Livedoor and a new wave in Japanese corporate governance

1st September 2006

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Acknowledgement

This work was made possible through the supervision of Simon Learmount, a lecturer at Judge Business School, University of Cambridge, who gave me insightful advice on the issue. I am also extremely grateful to Livedoor, its group companies, employees of its companies and any others involved. In particular, this work would not be possible without interviews with Kozo Hiramatsu, the current CEO of Livedoor, Takeshi Idezawa, Livedoor Operating Officer and Noriyuki Yamazaki, Livedoor’s former Representative Director. People involved in Livedoor have gone through an extremely hard time for more than half a year, but I believe that this hardship is a precious opportunity to learn and grow. I personally feel that I am part of this scandal because it is not only the accused who should face criticism, but also every director and senior manager, including myself. Although Livedoor’s actions have been judged as wrong, I believe that rehabilitation is possible by learning from this failure. Finally, I express my sincere condolences on the death of Hideaki Noguchi. As an ex-colleague of his on the board, I will cherish my memories of working with him and how amazing he was.
Abstract
Traditionally, Japanese corporate governance has often been characterised by the strong involvement of stakeholders, especially employees. While some have attributed the amazing recovery of Japan’s economy following World War II to its unique corporate governance style, others have criticised it for neglecting shareholders’ rights. Since the bubble economy burst in the early 1990s, Japanese corporate governance and its methodology has been questioned with regards to global competitiveness. In line with this, Japan now appears to be on the cusp of reforming its corporate governance style.

The rise and collapse of dot-com start-up company Livedoor was a symbolic event in the ongoing reformation of Japanese corporate governance. Livedoor stimulated extensive public response by placing the greatest emphasis on shareholder value, by attempting a large hostile takeover and, ultimately, by collapsing due to accounting fraud. The term ‘Livedoor shock’ was coined in reference to allegations of window-dressing accounting and following several days of panic selling on the Tokyo Stock Exchange prompted by the allegations.

This paper will look into the Livedoor case within the context of corporate governance. It will review theories of corporate governance comparing shareholder and stakeholder perspectives, discuss Japanese corporate governance and its ongoing reformation and introduce the Livedoor case. In the final chapter, several reasons for Livedoor’s collapse will be presented with the intent to uncover lessons for the future of Japanese corporate governance.

As a former board member of Livedoor, I feel somewhat responsible for the situation as well as a strong desire to understand the Livedoor case though an in-depth investigation.
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Part I: General review of corporate governance

1. Theories of corporate governance

1.1. Introduction
This chapter will review several mainstream theories of corporate governance to form a fundamental understanding of Japanese corporate governance and the Livedoor case. Among the perspectives in corporate governance study, this chapter will focus primarily on the contrasting views between shareholder and stakeholder concepts, which I believe is the most relevant perspective for this paper.

Definition of corporate governance
The OECD provides the most authoritative and functional definition of corporate governance:

‘Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance’.¹

With OECD’s vigorous attempts to search for corporate governance principles, this definition is thought to represent the integration of many important developments in corporate governance theories.

History of corporate governance ideas
The discussion of corporate governance began in 1930s. Berle and Means, who are widely received as initiators of contemporary corporate governance theories, introduced ‘the separation of ownership and control’ and pointed out that shares of large American corporations were held by a various number of institutions, and that the individuals and corporations were actually controlled by the management, who did not have shares. They argued that this could result in

¹ OECD, April 1999, OECD's definition is consistent with the one presented by Cadbury 1992
rampant corruption by the management. They also pointed out that corporations had become social as well as economic institutions that should be socially or publicly accountable.\(^2\)

Since then, one of the main issues in the study of corporate governance has been the contrasting perspective between shareholder and stakeholder concept.

In recent years, the significance of corporate governance has become more crucial in response to a series of corporate meltdowns, frauds and scandals, such as Enron, WorldCom, Tyco and so on. In the United States, the Sarbanes-Oxley Act of 2002\(^3\), which was established in response to these major scandals, has been implemented to discipline company operations and protect investors. Many developed countries tend to follow reorganising or reinforcing company laws. A majority of well-known business schools have or are incorporating corporate governance and business ethics modules into their core subjects.

1.2. Shareholder concept

In theories of accounting and finance, it is assumed that the ultimate objective of a corporation is to maximise shareholder value. In this view, the shareholder is the owner of the corporation\(^4\) and corporate governance is a matter of effective accountability to shareholders.

The shareholder concept was developed and is largely supported by the Anglo-American business world and forms a dominant corporate governance view.

The main theme of Anglo-American corporate governance is to construct an efficient governance structure to maximise shareholder value. The basic idea comes from agency theory: the agent of the principles (management) should perform for the principals (shareholders) and effort has to be made to control the agent and reduce agency costs and information asymmetrically.

**Anglo-American corporate governance**

The dominance of US and UK corporations over the global economy is outstanding. Fortune Global 500 lists 170 US and 39 UK corporations (including a Britain/Netherlands-hybrid

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\(^2\) Adolf Berle and Gardiner Means, 1932. *The Modern Corporation and Private Property*

\(^3\) Pub. L. No. 107-204, 116 Stat. 745, also known as *the Public Company Accounting Reform and Investor Protection Act of 2002* and commonly called SOX or SarbOx; July 30, 2002

corporation) among the 500, resulting in US and UK corporations accounting for 41.8%. Due partly to this overwhelming performance, Anglo-American corporate governance, namely shareholder concept, has become a dominant theory.

Table 1: How the Countries Stack Up (Fortune Global 500, 2006)

<table>
<thead>
<tr>
<th>Country</th>
<th>Number of Global 500 Companies</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>170</td>
</tr>
<tr>
<td>Japan</td>
<td>70</td>
</tr>
<tr>
<td>Britain</td>
<td>38</td>
</tr>
<tr>
<td>France</td>
<td>38</td>
</tr>
</tbody>
</table>

Shareholder perspective is thought to be good for profitability. Since company’s net profits belong to its shareholders, maximising shareholder value eventually means maximising net profits. In other words, from an Anglo-American perspective, corporations should not divide a large portion of its profits to other stakeholders, such as employees or the community. In general, Anglo-American corporations are reputed to be very profitable because of their focus on shareholders; seven out of top ten highly profitable companies are from either the US or UK according to the Fortune Global 500.

Table 2: Most profitable companies (Fortune Global 500, 2006)

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Fortune revenue ranking</th>
<th>Profits 500 ($ millions)</th>
<th>2004 Profits % Change from 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Exxon Mobil</td>
<td>1</td>
<td>36,130.00</td>
<td>42.6</td>
</tr>
<tr>
<td>2</td>
<td>Royal Dutch Shell</td>
<td>3</td>
<td>25,311.00</td>
<td>39.2</td>
</tr>
<tr>
<td>3</td>
<td>Citigroup</td>
<td>14</td>
<td>24,589.00</td>
<td>44.3</td>
</tr>
<tr>
<td>4</td>
<td>BP</td>
<td>4</td>
<td>22,341.00</td>
<td>45.3</td>
</tr>
<tr>
<td>5</td>
<td>Bank of America Corp.</td>
<td>37</td>
<td>16,465.00</td>
<td>16.4</td>
</tr>
<tr>
<td>6</td>
<td>General Electric</td>
<td>11</td>
<td>16,353.00</td>
<td>-2.8</td>
</tr>
<tr>
<td>7</td>
<td>HSBC Holdings</td>
<td>26</td>
<td>15,873.00</td>
<td>34.1</td>
</tr>
<tr>
<td>8</td>
<td>Total</td>
<td>12</td>
<td>15,250.00</td>
<td>27.6</td>
</tr>
<tr>
<td>9</td>
<td>Gazprom</td>
<td>102</td>
<td>14,865.20</td>
<td>113.4</td>
</tr>
<tr>
<td>10</td>
<td>Chevron</td>
<td>6</td>
<td>14,099.00</td>
<td>5.8</td>
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</tbody>
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Another aspect that forms a characteristic of Anglo-American corporate governance is the frequent use of Mergers & Acquisitions (M&A) as a means of achieving growth or a competitive advantage. The shareholder concept suits M&A because of its clear ownership concept: the shareholder is the owner of the corporation and that ownership is transferable. This simple logic has enhanced M&A activities without much consideration for other stakeholders. In Europe or Japan, it tends to be more difficult to conduct M&A because there is greater concern about stakeholder issues (e.g. employees have stronger rights, local communities have a say and so on).

**Agency theory**

Anglo-American corporate governance has a significant basis in agency theory. In corporations, the principal (shareholder) delegates decision rights to the agent (manager) to act in the principal's best interests. The firm is a team-oriented production system that entails several contracts (e.g. shareholders, debt holders, employees and so on). The shareholder, as a residual claimer who is at greatest risk, generally conducts regularly regular monitoring of the management.⁶

The separation of ownership from control includes a loss of effective control by shareholders over managerial decisions. Economists call this problem ‘transaction cost’, which includes self-interested opportunism and informational asymmetries.⁷ Hence, the system of corporate governance is designed to motivate managers to excel by offering large compensation awards, particularly completion bonuses such as share options, because it is essential that a corporation align their managers’ incentive with the shareholders’ in order to prevent managers from pursuing self-interests.

The board of directors plays a central role in Anglo-American corporate governance. Its responsibility is to monitor senior executives and to ensure the accountability of the organisation to its owners – the shareholders. Therefore, the relationship between the board and management can be highly strained. The board can, if necessary, replace management in an effort to improve the company’s performance.

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Limitations and pitfalls of the shareholder concept
There are a number of advantages of the shareholder value perspective, though it has been racked by a number of corporate scandals in Anglo-American corporations. Accordingly, increasing numbers of people have mounted criticism of the shareholder concept.

The basic question is this: ‘Is the corporation really owned by its shareholders?’ Some argue that shareholders are not, in the eyes of law, owners of the corporation despite their residual claims. In this view, the corporation is a social institution owned by no one, so it should serve a wider range of stakeholders.

Additionally, the pursuit of shareholder value often proves harmful to society. Customers may not respect companies that are solely profit-oriented; this is apparent in the increasing public concern over social, health-related or environmental issues. As global large corporations have become more influential in the society, they are being required to contribute to that society in turn.

A flood of massive corporate scandals is often seen as the result of overemphasis on maximising shareholder value. Some shareholders tend to pursue short-term profits and, as a result, company managers often try to fulfil these expectations by conducting unsustainable business that is only durable in the short term. Unfortunately, this situation may cause some managers to entertain and manipulate accounts illegally.

1.3. Stakeholder concept
The stakeholder model views the corporation as being not only accountable to their shareholders, but also having responsibility to a wider range of stakeholders (e.g. employees, environment, customers, and the society) in which the corporation exists. Stakeholder management principles require managers to incorporate the legitimate concerns of stakeholders, often in a broad sense, into their managerial decision-making. Namely, ‘the corporation is an organization engaged in mobilizing resources for productive uses in order to create wealth and other benefits (and not to intentionally destroy wealth, increase risk, or cause harm) for its multiple constituents, or stakeholders’.

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Traditionally, Continental Europe and Japan have held different perspectives on corporate government than Anglo-American concepts. In those countries, employees have a strong presence in the corporation as well as regarding the corporation’s contributions to society as highly admirable. Shareholder value is considered to be one of the many aspects that a corporation should prioritise.

Hiroshi Okuda’s statement represents the nature of stakeholder concept succinctly.

‘For the long term sustainability of the corporation, it has to have long-term close relationships not only with employees but also with clients, customers, suppliers and the local community. This means that the interests of various stakeholders need to be taken into consideration by the management of the corporation, which is a public concern. A corporation therefore does not belong solely to the shareholders’.  

European and Japanese corporate governance

There are two major characteristics of European and Japanese corporate governance: employees’ rights and social value.

Employees possess a great deal of rights in non-Anglo-American countries, particularly in Germany and Japan. For instance, German law requires a Supervisory Board of 20 seats, with half of the members representing company shareholders, and another half representing the employees. The shareholder representatives are elected at the Annual Shareholders’ Meeting, and the employee representatives are elected by an assembly of employee delegates. In contrast, Japan’s company law has close similarities to Anglo-American company law, while corporate culture resembles Germany’s in that employees have a strong say. This is thought to be based on Japan’s renowned employment culture, which purports characteristics like lifetime employment, functional flexibility and seniority. ‘Core employees do not seem to be so much contracted to the company, but appear to be perceived and to perceive themselves as constituting the company’.  

Another characteristic is the respect for social value, which can be seen throughout Continental Europe. For example, in Spain there is the Caja de Ahorros, a group of saving banks that combine their financial function with intense social activities. This system started in the 18th century.

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10 Hiroshi Okuda, Toyota Chairman, 2001
11 German Codetermination Act
12 Learmount, S., 2002. Corporate governance: what can be learned from Japan?, Oxford University Press
century, when Spain was reeling from the War of the Independence, in order to rehabilitate the devastated country. The mission of Caja de Ahorros is ‘extending financial service to large sectors of the population and distributing the profits obtained in the way of welfare work, with the purpose of contributing to the welfare and development of the society as a whole’.  

**Corporate Social Responsibility (CSR) and sustainable development**

The idea of CSR and sustainable development can be associated with the stakeholder perspective. The definition of CSR is ‘the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large’. The idea of CSR is closely linked to sustainable development, which is defined as ‘development that meets the needs of the present without compromising the ability of future generations to meet their own needs’.

Recently, these ideas have increased in importance as the influence of corporate activities has become more significant. Nowadays, the sales of General Motors exceed the gross domestic product (GDP) of Denmark, the world’s 23rd largest country in GDP. The application of the principles of sustainable development and CSR is often accompanied by triple bottom line reporting, which declares the social and environmental impact of a business as well as its financial results; some countries (e.g. France) have made such reporting mandatory. Furthermore, an increasing number of large companies now publish annual reports that cover sustainable development and CSR issues, and these reports are often externally audited.

**Limitations of the stakeholder concept**

Despite all the benefits of the stakeholder concept, there is one aspect that cannot be ignored: none of the stakeholders, legally or conceptually, own corporations. Even though corporations have a certain level of responsibility to the stakeholders, their primary accountability must be to the shareholders, who have direct and vested interest in the corporations. In this respect, imposing too much stakeholder concept on corporate managers is not logically supported.

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15 *Brundtland Report*, World Commission on Environment and Development (WCED)

16 *The Rise of Corporate Global Power*, Institute for Policy Studies
Additionally, overemphasis on employees’ benefits may sprout serious problems. The company’s overall profitability may be damaged because employees enjoy too much compensation, resulting in a decrease in global competitive advantage.

Lastly, there is some criticism of CSR or sustainable development. Some argue that CSR is mainly used for publicity; many companies allegedly confuse the natural order of things by aiming primarily at brand building rather than contributing to the society. Furthermore, companies can give fanfare to their efforts by publishing a beautifully tailored report: a good example of this was the annual production a glossy ‘Corporate Responsibility Annual Report by Enron.'
2. Characteristics of Japanese corporate governance

2.1. Introduction
Japan has developed a unique corporate governance structure during the rapid rebuilding of its economy after World War II. The rest of world was, at some point in the past, in awe of its miracle economic recovery and a number of Westerners have studied and tried to emulate the Japanese system. However, with the collapse of Japan's overheated stock and real estate markets at the beginning of 1990s, Japan has begun to struggle in a period of unprecedented economic stagnancy. Accordingly, the government and many Japanese corporations have come to consider methods of reforming the Japanese way of business, including its unique corporate governance style.

This paragraph will explore some characteristics of the traditional Japanese corporate governance and the current reformation.

2.2. ‘Traditional’ Japanese corporate governance

Some views
According to the Ministry of Finance (MOF), Japanese corporate governance has been seen as 1) a board that consists mainly of internally promoted senior managers; 2) incomplete separation of the board and executives; 3) a large number of the board members; and 4) relatively low and non-performance-linked compensation for directors. It also pointed out that, while this unique system could be attributed to the rapid economic growth that occurred until the late 1980s, it may also have caused the persistent, long-term recession that started from the 1990s onwards and has harmed the global competitiveness of Japanese companies.\(^\text{17}\)

The traditional Japanese corporate governance is also described as a ‘community of employees’, where employees have a strong presence in the corporation. Management is perceived as the 'elder of corporate community' rather than the agent of shareholders.\(^\text{18}\)

Although Japanese company law clearly prescribes that shareholders shall assign the board of directors at the Annual General Meeting (AGM), it is generally received that the AGM is merely a ceremonially procedure and that the board are virtually assigned by company insiders. With a

\(^{17}\) Ongoing reformation of corporate governance and revitalisation of Japanese Company, Policy Research Institute, Ministry of Finance, 20 June 2003

\(^{18}\) Learmonth, S., 2002. Corporate governance: what can be leaned from Japan?, Oxford University Press
considerable focus on employees’ rights, Japanese corporations have enjoyed high labour productivity derived from deep-rooted employee loyalty. Alternatively, employee-driven governance, however, has a tendency of neglecting shareholder value.

### Table 3: Who owns the corporation?\(^{19}\)

<table>
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<th>Who ‘should’ own the corporation? (%)</th>
<th>Who owns the corporation in practice? (%)</th>
</tr>
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<td>Shareholders</td>
<td>67</td>
<td>59</td>
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<tr>
<td>Management</td>
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<td>65</td>
</tr>
<tr>
<td><strong>Employees</strong></td>
<td><strong>80</strong></td>
<td><strong>77</strong></td>
</tr>
<tr>
<td>Society</td>
<td>70</td>
<td>23</td>
</tr>
<tr>
<td>Clients/customers</td>
<td>27</td>
<td>26</td>
</tr>
<tr>
<td>Local community</td>
<td>10</td>
<td>3</td>
</tr>
</tbody>
</table>

*M*Maximum three choices allowed*

Another perspective of Japanese corporate governance is that Japanese companies tend to have a more multidivisional (M-form) structure than US firms. Kim and Hoskisson suggested that this may be because the Japanese financial system is centralised, and Japanese large firms rely primarily on internal labour market.\(^{20}\) M-form organisation is defined as ‘one that is decomposed into self-contained units where complementary tasks (such as producing a given screw and the associated bolt) are grouped together’, while U-form organisation is, by contrast, ‘decomposed into specialized units where similar tasks (such as production and sales in a corporation or steel and textiles in a centrally planned economy) are grouped together.’\(^{21}\)

Michael Porter pointed out that the Japanese corporate model ‘consists a series of production practices, human resource policies, organizational and leadership approaches and modes of diversification.’ These policies are encourage companies with ‘rapidly improving the skills of employees, creating a strong sense of community, building employee loyalty and encouraging managers to take a long-term view of business decision.’ However, he also claimed that few Japanese corporations have ‘strategy’ that leads companies to competitive advantages.\(^{22}\)

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\(^{19}\) Survey by Nihon Keizai Shimbun, 1990  
\(^{21}\) Yingyi Qian, Gérard Roland and Chenggang Xu, 1999. *Coordinating Changes in M-form and U-form Organizations*  
\(^{22}\) Michael E. Porter, 2001. *Can Japan Compete?*
Background factors of Japanese corporate governance

Japan’s unique corporate governance system is thought to come from peculiar business circumstances. Below are some factors that I believe help to form Japanese corporate governance.

a) Powerful government intervention

The Japanese government, especially the MOF, has played an active role in rebuilding the post-war economy. Monks and Minow argued that the 'MOF has maintained strong regulatory control of all Japan’s business, supervising every aspect of industrial activity, including capital flow.'

Although this statement seems rather extreme, few people would disagree that the Japanese government has actively intervened in domestic business. Min Chen suggested that the intervention was encouraged by a catch-up mentality: Japan 'wanted to catch up with advanced industrialised nations within the shortest possible time.'

As a result of the close government-firm relationship, it is assumed that Japanese companies have come to think of broader stakeholders rather than profit-focused shareholders.

b) Keiretsu – business group

A keiretsu is a set of business units viewed together, which are usually linked with interlocking business relationships and cross-shareholdings; it is a type of business group. However, while a so-called business group may have a holding company and consolidated subsidiaries, a keiretsu does not usually have a holding company that retains major shares of group companies. In the pre-war era, keiretsu had a more firmly bound capital structure and were called zaibatsu, 'wealthy clique' or conglomerate. After Word War II and in line with the US occupation policy MacArthurs’ General Headquarters (GHQ) dissolved zaibatsu in order to prevent the US’ former enemy from becoming a threat again. The influence of zaibatsu, however, remained even after holding companies divested their subsidiaries' shares. Companies in the same zaibatsu merely formed a keiretsu – a firmly bound business group that did not hold the majority of shares.

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In the keiretsu hierarchy, a bank is positioned at the top and controls the group companies (i.e. main bank system) despite its tendency not to have a majority of shares of the subordinate companies. Simply put, in the keiretsu system, companies are governed and controlled by a company (here the bank) that does not control a majority of the voting shares. While the main bank asserts its influence over other keiretsu members, the member companies nurture and promote ties amongst themselves by cross-shareholdings or mochiai. Through this process, a keiretsu can become an exclusive business group.

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27 The bank law of Japan prescribe that 5% is the maximum allowable shareholdings by a bank in an industrial firm
Livedoor and a new wave in Japanese corporate governance
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The keiretsu system has significantly affected the formation of Japanese corporate governance. The complex structure, which consists of the main bank and its cross-shareholding companies, makes it difficult to distinguish the actual owners of participant companies in Japan. In the keiretsu context, it is unreasonable to consider the direct shareholder to be the sole owner of the corporation.

c) Main bank system
The main bank system is typical in keiretsu. Takeo Hoshi defined ‘main bank’ as the bank that is the firm’s ‘largest lender, one of its largest shareholders, and sometimes supplies one or two board members.’\(^{28}\) While scholars often mention the main bank ‘system’, there is no legal and official relationship between the corporations and banks. Hence, the main bank system is informal and implicit. Although the main bank began in the keiretsu system and originally meant the core bank at the top of a keiretsu structure, it is also used in a broader sense – i.e. a bank that has the closest relationship with a firm or individual. In this sense, the main bank system is beneficial for firms; it allows the maintenance of a long-term finance source at substantially low costs of capital. Also, it is safer for the bank(s) to lend to companies that are closely linked through this type of relationship.

In the main bank system, banks are expected to play an important role in corporate governance, namely by monitoring company management in the lieu of shareholders.\(^{29}\) It appears to be a practical method because the main banks possess shares, which allow them to represent shareholder interests if they seat a member on the board. However, the bank’s dispatching of a director(s) often does not work as expected; banks often outweigh their interests as debt holders and their 5% share, the maximum allowed, is not enough to motivate banks to actively pursue shareholders’ interests.

In recent years, the main bank’s influence over Japanese corporations is becoming polarised. While gearing ratios of Japanese companies have decreased dramatically over recent decades, some companies, ironically, are deepening their main bank dependency. This polarisation is believed to have developed through the fact that the average main bank dependency has increased since the 1990s, while standard deviation has implied that some companies go the other way around. (See tables 5 and 6)

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\(^{29}\) Watanabe, S. and Yamamoto, I., 1993. Corporate governance in Japan: Ways to Improve Low Profitability, Corporate Governance An International Review
Table 5: International comparison of corporate gearing ratios

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Japan</td>
<td>Gross</td>
<td>0.86</td>
<td>0.65</td>
</tr>
<tr>
<td></td>
<td>Net</td>
<td>0.68</td>
<td>0.84</td>
</tr>
<tr>
<td>UK</td>
<td>Gross</td>
<td>0.51</td>
<td>0.63</td>
</tr>
<tr>
<td></td>
<td>Net</td>
<td>0.21</td>
<td>0.25</td>
</tr>
<tr>
<td>US</td>
<td></td>
<td>0.45</td>
<td>0.50</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>0.25</td>
</tr>
<tr>
<td>Germany</td>
<td>Gross</td>
<td>0.72</td>
<td>0.81</td>
</tr>
<tr>
<td></td>
<td>Net</td>
<td>0.74</td>
<td>0.84</td>
</tr>
</tbody>
</table>

Table 6: Change in dependence on main bank

<table>
<thead>
<tr>
<th>Year</th>
<th>Mean (%)</th>
<th>Std. Dev (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>4.6</td>
<td>4.9</td>
</tr>
<tr>
<td>1991</td>
<td>4.8</td>
<td>5.4</td>
</tr>
<tr>
<td>1992</td>
<td>5.0</td>
<td>5.7</td>
</tr>
<tr>
<td>1993</td>
<td>5.3</td>
<td>5.7</td>
</tr>
<tr>
<td>1994</td>
<td>5.3</td>
<td>5.8</td>
</tr>
<tr>
<td>1995</td>
<td>5.3</td>
<td>5.8</td>
</tr>
<tr>
<td>1996</td>
<td>5.5</td>
<td>6.1</td>
</tr>
<tr>
<td>1997</td>
<td>5.8</td>
<td>6.3</td>
</tr>
<tr>
<td>1998</td>
<td>6.4</td>
<td>6.9</td>
</tr>
<tr>
<td>1999</td>
<td>6.6</td>
<td>7.9</td>
</tr>
</tbody>
</table>

*Dependence on the main bank: debts from the main bank / total assets, samples from all the listed companies, excluding financial institutions on the Tokyo Stock Exchange

d) Stable shareholding and *mochiai* – Cross-shareholding

Stable shareholdings are widely seen in Japan. In traditional Japanese business, stable shareholders are supposed to be in favour of company management: they are expected to agree with all the agendas proposed by the management at general shareholders’ meetings; not to sell shares to third parties, particularly unpleasant ones; and to consult with management when they need to sell shares for a compelling reason. Japanese companies have tended to

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31 Survey by Miyajima, Nitta, Saito and Omi, 2002
regard management stability as an important factor in the pursuit of long-term sustainability, so they have enthusiastically excluded managerial interference from general investors.

Mochiai is a situation in which two or more companies maintain stable shareholdings in each other’s business affairs. This is typically seen among keiretsu members, but can also be seen in a wider range of Japanese business. For instance, a supplier and a main buyer are often cemented with mochiai. Learmount revealed that Japanese companies, including institutional investors, usually keep mochiai and normal investment shares separate. Mochiai shares have a political intention: by exchanging shares, companies confirm their close relationships. This motivation is clearly illustrated in a questionnaire survey conducted by the MOF. (See table 7)

Table 7: Why companies do mochiai (2002)

<table>
<thead>
<tr>
<th>Reasons</th>
<th>Mochiai with business partners (%)</th>
<th>Mochiai with financial institutions (%)</th>
<th>(Reference) 1999 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Able to establish a long-term stable relationship</td>
<td>71.8</td>
<td>71.1</td>
<td>71.8</td>
</tr>
<tr>
<td>Able to prevent hostile takeovers</td>
<td>29.1</td>
<td>24.2</td>
<td>31.6</td>
</tr>
<tr>
<td>No merit</td>
<td>19.1</td>
<td>22.6</td>
<td>18.4</td>
</tr>
<tr>
<td>Able to cope with sokaiya (manipulators of stockholders' meetings)</td>
<td>21.1</td>
<td>18.3</td>
<td>30.4</td>
</tr>
<tr>
<td>Able to set a long-term business plan</td>
<td>12.0</td>
<td>15.9</td>
<td>9.5</td>
</tr>
<tr>
<td>Ability of mochiai shareholders to bail out the firm in a financial distress</td>
<td>0.8</td>
<td>2.5</td>
<td>1.7</td>
</tr>
<tr>
<td>Expect a high return as investment</td>
<td>1.5</td>
<td>0.3</td>
<td>1.5</td>
</tr>
<tr>
<td>Expect mochiai shareholders to underwrite new issues</td>
<td>0.8</td>
<td>1.0</td>
<td>1.5</td>
</tr>
<tr>
<td>Advantageous in rebuilding a business group</td>
<td>1.5</td>
<td>0.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Number of samples</td>
<td>602</td>
<td>678</td>
<td>1068</td>
</tr>
</tbody>
</table>

The mochiai system is thought to be the cause of the disregarding of shareholders rights. Although its primary motivation is to facilitate company activity by establishing long-term relationships with business partners or financial institutions, mochiai may also make shareholder’s rights worthless. In particular, foreign investors and pension funds often criticise this custom for its lack of transparency. The 1990s saw a dramatic promotion in capital markets globalisation; this lead to Japanese companies being unable to continue ignoring foreign

32 Learmount, S., 2002. Corporate governance: what can be leaned from Japan?, Oxford University Press
33 Survey by Policy Research Institute, Ministry of Finance
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Investors. In addition to this external pressure, the introduction of market price accounting for
securities pushed companies towards diminishing their mochiai shares. Again, according to
MOF’s survey, roughly half of the listed companies have plans to sell mochiai shares.

Table 8: Mochiai proportion and mochiai policy in the future (2002)34

<table>
<thead>
<tr>
<th>Future mochiai policy</th>
<th>Mochiai with business partners (%)</th>
<th>Mochiai with financial institutions (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Any mochiai relations?</td>
<td>69.5</td>
<td>78.5</td>
</tr>
<tr>
<td>Facilitate</td>
<td>0.8</td>
<td>0.3</td>
</tr>
<tr>
<td>Slightly facilitate</td>
<td>3.7</td>
<td>0.4</td>
</tr>
<tr>
<td>Maintain current level</td>
<td>52.0</td>
<td>48.5</td>
</tr>
<tr>
<td>Slightly diminish</td>
<td>28.2</td>
<td>32.9</td>
</tr>
<tr>
<td>Diminish</td>
<td>15.3</td>
<td>17.8</td>
</tr>
</tbody>
</table>

e) Lifetime employment and seniority system

The system of lifetime employment is an employment custom typically seen in Japan;
employees work for one company throughout their professional careers. Together with a
seniority-based promotion system, lifetime employment has played a central role in Japan’s
economic growth. It has clear advantages in the economic growth stage, enabling companies to
motivate their employees to take comprehensive professional training and to develop a sense of
employee loyalty. The seniority system also has a strong cultural foundation. Since Confucian
values are widely received in Japan, it is natural that junior employees follow senior ones. Also,
Japanese companies put strong emphasis on teamwork, so it is difficult to identify and measure
individual contributions within a group-based working style. This may be the reason why
Japanese companies have not adopted performance-based evaluation systems.

In a traditional Japanese company, young employees are usually underpaid in comparison to
their contributions, but at times eventually become overpaid as they become older (or as their
service record lengths). To reward loyal employees, companies retain a large number of
director’s positions, which are the career goal of most employees.

As a director’s position is the goal of employees, those who get promoted to director usually
behave accordingly: they do not regard the board as the representation of shareholders. Rather,
they view the board as the elders of the corporate community (i.e. representation of employees).

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34 Survey by Policy Research Institute, Ministry of Finance
This is why many Japanese businesspeople feel that employees rather than shareholders, own the corporation. Since the board itself is huge (a typical, traditional board of directors at a Japanese company will consist of more than 30 directors), it requires a hierarchy or ranks within itself. The hierarchy normally consists of a kaicho (chairperson), shacho (president), fukushacho (deputy president), senmu (senior managing director), jomu (managing director), hiratori (non-tile director), and sodanyaku (executive councillor and, normally, a retired chairperson or president). Many companies set a jomu-kai or management committee, which is comprised of those ranked at least as high as jomu, as a higher ranking, decision-making body than the board of directors' and their meeting. There is also a separate seniority system present inside the board hierarchy. Each directors’ compensation is not usually linked with performance, and directors are promoted step-by-step (e.g. from hiratori, jomu to senmu and so on).

This unique employment system is, however, subject to change in response to the recent management climate. Japanese companies can no longer sustain a system of lifetime employment under severe pressure from global competition, so they are shifting to a more flexible employment style. Also, the seniority system is diminishing. Many companies have introduced performance-based wage systems while a majority of Japanese companies have recently instituted a hybrid salary system between the seniority-based and performance-based compensation structures.

2.3. Reformation of Japanese corporations
The traditional Japan Corporation faces a turning point following the unprecedented scale of economic stagnation and ongoing globalisation. It is assumed that the Japan Corporation can no longer enjoy growth within its traditional management style. Furthermore, Japanese corporate governance is also being questioned: it may be a cause of many Japanese companies’ underperformance. Japanese share prices have also become and remained relatively low since 1990s, resulting in a constant presence of and activity in Japanese stock markets by foreign investors since the 1990s. Active investors like CalPERS (California Public Employees’ Retirement System) have exercised voting rights to improve the business quality of their investees. As a result of these external pressures, the shareholder concept is gaining more power and clout in Japan. More companies in 2002 perceived shareholders as an important stakeholder, a noticeable change with results from a questionnaire survey in 1999. (See Table 9)
Table 9: Important stakeholder

<table>
<thead>
<tr>
<th></th>
<th>2002 (%)</th>
<th>1999 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Customers</td>
<td>50.0</td>
<td>37.9</td>
</tr>
<tr>
<td>Shareholders</td>
<td>31.3</td>
<td>25.5</td>
</tr>
<tr>
<td>Employees</td>
<td>28.5</td>
<td>27.3</td>
</tr>
<tr>
<td>Banks</td>
<td>16.6</td>
<td>27.9</td>
</tr>
<tr>
<td>Buyers/Suppliers</td>
<td>44.1</td>
<td>49.4</td>
</tr>
<tr>
<td>Affiliated companies</td>
<td>8.5</td>
<td>12.2</td>
</tr>
</tbody>
</table>

The Japan Corporate Governance Forum

The Japan Corporate Governance Forum was established in 1994 and is composed of academics, company executives, lawyers and members of mass media. The forum issued a corporate governance code, called the ‘Corporate Governance Principles’, in May 1998 clarifying some aspects that required improvement.

This code was compiled with OECD Principles of Corporate Governance and served as a future beacon to aid the reform of Japanese corporate governance. It is of particular importance that the code placed emphasis on a balance between the shareholder and stakeholder concepts, which has become the basic position of Japanese corporate governance reformation thereafter.

‘The board of directors, behaving as the agent of the shareholders’ interests, must also bear important social responsibility for coordinating interests of all stakeholders. The board should actively provide information such as policy statements or environment-related reports, to divergent interests of all stakeholders.’

In addition to the emphasis on stakeholders’ interests, the code made some more specific recommendations, including the introduction of independent outside directors (Principle 5A), a reduction in the number of board members (Principle 6A), the importance of outside directors’ majority over the board (Principle 8B) and respect to shareholders, including an improvement of the General Meeting of Shareholders (Principle 14A, 15A, 16B).

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35 Survey by Policy Research Institute, Ministry of Finance
J-SOX – the Japanese version of the Sarbanes-Oxley Act

The Japanese version of the Sarbans-Oxley Act (J-SOX) is a frequently heard term among business practitioners in Japan. It refers, in the narrow sense, to the reformation of the Securities Exchange Law, which is to be re-titled as the Financial Instruments and Exchange Law. This law also refers to, in an expanded sense, a series of ongoing legal amendments that intend to improve the accounting audit systems and internal control structures. These legal reformations follow the wake of the US Sarbans-Oxley Act. The table below describes the main incidents regarding J-SOX. (See Table 10)

Table 10: Trend in legal reformations concerning J-SOX

<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 2003</td>
<td>The Commercial Code or Shoho was partly revised: Committee System was introduced.</td>
</tr>
<tr>
<td></td>
<td>Cabinet Office regulations 28 was implemented: it made it obligatory to disclose corporate governance and internal control evaluations, and to attach CEO’s personal certification with annual security reports.</td>
</tr>
<tr>
<td>April 2004</td>
<td>CPAAOB (Certified Public Accountants and Auditing Oversight Board) was inaugurated: a monitoring institution for auditing firms.</td>
</tr>
<tr>
<td>January 2005</td>
<td>Tokyo Stock Exchange made it mandatory to disclose confirmation notes on adequacy of annual security reports and on timely disclosure.</td>
</tr>
<tr>
<td>June 2005</td>
<td>New Company Law or kaisyaho was enacted: it made it compulsory for large corporations to compile a basic policy on corporate governance.</td>
</tr>
<tr>
<td>July 2005</td>
<td>The Sub-committee on Internal Control, Business, Accounting Council, Financial Services Agency issued the 'Standard for Assessment and Auditing of Internal Control Concerning Financial Reporting (Draft)'.</td>
</tr>
<tr>
<td>August 2005</td>
<td>Ministry of Economy, Trade and Industry issued the 'Guideline for disclosure and evaluation framework concerning corporate governance, risk management and internal control'.</td>
</tr>
<tr>
<td>December 2005</td>
<td>The Sub-committee on Internal Control, Business, Accounting Council, Financial Services Agency issued the 'Standard for Assessment and Auditing of Internal Control Concerning Financial Reporting'.</td>
</tr>
<tr>
<td>May 2006</td>
<td>New Company Law came into effect.</td>
</tr>
<tr>
<td>June 2006</td>
<td>The bill of Securities Exchange Law or shoken torihiki ho revision was approved: the law is to be renamed the Financial Instruments and Exchange Law or Kinyu shohin torihiki ho.</td>
</tr>
</tbody>
</table>

37 @IT Joho Management [online], IT media Inc., Available from: http://www.atmarkit.co.jp/im/
38 Corresponding to Section 302 of Sarbanes Oxley Act of 2002
39 Equivalent to PCAOB (The Public Company Accounting Oversight Board) prescribed by Sarbanes Oxley Act of 2002
40 Based primarily on COSO (the Committee of Sponsoring Organization of the Treadway Commission) Control Framework
Some of the topics, which I believe are fundamental to understanding this reformation, will be discussed in the following section.

a) **Introduction of the Committee System**

The Committee System or the committee-based corporate governance structure is a newly introduced corporate structure that came about through the revision of the 2003 Commercial Code. Under the Committee System, directors are primarily responsible for monitoring management. Executive officers, who are chosen by the directors, conduct business operations within the scope of authority that is delegated by the directors. There are three committees in the system: the Nomination Committee, the Audit Committee and the Compensation Committee. These committees are given the authority to make decisions on issues, including candidates for the Board of Directors; audits concerning the business execution of directors and executive officers; and compensation for directors and executive officers. (See Figure 1)

**Figure 1: The Committee System**

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41 Adopted from *Principle of Corporate Governance for Listed Companies*, Tokyo Stock Exchange, 14 March 2004
By introducing this system, companies can choose either the Committee System or the Auditor System. The Auditor System is the traditional Japanese corporate governance system where the board consists of the board of directors and the board of auditors. There has been some criticism that the board of auditors have not performed as shareholders would expect. This is why the Committee System was introduced, and this system is thought to be more in line with the Anglo-American style. There are 110 listed companies that have shifted into the Committee System out of Japan’s approximately 3,600 ~ 3,700 listed firms.42

b) CPAAOB (Certified Public Accountants and Auditing Oversight Board)
The recent economic environment requires investors’ faith in fair and transparent markets; high quality auditing and accounting to deal with complex, diversified and global business activities; and international trust in the Japanese CPA system. In response to the above circumstances, the CPAAOB was established in April 2004 by reorganising the existing CPAEIB (Certified Public Accountant Examination and Investigation Board). This agency is a government-related organisation of the Financial Services Agency. In the past, the CPAEIB conducted investigations concerning disciplinary action and the administration of CPA examinations, but its role did not include monitoring or general assessments of auditors. The CPAAOB has been designed to perform the oversight of ‘Quality Control Reviews’ conducted by JICPA (Japanese Institute of Certified Public Accountants). The Quality Control Review is a system that the JICPA has been operating since April 1999 as a self-regulation mechanism where members of the JICPA review quality control practices at audit firms and provide recommendations to audit firms when necessary.43

Figure 2: Relation between Quality Control Review by JICPA and oversight by CPAAOB44

42 Survey by Japan Corporate Auditors Association
43 CPAAOB [online], Available from: http://www.fsa.go.jp/cpaaob/english/index.html
44 CPAAOB Pamphlet
c) New Company Law

Company Law was newly implemented in May 2006. Before the new Company Law, there had been no law entitled ‘company law’ in Japan; the company law generally referred to a part of Commercial Code and private limited company law. The new integrated and regrouped those laws on corporate activities and given the title Company Law.

The new Company Law, in response to recent changes in the economic climate, was revised drastically, especially with regards to minimum capitalisation requirements, organisational structure of the corporation and organisational restructuring activities with mergers and acquisitions. It is worthy to note, at this time, that there are several revisions regarding corporate governance. First, the law requires that large corporations, meaning those companies with
either 500 million yen equity capital or 20 billion yen outstanding debt, must set up a basic policy concerning its internal control system. Secondly, the shareholders' representative action is rationalised. Thirdly, the law revised the operation of corporate dividends so that the corporation can distribute the proceeds to shareholders agilely.

**d) Financial Instruments and Exchange Law**

The bill of Financial Instruments and Exchange Law was approved in June 2006. This law is currently called the Securities Exchange Law and will come into effect in the fiscal year starting on the 1st April 2007. According to the Financial Services Agency, the implementation of this law will be based on Committee of Sponsoring Organizations of the Treadway Commission (COSO) framework.

COSO was originally formed in 1985 to identify the factors that cause fraudulent financial reporting and to make recommendations to reduce these incidents. It defines ‘internal control’ as (See **table 11**):

**Table 11: COSO framework**

<table>
<thead>
<tr>
<th>Definition of internal control</th>
<th>A process that is affected by an entity’s board of directors, management and other personnel and is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>- Effectiveness and efficiency of operations</td>
</tr>
<tr>
<td></td>
<td>- Reliability of financial reporting</td>
</tr>
<tr>
<td></td>
<td>- Compliance with applicable laws and regulations</td>
</tr>
</tbody>
</table>

**Key concepts**

- Internal control is a process. It is a means to an end, not an end in itself.
- Internal control is affected by people. It’s not merely policy manuals and forms, but people at every level of an organization.
- Internal control can be expected to provide only reasonable assurance, not absolute assurance, to an entity’s management and board.
- Internal control is geared to the achievement of objectives in one or more separate but overlapping categories.

**The five components**

- Control environment
- Risk assessment
- Control activities
- Information and communication
- Monitoring

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While the original COSO framework sets three objectives and five components, which are the so-called J-SOX, the Financial Instruments and Exchange Law is expected to add one objective and one concept: the safeguarding of assets (objective) and use of information technology (component). The Financial Services Agency has argued that it is important to conduct acquisitions and disposals of assets within appropriate procedures and approvals in Japan, and that information technology has become more important in business activities since the COSO framework was first published. In these respects, it adds the safeguarding of assets and the use of information technology onto the original framework.  

It is predicted that the Financial Services Agency will issue further information about the new law in 2006 as an implementation guideline.

**Best practice in Japanese corporate governance**

Nikkei Business, a major business magazine in Japan, ranked large Japanese corporations by the style and effectiveness of their board of directors (See Table 12). This ranking implies that Japanese companies go in two different directions. Some companies, such as Toyota Motor, maintain traditional Japanese board structure (i.e. the large size of the board with no independent outside directors) and pursue unique Japanese corporate governance, while others have adopted the Anglo-American model. Within the top 10, three companies scored 1, the minimum score, in terms of board structure, but these companies are still considered to have the best practice in corporate governance through their high scores in other categories.

<table>
<thead>
<tr>
<th>Rank</th>
<th>Company</th>
<th>Board structure score</th>
<th>Total score</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>HOYA</td>
<td>10</td>
<td>9.59</td>
</tr>
<tr>
<td>2</td>
<td>Daito Trust Construction</td>
<td>9</td>
<td>9.56</td>
</tr>
<tr>
<td>3</td>
<td>Ito En</td>
<td>1</td>
<td>9.47</td>
</tr>
<tr>
<td>4</td>
<td>Sundrug</td>
<td>10</td>
<td>9.35</td>
</tr>
<tr>
<td>4</td>
<td>Eisai</td>
<td>10</td>
<td>9.35</td>
</tr>
<tr>
<td>6</td>
<td>Canon</td>
<td>1</td>
<td>9.35</td>
</tr>
<tr>
<td>7</td>
<td>Nitto Denko</td>
<td>9</td>
<td>9.32</td>
</tr>
</tbody>
</table>

---


47 Nikkei Business, 3 July 2006
Toyota represents a company that is pursuing a unique Japanese model. These companies tend to see the Anglo-American style as not necessarily the role model for Japanese corporate governance. Rather, they typically emphasise the stakeholder concept. For instance, Toyota stated in its corporate governance report that the stable, long-term growth of corporate value has been a top-priority management issue, and this is made possible by building positive relationships with stakeholders, including shareholders, customers, business partners, local communities and employees.\(^4\) In terms of board structure, these companies are reluctant to appoint outside directors. Toyota currently has no independent outside director amongst its 26 board members despite stating in their report that ‘Toyota will consider the appointment of outside directors should there be suitable individuals.’ Shigenobu Nagamori, CEO of NIDEC,\(^4\) in a magazine interview, explained the reason why NIDEC does not appoint outside directors as ‘Outside directors do not understand the nature of business so they ask stupid questions. To put it extremely, they can just resign if the company goes bankrupt. So they do not stake their life on objections.’\(^5\) Yoshihiko Miyauchi, Chairman and CEO of ORIX,\(^5\) has a more subdued opinion in the same context. While admitting the importance of international coordination on fundamental principles of corporate governance, he argued that most of the board is not necessarily occupied by outside members because it is very possible, in Japanese culture, for corporate governance to be effective even when there is only one outside director on the board.\(^5\)

Sony is, by contrast, highly Americanised. It appointed two outside directors in 1970 when few Japanese companies recognised the importance of the monitoring function of the board. In 1997, it cut down the number of board members from 38 to 10, intending to make quick managerial decisions in the face of growing global competition. The following year, Sony introduced a committee system that predated the Commercial Code’s introduction of the legally supported Committee System and the implementation of the Compensation Committee and the


\(^5\) Nikkei Business, 3 July 2006

\(^5\) ORIX website: [http://www.orix.co.jp/grp/index_e.htm](http://www.orix.co.jp/grp/index_e.htm)

Nomination Committee. When the Commercial Code was revised in 2003, Sony became one of the first companies to shift to the Committee System. It decided to become a ‘Company with Committees’ on 20th June 2003 at the first AGM after the legal reformation. In addition to Sony, more than 100 companies have made the shift to the Committee System, including HOYA, Hitachi group companies, Nomura Holdings and Orix. These companies are thought to be pursuing a system of Anglo-American corporate governance.

Table 13: Comparison between Toyota and Sony board structure

<table>
<thead>
<tr>
<th></th>
<th>Toyota Motor</th>
<th>Sony</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of shares held by foreign investors</td>
<td>Between 20% and 30% (but no less than 20%)</td>
<td>More than 30%</td>
</tr>
<tr>
<td>Organisational form</td>
<td>Company with a Board of Corporate Auditors</td>
<td>Company with Committees</td>
</tr>
<tr>
<td>Chairman of the board of directors</td>
<td>Chairman</td>
<td>Outside director</td>
</tr>
<tr>
<td>Number of directors</td>
<td>26</td>
<td>14</td>
</tr>
<tr>
<td>Number of outside directors</td>
<td>None</td>
<td>10</td>
</tr>
</tbody>
</table>

53 Corporate Governance Report, Toyota, 30 May 2006, and Corporate Governance Report, Sony, 26 June 2006
Part II: Livedoor case

3. Methodology

3.1. Introduction
The following three chapters will explore the significance of the Livedoor scandal in the context of Japanese corporate governance. The Livedoor scandal, or the Livedoor affair as it is referred to in this paper, and allegations of violations of the Securities and Exchange Law by Livedoor and its executives was uncovered on 16th January 2006.

This chapter will describe the way information was collected to complete this case study.

3.2. Methodology
The following methods were used to collect information.

a) Firsthand experience as Director and employee of Livedoor
I, Shiro Yamada, the author of this paper, worked for Livedoor and its group companies for five years, starting in early 2000. (See Table 14)

Table 14: Service record of Shiro Yamada at Livedoor

<table>
<thead>
<tr>
<th>Date</th>
<th>Position</th>
<th>Job</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 2000</td>
<td>Joined Livedoor: working in Business Planning and Administration Department</td>
<td>Acted as a supportive player in the arranging and structuring of the Initial Public Offering (IPO) deal</td>
</tr>
<tr>
<td>April 2000 ~ March 2003</td>
<td>Managing Director (CEO from Jun 2002 onwards) of Capitalista Co. Ltd. (later renamed Livedoor Finance Co. Ltd.), a subsidiary set up April 2000 that was mainly devoted to investment and financial services</td>
<td>Invested in 15 venture companies, four of which successfully went public - Acted as director or member of audit board for four invested companies - Managed a team of five professionals</td>
</tr>
<tr>
<td>December 2001 ~ March 2003</td>
<td>Director</td>
<td>Conducted general management for over 30 group companies on the board - Initiated and developed Investment and Financial Service Department - Executed more than five M&amp;A deals, including sourcing, negotiation, evaluation, due diligence, and decision making - Reviewed disclosure of corporate information and investor relations</td>
</tr>
</tbody>
</table>
When I joined Livedoor (called Livin’ on the Edge Co., Ltd.) in March 2000, the company was at the pre-IPO stage and had only 80 employees; when I left in 2005 it was one of the most famous corporations in Japan and had more than 1,000 employees within its group. When I was scouted by CFO Ryoji Miyauchi to engage in investment and financial service business that Livedoor planed to initiate after IPO, I was employed as Manager of Corporate Strategic Planning Department at another Internet-based small business called CyberAgent. After joining Livedoor, I performed my duties as a core member of management in Japan for three years before managing an overseas subsidiary in Barcelona, Spain for two years. In 2005, I left Livedoor to obtain MBA degree at Judge Business School, University of Cambridge.

As a consequence, most of the information used in this study is my firsthand experience of working at Livedoor. This experience includes many conversations with colleagues (e.g. the board members, executives and fellow employees) and business acquaintances (e.g. the auditors, legal advisers, people in charge of Livedoor at investment banks or commercial banks, business partners, shareholders, institutional investors and so on). I have kept in touch with many people involved in the company even after resigning. As a result, many casual conversations with those individuals have also been used as sources of information.

b) Interviews with key persons
I conducted three interviews with the following people (see Table 15) to catch up on events happened during my three year absence from Japan.

Table 15: Interview list

<table>
<thead>
<tr>
<th>Person</th>
<th>Position after the affair (January 2006 ~)</th>
<th>Position before the affair</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kozo Hiramatsu</td>
<td>CEO</td>
<td>Operating Officer</td>
</tr>
<tr>
<td>Noriyuki Yamazaki</td>
<td>Representative Director (resigned in June 2006)</td>
<td>Director</td>
</tr>
<tr>
<td>Takeshi Idezawa</td>
<td>Operating Officer</td>
<td>Operating Officer</td>
</tr>
</tbody>
</table>

Interviews were conducted for 30 minutes to an hour. We discussed mainly factual information on activities at Livedoor from 2003 to 2005.
c) Official announcements from Livedoor
I reviewed information available on Livedoor’s corporate website, especially on the IR and pressroom site. Below is the list of documents used in this paper (See Table 16).

Table 16: List of documents

<table>
<thead>
<tr>
<th>Type</th>
<th>Document</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legally required disclosure</td>
<td>- Annual Security Report or <em>Yukashoken Hokokusho</em></td>
</tr>
<tr>
<td></td>
<td>- Semi-annual Report or <em>Hanki Hokokusho</em></td>
</tr>
<tr>
<td></td>
<td>- Financial Report (Quarterly and annually) or <em>Kessan Tanshin</em></td>
</tr>
<tr>
<td></td>
<td>- Regulatory notification or <em>Kokoku</em></td>
</tr>
<tr>
<td></td>
<td>- Security Registration Statement or <em>Yukashoken Todokedesho</em> or <em>Mokuromisyo</em></td>
</tr>
<tr>
<td>IR</td>
<td>- IR news</td>
</tr>
<tr>
<td></td>
<td>- Presentations at IR meetings (videos and presentation slides)</td>
</tr>
<tr>
<td></td>
<td>- Other information available on the IR website (<a href="http://finance.livedoor.com/ir/4753/ir-news.html">http://finance.livedoor.com/ir/4753/ir-news.html</a>)</td>
</tr>
<tr>
<td>PR</td>
<td>- Livedoor Bulletin (the corporate brochure issued quarterly)</td>
</tr>
<tr>
<td></td>
<td>- Press releases</td>
</tr>
<tr>
<td></td>
<td>- Other information available on the corporate website (<a href="http://corp.livedoor.com/">http://corp.livedoor.com/</a>) and service sites (e.g. <a href="http://www.livedoor.com/">http://www.livedoor.com/</a>)</td>
</tr>
</tbody>
</table>

Table 17: Book list

<table>
<thead>
<tr>
<th>Book</th>
<th>Reason</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yasuaki Oshika, Hiruzu Mokujiroku, Asahi Shimbun Company, April 2006</td>
<td>The author conducted comprehensive research, including interviews with Livedoor executives and other people involved. Quite a few insiders have assured that the stories in this book are true.</td>
</tr>
<tr>
<td>ISBN: 4022501758</td>
<td></td>
</tr>
<tr>
<td>Shinichi Tanaka, Livedoor Kansanin no Kokuhaku, Diamond Inc., May 2006</td>
<td>This book was written by one of Livedoor’s three auditors. This is a precious source of information</td>
</tr>
</tbody>
</table>
There are also a few case studies that were written by business school faculty. I particularly refer to ‘Livedoor: the rise and fall of a market maverick’ by Mitsuru Misawa.\(^{54}\)

e) News articles

Rigorous research has been done into news sources. These sources include both Japanese and foreign media. Below is the list of media to which I refer.

<table>
<thead>
<tr>
<th>Type</th>
<th>Media</th>
</tr>
</thead>
<tbody>
<tr>
<td>Newspaper and wire service</td>
<td>Nihon Keizai Shimbun, Asahi Shimbun, Mainichi Shimbun, Yomiuri Shimbun, Sankei Shimbun, Kyodo News</td>
</tr>
<tr>
<td>Web-based journalism</td>
<td>IT media, CNET Japan</td>
</tr>
<tr>
<td>Magazine</td>
<td>Shukan Post, Shukan Bunshun, Shukan Shincho</td>
</tr>
<tr>
<td>International</td>
<td>Financial Times, Times, Wall Street Journal</td>
</tr>
</tbody>
</table>

### 3.3. Limitations

This report may contain the following limitations.

a) An insider’s view

I, the author, have a substantially long service record in the surveyed company. As a consequence, this report may lack an objective perspective at times.

b) Ongoing case

With regards to the allegations and charges, the Livedoor trials are still in progress. It is possible that new evidence or facts that are contradictory to this paper may be uncovered during the legal process or the trials themselves.

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\(^{54}\) Mitsuru Misawa, 2006. *Livedoor: the rise and fall of a market maverick*, Asia Case Research Centre, University of Hong Kong
c) Translation

Since the Livedoor affair is mainly a domestic concern and does not draw extensive international attention, much of the information is only available in Japanese. As a result, there may be a possibility that English readers could misunderstand the line of argument due to problems of translation.
4. Overview of Livedoor and its scandal

4.1. The Livedoor shock

The course of the affair
The 16th of January 2006 will be remembered as a disastrous day by people at Livedoor. On this day, 80 investigators from the Tokyo District Prosecutors office went into Livedoor’s office where there were already more than 100 members of the press wielding flashing cameras that screamed with clicking noises. A few hours before the raid, Japan’s national broadcasting company NHK televised that Livedoor ‘was’ raided, and the Nikkei Shimbun (newspaper) also distributed news of the same sort on its website. This ‘premature start’ implied that Prosecutors had been preparing for the investigation for some time. However, alternatively, none of Livedoor’s executives was prepared for the raid. The charismatic leader of Japan’s Internet sector and CEO of Livedoor, Takafumi Horie was in the office and knocked all of a heap. Director Fumito Kumagai was present in the office and discussing something seriously with Horie when the prosecutors arrived. However, Ryoji Miyauchi, the CFO, so-called ‘No.2’ and head of the Finance Department, was on a business trip to a subsidiary company in Dalian, China, but made a hasty flight back to Tokyo on the following day.

The Prosecutors office also raided more than 10 other places, including another of Livedoor’s offices, Horie’s and some executives’ residences and the auditor’s office on the same day and the following few days. Interviews by investigators began on the 23rd of January, and four executives (i.e. CEO Horie, CFO Miyauchi and two presidents of subsidiary companies) were arrested on the night on the 23rd of January amid allegations of violating the Securities and Exchange Law by window-dressing accounts of group companies and providing false information to manipulate share prices. Those who were arrested resigned as directors shortly after, leaving Livedoor with Kozo Hiramatsu, who was not on the board, as the CEO and Kumagai as the Representative Director.

56 Sankei Shimbun, 17 January 2006
57 Yasuaki Oshika, 2006. Hiruzu Mokujiroku, Asahi Shimbun Company
58 Tokyo Shimbun, 18 January 2006
59 Sankei Shimbun, 17 January 2006
60 Financial Times, 24 January 2006
Prior to the arrests, a tragedy had occurred in Okinawa, a two hours and half flight from Tokyo, when Hideaki Noguchi, a former Livedoor executive, had been found dead in a business hotel. He was alleged to have been involved in the scandal while working for a security company called HS Securities.\footnote{Sankei Shimbun, 20 January 2006} It is strange that police quickly concluded that the death was a suicide, though it did not look like one: the body was cut in several places, including both wrists, belly and neck. Some still suspect that foul play (e.g. mafia’s involvement) was the cause of the death.\footnote{Shukan Bunshun, 2 February 2006 and Shukan Post, 24 February 2006}

On 22nd February, prosecutors arrested ‘ex-Livedoor executives’ including Horie, Miyauchi and Kumagai, the current Representative Director, under fresh allegations of material misstatements in Annual Security Reports. Simply put, they were accused for overstating profits in consolidated financial settlements.\footnote{The Wall Street Journal, 23 February 2006 and Financial Times, 23 February 2006} The arrest of Kumagai paralysed Livedoor’s operation. A member of the accounting staff said that ‘no one in the office knew important information about the company after Kumagai left, so decision-making had become fumbling around.’ Regulatory bodies like the Tokyo Stock Exchange (TSE) required a swift and accurate report on the scandal, but it was not possible with most of the related documents in the hands of the prosecutors and most of the executives in jail. Livedoor released an ‘Announcement concerning internal investigation’ twice with an excuse that it was substantially difficult to collect accurate information under the circumstances.\footnote{Announcement concerning internal investigation, Livedoor press release, 19 January 2006 and 7 February 2006}

The situation calmed down when prosecutors brought a second accusation against the arrested ex-executives on 14th March. The scandal was thereafter to be referred to a judicial court. The day before the accusation, the TSE decided to de-list Livedoor shares after a one-month announcement period.\footnote{The Wall Street Journal, 14 March 2006 and Financial Times, 14 March 2006} This was how Livedoor concluded its six year life as a listed company.

**Turmoil in the market**

The share market was upset by the scandal. Livedoor shares fell to the limited low on 17th January with an unprecedented wave of share selling: 259 million orders were made to sell, the equivalent of one fourth of Livedoor’s outstanding shares. Also, six listed group companies
recorded the limited low on the same day.\textsuperscript{66} Amazingly, the overwhelming orders to sell left the TSE with no choice but to halt the whole trading system on 18th January.\textsuperscript{67} Furthermore, the share market on the whole had declined dramatically. The Nikkei Index dropped by 1,113 yen during the three days following the 16th and recorded a low of 15,341 yen on the 18th. The sum of the market capitalisations in the first section of the TSE reduced to approximately 34 trillion yen during the same period.\textsuperscript{68} The Japanese mass media labelled this share market turbulence the ‘Livedoor shock’.

Figure 3: Livedoor share price (May 2005 to April 2006)\textsuperscript{69}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{livedoor_share_price_graph.png}
\caption{Livedoor share price (May 2005 to April 2006)\textsuperscript{69}}
\end{figure}

Livedoor market capitalisation was 803 billion yen at its peak in December 2006, but eventually dropped to 98 billion yen when it was de-listed in April 2006.

**Public reaction**

The Livedoor scandal became a national concern, despite drawing only limited international attention. This was because Livedoor and Horie were symbols of Japan’s reformation and very

\textsuperscript{66} Mainichi Shimbun, 18 January 2006

\textsuperscript{67} Nihon Keizai Shimbun, 19 January 2006

\textsuperscript{68} Chunichi Shimbun, 19 January 2006

\textsuperscript{69} Livedoor Finance website: \url{http://finance.livedoor.com/}
popular among the younger generation in Japan, though Livedoor was not an internationally recognised brand.

The mass media scrutinised the scandal daily with the mainstream media concurring in the strong criticism of Livedoor’s manner, arguing such thoughts as ‘This is a significant violation of the investor faith’ or ‘This scandal provoked a host of questions to Horie-style mammonism.’ News reports, however, often contained misinformation or unreliable information. For instance, Sankei Shimbun reported that ‘there were several hundreds employees left after the scandal’ on 14th February 2006. However, Livedoor’s internal investigation revealed that only 35 employees retired during the period from 16th January to 13th February.

To date, 18 books have been published on the Livedoor scandal or Livedoor’s attempt to buy Fuji TV. Horie and the company’s popularity is clear: Horie Takafuli received some 1,570,000 search results in Google Japanese and Horiemon, Horie’s nickname, received approximately 3,050,000 results when compared to 378,000 for Carlos Ghosn, 301,000 for Mikitani Hiroshi and 475,000 for Son Masayoshi. (These CEOs, including Horie, are ranked No.1 to No.4 in the corporate manager rankings.)

Foreign media dealt with this scandal in a different way. Some Anglo-American media described it as ‘the revenge of the old guard’, pointing out that Japan’s establishment had frowned on Livedoor’s unspeakably naughty manner. Others raised a question ‘about the level of scrutiny that regulators’ in particular the Securities and Exchange Surveillance Commission (SESC), did not work properly in comparison with the US counterpart SEC. In general, Livedoor’s attempt to democratise the Japanese market was valued, to an extent, in the foreign media: ‘the rise and fall of Livedoor - and its founder - may well have long lasting effects on Japanese financial markets and business practices.’

As situation calmed down and the overall picture of the incident became clear, the number of people who questioned Japan’s mass media and the prosecutors has increased. Those people

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70 Asahi Shimbun, 24 January 2006
71 Mainichi Shimbun, 24 January 2006
73 Search result on Amazon.co.jp: http://www.amazon.co.jp/
74 Allabout Japan [online], Available from: http://allabout.co.jp/career/careerplanning/closeup/CU20050302C/
75 Times [online], 24 January 2006, Available from: http://www.timesonline.co.uk/article/0,,25689-1995074,00.html
76 The Wall Street Journal, 24 January 2006
77 Financial Times, 30 January 2006
argued that Livedoor’s criminal did not deserve ‘the death of the company’: i.e. arresting so many executives and de-listing Livedoor from the TSE.\textsuperscript{78} Although it is well known that the Livedoor scandal has been a high profile case and has a significant meaning and impact to Japan’s financial and corporate systems, it is not significant in terms of the size of fraud when compared with similar cases in the past (See \textbf{Table 19}).

\textbf{Table 19: A comparison of the Livedoor scandal and other incidents}

<table>
<thead>
<tr>
<th>Company</th>
<th>Amount of profit manipulation (billion yen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yamaichi Securities</td>
<td>272.0</td>
</tr>
<tr>
<td>Long-Term Credit Bank of Japan</td>
<td>310.0</td>
</tr>
<tr>
<td>Kanebo</td>
<td>215.0</td>
</tr>
<tr>
<td>\textbf{Livedoor}</td>
<td>\textbf{5.3}</td>
</tr>
<tr>
<td>WorldCom</td>
<td>1026.0\textsuperscript{79}</td>
</tr>
<tr>
<td>Enron</td>
<td>136.8\textsuperscript{80}</td>
</tr>
</tbody>
</table>

\textbf{The charges}

Although some members of the mass media trumpeted many suspicions, including tax evasion, insider trading,\textsuperscript{81} money laundering\textsuperscript{82} or conspiracy with crime syndicates,\textsuperscript{83} the formal charges did not include any of the above. The formal charges were spreading rumour, fraudulent means and material misstatements of financial statement, all of which violated the Securities and Exchange Law. Prosecutors accused Livedoor and its executives of these charges twice: 13th February and 14th March 2006.

\textbf{a) Spread of rumour and fraudulent means}

\textsuperscript{78} \textit{Issatsu no Hon}, Asahi Shimbun Company, Mar 2006

\textsuperscript{79} US$ 11 billion

\textsuperscript{80} US$ 1.2 billion

\textsuperscript{81} Mainichi Shimbun [online], 14 February 2006, Available from: http://www.mainichi-msn.co.jp/shakai/jiken/livedoor/news/20060214k0000n040163000c.html

\textsuperscript{82} Yomiuri Shimbun [online], 24 January 2006, Available from: http://www.yomiuri.co.jp/feature/fe5900/news/20060124it06.htm

\textsuperscript{83} Shincho45, 1 August 2006
According to the charging document on 13th February 2006,\textsuperscript{84} Livedoor and some of its executives were charged as below (See Table 20).

**Table 20: 13th February charge**

<table>
<thead>
<tr>
<th>The accused</th>
<th>Livedoor Co., Ltd., Livedoor Marketing Co., Ltd., Takafumi Horie (ex-CEO), Ryoji Miyauchi (ex-CFO), Fumito Okamoto (ex-Director), Osanari Nakamura (ex-CEO of Livedoor Finance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charge</td>
<td>Violation of the Securities and Exchange Law</td>
</tr>
<tr>
<td>Section Violated</td>
<td>Section 197 1-7, Section 158, Section 207 1-1, Criminal Code Section 60</td>
</tr>
</tbody>
</table>

The document claimed that the accused, in conspiracy, conducted fraudulent means and spread rumours in order to manipulate share price. The outline of the plot is as follows:

- Livedoor Marketing, a subsidiary of Livedoor, announced on 25th October 2004 its acquisition of Money Life Co., Ltd. as of 1st December. However, in reality, Livedoor had already controlled Money Life because VLMA2 LLP, which had acquired a 100% stake in Money Life in June 2004, was already under Livedoor’s control. Hence, the announcement was fictitious.

- In the due diligence process, Livedoor, with a clear intention, overvalued Money Life’s corporate value and conducted a share swap deal on the overvalued terms. This was made for the benefit of VLMA2.

- Despite the fact that the due diligence process was conducted by Livedoor insiders, Livedoor Marketing announced that an independent accounting firm had conducted the valuation.

- In the financial statement announced on 30 September 2004, Livedoor Marketing had created made-up revenues to make a loss income statement into a profitable one.

Prosecutors regarded this series of transactions as one conspiracy.

**b) Material misstatements of financial statement**

This case is more complex and elaborate than the 13th February charge.

**Table 21: 14th March charge**

\textsuperscript{84} Livedoor press release, 16 February 2006
Livedoor and a new wave in Japanese corporate governance  
1st September 2006

<table>
<thead>
<tr>
<th>The accused</th>
<th>Livedoor Co., Ltd., Takafumi Horie (ex-CEO), Ryoji Miyauchi (ex-CFO), Fumito Kumagai (ex-Director), Osanari Nakamura (ex-CEO of Livedoor Finance)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charge</td>
<td>Violation of Securities and Exchange Law</td>
</tr>
<tr>
<td>Section Violated</td>
<td>Section 197 1-1, Section 24 1, Section 207 1-1, Criminal Code Section 60</td>
</tr>
</tbody>
</table>

Prosecutors, in the accusing document,\textsuperscript{85} claimed that Livedoor overstated its profits on the consolidated financial statement of 2004 by counting fictitious revenues. Through this accounting manipulation, Livedoor’s PBT became 5,034 million yen of profit, though its ‘real’ PBT was a loss of approximately 312 million yen.

According to Prosecutors, there were two lines of fictitious revenues. One was fictitious orders to Cueznet and Royal Shinpan. Livedoor was alleged to have recorded made-up revenues of 1,580 million yen at the end of the 2004 fiscal year by placing imaginary orders to Cueznet and Royal Shinpan, both of which were not connected undertakings at that time, but later became subsidiaries. Prosecutors claimed that Livedoor in fact controlled these two companies and forced them to cooperate in this dubious business. Another line of fictitious revenue was the trading of the company's own shares. Trading own shares normally comes along with share buyback. If a company happens to have profits or losses during such a deal, it must not record it on an income statement, but within the shareholders fund account on a balance sheet. However, prosecutors pointed out that Livedoor recorded profits from its own share trading in 2004 with cleverly devised schemes using a sort of special purpose entity (SPE or fund). Below is an example of the scheme that Livedoor allegedly used when acquiring Kurasawa Communications, a mobile phone retailer (See Figure 4).

\textbf{Figure 4: Livedoor's window dressing scheme using SPE and own shares}{\textsuperscript{86}}

\textsuperscript{85} Livedoor press release, 22 March 2006

Livedoor and a new wave in Japanese corporate governance
1st September 2006

(1) EFC, a SPE controlled by Livedoor Finance, placed money into M&A Challenger 1, a fund managed by HS Investment, which is a subsidiary of HS Securities. It is alleged that Hideaki Noguchi, the executive of the HS group who was found dead in January 2006, was in conspiracy with Livedoor, and that Livedoor in effect controlled the M&A Challenger 1.

(2) In the meantime, M&A Challenger 1 borrowed a large amount of Livedoor shares from Horie, the largest shareholder, and prepared to sell them when share price temporarily soared due to 100-for-1 share splitting. (To understand the reasons why share split causes share price soaring, please refer to 5. Controversial growth strategy, 5.3. Publicity stunts, Preposterous share splitting).

(3) Livedoor announced a share swap deal to acquire Kurasawa Communications and Kurasawa shareholders received Livedoor shares.

(4) M&A Challenger 1 bought the Livedoor shares from Kurasawa in cash.

(5) M&A Challenger 1 placed the Livedoor shares into VLMA 1 and VLMA 2, both of which were managed by Value Link, an independent investment firm.
(6) VLMA 1 and 2 sold the Livedoor shares in the market.

(7) VLMA 1 and 2 gained substantial profits on the returns. This is allegedly due to the share split announced at the same period.

(8) M&A Challenger 1 collected money from VLMA 1 and 2.

(9) The money went back to EFC, namely to Livedoor group.

Although each individual transaction appears to be lawful (share swap, SPE and borrowed shares are all legal), prosecutors insisted that this whole story was planned as a conspiracy to unjustifiably record profits from own share trading. In fact, if Livedoor influenced all of the above funds, it amounts to the same situation as dealing in its own shares. Prosecutors also claimed that Livedoor used the same scheme at a share swap with Webcashing.com and made 3,766 million yen in fictitious revenue.

Rumour says that Livedoor used a similar scheme to overstate profits when acquiring Trine (March 2004), Royal Shinpan (August 2004) and Cueznet (September 2004). Some pointed out that Livedoor’s ‘magic’ became too complex to prove guilt. Also, Credit Swiss was involved in the complicated Royal Shinpan and Cueznet deals, so it would be difficult for prosecutors to fight against such a renowned investment bank. In any case, prosecutors have not charged Livedoor with any new issues to date, some eight months after the raid.

The trials are currently (as of August 2006) in progress. Each accused has expressed their pleas as follows (See Table 22).

Table 22: Plea of the accused (As of Aug 2006)

<table>
<thead>
<tr>
<th>Accused</th>
<th>Plea</th>
</tr>
</thead>
<tbody>
<tr>
<td>Horie, ex-CEO</td>
<td>Expressed a plea of innocent and has claimed that he neither gave instructions nor recognised a series of the transactions.</td>
</tr>
<tr>
<td>Miyauchi, ex-CFO</td>
<td>Entered a plea of guilty on the whole, but has claimed that he did not clearly recognise illegality of revenue registration of the own shares trading at the time.</td>
</tr>
<tr>
<td>Kumagai, ex-Director</td>
<td>Entered a plea of guilty in fictitious revenue from Royal Shinpan and Cueznet, but entered a plea of innocent in revenue registration of the own shares trading</td>
</tr>
</tbody>
</table>

87 Yasuaki Oshika, 2006. Hiruzu Mokujiroku, Asahi Shimbun Company

Okamoto, ex-Director  Entered a plea of guilty on the whole, but has claimed that he did not clearly recognise illegality of revenue registration of the own shares trading at the time.

Nakamura, ex-executive  Entered a plea of guilty on the whole, but has claimed that he was unsure about illegality of revenue registration of the own shares trading

Livedoor  Entered a plea of no contest

Livedoor Marketing  Entered a plea of no contest

While Miyauchi, ex-CFO, and other ex-executives has basically admitted to the allegations and claimed that Horie was involved, Horie continues to deny his involvement. The situation now has developed into a bitter fight between the ex-CEO and his ex-followers.

4.2. The history of Livedoor – along with the dot-com boom
This sub-chapter will illustrate the history of Livedoor, which I think provide integral background information of the case, along with the tables at the end of the sub-chapter (Table 23 & 24).

Foundation and pre-IPO (1996 ~ 1999)
Livin’ on the Edge Co., Ltd., the predecessor of Livedoor, was founded by Takafumi Horie in 1996. Horie was a Tokyo University student who eventually dropped out of university to engage in business. Horie had not been an assiduous student and spent most of his time working at part-time jobs and gambling, but a computer programming part-time job changed his life dramatically. It was there that he met the Internet and felt, ‘This is a revolution. There is no choice, but to take this chance’. This was how he started a web design firm with some friends.89

Livin’ on the Edge was reputed to be a ‘solid’ company in the Internet sector at the time, having a firm technology base. During the pre-IPO period, the company made money mainly by designing websites, managing IP network and developing web-based systems. In September 1998, Edge entered into a partnership with CyberAgent to run a click guarantee-based Internet advertising network, Cyber Click. Under the partnership, Edge’s role was to develop and maintain the system while the partner was in charge of sales and marketing.

IPO and dot-com boom (2000)
1999 was a historic year for the Japanese securities market. The TSE set up a new section ‘Mothers’ for small-sized high-growth companies, such as Liquid Audio Japan and Internet

89 Venture Tushin [online], Available from: http://www.v-tsushin.jp/president/president.php?cid=0&pid=25
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Research Institute, both of which were dot-com start-ups who were the first to list their shares on 22nd December 2000. The share price of Internet Research Institute became 4.5 times the offer price followed by several companies benefiting from the Internet fever. Susumu Fujita, CEO of CyberAgent, whose company also went public at the peak of the boom, said, ‘It was a good timing to go public’.90

Livin’ on the Edge was one of the companies who took the chance to finance during the boom. It was listed on the TSE Mothers in April 2000 and succeeded in raising 6 billion yen from the market. This was enormous amount of fund considering the size of the company: Edge had merely recorded 263 million yen of sales and 10 million yen of PBT in the previous fiscal year.

Edge made vigorous attempts to meet investors’ expectation. Following the IPO, the company set up an investment company called Capitalista (Later renamed Livedoor Finance) as a core unit to conduct investment and finance business as well as launching a data centre business. However, as a result of active investment, Edge recorded a 180 million yen loss in the 2000 fiscal year; this was the first and only loss Edge ever recorded in its history until 2005. Share price decreased but did not bottom out for a long time. Livedoor executives, including Horie and Miyauchi, viewing the severe reaction of the share market, realised that they needed to make a sound profit by any means necessary.

At the same time as Edge was experiencing difficulties, the so-called dot-com boom ended suddenly. On 10th March 2000, NASDAQ Composite index peaked at 5,048.62 but it fell to the 1,000 range by 2002 (See Figure 5). Closely linked to the US market, Japan’s dot-com boom also peaked in the spring of 2000. Many dot-com firms were forced to change their business model from one that allows large investment and large return in the long-term to one that generates short-term profitability. Winners and losers were clearly identified after the dot-com babble burst. Companies like Yahoo! Japan and Rakuten were considered winners and have continued to expand their business and increase profitability.

Figure 5: History of NASDAQ Composite91

90 Nikkeibp.jp [online], Available from: http://bizns.nikkeibp.co.jp/cgi-bin/search/wes-bun.cgi?ID=119936&FORM=biztechnews
91 Yahoo Finance [online], Available from: http://finance.yahoo.com/q/bc?s=^IXIC&t=my
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Edge was regarded, arguably, as a company on the boarder line between winners and losers. Therefore, the management was desperate to build its business and make profits. It is generally received that companies, in particular small-sized ones, often need an investment period to generate sustainable long-term profits. Nonetheless, Edge had no choice but to pursue short-term profits (what investors like to see) and invest large amounts of money to show the potential of growth to the investors at the same time. To achieve such a goal, Edge often sold its businesses to business partners while acquiring and founding new businesses. It appeared to be a process of ‘select and concentration’, but, in reality, it was an erratic policy or a lack of strategy.

In December 2002, Edge acquired Livedoor, the largest free ISP in Japan with 1.5 million subscribers. Livedoor was a so-called ‘loser’ that had recorded a 1.7 billion loss against 1.9 billion sales in 2002 and had gone bankrupt under the Civil Rehabilitation Law. Edge took over Livedoor’s business rights, entering the consumer business.

Livedoor and its shift into the consumer business (2003 ~ 2005)
In December 2003, Edge was renamed Livedoor. It was unusual that an acquirer took on its target’s name. In particular, Livedoor was a bankrupt company, so some people felt this was a bad omen and bad luck. Horie, however, had a clear intention. ‘Livedoor’ was a more famous brand than ‘Edge’ due to its large advertising campaign to acquire users in the past. Therefore, Horie thought it was natural to use the stronger brand as the company’s name. This renaming
also meant that Livedoor would seek consumer business by using its recognised brand.\textsuperscript{92} In a sense, this was when the company was reborn into a B-to-C oriented ‘casual’ Internet portal from its beginning as a technology-based ‘solid’ B-to-B firm.

Over this period, Livedoor gradually established its unique and controversial growth strategy that entailed frequent use of M&A and publicity stunts. To be more precise, Livedoor acquired amazing 21 companies in the 2004 calendar year (i.e. from January to December), while it had only bought nine companies prior to 2004. Also, it expressed interest to buy a professional baseball team, the Kintetsu Buffaloes, in July 2004 and sought to enter into the professional baseball world, a national passion in Japan. After their offer was rejected, Livedoor wasted little time before offering into its next subject of general interest. On 8th February 2005, Livedoor suddenly announced that it had acquired a 35% stake in Nippon Broadcasting Systems (NBS). Since NBS had a 22.5% stake in Fuji TV, a core company of Japan’s largest media conglomerate, this attempt drew national attention.\textsuperscript{93} Although the acquisition did not come true, Livedoor benefited from unprecedented coverage by mass media and, as a result, the number of page views, an important indicator for internet portal businesses, soared.

Livedoor went on to acquire many companies, including three listed corporations, after the fight against Fuji TV failed. Its consolidated sales reached 78 billion yen with 11 billion PBT in the fiscal year that ended in September 2005. Many people, at that time, had come to consider Livedoor a winner in the Internet sector. Horie, however, was losing his passion for the Internet business and ran in the general elections in September 2006, which he lost. He was also obsessed by an idea of a space venture into which he planned to invest his private money.\textsuperscript{94}

\textbf{Table 23: History of Livedoor}\textsuperscript{95, 96}

\begin{tabular}{|l|l|}
\hline
Date & Event \tabularnewline
\hline
Apr 1996 & A web page design firm, Livin’ on the Edge PLC was founded with 6 million yen in capital. \tabularnewline
Jul 1997 & The firm was changed into a Company Limited (Co., Ltd., 10 million in capital) and it started Select Mail, a mail service. \tabularnewline
Sep 1998 & Launched Cyber Click, a click-guarantee-based internet advertising service. \tabularnewline
Dec 1998 & Launched Melma, a click-guarantee-based email advertising service. \tabularnewline
\hline
\end{tabular}


\textsuperscript{94} Yasuaki Oshika, 2006. \textit{Hiruzu Mokujirōka}, Asahi Shimbun Company, April 2006

\textsuperscript{95} Livedoor Corporate website [online], Available from: \url{http://corp.livedoor.com/company/outline.html}

\textsuperscript{96} Kyodo News [online], 25 May 2006, Available from: \url{http://topics.kyodo.co.jp/feature19/archives/ugoki0526.html}
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<table>
<thead>
<tr>
<th>Year</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct 1999</td>
<td>Co-founded CyberClick Agent S.L., with Marta Tomas and CyberAgent Co. Ltd., in Barcelona Spain.</td>
</tr>
<tr>
<td>Nov 1999</td>
<td>Co-founded Hoops Co., Ltd., an Internet-based community service company, with CyberAgent Co., Ltd.</td>
</tr>
<tr>
<td>Jan 2000</td>
<td>Moved the head office to 3-3-5, Shibuya, Shibuya-ku, Tokyo.</td>
</tr>
</tbody>
</table>
| Apr 2000 | Listed on Tokyo Stock Exchange Mothers.  
Established Capitalist Co., Ltd., an Investment company (It was later renamed Livedoor Finance Co., Ltd.).  
Established Squeeze Kenkyujo Co., Ltd., a system development company especially for mobile devices.  
Launched Data Hotel, a data centre service. |
| May 2000 | Established Edge Commerce Co. Ltd., a system development company especially for e-commerce. |
| Jun 2000 | Acquired a majority of CyberClick Agent’s shares (It was later renamed Livedoor Interactive S.L. in Apr 2004). |
| Oct 2000 | Established Edge Software Development Co., Ltd., a software development company in Dalian, China.  
Co-founded AD4Portal (Thailand) Co., Ltd., with Chuo Senko (Thailand) Public Co., Ltd. |
| May 2001 | Acquired Yabumi, an instant messenger service. |
| Jul 2001 | Tied up with FLE Singapore PTE Ltd and established a resident office in Singapore.  
Co-founded Innovation Lab Inc. an education service company for web producers. |
| Sep 2001 | Sold Hoops shares to Rakuten Co., Ltd. |
| Dec 2001 | Acquired Pineapple Server Service Co., Ltd., in share deal.  
Acquired business of Edge Commerce, a 100% owned subsidiary, by business transfer. |
| Feb 2002 | Started development and sales of Eudora, a e-mail client, tying up with Kuni Research International Co., Ltd. |
| Mar 2002 | Acquired @Server Co., Ltd., in share deal. |
| Apr 2002 | Executed share buy-back by TostNet-2. |
| May 2002 | Established Livin’ on the Edge Europe GmbH, a subsidiary operating business in Europe. |
| Jun 2002 | Acquired Ascii EC Co., Ltd., by business transfer. |
| Jul 2002 | Acquired a majority in Ad4Portal’s shares (it was later renamed Livedoor Interactive (Thailand) Co., Ltd., in May 2004). |
| Aug 2002 | Acquired Bitcat Co., Ltd., and Bitcat Communications Co., Ltd., in cash deal. |
| Sep 2002 | Acquired Sputnik Co., Ltd., in share deal.  
Acquired Pro-G Group Co., Ltd., in share deal. |
| Nov 2002 | Acquired Livedoor, the largest free ISP in Japan, by business transfer. |
| Mar 2003 | Established Edge Telecom Co., Ltd. and went into the fixed-line business (It was later renamed Livedoor Telecom Co., Ltd., in Dec 2003).  
Established EX Marketing Co., Ltd. |
<table>
<thead>
<tr>
<th>Date</th>
<th>Event</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apr 2003</td>
<td>Acquired BitCash Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Changed company name to Edge Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Moved head office to 2-9-25 Futaba, Shinagawa-ku, Tokyo.</td>
</tr>
<tr>
<td>May 2003</td>
<td>Acquired Vagabond Co., Ltd. (It was later renamed the Network and</td>
</tr>
<tr>
<td></td>
<td>Security Research Institute Co., Ltd.).</td>
</tr>
<tr>
<td>Oct 2003</td>
<td>Issued new shares for public offering (4.6 billion yen in registered</td>
</tr>
<tr>
<td></td>
<td>capital).</td>
</tr>
<tr>
<td>Feb 2004</td>
<td>Changed company name to Livedoor Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Moved the head office to 2-16-9 Kabukicho, Shinjuku-ku, Tokyo.</td>
</tr>
<tr>
<td></td>
<td>Established Broadband Pictures Co., Ltd.</td>
</tr>
<tr>
<td>Mar 2004</td>
<td>Established Livedoor Factoring Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Acquired Kurasawa Communications Co., Ltd., in share deal (It was</td>
</tr>
<tr>
<td></td>
<td>later renamed Livedoor Mobile Co., Ltd., in May 2005).</td>
</tr>
<tr>
<td></td>
<td>Acquired Webcashing.com Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Acquired Trine Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Acquired Value Click Japan Co., Ltd., by TOB (It was renamed</td>
</tr>
<tr>
<td></td>
<td>Livedoor Marketing Co., Ltd.).</td>
</tr>
<tr>
<td></td>
<td>Acquired Nippon Global Securities Co., Ltd., by TOB (It was renamed</td>
</tr>
<tr>
<td></td>
<td>Livedoor Securities Co., Ltd.).</td>
</tr>
<tr>
<td></td>
<td>Acquired Livedoor Credit Co., Ltd., in share deal (It was renamed</td>
</tr>
<tr>
<td>Apr 2004</td>
<td>Issued new shares for public offering (23.7 billion yen in registered</td>
</tr>
<tr>
<td></td>
<td>capital).</td>
</tr>
<tr>
<td>May 2004</td>
<td>Acquired Turbolinux Co., Ltd., in share deal.</td>
</tr>
<tr>
<td>Jun 2004</td>
<td>Acquired Tentler Communications Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Acquired Mailcreations Inc., a net advertising firm in Miami USA.</td>
</tr>
<tr>
<td>Jul 2004</td>
<td>Acquired Jlisting Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Sought to purchase Kintetsu Buffaloes, a professional baseball team.</td>
</tr>
<tr>
<td></td>
<td>Acquired Royal Shinpan Co., Ltd., in share deal (It was later</td>
</tr>
<tr>
<td></td>
<td>renamed Livedoor Credit Co., Ltd., in Feb 2005).</td>
</tr>
<tr>
<td>Sep 2004</td>
<td>Acquired Cueznet Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Acquired Session Co., Ltd., in cash deal.</td>
</tr>
<tr>
<td></td>
<td>Acquired Cyber Associates Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Established Livedoor Baseball Co., Ltd.</td>
</tr>
<tr>
<td></td>
<td>Integrated Livedoor Finance Co., Ltd., into Livedoor Securities Co.,</td>
</tr>
<tr>
<td></td>
<td>Ltd.</td>
</tr>
<tr>
<td>Oct 2004</td>
<td>Acquired Myrice Limited, an Internet portal site in Hong Kong, in</td>
</tr>
<tr>
<td></td>
<td>cash deal.</td>
</tr>
<tr>
<td>Dec 2004</td>
<td>Acquired Yayoi Co., Ltd., in cash deal.</td>
</tr>
<tr>
<td>Feb 2005</td>
<td>Acquired Best Reserve Co., Ltd., in share deal.</td>
</tr>
<tr>
<td></td>
<td>Established Livedoor Financial Holdings Co., Ltd.</td>
</tr>
</tbody>
</table>
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Table 24: Livedoor's five-year financial record (consolidated accounting)\(^7\)

<table>
<thead>
<tr>
<th></th>
<th>Sep 2001</th>
<th>Sep 2002</th>
<th>Sep 2003</th>
<th>Sep 2004</th>
<th>Sep 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (thousand yen)</td>
<td>3,601,470</td>
<td>5,890,678</td>
<td>10,824,893</td>
<td>30,868,668</td>
<td>78,421,566</td>
</tr>
<tr>
<td>Profit before tax (thousand yen)</td>
<td>302,778</td>
<td>1,137,544</td>
<td>1,314,371</td>
<td>5,034,211</td>
<td>11,261,542</td>
</tr>
<tr>
<td>Profit after tax (thousand yen)</td>
<td>121,261</td>
<td>452,655</td>
<td>488,864</td>
<td>3,577,131</td>
<td>15,475,443</td>
</tr>
<tr>
<td>Net assets (thousand yen)</td>
<td>6,263,374</td>
<td>6,608,422</td>
<td>11,941,596</td>
<td>53,556,353</td>
<td>193,603,500</td>
</tr>
<tr>
<td>Total assets (thousand yen)</td>
<td>7,755,411</td>
<td>9,332,107</td>
<td>16,639,618</td>
<td>100,219,516</td>
<td>330,239,746</td>
</tr>
<tr>
<td>Net assets per share (yen)</td>
<td>159,775.87</td>
<td>160,172.21</td>
<td>16,265.93</td>
<td>88.33</td>
<td>184.54</td>
</tr>
<tr>
<td>PAT per share (yen)</td>
<td>3,097.27</td>
<td>11,083.64</td>
<td>1,131.23</td>
<td>6.4</td>
<td>18.66</td>
</tr>
<tr>
<td>PAT per share adjusted residual securities (yen)</td>
<td>2,992.63</td>
<td>10,815.63</td>
<td>1,118.10</td>
<td>6.34</td>
<td>18.36</td>
</tr>
<tr>
<td>Equity capital ratio (%)</td>
<td>80.8</td>
<td>70.8</td>
<td>71.8</td>
<td>53.4</td>
<td>58.6</td>
</tr>
<tr>
<td>ROE (%)</td>
<td>2</td>
<td>7</td>
<td>7.1</td>
<td>10.9</td>
<td>12.5</td>
</tr>
<tr>
<td>PER (times)</td>
<td>104.93</td>
<td>23.46</td>
<td>59.93</td>
<td>65.14</td>
<td>23.95</td>
</tr>
<tr>
<td>CF from operating activities (thousand yen)</td>
<td>51,459</td>
<td>(543,286)</td>
<td>1,371,352</td>
<td>10,340,670</td>
<td>6,723,082</td>
</tr>
<tr>
<td>CF from investing activities (thousand yen)</td>
<td>(1,319,187)</td>
<td>48,233</td>
<td>(2,178,306)</td>
<td>(7,720,721)</td>
<td>(71,073,832)</td>
</tr>
<tr>
<td>CF from financial activities (thousand yen)</td>
<td>510,925</td>
<td>221,291</td>
<td>6,239,289</td>
<td>35,186,466</td>
<td>114,635,690</td>
</tr>
</tbody>
</table>

\(^7\) Livedoor, Annual Security Report or Yukashoken Hokokusho 2005
### Cash and cash equivalent (thousand yen)

<table>
<thead>
<tr>
<th></th>
<th>Sep 2001</th>
<th>Sep 2002</th>
<th>Sep 2003</th>
<th>Sep 2004</th>
<th>Sep 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash and cash equivalent</td>
<td>2,584,088</td>
<td>2,310,326</td>
<td>7,709,112</td>
<td>45,510,561</td>
<td>95,733,885</td>
</tr>
</tbody>
</table>

### The number of employees

<table>
<thead>
<tr>
<th></th>
<th>Sep 2001</th>
<th>Sep 2002</th>
<th>Sep 2003</th>
<th>Sep 2004</th>
<th>Sep 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Employees</td>
<td>219</td>
<td>296</td>
<td>359</td>
<td>1,019</td>
<td>2,456</td>
</tr>
</tbody>
</table>

### Reference information in US$

<table>
<thead>
<tr>
<th></th>
<th>Sep 2001</th>
<th>Sep 2002</th>
<th>Sep 2003</th>
<th>Sep 2004</th>
<th>Sep 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales (thousand US$)</td>
<td>32,741</td>
<td>53,552</td>
<td>98,408</td>
<td>280,624</td>
<td>712,923</td>
</tr>
<tr>
<td>Profit before tax (thousand US$)</td>
<td>2,753</td>
<td>10,341</td>
<td>11,949</td>
<td>45,766</td>
<td>102,378</td>
</tr>
<tr>
<td>Profit after tax (thousand US$)</td>
<td>1,102</td>
<td>4,115</td>
<td>4,444</td>
<td>32,519</td>
<td>140,686</td>
</tr>
</tbody>
</table>

---

*Assumed that 1US$ is 110 yen*
5. Controversial growth strategy

5.1. Introduction
This chapter will discuss the strategy that enabled Livedoor to achieve its amazing growth pace (See Figure 6). By reviewing the strategy, I aim to recognise the source of the problems that resulted in the accounting fraud.

Figure 6: Livedoor Sales and PBT

As previously discussed, Livedoor’s strategy contains two basic characteristics: frequent use of M&A and publicity stunts. Livedoor used these two as fuel to maximise its market capitalisation along with developing a unique corporate culture.

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99 Adapted from Livedoor, Annual Security Report or Yukashoken Hokokusho 2000 - 2005
5.2. Overall corporate culture of Livedoor

Corporate philosophy
It is questionable that Livedoor had a corporate philosophy, mission statement or vision. Instead, Horie often stated that Livedoor’s objective was to become the ‘world’s best company’ or to earn the ‘world’s biggest profits’. He explained that glossy philosophy and vision were too complex to share, and the company, instead, should use the world’s most common language, namely ‘money’.\textsuperscript{100} This is why he frequently said ‘money is everything’, despite knowing that this statement did not sit well with Japan’s business establishment, which values ethics or long-term sustainability.

Some features of Livedoor culture
Founded in 1996 and having a 33 year old CEO at the helm, Livedoor had a different corporate culture than traditional Japanese companies. Features of Livedoor culture include the following factors.

a) Speed
Speed in decision-making and business process was highly respected at Livedoor. Hiramatsu, the current CEO, was surprised to see how quickly people were moving when he first joined Livedoor; products or services usually went live they reached 70-80% completion. In a Strategic Meeting, a regular meeting that consisted of all department heads, ‘I’ll check it later’ was a taboo. Managers were required to make a decision then and there.\textsuperscript{101}

Although this emphasis on speed played an important role in competing in the ‘mouse year’ Internet world, it also had some disadvantages in operating a large company. Prudent plans may become more important as the company get larger.

b) Cost-consciousness
Livedoor’s extreme cost-consciousness has been a tradition since its foundation. In Livedoor, employees require approval from the boss even when buying a pencil with company money. In addition, there was a company rule that employees take at least three estimates of purchases from different suppliers. This rule enabled the company to avoid unnecessarily expenses and adhesion between suppliers and person in charge.

Even though Livedoor had no beautifully constructed philosophy, cost-consciousness was a comprehensively shared value. One episode occurred when Livedoor moved to luxury Roppongi Hills, a newly build office building in central Tokyo: it obtained free office fixtures and furniture from Yahoo! Japan, which wanted to dispose of the furniture during its move. Similarly, the company obtained most of its furniture from business partners or second-hand markets. As a result, the Livedoor office did not have a sense of unity through its furnishings and an executive confidently said that 'Second-hand desks cannot discourage work efficiency. Cost saving is a bigger issue'.

c) Flat organisational structure
Livedoor has no executive suites in the office. Even Horie, who was often regarded as one of the most charismatic figures in Japan, worked at his modest desk beside other employees. There are no barriers in the office, giving it an air of spaciousness. Similar to the office, the organisational structure of Livedoor is flat.

An online DVD rental service is now an important piece of Livedoor’s business portfolio. It was initiated by Yamana, a 26 year-old non-titled employee at the time of the business’ birth. It was Yamana who proposed the business idea to the board and, after a few meetings to review her business plan, the board gave her the OK to form a new department. With her business success, she quickly got promoted to Operating Officer and was eventually assigned as a CEO of a subsidiary when the business evolved to become Posren Co., Ltd.

Flat organisation is usually received as an affirmative structure. It may be true that this structure was the source of Livedoor’s amazing growth by generating a number of new projects, but it may also be the source of disorganization that arguably caused the accounting scandal. Some members of the mass media pointed out that the organisational structure was too simple to have an efficient back-office and checking function. As a result, there had been too much authority centralisation.

103 Nihon Keizai Shimbun, 30 January 2006
5.3. Frequent use of Mergers & Acquisitions (M&A)

**M&A as a means of growth**
Looking at the history of Livedoor (See Table 23), many people would be amazed by the enormous number of M&A activities. Livedoor’s history is its M&A history. Livedoor explicitly stated, ‘We consider M&A the most important task for businesses as a means of expansion’. Hence, it is undoubted that the use of M&A is integral part of Livedoor’s growth strategy.

M&A activities have accelerated, especially since 2004. Livedoor had 12 consolidated subsidiaries at the end of September 2003, but the number surged to 27 by the same period in 2004 and to 44 in 2005. It spent 12 billion yen in the 2004 fiscal year and 62 billion yen in 2005 for purchasing new consolidated companies, and the money spent on M&A accounted for 12% and 18% of the total assets respectively. It is assumed that a large part of Livedoor profits were attributed to newly acquired companies, although it is difficult to specify the contribution because Livedoor regularly absorbs acquired companies into its existing structure and lines of business.

One feature of Livedoor M&A is the heavy use of share swapping. Horie often said that ‘The best thing about being listed is that you can issue currency. You can buy companies with your own currency, namely own shares’. To make a good deal, Livedoor needed to enhance its ‘currency’ value, and a large M&A deal that attracts market attention often boosts the share price. In this way, Livedoor may have succumbed to ‘deal addiction’.

**Strong ‘Finance team’**
The unprecedented scale of M&A activities was made possible by the strong finance team led by CFO Miyauchi. The finance team started when Capitalista was established in April 2000 and was reinforced year after year. Capitalista originally devoted itself to corporate venture capital, pursuing both investment returns and creating an eco-system in which Livedoor exercised its strengths. However, it gradually shifted to becoming involved in M&A deals by the end of 2003. In addition, the team’s role has changed from a supportive section performing investment and M&A to a profit-making department that runs dozens of financial services.

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104 Livedoor, *Annual Security Report or Yukashoken Hokokusho 2004-2005*
The finance team had the greatest voice in the company partly because it was recognised as the source of rapid growth by conducting M&A deals, and also because it had the largest revenue stream through its e-finance segment (See Figure 7).

Figure 7: Livedoor’s revenue proportion by business

In particular, a large part of the revenue from e-finance came from the following three businesses: Bitcash, a prepaid payment service, Livedoor Securities, share trading and investment banking (e.g. underwriting MCBs) and Livedoor Finance, an alternative investment entity (e.g. venture capital and private equity finance). None of the aforementioned businesses could be associated with a high-growth dot-com. By comparison, parent company Livedoor, which was operating the portal site livedoor.com, recorded 9.3 billion in sales and a 2.1 billion yen operating loss in 2005. Therefore, Livedoor was a finance company in a sense despite many people considering it a dot-com company. Here is a big issue. Since Livedoor was regarded as a high-growth dot-com, its share price was set at a high level accordingly (e.g. its PER was 65 times in 2004). If, however, Livedoor made most of its profits by non-dot-com business, such as investment banking, would it be reasonable to maintain its share price?

Use of the pooling method
According to the Annual Security Report 2004, Livedoor changed its accounting policy on share swap consolidation from a purchase method to a pooling method without presenting a clear reason. This is questionable in several aspects. Most importantly, it departed from basic
principles. The pooling method is basically for a combination of two firms in a union of ownership interests where there is no acquirer and acquired. Livedoor’s share swaps were, by definition, acquisitions in which Livedoor had a clear intention of controlling the targets. Hence, this change is against principle. Secondly, it lacked consistency, another accounting principle. Regulators announced in 2003 that the pooling method would be inapplicable except in very special circumstances (i.e. strict merger of equality) from April 2006 onwards. Livedoor’s any share swap acquisition would not be lawful to use the pooling method under the new regulations. If Livedoor, knowing this fact, intended to change its accounting policy, it might prove a lack of faith because it knew that the use of the pooling method could not be consistent. Thirdly, it is obvious that the general international trend would select the purchase method. In the US, the Financial Accounting Standards Board (FASB) banned the pooling method in 2001 and in the EU, the International Accounting Standards Board (IASB) also decided to prohibit it in 2004. If Livedoor’s objective had been to become the ‘world’s best’ as Horie stated, it could not have shifted into the pooling method at that time. Finally, the change was done in a humble manner. Even though it was an important change that was worth notifying investors about because it would result in a significant change in the numbers of financial statement, Livedoor published only a few lines of explanation without stating any reason(s) for the change.

Furthermore, Livedoor was also unclear about its goodwill depreciation span. It only stated that the span would be decided individually. Since M&A is Livedoor’s core activity, it should have been very clear how to deal with M&A accounting. It is no exaggeration to say that Livedoor tried to leave the issue vague to mislead investors.

5.4. Publicity stunts

Free advertisement
Another method for Livedoor’s rapid growth is publicity. Livedoor has effectively used publicity to increase visitors to its portal site. Since it changed its company name to Livedoor, it has focused on the consumer business by putting the portal site livedoor.com at its core. A key success factor for portal business is maximising its traffic, such as reaches, page views and subscribers. As a website reaches critical mass in traffic, it generally begins to becoming most profitable.

Livedoor first enjoyed fame when it announced that it was seeking to take over the Kintetsu Buffaloes, a professional baseball team that was about to be merged with another team, the

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Orix Blue Wave. The Buffaloes and their baseball fans were, on the whole, unhappy with the planned merger with the Blue Wave because the Nippon Professional Baseball (NPB) planned to reduce the number of teams, which could possibly mean diminishing equilibrium. Livedoor opposed the diminution and made an offer to take over the Buffaloes. Although this attempt was unsuccessful, Livedoor enjoyed the publicity and was successful in building a famous and positive brand image.

Getting a taste of success through the baseball case, Livedoor has continued to create sensations. There have been national affairs like the bid for NBS in an attempt to control Fuji TV as well as many other, smaller publicity stunts. Consequently, Internet accesses to livedoor.com have increased in the amazing way that was Livedoor intention (See Figure 8). It is, however, ironic that livedoor.com recorded the peak page views during its own accounting fraud scandal.

Figure 8: Change in page views of livedoor.com

Horie was the most profitable character in Livedoor’s publicity strategy. He frequently appeared on TV shows ranging from business news to quiz shows and published dozens of books that

kept stimulating public opinion and feeding the fame. Additionally, he intentionally chose improper and eye-catching wording to draw public attention: ‘You can even buy a human mind with money’, ‘Women follow money’\(^\text{108}\) or ‘I’ll kill old-fashioned media like newspaper and TV’.\(^\text{109}\)

Taking advantage of Horie’s publicity, Livedoor made a number of public campaigns. It did not hesitate to use his nickname *Horiemon*, a manipulation of his surname and the name of popular *manga* character Doraemon, a futuristic cat, due to their similar plump figures. On the contrary, it registered *Horiemon* as a trademark to benefit from ‘*Horiemon* business’.

**Preposterous share splitting**

Even capital policy was used for publicity. On 19th November 2003, Livedoor (named Edge at that time) announced 100-for-1 share splitting. This unprecedented scale amazed market players. In Japan, there is usually a several-month period after a split announcement until the new shares are available. Within this period, market players can only trade mother shares. Hence, a supply-demand imbalance arises. As a result, share price normally increases to a certain extent during the period and returns to its intrinsic value after the new shares become available. However, on the 100-for-1 splitting, the increase was not ‘to a certain extent’ because the supply-demand imbalance was not within the normal range. The Livedoor share price surged up to 8.5 times its pre-announced price and recorded a stop high price 15 days in a row. Kumagai, the creator of the idea of the large-scale split, said that ‘We intended to promote the company by taking full advantage of the share market’.\(^\text{110}\)

The share splitting had another contribution: increasing the number of shareholders. Now that Livedoor share price was several hundred yen, equivalent to a few pounds, everyone could afford a share. Livedoor particularly aimed to increase the number of individual shareholders and try to promote its service to the shareholders to make them loyal customers. It called this ‘investomer (combination of investor and customer) strategy’. The number of shareholders increased to approximately 230,000, 100 times the number before the share splitting began. In 2005, Livedoor share trading accounted for 45% of the whole TSE trading. This is amazing because NTT DoCoMo shares, which were the second most traded, accounted for only 2%.

Although share splitting had some benefits, there was a lot of criticism as well. Market players on the whole frowned in displeasure. Michio Matsui, CEO of a leading online broker Matsui


\(^{109}\) Takafumi Horie, 2005. Interview with Shoko Egawa 

Livedoor and a new wave in Japanese corporate governance

1st September 2006

Securities, said in disgust at a seminar on 24 September 2004 that ‘Baffling share split. Go to hell. The market will revenge [on Livedoor]’. To a greater or lesser extent, market players shared the same feeling as Matsui’s because Livedoor had created mass confusion in the market. Another problem was that Livedoor shares were traded regardless of their corporate value. Few people would seriously think about corporate value if the investment could be done at a few pounds.

M&A as a means of publicity stunt – Fuji TV case
Livedoor used everything for publicity without exception, and M&A is one of the most entertaining publicity stunts Livedoor ever played. At 8:20 on the morning of 8th February 2005, Livedoor announced that it had raised 80 billion yen with moving strike convertible bonds (MSCB) from Lehman Brothers for ‘an M&A activity’ and had also acquired more than a 5% stake in Nippon Broadcasting Systems (NBS). Although Livedoor did not mention the specific M&A target for the 80 billion yen, it was obvious that it was aimed at NBS. Soon after the announcement, Livedoor successfully bought further shares in NBS using TSE’s ToSTNeT-1 and, in the end, accumulated a 35% stake on that day. The use of ToSTNet-1 was in the grey area. In Japan, a company that aims to obtain a majority stake (more than a 33%) of a target company is obliged to either announce a take over bid (TOB) or buy shares in the open market. ToSTNet-1 bordered upon being a negotiated transaction. Fuji TV, which was in a TOB process of trying to buy group company NBS, was astounded with this attack. This was the start of Japan’s most famous bidding war. Mass media covered the big battle extensively until both sides finally came to an agreement on 18th April 2005.

Although it ended in a publicity stunt, Livedoor had rationales for targeting NBS. NBS was a radio station company, but had been the crown jewels as a core member of Fujisankei Communication Group (FCG), Japan’s largest media conglomerate, which encompasses 76 companies, 5 foundations, 3 museums and over 10,000 employees. Since NBS held a large stake in Fuji TV (32.3% in early 2004) and a majority stake in Pony Canyon, it appeared to be the holding company of the conglomerate. In 2004, market capitalisation of NBS was 23% of Fuji TV and the net income of NBS was 15% of Fuji TV’s. This meant that if someone successfully acquired NBS, he could gain control of the larger Fuji TV and the conglomerate.

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112 Fujisankei Communication Group [online]. Available from: http://www.fujisankei-g.co.jp/about.html
For this reason, Fuji TV was trying to redefine the capital composition of the group. Livedoor struck at this vulnerability before Fuji TV could complete the restructuring.

Public opinion was of two minds about Livedoor’s attempt. Those who viewed it positively thought that Livedoor broke the ice and allowed Japanese people to think about the issue, ‘Who owns the corporation?’ However, those who viewed the attempt negatively saw Livedoor’s circumvention of the law as a big problem, and some of those simply hated the assuming attitude of Horie and his young bunch of followers. In any case, no one asked questions like ‘what is Livedoor?’ or ‘who is Horie?’ after this case – everyone knew.

Running for election
Although Livedoor’s and Horie’s rudeness were controversial, there were a substantial number of people who thought that the publicity strategy worked well. However, when Horie expressed his desire to run for the Lower House Election in August 2006, the situation changed. Hiramatsu and Idesawa, who were both Operating Officer at that time, were in favour of the series of the publicity stunts from baseball to Fuji TV case, but were uncomfortable with Horie’s desire to get involved in politics. It can be said that Horie had used his popularity and sacrificed his private life for the sake of company publicity before the election, but this time he, by contrast, used Livedoor’s resources for his own goals, i.e. personal political ambitions. Some of Livedoor’s staff retired from the company to support Horie in the election. Miyauchi felt uneasy and thought that Horie had become absent-minded as a result of his involvement in the election.

Despite the unwillingness of some executives, Horie went on to officially announce his candidacy in the Hiroshima sixth district on 19th August 2005. Although he ran as an independent, The Liberal Democratic Party (LDP) offered a variety of support. Some LDP executives made campaign speeches on Horie’s behalf in Hiroshima. Prime Minister Junichiro Koizumi had a talk with Horie and cheered him up. With his growing confidence, Horie really thought that he would (or ‘should’) become the next Prime Minister.114 Although Horie was seen as a symbol of Koizumi reformation and had captured the headlines, an election victory could not be achieved overnight, and he lost the election by a small margin.

Although it was a surprising publicity, the election campaign had a different result from previous publicity stunts that Livedoor had invoked. The election campaign was not for the sake of Livedoor, but was a personal campaign by Horie to become a political leader. Many people had

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114 Yasuaki Oshika, 2006. Hiruzu Mokujiroku, Asahi Shimbun Company
serious doubts about Horie’s decision, especially those people who seriously thought about Livedoor’s future expansion.

5.5. Review of Livedoor’s growth strategy
In short, Livedoor’s growth strategy was a combination of M&A and publicity stunts. Using M&A, Livedoor placed a huge amount of sales and profits on its income statements from its newly acquired companies. Looking at the superficial growth, many investors rushed into buying Livedoor shares. When Livedoor shares boomed, it was the chance to acquire bigger targets through share deals using this boosted ‘currency’. Share splitting enabled many individual investors to buy Livedoor shares without considering corporate value or company’s core competence. Livedoor shares were too easy and cheep to be seriously analysed. Some acquisitions may not have had synergy or acquired companies may have been overvalued, but few people cared about it. The pooling method played an important role in making Livedoor profitable as well. As Livedoor became bigger and more influential, it was able to operate more elaborate stage equipment. Publicity stunts became more effective when Livedoor became influential enough to raise the 80 billion yen from Lehman Brothers.

None of the above was unlawful despite some being very controversial. My impression is that Livedoor executives, excluding Horie, found this model unsustainable. Hence, they seemed to want to stop this tricky path and return to normal business operations. Livedoor might be able to get on the right track in the near future if the prosecutors had not raided. The prosecutors, however, did not tolerate Livedoor’s provocative growth strategy and regarded the entire story as one single conspiracy to cheat investors.
6. Corporate governance at Livedoor

6.1. Introduction
This chapter will explore corporate governance practice at Livedoor. It will discuss several aspects of corporate governance such as shareholders, stakeholders and the board of directors. OECD principles and traditional Japanese corporate governance practice will be used during a comparison.

6.2. Livedoor and its shareholders

Rights of shareholders
OECD principles put the shareholder issue before any other aspect. It admonishes that ‘the exercise of shareholders’ rights’ should be protected and facilitated.\(^{115}\) While traditional Japanese corporate governance is often criticised for ignoring shareholders’ rights due to keiretsu control and cross shareholdings, Livedoor put emphasis on shareholders’ rights. Firstly, Livedoor was not part of any keiretsu, which often caused confusion in corporate ownership. Livedoor’s ownership issue was simple and obvious: everyone can see the owners by checking Livedoor’s current listing of shareholdings. Secondly, Horie clearly stated the shareholder concept by saying, ‘the shareholder basically owns the corporation. It will create a mess if you say that the employees own the corporation. It will be difficult to make a sound profit if the management harmonies the differing interests’.\(^{116}\) Thirdly, Livedoor offered, or at least tried to offer, better services to its shareholders than those available at traditional Japanese corporations. For instance, it has broadcasted Annual Shareholders’ Meeting (AGM) since it was listed in 2000\(^ {117}\), and held AGM on weekends; traditional Japanese companies, by contrast, hold AGM dates on the same day of a week as if by common consent to prevent many shareholders from attending. Hence, it is undoubted that Livedoor, in contrast to the legacy Japanese corporations, tried to make AGM more accessible. Another example was the term of the board. Livedoor set, in its internal regulations, that the term of each director would be one year; most Japanese companies set it two years or longer. Therefore, shareholders appoint or reject each director at every AGM. Additionally, there were no anti-take-over devices introduced.

\(^{115}\) OECD Principle of Corporate Governance 2004, II. Rights of shareholders and key ownership function
\(^{117}\) Livedoor AGM videos are still available from: http://finance.livedoor.com/ir/4753/explanation.html
All in all, it can be said that the board of Livedoor faced its shareholders unarmed and were accountable.

Critics of Livedoor often argued that it violated shareholders’ rights when it issued the notorious MSCB during its attempt to acquire NBS.\textsuperscript{118} Lehman Brothers, the underwriter of the CB, was able to convert the bond for shares at a flexible price, while in a regular CB an underwriter would exchange bonds for shares at a fixed price. Livedoor’s CB allowed Lehman Brothers to obtain Livedoor shares at 10% below the current price and make an incredible profit in a short period with posing little risk to the underwriter. Lehman Brothers also borrowed Livedoor shares from Horie to hedge even the ‘minimal’ risk. In this scheme, Livedoor’s existing shareholders bore the loss that created the underwriter’s profits.\textsuperscript{119} In my view, however, this MSCB problem is not particular to Livedoor, but to Japanese firms in general; it is certain, though, that MSCB harms shareholder value by offering especially favourable conditions to specific investors. Use of MSCB has increased since 2004 as a means of expeditious financing. Over 100 companies in Japan have issued MSCB in various conditions. Since MSCB is a new financing method, there is not a clear standard. Recently the TSE has announced that it would strictly check terms when MSCB is issued.\textsuperscript{120}

**Horie as the largest shareholder**

OECD principles advise that all shareholders should be treated equally.\textsuperscript{121} Hereby, Livedoor had some problems. Horie has had the largest stake in Livedoor during its entire history (See **Figure 9**), and as a result, he have developed a strong sense of ownership. Unity of ownership and management are beyond the scope of the contemporary corporate governance view that is based on ‘separation of ownership and management’. It may be the case that the owner, who has an overwhelming stake, has too much power that may result in an impairment of minority shareholders’ rights. In addition, a corporate manager with ownership may distort the nature of monitoring function in terms of the monitoring of management.


\textsuperscript{121} *OECD Principle of Corporate Governance 2004*, III. The equitable treatment of shareholders
There is an episode that will illustrate this situation. At the AGM on 25th December 2005, a dispute arose over the company’s dividend policy: whether or not Livedoor distributes the proceeds to shareholders. Livedoor and its board argued that the company was in the process of rapid growth so it should maximise retained earnings to prepare further investment, especially M&A, for continued growth. However, one shareholder proposed to execute a 2 billion yen dividend, arguing about the balance between growth and distribution of profits. Horie, in response to the shareholder’s request, said to the effect, ‘I, as a shareholder, personally don’t want 400 million yen (If Livedoor distributed profits as proposed, Horie would receive 400 million yen)’. This seemingly appeared to be a good representation of the largest shareholder, but there is another issue. Since Horie received a huge amount of compensation as CEO and had also made large capital gains several times since Livedoor went public, he was in a different position from other shareholders. He could see his returns of investment as the total sum of compensation and capital gains. In this way, if Horie insisted on his own view, it may not represent other shareholders’ interests. Hence, it may result in an inequitable treatment of shareholders.

There is a data that may support Livedoor’s ignorance of minority shareholders. Livedoor had a relatively small proportion of financial or corporate shareholders. Instead, individual shareholders had a 55.5% stake in Livedoor (See Figure 10). In general, financial institutions

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**Figure 9: Change in Horie’s shareholding**

![Figure 9: Change in Horie’s shareholding]

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and corporate shareholders are expected to play roles in monitoring the corporation with their professional skills in investment and their resources. Absence of those professional shareholders could result in a lack of discipline in corporate governance. Additionally, Livedoor had had few major shareholders other than Horie during its short history. There were only two shareholders who had more than a 10% stake: Hikari Tsushin in 2000 and Fuji TV in 2005 (See Figure 9). Horie had been a ‘solo’ major shareholder for a long time.

**Figure 10: Shareholdings by type: comparison between listed companies and Livedoor**

<table>
<thead>
<tr>
<th>Type</th>
<th>Listed companies</th>
<th>Livedoor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>19.1%</td>
<td>55.5%</td>
</tr>
<tr>
<td>Foreigners</td>
<td>26.7%</td>
<td>17.8%</td>
</tr>
<tr>
<td>Business Corporation</td>
<td>21.1%</td>
<td>14.0%</td>
</tr>
<tr>
<td>Securities Companies</td>
<td>1.4%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Financial Institutions</td>
<td>31.6%</td>
<td>9.9%</td>
</tr>
<tr>
<td>Govt. &amp; Local Govt</td>
<td>0.2%</td>
<td>0.0%</td>
</tr>
</tbody>
</table>

6.3. **Livedoor and its stakeholders**

**Livedoor’s general view on stakeholders**

OECD principles admonish that the corporation should recognise the rights of stakeholders and encourage activities that create wealth and jobs.\(^{124}\) Traditional Japanese companies tend to

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123 Adopted from Tokyo Stock Exchange, 2005 Shareownership Survey, Available from: [http://www.tse.or.jp/english/data/research/shareownership.html](http://www.tse.or.jp/english/data/research/shareownership.html) and Livedoor, Annual Security Report or Yukashoken Hokokusho 2005

124 *OECD Principle of Corporate Governance 2004*, IV. The role of stakeholders in corporate governance
value the stakeholder concept, in particular the value of their employees. Livedoor, however, had a different idea on the stakeholder issue.

Horie often argued that the corporation should solely serve its shareholders and a wider set of responsibilities to stakeholders would be a source of bad management. For instance, he, in response to a shareholder who insisted on enriching CSR activities, said at the AGM in 2005 that ‘I think that the company only has to pay taxes’. Another example was when he sent out a New Year message to all employees a few years back. He argued that ‘You should concentrate on making profits so that the company can pay a lot of tax. This is the way we contribute to society’. It was assumed that Horie was personally interested in social activities: he donated 10 million yen for the Niigata earthquake and ran in an election. However, when it comes to corporate social responsibility, he categorically denies the importance of the stakeholder concept.

Employees
Unlike traditional Japanese companies, Livedoor was not a ‘community of employees’. Livedoor employees usually did not have a strong sense of belonging to the company; there was also no concept of ownership of the company. Nevertheless, quite a few Livedoor employees are staunchly loyal. Simply put, they like Livedoor. Interviews or conversations with some employees revealed that they considered Livedoor an opportunity for self-realisation. They expressed that Livedoor offers positions and responsibilities to those employees who have motivations and skills.

Although Livedoor is not a community of employees in the traditional Japanese style, which is based on seniority and lifetime employment systems, it offers a wide range of benefits. For example, it invited all of its employees to an annual company trip and there was a lump-sum allowance for the birth of a child and nursing. Livedoor’s basic policy seems simple: provide whatever benefit package is necessary if it can keep employees motivated. As a result, inter-employee communication appeared to be smooth and employees seem to work together as a team. By some chance, it could be said that Livedoor offered another type of ‘community of employees’ based on performance-based evaluation.

Community and society

Sticking to Horie’s view on stakeholders, Livedoor did not consider the local community and society. When attempting the acquisition of NBS, Livedoor was widely criticised for its ignorance of the public nature of the broadcasting business. Some NBS and Fuji TV employees, expressing anxiety and anger, argued that the media business required consideration for disadvantaged members of the society and, as a result, Livedoor’s way of mammonism could not fit. Other employees pointed out that Horie did not have a passion or love for the media business, so they could not work under such a boss. This may be a case where ignorance of corporate social responsibilities backfires. Above all, Japanese companies historically value public views, so it was hard for Livedoor to insist on its strong shareholder concept when doing business with legacy industries.

Notwithstanding, if someone said that Livedoor did not contribute to the community or society, it would be an exaggeration. Some have pointed out that Livedoor has contributing to the Internet community. It took a stake in Berkeley Software Design, a major distributor of Free BSD, in 2000 to make open source software more pervasive. Some Livedoor executives frequently contributed articles to technical magazines. Livedoor also disclosed its own application framework Sledge as GNU General Public License. Although the way it contributed is different from general industries, it cannot be denied that Livedoor has shown great dedication to a specific community or society as a whole in its own way. Furthermore, Livedoor offers an extensive number of services that are widely used all over Japan, including web-blogs, wiki, message boards, web mail, news, weather forecasting, e-commerce, on-line DVD rental, download, SNS, dating, Q&A, gaming and so on. Livedoor Blog, for instance, is the most widely used blog service in Japan with 250,000 active users. It can be said that Livedoor has brought, at the very least, some benefits to society.

129 GNU General Public License [online], Available from: http://www.gnu.org/licenses/gpl.html
130 Survey by Blog Fan [online], Available from: http://www.blogfan.org/
6.4. Livedoor and its board of directors

The board structure

OECD principles admonish that the board should conduct strategic guidance of the company and effective monitoring of management, and that it has accountabilities to the company and its shareholders.\textsuperscript{131} The board should have an appropriate structure to achieve the roles above.

Livedoor has been a company with a board of corporate auditors (See Table 25). The structure is two-tiered and separates the supervisory function (the board of auditors) from the management function (the board of directors). Although the committee system, which enables companies to have one-tiered boards with committees, was introduced in 2003, many Japanese companies maintain the structure of a company with a board of the corporate auditors. There were seven directors, including one outside director, and three auditors, including two outside auditors, on the board in December 2005. Yoshiaki Yamada, the only outside director of Livedoor and a managing director of Fuji TV, was appointed on 25 December at the AGM. Fuji TV at that time was the second largest shareholder, so Yamada was expected to represent their shareholders’ interests. Yamada, however, soon resigned as a director at Livedoor due to the scandal just a month after his appointment. Livedoor had two outside directors in 2003 from a business partner, eBank Corp.,\textsuperscript{132} but Taiichi Matsuo and Takateru Kono also resigned soon after their appointment because of a serious conflict between Livedoor and eBank. Over all, most of Livedoor’s directors have been internal employees who were also in charge of company operations as executives. Among the directors, CFO Miyauchi had the longest service record as a director, second only to Horie as founder and CEO. Auditors consisted of independent experts: Sakurai, an ex-police officer, Ohashi, a lawyer, and Sasamura, a CPA.

Table 25: Livedoor board members\textsuperscript{133}

<table>
<thead>
<tr>
<th>Directors</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
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<tbody>
<tr>
<td>Takafulmi Horie</td>
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<td>Ryoji Miyauchi</td>
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131 OECD Principle of Corporate Governance 2004, VI. The responsibilities of the board
132 eBank Corp. [online], website: http://www.ebank.co.jp/english/index.html
133 Adopted from Livedoor, Annual Security Report or Yukashoken Hokokusho 2000-2005
134 0/6: 0 outside director out of 6 directors
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| Dan Kogai       | Zen Funada        | Zen Funada        | Fumito Okamoto    | Fumito Okamoto    | Fumito Okamoto    |
| Shuji Wainai    | Shiro Yamada      | Shiro Yamada      | Taiichi Matsuo    | Fumito Kumagai    | Fumito Kumagai    |
| Naoyuki Fukumoto| Daisuke Enomoto   | Takateru Kono     |                  | Hiroshi Haneda    | Yoshiaki Yamada   |

Auditors

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Shunji Ohashi  | Shunji Ohashi  | Shunji Ohashi  | Shiro Sakurai  | Shiro Sakurai  | Shiro Sakurai  |
Hiroshi Hata   | Yasuyuki Maeda | Yasuyuki Maeda | Shunji Ohashi  | Shunji Ohashi  | Shunji Ohashi  |
Kumeho Takeishi| Kumeho Takeishi| Kumeho Takeishi| Yasuyuki Maeda | Masahiko Sasamura | Masahiko Sasamura |

*Independent outsider board members are bolded

Monitoring function
Since Livedoor’s board was mainly occupied by internal directors who also conducted management as executives, it would be difficult to say that the board had sufficient structure to monitor management. According to Livedoor’s investigation after the scandal, some directors had extreme power and authority and their judgements and decisions tended to be final. Horie and Miyauchi, in particular, had such power.

Nevertheless, some people argued that the board at Livedoor had internal check functions. Okamoto, ex-director and ex-CEO of Livedoor Marketing, said that all Livedoor board members could voice a number of difficult opinions to Horie despite many people believe that Livedoor was Horie’s one-man company. Shinichi Tanaka, an auditor of Livedoor, agreed with Okamoto’s view, but added that Miyauchi was an exception and no one could interfere in his business. Miyauchi and his finance team created a separate room in the office and locked it; even directors or executives could not enter the room. The finance team claimed this was necessary to ensure the Chinese Wall, but it was true that the board could not exercise its monitoring function due to the wall.

In Japanese corporate governance, the board of auditors is expected to perform an oversight function, but this does not often function as expected. Livedoor’s board of auditors played a limited role in corporate governance. Yamazaki, an ex-director, said that outside auditor, by their

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135 Livedoor press release, 24 February 2006
very nature, could not monitor the management in an effective manner because the operation of modern companies was too complex to be reviewed by outsiders. Another aspect that must be pointed out with concern of the board of auditors is that Ohashi, a lawyer and outside auditor working from 2000, belonged to the General Consulting Firm, an accounting and law firm that founded by Miyauchi. He knew Miyauchi even before 2000 and was an old friend.

**Accounting audit and internal audit**
The corporation should, in accompanying the board, ensure that the accounting auditor keeps financial statements accurate and fair. The accounting auditor must be independent and must not have a stake in the company. Koyo, a middle-sized auditing firm, was in charge of Livedoor’s audit. The auditing for Livedoor and its group companies accounted for a large part of Koyo’s revenues: 14% of its total revenue. Moreover, a CPA in Koyo had a personal stake in Livedoor; Kobayashi, who had been in charge of Livedoor audits until December 2004, assumed the position of Representative Director of General Consulting firm, which Miyauchi had founded. The General Consulting Firm took on accounting and payroll jobs from Livedoor. Therefore Kobayashi and Koyo would not be independent. Prosecutors accused two CPAs from Koyo, including Kobayashi, of violating the Securities and Exchange Law in cooperation with Livedoor and its executives.

Another possible stopper for the board’s overdrive would be the internal audit committee. Livedoor had an active working internal audit committee under the CEO’s supervision. The committee’s main aim was to ensure fair operations and detect possible wrongdoings. However, Yamazaki argued that the internal audit committee by nature could not detect critical frauds perpetrated by executives because investigators were internal and junior to those executives. According to the investigation after the Livedoor scandal, some directors ignored the reports from the internal audit committee and stated strictly that it was unnecessary to spend money on potential problems.\(^{138}\)

**Dependence on a specific director**
Livedoor had a simple but sufficient organisational structure to maintain the speed and control of its growth (See Figure 11). The board (directors and auditors) is under the general meeting of shareholders. The CEO is authorised by the board and ensures internal auditing. The CEO as a

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\(^{138}\) Livedoor press release, 24 February 2006
company executive manages 10 divisions. There is a meeting at which all the division heads and executives meet regularly: the sales strategy meeting.

Figure 11: Livedoor organisational chart (2005)

However, this is a superficial structure of the company. In reality, important decisions were often made behind the structure. Many people witnessed the centralisation of authority, specifically finance director Miyauchi and his team. Some executives said that the board was not the ultimate decision-making body: the finance team often originated and proposed plans to the board and, in many cases, decisions were often made before the board had time to review the plans. Since the finance team was firmly entrenched and extremely persuasive because of its expert knowledge and large contribution to company profits, it was difficult for other directors or executives to interpose an objection or question.

Livedoor has often been seen as a company led by the strong leadership of Horie, but Livedoor internals implied that Horie was often challenged and criticised by other directors.\textsuperscript{139}

Notwithstanding, Miyauchi was an exception. He was extremely respected and few people expressed or could express any sharp disagreement with him. Some executives said that they would die for him.\textsuperscript{140} Some executives said that they would die for him.\textsuperscript{141}

I will not delve into the details of Miyauchi’s character, but will put forth some of views on him considering various opinions and episodes comprehensively. He joined Livedoor in its pre-IPO stage. At the beginning, he was an advisor as a certified tax accountant, but eventually became fully involved in company management as the company aimed at achieving IPO. Along with a long service record, his charisma supported his popularity among Livedoor executives. He is very emotional and has a strong will. He did not go to university and obtained a tax accounting license after nine years of study. Livedoor executives, including Horie, a prestigious Tokyo University dropout, had relatively glossy academic records and were considerably less intense than Miyauchi. There is no wonder why they respected Miyauchi’s unyielding willpower.

Miyauchi is also known as a person who values his co-workers. He often shows great consideration towards colleagues and subordinates. My impression is that most of Livedoor internals follow Miyauchi rather Horie, while Horie had more charismatic public popularity.

When some colleagues visited him during his incarceration at the Tokyo Detention House in March 2006, he pretended to be calm and expressed concerns about Kumagai, the youngest accused executive, asking visitors to cheer him up. Miyauchi also supported Livedoor employees who were left in the chaos. His consideration was moving enough to cause staff who visited him to be moved to tears. While Horie lost his reputation by laying the blame on Miyauchi and his team after being arrested, Miyauchi accepted his responsibility and encouraged his subordinates.

It was tragic that so many people depended on Miyauchi. I have heard many times from Livedoor employees that ‘I will follow Miyauchi by all means’. It seems to me that they have abandoned themselves to Miyauchi and given up keeping their own ethical senses. As a general principle, managers have to be responsible to company shareholders and a wide range of stakeholders. It is suspected, however, that some Livedoor executives respected team leader Miyauchi before and above any stakeholders.

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141 Yasuaki Oshika, 2006. Hiruzu Mokujiroku, Asahi Shimbun Company
Part III: What can be learned from Livedoor?

7. What can be learned from Livedoor

7.1. Introduction
After considering all the factors that have been discussed, I would like to argue my position. Some people argue that Livedoor’s fraud allegation is too insignificant or unclear to be compared with what Livedoor has done so well. The scale of the fraud is much smaller than other cases, such as Kanebo or Yamaichi Securities, and the way that Livedoor has been implicated in its own share trading allegations could be seen as marginally legal. However, I would argue that Livedoor has done wrong on a fundamental level. Livedoor should be blamed not only because it violated the rules, but also, and more importantly, because it did not respect the spirit of the law and the course of justice.

In this chapter, I will explore the reasons of Livedoor’s collapse and try to find lessons for the future of Japanese corporate governance.

7.2. How did Livedoor fall?

Corporate governance or ethics
Before discussing the reasons, I would like to introduce some views about the Livedoor scandal. Some people with whom I discussed the Livedoor case said that it would be useless to consider corporate governance in this kind of fraud. They argued that it was a matter of individuals’ (the board members’ in this case) sense of ethics and not corporate governance. I must admit that this argument contains some truth. Ethics should be at the base of the management study. Nevertheless, I strongly believe that I must consider corporate governance in this case.

If we rely solely on individuals’ ethics, another Livedoor or even worse is inevitable. There needs to be a framework that may reduce the risk of management overdrive by setting a standard on ‘how the corporation should be governed’. Corporate governance is, or at least is exploring, such a framework. Even ethical issues can be discussed within the corporate governance context. For example, Livedoor introduced a mission statement and ethical standard guideline after the scandal on the advice of a corporate governance expert. The mission statement is on the top page of the corporate information section and states ‘we will
pursue, create and provide enjoyable and reliable services that can be used everywhere through the Internet and will contribute to the society.¹⁴²

The main reasons of the collapse
Although not everything that Livedoor did was wrong, but there are many things that could be done better. I will provide, from my point of view, the main reasons for the collapse in the following section.

d) Unfaithfulness
Firstly and most importantly, Livedoor was unfaithful. Livedoor seemed to consider that it could do anything unless it did not break the rules. In this respect, Livedoor bought NBS shares at ToSTNet-1 in 2005, changed its accounting policy into the pooling method in 2004 and made wrongful use of SPE to trade its own shares. By the same token, it did not foster its core competences in the Internet world, but engaged itself in non-core businesses such as brokerage, bond underwriting and private equity.

e) Lack of long-term views
Livedoor made a large part of its income through unsustainable business: some from newly acquired subsidiaries and others from non-core finance business. This revenue was expected to be highly volatile. Hence, Livedoor needed to put varnish on its financial statement to keep its appearance attractive. Livedoor should have fostered a core business that could have made sound profits in the long run instead of going for short-term gains.

f) Superficial imitation of Anglo-American style
Livedoor seemingly put a greatest emphasis on shareholder value and pretended to be Anglo-American. Notwithstanding, I would argue that it did not understand the essential part of the shareholder concept. Livedoor’s board structure was not independent enough to monitor managers for the sake of shareholders, and Livedoor executives looked at a specific director rather than serving shareholders’ interests. It appears that Livedoor took a convenient part of Anglo-American corporate governance without understanding the nature of the theory.

g) Too much emphasis on speed in decision-making

¹⁴² Livedoor corporate website: http://corp.livedoor.com/company/
Drivers look both sides even if the light shows green. By contrast, it is not recommended that football players take a lot of time to look carefully around before they pass. It would be difficult to identify whether the managerial decision resembles drivers or football players. Considering the rapid change in recent economic circumstance, managers need to make a swift decision while being expected to be prudent; this is fundamental because they are in a position to manage shareholders’ and debt holders’ assets. From what I have seen, however, Livedoor appears to have put too much emphasis on speed: it should have been more prudent in its decision-making.

**h) Too much dependence on a specific director**
Finally, Livedoor had a lack of mutual supervision in the board or among its executives. The dependence on Miyauchi is a prominent example. Livedoor should have introduced stronger supervision systems and tried to reduce its dependence upon a specific director.

**The background of collapse**
I believe that the aforementioned wrongdoings by Livedoor were backed by the factors and circumstances below.

**i) Shareholding structure**
The large shareholding by Horie distorted the nature of corporate governance: separation of ownership and management. By acting as the largest shareholder and the company manager, the monitoring functions were neutralised to some extent by Horie.

**j) Big media fuss**
Mass media covered Livedoor and Horie as a symbol of the new generation challenging Japan’s old-fashioned business world. Livedoor may have been seen as a more influential company than it really was. This may have caused Livedoor’s extreme drive for rapid growth to catch up with what it was perceived to be, rightly or wrongly, by the public.

**k) Transition from small business to large corporation**
Born in 1996, Livedoor was at the brink of becoming a large corporation from its humble beginnings as a small start-up. Small companies are allowed to have simple organisational structures with limited monitoring functions.

**l) Premature recognition of corporate governance in Japan**
Corporate governance is a relatively new term in Japan and there have not been enough active discussions on the issue. Under the circumstances, there may not have been enough criticism or suspicion of Livedoor’s methods in the context of corporate governance (e.g. internal control, independence of the board and so on).

7.3. Livedoor as learning material for the progress of the Japanese corporation

Significance of the Livedoor shock
The Livedoor shock stimulated a number of ‘reactions’. Due to the scandal, many people have pondered the question: ‘Who owns the corporation?’ This is a good start to improve corporate governance systems. Lawmakers have strengthened some regulations. For instance, the use of ToSTNet-1 in acquiring a majority stake is no longer lawful. Livedoor would need a TOB process, which is thought to be fairer, if it would acquire the NBS stake now. Violation of the Securities and Exchange Law is now punishable by stern sentences: a maximum ten-year sentence in comparisons to the former maximum of five years.

At the same time, the Livedoor shock is not perceived to be as seriously as Enron’s was. While Enron had been regarded as ‘America’s Most Innovative Company’ just before its bankruptcy, Livedoor was a maverick in the Japanese economy. Simply put, while Enron’s collapse arguably meant the collapse of the Anglo-American corporate governance or shareholder concept, the Livedoor shock does not mean the meltdown of Japanese corporate governance. If it had been Toyota instead of a mere dot-com start-up, the impact would have been completely different.

All in all, I am afraid that people will not go beyond their initial reactions and will not consider Livedoor as a learning opportunity.

Two major dimensions to consider
I believe that the Livedoor shock has two dimensions. The first one is corporate governance in small business or new business. The traditional Japanese governance style is deeply rooted in the traditional characteristics of Japanese firms (e.g. Lifetime employment system, keiretsu, main bank, mochiai and so on). Newly formed companies like Livedoor, however, are not built on the same foundation.

For instance, Livedoor’s capital structure represents that of many Japanese small and middle-sized enterprises (SME). Management by owner is not an underlying assumption of contemporary corporate governance. In addition, main banks or keiretsu companies do not play
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a significant role in new companies. Furthermore, stakeholders may be less important in those companies than in traditional companies.

There are issues: 1) whether or not we can share a single standard for Japanese corporate governance; 2) how we can bring discipline to small ‘casual’ firms; and 3) what kind of corporate governance (i.e. shareholder or stakeholder concept) is suitable for the new companies.

Another dimension is the importance of corporate governance education. Livedoor’s failure proved that superficial understanding of corporate governance may cause serious problems as Livedoor misunderstood the shareholder concept and misguided people. In another way, it is assumed that either the shareholder or stakeholder concept function well if it is comprehensively understood by company managers and the society.

Regulations have limited effects in preventing corporate frauds. Livedoor tried to go through regulation flaws and lawmakers filled up the crack with law revision. Is this sustainable? I believe that managers should be educated and understand basics, such as ‘what the corporation should be’, as well as obtaining legal knowledge.

TSE suspended IPO of Adways, a dot-com start-up because it found that the CEO did not understand corporate governance sufficiently. The CEO, feeling a sense of necessity, studied hard (6 hours a day!) to understand corporate governance, internal control and basic management. As a result, Adways went public on 20th June 2006.143 He is the youngest CEO ever to attain IPO and may be one of the most corporate-governance-conscious CEOs in Japan.

While managers should learn ethics individually, it is our job to set shared awareness about corporate governance. I would argue that Livedoor’s biggest mistake is not violating the law, but misunderstanding the nature of ‘the corporation’.

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