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EFFECT OF THE 2015 CODE REVISION TO THE CORPORATE GOVERNANCE CODE ON JAPANESE LISTED FIRMS

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ABSTRACT

The Corporate Governance Code, revised in 2015, recommends that the firms listed within the first and second sections of Japan's Tokyo Stock Exchange select two or more independent outside directors (Corporate Governance Code 4-8). Japanese listed firms must either comply with or explain the reason for non-compliance. This study investigates how the Corporate Governance Code affects Japanese listed firms. Using a difference-in-differences approach for my sample of 4,200 firm–year observations in 2014–2015, I find that the Corporate Governance Code increases the proportion of outside directors by approximately 8.8%. This finding implies that such companies might have found it difficult to explain non-compliance with this rule to their shareholders. Moreover, I find no evidence that increases in the ratio of outside directors are related to a firm's future performance.

Keywords: Board structure, corporate governance code, Japan, outside director, soft law

INTRODUCTION

Corporate governance codes and guidelines have proliferated since the publication of the Cadbury Report in 1992 (Cuomo et al., 2015). The Corporate Governance

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Code (CG Code) in Japan is a "soft law" that is not protected by the courts, while commercial law is a "hard law". Applicable to Japanese listed firms, the CG Code is predominantly updated by the Financial Services Agency and the Tokyo Stock Exchange. A firm should offer an explanation if it does not intend to comply with the CG Code, termed the so-called "comply or explain" principle. There is a distinction between bank-based systems and market-based systems in CG. In bank-based systems, stock markets are comparatively small compared with the national economy, banks are large shareholders, and boards are controlled by internal directors. Conversely, in market-based systems, stock markets are comparatively large compared with the national economy, ownership of corporation is dispersed, and markets for control are active. The first is popular in continental Europe and Asia, while the second is prevalent in Anglo-Saxon countries. Recently, codes of Anglo-Saxon CG based on the 'comply or explain' principle have been widely implemented and adopted by firms in bank-based systems worldwide (Krenn, 2014). However, it is unclear whether the codes will function as intended in the bank-based systems.

In Japan, the government published the "Japan Revitalisation Strategy" in 2014 and recommended enhancing CG to improve investor confidence and increase the earnings ability of firms. This strategy led to the Japanese CG Code. The most notable action in this code was to encourage the use of two or more outside directors. This 2015 code revision to the CG Code is unique. The number of outside directors in Japan was low compared with that of other countries.

Outside directors are resources for generating sustainable competitive advantages among the board of directors (Munir et al., 2020). In addition, outside directors are regarded as playing an important role in monitoring inside directors and mitigating the agency conflict between directors and shareholders. Generally, increasing the ratio of outside directors on the board improves governance (Ferris et al., 2007). Additionally, outside directors are considered to increase firm performance and enhance corporate value through good governance. However, empirical research does not always support this view. Some studies report a positive effect of outside directors (Black & Kim, 2012; Liu et al., 2015), whereas others find no positive impact (Bhagat & Black, 2001; Chancharat & Chancharat, 2019; Chen et al., 2021; Mehran, 1995).

The CG Code, revised in 2015, recommends that a firm listed within the first and second sections of Japan's Tokyo Stock Exchange selects two or more independent outside directors (CG Code 4–8). Japanese listed firms must comply with this guideline or explain their inability to do so. This study investigates how the CG Code affects Japanese listed firms. Using a difference-in-differences

approach for a sample of Japanese firms comprising approximately 4,200 firm-year observations in 2014–2015, I find that the revised CG Code increased the proportion of outside directors by 8.8%. The study uses the unique revision to the CG Code in Japan to report the change in ratio of outside directors on the board and its economic consequences. It provides fresh evidence for the mixed observations that outside directors do not increase firm performance and contributes to the literature on outside directors.

HYPOTHESIS DEVELOPMENT

The term "outside director" first appeared in the Companies Act in 2002 at the time of its amendment. Outside directors were introduced to improve firms' performance and investors' expectations. Initially, there was a plan to set up committees within firms to adhere to the Anglo-Saxon CG model that also appeared in 2002 when the Companies Act was amended. The board of directors tended to be dominated by internally promoted members, and the monitoring of operations was the responsibility of a company auditor or the board of company auditors. Japanese firms were hesitant to appoint outside directors because of a dislike for outside involvement in the affairs of their boards of directors. Hence, the appointment of outside directors was unusual in Japan and largely considered to be a practice followed in firms that experienced bad performance. Today, appointing outside directors is recommended in many firms.[1] The CG Code recommends that listed firms in Japan select two or more independent outside directors [2] or explain why they cannot comply with the suggestion. This "comply or explain" principle is a typical regulatory method that allows firms to determine their own best-suited governance structure. While firms have flexibility in terms of their own CG, shareholders can request modifications to the firms based on the "explained" information. Nevertheless, the effect of the 2015 code revision to the CG Code on Japanese listed firms is unclear. Responding to the diffusion of the code, Japanese firms might have appointed outside directors to observe institutional rules formally. In addition, legitimacy theory may support this view. This theory views organisations as captive to the institutional environment, and good governance is adopted because they are taken for granted. For example, Tolbert and Zucker (1983) noted that legitimation appears to dominate the late adoption of practices. Accordingly, my first hypothesis is as follows.

H1: The CG Code revision increases the proportion of outside directors.

Table 1 reports the average ratio of outside directors on the board in each country's listed firm board in 2012 based on Arikawa et al.'s (2017) study. The ratio for Japan is observed to be comparatively low. La Porta et al. (2013)

stated that the historical origin of a country's laws, especially common law or civil law, is highly correlated with a broad range of rules and regulations. Japan has been influenced by both common law and civil law and has experienced a unique development compared with other Asian countries. Japanese firms were characterised by a main bank system, which implies that lender banks and firms were strongly connected. Moreover, Japanese companies tended to burden their employees. For example, lifetime employment (*shushinkoyo*) was common. Furthermore, Japanese firms have been characterised by *Keiretsu*, which refers to the organisation of corporate groups. There are two types of *Keiretsu* in Japanese firms: one is a horizontal corporate group derived from large conglomerates that emerged in the pre-war period, and the other is a vertical corporate group, such as Toyota Motors, which includes a supply chain. Shareholder rights have not been considered as important. This poor corporate governance, which underplays shareholder rights, has resulted in the poor economic performance of Japanese firms and prompted the Japanese government to revise the CG Code.

Table 1
Average ratio of outside directors on the board in 2012

Country	Percentage
Malaysia	68.9
Singapore	59.4
India	54.5
Thailand	41.0
Turkey	1.7
China	35.7
Korea	46.9
Taiwan	19.9
America	70.4
The United Kingdom	51.1
France	53.8
Italy	41.7
Spain	36.1
Japan	14.2

Source: Arikawa et al. (2017)

Policymakers have paid attention to CG Code revisions on corporate social responsibility (CSR). Ooi et al. (2022) investigated listed firms across 35 countries and indicated that CG reform was an important driver of sustainable CSR engagement. Related to CSR, Ooi et al. (2021) focused on Japanese firms because Japanese institutions likely constrained the choices in engaging in CSR. They indicated that Japan achieved its objective of balancing stakeholders' welfare and shareholders' value creation through CG Code revisions. Linck et al. (2008) investigated the effect of the Sarbanes-Oxley Act (SOX) on CG in the United States. SOX had a significant impact on boards and accelerated the movement towards more independent and larger boards because firms added independent directors to comply with the new independence requirement, instead of dropping insiders. For a sample of Japanese firms comprising 5,346 firm–year observations for the period 1997–2008, Saito (2011) investigated the determining factors for outside directors and demonstrated that large sales firms, high market to book value ratio firms, and low free cash flow firms had had outside directors earlier. He also demonstrated that the proportion of outside directors is lower when a founder is the chairperson of the board or president.

The Financial Services Agency requires listed firms to increase the proportion of outside directors to one-third or more.[3] However, Egashira (2014) opposed the mandated appointment of outside directors for three reasons: first, there is no evidence that an increase in outside directors improves firm performance; second, there is no evidence that an increase in outside directors reduces illegal activity; and third, outside directors do not appear to work in small listed firms. In summary, scholarly opinions differ on the subject. Therefore, using a difference-in-differences approach, this study investigates how the CG Code, as a soft law, affected Japanese listed firms and provides new evidence to augment the literature on board independence.

Japanese listed firms characterised by *Keiretsu* form a special relationship led by a major affiliated bank (Choi et al., 2014). Japanese *Keiretsu* groups engage in long-term relationships by exchanging an equity stake, resulting in a credible mutual commitment between the firms. For example, "President's club" meetings regularly scheduled between the presidents or directors of *Keiretsu* firms are often a mechanism for intragroup coordination (Shuto & Kitagawa, 2011). This indicates the general camaraderie of internal directors and the inefficiency of outside directors because *Keiretsu* groups insulate themselves from stock market pressure by buying other group members' stock (Miwa & Ramseyer, 2010). Unlike market-based economies, such as the United States and the United Kingdom, the prevalence of industrial groupings may lead to a tendency to appoint an outside director in compliance with the CG Code, not based on their own demands.

While the results seem to suggest that the CG Code has increased the proportion of outside directors in Japanese listed firms, whether an increase in outside directors increases firm performance remains unclear. There are three views on how boards work (Duchin et al., 2010). First, the window-dressing view is that setting numerical targets for outside directors through regulation should have no effect on performance because inside directors can select outside directors who are independent according to regulatory definitions but still unduly influenced by management. Second, the entrenchment view is that managers cannot easily avoid the new board regulations and have to appoint outside directors who are effective monitors, which leads to improved firm performance. This view expects that market forces alone cannot produce a value-maximising level of board monitoring because of the limited pool of talent and capital that is available to target agency problem firms in the market for corporate control. Finally, the optimisation view is that asking a firm to increase the number of outside directors would result in a suboptimal board and reduce firm performance. This view assumes that managers trade off the strengths and weaknesses of inside and outside directors in advising and monitoring to maximise shareholder value. I posit that increasing the number of outside directors would not influence future performance because the *Keiretsu* effect neutralises outside directors' activities, based on the window-dressing view and the *Keiretsu* characteristics. Accordingly, my second hypothesis is as follows.

> H2: Increasing the number of outside directors does not influence future performance.

METHODOLOGY

My sample consisted of approximately 4,200 firm–year observations for the 2014–2015 period. I collected data of firms whose fiscal year ended in March and excluded financial sector firms (i.e., firms in the banking, securities, and insurance sectors). I acquired financial data using Nikkei NEEDS-Financial QUEST, governance data using Nikkei NEEDS-CGES, and family data from the Family Business White Paper 2015 version, published by Goto (2016).[4] For firms without consolidated financial statements, I used their unconsolidated accounting data. Table 2 presents the variables used in this study. To rule out the impact of outliers, I used data winsorised at the bottom 1% and top 99% levels for each variable, except the indicator variables.

Table 2
Variable definitions

Variable	Definition
$IDRTO_{i,t}$	Percentage of outside directors on the board of directors
$T_{i,t}$	Dummy variable for firms with less than two outside directors in March 2014; zero otherwise
$AFTER_{i,t}$	Dummy variable for the code revision time period; zero otherwise
$T_{i,t}$*$AFTER_{i,t}$	Interaction of $T_{i,t}$ and $AFTER_{i,t}$
$T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$	Interaction of $T_{i,t}$, $AFTER_{i,t}$ and $IDRTO_{i,t}$
$D\_FAMILY_{i,t}$	An indicator variable that takes one if the firm is a family firm and zero otherwise
$logSALES_{i,t}$	The natural log of total sales
$AdjROA_{i,t}$	Return on assets (ROA) minus the value-weighted industry average ROA in each year industry group, where ROA is defined as income before extraordinary items and taxes, scaled by total assets
$FCFASS_{i,t}$	Operating cash flows minus capital expenditures deflated by total assets
$R\&D_{i,t}$	Research and development expenditure, deflated by total sales
$AVEQ_{i,t}$	The market value of equity plus total liabilities, deflated by total assets
$FRGN_{i,t}$	Percentage of ownership held by foreign investors
$DASS_{i,t}$	Total debt deflated by total assets

To investigate the effect of the CG Code on the proportion of outside directors ($IDRTO_{i,t}$) in Japanese listed firms, I applied the difference-in-differences approach by letting $T_{i,t}$ denote a dummy variable for firms with fewer than two outside directors in March 2014, just before the application of the CG Code, and $AFTER_{i,t}$ denote a dummy variable for the subsequent (post-policy change) time period. Table 3 presents the number of outside directors in Japanese listed firms for the 2014–2015 period. The number of firms with no outside directors is shown to have decreased rapidly, and the number of firms with two outside directors increased after the 2015 code revision to the CG Code.

Table 3
Number of outside directors in Japan between 2014 and 2015

Number of outside directors	Number of firms	
	2014	2,015
0	1,160	266
1	1,422	1,417
2	631	1,286
3	226	402
> 3	166	260
Total	3,605	3,631

The treatment groups (denoted $T_{i,t} = 1$) comprised firms that had fewer than two outside directors, and the control groups comprised firms that had two or more outside directors in 2014. The control groups were assumed to have appointed outside directors based on their own demand, prior to the 2015 code revision to the CG Code. However, whether the CG Code was applied was exogenously determined by the composition of their own boards. My identification strategy was based on the observation that the regulation forced some, but not all, firms to review the composition of their boards. This policy change, represented by the 2015 code revision to the CG Code, is suitable for the difference-in-differences approach because it is free from self-selection problems.

The groups affected by a treatment or policy were used as treatment groups and those not affected as control groups. Although both the treatment and control groups were affected by the CG Code, I could, nevertheless, apply the difference-in-differences approach because the treatment groups were strongly affected by having to deal with the CG Code, whereas the control groups were only weakly affected because they did not have to. This approach is in line with that of Wooldridge (2016), who established treatment groups as those located within three miles of a garbage incinerator and control groups as those outside that distance to demonstrate the effect of the new garbage incinerator on housing value. In this case, the treatment groups were strongly affected by the treatment, whereas the control groups were weakly affected.

$D\_FAMILY_{i,t}$[5] is an indicator variable that controls for the influence of a founder or founder family because they are thought to have a strong influence (Saito, 2011). Firm size ($logSALES_{i,t}$) is controlled and proxied as the natural log of total sales, $logSALES_{i,t}$ represents business complexity; the more complex a firm's business, the more outside advice it requires (Saito, 2011). $AdjROA_{i,t}$ represents managerial power over shareholders and is a control for performance.

A firm may add more outsiders to the board following poor performance because the chief executive officer's (CEO's) bargaining power decreases (Linck et al., 2008). $FCFASS_{i,t}$ is a control for free cash flow. Agency theory posits that the principal–agent problem arises because increased free cash flow increases CEOs' discretionary control. When such private benefits are large, CEOs tend to dislike the loss of freedom caused by outside directors' monitoring and are reluctant to appoint new outside directors. To proxy for firm-specific knowledge, I used $R\&D_{i,t}$ for research and development intensity. When the cost of acquiring firm-specific information is high, outside directors are less effective at monitoring and advising management than when the cost of information is low (Huang & Hilary, 2018). When a firm requires its outside directors to have specific knowledge, it should appoint suitable persons. $AVEQ_{i,t}$ is a control for Tobin's Q, which is proxied as the ratio of market to book value. Firms with a high market to book value ratio are valued based on future income streams. Such firms represent a higher risk in the stock market. Therefore, $AVEQ_{i,t}$ represents information asymmetry regarding the firm's business. $FRGN_{i,t}$ controls for the ratio of foreign shareholders. Foreign shareholders require effective management in Japan. $DASS_{i,t}$ is the debt ratio. Firms with high debt ratios require external financial advice. Moreover, they may consider creditors to be more important than shareholders. Table 4 presents the descriptive statistics. The mean $T_{i,t}$ is 0.727, indicating that approximately 73% of firms had fewer than two outside directors in March 2014. The mean $D\_FAMILY_{i,t}$ is 0.511; therefore, almost half of the firms were family firms.

Table 4
Descriptive statistics

Variable	N	Mean	Min	P25	Median	P75	Max	SD
$IDRTO_{i,t}$	4,272	17.583	0.000	10.000	16.667	25.000	60.000	13.387
$T_{i,t}$	4,272	0.727	0.000	0.000	1.000	1.000	1.000	0.446
$AFTER_{i,t}$	4,272	0.498	0.000	0.000	0.000	1.000	1.000	0.500
$T_{i,t}$*$AFTER_{i,t}$	4,272	0.363	0.000	0.000	0.000	1.000	1.000	0.481
$T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$	4,272	6.333	0.000	0.000	0.000	12.500	60.000	10.125
$D\_FAMILY_{i,t}$	4,272	0.511	0.000	0.000	1.000	1.000	1.000	0.500
$logSALES_{i,t}$	4263	10.776	6.747	9.584	10.608	11.876	15.300	1.709
$AdjROA_{i,t}$	4,,229	–1.388	–19.238	–4.296	–1.629	1.377	16.238	5.371
$AdjROA_{i,t+1}$	4,179	–1.509	–19.018	–4.319	–1.671	1.259	17.440	5.281
$FCFASS_{i,t}$	4,253	2.020	–25.813	–1.005	2.249	5.461	24.738	7.114
$R\&D_{i,t}$	4,263	0.016	0.000	0.000	0.004	0.021	0.160	0.271
$AVEQ_{i,t}$	4,234	1.132	0.506	0.830	0.980	1.215	4.529	0.586
$FRGN_{i,t}$	4,265	11.055	0.000	1.090	6.100	18.165	47.712	12.121
$DASS_{i,t}$	4,265	48.323	6.700	33.550	48.470	63.035	88.010	19.152
$SALES_{i,t}$ *(million yen)*	4,263	279527.5	16.000	14,527	40,459	143,843	27,234,521	1,146,101.315

Table 5
Pearson's correlation matrix

	$IDRTO_{i,t}$	$T_{i,t}$	$AFTER_{i,t}$	$D\_FAMILY_{i,t}$	$logSALES_{i,t}$	$AdjROA_{i,t}$	$AdjROA_{i,t+1}$	$FCFASS_{i,t}$	$R\&D_{i,t}$	$AVEQ_{i,t}$	$FRGN_{i,t}$	$DASS_{i,t}$
$IDRTO_{i,t}$	1											
$T_{i,t}$	–0.606	1										
$AFTER_{i,t}$	0.268	0.004	1									
$D\_FAMILY_{i,t}$	–0.142	0.156	–0.001	1								
$logSALES_{i,t}$	0.079	–0.297	0.007	–0.198	1							
$AdjROA_{i,t}$	0.001	–0.057	–0.029	–0.005	0.289	1						
$AdjROA_{i,t+1}$	0.014	–0.075	0.010	–0.014	0.306	0.829	1					
$FCFASS_{i,t}$	–0.016	–0.016	–0.014	0.040	0.036	0.299	–0.025	1				
$R\&D_{i,t}$	0.102	–0.086	–0.004	–0.008	–0.014	0.016	0.015	0.014	1			
$AVEQ_{i,t}$	0.207	–0.123	0.073	–0.032	–0.099	0.257	0.001	0.119	0.132	1		
$FRGN_{i,t}$	0.198	–0.286	0.033	–0.148	0.634	0.353	0.018	0.073	0.166	0.188	1	
$DASS_{i,t}$	–0.042	–0.029	–0.024	–0.135	0.218	–0.199	–0.016	–0.140	–0.278	–0.045	–0.134	1

Table 5 presents the correlations between the variables used in the regression model. $logSALES_{i,t}$ is correlated with $FRGN_{i,t}$ (0.634). I addressed multicollinearity to check the variance inflation factor (VIF) and found it acceptable because each VIF value was no more than 10.

The following is my model:

$$IDRTO_{i,t} = \beta_0 + \beta_1 T_{i,t} + \beta_2 AFTER_{i,t} + \beta_3 (T_{i,t} \times AFTER_{i,t}) + \beta_4 D\_FAMILY_{i,t} + \beta_5 \log SALES_{i,t} + \beta_6 FRGN_{i,t} + \beta_7 AdjROA_{i,t} + \beta_8 FCFASS_{i,t} + \beta_9 R\&D_{i,t} + \beta_{10} AVEQ_{i,t} + \beta_{11} DASS_{i,t} + \beta_{12} INDUTRY\ Dummy_{i,t} + \varepsilon_{i,t} \quad (1)$$

In the difference-in-differences approach, it is important to consider whether the proportion of outside directors in the treatment and control group firms followed similar trends before treatment, that is, whether the parallel trends assumption holds. Figure 1 shows the parallel trends visually, plotting the average proportion of outside directors in the treatment and control groups. Accordingly, I observe that the treatment and control group firms had similar trajectories until 2014, suggesting that the parallel trends assumption is valid.

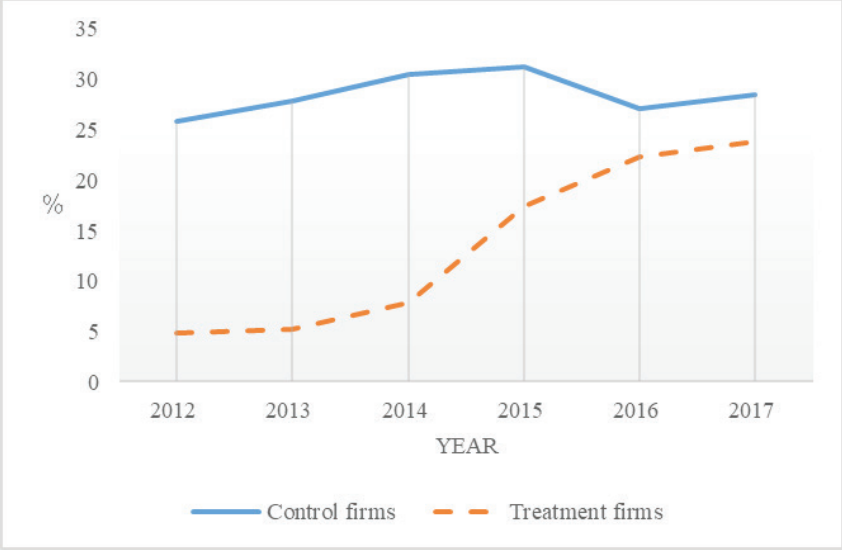

Figure 1. Time-series trend of the average ratio of outside directors on the board for the years 2012–2017

Kochiyama et al. (2019) investigated the effects of CG reform on firm performance for a sample of Japanese firms comprising about 4,100 firm–year observations for the period 2007–2018 and found no evidence that increases in the number of outside directors are related to firm performance. They divided the sample into

two groups and compared them. One group included firms that had no outside directors before the reform. These firms originally seemed to have lower incentives to appoint outside directors and were most likely subject to the reforms. The other included those that had outside directors before the reforms. I investigated the effect of an increase in outside directors on firm performance using the following model. The dependent variable $AdjROA_{i,t+1}$ in Equation (2) represents the next year's performance. As the difference-in-difference estimator may have varied according to the outside director ratio, I used $T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$. For the purpose of this study, the coefficients of $T_{i,t}$*$AFTER_{i,t}$ and $T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$ were relevant.

$$IdjROA_{i,t+1} = \beta_0 + \beta_1 T_{i,t} + \beta_2 AFTER_{i,t} + \beta_3 (T_{i,t} \times AFTER_{i,t}) + \beta_4 (T_{i,t} \times AFTER_{i,t} \times IDRTO_{i,t}) + \beta_5 D\_FAMILY_{i,t} + \beta_6 logSALE_{i,t} + \beta_7 FRGN_{i,t} + \beta_8 IDRTO_{i,t} + \beta_9 FCFASS_{i,t} + \beta_{10} R\&D_{i,t} + \beta_{11} AVEQ_{i,t} + \beta_{12} INDUTRY\ Dummy_{i,t} + \varepsilon_{i,t} \quad (2)$$

RESULTS

Table 6 reports the results of the regression analyses. The reported *t*-value is based on robust standard errors (White, 1980).[6] The coefficient of the variable of interest ($T_{i,t}$*$AFTER_{i,t}$, 8.766) is significantly positive at the 1% level, implying that the average proportion of outside directors for firms with fewer than two outside directors increased by approximately 8.8% because of the CG Code. $T_{i,t}$ is significantly negative at the 1% level, which indicates that the proportion of outside directors in the treatment groups was low before the policy change. $D\_FAMILY_{i,t}$ is significantly negative at the 1% level, which reveals that the proportion of outside directors in family firms was low. According to Cabrera-Suárez et al. (2001), family firms' tacit knowledge embedded in their respective founders and the transmission thereof can become a source of competitive advantage. To maintain such a competitive advantage, family firms may maintain a lower proportion of outside directors. $logSALES_{i,t}$ is significantly negative at the 1% level. The higher the sales, the lower the proportion, which is the inverse of the Japanese data (Saito, 2011). $FCFASS_{i,t}$ is significantly negative at the 10% level, implying that firms with large amounts of free cash flow maintain a lower proportion of outside directors. $AVEQ_{i,t}$ is significantly positive at the 1% level, which shows that firms with growth opportunities need to be monitored by outside directors. $FRGN_{i,t}$ is significantly positive at the 1% level, indicating that foreign shareholders require effective management in Japan.

Table 6
The impact of the 2015 code revision on the ratio of outside directors on the board

2014–2015			
Variable	Coef.	*t*-value	VIF
Constant	43.710***	23.716	
$T_{i,t}$	–22.589***	–43.216	2.207
$AFTER_{i,t}$	0.588	0.875	3.698
$T_{i,t}$ * $AFTER_{i,t}$	8.766***	11.853	4.677
$D\_FAMILY_{i,t}$	–1.770***	–5.747	1.147
$logSALES_{i,t}$	–1.293***	–8.242	2.745
$AdjROA_{i,t}$	–0.053	–1.343	1.666
$FCFASS_{i,t}$	–0.047*	–1.805	1.165
$R\&D_{i,t}$	–1.642	–0.194	1.826
$AVEQ_{i,t}$	1.342***	3.711	1.545
$FRGN_{i,t}$	0.126***	6.042	2.410
$DASS_{i,t}$	0.001	0.080	1.598
INDUSTRY $Dummy_{i,t}$		Yes	
Adj. R^2		0.507	
N		4196	

Note: The symbols ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively

As shown in Table 7, I find no evidence that an increase in the number of outside directors significantly affects future performance. This result indicates that the 2015 code revision to the CG Code regarding outside directors may simply be a form of "window dressing", that is, more form than substance.

Table 7
The impact of the 2015 code revision on future performance

2014–2015			
Variable	Coef.	*t*-value	VIF
Constant	–12.365***	–13.108	
$T_{i,t}$	0.035	0.115	3.947
$AFTER_{i,t}$	–0.366	–1.415	3.714
$T_{i,t}$*$AFTER_{i,t}$	0.415	1.123	7.237
$T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$	–0.005	–0.281	4.887
$D\_FAMILY_{i,t}$	0.403**	2.783	1.156
	*		

(*Continue on next page*)

Table 7 (*Continued*)

2014–2015			
Variable	Coef.	*t*-value	VIF
$logSALES_{i,t}$	1.015***	14.382	2.636
$IDRTO_{i,t}$	–0.016	–1.569	2.990
$FCFASS_{i,t}$	0.169***	10.394	1.068
$R\&D_{i,t}$	–18.558***	–3.658	1.792
$AVEQ_{i,t}$	3.155***	11.631	1.341
$FRGN_{i,t}$	0.021**	2.370	2.440
$DASS_{i,t}$	–0.076***	–16.253	1.429
INDUSTRY $Dummy_{i,t}$		Yes	
Adj. R^2		0.365	
N		4141	

Note: The symbols ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively

ADDITIONAL TEST

However, the effect of the 2015 code revision to the CG Code may not have been visible immediately. To address potential concerns about the brevity of the study period, I expanded the sample and collected data in a similar way, before and after the event, for the periods 2013–2016 (2 years) and 2012–2017 (3 years). Table 8 presents the descriptive statistics.

Table 8
Descriptive statistics (additional test)

Variable	N	Mean	Min	P25	Median	P75	Max	SD
$IDRTO_{i,t}$	11,261	17.754	0.000	8.333	16.667	25.000	60.000	13.832
$T_{i,t}$	11,294	0.715	0.000	0.000	1.000	1.000	1.000	0.452
$AFTER_{i,t}$	11,294	0.488	0.000	0.000	0.000	1.000	1.000	0.500
$T_{i,t}$*$AFTER_{i,t}$	11,294	0.348	0.000	0.000	0.000	1.000	1.000	0.476
$T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$	11,294	7.091	0.000	0.000	0.000	14.300	40.000	11.164
$D\_FAMILY_{i,t}$	11,294	0.486	0.000	0.000	0.000	1.000	1.000	0.500
$logSALES_{i,t}$	11,273	10.947	1.386	9.788	10.778	12.014	17.133	1.672
$AdjROA_{i,t+1}$	11,053	–1.254	–17.093	–4.017	–1.457	1.359	15.351	5.027
$FCFASS_{i,t}$	11,243	2.236	–43.261	–0.777	2.394	5.502	450.962	7.957
$R\&D_{i,t}$	11,210	0.014	0.000	0.000	0.005	0.019	0.104	0.021
$AVEQ_{i,t}$	11,197	1.100	0.416	0.822	0.965	1.175	36.216	0.624
$FRGN_{i,t}$	11,278	7.399	0.000	0.000	1.530	11.373	44.843	10.830
$DASS_{i,t}$	11,277	48.543	10.491	33.900	48.640	63.280	88.403	19.105
$SALES_{i,t}$ (million yen)	11,273	299370.170	4.000	17817.000	47938.000	164985.500	28403118.000	1154895.500

Table 9
Pearson's correlation matrix (additional test)

	$IDRTO_{i,t}$	$T_{i,t}$	$AFTER_{i,t}$	$D\_FAMILY_{i,t}$	$logSALES_{i,t}$	$AdjROA_{i,t+1}$	$FCFASS_{i,t}$	$R\&D_{i,t}$	$AVEQ_{i,t}$	$FRGN_{i,t}$	$DASS_{i,t}$
$IDRTO_{i,t}$	1										
$T_{i,t}$	–0.488	1									
$AFTER_{i,t}$	0.380	–0.005	1								
$D\_FAMILY_{i,t}$	–0.109	0.135	–0.007	1							
$logSALES_{i,t}$	0.100	–0.307	0.044	–0.190	1						
$AdjROA_{i,t+1}$	0.021	–0.067	0.001	–0.001	0.276	1					
$FCFASS_{i,t}$	0.020	0.001	0.021	0.033	0.001	0.293	1				
$R\&D_{i,t}$	0.085	–0.102	–0.036	–0.027	0.053	0.062	0.006	1			
$AVEQ_{i,t}$	0.174	–0.099	0.096	–0.017	–0.062	0.319	0.123	0.084	1		
$FRGN_{i,t}$	0.021	–0.208	–0.267	–0.087	0.422	0.250	0.010	0.170	0.093	1	
$DASS_{i,t}$	–0.053	–0.040	–0.052	–0.147	0.230	–0.211	–0.130	–0.176	–0.022	–0.089	1

Table 9 presents the correlations between the variables. Significant correlations are not found.

Table 10 reports the results based on the samples for the periods 2013–2016 and 2012–2017. $T_{i,t}$*$AFTER_{i,t}$ has a positive significance for 2012–2017 but only at the 10% level. Therefore, there is no evidence to indicate that an increase in the number of outside directors significantly affects future performance.

Table 10
The impact of the 2015 code revision on future performance

	2013–2016		2012–2017	
Variable	Coefficient	*t*-value	Coefficient	*t*-value
Constant	–15.014 ***	–26.524	–15.025 ***	–32.661
$T_{i,t}$	0.241	1.188	0.255	1.579
$AFTER_{i,t}$	–0.442 *	–1.875	–0.852 ***	–4.064
$T_{i,t}$*$AFTER_{i,t}$	0.398	1.437	0.447 *	1.932
$T_{i,t}$*$AFTER_{i,t}$*$IDRTO_{i,t}$	–0.006	–0.530	–0.007	–0.707
$D\_FAMILY_{i,t}$	0.517 ***	5.003	0.472 ***	5.552
$logSALES_{i,t}$	1.052 ***	23.874	1.021 ***	28.670
$IDRTO_{i,t}$	–0.016 **	–2.429	–0.013 ***	–2.580
$FCFASS_{i,t}$	0.164 ***	13.801	0.160 ***	16.247
$R\&D_{i,t}$	–3.121	–0.746	–3.746	–1.100
$AVEQ_{i,t}$	3.605 ***	18.862	3.836 ***	23.279
$FRGN_{i,t}$	0.014 **	2.162	0.012 **	2.262
$DASS_{i,t}$	–0.073 ***	–22.139	–0.075 ***	–27.957
YEAR $Dummy_{i,t}$	Yes		Yes	
INDUSTRY $Dummy_{i,t}$	Yes		Yes	
Adj. R^2	0.357		0.373	
N	7,834		10,898	

Note: The symbols ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

CONCLUSIONS

I found that the CG Code increased the proportion of outside directors by approximately 8.8% in Japanese firms with fewer than two outside directors in March 2014, just before its application. This result implies that such firms found it difficult to explain non-compliance with the CG Code to their shareholders. The

increase in outside directors does not lead to better firm performance in the future. This may be because of the *Keiretsu* effect neutralising outside directors' activity, based on the window-dressing view.

Media reports state that it is difficult for Japanese listed firms to appoint new outside directors.[7] Therefore, the listing price of hiring new outside directors and their salaries should increase dramatically. In addition, hiring outside directors in Japan is costly, which may account for its lack of significance in terms of firm performance. The cost would not reduce firm performance significantly because it is relatively small in relation to the firm size. Lamoreaux et al. (2019) demonstrated that lead independent directors charged with responsibilities that include reviewing board meeting agendas and serving as a liaison between independent directors and CEOs improve firm performance in the United States. Future research should further consider the appointment of such directors.

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NOTES

1. If a company has a board of company auditors (limited to public and large companies) and is required to submit a securities report to the Prime Minister at the end of the business year with respect to shares that the company issued pursuant to the provisions of Article 24, Paragraph (1) of the Financial Instruments and Exchange Act but does not have an outside director, the directors must explain the reason for this at the annual shareholders' meeting of the relevant business year (Companies Act, Article 327-2).
2. An independent outside director is an outside director whose interest is never averse to that of the shareholders (Securities Listing Regulations 436-2), although these two types of directors are practically identical in Japan.
3. *Nihon Keizai Shinbun,* 15 February 2018.
4. I started with 7,198 firm–year observations of Japanese listed firms drawn from data in Nikkei NEEDS-Financial QUEST, covering the 2014–2015 period. I excluded 382 observations from the bank, insurance, and security sectors. I also excluded 620 observations that were not listed within the first and second sections of Japan's Tokyo Stock Exchange and 1,923 observations whose fiscal year ends were before May. Therefore, I used approximately 60% of the full observations.

For most Japanese listed firms, the fiscal year ends in March. Moreover, the 2015 code revision to the CG Code came into effect in March 2015.

5. The definition of family firms is based on ≥5% family ownership or the presence of family members on the board or in top management.
6. As I used data between 2014 and 2015, autocorrelation was likely. Therefore, I also used clustered standard errors, and the main results remain unchanged (not tabulated).
7. *Nikkei Sangyo Shinbun,* 12 April 2019.

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