

**Toshiba Accounting Scandal**

The summary below has been compiled from the Investigation Report<sup>1</sup> into the accounting scandal published in July 20, 2015 and various news articles<sup>2</sup>.

Founded in 1938, Toshiba Corporation is a Japanese multinational conglomerate corporation headquartered in Tokyo, Japan. Its diversified products and services include information technology and communications equipment and systems, electronic components and materials, consumer electronics, household appliances, medical equipment, office equipment, lighting and logistics.

In 2010, Toshiba was the world's fifth-largest personal computer vendor and the world's fourth-largest manufacturer of semiconductors, based on revenues.

On July 21, 2015 its CEO announced his resignation amid an accounting scandal in which the company overstated profits by 151.8 billion yen (\$1.2 billion) over a seven year period. Eight other senior official also resigned, including the two previous CEOs who were still working at the company in different roles.

The scandal primarily related to understating of costs on long-term projects, a lack of internal controls and a corporate culture driven to inflate profits.

Upon investigation, it became apparent that Toshiba CEOs put pressure on subordinates to meet sales targets after the 2008 global recession. The pressure often came right before the end of a quarter or fiscal year, which pushed employees to postpone losses or bring forward sales.

Subordinates received no explicit instructions from the CEOs. Instead, top management set impossible targets and relied on a Japanese corporate culture of obedience and loyalty that led people lower in the hierarchy to do whatever it took to meet them.

The aggressive targets created a vicious circle with divisions manipulating accounts to meet targets as a result of being fearful of downsizing if they didn't. As a result of "meeting" the targets, they were given even tougher goals for subsequent years.

An investigation into the scandal revealed that most of the inappropriate accounting issues were not discovered by the external auditor. Internal accounts staff skillfully utilized complex accounting treatments to create a situation where obtaining corroborative evidence proved extremely difficult. In addition, in response to questions and requests for information from the external auditor, facts were hidden and the substantiating information that was provided intentionally created a very different picture from the actual facts.

The inaccurate accounting treatment related to long term projects which used valuation techniques, such as the percentage of completion method, that involve estimates based on internal data prepared by an expert with specialist knowledge. These techniques made it very difficult for an external auditor to independently evaluate the adequacy of estimates. Evaluations were thus premised on the effective functioning of internal controls designed to ensure appropriate estimates are used.

A whistleblower system existed at Toshiba which, during the period under review, received dozens of reports annually. None of these reports concerned the accounting treatments under scrutiny. A

---

<sup>1</sup> [https://www.toshiba.co.jp/about/ir/en/news/20150725\\_1.pdf](https://www.toshiba.co.jp/about/ir/en/news/20150725_1.pdf)

<sup>2</sup> WSJ, USA Today, Bloomberg, Economist, Fortune, CNN, Reuters, The Guardian.

whistleblower system can be considered the last line of defense in the internal control process. As no reports were filed relating to this case and very few reports filed at all (given the number of staff employed), it could be inferred that Toshiba staff did not trust the system or perhaps were not even aware it existed.

The inappropriate expectations of senior management ultimately resulted in the organization preventing the controls' effective functioning. An opportunity thus arose to conceal key facts from the external auditors and undertake inappropriate operations. The investigation noted that, in such circumstances, it is very difficult for an external auditor to obtain evidence to contradict explanations provided by a company.

The scandal surfaced less than two months after Japan adopted its first corporate governance code. Prime Minister Shinzo Abe made changes in corporate governance a key theme in his attempt to revive the Japanese economy, hoping such changes would attract more outside investors.

The drive to improve corporate governance had largely focused on increasing profitability, rather than preventing fraud. Japanese companies have long been seen to tolerate low profits, by putting off painful decisions such as closing down or selling money-losing divisions, in the name of social harmony. The code was intended in part to change that tendency by making managers more accountable to investors.

The new governance code requires roughly 2,400 publicly traded companies in Japan to appoint at least two independent outside directors and to curtail the practice of cross-holdings<sup>3</sup>. Superficially, Toshiba met or surpassed most of the code's provisions - four of the 16 Toshiba directors came from outside Toshiba.

In Japan, most company board members know the company and the employees intimately and their allegiances are to people inside the company. An independent investigation commission into the scandal found that the Toshiba board had been headed by longtime Toshiba insiders, a situation, it concluded, potentially contributed to the accounting problems.

A 2010 survey by the GMI Ratings research firm ranked Japan 36<sup>th</sup> in the quality of corporate governance out of 39 developed and emerging economies.

---

<sup>3</sup> Cross-holdings is a practice where companies buy and hold each other's shares. Cross-holdings can strengthen relationships and stabilize share prices but can also discourage activist shareholders.