The Role Of Corporate Culture and Cultural Background

In Olympus Case

Master Thesis

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Abstract

Since the Olympus case have been revealed to the surface, suddenly it has been a major blow for Japanese corporate governance that has been under pressure all this time. However, What is the most interesting about this case is not only such heavy losses that tried to hide, but "the man" behind the scene who dare to blow the whistle. Michael C. Woodford, British-born directors, who only serve as CEO for only two weeks into the job, being ousted from Olympus for questioning and cover up the fraudulent hiding losses practice to the public. Third Party Committee, appointed by Olympus shortly after the case have been revealed says that "the management was rotten to the core". Signaling that corporate culture in the board room was a main core problem.

Many people outside Japan said that Japan Corporate governance are viewed as insider dominated, with only directors with close ties management who can serve in the board room, giving room for collusive practice between board of directors and the Olympus case seem aggravated those presumptions. Indeed, Corporate governance is not formed solely by legal factors, Politics, Economics, and social factors are giving influence as well. However, In Japan Non legal norm which comprises of the Main Bank System, Cross-shareholding, and Long Term Employment, played a pivotal role shaping corporate governance and applied in practice. Even though those non-legal norm is weakened over time, due to globalization, social changes, political factors, and economic downturn, however they still exist and have power in Olympus case.

These non legal norms deeply rooted in Japanese culture, in the past they exert power and help Olympus to survive in "the lost decade", but now it seems pull the Olympus into the verge of the valley of the death. Learning from Enron demise it shows such corporate culture is really matters to driven the company either to its success or its failure.

Olympus as one of the big company with a long history is a main company in Japan and such practice must be highly affected toward the economic environment in Japan as general. Such scandal puts pressure to japan to once again reform their corporate law, but the question is, it is necessary? Since the post-war japan have been already begun to "copying" American model, but it seems the adoption of the American model into Japanese business culture was unsuccessful. Japan adopted corporate governance structures and rules based on American corporate law, but in practice, they deviated substantially from the American model.

Japan in the process of transformation period from stakeholders oriented to shareholders and this process reflected in cultural shift which being triggered by globalization, social, political, and economic condition worldwide. However, rapid and extreme transformation only results rising conflict from *keidanren*, Japan need time to digest such transformation while legal reform can help to trigger such transformation process. The "New" legal reform regarding whistle-blower protection, commercial code, shareholders protections and derivative suits, it is necessary to accelerate such transformation.

List of Abbreviations

BOD	: Board of Directors
CEO	: Chief Executive Officer
EU	: European Union
FA	: Financial Advisor
LTCB	: Long Term Credit Bank
M&A	: Merger and Acquisition
METI	: The Japan Ministry of External Trade and Industry
OECD	: Organization for Co-operation and Development
PRC	: The Peer Review Committee
SOX	: The Sarbanes-Oxley Act of 2002
TSE	: Tokyo Stock Exchange
UK	: The United Kingdom
US	: The United State of America

Chapter 1 – Introduction

1.1. Background

In the aftermath of ENRON and PARMALAT cases have been revealed, many people started to look at the importance of corporate governance. However, there have been other factors, for instance the worldwide privatization wave, growth of institutional investors, merger and takeovers that contributed to corporate governance failure. However, corporate scandals played an important role as momentum for the rising concern of corporate governance. Reformation of the corporate governance framework has become the main focus for the government to save the corporation and more importantly prevent the scandals in the future. The emergence of Sarbanes-Oxley Act of 2002 in the US, and Transparency Directive and Accounting Standards in EU, has become evident that the reformation has been taken by the governments to mitigate the devastating losses.

On the 14 October 2011 the Olympus Scandal was revealed. It happens when Michael Woodford was suddenly ousted as CEO (Chief Executive Officer) of Olympus Corporation. He had been only two weeks into the job when he exposed, one of the biggest and longest-running loss-hiding arrangements in Japanese corporate history.[1] The scandal raised concern about the strength and culture of corporate governance in Japan.

Michael Woodford alleged that his removal was related to several prior acquisitions. He had been seeking answers to, particularly the US$ 2,2 billion deal in 2008 to acquire the British Medical equipment maker (Gyrus Group).[2] Financial adviser based in the Cayman Islands received a total payout of $687 million as a fee, a sum equal to 31 percent of the purchase price, more than a third of the purchase price, and which ranks as the highest ever M&A fee, compared to normal fees which range between 1% to 2% of the purchase price. The company also acquired three small Japanese companies for a total of $ 940,1 million from 2006 to 2008

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[1] Inagi, Kana, & Phred Dovrack. (2011, November 8). Olympus Admits to Hiding Losses. *The Wall Street Journal*. Retrieved from http://online.wsj.com

[2] *Ibid.*

that had little discernible revenue or business history, and seemed peripheral to the company's core business.[3]

On 26 October, Tsuyoshi Kikukawa resigned as president, he was replaced by Shuici Takayama. On 8 November 2011, the company admitted that the company's accounting practice was "inappropriate" and that money had been used to cover losses on investments.[4] Olympus said it failed to disclose investment losses from the 1990s and then tried to clean up its books using four acquisitions made in 2008. Three of those acquisitions were overpriced (with much of their value written off as a loss a year later) and the fourth included vastly inflated payments to advisory firms.[5] The company blamed the inappropriate accounting on former president Tsuyoshi Kikukawa, auditor Hideo Yamada and executive vice president Hisashi Mori.

As a reaction of the scandal, an outside panel appointed by Olympus to investigate its financial scandal. The panel was led by a former Japanese Supreme Court Judge and was appointed on November 1st, shortly after accepting the resignation of Tsuyoshi Kikukawa over the scandal and replacing him with Shuici Takayama, who had been a managing director.[6] On Tuesday, December 6th the panel issued a harsh report and shifted the debate entirely. The nearly 200-page document is blistering condemnation of the company's practices. "The core management was rotten," the panel wrote, "and some around it were contaminated as well." Panel finds, the culture was corrupt in the Olympus, the reports also details the roles it claims were played by three former Nomura bankers in arranging a cover-up, and it says Olympus paid the bankers for their efforts.[7]

There is a correlation between the Olympus case and others big scandals like ENRON and PARMALAT. The accounting fraud in Olympus Corporation has been going on since the

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[3] *Ibid.*

[4] Dvorak, Phred, & Daisuke Wakabayashi. (2011, November 9). Olympus Coverup Spooks Investor. *The Wall Street Journal*. Retrieved from http://online.wsj.com

[5] *Ibid.*

[6] K.N.C. (2011, December 8). The Olympus Scandal: The end of the beginning. *The Economist*. Retrieved from http://www.economist.com/node/21541486

[7] Tabuchi, Hiroko & Keith Bradser. (2011, December 6) : The Culture was Corrupt at Olympus, Panel finds. *The New York Times.* Retrieved from http://www.nytimes.com

1990s, being that it happened in order to cover losses on the 1990s. This was the same period of time in which scandals such as ENRON and PARMALAT happened, but the difference is both ENRON and PARMALAT finally uncovered in the early 2000s, while the Olympus case uncovered in 2011 after an outsider, a non-Japanese recently nominated CEO, Michael Woodford having raised concerns about the "inappropriate" dealings.

One of the main feature of Olympus scandal is that the case was being revealed by someone "outside" Japanese, this issue arising the question whether, if the CEO of Olympus had remained a Japanese person or a member of the so-called Olympus clique, the accounting fraud would have probably continued unspotted. In the report, the panel characterized Olympus as having had a company culture that puts a premium on secrecy and obedience above sound corporate governance. "Past presidents had low regard for transparency and governance," the report said, "and standing up to them to speak the truth meant you risked being put out to pasture, which is apparent from what happened to Michael Woodford".[8] Japanese chief executives officers are often figureheads, while real (but informal) power resides elsewhere, perhaps with the chairman. Mr. Woodford challenged this convention. A traditional Japanese manager might have tackled the problem instead of embarrassing his peers. [9]

The recent corporate scandal like Olympus in Japan highlight the need for the reform of that country's corporate governance structure, just as the Enron case did in the US with Sarbanes-Oxley Act. However, besides corporate governance reforms in Japan, perhaps more important than corporate governance rule are the role of corporate culture and the cultural background of the board which can have a great impact on the soundness of the corporate governance of public companies. In Japan, which has very different culture with other countries for instance US and Europe. The corporate culture and cultural background of the members of the board have much more definitive influence in the establishment of corporate governance in

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[8] *Ibid.*

[9] (2011, October 22) :Corporate Governance in Japan : Olympians Depths. *The Economist.* Retrieved from http://www.economist.com

public listed companies than mandatory or non-mandatory corporate governance rules and/or codes.

1.2. Research Question

Based on the definition of the problem as outlined above the main research question to be examined in this thesis is the following: to what extent the role of corporate culture and cultural background of the members of the board can prevent accounting frauds of the sort seen in the Olympus case, even in the aftermath of corporate governance reforms? In order to answer this main question, I will provide answers to the following related questions:

- How corporate governance regulates in Olympus Corporation, before the scandal have been revealed?
- To what extent the role of corporate culture and cultural background of the members of the boards have definitive influence in the establishment of corporate governance in Japan
- What is the influence of corporate governance reforms in Olympus Scandal, and how to prevent accounting fraud in the future?

1.3. Methodology

In order to answer the main question and address the subsidiary problem mentioned above. This paper will include a literature review and examination of case law, as the main source. I will review Japan's existing legal regulation as regulate corporate governance in Japan. I will review in particular, corporate culture in public listed companies in Japan. I will also analyze the literature concerning current regulations in accordance with Olympus case and compare it with the other corporate case in the EU and the US.

1.4. Structure

This thesis divided into five chapters. Chapter 2 will firstly give a description of Olympus case and corporate governance code and rules in Japan, including reforms in corporate governance after the Japanese bubble burst around 1990s. Then, this chapter will also explain corporate governance in public listed companies in Japan. Chapter 3 will discuss the role of corporate culture and cultural background of members of the board in Olympus. In this chapter we will elaborate and provide more evidence on why corporate culture has decisive influence in the corporate governance in public listed companies. Chapter 4 will analyze the evidence presented in chapter 3 and then I will elaborate the other case for instance ENRON in US as comparison to Olympus case. Lastly, Chapter 5 will provide answers to the research question and draw conclusions.

Chapter 2 – Overview of Corporate Governance Culture in Olympus Corporation and Japan

To give a good understanding of the issues addressed on the topic, in this chapter, I will present a brief overview of the Fraudulent arrangement for hiding Losses in Olympus Case, with a focus on the Corporate Governance system in Olympus which failed to discover the fraudulent practice in Olympus Corporation. This is followed by the description of the development of the corporate governance in Japan. Then this chapter will also explain the role of corporate culture in corporate governance in Olympus Corporation which give a contribution in fostering the fraudulent practice and corporate culture in Japan as well.

2.1. Overview of Fraudulent Practice in Olympus Corporation.

Fraudulent arrangement for hiding losses transaction first came to attention in late July when an article in the Japanese finance magazine *Facta* raised the question about Olympus's acquisition of the three Japanese companies. Those articles attracted the concern of Michael C. Woodford, the British-born president of Olympus Corporation.[10] On October 12th, Michael C. Woodford commissioned PricewaterhouseCoopers (accounting firm) to examine the purchase of Gyrus, a British medical technology firm.[11] Separately, Michael C. Woodford held an inquiry against Olympus's acquisition in 2008 of three small Japanese companies unrelated to Olympus's core businesses for almost $ 600 million.[12] He found that those investments which were not covered in the accounting report were written down to only a quarter of their value within the same fiscal year. Michael C. Woodford said that the transactions he is questioning resulted in the destruction of $1,3 billion in shareholder value at Olympus.[13]

Subsequently, Michael C. Woodford sent a copy of the accounting firm's report and his inquiry to chairman of Olympus, Tsuyoshi Kikukawa. He outlined in that report that the transactions were "shameful" and called for the resignation of the chairman and two other executives. He also outlined in the report that Olympus completed the acquisition of three

[10] Tabuchi, Hiroko. (2011, October 17). Ex-Chief Executive of Olympus Ties Ouster to His Claim of Fraud by the Company. *The New York Times* . Retrieved from http://www.nytimes.com/

[11] *Ibid.*

[12] *Ibid.*

[13] *Ibid.*

companies (including maker of facial creams and Tupperware, like plastic cases for use in microwave ovens) in 2008 for $ 773 million. But later that fiscal year $586 million of their value was written off.[14] According to the report that was served by accounting firm, Olympus made $ 687 million in payments to two financial advisers in connection with its 2008 acquisition of Gyrus. That amount came to be more than a third of the $2 billion purchase price of Gyrus, far above the market fees for comparable services that typically amount to only 1 to 2 percent of the transaction fee.[15] The accounting firm's report commissioned by Michael C. Woodford outlined a range of possible offenses under Tsuyoshi Kikukawa's leadership, including false accounting and breaches of duties by the board. The report says that improper conduct of the board could not be ruled out. Michael C. Woodford wanted to confront such reports and his inquiry to the suspicious transaction to the Olympus chairman, Tsuyoshi Kikukawa.[16]

Michael C. Woodford sent the report to Tsuyoshi Kikukawa and all members of the Olympus board as well, and suggested to hold a meeting to discuss these issues. As reaction to the reports, Tsuyoshi Kikukawa held an emergency board meeting where Michael Woodford said he was not allowed to speak, and to declare the dismissal of Michael C. Woodford from his position in Olympus.[17] Michael C. Woodford is the only non-Japanese executive among the 15 directors that was fired because of questioning the suspicious transaction in Olympus, he stated that the entire board had known about the accounting firm's report but had not taken action.[18]

Olympus said, those payments were "appropriate" and it would set up an independent panel to examine its past merger payments. Meanwhile, the firing of Michael C. Woodford, who is British, and his subsequent accusation that he was forced out because he planned to expose the fees, has rocked the company, its shares have fallen 50 percent since these issues were exposed by the media.

On 26th October, Tsuyoshi Kikukawa, resigned as Olympus chairman, just two weeks after he had publicly fired Michael C. Woodford. In a statement announcing his own resignation, Tsuyoshi Kikukawa insisted that there was "no corruption" involved in the

[14] *Ibid.*
[15] *Ibid.*
[16] *Ibid.*
[17] *Ibid.*
[18] *Ibid.*

acquisition that Michael C. Woodford had questioned. Afterwards, Tsuyoshi Kikukawa was replaced by Shuichi Takayama, a managing director of the company.[19] The Olympus debacle involves accusations of money laundering, false accounting and other fraudulent practices totaling more than a billion dollars and potentially Japan's largest-ever financial scandal.[20]

Olympus formed and assigned an independent Third party committee, a committee of outside legal experts, to investigate the cover-up. Olympus said on 8th November, that more than $1 billion in merger payouts were used to hide years of losses on investments.[21] In news release notice, Olympus said the panel found that the money for mergers had in fact been used to mask heavy losses on investment racked up since about 1990. The panel found that the Olympus channeled money through several investment funds to "eliminate latent loses,"[22]

On 6th December, an outside panel appointed by Olympus to investigate its financial scandal issued a harsh report, calling the company's "rotten to the core". [23]The report says that Olympus had persuaded several banks, including *Societe Generale of France*, to submit incomplete financial statements to the auditors, apparently in an effort to conceal financial maneuvers that the reports say involved at least $1,7 billion and were meant to hide failed investment during the 1990s. Nevertheless, there is no indication that the banks knew of Olympus's cover up.[24]

Despite its harsh tone, and the fact that the report seemed to sharply define the limits of blame and potential wrongdoing, the panel had found no evidence of organized crime involvement in the Olympus scandal. The possibility of organized crime involvement in the cover-up has become a crucial issue because the evidence of mob links could prompt the Tokyo

[19] Tabuchi, Hiroko. (2011, October 26). At Olympus, Western Questions for Old Schools Ways. *The New York Times* . Retrieved from http://www.nytimes.com/

[20] *Ibid.*

[21] Tabuchi, Hiroko. (2011, November 7).Olympus Hid Investing Loses In Big Merger Payouts. *The New York Times* . Retrieved from http://www.nytimes.com/

[22] *Ibid.*

[23] Tabuchi, Hiroko and Keith Bradser. (2011, December 6).The Culture Was Corrupt in Olympus. *The New York Times* . Retrieved from http://www.nytimes.com/

[24] *Ibid.*

Stock Exchange to delist Olympus shares. Such a move could seriously damage shareholder value by making the stock difficult to sell.[25]

The reports also urged legal action against the executives implicated in the cover-up, including Tsuyoshi Kikukawa, the former chairman, and two other Olympus executives that have been leaving the company since the scandal began. Nevertheless, the panel had found no evidence to suggest that those of Olympus executive had personally gained from the scandal.[26] The reports also claimed that Olympus had instructed three banks in which the company had accounts that they did not need to respond to KPMG (Former Olympus's auditor) queries about collateral, which was used to finance loans to investment funds involved in the loss cover-up.[27]

On 10th January, Olympus sued 19 current and former executives and board members, including its current president, for around $50 million over an accounting scheme to hide losses going back more than a decade. Nevertheless, Olympus let the discredited president, Shuichi Takayama, and the implicated board members to stay until later this year.[28] Olympus contended that Shuichi Takayama failed to meet his fiduciary duties as a director while the fraud was under way and was being sued for $6.5 million.[29] These low amounts of money sued by Olympus to the suspected seems to be represented "the rotten to the core" in Olympus corporation, there no fairness to the amount of money they sued to the director which only around $ 50 million compare to loss of the company which total one billion dollars. These actions seem to be a mere formality to cover the collusion in the board of directors behind that scandal, the amount of money sued by Olympus, even does not near of the half the loss of Olympus. We can conclude such action is not common to the people who suffer loss, even they try to get more from the trial. We can easily picture that Olympus action is unreasonable and unjust, and it will not exaggerate if we can claim that all boards of directors of Olympus get involved in the scandal.

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25 *Ibid.*
26 *Ibid.*
27 *Ibid.*
28 Tabuchi, Hiroko. (2012, January 10). Olympus Sues Executives Over Cover-Up, but Does Not Dismiss Them. *The New York Times* . Retrieved from http://www.nytimes.com/
29 *Ibid.*

Some critics and analysts have warned that keeping tainted executives at the helm of Olympus threatened to undermine its turnaround effort by allowing discredited board members to name their successor and subvert meaningful changes in the management and accounting oversight of the company.[30] Analysts argued that the board in Olympus should be replaced and a new board should oversee the company's revival. However, Olympus defended its action, says the plan is for the current board members who were found responsible and are subject to lawsuits to complete passes their roles to avoid any impact on business. Michael C. Woodford later made a bid to return to Olympus with a fresh slate of directors, but he failed, after Japanese institutional investors, which have majority shares in Olympus, continued to back Olympus's current management.[31] These facts seem to reflect the collusion between major shareholders and Olympus current management.

Furthermore in the recent shareholders meeting of Olympus after the scandal arises, the company's management still maintains the backing during the vote from a solid voting bloc of institutional shareholders.[32] Although they try to shore up the oversight system in board by adding outside directors up to 8 (eight) outside board members but it seems to be useless without clean up the main problem in "rotten" board members. Some foreign and individual investors as well as proxy advisers call for the complete purge of the company's management, some had also called for the return of Michael C. Woodford.[33] Such practice is the perfect picture how the institutional shareholders have some collusion with the board of Olympus, although the investigation and facts that have been already blatantly urge to purge all the boards of Olympus but the institutional shareholders did not take such actions. Is ridiculous if major shareholders let somebody who have been already made suffer such huge losses but they still keep in charge in business except the major shareholder get involved in such practices or at least know and approve it.

2.2. Third Party Committee: Facts and Finding

[30] *Ibid.*
[31] *Ibid.*
[32] Tabuchi, Hiroko and Makiko Inoue. (2012, April 20).Olympus Shareholders Shake off Scandal. *The New York Times* . Retrieved from http://www.nytimes.com/
[33] *Ibid.*

Since the fraudulent practice was brought to the surface, Olympus requested an Independent investigation committee to conduct a strict and thorough investigation and find out whether or not there was a fraudulent or inappropriate conduct or unreasonable judgment and to provide a proposal for improvement and enhancement of the corporate governance regime in Olympus as well. The committee chair by Tatsuo Kainaka, former judge of the Supreme Court.

Investigation scope of the committee divided into two main areas. First, the committee held investigation of the situation of the unrealized loss and its settlement. In this area, the committee investigated how the unrealized loss incurred, how the separation of unrealized loss started and what the whole picture of the loss separation scheme of the delayed loss booking was. As to the loss settlement, the committee investigated how the acquisition of the Three Domestic Companies and Gyrus was proceeding, and determined the whole picture of the loss settlement scheme. Second, the committee considered it significant that the conduct of the fraudulent hiding loss arrangement was not found out for a long time and suspected that, there might be some problem in the corporate governance and internal control of Olympus.[34]

2.2.1. Background of the Fraudulent Practice

In the situation where the operating income decreased substantially because of the sharp rise of the Japanese yen after 1985, Olympus decided, during the era when Toshiro Shimoyama was the President, to introduce the *Zaiteku* (speculative Investment) as the important business strategy as well as the main business, and started conducting an aggressive financial asset management.[35]

However, in 1990 the bubble economy burst and the loss incurred on Olympus by the financial asset management increased. From then on, in the effort to recover the loss,Olympus started investing in high risk high return products, risky financial products that offered interest advancement and the riskier and complex structured bonds, and the loss financial assets

[34] The Third Party Committee. (2011, December 6). *Investigation Report: Summary*. Retrieved from **http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf**

[35] *Ibid.*

increased substantially and the unrealized loss piled up to slightly less than 100 billion yen by the latter part 1990. [36]

The unhealthy trend at the time by manufacturers to depend on *Zaiteku* to earn profit outside from core business itself may have to be reflected on, but the majority of fine companies which incurred large amount loss due to its failure in *Zaiteku* faced and accepted its failure, decided to recover losses due to such failure under the slogan of "back to core business" or "selection and concentration", actualized such losses in their accounting during the 1990s, amended their balance sheets to reflect the actual financial status of the company, and have now regained this figure as fine companies.[37] Unfortunately Olympus did not take such action and let the losses ballooning and concealed it eventually. In the investigation reports the committee asserted there are no correlation between the scandal and practice of crimes and the practices purely made by the Board of Olympus.[38]

Nevertheless, In June 1993 when the financial asset loss started increasing, Masatoshi Kishimoto became the president and tried to shift to the sound business operation, but he left the problem of financial asset losses with people of the portfolio management department and did not initiate a drastic solution. Hence he could be liable for a breach of the duty of care.[39] He did not take such actions to handle such losses when he still had a time to do so, but in fact he did not, which makes the loss getting bigger continuously and driven the management to conceal rather than to admit it because it was already too big. At that time Olympus was staring loss which nearly 100 billion yen hole on its balance sheet, instead of published their loss they turned to an even-more complex tobashi solution.[40]

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[36] *Ibid.*

[37] *Ibid.*

[38] *Ibid.*

[39] Joseph McCahery, Duty of care—owes a duty to corporation to exercise proper care in managing affairs of corporation. Director is expected to carry out duties in:

(1) good faith;

(2) with with the care that an ordinary prudent person would reasonably be expected to exercise in a like position and under similar circumstances;

(3) in manner that he believes is in the interests of the corporation

[40] Layne, Nathan. Taro Fuse and James Pomfret (2011, December 16). "Bubble Trouble: Olympus wanted $1.7 billion in financial market lossed from Japan's bubble days to fly away. Instead they came home to roost." *Reuters.*

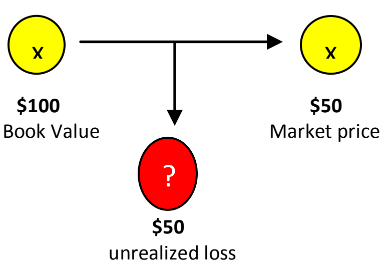
Under Masatoshi Kishimoto, Olympus formed a management structure that merely focused on pursuing management efficiency by introducing a new corporate system they left the loss problem even though he knew about the scandal. The maintained system under which a single leader moved the organizations with his strong leadership, not only concealed the existence of gigantic loses until the end of 1990s under such system, but used *Tobashi* (loss disposition scheme) by funds to continue concealing it and did not settle such losses, even though they had a chance to do so when the accounting standard was amended in 2000.[41] And Japan Financial regulator finally outlawed *Tobashi* Schemes in the same year. [42]

2.2.1.1 Anatomy of a Tobashi Scheme

in the 1990s, bankers often used *tobashi* schemes to help Japanese firms temporarily shift losses of their books[43]

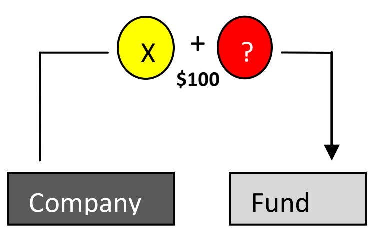
STEP 1

for instance, company buys a financial instruments X for $100 but the value of X falls to $50. The firm suffers an unrealized loss of $50.[44]



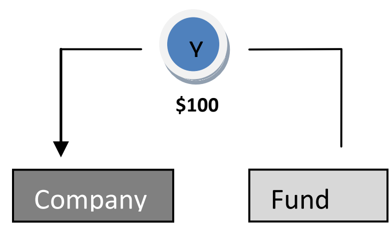
STEP 2

To hide its losses, the company shifts the bad assets X (now valued at $50) and the unrealized loss ($50) to a fund.[45]



STEP 3

the fund transfers another asset representing the book value of X ($100) back to the firm, to temporarily disguise the $50 unrealised loss.[46]



[41] *See* The Third Party Committee.
[42] *See* Layne, Nathan. Taro Fuse and James Pomfret (2011, December 16).
[43] *Ibid.*
[44] *Ibid.*
[45] *Ibid.*
[46] *Ibid.*

2.2.2. Method of Fraudulent Hiding Loss Arrangement

During the time from 1997 to 1998 when the unrealized loss was ballooning, the accounting treatment of financial assets was seriously promoted to change from the historical cost basis accounting to the fair value accounting. In that environment, Olympus started seeking a measure to avoid the situation where the substantial amount of unrealized loss would come up to the surface by the application of fair value accounting. In order to hide unrealized loss, Olympus applied two methods which are loss separation Scheme and loss settlement scheme.

2.2.2.1. Loss Separation Scheme

The loss separation scheme means the financial instruments incorporating the unrealized the loss were to be sold at the book value to the funds (separated to Olympus) that would not be required to be the consolidating entities into the Olympus consolidated financial statements.[47] In the loss separation scheme, a receiver fund, who had a role to receive the financial instruments incorporating the unrealized loss and who was not a consolidating entity, was needed and also the money for the receiver fund to buy the financial instruments at the book value was needed.[48] In order to flow the money into the receiver fund, Olympus had the bank provide a finance to the receiver fund under the pledge of a bank deposit served by Olympus and Olympus set up a business investment fund, from which money flowed into the receiver fund.[49]

The implementation of loss separation scheme that worked by Olympus, can be categorized into three main routes:[50]

1. Europe route

From 1997 to 1998 Olympus set up, as the receiver fund, Central Forest Corp (referred as **CFC**) and Quick Progress Co. (referred as **QP**) and in the same year had the LGT Bank provide a credit line of 30 billion yen to the Central Forest Corp and had 30 billion yen loaned to the Central Forest Corp under the pledge of a the deposit in LGT served by Olympus. LGT bank is a bank

[47] *Ibid.*
[48] *Ibid.*
[49] *Ibid.*
[50] *Ibid.*

located in Lichtenstein that used by Olympus to deposited Japanese Government Bond and obtained a finance which was to be used to buy the financial instruments incorporating the unrealized loss from Olympus.[51] In 2000 Olympus with a subsidiary company, Olympus Asset Management (referred to as **OAM**), invested 35 billion in total into a class fund managed by the LGT bank and subsequently flowed the money to CFC via separately set up funds called TEAO limited (referred as **TEAO**), and Neo Strategic Venture, L.P. (referred as **NEO**) During from 1998 to 2000, 65 billion yen in total was flowed into the loss separation scheme. To flow the money Olympus use various instrument such as Japanese Government Bond (JGB), Bank deposit securities, cash and time deposit accounts. [52]

2. Singapore Route

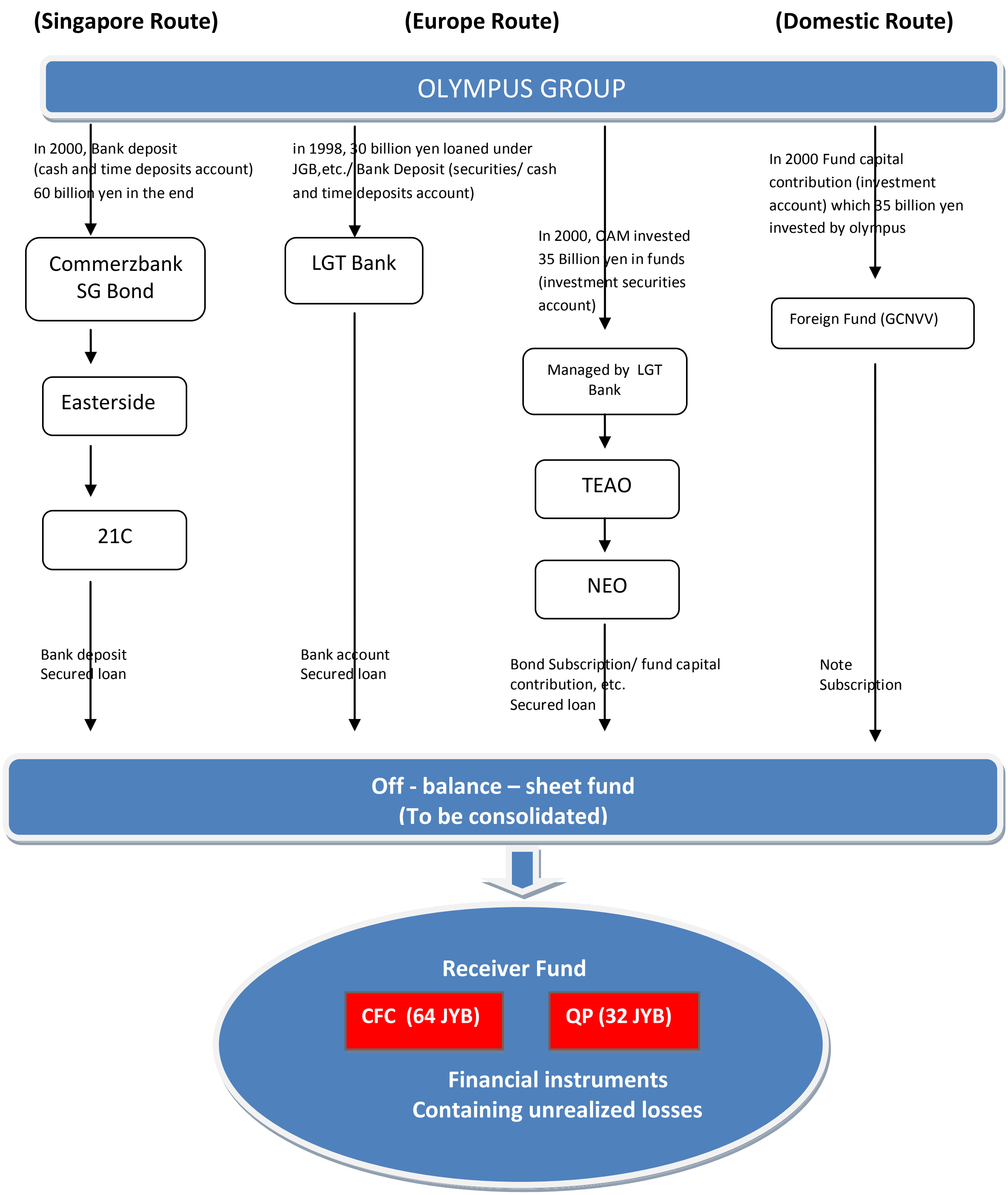
In 2000, Olympus had the Commerzbank to provide a loan of 45 billion yen under the pledge of a deposit served by Olympus in Commerzbank. Subsequently, funds which set up by Olympus flow the money into the CFC via funds such as Twenty First Century Global Fixed Income Fund Ltd. (referred as **21C**). Later the Singapore Route was changed in structure, and in the end Olympus invested 60 billion yen in SG bond plus fund (referred as **SG bond**) and lent the bond portfolio invested by the SG bond to Easterside Investments limited (referred as **Easterside**) That makes that 60 Billion yen in total was flowed into the loss separation scheme during the time from 2000 to 2005.[53]

3. Domestic Route

On March 1st 2000, Olympus set up besides two other funds, a business investment fund called G.C. New Vision Ventures, L.P (reffered as **GCNVV**), to which Olympus invested 30 billion yen and the funds invested 5 billion yen. However, is the Olympus who provided the entire amount of 35 billion yen. GCNVV invested some of the money into entrepreneurial ventures and also invested different amount at stages but about 30 billion yen in total to QP.[54]

[51] *Ibid.*
[52] *Ibid.*
[53] *Ibid.*
[54] *Ibid.*

LOSS SEPARATION SCHEME[55]



[55] Retrieved from *www.fsa.go.jp/sesc/english/news/...1/01.pdf*

2.2.2.2. Loss Settlement Scheme

Olympus transferred the loss of about 64 billion yen to the receiver funds, Central Forrest Corp as well as the loss of about 32 billion yen to another Quick Progress Co. The transaction was intended to separate the unrealized loss from consolidated financial statement of Olympus. However, because Olympus obtained the finance from the bank by the loan under the pledge of bank deposit, the loan was to be repaid sooner or later and the money invested in the funds was also to be reimbursed.[56] Under such circumstances, Olympus consulted the advisors and worked out the plan of a loss settlement scheme. In the loss settlement scheme, Olympus flowed out the money by buying entrepreneurial ventures at a high price or by paying fees to the funds for large M&A transactions, and flowed back the money settle the debit and the credit balance among the funds so that the bank deposit was to be released to Olympus and the invested money was reimbursed. Also, in the plan, the excess payment Olympus made was to be booked as goodwill which was to be gradually amortized.[57]

2.2.2.2.1. Loss Settlement Scheme Related to 3 Domestic Companies

During the Period from 2003 to 2005 Olympus work out the plan to buy the three domestic companies (Altis, Humalabo and NEWS CHEF) with higher prices in order to settle the European route and Domestic route.[58] The plan has two main ideas. First, the funds set up by Olympus subscribes shares at low price of 40.000 yen to 200.000 yen per share in the three domestic companies in order to increase the share capital. Second, Olympus buy the shares from the funds at the substantially higher price of between 5 million and more than 20 million per shares based on the business plan that assumed the high growth of the business.[59]

The Olympus's funds, NEO and Class fund IT Ventures (referred as **ITV**) obtained the shares from three domestic companies by investment for about 700 million which comprised 50.000 yen per shares for Altis and Humalabo and 200.000 yen per shares for NEWS CHEF. Later

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[56] *See* The Third Party Committee.
[57] *Ibid*.
[58] *Ibid.*
[59] *Ibid.*

on March 2006, GCNVV also bought some shares in three domestic companies from NEO and ITV for about 10,8 billion yen which comprised 1,7 billion yen bought from ITV and 9 billion yen from NEO. At the same time Dynamic Dragon II SPC (referred as **DD**) and global targets SPC (referred as **GT**) that both of them were set up by the request of Olympus bought the shares from NEO some shares in three domestic companies for about 8 billion yen.[60]

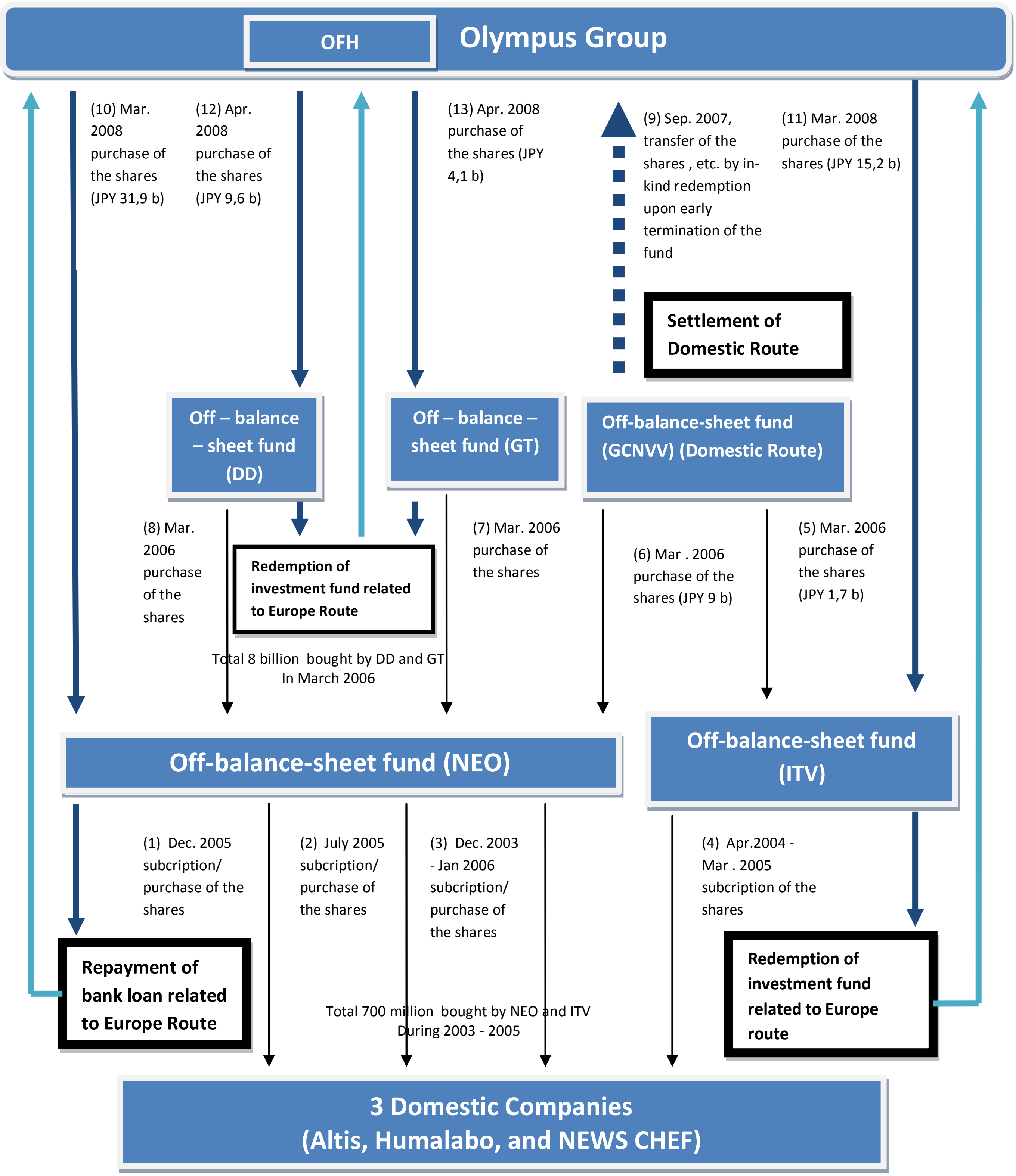
In 2007, as a result of the change of the accounting standard, GCNVV were required to be directly consolidated into the consolidated financial statement. Olympus considered the possibility as real that the unrealized loss booking by using QP fund might be revealed and decided to terminate GCNVV in September 2007. The shares held by GCNVV in the invested entities were decided to be transferred to Olympus.[61]

In March 2008, Olympus bought the shares of the three domestic companies from NEO for 31,9 billion yen and from ITV for 15,2 billion yen. In April 2008 Olympus also bought the shares of the three domestic companies via subsidiary finance company called Olympus Finance Hong Kong Limited (referred as **OFH**) for about 9,6 billion yen from DD and 4,1 billion yen from GT. The Total of the shares obtained by the Olympus including by direct investments, the shares of the three domestic companies for about 73,2 billion yen.[62]

The sale of 31,9 billion yen for the Three domestic companies that was paid by Olympus was used to repay via QP the loan provided by the LGT bank to CFC, and Olympus withdrew the deposit of 35,1 billion yen that were released by the LGT bank. And the sale of 15,2 billion yen that ITV received from Olympus was flowed into PS Global Investable Markets (referred as **GIM**) via NEO and TEAO. The total sale of 13.7 billion yen received by DD and GT from OFH was flowed to GIM via Easterside, Creative Dragon SPC (referred as **CD**), GPA Investment Limited (referred as **GPAI**), CFC and TEAO. As the results by October 2008, Olympus was received the reimbursement of about 37 billion yen. That made the Europe route settled.[63]

[60] *Ibid.*
[61] *Ibid.*
[62] *Ibid.*
[63] *Ibid.*

Loss Settlement Scheme Related to 3 Domestic Companies[64]



64 Retrieved from *www.fsa.go.jp/sesc/english/news/...1/01.pdf*

2.2.2.2.2. Loss Settlement Scheme Related to Large Acquisition in Medical Business (Gyrus)

In order to settle the Singapore Route, Olympus works out the plan to buy the target company (Gyrus) at a higher price. And since Juny 2006 Olympus has entered into financial advisor agreement (FA agreement) with Axes America in the large M&A transaction. The FA agreement provided that share option over the acquisition vehicle that was to succeed the assets of a target company, was to be granted to Axes America. Such provision was agreed based on the idea that Olympus was to flow money that was created by, among other means, buying back shares later at a high price, flowed the money into the fund via Axes America so as to use money to cover the loss.[65]

In November 2007 the FA agreement provided that upon the completion of the acquisition , 12 million dollars in cash, share option and warrant in respect of Gyrus shares were to be paid and given as the completion fee. The amount of money was agreed to cover the losses.[66]

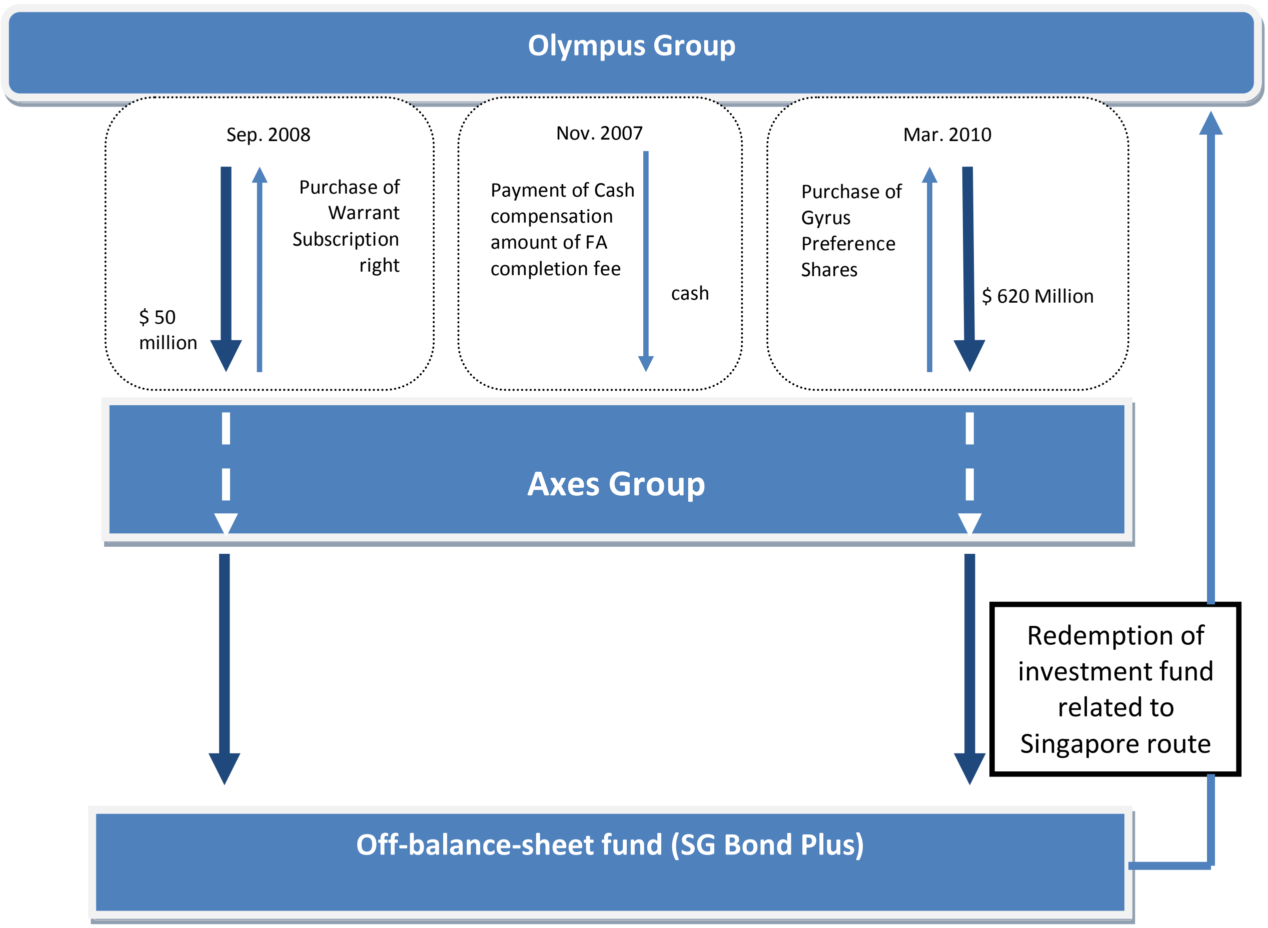
In September 2008, Olympus bought back the warrant from Axes America for 50 million dollars. In November 2008 Axes America requested Olympus either consent to the assignment of the share subscription agreement to a third party or a purchase back the dividend preference shares at a price between 530 million and 590 million dollars.[67] Later, the board meeting of Olympus consented to purchase back all dividend preference shares. However, the purchase back of dividend preference shares was not actually executed until the auditing firm was replaced from KPGM AZSA LLC to Ernst & Young ShinNihon LLC. In March 2010, the Olympus eventually bought the dividend preference shares for amount 620 million dollars.[68]

The 50 million dollar purchase price of the warrant paid to Axes America by Olympus in September 2008 was transferred to GPAI, and the 620 million purchase price of dividend preference shares paid to Axes America by Olympus in March 2010 was funneled to SG bond

[65] *See* The Third Party Committee.
[66] *Ibid.*
[67] *Ibid*
[68] *Ibid.*

via GPAI, CD, and Easterside. As a result, 63.2 billion yen were redeemed from SG bond by March 2011 and the Singapore Route was Settled.[69]

Loss Settlement Scheme Related to Gyrus Transaction[70]



2.3. Corporate Governance Failure in Olympus Case.

2.3.1. Company Structure

The corporate governance and internal control of Olympus are introduced with control the environment, for instance risk assessment and response, control of activities, information and communication, and monitoring. Such system only become as a matter of formality. The fraudulent practice in Olympus points out that such system was flawed and insufficient.

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[69] *Ibid.*

[70] Retrieved from *www.fsa.go.jp/sesc/english/news/...1/01.pdf*

Refer to the Olympus fraudulent practice that departments other than the Finance departments did not pay enough attention to the activities of the Finance Department which managed the financial assets.[71] In addition, check and supervision by other departments were totally nullified. Because the leadership model in Olympus dominates those departments mainly including HR and Finance Department. This manner resulted in the arbitrary and discretionary activities of the Finance Department.[72]

Since the beginning of the scandal, the Finance department was led by Hideo Yamada and Hisashi Mori. Being motivated with Toshiro Shimoyama as president of Olympus to use *zaiteku* and persuade from Nakagawa a genius investment banker to go more aggressive as the Finance department in Olympus, both of them start to pouring money into riskier business. Both of them were responsible in work out the plan of the loss separation and settlement schemes in Olympus's scandal since 1990 until 2010.[73] With the longest tenure as finance department we can conclude that Finance department has more discretionary rather than other department. There is no supervisory control to the Finance department's activity, because they backed by the president of Olympus. These facts make Finance department have extraordinary power to maintain the asset of Olympus. When Masatoshi Kishimoto became president in June 1993, he already knows about the problems caused by Yamada and Mori but he did not change the Finance Department with other people outside the department, and this practice continues until the scandal being revealed. In June 2001 when Kikukawa became president, Yamada and Mori still in charge as Finance department, even they reported twice a year to Kikuwa which these meetings also attended by Kishimoto.[74] This fact is picture how the practices of collusion already deepen in Olympus. Either Kishimoto and Kikukawa who has been serving as president of Olympus tried to help the scandal by letting the finance department held by Yamada and Mori for a long time.

This case was led and executed secretly by the top managements such as the president, vice president, and managing directors, and selected executives that surround them. This

[71] *See* The Third Party Committee.
[72] *Ibid.*
[73] *Ibid.*
[74] *Ibid.*

condition compounded by no risk management system that intended to counter such misconduct by top executives of the company. In terms of governance under the Companies Act, the corporate bodies that are required to check misconducts are the board of directors, auditor, board of auditors and accounting auditor. Even it is normally difficult to check the misconduct that involves top management as in the Olympus case. However, in this case such function lacked way too much. The Three Domestic companies were being acquired at an extremely high price in comparison to their status, and the financial advisor fee paid to Gyrus was enormous and beyond common sense.[75]

When a transaction so questionable from the point of view of a sound management mindset was submitted to the board of directors, there was no trail of sufficient discussion, even accurate information was not provided. The board of directors has mere formality and the outside director elected was not appropriate and defunct.[76] It is obvious that not enough outside directors to control the Olympus, and the capacity of the outside director of Olympus is so questionable, one outside director known as a doctor which is not qualified as an outside director. [77]The board of auditors had become far mere formality, appropriate auditor including appropriate outside director was not elected and there was no trail of objection from the board of auditors against the company's business policy.[78]

At Olympus, they established the system that had the same person responsible for the management of important asset for a long period of time and actually operated the HR system that lack of job rotation.[79] This system, contributed to the Olympus case. Olympus should have sought human resources outside the connection and interest of the company at a time when the fraudulent practice happened, put them in charge of the financial aspect of the company, and let them clean up the problem. Unfortunately, they did not do so. Under such damage system, human affairs which had to be indifferent were being distorted, and those who shared secrets and those who were involved in the concealment were treated favorably.

[75] *Ibid.*
[76] *Ibid.*
[77] *Ibid.*
[78] *Ibid.*
[79] *Ibid.*

Due diligence for corporate acquisition, examination by the legal department or other necessary procedures could be omitted intentionally without making it a problem and such system was maintained. Corporate organization that managed the internal control or risks within the company was not independent, and the internal whistle-blower system was not constructed appropriately.

2.3.2. Corporate Culture

Corporate culture in Olympus has pivotal role in contributing to conceal the fraudulent practice all the time. It must be impossible to conceal such biggest losses in the company with long period if there is no basic problem happened with Olympus. For a long time, Olympus deployed a one man system and atmosphere that restrained to speak up objection within the company. It is obvious, there was no "democracy" in Olympus. Koji Miyata who is the former board member in Olympus said in the interview with *Reuters,* the culture was created in Olympus where both employees and board members were reluctant to speak up, the feeling of not being able to voice opinion was not just felt in upper management both also felt beneath it. The corporate culture is stuffy. If you cause a stir, people will think it will come to them with negative implications and that creating the cooped up feeling in the company.[80]

Past presidents lacked the sense of transparency and governance, and one had to be prepared to be kicked out the company in order to make objection even if it was the right thing. And this is reflected on how Michael C. Woodford treated by Olympus because questioning suspicious transaction in Olympus. Michael C. Woodford who is British born executive have different approach differ to the common employee in Olympus. Koji Miyata said when Michael C. Woodford appointed as president in Olympus it was considered as a very bold move. At the time everyone knew he was since he had worked at Olympus for 30 years.[81] While he was a president for European operations, he uncovered two wrongdoings by his subordinates, he came out publicly and punished them. So everyone knew that he is the complete opposite of

[80] *Olympus was 'stuffy', lacked oversight .Interview with Olympus ex-director Koji Miyata retrieved from http://r.reuters.com/faz45s*

[81] *Ibid.*

someone that would look for Japanese-type consensus.[82] Unfortunately this different cultural approach between Michael C. Woodford and other Japanese type employee has to be resulted by the dismissal Michael C. Woodford eventually.

A system to replace presidents was not established among the executives, and it was possible to arbitrarily occupy such position. A corporate atmosphere where people can not freely speak up was formed, the mindset of personalizing the company prevailed, and the sense of duty of loyalty towards shareholders was sparse among the management. The mindset of executives was so blunt as not even to even sense any issue in the face of management and transfer of the enormous amount of funds, as well as enormous loss. They did not investigate the cause and determine the person responsible or pursued liability at all in the face of each fraudulent practice. These executives can be inevitably viewed that they had mindsets to avoid trouble, and only focus on those businesses that they were in charge of, and survive through their job without going through real trouble, whenever they sense some kind of trouble.

2.4. Corporate Governance in Japan.

2.4.1. Background

Japanese corporate governance has often been the subject of attention of foreign scholars, particularly in the debates on the comparative aspects of corporate governance. The current literature on Japanese corporate governance often relies on contrasting arguments. Some scholars suggest that it is fundamentally different from the western pattern and its character determined by the unique Japanese culture. To examine the corporate governance in Japan, we cannot analyze relying only on economic, political, and legal factors that have contributed to the development of corporate governance in Japan. We also have to focus primarily on the influence of non-legal norms that exist beyond legal norms. The culture lens, should not be forgotten when attempting to understand how disparate systems of corporate governance work in practice.

After Japan opens its doors to the outside world in the mid-nineteenth century, it embarked on a process of modernization but with a clear strategy to preserve its own values

[82] *Ibid.*

while importing Western Technology under the slogan “Japanese spirit, Western Skills” *(wakon yosai)*. This approach was buttressed by the Japanese educational system which continued to cultivate traditional values.[83]

Relating to the Japanese Legal system, there are two sets of rules in Japan that have co-existed for over a hundred years. First, legal norms transplanted from the Western legal system and Second, traditional informal norms, that grow and applied in practice. [84]The Japanese legal system is based on legal transplants originally imported from Germany. In post-war period, particularly in the area of corporate law, Japanese law made a distinct move towards the American model.[85] The genesis of the Americanization of Japanese corporate law came during the occupation period, when American law heavily influenced to Japan’s black letter corporate law which were aimed at implementing a US-Style shareholder primacy model.[86] The American influence was also dominant after the economic “bubble burst” in the 1990s. In Japan’s post bubble era, discussions surrounding a new approach to corporate governance often gravitated towards the need to adopt “global standards” in corporate governance reforms. The idea of adopting legal “global standards” was typically understood as thinly veiled disguise for adopting American standards.[87]

2.4.2 Reform

A major reform of Japanese corporate governance laws was introduced in 2002. There are several changes that have been introduced in the existing corporate management structure. Most of the debate on reforms of Japanese corporate governance has revolved around the clash between American models which is geared towards placing primary importance on shareholder and relying on external control, and the traditional Japanese model, which is primarily a stakeholder model based on internal control.[88]

[83]Pejovic, Caslav. (2011, July 21). “Corporate Law: Japanese Corporate Governance: Behind Legal Norms”. *Penn State International Law Review.* p.3.
[84] *Ibid.*p. 13
[85] *Ibid.*
[86] *Ibid.*
[87] *Ibid.*
[88] *Ibid.*

Under the new corporation law which entered into force in May 2006, taking the company law outside the Commercial code, Japanese corporations are given the option to select from two distinct corporate governance regimes.[89] First, the reformed large corporation which is based on conventional Japanese model and secondly, is the new type company with committees with an executive officer (CEO), based on the American model.[90] The biggest innovation of this model was the establishment of a totally new governance structure known as the "committee system" which was viewed as a sign of the Americanization of Japanese corporate governance. [91]

On the legal reform, outside directors have been in the center of the discussion and as an attempt to aimed improvement of monitoring in the company. The Tokyo Stock Exchange (TSE) has also regulated participation of independent directors. On March 2010, by rule 436-2 TSE obliges the companies listed to ensure at least one independent director/auditor who is unlikely to have conflicts of interest with shareholder.[92] Compared to another country and by learning Olympus one independent is very not enough to oversight the company. US and Europe require almost half of the board of members consist of the independent directors. Olympus has three independent Olympus, but it was failing to oversight the scandal. The important thing is not only to increase the number of independent directors but also to increase the qualified of independent director.

Since the TSE rules leave the choice between directors and auditors, majority companies have opted to appoint auditor, who are not typically independent.[93] By giving the choice of having either an independent director or auditor it is a sign that japan have bad corporate control. By giving a choice it will make the auditor does not have influence in the decision-making process of the company. If they do not have such power, the big question is so what is the function of the auditor and independent director? They only serve as mere formality and only to make company looks goods from the outside.

[89] *Ibid.*
[90] *Ibid.*
[91] *Ibid.*
[92] *Ibid.*
[93] *Ibid.*

2.5. Olympus Case: Sign for Corporate Reform in Japan

Japan cannot ignore that fraudulent hiding loss arrangement in Olympus Case is a sign to solve the problem in corporate governance issues that have been already a concern for so many years. Olympus as one of the big company with a long history is a main company in Japan and such practice must be highly affected toward the economic environment in Japan as general. Adoption of the American model into Japanese business culture was unsuccessful. Even in the post-war period Japan adopted corporate governance structures and rules based on American corporate law, but in practice, they deviated substantially from the American model.

One of the pivotal factors that have influence in deviation of the corporate governance in Japan is cultural factors that exist beyond legal norms and obeyed by the corporate entities such as top management and employee. The traditional corporate governance based on old culture facing failure and such phenomena reflected in Olympus case. Japan needs to reform their corporate governance, the reformation on corporate governance not merely on legal framework, but how to change the culture of corporate entities in practice.

Chapter 3 - Role of Corporate Culture and Corporate Governance System in Olympus Case

In this chapter, we discuss the role of corporate culture and cultural background of members of the board in Olympus and Japan's corporation as general. In this chapter we will further elaborate and provide more evidence why corporate culture has a decisive influence in the failure of corporate governance system in Olympus Corporation's case. We also discuss the connection between Olympus case and the corporate culture of public listed companies in Japan.

3.1. Corporate Culture: Definition and Concept

It has been long years ago that culture has become one of the main interesting research in corporate law. It is argued that culture has become one salient element that driven company to success in business. There are various ways in which culture can be conceptualized, Sorrensen (2002) define culture as a system of shared values (that define what is important) and norms that define appropriate attitudes and behaviors for organizational members (how to feel and behave).[94] Besanko (2007) which said that corporate culture referred to as organizational culture defined as a set of values, beliefs, and norms of behavior shared by its (a firm's) member that influence employee preferences and behaviors.[95]

Hofstede (2001) defines culture in broader sense said culture is the collective programming of the mind which distinguishes the members of one group or society from those of another. Culture consists of the pattern of thinking that parents transfer to their children, teachers to their students, friends to their friends, leaders to their followers, and followers to their leaders. Culture is reflected in the meanings people attach to various aspects of life; their way of looking at the world and their role in it; in their value, what they consider as 'good' and 'evil', in their collective beliefs, what they consider as 'true and false'; in their artistic

[94] Sørensen, J.B. (2002), The strength of corporate culture and the reliability of firm performance, *Administrative Science Quarterly*, 47(1), 70–91.

[95] Besanko, D., D. Dranove, M. Shanley, and S. Schaefer (2007), *Economics of Strategy* (4th ed.), John Wiley & Sons: Hoboken, NJ.

expressions, what they consider as 'beautiful' and as 'ugly'.[96] Schein (1992) defined culture as a pattern of shares basic assumption that the group learned as it solved its problem of external adaptation and internal integration, that has worked well enough to be considered valid and, therefore, to be taught to new members as the correct way to perceive, think, and feel in relation to those problems.[97]

From those definitions it is clear that culture has one of the important elements that driven employee and management in organizational or company. Unfortunately culture is not a mathematical stuff which can be measured scientifically, culture is broad and vague concept, Spencer-Oatey (2000) call as a fuzzy set of attitudes, belief, behavioral norms, and basic assumptions and values that are shared by a group of people and that influence each member's behavior and his/her interpretations of the "meaning" of other people's behavior.[98]

Until this point we agreed that culture is one of main element that influence company's life, but we don't have any clues that culture really matters for the company and why so many researchers desperately wanting to know about the correlation between culture and company. Is the culture having such great impact on the company's performance? Can culture lead the company to their 'greatness' era or otherwise to the 'brink' of the death like Olympus case?

3.2. Culture, Between Corporate Governance and Company's Performance

In the early 1980s Deal and Kennedy (1982) argued that a company's success was strongly influenced by corporate culture.[99] Since then, many researchers have been already tried to analyze the correlation between culture and company's performance and corporate governance as well. Van Dyck et al. (2005) discuss the concept of error management culture in

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[96] Hofstede, Geert, 2001. Culture's Consequences – Comparing Values, Behaviors, Institutions, and Organizations across Nations. 2nd ed., Sage Publications, Thousand Oaks, California.

[97] Schein, E.H. (1992), *Organizational culture and leadership*, second edition, San Francisco.

[98] Spencer-Oatey, H. (2000), *Culturally Speaking : Managing Rapport through Talk across Cultures*, London.

[99] Deal, T.E. and A.A. Kennedy (1982), *Corporate cultures: the rites and rituals of corporate life*, Reading (MA): Addison-Wesley.

65 Dutch and German Organizations and noted that firms with sound error management makes such error effectively handled and conclude that this positively contributes to firm survival.[100]

Dyck and zingales (2004) argued a country's culture may be another factor that influences corporate governance, they show that prevalence and level of private benefits of control (used as a direct proxy for investor protection) are also influenced by cultural norms within a country and not solely as a result of low investor protection. They conclude on their research that apart from the legal system, cultural aspect influence the way how investors are being protected.[101]

One of the interesting research held by Pascal Gantenbein and Christophe Volonte (2001) their research the influence of national culture to the corporate governance in Switzerland. Switzerland offers an excellent research opportunity because it is located in two cultural areas French and German speaking Switzerland, they found in Switzerland both area share one and the same federal company and they conclude that beside legal or historical reasons, corporate governance could be influenced by cultural norms.[102]

Back to the statement said by Deal and Kennedy (1982) which mention above, we still confused how could company success influence by the culture? Kotter and Heskett (1992) have answers to those questions they analyzed some benefits of a corporate culture for the company. They said widespread consensus of organizational values and norms facilitates social control within the firm. In Competitive environment cultures can exert powerful effects on individuals and on performance. This influence may even be greater than all of those factors that have been discussed most often in the organizational structure, management system, financial analysis tools, leadership, etc. The very best American and Japanese executives often devote time and energy expressly to creating, shaping, or maintaining strong corporate

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[100] Van Dyck, C., M. Frese, M. Baer and S. Sonnentag (2005), Organizational error management culture and its impact on performance: A two-study replication, *Journal of Applied Psychology,* 90(6), 1228–1240.

[101]Dyck, A. and L. Zingales, "Private Benefits of Control: An International Comparison," The Journal of Finance, 2004, 59 (2), 537–600.

[102]Gantenbein, Pascal., and Christophe Volonte, "Does Culture Affect Corporate Governance," *University of Basel – Faculty of Business and Economics Working Paper*, August- 2001.

cultures. [103] O'Reilly and Chatman (1996) support this argument by saying culture serves as an informal social control is therefore likely to be more effective and cost less than formal control structures. Culture also enhances motivation and performance of the employee, as they perceive that their actions are freely chosen and not dictated by the management.[104]

3.3. Corporate Culture: Evidence From Japan

We have seen that the culture has strong influence not only to the company's performance but also to the corporate governance as general, but we still miss the line to the Olympus Case. What about Japanese Corporate Culture? Do they have a great impact to the company's performance and corporate governance as well?

Shinichi Hirota, et al. (1992) said that their empirical results show that corporate culture have great impact on company performance in Japan. A Company with strong culture they succeed to survive in the period when Japanese firms were buffeted by unexpectedly large business fluctuations arising from the burgeoning and collapse of the bubble, the subsequent long term recession and the banking crisis of 1997. Surprisingly firms with the strong culture achieved relatively higher levels of performance throughout this period. This result indicates in Japan corporate culture enhance corporate performance in the long run. They conclude that the strong culture company more likely to adopt policies that encourage long-term employment, and to have more managers promoted within the firms, and also more likely to have less debt and high percentage of interlocking shareholdings.[105]

Curtis J. Milhaupt (2001) said in his research how culture shapes the corporate governance in Japan for large Japanese firms. He said that mainly comprised of 1) the main bank system and its roles in corporate monitoring, 2) the absence of an external market for

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[103] Kotter, J.P., Heskett, J.L. (1992), "Corporate Culture and Performance", *The Free Press A Divison of Simon & Schuster Inc*. New York.

[104] O'Reilly, C.A., Chatman, J.A. (1996), Culture as social control: Corporations, culture and commitment, in: Staw, B.M., Cummings, L.L. (eds.), *Research in Organizational Behavior*, 157-200.

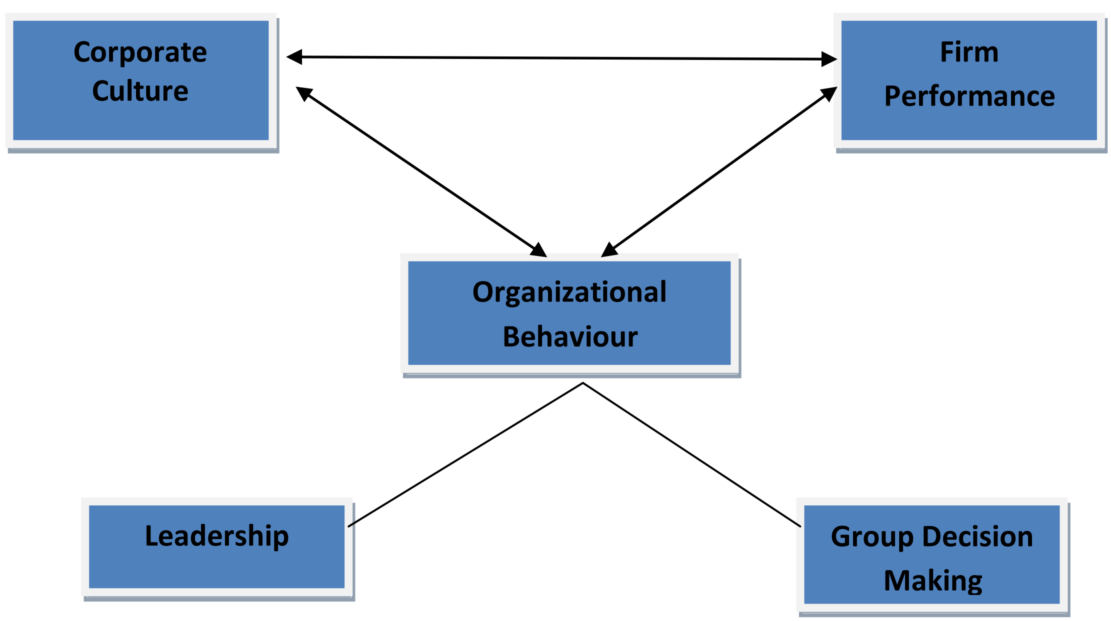
[105] Hirota, Shinichi., Katsuyuki Kubo, and Hideaki Miyajima, Does Corporate Culture Matter? Evidence from Japan. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1118196

corporate control, 3) the structure and role of Japanese boards and, 4) the lifetime employment system.[106] Olympus as one of the firm in Japan has characteristic which identical to the feature said by Curtis J. Milhaupt on his research.

At this point we can confirm that in Japan especially Olympus, Culture is matters and have great influence in the viability of Olympus's business. In the past the culture has been succeeded to carry Olympus through 'lost decade' in Japan, but now the culture seems to be drowning Olympus, demolish their reputation and eroded their shares in the market.

3.4. Corporate Culture: Organizational Behavior and Leadership.

In the beginning I will provide with the figure from Jakob de Haan and David-Jan jansen (2011) on their research concerning corporate culture and behavior as description how corporate culture it is. They argued that corporate culture comes from as a result from organizational behavior which eventually influenced in the firm performance.[107]



[106]Milhaupt, Curtis J. (2001, January 10). Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance. *Columbia University School of Law*. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=264202

[107] Haan, Jakob de., and David Jan Jansen (2011), " Corporate Culture and Behaviour: A survey". *University of Groningen.* Retrieved from http://ssrn.com/abstract=1979326

In their concept, corporate culture which driven organizational behavior influence by two salient element in the corporation, Leadership and group decision making. Leadership is defined as top management who in charge in lead the company, and group decision making as divisions in the company (employee).

Higgs, M (2009) argued that leadership has great impact on corporate culture, he said even though the ethical leadership has been underscored by various corporate scandals, but it emphasizes the impact of a leader in their organization either through direct actions of the leader and by creating a climate in which unethical or ethical behavior can sustain. He also analyzed “bad leadership” and identifies four recurring themes which are abuses of power, inflicting damage on others, over exercise of control to satisfy personal needs, and rule breaking to serve own purposes.[108] Its support by Simms and Brinkmann which argued that leaders can shape and reinforce both ethical and unethical organizations by their decisions.[109]

Obviously, those arguments correspond to the Olympus case which result from the ‘bad leadership’ in the top management decision. Nevertheless, the figure comes from de Haan and David-Jan jansen (2011) is an incomplete picture relating the Olympus case, we cannot ignore other cultural element outside of Olympus corporation which have influence in the scandal, hence, we have to consider not only leadership itself as one of the main elements which trigger Olympus case, but also the other corporate culture which help such fraudulent practice in Olympus.

3.5. Elements of Corporate Culture in Olympus Case

We have already mentioned, that culture is a vague and broad concept, we cannot limit where they come from, Kotter and Hesket (1992) said the idea that embedded in a culture can

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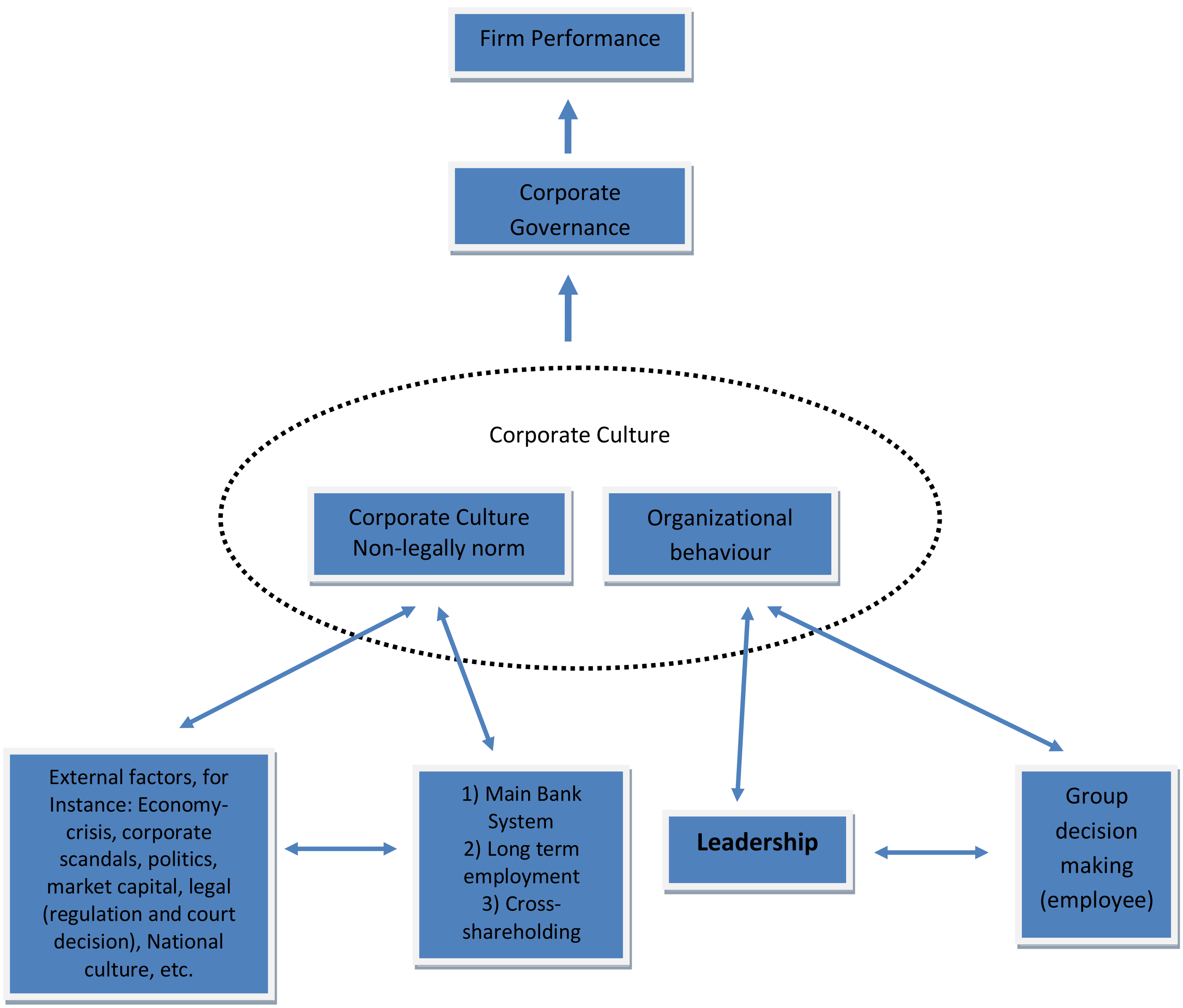
[108] Higgs, M. (2009), “The good, the bad and the ugly: Leadership and narcissism”. *Journal of Change Management,* 9(2), 165-178.

[109] Simms, R.R. and J. Brinkmann. (2002). “Leaders as moral role models: The case of John Gutfreund at Salomon Brothers”. *Journal of Business Ethics,* 35(4), 327-339.

originate everywhere, by continued leadership, stable group membership, geographical concentration, small group size and considerable success of the company.[110]

By combining the idea from Jakob de Haan and David Jansen (2001) with empirical research concerning corporate culture in Japan by Shinichi Hirota et al. (1992) and Curtis J. Milhaupt, we can have brighter pictures of how corporate culture creates and works on Olympus case.



[110] *See* Kotter, J.P., Heskett, J.L. (1992), "Corporate Culture and Performance", *The Free Press A Divison of Simon & Schuster Inc*. New York.

3.6. Leadership and Group Decision Making

We have already seen how leadership and group decision intertwined to influence organizational behavior as part of corporate culture in company, but we have not seen yet how can leadership has a fundamental impact to cause such fraudulent practices in Olympus case. Sternberg (2007) argued that effective leadership synthesizes wisdom, creativity and intelligence while unsuccessful leaders often show common fallacies related to a lack of wisdom. For instance, there is an *egocentrism fallacy*, when the manager believes only her interests are important or an *Omniscience fallacy* when the manager believes to know everything. Related is the *invulnerability fallacy,* when managers think to be able to get away with everything. Finally, there is the *unrealistic optimism fallacy*, when managers believe it pointless to worry about the outcomes of their behavior or decisions, in particular the long-term ones, as everything will work out fine.[111]

Lovallo and Kahneman (2003) argue that executives can be subject to the *planning fallacy*, when they have a tendency to overestimate the benefits and underestimates cost of investments. This is related to an optimistic bias, which leads people to judge future events too positively, which can result in inaccurate forecasts, inflated benefit-cost ratios and, potentially, in failing projects.[112] Miller and Friesen (1997) said once leaders take up a dominant position, there can be a little room to correct biases, which can affect an institution's stability and viability. There is a long literature that suggests unsuccessful firms are often led by dominant CEOs.[113] While Benson and Hogan (2008) note that 'bad' leadership can result in short-term performance successes. But will ultimately result in problems and dysfunctional performance.[114]

[111] Sternberg, R.J. (2007), A systems model of leadership, *American Psychologist,* 62(1), 34-42.

[112] Lovallo, D. and D. Kahneman (2003), Delusions of success, *Harvard Business Review,* July, 56-63

[113] Miller, D. and P.H. Friesen (1977), Strategy-making in context: Ten empirical archetypes, *Journal of Management Studies,* 14, 253-280.

[114] Benson, M.J. and R. Hogan (2008), How dark side leadership personality destroys trust and degrades organisational effectiveness, *Organisations and People,* 15(3), 10–18.

In company structure, the quality of leadership has 'trickle-down' effect to the employee and company they led. Hambrick and D'Aveni (1992) said dominant leaders tend to be wedded to their wisdom, greatly discount the potential contributions of subordinates, which can lead able employees to move on in frustration.[115] Dominance leadership restricts the information flow within the organization. This is strengthened by the fear of subordinates to raise issues that run counter to what the executive prefers. When the need for information processing is low, dominant leaders provide for minimum process loss by limiting unnecessary communication and conflict. However, because problems in a turbulent environment require substantial information processing, information restriction can lead to poor performance. In addition, this effect is significant when the top managers have much discretion in strategic.[116]

Strong culture in the company, cannot make in short-time with small resources however it is mostly needed leaders to make it happened, why? Because leaders are responsible for ethical standards and moral values that provide guidance for the behavior of employees.[117] Furthermore, leaders can shape and reinforce both ethical and an unethical organization by their decisions.[118]

From explanation and argumentation served above we can conclude that leadership and group decision making in Olympus have strong potential influence as a factor to triggering the fraudulent practice in Olympus case and create 'bad' corporate culture in Olympus. So far we have already explained the potential abusing of leadership (power) theoretically, but we do not know what kind of abuse it is in Olympus Case.

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[115] Hambrick, D.C. and R.A. D'Aveni (1992), "Top team deterioration as part of the downward spiral of large corporate bankruptcies", *Management Science,* 38(10), 1445-1466.

[116] Haleblian, J. and S. Finkelstein (1993), Top management team size, CEO dominance, and firm performance: the moderating roles of environmental turbulence and discretion, *Academy of Management Journal,* 36(4), 844-863.

[117] Grojean, M., C. Resick, M. Dickson and D. Smith (2004), Leaders, values, and organizational climate: Examining leadership strategies for establishing an organizational climate regarding ethics, *Journal of Business Ethics,* 55(3), 233-241.

[118] *See* Simms, R.R. and J. Brinkmann (2002) Leaders as moral role models: The case of John Gutfreund at Salomon Brothers. *Journal of Business Ethics,* 35(4), 327-339.

3.7 Non Legally Norm in Japan

3.7.1. Cross Shareholding

The most typical features of the Japanese model of corporate governance come from the non legally norm consist of: the main bank system, cross shareholding, long-term employment, and the close relationship between the business elite and the government.[119]

In Japan, the structure of a large publicly traded company is commonly characterized by cross-shareholding which is known as "*keiretsu*". This concept is simply defined as mutual shareholding through which a number of companies are interconnected in a network where each of them holds shares in the other companies. *Keiretsu* is a structural arrangement of Japanese firms characterized by close business relationships intertwined with long-term commitments among members. [120]

The history of cross-shareholding begin in the past economic period when Japan became a member of the OECD in 1964, one of the conditions for becoming a membership was the deregulation of its financial market and the government started to relax the entry of foreign capital into the country.[121] Afterwards, there was a growing concern about possible takeovers of Japanese Companies by Foreign Investors. As a response to these situations, Large Japanese corporations created a defense mechanism by establishing a stable shareholding system with the participation of "friendly companies".[122] Following these changes, the Commercial code was revised to allow issuance of new shares of companies, leading to the concentration of shareholdings in the hands of banks and corporations and the creations of *keiretsu*[123]*.* Because of the *keiretsu,* shareholder pressure and oversight of the board have traditionally been minimal. The cross-shareholding system makes controlling system in Japanese corporations flawed.[124]

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[119] *See* Pejovic, Caslav. (2011, July 21). p. 4.
[120] *Ibid.*
[121] *Ibid.*
[122] *Ibid.*
[123] *Ibid.*
[124] Davidoff, Steven M. (2011, November 1). Olympus Scandal Reveals How Little Japan Has changes . *The New York Times* . Retrieved from **http://dealbook.nytimes.com**

Cultural theories show the connection between the *keiretsu* system and the Japanese culture. In *Keiretsu* system if one company has difficulties, it is likely to be assisted by other companies from the same *keiretsu* system. This practice comes from the Japanese culture in which villagers would help each other in case of calamities; likewise, more powerful companies are expected to support smaller ones.[125] The sense of obligations towards the company may be linked with the sense of belonging to a family and the responsibility towards one's own family. In the same sense, *keiretsu* also represent a kind of family with members that feel close to each other. In this sense, keiretsu is not purely an economic concept but a cultural one, as well.[126]

3.7.2. Long-Term Employment

Long-term employment is another typical feature of the Japanese corporate governance model. Under this system an employee recruited directly from school or university and is expected to remain employed by the company for the length of his or her professional career.[127] In return, he or she can expect not to be fired or discharged, except under extraordinary circumstances. The basis of this agreement is the commitment of employers to provide secure employment in return for loyalty and "lifetime" service. The employer can rely on loyal employees and their dedication to work hard in exchange for the investment in their training.[128]

The origins of the long-term employment concept starts from the early part of the twentieth century, when it gradually developed as a business strategy to avoid the high fluctuation of workers that created difficulties for companies, particularly in key industries such as iron and steel. To solve that problem, companies started to offer incentives designed to encourage experienced workers to stay, for instance wages based on seniority and hefty retirement allowances for long term workers. The system was first institutionalized only in the 1950s and became popular in the 1970.[129] The modern long-term employment system was

[125] *See* Pejovic, Caslav. (2011, July 21). p. 5.
[126] *Ibid.*
[127] *Ibid.*
[128] *Ibid.*
[129] *Ibid.*

allegedly designed as a result of a compromise entered into between management and unions aimed to overcome existing labor problems. Nevertheless, political factors also played a role in the development of the system. The government supported the systems because it contributed to reduce the tensions between employers and employees that in case of escalation could have caused problems for the peace and stability of the state.[130]

Cultural theories of long term employment describe the company as a family system.[131] The seeds of this family concept of companies are deeply rooted in Japanese culture, based on obedience, hierarchy and loyalty which all make up important elements of Japanese culture. Japanese employees often refer to their companies as "*Uchi*" (home) to describe the company where they work.[132] The company symbolizes as "*Kaisha*", the organization where people are not united by contractual relationship, but includes an element of association resembling of a family. *Kaisha* not only provides income to the employee but also involves an emotional linkage. By characterizing employee as a family unit within the company, the company will achieve a greater level of loyalty from their employees.[133]

3.7.3. Main Bank System

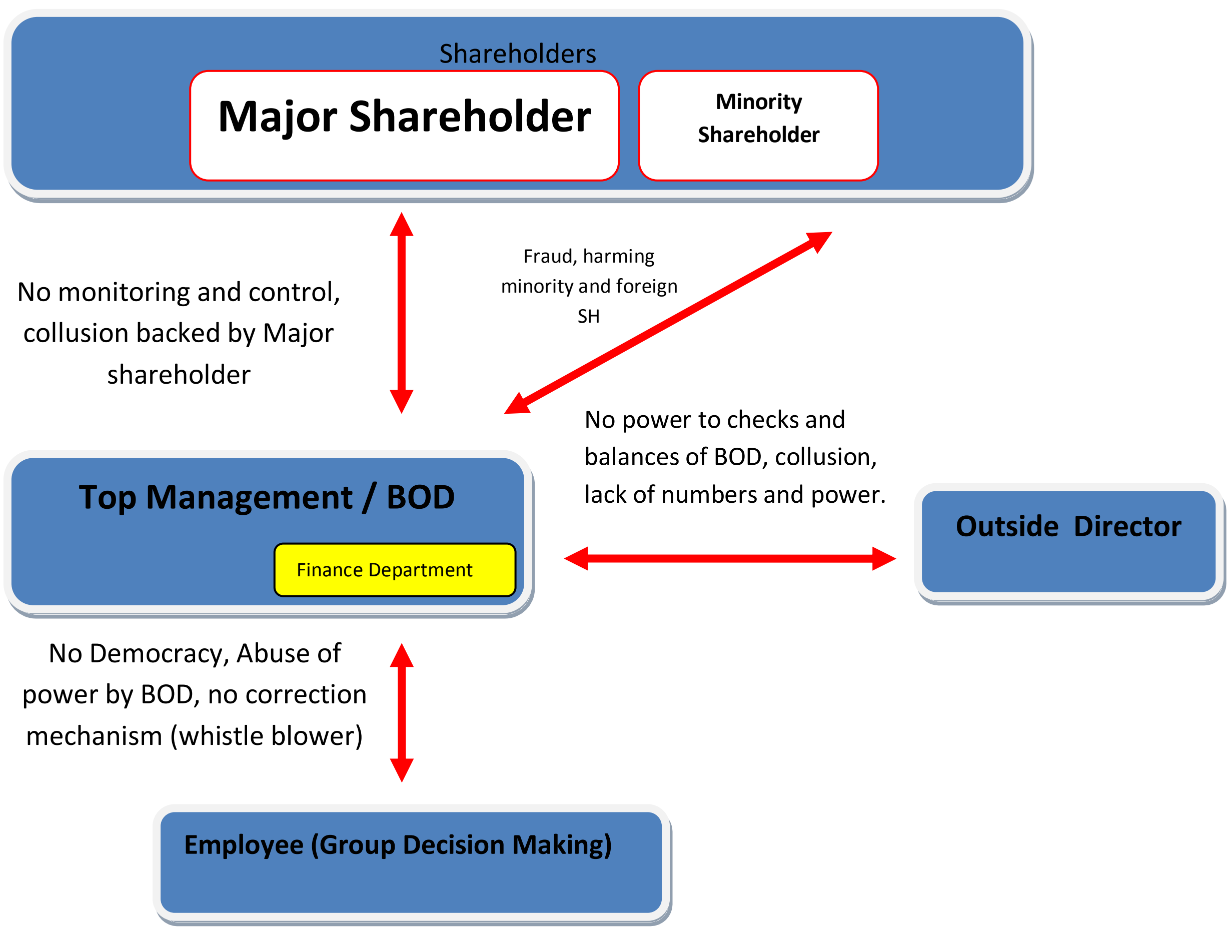
The main bank system can be characterized as the largest single lender to a corporate client as well as one of its principal shareholders. As a central repository of information on the borrower, in this system the main bank was positioned to play a key role in monitoring the firm's management and rendering assistance in case of managerial crisis of financial failure. This assistance could include loan forgiveness and guarantees of outstanding and new indebtedness.[134] Nevertheless such Monitoring from the bank as shareholder is failing to monitor the performance of the management of the company, because usually a bank lacked of

[130] *Ibid.*
[131] *Ibid.*
[132] *Ibid.*
[133] *Ibid.*
[134] Milhaupt, Curtis J. (2001, January 10). Creative Norm Destruction: The Evolution of Nonlegal Rules in Japanese Corporate Governance. *Columbia University School of Law*.

expertise and has limitation to control and oversight the company, hence practically controls from the Bank is an insufficient and mere formality.[135]

3.8. Corporate Culture : Center of Evil in Olympus Scandal

Called as Japan Largest-ever financial scandal, Hiding losses for amounts of 100 billion yen, and long term period for almost two decades, Olympus scandal is impossible if successfully done by one variable element, the scandal must come from as a chain from critical event. Above we already mentioned concerning elements of corporate culture which have an effect on Olympus case. In this chapter, by using a figure and facts in a case we will elaborate deeper what corporate culture has become an evil in Olympus scandal.



[135] *Ibid.*

3.8.1. Corporate Culture: Problems between BOD and Group Decision Making

The core problem in Olympus case comes from the 'bad' leadership in Olympus.[136] And this culture begins since Toshiro Shimoyama become a president and latter shift to his heirs Kishimoto and Kikukawa. Such bad leadership tends to result in poor performance and misjudgment. This fact shows when Toshiro shimoyama using *zaiteku* as main business for Olympus which eventually resulting a big loss for Olympus. Afterward, instead of correcting his loss and come back to the Olympus main business, they decide to hide such loss by using *tobashi* scheme, this practice corresponds to the 'bad' leadership said by Sternberg (2007) and Benson and Hogan (2008).[137]

Later by using their power in Olympus they manage the finance department to arrange those fraudulent practices to hiding such losses, hence it was not surprising if the finance department led by Yamada and Mori have discretionary power to manage assets in Olympus without being replaced from his position for two decades since the scandal begins. It shows how top management in Olympus has a dominant position on the company's policies. The main problems with the dominant position of the president in the company is not only to the poor policies they decided. But also there is no correction mechanism[138] and exchanging

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[136] *See* Lovallo and Kahneman (2003) argue that executives can be subject to the *planning fallacy*, when they have a tendency to overestimate the benefits and underestimates cost of investments. This is related to an optimistic bias, which leads people to judge future events too positively, which can result in inaccurate forecasts, inflated benefit-cost ratios and, potentially, in failing projects.

[137] *See* Sternberg (2007) bad leadership quality : 1. *egocentrism fallacy*, when the manager believes only her interests are important or an 2. *Omniscience fallacy* when the manager believes to know everything. Related is the *invulnerability fallacy,* when managers think to be able to get away with everything. Finally, there is the *unrealistic optimism fallacy*, when managers believe it pointless to worry about the outcomes of their behavior or decisions, in particular the long-term ones, as everything will work out fine. Benson and Hogan (2008) note that 'bad' leadership can result in short-term performance successes. But will ultimately result in problems and dysfunctional performance.

[138] *See* Miller and Friesen (1997) said once leaders take up a dominant position, there can be a little room to correct biases, which can affect an institution's stability and viability.

information[139] from the top tiers to the bottom line of hierarchy in a company which needed in turbulent conditions like Olympus was when they suffer loss cause by *zaiteku*.

Due to ‘bad’ leadership has a ‘trickle down’ effect for the employee beneath their position and the leader has responsibilities to maintain a culture in the company it is inevitable that no democracy culture and non-freely speak up culture will be materialized and help such fraudulent practice. Nevertheless blaming solely for ‘bad’ leadership to create such problems is not sufficient because no democracy and non-freely speak up culture also influence by non-legal norm in Japan which is Long Term employment. Long term employment concept characterizing employee as a family unit within the company, furthermore the company will achieve a greater level of loyalty from their employees[140]. It was true, such great loyalty helped many Japanese companies to exert more effort from their employee and help Japanese companies to survive in crisis in the past.[141] However in Olympus case this thought tends to be misused by the top management to create no democracy culture, they can easily pressure the employees to not speak-up as they feel open up the scandal same as open up the disgrace of your family. Obviously this culture does not work for Michael C. Woodford who does not Japanese person and open-up the case eventually in public.

3.8.2. Corporate Culture: Problems between BOD and Outside Director.

Olympus actually had three outside directors from fourteen directors on the board, Yasuo Hayashida, Hiroshi Kuruma and Junichi Hayashi, but in reality had no effective corporate

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[139] *See* Haleblian, J. and S. Finkelstein (1993) Dominance leadership restricts the information flow within the organization. This is strengthened by the fear of subordinates to raise issues that run counter to what the executive prefers. When the need for information processing is low, dominant leaders provide for minimum process loss by limiting unnecessary communication and conflict. However, because problems in a turbulent environment require substantial information processing, information restriction can lead to poor performance. In addition, this effect is significant when the top managers have much discretion in strategic

[140] *See* Pejovic, Caslav. (2011, July 21). p. 5.

[141] *See* Hirota, Shinichi., Katsuyuki Kubo, and Hideaki Miyajima.

governance. [142] We can say that the outside directors do not have the capabilities and qualities to oversight board of directors of Olympus. None of the company's independent directors have experience in the camera or electronics industries. One of the Olympus outside directors is a medical doctor, and no one outside director appears to have significant experience in risk management.[143] This gross negligence reflected when Michael C. Woodford says that he already sent letters to board members including the outside directors to questioning such fraudulent practice but they did nothing. Furthermore, the third party committee investigation asserted that outside directors was merely a facade and stocked with yes men culture, they are failing to prevent such fraudulent practice.[144]

Facts that mention above is a picture how collusion between board of directors in Olympus and outside directors happened, it resulted no checks and balance power mechanism to control the board of directors. Nevertheless the problem is not finished until the number of outside directors on a board but also the capacity and power of outside director in Olympus should be questioning. We consider a bold move should be taken to increase the power of outside directors, compare to other countries Japan has considerably few outside directors rather than the United States, France and Australia which require the outside directors at listed companies more than half of their entire board.[145]

Overall from the 392 Largest Japanese companies have an average level of a board outside directors of only 20 percent. Other companies like Canon, Toyota, Nintendo and Suzuki have more serious board accountability problems, not one of these companies has appointed a single outside director to oversee operations and help protect shareholder value.[146] By contrast, in the U.S. 92 percent of the largest publicly listed companies have majority

[142] Retrieved from http://www.olympus-global.com

[143] Flannery, Nathaniel Parish. (2011, October 10). Problems at Olympus a Sign of Investor Risk at Major Japanese Companies . *Forbes* . Retrieved from http://www.forbes.com

[144] Nagata, Kazuaki. (2012, Januari 17). Corporate Japan: Woeful lack of outside directors. *The Japan Times Online* . Retrieved from http://www.japantimes.co.jp

[145] *Ibid.*

[146] *See* Flannery, Nathaniel Parish. (2011, October 10).

independent boards. We cannot ignore that this fact resulted as enactment of the US Sarbanes-Oxley Act of 2002, after Enron Shocked-Scandal happened in the US. However, In Japan only 3% of the largest publicly traded companies have majority independent boards. Learning from US with the Enron Shocked-Scandal did, Law might be the best possible answer to change the problem relating to outside directors in Japan and obviously to increase the transparency and checks and balances in board level. Obviously Japan is different to US other variables should be taken into account before we decide it, and we will explain more in the next chapter.

3.8.3. Corporate Culture: Problems between BOD and Shareholders.

At the first shareholders meeting after the scandal, held on April 20, 2012 the new board of directors announced to the public, unfortunately the new slate of directors comes from the current management of Olympus. They get an opposition from some foreign and individual investors, as well as proxy advisers, who wanting for a complete purge of the company's top ranks.[147] The posts of president and chairman of Olympus occupied by Hiroyuki Sasa and Yasuyuki Kimoto. Mr. Sasa who headed marketing for Olympus's medical business does not have enough management experience to lead such a tough turnaround in Olympus. The proxy advisory firm Institutional Shareholder Service said in March. There were also concerns that Mr. Kimoto, a former banker at Olympus's main lender, Sumitomo Mitsui Banking, would put creditor's interest above that of shareholders.[148]

We can see might be this is the most blatant collusion practice in Olympus case. Controlling shareholder still backed up this fraud even they already suffered huge losses from this fraudulent practice, hence they did not want any change in the board of Olympus. Collusive practice between Controlling Shareholders and top management are resulted from two non-legal norm in Japan which are main bank system and cross-shareholding. In japan, practically the main bank would be positioned to play a key role in monitoring the firm's management and

[147] Retrieved from http://topics.nytimes.com/top/news/business/companies/olympus_corporation/index.html

[148] *Ibid.*

rendering assistance in case of managerial crisis or financial failure This assistance could include loan forgiveness and guarantees of outstanding and new indebtedness. Nevertheless as mentioned above such monitoring from the bank as shareholder is failing to monitor the performance of the management of the company, because usually a bank lacked of expertise and has limitation to control and oversight the company, hence practically controls from the Bank is an insufficient

The combination of the main bank system and cross-shareholding resulting the absence of market for corporate control. Curtis J. Milhaupt (2001) argued that Hostile takeovers have played no disciplining role over Japanese Management. This function, to the extent it existed was subsumed within the operation of the main bank, furthermore there are legal and structural impediment to hostile takeovers in Japan. The most formidable is the practice of stable cross-shareholding among Japanese firms and banks, most prominently in the form of the *keiretsu* corporate groups.[149] As Mark Ramseyer argued that these obstacles do not prevent hostile takeovers, they do make them more expensive relative to the alternatives.[150] Correspond to the case, Olympus is part of the *keiretsu* system which main center system held by Sumitomo Mitsui Banking Corporation.[151] So it can be said that there is no control to disciplining management in Olympus, that led to arbitrary of the top management.

Takeovers as a market mechanism for corporate control backed by the idea of competition, individualism, and concurrence between companies. This idea is adverse to the idea behind the *keiretsu* system which are consist of collaboration, collusion, and solidarity between companies. Correspond to this statement it is interesting to heed the argument said by Kelly Crab (1987), The Japanese company is an extension of the concept of the family; the

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[149] *See* Milhaupt, Curtis J. (2001, January 10).

[150] Ramseyer, J. Mark. *Takeovers in Japan: Ideology, Opportunism, and Corporate Control*, 35 UCLA L. REV. 1 (1987). For an excellent overview of obstacles to M&A in Japan, see Berkeley Scott, *M&A Japan: An Update from Morgan Stanley*, BUSINESS INSIGHT JAPAN (Nov. 1998), available at www.bi-japanmagazine.com/1998/nov

[151] Harner, Stephen. (2012, Januari 6).Olympus, Woodford, Duty, and Honor in Japan. *Forbes* . Retrieved from **http://www.forbes.com**

company cannot be separated from the people who comprise it. The sale of Japanese business, therefore, is said to have the flavor of the sale of people. It is said to be immoral, even the Japanese vocabulary used in acquisition supports this view. The purchase of a company in Japan is called "nottori" which can be translated as "a hijacking".[152]

Collusive practice between top management and controlling shareholders leave the problem for individuals and foreign shareholders or minority shareholders. Minority shareholders are the party who most suffered from fraud between controlling shareholders and top management. The value of the shares since scandal revealed fall down for almost half of it. It is necessary for Japan's authority to consider enhancing the protection to Minority Shareholders. One of the possible answer Japan needs a corporate law and corporate governance reform that enhancing protections for the minority and foreign shareholders against the potential abuse from *keiretsu* system and main bank system as well.

3.9. Cultural Shift : A Consideration in Olympus Case

Kotter (1992) said, cultures can be very stable over time, but they are never static. Crisis sometimes forces a group to reevaluate some values or set of practices. New challenges can lead to the creation of new ways of doing things. Turnover, coupled with the lack of perpetuating mechanisms, can destroy a culture or make it very weak. But conversely, cultures can grow to be extremely strong-where there are many common values, behavior patterns, and practices , and where the levels of culture are tightly interconnected.[153]

From time to time main bank system, cross-shareholding, and long-term employement as non-legal norm in Japan that mainly influence in Olympus case seems to change gradually Curtis J. Milhaupt says as 'Creative Norm Destruction', hence it is important to consider such changes and take into account all changes that happened before we came to the solution of the case.   We will elaborate more deeply concerning the cultural shift and lesson from US (Enron)

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[152] Kelly Crabb, *The Reality of Extralegal Barriers to Mergers and Acquisitions in Japan*, 21 INT'L LAW. 97, 116 (1987).

[153] *See* Kotter, J.P., Heskett, J.L. (1992)

before we reach the solution, it is necessary to get the right solution for Japanese Corporate governance in the future.

Chapter 4 – Improving Corporate Culture in The Aftermath of Olympus Case

In this chapter, we will analyze the evidence and theory regarding corporate culture in Olympus case which being presented in chapter 3. In this chapter we will further elaborate actual changes in corporate culture in Japan as a whole. We also take into account Enron's debacle in Corporate culture as compared to Olympus case. We also discuss what corporate governance system in Japan should be upgraded, what challenges and impediment in the future in the aftermath of Olympus case.

4.1. Cultural Shift in Japan Corporate Governance.

4.1.1. Factors

Main bank System, Cross-shareholding, and Long-term employment as non-legal norms in Japan which driven to the Olympus case, recently being pressured and weaken over time. Obviously, this is not only caused by legal factors. Social, political, and economic factors play a pivotal role as well. As said by Masako Ishi (1989) Japan has been gradually transformed, especially in the urban portion of society and among the younger generation. They have ideas about their careers which are different from their parents. They are less committed to long term employment and are more likely to change companies if others offer better conditions.[154]

The attitude of the Japanese toward law has also been changing for the past several decades. At the time of many legal reforms were being introduced, the readiness to use those legal norms was still lacking. However, over time things have changed as a result of the globalizations and urbanization in Japan which resulted in weakening of social ties in society and a more open attitude to the changes that coming from the outside world.[155] In particular

[154] Ishii-Kuntz, Masako. (1989). "Collectivism or Individualism? Changing Patterns of Japanese Attitudes" , *73 Sociol. & Soc. Research,* p. 174-179.

[155] *See* Pejovic, Caslav. (2011, July 21). p. 14.

the most notable of these facts can be seen from the increase in the number of cases litigated.[156]

Economic factors also have contributed in effecting cultural shift in Japan. Shisido (2000) argued that aggregate cross-shareholding in publicly traded shares has declined significantly since the stock market collapse and burst of Japan's 'bubble' economy in the early 1990s and the pace seems to be accelerating as well as the bank's immediate need cash.[157] The prolonged of economic crisis makes increase the number of foreign shareholders, banks that have to face with bad debts had to dispose of substantial parts of their shareholdings,which resulted reducing of main bank systems and increasing monitoring process in company by shareholders.[158]

For legal factor, since 2002 Japan have been already enacted commercial code as a cornerstone and an important step in Japan legal reforms. The most notable reform is the introducing of statutory auditors and the requirement of independent directors.[159] However several criticisms emerged says that these reforms have little real change in Japan Corporate governance. And the requirement of independent directors and statutory auditors is thought not to be strict enough, in other word the reform is 'elective'.[160] As said by Ahmadjian (2003) that the logic of Japan's Ministry of External Trade and Industry (METI) at that time was 'the market would eventually decide which form of governance was most effective. On the other hand, METI concedes that they initially favored more to the New type of Company, but leaving

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[156] Ginsburg, Tom and Glen Hoetker. (2006). "The Unreluctant Litigant? An Empirical Analysis of Japan's Turn to Litigation". *35 J. Legal Stud.* p.*31, 37.*

[157] Shishido, Z. (2001) 'Reform in Japanese Corporate Law and Corporate Governance: Current Changes in Historical Perspective', *American Journal of Comparative Law* 49(4), pp. 653-77.

[158] *See* Pejovic, Caslav. (2011, July 21). p. 15.

[159] Nottage, Luke R. and Leon T. Wolff. (2005). "Corporate Governance and Law Reform in Japan: From the Lost Decade to the End of History". *University of Sydney Law School, Legal Studies Research Paper No. 06/14*. p. 13.

[160] Nottage, L. (2003) 'Japan Inc Goes Global: Elective Corporate Governance Reform', *CCH Asiawatch* 57, pp. 6-8.

open choice was a result of compromise under pressure from *Kaidanren*,[161] facing its own internal pressure, both from global firms that wanted to reshape their boards to reflect US practices and from domestic firms which resisted change.[162]

Even though the experience with legal reforms in Japan seems unsuccessful and did not bring immediate changes, they may still bring results at a later stage. That is a sign of the gradual process of reform of society in Japan, which enables a smooth transition from a society governed by social norms towards society governed by legal norms. As a result of such reforms, it may be expected that the law will play increasingly important role in coming years.[163]

4.1.2. Cultural Shift in Japan Main Bank System

Curtis J. Milhaupt (2001) argued that there are three developments that are destroying the main bank. First, is a change in the economic of the operation of these norms. Second, a shift in belief systems about bank governance and corporate governance, and third, is a quirky exogenous shock that delivered a blow to the norms at the heart of the main bank system.[164]

The first step in the destruction process is a dramatic change in the payoff structure to banks from abiding by the main bank norms. For most of the postwar period, there was a compelling economic logic to the main bank system. Banks delegated monitoring and restructuring responsibilities for a given firm to its main bank, which possessed superior information about the firm's operations and prospects. As noted above, main banks were

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[161] *See* Okuda, H. (2003) 'A Business Leader on the Offensive', Japan Echo 30(2), pp. 47-50. *Nippon Keidanren* was formed in 2002 by amalgamating two important peak business bodies, *Keidanren* (Japan Federation of Economic Organisations) and *Nikkeiren* (Japan Federation of Employers' Associations). The former, in particular, includes larger firms which have increasingly pushed for liberalisation in Japan as they expanded their operations world-wide (Yoshimatsu 2000). The current Chairman of *Nippon Keidanren* (and Toyota), has been robust in his criticism of the Koizumi administration for not being decisive and innovative enough in carrying out structural reform.

[162] Ahmadjian, C. (2003) 'Changing Japanese Corporate Governance', in U. Schaede and W. W. Grimes (eds) Japan's Managed Globalization:Adapting to the Twenty-First Century, Armonk, N.Y.: M.E. Sharpe, pp. 215-42.

[163] *See* Pejovic, Caslav. (2011, July 21). p. 16.

[164] *See* Milhaupt, Curtis J. (2001, January 10). p. 20.

willing to perform this role at least in part because they extracted rents from their borrowers.[165] In turn, the importance of the main bank institution to the economy insulated banks from failure, and ensured a steady stream of regulatory rents, which provided incentive to continue behaving as a "good" main bank.[166] This logic began to unravel, however, when the moral hazard implicit in the main bank norms peaked in the bubble period of the 1980s, resulting in a massive nonperforming loan problem. By the mid-1990s, the international financial community began to perceive an unusual form of systemic risk arising from the norm-supplied safety net.[167] Eventually lead many major Japanese bank was allowed to fail in late 1997.

The second step in the destruction of the main bank norms is a significant shift in beliefs about the benefits of bank-oriented corporate finance and governance. In the past, Japan was a model for developing economies in Asia and Eastern Europe. But in the wake of the Asian financial crisis and Japan's long recession, "relationship financing" became "crony capitalism." Easy credit policies inherent in bank-oriented systems are now linked with monitoring lapses and poor corporate performance. It is finding that ineffective governance exacerbated the Japanese banking crisis and delayed restructuring.[168]

The third and perhaps most interesting step in the destruction of main bank norms is the nationalization and re-privatization of the Long-Term Credit Bank (LTCB), one of postwar Japan's largest and most politically connected banks. LTCB, which served as the main bank for many important firms, became insolvent and was temporarily nationalized in 1998. It was later sold to Ripplewood, a group of foreign investors including Citigroup and GE Capital, when no Japanese buyer for the bank could be found.[169] This leading to the high-profile bankruptcy of

[165] *Ibid.*

[166] Takeo Hoshi & Hugh Patrick, "The Japanese Financial System: An Introductory Overview, in CRISIS AND CHANGE IN THE JAPANESE FINANCIAL SYSTEM." 1, 7 (*Takeo Hoshi & Hugh Patrick eds*., 2000).

[167] *See* Milhaupt, Curtis J. (2001, January 10). p.20.

[168] Morck, Randall, and Masao Nakamura. (1999). "Banks and Corporate Control in Japan" , 54 *J. FIN*. P.319.

[169] *See* Milhaupt, Curtis J. (2001, January 10). p. 20.

Sogo Department Store, because failed to get loan forgiveness and leaving the firm no choice but to resort to legal protection under the bankruptcy regime.[170]

4.1.3. Cultural Shift in Japan Cross-Shareholding

In the past, openly hostile takeovers have certainly been rare. In large part, this is due to the development of extensive cross-shareholdings among firms. However, over time hostile takeover start to increase. For instance in May 2004 between UFJ and Sumitomo, and on April 2005 between Livedoor and Fuji TV.[171] The most prominent of this situation comes in the beginning of the end of the No Hostile Takeover Norm take in January 24, 2000. On that date, a Japanese firm called M&A Consulting, Inc. (MAC) launched a hostile tender offer for Shoei Corporation, a member of the Fuyo *keiretsu*. This was one of the first postwar hostile takeover bids for a Japanese corporation *by* a Japanese corporation. The bid was motivated by a desire to destroy the No Hostile Takeover Norm. This is evident from the nature of the offer itself and from MAC's own public pronouncements[172]

The Rise of hostile takeovers in Japan particularly is due to deal and the shareholding environment in Japan. Curtis J Milhaupt (2005) explain with data. He said shareholding by financial institutions has declined from a almost 43% of market capitalization in the early 1990s to less than less than 35% as of 2004. More significantly, within this group, shareholding by commercial banks has declined precipitously, from almost 16% in 1992 to less than 6% in 2004. Corporate share ownership has declined from about 30% to about 22% over the same period. Significantly, these declines in Japanese institutional share ownership have been completely offset by increases in foreign share ownership, which rose from about 6% of market capitalization in the 1992 to almost 22% in 2004.[173]

[170] *Ibid.*

[171] Milhaupt, Curtis J. (2005). "In the Shadow of Delaware? The Rise of Hostile Takeovers in Japan.". *Colombia Law Review. Vol.105.* New York. p. 12-14. Retrierived from http://ssrn.com/abstract=747524

[172] Milhaupt, Curtis J. (2001, January 10). p. 22.

[173] Milhaupt, Curtis J. (2005). p. 19 -20.

Since the early 1990s had been declining in cross-shareholding and stable shareholding. On a value basis, the cross-shareholding ratio has declined by over 10% over this period. The decline is attributable not only to unwinding of cross-shareholding arrangements, but also to the public listing of new companies that do not rely on long-term shareholding arrangements. The long -term shareholding ratio has declined by almost 20% over this period. Japanese institutional investors and corporate shareholders have also become more activist, at least in comparison to the past.[174]

4.1.4. Cultural Shift in Long Term Employment

Since in the end 1990s, a Labor Ministry survey indicates that many major firms plan to eliminate jobs, and the rate of soon-to-be college graduates who have yet to find employment is at a record high, indicating that firms have cut intake into the lifetime employment system.[175] Moreover, the market appears to be rewarding firms that depart from the non-legal norm, and punishing those that continue to abide by it. For instance Moody's Investor Service lowered the ratings of companies that intend to maintain lifetime employment, these endangers for the company who try to attract foreign investors. However, despite growing criticism that the old practice is destroying the economy, there still Japanese companies intend to maintain such lifetime employment system.[176]

4.2. Lessons From Enron Debacle

From the explanation above we are already witnessing the signs of important norm shifts under way in Japanese business and government to the "American Shareholders-model". Furthermore, these facts seem to correspond with what Hansmann and Reiner Kraakman (2000) said. They argued that at the beginning of the twenty-first century we are witnessing the rapid convergence on the standard shareholder-oriented model as a normative view of

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[174] *Ibid.* p. 22.

[175] Ito, Shuichi. (March 1, 2000). "The Changing Corporate Climate in Japan", *J. JAPANESE TRADE & IND.*, *available in* Westlaw,

[176] Hisada, Kishiko et al., (Dec. 2, 1999). "Japan Sticks to Lifetime Job System", *ASAHI SHIMBUN*, *available in* Westlaw, Allnews file.

corporate structure and governance, and we should expect this normative convergence to produce substantial convergence as well in the practices of corporate governance and in corporate law.[177] However copying American Model recklessly without considering the Japanese culture it is totally wrong, hence, it is necessary to learn from the Enron debacle, what should be transplanted from "American Model" and what should be not.

The transformation of Enron's Corporate culture and shift in control style were centers of Enron's Demise. When Kinder Left in 1996 and Jeff Skilling take in charge, Enron's culture was apparently influenced by the leadership style of Jeff Skilling who pressed for a 'cowboy capitalism' structure.[178] The company did not respect integrity, and actions of the top management signaled winding up of ethical values.[179] The fraud culture was perpetuated through the selection of new employees and systematic indoctrination of people during daily conversations and official ceremonies.[180]

Another vital link in Enron's management controls was *the Peer Review Committee* (PRC) system that Jeff Skilling devised, better known inside Enron as "rank-and-yank". PRC featured two basic motivating forces, fear and greed. Jeff Skilling wanted to keep only "The Very Best", so every six months one or two out of every ten employees were dismissed.[181] The PRC created and sustained Enron's Corporate culture. It promulgated, the ethic of short-term stock price appreciation at any cost, and in any way possible. [182] Former employees Fusaro and Miller (2003) argue that Enron's "rank and Yank" machinations created an environment where

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[177] Hansmann, Henry and Reinier Kraakman. (2000). "The End of History for Corporate Law". *Yale International Center for Finance*. Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=204528

[178] Gini, A. (2004). "Business, ethics, and leadership in a post Enron era," *The Journal of Leadership and Organizational Studies*, Vol. 11, No. 1, pp. 9-15.

[179] Tomasic, R. (2009) "Corporate collapse, crime and governance-Enron, Andersen and Beyond," *SSRN Working Paper Series*, July, pp. 1-20

[180] Gore, Amol and Guruprasad Murthy. (2011). "A Case of Corporate Deceit: The Enron Way . Retrieved from www.revistanegotium.org.ve

[181] Free, Clinton and Norman Macintosh. (2006). "Management Control Practice and Culture At Enron: The Untold Story". Retrieved From http://ssrn.com/abstract=873636

[182] Dobson , John. " Enron: The Collapse of Corporate Culture". *Enron and World Finance:A Case Study in Ethics.* Palgrave Macmillan.

employees were afraid to express their opinions or to question unethical and potentially illegal business practices. Because the rank-and-yank system was both arbitrary and subjective, it was easily used by managers to reward blind loyalty and quash brewing dissent.[183] This punitive environment brought the consequences of dissent sharply into focus. Enron's culture has been characterized as "ruthless and reckless" lavishing rewards on those who played the game, while persecuting those who raised objections.[184]

The Enron Trading Floor was said as mirror Jeff Skilling's personality, ultra competitive, highly individualized and highly tolerant of risk, they don't care about the shareholders or the business strategy or long-term interests of the company. They just wanted to make deals and get their bonuses.[185] Personal ambition and greed seemed to overshadow much of the Enron top executives and individual and eventually lead to its demise.[186]

So, what can we Learn from Enron Case. First, Enron's demise is the result of the jammed correction mechanism in company, we saw that the PRC which creates by Jeff Skilling block such mechanisms, increasing the domination and arbitrary of top management. Correction and objection is necessary to maintain transparency. Second, Enron case resulting the Enactment of Sarbanes-Oxley Act that increases the power of auditors and Independent directors in the Board member where Japan is still left behind in this area.

4.3. Improving Corporate Culture

4.3.1. Whistle-blower Mechanism.

The problem with non-legal norms In Japan, leaving a broad power to the top management, increase barrier to correct top management and impede communication between employee and top management. Enron and Olympus Case shows us when such communication blocked, it will tend to misuse by the top management. Because the gap of power between Top

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[183]Fusaro, P., and R. Miller.(2003) . "What went wrong at Enron: Everyone's guide to the largest bankruptcy in US History". (Hoboken, NJ: Wiley).

[184]Chaffin, J., and S. Fidler. (2002). "Enron Revealed to be rotten to the core". *Financial Times*, April 9, 3-6.

[185]Bryce, R. (2002). "Pipe dreams: Greed, ego, and the death of Enron" . *New York: Public Affairs*.

[186]Sims, Ronald R. (2003). "Why Giants Fall" , *Greenwood Press.*

management and employee is wide, sometimes it is not easy to employee to object and correct such misuse practice from their "boss". As said by Rothschild and Miethe (1999) they continue to experience victimization, redundancy, dismissal, resignation, transfer, constant scrutiny, verbal abuse, endless criticism, and even death threats. This retaliation is so well-defined that, the act of whistle-blowing becomes the whistle-blowers 'master status'. This new status is viewed by others, both co-workers and management, with suspicion and the whistle-blower is likely to be treated as an outsider[187].

In Japan, The Whistle-blower Protection Act (Law No. 122 of 2004) was passed by the House of Representatives on 25 May 2004 and, less than one month later, by the House of Councillors on 14 June. It was promulgated on 18 June. The new Act protects those who expose corporate or government misconduct from unfair treatment, such as dismissal, demotion or salary cuts.[188] Section 1 sets out the objectives of the Act.[189] Section 2 defines whistle-blowing.[190]

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[187]Rothschild, J and T. Miethe: 1999, "Whistle-Blower Disclosures and Management Retaliation", *Work and Occupations* 26(1), 107-128.

[188]Wolff, Leon. "New Whistleblower Protection Laws for Japan". *CCH Asiawatch Newsletter*. Retrieved from ://http: www. ssrn.com

[189]*See Id.* It explains that the purposes of the law include invalidating dismissals or other disadvantageous consequences for those who disclose public interest information about companies or government agencies, and mandating private and public organisations to respond to any allegations of improper conduct. The protection of the act is wider than just whistleblowers themselves; it also extends to the "life, body, assets and other interests" of the general public by ensuring corporate and government compliance with minimum legal standards.

[190]*See id.* According to the section, whistleblowing involves:

1. disclosure of "relevant disclosure information";
2. by a "worker";
3. to either:
   (a) an "employer";
   (b) a government agency or officer with relevant jurisdiction; or
   (c) any other person deemed necessary to prevent the matter from occurring or worsening; and
4. not for an illegitimate purpose.

However, The Whistle-blower act still needs to be improved there are several criticisms that should be notified. The Protection Act has its limitations particularly because its effectiveness has been compromised by narrow coverage and the setting of rigorous conditions for disclosure to an administrative organ and other external disclosure. The protection act should be made more effective by flexible implementation.[191]

On the procedures of protection, it is a problem that protection is restricted to workers within an organization and that conditions for external disclosure, such as disclosure to the mass media, are too rigorous.[192] In the majority of corporate scandals that became an issue, the company as a whole was systematically engaged in the wrongdoing or the company's executives were directly or indirectly involved. In the legislations in the U.K., U.S. and other countries, even if whistle-blowers are limited to insiders (i.e. Workers), internal and external disclosure is equally protected (the US federal laws Whistle-blower Protection Act, SOX, etc.), or even if disclosure should first be made to the business operator, disclosure to a related administrative organ or an ombudsman, etc. under certain conditions is equally protected (the U.K. and New Zealand).[193] The Japan, because its narrow coverage, It is difficult for such a legal system to function effectively in preventing and eliminating corporate scandals. The conditions for external disclosure should be eased to make the Protection Act more effective.[194]

The protection's effect is also limited to voidance of dismissal of whistle-blower and prohibition of disadvantageous treatment.to assure the truthfulness of the disclosure, a whistle-blower will in fact be required to present documents and other information, and in removing such documents and information, the whistle-blower may be subjected to criminal charges of larceny, etc. or civil charge for damages.[195] Protection against such charges is also lacking. Moreover, while the Protection Act is designed to promote and encourage internal

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[191] Mizutani, Hideo. "Whistleblower Protection Act". Retrieved from http://ssrn.com/abstract=408b9d01

[192] *Ibid.*

[193] *Ibid.*

[194] *Ibid.*

[195] *Ibid.*

disclosure, it does not obligate firms to introduce an internal disclosure system, which is an important key to promoting compliance by companies.[196]

4.3.2. Outside Director.

Outside directors are a key component of most prescriptions for good corporate governance of public companies, in the US, outside directors play a central role in overseeing external audits, hiring and firing chief executives, setting management compensation, and responding to takeover proposals, among other management decisions and the Sarbanes-Oxley Act of 2002 increases their role.[197]

One of the key elements of the Japanese corporate governance reforms is the introduction of outside directors, however it failed to play a substantial role in monitoring. They have outside directors who are not really independent and have no real power to influence the decision making process.[198] The Japanese companies may find it difficult to integrate outside directors because that would be the contrary to Japanese Culture, which have person in board member having longstanding and close personal relationship. However in Japan, this barrier in integration is not solely on cultural reason, other opposition is motivated by the interest of the business elite.[199] One notable example of these trends is the flexibility offered by Japanese reforms instead of mandatory requirement to adopt The New type Company. [200]

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[196] *Ibid.*

[197] Black, Bernard., Brian Cheffins., Michael Klusner., (2006). " The Liability Risk for Outside Directors: A Cross Border Anlysis." In John Armour, & Joseph A. McCahery (Eds.), "After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US." (pp. 343-366). US & Canada : Hart Publishing.

[198] *See* Pejovic, Caslav. (2011, July 21). p. 16.

[199] *See* Pejovic, Caslav. (2011, July 21) p. 17. During the procee of adoption of the new corporation law, Hiroshi Okuda, The Chairman of Toyota, who also served as the Chairman of *Keidanren*, expressed a view that reforms in Toyota should go in the direction of strengthening internal control, rather than introducing outside control. Fujio Mitarai, the president of Canon, who replaced Okuda as the Chairman of *Keidanren*, held identical views, taking the stance that Canon does not need outside directors to achieve more efficient management.

[200] *Ibid.*

The general complaint is that Japanese firms lack independent, outside directors. Most board members of a given company come from inside. This creates a cozy internal relationship and closes the doors to outside scrutiny. Olympus actually had three outside directors, but in reality had no effective corporate governance.[201]

On Oct. 27 2011, representatives of several foreign business groups in Japan, including the European Business Council and the American Chamber of Commerce, demanded that the Justice Ministry takes measures to compel Japanese firms to improve their governance.[202] A ministry panel has been working to amend the Company Law. The foreign business bodies told the ministry that many listed Japanese companies are viewed as insider-dominated and out of step with global governance standards, because only directors with close ties to management, the main bank or majority shareholders tend to be appointed.[203]

Outside directors are supposed to represent shareholders' interests, not the company's. But the legal system does not guarantee that because the Company Law does not prohibit a company from hiring an "outside" director who worked for the parent company or its affiliates.[204] Hence it is necessary for new corporate law to redefine the outside directors, increasing their independence and power in the board room.

Takeyuki Ishida, vice president of Institutional Shareholder Services K.K., a U.S.-based corporate governance solution provider give another solution, he said that the two main pillars of quality corporate governance are "human resources" and "money." He said the salaries of any given company's president or directors should be more strictly based on the company's performance.[205] Because executive compensation in Japan rarely changes, directors focus on maintaining the status quo instead of making bold challenges to spur corporate growth. This draws criticism that they are not looking out for the interests of shareholders. Providing more

[201] *See* Nagata, Kazuaki. (2012, January 17).Corporate Japan: Woeful Lack of outside directors. *The Japan Times Online* . Retrieved from http://www.japantimes.co.jp/text/nn20120117i1.html

[202] *Ibid.*

[203] *Ibid.*

[204] *Ibid.*

[205] *Ibid.*

financial incentives to people in top management would compel them to work harder to improve corporate performance and take shareholders' interests more to heart.[206]

4.3.3. Shareholders Protection

Mathias M Siems (2007) tried to measure Shareholders protection in 20 countries including Japan between 1995 – 2005 by using *leximetric* approach which has been used by Lele and Siems to quantify Shareholder protection in five countries (Germany, France, UK, US, and India) and coded the development of the law over three decades.[207] Mathias M. Siems uses 10 variables in his research to measure shareholder protections in 20 countries.[208] Based on his research we found that Japan Shareholder protection aggregate between 1995 to 2005 is among in the highest score countries including France, UK, and US.[209] Even though such research crowned Japan as a country with good shareholder protection such perception is not entirely true because, there is a lot of deviation in practice as we mentioned above there are many reformations that mere facade, and corporate governance still rooted in Japan's traditional culture.

Under corporate law, directors owe duties to the company that can be divided into two broad categories, duty of care and loyalty. Under such reason shareholders in Olympus is entitled to sue directors because the damage they suffer[210]. In Olympus case, Shareholders

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[206] *Ibid.*

[207] Lele, Priya P. and Mathias M. Siems., (2007). "Shareholder Protection: a Leximetric Approach", *Journal of Corporate Law Studies*, 17-50.

[208] *See* Siems, M. Mathias. (2007). "Shareholder Protection Around The World: Leximetric II" CBR Research Program, University of Cambridge, No. 359. Variables on Shareholder Protection 1)Powers of the general meeting for de facto changes. 2) Agenda Setting Power. 3) Anticipation of shareholder decision facilitated. 4) prohibition of multiple voting rights (super voting rights). 5) Independent Board Member. 6) feasibility of director's dismissal. 7) Private enforcement of directors duties (derivative suits). 8) Shareholder action against resolutions of the general meeting. 9)Mandatory bid. 10) Disclosure of Major share ownership.

[209] *Ibid.*

[210] Osugi, Kenichi. "Companies Act-Overview". Retrieved from http://www.tomeika.jur.kyushu-u.ac.jp/corporate/index.html. When a director neglects his or her duties, the director will be liable to

face a problematic situation to sue the company. Because, unlike in the United States, there is no class-action litigation in Japan. Shareholders must actively band together to sue Olympus. They must opt into a lawsuit rather than opt out. This makes it harder to get large groups of plaintiffs together to seek bigger recoveries, and keeps legal costs down.[211] Another way stockholders and bondholders often turn to U.S. courts in hopes of winning damages from companies, banding together in class-action lawsuits that let them sue as a group. But in 2010, the U.S. Supreme Court, in a case known as Morrison v. National Australia Bank Ltd, curbed investors' ability to sue in U.S. courts over their purchases of securities on non-US exchanges.[212]

So, why not filing derivative suits in Japan's court? Mark D. West (1994) has said in 1993 since legislative reduce filing fees, is brought an "explosion" in Japanese derivative litigation, he argued that Japanese shareholders chosen not to sue before, is not because of cultural reason but higher filing fees, high attorney fees, corporate governance constraints and low incentives for Japanese attorneys[213]. The *Daiwa* bank case which The Osaka District Court found the directors liable for breach of duty and ordered them to pay about $775 million in damages, seem to give hope to the shareholder protection.[214] However, these facts gradually changing over time. Mark D. West (2000) found in japan Plaintiff-Shareholders usually lose. And filing fees, though reduced, are still non zero. Why should a plaintiff pay $75 for a losing case?[215]

Other study that Mark D. West found in Japan, is shareholders appear to receive few gains from derivative litigation. Most suits are losers. He argued that shareholders in Japan have even less reason that shareholders in the US to bring suit. Even the winners do not result

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compensate the company for losses arising in the company as a result (Article 423(1)) 2005 Companies Act.

[211]Stempel, Jonathan. (2011, November 9).Olympus Investors May Find Courthouse door closed. *Reuters* . Retrieved from http://www.reuters.com/article/2011/11/09/us-olympus-lawsuits

[212]*Ibid.*

[213]West, Mark D. (1994). "The Pricing of Shareholder Derivative Actions in Japan and the United States", 88 *NW. U. L.REV.* 1436, 1437-38

[214] Judgment of Sept. 20, 2000, [Nishimura v. Abekawa] (The Daiwa Bank Case), Osaka Chisai [D. Ct.], 199 Shiryôban shôji hômu 248 (2000).

[215] West, Mark D. (2000). " Why Shareholders Sue: The Evidence from Japan" *Michigan Law and Economics Research Paper No.00-010.* Retrieved from http://papers.ssrn.com/sol3/papers.cfm?abstract_id=251012

in increases in shareholder wealth.[216] Roberta Romano found in her study that in the US system the principal beneficiaries of the litigation appear to be the attorney, who win fee award in 90 percent of settled suits. Something that lacks in Japan, which makes japan's attorney lees incentives than US.[217]

[216] *Ibid.*

[217] Romano, Roberta. (1991). "The Shareholder Suit: Litigation Without Foundation?", 7 *J. L. ECON. & ORG.* 55, 58.

Chapter 5 – Concluding Remarks

This chapter comprises conclusions and recommendations. The conclusions endeavor to answer the research and main research questions, while the recommendation anticipates the drawback mentioned in the conclusions.

5.1. Conclusion

1. How corporate governance regulates in Olympus Corporation, before the scandal have been revealed?

A major reform of Japanese corporate governance laws was introduced in 2002. There are several changes that have been introduced in the existing corporate management structure. Most of the debate on reforms of Japanese corporate governance has revolved around the clash between American models which is geared towards placing primary importance on shareholder and relying on external control, and the traditional Japanese model, which is primarily a stakeholder model based on internal control.

Japan cannot ignore that fraudulent hiding loss arrangement in Olympus Case is a sign to solve the problem in corporate governance issues that have been already a concern for so many years. Olympus as one of the big company with a long history is a main company in Japan and such practice must be highly affected toward the economic environment in Japan as general. Adoption of the American model into Japanese business culture was unsuccessful. Even in the post-war period Japan adopted corporate governance structures and rules based on American corporate law, but in practice, they deviated substantially from the American model.

One of the pivotal factors that have influence in deviation of the corporate governance in Japan is cultural factors that exist beyond legal norms and obeyed by the corporate entities such as top management and employee. The traditional corporate governance based on old culture facing failure and such phenomena reflected in Olympus case. The most typical features of the Japanese model of corporate governance come from the non legally norm consist of : the main bank system, cross shareholding, long-term employment, and the close relationship between the business elite and the government

In Japan, the structure of a large publicly traded company is commonly characterized by cross-shareholding which is known as "*keiretsu*". This concept is simply defined as mutual shareholding through which a number of companies are interconnected in a network where each of them holds shares in the other companies. *Keiretsu* is a structural arrangement of Japanese firms characterized by close business relationships intertwined with long-term commitments among members. Long-term employment is another typical feature of the Japanese corporate governance model. Long term employment describe the company as a family system. The seeds of this family concept of companies are deeply rooted in Japanese culture, based on obedience, hierarchy and loyalty which all make up important elements of Japanese culture. The main bank system can be characterized as the largest single lender to a corporate client as well as one of its principal shareholders. As a central repository of information on the borrower, in this system the main bank was positioned to play a key role in monitoring the firm's management and rendering assistance in case of managerial crisis of financial failure. This assistance could include loan forgiveness and guarantees of outstanding and new indebtedness.

2. To what extent the role of corporate culture and cultural background of the members of the boards have definitive influence in the establishment of corporate governance in Japan?

Olympus case and Enron Debacle have confirmed, that corporate culture really matters in performance and the downturn on the company, even though they have different backgrounds and different motives, but they have one common answer that corporate culture is main factors that have to be considered for top management and shareholders in a company.

The core problem in Olympus case comes from the 'bad' leadership in Olympus. And this culture begins since Toshiro Shimoyama become a president and latter shift to his heirs Kishimoto and Kikukawa. Such bad leadership tends to result in poor performance and misjudgment. Furthermore they create no democracy and non-freely speak up culture which also influence by Long Term employment culture in Japan.

With the Long term employment concept, the company will achieve a greater level of loyalty from their employees. It was true, such great loyalty helped many Japanese companies to exert more effort from their employee and help Japanese companies to survive in crisis in the past. However in Olympus case this thought tends to be misused by the top management to create no democracy culture, they can easily pressure the employees to not speak-up as they feel open up the scandal same as open up the disgrace of your family. Obviously this culture does not work for Michael C. Woodford who does not Japanese person and open-up the case eventually in public.

Collusive practice between Controlling Shareholders and top management In Olympus case are resulted from two non-legal norm in Japan which are main bank system and cross-shareholding. Main bank system, makes the monitoring role of the management by Shareholders is flawed and mere façade, because in term company in poor performance bank as shareholders tend to help by giving loan forgiveness, and guarantees. The combination of the main bank system and cross-shareholding resulting the absence of market for corporate control. This concept impedes hostile take over, as one tool for disciplining management. Such collusive practice between top management and controlling shareholders leave the problem for individuals and foreign shareholders or minority shareholders.

3.What is the influence of corporate governance reforms in Olympus Scandal, and how to prevent accounting fraud in the future?

Corporate governance reforms in Japan, is main factors that trigger cultural shift in Japan besides other factors such as economy, globalization, and social factors. There is a sign of the gradual process of reform of society in Japan, which enables a smooth transition from a society governed by social norms towards society governed by legal norms. As a result of such reforms, it may be expected that the law will play increasingly important role in coming years.

Enron and Olympus Case shows us when such communication blocked between employee and top management, it will increase the domination power of top management and tend to misuse it. Because the gap of power between Top management and employee is wide, sometimes it is not easy to employee to object and correct such misuse practice from their "boss". Even though there is still shortcoming in recent whistle-blower protection mechanism in Japan, however it could be a solution to increase power to employee to correct and raise objections to their “boss” and reduce the abusing power in the top management.

Outside directors are another solution to balance power from top management and increase transparency in the board room. They are supposed to represent shareholders' interests, not the company's. But the legal system does not guarantee because the Company Law does not prohibit a company from hiring an "outside" director who worked for the parent company or its affiliates. Hence it is necessary for new corporate law to redefine the outside directors, increasing their independence and power in the board room. Another solution is by giving incentives to the top management, Providing more financial incentives to people in top management would compel them to work harder to improve corporate performance and take shareholders' interests more to heart. Financial incentives also have an influence to change the payment system from seniority-based payment being resulted of long-term employment toward the performance-based payment. However learning from Enron case such solution should be governed by some ‘proper’ restrictions.

In Japan, under corporate law 2005 in Article 423(1) When a director neglects his or her duties, the director will be liable to compensate the company for losses arising in the company. Directors owe duties to the company that can be divided into two broad categories, duty of care and loyalty. Under such reason shareholders in Olympus is entitled to sue directors because the damage they suffer. Even though it is well known in Japan derivative suits is hard and costly, but refer to the *Daiwa* bank case, it is still possible to use derivative suits for shareholders to protect their rights and increase the liability of directors in a Japanese company.

5.2. Recommendations

- The fact that Japan has been in the process of transformation period from stakeholders oriented to shareholders oriented is reflected in cultural shift which being triggered by globalization, social, political, and economic condition worldwide, especially in the recent scandal Including Olympus case has put pressure to cultural shift as well. However, rapid and extreme transformation only results rising conflict from *keidanren*, Japan need time to digest such transformation while legal reform can help and necessary to accelerate such transformation smoothly.

- Japan needs to improve and enacting “New” legal protection regarding Whistle-blower mechanism, due to recent legal protection for whistle-blower still have a shortage and failed to protect the whistle-blower. The “new” legal protection will increase communication, democracy culture, and correction mechanism between employee and directors, hence it will reduce the domination practice of directors to their employees. Enactment of the “new” protection act and considering a cultural shift in Japan will change “blind” loyalty culture from the employee which being resulting from a long-term employment system in Japan which tend to being abused by top management.

- Amendment of commercial code and TSE rule should redefine the power and number of independent directors. The application should not be ‘elective’ anymore, but must be mandatory. The “new” commercial code and TSE rule should address the mandatory requirement for companies to put outside directors and Increase the number of outside directors in board member. The “new” commercial code should address the requirement and capabilities of outside directors as well. The “new” law will balance the power of directors in the board room, hence it will increase checks and balances mechanism, increase transparency, and reduce collusive practice in a board room. Increasing the number of outside directors will attract foreign investment, and undermine of cross-shareholding system and increase hostile takeover in japan.

- Japan should increase their court's ability to handle a derivative suit case, reduce the filing fees, find the way to stimulate attorney in derivative suits, and increasing the threshold and scope for directors liability. This mechanism enhanced legal protection for minority shareholders, increase liability for directors, and enhanced risk of directors for being sued if they neglect their duties to the company. This mechanism also prevent and impede the collusive practice between directors with major shareholders (bank) which Olympus did on that case. In a nutshell these mechanisms will change the main bank system gradually, because control mechanism and liability not only in the hand of bank as major shareholders but they have to liable to the minority shareholders as well.

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