

**Doctoral Dissertation (2020)**

**A mixed methods analysis of root causes of  
corporate frauds in Japan:  
board composition and internal power factors**

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## ABSTRACT

Until recently, corporate frauds have been mainly examined in relationship with explicit, external, and formal factors such as board composition, percentage of outside directors and/or independent chairmen, committee structure, and company performance. In contrast, the present work sheds light on the implicit, internal, and informal factors associated with the occurrence of corporate frauds to uncover the entire picture of these frauds from the inside and the outside.

Herein, quantitative analysis is used to empirically test whether board homogeneity can affect the occurrence of frauds in companies listed in the first section of the Tokyo Stock Exchange. According to the results of panel regression analyses performed between 2015 and 2019, an increase in the proportion of lifetime directors (i.e., those who joined the company as fresh graduates) significantly increases the frequency of corporate fraud occurrence, while an increase in the proportion of outside directors does not significantly help to prevent fraud. Moreover, board homogeneity is shown to negatively affect board decision-making on dealing with frauds and eventually increase their occurrence frequency, particularly in the case of organizational frauds.

Qualitative content analysis of 133 third party reports on corporate frauds identified four categories of internal power factors (*position power, informal power, perceived power, and neglect*) and revealed how they can strengthen each factor of the so-called fraud triangle (*opportunity, pressure, and rationalization*) to promote the occurrence of frauds and their concealment.

**Keywords:** frauds, corporate governance, board diversity, board composition, financial indicators,

lifetime directors, homogeneity, power, cover-up

## **Chapter 1      INTRODUCTION**

In Japan, the number of disclosed accounting frauds doubled over the past 10 years (Tokyo Shoko Research, January 24, 2019), as exemplified by the fact that numerous holding companies have experienced frauds at their foreign subsidiaries. In response to these issues and as a follow-up measure of the Corporate Governance Code issued in 2015, the Japanese government has enacted guidelines regarding the group governance system in June 2019. Accordingly, leading proxy advisory firms, Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., LLC (Glass Lewis) have elevated the level of advice policies on the exercise of voting rights to strengthen corporate governance among the listed companies. In March 2018, Japan Exchange Regulation (JPX-R) formulated preventive measures of frauds. However, these measures proved to be ineffective, and the number of frauds reached its maximum in 2019.

As described further in the next theory review section, cases of corporate fraud have been independently examined from the perspectives of accounting and finance, economics, governance, and psychology, as exemplified by studies of relationships between corporate fraud and financial ratios. Additionally, recent fraud studies show mixed results in terms of which factor actually helps to lessen corporate fraud. Furthermore, regardless of the significance of formal and informal power in an organization, several researchers have considered the relationship between power and fraud. The lack of comprehensive studies on corporate fraud, mixed findings in recent literature, and only a few



focusing on power behind corporate frauds served as motivation for the present work, as it is clear that there is a need for further research in this area. More importantly, there are a few studies focusing on corporate fraud in the Japanese context, regardless of their distinct uniqueness. Therefore, I aim to propose theoretical findings as well as practical insights on how to tackle an increase in corporate fraud in the Japanese context. Furthermore, this study would hopefully contribute to the broader, global context as well, through shedding light on new factors and aspects related to corporate fraud. In view of the above, the present study aims to deepen our understanding of *why* and *how* corporate frauds happen in Japan by identifying factors associated with the occurrence of corporate frauds and their underlying mechanism, helping CEOs and stakeholders to predict and prevent frauds.

Frauds are defined as deliberate actions taken by management at any level to deceive, con, swindle, or cheat investors or other key stakeholders (Zahra et al., 2005), thus having a broad variability. The present work covers all kinds of frauds, including those associated with accounting, misconduct, crimes, corruption, embezzlement, insider deals, data falsification, unfair deals, antitrust violations, and other legal violations.

Chapters 2 and 3 present the results of quantitative and qualitative analyses, respectively, dealing with theory review, hypothesis development/research questions, methods, and (empirical) results, while the concluding Chapter 4 summarizes the theoretical contributions and managerial implications of this study and provides limitations and suggestions for future research.

## **Chapter 2      QUANTITATIVE ANALYSIS**

### **2.1      THEORY REVIEW**

Over the past decades, corporate frauds have been independently examined from the perspectives of accounting and finance, economics, governance, and psychology, as exemplified by studies of relationships between corporate frauds and financial ratios. The empirical investigation of fraud risk was pioneered by Calderon and Green (1994), who used publicly available information to construct a fraud model (Lou and Wang, 2009). Persons (1995) probed the effect of financial ratios on the likelihood of fraudulent financial reporting and identified financial leverage, capital turnover, asset composition, and company size as significant factors for fraud occurrence (Lou and Wang, 2009).

Frauds have also been examined over decades using the agency theory, stewardship theory, cognitive evaluation theory, and the behavioral agency theory. The agency theory highlights the notion that dedicated investors can heighten managerial concerns regarding being caught for wrong-doing, thus mitigating the likelihood of financial fraud (Shi et al., 2016). Therefore, close monitoring and low levels of information asymmetry should constrain self-serving managerial manipulations of financial information by increasing the risk of detection (Hadani, Goranova and Khan, 2011). As an alternative to the agency theory, psychologists and sociologists (e.g., Arthurs and Busenitz, 2001; Syndaramurthy and Lewis, 2003) have put forward the stewardship theory, which focuses on intrinsic motivation and enabling managers rather than controlling them (Albrecht, 2004). Furthermore, the cognitive

evaluation theory, designed to explain the effects of external consequences on internal motivation, has been used in numerous empirical researches since 1964. Schweitzer, Ordonez, and Douma (2004) concluded that high performance expectations by security analysts can actually lead to fraudulent behavior owing to the increased pressure perceived by leaders. The recently developed behavioral agency theory incorporates cognitive biases into agency theory assumptions on internal governance, therefore directing less attention to external governance (Wiseman and Gomez-Mejia, 1998). Pepper and Gore (2015) claimed that the behavioral agency model reevaluates the original agency theory and places particular emphasis on internal governance and executive compensations. Many empirical studies confirmed the existence of relationships between fraud occurrence frequency and board composition. Typical board composition variables include the percentages of outside directors and independent outside directors, the presence of audit, compensation and nomination committees, and the number of meetings held annually by the board of directors and each committee. Beasley (1996) concluded that no-fraud companies have boards with a significantly higher percentage of outside members than fraud companies. Furthermore, Uzun, Szewzyk, and Varma (2004) found that the presence of audit/compensation committees and their independence are significantly related to fraud occurrence.

Psychologists have attempted to explain the causes of frauds for years, with the two most cited theories being the fraud triangle theory of Cressey (1950) (Figure 1) and the fraud diamond

theory of Wolfe and Hermanson (2004) (Figure 2) (Abdullahi, Mansor and Nuhu, 2015).

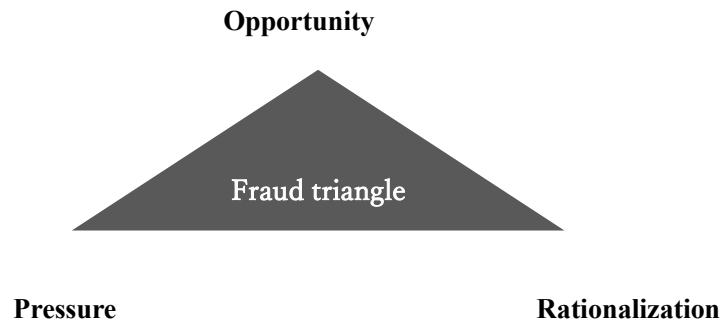
Cassey first proposed his fraud triangle theory in a book called “Other People’s Money: A Study in the Social Psychology of Embezzlement” in 1953 and concluded that “trusted persons become trust violators when they conceive of themselves as having a financial problem which is non-shareable, are aware that this problem can be secretly resolved by violation of the position of financial trust, and are able to apply to their own conduct in that situation verbalizations which enable them to adjust their conceptions of themselves as trusted persons with their conception of themselves as users of the entrusted funds or property” (Cressey, 1953). According to Lou and Wang (2009), the fraud triangle indicates pressure/incentive to perpetrate fraud, opportunity to carry out the fraud, or attitude/rationalization to justify fraudulent action. If these three factors come together, even ordinary people can commit frauds.

Wolfe and Hermanson proposed the fraud diamond theory in the CPA Journal in 2004, arguing that “in addition to addressing incentive, opportunity, and rationalization, the four-sided ‘fraud diamond’ also considers an individual’s capability: personal traits and abilities that play a major role in whether fraud may actually occur even with the presence of the other three elements. In other words, opportunity opens the doorway to fraud, and incentive (i.e., pressure) and rationalization can draw a person toward it. However, the person must have the capability to recognize the open doorway as an opportunity and to take advantage of it by walking through, not just once, but repeatedly” (Abdullahi,

Mansor and Nuhu, 2015).

**Figure 1: Fraud triangle.**

(Source: Wells J.T., “Occupational Fraud and Abuse”, Obsidian Publishing Co., 1997)



**Figure 2: Fraud diamond.**

(Source: Wolfe, D.T. and Hermanson, D.R., “The Fraud Diamond: Considering the Four Elements of Fraud”, CPA Journal, 2004)



Recently, governance scholarship has revealed several contradicting findings. For instance, according to Schnatterly (2018), the effect of tenure remains unclear. It appears that the CEO's

opportunity for wrongdoing decreases as boards become more experienced and knowledgeable, but increases as friendships with board members develop (Boivie et al., 2016; Brown et al., 2017; Donoher et al., 2007). Zahl et al. (2005) reviewed the role of directors and its influence on fraud, generally concluding that weaker governance mechanisms and passive boards increase the likelihood of fraud. However, these authors also noted conflicting findings regarding the effectiveness of outside directors. Agrawal and Chadha (2005) found that several key governance characteristics such as board and audit committee independence are essentially unrelated to the probability of a company restating its earnings.

As an extension, the recently presented insider-outsider studies of corporate governance (e.g., Heracleous, 2008; Wagner, 2002; and Chaganti, 1985) have examined relationships between board characteristics and organizational performance, providing mixed results. Heracleous (2008) concluded that the relationship between two such “best practices” (CEO/chair duality and insider/outside composition) and organizational performance is insignificant. Wagner (2002) suggested the existence of a curvilinear homogeneity effect, according to which performance is enhanced by the greater relative presence of either inside or outside directors. Chaganti (1985) argued that non-failed retailing companies, as compared to failed ones, tend to have bigger boards within the size range suggested by activists and that the differences in the percentage of outside directors and multiple offices held by CEOs between the failed and non-failed companies are not significant. These mixed findings motivated the present work, as they clearly show the need for further research in this

area.

Furthermore, although a predictive model considering a single aspect is apparently insufficient (Lou and Wang, 2009), few related multi-aspect approaches have been reported thus far. Therefore, this study makes the following contributions to the field of corporate fraud analysis. First, corporate frauds are examined from multiple (governance, organizational behavior, and psychology) aspects both quantitatively and qualitatively to obtain a comprehensive understanding of the underlying fraud mechanism. Second, new independent variables (e.g., the percentage of lifetime directors and that of directors with postgraduate degrees) strongly related to corporate frauds are identified, which makes an important contribution to the behavioral agency model. Third, Japanese frauds are comprehensively analyzed according to fraud type and industry, and their mechanism is revealed by careful analysis of third-party committee reports on corporate frauds. Specifically, this qualitative study identifies new internal power factors leading to the occurrence of corporate frauds (as an extended implication of the fraud triangle and fraud diamond theories) and their mechanism, which have not yet been discussed thus far.

## 2.2 HYPOTHESIS DEVELOPMENT

Considering Japan's unique culture, new independent variables indicative of Japan's unique board homogeneity (e.g., the percentage of lifetime directors who joined the company as fresh graduates, the educational backgrounds of directors with postgraduate degrees, and the average age of directors) were examined in addition to traditional variables such as the percentages of outside directors and outside auditors.

After 2015, when the Corporate Governance Code requested listed companies to have two or more independent outside directors, most Japanese listed companies started to search for outside directors earnestly and not as a formality. The aim of requesting independent outside directors is (i) the supervision of management and potential conflicts of interest between the company and stakeholders as well as (ii) the representation of broader stakeholders' interests to the board meeting from an independent standpoint (Revised Corporate Governance Code, June 1, 2018). The Revised Corporate Governance Code (2018) requested that listed companies should assign at least two independent outside directors and further recommended assigning a sufficient number of independent outside directors beyond just two if there is a need to do so. Nonetheless, a corporate governance survey conducted by the Japan Association of Corporate Directors in August 2019 showed that among the companies listed in the first section of the Tokyo Stock Exchange, only 43.9% of boards held one third or more independent directors, revealing that many companies still employ "gray" (i.e., non-



independent) outside directors. Examples of “gray” outside directors include family members, former employees, and lawyers and consultants who have or had some relations with the company, i.e., people who are not independent. Given their business or family ties to the company, gray directors are less likely to strictly monitor management than truly independent directors (Uzun, Szweczyk and Varma, 2004). As a result, outside directors are less likely to play the expected appropriate “monitoring” roles, which reduces the likelihood of fraud occurrence in Japanese companies. Furthermore, Japanese companies currently struggle to find the right and competent outside directors because of the lack of the corresponding candidate pool. Unlike the US and the UK, where the outside director market is mature and highly competitive, Japan currently needs to foster a larger group of candidates for outside directors. In this situation, it is less likely that every outside director can play a pivotal role in his or her company’s critical governing decisions. Therefore, it was hypothesized that when it comes to preventing or letting corporate frauds happen in Japan, internal directors rather than outside directors matter. Accordingly, the following hypotheses were quantitatively tested.

***Hypothesis 1a. Lifetime director percentage is positively correlated with corporate fraud likelihood.***

Henceforth, a lifetime director is defined as an individual who joined the company as a fresh graduate and worked his way up to the top table. The lifetime director percentage is viewed as a proxy for board homogeneity.

Board diversity has always been a keen agenda but remains a goal yet to achieve.

Homogeneous boards make it difficult for a minority member to speak up things that can contradict the group consensus and/or interests, particularly in the Japanese culture where “seniority matters” and “silence is gold”. Therefore, the following hypothesis was put forward:

***Hypothesis 1b. The percentage of outside directors has no significant effect on the likelihood of corporate fraud.***

The importance of seniority in Japan is due to several reasons, having its roots in Confucianism, which highly values seniority and respects seniors as masters of life, and originating from the traditional system of recruiting students in science and engineering majors. Historically, students in these majors can apply for jobs in two ways, namely openly or by recommendation from his/her university (i.e., laboratory professor). As a result, ~20% of students with science and engineering majors opt for the recommendation method (Disco Caritas Research, 2018). The Japanese lifetime employment system makes their relationships from university, graduate, or post-graduate days continue throughout their careers, which helps to create tightly connected and closed in-house communities where seniority matters. According to Hirschman’s (1970) “Exit, Voice and Loyalty,” an exit from such a group just because the person disagrees with the government policies is an exceedingly costly and painful process (Dowding, John, Mergoupis and Van Vugt, 2000). Combined with the currently illiquid job market, such a simple exit is not a realistic option for Japanese employees.

In Japan, the code of silence is omnipresent at all levels because of the high-context culture, with homogeneous groups being more affected than diversified ones. Stoddard (1968) claimed that corrupt behavior is socially conditioned and shaped by the “code of silence” rather than by individuals. In a homogeneous setup, negative peer pressure to conform with group interests can lead to silence and fraud cover-up/commitment for the sake of short-term company interests, as the company interest comes before the individuals’ morale. Accordingly, the two abovementioned hypotheses were quantitatively tested.

In the next step, specifics such as fraud types and fraud industries are discussed to present a comprehensive picture of frauds in Japan.

Fraud types are subject to broad variability. SUSTAINA is a fraud database providing details on all kinds of frauds committed since 2015 and using the fraud type classification given in Table 1. According to this database, a total 430 frauds could be broken down into 17 fraud types (Table 1), namely those related to accounting, anti-trust violation and collusion, data falsification, legal violation, data leakage and security issues, labor issues and accidents, crimes, illegal trades, embezzlement, insider deals, lawsuit, breed graft and corruption, mistaken charge, (inappropriate) product services, governance issues, and inappropriate production.

**Table 1: Fraud type classification.**

Code	Fraud type
1	Accounting
2	Anti-trust violation and collusion
3	Data falsification
4	Legal violation
5	Data leakage and security issues
6	Labor issues and accidents
7	Crimes
8	Illegal deals
9	Embezzlement
10	Insider deals
11	Lawsuit
12	Breed graft and corruption
13	Mistaken charge
14	Product services
15	Governance issues
16	Inappropriate production
17	Others

**Table 2: Seventeen industry classes according to the Tokyo Stock Exchange.<sup>1</sup>**

Code	Industry class	Included industries
1	Food	Food, fishery, agriculture, and forestry
2	Energy resources	Mining, oil, and coal
3	Construction and materials	Construction, metallic and glass products
4	Chemicals and fabrics	Fiber, pulp, paper, chemicals
5	Pharmaceutical products	Pharmaceutical products
6	Automobile and aircraft	Rubber products, transportation equipment
7	Steel and non-ferrous	Steels and non-ferrous metals/alloys
8	Machinery	Machinery
9	Electronics and precision machinery	Electronics
10	Information and communication	Information and communication, services, other products

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<sup>1</sup>Source: Tokyo Stock Exchange

Code	Industry class	Included industries
11	Electricity and gas	Electricity and gas
12	Transportation and logistics	Land, maritime, air transportation, warehousing
13	Trading and wholesale	Trading and wholesale
14	Retail	Retail
15	Banking	Banking
16	Finance (excluding banking)	Securities, insurance, and other finance
17	Real estate	Real estate

Rasha and Andrew argued that the motive to commit fraud is often associated with personal pressures or corporate pressures on the individual (Rasha and Andrew, 2012). Wolfe and Hermanson, the founders of the fraud diamond theory, stated that many financial reporting frauds are committed by subordinates reacting to an edict from above to "make your numbers at all costs, or else" (Wolfe and Hermanson, 2014). Stoddard (1968) claimed that corrupt behavior is socially conditioned and shaped by the "code of silence" rather than by individuals. Thus, the above arguments suggest that in certain situations, frauds happen because of external pressure on the individual and not necessarily because of the personal motives or incentives arising from the individual himself/herself.

Depending on the fraud agent characteristics, the above fraud types can be classified as either individual or organizational. Individual frauds are committed by an individual or a small number of individuals in his/her own interests and are expected to occur across all industries, as it is hard to assume that a certain industry has a higher percentage of suspects for these frauds. Conversely,

organizational frauds can only happen when a group of people in the company get involved for its sake and put corporate pressure over individuals in one way or another. Representative organizational frauds are therefore associated with accounting, data falsification, and anti-trust violation. Accounting frauds can potentially happen everywhere, but data falsification and anti-trust violation seem to be associated with certain industries. Therefore, assuming that the organizational fraud ratio is higher in certain industries where corporate pressure is higher, the fraud ratio<sup>2</sup> was hypothesized to depend on the type of industry.<sup>3</sup>

So, which industries tend to have higher corporate pressure? As argued earlier, one can hypothesize that industries with higher homogeneity (i.e., those characterized by silence and corporate pressure) experience a higher fraud ratio. Thus, the potential markers would be a long-standing corporate history, low employee turnover, relatively fixed organizational structure, longer product life-cycle, and a traditional Japanese corporate culture. According to Clark's (1953) industry classification, secondary-sector industries<sup>4</sup> better fit these characteristics than primary-<sup>5</sup> and tertiary-sector<sup>6</sup> industries. Specifically, secondary-sector industries include manufacturing, construction, and electricity and gas, i.e., process the produce of primary-sector industries. Therefore, fraud ratio was

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<sup>2</sup>Fraud ratio is calculated as the number of total fraud incidents between 2015 and 2019 divided by the total number of targeted companies listed in the first section of the Tokyo Stock Exchange between 2015 and 2019.

<sup>3</sup>The Tokyo Stock Exchange defines and assigns one of the 17 industry codes to each listed company.

<sup>4</sup> Manufacturing, construction, and electricity and gas

<sup>5</sup> Agriculture, forestry, mining, and fishery

<sup>6</sup> Retail, services, financial services, and information communication

hypothesized to be higher in secondary-sector industries than in primary- or tertiary-sector ones.

*Hypothesis 2a. There are significant differences in fraud ratio across industries.*

*Hypothesis 2b. Fraud ratio is significantly higher in secondary-sector industries such as manufacturing, construction, and electricity and gas.*

## 2.3 DATA AND METHODS

### 2.3.1 Hypotheses 1a and 1b

#### Data

The sample used to test the above hypotheses consisted of 1,652 companies listed in the first section of the Tokyo Stock Exchange between 2010 and 2019. The 430 frauds committed between 2015 and 2019 were used as countable dependent variables (DVs), while the details of the 134,438 directors of the targeted listed companies between 2010 and 2016 were used as the independent variables (IVs) of internal governance, and various financial indicators were used as control variables (CVs). As this research aimed to examine the impact of prior internal governance on fraud occurrence, a panel data sample by year was created as follows (Table 3).

**Table 3: Data availability by year (x=sample data collected).**

Year	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
<b>DVs:</b> Frauds						x	x	x	x	x
<b>IVs:</b> Prior internal governance indicators	x	x	x	x	x	x	x			
<b>CVs:</b> Prior financial indicators	x	x	x	x	x	x	x	x	x	



## **DVs**

Companies with a track record of frauds were obtained from multiple sources in view of the absence of a single comprehensive database. The first of these sources is Tokyo Shoko Research, a leading provider of corporate information that has disclosed accounting fraud details since 2008. The second source is SUSTAINA, a membership research database focusing on Environmental, Social, and Governance (ESG), Corporate Social Responsibility (CSR), and frauds of all kinds since 2015. The third source is daisanshaiinkai.com, a database owned by a tax advisory company that publishes all third-party committee reports of listed company frauds since 2012. The three sources were used to create a comprehensive database of frauds (430 in total) that occurred in 2015–2019 at companies listed in the first section of the Tokyo Stock Exchange.

## **IVs**

As regards internal governance indicators, Toyo Keizai Yakuin Shikiho (Toyo Keizai Directory of Executive) provides detailed information on the directors of listed companies, including birth year, gender, and educational background (e.g., *alma mater*, company joining year, position title, etc.). The data provided by Toyo Keizai Yakuin Shikiho for 2010–2016 were used as the first group of IVs, i.e., prior internal governance indicators.

## **CVs**

Financial indicator data obtained from the Nikkei NEEDS database for the period of 2010–

2018 were used as CVs. The collected data included current ratio, fixed ratio, equity ratio, debt ratio, equity ratio growth versus previous year, return on equity, sales growth ratio versus previous year, net profit ratio, and net profit growth ratio versus previous year.

### Model

As the sample data (numerical panel data with countable DVs) were unbalanced, the following mixed linear model was applied as described below, and frauds were shown to be rare events, as follows from the descriptive statistics in Table 4. To address this skewed dataset with DVs tending toward zero, Poisson regression was performed, and the obtained results supported the validity of the mixed linear model (Table 5 and Table 7).

$$Y_{it} = \alpha_0 + \beta_i X_{it} + \alpha_i + \gamma_t + e_{it}.$$

Assuming that the individual effect  $\alpha_i$  and the time effect  $\gamma_t$  both equal zero, the above equation becomes

$$Y_{it} = \alpha_0 + \beta_i X_{it} + 0 + 0 + e_{it}.$$

$$\begin{aligned} \text{FRAUD}_{it} = & \alpha_0 + \beta_{it} \times \% \text{LIFETIMEDIR} + \beta_{it} \times \% \text{OUTSIDEDIR} + \beta_{it} \times \% \text{OUTSIDEAUDIT} + \beta_{it} \\ & \times \% \text{HIGHSCHOOLGRADDIR} + \beta_{it} \times \% \text{POSTGRADDIR} + \beta_{it} \times \% \text{FORGRADDIR} + \beta_{it} \\ & \times \% \text{AVGDIRAGE} + \beta_{it} \times \% \text{CURRENT} + \beta_{it} \times \% \text{FIXED} + \beta_{it} \times \% \text{EQUITY} + \beta_{it} \times \% \text{DEBT} + \beta_{it} \\ & \times \% \text{EQUITY GROWTH} + \beta_{it} \times \% \text{ROE} + \beta_{it} \times \% \text{SALESGROWTH} + \beta_{it} \times \% \text{PROFIT} + \end{aligned}$$

$$\beta_{it} \times \%PROFITGROWTH + e_{it}$$

$i$  = company 1 through 1,652

$t$  = time period from 2010 through 2019

FRAUD = countable variable equaling the number of frauds a company is alleged to have experienced in a year (0–5). **[DV]**

%LIFETIMEDIR = percentage of lifetime directors who joined the company as fresh graduates **[Internal Governance Indicators IV]**

%OUTSIDEDIR = percentage of board members who are non-employee directors **[Internal Governance Indicators IV]**

%OUTSIDEAUDIT = percentage of board members who are non-employee auditors **[Internal Governance Indicators IV]**

%HIGHSCHOOLGRADDIR = percentage of directors with a high school degree **[Internal Governance Indicators IV]**

%POSTGRADDIR = percentage of directors with a domestic (Japanese) postgraduate degree **[Internal Governance Indicators IV]**

%FORGRADDIR = percentage of directors with a foreign university degree **[Internal Governance Indicators IV]**

%AVGDIRAGE = average age of all directors **[Internal Governance Indicators IV]**

%CURRENT	= current ratio [CV]
%FIXED	= fixed ratio [CV]
%EQUITY	= equity ratio [CV]
%DEBT	= debt ratio [CV]
%EQUITY GROWTH	= equity growth ratio against the previous year [CV]
%ROE	= return on equity [CV]
%SALES GROWTH	= sales growth ratio against the previous year [CV]
%PROFIT	= net profit ratio [CV]
%PROFITGROWTH	= net profit growth ratio against the previous year [CV]

### 2.3.2 Hypotheses 2a and 2b

#### Data

The sample used to test the above hypotheses consisted of 1,652 companies listed in the first section of the Tokyo Stock Exchange between 2010 and 2019. The total numbers of fraud incidents by company listed in the first section of Tokyo Stock Exchange between 2015 and 2019 were used as DVs. Seventeen industries defined by the Tokyo Stock Exchange (Table 2) were used as dummy variables. Details of the 134,438 directors of the targeted listed companies between 2010 and 2016 (provided by Yakuin Shikiho) were used as CVs.

#### Model

Poisson's regression analysis was conducted using the dummy variables for 17 industry classes. This regression was performed in preference to the standard multiple regression to address the highly skewed (toward zero) datasets of DVs.

$$\ln(\lambda) = \beta_0 + \beta_1 X_1 + \dots + \beta_{17} X_{17} + e$$

$\lambda$  = theoretical total number of fraud incidents by company in the first section of Tokyo Stock Exchange between 2015 and 2019 **[DV]**

$\beta_0$  = constant

$\beta_{1-17}$  = partial regression coefficient for industry codes 1–17

$X_{1-17}$  = countable dummy variable equaling unity when a company can be assigned to one of the

industry classes 1–17 (Table 3) and equaling zero otherwise [IV]

## 2.4 EMPIRICAL RESULTS

### 2.4.1 Hypotheses 1a and 1b

Hypothesis 1a states that the percentage of lifetime directors is positively correlated with the likelihood of corporate frauds. The estimated coefficient for this IV (Table 5) was positive ( $\beta = 0.008337, p < 0.05$ ), which supported the validity of the above hypothesis.

Hypothesis 1b, which states that the percentage of outside directors on the board is not significantly correlated with the likelihood of corporate frauds in companies listed in the first section of Tokyo Stock Exchange, was also supported by the results listed in Table 5. However, I acknowledge that the coefficient for outside directors is marginally significant.

Overall, one can conclude that when it comes to the likelihood of corporate frauds in Japan, internal directors have a larger influence than outside directors, and that board homogeneity (evaluated in terms of the percentage of lifetime directors) is positively correlated with the occurrence of corporate frauds. These findings support the behavioral agency model with particular emphasis on internal governance, allowing one to predict the relationships between frauds and board composition. Thus, internal factors do matter.

**Table 4: Descriptive statistics.**

Variable	<i>N</i>	Minimum	Maximum	Mean	Std. Deviation
FRAUD	430	0	5	.03	.191
% lifetime directors	10,453	0	1.0	.35224	.35429
% outside directors	10,453	0	1.0	.29412	.11245

% outside auditors	10,453	0	1.0	.20491	.07631
% directors graduating from high schools	10,453	0	1.0	.38621	.39387
% directors graduating from domestic graduate schools	10,453	0	1.0	.05002	.08692
% directors graduating from foreign universities	10,453	0	0.75	.01298	.04512
Average age of directors	10,362	41.3	75.25	61.58	3.5972
Current ratio	15,059	7.19	5,845.10	220.84	193.73
Fixed ratio	15,049	.56	44,724.24	118.90	395.52
Equity ratio	15,065	-139.60	99.33	50.66	19.94
Debt ratio	15,055	.65	55,924.24	160.41	592.26
Equity growth ratio	14,738	-4,593.54	2,857.14	8.30	57.53
ROE	14,741	-5,558.28	522.38	6.44	50.55
Sales growth ratio against previous year	14,726	-85.73	2,122.22	4.78	32.87
Profit ratio	15,043	-186.36	1,166.67	3.96	12.14
Profit growth ratio against previous year	13,108	-109,258	117,250	26.39	1,622.00

**Table 5: Mixed linear models with numbers of frauds as DVs.**

Type III tests of fixed effects

	Estimate	<i>t</i>	Significance
Intercept	-0.019913	-1.219	0.223
% lifetime directors	0.008337	2.480	0.013*
% outside directors	0.016982	1.802	0.072
% outside auditors	-0.003571	-0.256	0.798
% directors graduating from high schools	0.004649	1.539	0.124
% directors graduating from domestic graduate schools	0.023101	2.082	0.037*
% directors graduating from	0.004667	0.221	0.825



foreign universities			
Average age of directors	0.000347	1.403	0.161
Current ratio	-6.90624	-0.108	0.914
Fixed ratio	-6.53354	-0.611	0.541
Equity ratio	-0.000103	-1.435	0.151
Debt ratio	-2.07357	-0.538	0.590
Equity growth ratio	-7.34425	-0.986	0.324
ROE	0.000193	1.43	0.152
Sales growth ratio against previous year	-5.89583	-0.101	0.920
Profit ratio	-5.70194	-0.293	0.770
Profit growth ratio against previous year	-3.48528	-7.864	0.000

DV: number of frauds. \*Relationship significant at the  $p < 0.05$  level.

### **Robustness Check of Data Analysis**

The DVs, namely the number of fraud incidents, contained a large number of data points for just a few values, which resulted in a fairly skewed frequency distribution. To address this issue and increase the validity of the mixed model analysis, a Poisson regression was also conducted with fraud counts as DVs.

As shown in Table 7, the results of the robustness test further supported the findings obtained using the mixed models reported in section 2.3.1. The estimated coefficient for the percentage of lifetime directors was positive and significant, supporting Hypothesis 1a.

Hypothesis 1b was supported by the results listed in Table 7, according to which the coefficient of outside directors was not statistically significant. However, I acknowledge that the coefficient and the p value for outside directors are marginally significant. There might be a possibility that the

significance of the percentage of outside directors will increase along with different samples.

**Table 6: Descriptive statistics.**

Continuous variable information

	<i>N</i>	Minimum	Maximum	Mean	Std. Deviation
DVs	8830	0	2	0.01	0.079
Covariate					
% lifetime directors	8830	0	1	0.35016	0.35352
% outside directors	8830	0.02	1	0.29387	0.11196
% outside auditors	8830	0	1	0.20347	0.07548
% directors graduating from high schools	8830	0	1	0.39040	0.39390
% directors graduating from domestic graduate schools	8830	0	1	0.04920	0.08642
% directors graduating from foreign universities	8830	0	0.75	0.01263	0.04359
Average age of directors	8830	41.33	75.25	61.63	3.5733
Current ratio	8830	7.19	3492.32	217.18	174.87
Fixed ratio	8830	2.48	2196.62	112.39	103.26
Equity ratio	8830	0.85	97.53	51.26	19.594
Debt ratio	8830	2.53	11673.99	146.15	270.84
Equity growth ratio	8830	-84.54	324.64	7.0164	13.829
ROE	8830	-197.36	77.89	7.1771	9.2630
Sales growth ratio against previous year	8830	-79.85	449.87	3.8956	15.6702
Profit ratio	8830	-135.32	86.03	4.0195	6.1958
Profit growth ratio against previous year	8830	-109258	117250	17.485	1903.72

**Table 7: Poisson regression model results predicting the likelihood of frauds across board composition parameters**

Parameter Estimates

Parameter	$\beta$	Std. Error	Wald Chi-Square	df	Sig
(Intercept)	-11.298	3.0016	14.167	1	.000
% lifetime directors	1.358	.6804	3.983	1	.046*
% outside directors	2.972	1.5374	3.738	1	.053
% outside auditors	-1.513	2.0607	.539	1	.463
% directors graduating from high schools	.774	.6853	1.276	1	.259
% directors graduating from domestic graduate schools	2.727	1.3260	4.229	1	.040*
% directors graduating from foreign universities	.442	2.1785	.041	1	.839
Average age of directors	.072	.0489	2.190	1	.139

Dependent Variable: Fraud Times

\* The relationship is significant at  $p < 0.05$  level

### 2.4.2 Hypotheses 2a and 2b

This section presents the results of industry analysis obtained using Poisson regression with dummy variables for 17 industries.

Hypothesis 2a states that fraud ratio significantly varies across industries, while Hypothesis 2b states that this ratio is particularly high in secondary-sector industries such as manufacturing, construction, and electricity and gas.

Table 8 shows results of Poisson regression model predicting the likelihood of fraud across industries. The reference category is the combined industries of trading and wholesale, retail, finance, energy resources, food, and real estate. The results suggest that four industries, namely electricity and gas ( $\beta = 1.027$ ,  $p = 0.025$ ,  $EXP(\beta) = 2.794$ ), automobile and aircraft ( $\beta = 0.949$ ,  $p = 0.000$ ,  $EXP(\beta) = 2.584$ ), transportation and logistics ( $\beta = 0.841$ ,  $p = 0.005$ ,  $EXP(\beta) = 2.319$ ), and construction and materials ( $\beta = 0.664$ ,  $p = 0.02$ ,  $EXP(\beta) = 1.943$ ), are associated with significantly low  $p$  values ( $p < 0.05$ ) and high positive  $\beta$  values, as well as high positive  $EXP(\beta)$  values. These statistically significant differences are striking in terms of magnitude. For example, in the electricity and gas industry, the estimated beta coefficient of 1.027 suggests that cases of fraud was 2.794 times greater ( $=e^{1.027}$ ) in this industry, relative to the benchmark. This finding implies the existence of significant differences in fraud ratio across industries, particularly for the four abovementioned industries of the secondary sector.

**Table 8: Poisson regression model results predicting the likelihood of frauds across industries**

Parameter estimates

Parameter	$\beta$	Std. Error	Wald Square	Chi- Square	df	Sig	Exp(B)
(Intercept)	-1.520	0.1014	224.771		1	0.000	0.219
Construction and materials	0.664	0.2114	9.872		1	0.002*	1.943
Chemicals and fabrics	-0.062	0.2133	0.085		1	0.771	0.940
Pharmaceutical products	-0.326	0.4556	0.512		1	0.474	0.722
Automobile and aircraft	0.949	0.2494	14.491		1	0.000*	2.584
Steel and non-ferrous	-0.253	0.3897	0.422		1	0.516	0.776
Machinery	-0.528	0.3098	2.904		1	0.088	0.590
Electronics and precision machinery	-0.119	0.2619	0.205		1	0.651	0.888
Electricity and gas	1.027	0.4593	5.004		1	0.025*	2.794
Transportation and logistics	0.841	0.2967	8.036		1	0.005*	2.319

**DV:** fraud occurrence. Reference category: trading and wholesale, retail, finance, energy resources, food, real estate. \*Relationship significant at the  $p < 0.05$  level.

As such, the results in Table 9 (cumulative fraud ratio by industry in five years) partially support Hypothesis 2b. One can therefore conclude that the fraud ratio is particularly high for the four abovementioned secondary-sector industries, followed by three tertiary-sector industries and four other secondary-sector industries. Notably, significantly lower fraud ratios of 2.86 and 2.63% were observed for the primary-sector industries of food and energy resources, respectively.

The following chapter investigates the influencing factors and mechanism of frauds based

upon 133 publicly available third-party committee reports to understand *how* frauds happen in Japanese companies.

**Table 9: Fraud ratio\* by industry.**

\*Calculated by dividing the number of total fraud incidents between 2015 and 2019 by the total number of targeted companies in the chosen industry listed in the first section of the Tokyo Stock Exchange between 2015 and 2019.

Industry	Fraud ratio in five years	Industry sector
Electricity and gas	12.22%	Secondary
Automobile and aircraft	11.28%	Secondary
Transportation and logistics	10.15%	Secondary
Construction and materials	8.51%	Secondary
Trading and wholesale	5.17%	Tertiary
Retail	4.82%	Tertiary
Information communication	4.70%	Tertiary
Chemicals and fabrics	4.13%	Secondary
Electronics and precision equipment	3.88%	Secondary
Steel and non-ferrous	3.40%	Secondary
Medical products	3.27%	Secondary
Finance	2.96%	Tertiary
Machinery	2.72%	Secondary
Energy resources	2.86%	Primary
Food	2.63%	Primary
Real estate	1.70%	Tertiary

**Table 10: Descriptive statistics.**

Continuous variable information

	N	Minimum	Maximum	Mean	Std. deviation
DVs	1686	0.00	8	0.26	0.711
Covariate:					
Construction and	1,686	0.00	1.00	0.0949	0.29316

materials					
Chemicals and fabrics	1,686	0.00	1.00	0.1068	0.30890
Medical products	1,686	0.00	1.00	0.0225	0.14847
Automobile and aircraft	1,686	0.00	1.00	0.0409	0.19818
Steel and non-ferrous	1,686	0.00	1.00	0.0314	0.17454
Machinery	1,686	0.00	1.00	0.0735	0.26111
Electronics and precision equipment	1,686	0.00	1.00	0.1038	0.30509
Electricity and gas	1,686	0.00	1.00	0.0107	0.10280
Transportation and logistics	1,686	0.00	1.00	0.0409	0.19818

## **Chapter 3. QUALITATIVE ANALYSIS**

### **3.1 THEORY REVIEW**

In this chapter, the mechanism of organizational frauds is qualitatively examined based on 133 third party committee reports of frauds to answer the opening research question of *how* frauds happen in Japanese companies.

Rasha and Andrew (2012) believed that the motive to commit fraud is often associated with personal pressures or corporate pressures on the individual. Wolfe and Hermanson (2014), the founders of the fraud diamond theory, stated that many financial reporting frauds are committed by subordinates reacting to an edict from above to "make your numbers at all costs, or else". These authors also identified a common personality type among fraudsters, namely the "bully," who "makes unusual and significant demands of those who work for him or her, cultivates fear rather than respect and consequently avoids being subject to the same rules and procedures as others". All of the abovementioned researchers suggest that in certain situations, frauds happen because of some "power" rather than because of the personal motives or incentives of an individual. Then, what exactly is this power? The basic dictionary definition of power is the ability or official capacity to exercise control, i.e., authority. According to another extended definition, power is the capacity of individuals or groups to effect or affect organizational outcomes (Kanter, 1977). That said, power is invisible, subjective, and relative, being something that is perceived and therefore not easy to tangibly identify. Robbins



(2004) mentioned that “power has been described as the last dirty word. People who have it deny it, people who want it try not to appear to be seeking it, and those who are good at getting it are secretive about how they got it” (Maric and Ferjan, 2010).

Organization theorists have started to consider the power issue since the 1970s. Earlier representative works highlighting the role of the power factor in organizations have been performed by Pfeffer and Salancik (1978), while Mintzberg (1984) derived a model of power and organizational life cycle in steps. The increased focus on power among organization scholars in those days seemed to reflect “certain fundamental trends in developed societies, namely, the increasing size of organizations, and as a result, the enhancement of their external power as systems as well as the pervasion of conflict” (Mintzberg, 1984). Mintzberg (1983) also argued that “in a company or in an organization, there are basically two kinds of power: formal and informal power.” Formal power can also be rephrased as position power and can be exercised in the form of orders or pressures, while informal power is less defined and often more important (Maric and Ferjan, 2010). Importantly, informal power originates from interpersonal connections and therefore cannot be apparently seen from the outside, but can be manifested in the form of silent pressure in the context of frauds. Informal power receivers naturally speculate or read what the informal power giver is implying, which is described by the Japanese term “*sontakusuru*.”

Regardless of the significance of formal and informal power in an organization, few

researchers have considered the relationship between power (formal, informal, or both) and frauds. Most recently, Krause, Withers, and Semadeni (2018) argued the power dynamics between the CEO and the board and the appointment of a lead independent director (Schnatterly et al., 2018). In Japan, however, as was argued in previous chapters, internal factors matter more than external ones when it comes to frauds. Therefore, this chapter analyzes 133 third party committee fraud reports to shed light on the internal and informal power factors associated with organizational frauds in the relationship with fraud triangle factors and thus uncover the entire picture of Japanese organizational frauds and reveal the mechanism of *how* frauds happen from power perspectives.

This qualitative study identifies a new set of internal power factors as an extension of fraud triangle and fraud diamond theories, both of which focus on fraud agents or drivers of fraud participants and identify the critical factors that make people commit frauds, i.e., *pressure*, *rationalization*, and *opportunity*. The introduction of internal power factors further heightens *pressure*, *rationalization*, or *opportunity* and theoretically explains how organizational frauds happen in Japan. Moreover, this work provides a contextual mechanism of organizational frauds in Japan.

### 3.2 RESEARCH QUESTIONS

*Research Question 1: What kinds of unique internal power factors occur in Japanese frauds in relation to the fraud triangle theory?*

As argued above, seniority matters in Japan. Leading companies in infrastructure, construction, automobile, and manufacturing industries have historically hired fresh graduates from the designated laboratories of top universities based upon professors' recommendations within the engineering- and science-majored recruiting system. The Japanese lifetime employment system makes relationships from university days continue throughout the career and thus helps to create tightly connected closed in-house communities where seniority matters. In many cases, exit is not an option, as claimed by Hirschman (Hirschman, 1970). Dowding, John, Mergoupis, and Van Vugt (2000) argued that "to exit from such a group just because he (or she) disagrees with the policies of the government is an exceedingly costly and painful process." As such, the internal and informal vertical power relationship between seniors and juniors tends to stay for a long time as a default.

Additionally, in infrastructure, construction, automobile and manufacturing industries, internal power tends to concentrate on certain functions. Typically, core manufacturing technology ("*monozukuri*")-related functions such as product planning, design, and development, as well as front-line functions such as large account sales tend to have stronger power over other functions such as quality assurance, supply and demand management, and production and logistics. Thus, an imbalanced power relationship arises between the core or upstream functions as pressure givers and others as

pressure receivers.

Accordingly, one can assume that in the case of Japanese organizational frauds, internal power imbalance somehow heightens the fraud triangle factors and eventually leads to frauds. Therefore, the first research object to explore are the kinds of unique internal power factors occurring in Japanese frauds in relation to the fraud triangle theory.

***Research Question 2: What is the mechanism of Japanese frauds?***

Homogeneity worked well in the high growth era of the 1960s, when Japanese companies headed for a common growth goal as one team. However, once a homogeneous team is faced with gray matters, the risks are groupthink, overlooking, neglect, silence, group covering-up, and organizational frauds.

Groupthink is defined as “a model of thinking that people engage in when they are deeply involved in a cohesive in-group, when the members’ strivings for unanimity override their motivation to realistically appraise alternative courses of action” (Janice, 1972, Choi and Kim, 1999). Janice (1972) also defined groupthink as a psychological drive for consensus at any cost that suppresses the dissent and appraisal of alternatives in cohesive decision-making groups. Stoddard (1968) described that corrupt behavior is socially conditioned and shaped by the “code of silence” rather than by individuals. In view of the above, processes involved in Japanese frauds are herein explored to capture the internal mechanism of these frauds.

### **3.3 METHODS**

Herein, an inductive study aimed to identify power factors and process models leading to corporate frauds was conducted using a combination of the comparative multiple-case study method (Eisenhardt, 1989; Yin, 1994) and the Gioia method (2004), as these methods best fit the study objective. Specifically, the present work ultimately aimed to identify a list of novel internal power factors building on the current fraud triangle and fraud diamond theories and come up with a fraud process mechanism. To achieve these goals, one should better refer multiple comparable cases to be sharply distinct between organizational and individual frauds rather than analyze a single case. Following Eisenhard (1989) and Yin (1994), a four-step approach was applied to selected target cases, and an eight-step approach was applied to data analysis.

#### **Data Gathering Steps**

First, 133 third party committee reports of corporate frauds sourced from SUSTAINA and company websites were collected. In Japan, once a large-scale fraud is detected, companies establish a committee typically composed of a group of third-party lawyers or, in some cases, accompanied by internal auditors. The lawyers conduct investigations through digital forensic surveys, interviewing all stakeholders and sampling the opinion of broader employee groups through questionnaires. The results are then reported to the company board, and the company issues an external report. The final report therefore includes abundant raw interview comments made by every stakeholder and is written from a third-party perspective, which is why these third-party committee reports are referred to in the

present qualitative study. Second, out of these 133 reports, two sample cases, namely those of individual and organizational fraud, were selected for comparison, as organizational frauds are more affected by internal power factors than individual ones. Third, three more cases for each of these fraud groups were collected to afford a total of eight comparable cases. Fourth, two more organizational cases were added to deeply analyze organizational frauds, which afforded a total of 10 cases. For case selection in the second and third steps, the following three selection criteria were considered while keeping other conditions between individual and organizational frauds identical. (1) Fraud scale. Larger-scale frauds in larger companies were prioritized to capture more power issues inside and outside the organization. (2) Richness of raw interview comments. Some reports were very detailed, listing a significant number of lengthy raw interview comments by every stakeholder, while others were not. Herein, the most detailed reports, particularly in terms of the volume of raw comments by every stakeholder, were selected. (3) Company homogeneity. Informal power can originate from strong personal networks that are more easily created in a long-standing fixed environment with a low employee turnover rate. Consequently, traditional large-scale homogeneous companies were selected. In summary, to surely capture power factors in organizational frauds, comparable samples with otherwise identical conditions were selected. Figure 3 shows the data gathering steps, and Table 11 lists the 10 selected cases.

## Data Analysis Steps

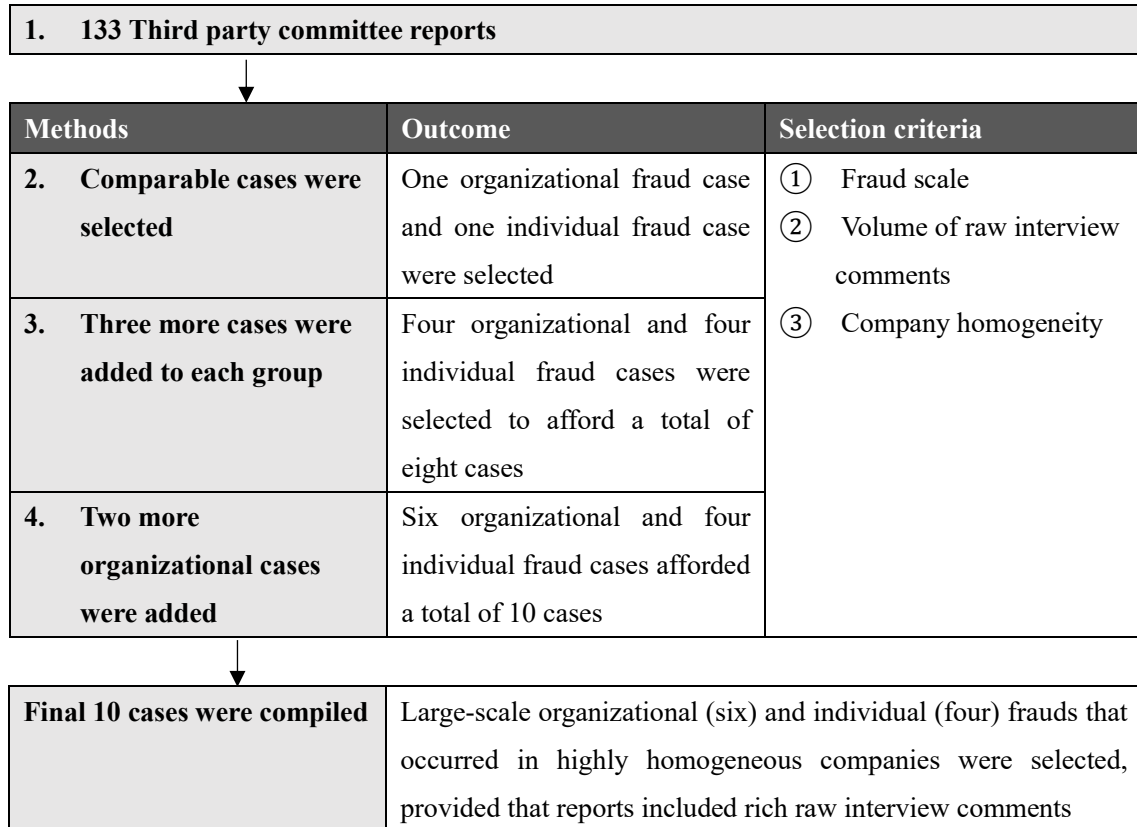
Data analysis was performed in eight steps according to Eisenhard (1989) and Yin (1994) (Figure 4). First, all cases were analyzed to generate a potential list of ideas for power-relating behaviors that differentiate organizational cases from individual ones and specifically occur in organizational frauds. Second, all power-relating behaviors were coded by power factors identified in the first step (Table 12). In the third step, after numerous reviews aimed to combine/drop factors or rephrase the factor name, the final list of 11 power factors was established. These 11 power factors included (1) orders, (2) vertical relationship power, (3) horizontal power imbalance, (4) intra-company relationships, (5) sales/profit supremacy, (6) “customer is always right” perception, (7) excessive error-free policy, (8) non-intervention policy, (9) governance/organizational failures, (10) lack of knowledge and interests, and (11) intentional neglect. In the fourth step, these 11 factors were categorized into four groups based on the power source, namely (A) position power, (B) informal power, (C) perceived power, and (D) neglect. Position power originates from a senior position and is manifested in the form of orders. Informal power, on the other hand, originates from implicit, unseen, informal power relationships in a vertical, horizontal, or intra-company set up. Surprisingly, the 133 third party committee reports revealed that many power-related behaviors are due not to actual position power but to various informal power sources. Examples include a long-term vertical relationship, called “*senpai - kohai*” in Japanese, i.e., an unhealthy horizontal power imbalance between, for

instance, quality assurance and development teams (in which case the development team tends to put pressure over the quality assurance team) and intra-company relationships that have been built for a long time in certain industries. Perceived power means something that Japanese employees perceive as a standard norm, typically after having worked for their company for years. In other words, although it is not an official forcing power for employees to follow as laws or rules, the majority of employees perceive them as a forced standard and therefore naturally follow them. Examples include sales/profit supremacy, “customer is always right” perception, excessive error-free policy, and non-intervention policy. There are cases when Japanese employees take these policies too seriously and attempt to follow them perfectly, which results in frauds. Neglect due to organizational flaws and lack of knowledge, as well as intentional neglect were observed in different forms in all 133 cases. After the above structuring was completed, each quote was matched to the three factors of the fraud triangle model to identify the relationship between these factors and the power factors presented herein. As a result, power factors identified in organizational frauds were shown to strengthen fraud triangle factors basically associated with individual frauds. In the next step, a typical fraud mechanism was identified by detailed microanalysis of processes between backgrounds, power factors, and frauds for the 10 selected cases. In the eighth step, for the sake of validation, the developed model was brought to the attention of non-executive directors knowledgeable about corporate frauds, a media member of an editorial board with expertise in broader corporate governance, and some researchers, and the received



feedback and suggestions were incorporated into the final mechanism (Figure 5).

**Figure 3: Data gathering steps.**



**Figure 4: Data analysis steps.**

<b>1. Content analysis</b>	All cases were analyzed to generate a list of ideas for power-relating behaviors differentiating between organizational and individual frauds and specifically occurring in organizational frauds.
<b>2. Behavior coding by power factor</b>	For all organizational fraud cases, power-related behaviors were coded by power factor.
<b>3. Establishment of a list of 11 differentiating power factors</b>	After numerous reviews, the final 11 power-related factors differentiating organizational frauds from individual ones were identified.
<b>4. Division of the 11 factors into four large categories</b>	The 11 power-related factors were divided into four large categories.
<b>5. Linkage of each power factor to fraud triangle factors</b>	Each power factor was linked to fraud triangle factors.
<b>6. Process analysis</b>	Data were microanalyzed to identify the list of processes between power factors and frauds.
<b>7. Identification of typical processes</b>	Most typical processes were identified.
<b>8. Model validity testing</b>	The data were reviewed, and ideas were tested with non-executive directors, a media member of an editorial board, and researchers.

**Table 11: List of 10 selected cases.**

No.	Category	Title of the third-party committee reports
1	Organizational frauds	株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日
2	Organizational frauds	東亜建設工業株式会社社内調査委員会、「平成27年度東京国際空港C滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016年7月26日
3	Organizational frauds	富士フイルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日
4	Organizational frauds	株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

5	Organizational frauds	東レ株式会社有識者委員会、「調査報告者」、2017年12月25日、「議事録」、2018年3月26日
6	Organizational frauds	関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日
7	Individual frauds	イオンデイライト株式会社特別調査委員会、「株式会社カジタクの不正会計に関する調査結果最終報告書（開示版）」、2019年6月27日
8	Individual frauds	平和不動産株式会社社内調査委員会、「調査報告書（開示版）」、2019年12月13日
9	Individual frauds	日本郵船株式会社調査委員会、「調査報告書（開示用）」、2018年3月22日
10	Individual frauds	KDDI株式会社外部調査委員会、「調査報告書（公表版）」、平成27年8月21日

Table 12: Results of coding by category and factor.

Four categories (total number of quotes by category)	11 power factors (total number of quotes by factor)	Quotes from 10 cases <sup>7</sup>	Affected fraud triangle factor
<b>A) Position power</b> (21)	<b>1. Orders</b> (21)	Once Mr. T became vice president, there was no one who objected him.	<i>Pressure</i>
		Virtually, Mr. T dominated the decision-making authority as to approve or not to approve orders above JPY 3 billion.	<i>Opportunity</i>
		Mr. E immediately and secretly asked his subordinate (Mr. I) to conceal all documents relating to that order as soon as he noticed that the task force of the Tokyo District Public Prosecutors Office visited his company.	<i>Pressure</i>
		Mr. X had Mr. E attend the meeting with two sector peer companies. Since then, Mr. X and Mr. E always attended the three-party meeting.	<i>Pressure</i>
		Mr. E ordered Mr. I to put the document into the shredder. Mr. I did so accordingly.	<i>Pressure</i>
		Mr. E ordered Mr. I over the phone that Mr. I should throw away all documents relating to the deal that Mr. E had.	<i>Pressure</i>
		Mr. I received all the relating files from Mr. E and saved them in a different division. Later, Mr. I shredded all of them upon the ordered of Mr. E.	<i>Pressure</i>
		As of the linear matter, Mr. E directly reported to Mr. T. Decisions were made between Mr. E and Mr. T.	<i>Pressure</i>
		Management put pressure over the internal audit division to the extent that internal audit failed to function.	<i>Pressure</i>
		Field B ordered Mr. E to dispose of the unused drug solution.	<i>Pressure</i>
		Ordered by Field B, Mr. E created the final output based on falsified data.	<i>Pressure</i>
		Ordered by Field H and Field F, Mr. N created the final output based on falsified data.	<i>Pressure</i>
		Field O created the final output based on falsified data.	<i>Pressure</i>
		Field X compiled the report based on falsified data.	<i>Pressure</i>
		As suggested by Head F, he created a falsified sample and sent it to the research company.	<i>Pressure</i>
		Major issues relating to MSA that were identified by audit in June 2015 was that the fraud had not been reported to the CEO or its parent company, as ordered by the headquarters vice president and the executive managing director.	<i>Pressure</i>
		Mr. A tended to run out of control. As long as Mr. A approved, everything was let go without any control.	<i>Pressure</i>
		The vice president ordered to write “there was no problem” in response to its parent company and auditing report.	<i>Pressure</i>
		The executive managing director ordered the head of accounting to adjust fraud impact in the March 2016 financial closing.	<i>Pressure</i>
		The vice president and executive managing director ordered the answer while recognizing it being an accounting fraud.	<i>Pressure</i>
Microscopy images in microscope tests had been manipulated by quality assurance staff before July 2005. Between July 2005 and February 2003, this manipulation had been done by some staff upon the order of a development team manager.	<i>Pressure</i>		
Mr. M intimidated executives at the X electricity company requesting the construction company O to give up the order. Company K got the order.	<i>Pressure</i>		
Mr. M intimidated, scolded, and mentally broke down staff at the X electricity company on every occasion such as training, meetings, and dinners, where Mr. M had contact with executives at the X electricity company.	<i>Pressure</i>		
<b>B) Informal power</b> (18)	<b>2. Vertical relationship power</b> (4)	Mr. T was respected by broader subordinates.	<i>Pressure</i>
		Mr. E significantly respected Mr. T. “When my respected Mr. T asked me (Mr. E) with trust, I had no choice other than following his requests.”	<i>Pressure</i>
		The head of Asia Pacific Operation Sales directly discussed the matter with the vice president and top executives and gained their approval. This non-	<i>Pressure</i>

<sup>7</sup>Quotes in the third-party committee reports were translated from Japanese into English by the author.

Four categories (total number of quotes by category)	11 power factors (total number of quotes by factor)	Quotes from 10 cases <sup>7</sup>	Affected fraud triangle factor
		transparent, stakeholder-dependent decision-making process has been widely accepted.	
		These falsification acts have been conducted by most staff at inspection and quality assurance teams. Almost all quality assurance and technology services teams got involved in falsification.	<i>Pressure</i>
	<b>3. Horizontal power imbalance (7)</b>	The civil engineering division did not inform branches' sales or headquarters about the construction failures, considering the potential impact of following orders.	<i>Pressure</i>
		The quality assurance division has not been independent of production functions.	<i>Pressure</i>
		Personnel reshuffling had been on hold for a long term, and a small group of specialists was always responsible for the inspection as a black box.	<i>Opportunity</i>
		The reason for this was the higher expertise of construction methods, the lack of cooperation with the R&D division, and consideration toward other fields.	<i>Opportunity</i>
		Result falsification was conducted by 25 members of the quality assurance team and 26 members of the technical team, who had received consultation and decided to overwrite inspection results, rationalizing that this overwriting would help to meet clients' requests.	<i>Rationalization</i>
		The lack of communication regarding the decision-making on specifications among the sales team, the technical team, and the development team.	<i>Opportunity</i>
		Development, technical, sales and quality assurance teams suffer from latent conflict of interests. In order for the quality assurance team to put a brake on these functions, it should be independent of these functions as an organizational structure. However, this quality assurance team reported to the development team between January 2001 and October 2018 without having independence.	<i>Pressure</i>
	<b>4. Intra-company relationship (7)</b>	Mr. X and Mr. Y from another construction company graduated from the same engineering laboratory of W University, having known each other for more than 30 years.	<i>Opportunity</i>
		Mr. T proactively demonstrated his authority across all civic undertakings through making final judgments on selecting candidate companies for joint ventures.	<i>Pressure</i>
		Mr. T was contacted by and met with Mr. T of construction company S. Mr. T requested that the construction company S would join the bid that construction company O represents.	<i>Pressure</i>
		Mr. M aggressively requested order placement to the staff of electricity company K in the form of intimidation.	<i>Pressure</i>
		Mr. M had provided considerable amounts of money and goods to the staff of electricity company K multiple times for a long term to create a situation where the staff would surely follow his order placement request, i.e., to gain control over the staff of the K electricity company.	<i>Pressure</i>
Mr. M requested the staff of the K electricity company to place an order for Mr. M's company and share information about constructions. In return, Mr. M received remuneration, charge, and financial return from partners.		<i>Pressure</i>	
Mr. M was recognized as a key person in the K electricity company, taking positions such as construction/planning manager, and strengthened his influence over companies who received orders from the K electricity company. Furthermore, Mr. M resolved many issues that the K electricity company had been supposed to solve, thus strengthening his influence over company executives to become a person knowledgeable of the weaknesses of this company.		<i>Pressure</i>	
<b>C) Perceived power (27)</b>	<b>5. Sales/profit supremacy (10)</b>	Expensive capital investment for nine drilling machines was a huge pressure for the branch management.	<i>Pressure</i>
		There was a severe competition with other preceding companies. They knew that another company had successfully completed.	<i>Pressure</i>
		It was hard to expect further sales growth in the domestic market, given its recession and maturity. Hence, the company policy was to increase sales in China and Asia as the next drivers. A challenging target was set for these markets, and even in Japan branches, there was excessive sales pressure.	<i>Pressure</i>
		Due to severe competition, they refrained from discussing the revision of specifications with their clients.	<i>Pressure</i>

Four categories (total number of quotes by category)	11 power factors (total number of quotes by factor)	Quotes from 10 cases <sup>7</sup>	Affected fraud triangle factor
		(He) thought he could not bring the issue to the surface, as this could affect the future acceptance of orders.	<i>Pressure</i>
		At company F, this commission and bonus accounted for a large amount since 2011. This incentive structure helped to escalate sales supremacy thinking, aiming at larger sales.	<i>Pressure</i>
		The sales supremacy concept prevailed across operating company N.	<i>Pressure</i>
		It seems that Mr. A himself had demonstrated strong leadership to increase sales driven by incentive remuneration.	<i>Pressure</i>
		Staff involved in roll production received strong mental pressure to decrease the defect ratio.	<i>Pressure</i>
		Staff involved in roll production received strong pressure to avoid any potential compensation cost due to delay.	<i>Pressure</i>
	<b>6. “Customer is always right” perception (5)</b>	In view of the power relationship with clients and competitors, they tended to refrain from requesting specification adjustment and negotiating it with their clients.	<i>Pressure</i>
		Sales agreed with clients on the specification without sufficient consideration of whether products meeting the requested specifications could be developed in the light of the development capability of this factory.	<i>Pressure</i>
		Staff involved in roll production recognized that defected products would lead to order loss in a situation where it was hard to differentiate themselves by their product functionality against competitors. Considering the pressure from the sales team to be in time, production staff was stressed by the strong pressure to avoid any potential late deliveries.	<i>Pressure</i>
		They tended to refrain from asking to relax specifications requested by clients because of the severe competition and power relationship with clients.	<i>Pressure</i>
		They felt pressure about due quality from clients.	<i>Pressure</i>
	<b>7. Excessive error-free policy (5)</b>	Field F and the Field Head H felt strong pressure that they could never make mistakes, which prevented them from reporting to the employer.	<i>Pressure</i>
		Field B felt pressure that they could never make mistakes, particularly because they had heard that a competitor had completed steadily.	<i>Pressure</i>
		Branch C felt strong pressure that they could never make mistakes and that the head of the Tokyo branch would not have solutions even if they asked for help.	<i>Pressure</i>
		There was a shared pressure that they could not make any mistakes, therefore, it was decided not to report the issue to contractees, which they had reported to Mr. I and Mr. J.	<i>Pressure</i>
		Branch staff recognized the management policy to expand orders and the process toward accepting offers, therefore failing to report poor construction to the sales and civil engineering team.	<i>Pressure</i>
	<b>8. Non-intervention policy (7)</b>	We had a non-intervention policy between construction and engineering divisions. No personnel exchange or mutual checking occurred between these divisions.	<i>Opportunity</i>
		There was a perception that employees do not have any obligation to report gray accounting matters to the auditing company. The matter was dealt with by employees only when pointed out by the auditing company.	<i>Rationalization</i>
		Fraud participants had a wrong perception that as long as functions and performance are secured, so its product quality.	<i>Rationalization</i>
		They shared the perception that all seniors and colleagues around them committed the same frauds.	<i>Rationalization</i>
		Regardless of internal fraud reports in 2013 and 2016, the headquarters corporate division failed to recognize this as a serious quality issue. As a result, these frauds were not reported to the headquarters or management. Under these conditions, sectionalism existed among broader executives and employees.	<i>Opportunity</i>
Fraud had not been disclosed beyond the division because of excessive sectionalism, which resulted in a lack of awareness of reporting to the headquarters		<i>Opportunity</i>	

Four categories (total number of quotes by category)	11 power factors (total number of quotes by factor)	Quotes from 10 cases <sup>7</sup>	Affected fraud triangle factor
		corporate division and management.	
		The quality assurance team had little relationship with executives including the CEO and other divisions. The quality assurance function was a highly independent division as an organizational structure.	<i>Opportunity</i>
<b>D) Neglect (31)</b>	<b>9. Governance/organization failures (9)</b>	Branches accepted multiple orders at the same time without being controlled by the headquarters. Thus, the workload exceeded the construction capability, which resulted in construction failures.	<i>Opportunity</i>
		Construction and engineering divisions are clearly separated. There is no resource exchange between these divisions or reporting line exchange.	<i>Opportunity</i>
		As a governance structure over subsidiary companies, Asia Pacific Operation was responsible for managing Asia subsidiary companies. The parent company F had no authority to manage its subsidiary companies as an organizational reporting structure.	<i>Opportunity</i>
		The internal audit department in Asia Pacific Operations was too small to conduct annual auditing. In particular, it took a long time for the Singapore internal audit team to identify accounting frauds because of the large distance between New Zealand/Australia and Singapore, and these frauds therefore continued from 2009 to 2015.	<i>Opportunity</i>
		These accounting frauds were never discussed at the board meeting of the parent company. Governance control by the board meeting failed to function in this case.	<i>Opportunity</i>
		There were organizational issues where the parent company's auditing officer could not get the information on overseas subsidiary companies.	<i>Opportunity</i>
		The organizational reform of 2001 got rid of the independence of the quality assurance division. The management did not have sufficient knowledge on the potential quality risks posed by this reform and failed to take necessary actions.	<i>Opportunity</i>
		The factory head did not have management authority over quality assurance. The development head virtually played a factory head role over its P&L and quality assurance. This imbalanced organizational structure and assignment brought about a lack of independence of the quality assurance division.	<i>Opportunity</i>
		They failed to build a capable organizational structure allowing one to identify and prevent frauds.	<i>Opportunity</i>
	<b>10. Lack of knowledge and interests (5)</b>	The management failed to recognize a problematic situation where few employees dominated the quality assurance division and there was no interaction with the R&D division.	<i>Opportunity</i>
		The management presented a direction to expand orders without checking the construction capability in detail.	<i>Opportunity</i>
		The headquarters and management did not have good knowledge of quality risks at the production site.	<i>Opportunity</i>
		The management made light of the quality assurance function and assigned a non-capable person as the head of the quality assurance team.	<i>Opportunity</i>
		The management had little interest in quality assurance. The head of quality assurance was insufficiently capable for this position.	<i>Opportunity</i>
		The management did not make decisions to deal with this matter and correct it.	<i>Opportunity</i>
	<b>11. Intentional neglect (17)</b>	When an employee from the accounting division reported that the accumulated unrealized gain reached JPY 2 billion, the boss said, "let's just hang in there."	<i>Opportunity</i>
		After consulting with the advisor, chairman Y and CEO I decided not to disclose this matter externally and not to report it to each executive director or the board, considering the potential leakage of information.	<i>Opportunity</i>
		Branches I and J heard about the issue from Field H, but overlooked it because they were unable to identify solutions.	<i>Opportunity</i>
		Field B consulted with manager A at the headquarters engineering division, but no revised plan was presented.	<i>Opportunity</i>
		Branch C ordered Field B to continue construction, as Branch C failed to present a solution due to the lack of technical knowledge.	<i>Opportunity</i>

Four categories (total number of quotes by category)	11 power factors (total number of quotes by factor)	Quotes from 10 cases <sup>7</sup>	Affected fraud triangle factor
		Branch C tolerated the fact that the data on the drug solution had been falsified and failed to report that to branch D.	<i>Opportunity</i>
		Branches I and J heard about the data falsification from Field H. However, the construction method required expertise and know-how, and Fields F and G failed to come up with a solution. Therefore, Branches I and J eventually tolerated the falsification.	<i>Opportunity</i>
		Branches I and J did not report the falsification matter to the head of construction of the Kyushu branch, Mr. L, as they thought Mr. L would not have any solutions.	<i>Opportunity</i>
		Fields F and H had reported inability to put the drug solution as defined in the specification to Branches I and J and to manager K. However, Branches J and I and manager K overlooked this issue, as they could not come up with technical solutions.	<i>Opportunity</i>
		Branch I tolerated the fact that data had been falsified, and did not report this to the head of the Kyushu branch, Mr. L.	<i>Opportunity</i>
		Given that construction had been almost completed, Branch Q did not report to its boss or issue an order to field staff.	<i>Opportunity</i>
		Managers I, J, and W heard about the falsification matter from Field S. However, they overlooked it, as they could not come up with an appropriate solution.	<i>Opportunity</i>
		Field B reported the situation regarding the drug solution to Branch C, which, however, overlooked this fact because of the lack of solutions.	<i>Opportunity</i>
		The accounting division and the auditing division agreed not to investigate past incidents.	<i>Opportunity</i>
		Asia Pacific Operation had reported fraud to the CEO; However, a detailed description of auditing risk had been removed	<i>Opportunity</i>
		Though he himself got involved in the frauds, he tolerated it.	<i>Opportunity</i>
		The K electricity company had an organizational culture originating from long-term traditions and defensiveness. In this culture, steady operation comes first, and internal contexts are prioritized over external expectations and perspectives.	<i>Opportunity</i>



### 3.4 RESULTS

#### Research Question 1

Research Question 1 asks what kinds of unique internal power factors occur in Japanese frauds in relation to the fraud triangle theory. Table 12 lists quotes by 11 power factors and 4 power categories based on the analysis of 10 selected cases. According to power categories, the total number of quotes can be subdivided into contributions from neglect (31 quotes), perceived power (27 quotes), position power (21 quotes), and informal power (18 quotes). According to power factors, the overall number of quotes can be subdivided into contributions from orders (21 quotes), intentional neglect (17 quotes), sales/profit supremacy (10 quotes), governance/organizational failures (9 quotes), horizontal power imbalance, intra-company relationship, and non-intervention policy (7 quotes), excessive error-free policy, lack of knowledge and interests, “client is always right” perception (5 quotes), and vertical relationship power (4 quotes). These numbers show that in Japanese organizational frauds, various types of power behaviors happen across cases, with neglect being the most common behavior. Every quote could also be associated with the fraud triangle factors, i.e., *opportunity*, *pressure*, and *rationalization*, to show the relationship between power factors and fraud triangle factors.

#### A) Position Power

##### Orders

Position power is a straightforward factor associated with frauds everywhere in the world.

Notably, position power-related quotes (21) were the largest contributor to the overall number of quotes. Example quotes include “Mr. E ordered Mr. I to put the document into a shredder. Mr. I did so accordingly,<sup>8</sup>” “Field B ordered Mr. E to dispose of the unused drug solution,<sup>9</sup>” “the executive managing director ordered the head of the accounting to adjust fraud impact in the March 2016 financial closing,<sup>10</sup>” “Mr. M intimidated executives at the X electricity company, requesting the construction company O to give up the order. Company K got the order.<sup>11</sup>” It should be noted that these comments appear in a form of “order” from the boss to his/her subordinates, from a parent company employee to a subsidiary company employee, and even from an external big figure to internal executives. We need to understand that order receivers may blindly follow orders without making objections, both internally and externally, depending on the context. An internal example is a large-scale anti-trust violation case where the main fraud participant held significant authority, dominating the decision-making power for budget, personnel assignment, and broader decisions.<sup>12</sup> This position provided an *opportunity* to make arbitrary decisions leading to frauds and *pressure* to make subordinates blindly follow the person with power. Another external example is a corruption case

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<sup>8</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

<sup>9</sup> 東亜建設工業株式会社社内調査委員会、「平成27年度東京国際空港C滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016年7月26日

<sup>10</sup> 富士フイルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>11</sup> 関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日

<sup>12</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

where an external big figure frequently intimidated internal executives at an electricity company to make them accept unreasonable requests for decades.<sup>13</sup> These intimidating orders from an extremely influential figure in the community apparently heightened the *pressure* on internal executives.

## **B) Informal Power**

Informal power accounts for 18 of the total number of quotes and can be divided into the factors of vertical relationship power, horizontal power imbalance, and intra-company relationships.

### **Vertical Relationship Power**

The first vertical relationship occurs between seniors (“*senpai*” in Japanese) and juniors (“*kohai*” in Japanese) beyond the formal boss-subordinate relationship and is caused by the abovementioned traditional recruiting system, lifetime employment, high-context culture, Confucian way of thinking to respect seniors as masters of life, and homogeneity. Example quotes are “Mr. E significantly respected Mr. T. When my respectful Mr. T asked me (Mr. E) with trust, I had no choice other than following his requests,<sup>14</sup>” and “The head of Asia Pacific Operation Sales directly discussed the matter with the vice president and top executives and gained their approval. These non-transparent, stakeholder-dependent decision-making processes have been widely accepted.<sup>15</sup>” Here, we see that

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<sup>13</sup> 関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日

<sup>14</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

<sup>15</sup> 富士フイルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

informal relationships originate from respect and trustworthy relationships, which in ordinary times are good things. However, in the case of fraud, there are cases where such good relationships can be used for wrongdoing, e.g., to move things forward under the table.

### **Horizontal Power Imbalance**

Typically, horizontal power imbalance occurs between upstream functions such as design, product planning and development, and sales, and receiver-type functions such as quality assurance and supply/demand control divisions. Once this power imbalance becomes intense or defaulted, upstream functions might provide excessive *pressure* over receiver-type functions, which are forced to rationalize themselves and take inappropriate actions. Notably, this issue was observed in the majority of data cover-up cases, where the quality assurance or inspection team had received severe pressures from other divisions without any help from their bosses, divisions, or the company overall, which ended up in data falsification and a certain period of fraud cover-up. A representative quote is “Development, technical, sales and quality assurance teams suffer from latent conflict of interests. In order for the quality assurance team to put a brake on these functions, it should be independent of these functions as an organizational structure. However, this quality assurance team reported to the development team between January 2001 and October 2018 without having independence.<sup>16</sup>” In this

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<sup>16</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

case, the root cause lies not solely in the quality assurance team that performed falsification, but also in other functions such as development, technical, and sales teams. Horizontal power imbalance brings about unhealthy pressure over the quality assurance team and thus promotes frauds. Particularly in a high-context homogeneous culture, where juniors tend to feel pressure from respected seniors from the same *alma mater* or when members in division A perceive pressure from division B with higher power concentration, this power imbalance has the possibility of creating forcing power beyond simple *pressure*.

### **Intra-Company Relationships**

Lastly, intra-company relationships also generate informal power in certain fraud cases. Representative quotes include “Mr. X and Mr. Y from another construction company graduated from the same engineering laboratory of W university, having known each other for more than 30 years,<sup>17</sup>” and “Mr. T was contacted by and met with Mr. T of construction company S. Mr. T requested that the construction company S would join the bid that construction company O represents.<sup>18</sup>” These intra-company relationships, particularly in anti-trust violation cases of construction industries, heighten *pressure* over another company, thereby forcing power receivers to act accordingly.

### **C) Perceived Power**

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<sup>17</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

<sup>18</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

Cohesive and homogeneous Japanese companies naturally encourage employees to have shared perceptions. Looking at superiors' behaviors and decision-making attitudes, juniors and new-joiners can evolve shared perceptions. However, such perceptions can be both positive and negative. Examples of positive perception include mutual respect, collaboration across divisions, contribution to the society, as reflected by company values or code of conduct, whereas negative perception can lead to unfortunate outcomes and, in extreme cases, frauds.

### **Sales/profit supremacy**

According to the sales/profit supremacy doctrine, employees are overly pushed to increase sales/profit at any cost, which can trigger frauds, typically accounting ones. Although every company aims to increase sales and profit, the important point is to what extent the employees are unduly pushed, and as a result, to what extent they find it difficult to put compliance before increasing sales/profit. Example quotes include “there was excessive sales pressure<sup>19</sup>,” “staff involved in roll production received strong mental pressure to decrease the defect ratio,<sup>20</sup>” and “this commission and bonus accounted for a large amount since 2011. This incentive structure helped to escalate sales supremacy.<sup>21</sup>”

The threshold between excessive and healthy sales/profit supremacy is determined by receivers’

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<sup>19</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>20</sup> 東亜建設工業株式会社社内調査委員会、「平成27年度東京国際空港C滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016年7月26日

<sup>21</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

perception. Therefore, it seems that companies should be responsible for proactively checking if the level of sales/profit pressure is reasonable for the majority of employees.

### **“Customer is always right” perception**

According to the “customer is always right” perception, employees blindly address clients’ requests to the extent of committing frauds. Typically, this perception leads to data concealment. Example quotes are “in view of the power relationship with clients and competitors, they tended to refrain from requesting specification adjustment and negotiating it with their clients,<sup>22</sup>” “sales agreed with clients on the specification without sufficient consideration of whether products meeting the requested specifications could be developed in the light of the development capability of this factory,<sup>23</sup>” “they tended to refrain from asking to relax specifications requested by clients because of the severe competition and power relationship with clients.<sup>24</sup>” The very root cause of frauds due to excessive client focus policy comes back to the saying that the customer is always right.

### **Excessive Error-Free Policy**

According to the excessive error-free policy, employees have a strong perception that they

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<sup>22</sup> 東レ株式会社有識者委員会、「調査報告者」、2017年12月25日、「議事録」、2018年3月26日

<sup>23</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

<sup>24</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

can never make mistakes, as they will be gone down as critical faults otherwise. Excessive error-free perception, in the worst cases, can lead to data concealment or data falsification. Example quotes are “branch C felt strong pressure that they could never make mistakes and that the head of the Tokyo branch would not have solutions even if they asked for help,<sup>25</sup>” “there was a shared pressure that they could not make any mistakes, therefore, it was decided not to report the issue to contractees.<sup>26</sup>” Again, it is critical for any company to understand the significance of compliance across the entire organization.

### **Non-Intervention Policy**

According to the non-intervention or independence policy, each function is too independent to get monitored and/or fixed by other functions. Example quotes are “we had a non-intervention policy between construction and engineering divisions. No personnel exchange or mutual checking occurred between these divisions,<sup>27</sup>” “fraud had not been disclosed beyond the division because of excessive sectionalism, which resulted in a lack of awareness of reporting to the headquarters corporate division and management,<sup>28</sup>” “the quality assurance team had little relationship with

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<sup>25</sup> 東亜建設工業株式会社社内調査委員会、「平成 27 年度東京国際空港 C 滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016 年 7 月 26 日

<sup>26</sup> 東亜建設工業株式会社社内調査委員会、「平成 27 年度東京国際空港 C 滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016 年 7 月 26 日

<sup>27</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019 年 1 月 31 日

<sup>28</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018 年 11 月 29 日



executives including the CEO and other divisions. The quality assurance function was a highly independent division as an organizational structure.<sup>29</sup>”

All these types of perception are not necessarily verbalized or documented anywhere in the company. However, in the case of immobilized organizations with a long-standing history, these perceptions are inscribed deep into employees’ minds and are omnipresent across the company, thus governing employees’ behaviors.

## **6. Neglect**

Neglect seems to be due to three reasons, namely (i) physical, organizational, and governance failures, (ii) management’s and/or headquarters’ lack of knowledge and/or interest in potential frauds, and (iii) malicious intentional neglect.

### **Governance/Organization Failures**

The first example originates from organizational structure issues. Typically, lack of governance from the headquarters or management creates a hole of reporting flow, eventually leading to frauds. Example quotes are “as a governance structure over subsidiary companies, Asia Pacific Operation was responsible for managing Asia subsidiary companies. The parent company F had no

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<sup>29</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

authority to manage its subsidiary companies as an organizational reporting structure,<sup>30</sup> “the organizational reform of 2001 got rid of the independence of the quality assurance division,<sup>31</sup> “the factory head did not have management authority over quality assurance.<sup>32</sup>” These quotes suggest that design failures in reporting lines and organizational structures create governance issues and lead to frauds. Hence, to prevent such frauds, companies should carefully design their reporting lines and organization so that governance and monitoring work well across all functions.

### **Lack of Knowledge and Interests**

Examples of management’s and/or headquarters’ lack of knowledge and/or interests include “the management failed to recognize a problematic situation where few employees dominated the quality assurance division and there was no interaction with the R&D division,<sup>33</sup> “headquarters and management did not have good knowledge of quality risks at the production site<sup>34</sup>,” “the management made light of the quality assurance function and assigned a non-capable person as the head of the

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<sup>30</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>31</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

<sup>32</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

<sup>33</sup> 東亜建設工業株式会社社内調査委員会、「平成27年度東京国際空港C滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016年7月26日

<sup>34</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

quality assurance team.<sup>35</sup>” As such, these examples do not reflect malicious thought but rather a simple absence of required knowledge.

### **Intentional Neglect**

Intentional neglect, i.e., ostrich policy, is more of an individual, managerial issue when the boss has a fear of rocking the boat and leaves the scene instead of facing the challenge head-on the frauds. Example quotes include “when an employee from the accounting division reported that the accumulated unrealized gain reached JPY 2 billion, the boss said, ‘let’s just hang in there,’<sup>36</sup>” “after consulting with the advisor, chairman Y and CEO I decided not to disclose this matter externally,<sup>37</sup>” “the accounting division and the auditing division agreed not to investigate past incidents.<sup>38</sup>” As seen in this chapter and Table 12, one can recognize the existence of various powers at the back of each quote of organizational frauds, which strengthens each factor of the fraud triangle theory that originally described the mechanism of individual frauds.

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<sup>35</sup> 東レ株式会社有識者委員会、「調査報告者」、2017年12月25日、「議事録」、2018年3月26日

<sup>36</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>37</sup> 関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日

<sup>38</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

### ***Research Question 2: What is the mechanism of Japanese frauds?***

Table 12 illustrates the assignment of affected fraud triangle factors to power factors, while Table 13 shows the list of resulting events at an organizational level by case, and Figure 5 shows the mechanism of frauds as an extension of the fraud triangle model.

The identified power factors directly or indirectly strengthened fraud triangle factors, which brought about company-wide organizational frauds. Moreover, all six organizational fraud cases have experienced organizational cover-ups after frauds had happened, although the cover-up period varied from case to case.

So, how do power factors directly or indirectly strengthen fraud triangle factors? Regarding one of the fraud triangle factors, *pressure*, a typical phenomenon is that bosses' orders can become an undeniable forcing power beyond simple pressure. In the second data falsification case,<sup>39</sup> for example, numerous fields made orders to falsify data, and the corresponding employees blindly followed these orders instead of making objections, although it was clear that data falsification is unacceptable. The series of data falsifications across the company shows that position power, in the form of orders, not only makes subordinates feel strong pressure and be pushed into a corner, but also heightens the pressure level, thereby literally forcing subordinates to blindly follow whatever orders they are given.

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<sup>39</sup> 東亜建設工業株式会社社内調査委員会、「平成 27 年度東京国際空港 C 滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016 年 7 月 26 日

Another example is the sixth corruption case, where a local big figure, Mr. M, aggressively requested order placement from the staff at the K electricity company in the form of intimidation.<sup>40</sup> Informal power in the form of an intra-company relationship coupled with intimidation and a heightened pressure level forced the internal executives to do whatever requested by Mr. M. In this case, we again see a heightened level of pressure due to power-relating behaviors exercised by power givers toward power receivers even in an intra-company relationship. As such, *pressure* is heightened by position power in the form of orders, by informal power in the forms of vertical relationship power, horizontal power imbalance, and intra-company relationships, and by perceived power in the forms of sales/profit supremacy, “customer is always right” perception, and excessive error-free policy.

Regarding *opportunity*, another factor of the fraud triangle model, a typical phenomenon is the ability of horizontal power imbalance, non-intervention policy, and neglect to provide the perfect black-box *opportunity* to commit frauds. For example, in the fourth data falsification case,<sup>41</sup> the reshuffling of the inspection division personnel had been on hold for a long term, and a small group of specialists was always responsible for the inspection, which facilitated the occurrence of black-box inspection. In the second data falsification case,<sup>42</sup> the higher expertise of the construction methods

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<sup>40</sup> 関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日

<sup>41</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

<sup>42</sup> 東亜建設工業株式会社社内調査委員会、「平成27年度東京国際空港C滑走路他地盤改良工事における施工不良等に関する調査報告書」、2016年7月26日

and the lack of collaboration with the R&D function again created a perfect black-box *opportunity* for committing frauds. As of neglect, the third accounting fraud case was characterized by organizational issues, i.e., the parent company's auditing officer could not get the information on overseas subsidiary companies.<sup>43</sup> This organizational and governance defects combined with intentional neglect provided the perfect environment, in other words, *opportunity*, to commit frauds. In summary, we see how in every case, horizontal power imbalance, non-intervention policy, and neglect provide the perfect black-box opportunity to commit frauds.

Lastly, regarding the *rationalization* factor of the fraud triangle model, perceived power in the form of non-intervention policy heightens the level of rationalization for coming frauds. For instance, in the fourth data falsification case, fraud participants had a wrong perception that as long as functions and performance are secured, so is product quality, sharing the perception that all seniors and colleagues around them committed the same frauds.<sup>44</sup> In the third accounting fraud, there was a perception that employees do not have any obligations to report gray accounting matters to the auditing company.<sup>45</sup> These non-intervention policy-based perceptions provide a rationale to commit frauds.

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<sup>43</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>44</sup> 株式会社クボタ調査チーム、「検査成績書の不適切行為に関する報告書」、2018年11月29日

<sup>45</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

This way, perceived power can help to heighten the rationalization level. As such, each power-related behavior is associated with, either directly or indirectly, fraud triangle factors, as listed in Table 12.

In the case of organizational cover-ups after fraud had happened, none of the affected companies took immediate actions to respond to the first sign of fraud occurrence. Instead, every organization pretended not to notice fraudulent facts and intentionally concealed them for a certain period before being officially accused by external or internal whistleblowers. As it is impossible for individuals to disguise company-wide organizational frauds, cover-ups are arranged at an organizational level based upon organizational decisions. For instance, in the first anti-trust violation case,<sup>46</sup> illegal actions had continued for a long time until a police investigation started, although numerous employees had recognized illegal actions. In the third accounting fraud case, it took a long time for the Singapore internal audit team to identify accounting frauds, which continued from 2009 to 2015.<sup>47</sup> In the sixth corruption case, after consulting with an advisor, the chairman and the CEO decided not to disclose the matter externally or report it to executive directors or the board, considering the potential leakage of information.<sup>48</sup>

So, what are the backgrounds of these cover-ups and how can such concealments happen?

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<sup>46</sup> 株式会社大林組第三者委員会、「調査報告書（開示版）」、2019年1月31日

<sup>47</sup> 富士フイルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

<sup>48</sup> 関西電力株式会社第三者委員会、「調査報告書」、2020年3月14日

Apparently, neglect occurred in all cases. In addition to obvious neglect, it should be noted *how, as a sequence of events*, other power-related behaviors came together, either concurrently or sequentially, and interacted with each other to create organizational decision-making to hide frauds. The third accounting fraud demonstrates combined power factor behaviors. In the first place, organizational issues were present, e.g., the internal audit department in Asia Pacific Operations was too small to conduct annual auditing (for all operating companies across Asia), and as of governance structure over subsidiary companies, (only) Asia Pacific Operations was responsible for managing Asia subsidiary companies, while the parent company had no authority to manage its subsidiary companies as an organizational reporting structure. Moreover, a prevailed perception of sales/profit supremacy was present across the company as a background, and the company had a homogenous board with a 79.3% share of lifetime directors. Right after the accounting fraud was revealed at one of the operating companies of the subsidiary company, position power was executed at a subsidiary company level in a way that the vice president of the subsidiary company ordered to write “there was no problem” in response to its parent company’s request. As the situation got worse, intentional neglect occurred in series. As a result, the management did not make decisions to deal with this matter and correct it, and the accounting and auditing divisions agreed not to investigate past incidents. Moreover, such



accounting frauds had never been discussed at the board meeting of the parent company.<sup>49</sup>

Figure 5 illustrates the contextual mechanism of organizational frauds. For the third accounting fraud, similar to other numerous organizational frauds, the prerequisites are board homogeneity as a proxy, organizational/governance issues, prevailed perceptions, orders in the form of position power, and vertical/horizontal and intra-company relationships in the form of informal power. Several internal power factors come together to strengthen the level of individual fraud triangle factors here and there and eventually become undeniable forces leading to frauds. Once frauds happen, this combined group of power factors pushes companies into making organizational decisions to conceal frauds for a certain period. Thus, power-related behaviors affect not only organizational frauds but also the organizational concealments of frauds when they come together.

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<sup>49</sup> 富士フィルムホールディングス株式会社第三者委員会、「調査報告書」、2017年6月12日

Table 13: List of resulting events (X=happened).

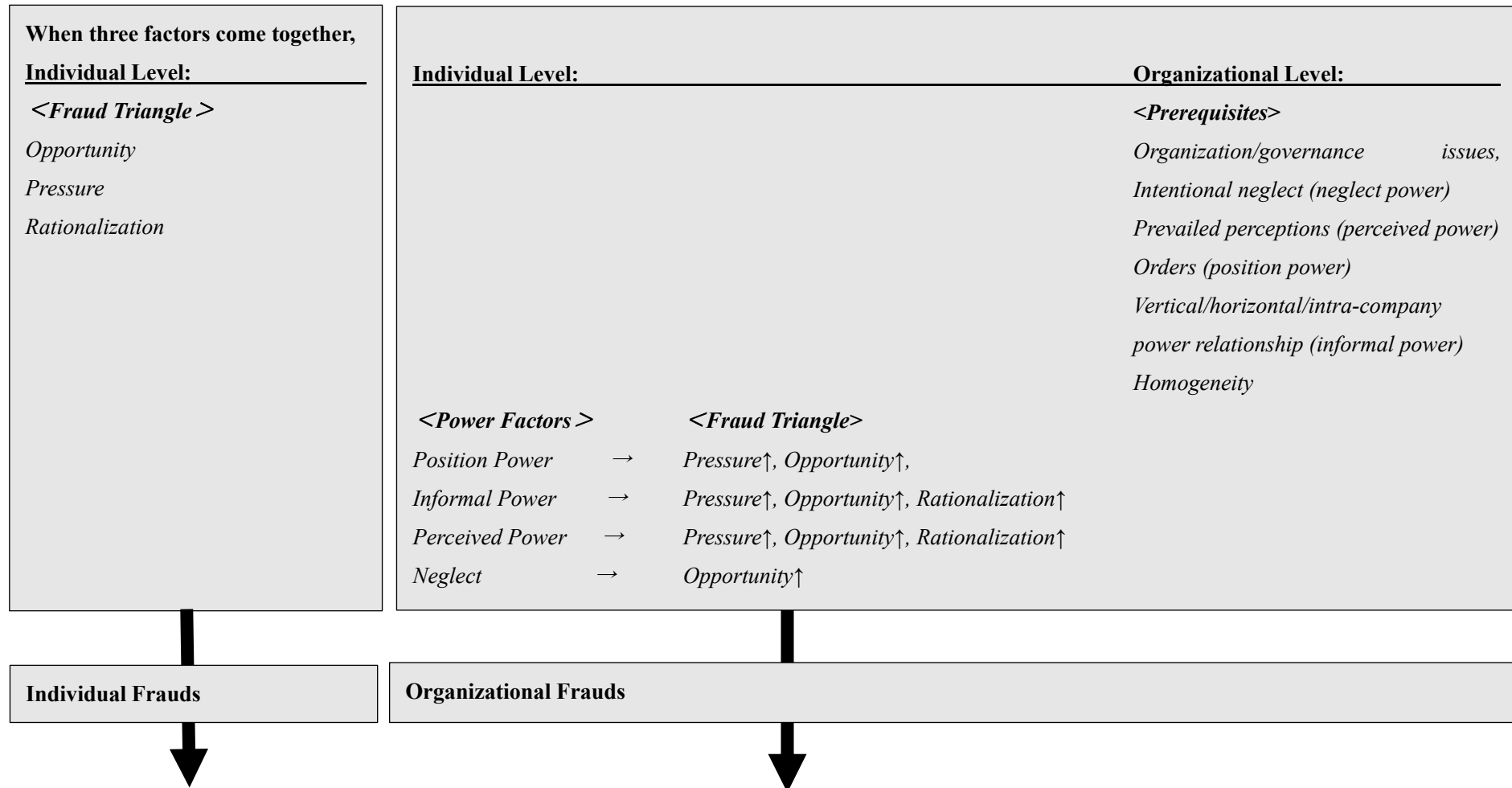
Case No. Fraud type	Homogeneity % of lifetime directors <sup>50</sup>	Individual level		Organizational level	
		Power type	Affected fraud triangle factor	Following events	Resulting events Cover-ups
1. Anti-trust violation	100%	Informal power	<i>Pressure</i>	“Illegal actions had continued for a long time until a police investigation started, without letting management notice, although numerous employees had recognized illegal actions.” “Mr. E had recognized the illegality at some point but failed to stop dealing with that collusion.”	X
		Perceived power	<i>Pressure</i>	“Nobody even asked a single question about the possibility of collusion.”	
2. Data falsification	100%	Informal power	<i>Opportunity</i>	“The civil engineering division did not report construction failures to branches’ sales or headquarters, considering the potential impact of the following orders.”	X
3. Accounting frauds	79.3%	Position power	<i>Pressure</i>	“Major issues relating to MSA identified in the June 2015 audit were that the fraud had not been reported to the CEO or the parent company, as ordered by the headquarters vice president and the executive managing	X

<sup>50</sup>Average percentage of lifetime directors between 2010 and 2016.

Case No. Fraud type	Homogeneity % of lifetime directors 50	Individual level		Organizational level	
		Power type	Affected fraud triangle factor	Following events	Resulting events Cover-ups
				director.”	
				“Asia Pacific Operation had reported the fraud to the CEO, although a detailed description of auditing risk had been removed.”	X
		Informal power	<i>Pressure</i>	“The head of Asia Pacific Operation Sales directly discussed the matter with the vice president and top executives and gained their approval. This non-transparent, stakeholder-dependent decision-making process has been widely accepted.”	X
		Neglect	<i>Opportunity</i>	“In particular, it took a long time for the Singapore internal audit team to identify accounting frauds because of the large distance between New Zealand/Australia and Singapore, and these frauds therefore continued from 2009 to 2015.” “These accounting frauds were never discussed at the board meeting of the parent company. Governance control by the board meeting failed to function in this case.”	X
4. Data falsification	100%	Position power	<i>Opportunity</i>	“Fraud methods have been passed down from a predecessor to a successor.”	X
		Perceived	<i>Pressure</i>	“Fraud participants had a wrong perception that as long as functions and	

Case No. Fraud type	Homogeneity % of lifetime directors 50	Individual level		Organizational level	Resulting events
		Power type	Affected fraud triangle factor	Following events	Cover-ups
		power		performance are secured, so is product quality.”	
		Neglect	<i>Opportunity</i>	“They shared the perception that all seniors and colleagues around them commit the same frauds.”	
5. Data falsification	97.6%	Neglect	<i>Opportunity</i>	“The teammates of fraud participants were not aware of frauds or sufficiently capable of detecting them.”	X
6. Corruption	95.2%	Neglect	<i>Opportunity</i>	“After consulting with the advisor, chairman Y and CEO I decided not to disclose this matter externally and not to report it to each executive director or the board, considering the potential leakage of information.” “The management did not make decisions to deal with this matter and correct it.”	X

**Figure 6: Fraud contextual mechanism.**





**Power factors further strengthen fraud triangle factors**

**Individual Level:**

*Intentional neglect (neglect power)*



**Organizational Level:**

*Organizational decision-making to cover up frauds*



*Organizational cover-up of frauds*

### 3.5 DISCUSSION

This section further deals with some unique backgrounds of organizational frauds to explain the reasons of why *neglect* happens so frequently at Japanese companies, aiming to provide additional backgrounds and contexts of the fraud mechanism. In my opinion, the following three unique characteristics separate Japanese companies from western ones.

First, most Japanese boards of directors suffer from an overly large number of agenda proposals, which, on average, equals 101.5 proposals per year (Deloitte Tohmatsu Consulting, 2016 Board of Directors Survey). As of 2017, 39% of all Japanese companies had already revised their criteria for these proposals, and 59% of them were in the process of revising it (Nishimura Asahi Law Firm, Presentation, October 16, 2017). Considering the governing role of boards of directors, their main discussion should be ideally focused on a) mid- to long-term strategy directions, b) large-scale M&A matters, and c) risk management, instead of covering too many things (Willis Towers Watson, Presentation on Corporate Governance Seminar, April 20-21, 2017). In case of the possibility of fraud in a given company, the board of directors should discuss it as a top agenda from the perspectives of risk management. In reality, however, the excessive number of agenda proposals suggested by execution teams hinders the prioritization of fraud matters over many other non-discussed waiting proposals.

Second, Japanese companies are characterized by the lacking independence of the chairman of the board of directors. Most of such chairmen are still internal in Japan, whereas the situation in

western companies is totally different, e.g., in Germany, CEOs are not allowed to concurrently act as chairmen, while in the UK, only 3% of CEOs double as chairmen, and 52% do so in the US (Brunswick Review, Spring 2016). Chairman independency should affect agenda selection, the time allocated for each agenda, and the direction and prioritization of the board discussion. It is natural for independent chairmen to avoid overlooking potential frauds from independent, objective, and governing perspectives.

Third, for each position, most western companies prepare a job description document that includes clear reporting lines, whereas many Japanese companies do not provide a job description even for senior positions, which makes the scope of work and reporting lines vague. As such, the work is not necessarily linked with the position but can up to an individual as a system, i.e., if the employee is capable, the scope of work is expanded, while if the employee is very junior, the scope of work can be adjusted accordingly. In cases of frauds, these vague reporting lines can go wrong, as employees are not, according to an official job description, clearly managed to report thing A to Mr. X as a rule. This ambiguity provides an excuse for employees who recognized the fraud for not reporting it to the designated people.



## **Chapter 4. CONCLUSIONS**

### **4.1 THEORETICAL CONTRIBUTIONS**

This research quantitatively and qualitatively examined corporate frauds from multiple aspects to uncover Japanese corporate frauds and their mechanism, thus making the following three significant theoretical contributions.

First, quantitative analysis introduced new IVs, and the obtained results suggested that internal directors matter more than outside directors when it comes to the likelihood of corporate fraud occurrence in Japan, further showing that board homogeneity as a proxy of the higher percentage of lifetime directors is positively correlated with the occurrence of corporate frauds. These findings support the behavioral agency model with particular emphasis on internal governance, helping to predict relationships between frauds and board composition. With these findings in hand, the behavioral agency model could be extended.

Second, quantitative analysis revealed significant differences in fraud ratio across industries, demonstrating that the highest ratios were observed for the four secondary-sector industries (electricity & gas, automobile & aircraft, transportation & logistics, and construction & materials).

Third, qualitative content analysis of 133 third-party committee reports identified root causes of corporate frauds: a set of internal power factors associated with fraud occurrence, namely position power, informal power, perceived power, and neglect. In turn, these factors featured the

contributions of 11 internal power factors, namely orders, vertical relationships, horizontal power imbalance, intra-company relationships, sales/profit supremacy, “customer is always right” perception, excessive error-free policy, non-intervention policy, government/organization failures, lack of knowledge and interests, and intentional neglect. Japanese companies latently inhere a number of internal power factors, which originate from its traditional recruiting system, lifetime employment, high-context culture, Confucian way of thinking (to respect seniors as masters of life), and homogeneity. The fact that I analyzed these unique Japanese frauds did help identify all these new power factors behind corporate frauds.

Additionally, the mechanism behind corporate frauds was uncovered as an extended implication of the fraud triangle model, which has not yet been discussed. In summary, when several internal power factors come together, the individual fraud triangle factors are strengthened to generate undeniable forces that can eventually lead to frauds. Furthermore, once frauds happen, this combined group of power factors pushes companies into making organizational decisions to conceal their frauds for a certain period. Thus, as a mechanism, power-related behaviors can affect not only organizational frauds but also their subsequent organizational concealments, if these behaviors come together.

To my knowledge, no research has yet discussed internal power factors in relation to corporate frauds, nor the mechanism in the Japanese context. In view of this, I trust that my present work makes a significant contribution to the literature.

## 4.2 MANAGERIAL IMPLICATIONS

Over the past nine years, I have been conducting corporate governance consulting in the UK and Japan, mainly supporting the boards of directors and nomination committees of listed companies.

In my opinion, board homogeneity and its implicit power balance are the most notable features of Japanese boards compared with UK ones. Concurrently, the number of Japanese frauds has dramatically increased in the past 10 years, which provided inspiration for the present research.

In the past years, particularly since the Corporate Governance Code has been enacted, the listed companies made significant efforts to prepare for a formal governance structure by inviting outside directors and outside auditors, establishing remuneration and nomination committees, and redesigning governance structure. By 2020, most companies have taken actions to strengthen their governance mechanism through explicit, external, and formal measures, and should therefore now move to implicit, internal, and informal aspects, particularly when it comes to corporate fraud prediction and prevention.

The present work revealed the root causes of corporate fraud: power, employment system, board homogeneity, and unhealthy organizational behaviors. To tackle these root causes, the following actions are suggested for corporations.

First, to minimize group-think and achieve healthy, open discussions among the board of directors, the proportion of lifetime directors should first be carefully managed. Board diversity does

help in decreasing frauds. In the case where signs of fraud surface, this agenda should be immediately prioritized to make decisions on how to correct and deal with the situation. In fact, many cases of fraud have not even been discussed at the board meeting, which led to even more serious outcomes, including frauds increasing to a larger scale, long-term frauds, and organizational concealment of frauds.

Second, corporations should make significant investments to help identify and control various power-originating behaviors across the organization. This can be done through redesigning the organizational structure and strengthening human resource management. Typically, the lack of governance from the corporate headquarters or management and the non-intervention policy-based perceptions create a hole in the reporting flow, eventually leading to frauds. Hence, to prevent such frauds, companies should carefully arrange their reporting lines and organization, simulating frauds, so that corporate governance and monitoring may work well across all functions. Moreover, the most noticeable form of power comes in the form of having the authority to give orders. A typical phenomenon is that bosses' orders can become an undeniable power beyond simple pressure, thereby literally forcing subordinates to blindly follow whatever orders they are given. A zero closed, black-box team should exist in the organizational structure as a set of eyes to ensure checks and balances across the company. It is ultimately a human resource management responsibility to address the list of excessively perceived perceptions that are inscribed deep into the employees' minds and govern their

behaviors. The threshold between excessive and healthy perceptions tends to be implicitly determined by receivers. Therefore, companies should be proactively checking if these perceptions, such as the sales/profit supremacy, “Customer is always right” perception, excessive error-free policy, and non-intervention policy are reasonably operated, while ensuring compliance.

The presented results and suggestions will hopefully reach the top management of Japanese companies and broader stakeholders, triggering them to further manage board composition and directly tackle the list of power factors, thereby strengthening governance in a real sense and eventually helping to prevent frauds.

### **4.3 LIMITATIONS AND SUGGESTIONS FOR FUTURE RESEARCH**

The following three limitations and suggestions for future research come to mind.

First, regarding quantitative analysis, the results of past research are mixed. As mentioned above, Wagner (2002) suggested the existence of a curvilinear homogeneity effect, according to which performance is enhanced by the greater relative presence of either inside or outside directors. These mixed findings inspired the present work but clearly show the need for further research and the evaluation of multiple research methods such as logit analysis using binary DVs to increase validity.

Additionally, further valuable insights can be obtained by exploration of board diversity indicators such as the number of different expertise (functions) of directors, the percentage of directors with overseas working experiences, the percentage of female and/or foreign directors, etc. Another dimension possibly influencing frauds is the level of directors' commitment toward the board decision-making activities, given that this level can be quantified. Examples include the yearly attendance rate of all directors, the number of comments at board meetings, and the number of directors' communications with the company members.

Regarding qualitative analysis, the validation process could be further strengthened, e.g., by having external coders not informed of the research details do objective coding to increase coding accuracy and validity. Another way to strengthen validation, which I am planning to look into in the near future, is to conduct a large-scale interview with outside directors of fraud companies, or if that

is impossible, with veteran outside directors of any listed companies to test and improve the qualitative findings presented herein.

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## APPENDIX: THIRD-PARTY COMMITTEE REPORTS REFERENCES

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