Outside Directors and CSR in Japan: The Moderating Effect of Director Shareholding and Financial Leverage[1]

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ABSTRACT

This paper aims to extend earlier research on the relationship between corporate governance and corporate social responsibility (CSR) in the Japanese context. Using a sample of 125 Japanese companies listed on Tokyo Stock Exchange from 2010–2020, this paper investigates how outside directors impact the CSR outcomes of firms, and further how this relation is moderated by director shareholding and financial leverage. The results show that the proportion of outside directors positively affects the CSR outcome of firms, and director shareholding negatively moderates this relationship. Only a weak support is found for the negative moderating effect of financial leverage on the relationship between outside directors and CSR outcomes.

Keywords: CSR, Director shareholding, Financial leverage, Board composition, Board independence
JEL Classification code: M14, G30

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1 This paper is based on my Master's thesis titled “Outside Directors and CSR in Japan: The Moderating Effect of Director Shareholding and Financial Leverage” submitted to the Graduate Scool of Economics, Kyoto University, in July 2021. The thesis was awarded “Best Dissertation of Graduate School of Economics 2021”.

1. Introduction

The business community's concern for society can be traced back for centuries, however the actual construct of corporate social responsibility (CSR) began in the 1950s. The formal writings on CSR are thus largely a product of the 20th century – mainly evident in the U.S. (Caroll, 1999). The discussion on CSR has continued into the 21st century and remains vigorous today. Most previous literature on CSR is based on observations from Westerns societies (Matten and Moon, 2008), however the growing interdependence between Western and Asian economies has increased the focus on CSR in an Asian context (Chang et. al., 2017).

Among the growing interest in CSR, recent literature has started focusing on corporate boards and the role they play towards the CSR outcomes of firms. Especially board composition and characteristics of board members have attracted attention in recent literature (Bryan et. al. 2000), including the proportion of outside directors and the impact of their presence at the board (e.g. Jo and Harjoto, 2011 and Fernández-Gago et. al., 2016).

Despite the increase in research on CSR, corporate governance, and the interaction between the two, the current literature is lacking in three profound ways: First, the literature on corporate governance and its impact on CSR outcomes of firms is largely inconclusive recording neutral, positive, and negative results (see e.g. Jo and Harjoto, 2011; Walls et. al., 2012; McWilliams and Siegel, 2000; Coffey and Wang, 1998). Second, most research has been based on data from a Western context. Institutional differences and growing interdependence between Western and Asian economies and unique CSR practices of Asia call for further investigation of the area in an Asian context (Chang et. al., 2017). Third, even though a relatively large amount of research is dedicated to understanding the relation between corporate governance and CSR outcomes of firms, current literature is lacking in terms of investigating more sophisticated relations between the two areas, such as whether a third area of interest could potentially moderate, i.e., increase or decrease, the impact of corporate governance on CSR (Fernández-Gago et. al., 2016).

The aim of this study is to contribute with findings on how outside directors impact the level of CSR in the Japanese context and how this relation might be further strengthened or weakened by director shareholding and financial leverage. The research question of this paper is: *How does director shareholding and financial leverage impact the relation between outside directors and the CSR outcomes of Japanese firms?*

This paper analyses panel data from listed firms in the chemical industry in Japan between 2010–2020. The data compromise 125 listed Japanese firms in one, multiple, or all years between 2010–2020 resulting in 794 unique firm-years with corresponding data on board of directors (BoD), CSR ratings, and financial information. This paper attempts to shed light on the relation between corporate governance and CSR in an Asian context as well as investigating a potentially more sophisticated relation than what has previously been suggested.

Following this introduction, Part 2 of this paper provides a review of the existing literature on CSR and corporate governance. Part 3 introduces the conceptual framework and development of hypotheses. Part 4 presents the methodological considerations of the paper. Part 5 presents the results found through ordinary least-square linear regression. Part 6 discusses practical and theoretical implications as well as limitations and future research and Part 7 concludes the paper.

2. Literature review

2.1. CSR in the Japanese context

While CSR brings focus on an "apparent all pervasive currency" (Fukukawa and Teramoto, 2009; p. 134) the development of the construct and thus its definition is based primarily upon Western ideologies and understandings. In their article from 2009, Fukukawa and Teramoto argue that "The philosophical and ideological underpinnings of CSR remain rooted in AngloAmerican and European principles of liberal democratic rights, justice, and societal structures" (Fukukawa and Teramoto, 2009; p. 134) stating that the most critical frameworks do not advance beyond Western literature. For these reasons, the conceptual construct of CSR was adopted relatively late in Japan. The discussion of CSR did not intensify in the Japanese context until 2003, referred to by some as *CSR gannen*, i.e., the first year of CSR, where firms started to deal specifically with CSR at corporate management level by e.g., establishing specialized units dealing with the responsibility of CSR (Fukukawa and Teramoto, 2009).

Japan is the only Asian country that is a member of the G7 (originally G8), an informal forum that brings together the leading industrial nations of the world for "determining the course of multilateral discourse and shaping political responses to global challenges." (European Commission, 2021). Furthermore, Japan has ranked among the third largest economies measured in nominal GDP since the mid-20th century (JETRO, 2019) – ranked third as of today, following U.S. and China. Considering Japan's apparent importance on the global scene, one would hope that CSR would have attracted more academic attention in the domain of the English language. As first cited by Fukukawa and Teramoto in 2009: "the 1990s can be seen as a lost decade not only for the Japanese business system, but for the field of Japanese business studies" (Westney, 2006, p. 168). Literature on the subject of CSR from a corporate governance perspective has had some attention but tends to be limited to conceptual and discussion-based papers. In particular, this area in Japanese business studies has not extended to empirical and statistical analysis (e.g. Miles, 2006; Demise, 2006, and Fukukawa and Teramoto, 2009).

The importance of CSR in the Japanese context, both in theoretical and practical terms, has been growing since the *CSR gannen* in 2003 due to international pressure and increased global competition. As a result, most Japanese businesses have come to realize that CSR is essentially based on the decisions of management

and thus its practical implication has been evident in recent years (Tanimoto, 2009). Yet, how companies and different industries view the construct of CSR still differs widely in Japan, ranging from being understood solely as philanthropic activities to being the core business itself (Tanimoto, 2009).

In conclusion, bringing a Japanese perspective to light carries the potential of advancing current literature on CSR and in turn influencing environmental and social change in a positive way.

2.2. Corporate governance and its relation to CSR

2.2.1. Agency theory vs stakeholder theory

The current literature on corporate governance and its impact on CSR is split between two theories, i.e., shareholder /agency theory and stakeholder /resource-based view (Fernández-Gago et. al., 2014). According to Fernández-Gago et. al. (2014) most literature on corporate governance has adopted the agency theory approach whereas most literature on CSR has adopted the stakeholder management approach (Chang et. al., 2015).

According to Jensen and Meckling (1976) an agency relationship can be described as "a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf […] If both parties are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal" (p. 308). This can be applied to the relationship between the corporate board of a firm, who operate as the principals, and the managers of that firm, who operate as the agents. When analyzing the BoD's impact on CSR, agency theory would claim that top management might overinvest in CSR activities (Barnea and Rubin, 2010) to enhance their own reputation as "good global citizens" (Harjoto and Jo, 2011; 332) and it is thus the job of the BoD to control top-management and reduce potential CSR over-investment. According to agency theory, higher board independence would result in lower investment in CSR (Harjoto and Jo, 2011).

Stakeholder theory can be described as "a set of relationships among groups which have a stake in the activities that make up the business. Business is about how customers, suppliers, employees, financiers, communities and managers interact and create value" (Freeman, 2010; p. 7). Stakeholder theory thus extends the relationships upon which agency theory is built to a "multilateral relation amongst all stakeholders" (Fernández-Gago et. al., 2014; p. 86). Applying this theory to the link between corporate governance and CSR, investing in CSR can be done to reduce conflict between the different stakeholders. In this case, higher board independence would result in higher investment in CSR (Harjoto and Jo, 2011) as outside directors carry the objective of representing their constituents resulting in a higher sensitivity towards the firm's surrounding environment, e.g., communities, minorities and product quality issues (Johnson and Greening, 1999). The resource dependence framework operates on the same premises as stakeholder theory,

claiming that the selection of outside directors can be seen as a strategy to deal with a firm's surrounding environment and thus help better manage potential CSR issues (Johnson and Greening, 1999; Chang et. al., 2014; Zhang, 2012; Bear et. al., 2010).

The two competing approaches to the link between corporate governance and CSR has resulted in inconsistent results and contradictory arguments within current literature (Fernández-Gago et. al., 2014) and reveals potential for further investigation.

2.2.2. Corporate governance in Japan

Japan is often referred to as the archetype of the stakeholder model (Sarra and Nakaghigashi, 2002; Aoki et. al., 2007; Jacoby, 2018) whereas shareholder-oriented governance is traditionally known to be present in the U.S.[2] and U.K.: "In the past, Japan distinguished itself for having […] a mode of corporate governance whereby the interests of different stakeholders were balanced, whereas in the United States sovereignty was given to shareholders" (Jacoby, 2018; p.1). In contrast to the individualism of U.S. society, Japan is considered to have a stronger collectivistic orientation (Hofstede, 2001), although not as strong as some of its neighbors, e.g., China and Korea. As a collectivistic nation, the ideology that firms must benefit the community rather than focusing solely on profit maximization is considered to be an important part of the corporate governance model in Japan (Sarra and Nakaghigashi, 2002).

The stakeholder model of Japan is argued to be conveyed especially through the firms' treatment of its employees. This is expressed in several ways including intensive training of employees, sheltering employees from downturns, lifetime employment – valuing human capital equal to its equity – and internal promotion system of employees through, e.g., board membership (Jacoby, 2018; Sarra and Nakaghigashi, 2002; Gilson and Milhaupt, 2005; Shishido; 2000). This system is further supported by seniority-based wages and promotion according to rank-hierarchy making mid-career hiring a rare event resulting in high average job tenures (Aoki et. al., 2007).

The BoD can somewhat be viewed as an extension of this internal promotion system. In order to ensure employee protection in the corporation, their participation is guaranteed through e.g., board membership as a strong corporate practice in Japan, typically selected from among senior managers who have served the firm for long periods (Sarra and Nakaghigashi, 2002; Gilson and Milhaupt, 2005; Aoki et. al.,

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2 Although corporations in the U.S. are traditionally famous for adopting shareholder primacy, this has changed over the last couple of years. In August 2019, the Business Roundtable issued a Statement on the Purpose of a Corporation signed by 181 CEOs from leading American companies, including Amazon, Apple, AT&T, Bank of America, CISCO, Ford, McDonalds etc. The statement commits to follow a stakeholder approach, seeking the benefit of all stakeholders and not just shareholders. All previous statements issued since 1997 supported principles of shareholder primacy. The 2019 statement thus supersedes previous statements and outlines a new modern standard for corporate responsibility in U.S. corporations (Business Roundtable, 2019). As the 2019 statement is still relatively new, most existing literature on the subject recognizes U.S. corporations as relying on shareholder theory.

2007). Until recently, a typical Japanese BoD consisted mainly of internally promoted managers who had worked their way up the corporations' ranks as employees (Aoki et. al., 2007). External recruitment of board members was uncommon and tended to come from banks, group companies, or ministries reflecting a relatively low degree of formal separation between a firm's strategy and its operations in addition to managing vs monitoring roles (Aoki et. al., 2007). However, in recent years, the corporate governance system in Japan has been reformed, particularly with focus on increasing the number of outside and independent directors.

2.2.2.1 *The reformed model of corporate governance in Japan, 2014-2015*

The present corporate governance system in Japan was introduced in 2014 and 2015 following the implementation of the Companies Reform Act in 2014 and the Japanese Corporate Governance Code in 2015, especially as a result of pressure from the increasing numbers of foreign investors in Japan (Goto, 2018).

In 2014, most discussions leading to the final reform were focused on whether firms should be required to appoint a minimum number of outside directors to their BoDs (Goto, 2018). The final reform, however, did not include such requirement due to resistance from industry lobby groups, i.e., Nippon Keidanren (the major industry association). Such opposition was not new and given the power of Keidanren most reforms had so far focused on the independence of statutory auditors instead of the BoD (Jackson and Miyajima, 2007). Thus in 2014, instead of mandating outside directors by law, the reform introduced a so-called "comply or explain" approach, where corporations that failed to appoint at least one outside director to its BoD had to explain why (Goto, 2018).

Following the reform of 2014, the 2015 Japanese Corporate Governance Code was implemented requiring listed companies to appoint at least two independent directors and advising companies to consider appointing independent directors as at least one-third of the BoD, depending on industry, size, and business characteristics (JPX, 2018). Again, the code, which is the current code in effect, is based on the comply or explain approach distinguishing Japan from its Asian neighbors as not having any mandatory legal requirements for a certain number of outside and/or independent directors (Goto, 2018). The 2015 Code clearly outlines the difference between outside and independent directors: an outside director is "a director who satisfies certain requirements such as not holding specific positions, including the position of executive director, in the company or its subsidiaries" (JPX, 2018; p. 11), whereas an independent director is defined as: "The listing rules of securities exchanges provide that the outside directors […] are independent directors where they satisfy independence criteria of securities exchanges and the company determines that they do not have the possibility of conflicts of interest with its shareholders." (JPX, 2018; p. 21). From this definition it follows that the number of outside directors is either equal to or greater than the number of independent directors.

2.2.2.2 *Director shareholding on the corporate board*

As opposed to the purpose of outside directors, namely decreasing the self-interest of insiders, another distinctive mechanism seeks to accomplish the exact opposite, i.e., satisfying the self-interest of company insiders by providing the BoD with company shares (Aoki et. al. 2007). Company shares can be provided through stock options, bonuses, and other forms of incentive payments.

Current literature argue that shareholdings can mitigate the agency problem by aligning the interest of e.g., the CEO with the interests of the shareholders (Ertugrul and Hegde, 2008). There is an agreement in current literature that shareholdings can also help mitigate potential conflicts among outside directors and shareholders, if provided to the former, thus increasing the *financial performance* of firms (Ertugrul and Hegde, 2008; Fich and Shivdasani, 2005), yet decreasing firm size, the number of business segments, and regulation (Bryan et. al. 2000).

Director shareholding in Japanese firms was almost non-existent until 1997. In 1997, when board reforms introduced both the system of outside directors and deregulated the stock options mechanism, Japanese firms started to adjust these areas of their governance structure (Jackson and Miyajima, 2007). In 2001, stock options became entirely deregulated allowing firms to issue such to anyone of interest without the attachment to bonds (Shishido, 2007). In a 2007 article, Zenichi Shishido identified five characteristics of Japanese stock options: 1) Stock options are provided widely, also to core employees of the firm, 2) stock options remain a small percentage of total compensation for the BoDs, 3) the gap between current price of stock and its option price is relatively small, 4) the option is a short-term incentive – typically around four years, 5) companies providing stock options are typically high performance and market oriented companies.

While the reforms of 2014 and 2015 changed the internal structure of BoDs by mandating numbers of outside and independent directors through the comply or explain law, the complete deregulation of the boards' incentives, e.g., the provision of stock options, have produced more limited changes. Even though stock options have become more common in the Japanese business environment, both their size and significance remain minimal compared to stock options in the Western business environment, e.g., in the U.K. and U.S. (Jackson and Miyajima, 2007).

Current literature has paid little attention to the effects that director shareholding might have on specific outcomes of firms. Deutsch et. al. (2011) investigated the effect of outside director's stock options on firm risk, Ertugrul and Hegde (2008) researched how stock options for outside directors affect corporate bond yields, Deutsch (2007) researched the influence of outside directors' stock options on firms' R&D, Fich and Shivdasani (2005) researched the impact of stock options for outside directors on firm value, Bryan et. al. (2000) investigated outside director stock option awards and their effects on several economic determinants, and Kren and Kerr (1997) studied the effects of outside directors and board shareholdings on the relation between executive compensation and firm performance. All of the abovementioned papers build on data from a U.S. context. The overall director

shareholding of BoD and its impact on CSR still remains a largely under investigated area.

2.3. Gap in current literature

Despite the relatively comprehensive research on CSR, outside directors, and interactions among the two, the current literature is lacking in three profound ways: 1) Current literature has produced inconsistent results, 2) most research has been based on data from a Western context, particularly concentrated around corporations in the U.S., and 3) most research is lacking sophistication in its relation between components of corporate governance and CSR. First, previous research has investigated the relationship between BoD and the CSR outcomes of firms (Ibrahim et. al., 2003). Such research includes the effect of board independence on CSR (e.g., Jo and Harjoto, 2012; Johnson and Greening, 1999), effect of board diversity on CSR (e.g., Zhang, 2012; Bear et. al., 2010; Coffey and Wang, 1998), as well as the link between corporate governance, CSR, and financial performance of firms (e.g., Fernández-Gago et. al., 2016). In general, the literature on corporate governance and its impact on CSR outcomes of firms are largely inconclusive recording neutral, positive, and negative results (see e.g., Jo and Harjoto, 2011; Walls et. al., 2012; McWilliams and Siegel, 2000; Coffey and Wang, 1998). Second, the role of CSR and corporate governance in Asia plays a different role from what they play in Western contexts due to institutional differences. Despite an increased focus on CSR in an Asian context, the growing interdependence between Western and Asian economies and unique CSR practices of Asia calls for further investigation (Chang et. al., 2017). Third, even though a relatively large proportion of research is dedicated to understanding the relation between the mechanisms of corporate governance and CSR outcomes of firms, current literature is lacking in terms of investigating more sophisticated relations between the two areas, such as whether a third area of interest could potentially moderate, i.e., increase or decrease, the impact of corporate governance on CSR (Fernández-Gago et. al., 2016).

3. Conceptual framework and hypotheses development

The aim of this paper is to investigate how the proportion of outside directors impact the CSR outcomes of Japanese firms, and further how the relationship is moderated by director shareholding and financial leverage.

Based on the literature review, three hypotheses are formulated with the objective of addressing the identified gap in existing literature. This section presents the three hypothesized relations between: 1) the proportion of outside directors and its impact on the CSR outcomes of firms, 2) the moderating effect of director shareholding, and 3) the moderating effect of financial leverage.

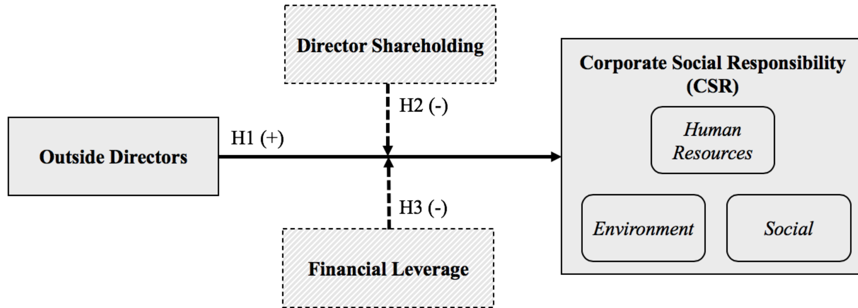

Figure 1: Conceptual framework. Own work.

The three hypotheses set forth disclose the relationships that can help answer the stated research question. The hypothesized relationships are conceptualized in Figure 1. By investigating the current literature, four main components are identified whose relation this paper aims at uncovering. The four identified components are: 1) outside directors, 2) CSR, 3) director shareholding, and 4) financial leverage of firms. The next section discusses the rationale behind the development of the hypothesized relations among these components.

3.1. The impact of outside directors on CSR outcomes of Japanese firms

Both the concepts of corporate governance, and more specifically the role of outside directors, and CSR have been discussed vigorously in the existing literature. In today's competitive global environment managers are expected to balance shareholder value and social responsibility (Mishra and Modi, 2013). CSR no longer serves only a legal purpose but has come to also serve a strategic purpose by markets, regulations, and ethical beliefs. Adapting strategically to this way of viewing CSR, has become crucial for managers, and specifically the BoD, who have to decide upon the allocation of the firm's corporate resources (Chapple and Moon, 2005), summarized in the Japanese context by Demise, 2006: "In Japan, corporate governance is most likely to take place at the level of the board of directors. Top managers usually carry out the reforms that the board has decided on as they are expected to have a commitment to business ethics" (p. 216). Indeed, if BoDs are seen to have a significant influence on the CSR outcomes of firms, not only shareholders, but all of a firms' stakeholders are motivated to focus on the composition of the BoDs. Current scholars are split between two theories on the impact of corporate governance on CSR, i.e., shareholder/agency vs. stakeholder theory/resource-based views. Most literature on corporate governance has adopted the agency theory approach whereas most literature on CSR has adopted the stakeholder management approach (Fernández-Gago et. al., 2014). Whether outside directors affect the CSR

outcomes of firms in a positive or negative way remains a topic of intense debate among researchers.

This paper adopts the stakeholder theory and resource-based view to suggest how increasing the proportion of outside directors may increase the CSR outcomes of Japanese firms. Most previous literature is based on data from Western environments, especially from U.S. corporations which are known to adopt the shareholder view. However, Japanese corporations are famous for adopting stakeholder-oriented governance, balancing the interests of shareholders, customers, banks, and employees, and are known for having a greater collectivist orientation than e.g., U.S. corporations (Hofstede, 2001). Conclusively, the corporate governance model in Japan relies on advancing the community instead of focusing solely on profit maximization for shareholders (Sarra and Nakaghigashi, 2002). Following the stakeholder-oriented logic, Japanese corporations are believed to exhibit greater CSR outcomes when board independence, i.e., the proportion of outside directors, is higher. Thus, appointing outside directors to the corporate board of Japanese firms increases the focus on matters such as stakeholder engagement, environmental awareness, female employee ratio, and social contribution to mention a few. The first hypothesis of this paper is proposed as follows:

Hypothesis 1 (H1): The proportion of outside directors is positively related to the CSR outcomes of Japanese firms.

3.2. The moderating effect of director shareholding

While the proportion of outside directors are hypothesized to have a positive effect on the CSR outcomes of Japanese firms, other mechanisms might have an impact on this relation, either increasing or decreasing its effect. While outside directors are appointed with the main purpose of controlling and reducing the self-interest of the company's insiders, other mechanisms do the opposite, i.e., rewarding company insiders by nurturing their self-interest. One mechanism seeking to do so, is providing the corporate board with company shares (Aoki et. al. 2007). Even though there is an overall agreement in existing literature that the provision of shares can mitigate potential agency problems between the CEO and shareholders, e.g. by offering the CEO company shares and thus aligning their objectives (i.e. maximizing profit), similar incentive pay offered to the BoD could potentially motivate the directors to overlook opportunistic behavior committed by the CEO and other top-managers of the firm by e.g., favoring risky investment opportunities or pursuing policy alternatives (Ertugrul and Hegde, 2008). This could affect the investment in CSR in a negative way, since the BoDs would be inclined to favor the interest of shareholders over stakeholders, ultimately pursuing a sole goal of maximizing profit. On one hand company shares offered to top management encourage maximizing profits and increasing firm value. On the other hand, providing shares as compensation may create agency problems in the firm as top management has an incentive to e.g., "manipulate earnings, time the release of information, and select investments that

increase the short-term stock price, perhaps at the expense of intrinsic firm value" (Kato et. al., 2005; p. 439).

Increased director shareholding could potentially lead to misaligned interests among board members (Bryan, 2002) where the shareholding board members might prioritize profit maximization while outside directors would seek to serve the interest of all stakeholders. All in all, such misaligned interest might eventually compromise the investment in CSR. The second hypothesis of this paper is proposed as follows:

Hypothesis 2 (H2): Director shareholding will negatively moderate the impact of outside directors on the CSR outcomes of Japanese firms.

Where director shareholding is defined as aggregated shareholdings of members of the BoD in percentage of total shares of the firm.

3.3. The moderating effect of financial leverage

Preston and O'Bannon's framework of "Possible Social-Financial Performance Relationships" from 1997 has inspired several researchers to examine the impact of firms' financial performance on social performance, e.g., Simon and Kohers, 2002 and Fernández-Gago et. al., 2016. The framework presents two opposing arguments as to how financial performance impacts social performance, i.e., 1) higher (lower) levels of profitability lead to higher (lower) levels of CSR, and 2) higher (lower) levels of profitability lead to lower (higher) levels of CSR. Following the first line of argument, Preston and O'Bannon suggest that even if firms desire to focus on and/or increase their CSR activities, their decision to do so eventually depends on availability of resources, also argued by Fernández-Gago et. al. (2016): "Social activity is often an area that is subject to relatively high management discretion, so both the start and the continuation of voluntary socially responsible policies may depend on whether or not there are surplus financial resources." The second line of argument follows the arguments of neoclassical economists (Simpson and Kohers, 2002) suggesting that when financial performance is high, managers are likely to reduce CSR expenditures and focus on short-term profitability that increases personal compensation. In contrast, poor financial performance increases managers' focus on CSR to divert attention (Simpson and Kohers, 2002). As this paper adopts the view of stakeholder theory, in contrast to the neoclassical view, the first line of argument is suggested to be true in the Japanese context. Following this logic, Japanese corporations are believed to have better (worse) CSR outcomes if their financial performance is strong (weak), establishing a relation between financial performance and CSR.

Previous research investigating this relationship has adopted different measures for firms' financial performance, e.g., Simpson and Kohers (2002) measure financial performance through ROA and loan losses, Fernández-Gago et. al. (2016) and Harjoto and Jo (2011) use firm value and ROA as measurement of financial performance and Waddock and Graves (1997) use the measurement of ROA, ROE, and return on sales. So far, few scholars have investigated the effect of financial leverage as an indicator of financial performance and no research, to the best of the author's

knowledge, has investigated its moderating effect on the relation between outside directors and CSR outcomes.

As proposed by Titman (1984) the key stakeholders of firms are inclined to decide on their level of commitment towards the firms depending on the firms' financial leverage: "A firm's [liquidity] can impose costs on its customers, workers, and suppliers. An agency relationship between these individuals and the firm exists in that the [liquidity] decision controlled by the firm (as the agent) affects other individuals the customers, workers, and suppliers (as principals)" (p. 137). Following this logic, other researchers have suggested that stakeholders are reluctant to engage in business with firms of high liquidity as it might influence the firms' ability to accommodate implicit contracts between them (Mishra and Modi, 2012). This logic follows the one presented by Fernández-Gago et. al. (2016) stating that the commitment to CSR eventually depends on the financial resources of the firm. In addition, highly leveraged firms may incur greater risk resulting from higher interest expenses resulting in reduced availability of funds for implementing CSR activities. Along these lines, the third hypothesis of this paper is proposed as follows:

Hypothesis 3 (H3): Financial leverage will negatively moderate the impact of outside directors on the CSR outcomes of Japanese firms.

4. Methodology

4.1. Data and variables

The data used in this paper covers Japanese companies listed on Tokyo Stock Exchange that operate in the chemical industry. The data has been collected from three sources 1) board information provided by Toyo Keizai, 2) CSR ratings provided by Toyo Keizai, and 3) financial information provided by Yukashoken-Hokokusho through the eol-database. This data provides the research with three different measures, i.e. dependent (criterion), independent (focal predictor and moderator), and control variables. The data is collected from year 2010–2020. This period is chosen as the financial information provided by Yukashoken-Hokokusho is not present for a majority of the companies of interest before 2010.

The sample is drawn from the chemical industry as this industry has generally faced a more challenging public relations environment due to its classification as an environmentally sensitive sector (Fernández-Gago et. al., 2016). As a result, corporations operating in this industry may be more proactive in managing their external environment and reputations to enhance their stakeholder relations (Bear et. al., 2010) as noted by Fernández-Gago et. al., 2016: "This positive association [of belonging to an environmentally sensitive sector on CSR] may be due to […] their greater impact on the socioeconomic environment […] and to a more concentrated interest on the part of stakeholders and the need to efficiently meet their demands" (p. 96).

The following sections describe the process of data collection through each source, explain the merged data, and provide a short discussion of the choice of data and specific variables.

4.1.1. Board of directors

In this paper, outside directors are chosen as the measure of board independence despite the distinction of outside and independent directors in Japanese corporate governance which favor independent directors as more independent. As argued by Fernández-Gago et. al. (2016), outside directors are more likely to exhibit greater efficiency when monitoring external contingencies compared to their inside counterparts. As both outside and independent directors are assessed to have greater understanding of the firm's external environment compared to inside directors, both are included in the measure of independence, without distinguishing between the two. As previously outlined, the number of outside directors in Japanese corporations is either equal to or greater than the number of independent directors.

The proportion of outside directors in Japanese firms are presented by the *OutsideDir* variable and is the independent measure (and the focal predictor) of this paper. The most comprehensive and reliable data on the BoD in Japanese firms is collected by Toyo Keizai and published annually in the "Yakuin Shikihō" (役員四季報 [Quarterly Report on company executives]) report covering all listed companies in Japan, e.g., data on 3.740 listed companies in 2020. The data collected on the BoD covers a period of 11 years ranging from 2010–2020 for 147 companies in the chemical industry in Japan. The variables chosen for analyzing the information obtained through the database on BoD are: 1) Proportion of outside directors on the board, 2) director shareholding (another independent variable for this paper, i.e. one of two moderators), 3) total number of board members, 4) average age of board members, 5) average tenure of board members, 6) total number of employees, and, 7) firm age. Additionally, unique firm identifiers (Shoken codes) and the year of entry were extracted.

4.1.2. CSR ratings

The CSR outcomes of Japanese firms are presented by the *CSRScore* variable and is the dependent (criterion) measure of this paper. Similar to the data on the BoD, the CSR ratings for the listed, and major unlisted, Japanese companies in the chemical industry is collected by Toyo Keizai and published annually in the "CSR Kigyō Sōran" (CSR企業総覧 (雇用・人材活用編) [CSR Corporate Directory (Employment and Human Resource Utilization)]) report covering all listed and major unlisted companies in Japan. The CSR ratings are calculated based on a voluntary survey sent to all listed and major unlisted companies in Japan; the response rate thus varies from year to year but are consistently high. The data collected on the CSR ratings covers a period of 11 years from 2010–2020 for 147 companies in the chemical industry in Japan. The survey consists of questions in four categories: 1)

human resources with 45 questions, 2) environment with 28 questions, 3) corporate governance with 38 questions, and 4) social efforts with 30 questions. Based on the survey data, Toyo Keizai evaluates each company in each of the four fields resulting in a 5-point scale rating of either AAA, AA, A, B, or C, listed from highest to lowest rating. For statistical purposes these are converted into a number scale ranging from 5–1 with AAA allocated the highest number (5) and C the lowest (1). As the third category, i.e., corporate governance, includes information on the proportion of outside directors and other basic data on the BoD, this category is excluded from the total aggregated score of the CSR ratings in this paper. Additionally, unique firm identifiers (Shoken codes) and the year of entry are extracted.

As previously mentioned, existing literature within the field of corporate governance and its impact on CSR has mainly been conducted within Western contexts, mostly using data on CSR provided by Kinder, Lydenberg, and Domini Research and Analytics Inc. (the KLD database), e.g., Mishra and Modi (2013), Orlitzky (2001), Johnson and Greening (1999), Zhang (2012), Harjoto and Jo (2011), Deckop et. al., (2006), Bear et. al. (2010) and Chang et. al., (2015) to mention a few. The KLD index shares common traits with the Toyo Keizai database, as both focus on observable corporate policies aimed at accommodating the needs of several stakeholders, e.g., treatment of women and minorities, employee relations, treatment of environment, etc. (Zhang, 2012). As much less research has been conducted in the Japanese context in the field of corporate governance and its effect on CSR, Toyo Keizai's CSR ratings are naturally less used. However, the CSR Kigyō Sōran report is considered the most comprehensive and reliable data on CSR performance of Japanese firms (Kato and Kodama, 2018).

4.1.3. Financial performance

The financial data for the identified Japanese companies operating in the chemical industry is collected by Yukashoken-Hokokusho and published in the eol database that offers financial and corporate information on approximately 6,000, mainly listed, Japanese companies. The data covers a period of 11 years from 2010–2020 for companies found through the previous sources of Toyo Keizai. The financial data collected includes information on 1) total assets, 2) debt, 3) profit, and 4) equity. Similar to the above, unique firm identifiers (Shoken codes) and the year of entry were extracted as well as the financial data.

The categorization and description of the measures can be found in the below table.

Variable name	Variable description
Independent variables	
OutsideDir (*focal predictor*)	Ratio of outside directors to the total number of board members
Out_Share (*moderator*)	Interaction term between outside directors and director shareholding
Out_Leverage (*moderator*)	Interaction term between outside directors and financial leverage
Dependent variables	
CSRScore (*criterion*)	Aggregated numerical score from the three dimensions of CSR
Control variables	
FirmSize	Natural logarithm of total assets
Employees	Total number of employees
Leverage	Ratio of short and long-term debt to equity
ShareDir	Shareholdings of members of the board of directors in percentage of total shares of the firm
ROA	Return on assets calculated as net profit/total assets
FirmAge	The age of the firm in total number of years since establishment date
BoardSize	The total number of board members
Age	Average age of board members
Tenure	Average tenure of board members

Table 1: Definition of variables.

4.1.4. Control variables

A number of variables are identified as potentially associated with the CSR ratings of firms as identified by previous scholars. These variables are included as control variables in the regression analysis as described below.

FirmSize. The firm size may have a significant effect on a firm's CSR activities as argued by Johnson and Greening (1999), McWilliams and Siegel (2000), Surroca et al. (2010) and Mishra and Modi (2013). Larger firms may have an edge in offering goods/services with CSR attributes due to economies of scale and scope. In addition, following the stakeholder logic, larger firms are more likely to attract attention from several stakeholders who potentially devote resources to control the CSR commitments of such firms. Thus, the log of total assets is included as a control variable to represent the size of the firms.

Employees. Other scholars have used total number of employees in the firm as a variable of firm size (Kato and Kodama, 2018; Waddock and Graves, 2000), and some scholars include multiple variables of firm size as statistical controls, e.g., Johnson and Greening (1999) following the same argument as above (for *FirmSize*).

Leverage. The ratio of short and long-term debt to equity. As previously argued, stakeholders might be somewhat reluctant to engage in business with firms of high liquidity (Titman, 1984) resulting in a potential lack of monitoring from stakeholders in regard to CSR activities of firms and further, it has been argued that CSR activities ultimately depend on the availability of resources within the firm (Fernández-Gago et. al., 2016). Thus, similar to previous studies, e.g., Arora and Dharwadkar (2011) and Fernández-Gago et. al. (2016), leverage is included as a statistical control.

ROA. Return-on-assets might be a significant predictor of CSR, as the measure provides investors with information about the profitability of the firm, net profit/total assets, as profitable firms are more likely to invest in CSR following the stakeholder logic (Johnson and Greening, 1999).

ShareDir. As previously done by Coffey and Wang (1998), the director shareholding is included as a control variable as the number of shares owned by board members may be positively related to their ability to influence board decisions not in favor of CSR.

FirmAge. As found by Moore (2001) and Harjoto and Jo (2011), the age of firms is correlated with CSR engagement. Thus, firm age is included as a statistical control in the regression test, previously done by Chang et. al. (2015).

BoardSize. The size of the board is expected to impact the CSR ratings of Japanese firms. A large board potentially seats directors of different backgrounds and characteristics, enhancing the different resources of those directors, which may link the corporation to its external environment resulting in additional CSR activities (Cuadrado-Ballesteros et. al., 2015).

Age. As argued by Chang et. al. (2015), average age of board members may impact the level of CSR in Japanese firms: “Older directors may be less favorable to CSR-supportive decisions due to their shortened time horizon.” (p. 11–12). Following this line of argument, average age of directors is included as a control variable.

Tenure. The average tenure of board members is included as a control variable as well. As argued by Kesner (1988): “it takes at least three to five years for directors to gain an adequate understanding of a firm and the way it operates, and many [scholars] have insisted that a more thorough understanding of firm takes much longer” (p. 70). As longer tenure may enhance the directors’ understanding of the corporation and its operations, and as their influence increases over the years, directors with higher tenure potentially have greater understanding of the firm’s external environment as well, thus mindfulness of the needs of all stakeholders, eventually increasing its CSR activities.

4.1.5. Merged datasets

After collecting the data on BoD, CSR ratings, and the financial performance of Japanese companies operating in the chemical industry, the three panel datasets are merged using the unique firm identifiers: Shoken codes. The merged dataset consists of 125 companies listed on Tokyo Stock Exchange in Japan during the period 2010–2020. As previously mentioned, Toyo Keizai's "Yakuin Shikihō" report covers 147 listed Japanese companies in the chemical industry from 2010–2020, of which 125 companies voluntarily answered the CSR survey conducted by Toyo Keizai in one, multiple, or all years between 2010–2020 resulting in 794 unique firm years with corresponding data on BoD, CSR ratings, and financial information. This represents approximately 80 pct. of all listed companies in the chemical industry in Japan in at least one year and on average in 7.5 years from 2010–2020, which is considered a representative sample. Since Toyo Keizai's Yakuin Shikihō report covers all listed companies in Japan, the sample attrition is caused solely by non-responses in the CSR rating survey conducted by Toyo Keizai. Finally, the merged dataset provides longitudinal information on varying attributes of BoD, CSR ratings, and financial information for each firm.

4.1.6. Empirical analyses

The collected data from Toyo Keizai and Yukashoken-Hokokusho are analyzed using ordinary least square (OLS) linear regression including the interaction terms (moderators). Linear regression can be used to model potential correlations between a dependent (criterion) variable and one or more independent (predictor) variables. If correlation exists and is sufficiently consistent, the independent variable(s) can be used to predict and estimate the dependent variable (Veal and Darcy, 2014). Interaction terms can be used to determine whether the correlation between the criterion variable and predictor variable(s) depends on a third variable or not, namely a moderator variable. The potential effect of such a moderator is statistically characterized as an interaction affecting the direction and/or strength of the correlation between the criterion variable and the *focal* predictor, i.e. the independent variable in question (Hayes, 2017). For the purpose of this paper, an OLS linear regression is carried out using the overall CSR score of the Japanese companies as the criterion variable, the proportion of outside directors as the focal predictor, and the director shareholding and financial leverage as the moderator variables.

The linear regression is performed in the statistical software program Stata/SE, an acknowledged tool used for statistical analysis in previous literature investigating the relation between corporate governance and CSR, e.g., Cuadrado-Ballesteros et. al., 2015. The direction and strength of the correlation between the overall CSR score and proportion of outside directors as well as the moderation effect of director shareholding and financial leverage is analyzed based on the regression output in Stata. The analysis focuses on the following components of the regression output: 1) Prob > F, 2) adjusted R^2, 3) $P > | t |$, 4) Coef. of each

variable. The Prob > F component in the regression output represents the P value for the F test. Looking at this component, it is possible to either accept or reject the null hypothesis which states that the specific model explains none of the variation in the dependent variable, i.e., R-squared = 0. The P value of the F test represents the significance probability, i.e., the probability of rejecting a true null hypothesis (Agresti and Franklin, 2014). In this paper, statistical significance is assessed based on three levels of statistical significance: with a P value of * <0.1, ** <0.05, or *** <0.01 (the lower the number of asterisks the lower the significance). The R^2 value, also referred to as the coefficient of determination, explains how well the variation in the criterion variable can be explained by the predictor variable(s). The adjusted R^2 value accounts for the number of components in the model, adding additional and useful independent variables increases the adjusted R^2 value. The adjusted R^2 value can thus be used to determine the predictive power of the specific model: the closer to 1 the stronger the predictive power. The $P > | t |$ represents the P value for the t tests in the model. For each independent variable the regression output produces a t test making it possible to either accept or reject the null hypothesis for each variable, stating that the specific independent variable explains none of the variation in the dependent variable. The P values are interpreted on the same criteria as the P value of the F test. The Coef. of each independent variable show the nature of the correlation between the criterion and the specific predictor in question. If the coefficient is positive, so is the correlation between the dependent and independent variable and vice versa. Additionally, the coefficients indicate the change in the criterion variable, i.e., the overall CSR score, for an increase of 1 in the independent variable, e.g., the proportion of outside directors.

5. Results

5.1. Descriptive statistics and multicollinearity test

Table 2 presents the descriptive statistics of the variables used in this paper. As previously described, not all companies responded to the CSR survey from Toyo Keizai, thus the number of observations is 802 for the variable of “CSRScore”, whereas all other variables have 942 observations except “ShareDir” and “Out_Share” which carry 934 observations.

The lowest aggregated CSR score obtained among the 802 firm-years is 4 whereas the highest is 15 with a mean of 11.2. Among the 942 firm-years, the max proportion of outside directors is 56.3 pct. whereas the min is 0.0 pct. with a mean of 12.3 pct. For director shareholding, the maximum percentage of total shareholdings of the firm is 60.9 pct. whereas the minimum is 0.0 pct. with a mean of 2.3 pct. which aligns well with the claim of Shishido (2007) who characterizes Japanese stock options as a small percentage of total compensation for the BoD. The financial leverage ratio ranges from -66.0 to 47.4 with a mean of 1.1. Only one company in the observations carried a negative leverage ratio due to negative shareholder’s

equity of YEN 186 million and total liabilities of YEN 12.271 million. Apart from the company with a negative leverage ratio the minimum leverage of the remaining sample equals 0.1. The board size ranges from 6 to 30 directors with a mean of 12.8 directors.

Variable	Obs	Mean	Std. Dev.	Min	Max
CSRScore	802	11.18454	2.5333	4	15
OutsideDir	942	.12293	.0964	0	.5625
ShareDir	934	2.3140	6.0257	0	60.9
Out_Share	934	.1809	.6169	0	8.36
Leverage	942	1.1428	2.9814	-65.9731	47.4371
Out_Leverag	942	.1257	.1691	0	1.6309
FirmSize	942	11.7947	1.5523	8.0833	15.5334
Employees	942	6966.649	12227.3	3	81691
ROA	942	.2677	.1626	.0556	1.0881
FirmAge	942	71.1115	21.2191	2	122
BoardSize	942	12.793	3.4290	6	30
Age	942	62.2271	2.8704	53	72.1
Tenure	942	5.7913	2.7920	.8	18.4

Table 2: Descriptive statistics. Output from StataSE.

Table 3 presents the correlation matrix and table 4 presents the VIF test. As shown in table 3, there is a positive correlation between the proportion of outside directors and the CSR score (29.1 pct.). This positive correlation is suggestive of hypothesis 1, according to which Japanese corporations with a higher proportion of outside directors are more likely to have a higher CSR score. Additionally, to assess the potential risk for multicollinearity in the model, the variance inflation factors (VIF) are tested as shown in table 4, which ranges from 1.23 to 3.22 with tolerance ranging from 0.31 to 0.81. As the range of VIFs falls outside of the conventional threshold of 10 (Kleinbaum et. al., 1998), there is no indication that multicollinearity should be a cause for concern.

5.2. Regression analyses

With the aim of establishing a mathematical relationship between the variables included in the conceptual framework, i.e., proportion of outside directors, director shareholding, financial leverage, and CSR, based on the collected data ranging from 2010–2020, two models of OLS linear regression are carried out, thus testing the three hypotheses presented in section 3. In reality, within the field of social sciences one factor alone most likely does not predict the outcome of an event. This is also assessed to be the case with outside directors' impact on CSR outcomes of

	CSRScore	OutsideDir	ShareDir	Leverage	FirmSize	Employees	ROA	FirmAge	BoardSize	Age	Tenure
CSRScore	1.0000										
OutsideDir	0.2907	1.0000									
ShareDir	-0.1486	-0.1526	1.0000								
Leverage	-0.1654	-0.1075	0.0643	1.0000							
FirmSize	0.7811	0.2659	-0.2639	-0.0913	1.0000						
Employees	0.5564	0.2312	-0.1561	0.0458	0.6970	1.0000					
ROA	0.2130	0.1295	0.3554	-0.1904	-0.0293	0.0899	1.0000				
FirmAge	0.1048	0.1260	-0.2680	-0.0737	0.2628	0.0206	-0.1543	1.0000			
BoardSize	0.3287	0.0752	-0.1245	-0.1243	0.5075	0.2903	-0.0261	0.1638	1.0000		
Age	0.2774	0.1151	-0.3035	-0.1305	0.3997	0.2709	-0.2214	0.2317	0.1981	1.0000	
Tenure	-0.1267	-0.3073	0.2731	-0.0861	-0.2505	-0.2107	0.1260	-0.0792	-0.0740	0.2622	1.0000

Table 3: Correlation matrix. Output from StataSE.

Variable	VIF	1/VIF
OutsideDir	3.08	0.3250
ShareDir	2.42	0.4135
Out_share	2.37	0.4218
Leverage	2.16	0.4626
Out_Leverage	3.22	0.3101
FirmSize	3.12	0.3201
Employees	2.23	0.4487
ROA	1.44	0.6959
FirmAge	1.23	0.8146
BoardSize	1.41	0.708
Age	1.88	0.533
Tenure	1.73	0.5785

Table 4: VIF. Output from StataSE.

Japanese firms where more than two variables are present. Accommodating this, linear regression approximates all individual data points by establishing a linear relationship (Agresti and Franklin, 2014). The sole difference between model 1 and model 2 is that all but the dependent variable (CSR score) is lagged by one year in model 2 in order to account for potential endogeneity of the variables, causing the number of firm-years to decrease from 794 in Model 1 to 708 in Model 2. The use of lagged variables can help accommodate the issue of reverse causality (higher CSR score causing higher proportion of outside directors rather than outside directors affecting CSR) making it less likely to be serious in the analysis. In addition, the independent variable of proportion of outside directors is lagged under the assumption that outside directors must be in their role for some time to have an impact on the overall CSR score of the companies they serve.

From the OLS linear regression test it is possible to confirm H1, H2, and to reject H3. In the below sections, the results from the OLS linear regression test is presented for each hypothesis and the overall model, including an interpretation of the 1) Prob > F, 2) Adjusted R^2, 3) $P > | t |$, and 4) Coef. of each variable.

5.3. Hypothesis 1

As stated in section three, Hypothesis 1 is specified as follows: *The proportion of outside directors is positively related to the CSR outcomes of Japanese firms.* The statistical significance of the relation between proportion of outside directors and the CSR outcomes in Japanese firms is expressed by $P > | t |$ representing the P value for the t tests in the model and is analyzed based on the result from model 2. With a P value of 0.000 it is possible to reject the null hypothesis, stating no significant relation between the two components. Furthermore, with a positive beta coefficient

Source	SS	df	MS			
Model	3542.51846	22	161.023567	Number of obs	=	794
Residual	1524.1163	771	1.97680453	F(22, 771)	=	81.46
Total	5066.63476	793	6.38919894	Prob > F	=	0.0000
				R-Squared	=	0.6992
				Adjusted R-Squared	=	0.6906

CSRScore	Coef.	Std. Err.	t	P >| t |	Beta
OutsideDir	3.7190	.9000	4.13	0.000	.1432
ShareDir	-.0090	.01631	-0.55	0.580	-.017
Out_Share	-.2872	.1341	-2.14	0.033	-.0651
Leverage	-.0156	.0596	-0.26	0.793	-.0076
Out_Leverage	-1.1050	.5097	-2.17	0.030	-.0769
FirmSize	1.4968	.0584	25.65	0.000	.8955
Employees	-.0000	5.7706	-1.98	0.048	-.0584
ROA	3.1719	.3562	8.90	0.000	.2108
FirmAge	-.0113	.0026	-4.31	0.000	-.0944
BoardSize	-.0650	.0172	-3.79	0.000	-.0890
Age	-.0361	.0240	-1.51	0.133	-.0407
Tenure	.0855	.0234	3.65	0.000	.0947

Table 5: Model 1: OLS Regression. Output from StataSE.

Source	SS	df	MS			
Model	3202.73555	21	152.511217	Number of obs	=	708
Residual	1295.10626	686	1.88791	F(22, 771)	=	80.78
Total	4497.84181	707	6.3618696	Prob > F	=	0.0000
				R-Squared	=	0.7121
				Adjusted R-Squared	=	0.7032

CSRScore	Coef.	Std. Err.	t	P >| t |	Beta
OutsideDir L1.	3.9186	.9636	4.07	0.000	.149
ShareDir L1.	-.0206	.01559	-1.32	0.187	-.0425
Out_Share L1.	-.2988	.1295	-2.31	0.021	-.0730
Leverage L1.	-.0529	.0629	-0.84	0.401	-.0260
Out_Leverage L1.	-.7060	.5316	-1.33	0.185	-.0506
FirmSize L1.	1.5064	.0601	25.07	0.000	.9021
Employees L1.	-.0000	5.9806	-2.16	0.031	-.066
ROA L1.	3.2504	.3738	8.70	0.000	.2166
FirmAge L1.	-.0109	.0027	-3.99	0.000	-.0908
BoardSize L1.	-.0534	.01779	-3.00	0.003	-.0731
Age L1.	-.0642	.0249	-2.58	0.010	-.0722
Tenure L1.	.1082	.0246	4.41	0.000	.1191

Table 6: Model 2: OLS regression with lagged variables. Output from StataSE.

equaling 3.919 it is possible to confirm that the relation between the independent and dependent variable is a positive one: i.e., an increase in one of the variables leads to an increase in the other. More specifically, the criterion variable, i.e., total score of CSR, increases by 3.919 following an increase of 1 in the predictor variable, i.e., proportion of outside directors.

H1 is thus accepted, confirming a positive relationship between outside directors and CSR outcomes of firms. The relation is found to be of high statistical significance (***).

5.4. Hypothesis 2

As stated in section three, Hypothesis 2 is specified as follows: *Director shareholding will negatively moderate the impact of outside directors on the CSR outcomes of Japanese firms.* Hypothesis 2 is analyzed based on the result from model 2 including lagged variables. The moderating effect is found through the interaction term between proportion of outside directors and director shareholding (Out_Share). With a *P* value of 0.021 and beta coefficient of -0.299 it is possible to reject the null hypothesis stating zero impact of the interaction term. Thus, it can be concluded that the director shareholding reduces the effect of the proportion of outside directors on the CSR outcomes of Japanese firms. The interaction term is significant at a 0.05 level resulting in a moderate significance (**). In consequence, even though the proportion of outside directors positively affects the CSR outcome, the effect depends on the shareholdings of the board members, i.e., the higher the director shareholding the lower the impact of outside directors on the CSR outcomes.

5.5. Hypothesis 3

As stated in section three, Hypothesis 3 is specified as follows: *Financial leverage will negatively moderate the impact of outside directors on the CSR outcomes of Japanese firms.* Based on the results of model 1 without lagging the variables, the moderating effect of proportion of outside directors and financial leverage of the Japanese firms (Out_Leverage) is significant at a 0.05 level. However, after lagging the independent and control variables by one year, the interaction term is no longer significant following an increasing *P*-value of 0.185. Thus, it is not possible to reject the null hypothesis stating zero impact of the interaction term. It can be concluded that financial leverage reduces the effect of the proportion of outside directors on the CSR outcomes of Japanese firms due to the negative beta coefficient of -0.706. However, the interaction term is not significant. In consequence, even though the proportion of outside directors positively affects the CSR outcome, the effect depends on the financial leverage of the firms, i.e., the higher the leverage the lower the impact of outside directors on the CSR outcome, but the effect is not statistically significant and the hypothesis is rejected as a general statement.

The above findings and their implications are discussed in the following section.

6. Discussion

The objective of this paper is to investigate how outside directors impact the CSR outcomes of Japanese firms and further how this relation is moderated by director shareholding and financial leverage as initially posed by the research question: *How does director shareholding and financial leverage impact the relation between outside directors and the CSR outcomes of Japanese firms?*

In order to answer this research question, three hypotheses were developed and tested to analyze the relationships amongst outside directors, CSR outcomes, director shareholding, and financial leverage. As stated in section 5, the regression analysis revealed three overall relations in the conceptual framework: 1) a positive relationship between the proportion of outside directors and the CSR outcomes with statistical significance of ***, 2) a moderating effect of director shareholding on the outside director and CSR relation with statistical significance of **, 3) a moderating effect of financial leverage on the outside director and CSR relation with no statistical significance. Thus, H1 and H2 were supported and H3 was rejected.

This part is divided into three sections. The first section discusses the results of the hypotheses in the consecutive order of H1, H2, and H3. The second section discusses the theoretical and managerial implications of the results. The third section discusses the limitations of this paper and potential for future research within the intersection between corporate governance and CSR.

6.1. Hypotheses discussion

6.1.1. The relationship between outside directors and CSR

The importance of CSR has been discussed for decades in both Western and Asian societies and has been of growing concern in the Japanese context since the *CSR gannen* in 2003 as a result of increasing globalization and international pressure. Today, it is widely accepted that the CSR outcomes of firms, including those based in Japan, is essentially the product of top management's efforts to focus its resources on areas concerning CSR. In particular, the BoD of Japanese firms carry a large part of this responsibility, as they decide on the final allocation of firms' resources. Increased globalization has not only directed Japan's focus on CSR but has put pressure on the traditional corporate governance model in Japan to increase its focus on the composition of BoDs. The first hypothesized relationship looks into how the proportion of outside directors impacts the level of CSR outcomes of Japanese firms. After conducting an OLS linear regression test, the hypothesized relationship turns out as expected, i.e., H1 is confirmed. The linear regression test produced a beta coefficient of 3.919 and a P value of $<.001$.

The results of the linear regression test reveal that Japanese firms with a higher proportion of outside directors are more likely to produce better CSR ratings measured as the firms' focus on its efforts in three distinct areas, i.e. 1) human resources, 2) environment, and 3) social efforts. This outcome confirms

the assumption that outside directors of Japanese firms on average show a higher concern for all the firms' stakeholders and surrounding environment, rather than focusing solely on shareholders and profit maximization.

The relationship between proportion of outside directors and the CSR outcomes of Japanese firms is consistent with existing literature on the intersection between board independence and CSR in the *stakeholder realm*. Edward Freeman, who popularized stakeholder theory with his article from 1984 (Caroll, 1999), argues that: "Customers, suppliers, employees, financiers, communities, and managers are all key parts of today's business organization. Building and leading a great company has always been about managing for stakeholders […] if you take away the support of any stakeholder you simply do not have a viable business" (Freeman, 2011; p. 7). Yet, the findings contradict the theory of the *shareholder realm* claiming that management might overinvest is CSR (Barnea and Rubin, 2010) in order to enhance their own reputation. As Japan is known as the archetype of the stakeholder model (Sarra and Nakaghigashi, 2002; Aoki et. al., 2007; Jacoby, 2018), the positive relationship between board independence and CSR, as found through the linear regression test, is in line with existing theory. However, as current literature on corporate governance and CSR in the Japanese context has produced limited research on the impact of board independence on CSR outcomes, at least in the English language, it is not possible to compare the findings to literature on corporate governance and CSR in the Japanese context.

6.1.2. The moderating effect of director shareholding

While in the realm of stakeholder theory, outside directors are believed to decrease the self-interest of insiders resulting in an increased concern for all stakeholders, the provision of company shares is believed to work the opposite way by satisfying the self-interest of insiders increasing an isolated concern of shareholders. Providing the board members with shares might motivate them to overlook opportunistic behaviors if they result in profit maximization. The second hypothesized relationship looks into how director shareholding moderates the relationship between the proportion of outside directors and the level of CSR outcomes. After conducting an OLS linear regression test, the hypothesized relationship turns out as expected, i.e. H2 is confirmed. The linear regression test produced a beta coefficient of -0.299 and a P value of $<.05$.

The results of the linear regression test reveal that Japanese firms with shareholding board members are less likely to produce higher CSR ratings despite its potentially high proportion of outside directors compared to firms where shareholding of board members are lower. This outcome confirms the assumption that the provision of shareholdings to board members results in misaligned interests among the members, where the shareholding members might seek profit maximization making it more challenging for outside directors to decrease the self-interest of the general board.

The moderating effect of director shareholding is in line with the theoretical literature within the *stakeholder realm*, where the provision of shares potentially creates agency problems within the corporations as top management, including the BoDs, may gain an incentive to “manipulate earnings, time the release of information, and select investments that increase the short-term stock price, perhaps at the expense of intrinsic firm value” (Kato et. al., 2005; p. 439). Despite the consistency within existing theoretical literature, limited empirical research has been carried out measuring the moderating effect of director shareholding. Previous studies have found that the provision of shares to outside directors increase the market-to-book ratio, ROA, and capital expenditures over sales, and that the adoption of such plans is met with positive investor reactions when announced by the firm (Fich and Shivdasani, 2005). Another study found that the provision of shares to outside directors is positively related to firms’ growth opportunities and institutional stockholdings – components that are aligned with the interest of shareholders. The provision of company shares to outside directors has been found to be negatively related to the number of business segments and regulations, which are assessed as important not only for shareholders but for several stakeholders (Bryan et. al., 2000). The existing literature within the provision of company shares to BoD is limited in terms of context and level of analysis. E.g., both studies are based on data from a U.S. context and are concerned with the provision of shares to outside directors only, not the provision of shares to board members in general. It is therefore difficult to compare the findings in H2 with current literature as the area, to the best of the authors knowledge, has not yet been explored in this specific context.

6.1.3. The moderating effect of financial leverage

Again, operating within the realm of stakeholder theory, several scholars have suggested that a firm’s desire to invest in CSR activities eventually depends on the availability of resources within the firm, establishing a positive link between financial performance and CSR. As stakeholders involved with a highly leveraged firm may suffer from additional costs (Titman, 1984; Mishra and Modi, 2012) they might reconsider their level of commitment towards such a firm, potentially resulting in lower stakeholder commitment for firms with high liquidity. Furthermore, highly leveraged firms may incur greater risk resulting from high interest expenses resulting in reduced availability of funds to implement CSR activities within the firm. The third hypothesized relationship looks into how financial leverage moderates the relationship between the proportion of outside directors and the level of CSR outcomes. After conducting an OLS linear regression test, the hypothesized relationship, i.e., H2, is rejected with a P value of 0.185.

As the linear regression test produced a beta coefficient of -0.706 one could infer that highly leveraged Japanese firms are less likely to produce higher CSR ratings despite a higher proportion of outside directors compared to firms with lower financial leverage. This outcome confirms the assumption about the *direction*

of the moderation, i.e., that financial leverage of firms results in *less* available funds for investment in CSR activities. However, with a P value of >0.1 the relation is not statistically significant.

The direction of the moderating effect of firms' financial leverage on the relationship between outside directors and CSR is consistent with the theoretical literature within the stakeholder realm, claiming that the commitment to CSR eventually depends on the financial resources of the firm. Most previous studies investigating the relationship between financial performance and CSR have chosen different measurement for the former, e.g., ROA, loan losses, firm value, ROE, return on sales etc., whereas the measure of financial leverage has remained limited. As previously mentioned, existing literature on the relation between financial performance and CSR has produced inconsistent results, showing both positive, negative, and non-existent, relationships (Fernández-Gago et. al., 2016). The results from H3, despite its non-significance is consistent with the empirical research finding a positive link of financial performance on CSR activities, such as Waddock and Graves (1997), Simpson and Kohers (2002), and Fernández-Gago et. al. (2016).

6.2. Theoretical implications

This paper joins previous scholars of stakeholder theory and contradicts scholars operating within the shareholder realm. The findings of this paper are consistent with theories and findings of, e.g., Fernández-Gago et. al. (2014), Harjoto and Jo (2012), Ibrahim et. al. (2003), and Wang and Coffey (1992) in regard to the relationship between outside directors and CSR outcomes of firms on an empirical level, and consistent with their theoretical arguments in regard to the moderating effect of director shareholding and the financial leverage of firms.

By addressing the link between corporate governance and CSR in the Japanese context including two moderating variables in the statistical analysis, this paper contributes to advancing beyond the Western dominated literature and level of sophistication of the relations. Even though some researchers have begun to consider CSR in an Asian context, the relationship between outside directors and CSR has remained relatively under-investigated (Chang et. al., 2015). In response to a lack of understanding of the link between corporate governance and CSR in an Asian context, this paper seeks to confirm that the stakeholder theory can be used to establish such understanding in Japan.

6.3. Managerial implications

This paper builds upon the fields of corporate governance and CSR and further touches upon how the relationship between outside directors and CSR is potentially impacted by director shareholding and financial leverage. The results reveal that the proportion of outside directors has a significant impact on the CSR ratings of the firms, suggesting that a higher proportion of outside directors have a positive impact on such CSR ratings in relation to three areas: 1) human resources, 2)

environment, and 3) social efforts. This suggest that Japanese firms can choose outside directors as a potential tool for increasing their efforts in CSR, confirming a popular recommendation for improving social performance of firms (Coffey and Wang, 1998).

Despite outside directors' positive effect on the CSR ratings of Japanese firms, having directors with shareholdings serving on the board decreases this effect. Therefore, in order to obtain the maximum possible benefit in regard to CSR from appointing outside directors to the board, firms should bear in mind that allowing shareholdings for directors can decrease these possible benefits.

6.4. Limitations and future research

6.4.1. Limitations

Although this paper provides some important theoretical and managerial implications, the findings must be interpreted with care, since the research is subject to certain limitations. More specifically, this paper suffers from at least three limitations of: composition of sample, measurement of CSR, and distinction of board independence. These three limitations are discussed below.

First, the sample chosen for analysis is restricted to listed Japanese companies operating within the chemical industry from 2010–2020, using the limited information available from the databases of Toyo Keizai, i.e. Yakuin Shikihō and CSR Kigyō Sōran as well as the database of Yukashoken-Hokokusho. Focusing on a single industry within a single country limits the generalizability of the findings, as they are mainly applicable within the chemical industry in Japan. In addition, previous scholars have suggested that different geographical areas provide different institutional contexts, potentially influencing the relationship between corporate governance and CSR (Mishra and Modi, 2013). Thus, the moderating effect of director shareholding on the link between outside directors and CSR might only be present among Japanese firms due to different models of corporate governance depending on country specific contexts such as the applicability of shareholdings, which remains a relatively small percentage of total compensation for the BoDs compared to, e.g., the U.S. (Zenichi Shishido, 2007).

Another limitation is the CSR ratings of Toyo Keizai in their CSR Kigyō Sōran publication. Although the publication provides information on a relatively large sample of firms covering all major listed and unlisted companies in Japan over a longitudinal time period, it suffers from the limitation of being Toyo Keizai's own assessment of the firms' CSR activities based on surveys and in-house analysis. As Graafland et al. (2004) reported, a solution to this may be to rely on the judgement of a third party or include direct feedback from stakeholders, which has not been included in this paper. Furthermore, as there is no overall agreed upon objective measurement of CSR, several other metrics could have been included to measure CSR and there is no guarantee that Toyo Keizai captures all of the metrics of CSR.

The last, probably most important, limitation of this paper is the missing distinction between outside directors and independent directors. For the purpose of this paper, only outside directors have been used as point of departure for measure the BoDs impact on CSR. As previously outlined, the Japanese Corporate Governance Code clearly states the difference between outside and independent directors. The distinction depends on the degree to which independent directors have a higher degree of independence compared to outside directors. Following the Companies Act Reform in 2014, companies were asked to appoint at least one outside director to its BoD or explain why they failed to do so. A year later, in the Japanese Corporate Governance Code of 2015, Japanese companies were required to appoint at least two independent directors, showing a clear distinction between independent and outside directors and their different functions. Thus, it is important to acknowledge the limitation of excluding potential impact from independent directors on CSR of Japanese firms.

6.4.2. Future research

Not only should the limitations of this study be acknowledged, they also provide opportunities for future research. Additional insights could be provided by expanding on the sample, e.g., by looking into other industries or countries with different institutional contexts and thus potentially establishing a higher degree of generalizability. Future research could also include evaluation from important stakeholders of the firms in regard to CSR evaluations instead of relying on only one source of evaluation. Last and most interestingly, future studies on corporate governance and its impact on CSR in Japan could look into the differences between outside and independent directors and their potentially different impact on CSR outcomes of firms.

7. Conclusion

The aim of this paper was to contribute with findings on how the relationship between outside directors and CSR outcomes of Japanese firms is impacted by director shareholding and financial leverage. This was done by investigating listed Japanese firms operating within the chemical industry from year 2010–2020, comprising 708 firm-years, after lagging the independent and control variables.

In order to answer the stated research question, three hypotheses were developed and tested. The hypotheses sought to identify 1) the relation between the proportion of outside directors and CSR ratings, as well as the potential impact on this relationship from 2) the moderating effect of director shareholding, and 3) the moderating effect of financial leverage. The hypotheses were tested through two models of OLS regression, one including lagged independent and control variables, making it possible to confirm two out of three hypotheses.

The results suggest that outside directors have a positive impact on the CSR activities in Japanese firms, confirming the assumption that outside directors carry a greater concern for the external environment of firms. In addition, it was found that director shareholding reduces the positive effect of outside directors. Thus, even though outside directors may have a greater concern for the firms' external environment, the engagement in CSR activities will be constrained by shareholding directors serving on the board. At last, even though a moderating effect of financial leverage was found to decrease the impact of outside directors on CSR ratings, such effect could not be significantly established, and the hypothesis was rejected.

Further research within the area is called for. There is still a lack of non-Western literature investigating the relation between corporate governance and CSR. Bringing an Asian, such as Japanese, perspective to light may influence environmental and social change in a positive way. As an example, the current literature could benefit from a broader industry view and a distinction between outside and independent directors in Japanese corporations and their potentially different impact on CSR.

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