Lessons from the recent Toshiba problem

By

Ramki

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The extent of the scam

• Expected hit estimated at $1.2B to $1.6B

• Some reports suggest it could be as high as $3.2 B
Was a star in Corporate governance!

- 140 years old Company
- Very reputed
- Shares in every pension fund of Japan
- In varied businesses like Nuclear power, Laptops/PC, Infrastructure, Chip making, Televisions etc
- **Met or surpassed new set of Corporate Governance guidelines brought in last year by Japanese Govt.**
- 4 outside directors (quarter of total no.) –twice the norm!
- One of the earliest to admit outside directors in Board
- One independent director was a Morgan Stanley banker and another University professor of repute
  - Satyam also had a great Board and stars in it!
How it surfaced?

• Whistle blowing
• SESC (Securities exchange surveillance committee) launched investigation
• By an external panel of lawyers and accountants
• Result- 82 page summary of findings
The scam –details

• Accounting gimmicks and short cuts in all divisions of the company
• Intentional inflation of profits
• ‘Institutional accounting malpractices’
• Over 6 years!
• Initial estimates were around 50B yen and now over 170B yen (Profit for last year 51B yen)
• Biggest scam in Japan after Olympus (in 2011 spread over 13 years)
  – Read Lessons from recent Olympus problem 29.11.11
Areas of accounting problems

- Percentage of completion estimates wrong/inflated in infrastructure projects
- Despite rise in material costs and loss due to exchange rate fluctuation, adequate reserves not created
- Losses in construction contracts not recorded in timely manner
- Under-stating /deferring reporting of costs
- Failing to book appraisal/valuation losses
- Less loan loss allowances
- Deferred tax assets overstated
- Medical subsidiary Toshiba medical info. Systems also overstated results for many years
Reason

• Due to recession and Fukushima disaster, sales and profits were under huge pressure
• As demand fell for products, pressure built up to show better sales and profits, from bosses
• Corporate culture where it was impossible to go against the wishes of the bosses.
• Pressure also from clients who were Government linked projects
What went wrong?

• Two out of four independent directors diplomats with no commercial experience

• Past CEO/CFO’s had a huge say in Company
  – “Biggest cause that ruins Japanese companies is Governance led by former executives”

• Past CFO’s were audit committee chairman

• Rivalry between key top management people leading to employees falling into 2 factions that blamed each other
Was top management involved?

• Suspected systematic involvement by top management
• Top management pressurized executives to meet increasingly difficult profit goals
• Instead of telling executives to cook the books they told under performing divisions such as TV, that they may withdraw from the business if targets were not met.
Auditors

- Ernst & Young Shin Nihan, Japan
- Insufficient explanations were provided to auditors
- Japanese Institute of CPA’s reviewing files and interviewing auditors
  - They can
    - admonish, suspend or expel auditors and
    - Impose penalties
The impact

• Share value has come down by 25% since Apr 15
• Hisao Tanaka –CEO resigned along with 7 other officials
• Half of the board removed
• Mar 15 accounts not yet finalized (may take upto Aug end)
• Dividend suspended
• Cost to insure debt has jumped by 62 basis points
• Company bonds downgraded to lowest investment grade
  – Big blow to PM Shinzo Abe who is campaigning for Corporate Governance reform
Lessons

• Corporate governance can not ever be legislated
• Corporate governance rules, Jsox etc. can be easily followed or even surpassed without any visible results
• Governance led by former executives is a joke
• Quality and not quantity of directors counts
• Corporate culture should allow employees to show dissent to bosses
• Scams do not happen overnight
  – But once you ‘mount the tiger’ there is no looking back!
• Auditors need to show much more skepticism?
• Whistle blowing works! (Thank God something works!)
Sources

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