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TOSHIBA'S WESTINGHOUSE DILEMMA[1]

Eden Ip wrote this case under the supervision of Professors Vaughan Radcliffe and Mitchell Stein solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

In October 2017, Munenori Ohtani, managing director at Ohtani Capital (Ohtani), faced a critical decision regarding the firm's investment in Toshiba Corporation (Toshiba). Toshiba had just submitted its updated securities report to the Tokyo Stock Exchange (TSE) for evaluation, in the hope of once again preventing its involuntary delisting from the TSE, which would have serious consequences for the company and its share price. While Ohtani had been a long-time shareholder of Toshiba, recent events surrounding Toshiba's profitability, internal management, and possible delisting from the TSE had led the firm to consider divesting its holdings.

Once the corporate darling of Japanese industry, Toshiba had just endured a year of losses and multiple flirtations with delisting[2] and was struggling to regain public trust following a 2015 accounting scandal. Toshiba's problems had worsened over the summer as a result of a disagreement between the company and its auditor, PricewaterhouseCoopers Aarata LLC (PwC Aarata), over how best to report Toshiba's writedown of its US nuclear power unit, Westinghouse Electric Co. LLC (Westinghouse). Toshiba had selected PwC Aarata as its new accounting auditor in 2016 following the fallout of a 2015 accounting scandal,[3] which had resulted in Toshiba ending its 60-year relationship with its previous auditor, Ernst & Young ShinNihon LLC, which had failed to detect US$1.3 billion[4] in inflated profits over seven years.[5]

While Ohtani remained committed to Toshiba's efforts to reform its practices after the 2015 scandal, continuing problems over the writedown of Westinghouse suggested that Toshiba's corporate governance issues remained unresolved.

ORIGINS OF TOSHIBA

From humble beginnings in a small telegraphy equipment shop in 1875, Toshiba was the embodiment of Japan's industrial growth and was long considered a blue-chip Fortune 500 global corporation. The present-day company was founded in 1939 as part of a merger between Tokyo Electric Company and Shibaura Engineering Works.[6] Toshiba's growth expanded exponentially during the 1980s and 1990s, as the Japanese government encouraged domestic innovation through low-interest loans, subsidies, and artificial limits on external competition. By the early 2000s, Toshiba was a leader in electronics, holding large market shares in flash memory, laptops, and computer chips. However, Toshiba's lustre began to fade as low-cost competitors from competing Asian countries began offering rival products at lower prices, leading to declining revenue in Toshiba's PC (personal computer) division (see Exhibit 1). The failure to innovate, ill-timed investments, and the fallout from the Great Recession left Toshiba and its Japanese electronic counterparts lagging significantly behind its competitors. By 2015, Toshiba had begun to follow the paths of Sanyo, Hitachi, and Fujitsu in divesting many of its former core business lines, leaving the company a shell of its former self.[7]

THE 2015 SCANDAL

Toshiba's accounting and governance troubles first began in February 2015 when an anonymous whistle-blower alerted Japan's Securities and Exchange Surveillance Commission of concerns regarding the company's accounting methods relating to infrastructure projects.8 The company would eventually acknowledge the deceptions in April 2015, establishing a special independent committee to conduct an internal investigation into the issue. The independent committee concluded that a series of inappropriate accounting entries had overstated profits from 2009 to the third quarter of 2014 across Toshiba's entire business line, with the personal computer (PC) division accounting for more than a third of the inflated profits.[9] The fraud had commenced under Toshiba's chief executive officer (CEO), Atsutoshi Nishida, in 2008, in the middle of the global financial crisis, which had drastically reduced Toshiba's profitability. The recording of losses or charges were pushed back to subsequent quarters, which further intensified Toshiba's sales targets within its various divisions in the following period.[10]

Most concerning was the committee's determination of systemic fraud, as all levels of management were actively involved in the profit manipulation with a lack of internal controls to stop the malpractice. In the report filed with the TSE, the investigators placed blame directly on a corporate culture that "avoided going against superiors' wishes."[11] Top management presented challenges to the division presidents, putting immense pressure on subordinates to meet their goals and thereby emboldening lower-level managers to engage in inappropriate accounting practices. The report also noted the top-down culture of the organization created an expectation that all workers exhibit blind loyalty to superiors without question, which led to illegal accounting practices being unreported. With an organization-wide focus on profit, the systemic nature of employees to manipulate earnings made it impossible for whistle-blowers or existing control systems to prevent such practices. As a result of the scandal, CEO Hisao Tanaka, Vice-Chairman Norio Sasaki, and eight board members resigned amid the public backlash.[12]

ATTEMPTS AT RECOVERY

Following the 2015 scandal, Toshiba pledged to reform its corporate governance and internal control structures.[13] Satoshi Tsunakawa, a senior vice-president who had joined Toshiba in 1979, was promoted to president and CEO in 2016. Tsunakawa had been credited with growing the medical equipment division into a prominent profit centre and had avoided any involvement with the scandal. Under Tsunakawa's leadership, Toshiba initiated broad corporate governance and management control improvements such as establishing an internal audit division and an audit committee consisting of only outside members.[14] Furthermore, in an effort to increase oversight, Toshiba's board of directors was overhauled to feature a majority of independent directors. Despite the reforms, controversy surrounded the hiring of Shigenori Shiga as the new chairman alongside Tsunakawa. During Shiga's previous tenure as the chairman of Westinghouse, he had allegedly overseen inappropriate pressures on subordinates to fabricate impairment losses, an offence that Toshiba had failed to flag.[15]

Toshiba also continued to face financial problems on multiple fronts as the company struggled to recover its reputation (see Exhibit 2). The company posted a $6.3 billion loss for 2016,[16] with dwindling cash reserves forcing the company to sell assets, including profitable divisions such as its growing memory-chip business.[17] Due to the restrictions imposed by the TSE, Toshiba was also unable to raise cash by issuing additional shares, leaving little option for emergency funding outside of private equity or third-party investment. In March 2017, credit agency Standard & Poor's dropped Toshiba's rating to CCC−, the third downgrade in three months, citing concerns of "a growing likelihood that Toshiba will become unable to fulfill its financial obligations in a timely manner or undertake a debt restructuring we classify as distressed in the next six months."[18] The final insult came in August 2017 when the TSE removed Toshiba from Japan's benchmark Nikkei 225 index to the secondary index after the company lost more than 45 per cent of its market value, an embarrassing decline for a once bludgeoning giant.[19]

GOING NUCLEAR

Contributing further to Toshiba's troubles was a sudden downturn in its nuclear power business, which had initially held out great hope for the company's future.[20] As Toshiba's electronics business struggled to adapt to the influx of Chinese and South Korean competitors in the early 2000s, it started to build a portfolio within the booming nuclear power industry. In 2006, Toshiba acquired, for $5.4 billion, American-based Westinghouse, which specialized in constructing nuclear power facilities.[21] The acquisition broadened Toshiba's existing energy portfolio from maintaining domestic power plants to constructing and operating contracts globally.

The 2011 nuclear meltdown at the Fukushima Daiichi Nuclear Power Plant immediately dampened worldwide demand for nuclear power and caused a temporary shutdown of all nuclear facilities within Japan. Soon Westinghouse began to struggle financially as countries shifted toward natural gas as the fuel of choice. Despite these concerns, Toshiba's managers continued to set ambitious profit targets across Westinghouse in hopes of mitigating the losses with new business.[22] Compounding the struggle was the decommissioning and recovery costs Toshiba was responsible for in Fukushima, which pushed the company's ambitious profit targets out of reach. Initial problems within Westinghouse began to surface as early as the 2015 accounting scandal, when Toshiba failed to account for $100 million in losses stemming from a nuclear plant construction project in Florida; these concerns, however, were ignored.[23]

PROBLEMS AT WESTINGHOUSE AND RUN-INS WITH THE TOKYO STOCK EXCHANGE

In February 2017, amid mounting losses, Toshiba finally announced a writedown of its Westinghouse nuclear power business for ¥712.5 billion,[24] resulting in a provisional ¥500 billion loss for the nine months ended December 31.[25] News of the writedown and troubles with Toshiba's nuclear business led to a plunge in Toshiba's stock price and the resignation of Shiga, who took responsibility for the writedown.[26] Westinghouse would file for Chapter 11 bankruptcy in the United States in March, with Toshiba declaring losses of more than $6 billion, which were expected to rise to $10 billion.[27] The writedown erased $7 billion in market value with a negative ¥150 billion in shareholder equity.[28] Particularly concerning was knowing that if the company failed to solve its excessive debt and negative net worth problems by its next fiscal year-end (March 2018), the TSE's delisting penalty would be automatically triggered based on the TSE's delisting criteria (see Exhibit 3).[29]

Stemming from the fallout of the 2015 accounting scandal, the TSE had first placed Toshiba on its "Securities on Alert" list in 2015, citing that "improvement of the internal management system, etc. of the company was highly necessary."[30] A company placed on this list was required to file a report one year after its placement on the list demonstrating improvements within its internal controls systems. Failure to improve conditions could result in a decision to delist. The TSE rejected Toshiba's 2016 report on improvements to its internal management system but opted to grant Toshiba an extension, in an effort to avoid a delisting. However, in March 2017, the TSE placed Toshiba on its "Securities under Supervision

(Examination)" list, requesting a resubmission of improvements for evaluation, with a subsequent decision on whether to delist the company's stock at a future date.[31]

SUMMER 2017—A DISPUTE WITH THE AUDITORS

Of the world's "Big Four" accounting firms, PwC held the smallest market share of the Japanese market, which made its assumption of Toshiba's accounts both a risk and an opportunity. It represented a gamble for the firm, which hoped to expand its Japanese presence and foster an image of a "tough auditor capable of asking clients the hard questions."[32]

This new image of a tough auditor was tested throughout the first half of 2017 as a result of a disagreement over PwC Aarata's concerns that losses stemming from Toshiba's Westinghouse unit, which were posted in October–December 2016, had been known by Toshiba as early as 2015 and accordingly should have been reported in 2015.[33] PwC Aarata demanded a probe to determine the correct period to record the losses. After Toshiba failed to convince PwC Aarata that no evidence could be found to support Toshiba being aware of the losses in 2015, despite an internal investigation, Toshiba decided to file its April–December 2016 earnings report, which had already been delayed, without an opinion from PwC Aarata.[34]

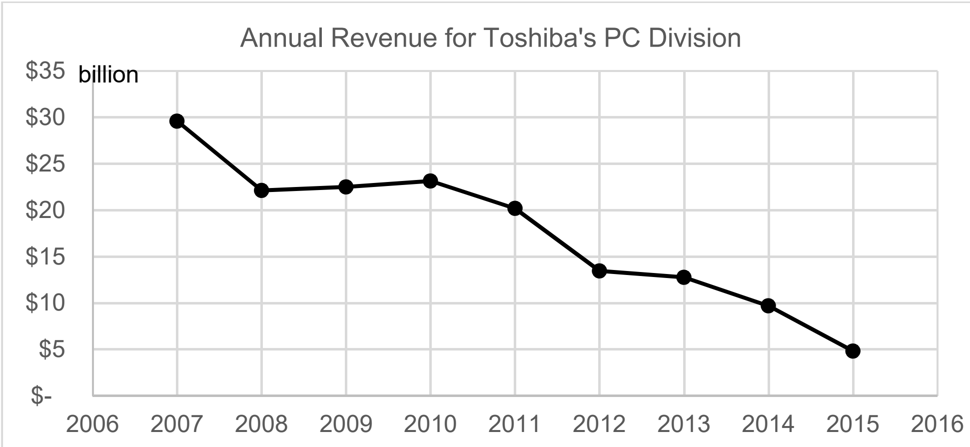
The dispute also led to a delay in the filing of Toshiba's annual report and even to talk that PwC Aarata was considering expressing no opinion on Toshiba's 2016 annual report.[35] The issue was contentious for both parties, as having two consecutive years with negative net worth (i.e., liabilities exceeding assets), which would have occurred if the losses had been booked according to PwC's opinion, or the issuance of an adverse opinion from PwC, would have resulted in Toshiba meeting the TSE's criteria for delisting (see Exhibit 3).[36] The disagreement reached a critical point when Toshiba executives began identifying replacements for PwC Aarata[37] and went as far as threatening legal action in an attempt to find an auditor willing to sign off on its financial statements.[38]

After the TSE granted a series of deadline extensions, Toshiba and PwC Aarata were finally able to reach a settlement, allowing for the filing of the company's annual securities report for 2016 in August 2017. The auditor agreed to provide a qualified opinion on Toshiba's 2016 and first quarter 2017 financial reports.[39] However, PwC Aarata unilaterally issued an adverse opinion on Toshiba's corporate governance and internal controls stemming from the handling of the Westinghouse losses.[40] While this two-pronged opinion was not as conclusive as either a single qualified or adverse opinion, the decision appeared to, once again, allow Toshiba to at least temporarily avoid delisting.

THE DECISION

While Toshiba had made improvements to its internal controls, PwC Aarata's adverse opinion on the matter cast doubt on whether the internal management concerns raised by the TSE had been fully resolved. If the TSE found that Toshiba had not sufficiently improved its internal management, a hard-line stance by the TSE to possibly delist Toshiba would set a precedent for the future of corporate governance in the country and was bound to face a sharp reaction from the government. If the TSE eventually decided to delist Toshiba, it would be difficult for the company to secure the emergency funding necessary to survive. Toshiba could also face automatic delisting if it failed to recover from its negative net worth by the following year. Toshiba faced a difficult path to recovery but had likely weathered the worst of the scandal with a potential return to profitability in sight. With the TSE's decision regarding improvements in Toshiba's internal management looming, Ohtani had to make his decision soon. Was Toshiba's internal management and financial situation concerning enough to warrant dropping the company, or was there still a glimmer of hope for Toshiba?

EXHIBIT 1: ANNUAL REVENUE FOR TOSHIBA'S PC DIVISION



Note: PC = personal computer
Source: Adapted by the case authors with information from "Annual Revenue for Toshiba's PC Division," The Atlas, April 26, 2017, accessed October 17, 2019, www.theatlas.com/charts/SklqX4R0g.

EXHIBIT 2: TOSHIBA'S FINANCIAL INFORMATION, 2013–2017 CONSOLIDATED STATEMENTS OF INCOME, TOSHIBA CORPORATION (IN ¥ BILLIONS)

Net Sales, Operating Income (Loss) and Net Income (Loss)	2013/3	2014/3	2015/3	2016/3	2017/3
Net sales	4,786.1	5,527.4	5,699.1	5,154.8	4,870.8
Cost of sales	3,739.5	4,149.4	4,373.7	4,403.3	3,576.5
Selling, general, and administrative expenses	986.6	1,116.7	1,159.2	1,187.2	1,006.6
Operating income (Loss)	60.0	261.4	166.2	−483.0	270.8
Income (loss) from continuing operations, before income taxes and noncontrolling interests	43.5	191.7	140.4	−399.4	225.5
Income taxes	33.9	90.7	133.1	246.4	105.6
Net income (loss) attributable to shareholders of Toshiba Corporation	13.4	60.2	−37.8	−460.0	−965.7

Note: Financial data reported for the annual financial year ended March 31. ¥ = JPY = Japanese yen; ¥113.1 = US$1 on average between February 1 and March 31, 2017.
Source: Toshiba, *2017: Annual Report Year Ended March 31, 2017, Financial Review*, 2, accessed April 10, 2018, www.toshiba.co.jp/about/ir/en/finance/ar/ar2017/tar2017e_fr.pdf.

CONSOLIDATED STATEMENTS OF CASH FLOWS, TOSHIBA CORPORATION (IN ¥ MILLIONS)

Cash Flows	2013/3	2014/3	2015/3	2016/3	2017/3
Net cash provided by (used in) operating activities	132,316	284,132	330,442	−1,230	134,163
Net cash used in investing activities	−196,347	−244,101	−190,130	653,442	−178,929
Free cash flows	−64,031	40,031	140,312	652,212	−44,766
Net cash provided by (used in) financing activities	41,772	−89,309	−125,795	135,747	−219,758
Effect of exchange rate changes on cash and cash equivalents	17,123	11,449	13,509	−11,796	−3,312
Net increase (decrease) in cash and cash equivalents	−5,136	−37,829	28,026	776,163	−267,836
Cash and cash equivalents at beginning of year	214,305	209,169	171,340	199,366	975,529
Cash and cash equivalents at end of year	209,169	171,340	199,366	975,529	707,693

Cash Flow Indicators	2013/3	2014/3	2015/3	2016/3	2017/3
Debt/cash flow ratio (%)	17.73	18.01	12.34	−18.52	−60.70
Interest coverage ratio (Times)	2.4	8.6	8.3	−26.5	17.0

Note: Financial data reported for the annual financial year ended March 31. Free Cash Flow = Net Cash Provided by Operating Activities + Net Cash Used in Investing Activities
Source: Toshiba, *2017: Annual Report Year Ended March 31, 2017, Financial Review, 2,* accessed April 10, 2018, www.toshiba.co.jp/about/ir/en/finance/ar/ar2017/tar2017e_fr.pdf.

EXHIBIT 3: JAPANESE STOCK EXCHANGE DELISTING CRITERIA

Items	Delisting Criteria
Number of Shareholders	Less than 400 (1-year grace period applies)
Number of Tradable Shares	Less than 2,000 units (1-year grace period applies)
Market Capitalization of Tradable Shares	Less than ¥500 million (1-year grace period applies)
Ratio of Tradable Shares	Less than 5% (excluding cases where predetermined documents are submitted) (no grace period)
Market Capitalization	1. In the event that it is less than ¥1 billion, it does not increase to ¥1 billion or above within 9 months (or within 3 months if predetermined documents are not submitted); or 2. In the event that it is less than 2 times of the listed number of shares, it does not increase to said value within 3 months
Liabilities	Liabilities exceed assets and this state remains unchanged for 1 year (as a general rule, based on consolidated balance sheets)
Trading Volume	1. For the last year: Average monthly trading volume: less than 10 units; or 2. No trades during the last 3 months
Delay in Submission of Securities Report	A securities report or a quarterly report, to which an audit report or a quarterly review report is attached, is not submitted within a month after the statutory deadline (or, if the extension of the deadline for submission of a securities report or a quarterly report has been approved, and it is not submitted by the 8th day (excluding non-business days) after such extended deadline)
False Statement or Adverse Opinion, etc.	1. In the event that a listed company has made false statements in a securities report, etc., and TSE deems that it is clearly difficult to maintain order in the market if the listed company is not delisted immediately; or 2. In the event that a certified public accountant, etc. expresses an “adverse opinion” or the fact that “opinions are not expressed,” etc. in an audit report or quarterly review report, and TSE deems that it is clearly difficult to maintain order in the market if the listed company is not delisted immediately
Securities on Alert, etc.	1. Although a listed company falls under the criteria for designation as a security on alert, TSE deems that it is not expected to improve its internal management system, etc.; 2. A listed company is already designated as a security on alert, and TSE deems that it can no longer be expected to improve its internal management system, etc.; or 3. TSE deems that the listed company has not improved its internal management system, etc. despite its designation as a security on alert.

Note: ¥ = JPY = Japanese yen; ¥113.1 = US$1 on average between February 1 and March 31, 2017. TSE = Tokyo Stock Exchange.
Source: “Criteria for Delisting,” Japan Exchange Group, October 1, 2017, accessed April 10, 2018, www.jpx.co.jp/english/equities/listing/delisting/.

ENDNOTES

[1] This case has been written on the basis of published sources only. Consequently, the interpretation and perspectives presented in this case are not necessarily those of Toshiba Corporation or any of its employees.
[2] Rajesh Chhabara, "Asia Column: Toshiba—Japan's Latest Corporate Catastrophe," Ethical Corporation, August 6, 2015, accessed April 10, 2018, www.ethicalcorp.com/stakeholder-engagement/asia-column-toshiba-japans-latest-corporate-catastrophe.
[3] Toshiba Corporation, "Notice on Change of Accounting Auditor," press release, May 23, 2016, accessed April 10, 2018, www.toshiba.co.jp/about/ir/en/news/20160523_2.pdf.
[4] All currency amounts are shown in US$ unless otherwise specified.
[5] Quentin Webb, "Toshiba's Move to Ditch Its Accounting Firm Looks like a Desperate Attempt to Stay Listed," CNBC, April 26, 2017, accessed April 10, 2018, www.cnbc.com/2017/04/26/toshiba-axing-pwc-would-be-a-desperate-move-to-stay-listed-commentary.html.
[6] "Chronology of History," Toshiba: Global, accessed October 17, 2019, www.toshiba.co.jp/worldwide/about/history_chronology.html.
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[8] Nathan Layne and Ritsuko Ando, "In Toshiba Scandal, the 'Tough as Nails' Target Setter," *Reuters*, August 24, 2015, accessed April 10, 2018, www.reuters.com/article/us-toshiba-accounting-nishida-insight/in-toshiba-scandal-the-tough-as-nails-target-setter-idUSKCN0QT2B520150824.
[9] Ibid.
[10] Ritsuko Ando, "Toshiba Inflated Profits by $1.2 Billion with Top Execs' Knowledge: Investigation," *Reuters*, July 20, 2015, accessed April 10, 2018, www.reuters.com/article/us-toshiba-accounting/toshiba-inflated-profits-by-1-2-billion-with-top-execs-knowledge-investigation-idUSKCN0PU0E920150720.
[11] Ibid.
[12] Ibid.
[13] Eni Iljazi, "Japan's Corporate Governance Landscape: The Case of Toshiba Corporation," Toshiba, September 2017, accessed April 12, 2018, https://learn.diligent.com/rs/946-AVX-095/images/JAPANS-CORPORATE-GOVERNANCE-ANALYSIS-1.pdf.
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[15] Makiko Yamazaki, Osamu Tsukimori, and Anya George Tharakan, "Toshiba Chair Ready to Resign over Westinghouse Writedowns: Nikkei," *Reuters*, January 27, 2017, accessed April 15, 2018, www.reuters.com/article/us-toshiba-chairman/toshiba-chair-ready-to-resign-over-westinghouse-writedowns-nikkei-idUSKBN15B1YF.
[16] Kana Inagaki, "Toshiba Chairman to Resign Amid $6.3Bn Writedown," *Financial Times,* February 14, 2017, accessed October 24, 2019, www.ft.com/content/ebab150e-a422-3ab1-bc1a-7e5c8976cff1.
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[24] ¥ = JPY = Japanese yen; ¥113.1 = US$1 on average between February 1 and March 31, 2017.
[25] "Toshiba's Shareholder Equity Turns Negative after $8.3B Write-Down," *Australian Review*, February 15, 2017, accessed April 12, 2018, www.afr.com/news/world/toshibas-shareholder-equity-turns-negative-after-83b-writedown-20170215-gud0z2.
[26] Yamazaki, Tsukimori, and Tharakan, op. cit.
[27] James Conca, "Westinghouse Bankruptcy Shakes the Nuclear World," *Forbes*, March 31, 2017, accessed April 10, 2018, www.forbes.com/sites/jamesconca/2017/03/31/westinghouse-bankruptcy-shakes-the-nuclear-world/#766f12626887.
[28] "Toshiba's Shareholder Equity," op. cit.
[29] As a result of the issuing company having failed to meet the requirements set by the exchange, delisting occurred when a security was involuntarily removed from the exchange where it was traded. Non-compliant companies that met any of the listed criteria were first placed on the "Securities on Alert" list, the "Securities under Supervision" list, or both lists, and given a grace period to correct the issue before a final delisting decision was made.
[30] "Designation of Securities Under Supervision (Examination): TOSHIBA CORPORATION," Japan Exchange Group, March 14, 2017, accessed April 8, 2018, www.jpx.co.jp/english/news/1021/20170314-12.html.
[31] Ibid.

[32] Kana Inagaki, "Brave Is the Auditor That Takes on Toshiba's Accounts," *Financial Times*, May 2, 2017, accessed April 10, 2018, www.ft.com/content/d5709622-2ef8-11e7-9555-23ef563ecf9a.
[33] "Fierce Tug-of-War between Toshiba, PwC Arata Auditors before Settlement," *Mainichi,* August 11, 2017, accessed April 10 2018, https://mainichi.jp/english/articles/20170811/p2a/00m/0na/010000c.
[34] Ibid
[35] Peter Wells, "Toshiba Denies Report on Auditor Withholding Opinion," *Financial Times,* July 13, 2017, accessed July 25, 2019, www.ft.com/content/75d30bc3-bed1-3c90-b8dc-d2c81821a8a4.
[36] An unqualified opinion of the audit firm indicated that the financial statements that had been audited had no material problem of any sort while a qualified opinion found that statements had not been produced to comply with generally accepted accounting principles (GAAP) often due to insufficient evidence or verification. An "adverse opinion" represented the worst-case scenario as the auditor indicated that statements both violated GAAP and were grossly misstated, often an indicator of fraud. Any adverse opinions required a re-audit or resubmission.
[37] "Toshiba Considering Releasing Unaudited Full-Year Earnings," *Japan Times*, May 8, 2017, accessed July 25, 2019, www.japantimes.co.jp/news/2017/05/08/business/corporate-business/toshiba-considering-releasing-unaudited-full-year-earnings/#.XTndiehKi70.
[38] "Fierce Tug-of-War," op. cit.
[39] Toshiba Corporation, "Toshiba Receives Qualified Opinion from Auditor on FY 2016 Securities Report and FY2017 First Quarter Report," press release, August 10, 2017, accessed April 10, 2018, www.toshiba.co.jp/about/ir/en/news/20170810_3.pdf.
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