



## An Analysis on Selection Efficiency of Japanese Internal Supervision System

Benxu Zou

Department of Management, Shengyang Sport University  
36 Jinqiansong East Road, Sujiatun District, Shengyang 110102, China  
Tel: 86-24-8916-6656 E-mail: zoubenxu@163.net  
College of Business Administration, Liaoning Technical University  
Fuxin, 123000, China

Guoyin Shang

School of Business Administration, Northeastern University  
Shenyang 110004, China

### Abstract

This article, aiming at the reality of the appearance of optional governance structure between the supervision of the supervisory board and that of the board of independent directors, firstly applies the model to analyze the efficiency of this oversight pattern, and then on the basis of relative data, analyzes the status quo of internal supervision system implementation. The research shows, although there is still some doubt about whether the board of independent directors could brandish its role after being introduced into Japanese corporate governance environment, primarily it could be affirmative that this kind of introduction is efficient. Moreover, from its future trend, although internal overseeing mode of Japanese corporation could realize optimal choice by developing the superior and weeding out the inferior between the board of supervisors system and the board of independent directors system, which are sure to be co-existing and play a very important role for the time being, and the revelation from which is that no matter how to choose governance system, as a general rule to be obeyed, it should reflect definite policy direction and make spontaneity and self-organization to dominate. However, What kind of governance system to be chosen by the enterprises should be decided by China listed companies themselves during their trial and error process, while the supervising idea that monitoring departments should believe in is "invisible hands".

**Keywords:** The supervisory board, Independent directors, Commercial laws, Corporate governance

Since entering the new millennium, with the appearance of the new governance environment, many countries in the world set off an upsurge of revising commercial laws and company laws. Following the trend, Japan also revised its commercial law in 2002. Under the newly-revised Commercial Law, we can see that the Board of Supervisors based Japanese companies' internal supervisory model has been changed to an optional governance structure between the board of supervisors and board of independent supervisors. What is the impact of this profound change on Japanese companies' governance system and what is the implementing situation after the reform are of great concern to both the theoretical and practical world. This paper will first find out the context of the reform of Japanese commercial law, based on which an efficiency analysis of the optional internal supervisory system will then be carried out, also a current implementing situation analysis of this system based on relative data will also be conducted, in the hope of providing reliable experiential support for the construction of Chinese listed companies' Board of supervisors system and independent supervisors system and the next step of reform of corporate governance.

### 1. Reform context of Japanese commercial law and the optional structure of internal supervisory system

Since the 1990s, along with the promotion of international enterprises, foreign institutional investors have begun to intervene in the Japanese stock market; the traditional corporate mutual holdings began to have a dissolving tendency and the shareholding structure also appeared to have a decentralized trend. Among them, some powerful domestic and foreign institutional investors began to speak as a shareholder, demanding that the Japanese companies improve their governance structure. For example, the California Civil Service Retirement Fund strongly suggested that Japanese companies should set up independent director system. These initiatives and external calls had impinged on the Japanese government and business circles, but because of the resistance from Japan's business circles, as well as some members

of Congress, the reform had not been put into legislative practice for a long time.

At the same time, along with the reform of the board of supervisors system, all walks of life in Japanese society (such as Japan Corporate Governance Forum, the Economy and Friends, etc.) also put forward suggestions to improve corporate governance, asking to reform the system of the board of directors and strengthen the governance function of stockholders and board of directors. Under the pressure of different interest groups and external appeals, how to absorb and learn the advanced concept and outstanding system from the advanced countries of Europe and the United States, how to change the prior control model to the subsequent monitoring laws, how to fully release the government controls, and increase companies' autonomy space, at the same time, strengthen the company's internal and external controls, to enhance the companies' international competitiveness in the environment of globalization have become urgent issues. Based on these, in the multi-party efforts, in April 2002, "Business Law etc., the draft amendment of some laws" was put forward in the House, asking to introduce committee system in the improvement of corporate governance structure. In May 2002, the final revision of the Japanese *Commercial Code* marked the formal introduction of the system of board of directors into Japan. And, according to the revised commercial law, if large companies or enterprises considered to be large companies can meet certain conditions, they can choose to set up a board of supervisors governance structure, or a committee of important property structure or committee governance structure, and small companies can only choose to board of supervisors governance system, (See Figure 1). The board of supervisors governance structure follows the original governance structure without any change; Committee of important property refers to appointing the special decision-making powers which formally solely belong to the board of directors to the committee of important property, at the same time there still exists the board of supervisors. The aim of setting up the committee of important property is to overcome the shortcomings of immobile operations due to too many directors, and it usually consists of more than 3 members. Committee governance structure includes 3 special committees, i.e. the nominating committee, the oversight committee and the remuneration committee and one or more executive managers (CEO), meanwhile, the system of the board of supervisors is abolished (Tsutiyakamisyou and Okamotoyoukiti, 2003, pages 321-322). Subsequent amendments of the *Commercial Code* in 2003 (May 29, July 30, August 1 all together three times) and 2004 (June 2, June 9 (2), December 1, December 3 (2) a total of six times) had no substantive changes, just made some technical level treatments.

## 2. Efficiency analysis of the options of Japanese internal supervisory pattern after reformation

According to the reformed commercial law, we can see that Japan's corporate governance structure reform didn't adopt across-the-board strategy, but a relatively free choice method. Despite still there are some doubts on whether the independent director system can function well or not in the environment of Japanese corporate governance after its introduction, but what can be certain is that this way of introduction is efficient, which can be proved by the following model.

Assuming that under Japan's governance environment, the market enterprises choosing an independent director system (or board system) has experienced three stages: at the initial point in the decision-making, enterprises can choose either the system of independent directors or the board of supervisors system, with the selecting standard being the expected governance cost and proceeds. In this paper the process is called: the initial system-selection stage. After selecting an independent director system, the enterprise will try to make the system play a role through various internal institutional arrangements, but it will still face two results: the independent director system is brought into play and it is not. However, whether the independent system is brought into play or not, the enterprise will bear the cost of selecting the independent director system (it is called governance cost of independent director system in this paper), and this phase is called the stage of trial and error system. When the enterprise went through trial and error after some time, other enterprises will make a comparison of the revenues and costs with and without the introduction of independent director system in the same system environment, and ultimately determine whether the independent director system will be chosen in the next phase, which is called in the paper : System reselecting stage. At this stage, some enterprises that have already introduced the system of independent directors may choose to reestablish their original system, however, this paper assumes that the enterprises that will make a choice are those without the system of independent directors or newly set-up enterprises.

In Figure 2, in the initial system-selection stage, if enterprises do not choose the independent director system, their practical governance revenue is 5, and the governance implementation cost of the system of independent directors is 0. However, after selecting independent directors, the enterprise will also face with the issue that whether the independent directors can function or not. Thus, at the stage of system trial and error, if an independent director system can effectively play the role, the enterprise's governance performance will become 10, and the final proceeds is seven, minus the governance cost (that is, at this time the proceeds of the independent directors) 3. Conversely, if an independent director system is not functioning, corporate governance revenue will become  $5 - 3 = 2$ , still with governance cost 3. After the enterprise system going through trial and error stage, it will enter the system-reselecting stage; at this stage, other companies make a choice of the future system based on the ratio of the governance revenue to

cost. Obviously, at this time for a rational enterprise, if the system of independent directors is found not to function well, it would not choose the system of independent directors.(See Figure2)

In Figure 3, a crucial factor – government mandatory is taken into further consideration. Due to the government's intervention in the re-selection phase, the enterprise has to choose the system of independent directors even if it does not work; meanwhile those enterprises already implemented the independent director system can not abolish this system. Thus, the enterprise governance cost must always be 3, and the governance revenue can only be  $5-3=2$ .(See Figure3)

Based on the analysis of Figure 2 and Figure 3, from a cost-benefit point of view, at the system selection stage, there is no doubt that the introducing method of Japanese independent director system has reduced the cost of system trial and error. For example, the lifelong employment and sequence of work formed by the long-term accumulation in Japanese culture have become routine in Japanese enterprises. The objective of working hard for an employee is to get the chance of promotion, however, if the system of independent directors was established, not only the number of directors would decrease, but also part of the original director positions would be taken by independent directors, which will be boycotted by staff members, consequently increasing governance cost. In addition, the companies without independent directors will arrange their own governance system according to the performance of those enterprises with independent director system. Even if in certain phase of the future, judging from the good revenues of enterprises with corporate governance, the supervisory department will require all the listed companies to introduce the system of independent directors through laws and regulations, which would be a buffer opportunity for those enterprises without the system of independent directors, and is more contributed to rapid integration after the system is introduced.

### 3. Conclusions and revelations

The above analysis shows that was introduced a major property commission and the Committee set-up system after the 2002 Japanese commercial law reform, and after two years of trial and error, the relevant system arrangement also became more and more perfect, which undoubtedly further enriched the contents of Japanese corporate governance. Although the future trend of Japan's mode of supervision will probably make an optimal choice between the board of supervisors system and the independent director system, but in the near future, the two systems will co-exist and will play an important role respectively.

Japan's reform path has also provided valuable experience for the Chinese corporate governance structure reform, which has a similar cultural background. In the reform process of China's state-owned enterprises, in order to establish modern enterprise system, from the system conversion of enterprises to the choices of corporate governance system, the mandatory system conversion is available to everywhere. It can be said that in the transitional period, many mandatory system changes has greatly accelerated the process of reform. But it is found that the system being implemented has serious deficiencies, with the prerequisite of not acknowledging the market's main body status. However, when there is no clear understanding of the effects of the existing system or there is still much room for the existing system to improve, the mandatory system changes will bring the inefficiency of system introduction. As to the introduction of the system of independent directors, in some sense it is a judgment of efficiency of the existing system. However, the fundamental reason for the malfunction of existing supervisory system is the existing shareholding structure. Under the same shareholding structure, it is bound to appear the same agent mechanism, and some inevitable problems that will lead to malfunction of the Board of Supervisors will come into being. Trying to solve Chinese listed companies' governance problems in a short time by way of grafting and transplanting the exotic independent director system is unrealistic.

Judging from the current situation, China's future governance structure of listed companies at most has two possible models, one is to fully adopt system of independent directors while abolishing the system of board of supervisors; Another is the two systems co-exist on the basis of further clarifying functions of independent directors and board of supervisors. However, regardless of the governance system chosen, as a general rule to be obeyed, it should reflect definite policy direction and make spontaneity and self-organization to dominate. What kind of system of governance to choose, the listed companies should decide on their own in the process of trial and error; and the supervising concept that monitoring departments should hold is the "invisible hands".

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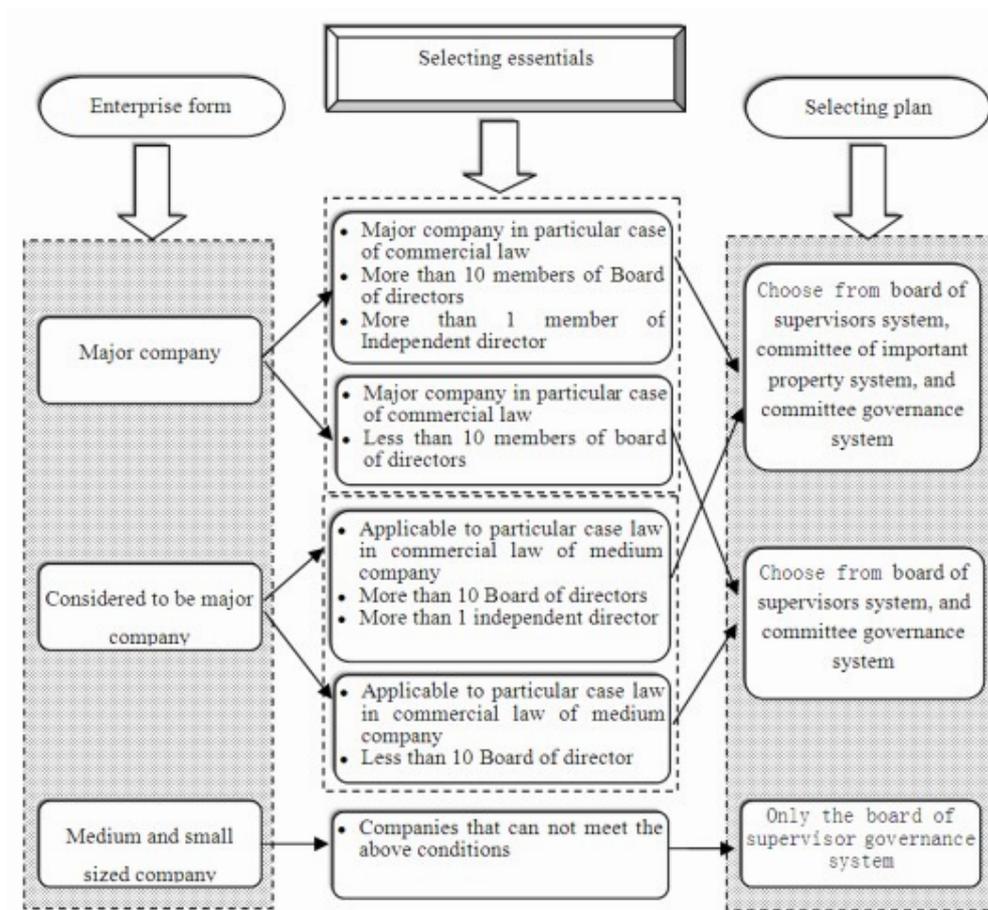


Figure 1. Enterprise Form and the Options of Corporate Governance System  
 Source of data: 2002 Japan Commercial Code and Tsutiyakamisyou and Okamotoyoukiti (2003).Corporate Governance Theory: Basic Theory and Practice[M].Tokyo: yuhikaku, p322 (processed by the writer).

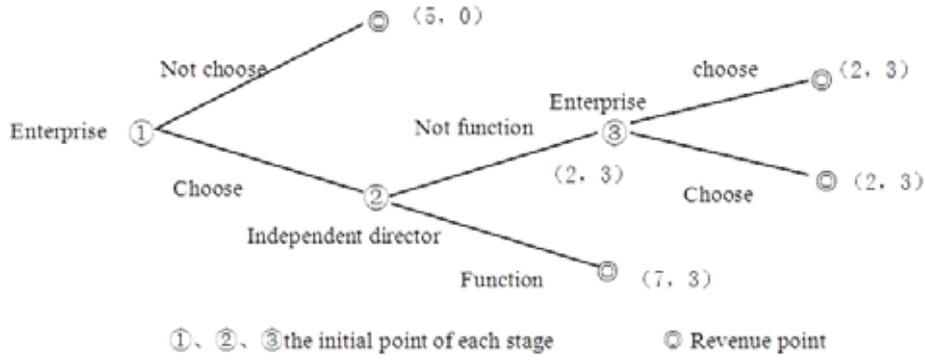


Figure 2. Revenue and Cost of Corporate Governance on the Basis of Government Mandatory System Change

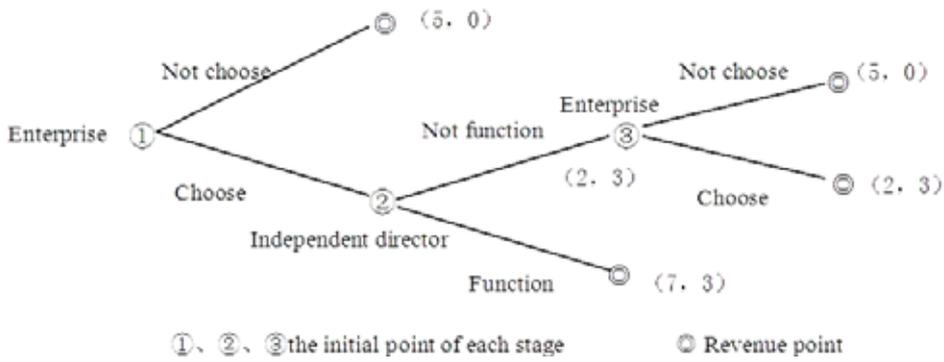


Figure 3. Revenue and Cost of Corporate Governance on the Basis of Government Mandatory System Change