Toshiba Accounting Scandal
A Case Study in Corporate Governance Failure

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***Abstract*—**This case study examines the 2015 Toshiba accounting scandal. At first glance, the misrepresentation of Toshiba's financial statements appears to mirror recent accounting frauds in the U.S. and India motivated by the avarice of self-indulgent corporate executives. Toshiba's accounting malfeasance, however, resulted from the unwillingness of senior executives to disclose massive losses suffered following the 2008 global financial crisis.

***Keywords*—** Corporate governance, accounting scandals, audit committee.

I. Introduction

In 2015, Japan's Securities and Exchange Surveillance Commission investigated a whistleblower's allegations of Toshiba's use of improper accounting practices in preparing its financial reports. That investigation ultimately revealed that from 2008-2015, Toshiba misrepresented its earnings by $1.2 billion, nearly 40% of its previously reported income. Even more disturbing, the investigation also revealed that the misrepresentation occurred with the full knowledge and complicity of Toshiba's CEO and his two predecessors.

This case study examines the Toshiba scandal vis-à-vis similar accounting scandals at Yamaichi Securities, Seibu Railway, Kanebo Ltd., and Olympus Corporation, each of which occurred after the collapse of Japan's economy in the 1990s. The objective of this analysis is to posit three arguments. First, the Toshiba scandal was not an anomaly, but rather the continuation of a pattern and practice by Japanese corporations to conceal financial losses through fraudulent accounting practices. Second, flaws in Toshiba's corporate governance program, coupled with weaknesses in Japan's accounting profession, resulted in the failure to detect Toshiba's fraud. Finally, attributes of Japan's culture in general, and Toshiba's corporate culture in particular, thwarted prevention of the fraudulent accounting practices by enabling senior executives to influence unethical behavior in the organization free from any concern about opposition from junior employees or punishment if regulators discovered their misdeeds.

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II. The Scandal

In January 2015, Japan's Securities and Exchange Surveillance Commission[1] (the "SESC") received an e-mail from a whistleblower alleging Toshiba's use of inappropriate accounting practices in preparing financial reports for its infrastructure-related business.[2] The allegations prompted the SESC to meet with Toshiba executives to discuss the company's use of the "percentage-of-completion" method to record revenues and expenses for long-term infrastructure contracts.[3] During the meeting, the SESC questioned Toshiba's compliance with generally accepted accounting principles[4] in its use of the percentage-of-completion method. As a result, Toshiba launched an internal investigation which uncovered evidence clearly suggesting a deliberate attempt by senior executives to misrepresent the company's financial performance, not the mere occurrence of accounting errors. Following this discovery, Toshiba appointed an independent panel of attorneys and accountants to conduct an impartial investigation of the company's accounting practices.

After concluding its investigation, the independent panel released an 82-page report which concluded that pressure applied to business units by Toshiba's CEOs to meet unrealistic profit targets, coupled with a corporate culture which discouraged employees from challenging directives from senior executives, influenced managers to misrepresent the financial performance for their units. The panel also determined that weaknesses in Toshiba's corporate governance program hindered the prevention and detection of the fraudulent accounting activities. The panel's report led to the resignation of Toshiba's CEO (Hisao Tanaka) and his two

[1] The SESC is part of the Financial Services Agency, the financial regulatory authority overseeing Japan's banking, securities and exchange, and insurance sectors to ensure the stability of the country's financial system.

[2] The whistleblower's actions were noteworthy because Japan's cultural norms discourage individuals from reporting organizational misconduct, and its laws offer little protection to whistleblowers against retaliatory actions (i.e., threats, acts of physical violence, demotion, termination of employment, etc.).

[3] The "percentage-of-completion" method permits a business to record the revenues and expenses of long-term construction contracts for each year as a percentage of the construction it completes during that year.

[4] Generally accepted accounting principles consist of a common set of accounting principles, standards and procedures that companies must comply with when preparing financial statements.

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predecessors,[5] the resignations of other members of the board of directions, and restatement of Toshiba's financial reports for fiscal years 2008 through 2015. In December 2015, the SESC fined Toshiba Corp a record ¥7.37 billion ($66 million) for its misdeeds, and also fined Toshiba's external auditor ¥2.1 billion ($17.4 million) for failing to detect the fraud when it audited the company's financial statements. A brief analysis of Japan's post-World War II economy highlights some of the factors that motivated Toshiba and other Japanese corporations to falsify their financial reports.

III. Japan's Economy

Following the conclusion of World War II, Japan experienced rapid economic development due to the development of key industrial sectors (e.g., steel and shipbuilding) which powered the country's growth. Exports fueled a 9% annual increase in Japan's Gross Domestic Product (GDP) from 1953-1965. The period between 1985 through 1990 in particular represented a time of unparalleled prosperity during which Japanese companies purchased businesses and real estate in foreign markets, and land and stock prices in Japan rose dramatically (the "bubble economy"). In 1990, however, real estate and stock values plummeted when the stock market crashed. Thereafter, Japan's economy lapsed into a recession which ended four decades of unprecedented growth. Then late in 1997, the Asian financial crisis indirectly caused a banking crisis. As the banking crisis continued into 1998, news surfaced of widespread accounting fraud involving banks attempting to hide their exposure to nonperforming loans.[6]

Japan's economy finally began to rebound in 2001 due to robust automobile exports and by 2007 economists hailed the end of a 20-year period of economic stagnation eventually dubbed "the Lost Score."[7] However, the 2008 global financial crisis battered Japan's economy and crushed economists' optimism as exports declined by 50 percent. Making matters worse for Toshiba, severe damage to the Fukushima nuclear power plant in 2013 caused by a 9.0 magnitude earthquake and ensuing tsunami served as the death knell for the company's ill-fated diversification into nuclear energy as global demand for nuclear energy plunged.[8] The precarious state of Japan's economy following the collapse of the bubble economy provides a backdrop for the analysis of the accounting scandals at Toshiba and four aforementioned Japanese corporations.

IV. Post-Bubble Economy Accounting Scandals

At first glance the Toshiba accounting scandal appears to mirror recent accounting scandals at Enron (U.S.) and Satyam Computer Services (India) where the avarice of self-indulgent senior executives provided the motivation for their nefarious deeds. In contrast, Toshiba's actions emulated a pattern and practice in Japan of misrepresenting corporate earnings to avoid public humiliation for unprofitable operations. As a case in point, Sanyo Special Steel (like Toshiba) inflated its earnings for six years (1959-1965) rather than disclose its insolvency. Following additional bankruptcies in 1965, the Ministry of Finance inspected the financial statements of other companies listed on the Tokyo Stock Exchange and discovered that one hundred sixty-nine companies committed similar transgressions.

The collapse of Japan's bubble economy after four decades of unprecedented growth created even greater pressure on senior executives at previously profitable companies like Toshiba, Yamaichi Securities, Kanebo Ltd., and Olympus Corporation (*see* Table 1, "Comparison of Accounting Scandals") to continue such practices. Japanese corporations in general, overburdened with excess debt and high labor costs, struggled to remain profitable in an economy mired in deflation and economic stagnation,[9] and compete globally against reenergized competitors that increased productivity and reduced costs in the 1990s through innovation. The accounting scandals at Kanebo, Olympus and Toshiba illustrate this struggle because each firm misrepresented its financial performance for multiple financial reporting periods. Some Japanese corporations, like Yamaichi Securities, Kanebo, and Olympus, also suffered significant investment losses resulting from the bubble economy's collapse[10] and used *tobashi* schemes to avoid public disclosure of their losses.

[5] Atsutoshi Nishida, CEO from 2006 to 2009, resigned from his post as a paid advisor to Toshiba. Norio Sasaki, CEO from 2009 to 2013, resigned from his position as Vice-Chairman of the board of directors.

[6] The Asian financial crisis severely affected the economies of Thailand, Indonesia and South Korea. Although the crisis did not directly affect Japan, Japanese banks suffered great losses because they were saddled with $25 trillion dollars of non-performing loans. To foster greater transparency in light of the accounting frauds, Japan's government revised laws related to accounting practices and financial reporting for the financial industry in a reform package dubbed the "Big Bang."

[7] The Lost Score refers to the 20-year period of economic stagnation that followed the collapse of the real estate bubble in late 1991. During the period from 1995 through 2007, Japan's GDP fell from $5.33 trillion to $4.36 trillion in nominal terms.

[8] In 2006, Toshiba bought Westinghouse Electric, a U.S. builder of nuclear plants, for $5.4 billion, but the Fukushima nuclear disaster greatly reduced demand for nuclear facilities worldwide. Consequently, Toshiba's senior executives set aggressive sales and profit targets to try to offset the loss of the revenue they anticipated from the company's investment in nuclear energy.

[9] Deflation, a period in which prices decline, leads to economic stagnation (i.e., a prolonged period of slow economic growth) because falling prices encourage customers to delay purchases for consumer and industrial goods that will cost less in the future. Consequently, businesses struggle to reduce their debts as their revenue decreases.

[10] Investment firms like Yamaichi Securities, for example, orchestrated a *tobashi* scheme to conceal Client A's losses by shifting them between the portfolios of Clients B, C and D to make them disappear from Client A's financial statements.

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V. Factors Contributing to the Toshiba Scandal

Three factors hindered the prevention and detection of Toshiba's accounting malfeasance: (1) an ineffective corporate governance program;[11] (2) weaknesses in Japan's accounting profession; and (3) unique characteristics of Japanese culture in general, and Toshiba's corporate culture in particular. Of the three, the flaws in Toshiba's corporate governance program was the most critical obstacle.

A. Weak Corporate Governance

Many considered Toshiba in the vanguard of the efforts to improve corporate governance in Japan. As a case in point, the Japanese Corporate Network in 2013 ranked Toshiba 9th out of 120 publicly-traded companies in terms of effective corporate governance programs. This perception stemmed from the fact that Toshiba became one of the first Japanese corporations to adopt three of the Cadbury Committee's recommendations[12]: (1) appoint non-executive directors to the board of directors to provide objective judgement regarding a corporation's operation and conduct; (2) create a board-level audit committee to ensure compliance with accounting regulations; and (3) appoint non-executive directors to serve on the audit committee.[13] Three major flaws in Toshiba's corporate governance program, however, militated against the prevention and detection of its accounting fraud. First, Toshiba executives dominated the decision-making of the board as executive directors held fourteen of the eighteen seats on the board. Some academics argue, however, that boards composed of a majority of non-executive directors prove more effective in promoting ethical corporate behavior than executive-dominated boards. Second, the appointment of Toshiba's former chief financial officer to serve on, and worse, chair the audit committee created a blatant conflict of interest as it afforded him the opportunity to influence the approval of financial statements he helped falsify. The Cadbury Committee, however, recommended that only non-executive directors serve on the audit committee to help prevent corporations from falsifying their financial reports. Finally, the majority of the non-executive directors serving on the audit committee lacked not only financial expertise, but also basic business experience. The Cadbury Committee, however, suggested that boards appoint directors with financial backgrounds to the audit committee who could actively participate in discussions regarding the financial issues before the committee.

B. Japan's Accounting Profession

Secondly, the failure of internal and external auditors to detect Toshiba's accounting irregularities comes as no surprise. According to studies published by PricewaterhouseCoopers (PwC) and the Association of Certified Fraud Examiners (ACFE), whistleblowers play a more vital role in fraud detection than internal or external audits[14] due to the fact that audits focus primarily on verifying the accuracy of a corporation's math and the correct application of accounting rules, not fraud detection.

Effective fraud detection requires forensic accountants and fraud examiners trained and experienced in uncovering evidence of fraud. In Japan, however, the number of qualified accountants and auditors pales in comparison to the U.S. and the U.K. They also rank among the worst paid internationally. More importantly, until recently the regulatory body overseeing Japan's public accounting profession rarely instituted enforcement action against certified public accountants that violated regulatory standards when performing an audit. Consequently, little incentive existed for accountants in Japan to perform thorough and accurate audits.

C. Japanese Culture and Toshiba's Corporate Culture

Finally, three attributes of Japan's culture in general, and Toshiba's corporate culture in particular, permitted senior executives to influence unethical behavior free from concern that junior employees might raise objections. First, Japan's culture places great emphasis on intra-group harmony. Group members implicitly understand the importance of not revealing unflattering information regarding the group or its members because their self-esteem is inextricably linked to the group's success. Unfortunately, this may persuade group members to remain silent regarding "questionable" conduct, especially if they believe that the motivation for such conduct was to protect the group's best interests. Second, white-collar criminals in Japan rarely serve time in prison as punishment for their crimes.[15] Executives typically receive a suspended sentence in the rare instance where a court convicts a defendant of committing a white collar crime. Accordingly, the lack of severe punishment for such criminal behavior provides little incentive for senior executives to adhere to ethical and legal standards in managing their organizations. The accounting scandals in Table 1 clearly illustrate this point

[11] Corporate governance refers to systems and controls implemented to minimize the commission of any misdeeds that could harm a corporation's reputation, brand and stakeholders.

[12] In 1991, U.K. officials created the Cadbury Committee to improve corporate governance standards.

[13] The audit committee is arguably the most important committee in an effective corporate governance program. The audit committee's primary responsibility is to ensure both the accuracy of a company's financial statements and the adequacy of internal controls designed to prevent accounting malfeasance.

[14] PwC in 2007 published a study of over 5,400 companies in 40 countries that concluded that whistleblowers account for 43% of the fraud detection, corporate controls account for 34% and law enforcement officers account for 3%. The ACFE's 2017 study found that whistleblowers account for more than 34% of the detection of corporate fraud while 25% of frauds are detected by accident.

[15] Japan's criminal justice system does not severely punish criminal behavior, especially not for white-collar crimes. Statistics indicate that less than 5% of defendants convicted of crimes serve time in prison and the few who do seldom serve more than five years.

as none of the executives at these firms served any prison time for their misdeeds. In contrast, former Enron Corp CEO Jeffrey Skilling and former Satyam CEO Ramalinga Raju are serving 14-year and 7-year prison sentences, respectively, for participating in the accounting frauds at their firms. Third, the corporate culture in Japan in general, and at Toshiba in particular, require lower-level employees to show great deference to senior executives. Such deference, therefore, discourages lower-level employees from questioning directives from senior executives or their decisions.[16] Thus, when Toshiba's CEOs demanded that business units meet aggressive profit targets, lower-level employees faced little choice but to comply with their demands. For some managers, this meant misrepresenting the financial performance for their business units, even if doing so contravened their personal ethical standards.

VI. Conclusion

Accounting irregularities such as those witnessed in the Toshiba scandal present a major threat to the viability of global financial markets. Misrepresentation of corporate financial performance destroys trust in the financial markets because financial statements provide critical information investors need to intelligently evaluate investment opportunities. Effective corporate governance programs, however, help ensure that corporations prepare their financial statements with accuracy and integrity. The fact that Toshiba's internal auditors, external auditor and audit committee failed to detect the company's accounting malfeasance for six years necessitates yet another clarion call for regulators to implement strict corporate governance standards and for courts to severely punish corporations that fail to comply.

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[16] The Olympus accounting scandal provides an excellent illustration of the potential consequences of failing to display such deference. In that case, the board of directors fired Michael Woodford, the first non-Japanese CEO in the company's history, after he challenged the chairman of the board and the company's group president **about the authenticity of advisory fees pain in connection with suspicious business acquisitions that the board approved before he became CEO. Woodward reported Olympus' misdeeds to law enforcement and regulators after his termination.**

TABLE 1: COMPARISON OF ACCOUNTING SCANDALS

	YAMAICHI SECURITIES	**SEIBU RAILWAY**	**KANEBO**	**OLYMPUS**	**TOSHIBA**
Year Founded	1897	1894	1887	1919	1939
Year Of Scandal	1997	2004	2005	2011	2015
What Happened	Firm secretly reimbursed clients for huge investment losses. Also paid bribes to a "sokaiya"[17] to prevent public disclosure.	Paid bribe to a "sokaiya" to prevent disclosure that shareholders owned more than 80% of the firm.	New owners discovered former managers misrepresented the company's financial performance by ¥215B ($1.6B) from 2000-2002.	Overstated earnings by ¥200B yen over a 5-year period to conceal over ¥134.8B ($1.7B) in investment losses dating back to the 1990s. Paid bribes in the form of advisory fees to hide the losses.	Overstated earnings by ¥136B ($1.2B) from 2008 through 2015 to conceal losses caused by the 2008 global financial crisis.
Motivation For The Accounting Fraud	To conceal losses due to reimbursing clients for investment losses.	To conceal violation of Tokyo Stock Exchange ownership rule.	To conceal losses.	To conceal investment losses.	To conceal losses (e.g., losses from diversification into nuclear energy).
How The Fraud Was Uncovered	Police found evidence of the bribes.	Police found evidence of the bribes.	Investigation initiated by new management.	Whistleblower (its former CEO)	Whistleblower
Weakness In Corporate Governance Program	No non-executive directors. Board of directors comprised only of senior executives.	No non-executive directors. Board of directors comprised only of senior executives.	No non-executive directors. Board of directors comprised only of senior executives. External auditor was complicit in the fraud.	Only 3 of 15 board members were non-executive directors. One non-executive directors had no business experience and another had a conflict of interest with the company.	Only 4 of 18 board members were non-executive directors and its former CFO chaired audit committee. Only 1 of 3 non-executive committee members had a financial background.
Regulatory Fine	None	Seibu paid ¥200M and parent company paid ¥150M.	None because the company's former management committed the accounting fraud.	¥700M ($7.6M)	¥7.6B ($60M)
Criminal Punishment	Two former executives received suspended jail sentences.	Former CEO received suspended jail sentence.	Three former executives received suspended jail sentences.	Three former executives received suspended jail sentences.	No criminal charges filed against former executives.

[17] Sokaiya extort money from companies by threatening to disrupt their annual shareholder meetings by publicizing the sexual and financial improprieties of their management.