. There are differences between the Japanese and South Korean companies. Japanese companies dispose on average of larger boards than South Korea but still a smaller number of outside directors than South Korea. Equally a smaller percentage of Japanese firms has introduced the board committees system. On the other hand fewer South Korean companies dispose of corporate social accounting practices and a separation of CEO and chairman.

In addition we conducted a correlation analysis, as well as multiple regression analysis for each country and year and finally random effects models for each country and dependent variable. Nevertheless none of the quantitative results showed a significant relationship between ROE and ROA and our independent variables. As a conclusion we can say that our study did not show any significant relationship between corporate governance (in our case board characteristics and corporate social reporting) and firm performance for the companies in both Japan and South Korea.

6. Summary, Findings and Conclusion

6.1 Research Question and Methodology

In this thesis we aspired to analyse the relationship between corporate governance and firm performance in Japan and South Korea. Due to a major corporate scandal of the Japanese manufacturer Olympus, Japan has been strongly criticised for its corporate governance practices as they lag behind international standards regarding board characteristics, accountability and corporate social responsibility. It has been suggested that this is the main reason for Japan's weak economic performance of the last years.
In order to answer our research question we conducted an extensive analysis of the literature on that subject. Results on the subject were divided and no consensus could be found, as some of the results showed a positive, some a negative and some no significant relationship at all. Furthermore there were many differences in regards to the variables of corporate governance and firm performance analysed. Subsequently we looked further into theories on corporate governance and areas that are influenced by this. This allowed us to extract a framework of analysis by focusing on variables that have been in the focus of research and are considered as crucial for corporate governance.
In addition we explored how corporate governance, corporate accounting and corporate social responsibility have evolved in the past and are applied in both countries today.
Finally we used statistical means in order to analyse the relationship between corporate governance and firm performance for 30 companies in Japan and South Korea from 2008 to 2012, respectively.
We extracted a framework of analysis consisting of five independent variables (board size, number of outside directors, CEO duality, committees system and corporate social responsibility) and two dependent variables of performance (ROE, ROA).
We created descriptive statistics and conducted correlation and multiple regression analysis' for every single year, as well as panel data analysis' for the whole time period.

6.2 Main Facts

There are different basic theories and regulatory frameworks that give ideas and advice on how to best shape corporate governance. A lot of the literature focuses on corporate governance and especially board characteristics as a crucial factor for a company's long-term success, event though theories are divided on how to best achieve this. A series of corporate scandals resulted in the introduction of frameworks like the Cadbury report and the OECD principles as well as mandatory regulations such as Sarbanes-Oxley and NYSE requirements which were based on ideas expressed by the Cadbury Report and the OECD principles. These frameworks expressed the need for powerful shareholders, more board independence as well as more accountability and disclosure in order to secure good corporate governance.

Corporate governance has been a subject of vivid discussion in Japan over the last years. The burst of the economic bubble was followed by a series of corporate scandals and illegal behaviour and the following bankruptcies of certain companies laid open severe flaws in the Japanese corporate governance system when compared to the western, especially the Anglo-Saxon system. There was very little capital market orientation. Also the government and banks but also entrepreneurs associations like Keidanren were major players in the past. These days these instances seem to be loosing influence and the reform of 2003 seems to have brought Japanese corporate governance closer to the Anglo-Saxon system. When compared to older standards, boards are diminishing in size and gaining more outside directors. Capital market orientation has risen as well as the number of mergers and acquisitions

Nevertheless in reality Japan is still far away for what is considered good corporate governance internationally. Many of the changes are not applied correctly and many of the reforms only touch the surface. For example there is still no mandatory law determining the required number of outside directors. Japanese companies are still strongly influenced by old practices and habits. Major factors are kereitsu, cross-shareholding and appointment of only seemingly independent directors as they often belong to the same business group.

In South Korea the Asian financial crisis, which was caused by major mismanagement of the chaebol, expansion of companies into on related markets without aspiring actual profitability as well as a large number of bank loans which did not need to be paid, resulted in a high number of structural and economic reforms. South Korea transformed form an insider to an more of an outsider model, introduced a mandatory majority of independent directors as well as the committee system based on the Sarbanes-Oxley Act, introduced minority shareholder protection and banks lost influence. Nevertheless all of these changes happened over a very short time span and have not had the time to root yet. In addition law enforcement in rather weak in South Korea. Further reforms are necessary as there is still a large gap between regulations and actual application. Nevertheless South Korea has made progress enormous over the last decade.

6.3 Findings

Regarding the results of our descriptive statistics the average of board characteristics did not change much over the course of five years for both countries.
Japanese boards were larger in numbers on average than Korean boards still Korean boards disposed of a larger number of outside directors than Japanese boards. One of the main reasons can be the fact the Japanese companies are not required by law to even have outside directors. On average more Japanese companies practiced corporate social reporting than South Korean companies. They equally had a larger percentage of separation of CEO and chairman.
Board Committees have become mandatory for most South Korean companies. In Japan on the other hand this can be introduced on a voluntary basis. Many companies prefer to introduce certain committees but avoid the audit committee system.
ROA and ROE have varied over the course of five years for both countries. While they went down straight after 2008 in Japan, the average values increased in South Korea until 2012 where they dropped below 2008 values. Japanese values rose again but did not reach their 2008 level in 2012.

Our correlation matrix' results did not show any significant relationships (which require a correlation of 0.80 in order to be truly significant) between our performance indicators and our governance indicators for any of the years for both countries.
In the case of Japan there were a few weaker correlations (below 0.40) but none of the reached moderate or strong levels, not to mention a high correlation.
South Korea showed similar results. Again there were a few weak and moderate correlations between the independent and dependent variables but none of them were strong enough to be truly significant.
Therefore our correlation analysis did not show any significant relationships between the dependent and independent variables for any of the years.

We performed multiple regression analysis for Japan and South Korea by analysing annual data separately in order to find a relationship between the dependent variables of performance and the independent variables of governance. None of the relationships showed significance

with a P-value of 0.05 or below. However in 2008 the relationship between ROE and BC showed significance on the ten percent level with a P-value of 0.09 (<0.10) and in 2009 ROA and BC showed significance due to a P-value of 0.055, <0.10. This means that there is a probability of more than 90 percent that these variables are correlated but there is also a ten percent probability that the results are random. As mentioned before usually a P-value of 0.05 is necessary to categorize a relationship as significant therefore we have to conclude that there is no significant relationship between all the variables.
In the case of South Korea the multiple regression analysis did not show any significant relationships between the independent and dependent variables in any of the years.

Lastly we performed panel data analysis'. After concluding a necessary test in order to decide which model to use, we applied the random effects model for all four cases.
In the case of Japan no significant relationship between independent and dependent variables could be found. There were negative and positive relationships but none of the relationship were significant due to P-values larger than 0.05. The only exception was the independent variable board committees which had a positive relationship with ROA and significant on the 10 percent level with a P-value below 0.10. Nevertheless a P-value of maximum 0.05 is necessary in order for a relationship between variables to be considered significant.
In the case of South Korea no significant relationships were found between both sets of variables.

6.4 Conclusion

To conclude this study could not find any significant relationship between corporate governance variables (board size, number of outside directors, CEO duality, board committees and corporate social reporting) as defined in this study and firm performance represented by ROE and ROA. The corporate governance variables were chosen as they represent factors that were analysed in research on our subject as well as different theories on corporate governance. ROA and ROE represent two accounting-based measures of firm performance that are used on a regular basis by many companies.
Past research has been divided into different categories regarding outcomes (positive, negative relationship or no significant relationships at all) but even within these three categories there were many different variables analysed so to this day it is not possible to draw an ultimate conclusion.
This study can be sorted into the category of research that did not find any significant relationship between the variables. Given the results of our literature research this makes sense, as in any case there is no consensus to be found amongst researches analysing the subject. Also it is very difficult to create a perfect framework to analyse all dimensions of corporate governance, especially as behavioural characteristics and personal relationships on corporate boards are rarely part of the analysis.
As we indicated before it is possible that there is simply no actual connection between corporate governance and firm performance, meaning that good corporate governance does not guarantee firm success, especially given the fact that there are strong disagreements about what constitutes good corporate governance. The theories we analysed before (shareholder, stakeholder, agency, stewardship and resource dependency theory) disagree on many levels in regard to this question. They show different preferences regarding board size, separation of CEO and chairman, number of outside directors, general board and auditing independence as well as the question of corporate social responsibility. Legislation that has been introduced in the past years (NYSE requirements, board committees system, Sarbanes-Oxley etc.) shows a trend towards emphasising board independence through a required majority of independent directors and auditors, as well as more accountability CEOs and their separation from the role

of the chairman and a higher demand for disclosure. However at the same time research has shown that companies which practice corporate governance according to those standards did not necessarily go untouched through the recent financial crisis whilst other firms that could have been seen as an example of bad corporate governance, according to these standards, made it out relatively well.

Thus we have to look beyond the question of corporate governance when we want to find determinants of firm performance. This may be an area of further research in order to find out what determines firm performance most.

At the same time this does not mean that corporate governance should be neglected especially in regards to accountability and disclosure. As we explored before corporate governance is a framework that should give strategic guidance to the company as well as effective monitoring of the management by the board and ensure accountability to the company and the shareholders/stakeholders.[335] Even though scholars are divided on the question of how far corporate social responsibility goes, the set of responsibilities of corporate governance has been enhanced over the past few years. Also scholars that did not encourage corporate social responsibility, never justified unethical behaviour and practices and upheld accountability towards shareholders as one of the most important tasks (e.g. Milton Friedman) of corporate governance. Therefore good corporate governance remains important even though theories are divided when it comes to board characteristics. So it should be considered that possibly there is no simple “one size fits all”- framework of corporate governance but that every company has to develop their own framework within the range of legislation as well as theories on governance.

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Appendices

1. Zusammenfassung der wissenschaftlichen Arbeit in deutscher Sprache

Ziel dieser wissenschaftlichen Arbeit war es die Beziehung zwischen Unternehmensführung und Unternehmenserfolg in Japan und Südkorea zu untersuchen. Im Verlauf des letzten Jahres war Japan stark im Fokus der internationalen Medien aufgrund eines Unternehmensskandals des Herstellers Olympus, im Laufe dessen starke Diskrepanzen der Unternehmensführung gemessen an internationalen Standards aufgedeckt wurden. Japan musste scharfe Kritik über sich ergehen lassen und es wurde ausgesprochen, dass Japans schwache wirtschaftliche Leistung der letzten Jahre, in schlechter Unternehmensführung begründet sei.
An diese Behauptung anknüpfend wollten wir die Beziehung zwischen Unternehmensführung und Unternehmenserfolg in Japan und Südkorea untersuchen.
Auf Basis von Literaturrecherche haben wir Unternehmensführung selbst näher untersucht. Wir haben den Begriff identifiziert, abgegrenzt und verschiedene Theorien und Regelungen zu dem Thema untersucht. Anschließend haben wir einen Überblick über generelle Praktiken und Entwicklungen von Unternehmensführung in Japan und Südkorea gegeben. Im Anschluss daran folgte der empirische Teil.
Der aktuelle Stand der Wissenschaft kann kein einheitliches Ergebnis liefern. Untersuchungen kann man in drei Ergebniskategorien unterteilen: ein Teil konnte eine positive Beziehung zwischen beiden Faktoren finden, ein anderer Teil fand negative Beziehungen, während ein anderer Teil wiederum keine statistisch signifikante Beziehung finden konnte. Es kommt noch hinzu, dass selbst innerhalb dieser Kategorien, unterschiedliche Variablen für Unternehmensführung und Unternehmenserfolg analysiert wurden. Der Fokus bei vielen Untersuchungen liegt auf dem Aufsichtsrat eines Unternehmens und dessen Eigenschaften, z.B. die Größe des Aufsichtsrats, die Zahl unabhängiger Direktoren und die Trennung des Aufsichtsratsvorsitzenden und des CEO. Im Bezug auf die Ausprägungen dieser Eigenschaften ist sich die Wissenschaft jedoch nicht einig. Es gibt Theorien die befürworten große Aufsichträte, andere wiederum halten kleine Aufsichtsräte für effektiver usw. Was alle Theorien gemein haben ist die Tatsache, dass sie sich auf gewisse Bereiche der Unternehmensführung konzentrieren.
Deshalb untersuchen wir in dieser wissenschaftlichen Arbeit fünf Variablen für Unternehmensführung (Größe des Aufsichtsrates, Zahl unabhängiger Direktoren, Trennung von CEO und Aufsichtsratsvorsitzendem, Komiteesystem und Corporate Social Reporting) und zwei Variablen für Unternehmenserfolg (Return on Equity, Return on Assets).
Unternehmensführung war in Japan Thema starker Diskussionen im Laufe der letzten Jahre. Nach der Finanzkrise 1998 folgte eine Reihe von Unternehmensskandalen und illegalen Verhaltens von Führungskräften. Es folgten Insolvenzverfahren, welche die Schwächen im System offenbarten, besonders im Vergleich zu westlichen Standards. In Japan herrschte eine schwache Kapitalmarktorientierung und Banken und die Regierung hatten sehr viel Einfluss. Nach der Finanzkrise folgten Reformen und besonders die Reform von 2003 schien das japanische Unternehmensführungssystem näher an internationale Standards gebracht zu haben. Die Zahl der Mitglieder der Aufsichtsräte insgesamt verringerte sich, während die Zahl der unabhängigen Direktoren stieg. Kapitalmarktorientierung nahm zu, der Einfluss von Banken und der Regierung verringerte sich. Nichtsdestotrotz ist das japanische System noch weit entfernt von dem, was international als gute Unternehmensführung angesehen wird. Viele der Reformen werden nicht korrekt angewandt und manche berühren lediglich die Oberfläche, beispielsweise gibt es noch kein Gesetz, das die Zahl der unabhängigen Direktoren

vorschreibt. Gleichzeitig sind japanische Unternehmen noch stark von alten Gewohnheiten und Praktiken geprägt.
Die Finanzkrise von 1998, die in Südkorea maßgeblich durch schlechtes Management der Chaebol (Eintritt in nicht verwandte Märkte ohne auf Gewinne zu achten, ein hohe Zahl von Bankkrediten, auf deren Rückzahlung nicht bestanden wurde etc.), führte zu einer Reihe von strukturellen und ökonomischen Reformen. Das Land wandelte sich von einem Insider- zu einem Outsidersystem, führte z.B. das Komiteesystem auf Basis von Sarbanes-Oxley und eine Mindestquote von unabhängigen Direktoren ein und setzte verstärkte auf den Schutz von Minderheitenaktionären und verringerte den Einfluss von Banken. Jedoch passiert all diese über einen sehr kurzen Zeitraum und ist noch nicht fest verankert. Theorie und Praxis unterscheiden sich sehr stark voneinander und eine schwache Strafverfolgung verstärkt dies. Trotzdem hat Südkorea starke Fortschritte über einen kürzen Zeitraum gemacht.

Wir führten statistische Analysen für je 30 japanische und südkoreanische Unternehmen durch um mit Hilfe von Korrelationsanalysen, Multiplen Regressionen und Random Effects Modellen die Beziehung zwischen den Variablen für Unternehmensführung und Unternehmenserfolg zu analysieren. Keine unserer Analysen zeigte eine signifikante statistische Beziehung zwischen genannten Variablen.
Daraus schließen wir, dass es keine signifikante Beziehung zwischen Unternehmensführung und Unternehmenserfolg gibt und dass Unternehmenserfolg durch andere Faktoren beeinflusst wird. Nichtsdestotrotz sollte die Bedeutung von Unternehmensführung nicht unterschätzt werden, auch wenn sie laut unserer Untersuchung keinen direkten Effekt auf Unternehmenserfolg hat, da gute Unternehmensführung dazu anhält rechtmäßig und ethisch zu verhalten.

2. Resume

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Date of Birth: 10.08.1987

Nationality: German

EDUCATION

03/2012 – 02/2014 **University of Vienna** **Vienna, Austria**

Master of Arts in East Asian Economy and Society

- Main areas of interest are economic systems, business and international relations in East Asia, with a special focus on economy and business in Japan.
- Master Thesis: The Relationship between Corporate Governance and Firm Performance in Japan and South Korea

03/2008 - 02/2011 **Hochschule RheinMain** **Wiesbaden, Germany**

Wiesbaden Business School

Bachelor of Arts in Business Administration

- Focus on marketing, international business and economics
- Bachelor Thesis: The Presidential Council on Nation Branding, Korea

09/1998 - 03/2007 **Lina-Hilger-Gymnasium** **Bad Kreuznach, Germany**

Baccalaureate

PROFESSIONAL EXPERIENCE

10/2011 - 11/2011 **KIMBERLITE CONSULTING GMBH** **Frankfurt, Germany**

Recruitment Consultant Intern

- Developed client and candidate networks in Germany, Austria and Switzerland
- Key account management and business development
- Search for and placement of information technology specialists
- Development of complex recruitment projects through job advertisement, head-hunting and direct recruitment
- Developed direct marketing activities (cold calling, newsletters)

04/2011 - 08/2011 **DISNEYLAND RESORT PARIS** **Paris, France**

Opérateur Animateur Attractions

- Multilingual guest assistance and guidance

09/2010 - 11/2010 **20th CENTURY FOX OF GERMANY** **Frankfurt, Germany**

Trade Marketing Intern

- Planning and realisation of trade marketing measures in the theatrical department
- Organisation of special events
- Responsible for communication and co-operation with partner agencies
- Co-ordination of projects executed by creative and promotion agencies
- Conducted internet-based research
- In charge of general administrative tasks

06/2007 - 08/2007 **DISNEYLAND RESORT PARIS** **Paris, France**

Opérateur Animateur Attractions

- Multilingual guest assistance and guidance

SKILLS

Computer: Microsoft Office

Languages:

German (Native proficiency)	French (Full professional proficiency)
Polish (Native proficiency)	Spanish (Professional working proficiency)
English (Full professional proficiency)	Japanese (Limited working proficiency)

Extracurricular Activities and Conferences:

Model United Nations Club Vienna: Regular participation
University of Vienna Buddy Programme: Guiding exchange students during their first days in Vienna
United Nations Industrial Development Organization Roundtable: "ASIA 2050 – The Sustainable Route to Prosperity", September 13th, 2012 in Vienna, Austria
United Nations Industrial Development Organization: Vienna Energy Forum 2013 in Vienna, Austria, May 28th - 30th, 2013