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

Asuka Takaoka

DBA Program in International Business Strategy
Graduate School of International Corporate Strategy
Hitotsubashi University

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.

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 &d 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.

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.

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.