

Toshiba and the Myth of Corporate Governance

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Abstract

On paper, Toshiba had a very well-organized system of corporate governance, and was one of the few Japanese companies to embrace a “three-committee structure” system of management that is prevalent in the U.S. Nevertheless, lack of diversity in the workforce, failure to check a series of autocratic CEOs, and regulations which discourage investors from joining forces to champion an agenda led to the downfall of the company.

Toshiba has been a model for corporate governance in Japan. For more than a decade, independent directors have made up a quarter of its board. In 2003, long before the country’s corporate governance code was introduced, the company adopted a U.S.-style board structure with separate committees, meant as a form of check and balance, to oversee compensation, nominations, and auditing.

Yet none of this protected the electronics-to-nuclear conglomerate against grave mismanagement by its top executives. The initial scandal at Toshiba surfaced in 2015, when it was found to have overstated operating profits by close to \$1.2 billion over several years. Three successive chief executives apparently placed immense pressure on subordinates to achieve unrealistic sales targets and asked no questions about how their goals were met. The company was also found to have failed to account for more than \$100 million in losses related to the construction of a nuclear power plant in Florida by U. S. subsidiary Westinghouse Electric. The wrong numbers have only multiplied since then.

How did things go so awry? First, shareholders were mostly silent, and those few who attempted to raise issues were ignored. In most other developed markets, engaged shareholders, and activist funds in particular, would have joined with multiple stakeholders to mount a challenge to the company’s increased focus on nuclear power. Watchful trustees

would almost have certainly questioned squirrely accounting. But like many other established Japanese companies, Toshiba was protected by a block of silent shareholders.

Much attention has been paid to the gradual decline of cross-shareholdings among Japanese companies and their local lenders. In many cases, those shares have been transferred to other group companies, customers, or suppliers. This has simply resulted in the transfer of shares from one loyal, silent shareholder to another.

In the case of Toshiba, more than 305 of its shares as of March 2016 were held by friendly banks and other companies, representing a significant shield from market discipline for management. A major proxy advisory company recommended that investors vote against Shigenori Shiga's appointment as Toshiba chairman in 2016, given his role at Westinghouse during the years that accounting irregularities occurred, yet very few shareholders acted on this advice.

For more than a few decades, activist funds have long been viewed as unwelcome vultures who seek to disturb the harmony of Japanese society. Toshiba's governance failure is evidence that this stereotype needs to be challenged.

A few foreign minority shareholders questioned Toshiba's heightened focus on nuclear power, but these concerns were ignored. Unfortunately, Japanese securities regulations discourage such investors from forming a group to press their concerns on management.

Pension funds are the ultimate long-term disinterested investors. They should be encouraged to join forces to champion more transparency and accountability from the companies they are invested in. Current Japanese rules discouraging shareholder cooperation were made to address concerns of insider trading and hostile takeovers, but should be modified as the U.K. has done to allow investors to act as responsible fiduciaries and raise their voices jointly when things look to be going awry.

The second point of failure for Toshiba was that nobody inside the company spoke up. Japan's lifetime employment system normally sees job security exchanged for loyalty to the boss and demands deep respect for hierarchy. The CEO's authority is often unquestioned. According to an internal company review, Toshiba's employees felt unable to challenge management's order to delay booking Westinghouse's losses.

As is the tradition with Japanese companies, midcareer hires from outside are rare. Fresh sets of eyes joining the company after experience elsewhere might have helped shine a light on some of Toshiba's practices. Two of the four independent directors on Toshiba's board at the time the accounting scandal emerged were found to have little background in finance and accounting, making it even more difficult for them to mount challenges.

At Toshiba, like many Japanese companies, former CEOs have remained involved after retirement as advisers to the company. While they do not participate at board meetings, their very presence serves to discourage any questioning of actions taken in the past.

Toshiba is proof that good corporate governance is not defined by the number of independent directors and oversight committees; it is about the commitment of senior management to promoting an environment where active debate and questioning is both encouraged and respected.

However, as Japan's Financial Services agency has noted frequently and forcefully, governance is more about substance than form. The tendency of companies to pay lip service to corporate governance is certainly not limited to Japan. But the country has a special vulnerability in this area, given the insularity that characterizes its companies. For this reason, engaged investors are especially important as long as internal checks and balances remain weak.

Japan's recent adoption of a corporate governance code as well as a stewardship code for institutional investors are important and significant steps. A more fluid workforce, the empowerment of managers of foreign operations, better protection for whistleblowers, and an end to the practice of keeping retired executives as unofficial advisers will also increase oversight and bring fresh ideas and innovation.

Activism, particularly of the sort practiced by pension funds whose objectivity and long-term investment horizon are indisputable, should be welcomed. The decision, announced by the Financial Services Agency on May 29, to require signatories to the stewardship code to disclose their voting record on corporate agenda items may shame silent shareholders into being better fiduciaries. But the real key to effective governance is the existence of a dialogue inside and outside the company, a tolerance for disagreement, and a respect for a diversity of opinions as well as of people. These must come from the very top.

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<http://asia.nikkei.com/magazine/20170622/Viewpoints/Alicia-Ogawa-Japanese-boards-must-learn-to-hear-no>