Why the traditional principal agent theory may no longer apply to concentrated ownership systems and structures

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ABSTRACT

This paper not only considers why many concentrated ownership structured systems and jurisdictions are considering a shift to the Anglo American style of corporate governance, but also explores why the traditional principal agency theory may no longer hold in many concentrated ownership structures.

Key Words: principal agent theory, stakeholder theory, informational asymmetries, risk, corporate governance, UK, India, Germany, U.S, Japan
Why the Traditional Principal Agent Theory May No Longer Apply To
Concentrated Ownership Systems and Structures

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A. Introduction

The lack of knowledge is certainly one of the biggest obstacles to advancement. To choose to ignore because of difficulties associated with change – whilst logical, constitutes an even greater challenge to progress. However, to choose to ignore, for no plausible reason at all, constitutes the greatest challenge in the path of progress. What constitutes the definition of progress may also be viewed from several perspectives. Whilst cost reductions enhance progress, failure to address risks which have been building up, may eventually generate problems which are greater than the initially perceived costs. Many decision making processes involve cost benefit analyses and whilst agency costs – particularly those attributed to monitoring, may, initially be greater, the eventual benefits will gradually exceed those costs.

The past three to four decades have witnessed waves of global changes in respect of globalisation, conglomeration, improved technology, increased competition, as well as a rise in transactions involving complex derivatives and financial instruments in financial markets. Such global changes have necessitated huge shake-ups in various jurisdictions whose structures of financial regulation have evolved from that of functional regulation to unified and integrated structures. One typical example being the UK and German banking systems of regulation. Various jurisdictions, notably, within Scandinavian jurisdictions, have also adopted unified structures of regulation and whilst other jurisdictions, are attempting to address the challenges attributed to cross sectional services risks, such move has been difficult owing to the level, scope and size of embeddedness of such jurisdictions' financial and institutional structures in the existing systems of regulation. Whilst a "one-size-fits-all" approach can certainly not address every jurisdiction's needs, the importance of Basel Committee rules and regulations as a means of ensuring a degree of consistency – as well as incorporating rules in relation to increased transparency and disclosure, cannot be over emphasised.

Risk, regulation and conglomeration have become so inter-woven owing to the evolving nature of
risks – particularly as a result of complex changes within the financial environment. Counter party credit risks, as well as other forms of risks, complex financial instruments, and increased shadow banking activities, all contributing to the problem of effectively monitoring and managing such risks.

With such changes taking place, and the financial environment constantly evolving, the need to effectively monitor and address such risks becomes all the more important in corporate governance structures and systems.

Sarker argues that ownership and control structures, as well as institutional set-ups in which such corporations are assimilated, determine, to a large extent, the nature of corporate governance problems in business enterprises and corporations.\(^1\) In so doing, he distinguishes between the nature of agency problems which are peculiar to concentrated ownership and control and those which are synonymous with diffuse ownership structures. With diffuse structures or dispersed ownership structures, „agency problems arise on account of shareholder manager conflicts“ - such agency problems being referred to as Type 1 or vertical agency problems.\(^2\) The agency problem attributed to dispersed ownership is also principally regarded as being that of the control over powerful management.

Contrastingly, „additional agency problems“ are considered to arise under concentrated ownership: namely, the control of dominant shareholders and their influence over management.\(^3\) According to Eun and Resnick,\(^4\) in many countries with concentrated ownership, conflicts of interest are greater between large controlling shareholders and small outside shareholders, than between managers and shareholders. They also make reference to studies undertaken by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (LLSV) which document „sharp differences between countries“ in respect of:

- Corporate Ownership Structures
- Depth and Breadth of Capital markets
- Access of firms to External Financing
- Dividend Policies

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\(^1\) J Sarkar, *Ownership and Corporate Governance in Indian Firms* at page 217
\(^2\) Ibid at page 220
\(^3\) J Odenius, „Germany's Corporate Governance Reforms: Has the System Become Flexible Enough? IMF 2008 WP/08/179 at page14 of 21
LLSV, are cited by Eun and Resnick as stating that „such differences can be explained largely by how well investors are protected by law from expropriation by the managers and controlling shareholders of firms.“ Furthermore, they highlight observations that English common law countries, such as Canada, the U.S and the U.K, provide the strongest form of protection for investors whilst French civil law countries such as Belgium, Italy, and Mexico, provide the weakest.

It is therefore interesting to note that whilst there are conflicting views in respect of the degree of agency problems which arise under dispersed and concentrated ownership structures, it appears that additional or greater agency problems will eventually necessitate the need for greater monitoring. Ownership of shares definitely also has a role to play in ensuring greater monitoring – however where a more harmonious relationship exists between principal and agent – particularly based on trust and long term relationships, the principal may see no reason to undertake „unnecessary“ levels of monitoring – which may be considered costly. In other words, the traditional professional business like principal-agent relationship is transformed over a long period of term during which the long term harmonious relationship is sustained. In this respect, the traditional principal agent relationship in concentrated ownership systems and structures, would exist not between dominant shareholders and the agent – rather between the agent and the minority shareholders. The minority shareholders, unfortunately, are unable to afford or commit the same level of control or funds (as that available to dominant shareholders), necessary to monitor the agent.

B A Comparative Analysis Between Ownership Systems and Structures Operating in Selected Jurisdictions: The UK, Germany, India, the US and Japan.

This section considers the two main ownership systems and structures which prevail across jurisdictions, namely, dispersed ownership systems and concentrated ownership systems. In respect of the former, reference will be made to the U.K and the U.S whilst a consideration and analysis of concentrated ownership systems will consider such jurisdictions such as Germany India and Japan. From this broad categorisation into concentrated and dispersed ownership system and structures, a further distinction will be sought between developing concentrated ownership systems (India) and more developed concentrated ownership systems (Germany and Japan).

Whilst it is argued that some of the costs and benefits resulting from the presence of large shareholders (as illustrated in developed economies) could be as equally relevant in the context of
developing countries, certain reasons are propounded for the inability to simply „extrapolate“ experiences of corporate governance in developed countries into developing countries:\(^5\)

– Some of the institutional specificities of developing countries – such as a less developed capital market, less active takeover markets, absence of well developed managerial market, may impact costs and benefits of large shareholdings in countries uniquely;\(^6\)
– Monitoring by large shareholders in developing countries may not be as effective as in developed countries because of poor availability of information on performance parameters of firms – owing to inadequate disclosure standards and weak enforcement mechanisms, as well as opaqueness associated with insider ownership and concentrated ownership structures.

C Concentrated and Dispersed Ownership Systems and Structures

Concentrated Ownership Structures

Germany

According to Jürgens and Rupp,\(^7\) Germany is often cited as a classical case of „non-shareholder value orientation“ whose production-oriented, long term, risk averse and consensus-driven values, have been constrained often with the Anglo Saxon approach. In addition to management, insiders within the German system of corporate governance are highlighted to be large shareholders, lenders and labour.\(^8\)

Forces considered to be currently responsible for the move towards a „shareholder value orientation“ are summarised as follows:\(^9\)

– State measures to deregulate financial markets
– Pressure of managers of investment and pension funds (in particular from the U.S.A)

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\(^5\) See J Sarkar, *Ownership and Corporate Governance in Indian Firms* at page 223
\(^6\) See also J Sarkar & S Sarker, „Large Shareholder Activism in Corporate Governance in Developing Countries: Evidence from India“ International Review of Finance (2000) Volume 1 No 3 pages 161-194
\(^7\) U Jürgens and J Rupp, „The German System of Corporate Governance: Characteristics and Changes“, Veröffentlichungsreihe der Abteilung Regulierung von Arbeit des Forschungsschwerpunkts Technik, Arbeit, Umwelt des Wissenschaftszentrums Berlin für Sozialforschung No FS1102-203 May 2002 at page 3 of 78
\(^8\) J Odenius, „Germany's Corporate Governance Reforms: Has the System Become Flexible Enough? IMF 2008 WP/08/179 at page 7 of 21
\(^9\) U Jürgens and J Rupp, „The German System of Corporate Governance: Characteristics and Changes“, Veröffentlichungsreihe der Abteilung Regulierung von Arbeit des Forschungsschwerpunkts Technik, Arbeit, Umwelt des Wissenschaftszentrums Berlin für Sozialforschung No FS1102-203 May 2002 at page 3 of 78

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In Germany, the corporate board is not „legally charged“ with representing the interests of shareholders – rather, it is mandated with looking after interests of stakeholders generally, and not just shareholders.\(^{10}\) As well as a two tier board system, comprising the supervisory and management boards, which exists under the codetermination system, it is legally mandated that workers are represented on the supervisory board – a similar situation to that which exists in the U.S where some U.S companies have labour unions representatives on their boards – although this is not legally mandated.\(^{11}\) In the UK, based on the Cadbury's Committee's recommendation, many public companies voluntarily abide by the Code of Best Practice which recommends that there should be at least three outside directors and that the board chairman and the CEO should be different individuals.

Three Unique Characteristics Peculiar to German System of Corporate Governance

The three pillars on which the „traditional German system of corporate governance“ are considered to lie, are as follows:\(^{12}\)

- The dominant role of banks in a complex system of cross shareholding and in company financing
- The system of industrial co-determination
- The production -oriented, company centred management system

The above mentioned three unique characteristics of the German system of corporate governance, are considered by Odenius\(^{13}\) to contribute to difficulties in attaining corporate governance objectives. The problem of „self dealing“ - „asset diverting behaviour on the part of insiders to the detriment of outsiders, typically minority shareholders“, is also highlighted. Furthermore, high ownership concentration and managerial control by insiders are not only considered to encourage the rise of risk of managerial fraud, but are also illustrated by way of managerial fraud cases such as Parmalat.

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\(^{10}\) C S Eun and BG Resnick, *International Financial Management* Fifth Edition 2009 at page 84
\(^{11}\) See ibid
\(^{12}\) U Jürgens and J Rupp, „The German System of Corporate Governance: Characteristics and Changes“,at page 7 of 78
\(^{13}\) See J Odenius, „Ger,many's Corporate Governance Reforms: Has the System Become Flexible Enough?“ July 2008 IMF WP/08/179 at page 9 of 21
The above mentioned complexities, complex ownership structures, as well as problems attributed to opacity – these arising from complicated transparency and complex ownership structures, are features which will be demonstrated in other concentrated ownership structure jurisdictions – namely, India and Japan.

In Germany, share ownership is heavily concentrated – with over half of all shares being owned by non financial companies, banks and insurance companies – main motive of shareholding being to strengthen long term relationships and business interdependencies, as well as long term commitment. According to Jürgens and Rupp, whilst the ownership stake of banks is substantial, their dominating role is based less on direct share ownership than a system of proxy voting (Depotstimmrecht) - under which votes are cast for other shareholders.

Effects of Shift Towards Less Domination by Banks and Impact of the Development of Financial Markets as Impetus For Changes to Corporate System in Germany

The status of banks as „dominant shareholders (mainly by proxy)“, according to Jürgens and Rupp, provides explanation for why bank representatives are prevalent on most companies' supervisory boards.

Effective corporate governance mechanisms is considered to include both:

- Internal mechanisms such as board of directors and their major committees
- External mechanisms such as hostile takeover bids, leveraged buyouts, proxy contests, legal protection of minority shareholders, the disciplining of managers in the external labour markets

Odenius also adds that external control mechanisms are important complementary mechanisms to internal control mechanisms. Leveraged buyouts, as well as hostile take overs are considered to be more difficult in environments involving concentrated ownership systems and structures than in

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14 U Jürgens and J Rupp, „The German System of Corporate Governance: Characteristics and Changes“,at page 9 of 78
15 See ibid at page 10 of 78; it is also added that under this system, private shareholders authorize banks that hold their shares (in custody) to represent their interests at the annual general meetings of the companies.
16 Ibid at page 11 of 78; They add furthermore, that the position of banks ws traditionally strengthened as a result of their role in business financing and that they also used to be the most important source of outside finance – this being the case with other advanced capitalist countries, see ibid aat page 12 of 78.
dispersed ownership systems. For these and other reasons which will be highlighted as follows, the dominance of banks on companies' supervisory boards, as well as their influence on minority shareholders has constituted the topic of various debates. Opposing views regarding the interests and disadvantages of the „historically prominent role of banks“ in the German corporate governance system are illustrated thus:

– Through their continued presence at shareholders' meetings, banks provide an independent outside monitor of corporate decision making. Outside monitoring........ serving to alleviate the so called „free rider problem“ which arises whenever many small shareholders have to form a common standpoint vis-a-vis top management.\(^{18}\)

In opposing the above view, it is further illustrated by Wenger and Kaserer that \(^{19}\):

– In reality, a large number of German banks are sheltered from outside pressures by a dense network of cross holdings, proxy votes and wider developed disclosure obligations. Therefore bank managers are not forced to pursue value maximizing investments and monitoring policies.

Hence opacity is also a feature which appears to be prevalent in Germany and such issues of opacity will be illustrated in prevailing characteristics which also exist in India in the next section – as well as considered under the ownership structures and systems of governance in Japan.

As indicated by Odenius, since both stakeholder and shareholder systems should aim to maximize flexibility, and observing that both systems have their comparative advantages and specific agency risks, „system selection should be left to markets as final arbitrators and therefore the normative challenge is to devise regulatory frameworks within which the open competition between different forms of ownership structures can take place, without distortion."\(^{20}\)

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\(^{18}\) See U Jürgens and J Rupp, „The German System of Corporate Governance: Characteristics and Changes“, at page 15 of 78; and particularly OECD, Economic Surveys Germany 1995 at page 96


\(^{20}\) J Odenius, „Germany's Corporate Governance Reforms: Has the System Become Flexible Enough? IMF 2008 WP/08/179 at page 6 of 21
India

In India, the „traditional culture of big corporate family owned houses“ or blocks of shareholding, are considered to prevail.\textsuperscript{21} Based on evidence from insignificant shareholding of individuals in sample companies, Kaur and Gill illustrate how individual shareholders have no incentive and no capability to monitor and influence the behaviour of management. They also add that in contrast to findings on other emerging economies in Asia, that „affiliations with banks and institutions“ are not a prominent feature of Indian corporations.\textsuperscript{22}

Firms which have large controlling shareholders can be distinguished from those of publicly held corporations which are so numerous and small that they are unable to effectively control decisions of the management team, in the sense that „a large controlling shareholder has both the incentives and power to control the management team's actions.“\textsuperscript{23} According to Srivastava, the main problem then becomes controlling the large shareholder's abuse of minority shareholders. Furthermore, he adds that holders of a majority of the voting shares in a corporation, will therefore, through:\textsuperscript{24}

\begin{itemize}
  \item their ability to elect and control a majority of the directors;
  \item as well as being able determine the outcome of shareholders' votes on other matters;
\end{itemize}

be able to acquire immense power to the extent of benefiting themselves at the expense of minority shareholders. Gill and Kaur\textsuperscript{25} also lend their support to this view by stating that one of the major governance challenges in India lies with unaddressed conflicts between dominant shareholders and minority shareholders.

Firms with highly concentrated shareholdings are considered more likely to be able to transfer business risks to third party insurance companies – as a means of reducing costs. It is argued that the role of ownership structures, and particularly concentrated ownership, as means of corporate governance measure\textsuperscript{26} in monitoring management, may constitute the reason why banks may be

\textsuperscript{21} P Kaur and S Gill „The Effects of Ownership Structure on Corporate Governance and Performance: An Empirical Assessment in India“ Research Project NFCG 2007-2008 at page 3 of 6
\textsuperscript{22} Ibid at page 4 of 6
\textsuperscript{23} A Srivastava, „Ownership Structure and Corporate Performance: Evidence from India“ International Journal of Humanities and Social Science Volume 1 No 1 January 2011 at page 1 of 7
\textsuperscript{24} ibid
\textsuperscript{25} P Kaur and S Gill „The Effects of Ownership Structure on Corporate Governance and Performance: An Empirical Assessment in India“ Research Project NFCG 2007-2008 at page 5 of 6
\textsuperscript{26} Sarker adds that with diffuse ownership structures, agency problems arise on account of shareholder manager conflicts (Type 1 or vertical agency problems) whilst with concentrated ownership and control, agency problems arise primarily due to conflicts between the two categories of principals – the controlling inside shareholders (dominant shareholders) and the dispersed minority outside shareholders (this being referred to as Type II or horizontal agency problems). Hence the role of ownership structure as a mechanism of corporate governance is
more willing to lend, as well as also a reason for the degree of ability by such concentrated ownership firms to obtain property insurance in more debt based lending jurisdictions such as India than in the UK and the U.S.27

Results of a study by Jia, Adam and Buckle28 highlight the fact that „firms with more insider ownership, greater leverage, more growth options, more tangible assets and publicly listed firms, are more likely to purchase property insurance.

Would this imply that such firms are able to manage their risks more effectively?

Chakrabarti, Megginson and Yadav are cited as highlighting the fact that ownership structure could have significant influences on the risk management and internal control decisions of Indian firms.29 Similar views are illustrated30 by Zou and Adams in an analysis which is provided on corporate ownership and equity risks in China. Liability insurance, according to Jia, Adams and Buckle,31 are not as popular compared with property insurance lines of business, owing to relatively undeveloped legal tort systems.

Some of the following are factors, which according to Jia, Adams and Buckle, are considered to be influential and beneficial in corporations' decisions to obtain property insurance – particularly in India:32

- Insurance serves as a commonly used risk management technique which is important for firms in developing countries because unanticipated (uninsured) losses can result in reallocation of resources from those resources for planned long term investment to those

27 ibid
28 J Jia, M Adams and M Buckle, „Insurance and Ownership Structure in India's Corporate Sector“ July 2009 at page 6 of 29. They conclude that firms with „high degree of managerial ownership and leverage, plus firms with high growth options, high asset tangibility and public listing status, are more likely to insure their assets than other entities."
29 See ibid at page 5 of 29. The transfer of of business risk to third party insurance companies as an alternative means to risk retention „within an undiversified ownership structure“, is also highlighted.
31 Ibid; Sinha cited, see T Sinha, „The Indian Insurance Industry: Challenges and Prospects Swiss Re, Zurich
32 See ibid at pages 2 and 7
associated for tasks of reconstruction;

− The presence of appropriate levels of property insurance cover allows debtholders' payoffs to become relatively independent of project selection and in so doing, limits the ability of borrowing firms to shift business risk to debt holders.\textsuperscript{33}

− The ability of insurance to mitigate agency incentive conflicts in firms is expected to be particularly important in India where publicly quoted and non quoted companies tend to rely heavily on debt financing – particularly from banks (this being also attributed to the fact that the issue of public equity is strictly controlled by the Securities and Exchange Board of India (SEBI)).

It is also to be added that apart from the complexity of ownership structure, an important source of agency costs in Indian listed companies which makes it difficult for outsiders to ascertain the complete chain of ownership and control between firms, is the opacity of ownership structures.\textsuperscript{34}

Hence the legal and regulatory system in India will have an immense role to play in providing more effective corporate governance mechanisms, as well as in facilitating economic growth and the development of ownership structures and systems in India. Transparency, being a key area to be focussed on. In India, the regulatory framework of corporate governance consists of the Companies Act, the Listing Agreement, the Securities and Exchange Board of India (SEBI) Act 1992, the Securities Contracts (Regulation) Act 1956, Sick Industrial Companies (Special Provisions) Act 1985.

Japan

Dominance of Banks and Barriers to External Corporate Governance Controls

The dominance of banks and financial investors in the Japanese corporate system of governance is reflected thus:\textsuperscript{35}

− Results reveal that the equity investments of financial investors (institutional investors and banks) in Japanese listed companies, were predominantly in high tech manufacturing.

\textsuperscript{33} Jia, Adams and Buckle also argue further that corporate purchase of property insurance could help mitigate borrowers' assets substitution incentives – hence lowering lenders' risk exposures.

\textsuperscript{34} See J Sarkar, \textit{Ownership and Corporate Governance in Indian Firms} at page 236

\textsuperscript{35} Y Altunbas, A Kara and A van Rixtel, „Corporate Governance and Corporate Ownership: The Investment Behaviour of Japanese Institutional Investors“ 2007 Documentos Ocasionales No 0703 Banco de Espana at page 8
traditional manufacturing and communications industries. All financial investors combined, held more than 60% of the equity capital of the firms listed on the Tokyo and Osaka Stock Exchanges – with banks being the largest group of such investors.

The dominance of banks in concentrated ownership structures and systems such as Japan and Germany has already been discussed. It was earlier highlighted that concerns are directed particularly at the level of protection which is afforded to minority shareholders in cases where such dominance prevails. This being particularly the case given the rarity of external corporate governance measures – such as take-overs.

It is acknowledged that whilst hostile takeovers are rare in Japan, they are common place in the U.S and U.K – the role of cross shareholdings as „formidable“ barriers to hostile takeovers in Japan being also highlighted.36

Further such flaws attributed to a „lack of market for corporate control“ in Germany and Japan, possible weaknesses resulting from financial banking institutions acting as outside monitors – particularly the long-term relationships between banks and those firms they are supposed to be monitoring are areas of concern. Such long term relationships having the tendency to alter the traditional and assumedly professional principal- agency relationships supposed to exist between such banks and their clients.

Whilst long term relationships definitely foster a better environment to improve communication and address agency problems, too much proximity between banks and client firms could also result in the abuse of rights of the minority shareholders.

Other institutions for monitoring and disciplining corporate management in Japan, as identified include:37

- corporate groups (Keiretsu)
- the „main bank“ system;
- concentrated shareholdings

36 F Allen and M Zhao, „The Corporate Governance Model of Japan: Shareholders are not Rulers“ May 2007 see abstract and page 11
Altunbas, Kara and van Rixtel also refer to results of various studies which highlight the fact that financial liberalisation and globalisation – as well as „structural changes in the flow of funds and related diversification of the sources of corporate finance“; have undermined the foundation of the „main bank“ system.\(^{38}\) The organisation of Keiratsu conglomerates around large commercial banks, it is further observed,\(^ {39}\) has been „significantly undermined – owing to revolutionary merger processes in the Japanese banking industry“ which involved banks that traditionally belonged to various Keiratsu.

According to Sakai and Asaoka,\(^ {40}\)

- Despite the progress of deregulation and market mechanism, Japan is facing ongoing recessions after the bubble economy. One of the reasons is the malfunctioning corporate governance, the demerits of insider type governance as represented by main bank system and cross - shareholding, brought to light. Lingering bad debt problems also mean that main bank system could not discipline the management any more. Then, why does insider type governance does not work well in current Japan?

The reasons, as suggested by them, are, as follows:

- Indirect finance to direct finance by financial deregulation
- Deregulation of Japanese financial markets, as well as alternatives to bank debt have become available to large Japanese firms

Financial liberalisation is definitely an obvious response and confirmation to the above suggestions – having also considered other opinions on the topic. However, it would be premature to conclude that this constitutes the only reason why the insider type of governance has not been functioning well in Japan. Other possible considerations including dominant banking institutions acting as outside monitors – as well as lack of external corporate governance controls.

\(^{38}\) Ibid at page 17
\(^{39}\) „With the result that the importance of the Keiratsu has declined: Both as an important feature of Japanese industrial structure as well as a corporate governance mechanism“; Ibid
\(^{40}\) H Sakai and H Asaoka, „The Japanese Corporate Governance System and Firm Performance: Toward Sustainable Growth“ Research Center for Policy and Economy, Mitsubishi Research Institute, Inc Jan 2003 at page 5 of 28
Further, the shift in external sources of funding, "the replacement of bank loans with direct borrowing from capital markets, such as bonds and commercial paper" is highlighted.\textsuperscript{41}

According to an interim report by the Corporate Governance Forum of Japan,\textsuperscript{42} the conventional Japanese corporate governance model consists of a dual structure composed of:

- The board of directors – which execute functions of strategic decision making
- The board of auditors – which audit management's execution of business activities

Furthermore, it is highlighted by the report that the board of auditors execute "ex post facto" auditing whilst the board of directors do not have real decision making power – with decisions actually being taken by the "management board" or the management board of directors. It is also added that in actual fact, "most members of the board of directors are executive directors selected from within the company" - hence making effective governance difficult to achieve.

In their article,\textsuperscript{43} Allen and Zhao highlight that in contrast to the Anglo-American system of corporate governance which focuses on the "narrow goal" of ensuring wealth maximisation of shareholders, that the Japanese approach, a focus on a wider range of stakeholders, could be more efficient.

Further, they relate the U.K, U.S style of governance and wealth maximisation of shareholders to Adam Smith's invisible hand theory\textsuperscript{44} of the market through which they highlight the point that "if firms maximise the wealth of their shareholders and individuals pursue their own interests, then the allocation of resources is efficient in the sense that nobody can be made better off without making somebody worse off."\textsuperscript{45}

Allen and Zhao provide further support for the Japanese approach of a broader view and objective\textsuperscript{46}

\textsuperscript{41} In their opinion, a diversification of the means of financing has weakened the function of main banks. They also add that "banks are becoming less powerful in corporate governance matters in many firms, and at the same time are growing more interested in high share values. As a result, the ability of the Japanese corporate governance system to use bank monitoring to reduce the agency costs of debt have fallen and can be expected to continue falling." see ibid at page 6

\textsuperscript{42} Corporate Governance Committee, Corporate Forum of Japan, "Corporate Governance Principles: A Japanese View (Interim Report) October 1997 at pages 6 and 7 of 13

\textsuperscript{43} F Allen and M Zhao, "The Corporate Governance Model of Japan: Shareholders are not Rulers" May 2007 see abstract and page 1 of 19

\textsuperscript{44} A Smith, "An Inquiry into the Nature and Causes of the Wealth of Nations" 1776 Dublin:Whitestone

\textsuperscript{45} See F Allen and M Zhao, "The Corporate Governance Model of Japan: Shareholders are not Rulers" May 2007 see abstract and pages 2-3 of 19

\textsuperscript{46} Ibid at page 3
in focussing on a broader range of shareholders since, in their view, a consideration and application of Adam Smith's invisible hand, is more relevant in a world or market without externalities.

Is it really the case then, that a „better allocation of resources can be achieved by firms“ under the broader view than is the case where a narrow approach (synonymous with that adopted by Anglo American systems) is adopted? Allen and Zhou however, have not taken into consideration other costs, demerits and disadvantages arising from complex concentrated structures.

The following section attempts to address certain features and characteristics of dispersed ownership structures and systems as well as draw comparisons between the Anglo American system of corporate governance and that of Japan.

**Dispersed Ownership Systems and Structures**

**UK and US**

It is generally acknowledged that the legal framework for corporate governance in the U.S, U.K, Canada and other English common law countries offer strong protection for shareholders. Differences in the U.S, UK style of corporate governance and that which exists in Japan are highlighted within the following contexts:\(^{47}\)

- Board of Directors
- Executive compensation
- The managerial organization of corporations
- The market for corporate control
- Concentrated holdings and monitoring by financial institutions

In contrast to the Anglo American system of corporate governance, costs of concentrated ownership structure systems include:\(^{48}\)

- reduced liquidity and higher risks for large shareholders – owing to concentration of their investments in one specific company
- A relatively under developed market for corporate control;

\(^{47}\) Ibid at pages 6-7

Risk for small shareholders that large shareholders can extract private benefits from the company

Further, „direct control“ through debt, takes place through the means of „relationship banking“ under concentrated ownership structures.

Board of Directors

Whilst the board of directors in the UK and the U.S are elected by shareholders (such board consisting of outside and inside directors), a distinction between the composition of such boards can be made in the sense that in the U.S, a majority are typically from outside the firm, whilst in the U.K, a minority are from outside the firm.\(^49\) In contrast, the structure of Japanese boards of directors is such that shareholders, actually do not have much influence – even though in theory, rights of Japanese shareholders are supposed to be greater than those of shareholders in the U.S and the U.K.\(^50\)

A prominent feature of UK codes is illustrated by way of the „Agency Cost Reducing Measure“ whose objective is to increase independence and monitoring ability of Board whilst curtailing the powers of management through the ending of the CEO duality characteristic. In this sense, a creation of an outsider director as a Chair is undertaken as substitute for the previous CEO dual position which embodied separate roles of Chair and CEO.\(^51\)

D Conclusion: The Role of the External Auditor in Incorporating Beneficial Strategies into Business and Management Models

The fact that fraud cases are probably more reported in the U.S than (certain) other jurisdictions should rather, provide some encouragement that there is greater level of transparency and disclosure in operation than is the case with jurisdictions where less transparency and less effective corporate governance mechanisms are in operation.

\(^{49}\) F Allen and M Zhao, „The Corporate Governance Model of Japan: Shareholders are not Rulers“ May 2007 see abstract and page 7

\(^{50}\) It is also highlighted that over the years, the size of boards have been reformed to bring them in line with UK and U.S boards; See ibid

\(^{51}\) See P Burton, „Antecedents and Consequences of Corporate Governance Structures“ Corporate Governance Volume 8 No 3 July 2000 at page 196
It is certainly the case that less or limited roles exist for external auditors in particular jurisdictions than others. This is certainly the case with China where it is observed by certain academics that the institutional background in China is different from western countries, such as "flight from audit quality" in Defond et al. (2000). Furthermore, it is argued that Chinese companies may not have the demand for high audit quality, which may lead to a different role played by external auditors in China. However, China is certainly doing its best to adopt Basel rules – particularly Basel III regulations in a timely manner and fashion and it will be interesting to see how other aspects of Basel rules and regulations impact on the levels of disclosure and transparency in financial regulation – both as regards the structure, systems ad framework.

And whilst a change from insider type governance (concentrated ownership structures) to outsider type governance (dispersed ownership) may be generally advocated in certain jurisdictions, as rightly observed, by Sakai and Asaoka,52 it should be noted that institutional complementarities exist among the Japanese corporate governance system, including main bank system and cross share -holding, labor system, business transaction system, financial system, and legal system. Because of institutional complementarities among the systems, changing the corporate governance system alone would likely yield an undesired outcome."

52 H Sakai and H Asaoka, „The Japanese Corporate Governance System and Firm Performance: Toward Sustainable Growth“ Research Center for Policy and Economy, Mitsubishi Research Institute, Inc Jan 2003 at pages 6-7 of 28
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