JAPAN'S CORPORATE GOVERNANCE LANDSCAPE

The Case of Toshiba Corporation

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INTRODUCTION

Toshiba Corporation is a world leader and innovator in pioneering high technology, and a manufacturer of advanced electronic and electrical products and systems. Toshiba operates a global network of more than 550 companies, with approximately 188,000 employees worldwide and annual sales of 5.7 trillion yen ($50.2 billion). The multibillion dollar company has a history spanning back over two centuries; however, recently it has been in the "hot seat" for being entangled in a variety of scandals ranging from improper accounting to bankrupt powerhouses.

Toshiba's troubled year has simply brought to light systematic problems, which many Japanese firms face.

Previous crises of this scale, such as the infamous Olympus or Kanebo scandals, could have been passed off as company specific, but Toshiba serves the role of an exemplar of corporate Japan. Its problems are Japan's problems (*The Financial Times, 2017*). Almost every issue revolving around Toshiba's crisis is one that stems from a failure of corporate governance. The corporate hierarchy in Japan has consistently failed to grasp that better corporate governance makes for better companies. With the entangled web connections covering financial institutions, pension funds and their government support, known as *keiretsu*, comes the risk of systemic contamination. Many investors and observers speculated that, were Toshiba to file for bankruptcy in Japan, the government would quickly come to its rescue. Furthermore, Japan's aversion to foreign entities having voting stakes in Japanese companies makes for a less transparent corporate culture. While Japanese traditional and conservative values remain important in both public and private spheres, the corporate culture in Japan ought to be challenged with necessary reforms sooner or later, if Japan's corporations aspire to remain relevant among international investors.

Setting Toshiba's crisis aside for a moment, it becomes easy to see that the more important issue at heart of the bigger picture is that of the absent long-due reform in Japanese Corporate Culture. As some investors know well, the issue about which overseas clients care more about than any other in Japan is progress on corporate governance reform. This is a topic that the current administration, led by Shinzo Abe, has claimed to be one of the many goals in his structural reform 'Abenomics' plan. Since the introduction of Japan's *Stewardship Code* in 2014, and its first-ever corporate governance code the following year, prime minister Abe has battled to convince Japan and the world that it has not only identified the problems with stock investment in Japan, but that it also has meaningful solutions. The domestic audience has proved more difficult to sway than the foreign investors, which is maybe why the corporate governance reforms that should spring from the Japanese firms itself, has been slow to materialize. By October 2016, the Stewardship Code had been adopted by just one non-financial corporate pension fund. Governance advocates admitted the figure was demoralizing, given the government's three yearlong efforts to persuade companies across industries to back the code. To understand why corporate governance practices are lagging behind in Japan compared to the Western corporate world, it is valuable to take a look at the mounting problems of Toshiba Corp., the archetypical Japanese firm.

BRIEF HISTORY OF COMPANY

Toshiba was originally founded back in 1875, when the Ministry of Engineering commissioned Hisashige Tanaka to develop telegraphic equipment. Throughout the years the company developed, and officially adopted the name “Toshiba” in 1984, replacing “Tokyo Shibaura Denki”. Economic stagnation in Japan during the 1990s led Toshiba to adopt the ‘*concentration and selection*’ approach to achieve sustained growth; concentrating resources in sectors with growth potential and new businesses, while selectively promoting growth in mature or declining sectors through reform and restructuring. In 1999, Toshiba introduced the in-house company system, creating eight in-house companies. Since 2000, Toshiba aims to continue to focus on restructuring businesses to reinforce their earnings base while seeking to transform its overall business structure by targeting growth sectors and emerging businesses.

BOARD STRUCTURE

As of July 1, 2017, Toshiba’s Board of Directors comprises of the following Directors:

Directors			
	**Satoshi Tsunakawa** President and CEO		
	**Yasuo Naruke** Corporate Senior Executive Vice President		
	**Masayoshi Hirata** Corporate Executive Vice President		
Outside Directors			
	**Teruko Noda**		**Yoshimitsu Kobayashi**
	**Kouichi Ikeda**		**Ryoji Sato**
	**Yuki Furata**		**Shinzo Maeda**

JAPANESE CORPORATE GOVERNANCE CULTURE

Corporate Governance in Japan differs from the Anglo-American model. The Japanese model is characterized by a high level of stock ownership by affiliated banks and companies. A banking system that is characterized by strong, long-term links between bank and corporation, a legal, public policy and industrial policy framework designed to support and promote what is known as “keiretsu”. *Keiretsu* represents industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity. In the Japanese model, boards of directors are composed almost solely of insiders, and a comparatively low (in some corporations, non-existent) level of input of outside shareholders. Equity financing is important for Japanese corporations. However, insiders and their affiliates are the major shareholders in most Japanese corporations. Consequently, they play a major role in individual corporations and in the system as a whole. The interests of outside shareholders are marginal. The little influence of outside shareholders is caused and exacerbated by complicated procedures for exercising shareholders’ votes. The Japanese system of corporate governance is many-sided, centering on a main bank and a financial/industrial network or keiretsu. The main bank system and the keiretsu are two different, yet overlapping and complementary, elements of the Japanese model. Almost all Japanese corporations have a close relationship with a main bank. The main bank is generally a major shareholder in the corporation. Comparatively, in the US, anti-monopoly legislation prohibits one bank from providing this multiplicity of services. Instead, these services are usually handled by different institutions: commercial bank - loans; investment bank - equity issues; specialized consulting firms - proxy voting and other services.

CORPORATE GOVERNANCE

The Board of Directors has adopted “Corporate Governance Guidelines[1]” that form the framework of governance of the Company. These Guidelines are subject to laws and regulations as well as the Articles of Incorporation but take precedence over other internal rules.

These Guidelines set forth the Company’s basic views and systems regarding corporate governance in order to achieve the sustainable growth and mid- to long-term increase of corporate value of the Company Group, thereby contributing to the interests of all stakeholders, such as investors, employees, customers, and the community at large.

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1 https://www.toshiba.co.jp/about/ir/en/governance/pdf/corporate_governance_guidelines.pdf

FINANCIAL OVERVIEW

	YTD	2016	2015	2014	2013	1Y	3Y	5Y
Share Price	2,55	2,42	2,32	4,28	4,20	20,0%	-24,7%	-27,1%
Total Shareholder Return (1Y)	6,1%	132,3%	-50,5%	17,9%	33,5%	63,8%	-20,2%	40,6%
ROE	-228.6%	-228,6%	-47,5%	9,1%	29,4%	-181,1%	-237,6%	-239,4%
EPS	-2,08	-1,99	-1,37	0,24	0,17	-67,1%	-1.671,8%	-837,1%
Net Income (mln)	-4.586	-4.395	-5.790	916	989	13,0%	-679,6%	-479,2%
Operating Margin	-20,7%	-20,7%	-4,1%	6,1%	5,4%	-16,6%	-26,1%	-24,3%
EBITDA (mln)	-7.848	-7.521	-503	5.066	5.233	-1.613,6%	-287,5%	-252,2%

INAPPROPRIATE ACCOUNTING

In recent years Toshiba has been under public scrutiny regarding an accounting scandal that led to the resignation of its Chief Executive Officer, and initiated a range of necessary reforms within the company. On July 20, 2015, an Independent Investigative Panel (hereinafter, 'the Panel') released a report describing the accounting improprieties in detail.

Improper accounting techniques were found to have been employed in various divisions within the company throughout the period of seven years.

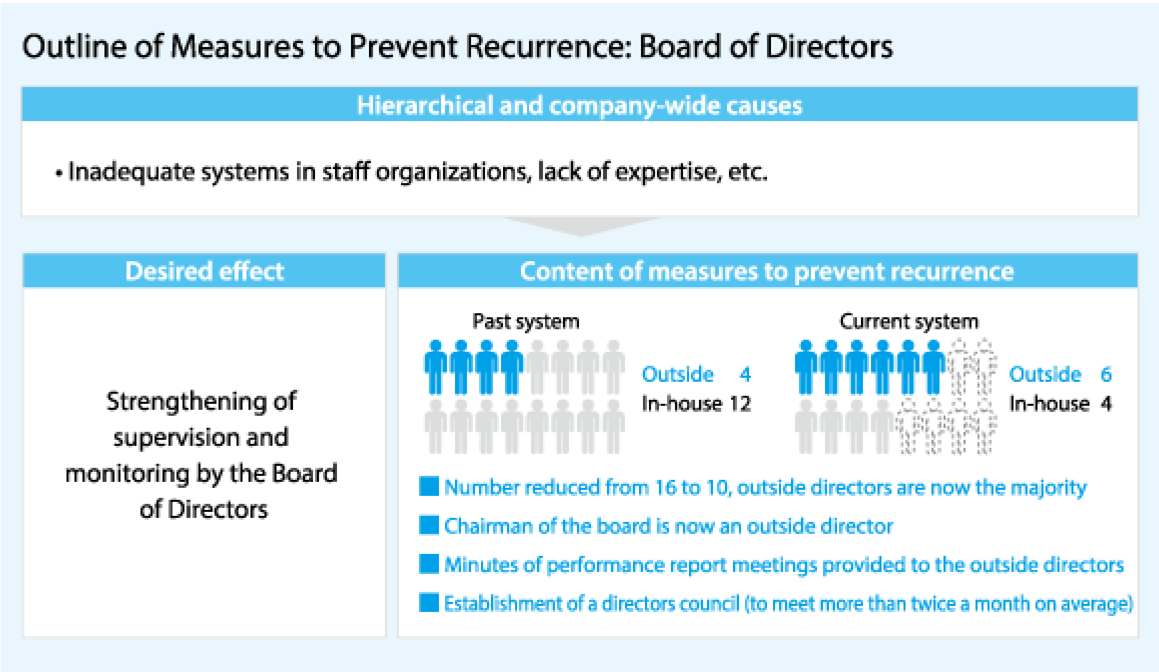
The following day, the CEO Hisao Tanaka resigned. Investigators found direct evidence of inappropriate accounting practices such as overstated operating profits in multiple business units, amounting to a total of $1.2 billion. The report stated that the misconduct began under CEO Atsutoshi Nishida in 2008, and continued unabated under the next CEO, Norio Sasaki, until it surfaced under Tanaka.

The 334 pages report provides a detailed description of the direct and indirect causes of such inappropriate accounting treatment concerning different projects. The Panel describes how Toshiba's corporate leadership handed down strict profit targets (known as *Challenges*) to business unit Presidents, often with the implication that failure would not be accepted. This is closely tied to the prevailing corporate culture in Japan, where obedience to superiors is often demanded and there are few, if any, whistleblowing policies in place. The panel concluded that Toshiba's rigid corporate culture was an important factor enabling the emergence of fraudulent practices. The investigative panel also pointed to weak Corporate Governance and a poorly functioning system of internal controls at every level of the Toshiba conglomerate. Internal controls in the finance division, the corporate auditing division, the risk management division and in the securities disclosure committee did not function properly to identify and stop the inappropriate behaviors.

Toshiba's corporate governance prior to the scandal was not considered problematic by Japanese market standards. The company voluntarily switched to a Western-style system of a one-tier board with three committees. The internal audit committee comprised of independent members. However, as part of Toshiba's modification of the committee structure, the head of the audit committee was an inside director. The committee chairman did not proceed with repeated requests to review certain accounting treatments when submitted by the other members; as the former CFO of the company, the chairman presumably knew of these accounting irregularities.

RECENT REFORMS

Current CEO and President, Satoshi Tsunakawa, has stated that in response to the accounting problem, Toshiba initiated wide ranging reforms of their internal controls and corporate governance in 2015. These included establishing an Internal Audit Division, and an Audit Committee composed entirely of outside directors. At the board level, they reinforced oversight of top management and operations by appointing a majority of outside directors. The company also issued an apology on their Investor Relations website, stating that they are promoting recovery from the events that deeply impacted their results and undermined stakeholder trust with a new business structure. They split off three of their in-house companies, and will soon split off the fourth, and Toshiba Group will work to restore credibility with its stakeholders.



Source: Toshiba Corporation Investor Relations

FINANCIAL COMPLICATIONS

Another main concern for the company recently has been the financial collapse of its Westinghouse Electric nuclear business. Westinghouse filed for Chapter 11 bankruptcy on March 29, 2017 after facing cost overruns amounting to billions of dollars at four nuclear reactors under construction in Pittsburgh, U.S. Westinghouse has 12,000 employees globally, including 4,500 in the Pittsburgh region. Costs for the project soared due to increased safety demands by U.S. regulators, and Toshiba declared $9.8 billion of Westinghouse-related liabilities. Toshiba posted an operating loss of 576.3 billion yen ($6.9 billion) for the nine months ended December 31, 2016, and said it had negative shareholders' equity of 225.6 billion yen, but, it was not able to get auditor PricewaterhouseCoopers Aarata to approve those figures. The company took an unusual step in reporting third quarter earnings without the approval from its auditors, after twice delaying publication. The collapse of Westinghouse Electric endangers the future of Toshiba itself, which risks being delisted from the Tokyo Stock Exchange (TSE) in case it fails to repair the damaged balance sheet by March 2018.

Toshiba has initiated a bidding process to sell off its memory chip unit, prized at $18 billion, in order to recover from said losses. The sale has encountered a fair share of complications, most notably the litigation initiated by Toshiba's partner with whom it has a joint venture, Western Digital. Western Digital, an interested buyer in Toshiba's chip unit, took matters to a California Court after Toshiba chose as its preferred bidder a consortium backed by the Japanese government, claiming that Toshiba needed Western Digital's permission to finalize the sale of the chip unit. The consortium consisted of Innovation Network Corporation (INCJ), the Development Bank of Japan, U.S. fund Bain Capital and South Korean chipmaker SK Hynix Incorporated. Due to the complications arising from the litigation, investors are becoming increasingly uneasy and pressuring Toshiba to find alternative buyers. It remains to be seen what the verdict coming from San Francisco's Court is going to be, however, Toshiba is in no position to sustain a long, expensive legal battle.

LATEST DEVELOPMENTS

August has been an eventful month for Toshiba, which on August 10th met the postponed deadline for submitting its delayed financial results for fiscal year 2016, avoiding immediate delisting from the Tokyo Stock Exchange for now, after gaining partial approval from its auditor. PwC LLC has issued an "opinion with qualifications" for Toshiba's annual earnings report, meaning the figures are presented fairly overall and that only minor problems exist. However, the auditor also issued an "adverse opinion" on Toshiba's internal controls, since the company overlooked massive losses related to its now-bankrupt U.S. nuclear unit. Less than a week later, Toshiba Corp.'s talks to sell its chip business to a consortium led by Bain Capital stalled over the timing of payments for business and governance issues. The Bain group wants to make cash payments after Toshiba resolves its legal dispute with partner Western Digital Corp., while Toshiba prefers to receive the payment earlier. Toshiba President Satoshi Tsunakawa said that the company would hold talks with other possible purchasers because it hadn't been able to reach final terms with the Bain group — which had been designated the preferred bidder. On August 24th, Toshiba Corp. held intensive talks with partner Western Digital Corp. on the planned sale of its memory chip operations, hoping to reach an agreement by the end of the month. The following day, Toshiba decided to pick a Western Digital Corp.-led group as the preferred bidder for its chip unit. Toshiba has thus ended negotiations with a Japan-U.S.-South Korean consortium. Western Digital is set to offer 150 billion yen through convertible bonds and will not seek voting rights in the business. It seems like Toshiba solved one of its major problems last minute, however systematic problems will require long-term solutions and will not go away with a 'quick fix' like a settlement. If the Tokyo Stock Exchange deems Toshiba's corporate governance insufficient, the company could still face potential delisting of its shares.

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ABOUT US

DirectorInsight is a specialist provider of data analytics and intelligence on the "G" of ESG. We help corporations, institutional investors, financial institutions and professional services firms to efficiently and effectively manage the increasing challenges they face in reviewing and addressing corporate governance risks and associated decision-making. DirectorInsight provides an integrated web-based, data technology solution, to independently analyze data on the value creation and governance practices of leading listed companies across the globe, in a single convenient solution. **Please contact us on +31 (0) 20 416 0662 or visit our website when you would like to obtain further information or a demo.**