The US$1.2 billion profit padding discovered at Toshiba is an embarrassing blow to the Japanese government’s reform plans. Stakeholders tell George W. Russell that even though many hallmarks of corporate governance are lacking, this latest scandal will add momentum to changes already afoot.

Illustrations by Takeo Chikatsu

It is a Japanese ritual that seems as familiar as a tea ceremony: a top executive bows to an assembled media conference, ticks off his company’s wrongdoings and resigns or, more likely, fires a scapegoat.

Recent years have seen several large Japanese corporations – from cosmetics maker Kanebo to brokerage Nikko Cordial, and machinery giant IHI to optical equipment manufacturer Olympus – admit to fraudulent accounting or profit manipulation. Last month, it was the turn of the biggest corporate name yet – Toshiba.

After months of speculation, Toshiba in May appointed a third-party committee to look at mounting allegations of fraud. The report, released on 21 July, found that Toshiba had engaged in improper accounting that resulted in US$1.2 billion of inflated profits and extended to almost every business unit of the sprawling conglomerate.

Chief Executive Officer Hisao Tanaka and other executives quit while Toshiba expects to take at least US$2.4 billion in charges and writedowns over the scandal. Chairman Masashi Muromachi will lead the company as interim CEO on 10 percent of his previous salary.

That scandal should envelop such a venerable corporation was a further blow to corporate Japan’s prestige. “Toshiba was considered one of the frontrunners of corporate governance reform initiatives among listed companies in Japan,” says Ken Kiyohara, Partner at the Jones Day international law firm in Tokyo, whose practice includes advising on corporate governance and compliance.

Japan’s accounting profession is also under scrutiny. The Japanese Institute of CPAs, a Global Accounting Alliance member, says it had begun an investigation into EY ShinNihon’s auditing practices for Toshiba. JICPA Chairman and President Kimitaka Mori says the institute would review accounting standards and procedures. “We may [also] look into issues pertaining to enhancing corporate governance,” he adds.

The Toshiba scandal is also an embarrassment to Japan’s government, led by Prime Minister Shinzo Abe, who had trumpeted better corporate governance as part of his economic revitalization platform. Announcing a government probe of Toshiba on 22 July, Finance Minister Taro Aso said that without “appropriate” corporate governance, Japanese companies would “lose the market’s trust.”

Japan’s first formal Corporate Governance Code went into effect on 1 June and while many companies pre-empted the rules by adding independent directors and improving transparency, Toshiba had fallen by the wayside in several metrics, such as the composition of its audit committee (See Audit committee under scrutiny on page 13).

In addition, the government last year introduced its Stewardship Code, in which about 200 institutional investor signatories engage in dialogue with companies and are encouraged to question governance and transparency.
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Blowing the whistle

Aspects of the Toshiba case are reminiscent of the Olympus scandal in 2011. The fraudulent accounts were a legacy of previous management teams – decades in the case of Olympus, several years for Toshiba’s – and both were brought to light by whistleblowers leaking data.

Since 2009, Toshiba had been setting unrealistic goals for business units. Senior managers had to manipulate figures to appear to meet their targets, investigators said in their report.

Long-held suspicions about Toshiba padding profits were strengthened when news emerged earlier this year that an anonymous email pointing to accounting malpractices had been sent to the Securities Exchange and Surveillance Commission, Japan’s major corporate watchdog.

“There have been activities amounting to incorrect accounting in Toshiba’s infrastructure-related business,” the email read, according to a translation by Nikkei. Media speculation initially focused on the identity of the whistleblower, concluding it was likely to be a woman within Toshiba, acting on her own and who was not a trained accountant or lawyer.

“Culturally, it is not easy for an employee of a Japanese company to blow the whistle – even though it might be considered to be a right thing to do under the circumstances – for fear of negative consequences,” says Kiyohara at Jones Day. “Without such reporting to the SESC, this incident may not have come to light.”

Furthermore, Japan’s whistleblowing rules are complex: if an employee reports wrongdoing to the company and is ignored, then goes to the authorities, legislation will offer protection against any retribution. That protection does not apply if the employee goes straight to the authorities.

“Whistleblowing in the West is seen as a positive force,” says Michael Woodford, the former Olympus CEO who was sacked after drawing attention to the company’s attempt to hide US$1.7 billion in losses. “I believe most reasonable people will accept that whistleblowing is something to be nurtured. Immediate change is needed to ensure that whistleblowers are given the confidence to speak out without fear of adverse repercussions.”

Corporate governance experts counter that no country has an overt whistleblowing culture. Even the United States, considered the vanguard of whistleblower protection, had to include financial rewards for informants into its Dodd–Frank legislation of 2009.

“The U.S. Securities and Exchange Commission has 10 people to man a whistleblower hotline,” points out Nicholas Benes, Representative Director of the Board Director Training Institute of Japan and a leading corporate governance advocate. Its Japanese equivalent provides no such service, he adds.

Institutional issues

After news of the SESC complaint leaked out, Toshiba initially claimed that any possible accounting irregularities were confined to its infrastructure business, and opened a third-party investigation, traditional in Japan under such circumstances.

Unlike Olympus’s third-party investigation, which backed management, the Toshiba probe found evidence of manipulation across the entire corporation. Announcing his resignation on 21 July, Tanaka, the former CEO, claimed he did not tell anyone to falsify accounts but he took responsibility for the company’s shortcomings.

Tanaka’s predecessors as CEO, Norio Sasaki, who served as vice-chairman, and Atsutoshi Nishida, a board adviser, also quit. Two former CEOs holding on to such influential positions is unique to Japan, and created a situation in which the two men passed on their manipulation to the next regime. A similar situation emerged with Olympus, where decisions taken in the 1980s caused enough ripples through the decades to nearly sink the company.

The Toshiba case has put the need for more independent directors in the spotlight. “If Abe really wants
Audit committee under scrutiny

Toshiba was considered a reform pioneer, first appointing independent directors in 2001. But the company’s five-person audit committee – of which two members were former Toshiba executives and two others lacked any business experience whatsoever – was a classic study of Japan’s corporate insider culture that can often create compliant committees under the thumb of management.

Audit committee chairman Makoto Kubo rose to president and chief executive officer of Toshiba Mobile Display Co. and senior executive vice president of Toshiba Corporation in a 40-year career. Lawyer Seiya Shimaoka worked for Toshiba for 36 years, rising to general manager of the legal affairs division.

While the other three members were external directors, only one, Kiyomi Saito, was reasonably well versed in financial matters. Saito, who had previously worked for Morgan Stanley in Tokyo, was a kansayaku, or “corporate auditor,” a uniquely Japanese position referring to someone with a supervisory role over governance matters who does not necessarily hold any qualifications in auditing or accounting.

The other two audit committee members were retired diplomats. Ken Shimanouchi was a former ambassador to China, while Sakutaro Tanino had served as consul-general in Miami and ambassador to Brazil.

Kubo resigned from the committee last month. Hiroyuki Itami, an external director who was most recently dean of the Graduate School of Innovation Studies at Tokyo University of Science, was appointed as the new chairman.

“While the accounting errors probably would have been hard for any audit committee to spot if managers wanted to keep them hidden, this committee composition could not possibly have helped,” says Nicholas Benes, Representative Director of the Board Director Training Institute of Japan.

“Director skill sets matter,” says Benes, a leading transparency advocate who first proposed the Corporate Governance Code to the Japanese government. “Just because you were the ambassador to Brazil does not mean you are fit for the audit committee.”
“I suspect that the Toshiba affair will go down in history as a bump in the road of general upwards progression towards better corporate governance in Japan.”

to make some corporate governance changes, allow minority shareholders, not management, to nominate two independent directors,” says Robert Medd, Partner with GMT Research, a Hong Kong-based strategic investment data consultancy.

Medd adds that large listed Japanese companies tend to be controlled by professional managers who aren’t necessarily shareholders. “They don’t have a meaningful shareholding,” he says. “There is therefore no culture of looking after the shareholders. Promotion and pay are far more important than creating shareholder returns.”

Woodford, the former Olympus CEO, says companies are unlikely to voluntarily undertake wholesale reform of their corporate governance. “Toshiba cancelled their earnings forecast and dividend because of an endemic problem they have with accounting. I’m rather pessimistic about Japan and I think it will get a lot worse before it gets better.”

The flurry of resignations last month caused an initial rebound in Toshiba share price and some observers remain cautiously optimistic about long-term outlook. “Without any new material developments, the company’s current key financial metrics are in line with our present expectations,” says Motoki Yanase, Vice President and Senior Analyst at credit rating agency Moody’s Japan.

“We also expect the financial effects to be mostly trailing historical non-cash impacts,” Yanase adds. “However, we would like to fully understand the company’s plans to avoid a repeat of such a situation and the details of its measures to implement proper controls and appropriate governance.”

**Forcing the momentum**

Some executives are hopeful that the corporate governance issues highlighted by the Toshiba scandal will force authorities to act. “I don’t think the Corporate Governance Code and the Stewardship Code can remove Toshiba-type problems perfectly,” says Shinya Tsujimoto, Chief Operating Officer of Nippon Life Global Investors, the asset management unit of the insurance giant. “But the government might continue to focus on corporate governance and the momentum might be accelerated.”

Questions have been asked about whether gatekeepers, such as the audit committee, internal and external auditors and internal control functions are effective or properly functioning in Japan. “The Japanese Corporate Governance Code does not provide clear details as to what is required of them, unfortunately, and relevant principles are provided only in general terms, such as a list of items to be addressed,” says Kiyohara at Jones Day.

There is a need for reviews and revisions of the code to address gatekeeper roles so that there are specific principles for listed companies to comply with or explain.

“Rules requiring the independence of external auditors are not yet fully developed in Japan,” says Kiyohara, “and the legal framework to ensure the independence of the audit committee should also be tightened.”

Meanwhile, the accounting profession will be watching the JICPA, which will address any issues that might be related to external auditing and submit a report to the
Certified Public Accountants and Auditing Oversight Board, Japan’s independent audit watchdog.

“Depending upon the finding of any deficiencies by the JICPA and the CPA AOB,” says Kiyohara, “the Financial Services Agency [which serves as a secretariat to the Business Accounting Council] might consider initiating discussions about revising the auditing standards to address such issues as it did after the Olympus scandal.”

Benes at the director-training institute, who first proposed the Corporate Governance Code, is also upbeat. “I suspect that the Toshiba affair will go down in history as a bump in the road of general upwards progression towards better corporate governance in Japan,” he says.

Some conclude that a massive cultural shift might first be required in Japan. “A change in the overall corporate governance landscape may help promote a culture in Japanese companies that misconduct, if suspected, is supposed to be addressed and discouraged or stopped sooner rather than later,” says Kiyohara. “This may be achieved if Japanese companies have more non-Japanese employees and a diversity of employees can help facilitate such cultural change.”

"Tōshi" (とうし, 代行) means "investments" in Japanese. As its years of accounting irregularities finally unravelled, Toshiba’s stock took a battering, losing more than 20 percent of its value since May. But in July, shares started to rebound on the release of an independent report and the mass resignation of the company’s leadership.