Comment on "Directors' Incentives in Japan and the UK"

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There is a significant difference in the way managers are selected and monitored between Japan and the UK (Odagiri, 1992). There should also be differences with respect to the determination of executive compensation between these two countries, and an empirical investigation of this hypothesis in this paper is a welcome contribution.

The author's main conclusion is that, while executive compensation is positively related with firm size (measured by sales in logarithm) in both countries, it is significantly related with shareholder return or value only in the UK. He thus concludes that directors have an incentive to pursue shareholder interest in the UK but not in Japan. Though I am sympathetic to this argument, I believe there are a few points that the author should clarify before making this conclusion.

First, to measure shareholder interest, the author uses shareholder return for Japan and market capitalization for the UK. The former is a rate-of-change variable while the latter is a level variable. There is no explanation why shareholder interest has to be measured differently between the two countries. Neither is there a discussion of the variable to which executive compensation should be theoretically related. If we ignore dividends, shareholder return consists only of capital gains which are proportional to the change in market capitalization provided the number of shares is constant. Even if market capitalization is large, therefore, there is no gain to shareholders unless it increases. It thus seems to the author that, from the shareholders' viewpoint, executive compensation should be associated with the shareholder rate of return and not with market capitalization. Market capitalization is insignificant even in the UK in table 5, and I speculate that the results might have been different if the shareholder rate of return were used.

In addition, I assume that the author's market capitalization variable does not include debts; therefore, as the MM theorem indicates, it is affected by the debt ratio. If, for instance, a firm with a higher debt ratio is monitored more effectively by banks, the executive compensation may be set at a lower level, causing a positive capitalization-compensation correlation.

It is interesting to note that, for both bonuses in Japan and incentives in the UK, profits exert significant influence but stock-related variables do not. The result for Japan appears reasonable for reasons to be discussed below, but, given the author's discussion of Japan-UK differences, the result is rather puzzling for the UK. There is clearly more similarity here between the two countries than what one would expect from the author's discussion. Put differently, if directors in the UK wish to link the compensation of the highest-paid director with shareholder interest, why do they not link the highest-paid director's annual incentive, as well as his/her fixed pay, to capitalization rather than profits? There seems to be an opportunity for further investigation here.

In Japan's accounting rule, directors' salary (*hoshu*) is treated as costs whereas their bonus (*shoyo*) is treated as payment out of after-tax profits. There are two consequences. The first is that the amount of bonus is formally determined at the annual shareholders' meeting. Of course, the directors' proposed amount is normally approved with little argument. Still, the requirement that it has to be revealed and proposed to the shareholders makes it difficult for the directors to propose a large amount when profits are small.

Second, directors' salaries are tax-deductible similarly to employees' salaries but directors' bonuses are not. Thus, increasing the bonus does not reduce corporate income tax. Without any tax-saving effect, shareholders (including main banks) will be less happy to pay a large bonus when profits are low.

These factors give a good reason for the shareholders to monitor directors' bonus more closely than their salary. That the bonus is significantly correlated with profits must be a consequence of this fact.

Bonuses are an important part of compensation in Japan not only among directors but also among ordinary employees. It has been also found that employees' bonuses are dependent on profits. Some authors have even called it a profit-sharing mechanism. Directors are mostly promoted internally, and they are regarded more as uppermost-rank employees than the representatives of shareholders (Odagiri, 1992). Hence, their compensation is made more or less proportional to that of ordinary employees. Together with the fact that even employees' bonuses are related with profits, the author's finding that directors' bonuses is significantly related with profits appears only natural.

Reference

Odagiri, Hiroyuki (1992): Growth through Competition, Competition through Growth: Strategic Management and the Economy in Japan, Oxford.

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