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The impact of firm strategy and foreign ownership on executive bonus compensation in Japanese firms

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ABSTRACT

Building on information-processing perspectives and the Japanese contextual factors, this study investigates the relationships between firm strategy and executive bonus pay as well as the moderating role of foreign ownership on the strategy–compensation relationship in Japanese firms. We focus on R&D investment and product diversification as strategy variables and investigate their direct effects on executive bonus pay. Further, we examine the moderating effects of foreign ownership on the strategy–pay sensitivity. The results, based on a sample of the 148 largest industrial firms in Japan for the 1990–1997 period, show that both R&D investment and product diversification are positively related to executive bonus pay. Our findings also indicate that foreign ownership negatively moderates the relationships between the strategy variables and executive compensation, suggesting that foreign investors play an active monitoring role, reducing cash bonus payments when their invested firms choose to increase R&D or pursue diversification strategy.

1. Introduction

Executive compensation is considered as one of the most important mechanisms to align the interests of managers and shareholders. A large number of studies have examined its determinants and performance effects. The most researched question in this area has been the link between executive compensation and firm performance (Barkema and Gomez-Mejia, 1998). The major antecedents of executive compensation examined so far include corporate governance factors such as ownership structure, board of directors, remuneration committee, etc. as well as firm strategy (Balkin and Gomez-Majia, 1990; Tosi and Gomez-Mejia, 1989; Firth et al., 2007). The majority of these studies have been carried out in the U.S. context. This may be mostly attributed to the fact that while many U.S. firms have been using performance-based executive pay such as stock options extensively, firms in other countries have been slow to do so. Recent years have seen a gradual diffusion of performance-based compensation to other countries (Fiss and Zajac, 2004; Sanders and Tuschke, 2007). However, there has hardly been any empirical examination of the effects of either corporate governance or firm strategy on executive pay in non-U.S. contexts so far. Further, there is a view that the principal–agent approach that is so widely used in the U.S. to investigate the determinants of executive compensation may not be appropriate in international research, because it ignores the differences in institutional contexts across countries (Buck et al., 2003; Bruce et al., 2005).

This study attempts to address these gaps in the literature by investigating the strategic and governance determinants of executive compensation in the Japanese context. In this study, we examine the relationship between two important strategic decisions of firms—R&D investment and diversification—and executive bonus payment. The specific impact of executive compensation on R& D and diversification has been attracting increasing attention (Gomez-Mejia, 1992; Hoskisson et al., 1993). R&D expenses reflect a firm's time orientation and capacity to bear risk. Diversification decisions are fundamental decisions about the scope of the firm and represent one of the major approaches to growth. While R&D expenses capture patterns in annual resource allocations, diversification reflects the cumulative impact of strategic decisions made over a period of time. Further, we investigate how corporate governance, especially shareholding by foreign portfolio investors, has any moderating effects on this relationship, because executive pay reflects choices made by owners of the firms regarding how their agents should be compensated. Given the foreign investors' focus on financial returns, we expect their presence to have a significant impact on the relationship between strategic choices by the firm and executive pay.

We believe that Japan provides an interesting research context for a number of reasons. First, Japan's institutional context is characterized by the absence of a managerial labor market as well as a market for corporate control. Second, although there are a limited number of

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studies that have examined the effects of such determinants as firm performance (Kaplan, 1994; Kato and Kubo, 2006), *keiretsu* affiliation (Kato, 1997), and top executive characteristics (Kato and Rockell, 1992) in the Japanese context, there has been virtually no attempt to examine the effects of firm strategy and corporate governance on executive pay in Japan. Our study attempts to address this issue.

2. The empirical context

Traditionally, studies on executive pay have paid little attention to national differences. Increasingly, however, it is being recognized that in explaining organizational decisions and actions, institutional differences may be even more important (Jackson and Deeg, 2008; Kosaka, 2004). Comparative governance research reveals that corporate governance practices vary substantially among different institutional contexts (Buhner et al., 1998). Nations also differ significantly in terms of institutional norms and legal traditions that impose constraints over what firms can do. Executive compensation practice is one area that is particularly institutionally embedded (Bruce et al., 2003). The determination of both the amount and structure of an executive's compensation is affected by institutional norms, corporate governance practices, legal restrictions, and the managerial labor market. This makes the consideration of institutional factors critical to the study of executive compensation.

2.1. Ownership structure of Japanese firms

Many Japanese firms are linked through extensive cross-shareholding arrangements with their main banks, business partners, and client firms. Further, a large portion of Japanese stocks are owned by “stable” investors (Gerlach, 1992). Stable investors own shares primarily to cement long-term stable business relationships rather than to earn a return on their stock investments (Charkham, 1994; McGuire and Dow, 2002). They own shares in other firms to ensure stability in earnings and sales so that they can protect the interests of important stakeholders including employees, management, and business partners that are often members of the same *keiretsu* group (Gedajlovic and Shapiro, 2002; Nakatani, 1984). Because of this “insider” oriented ownership structure, Japanese firms are able to make strategic investments for long-term competitiveness (Porter, 1992). Therefore, research on Japanese corporate governance suggests that capital markets or external market investors do not function as an effective monitoring mechanism to protect and promote the interests of shareholders who often seek short-term financial returns (Yoshikawa and Phan, 2003).

The ownership structure of Japanese corporations, however, is beginning to change, primarily due to the increasing role played by foreign and domestic market investors. Since these investors have only arm's-length relationships with firms in which they own shares, they look for higher investment returns and follow a more shareholder-oriented corporate governance model (Jackson and Moerke, 2005). In fact, several studies have found a positive association between foreign ownership and firm performance (Miyajima and Kuroki, 2005). Foreign share ownership has also been found to foster appropriate strategic investment by Japanese firms (David et al., 2006). Thus, there is growing evidence to suggest that the stable world of Japanese corporate governance may be beginning to change as a result of the growing influence of foreign portfolio investors.

2.2. Executive compensation in Japanese firms

Executive compensation of large Japanese firms usually consists of regular monthly salary and annual or semi-annual bonus. Executive salary has been traditionally determined by setting limits to total salary amount to all directors in the statutes of a corporation or in the resolution in the shareholders' meeting, and then the board meeting approves the exact amount for each executive (Colpan et al., 2007). Although an increasing number of firms have begun to adopt performance-based pay plans in recent years, the salary component of executive pay was traditionally determined by the rank or seniority of each manager, and changes in their salaries were often linked to changes in employee wages (Kubo, 2005).

In contrast to salaries, executive bonus payments in Japan as in firms in other countries were more closely tied to performance. The bonus payment amount of executives' compensation is typically between 10 and 30% of their total salary (Kubo, 2005). Executive bonuses are often reduced or entirely eliminated in the case of poor firm performance (Xu, 1997). Until the revision of the Commercial Code in 1997 which allowed the introduction of stock options to compensate management and employees, the bonus payment was the major compensation component that was linked to firm performance. These contextual factors lead us to focus on executive bonus payments in Japanese firms during the period of 1990–1997.

3. Theory and hypotheses

3.1. Strategy and executive compensation

There is an increasing recognition in the literature that firm strategy can have a significant influence on executive compensation (Balkin and Gomez-Majia, 1990; Gomez-Mejia, 1992). The case for a relationship between firm strategy and executive compensation can be made from an information-processing perspective. In the case of Japan, the precise nature of such a relationship can be derived from an understanding of institutional characteristics specific to Japan.

3.1.1. Information-processing perspective

Firm strategy is likely to be one of the key determinants of the level of executive compensation because different strategies have different levels of complexity and hence varying levels of demand for information processing (Finkelstein and Hambrick, 1988; Henderson and Fredrickson, 1996). Since the ability to process complex information is a valuable resource, managers with such ability are likely to be paid higher compensation than managers who do not possess such capabilities. Prior studies show that strategies that require the CEO to process complex information tend to be associated with higher CEO compensation (Duru and Reeb, 2002; Henderson and Fredrickson, 1996).

Greater R&D investment usually leads to high levels of information-processing demands on managers for three reasons. First, R&D investments are typically associated with high levels of outcome uncertainty or risk. Second, the lead times in many R&D projects are very long. Third, R&D activity may require high degrees of coordination among different departments as well as the more complex task of managing technical staff. Hence, the need to process large amounts of complex information, outcome uncertainty, long time horizons, and high overall risk lead to high levels of executive compensation.

Product diversification is another strategy that is likely to increase the information-processing demands on managers. As diversification increases the scope of the firm and hence the range of strategic decisions that managers have to make, managers' task becomes more complex. Related diversification increases interdependencies among business units and hence leads to more coordination needs (Henderson and Fredrickson, 1996). Unrelated diversification increases the information-processing demands for a number of reasons. First, the success of a conglomerate strategy hinges on the management's ability to ensure the functioning of an efficient internal capital market. Such an internal capital market would place enormous information-processing needs on the top management to choose between competing demands by divisions. Second, monitoring the performance of several unrelated businesses requires more information processing than monitoring either a single business or related businesses. Third, managing a portfolio of