TOSHIBA: A SHORT CIRCUIT IN CORPORATE CULTURE

Case overview

Toshiba is a Japanese electronics company with humble beginnings as a factory in 1875. Through years of growth, Toshiba now offers a wide array of products and services, ranging from home appliances to medical equipment. However, in July 2015, Toshiba's questionable accounting practices were brought to light by an anonymous whistleblower. It was revealed that the company had overstated its profits by ¥151.8 billion between 2008 to 2014, a move driven in part by the performance-driven company culture. The objective of this case is to allow a discussion of corporate governance issues such as the impact of company culture; responsibilities of various stakeholders; effectiveness of corporate governance reforms; and whistleblowing policies.

Toshiba: Corporate culture gone wrong

"I deeply apologise to all stakeholders for causing all these problems."
– Hisao Tanaka, CEO of Toshiba Corporation[1]

This is the abridged version of a case prepared by Daniel Zheng, Nirmal Selvam, Xu Hao Yu, Cheong Song Yu and Koh Tien Leng Jeremy under the supervision of Professor Mak Yuen Teen. The case was developed from published sources solely for class discussion and is not intended to serve as illustrations of effective or ineffective management or governance. The interpretations and perspectives in this case are not necessarily those of the organisations named in the case, or any of their directors or employees. This abridged version was edited by Nick Wee under the supervision of Professor Mak Yuen Teen.

Hisao Tanaka, the then-CEO of Toshiba Corporation, expressed his remorse with a 15-second bow of contrition at a news conference in Tokyo for the accounting scandal that Toshiba had found itself embroiled in. Tanaka and vice chairman Norio Sasaki – former president of the company – stepped down on 21 July, 2015. Board Chairman Masashi Muromachi would take over the position of interim CEO as the company looked to regain public trust and investor confidence through reviewing and reforming its entire corporate governance structure.[2]

The accounting scandal dealt a huge blow to Prime Minister Shinzo Abe's efforts to attract more foreign investments through sweeping corporate governance reforms. Toshiba's overstatement of profits by ¥151.8 billion (US$1.22 billion) between April 2008 and March 2014, as well as Hisao Tanaka's departure, left Muromachi with the gargantuan task of restructuring Toshiba's corporate culture and revitalising the company.[3]

History of Toshiba

Toshiba was founded in 1875 when Hishagake Tanaka built a factory, Tanaka Seizo-sho (Tanaka Engineering Works), in Tokyo to develop telegraphic equipment.[4] Separately, Ichisuke Fujioka developed Japan's first new arc lamp in 1878 and established Hakunetsu-sha Co. Ltd in 1890 to manufacture light bulbs.[5] As co-members of the Mitsui zaibatsu, led by Mitsui Bank, Shibaura Seisaku-sho (Shibaura Engineering Works) and Tokyo Electric Company merged to form Tokyo Shibaura Denki in 1939, amidst growing demand for home appliances that incorporated the technological innovations in heavy electrical machinery. Tokyo Shibaura Denki was officially renamed Toshiba Corporation in 1983.[6] Toshiba rode the post-war Japanese expansion in the 1950s, creating many novel products and developing original technologies. It also established overseas sales and manufacturing subsidiaries to develop its international businesses. As of 2015, Toshiba provided a wide range of products and services including semiconductors, consumer electronics, home appliances, medical equipment and infrastructure.

The investigation

In February 2015, the Securities and Exchange Surveillance Commission ordered an inspection of Toshiba's projects that used percentage-of-completion accounting after receiving anonymous reports about accounting irregularities.[7] Realising the gravity of this issue, Toshiba set up a special investigation committee on 3 April, 2015. Chaired by board chairman Masashi Muromachi, the committee's focus was to further investigate the accounting issues.[8]

On 8 May 2015, Toshiba redacted its earning guidance and announced the scrapping of its year-end dividend payout. This was due to the committee's decision that the investigation would be widened to other non-percentage-of-completion projects. Subsequently, improper accounting was found to have been used in some of its other projects. The group had previously projected a 136% gain in net profit to ¥120 billion (US$1 billion) for the fiscal year ended in March and a 3% gain in sales to ¥6.7 trillion.[9]

The investigation was then passed to an independent committee, consisting of a panel of professionals including Koichi Ueda, the former superintending Prosecutor of the Tokyo High Public Prosecutors Office, and Taigi Ho, the former Deputy Chairman of the Japanese Institute of Chartered Accountants.

In June 2015, shareholders demanded a total management overhaul[10], which was sparked by Toshiba's plunging share price. The company then proposed to reappoint all 16 board directors, including four outside directors.

On 20 July 2015, the independent investigation committee identified ¥152 billion of inflated profits since 2008, detailing various "institutional" accounting malpractices.[11]

Rising tides leading to impossible "challenges"

In 2008, the global financial crisis caused stock markets worldwide to plunge. In 2011, Japan experienced one of the most devastating earthquakes in history, which caused extensive damage in north-eastern Japan. Furthermore, Japan's household electronics industry faced tremendous challenges for two decades due to the rise of low-cost competitor firms in Asia, such as Samsung and LG. This rising competition caused Toshiba's sales to take a hit, and put pressure on the board and management to take on more aggressive strategies.[12]

In the wake of these growing pains, Toshiba's situation became very difficult due to the dire state of the Japanese economy. Unrealistic targets known as "Challenges" were set by top management. In 2013, top management insisted on the achievement of these "Challenges" despite the weak global and domestic economy. Business Units (BUs) were threatened with possible shutdown, and had to intentionally overstate their profits in order to meet the "Challenges".[13] This resulted in a culture which prioritised the achievement of "Challenges" above all else.

The damaged pride in Toshiba

According to Sustainalytics, a financial research firm for investors, Japanese companies had the "lowest average governance ranking of developed markets, in line with the lowest levels of board independence and gender diversity."[14] Noting this, the Japanese government drafted a new code of corporate governance as part of Prime Minister Shinzo Abe's efforts to restructure the corporate governance landscape and bolster international investors' confidence in the country in order to boost economic growth.

For many years, Toshiba was lauded as one of the frontrunners for corporate governance in Japan. The company was said to be the embodiment of corporate strength in Japan. Even when the new code was introduced in June 2015, Toshiba had already satisfied many of the guidelines. For example, the new code recommended at least two independent directors on the board, and Toshiba already had four such directors since 2006. As such, the Toshiba scandal placed a huge dent in the government's corporate governance reform efforts, seeing as how one of its leading firms on corporate governance was implicated in such a scandal.

Management apathy and "tyranny"

The findings by the independent committee indicated that there was ineffective management monitoring in Toshiba. Top management were aware that there was "intentional overstating of apparent current-period profits, and the postponement of recording expenses and losses." Despite the knowledge of certain BUs needing to overstate their profits to meet the targets, top management continued to impose strict "Challenges", which only exacerbated the corporate culture of "meeting Challenges by any means necessary".

It was also found that there was a "lack of awareness and knowledge among top management about appropriate accounting treatment."[15] It was noted in some projects that the BU heads and even the president himself who carried out the accounting treatment did not have sufficient knowledge of accounting standards that are generally accepted as fair and appropriate. They understood the basic accounting principles (for example, in this case, they knew that they needed to record provisions), but did not know the exact appropriate accounting treatments.

Unwatched watchdogs: Inefficient *Kansayakus*

The investigation of Toshiba also highlighted the failure of supervisors, particularly that of the *Kansayaku* (Japanese for auditors) who did not operate efficiently. This was attributed to inadequate internal controls. For example, despite being aware of inappropriate conduct going on (e.g. selling a higher volume of parts than required to original design manufacturing), the audit committee's (AC) Chairman, CFO Makoto Kubo, failed to take any action. Even his predecessor, then CFO Tomio Muraoko, did not take any action despite having knowledge.

This behaviour was not limited to the CFOs. On 26 January 2015, even when AC member Seiya Shimaoka resurfaced accounting issues relating to their PC business (which was supposedly resolved in September 2014), no action was taken. This was the case after Shimaoka's repeated requests, even to executive officers like Hisao.

The way the internal audit was conducted was also questionable.[16] The main focus of the internal audit function within Toshiba was not to evaluate internal controls, risk management and governance processes, but rather, to inspect the efficiency of the operations.

Additionally, Toshiba's AC members did not have finance or accounting knowledge. A majority of the AC members, including the external AC members and supporting staff, were not trained or equipped with the requisite knowledge to discover inappropriate accounting treatments. Only the former CFOs had such knowledge, but these creative accounting methods were not discovered.[17]

Inappropriate performance measures?

Toshiba evaluated its employees and officers based on performance. For example, a typical executive officer compensation package consisted of base pay and bonus. Between 40% to 45% of the bonus was based on the officer's performance. Together with the aggressive "Challenges" that made attaining the target almost impossible through normal means, it caused management to eventually succumb to pressure and manipulate figures to meet the targets.

A culture of not challenging "challenges"

These incidents revealed that at the heart of Toshiba's corporate culture was a reluctance of employees to defy superiors and a very strong hierarchical system within the company. As a result, aggressive and unachievable "Challenges" set by top management were not challenged by employees and unethical methods were subsequently used. Furthermore, Japanese society is very hierarchical, and Japanese are also known to be very loyal to the company they work for.[18] Thus, when targets are set, it is common for employees to want to satisfy top management by any means necessary. Employees would also not challenge top management due to their strong cultural inclinations.

No wind from whistleblowers

The investigation report showed that Toshiba had a weak whistleblower system in place. Despite having reports made on other issues, there had been no employee complaints prior to the incident. Consequently, the committee "surmised that the whistle-blower system has not been sufficiently used for some reason".

Muromachi-ing ahead: What's next for Toshiba

In July 2015, nearly two thousand shareholders turned up at an investor meeting outside Tokyo to voice their concerns to the new management. Part of Toshiba's action plan focused on the correction of past accounting irregularities. These would be carried out by Toshiba's independent investigation committee and Ernst & Young ShinNihon LLC, the company's previous auditors. Toshiba also announced the creation of new divisions and emphasised the strengthening of the company's governance and internal controls.[19]

However, experts remained skeptical of Toshiba's ability to overhaul its corporate governance. The company's reform of the management team was seen as superficial on account that three members of the previous board of directors were re-appointed.

In October 2015, according to The Japan Times, Toshiba planned to carry out litigation against the former executives to recover compensation in order to cover expenses required for the investigations as well as to restore reputation to the company.[20] It was argued that even if the company did not file lawsuits against the executives within sixty days of the proposal, shareholders could look to directly sue the former executives on behalf of the company under Section 847(1) of the Japanese Companies Act.[21] Court intervention was seen to be unavoidable.

In early November 2015, Toshiba announced that it had officially sued five former executives, including former presidents Hisao Tanaka, Norio Sasaki, Atsutoshi Nishida, and two other CFOs. The lawsuit, filed at the Tokyo District Court, came after an outside panel of three lawyers found that the five individuals had neglected their duties, citing the improper accounting practices.[22]

In its efforts to recover from the scandal, Toshiba decided to focus its restructuring on its semiconductor business, the sector in which current president Masashi Muromachi had built his career.[23] In light of this restructuring, Muromachi seems to display the resolve needed to lift Toshiba from the scandal. However, the effectiveness of the company's efforts to restore its tattered reputation and regain public trust remains to be seen.

Discussion questions

1. Identify potential weaknesses in the corporate governance of Toshiba that may have contributed to the accounting problems. To what extent did Toshiba's corporate culture contribute to the scandal?

2. Do you think all three CEOs should be held responsible for the incident? Besides the CEOs, who else do you think is responsible for the scandal? Why?

3. Prime Minister Shinzo Abe had just embarked on corporate governance reforms for Japan, with a new corporate governance code effective from 1 June 2015. With regards to Toshiba, do you think that such a new code of corporate governance would be effective? Why?

4. Toshiba had implemented a whistleblower system which was well utilised until the scandal occurred. Why do you think the whistle-blower system lost its effectiveness for this particular incident? What steps should a company like Toshiba take to ensure that its whistle-blower system continues to operate effectively?

Endnotes

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