

Toshiba Corporation—How Could So Much Be So Wrong?

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Introduction

Haruto Takahashi, a new business school graduate, was speaking with his friend, Sara Marx, and lamenting the decrease in the stock price of Toshiba Corporation. He had invested in the company in 2011 and anticipated that it would be a solid investment to start his retirement savings account. Sara could not believe that her friend was already thinking about retirement or that Haruto had thought about it before getting his MBA. She was thinking about how little she had saved since graduation and thought Haruto was a good model for her to follow.

But Haruto's investment appeared to be in trouble. In May 2015 accounting irregularities surfaced at Toshiba. According to Bloomberg, while the Nikkei 225 Stock Average (Japan's main stock exchange) had a 7.6% gain, the stock price of Toshiba had declined seventeen percent since the company initially announced its accounting problems on May 8, 2015 until now, mid-July 2015 (Alpeyev, 2015). Haruto had watched the stock price decline as the company announced that it was restating earnings for the last seven years because they had overstated net income during that period by over US\$1.2 billion. Due to the accounting reporting issues, most of the company's Board of Directors had resigned as had the President and CEO. As part of their course work, Sara and Haruto had studied best practices for corporate governance and ethics in their business school classes. These violations of shareholder trust implied significant fraudulent activity on the part of the company's executives.

Toshiba Corporation History

Prior to the disclosure of the accounting frauds, Toshiba was described as a pillar of the Japanese economy and a global brand recognized around the world. It is a 140-year-old diversified company that sells a diverse group of offerings ranging from home appliances, computers and cameras to power plants, nuclear reactors and healthcare solutions. It is organized in five global businesses: Energy and Infrastructure; Community Solutions; Healthcare Systems and Services; Electronic Devices and Components; and Lifestyle Products and Services (Toshiba, 2015b).

Appendix A contains the history of Toshiba from the company's website. The final paragraph of the company's discussion reads like a mission statement that acknowledges the complexities of maintaining and growing market share in a highly competitive market and changing market place:

To prevail amid intensifying global competition transcending national borders, Toshiba continues to focus on restructuring businesses to reinforce their earnings base while seeking to transform its overall business structure by targeting growth sectors and emerging businesses. The aim is to become an even stronger global contender by pursuing the "concentration and selection" approach while creating the world's first and world's number one products and services that are cost-competitive and captivate customers (Toshiba, 2015c).

The many complexities of this ever-changing environment and intense competition led executives to cook the books to maintain an illusion of superior success.

Toshiba Accounting Scandal

When the accounting problems surfaced, the company hired external investigators to determine what had occurred and why it happened. After a two-month investigation, the devastating results for stakeholders were announced in July 2015. The president, Hisao Tanaka, and his two predecessors, vice chairman Norio Sasaki and company advisor Atsutoshi

Nishida, resigned after the investigators found that earnings had been manipulated while they were in control of the Tokyo based company. At a July briefing, company president Tanaka, chairman Masashi Muromachi, and vice president Keizo Maeda all bowed deeply in shame and contrition as an apology (Alpeyev, 2015). By July 21, eight members of the company's sixteen-member board of directors had resigned. At that time, Toshiba had four outside directors on their board of directors, more than most other Japanese companies (Du, 2015).

Operating results appeared to have been inflated by more than US\$1.2 billion. The problems started right after the global financial meltdown in 2008 and continued through 2014. The problem for this 140-year-old company was the result of senior employees being encouraged to achieve seemingly unattainable operating results. No written documents from senior management were found to document this "encouragement" and company leaders deny knowledge of the problems. What external investigators found indicated that there was a systemic overstatement of profits that occurred over many years. Lack of internal controls and a corporate culture demanding deference and achievement contributed to the unchecked management actions (Spitzer, 2015).

There were several ways that company employees inflated operating results. Many of the suspicious transactions occurred just prior to closing the financial records to report monthly, quarterly, or annual operating results. This pattern was a red flag that their auditors failed to note. It appears that to achieve expected levels of operating success, business unit managers were told that it was hoped they would meet goals. Even if unit numbers were not indicative of the expected result just two days before closing, senior management had confidence that goals and benchmarks would be met. So, despite setting impossible "challenge" targets, company leaders relied on the company and country's hierarchical corporate culture of conformity, obedience, and loyalty to achieve the impossible. People lower in the corporate hierarchy would do whatever was necessary to meet expectations in an environment where teamwork is valued, and whistle blowing is frowned upon (Kagyama, 2015).

The fraudulent activities started in 2008 under then chief executive Atsutoshi Nishida. Nishida called a loss of ¥18.4 billion "so embarrassing that we cannot announce it". Apparently, the company employees doctored the numbers as the actual reported profit for the period was ¥500 million. No written documents attributed to Mr. Nishida were found during the investigation. As is common with fraudulent activities, once a company starts to misstate financial statements, it is difficult to stop, and the amount misstated grows each period. In this instance, once unachievable results were achieved, new, tougher goals were set by upper management for subsequent years. These activities occurred throughout the organization including in the infrastructure, semiconductor, personal computer and television divisions. In a competitive global landscape, continually achieving increasing profitability became the norm and an obsession that continued until 2014 (*The Economist*, 2015). The corporate culture, poor internal controls, and weak system of corporate governance allowed the misstatements to go unchecked.

Toshiba has a new Board of Directors and management in place. The company's new representative executive officer president and CEO Masashi Muromachi wrote an apology letter to the shareholders presented in Appendix B. Lawsuits have been filed. Lives have been disgraced. Is achieving corporate financial success at all costs worth the sacrifices and penalties?

The Investigation Findings

Japan's Securities and Exchange Surveillance Commission (SESC) (2015) recommended to the Prime Minister and the Commissioner of the Financial Services Agency (FSA) an administrative monetary penalty payment order regarding the misstatements of financial reports by Toshiba pursuant to Article 20(1) of the Act for Establishment of the FSA. The recommendation was based on the findings of their inspections focusing on false statements prepared by Toshiba. Among the many accounting violations, The Independent Investigation Committee found four main fraud schemes at Toshiba. See Appendix C for a summary of the misstatements by category. In the first scheme, the total cost of contract work using percentage of completion accounting was underestimated and the extent of work progress was overstated, resulting in overstated sales and understated expenses. For contract work that was losing money, the total cost of contract work at the end of quarter was underestimated. This resulted in the provision for contract losses to be understated (Independent Investigation Committee 2015, 20). The second and third schemes resulted in misstating the number of part transactions and misstated operating expenses in the visual products business and the PC business from about 2008 to 2014.

In an attempt to meet profits, management created a process called carry-over (C/O) to overstate profits by adjusting profits and losses. The fictitious C/Os were used to adjust the gap not covered by other sales initiatives. The C/Os were

broken down into four methods: used cash basis accounting instead of accrual-based accounting; asked vendors for advertising or logistics expenses to hold off billing; overstated the product values in consolidation; and recorded cost reductions early (Independent Investigation Committee, 2015, 42, 43). The fourth main fraudulent scheme involved misstatement of semiconductor inventory by how buy-sell transactions were recorded. Bad accounting practices included channel stuffing, overstating profits from these sales, and failure to eliminate overstated inventory costs (Independent Investigation Committee, 2015, 54). From 2008 to 2014, the total restatement for the income (loss) from continuing operations, before income taxes and noncontrolling interests, was ¥224 billion (Toshiba, 2015e).

There was a conflict between the government's public prosecutor's office and the SESC. When the SESC began to investigate the accounting fraud at Toshiba, they presumed it would result in the criminal charges for the three former presidents due to the window-dressing of the financial statements. The prosecutor's office stated that it was difficult to pursue a criminal complaint for the former three presidents over overstating earnings. The SESC encouraged the prosecutor's office to reconsider the case after establishing each of the presidents' roles in the fraudulent reporting. Further, there was a conflict regarding whether the earnings manipulation through buy-sell transactions for computer parts was illegal (Murayama, 2016).

Corporate Culture in Japan

The British executive, Michael Woodford, who exposed a \$1.7 billion fraud at Olympus stated that, "What is Japanese is the culture of deference and obedience. These qualities make hiding corrupt transactions much easier. You have people blindly following leadership" (Luban, 2012). Linda Sieg (2015) noted that, "A spate of high-profile scandals at leading Japanese companies show reforms and rhetoric aimed at improving the country's corporate governance do not go far enough to unwind the culture of secrecy and hierarchy that plagues Japan Inc." She quoted University of Technology's Clarke as saying, "It is a cultural issue—they have to give up hierarchical obedience...They have to do this because if they cannot be more alert and agile as companies, they will not succeed in the modern world."

Corporate Governance in Japan

After the "dotcom" bust in the early part of this century and the 2008 economic meltdown, the United States passed the Sarbanes-Oxley Act of 2002 and the Dodd Frank Wall Street Reform and Consumer Protection Act in 2010 to improve external oversight over publicly held American corporations. These laws focus on how to implement corporate governance to protect outside stakeholders. They require: a strong system of internal controls over financial statement reporting to be in place; the Board of Directors and management to be held responsible for errors in the financial statements; and assessment of internal controls over financial statements by external auditors. The laws support majority corporate board membership by external, unrelated directors and require that significant board committees be chaired by external directors. The goal is for board members to take their fiduciary role as shareholder representatives seriously and be responsible to external stakeholders and not internal management.

The Japanese corporate governance system was not as developed as in the United States. A 2010 survey of thirty-nine developed and emerging countries by a GMI research firm ranked Japan thirty-six out of thirty-nine countries in the quality of corporate governance. The current Japanese Prime Minister believes that a stronger governance model will improve the economy and encourage foreign investment. In April 2003, "the company with committee" became the new corporate structure for governance. It was created by the Special Law on the Audit Practices under the Commercial Law in order to enforce corporate governance and improve transparency (Ministry of Justice, 2003). "The company with committee" really consisted of three committees, such as a nominating, an audit, and a compensation committee. In this new governance system, the directors were supposed to focus on the monitoring function of management through appointing executive officers. In 2003, along with many other public firms, Toshiba created a nominating committee. (Nikkei, August 14, 2015b).

The Revision of Company Act of 2015, in Company Law Article 2-12, changed the terminology from "the company with committee" to "the company with nominating committee." The law requires that half the members of the nominating committee must be outside directors who monitor management plans (Ministry of Justice, 2015). This follows corporate governance in the U.S.

According to the 2014 Annual Report of Toshiba, the company had sixteen members on its board of directors of which four (twenty-five percent) were outside, independent directors (Toshiba, 2014, p. 59). The board of directors at Hitachi,

Mitsubishi, and Sony all had twelve members on the board of which respectively seven, five, and nine were outside directors. The percentage of independent directors were respectively 58.3%, 41.7%, and 75 % (Otomasa, 2016, p. 33). After the Toshiba fraud became public, Toshiba had eleven members on its board of directors of which six (54.5%) were outside, independent directors (Toshiba, 2015a).

In Japan, the Whistleblower Protection Act of 2006 was enacted in April 2006 and an internal notification system was established for public firms in Japan (Consumer Affairs Agency, Government of Japan, 2006). The Toshiba fraud was discovered by an e-mail from a whistleblower to the Japanese Securities and Exchange Surveillance Commission (JSESC). (Nikkei, 2015c) The previously established internal notification system at Toshiba worked! In December 2014, the JSESC received the e-mail and began to investigate Toshiba. Subsequently, the number of whistleblowers at Toshiba increased under the internal notification system right after the announcement of the delay of financial disclosure of 2015 (Nikkei, 2015c).

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Case Requirements

Based on the following questions, write a report to the new Board of Directors to help them understand what went wrong. Groups will be formed in class. Each group will be assigned one or more question to prepare a presentation to the class.

Questions

1. What is accounting fraud?
2. Using the Fraud Triangle Theory (Cressey, 1973), what were the pressure, rationalization, and opportunity points in the Toshiba Fraud?
3. What red flags should have indicated a problem to external reviewers for the following identified accounting areas where fraud occurred:
 - a. Market conditions
 - b. Percentage of completion on long-term contracts
 - c. Channel stuffing
 - d. Pre-booking sales
4. What was the root cause of Toshiba fraud? Do some research to find out what caused the initial losses.
5. How could the external auditors, Ernst and Young Shin Nihon, miss the accounting frauds that occurred over seven years? What types of analysis and analytics during the audit process could have uncovered these frauds? Use Appendix D and E to do some comparisons with Toshiba's competitors. (Fiscal year 2014 is not included as the fraud was found during that year so that full year fraudulent statements were not published.) Would this information have helped the auditors find the fraud?
6. What is corporate governance? How can a company's corporate governance structure allow an accounting scandal to continue for seven years and not be found by the company's external auditors?
7. How did the corporate culture within Toshiba allow the accounting scandal to continue for seven years without anyone speaking to governmental oversight authorities or Nikkei governance group? In Appendix E, calculate how much the Sales and Pre-Tax income were under/over stated from one year to the next.
8. Are the fraudster's motives in committing accounting fraud at Toshiba in Japan different from accounting fraud in the U.S.?

Appendix A

Toshiba History from Their Website*

The company got its start back in 1873, when the Ministry of Engineering, responsible for promoting Japan's modernization, commissioned Hisashige Tanaka to develop telegraphic equipment. He built a factory in Tokyo in 1875 to accommodate the growing government orders. This was Tanaka Seizo-sho (Tanaka Engineering Works), one of the forerunners of Toshiba. Separately, in 1878, Ichisuke Fujioka developed Japan's first arc lamp while studying at the Imperial College of Engineering (now the Faculty of Engineering of the University of Tokyo), under the tutelage of visiting professor William Ayrton. At that time, Japan had to import all of its electric lamps. Fujioka established Hakunetsu-sha Co., Ltd. in 1890 to manufacture light bulbs in Japan.

The two firms pioneered the development of electrical equipment in Japan. Tanaka Engineering Works created a waterwheel-powered turbine generator and Hakunetsu-sha developed a radio transmitter. In 1921, Tokyo Denki (Tokyo Electric Company; the name was changed from Hakunetsu-sha in 1899) invented the double-coil electric bulb, later recognized as one of the six great inventions in the history of bulb technology.

The Great Kanto Earthquake of 1923 caused immense damage, leaving over 100,000 people dead. Tokyo Electric Company lost many employees in the disaster. The company's vice-president helped to inspire the reconstruction effort, famously remarking that, "A factory without a research institute is like an insect without antennae." The company actively entered new fields around this time, including medical equipment and radio devices.

Co-members of the Mitsui business conglomerate led by Mitsui Bank, Shibaura Seisaku-sho (engineering works) and Tokyo Electric Company held cross-shareholdings and collaborated in a number of areas. As technology advanced, demand started to grow for home appliances that incorporated the advances made in heavy electrical machinery. The two companies merged in 1939 to form Tokyo Shibaura Denki (Tokyo Shibaura Electric Co., Ltd.). The merged entity already had ambitions to become one of the world's leading electrical machinery manufacturers.

As the World War II intensified, the company grew rapidly by filling state orders for radios, vacuum tubes, and other military supplies, and also producing generators. However, production capacity was crippled by bombing raids targeting factories.

As production recovered in the postwar years, the company focused initially on heavy electrical machinery and then returned to making smaller electrical equipment as reconstruction progressed. New sales subsidiaries were established to strengthen sales capabilities and exports to Southeast Asia began.

Japan's economy was booming by the second half of the 1950s, leading to rapid growth in the heavy electrical machinery, electronics, and communications industries. Sales and profits grew quickly as Toshiba created novel products, developed original technologies, expanded existing factories, and built new production facilities to supply fast-growing markets.

Overseas sales and manufacturing subsidiaries were established to develop the international business. The ratio of overseas sales gradually rose.

The economic downturn following the first oil crisis in 1973 led Toshiba to invest more heavily in RandD, the rationale being that profits were the source of corporate vitality while technology was the driving force behind business development. The expanded RandD organization and higher RandD spending led to many new technologies that were the first in the world or the first in Japan.

Other initiatives to improve production technology, maintain high quality, save labor and shorten delivery lead-times contributed to significantly higher profits.

In 1984, the abbreviated form "Toshiba" replaced Tokyo Shibaura Denki as the company's official name (in English, "Toshiba Corporation" was adopted in 1983).

Economic stagnation in Japan during the 1990s led Toshiba to adopt the "concentration and selection" approach to achieve sustained growth. This involved concentrating resources in sectors with growth potential and new businesses, while selectively promoting growth in mature or declining sectors through reform and restructuring. Toshiba focused resources on semiconductors and expanded the PC business.

In 1999, Toshiba introduced the in-house company system, creating eight in-house companies. Authority was delegated to these in-house companies to give them greater autonomy and promote faster decision-making.

Rapid economic growth in developing countries and sluggish growth in the developed world have led to major changes in economic and industrial paradigms in the 21st century. To prevail amid intensifying global competition transcending national borders, Toshiba continues to focus on restructuring businesses to reinforce their earnings base while seeking to transform its overall business structure by targeting growth sectors and emerging businesses. The aim is to become an even stronger global contender by pursuing the “concentration and selection” approach while creating the world's first and world's number one products and services that are cost-competitive and captivate customers.

*Toshiba Corporation website (1995–2016). <http://www.toshiba.co.jp/worldwide/about/history.html>.

Appendix B

Letter to Shareholders of Toshiba Corporation*

Toshiba Corporation expresses sincere apologies to our shareholders, customers, business partners, and all other stakeholders for any concern or inconvenience caused by issues relating to the appropriateness of its accounting.

Following the September 30 Extraordinary General Meeting of the shareholders, Toshiba now has a new management team in place. Our immediate aims are to regain trust and revitalize the company. We are responding resolutely to the discovery of inappropriate accounting by enhancing internal controls. In October, we initiated wide ranging reforms of our corporate governance, including establishing an Internal Audit Division, and an Audit Committee composed entirely of outside directors. At the board level, we have reinforced oversight of top management and operations by appointing a majority of outside directors. Going forward, we will continue to implement necessary measures, while working to fulfill our social responsibilities through business activities that place the highest priority on human life, safety, and compliance.

In an environment where the only certainty is change at an ever-faster pace, we must overcome many complex problems, including population growth, resource depletion, and the ever-growing need for energy. As we restructure Toshiba Group as a forward-looking, globally competitive organization, we will seek to contribute to society and overcome these issues. We will focus on three main business domains, energy, storage and healthcare, and channel our energy into creating value that our customers need today. We will also grow the seeds that will become next generation solutions, taking advantages of our strengths in hydrogen-based energy systems, in power electronics that can make great contributions to energy saving and other areas.

Through its new organization, Toshiba Group as a whole will make a united effort to regain the trust of its stakeholders, including customers and shareholders and the public. As we do so, I ask for your understanding and ongoing support.

Masashi Muromachi
Representative Executive Officer
President and CE

*Toshiba Corporation (2015c), <http://www.toshiba.co.jp/worldwide/about/message.html>.

Appendix C

Adjustment amounts in the Investigation (by consolidated fiscal year)*

Delegated Item (100 million JPY)	Item	FY 2008	FY 2009	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014	Total
		Annual	Annual	Annual	Annual	Annual	Annual	Q1-Q3	
Percentage-of- Completion Method	Sales	(40)	(0)	53	(2)	(30)	(73)	(37)	(128)
	Pre-Tax Income	(36)	1	71	(79)	(180)	(245)	(9)	(477)
Parts Transactions ¹	Sales	-	-	-	-	-	-	-	-
	Pre-Tax Income	(193)	(291)	112	(161)	(310)	(3)	255	(592)
Recording of Operating Expenses ²	Sales	-	-	-	(3)	2	(5)	(15)	(21)
	Pre-Tax Income	(53)	(78)	(82)	32	(1)	30	64	(88)
Semiconductor Inventory	Sales	-	-	-	-	-	-	-	-
	Pre-Tax Income	-	(32)	(16)	(104)	(368)	165	(5)	(360)
Total	Sales	(40)	(0)	53	(5)	(28)	(78)	(52)	(149)
	Pre-Tax Income	(282)	(400)	84	(312)	(858)	(54)	304	(1,518)

¹ Total amount of revisions related to parts transactions of the Visual Products Business and the PC Business.

² Total amount of revisions related to recording of operating expenses of the Visual Products Business and the PC Business.

*Independent Investigation Committee for Toshiba Corporation. 2015. *Investigation Report summary version*. July 20. (17–18) Available at:

https://www.toshiba.co.jp/about/ir/en/news/20150725_1.pdf

Appendix D

Comparison of Unadjusted Toshiba Pre-Tax Income and Sales to Competitors Panasonic and Fujitsu

(Millions JPY)		2008	2009	2010	2011	2012	2013
Toshiba* (unadjusted)	<i>Sales</i>	7,404,300	6,512,700	6,291,200	6,398,500	6,100,300	6,502,500
	<i>Pre-Tax Income</i>	258,100	(261,500)	34,400	195,500	152,400	180,900
Panasonic**	<i>Sales</i>	9,068,928	7,765,507	7,417,980	8,692,672	7,846,216	7,303,045
	<i>Pre-Tax Income</i>	434,993	(382,634)	(29,315)	178,807	(812,844)	398,386
Fujitsu***	<i>Sales</i>	5,330,865	4,692,991	4,679,519	4,528,405	4,467,574	4,381,728
	<i>Pre-Tax Income</i>	109,444	(113,314)	112,706	102,236	66,717	(45,113)

* Toshiba. 2012. Annual Report. Year ended March 31, 2012 Financial Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2012/tar2012e_or.pdf

*Toshiba. 2014. Annual Report. Year ended March 31, 2014 Operational Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2014/tar2014e_or.pdf

** Panasonic Corporation. 2012. Annual Report 2012. For the year ended March 31, 2012. Available at:
https://www.panasonic.com/global/corporate/ir/pdf/panasonic_ar2012_e.pdf

**Panasonic Corporation. 2013. Annual Report 2013 For the year ended March 31, 2013. Available at:
https://www.panasonic.com/global/corporate/ir/pdf/panasonic_ar2013_e.pdf

*** Fujitsu. 2012. Limited Annual Report 2012. Available at: <http://www.fujitsu.com/downloads/IR/annual/2012/all.pdf>

*** Fujitsu. 2013. Limited Annual Report 2013. Available at: <http://www.fujitsu.com/downloads/IR/annual/2013/all.pdf>

Appendix E

Toshiba's Unadjusted and Adjusted Sales and Pre-Tax Income

(Millions JPY)			2008	2009	2010	2011	2012	2013
Toshiba	Unadjusted*	<i>Sales</i>	7,404,300	6,512,700	6,291,200	6,398,500	6,100,300	6,502,500
		<i>Pre-Tax Income</i>	258,100	(261,500)	34,400	195,500	152,400	180,900
	Adjusted**	<i>Sales</i>	7,208,835	6,373,020	6,137,689	6,263,990	5,996,414	5,722,248
		<i>Pre-Tax Income</i>	254,542	(336,059)	(14,342)	201,785	61,427	74,926

* Toshiba. 2012. Annual Report. Year ended March 31, 2012 Financial Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2012/tar2012e_or.pdf

*Toshiba. 2014. Annual Report. Year ended March 31, 2014 Operational Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2014/tar2014e_or.pdf

** Toshiba. 2012. Annual Report Year ended March 31, 2012 Financial Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2012/tar2012e_fr.pdf

**Toshiba. 2015d. Annual Report Year ended March 31, 2015 Financial Review. Available at:
https://www.toshiba.co.jp/about/ir/en/finance/ar/ar2015/tar2015e_fr.pdf