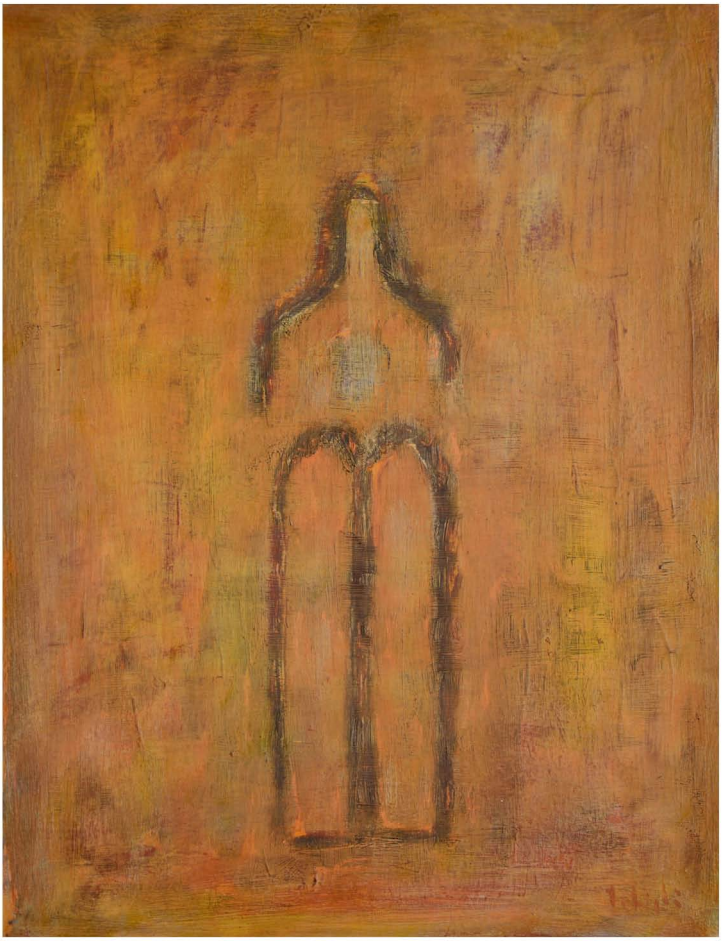

Corporate Fraud in Japan

Risk Management and Governance

Takashi Yasuoka

Corporate Fraud in Japan

Corporate Fraud in Japan:

Risk Management and Governance

By

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Cambridge Scholars Publishing

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FOREWORD

YB DR. MASZLEE BIN MALIK

MINISTER OF EDUCATION, MALAYSIA

I recall the moments of my talk to a group of Malaysian students in Tokyo, Japan during the Golden Weeks of 2002. In the discourse, my advice to these "young hearts" was to strive for the pinnacle of academic excellence whilst not neglecting the importance of mingling with locals and assimilating the positive features of the Japanese culture, spirit of competitiveness and nation-building. As the privileged few who were fortunate enough to study abroad, it was also their duty to bring home enabling value systems as well as the varsity scroll. Where better than Japan, an exemplar in rising from the ashes following Hiroshima and Nagasaki to developed-nation status and a global superpower—largely due to enormous amounts of best practice, discipline and *kaizen*.

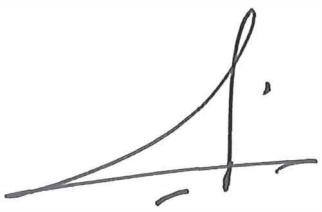
It is indeed a pleasant surprise that those very "students" have come back to me recently. This time around, it is to write a foreword on this superb piece of work entitled *Corporate Fraud in Japan: Risk Management and Corporate Governance*, a Japanese-to-English translation project with their sensei, Professor Takashi Yasuoka of the Shibaura Institute of Technology.

Albamdulillah, my advice had yielded fruition 15 years later in no better a time than in Malaysia Baru, which further emphasizes and revisits the "Look East Policy" initiated by our current prime minister, Tun Dr. Mahathir Mohamad, back in 1981.

The book is unique since the contents highlight the lessons learned from the fraud cases of Japan's big corporations, such as Toshiba, Olympus and Mitsubishi, presenting invaluable knowledge and inputs for readers worldwide about business management, risk management and corporate governance. Malaysians are constantly reminded of the dire consequences—to taxpayers' pockets—of money laundering and serious governance issues. Academic-wise, I have a keen interest in governance and have had a fair chance to publish a few books on the subject; namely from the perspectives of religion.

Last but not least, I hope this constructive collaboration between a professor and students of two different countries will further foster and enhance bilateral ties between Japan and Malaysia. I also hope and pray that readers find this work beneficial.

EDUCATION IS HAPPINESS, LOVE AND MUTUAL RESPECT



YB Dr. Maszlee Bin Malik

PREFACE

In recent years, numerous incidents of corporate fraud have been reported in Japan, with many of these incidents occurring at world-famous Japanese companies, including Toshiba, Olympus, Kobe Steel, Nissan and Toyo Rubber. Needless to say, risk management systems were already incorporated into these companies. The question is why the risk management systems did not function there. The risk management system might be only a formality in these corporations.

On this issue, I published a book in Japanese for businesspeople, entitled *Study of Corporate Fraud*.[1] This book introduces how enterprise risk management should be. For case studies, the book investigates eight scandals from 2011 to 2017 based on the reports of third-party investigations of the incidents, and it studies the causes and measures for preventing the recurrence of these types of fraud from the viewpoint of risk management.

These observations are also valuable for readers worldwide who study business management, risk management and corporate governance. However, these companies published their investigation reports in Japanese. People worldwide, including investors and stakeholders, cannot easily understand the content of these reports or the details of the incidents of fraud.

For this reason, this book is written as a new English-language book based on the previous Japanese book. For this English book, I have revised the Japanese text for readers in Western countries by:

(1) providing additional explanation of the management style and its associated problems in Japanese corporations
(2) revising the book to take an academic perspective
(3) changing the chapter structure of the book to facilitate the objectives above

Accordingly, this book will allow these readers to know what happened, and it will show weaknesses in corporate governance and

[1] Takashi Yasuoka, *Study of Corporate Fraud*, [in Japanese], Tokyo: Nikkei BP, 2018.

internal control in Japanese corporations.

Finally, it should be noted that the Japanese manuscript for this book—specifically Chapters 2 to 9—was translated into English by eight Malaysian collaborators. They all were students staying in Japan who graduated from Japanese universities. We call this work "Project MJ". It is my pleasure to publish this book to the world within the friendly relation between Malaysia and Japan.

Takashi Yasuoka
Tokyo
October 2018

LIST OF CONTRIBUTORS

Takashi Yasuoka: Original author and translation supervisor.

He has been a Professor in the Graduate School of Engineering Management at the Shibaura Institute of Technology (Japan) since 2009. He is working in the field of financial engineering and risk management.

He is the author of *Study of Corporate Fraud* (Nikkei BP, 2018, in Japanese), *Interest Rate Modeling for Risk Management: Market Price of Interest Rate Risk* (Bentham Science, 2018) and several other books.

From 1986–2009, he worked at the Mizuho Information & Research Institute.

He holds a B.S. in Mathematics from Osaka University, an M.S. in Mathematics from Kobe University and a Ph.D. in Mathematical Science from Kyushu University.

Alirnus Che Mat: Translator of Chapter 2

He is a General Manager at Standard Energy Solutions Sdn Bhd (Malaysia). He has 12 years' experience in Project Management and Design Engineering for Engineering, Procurement, Construction, Installation and Commissioning (EPCIC) projects for oil and gas facilities and marine and infrastructure works.

He holds a B.Eng. in Mechanical System Engineering from Takushoku University. He was one of the JSME Hatakeyama Award recipients nominated by Takushoku University for the year 2005 batch.

Azizul Helmi B. Sofian: Translator of Chapter 3

He has been a Senior Lecturer at the Universiti (Malaysia) Pahang since 2014. He worked at Polymatech Co. Ltd. from 2008 to 2011 and at Sunaga Polymer from 2007 to 2008.

He holds a B.S. in Materials Science Engineering from Gunma University, an M.S. in Materials Science Engineering from Gunma University and a Ph.D. in Regional Environment Systems from the Shibaura Institute of Technology.

Muhammad Zulfahmi Bin Samsudin: Translator of Chapter 4

He has been a Mechanical Engineering Lecturer for the Malaysia Japan Higher Education Program under Yayasan Pelajaran MARA since 2012. He also became an AutoCAD instructor at Mirai Techno Enterprise in 2015.

Before being a lecturer, he worked as a Steam Turbine Design Engineer at Fuji Electric Co. Ltd. in the Kawasaki Factory in Kanagawa, Japan during the period of 2008 to 2012.

He has a first degree and Master in Mechanical Engineering from Waseda University, Tokyo, Japan.

Muhammad Zaimi Bin Zainal Abidin: Translator of Chapter 5

He has been a Senior Lecturer in the Faculty of Manufacturing Engineering at Universiti Teknikal Malaysia Melaka (UTeM) since 2013. He worked at the PETRONAS Refinery from 2015 to 2016 and Showa Denko HD (Malaysia) in 2006.

He has a Bachelor in Advanced Materials Engineering from Yamaguchi University, a Master of Engineering in Materials Science and Engineering from the Shibaura Institute of Technology and a Ph.D. in Regional Environment Systems from the Shibaura Institute of Technology.

His recent publications include (with Kok-Tee Lau and Cheng-Guan Ong) "Investigation of Lead-free Solder Strength on Different Nickel Phosphorous-plated Nickel's Roughness," *International Journal of Applied Engineering Research* (2018).

Halim Bin Ghafar: Translator of Chapter 6

Halim Bin Ghafar is a Lecturer at Universiti Teknologi MARA (Malaysia). His work experience includes roles at Nissan Shatai Co. (Japan), Toyota Autobody (Malaysia) and the Malaysian Institute of Road Safety Research (MIROS).

He holds a Bachelor in Mechanical Engineering from Keio University and a Master of Science in Mechanical Engineering from UiTM Shah Alam. His recent publications include "The Influence of Oxygen in the Carbonization of Oil Palm Shell on Bio-Char Yield and Properties," *Applied Mechanics and Materials* (2013).

Muhammad Ibrohim B. Mazalan: Translator of Chapter 7

He has been a Manager at Koperasi Ummah Sejahtera Pahang Berhad (Malaysia) since 2016. He was a Lecturer at IKIP International College in 2015. He worked at the Islamic Center (Japan) from 2013 to 2014 and at JGC Plant Solutions Co. Ltd. from 2009 to 2012.

He holds a Bachelor Degree in Mechanical Information Engineering from Meiji University (Japan).

Nasrul Hakim bin Ghazali: Translator of Chapter 8

Nasrul Hakim bin Ghazali is currently a Senior Assistant Director for the Public Service Department of Malaysia.

He was previously a Senior Assistant Secretary in the Ministry of Science, Technology and Innovation (Malaysia), an Engineer in NEC Semiconductors and a Research Engineer in Telekom Malaysia (TM).

He holds a Bachelor Degree in Electrical & Electronic Engineering from Tokyo University of Agriculture and Technology, and a Master's Degree in Management of Technology (Professional) from the Shibaura Institute of Technology.

Muhammad Yassir Bin Salehuddin: Translator of Chapter 9

Muhammad Yassir is currently a General Manager at CRI Sdn Bhd, and he was formerly a manager at GTI Sdn Bhd, Malaysia. He was also a Product Design Engineer at Sony Corporation, Japan.

He holds a Bachelor Degree in Electrical & Electronic System Engineering from Saitama University, and a Master's Degree in the same field.

ACKNOWLEDGMENTS

A preliminary version of this book called *Study of Corporate Fraud*, in Japanese, was published by Nikkei BP. I am very grateful to Nikkei BP, who allowed me to translate the original book into an English version.

In order to write this English book, eight collaborators were compiled by Mr. Nasrul Hakim bin Ghazali while he was a graduate student at the Shibaura Institute of Technology, Tokyo. It is due to their cooperation and translation to English that I could make this English book.

Additionally, I am grateful to many graduate students of the university, with whom I could practically discuss and study the actual cases of corporate fraud.

Conflict of Interest

The author declares no conflict of interest, financial or otherwise.

INTRODUCTION

This book introduces recent incidents of Japanese corporate fraud from 2011 to 2017 and investigates the reports of third-party investigations of the incidents. Specifically, we investigate the causes of fraud from the viewpoint of risk management and examine the effectiveness of measures to prevent recurrence. For this study, we work with the Three Lines of Defense model. This analysis also shows weaknesses in corporate governance and internal control in Japanese corporations.

This book is composed of 10 chapters. Chapter 1 summarizes the state of corporate governance and risk management needed for analyzing incidents of fraud in Japanese corporations. Chapter 2 studies the data falsification scandal of Toyo Tire & Rubber, and Chapter 3 studies misrepresentation at the Fukumusume Sake Brewery.

Chapter 4 deals with the data fabrication scandal of Kobe Steel. When I was writing the manuscript for the Japanese-version book, Kobe Steel had not yet published the investment report. After reading the investment report, which was published in March 2018, I drastically revised the content of the previous manuscript for this book.

Chapter 5 studies falsified inspection records at JXTG Energy's Mizushima Refinery. Chapter 6 studies fabricated fuel efficiency data at Mitsubishi Motors. Chapter 7 studies circular transactions at Tsubakimoto Kogyo. Chapter 8 studies accounting fraud at Olympus, and Chapter 9 studies the accounting scandal at Toshiba.

Finally, Chapter 10 summarizes these incidents from the viewpoint of the Three Lines of Defense model.

The author hopes that this book will allow readers worldwide to know what happened at Japanese enterprises and to make use of this study for enterprise risk management.

CHAPTER ONE

CORPORATE GOVERNANCE AND RISK MANAGEMENT IN JAPAN

This chapter summarizes the state of corporate governance and risk management needed for analyzing incidents of fraud in Japanese corporations. First, it explains risk management as carried out under Japan's Corporate Governance Code. Next, it touches upon corporate risk management from the perspective of preventing corporate fraud. Finally, it explains the limitations of risk management in protecting against corporate fraud.

1.1 Japanese companies' corporate governance

Japan's Corporate Governance Code

An appendix to the Tokyo Stock Exchange's listing rules sets out Japan's Corporate Governance Code, which has been in force since June 2015. We provide an overview using extracts from the English version (Japan's Corporate Governance Code 2018).

> In this code, "corporate governance" means a structure for transparent, fair, timely and decisive decision-making by companies, with due attention to the needs and perspectives of shareholders and also customers, employees and local communities.

Next, Japan's Corporate Governance Code discusses five general principles for listed companies as follows:

General Principle 1. Securing the Rights and Equal Treatment of Shareholders
General Principle 2. Appropriate Cooperation with Stakeholders Other Than Shareholders
General Principle 3. Ensuring Appropriate Information Disclosure and Transparency
General Principle 4. Responsibilities of the Board
General Principle 5. Dialogue with Shareholders

General Principle 1 and General Principle 2 are related to risk management, as explained below.

General Principle 1.
Companies should take appropriate measures to fully secure shareholder rights and develop an environment in which shareholders can exercise their rights appropriately and effectively.

General Principle 2.
Companies should fully recognize that their sustainable growth and the creation of mid- to long-term corporate value are brought about as a result of the provision of resources and contributions made by a range of stakeholders, including employees, customers, business partners, creditors and local communities.

The thinking behind these principles is in line with basic risk management.

Furthermore, among the responsibilities of the Board of Directors (BOD) (shown below), are six points—principles regarding risk management and corporate fraud—as shown below.

Principle 2.5 Whistle-blowing
Companies should establish an appropriate framework for whistle-blowing such that employees can report illegal or inappropriate behavior, disclosures, or any other serious concerns without fear of suffering from disadvantageous treatment.

Principle 3.2 External Auditors
3.2.1 The *kansayaku* [auditor] board should, at minimum, ensure the following:
i) Establish standards for the appropriate selection of external auditor candidates and proper evaluation of external auditors; and
ii) Verify whether external auditors possess necessary independence and expertise to fulfill their responsibilities.

Principle 4.1 Roles and Responsibilities of the Board (1)
The board should view the establishment of corporate goals (business principles, etc.) and the setting of strategic direction as one major aspect of its roles and responsibilities.

Principle 4.3 Roles and Responsibilities of the Board (3)
The board should engage in oversight activities in order to ensure timely and accurate information disclosure, and should establish appropriate internal control and risk management systems.

Principle 4.4 Roles and Responsibilities of *Kansayaku* and the *Kansayaku* Board
Although so-called "defensive functions," such as business and accounting audits, are part of the roles and responsibilities expected of *kansayaku* and the *kansayaku* board, in order to fully perform their duties, it would not be appropriate for *kansayaku* and the *kansayaku* board to interpret the scope of their function too narrowly, and they should positively and proactively exercise their rights and express their views at board meetings and to the management.

Principle 4.8 Effective Use of Independent Directors
Companies should therefore appoint at least two independent directors that sufficiently have such qualities.

Japan's Corporate Governance Code is self-regulation without legally binding force, so listed companies are not required to follow it. However, they must explain their reasoning when they choose not to follow it (Comply or Explain).

Corporate governance and organizational design

Japanese companies employ various organizational design formats (governance formats). Japan's Companies Act (2005) provides for the following three types of large listed companies (stock companies that have had a public offering of shares and have at least JPY 500 million or total liabilities of at least JPY 20 billion). The explanation focuses mainly on the function of auditors (committee members).

(1) Board of directors + board of auditors + accounting auditors = (Company with a Board of Directors)

This type is called a Company with a Board of Directors, and it has auditors. Due to differences between this type and types 2) and 3), it is also known as a Company with a Board of Auditors. At least half of the auditors must be outside auditors (Article 335 of Japan's Companies Act).

The auditors monitor the directors and investigate the business and company finances themselves. They do not have the authority to use members of the Internal Audit Department to conduct investigations, so there is a limit to the work they can do. The Company with a Board of Auditors company type is peculiar to Japan, and it has a number of problems.

(2) Board of directors + three committees (nominating, audit and compensation) + accounting auditors = (Company with Committees)

This is called a Company with Committees, and it follows a US-style governance model. In this case, there is no Board of Auditors, but there is instead an Audit Committee. The Audit Committee is within the BOD, and the members monitor directors and executive officers. Because directors serve on the Audit Committee, they can instruct members of the Internal Audit Department to carry out investigations. Due to this fact, Audit Committee members have more authority than auditors.

To ensure effective oversight by the Audit Committee, Japan's Companies Act (Article 400) places restrictions on this format, including the stipulation that the majority of Audit Committee members must be outside directors. In this sense, this scheme is more effective in management oversight than the use of traditional auditors, and overseas investors appear to view this format favorably.

Toshiba adopted this organizational format long ago, but the management team was still involved in an instance of major corporate accounting fraud. This was due to issues with the appropriateness of the outside directors and the selection of personnel for the Audit Committee. The key to an effective governance structure lies in the authority of the Nominating Committee and the makeup of the Audit Committee.

(3) Board of directors + Audit Committee + accounting auditor = (Company with Audit and Supervisory Committees)

This format fits between (1) and (2), and it is known as a Company with Audit and Supervisory Committees. In this format, as in (2), the Audit Committee is within the BOD, and directors serve as Audit Committee members. Under this format, supervision by Audit Committee members looks promising. However, Kobe Steel employed this format and was still involved in a major quality-related fraud. Even when a governance format is employed, it may be difficult for it to function well.

Japanese corporate governance formats

Table 1.1 shows the number of companies listed on the First Section of the Tokyo Stock Exchange grouped by organizational format, as well as representative examples of each. This shows that 75% of companies employ the Company with a Board of Auditors format peculiar to Japan.

Table 1.1 Companies listed on TSE First Section by governance format

Source: eol,[2] 2017

	Company with a Board of Auditors	Company with Audit and Supervisory Committees	Company with Committees
Number of companies	1548	453	65
Share (%)	75	22	3
Notable companies	KDDI, Kyocera, JAL, Fuji Film HD, Shin Etsu Chemical, Komatsu, Ricoh, Subaru, SoftBank, Seven & I HD, Panasonic, Kao, JR West, Fujitsu, Suzuki Motors, Isuzu Motors	Takeda Pharmaceutical, Murata Mfg., Seiko Epson, Honda Motor, Cosmo Energy HD	Lixil Group, Mitsubishi Chemical HD, Mitsubishi Estate, Sony, Kobe Steel, Hitachi, Toshiba, Mitsubishi Electric

Japanese corporate employment formats and directors

From the year 2000 onward, Japanese companies restructured as they globalized, and lifetime employment is no longer guaranteed. This change has resulted in increased diversity of employment formats and an increase in fixed-term contracts. However, workers are almost never fired once they have been hired as regular employees. The proportion of persons switching companies has increased since 2000, but lifetime employment is still a basic format.

Employees are promoted to managerial positions, outstanding managers become executive officers, and selected individuals move up to become directors. As a result, the bulk of the management team is made up of employees from within the company.

Also, to gain promotions, employees have to be rated highly by their superiors. To become a director, they need to be looked upon favorably by

[2] eol is a corporate information database developed by Pronexus inc. in Japan.

other directors or by the company president. The president can build the management team with a coalition of internally promoted yes-men.

This is the background to the Japanese corporate management style. As a result, one issue is that management tends to become closed and opaque. Under Principle 4.8 of Japan's Corporate Governance Code, there should be at least two outside directors as a rule, but many companies have one or even none.

Table 1.2 shows the number of directors for 2,050 Tokyo Stock Exchange First Section listed companies in 2017. There is an average of 9.3 directors (2.4 independent) per company. Of all included companies, 229, or over 10% of the total, have fewer than two independent outside directors. These data also show that promoting directors from within is a common pattern.

Table 1.2 Number of directors at 2,050 TSE1 listed companies

Source: eol, 2017

Number of directors	Number of companies
3 4	20
5 6	288
7 8	579
9 10	599
11 12	308
13+	256
Average	9.3

Number of independent outside directors	Number of companies
0	14
1	215
2	1184
3	434
4+	201
N/A	2
Average	2.4

1.2 Japanese corporate risk management and corporate fraud

Under Japan's Companies Act, internal control (including risk management) is the exclusive responsibility of the BOD (Japan's Companies Act: Article 362, among others). Large companies (defined as those with capital of at least JPY 500 million or total liabilities of at least JPY 20 billion), in particular, must exercise internal control. This is hard to interpret for those not familiar with the law, but for the sake of simplicity we assume the board is responsible for preparing risk management and internal control measures.

Enterprise risk management

Enterprise risk management (ERM) refers to corporate risk management. However, this does not entail individual divisions managing their own risks. Instead, it involves integrated strategic risk management across the whole company.

Among ERM frameworks, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in the United States is well-known. International risk management guidelines (ISO31000) were established along these lines. Almost all Japanese companies are believed to have risk management structures that comply with ISO31000.

The ISO31000 standard was translated and became part of Japan's Industrial Standards as JISQ31000. Although JIS rules are called "standards", JISQ31000 is not legally binding.

Internal control and compliance

Internal control refers to regulations and other arrangements which make internal monitoring systems and financial reporting reliable. In other words, it is explained as arrangements that enable risk management to function.

The mere presence of a Risk Management Department (or Committee) is not sufficient for risk management. Internal regulations or the internal organizational structure shown in Figure 1.1 enable risk control.

In addition to having structures and regulations, it is important that a company abides by laws and regulations and that each individual employee obeys laws and rules (compliance). In this sense, it is said that "risk management functions with internal control and compliance in tandem".

Risk management and independence between departments

For the sake of simplicity, we consider the case of a Company with a Board of Auditors in Sections 1.2 and 1.3. If we replace "auditors" with "audit committee," the situation is basically the same, except for the differences mentioned in the previous section.

For the of sake convenience, Figure 1.1 shows the organizational structure of a company (specifically, a manufacturer). Let us describe the thinking behind the risk management structure in this case. First, the BOD decides on risk management policies. For a Company with a Board of

Auditors, the auditors are in a position to supervise the BOD. For the case in Figure 1.1, there is no Risk Management Department, and the Risk Management Committee is placed below the BOD, which is responsible for overall company-wide risk management.

The departments inside the box bordered by the dotted line are responsible for conducting company business and are known as Operating Departments. The Internal Audit Department is independent from the Operating Department. It is responsible for carrying out risk management under the direct control of the president, and it checks on the Operating Department's risk management. The Internal Audit Department is also independent from the auditors. It is important to note that this point differentiates a Company with Auditors from a Company with an Audit Committee.

In the Olympus incident, the directors involved in the fraud were in charge of the Internal Audit Department. In this situation, internal audit does not work.

When the Internal Audit Department is made up of members originally from a certain division, checks of that division become looser. To prevent this, it is better to have the department made up of members from various departments and to conduct regular personnel rotations.

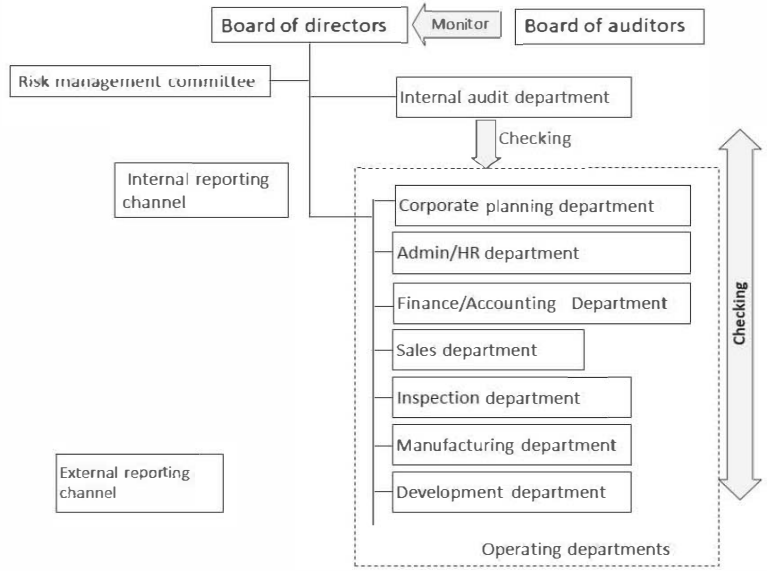


Figure 1.1 Internal organizations for risk management

It is important that departments be both independent of each other and able to check on each other. For example, the Inspection Department must conduct quality inspections from a position independent of the Development and Manufacturing Departments. It is also necessary to ensure that mistakes made or fraud committed by members of one department do not continue, the chance of which can be reduced by regular personnel rotation between departments and divisions.

In the examples in this book, quality issues and fraud occurred because these fundamentals were not in place. In such cases, the Development Department may only be able to produce substandard products due to lack of technological capability, or it may be unable to develop technology by the scheduled date. In some cases of fraud, the Sales Department may conspire with the Inspection and Manufacturing Departments to sign off on defective products in order to win orders. It is vital to ensure independence for each department and clearly apportion authority and responsibility to prevent such incidents.

Three lines of defense

When checking a company's internal control and risk management structures, one way of thinking employs the "Three Lines of Defense model". In simple terms, this is three-step risk management as follows:

(1) Risk management in the workplace
(2) Risk management in the Finance Department, Risk Management Department, Inspection Department, and similar
(3) Risk management by the Internal Audit Department

This way of thinking applies to a company with an Audit Committee, but it may also be applied to a Company with a Board of Auditors.

First defense line

The first defense line refers to risk management in the workplace. For example, the ordering system employed by a company can be thought of as a mechanism to prevent the Sales Department from placing fraudulent orders. Schemes to enforce safety checks on a construction site or factory are first defense lines. Product inspections carried out by the person in charge in the Manufacturing Department and checks from those in charge of software development are also first defense lines. I also think that, in many cases, internal regulations are part of the first defense line.

Second defense line

The second defense line carries out risk management from a position independent of the workplace. Financial institutions have what are called Risk Management Departments, but it is common for ordinary companies not to have one; this role is instead carried out by an Inspection Department or Quality Control Department.

For example, the quality and performance of a product made in a factory is typically investigated by an Inspection Department independent from the Manufacturing Department. However, in reality, this is sometimes not the case. In the Toyo Rubber incident described in this book, the Manufacturing Department was more powerful than the Inspection Department, and the inability of the Inspection Department to carry out independent inspections was said to be a major factor in the fraud.

The difference between the first and second lines of defense is whether business risk is involved. For example, the Manufacturing Department takes business risk with respect to its products' quality and performance as well as sales. The Inspection Department will not pass defective products in order to boost productivity. That is, the Inspection Department does not bear any business risk. However, when the Manufacturing and Inspection Departments are in the same business unit, both departments share the same earnings targets, and this erodes the independence of the Inspection Department. In this case, the Inspection Department is part of the first defense line.

Regarding accounting, the person who orders something to be procured and the person who does the actual purchasing (procurement) should be in different departments. This is because when the ordering department has authority to purchase and accept orders, it is easier for frauds such as fictitious orders to occur.

Third defense line

The third defense line can be considered the work of the Internal Audit Department. In some companies, this department is named the Business Audit Department. The differences between these departments and the Inspection Department and Risk Management Department depend on whether the department is part of the Operating Departments.

The Internal Audit Department is supposed to conduct audits of business processes—mainly those relating to contracts, as well as approvals and settlements. For companies like manufacturers, technology-heavy audits of manufacturing and inspection are not straightforward.

When technical expertise is lacking for an audit, it becomes an audit in form only, and thus risks are overlooked. The fraud cases in this book almost all involve audits of only form in terms of technology.

If the Manufacturing or Inspection Departments are aware that only formal audits are being carried out, far from being an audit, the checking function itself is missing in the third defense line. The Mitsubishi Motors mileage scam was certainly such a case.

Main causes of corporate fraud

This book discusses various instances of corporate fraud. In these cases, there are serious problems with management or internal control. Summarizing these from the perspective of internal control and risk management yields the following insights about sources. Among these, it is not possible to verify improvements in (1) or (6) visually, but it should be possible for the others.

(1) Management pressure and dysfunctional auditors

"Management pressure" refers to management placing impossible performance and management targets on the workforce. Employees who have the impossible targets forced on them may discuss these with the auditor.

However, in Japanese companies, in many cases the auditors treat former managers or CEOs favorably. Even if employees seek counsel from them, they may not always respond appropriately. This is a problem peculiar to Japanese auditors and a reason why overseas investors point out uncertainty regarding governance.

As seen in the Olympus and Toshiba scandals, cases become even more complicated when the manager is involved in the fraud.

(2) Loopholes in internal control

Among manufacturers, fraud in the Inspection Department sometimes occurs under pressure from the Manufacturing Department. Alternatively, amid lax data security in the Inspection Department, in some cases, other departments tamper with the inspection results. In this manner, when individual divisions are not sufficiently independent, it is easier for fraud to occur.

Also, fictitious orders are possible if there is no independence between the departments that order, procure and accept orders, such as when the person who orders a machine buys and accepts it themselves. People in this situation may exploit this to receive kickbacks or engage in circular

transactions. In addition, there have been problems when politicians have used blank invoices to claim expenses.

In these cases, individual departments have not maintained independence; that is, there are loopholes in internal control—a shortcoming seen in all cases in this paper.

(3) Failure to have three lines of defense

This has previously been explained.

(4) Shortcomings and limitations of internal reporting systems

Even if there is an internal reporting system, it may not work if the president or management team conceals the fraud. Even if there is a reporting system, if internal rules publicize the name of the information provider, nobody will dare report. While this appears to be purely hypothetical, this actually happened in a well-known company: the ●lympus incident described in this book.

(5) Fixed personnel deployment

If the same person is in the same workplace for many years, they may become too close to the organization or business partners, and if fraud occurs it is difficult to uncover in such cases. The Toyo Rubber, Tsubakimoto Kogyo and ●lympus incidents in this book are examples of such cases.

(6) Inadequate technology

Inadequate technology refers to, for example, circumstances whereby performance targets are set in line with those of a rival company (for fuel consumption, etc.) but cannot be achieved due to inadequate technology. In order to meet unrealistic targets, a company may cheat on the tests or give inferior products passing marks.

In this book, the Toyo Rubber, Kobe Steel and Mitsubishi Motors incidents are examples of this.

These are all difficult issues to deal with, but they could occur in any company. Improvement requires company-level responses. Particularly, (1) is a governance problem, which is difficult to solve. And others are the responsibility of the B●D and can be considered risk management issues.

1.3 Limitations of risk management

The BOD conducts risk management. As a result, when the management team is involved in fraud, sometimes they weaken the risk management system so the fraud is not discovered. The Risk Management Division covers Operating Divisions and does not have a management-team-checking capability. If an employee reports fraud by the management team, it will be to no avail.

Due to such instances, there are limits to risk management, and it is difficult to deal with fraud via the management team. Because it is impossible for the management team to put the brakes on fraud, major incidents like those at Olympus and Toshiba occur. Also, in many cases, major fraud in the workplace is overlooked because the management team has poor awareness of risk management. The Mitsubishi Motors and Kobe Steel incidents are examples of this.

Independence of outside auditors

The Company with Auditors is a format specific to Japan, and it is employed by almost all companies there. Because the auditors are in a position to supervise management, it is ideal for there to be no interests shared with the directors. In practice, in many cases the auditor is somebody subordinate to the president. Of course, in many cases, the role is held by a former director.

Under Japan's Companies Act (Article 335), at least half of the auditors must be outside auditors, as defined under the Act. However, in some cases the outside auditor is a former manager of a subcontractor, which is permitted under the law. Of course, such individuals will be deferential to the directors and thus do not have much potential as external auditors.

Further, there have been cases where executives who had been involved in fraud with managers have become auditors. In such cases, there is little hope of rectifying fraud by the managers, and the appointment may have been for the purpose of concealment.

In the case of fraudulent accounting by Olympus, one of the two outside auditors was a classmate of the president, and the other was the former manager of a subcontractor. Still, in this case, they met the legal requirements for outside directors. In cases like this, the outside auditors will be unable to carry out the auditor's original role.

Auditor from the parent company

There must be many cases in which directors and auditors of subsidiaries of major companies have been seconded from the parent company. This means that former colleagues are working as directors and auditors and it is doubtful whether they can supervise management properly. However, because the parent company is the shareholder, nobody opposes the proposed appointments.

The parent company will want to monitor and supervise the management of its subsidiary, but in many cases the parent company gives the subsidiary tough earnings targets. If managers of the subsidiary pressure employees to commit to meeting the profit targets, there will be dysfunction in the auditors' checking of directors. As a result, a risk emerges that there will be performance and quality fraud from the workplace out of desperation.

Limitations of the Whistleblower Protection Act

Limitations of internal reporting

As touched on in Section 1.2, internal reporting systems absolutely do not work to prevent fraud by management teams. This is because, even in cases where the organization that deals with reports is a neutral committee, the committee is made up of the president's confidants or their subordinates. Reports regarding fraud by committee members' superiors will be rejected, and the name of the reporter or details of the report will certainly be informally conveyed to the president.

Further, even if some sort of incident is reported, in order to avoid it becoming a major incident, management has a tendency to downplay it. In this case, the matter will end without the true cause being resolved. However, as long as downplaying the incident is not against the law, there is no hope for further improvement.

Limitations of external reporting channels

Typically, there are external reporting channels, with the recipients at law firms. However, in almost all cases the law firms have close relationships with the company and reports of management fraud are ineffective.

Even if management is not involved, many managers want to avoid incidents, and downplaying or concealing such events is a daily occurrence. In such cases, the external reporting channel functions as a messenger.

There have also been cases where the wrong e-mail address for the external reporting channel has been listed on the company website. Even if this mistake is not deliberate, in such cases the reporting will go no further.

Whistleblower Protection Act

Japan's Whistleblower Protection Act (2004) was enacted to protect the employment status and other interests of the reporter, and it came into force in Japan in 2004. There are some constraints on the reporter, which we will briefly summarize.

Persons protected under this law are limited to employees and temporary employees of the problem company. In other words, they lose protection if they quit the company and subsequently file a report. Furthemore, reports are to be made in the following priority order (highest to lowest):

(1) Place of employment

Employees fall under Japan's Whistleblower Protection Act if they report to their place of employment when a problem appears likely to occur. This means that they can report to the workplace before a problem occurs.

(2) Regulatory agency

Reports to a regulatory agency are limited to instances where the problem has already occurred or when there can be confidence that it will surely occur. Accordingly, reports to government offices require solid confidence or evidence.

However, there have been press reports of occasional incidents whereby the name of the reporter has been leaked to the subject of the report (company) by the government agency or administrative organization. Some view this route as untrustworthy.

(3) Mass media and similar

Reports to the mass media may be used when ● and ● are not possible. This is thought to be to prevent false rumors from being circulated in the media.

When there is fraud by the management team, not only is reporting to the workplace ignored but there are concerns that the reporter may be

demoted. There must be many individuals who think that, even if they are not demoted, the pathway to the executive team will be closed to them.

Regarding reporting to regulatory agencies, there have been many cases where the reporter's name has been communicated to the company. This route can be used only if it does not matter whether the reporter's name is specified. Still, those bypassing (1) and (2) and going first to the media do not receive protection. On the contrary: there is a risk that they will be sued by the company for leaking company secrets.

There are no penal provisions[3] in Japan's Whistleblower Protection Act, so some harbor doubts about its effectiveness. Further, reporting through the media faces tough restrictions, so the law is said to have loopholes regarding management fraud. From the company's perspective, it certainly does not wish for baseless rumors to be fed to the media.

In the Olympus incident, management fraud was discovered by an employee passing information to a magazine. This was a typical case whereby methods (1) and (2) were not feasible, and there was only (3) available.

Limitations to internal reporting

Internal reporting scheme

Thus far, we have discussed systems for checks from above downwards and mutual, horizontal oversight. Conversely, there is need for oversight from below upwards.

As discussed previously, in some cases persons in charge of the Inspection Department are under pressure from superiors or other divisions to pass defective products. Corporate fraud is, in many cases, an organizational phenomenon, and a solitary inspector cannot resist such pressure. To prevent such incidents, a company may adopt internal regulations ordering employees to make an internal report if they are instructed by their superior to engage in illegal acts. At the same time, setting up internal reporting channels (such as compliance hotlines) and having regulations to protect whistle-blowers are necessary.

Internal reporting channels are run by company personnel, and reports to those involved in internal reporting channels are sometimes concealed. This is why external reporting channels are necessary.

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[3] According to the *Nihon Keizai Shimbun*, "*Protection of internal whistleblower thicker*" (February 13, 2018), the government has started to consider the introduction of penal provisions under the Act.

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CHAPTER TWO

THE TOYO TIRE & RUBBER DATA FALSIFICATION SCANDAL

This chapter will elaborate on Toyo Tire & Rubber's data falsification scandal. The scandal occurred during the product development stage and will be further explained here, as outlined in the *Nikkan Kogyo Shimbun* newspaper.[4]

2.1 Incident summary

As highlighted in the *Nikkan Kogyo Shimbun* newspaper on March 16, 2015,[5] all the seismic isolation rubber for building use that was delivered by Toyo Tire & Rubber between July 2004 and February 2015 did not perform according to the specification, thus creating a perception that the performance evaluation data for the specific product was deliberately falsified. This seismic isolation rubber was installed between the building foundation substructure and the building superstructure to minimize the quaking impact on the building itself. Figure 2.1 illustrates the seismic isolation rubber installation location.

The problematic product has been discontinued, as instructed by the Minister of Land, Infrastructure, Transport and Tourism, and the affected buildings have been regarded as illegal.[6]

In a nutshell, this incident happened due to the development team being unable to complete the product development in time; thus, the performance evaluation data was falsified. From this perspective, it is

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[4] *NikkanKogyo* is Japanese for "daily industry".

[5] *Nikkan Kogyo Shimbun*, "Toyo Tire & Rubber falsifies the data of the seismic isolation rubber for building," March 16, 2015.

[6] *Nikkan Kogyo Shimbun*, "Ministry of Land, Infrastructure and Transmission Instructions for Toyo Rubber on Performance Impersonated Isolation Rubber Manufacturer," March 19, 2015.

similar to the Mitsubishi Motors' fabricated fuel efficiency data incident that was discovered in 2016.

Toyo Tire & Rubber had illegally acquired the ministry certification endorsement for the use of a construction insulation panel in 2007. Thereafter, the public complained that the previous lesson learned did not lead to corporate constitution improvement.

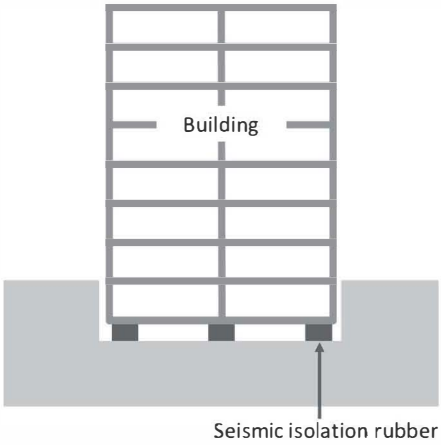

Figure 2.1 Building and seismic isolation rubber

The problematic products were used in 55 buildings, including government buildings, hospitals, condominiums and office buildings throughout Japan. All seismic isolation rubbers that were installed in these buildings required replacing. Therefore, the building's users and residents felt uneasy. This incident has had a great impact on the public as Japan is the world's most earthquake-prone country. Although Toyo Tire & Rubber is famous for its tire business, the Toyo brand's customer confidence level has plunged significantly as a result of this incident.

In October 2015, it was reported that the company falsified material identification value and sampling inspection numbers for rubber vibration dampers used for ships and railways.[7]

This incident tainted a reported 88,000 units, which were supplied to 18 companies. Furthermore, in November 2016, an additional 3,000 units

[7] *Nikkan Kogyo Shimbun* , "Toyo rubber, industrial use is also wrong," October 15, 2015.

of nonconforming products were reported.[8] In context, around 44,000 units of the products reported in October were found to be without any further issues while the remaining 47,000 units in total were found to have a problem.

Countermeasure costs, such as for product replacement and repair, caused an exorbitant loss of JPY 67.8 billion to the company in the December 2016 audited account; thus, the company recorded its first deficit in an eight-year financial period. Furthermore, the company was charged with a civil liability and criminal case.

Illegitimate content

In connection to this incident, the External Investigation Committee and the Third-Party Investigation Committee scrutinized and published the investigation reports. On the other hand, doubt was raised in the report by Toyo Tire & Rubber (2015a) regarding the independence of the External Investigation Committee from the company in relation to the committee chairman himself. Therefore, this chapter studies the causes according to the Third-Party Investigation Committee report (Toyo Tire & Rubber 2015b). The illegitimacy is regarding both seismic isolation rubber and vibration isolating rubber, but we will only elaborate on the seismic isolation rubber.

The Third-Party Investigation Committee report's Chapter II.1 states that there were two illegitimate aspects of the seismic isolation rubbers:

> 1) The performance evaluation and ministry certification endorsement was obtained by means of inappropriate application forms.
> 2) The products were manufactured and delivered in spite of the fact that these products did not satisfy the criteria for certification by the ministry.

Briefly speaking, the inappropriate method of obtaining ministry certification endorsement and the production and delivery of the nonconforming products are the two main problems identified. Therefore, not only the Development Department but also the Production, Inspection and Sales Departments are suspected to be involved in these falsification activities. We will study from this incident what inadequacy exists in Toyo Tire & Rubber's risk management system.

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[8] *Nikkan Kogyo Shimbun* , "Nikkan Kogyo Shimbun , "Toyo rubber, anti-vibration rubber fraud, 2880 items newly found," November 2, 2015.

2.2 Falsification details and causes

Technical expertise issues in the Development Department

The Investigation Report's Chapter III.2 (1) stated that the company's Development Department was failing to compete with other companies in terms of the seismic isolation rubber's performance.

Chapter III.1 (1) emphasized that although the seismic isolation rubber was not performing well enough to acquire the ministry certification endorsement, the head of department had instructed the development team to fabricate any performance evaluation value needed to satisfy the performance requirement.

Chapter III.1 (1) also elaborated that several coefficients should be corrected for the seismic isolation rubber's performance evaluation, and for this to be done, a couple of complex mathematical equations should be solved. Unfortunately, not many engineers can understand it fully.

Thus, the fabricated value cannot be easily detected if corrections are made without any technical basis. Chapter III.1 (2) stated that there was a rotation of the personnel afterwards, and the successors were performing the performance evaluation according to the instructions of the predecessor.

Because of this, the fabricated method had been handed over as an ordinary task. One successor was suspicious of the correction method that he took over and reported to the head of department that "the corrections to the coefficients are being made without any technical basis".

However, as no further instructions were given by the head of department, the successor decided to follow the predecessor's method. Subsequently, the successor reported the problem to the president of the subsidiary and it developed into a fault-finding situation.

Figure 2.2 illustrates the relationship between the organizational issues, namely that the problem lies in the Development Department rather than with the person in charge of the evaluation process. In other words, the technical skills necessary for product development were insufficient.

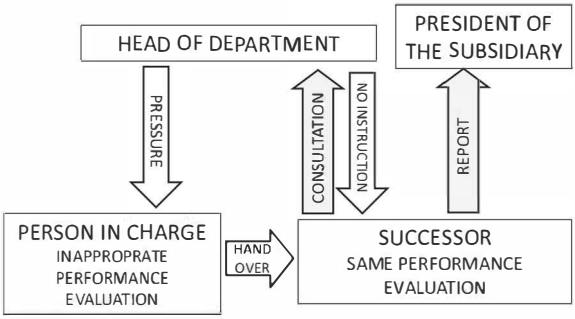

Figure 2.2 Pressures and consultation of the Development Department

The lack of technological capability means not only the lack of technical capabilities of individual personnel but also that the organization of personnel for development was inadequate.

As a result, a specific employee was in charge of development for a long time. If the personnel rotation is not done regularly, checks and balances within the Development Department will not work.

In any company, there are few engineers in the special field work, and personnel change is limited. This is a deep-rooted problem that involved many other companies.

Power relations with the Manufacturing Department

As the developed seismic isolation rubber did not meet the performance requirement, the mass-manufactured product would also have similar performance non-compliance.

The Manufacturing Department is responsible for the performance evaluation for the manufactured product. If the Manufacturing Department and the Development Department are kept independent, the Manufacturing Department will be aware of the lack of performance and should stop any further delivery of the product.

However, as stated in Chapter III.1 (2) of the report, the Manufacturing Department instructed the person in charge of the development to fabricate the evaluation value to satisfy the performance requirement.

This relationship is shown in Figure 2.3. The department independence is not maintained since the Manufacturing Department is stronger than the Development Department. This is the situation in which the first defense line is not working.

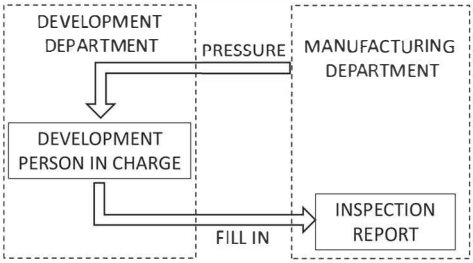

Figure 2.3 Performance evaluation of the Manufacturing Department

Quality Control Department without monitoring ability

The Quality Control Department examines the products made in the Manufacturing Department independently from the Manufacturing Department. Because the performance of the problem product is insufficient, it is the original role of the Quality Control Department to detect the lack of performance.

However, according to Chapter III.1 (2) of the report, in the Quality Control Department, in order to avoid complaints of customers, the numerical value of the performance was again fabricated. Figure 2.4 shows the flow for a product that does not meet the performance requirement until it is delivered.

The Quality Control Department and the Manufacturing Department seem to be independent, but they take virtually the same risk. Therefore, the Quality Control Department does not fulfill its role as the second defense line.

Also, Chapter III.2 (1) highlighted that the flow from the performance evaluation to the issuance of the performance certificate and the divisional roles were not appropriately realized. In other words, the internal control at the Quality Control Department was not established.

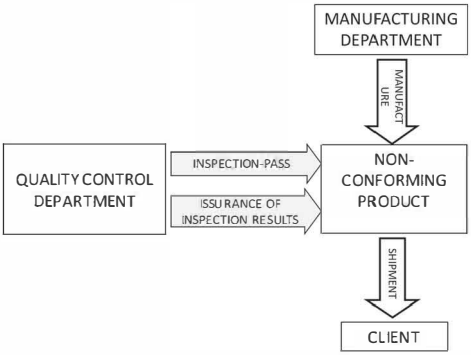

Figure 2.4 Performance evaluation of the Inspection Department

For the Toyo Tire & Rubber case, the performance evaluation was conducted in each of the Development, Manufacturing and Quality Control departments. Chapter III.1 (1) of the report states that each department had managed the evaluation results individually. If the data of each part of the product is shared, the incompatibility of the evaluation results in each department can be found while another department falsified the evaluation result.

By sharing the data, checks and balances between the departments can effectively be made. In this case, any fabricated evaluation value by another department should be prevented. The Kobe Steel case can be used as an example.

Internal audit

According to Chapter III.2 (1) of the report, persons in charge of quality control were appointed, and internal audits were also conducted. However, they did not verify the validity of the performance evaluation value.

It is difficult for the Audit Division and the person in charge of quality control to understand the detailed meaning of technical data used in the Development Department. The same problem may exist for other manufacturers.

In this situation, the third defense line can work properly by adding experienced persons of similar technology expertise to the internal audit members. JXTG Energy's Mizushima Refinery's measures to prevent recurrence can be used as an example.

2.3 From whistle-blow to publication

Internal control and compliance

Based on the above, the Report of the Third-Party Committee points out that the internal control of the Business Department as a whole was not effective and that the awareness of compliance among employees was low.

Chapter III.1 (2) describes the following:

> Even when the auditor's site hearing was done at the Business Department of seismic isolation rubber, the head of the department checked "nothing" about "business misperception, scandal", "matter of concern about compliance", and he did not report this problem to the corporate auditors. As a result of this, the awareness of compliance was low as a corporate culture.

Limits of internal reporting

We can confirm the status of the establishment of a compliance system at the company website. An internal reporting system was established there in 2006 and a "Hotline consultation desk" was established inside and outside the company as a reporting window. This is available not only for employees but also for business partners, and anonymous reporting is also possible.

The person in charge of development of the seismic isolation rubber was in a position to be instructed by their superior and other departments regarding misconduct. Why did he not talk to the hotline at that time? It is too simplistic to conclude that this is to be treated as a matter of compliance awareness of the person in charge. It seems that there are reasons for the inadequate development system.

In technical development within a specific field, if the person in charge has been doing the work for many years, there exist few people who are familiar with the specific engineering matter. In such a situation, it is easy for a company to identify whistle-blowers even if they report anonymously. That is, it becomes difficult for internal reporting to function. From this, it can also be seen that regular rotation is important for risk management. Of course, it is difficult for engineers in niche fields to rotate, and every company might have this issue.

One year from reporting to publication

Since the performance of the seismic isolation rubber cannot be distinguished by either the construction contractor or the building user, it will not be detected unless the relevant person whistle-blows.

Chapter III.1 (2) of the report states that in February 2014, successors in the seismic isolation rubber development and others reported to the president of the subsidiary Toyo Chemical Industrial Products Co. Ltd.: "There is a possibility that the isolated rubber that was manufactured and sold does not meet the criteria for certification from the minister."

The president of Toyo Tire & Rubber received a series of reports from the president of the subsidiary in May 2014. The management team of Toyo Tire & Rubber discussed the matter and concluded that they would not take new orders, would prepare for shipping stops and would consider recalls at the subsequent Board of Directors meetings. And in February 2015, they wrote a letter to the ministry. It took one year from the employee's report.

What is worrisome is the role of the outside director and corporate auditor. Since outside directors and corporate auditors should attend the BOD meeting, they should be aware of the problem of nonconforming items. It is wondered whether they could recommend reporting to the ministry more quickly.

Not only is the awareness of compliance in the officers' group low but the auditors are also not functioning.

2.4 Content of improvement measures

Improvement measures recommended by the Third-Party Investigation Committee

Section IV.1 of the Third-Party Committee Report suggests recommendations for the Ministry of Land, Infrastructure, Transport and Tourism and measures to prevent recurrence for Toyo Tire & Rubber. The improvement measures for the company are as follows:

(1) Reorganization and strengthening of the authority of the Quality Assurance Department[9]

[9] In the Report of the Third-Party Investigation Committee, the terms "Quality Control Department" and "Quality Assurance Department" are used interchangeably, but these are considered to be the same department.

(2) Introduction of a Compliance Officer System
(3) Scheduling and visualization of recurrence prevention measures
(4) Receiving technical guidance from experts in isolated base building

With this, (1) corresponds to strengthening the second defense line. However, the first and third defense lines were not mentioned, and therefore the recommended remedy is incomplete.

Company announcement of measures to prevent recurrence

The company published a recurrence prevention measure (Toyo Tire & Rubber, 2015c), which was made up of emergency measures and thorough measures. The emergency measures are categorized into three items:

(5) Company-wide re-audit across all projects
(6) Drastic reform of the Akashi factory of the Toyo Chemical Industrial Products Co. (measures to prevent fraud in inspections, etc.)
(7) Restructuring of the quality assurance and management system

These are concrete plans of the Third-Party Investigation Committee Improvement Plan, and (1), (5) and (6) are considered to lead to the strengthening of the first and third defense lines.

Thorough measures are recommended as per the following three items:

(8) Strengthen compliance and governance
(9) Early detection of fraud
(10) In-company education and corporate culture reform

These correspond to (2) of the Third-Party Investigation Committee improvement plan.

However, because of its weak competitiveness, the company may be vulnerable because of the cost constraints. Unless the structure is further developed, it will be difficult to improve the situation by merely strengthening internal controls. If the cost of system improvement cannot be borne, the business should be sold to make employees happy.

Another falsification of valve rubber

In February 2017, another falsification scandal was discovered. According to the *Nikkan Kogyo Shimbun* newspaper,[10] it related to a part

[10] *Nikkan Kogyo Shimbun* , "Toyo Rubber, Valve rubber fraud," February 8, 2017.

of industrial rubber for valves used for tankers and other applications. It was said that the products were delivered without complying with the customer inspection rules. Although the details regarding the cause are as yet unknown, it is considered to be the labor shortage among inspectors, and naturally the inspection system itself has fallen into an unreliable situation.

If there is a cause for the shortage of people, the profit structure is unsustainable, so drastic countermeasures such as shrinking business volume or withdrawing or selling are necessary. In fact, in 2017, the company sold its industrial rubber and other chemical products business to the Nitta Corporation.[11]

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[11] *Nikkan Kogyo Shimbun* , "Toyo Rubber, Industrial Rubber and other chemical products business sold to Nitta and Sekisui Plant," July 31, 2017.

CHAPTER THREE

TECHNICAL PROBLEM: FAKE LABELS AT THE FUKUMUSUME SAKE BREWERY

3.1 Outline of the case

Nihon-shu

Firstly in this section, we briefly summarize the Japanese class of *Nihon-shu*, which is Japanese rice wine usually called "sake" in Japanese. *Nihon-shu* includes *Futsu* sake (non-premium sake) and *Tokutei-meisho* sake (premium-grade sake). *Tokutei-meisho* sake is high-quality liquor such as *Honjozo* sake, *Junmai* sake and *Ginjo* sake.

Material rice is ranked as extra special, special class, first class, second class, third class and other grades in order of quality. Specifically, *Honjozo* sake is a *Nihon-shu* made with rice, rice koji[12] and brewed alcohol. *Junmai* sake is made with rice and rice koji. Ginjo sake is a premium *Nihon-shu* made with fine rice, rice koji and brewed alcohol. Raw material and quality requirements are determined for each grade, as shown in Table 3.1.

Outline of the case

As *Nihon-shu* containing brewed alcohol is classified as *Honjozo* sake, if it is sold as *Junmai* sake it will be considered as faked.

In addition, *Tokutei-meisho* sake must use rice rated third class or higher. The rice below third class is considered as "out of the standard". If such rice is mixed in and sold as *Ginjo* sake, it will be considered mislabeled. The Fukumusume Sake Brewery Co. was in violation of

[12] Rice koji: Breeding koji molds on steamed rice.

Japan's Liquor Tax Act;[13] specifically, declaration obligation and labeling obligation.

It was found that, in 2013, the Fukumusume Sake Brewery Co. displayed *Junmai* sake in which they mixed brewed alcohol. The Fukumusume Sake Brewery[14] is a subsidiary of Kenon Holdings (HD).

Table 3.1 Grades of *Nihon-shu* (sake). This table is adapted from the webpage of the Japan National Tax Agency.

	Class of sake	Material	Class of rice	Additive
Futsu sake (ordinary quality)	*Futsu* sake	Rice, rice koji, brewed alcohol, other	-	Chemical seasoning, etc.
Tokutei-meisho sake (specific class)	*Honjozo* sake	Rice, rice koji, brewed alcohol	Better than third-class rice	Additive-free
	Junmai sake	Rice, rice koji		
	Ginjo sake	Fine rice, rice koji, brewed alcohol		

According to the *Asahi*[15] *Shimbun* newspaper,[16] the company mixed brewed alcohol with *Junmai* sake to stabilize the quality. Also, nonstandard rice was mixed into *Ginjo* sake, *Junmai* sake and *Honjozo* sake. There were 49 items in total, about 250 thousand pieces (converted into a 1.8 liter bottle), and all the items were collected. Figure 3.1 is a label of a Fukumusume *Junmai* sake package.

[13] Japan's Liquor Tax Act: Japanese law on liquor taxes, manufacturing and sales, Article 47. This has not been translated into English.

[14] The Fukumusume Sake Brewery transferred the sake business to Fukutokucho Co., Ltd. in 2017, and the Fukumusume Sake Brewery Co., Ltd. changed its company name to Kenon Product Support Co., Ltd. in 2018.

[15] *Asahi* is Japanese for "morning sun".

[16] Asahi Shimbun, "Even you, Fukumusume? Junmai sake 40 items collected," November 12, 2013; "Fukumusume misrepresentation of 40 items," December 12, 2013; "Fake labels at Fukumusume Sake Brewery, the third-party committee published an investigation report," February 15, 2014.

Figure 3.1 Package of Fukumusume *Junmai* sake. Photo by the author, 2018.

The president of the Fukumusume Sake Brewery apologized: "I am sorry that I lied to my customers due to inadequate management." In this case, the person in charge of the subsidiary (Fukumusume Sake) of the holding company (Kenon HD) was carrying out wrongdoing, so it is a helpful case for thinking about the risk management of the holding company and its subsidiaries.

According to the report by the Third-Party Committee, the important causes are the shortage of technology and strict schedule of production. Also, it points out that communication between the administrator and the manufacturing site was insufficient. Reading the report from the perspective of the three defense lines, the first defense line was not working in this factory. Below, we study the cause of the incident according to the Report of the Third-Party Committee and think about measures to prevent recurrence.

Findings and violation of laws and regulations

There was a National Tax Agency survey in August 2013 at the Nada[17] Factory of the Fukumusume Sake Brewery. At that time, they found that:

(1) The quantity of raw material rice purchased does not balance with the quantity of it consumed

[17] "Nada" is the name of a place in Kobe-city in Hyogo prefecture.

(2) The *Moromi*[18] history book was not properly updated

Then, an internal investigation was conducted in the Fukumusume Sake Brewery by Genon HD. It found that:

(3) Brewed alcohol was used for *Junmai* sake
(4) Nonstandard rice was used improperly

The *Nihon-shu* maker must always record the type and quantity of raw materials used. If they do not use the high-quality rice, the product will be inconsistent with the record. The same contradiction arises with respect to the amount of brewed alcohol used.

There are obligations (so-called record obligation) for *Nihon-shu* makers to leave these records. If the Fukumusume Sake Brewery intentionally used nonstandard ingredients, there is a possibility that they did not create a record in order to hide that fact. In this case, they are in violation of the tax liability obligation of the Liquor Tax Act.

3.2 Technology problem

Points of analysis

The taste of sake is different for each person; however, consumers cannot tell the contents of the raw materials of sake. In low-profit manufacturers, it is easy for incorrect practices to lead to the addition of hidden cheap ingredients. In addition, manufacturers who do not have sufficient technical capability are prone to fraud by mixing improper ingredients to stabilize quality. This is a risk that any food maker is liable to run.

It is doubtful whether this injustice is due only to the judgment of the manufacturing site or to the pressure from the top management. Also, considering whether a system to prevent fraud was implemented in the company, we will introduce the contents of the Third-Party Committee report (Genon HD 2014a).

Background of fraud

First of all, we summarize the background of the fraud from Section 4.3 of the Third-Party Committee report. Sake making involves natural

[18] *Moromi*: Fermented rice. The liquid before the *Nihon-shu* stage.

phenomena—that is, fermentation—which is an unstable process in manufacturing. At the Fukumusume Brewery, they started using rice for processing in 2011, and they switched the brewing method from *shubo*[19] brewing to *koubo*[20] brewing. As a result of this change, the fermentation did not proceed as expected by the manufacturing staff.

The staff consulted with their superior (manager in the Manufacturing Department) and tried various measures, but it did not go very well. So a staff member decided to add brewed alcohol to *Junmai* sake at his own discretion.

The solution seems to be to take enough time for fermentation. But as the fermentation period was extended, the production was delayed. Due to the constraints of the production facilities, it was not possible to start production of other varieties. In order to adhere to the production schedule, they could not spend more time than planned and take things easy.

After that, three employees took over this task and also took over the addition of brewed alcohol. One of them noticed that this addition was cheating, but the other two were unaware of the wrongdoing.

The Manufacturing Department conducts job rotation of managers, and five people were replaced. They said that they were not involved in this corruption and that the factory director and the president, who were more senior than the manager, were not involved.

Reason for fraud

The direct cause of this incident is that the company tried to cope with a lack of technical skills with inappropriate judgment from the person in charge. It was not because of the desire of the person but rather an action that was done in an attempt to keep the factory's production schedule intact. So it was a situation where it was easy for this employee to make an excuse. His superiors and managers were not involved in the fraud, but since it was his manager who set up a tough schedule of production, impossible planning became a source of pressure to the person in charge of the site. Under such circumstances, what kind of preventive measures do we have in place against fraud?

It cannot be expected that the person in charge who initially committed the fraud will whistle-blow. If the successor who noticed the fraudulent act

[19] *Shubo* is cultured yeast mixing koji, rice and *koubo* for brewing *Nihon-shu*.
[20] *Koubo* is sake yeast.

decided to be a whistle-blower, it would not have prolonged the corruption. Even though the successor used a method that was not legal, there would have been no guilt in taking over the method of his predecessor; or, perhaps he did not carefully consider whether the method he took over was correct, in order to protect the production schedule.

3.3 Process and material management

Next, we analyze the mechanism of checking the unauthorized use of raw materials from the perspective of the first and second defense lines.

Violation of record obligation

Section 4.3 (5) of the report explains the violation of the "*moromi* history book" record. The outline is as follows.

The person in charge added brewed alcohol to *moromi* so that the total weight of the *moromi* would increase. For the sake of being consistent, the person in charge recorded this as "adding water" to the *moromi* history book. In actuality, it is supposed to be written as "I added brewed alcohol", so this is a breach of record obligation.

Since this brewed alcohol uses one of the storage tanks, it must be recorded in the "payout book" of alcohol. The person in charge kept logging it as "to use it for making ordinary sake" to conceal it, and they rationalized the alcohol stocks in the storage tanks. This was not conspicuous because most of the factory is used for making regular sake, for which the brewed alcohol is used.

Also, using brewed alcohol will cause brewed alcohol to be moved from the storage tank to another location, so the person in charge must record the move in the "container moving book". The person did not keep to the rule of recording the move in the movement operation book, so this led to a situation in which nobody knows what the brewed alcohol was used for.

When the person adds brewing alcohol to *moromi*, he should record this process in the "movement operation book" and provide instructions for this operation to other persons in charge. It is written in Section 4.3 (1) – (3) of the report that this action was recorded in the movement operation book.

These books are systems for preventing illegal use of raw materials in the factory, but these systems were easily broken because the person who registers the book is the same person who uses the ingredients. When

using raw materials, there were no monitoring mechanisms such as multiple people in attendance. In other words, it can be said that the first defense line was not created.

Use of nonstandard rice

The contents of Section 4.4 (5) of the report are summarized below.

Regarding the receipt and use of white rice at the factory, inventory is managed with a "white rice receipt and payment book". Since the factory is supposed to use rice of third-class or higher quality for *Tokutei-meisho* sake, if it used something outside the standard then there are places where the product is inconsistent with the receipt and payment table. Otherwise we have to adjust logs by writing a lie.

Also, the survey by the National Tax Agency in August 2013 pointed out that the quantity of raw material rice received did not match the quantity in the records; from this, the false advertising was discovered. Several other inappropriate acts have been pointed out, but in the following section we focus on and analyze the addition of brewed alcohol.

Administrator's problem

The contents of Section 4.3 (4) of the report are summarized below.

It was a rule that the president, the plant manager, the quality management group manager and the person in charge stamped the *moromi* history book.

Mixing brewed alcohol with the *moromi* of *Junmai* sake would change the sake meter value[21] (SMV) and the alcohol. As these figures were recorded accurately, the report points out that if there was sufficient knowledge and experience among the senior people, they may have noticed a change in the unnatural numerical value.

Also, the movement operation book where the addition of brewed alcohol was recorded was available for viewing by a group manager and others. The report pointed out that it was able to notice the addition to the Junmai sake by checking this thoroughly.

Group managers, plant managers and presidents were not involved in the irregularity, and they did not recognize this irregularity, but supervisory responsibility is required. The second defense line was not effective in that

[21] Sake meter value (SMV) is one of the Japanese measures used to express the taste of *Nihon-shu*. When the SMV is positive (negative), the taste is dry (sweet).

the person in the company did not notice the unnaturalness of the record that the outside person noticed.

3.4 Cause analysis

Section 5.1 of the Third-Party Committee report points out the cause of fraud concerning the use of brewed alcohol as follows:

> (1) Technological shortage of manufacturing personnel
> We already explained about technological shortage. Also, replacing the external brewer with the in-house brewer is one of the reasons for lack of technological expertise.
>
> (2) Problem of production schedule
> Fukumusume Sake Brewery continues to be in deficit management, and personnel reduction has been implemented for cost reduction. Since the sales of *Junmai* sake have increased dramatically, the raw sake of *Junmai* sake has been scarce, and the person in charge had to manufacture it according to the production plan. This is also a cause of the fraud.
>
> (3) Selection of raw material rice
> Oenon HD has launched a policy to use a certain amount of rice for processing[22] as a raw material, and Fukumusume Sake Brewery followed its policy. As a result of using this rice, the person in charge communicated to the group manager that there was a manufacturing problem. However, there was no authority for the person in charge to decide on the raw material rice, and the manager did not change the raw rice. The manager's decision is also one cause of the fraud.
>
> (4) Insufficient communication between administrator and site
> This is because there was no place to exchange information regularly between the group manager and the staff in the field, so they could not share knowledge of the problem.
>
> (5) Insufficient management awareness by administrator
> It was pointed out that the group manager was not conscious of risk management at the manufacturing site and did not check the books in detail. Because the unnaturalness of the records was discovered by the National Tax Agency, the group manager should have noticed inappropriate conduct if he was watching the record closely.
> Also, since the group manager would be transferred in a few years, it is concluded that the consciousness of understanding and supervising at the manufacturing site were low. Although the same person works for many

[22] Rice for processing is a kind of lower-class rice, and it is cheaper than food rice.

years at the same division, and this is the cause of the connection and injustice, it is not easy to change the person in a short period of time.

(6) Quality control problem

The quality management group analyzed the sample of *moromi* and did not read the *moromi* history book. In other words, they checked only the results without checking the process. Also, this group was not expected to play a role in checking for problems at the manufacturing site.

It is pointed out that the Manufacturing Department and the Quality Control Department are connected only by the finished product, but that the Quality Control Department should also inspect the manufacturing process. Information exchange between Manufacturing Department and Quality Control Department is not organizationally done. This bad communication is the reason why corruption continued for many years. This indicates that the second defense line was not effective.

(7) Lack of awareness of compliance

In this case, the low level of awareness of compliance is the biggest cause; but, as mentioned above, it is pointed out as "Leaving the factory to the manufacturing site" in terms of management awareness and compliance awareness of group managers. And the lack of awareness of compliance is written as a serious risk for the whole Fukumusume Sake Brewery organization.

Audit function

The report has little description about the internal audit function, and it does not refer to the auditor at all. This is an important oversight of the report.

3.5 Measures to prevent recurrence and issues

In Section 6 of the report, the responsibility of stakeholders in this case is indicated. We will summarize the outline.

Responsibilities of the company and the subsidiary company

This case was a site-level fraud case of a subsidiary company. In this case, how much is the responsibility of the parent company to be questioned?

In Section 6.2 of the Report of the Third-Party Committee, it is said that the site leader of the Fukumusume Sake Brewery has the most

serious responsibility, and the responsibilities of group managers, plant managers and the president are also important.

In Section 6.5, the responsibility of the parent company ●enon H■D is stated. The managers above the manufacturing group manager of the Fukumusume Sake Brewery were all transferred from other companies in the ●enon Group, and they had repeatedly been transferred within a short period of time. This shows that the influence of ●enon H■D's management on the Fukumusume Sake Brewery is strong, and it is said that the president of ●enon H■D and the director in charge are also responsible.

Third-Party Committee's measures to prevent recurrence

Section 7 of the report recommends several recurrence prevention measures. In addition to thoroughly ensuring compliance, the report proposes replenishment of production facilities, adopting an appropriate production schedule, collaboration between the quality management group and manufacturing group, and communication between site and administrator, among other measures.

Recurrence prevention measures

Are the above measures enough to prevent recurrence? It seems that the report referred to only plant investment and mental theory measures. The problematic behavior of the person in charge of the site was due to insufficient internal control.

In particular, regarding the use of raw materials (brewery alcohol, rice, etc.), there should be something that can be improved structurally, such as a third party to monitor updating of records. In other words, maintenance of the first defense line is the key.

Measures to prevent recurrence from ●enon H■D (●enon H■D 2●14b) were announced in February 2●14. They focus on compliance, thorough inventory control and similar measures—basically, these contents respond to the recommendations of the Third-Party Committee.

In terms of the first defense line, it is better than the recommendation that the secondary factory director will be present when checking the use of raw rice. However, it is worrying that there are no specific improvement measures for checking when using brewed alcohol.

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CHAPTER FOUR

DATA FABRICATION AT KOBE STEEL

In October and November 2017, during the inspections for Nissan Motors, Kobe Steel, a Mitsubishi Materials and Toray subsidiary, was reported to have fabricated the quality data of their products. Since scandals like these continued in the top levels of industry in Japan and symbolize Japan's manufacturing quality, it is broadly worried that the trust in Japanese products will reduce.

In this chapter, we will address the problem of quality fabrication of Kobe Steel. First, we will see from the viewpoint of the company's risk management concept whether there was a problem or not, and our analysis will be based on newspaper reports and company materials.

4.1 Overview of the incident

First of all, we will look at the article from the *Nihon Keizai Shimbun newspaper*[23] and summarize this incident. From the article on October 9, 2017,[24] Kobe Steel tampered with product quality data for the customer, although products such as aluminum parts did not meet product standards. There are four factories, including Chofu Factory in Yamaguchi prefecture, that tampered with data for the customer. They faked the strength and dimension data for products such as aluminum and copper from September 2016 to August 2017; these products made up 4% of their annual sales. Data fabrication from that company started a decade previously, and dozens of employees—including managers—were involved, which suggests the fabrication was carried out at an organizational level.

[23] *Nihon Keizai* is Japanese for "Japanese economy". *Nikkei* is the shortened form of *Nihon Keizai Shimbun* and is also known as *Nikkei 225*.

[24] *Nihon Keizai Shimbun*, "Kobe Steel alters data on aluminum parts," October 9, 2017.

Table 4.1 is a summary from the *Nihon Keizai Shimbun* article dated October 12, 2017.[25]

The customers of that problem product are comprised of around 200 companies, including the subsidiary of Mitsubishi Heavy Industries which developed the national aircraft "MRJ", the Central Japan Railway Company (JR Central) and Toyota. And the news spread globally because the problem related to the safety of passengers. Then, the discovery of quality fabrication continued with the company's iron powder and metal materials at Kobelco Research, which is a subsidiary of Kobe Steel, and on October 13 the main product of iron products was found to have fake quality certification data.

After that, at Kobelco Material Copper Pipe's Hadano Plant, copper pipes were supplied with Japan's Industrial Standard (JIS) mark, but it was found that these products did not satisfy the JIS standards. Naturally, the JIS certification was canceled. Originally, it was explained that the company's crime had been committed ten years ago, but according to the latest announcement, it was said that it had continued from several decades ago.

Table 4.1 Data tampering at Kobe Steel

Aluminum and aluminum-forged product	Chofu Factory (Shimonoseki City, Yamaguchi Prefecture) Mooka Factory (Mooka City, Tochigi Prefecture) Daian Factory (Inabe City, Mie Prefecture)
Copper product	Chofu Factory (Shimonoseki City, Yamaguchi Prefecture) Kobelco Pipe Material, Hadano Factory (Hadano City, Kanagawa Prefecture: Cancelation of JIS)
Ironpowder	Takasago Factory (Takasago City, Hyogo Prefecture)
Film forming material for optical disc, etc.	Kobelco (Kobe City, Hyogo Prefecture)

[25] *Nihon Keizai Shimbun*, "Shinkansen components, outside JIS standard, Kobe Steel alteration problem," October 12, 2017.

The fraud was revealed by the voluntary inspection of the Aluminum and Copper Division in August and was reported to the president and the directors on August 30, 2017. The announcement was on October 9, and because it took more than a month to be announced, the delay of the response was also criticized.

Chairman and President Mr. K said that it is not "a law violation" or "there is no fraud in the steel business".[26] However, after that the JIS certification was canceled at a subsidiary, and a new steel fraud was found out. So, the situation was totally different from the announcement from the president.

4.2 Risk management of Kobe Steel

The basis of risk management is to set the management philosophy as the central axis of risk management. Was the management philosophy applied in risk management at Kobe Steel? First of all, let us confirm the company's management philosophy, then we will investigate the situation of risk recognition and analyze their relationship.

Management philosophy

Kobe Steel set its group management philosophy in 2006.

Kobe Steel Group Corporate Philosophy[27]
1. We provide reliable technology, products and services
2. We honor each employee to respect the group's harmony
3. We will create new value through constant change

In that year, "Kobelco" was established as a group brand. And they are working to make the people around the world recognize that "Kobelco" means a "trusted corporate group".

In 2017, the company philosophy was changed to "Kobelco's Three Promises". Although the naming was changed, the "reliable technology, products, services" is listed first, as before; that is, the attitude of respecting trust is unchanged.

The "philosophy" is declared to the public, so it is like a billboard. On the other hand, "promise" has a strong meaning like a contract with

[26] *Nihon Keizai Shimbun*, "Kobe Steel admits Steel Product Tamper," October 13, 2017.

[27] From Kobe Steel website: http://www.kobelco.co.jp/progress/core-value.html, Accessed January 31, 2019.

stakeholders, or an obligation imposed on them. In other words, they tried to make their pledge to be a "trusted" company stronger than ever. But only six months after that detemination, they were found betraying "trust" around the world. Because breaking their promise is more wicked than breaking their own philosophy, they fundamentally lost the reliability.

The most important purpose of risk management is to make sure the management philosophy becomes reality. Was the management philosophy applied in risk management at Kobe Steel?

Business risk in annual securities report

Let us check how Kobe Steel deals with business risk from its annual securities report (Kobe Steel 2017a). Eight important business risks are stated in Chapter 2.4 of the securities report. This is summarized in Table 4.2 and classified according to four concepts of risk (market risk, operational risk, strategic risk, hazard risk).

Among the eight risks, the top three items are sales and cost fluctuation risks, and these are all classified as market risks. Because the content of financial risk also describes market risk, half of the items (four items) are classified as market risks. Each risk has internal and external factors, and this is also roughly stated in the table. As a result, we can understand that the company set the market risks with external factors as the top priorities.

It is noteworthy that the risks related to quality defects are not taken up at all. From this we can say that the company has absolute confidence in the quality of their products. However, the "trust" of Kobe Steel collapsed catastrophically due to quality incompatibility and the hiding of quality misrepresentation.

Quality fabrication falls under the internal fraud risk type, which has also not been taken up. Of the eight risks, only two of them have internal factors, and we can see that they are not looking at internal risks.

By falsifying quality data, the brand value of Kobe Steel was largely discarded. It is known that the purpose of risk management is to maintain and improve corporate value, especially brand value. Therefore, quality defects and camouflage were the most important risks for Kobe Steel.

Table 4.2 Business risks of Kobe Steel

Business risk	Type of risk	Factor
1. Economic situation of major markets	Market risk	External
2. Changes in steel material sales quantity/price	Market risk	External
3. Price fluctuation of raw materials, etc.	Market risk	External
4. Impact of environmental regulations	Strategic risk	External
5. Impact on operations due to accidents, disasters, etc.	Operational risk	Internal/External
6. Risks of litigation, etc.	Strategic risk	External
7. Financial risk	Market risk	External
8. Realization of medium-term management plan	Strategic risk	Internal/External

Management philosophy and risk management

From the business risk in the securities report, it appears that the management team believes its employees and has absolute confidence in the quality of its products. Despite the importance of "trustworthy technologies, products" in their management philosophy, they are missing quality risks.

If the management philosophy is not reflected in risk management, the philosophy will only float in the air. To make matters worse, the company's "promise" was an empty promise. It can be said that there was a serious disadvantage in the policy of risk management that the BOD set up. Because of this, the Audit Committee also has problems.[28]

In risk management, the most important thing is to deal with something that was experienced in the past or predicting what will happen in the future. On the contrary, when an unprecedented and unpredictable incident occurred, it was taken as an accident.

[28] The company was a company with a Board of Corporate Auditors, but it was changed to a company with an Audit Committee in 2016.

Kobe Steel is a company that insists on "trust" at first priority. Was quality fraud unprecedented and unpredictable?

Unfortunately, its subsidiary Nihon Koshuha Steel discovered the scratching of steel tensile test data in 2008, and its JIS certification has been canceled. Since quality fraud is a risk that has been experienced by a group within the company, quality risks should be included in its risk management.

In other words, there are double deficiencies in the fundamental part of risk management. With regard to this incident, Kobe Steel published two reports: one in 2017 (Kobe Steel 2017b) and one in 2018 (Kobe Steel 2018). In this chapter, we refer to them as the provisional report and the final report, respectively.

The above-mentioned deficiency has not been referred to in the provisional report, nor in the final report. The company has launched various countermeasure policies in response to the subsidiary's fraud, but in order not to be regarded as perfunctory measures, it is necessary to rethink the fundamentals of its risk management.

Comparison with Canon

The annual securities report of Canon Inc. (Canon 2017) addresses "bad quality of products that discard brand value" as one of the business risks. Despite the presence of a fine management philosophy in Kobe Steel, a humble attitude like Canon's was lacking.

4.3 Quality problem

From the report from the *Nihon Keizai Shimbun*, we know that the strength of the aluminum product that is used for the Shinkansen[29] of JR East, JR Tokai and JR West[30] is not sufficient. Specifically, the ratio of inadequate products in which the strength did not meet the standard set by JIS is inappropriate. This is summarized in Table 4.3.

[29] A network of high-speed railway lines in Japan.

[30] In April 1987, Japanese National Railways became privatized, and railroad companies such as JR East, JR Central (JR Tokai) and JR West were established. JR East has a head office in Tokyo, and it operates in the Kanto and Tohoku districts. JR Central has its headquarters in Nagoya and operates mainly in the Chubu region. JR West has its headquarters in Osaka, and it operates in the Kansai, Hokuriku and Chugoku regions, among others.

From this we can understand that there are mixed amounts and percentages of the material of which the strength is less than the standard. Therefore, some people say "the average value is over the standard, so it is not a fraud in quality". In order to clarify this point, the way of thinking about quality is organized as follows.

Table 4.3 Insufficient strength of aluminum parts of Shinkansen for the three JR companies

JR East[31]	Compared with Japan's Industrial Standard (JIS), the strength of the shaft box of the Shinkansen truck used in the past ten years is about 0.4% lower than that of the JIS of the "E5 series" of the Tohoku Shinkansen, in which the risk of breaking because of corrosion is up to 5%. The percentage of shaft-box-incompatible parts is 1.6%.
JR Tokai[32]	For the past five years, 310 parts from two types of the Tokaido Shinkansen "N700A" parts did not satisfy JIS standards. In the survey for the past ten years, there were parts whose strength was up to 3% below the JIS standard that JR Tokai was looking for, such as parts used for the Tokaido Shinkansen to connect the damper and the car body. A significant percent of the parts have insufficient strength.
JR West[33]	The strength of the parts used for bullet trains is several percentage points below the standards of JIS.

Concept of quality assurance

In manufacturing, quality varies with strength and dimensions. To make it simple we describe it as "quality". Then, when the horizontal axis shows quality and the vertical axis shows the number produced, in many cases the quality is uneven, as shown in Figure 4.1. At this time, those whose quality is outside the allowable range are nonconforming items.

In the case of a dimensional error, it is thought to be an error on both sides (within the allowable error range of the dimension), but in the case

[31] *Nihon Keizai Shimbun*, "Kobe Steel made a difference in information disclosure," October 21, 2017.
[32] *Nihon Keizai Shimbun*, "Kobe Steel, tampering is not wiped out," October 20, 2017.
[33] *Nihon Keizai Shimbun*, "Kobe Steel falsified steel products," October 13, 2017.

of the strength, it can be thought of as one side error (more than the standard), so here only the left side of the graph is nonconforming.

The occurrence of nonconforming items can be reduced in three ways. This is shown at the lower part of Figure 4.1. The graph at the bottom right of the figure shows how to improve the precision of production and reduce variations in quality. By narrowing the range of variations, we can reduce the number of products below the standard.

Alternately, quality level can be improved as a whole, as shown at the bottom of the figure. This method reduces nonconforming products. Either way, the cost will be high, so it will be a balance between cost and effect.

In addition, there is a method used to detect and repel nonconforming products in the Inspection Department. Which method to take depends on cost performance, which is also the challenge of risk management itself.

Three σ method

Usually, in quality control, the 3σ method is applied. By using this method, the incidence of nonconforming products (one side) should be suppressed to 0.14% or less. This is a way of thinking about accepting nonconforming products if there is less than one nonconforming product per 700 items.

There is a significant abnormality because only 1.6% of the goods in the exile boxes used for JR East's Shinkansen were nonconforming (one in about 60 items). There are items that are said to have a few percentages of strength shortages in JR Tokai, which is also an abnormal nonconformity rate.

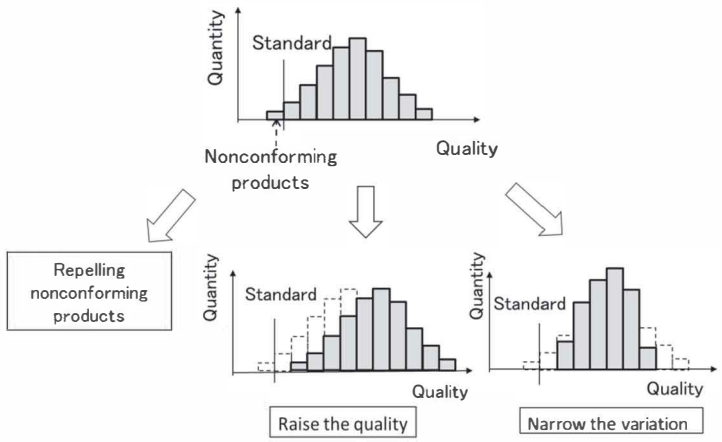


Figure 4.1 How to ensure the quality of products

Therefore, in order to pass acceptance at the time of delivery, it is thought that this incompatibility rate had been faked at the stage of inspection.

4.4 Outline of fraud and management responsibility

The final report, "Report to Inappropriate Acts in Our Group" (Kobe Steel 2018), has been published by Kobe Steel. The company is under investigation from US judicial authorities concerning this matter, and damages claims in Canada have been filed. For this reason, Kobe Steel did not publish the whole report by the External Investigation Committee as it is.

The published report was summarized on the company side for the same reason. Therefore, the responsibilities of the BOD and the former supervisory board are not investigated. There is also no explanation of specific facts concerning the fraud. There are many unclear parts left in the report, and from this fact, it cannot be said that it is fulfilling society's expectation.

In the following section, we will analyze the incident by referring to this report. Table 4.4 summarizes the fraud from Chapter 3 of the report. The report describes the instructing person, the department that committed the wrongdoing, and the method and period of inappropriate conduct. And there were 43 cases of tampering with and creating inspection data at 19 sites in Japan. As can be seen from the table, the majority of data tampering was done in the Quality Assurance Office. And we can see that there was an order from the senior at the Manufacturing Department or Quality Assurance Office in the same site to the person in charge.

Table 4.4 Instructor and performer of test data tampering in Kobe Steel

	Site	No.of cases	Instruction	Department / person in charge	Term / Supplementary matter
Aluminium & Copper Division (Kobe Steel)	Mooka Factory	3		Each quality control room of the quality assurance office	1970's-
			Production department staff	Same Inspection team	2005/5-2018/2
	Copper Plant, Chofu Factory	3	Copper plate quality assurance office head · Staff	Subsidiary SKSS inspector	
	Aluminum Extrusion Plant, Chofu Factory	2		Dimension / appearance inspection consigned to: Shinko Fab Tech Co., Ltd.	1970's- Disturbance of internal investigation
	Daian Factory	4	Hydraulic forging room leader and chief	Quality Assurance Office Staff	Former two directors were tampering when they were employees
			Machining room	Quality assurance office inspector	
Business unit other than aluminium and copper (Kobe Steel)	Iron powder plant, Takasago Factory (steel business unit)	1	Quality Assurance Office Staff ⇒	Inspector in the same office	
	General purpose compressor plant (machine business unit)	3		Manufacturing group (office) inspector, quality assurance group	
	Industrial Machinery Unit (Machinery Business Unit)	1	Trustee group head	Person in charge of inspection department in high function product	
Group company of aluminium and copper business unit	Kobelco Material Co., Ltd. Copper pipe Hadano Factory	3	Technical department quality assurance office staff	Inspector in the same office	
	Shinko Metal Products Co., Ltd.	8	Quality assurance office manager	Staff in the same office	
				Director of Quality Assurance office	
				First Manufacturer, Second Manufacturing Department Inspector	
				Second Manufacturing Department Inspector	
	Shinko Aluminum Wire Materials Co., Ltd.	2	Head of Engineering Department, Quality Assurance Department⇒	Quality technology group inspector	The plant manager concurrently serves as the quality assurance office manager
	Shinko Mooka Integrated Service Co., Ltd.	1		Director of commissioned research	
Group companies other than aluminium and copper business unit	Shinko steel wire stainless steel Co., Ltd.	1	Production department technical design staff	Quality assurance office inspector	Initially found, JIS violation
	Shinko Steel Plate Processing Co., Ltd	1	Manufacturing team leader	Sales staff	
	Nippon Koshuha Steel Co., Ltd. Toyama Factory	1		Technical department strait engineering office, laboratory, quality assurance office	
	Kams Kanto Techno Center Co., Ltd.	1		Sales representative	
	Shinko Seiki Co., Ltd.	2	Quality Assurance Room Staff	Quality assurance office inspector	1977-
	Shinko Environmental Solutions Co., Ltd.	3		Chief examiner of the analytical laboratory of the Technology Development Center	
	Target Business Unit Kobel Kaken Co., Ltd.	2		Inspector of Production Department Manufacturing Unit, Division Production Control Unit Inspector	
	Materials Solutions Unit, Kobel Kaken Co., Ltd.	1		Material Evaluation Engineering Department Corrosion Protection Technology Office Manager	

Expansion of fraud

As we shall see later, the fourth chapter of the report states "the management of profitability" as the first factor that caused the fraud. Therefore, management pressure was a serious cause. But "Why did it happen at the Quality Assurance Office in each site?" is not referred to. In other words, we do not know how management pressure has affected the Quality Assurance Office.

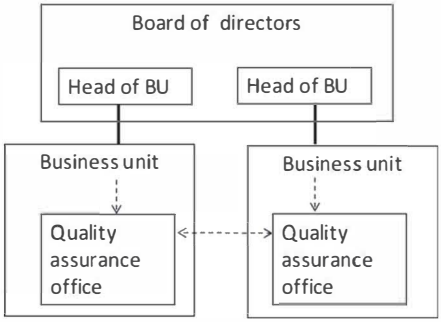


Figure 4.2 By what route did the fraud expand?

According to Chapter 5-I-2 (4) of the report, at this company, all heads of the business units were members of the BOD. Therefore, management pressure came directly from the head to the business unit. However, this pressure has not been analyzed regarding the route by which the Business Department head gave an order to pressure the Quality Assurance Office. This is the most unclear aspect of the report. This problem is shown in Figure 4.2.

Chapter 4.2 (3) of the report states that one of the causes of the fraud is that the company style is closed due to the fact that there is no employee transfer among Business Departments. Because there is no employee transfer between bases, it cannot be said that fraud has expanded through employees.

So why did the fraud spread to the Quality Assurance Office of each site? It is necessary to clarify this question and think about measures to prevent recurrence.

Problem of organizational structure

Since the Quality Assurance Office is an Inspection Department, it should be expected to conduct inspections in a stand-alone position from the production site. In order to ensure its independence, in theory it must be positioned without profit responsibility. This is because if the Inspection Department has the same profit responsibilities as the Production Department, it may deliberately pass defective products.

It is easy for users to understand defects in products like electric appliances. Accordingly, if the user notices the initial malfunction, it will be repaired free of charges. For this reason, the Inspection Department will not deliberately pass defective products of this nature.

However, it is not easy to see the quality of the material. Assume that the percentage of nonconforming items was 1%. If you tamper with this to make it appear as 0.1%, the user does not notice this fraud. Explicit problems may not always occur practically. If the production schedule is difficult to follow, inspection tampering will be more likely to occur, in order to make it in time for the delivery date.

In Kobe Steel, the Quality Assurance Office is located as the substructure of factories or business units. So, the independence of inspections is not ensured. Indeed, Table 4.3 shows a case in which the head of a factory concurrently serves as the manager of the Quality Assurance Office at Shinko Aluminum Wire Co., Ltd., but this also makes us understand the easygoing attitude to quality control in this company.

4.5 Cause analysis and measures to prevent recurrence

Cause analysis

In the fourth chapter of the final report, the following are given as the three direct causes of the fraud.

Direct causes
(1) Received orders / manufactured products based on customer specifications which did not possess manufacturing capability
(2) Tampering and modification of test results, etc. because the environment at the company made it easy to do so
(3) Apathy of employees regarding quality compliance

And the root causes of the fraud are specified as the following three points.

Root Causes
(4) Management of profit first and insufficient organizational structure
(5) Factory management lacking balance, and declining awareness of quality compliance among employees
(6) Insufficient quality control procedures facilitating this inappropriate behavior

Cause (1) means that orders were prioritized over the capability of production. As a result, it means that the product was delivered in time for delivery, even though the quality was bad.

Causes (2) and (3) mean that there was no system to prevent falsification of inspection results and employees are not aware of compliance responsibilities. For example, the inspection value entered at the Quality Inspection Department could be rewritten by the Manufacturing Department or the Quality Assurance Department. In the case of Toyo Rubber, the reason for fraud easily occurring is that the data was not shared among departments. In contrast, Kobe Steel could tamper with the data via the system that can share the data.

To prevent a fraud by using the data sharing system among several departments, it is also necessary to introduce the rules of the authority for access to and entry of data, record keeping, and so on.

Governance improvement

As a countermeasure in governance to prevent recurrence, Chapter 5 I-8 of the final report proposes that Kobe Steel sets a quality charter, and by this they are trying to recover the trust.

Chapter 5 I-2 of the final report proposed a reform plan at the governance level, such as reviewing the composition of the BOD. Specifically, this is to increase the ratio of independent outside directors on the BOD to one third or more (five people), and to set up a "nomination and compensation committee". The organization of this committee is not shown.

Since the three members of the Audit Committee are outside directors, it seems that the in-house directors will maintain the controlling power in the nomination and compensation committee. Therefore, it is almost unknown whether substantive governance reform will progress.

However, it is not explained how such governance reform will lead to prevention of data tampering. Again, it is because the final report does not state the responsibilities of the management team, and by which route the pressure of management has been transmitted to the site of the crime has also not been clarified.

4.6 Three lines of defense

Let us check the recurrence prevention measures in the executive department from the perspective of the three defense lines.

Strengthen quality assurance

In Chapter 5 II-1 of the final report, in order to strengthen the quality assurance system, the Quality Assurance Department under the direct control of each business unit is to be established to separate the quality control and quality assurance functions of each establishment, and so that the Quality Assurance Department should be under the direct control of the head of each business unit.

It is the role of the second defense line to monitor at site so that no mistakes or frauds occur. Originally, the Quality Assurance Department was supposed to be the second defense line, but because it is under the direct jurisdiction of the business establishment, it cannot inspect manufacturing positions within the business unit.

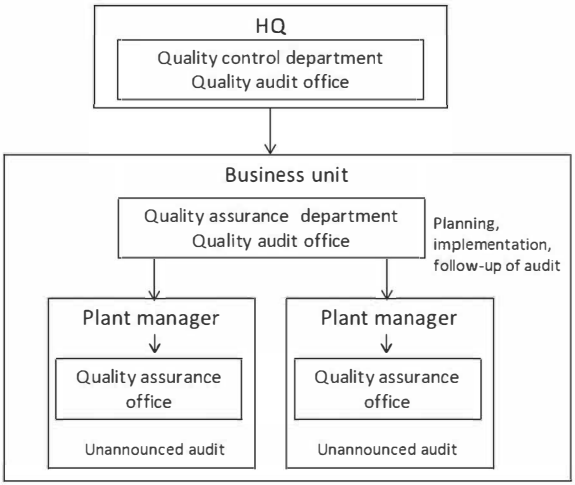
In sites where tampering continues for a long time, there is a possibility that the employee who committed the fraud has been promoted to the position of business manager or director. In that particular system, the monitoring from the Quality Assurance Department may not work. In fact, in Chapter 3.1 (5) of the report, it is said that two of the unauthorized performers later became directors through the manufacturing manager, the plant manager and the manufacturing director, etc.

Chapter 5 II-1 (3) strengthens the independence of the Quality Assurance Office by not having the head of the Quality Assurance Office concurrently also be the head of the Design and Manufacturing Department of the factory. However, as long as the Quality Assurance Office is under the direct control of the factory, the second defense line remains absent.

The third defense line

In Chapter 5 II-1 (1) of the final report, the Quality Control Department and Quality Audit Office were to be established at the headquarters, and the internal audit was to be conducted. In other words, the Quality Audit Office would play the role of the third defense line. As written above, the audit is conducted as a third defense line, and it should be independent from the executive department. If we put an audit function in the Business Department, we cannot monitor fraud at the Business Department level.

Specifically, as stated in Chapter 5 IV, in the Aluminum & Copper Business Division, the Quality Audit Office of the Quality Assurance Department plans, conducts and follows in-house audits. Planning and implementing the audit there may make it easier for the business unit to control the auditing function. Monitoring of the third defense line becomes less effective in this system. Figure 4.3 illustrates the concept of these enhanced systems.



Second defense line is absent. Independence of the third defense line is weak. The quality audit office is placed in the quality assurance department only for aluminum and copper business unit.

Figure 4.3 Strengthening the system for the quality assurance function

It is stated in Chapter 5 III-1 (2) of the final report that the Quality Assurance Office in the business unit will perform unannounced audits of their business unit. Although it is a principle that the audit function should be independent from the executive department, this measure goes against that principle. The effect of this measure is questionable.

As a result, there is a danger that the audit function will be redundantly distributed to business divisions and subordinate business sites, and the audit responsibility will be ambiguous. The triple audit system misleads us. If the site is strongly involved in the audit, it is counterproductive.

To summarize the risk management problems of recurrence prevention measures, the second defense line is absent, and the independence of the

audit function is weakened by duplication of the audit function Although the first defense line was strengthened as a whole, it cannot be said that the second and third defense lines were improved.

Management responsibility

In accordance with the publication of the final report, the president and the responsible vice president resigned to take responsibility. However, the report does not explain the responsibilities of the current and past management team and corporate auditors. From this point, it cannot be said that the report was fulfilling the accountability that is expected from social norms.

As noted in Table 4.3, fraud is a problem that has been present since the 1970s, and past directors also have committed fraud. Both the current management team and past management teams bear the same amount of responsibility, so it is not sufficient to have only the current president resign.

Since 1972, there have been 11 presidents who served Kobe Steel (excluding the current president), so the term in office of each president is 4.2 years on average. The president who resigned was in his fifth year in office, so it was just the right time to change. The resignation at this time may be a natural change rather than taking responsibility.

4.7 Challenges for recovery of trust

Disparity between management team and employees

Chapter 3.1 (4) of the final report states that around the year 2009 at the company's Daian factory, the plant manager knew that there was inappropriate conduct occurring, so he instructed the Quality Assurance Office manager, Hydraulic Forging Office manager and Forging Office general manager to stop. However, his instructions were not followed, and the tampering continued.

It is a simple matter to understand that the factory operated wrongly without obeying the instructions of the boss. The reason why it occurred was not explained. It is up to the boss to evaluate the performance of the employees, so there should have been a solid reason why they were not able to follow the instructions of their boss. If the employee does not follow the production plan, the performance evaluation of the employee will be bad, so they may commit fraud. The report gives the impression that only the person in charge is the cause of the fraud.

Furthermore, Chapter 1 of the final report stated that the investigation by the External Investigation Committee was started because there was a sabotage act during the voluntary inspection at the aluminum extrusion plant at the Chofu Factory.

Furthermore, the company issued a press release (Kobe Steel 2017c), "About obstruction in our group's quality voluntary inspection", where it is stated that the company would strictly punish the persons who obstructed. it.

Meanwhile, the report's Chapter 3.1 (5) states that the person who performed the data tampering in the past was promoted to a senior managing vice president or vice president position and reported no frauds to the BOD.

The company did not seem to issue press releases about this case. It is thought that this case also deserves a press release as much as the obstruction of employees does. The difference between these releases suggests that there are disparities in position rather than in the distance between management and the site.

From the series of reports on the Kobe Steel incident last year, the impression that we received was "the managers are honestly doing their best". However, because of the gap which hid in the company's release or final report, it feels like there was a manipulation tactic to preserve the company's image.

It is not an impression that the company expected to make; the quality should be guaranteed by the numerical performance. In this respect, these incidents are something very disappointing.

Distance between employees and the management team

Chapter 5 I-7 (1) of the final report states, "Executives regularly will visit multiple domestic and overseas business offices and bases, and speak directly to employees". This is an action taken to shorten the distance between employees and the management team. However, the gap will not disappear unless the uncertainty of the report and the stance of the press release are corrected, and the effect of a visit cannot be expected.

Challenges for recovering trust

Currently in Japan, the elite bureaucracy tamper with the official documents, and the presidents of superior enterprises such as Toshiba and Olympus take the leading role in accounting fraud. Even in the case of

employees pointing out suspicions data for fuel consumption at Mitsubishi Motors, the management team neglected to make a serious response.

Nonetheless, the quality assurance of Kobe Steel depends on the compliance of Business Department managers' and plant managers' classes. Having drastic measures to rebuild the second and third defense lines shall be a challenge for the recovery of trust.

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CHAPTER FIVE

FACTORY INSPECTION ISSUE: JXTG ENERGY MIZUSHIMA REFINERY FRAUDULENT INSPECTION RECORDS

In July 2012, JX Nippon[34] Oil & Energy (currently JXTG Energy) was found to have sent falsified safety inspection reports to the Okayama Prefecture. The outline of this case is explained based on reporting from the *Asahi Shimbun* newspapers.[35]

5.1 Case outline

Falsified reports and incidents in the Mizushima Refinery

The problem occurred at the Mizushima Refinery in Kurashiki City, Okayama Prefecture, Japan. In the refinery, there are Factory A and Factory B. In February 2012, a subsea tunnel connecting the two factories collapsed during construction. Although the tunnel incident was the responsibility of the construction contractor company, it claimed five lives.

Furthermore, in the previous year, 2011, it was discovered that soot measurement was not done in the refinery for 40 years, and that resulted in falsified records. In this case, since the tank's falsified record had been uncovered, the executive of the Kurashiki City Govemment stated that:[36]

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[34] "Nippon" is often read as "Nihon"; both are the Japanese readings of a country name of Japan.

[35] *Asahi Shimbun*, "JX Nippon Oil & Energy did not measure dust," March 1, 2011; "JX refinery, submarine tunnel flooding, 5 people missing," February 8, 2012; "Mizushima Refinery gas tank false test record," July 14, 2012; "Okayama prefecture orders JX compliance with false inspection records," September 12, 2012; and others.

[36] *Asahi Shimbun*, "JX, administrative disposition by false report," December 29, 2012

> The series of falsified records and incident are impossible to be explained to the citizens.

Thus, JX Nippon Oil & Energy had lost the trust of the public.

Falsified records content

At Factory B, the falsified safety inspection records of 18 liquid propane gas tanks had been sent to the Okayama Prefecture for about ten years. The iron plate used in the tank was gradually thinning due to corrosion. If the thickness of the plate reduces below standard value, the prefecture must be notified and the plate requires maintenance.

However, the maintenance was carried out without notifications, and steel plate areas with lower-than-standard thickness were not adequately recorded; that is, their deterioration areas were recorded as less than they actually were. The reason is that, if the maintenance is done without notification, there is no need to do a pressure test after the maintenance work. Moreover, there are two tanks with thickness lower than standard that were overlooked.

Then, according to the Okayama Prefecture investigations, there were 16 violations related to falsified inspection and maintenance records, and 12 cases related to unauthorized piping replacement. The Okayama Prefecture ordered JX to obey rules of safety management and pointed out this incident as a "Serious and Malicious Act" in the order.

Challenges in a refinery

The author has been informed by Mr. C, a former executive from an oil company, who stressed,

> Fuel leakage risk due to piping and tank corrosion may exist in a refinery. Corrosion also can lead to high risk of fire and explosion accidents.

Nevertheless, in the actual case,

> The rationalization caused maintenance personnel decreases; hence, the inspection and maintenance efficiency became the biggest challenge.

These comments indicate that the petroleum industry is in a harsh business environment.

Mizushima Refinery history

The Mizushima Refinery has two factories, A and B. Factory A is the factory of the former Nippon Petroleum Refining Co. Ltd. (a subsidiary of Nippon Oil Corporation), while Factory B is the Japan Energy Corporation's factory.

According to JXTGHD (2018), Nippon Oil Corporation merged with Japan Energy Corporation in 2010 and became JX Nippon Oil & Energy Co. Ltd. Through this merger, the companies' refineries in the Mizushima area were named Factory A and Factory B, respectively. In other words, Factory A is related to Nippon Petroleum Refining Co. Ltd. and Factory B is related to the Japan Energy Corporation. Since the above report is for Factory B, the misconduct that continued in the Mizushima Refinery originated from Japan Energy. In the following investigation, the unauthorized construction in Factory A was also discovered.

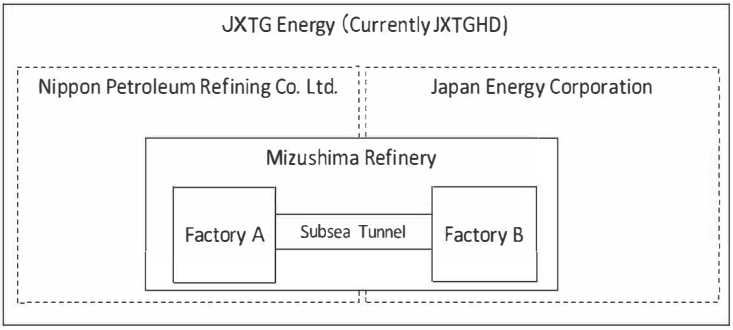


Figure 5.1 JXTGHD and the Mizushima Refinery

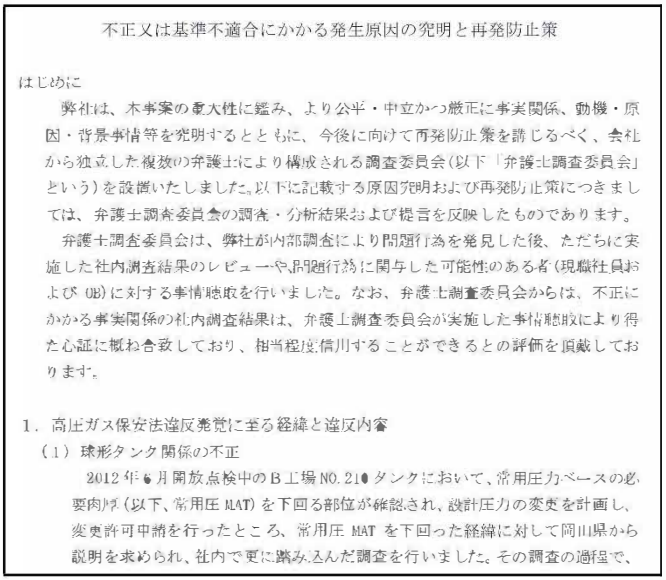
The company name changed from time to time after the merger. Currently, the Mizushima Refinery is the plant of JTXG Energy. Figure 5.1 shows the relation between Factories A and B. To make things easy, the name JXTG Energy will be used to refer to the company from here on.

5.2 Ambiguous corporate culture

Ambiguous report

The JXTG Energy case was investigated by both an Internal Investigation Committee and a Lawyer Investigation Committee, but the Investigation Report has not been published. The "Report to Okayama

Prefecture (The Cause of Fraud or Standard Non-conformance Investigations and its Preventive Countermeasures)" was announced by JXTG Energy in 2012. This report is published on the company's website, and part of the first page of the report and its translation by the contributor of this section are shown in Figure 5.2 and Figure 5.3, respectively.



不正又は基準不適合にかかる発生原因の究明と再発防止策

はじめに

弊社は、本事案の重大性に鑑み、より公平・中立かつ厳正に事実関係、動機・原因・背景事情等を究明するとともに、今後に向けて再発防止策を講じるべく、会社から独立した複数の弁護士により構成される調査委員会（以下「弁護士調査委員会」という）を設置いたしました。以下に記載する原因究明および再発防止策につきましては、弁護士調査委員会の調査・分析結果および提言を反映したものであります。

弁護士調査委員会は、弊社が内部調査により問題行為を発見した後、ただちに実施した社内調査結果のレビューや、問題行為に関与した可能性のある者（現職社員および OB）に対する事情聴取を行いました。なお、弁護士調査委員会からは、不正にかかる事実関係の社内調査結果は、弁護士調査委員会が実施した事情聴取により得た心証に概ね合致しており、相当程度信用することができるとの評価を頂戴しております。

1．高圧ガス保安法違反発覚に至る経緯と違反内容

（1）球形タンク関係の不正

2012 年 6 月開放点検中の B 工場 NO. 210 タンクにおいて、常用圧力ベースの必要肉厚（以下、常用圧 MAT）を下回る部位が確認され、設計圧力の変更を計画し、変更許可申請を行ったところ、常用圧 MAT を下回った経緯に対して岡山県から説明を求められ、社内で更に踏み込んだ調査を行いました。その調査の過程で、

Figure 5.2 Report to Okayama Prefecture (JXTG Energy 2012)

There are some incomprehensible items in this report. First, the address, date and author (company name) are not written. Thus, it is not known who the author is and to whom it is written. Moreover, the report starts with "Our company…" and is not referring to any specific company.

As shown in Figure 5.3, the report reads "at Factory B, tank No. 210" at the beginning of the report's first chapter. It is not known whether "Factory B" is a temporary name or the actual name in the refinery. Even if "Factory B" is a real name, the location of Factory B is not indicated. In addition, "Mizushima Refinery" has been used several times in the sentence, but there is no clear statement calling Mizushima Refinery's factories A and B.

Furthermore, in the whole report, the word "plant manager" is used twice, and "director" is used four times; however, it does not mention which organization's president or plant manager it's referring to.

This report is not a conclusive document since it does not specify which company produced it. Hence, this report is not easily found by web searching the company name or the factory name.

This document alone does not show to whom the report is addressed. Thus, there must be a separate form or cover letter, and the date, sender, address, etc. were written there. In order to show the accuracy of the material, the form and the report should be made public in a single document. Since they are not, the questions "Is this report the same as the one reported to the prefecture? Or is it all?" remained.

Ambiguous corporate culture

The report from the Lawyer Investigation Committee is disclosed on the company's website. Therefore, questions arise as to whether the report to the Okayama Prefecture is reflected in the Lawyer Investigation Committee or not. Moreover, the list of members of the Lawyer Investigation Committee is not written; hence, the trustworthiness of the investigation by the committee is doubtful because the independency between the Legal Investigation Committee and the company is not justified.

The transparency and clarity of JXTG Energy are inferior compared to other companies whose incidents are dealt with in this book. This management style shows that they think the responsibility to the Prefectural Office is the most important and they disregard the importance of the local community as an important stakeholder.

The Cause of Fraud or Standard Non-conformance Investigations and its Preventive Countermeasures

Introduction

Our company, in consideration of the seriousness of this case, will investigate factual relationships, motives, causes, circumstances, background, etc. fairly, unbiased and strictly, to prevent future recurrence. As a countermeasure for the future, an investigation committee comprising several company-independent attorneys (hereinafter referred to as "Legal Investigation Committee") has been formed. The investigation of causes and preventive countermeasures, as described below, reflects the investigations/analysis results and the recommendations of the Legal Investigation Committee.

The Legal Investigation Committee conducted a review on the internal investigation results, and interviewing of personnel who may have contributed to the misconduct (employees and retirees) immediately after the company's internal investigation was carried out after discovering the misconduct. In addition, the Legal Investigation Committee generally agrees with findings from the internal investigation considering the convincing statement gained during the interview conducted and evaluated the investigation as reliable to a considerable degree.

1. The timeline and the violation content related to the discovery of the high-pressure gas safety violation.

(1) Fraud related to Spherical Tank

During an open inspection in Factory B, tank No. 210 in June 2012, it was discovered that the tank has an area with thickness lower than the minimum thickness required in a normal pressure base (herein referred to as "MAT normal pressure"). The company planned to change the pressure design by applying for permission from Okayama Prefecture.

Figure 5.3 Translation of the first page of the report to Okayama Prefecture, as in Figure 5.2

5.3 Fraud discovery and violations content

The following content is based on the report to the Okayama Prefecture.

The timeline of the discovery was written in Chapter 1(1). In June 2016, the company refinery applied to the Okayama Prefecture to change the design pressure in a tank in Factory B. Then, the prefecture inquired into further details and consequently discovered the fraud during the internal investigation.

Thus, if the prefecture had not inquired about an explanation, the fraud would not have been found, and the business would have proceeded as usual. This shows that the compliance and risk management system are problematic at the company.

After several subsequent investigations, more frauds have been found. The frauds can be divided into two main categories: fraud related to the spherical tank and inadequate management/misinterpretation of legislation. There are also several unexplainable statements in the report to the prefecture. We here study this incident according to the report in the following sections.

Spherical-tank-related fraud

Based on Chapter 1(1) of the report, from both Factory A and Factory B internal inspections, frauds were found in 18 vessels at Factory B.

(1) Falsified internal inspection report, 16 cases
(2) Nonconformity in technical standards, 16 cases
(3) Inspection data tampering and fabrication of repair area, 7 cases

These are the unauthorized maintenance works due to the lack of a pressure test. In this fraud, some of the managerial positions in all divisions related to facility maintenance were involved.

Inadequate management/misinterpretation of legislation

According to Chapter 1(2) of the report, irregularities were found in the inspection during overall inspections in both Factory A and Factory B, including all high-pressure gas facilities as shown in the following.

(4) Irregular notifications, 34 cases
(5) Nonconformity in technical standards, 19 cases

However, it is not described whether these results were found by the Internal Investigation Committee or by the Lawyer Investigation Committee. (1) is the construction without permission, and (5) is due to the lack of a pressure test. These non-conformities are not intentional; thus, they are not considered as frauds but regarded as inadequate management/misinterpretation of legislation.

Rationalization and technological development

Former business manager Mr. C stated,

> I want to increase the inspection efficiency by making inspection records into a database, and develop an advanced data analysis method.

Technological development for rationalization is a very important management task. However, in a factory where the inspection data has been tampered with, the database itself cannot be relied upon. With such a company, those advanced analytical methods are meaningless. Thus, the challenge is how to ensure the data accuracy so that it will be reliable.

5.4 Root cause and its preventive countermeasure

Spherical-tank-related fraud

The fraud related to the spherical tank is written up as follows based on Chapter 2(1) of the report. In the background of the fraud, there was fierce competition in the petroleum industry; accordingly, the company was promoting company rationalization and optimization. In the Mizushima Refinery, full operation is expected; thus, the loss from stopping operation due to inspection and construction are required to be reduced. For that reason, there were unauthorized construction and reports showing plate thickness higher than the inspected value.

From Chapter 2(1) of the report, the cause of the fraud is shown as the following:

(1) Management's strong sense of crisis and pressure for full operation caused the lack of compliance
This means that the pressure from management existed, but it is considered as lack of compliance awareness.

(2) The Facility Management Department responsibility role and authority are not clear
Checks from top to bottom of the organization are not effective due to a chief engineer having some authority and the decision bypassing the section chief.

(3) Cross-checking among departments is not working
This shows that there is no independency between each department. Specifically, since both inspection and maintenance are the Facility Management Division's responsibility, the cross-check between the departments is not applied.

(4) Insufficient management system for rule compliance
This may be related to systems such as the internal reporting system.

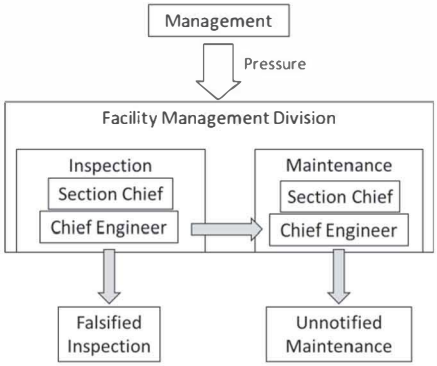


Figure 5.4 Facility management in the Mizushima Refinery

Figure 5.4 shows the situation related to the spherical tank fraud. The Facility Management Division that takes the same risk as the Revenue Department is responsible for the operation efficiency; thus, it can be said that the fraud happened at the first defense line. Originally, the Inspection Department needed to be independent from the Revenue Department. However, it is not in this case; therefore, the second defense line does not exist.

To strengthen the second defense line, the Inspection Department must be separated from the Revenue Department. From Chapter 2(1) of the report, the facility maintenance and inspection functions are to be separated. From this, the separation within the organization can ensure that recurrence prevention can be achieved.

Inadequate management/misinterpretation of legislation

In Chapter 2(2) of the report, the main causes of the inadequate management and misinterpretation of legislation are shown as the following:

(1) Lack of understanding of the legislation by the staff in charge.
(2) Documents related to procedure are not provided.
(3) The cross-check among organizations is not functioning well.

In response to these causes, several improvement measures were implemented, including thorough education on compliance and workflow manuals revision.

Common preventive countermeasures

In Chapter 2(3) of the report, the common preventive countermeasures against the above-mentioned fraud and misconduct are as follows. First, the Audit Department needs to report directly to the headquarters to ensure the independency of the department. Also, during audits, people from similar lines of business at other factories are required to participate, thus enhancing the monitoring function. From this, it can be considered that the third defense line performs well.

To prevent problems due personnel in charge becoming fixed at a position for a long period of time, working personnel rotation is required. This will enforce the first defense line.

Internal reporting system improvement

According to Chapter 2(1) of the report, an internal reporting window was already provided; the window person was the headquarters general manager and lawyer. In the Mizushima Refinery, the internal reporting channel is required to be installed in the immediate vicinity within the factory.

However, the expected effect of the reporting window near the workplace is still questionable. In contrast, a collusive relation between the worksite and the reporting window will easily occur. Nowadays, the report can go through e-mail and telephone; hence, there is no merit in having a nearby reporting window. Having an external auditor as the reporting window is far more effective than the nearby reporting window.

Concerns related to preventive countermeasures

Although the company is also working on other improvement strategies, it seems that some basics are not well covered.

The important cause of this case is the management problem where the factory cannot operate at low efficiency due to fierce competition. The suggested preventive countermeasure to eliminate fraud will complicate things during working at the site. Increasing the employee training will increase working hours, exceeding the maximum allowed working time. If proper notification is given, the construction and inspections will increase, reducing the operation efficiency. To compensate for the decrease of work and operation efficiency, improvement of inspection technology and productivity are necessary; nevertheless, no strategy regarding these matters is provided.

The preventive countermeasure causes the factory's overall productivity to reduce. To maintain productivity, more efforts at the worksite are required. Thus, this will increase the pressure from the management. As mentioned previously, there is not only low transparency about information disclosure but there is also the impression that the preventive countermeasure is worksite-dependent.

Moreover, it is not known from the report whether the monitoring function was investigated or not. Also, there is no mention of the improvement of the auditor function. This also indicates that the preventive countermeasure is worksite-dependent.

Then, in January 2017, there was a case where a large-scale factory fire occurred at the Wakayama Refinery of the same company, and evacuation orders were issued for about 3,000 residents. Also, in June of the same year, an oil leakage incident occurred at this refinery. Still, the harsh business environment continued after that.

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CHAPTER SIX

PERFORMANCE EVALUATION FRAUD: MITSUBISHI MOTORS' FUEL CONSUMPTION FRAUD

In April 2016, the Mitsubishi Motors Corporation announced that there was manipulated fuel consumption measurement of its light vehicles. The company had been severely criticized by society over the hidden recall incidents in 2000 and 2004, and it has fallen into management difficulty. As fraud was discovered again 12 years after the incidents, there was strong distrust of the company's constitution.

Consequently, vehicles sales declined sharply, and the company fell into management difficulties. As a result, it became the subsidiary of Nissan Motor Corporation six months after the incidents of the fuel consumption fraud. This shows that the eyes of consumers on corporate fraud are becoming very strict. The overview of the case is summarized based on reporting from the *Nihon Keizai Shimbun* newspaper.[37]

6.1 Overview of the case

The fuel consumption misconduct was announced on April 20, 2016. The automobiles affected by the misconduct were 625,000 units of four models of light vehicle,[38] including the eK Wagon and Dayz that were being supplied to Nissan. The actual fuel consumption was 5% to 10%

[37] *Nihon Keizai Shimbun*, "Mitsubishi Motors mileage injustice, 620,000," April 21, 2016; "Mitsubishi Motors piercing the system, tampering with fuel consumption data," April 22, 2016; "Mitsubishi Motors, Injustice at the end of impatience," April 24, 2016; "Mitsubishi Motors, Injustice from 1991," May 12, 2016; "Mitsubishi Motors, 8 car models below catalog value," August 30, 2016.

[38] "Light vehicle" is a Japanese standard vehicle model. The maximum engine size for light vehicles is 660cc.

worse than the reported value, and from that day Japan's Ministry of Land, Infrastructure, Transport and Tourism started on-site inspections.

This misconduct was discovered when Nissan as the partner measured the fuel consumption, which was different from the performance reported to the authorities. Misconduct was not found by Mitsubishi Motors; Mitsubishi Motors' self-regulating ability was suspected because the fraud was discovered by Nissan's inspection as the client.

Fuel consumption was measured by placing the car body on the indoor measuring instrument (chassis dynamo) and rotating the wheels by starting the engine. At this time, in order to approximate actual driving conditions, the load was applied according to the resistance of the tire and air. The numerical value of this load had been tampered with so as to be advantageous for fuel efficiency measurement.

The eK Wagon is a flagship car that accounts for 60% of Mitsubishi's domestic sales in Japan (about 100,000 units per year), and its sales will have a significant impact on the company's management. According to the company's explanation, the problematic units had their fuel efficiency targets raised five times in the two years before the launch. Executives such as the president were involved in this decision because of fuel economy competition with competitors. In addition, in-house tests were different from the procedures set in Japan, which were carried out even for cars other than the four affected types of vehicles. This data alteration took place for about 25 years beginning in 1991.

As a result, the company's light vehicle sales in April 2016 decreased about 45% compared with the same month the previous year, and Nissan's light vehicles supplied from Mitsubishi also decreased by about 51%. Production lines at the factory in Okayama Prefecture did not have a plan of operation, which caused concerns about the regional economy and employment, and related parts makers also fell into management deterioration.

According to the company's explanation published in May 2016, when measuring fuel consumption according to the method prescribed by Japanese authorities, it was found that the difference in fuel consumption was between 5% and 15%. Mitsubishi Motors was also criticized in this regard as the discrepancy was worse than the difference of 5% to 10% explained initially.

Then, in August 2016, it was discovered that newcomers at the time in 2005 pointed out problems concerning fuel consumption measurement methods, and the problem had been ignored. As a result of this, the company's culture was brought into question. In the same month, we also

discovered that fuel efficiency performance was lower than the catalogue value even in eight models such as the Pajero.[39]

6.2 Risk management relied on compliance

At Mitsubishi Motors, the hidden recall problem of 690,000 passenger cars and trucks became a problem in 2000, and in 2004 there were also 740,000 recalls hidden. Two fatal accidents were caused by this defect in Japan in 2002.

After the recall concealment incident, the company's Corporate Ethics Committee issued a report (Mitsubishi Motors 2007). The report advocated the strategies for the company's regeneration in Chapter 3, but the point was thorough compliance. The recommendation of Chapter 3 of the report begins with "Compliance First", and "compliance" is used 27 times in this chapter alone. The word "compliance" appears 100 times throughout the report.

However, "internal control" is used nine times in total in the report and "risk management" is used only once. As can be seen from these figures, discussion has not taken place in terms of risk management and internal control. To put it briefly, recommendations for regeneration depend on compliance. Since the Corporate Ethics Committee wrote the report, it may have been a recommendation that depended on compliance. From this, it is doubtful whether the organization called the Ethics Committee was appropriate for this problem.

Fuel misconduct was carried out continuously for 25 years from the recall concealment case, and finally it was discovered by inspection of the supplier. As a department that continues injustice, idealism such as strengthening compliance will not make any difference. Mitsubishi Motors' fuel consumption fraud is a typical example that shows the ineffectiveness of compliance for risk management.

Corporate value for stakeholders

This case is an example in which Mitsubishi Motors greatly diminished its corporate value by corporate fraud. A sharp decline in the sales volume of cars indicates that corporate value for customers has declined. It has not met expectations from clients, employees and the regional economy. The

[39] The Pajero is a SUV by Mitsubishi; it is named Montero in Spain and Shogun in the United Kingdom.

stock price decreased by half before and after the incident, and corporate value for shareholders also decreased sharply.

Risk management aims to raise corporate value for stakeholders. However, this fraud case caused a result in contradiction to the purpose of the risk management.

6.3 Fuel economy measurement system and three defense lines

Below is the summary of the outline and reasons for the incident based on the "Investigation Report on Fuel Fraud Problem" (Mitsubishi Motors 2016).

Performance Test Department

The organization name and department headquarters of the department related to fuel consumption measurement at Mitsubishi Motors have changed with the times. At the time the report was released, it can be considered that the organization was as shown in Figure 6.1.

According to Chapter 2.3 (2) of the report, the Performance Test Department of the Development Division was conducting fuel consumption measurement. Factors affecting fuel economy include not only engines but also drive systems such as bodies, designs and transmissions.

In the Performance Test Department, test vehicles are made by combining prototyped components in each part and products delivered from the outside, before fuel consumption is measured. The Performance Test Department was also carrying out work to optimize vehicles by adjusting the engine control computer and other components; this process is called "adaptation".

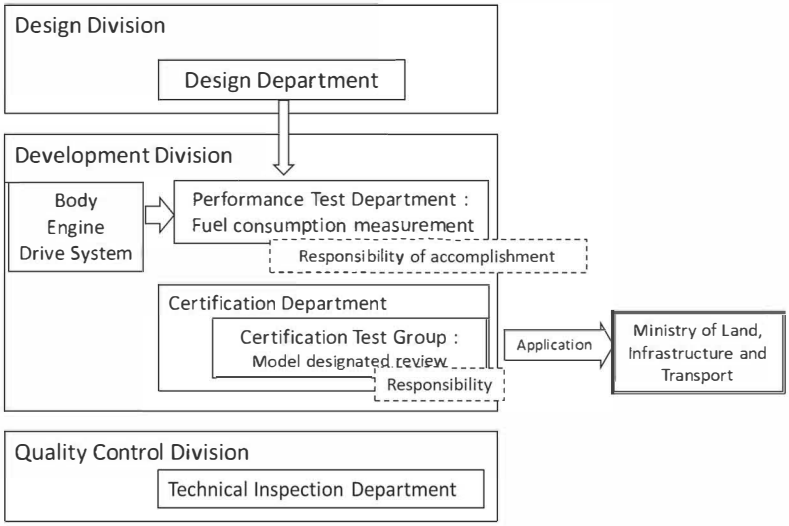

Figure 6.1 Fuel consumption measurement system at Mitsubishi Motors

The difficulty with fuel economy measurement is that it can't be predicted how much the improvement effect in each component unit will improve fuel efficiency as a whole. The performance of each component is the most important factor for fuel efficiency. Therefore, it is difficult to achieve the target fuel economy merely by adjusting at the final stage of adaptation.

However, the responsibility for improving fuel economy focused on the Performance Experimental Department, and a heavy burden was placed on this department. As a result, it was falsely claimed that the target fuel consumption was achieved by inappropriate measurement of fuel economy.

Certification Test Group

The cars that are ready for mass production are inspected, and if the Ministry of Land, Infrastructure, Transport and Tourism of Japan approves the model designation, the car can be sold. This model designation review is the work of the Certification Test Group.

Prior to the model designation review, the group was also responsible for checking whether the test vehicle would show the same running resistance as the measurement result of the performance test section.

Therefore, the original role of the group was to monitor the Performance Test Department in order to follow the laws and regulations.

The Certification Test Group performs the performance check in the Development Division, so it is the first defense line. The reason is that this organization is in the Development Division and takes the same risk as the Development Division. Therefore, the Certification Test Group was not a system to monitor the Performance Test Department.

Technical Inspection Department

The Technical Inspection Department of the Quality Control Division checks the achievement of the development progress and target performance. Their checking method is receiving reports and documents from the Development Department. The Technical Inspection Department does not test the performance itself. Since the Technical Inspection Department is in the quality headquarters, independent from the development headquarters, this is the second defense line, which was only a formality.

Business Audit Department and Quality Audit Department

The audit system of Mitsubishi Motors is explained in Chapter 8.2 (3) of the Investigation Report. The company has an Audit Division, which involves the Business Audit Department and the Quality Audit Department. The Internal Audit Department conducts internal audits in a usual sense, and the Quality Audit Department conducts audits related to development, quality, etc. The Quality Audit Department conducted two types of audits: daily audits and individual case audits. A daily audit is a conference-type audit, so it is difficult to see organizational fraud like fuel consumption misconduct from it. Auditing an individual involves checking in case when a problem occurs in one department there are similar problems occurring in other departments. Of course, problems that have been hidden—like misconduct—are not subject to audit.

The Quality Audit Department is the third defense line, but it has not functioned on technical matters like fuel consumption misconduct.

Three lines of defense

The Performance Test Department is responsible for fuel economy performance, so it is the first defense line. Since the Certification Test Group is also the first defense line, the first defense line was overlapped.

If the fuel consumption performance does not meet the target, the Certification Test Group should be aware of the lack of performance. The Certification Test Group neglected the check and applied for model designation. In other words, not only did the first defense line not work, it was also the lead perpetrator of the fraud.

According to Chapter 8.2 (3) of the report, the duty of the Certification Test Group changed as follows. Previously, the Performance Test Department was in charge of the duty of the Certification Test Group, but after that, it changed to the duty of the Certification Department—specifically, the duty of the Certification Test Group of the same department. In any case, since it is under the same organization as the Development Division, independence between the Performance Testing Department and the Certification Testing Group has not been secured.

As mentioned before, the Technical Inspection Department is only checking documents, so it is impossible for them to notice the fraud of the Development Division. Therefore, the Development Division did not need to be conscious of the monitoring from the Technical Inspection Department. In other words, the second defense line had no checking function.

The Quality Audit Department also has similar problems. Since the Development Division knows the auditing style of the Quality Audit Department, they are not afraid of quality audits. The third defense line did not have a check function.

Where should the Inspection Department be placed?

From the above discussion, it can be seen that Mitsubishi Motors has an organizational structure in which risk management does not function. Originally, an Inspection Department is an independent organization from a Manufacturing Department and should be the second defense line. However, in Mitsubishi Motors it is a problem that the Inspection Department is the first defense line. The Technical Inspection Department, as the second defense line, did not do its own inspections but only had document examination done.

The Quality Audit Department also has similar problems. Since the Development Division knows the auditing style of the Quality Audit Department, they are not afraid of quality audits. The third defense line did not have a check function.

Given the efficiency of the inspection, it may be unavoidable that the Performance Test Department is in the Development Division. However,

Mitsubishi Motors should set up at least one department as the second defense line which tests the fuel consumption for itself. For that purpose, for example, a system that creates a testing group that is independent from the Development or Manufacturing Department may be considered.

6.4 Method of fuel economy measurement

Running resistance

Based on Chapter 2.5(1) of the report, fuel economy measurement is carried out by placing the car on the chassis dynamo, starting the engine and rotating the tire. At this time, in order to reproduce the state of actual driving in an artificial manner, the load corresponding to the running resistance of the car is added.

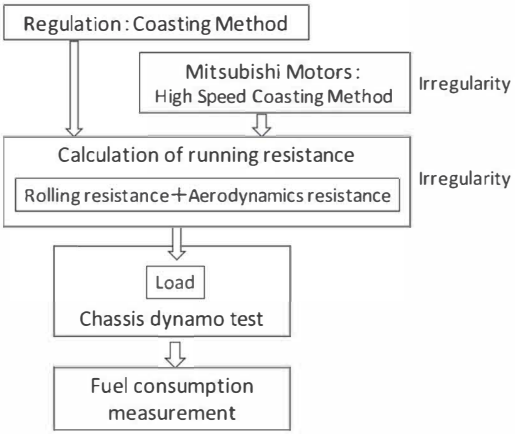

Figure 6.2 Flow of fuel consumption measurement system and irregularity

Running resistance is the sum of rolling resistance and aerodynamic resistance. Rolling resistance refers to resistance by tires and brakes, and aerodynamic resistance is roughly determined from the shape of the car body. This running resistance is measured by actually running the test car. Figure 6.2 shows the flow of fuel consumption measurement by Mitsubishi Motors.

Coasting method and high-speed coasting method

Running resistance is measured using the coasting method as it is detemined by Japanese law. However, since Mitsubishi Motors used the "high-speed coasting method", it was in violation of the law.

Based on the report's Chapter 2.6(4), with the coasting method, for example, when run at 95 km/h with the gear in neutral position, the coasting time is measured until the speed reaches 85 km/h. Then change the speed by 10 km/h, measure the coasting time, and average these coasting times to calculate the running resistance.

Based on the report's Chapter 2.6(6), the high-speed coasting method is a measurement method that is used in the United States. It involves coasting at 150 km/h and measuring coasting time every time the speed drops 10 km/h, and running resistance is measured from these values. The high-speed coasting method is efficient because it can acquire many data points with a single coasting. Also, although the test results are influenced by wind direction and wind speed, the effect of wind becomes relatively small at high-speed driving, so it is said that measurement is easily stabilized in the high-speed coasting method. Figure 6.3 conveniently shows the measurement of the coasting method and the high-speed coasting method.

Testing using the coasting method has to be done over and over again unless a stable result can be obtained. Because of this, the coasting method is complicated and motivates testers to use the high-speed coasting method. The company used the high-speed coasting method since December 1991 at the latest.

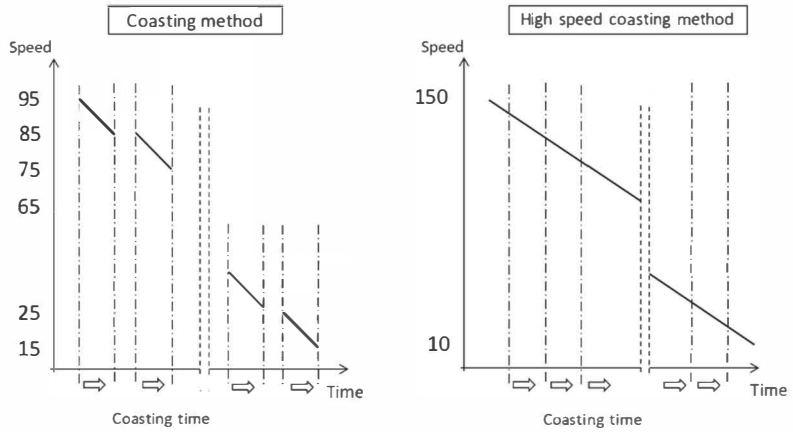

Figure 6.3 Measurement of running resistance

Inverse calculation program

It was written in the report's Chapter 3.3(2) that the company used the inverse calculation program to measure fuel economy. The Performance Test Department developed a program to convert the measured value of the running resistance obtained by the high-speed coasting method into a record that appeared as if it was measured by the coasting method. This inversion program was developed by the Computer Aided Testing (CAT) group within the Development Division. Since the CAT group and the Performance Test Department are organizations within the same Development Division, the head of the Development Department could instruct the CAT group to develop the inverse calculation program.

As a result, the Performance Test Department combined the high-speed coasting method and the inverse calculation program, producing a running resistance test record that appears as if it had been tested by the coasting method.

6.5 Irregularity contents and indication from within the company

Fuel misconduct was committed on various models for 25 years. In accordance with Chapter 4 of the report, the content of the fraud was divided into two cases in the Performance Test Department and two cases

in the Certification Test Group, which equal four cases in total, and are summarized as follows.[40]

Performance Test Department

(1) The Performance Test Department did not use the coasting method and measured the running resistance by the high-speed coasting method (violation of law).
(2) Running resistance values calculated by desk calculation were used to achieve fuel efficiency targets.

In other words, the fuel economy test was carried out using the artificial running resistance value which was better than the result of the high-speed coasting method in order to show that the fuel consumption target was achieved (Fraud).

Certification Test Group

(3) The Certification Test Group did not conduct its own tests but applied for model application using the running resistance value used by the Performance Test Department. This is a violation of the law at the point that it did not use running resistance based on the coasting method.
(4) The running resistance was arbitrarily reduced so that the vehicle would not fail, with exhaust gas and fuel consumption by model-designated inspection (Fraud).

If the vehicle fails the model application inspection, the problem will be the responsibility of the Certification Test Group. In order to avoid this responsibility, the Certification Test Group was conducting fraud in order to pass cars which do not satisfy the performance requirement.

Both the Performance Test Department and the Certification Test Group played a role of inspection. Since these Inspection Departments belonged to the Development Division, the monitoring function from these departments did not work. To make matters worse, the Inspection Departments were the perpetrators of the fraud.

[40] Chapter 5.2 (2) of the investigation report does not use the above classification, but the irregularity pattern is summarized into four points: A, B, C and D.

Indication from the company and compliance

After that, there were indications from inside the company about a series of fuel consumption frauds, but the company reported that it did not improve the situation. The company's constitution was criticized again by this report.

The Investigation Report's Chapter 8.2 (2) contains the following items. In December 2005, a new recruitment presentation was held at the company's new recruitment training. In this presentation, the newly hired employee recommended that, although the high-speed coasting method was used for measuring running resistance, the coasting method should be used according to law. However, the company did not revise their processes.

Furthermore, from February to March 2011, the Compliance Department sent compliance questionnaires to all employees. The questionnaires indicated:

False description of the evaluation record
Tampering of quality records, misstatements in reports
Misstatements in certified material, etc.

The Compliance Department has disclosed these contents to management, every officer, department chief and head of department, etc. at that time. To respond to this problem, in the Development Division, the department head of the Performance Test Department conducted a hearing with the manager in the same department. However, the head reported to the Development Division that there was no problem.

Since the Compliance Department has not independently investigated, the indications from within the company were hidden in the Development Division. This problem left the investigation to a department with suspicion of fraud. The Compliance Department should have carried out its own investigation as the second defense line. It can be said that the management team has allowed for negligence in the Compliance Department.

Let us recall the previous report (Mitsubishi 2007) at the time of the hidden recall cases, in which the revival plan was thorough compliance. We see that a bad example of "the form of compliance activities does not function properly" was repeated.

Organization problem

A large number of causes of fraud are stated in the Investigation Report's Chapter 8.3. The first cause is that "the Performance Testing Division and the Certification Testing Group were responsible for achieving fuel efficiency targets" (Chapter 8.3.1). This is the same as what is written in Section 6.3 of this book, which is an important point. In other words, it means that the Performance Test Department and Certification Test Group are not functioning as the second defense line because they are taking business risk (fuel efficiency goal). This means that monitoring from the inspection department does not work for the Development Division and it can be said that the internal control system is inadequate.

Problem of auditors

It is the management team that has set up this sloppy development system. It is clear that there is no independence or effectiveness of each defense line, so the auditor should recommend improvement to the management team. Since the pressure of management was the cause of the fraud, it was also the work of the auditor to monitor this.

However, the Investigation Report does not mention the responsibilities of the auditors at all. As the form that the corporate governance system and internal control system should have was not considered, there is the impression that the recurrence prevention measure of the report is only a formality. Let us explain in the following example.

6.6 Corporate philosophy and preventive measures

According to Mitsubishi Motors (2007), the revival plan at the time of the hidden recall cases was thorough compliance. It was explained in Section 6.2 of this book that this strategy did not work.

There are four aspects of the Mitsubishi Motors corporate philosophy introduced in Chapter 8.3(7) of the report. The outlines are as follows.

(1) The Customer First principle will be strived for.
(2) The direction of Mitsubishi Motors car manufacturing will be clarified.
(3) Respect the specialty of Mitsubishi Motors.
(4) Treasure the continuity of the business.

Regarding the measures to prevent recurrence in the Investigation Report (Mitsubishi Motors, 2016) Chapter 9, it is pointed out that:

The firm idea as an automaker came to an end.
The philosophy that the automaker should have was postponed.
Since there is no philosophy that employees return to when they face the problem, the making of the car has gone astray.

As can be seen, "corporate philosophy" is the keyword to prevent recurrence against fraud incidents. The report recommends "making guidelines for action based on the ideal that you want as an automaker". The following shows five guidelines for preventing recurrence.

(1) Development process review
(2) Overlapping institutions, organizations, efforts that are useless
(3) Personnel system to eliminate organization closure and black box
(4) Understanding the purpose of laws and regulations
(5) Extensive efforts to discover and rectify fraud

The purpose of risk management is the realization of the corporate philosophy. Therefore, returning to the corporate philosophy as measures to prevent recurrence is more productive than stating that the recovery recommendation for the hidden recall cases is compliance thoroughness. However, the above five guidelines are abstract, and concrete actions are not written.

The Investigation Report is an exercise of 240 pages, but the term "internal control" appears in it only twice, and "risk management" has never been used in it. On the other hand, the term "compliance" is used quite often—104 times—and "philosophy" is used 23 times.

From these figures, it is found that the Investigation Report is abstract without a risk management viewpoint. The Investigation Committee may not have an expert on internal control and risk management. From the viewpoint of risk management, visualized countermeasures are necessary; specifically, reviewing for independence of Inspection Departments.

The difference from Suzuki Motors' fuel economy fraud incident

In May 2016, it was discovered that Suzuki Motors had been measuring the fuel economy of its light vehicles in a different way from that specified in the laws and regulations. It was an incident that followed Mitsubishi Motors' fuel misconduct, and the impact on society expanded.

However, when Suzuki Motors measured fuel economy in the right way, it got better fuel consumption than the catalogue value. This is the opposite result of Mitsubishi Motors. Suzuki Motors also violated laws and regulations, but it was understood that it was not fuel consumption

fraud. As a result, the criticism of Suzuki Motors ended. Rather, the company's evaluation was higher than before.

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CHAPTER SEVEN

CIRCULAR TRANSACTIONS AT TSUBAKIMOTO KOGYO

7.1 Summary of the case

Tsubakimoto Chain Corporation is a large manufacturer focusing on mechanical equipment and related items. Tsubakimoto Kogyo Corporation is a sister company of Tsubakimoto Chain; it is a medium-sized trading company.

In 1997, Tsubakimoto Kogyo became infamous because of a fraud transaction worth JPY 1.2 billion involving the head of its Sales Department. As a result of repeat fraud orders with trading partners, it incurred a loss of JPY 800 million even though a profit in sales was forecasted at first.

Such fraud orders could have been placed due to bad internal control; however, this mismanagement might not be not improved. Another executive had been repeating fraud orders for 15 years since 1998. It was in October 2014 that Senior Executive Mr. M and two presidents of trading companies were arrested on charges of fraud. The summary of the case was based on reporting from the *Asahi Shimbun* newspaper.[41]

Fraud caused by an able businessman

Senior Executive Mr. M was the head of the Sales Department at the Tokai[42] region branch, and he was also second in rank after the chief director at the Central Japan Sales Department of Tsubakimoto Kogyo. From 1998 onward, he repeatedly committed fake construction and fraud transactions for 15 years, and he was involved in most of the branch transactions that added up to about JPY 8 billion in total.

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[41] *Asahi Shimbun*, "Tsubakimoto Kogyo Losses in fictitious transactions JPY 1.2 billion," February 13, 1997; "Tsubakimoto Kogyo Fictional construction, former executives arrested," October 28, 2014; "Tsubakimoto Kogyo Fictional trading 15 years," November 1, 2014; etc.

[42] Tokai region is a region in central Japan that includes Nagoya city.

Payment delay from trading partner companies in 2011 created serious problems for Tsubakimoto Kogyo, and, as a result, an internal investigation was carried out. Mr. M finally confessed his mismanagement one and a half years later in March 2013, and he was dismissed by the company in May that year. Later, in October 2014, he was arrested for misappropriating JPY 22 million from the company, and he was convicted by Osaka District Court in March of the following year. President Mr. K of one of the trading partners was also convicted in July 2015.

This case was an example of fraud caused by an able businessman that likely occurred due to a bad internal control system. The financial loss of the company due to fraud transactions was obvious; however, the loss of social credibility is immeasurable. Its corporate value was hugely tarnished by considering that:

Corporate value = Brand power.

7.2 Organization that is prone to fraud

Here are the reference points to check whether a company is prone to fraud or not:

(1) Limit on accounts receivable

The spreading of circular transactions could be controlled by deciding on the limit on transaction amounts by trading companies, so that every salesperson or head of department is responsible for limited accounts receivable only. Stock will definitely be inflated when a circular transaction is committed. Limitation on accounts receivable could cause difficulty in committing circular transactions. An explanation for this will follow later.

(2) Separation of order and procurement

The separation of order and procurement into different departments would make it difficult to commit fraud transactions because the Procurement Department could monitor the Orders Department.

(3) The independence of the Acceptance Inspection Department

Since the roles of an Acceptance Inspection Department are to monitor orders and procurements, it could monitor effectively when it works as an independent department. This could prevent fraud orders considerably.

(4) Fixed position for Human Resource

A close relationship with trading partners is prone to facilitating fraud orders. Regular personnel rotation in the role/position would make salespersons less likely to bond with any specific trading partners.

(5) Monitoring of employee lifestyle

The lifestyle and friend relationships of an employee will drastically change when they embezzle money from the company. This is a reason why the branch or department manager of the bank or financial institution casually follows their subordinates' private lives occasionally.

Illegal action such as fraud could not be prevented by compliance education alone. Fraud orders like this could be committed in the wrong sense of "helping fellow trading partners" in the misinterpretation of manners.

7.3 Circular transaction

Senior Executive Mr. M was charged with an enormous number of circular transactions involving many companies. The case was complicated, so here we will explain circular transaction in a simple case.

Circular transaction is a transaction where a supplier collaborates with a purchaser and a company to perform repeat selling of products and raises the imaginary sales. Besides Tsubakimoto Kogyo's incident, there were a few other cases in Japan involving circular transactions, such as Kurabo Industries (discovered in 2015) and Showa Denko's subsidiary company (discovered in 2017).

In this section, let us briefly explain the mechanism of circular trading. As shown in Figure 7.1, Company A purchased a certain item at 80 USD and sold it to Company B at 80 USD as an example. Company B decided to sell it to Company C at 90 USD. Then, Company C sold it back to Company A at 100 USD.

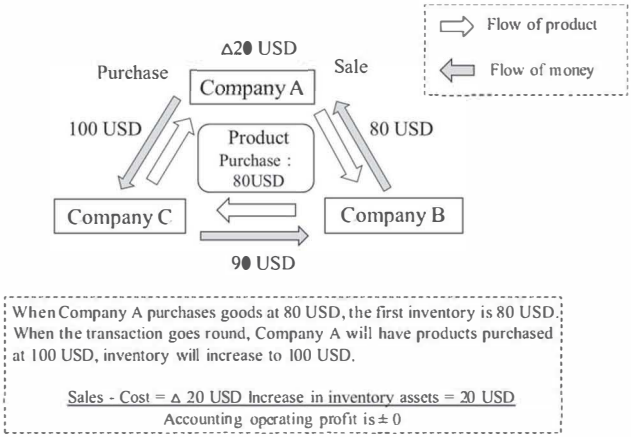

Figure 7.1 Example of a circular transaction

These companies will clear the acceptance inspection even if they leave the product in the warehouse without moving it and only rewrite the owner's name. Therefore, there is no movement of products, but only the money moves. Every company will receive the payment from its counterparties; however, Company A will lose the difference of 20 USD as a result.

Why does Company A want to perform a transaction resulting in a loss in the first place? The reason is: Company A could receive 80 USD from Company B first and use it as working capital for a while by delaying the payment to Company C. In other words, Company A procures a short-term fund of 80 USD with the cost of 20 USD (equivalent to interest payment). The fund could be raised with a lower cost by minimizing the margin of sales and purchases between Company B and Company C.

It will become difficult for a company with a bad cash flow to raise funds from a bank because of its reputation. Such companies will end up bankrupt because they will be weeded out due to the market principle. A manager who wants to avoid this ending may perform circular transactions in order to secure short-term funds.

Collusion among purchaser (Company B), supplier (Company C) and Company A is necessary to perform circular transactions. Company B and Company C will gain margins of 10 USD by joining without doing anything, so it is easy earnings. Since general employees don't have to suffer with the cash flow of company management, the manager of Company A will take a lead as a key person in the transaction.

Salespersons from Company B and Company C who want to achieve their sales targets will pursue involvement in the circular transaction.

Sometimes the collaborator from Company A may also receive a rebate from Company C, and the same goes for the collaborators from Company B and Company C. The circular transaction was easy because it is a win-win situation to all three persons, and it could easily occur in a company with problems like those described in Section 7.2.

Benefit of circular transaction

Let us explain profit and loss from circular transactions. Here we will briefly explain the profit and loss account, and the cash flow calculation from the previous example. Company A has purchased a certain product at 80 USD, and value of the inventory item (inventory asset) is 80 USD. The same product returns to Company A again at a price of 100 USD when the transaction goes around. So, the inventory asset at Company A will be revalued as 100 USD. Circular transactions will inappropriately increase the inventory asset of 80 USD to 100 USD.

The increase of the inventory asset will be considered as profit in accounting. Therefore, the operating profit from the profit and loss account is shown as:

$$\text{Operating profit} = \text{Sales} - \text{Costs} + \text{Increase in inventory}$$

Losses in cash flow from the transaction will be balanced out by the increases of inventory value and become zero in total on the calculation for the fiscal year.

$$\text{Operating profit} = \Delta\ 20 + 20 = 0$$

Therefore, the effects of circular transactions do not appear in the profit and loss statement.

However, the statement of cash flow calculation indicates a different story. Let us calculate the difference between the debit and credit of the company. The statement of cash flow will ignore the increase in inventory as it is only on the books. It becomes:

$$\text{Sales Profit} = \text{Sales} - \text{Cost} = \Delta\ 20.$$

This results in the loss of 20 USD from the estimated profit. The special pattern for circular transaction is a negative profit on the statement of cash flow, even though the total shown in the profit and loss account is zero (or even a positive number sometimes).

End of circular transaction

There would not be a problem if Company A's performance recovers afterwards, as the process will end with a single circular transaction. However, if the bad cash flow continues, the debt of circular transactions becomes a bad spiral without an end. As a result, circular transactions will persist, and the resolution of debt would be postponed. Since the situation is convenient for each participant, it is difficult to discover the circular transaction.

The negative on Company A's cash flow would be expanded accordingly by repeated circular transactions, even without any product movement. As explained earlier, the increases of inventory value on the balance sheet will offset the negative cash flow, so that losses do not appear in accounts.

Cash flow should be deteriorated due to expansion of the negative balance; as a result, the payment would be impossible to make in the future. The problem will be discovered when the funds for the other two companies could not be regained after the payment was unfortunately stopped. For example, the accounts receivable will increase continuously when the collection of sales at Company B is delayed. This may trigger Company B's inspection to check and happen to discover the problem.

In addition to pecuniary loss, Company A has to revise the past accounts report, which results in a significant loss of social credibility. The culprit of the circular transaction will be dismissed from their job due to the company's internal regulations, plus they will be charged with fraud and also individually held responsible for the damage incurred by the company.

Separation of order and procurement

The most fundamental way to prevent circular transactions is by establishing a mechanism ensuring that the person in charge of orders could not make a purchasing order and that procurement mechanisms are different depending on the company. However, let us think about a simple example. A company's Manufacturing Department will send a request form to the Procurement Department when they decide to buy an item, and

then the Procurement Department will decide where to buy the item from based on the request. In this case, the Manufacturing Department is placing an order, but the Procurement Department is the purchaser.

The two parties (Manufacturing Department and supplier) are more likely to get close with a specific partner when orders are requested repeatedly. The purpose of establishing an independent Procurement and Acceptance Inspection Department unit is to avoid such intimacy. Therefore, Procurement Departments are commonly located at the headquarters in many companies and divided from the Sales Departments which also perform ordering.

For this reason, there is an internal rule that the "Purchasing Department has full authority to place orders for 10,000 USD or more", for example. However, the schemer could divide the order into several smaller orders of 10,000 USD or less to escape it. Then, internal rules should also include a rule of prohibiting the split of orders when deciding to put the upper limit on the order.

Set up the credit limit

Separation between orders and procurement may not be easy for small companies because there is not much room to have personnel in charge. Even if it can be systematically separated, each person in charge of orders and procurement may collaborate through mutual interest. Therefore, it is necessary to have a mechanism to prevent circular transactions from reoccurring once they started.

In order to prevent the expansion of circular transactions, it is effective to establish a credit limit for each business partner. In the example shown in Figure 7.2, considered from Company C's point of view, the credit limit for Company A is set up to 100 USD on accounts receivable. In order to operate this system, it is necessary for Company C to have a mechanism to monitor both the accounts receivable and the credit limit.

If such a system is included, products from a new order could not be sold to Company A until Company C receives 100 USD of previous sales. So, Company A will not be able to purchase a new product from Company C, and Company A also could not sell the products to Company B . As a result, circular transactions are stalled by this. Therefore, the credit limit will restrict the schemer who plans circular transactions.

There are other methods which do not pemit transactions with individuals with weak governance or micro enterprises. According to this idea, certain companies make an obligation to conduct a credit check by the Headquarters Department first before starting transactions with a new

business partner. However, the rule of not performing a trade with individual or micro enterprises may be detrimental in terms of creating new industries.

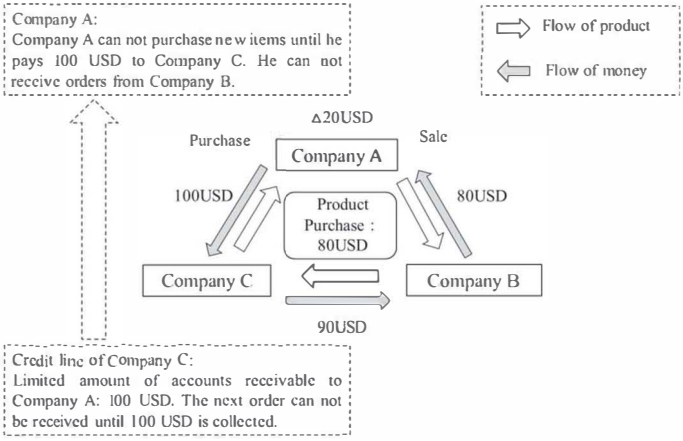

Figure 7.2 Setup of a credit line to prevent circular transactions

7.4 Sequence of fraud

From the case of Tsubakimoto Kogyo, a Survey Report of the Internal Investigation Committee (Tsubakimoto Kogyo 2013a) and a Survey Report of the Third-Party Committee (abridged version) (Tsubakimoto Kogyo 2013b) were announced. Below we will analyze the contents of the incident based on these reports.

History of perception

According to Chapter 2.1 (1) of the internal survey report, inventory of JPY 900 million or more became a problem in the company concerning Mr. M's transactions in 2012. As explained in the previous section, this asset will not decrease, as this is the result on the balance sheet due to circular transactions. Considering that the company's operating profit is about JPY 1 billion, the increase in inventory to JPY 900 million from only one person's project indicates that internal control was not effective at all.

Since then, inventory increased to JPY 1.3 billion, and it did not improve at all after that. Mr. M had been forced to stop trading. As the

purchase stopped, no selling could be made, no money generated, and eventually, the transaction had come to a deadlock. After the incident, Mr. M finally confessed that he had been doing circular transactions and fictional transactions for about ten years.

Circular transaction by collusion of two companies

As mentioned in Section 7.3, a circular transaction can be conducted with the collusion of three companies. Circular transactions by three companies are normally difficult to detect.

In this incident, a circular transaction was conducted through collusion of two companies—Tsubakimoto Kogyo and Company A (Kawabata Engineering). Is circular transaction possible with collusion of two companies? The scheme is shown in Figure 7.3.

Company B enters between Tsubakimoto Kogyo and Company A for purchase. Company C also entered between Tsubakimoto Kogyo and Company A for sale. In other words, B and C were involved in the transaction without knowing that they were engaged in circulation transactions.

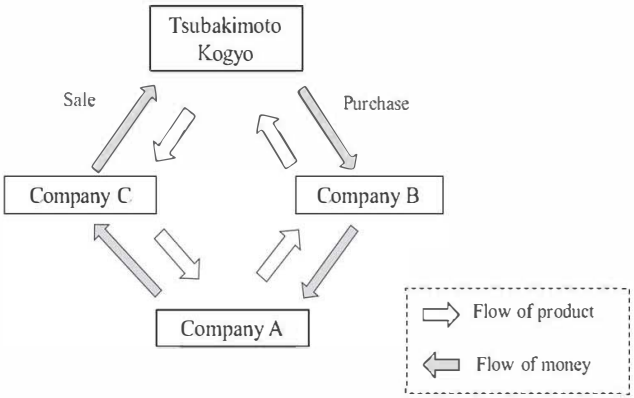

Figure 7.3 Circular transactions by collusion of two companies

According to Chapter 4.1 of the internal survey report, in fact, seven companies were involved in transactions on the sales side and four companies on the purchasing side. A total of 1,000 cases with a sale of JPY 7.8 billion were involved in the transaction. Apart from that, there was also an order for an aerial construction for the purpose of a kickback to Mr. M.

Factors contributing to circular transactions

According to Chapter 2.3 (5) of the Third-Party Committee report, the cause of the circular transaction was the deterioration of the funds of Company A. Mr. M proposed a circular transaction to help Company A. Company A bears a loss (margin) from circular transactions, and the total amount is about JPY 850 million. As a result, Tsubakimoto Kogyo gained a profit of about JPY 300 million, and other affiliates benefited to some extent.

According to Chapter 2.1 (5) of this report, in addition to circular transactions, there were also other illegal transactions done by Mr. M and his associates which lasted for almost 15 years.

Other illegal transactions

Apart from circulation transactions, several subordinates and others had made inflated orders, pools of inflated amounts, fictitious orders and requests for inflated travel expenses. We will skip the explanation of these details. According to Chapter 4.1 of the internal survey report, the total amount of the embezzlement made by internal persons was estimated to be about JPY 150 million as a whole.

7.5 Causes and prevention of recurrence

In the fifth chapter of the Third-Party Committee report, the causes of this fraud transaction are pointed out as follows.

> (1) Extensive authority of sales approval
> In the company, sales staff were involved in customer negotiation, order receipt, purchase and acceptance, payment, and collection of accounts receivable. The first defense line does not work because order placement and acceptance are not independent. Payment and receipt of money are also usually done in a department independent from the Operational Department, such as the Accounting Department. Therefore, the second defense line does not exist either. It is in a situation where mutual checks at the Operational Department and monitoring from the headquarters to the Operational Department are ineffective, and internal control has not been established.
> Regarding the problem of authority concentration, the auditing firm in charge of the company pointed out the high fraud risk in 2006, but the management team did not make concrete improvement measures.

(2) Low number of personnel changes
Mr. M had worked at the Central Japan Sales Department since joining the company, and he had been in the Equipment Sales Department for almost 20 years beginning in his 14th year. As a result, it was too easy for him to get in touch with customers. Also, two of the fraud cases involved employees who had been working with Mr. M since joining the company.

(3) Company that can make self-approval
At the company, there was a rule that staff in the role of section chief or above do not issue order slips. Mr. M's position at that time was higher than section chief. However, he did the actual drafting and approval by himself and using his subordinates, for the cases where he himself received orders.
And for the project involving Mr. M, it was understood that his direct supervisor (executive) did not perform any check for a long time. In other words, it was a work environment that allowed for self-approval. From this point also we can see that the first defense line is not working.

(4) Compliance system
Some of the senior executives who knew Mr. M's illegal transactions had been complicit in the illegal transactions to receive some share. Also, despite many employees being aware of the illegal activity, no one consulted any other senior or corporate auditor. In this respect, poor awareness of compliance among employees and officers is pointed out.
Since there was no sales experience in the Management and Auditing departments, there was a tendency to accept the explanation of sales employees, and monitoring was not effective. The third defense line was also ineffective. Since Tsubakimoto Kogyo is a trading company, many of its employees are in the Sales Department, and the number of head office employees should be small. It means that there is such harmfulness in personnel policies that do not place experienced people in the headquarters and Auditing Department.

Measures to prevent recurrence

Looking at the causes mentioned above, it is clear that the absence of internal control creates a corporate culture in which fraud can easily occur. Therefore, the responsibilities of the management team and corporate auditors should be questioned. As a result, salary reductions were made to the president's 11 directors and one full-time corporate auditor.

Although some specific measures to prevent recurrence were established, the contents specifically corresponded to each of the above causes. Fraud will happen even in a company that has a substantial risk management system. So risk management at Tsubakimoto Kogyo would be expected from this time.

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Tsubakimoto Kogyo. 2013a. Internal Investigation Committee: Survey Report. [In Japanese], May 2, 2013. http://www.tsubaki.co.jp/ir/pdf/release/13/130508 01.pdf, Attachment 1.

Tsubakimoto Kogyo. 2013b. Third-Party Committee: Report (Summary Version). [In Japanese], May 2, 2013. http://www.tsubaki.co.jp/ir/pdf/release/13/130508 01.pdf, Attachment 2.

CHAPTER EIGHT

MANAGEMENT FRAUD: OLYMPUS ACCOUNTING SCANDAL

Olympus Corporation is a well-established precision machinery and instruments manufacturer. It is also well-known as a camera manufacturer. Olympus' accounting fraud was discovered in 2011 and had become a world-famous scandal, especially after the dismissal of and accusation by the newly appointed British president. In this chapter, we will analyze this case from the perspective of corporate governance and risk management. We will also go through in detail the outlines of the incident, using reporting from the *Asahi Shimbun* newspaper[43] as a reference.

8.1 Fraud caused by management team

Failure of zaiteku[44] *and* tobashi[45] *schemes*

Since 1985, Olympus had employed *zaiteku* as its management strategy and began conducting "aggressive financial asset management". After the bubble[46] economy in Japan burst in 1990, the value of shares invested by Olympus had fallen significantly and the losses began. This

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[43] *Asahi Shimbun*, "Olympus whistle-blower, winning backwards," August 31, 2011; "Olympus president, dismissed in half a year," October 14, 2011; "Olympus removed the president. Stock price shunp," October 18, 2011; "Olympus, stock price, half price in one week," October 22, 2011; "Olympus, Sloppy acquisition, profit outlook excessive," October 28, 2011.

[44] *Zaiteku* is Japanese for "money management", where *zai* means "finance" and *teku* means "technology".

[45] *Tobashi* is Japanese for "let fly". A *tobashi* scheme is an act of selling assets that dropped down to other companies with a book value so not to make losses appear. In Japan, *tobashi* schemes are prohibited by the Securities and Exchange Law.

[46] The collapse of the bubble was due to the recession in Japan from 1991 to 1993. As a result, land prices and stock prices dropped sharply. Japan later fell into long-term deflation.

loss increased to JPY 117.6 billion around 2003. This was a very large loss since the capital of Olympus at this time was about JPY 150 billion (FY2007). In Japan's accounting rules, investment losses must be recorded by impairment when the loss exceeds a certain level. However, in order to hide the loss, the management team began a *tobashi* scheme by shifting losses and selling stocks to overseas funds. In this case, stocks were sold at their book value instead of market value to hide their accounting losses.

The big question here is: is there any place in the world where you can buy stocks at a much higher price than their market price? If the stock price rises, you will have the chance to recover the investment principal, but that is something hard to predict.

Strange acquisition

In 2008, Olympus bought a British medical equipment maker called Gyrus for JPY 210 billion, and it paid a fee of JPY 66.6 billion to the advisory company. It was too high as a commission, and there was a sense of inflated orders in the form of the consulting fee.

In the same year, three companies—domestic health food firm Humalabo, resource recycling company Altis and cookware maker NEWS CHEF—were acquired for JPY 73.4 billion. Since the total sales of these three companies was only JPY 5.4 billion at that time, we can imagine that the corporate value in financial terms was around JPY 10 billion at most. When compared to the real capability of the three companies, the acquisitions were not only exorbitant but also a risky investment.

Goodwill and impairment

When acquiring a company, the acquisition price is often higher than the corporate value, so the difference is recorded as goodwill. Goodwill refers to the prudent value that a company can have beyond its assets. Goodwill gradually decreases over several years for up to 20 years by depreciation.[47]

However, in merging and acquisition (M&A), failure is not uncommon. As the value of the acquired company declines, goodwill must be recognized as a loss (impaired). Although this is the same as impairment

[47] Depreciation of goodwill is based on Japanese accounting rules. Under US GAAP (generally accepted accounting principles) and IFRS (International Financial Reporting Standards), goodwill is not depreciated.

treatment of stocks invested, rules for impairment treatment differ slightly between Japanese GAAP and IFRS.

Olympus completed the acquisition of the three companies, and, a year later, it carried out an impairment loss of JPY 55.7 billion. The decision to purchase the three companies with a high price was made too early when we think of the capability of these three companies.

And, if you add the Gyrus acquisition fee of JPY 66.6 billion and the impairment loss of the three companies of JPY 55.7 billion, the total would be JPY 122.3 billion. The fact that this figure is close to the loss of stock investment of JPY 117.6 billion is a hint to solving the mystery of the fraudulent settlement of accounts. After that, it was clarified that these accounting processes were accounting fraud committed by management.

Combination of tobashi *scheme and acquisition*

This section explains the Olympus accounting fraud mechanism with a simple example. Company ● invested JPY 1 billion in stock, but let us assume that the stock price has fallen to JPY 200 million. This is not a fraud, but more due to bad luck.

Since the stock price has fallen by JPY 800 million from the purchase price, it must be recorded by impairment processing. In order to hide this loss, Company ● has sold stocks to the fund for JPY 1 billion. This operation is called a *tobashi* scheme. Although the loss of Company ● will not be seen by this operation, they are actually losing JPY 800 million. Company ● is in a state to borrow from the fund.

Next, suppose that Company A is a company with a value of JPY 300 million. Company ● buys Company A for JPY 1.1 billion. Since this is a kind of inflated order, in theory Company A should have JPY 800 million in extra cash. If Company A hands this cash to the fund, the fund can fill the loss of JPY 800 million, and Company ● can cancel its borrowing to the fund.

From Company ●'s perspective, the corporate value of Company A after the acquisition is JPY 300 million with a goodwill of JPY 800 million as an asset. The question here is: what will happen if you implement an impairment treatment in one year without depreciating this goodwill?

As a result, Company ● has treated the loss of equity investment with the impairment of the purchase case. This scheme is possible with the cooperation of Company A and the fund. Figure 8.1 shows how this scheme works.

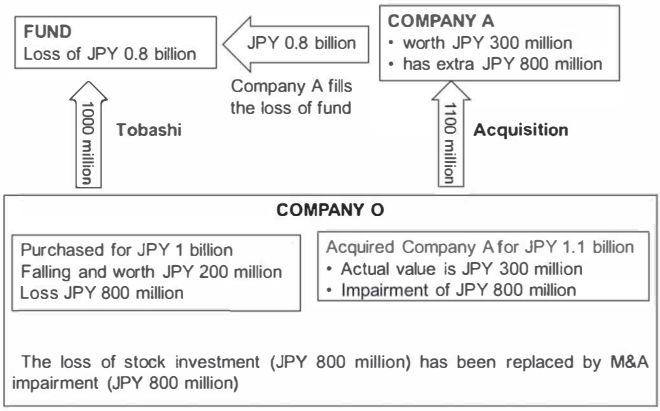

Figure 8.1 Combinations of M&A and *tobashi* scheme

The Olympus fraud incident involved more funds and acquiring companies, and it was very complicated. Of course, there were multiple external collaborators involved in this case. If the loss on equity investment was first impaired, the management team would not have been arrested. Also in this case, due to ineffective monitoring or supervision of the management team that runs this company, the managers could easily get away with their misconduct.

8.2 Limitation of risk management

Limitation of the internal reporting system at Olympus

There were officers assigned for handling and auditing the administrative procedures; specifically, procedures related to accounting fraud. Supposedly, personnel such as those in the Finance Department should be aware of the accounting fraud that occurred at Olympus. However, in the case of Olympus, the directors involved in the fraud were in charge of the Internal Audit Department and, in this situation, the Internal Audit Department was not functioning. Furthermore, even if the internal report had been made, not only would it have been concealed but there may also have been potential for the reporter to have been demoted.

In 2004, the Whistleblower Protection Act was established in Japan. Olympus established an internal reporting system the following year. However, in 2007, an incident occurred in which an employee who informed on their superior's inappropriate behavior was to be demoted.

The employee sued the company, but unfortunately in the first trial, which was held at the Tokyo District Court, he lost this case. After that, the case was appealed to the Tokyo High Court and, as a result, the company lost the trial held in August 2011. Ultimately, the second trial was finalized by the Supreme Court in 2012 and it took five years until the case was completely closed.

Even if you know that you can win a trial, the process requires a lot of courage; furthermore, people who report the fraud get nothing as a token of appreciation.

Olympus' internal reporting system

After the trial, to further improve the reporting system, the company established an external law firm office for a reporting channel. However, a mechanism to disclose the name of the informant who makes the report was also added. Nobody would file an external report with this kind of mechanism that would jeopardize them. This kind of risk management was totally impractical. However, the problem was that this mechanism was valid from the legal point of view.

The only way to expose the fraud by the management at that time was by reporting it to an outsider. However, there was another issue: there was a possibility that you may be dismissed and charged due to leaking internal information to the outsider (Japan's Whistleblower Protection Act 2004). Due to a few weaknesses found in the previous Whistleblower Act, this act is currently under revision for improvement in Japan.

Report from magazine

After that, the fraud at Olympus began to receive wide attention when it was first published in the August 2011 issue of a monthly magazine called *FACTA*, and it was continuously published until December 2011. According to Yamaguchi (2016), *FACTA*'s articles did not reveal any information about the informant, and they were very careful in their writing to avoid accusations from Olympus. The expose was later selected to receive the Editors' Choice Magazine Journalism Award[48] in 2012.

[48] This is an award in Japan.

8.3 Accusation by a new president

Accusation by a new president

The story goes back to April 2011, when Mr. W was promoted to President and Chief Operating Officer (COO) of Olympus. President W read the article[49] in *FACTA* at the end of July 2011 and began to feel suspicious. He pursued an in-house investigation and learned that JPY 140 billion had leaked out from the company. He then asked the chairman of the Board of Directors, Mr. K, to resign by e-mail. In this situation, President W was the COO, but the chairman, Mr. K, had the power of the board as he was also the CEO of Olympus. As a result, the new president was dismissed at the Board of Directors Meeting on October 14, 2011. According to the newspaper,[50] the reason for dismissal was: "ignoring the organization's decision-making process and unable to cooperate within the company". Although the whistle-blowing on the fraud had been made by President W, no action was taken and consequently he was replaced by President T. The appointment of the British president and his dismissal six months later had gained wide attention from the world.

Stock market reaction

Immediately after the dismissal, Mr. W explained the circumstances to the reporters of the *Financial Times* in Tokyo and handed out materials of the evidence. On October 15, the overseas media published his claim that, "I was dismissed while investigating the acquisition of several companies that Olympus carried out in 2006–08".

In Tokyo, when the dismissal was announced on October 14, the share price of Olympus fell 18% from the previous day. In addition, due to the report by the overseas media, the shares hit the limit down on October 17, and in the beginning of the week, the shares dropped further by more than 20% from the previous week.

In November, the company set up a Third-Party Committee. Olympus had its press release published on its homepage saying that "there is no scandal involved on any of the acquisitions made by Olympus". However, it seemed to be taken off its homepage on November 8, and on the same day the company held a press conference and admitted the accounting loss and that the Third-Party Committee would be set up to investigate the loss.

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[49] A friend of Mr. W's translated the article into English and delivered it to him.

[50] *Asahi Shimbun*, "Olympus president, dismissed in half a year," October 14, 2011.

On that day, the company's stock price hit the threshold once again. Overall, it fell nearly a quarter, betraying the expectations of shareholders who were also the stakeholders of the company.

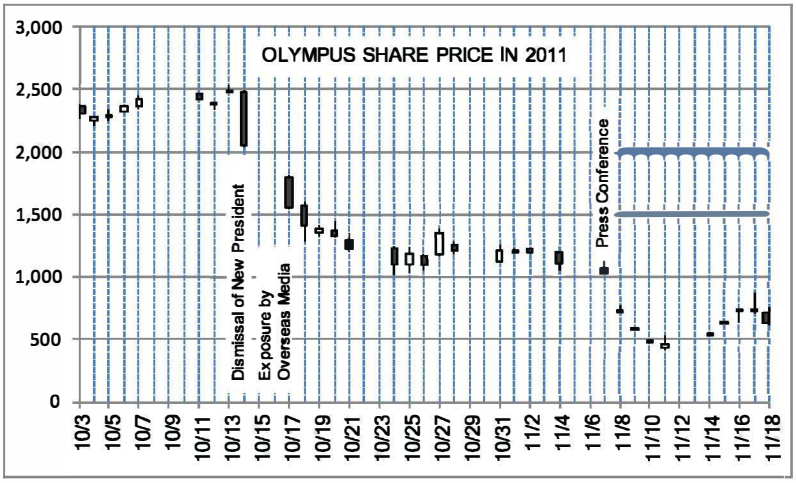

Figure 8.2 Olympus share price in 2011[51]

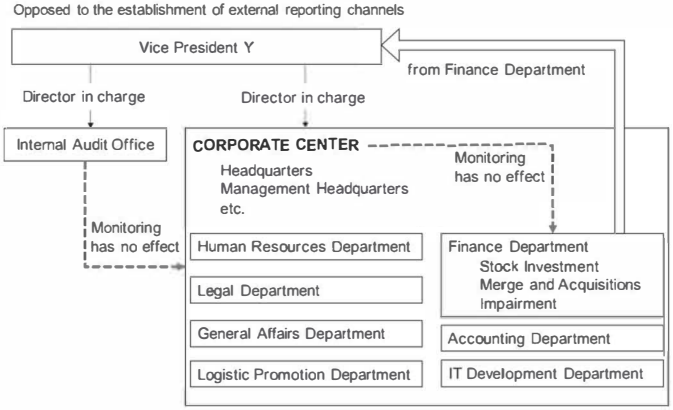

Figure 8.3 Olympus' governance system (2003–2009)

[51] Stock data is retrieved from Yahoo Finance. https://stocks.finance.yahoo.co.jp/stocks/chart/?code=7733.T (accessed November 30, 2017).

8.4 Problem of governance and internal control

In December, about a month after the press conference, the Third-Party Committee announced the Investigation Report through the company's homepage (Olympus 2011).

Governance problem

Mr. Y and Mr. M were in charge of the Finance Department in the 1980s, and then they were promoted to the head of the Finance Department. Management of the fund in this period was monopolized by a few people, mainly these two persons. Chapter 5.2 (1) of the Investigation Report states, "the control environment of Olympus that allowed such concentration of power had many problems".

According to Chapter 5.2 (1) of the report, the company established the Corporate Center (so-called head office function) in April 2001. The Corporate Center established multiple headquarters, management headquarters and management divisions as subsidiary organizations, and through them, managed the Administration Department, Finance Department, Legal Affairs Department, Human Resources Department, Accounting Department, Logistics Promotion Department and IT Development Department.

Mr. Y and Mr. M, who were from the Finance Department, served as Corporate Center Directors from April 2003 to March 2009 and from April 2009 to March 2011, respectively.

Since Mr. Y and Mr. M had been appointed the Corporate Center Managers for many years, the Corporate Center lost independence with respect to the Finance Department. From this, the Corporate Center could not sufficiently exercise a check-and-balance function to avoid losing corporate value.

This is where the first and second lines of defense were not working for the Finance Department. In particular, Mr. Y became the vice president (afterwards, full-time corporate auditor), and since April 2003, he also served concurrently as an officer in charge of the Internal Audit Office. In other words, inappropriate individuals concurrently served as Corporate Center chief and officer in charge of the audit office. Therefore, the Internal Audit Office could not perform internal audits that were independent of the Finance Department and each department of the head office function. Naturally, the third defense line was also not working. Figure 8.2 shows this situation and shows that it was a system to conceal the fraud in the Finance Department.

Rotating financial personnel on a regular basis is basically making fraud harder. But because there are few people who have expertise in fund management, this job rotation is not that easy. In other words, even if the organization has a separate authority or independent authority, it can be understood that the check-and-balance function within the organizations does not work if the executive placement is inappropriate. This is the lesson learned from the Olympus incident. It is the corporate auditor's duty to advise on improvement of this officer's placement, but this was not done. The reason was that the independence between the corporate auditors and the directors was not secured, which will be explained later.

Lack of risk assessment ability

The Third-Party Committee also investigated the point that the BOD was responsible for risk management. In Chapter 5.2 (2) of the investment report, the following is stated.

The company conducted a "corporate risk survey" for 243 people, including 27 officers (directors, executive officers), 21 people in the class of Business Department managers and headquarter managers, and 195 people in the class of heads of departments, in 2010. The survey reported the following as items having significant damages and effects:

(1) Accounting problems (account-rigging, inappropriate accounting process)
(2) Concealment and falsification of problem information
(3) False reports to regulatory agencies, etc.

However, this in-house survey did not treat these as a priority risk. These risks were underestimated with the conviction that misconduct by managers could not happen. The report also pointed out that the overall assessment of internal controls was too formal.

Chapter 5.1 (4) of the report points out that:

> Although the Risk Management Committee is established and it is being held on a regular basis, there are problems with regard to risk assessment and so forth.

Internal reporting system

The company introduced a Compliance Help Line in 2005. In this system, the Compliance Office receives reported information from the Help Line. Since it is difficult in this system to report on matters

concerning the Compliance Office and its stakeholders, an external reporting channel is also necessary.

The following items are written in Chapter 5.2 (4) of the report.

> A person from the Compliance Office several times proposed to set up some external reporting channel. However, the head of the Corporate Center, who is also a director Y in charge of the audit, was strongly opposed to this plan. Accordingly, the system without external contacts continued.

The compliance hotline is the second defense line, but it did not work because an unauthorized party dominated the compliance hotline.

Independence of corporate auditors

In Chapter 5.2 (5) of the report, it was written that:

> The company's Board of Auditors consisted of two full-time corporate auditors and two outside corporate auditors. The full-time corporate auditors were former employees or directors who worked for many years at the company. And one of the two outside directors at that time was a former classmate of the president and the other was a supplier to Olympus.

The report pointed out that there were problems with the fact that:

> The four corporate auditors were nominated and recommended by the representative director and assumed office as corporate auditors.

Also, the report pointed out that:

> It cannot be guaranteed that there will be mental independence on the part of both the full-time corporate auditor and the outside corporate auditor from the representative director.

In terms of officer assignment, the fact that the same person dominated the second and third lines of defense shows the problems in terms of governance.

The Olympus incident is a case where the independence of the corporate auditors is not maintained, and hence it is impossible to monitor misconduct committed by the manager. Most companies in Japan appoint their former executives and staff members as corporate auditors, which actually can cause problems in corporate governance and subsequently contribute to management fraud.

8.5 Responsibility of directors

Based on reporting from the *Asahi Shimbun* newspaper again, we will summarize the outcome of the incident.

Arrest of former management team

In December 2011, the Metropolitan Police Department and the Securities and Exchange Surveillance Commission began investigating Olympus. The following year, in February 2012, three people were arrested on suspicion of violating the Financial Instruments and Exchange Act, including former president Mr. K, former full-time corporate auditor Mr. Y and former vice president Mr. M. Four other external collaborators involved in hiding losses were also arrested.

In July 2013, the Tokyo District Court convicted three people from Olympus. According to the presiding judge:

> The Board of Directors and Board of Auditors, which should monitor management, had become mere shells.

In connection with this, the Financial Services Agency established a "Standard to Address Risks of Fraud in an Audit" and set out "Conducting the Audit to Address Risks of Fraud" in Chapter 2. With the establishment of these standards, the audit corporation is expected to detect fraud occurrences more effectively.

Governance reforms in Olympus

After that, Olympus established internal regulations that outside directors would hold a majority of the board member positions and listed actions for reform. The stock price of Olympus in 2018 has recovered to about JPY 4,000.

Mr. W received one e-mail shortly after the president was dismissed. It was on October 22, just before the Third-Party Committee stood up. It was from the person who had exposed the fraud information from Olympus to the *FACTA* magazine. Written in the e-mail was:

> I am an employee of Olympus; I am grateful for what you did for our company.

Appropriate accounting treatment

Due to losses from stock investment, the Olympus management had decided that the policy of impairment treatment must be based on accounting rules. However, managers at Olympus hid the loss with a *tobashi* scheme and replaced it with funds. They acquired several companies at an excessively high price, and built up fraudulent funds to compensate for the loss of the fund. If they were treating the equity impairment honestly from the beginning, the management team would not have been arrested.

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CHAPTER NINE

FRAUD AT OPERATING DEPARTMENTS PRESSURED BY CEO: TOSHIBA'S ACCOUNTING SCANDAL

From 2008 to 2014, more than JPY 150 billion had been irregularly added to Toshiba's profit and this led to an accounting scandal at the company. These irregularities were committed by many of its "in-house companies",[52] which broadened the case. Since the top management was directly involved in the scandal, it extended beyond what the risk management could control.

What was wrong in the company's corporate governance and its risk management? Then, what could be done by the employees who found out about the irregularities? And what kind of prevention policy can be derived from this issue?

Thus, this chapter is going to discuss the case based on those points of view, and based on reporting from the *Nihon Keizai Shimbun* newspaper[53] and three reports by Toshiba.[54]

9.1 Background of the scandal

Revelation of the scandal

Toshiba's accounting scandal was first whistle-blown to Japan's Securities and Exchange Surveillance Commission (SEC). The accounting

[52] For details of the in-house companies, see Chapter 9.3.

[53] *Nihon Keizai Shimbun*, "Toshiba, inappropriately accounting deeply rooted," May 23, 2015; "Toshiba, corrected profit reduction of 224.8 billion yen, settlement of 7 years," September 7, 2015; "Toshiba sued the past three presidents," November 8, 2015; "Toshiba, third party committee report lacks independence," November 27, 2015; etc.

[54] Toshiba (2015a, 2015b, 2017).

irregularities by Toshiba and its in-house companies were discovered by both SEC and Toshiba's internal investigation themselves.

Later, a Third-Party Committee was found and a deep investigation started. According to the report by the Third-Party Committee (Toshiba 2015a), the company's whistle-blowing system was not functioning because there was no trust in the company's compliance policy by the employees.

We can say that the SEC acted fairly after receiving the information from the whistle-blower. When the employees realized the wrongdoing committed by the top management, it was the right move to report to the SEC in order to stop the act.

Background of the scandal

According to the Investigation Report of the Third-Party Committee (No. 2, Chapter 3), there were six in-house companies reported to have accounting irregularities:

- Power system company (power generator)
- Social infra-system related company (power distribution, logistics, etc.)
- Communication solution related company (social smart city, etc.)
- Audio visual industry related company (later the company was split up)
- Personal & client solution (computer department, etc.)
- Semiconductor & storage related company

According to the report's Chapter 1.6, the total amount of profit-before-tax that was irregularly amended was staggering at JPY 151.8 billion. Due to the vast amount and the complex nature of these cases, we will omit the explanation for each of them. Nevertheless, according to the materials obtained from the Financial Services Agency (FSA), we are able to summarize this issue as below.

- In some of the construction projects, the construction loss allowance was reduced to declare extensive improvement in revenue
- Cost of goods sold (COGS) and expenditure were irregularly slimmed down in video, PC, semiconductor and other business divisions

To summarize, in order to show that the company's performance was good, the accounting profit was manipulated by postponing the calculation of expenditure to the next fiscal year.

When the company's performance became good after this, it was thought that it may have gone unnoticed when the postponed expenses were calculated together. But, when the company's performance was continuously being poor, adding up the postponed expenses showed that the amount of profit was increasing year by year. Not surprisingly, the cash flow should not be positive, unlike net profit.

When the gap between net profit and cash flow continued, the audit firm must have realized that there was a financial window-dressing happening. Like what had been discussed regarding the Olympus scandal in Chapter 8.1 of this book, the audit firm was expected to play a role in this fraud detection. But there was no action taken by the auditing firm.

Later, according to the *Nihon Keizai Shimbun* newspaper (May 23, 2015), the amended figure in the company's financial statement (reduction of profits) was increased to JPY 224.8 billion for its profit-before-tax. Furthermore, according to the Reuters report (Reuters 2016), the padding amount of profit-before-tax was increased by JPY 5.8 billion to be JPY 230.6 billion.

Accounting profit and cash flow

Generally, a company's performance is measured by its net profit. Because this is about accounting profit, if there is a circular transaction or accounting irregularity, the actual state of profit and loss of the company cannot be determined correctly. It is common to use free cash flow (FCF) as an indicator to measure a company's earning strength.

Cash flow consists of operating cash flow, investment cash flow and financial cash flow, and the FCF is the sum of the operating cash flow and investment cash flow.

$$\text{FCF} = \text{Operating cash flow} + \text{Investment cash flow}$$

Toshiba had been manipulating its accounting profit, and because of that, after the incident was discovered, the financial statements of FY2008 to FY2014 were corrected. From the company's annual securities report, we compare the differences between before- and after-corrected net profit and FCF figures, which are shown in Figure 9.1.

According to this, we know that the net profit of JPY 30 billion to JPY 70 billion from FY2008 to FY2012 was reported to be more than the actual performance.

But there is almost no difference between the before- and after-correction for the FCF. From this we know that cash flow is an indicator which is difficult to manipulate, in contrast to accounting profit. For the

cumulative total of net income of JPY 48 billion in this period, the total accumulated figure for the FCF was negative JPY 165 billion. This means that there was a gap between the net profit and the FCF of JPY 213 billion. However, we still cannot conclude that these differences proved that the financial window-dressing happened. But there remains a question of why the auditing firm did not suspect this gap.

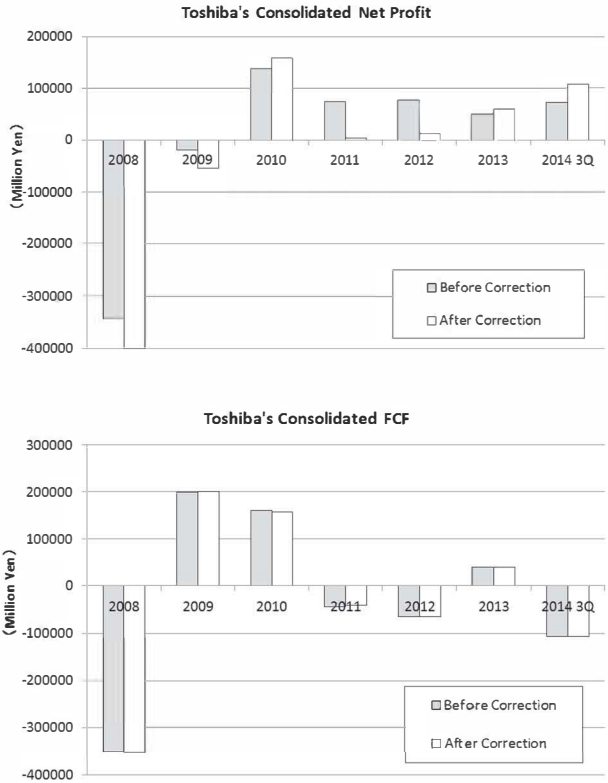

Figure 9.1 The transition of Toshiba's net profit and FCF[55]

[55] Accounting data is retrieved from the annual securities reports of Toshiba.

9.2 Violation of Financial Instruments and Exchange Act

Toshiba's accounting irregularities were found to have violated the Financial Instruments and Exchange Act, and the company was fined around JPY 7.3 billion by the Japan Financial Service Agency in December 2017. It was the highest penalty ever charged in Japan. The summary of the decision pointed out that the following misstatement was made in the company's Financial Statements.

(1) A provision for loss on some of the construction projects was declared to be less than the actual amount to create a large increase in revenue.
(2) The cost of sales and expenses of video, PC, semiconductor and other business units were deliberately reduced.
(3) Net loss for FY2009 was reported to be JPY 34 billion less.
(4) A net profit of JPY 130 billion more was reported only for FY2011 and FY2012.
(5) By decreasing the deficit and inflating the size of the profit, the composition of the finances was made to appear better; thus, from FY2008 to FY2014, JPY 320 billion in corporate bonds was issued as fundraising.

Fundraising issues

Statements (1) to (4) in the above are the explanation of the accounting irregularities, while (5) is pointing out the deceiving investors. Since the company performance had been reported as better than its actual capability, the balance sheet of the company looked better. Because of this, Toshiba's credit strength was highly valuated and that made them able to issue the company's bond with low interest.

Since normally investors will ask for the interest rate that meets Toshiba's financial strength (which was at bankrupt risk), this time they were able to find out the losses, which were equivalent to the interest rate difference.

The financing with benefits from the accounting irregularities means that a representative of a leading Japanese company is doing something like a trick. As a result, mistrust from overseas towards Japanese companies has increased.

Toshiba's amount of loss

On the construction works, system development and other departments' contract jobs, according to the judgment of the general manager or person

in charge, the progress of the project was reported to be a little ahead of the schedule, and a little delay in cost was also reported sometimes. In some cases, such accounting treatment is deemed inappropriate. It means that most of the businesspersons were working in a situation that is prone to fraudulent accounting.

Toshiba's accounting fraud is different from embezzlement, so the financial damage did not directly affect the company. But it was directly hit by the cost of correcting the financial statement and by the fines due to law violations.

According to the *Nihon Keizai Shimbun*, the penalty for listing agreement was exceeding JPY 1 billion, the administrative monetary penalty was reported to be JPY 7.3735 billion and for the correction of the financial statement they had to pay around JPY 2.07 billion to the auditing firm. The details of the figures were not announced, but the total loss was believed to be around JPY 10 billion. On top of that, unnecessary work-load had increased and indirectly hit the related staff members.

Toshiba assumed that there was a loss of JPY 1 billion due to fraudulent accounting and they have filed a lawsuit for damages of JPY 300 million to their five directors. Later, because of the penalty from the FSA, the total compensation amount to the directors was increased to JPY 3.2 billion.

On the other hand, Westinghouse Electric Company LLC[56] (WH) was bankrupt and, because of that, its consolidated final deficit in the financial statement dated March 2017 was reported to be more than JPY 1 trillion, which resulted in an excess of debt of JPY 620 billion. Because this loss was too much, the loss of the accounting fraud was discreet.

Who is the victim of this fraud?

Who suffered the most from the Toshiba accounting fraud? The first victim was the investor who bought shares after believing in Toshiba's earning capacity. Next is the investor who bought the corporate bond after believing in Toshiba's financial health.

After the incident was exposed, Toshiba's real financial strength was reflected in the price of its corporate bond, and then the price had dropped. Bondholders suffered the losses of the price drop. As described earlier, the disadvantage of the corporate bond's interest rate differences was reflected in the declination of the corporate bond's market value. Later, Toshiba

[56] Westinghouse Electric is a US subsidiary company of Toshiba.

suffered another declination in creditworthiness after a great impairment of WH. As a result, the corporate bond was largely declined, and the bondholders had terrible experiences.

The third victim was Toshiba themselves. The clean-up process of this accounting fraud cost them the unnecessary expense of more than JPY 10 billion. On top of that, the intangible loss was immeasurable, such as damage to trust and brand image.

Accountability as a global company

Most of Toshiba's stakeholders are overseas. Most of them are overseas subsidiary companies, their employees, suppliers, customers, community members and others. And for sure the most important stakeholders were the foreign investors.

After the scandal occurred, the investment report should have been prepared so as to fulfill the corporate accountability to the stakeholders. But most Japanese companies prepare the report in Japanese only without an English translation. Even though this Japanese company is considered as a global company, this kind of behavior shows how they ignore their overseas stakeholders.

Exceptionally in the Toshiba's scandal, the summary of the report of the Third-Party Investigation Committee was translated to English as "Investigation Report and Summary Version".

9.3 Corporate governance and risk management at Toshiba

Company structure

In 1999, Toshiba introduced a "company system". This company is like an in-house company, where it possesses the function of human resource, investment and accounting, and it is more independent and has more authority than the other business divisions.

However, it is not as independent as a subsidiary of a holding company and it does not even have its own BOD. Therefore, risk management of the company is handled by the BOD of the headquarters.

Figure 9.2 shows the organization chart of Toshiba's Finance and Accounting Department at that time.

At Toshiba, headquarter functions are called "Corporate". The Finance Division was placed under the Corporate umbrella. On the other hand,

every in-house company has its own Accounting Department and holds its own account-related responsibilities and authorities. According to the Three Lines of Defense philosophy, risk management will be less effective with this structure. We will explain about this later.

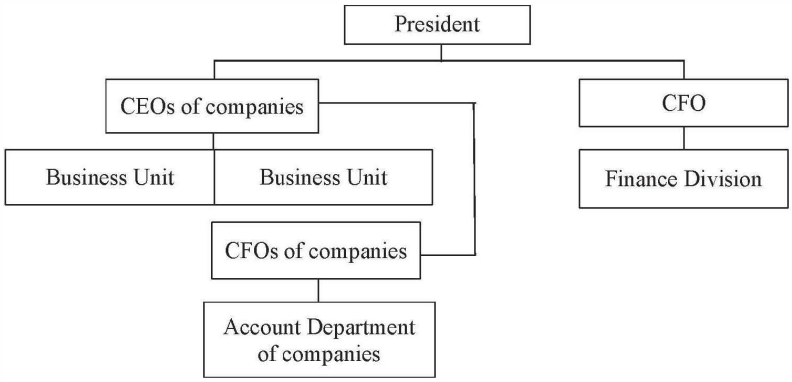

Figure 9.2 Organization of Toshiba's Finance and Accounting Department

Migration to a Company with Committees

Toshiba was the first company in Japan to migrate to the Company with Committees structure, and it was called a role model of corporate governance. It was reported in a Toshiba press release in 2003 [57] as "Reinforced supervisory functions and improved transparency". By introducing an External Board of Directors, the transparency of management and discipline was expected to be improved. Furthermore, since they had announced a policy that "It provides for executive officers to execute business, while the board concentrates on supervision of management", the executive officers automatically are the top managers of each in-house company.

Moreover, the CRO (Chief Risk Officer), Risk Management Committee, Compliance Committee and other committees were established and aimed to strengthen the risk- and compliance-related structure. Even though at Toshiba the corporate governance and risk management were well

[57] Toshiba, "Toshiba to adopt 'Company with Committees System'," January 29, 2003. https://www.toshiba.co.jp/about/press/2003_01/pr2903.htm (accessed February 9, 2013).

structured, we wonder why this kind of major accounting irregularities still happened.

The reason behind the scandal was that because the CEO was putting a heavy pressure on every in-house company to be profit-target oriented, this made all in-house companies prone to inflating their earnings. It was a fraud by the top management and the executive officers, and it seems that the risk management structure was watered down. We will explain the situation based on the Independent Committee Investigation Report. This report highlighted many problems, but we will explain later about it.

Audit Committee and external board members

Chapter 7.2.4 of the Investigation Report by the Third-Party Committee stated that the Audit Committee did not make any indications to the BOD. Furthermore, it stated that a number of Audit Committee members recognized the irregularities during the accounting process, but nobody highlighted or made any indications about the problems to the BOD.

Chapter 2.3.1 of the report said that there were 16 members of the BOD including four persons serving as external board members at that time. The members of the Audit Committee consisted of two persons from the company and three external audit members.

However, Chapter 7.2.4 of the report said that only one of the Audit Committee members who were from the company was in charge of finance and accounting, but the other three External Audit Committee members were not professionals in finance and accounting.

From this we know that the auditing process was done only by one person from the company. Furthermore, Chapter 4.4.4 (5) said that a person from the company was the chairman of the Audit Committee. This structure is no different from a self-audit structure.

CEO monthly meetings and "challenge"

At Toshiba, there was a monthly event held across all in-house companies called the "CEO monthly meeting". This meeting was a place where all in-house companies and their subsidiaries had a chance to present their performances, market projections and other updates directly to the CEO. Chapter 7.1.3 of the Investigation Report states that the president put pressure on all of the top management towards the profit-oriented mentality at this event, a so-called "challenge". Thus, each in-

house company deliberately altered its account to increase the profit in response to the event.

The *Nihon Keizai Shimbun* (August 11, 2015) wrote that the monthly meeting was supposed to be a constructive argument meeting, but it had turned out to be a place to force out the challenge.

The CEO monthly meeting was the beginning point of this accounting scandal; since it was not a meeting of a BOD, there were no external board members present at that time. From this we know that the supervision from the external board members was not functioning.

Audit Management Department

Chapter 7.2.2 of the Investigation Report states that, under the Corporate Division, there was an Audit Management Department which held responsibility for the internal audit as well, but under the administration of the CEO. This is a common structure which results in the internal audit being unable to function for cases related to the CEO.

As a matter of fact, the main objective of the Audit Management Department is to focus on auditing all business operations and it should not be involved in financial audits. Furthermore, it is also stated that in the department there were only a few members competent in accounting. This system is determined by the CEO. In other words, it can be said that the president didn't want the Audit Management Department to be fully functional.

Three lines of defense

A series of fraudulent accounting processes, involving the top management and others, is said to have been done systematically at each in-house company. When a scandal involves the top management, the supervision from the Accounting Department does not impose any effect. Furthermore, even if the person in charge of the Accounting Department whistle-blows about any irregularities related to the top management, there will be no action taken.

The Accounting Department in each company is the first defense line. Indeed, Toshiba's performance was measured by the performance of each in-house company, and the company's performance was reflected in the performance evaluation of the Accounting Department. In other words, the Accounting Department holds the same risk as the in-house company and this is why it is considered as the first defense line.

Meanwhile, in many other corporates the Accounting Department is placed under the headquarters, and the structure is separated from the Business Unit Department. To ensure that there will be no wrongdoing in the business unit, the Accounting Department should be placed as the second defense line.

At the beginning of this chapter, we showed the organization structure of Toshiba's Finance & Accounting Division. When the Accounting Department was structured under each in-house company, it symbolized the vulnerability of Toshiba's risk management structure.

The second defense line against the accounting fraud was the Corporate Finance Department and Risk Management Department. Chapters 5.4.3 (6) and 6.4.4 (3) of the Investigation Report state that there was no appropriate action taken by the person in charge in the Finance Department even after the accounting irregularities were recognized. Furthermore, there was a wrongdoing by the Chief Financial Officer (CFO) himself, and regarding that, we know that the internal control by the Finance Department was not functioning.

On the other hand, Chapter 7.2.2 (2) stated that the Risk Management Department did not check the in-house company's financial report. Even though there were two departments—the Finance Department and Risk Management Department—as the second defense line, from the scandal we know that both were not functioning.

The third defense line is the Audit Management Department; but, as stated before, the department had never monitored the accounting. In other words, in Toshiba's risk management structure, these three defense lines were not functioning at all.

External audit

Toshiba had a good governance system called Company with Committees, but how it is seen from the outside was totally different from how it was managed inside. The risk management structure was broken apart, which made the scandal worse compared to other scandals presented in this book. With this scandal, there was no appropriate action that could be taken even if the employees found out about the irregularities. Thus, the external audit by the auditing firm served the monitoring function.

Chapter 7.2.5 of the Investigation Report stated as follows.

> Account irregularities were not being pointed out by the auditing firm during the auditing process, which showed that the external monitoring system was also not functioning.

The root cause can be summarized as below:

(1) There was a deliberate operation to do the accounting irregularities internally, which caused many of these problems.
(2) There was a concealment of facts in response to the queries or request of documents from the accounting auditors.
(3) Information about the company was announced based on documents that differed from the fact.

The involvement of the auditing firm was not a subject of this investigation since it was not aimed at assessing the adequacy of accounting audits.

The *Nihon Keizai Shimbun* newspaper (July 27, 2015) quoted from a lawyer who is an expert on corporate compliance.

> Although Toshiba's way of concealing the fact was clever, since they were unable to detect (the account irregularities) in years, I would say that they (the audit firm) were not professionals.

Looking at the gap between accounting profit and cash flow, which kept expanding as mentioned in Chapter 9.1, we agree with this comment.

9.4 Problems with the investigation by the Third-Party Committee

The Third-Party Committee was founded in April 2015 and the Investigation Report was released in July 2015. The report consisted of almost 300 pages showing that a tremendous effort had been made to complete the investigation within three months. However, when reading the report from a risk management point of view, several illogical descriptions were found in the cause analysis of Chapter 7 of the report.

Limitations of risk management

In this scandal, the illegal involvement from CEO level to all top managers showed that it was a typical case which is beyond the limits of control of risk management. Even if the person in charge of the Accounting Department or Finance Department had a suspicious feeling about the account irregularities, it was impossible to point it out or even to consult with their managers.

In Chapter 7.2.2 (2) of the Investigation Report, the Third-Party Committee pointed out that the person in charge of the Finance

Department did not take any appropriate action, but actually it was not "he did not" but rather "he could not". Furthermore, it was stated that the Risk Management Department has never checked the in-house company financial report, but it was not "they did not" but rather "they could not".

Moreover, another outrageous finding in the report was as stated in Chapter 7.2.8, which mentioned that the fact that the whistle-blowing system did not fully function was one of the root causes of the scandal. The fact was that the top management had never taken seriously what had been brought up by the whistle-blower. All the findings seemed to impute the wrongdoing to the employees.

In particular, the worst part is as mentioned in Chapter 7.1.1(1), such that:

> When organized accounting irregularities involving the top management are presumed, there is no such risk management system in place for it at Toshiba.

The direction of the risk management was decided by top management, and there are no directors who will take measures to put themselves in a disadvantaged position. Recall that any fraud by the top management is beyond what the risk management can address. The reason why any accounting fraud could not be prevented is not because of the lack of risk management, but it is more due to the management who run out of control. Therefore, we can say that the findings in the Investigation Report failed to evaluate the truth.

Ambiguous root cause analysis

As seen in other cases in this book, normally investigation reports by Third-Party Committees elucidate the facts such as "What sort of instruction was given from whom to whom?" or "Who did what?" But in Toshiba's case, there were so many ambiguous terms such as "involvement of top management" that were written abstractly in many parts of the reports.

Toshiba managed to raise funds with some advantageous conditions through the improper accounting, and the fact that it deceived the investor was the reason why Toshiba was penalized by Japan's FSA. But this was never mentioned in the Investigation Report.

Since the Third-Party Committee was formed by Toshiba, it investigated this incident for Toshiba. Therefore, the investigation was not necessarily done on behalf of the stakeholders. As a matter of fact, Chapter 1.5.2 of the report said that, "Arbitrary cooperation by Toshiba's executives and employees" was the precondition, and "Purposely done for Toshiba" was

clearly stated. In other words, it was never an investigation to fulfill the accountability to the stakeholders.

Guidelines of the Third-Party Committee

According to the Japan Federation of Bar Associations (JFBA), a guideline of the Third-Party Committee established a proposal for root cause investigation and of preventive measures for any scandal related to any enterprise. Below is a part of the guideline.

(1) It must fulfill accountability to the stakeholders.
(2) It must be independent from the enterprise and must conduct a neutral and fair investigation for the purpose of the stakeholders.
(3) It is able to describe in the report whether there is not enough cooperation or any sabotage from the enterprise.

Compared to this, the Third-Party Committee of Toshiba's case seemed to act on behalf of Toshiba, not the stakeholders. Furthermore, since the investigation had a limitation of voluntary cooperation from the executives and staff, Toshiba's committee was far behind what the JFBA expected. Besides this example, there were a few other findings that didn't fulfill the accountability requirements in Toshiba's report. From this, a voluntary group of lawyers formed a rating committee for Third-Party Committee reports.

Criticism by rating group

The *Nihon Keizai Shimbun* newspaper (November 27, 2015) reported that the Rating Committee for Third-Party Reports sternly stated that the Investigation Report was barely independent from the company, and it cannot be called an Investigation Report by the Third-Party Committee. The reason for this is because the committee removed the impairment loss of WH, a nuclear power subsidiary company, and the problem with the audit firm from the Investigation Report.

The Investigation Report by the committee appointed by Toshiba had never reached the expectation of the stakeholders. However, the above guidelines were not an official standard, so Toshiba might not obey this guideline. But there was a question as to whether this kind of report may bring back the brand image of Toshiba.

9.5 Directors' liability and preventive measures

Later, the Directors Liability Investigation Committee was formed in September 2015. The objective was to judge the responsibilities and to request indemnity from the directors who were involved in the scandal based on the Third-Party Investigation Report. This committee was formed by three external lawyers.

Liability of directors

The report by the Liability Investigation Committee (Toshiba 2015b) analyzed the actual condition of the damage and the responsible cause for each case, which was deemed inappropriate in the Third-Party report. Chapter 11.1.2 of the report of the Liability Investigation Committee stated that Toshiba's damages included a huge penalty that was unnecessary payment, and damages that cannot be financially measured, such as a loss in public trust, were extremely huge.

From this, Chapter 6.2 of the same report stated that the root cause and the responsibilities were analyzed based on Japan's Companies Act, Japan's Accounting Standard and the US Accounting Standard:

- Duty of diligence
- Duty to comply with fair accounting practice
- Duty of Auditing and supervising
- Duty to form and operate the internal control system

This book will omit detailed content, but in conclusion, Chapter 12 concluded that all five directors violated a duty of diligence; specifically, three former CEOs and two former CFOs. And the chapter concluded that they could not question the responsibilities of the external BOD and the executive officers.

The CEO who put constant pressure on the companies was responsible, but it was concluded that the other directors who attended the same meeting, the external directors and the executive officers were not responsible.

Since this was the result of the investigation in order to file a lawsuit against the wrongdoer, it may be different from what we as a society expect about responsibility in a social common sense.

A violation of duty of diligence

Generally, for example, if the president of an in-house company is involved in inappropriate accounting to make his performance better, and the wrongdoings were not noticed by the CEO and other top managers, they would have violated the duty of diligence.

In the Toshiba case, the CEO put huge pressure on every in-house company and led to the inappropriate accounting by the in-house companies. We feel that the CEO would hold a heavier responsibility compared to the violation of a duty of diligence.

By doing the inappropriate accounting, Toshiba managed to fake its capability and managed to issue its corporate bond with lower interest rate than its capability. From this, it was said that Toshiba's bond was a fraud.

The objective of the investigation by the Directors Liability Investigation Committee was to clarify Toshiba's incurred damages and its responsibilities. Thus, it is thought that issuing the bond was not a point of concern for the committee to investigate, since Toshiba had gained from this issuing.

The committee might have considered the losses of corporate bonds and stock investment as problems if the investors were to file a lawsuit. If compensation needed to be paid because of the lawsuit, they might think that Toshiba should demand all the expenses from the previous management team.

Preventive measures

Let us go back to the report by the Third-Party Committee. According to the report, the preventive measures can be divided into direct causes and indirect causes as below:

(1) Direct Causes

Chapter 8.2.1 of the same report proposed a countermeasure for direct causes as below:

- The awareness of management's responsibility against anything related to irregularities in the accounting process
- Clarification of the responsibility of the related person
- A reformation in the way of thinking of the top management
- The establishment of a revenue plan that should be based on the company's ability, and abolishment of the "challenge"
- Reformation of the company's culture
- Reviewing the accounting standard, and strict application of the accounting rule

"Clarification of related person's responsibility" was completed with the investigation by the Directors Liability Investigation Committee and a damage suit against the former directors. With the other preventive measures, it was difficult to expect their explicit effect and the verification method.

For example, the effectiveness of one of the preventive measures, like "The establishment of a revenue plan that should be based on the company's ability," cannot be expected to be effective unless it is in a socialist-planned economy like the former Soviet Union. Even if the plan is made according to the company's ability, it is not unusual for the plan to be difficult to follow.

As the basic principle of risk management, what had been experienced once should be a subject of risk management. Consider a case where it is difficult to make a profit. It is compulsory to have a risk management strategy against the case where the CEO puts pressure on in-house companies to make their profit. From this perspective, "Abolition of the Challenge" seems like a superficial policy.

(2) Elimination of indirect causes

In the same report, Chapter 8.2.2 recommended preventive measures against the indirect causes, commenting from hard-side and soft-side perspectives.

Preventive measures from the hard-side perspective:
- Establish a powerful internal control division
- Strengthen the internal control function of the BOD
- Strengthen the internal control function in the Audit Committee
- Utilize the whistle-blower function

Preventive measures from the soft-side perspective:
- Increase the number of external board members, and review the constituent member of the board
- An adequate Human Resource rotation

"Establish a powerful internal control division" means strengthening the Audit Committee and setting up the policy of appointing an external board member as the manager of an Internal Audit Department. This could be an effective measure.

"Strengthening the internal control function in the Audit Committee" means appointing an external board member as a chairman of the Audit Committee and strengthening the Audit Committee by forming the committee consisting of staff members that have deep experience in

financial accounting. This policy may be effective if it started with proper selection of the persons to be in the Audit Committee.

There was a famous scholar of business management as a (former) Toshiba external board member. He was neither an expert on risk management nor an expert on finance but an expert in corporate strategy and technology management. This kind of talent was suitable for a role as a strategy advisor to an in-house company but not a suitable candidate to be a supervisor or auditor to the management or executives. This example shows that it was not only about the form of corporate governance but that the selection of board members plays a significant role.

9.6 Improvement report of internal control system

As per the analysis so far, there were a lot of problems found in the reports of both the Third-Party Committee and the Directors Liability Investigation Committee. It is uncertain whether Toshiba really reformed. In addition to that, it was also in a difficult situation, namely the collapse of WH and the burden of excessive debt.

At that time, in October 2017, Toshiba announced the Improvement Report of Internal Control Structure (Toshiba 2017). It was almost overlooked by the public due to the lack of coverage by the media, but it was a very important turning point for the company.

Toshiba has been consistently using "inappropriate accounting" as its expression, but in this improvement report it has started using "accounting fraud" to refer to the scandal. Thus, this report showed a specific improvement plan in every aspect such as corporate governance, internal control, risk management structure and others.

Chapter 4 of the report showed the content of the improvement plan and its implementation status, while Chapter 4-1 was about strengthening the corporate structure and its governance.

From this Toshiba scandal, we know that there was a huge problem in corporate governance, so the important point from the improvement plan related to the governance issues will be introduced below. For the structure of a Company with Committees, refer to Chapter 1.1 of this book.

(1) Strengthening the corporate governance
Confirming that the functions of the BOD are monitoring and auditing the execution, a chairman of the board meeting is selected from the external members.
Making sure the majority of the board members consist of external directors.

(2) The check-and-balance function of the Nominating Committee
The Nominating Committee is formed only by independent external directors, and it executes the formulation of the CEO's successor plan and the confidence survey of the CEO. This will improve the transparency of the CEO's selection process. And they will conduct a survey from around 100 top-management officers to investigate their confidence level regarding the CEO, and will use it as a reference in selecting the CEO. Through this survey, the monitoring function by the employees of the CEO will be effective.

(3) The monitoring function of the Audit Committee
Up to now, the CFO was the chairman of the Audit Committee. This becomes a self-internal audit and has no meaning at all. To overcome this issue, the Audit Committee will be formed by around five persons only from the external board members. This will strengthen the stance of monitoring and supervision of the corporate governance.
Furthermore, the internal audit will not only address the business risks but will also work as a risk assessment including accounting and financial risks.
The whistle-blower unit will not only be placed in the Operating Departments but will also be placed in the Audit Committee.

The conventional internal contact office does not function against the irregularities by top management. The effect of making a direct point of contact to the external board members is huge against the irregularities:

Furthermore, every member of the Audit Committee will be able to access the reports that have been made to the Operating Departments. Also, the anonymity of the whistle-blower must be strictly protected.

This will ensure that the whistle-blowing is hard to smother. Certainly, the precondition of this mechanism is that the independence of the external board members is substantially secured.

(4) The Independency of the Internal Audit Department
The existing Management Audit Division is abolished, and a new Internal Audit Department is formed. The Internal Audit Department is placed directly under the Audit Committee, and the Audit Committee has the right to claim and to give consent on the change or transfer of the division manager. This will strengthen the independency of the Internal Audit Department.

(5) Reviewing the Revenue Plan Control
Refining the current-profit doctrine, and clarifying the revenue plan policy from a medium-to-long-term point of view.
Improve the method for profit planning and performance evaluation in each in-house company.

(6) Performance report based on cash flow
After abolishing the CEO monthly meeting that was the place for the "challenge", a performance report meeting based on cash flow was introduced. As explained in Chapter 9.1 of this book, cash flow is different from net profit; it is an indicator that is harder to manipulate. If the company's performance is managed by the cash flow, there will be less room for the top management to manipulate the profit with improper accounting.

Above is a part of the improvement plan for this scandal. Points (1) to (4) in the above teach us an ideal image for the Company with Committees. Other than that, there are a number of specific improvement strategies such as enrichment of compliance-related training and restructuring the business risk management system. We hope that all these countermeasures will bring back the motivation of the employees and Toshiba will surely be reborn with a new identity.

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CHAPTER TEN

SUMMARY OF CORPORATE FRAUD INCIDENTS

Table 10.1 summarizes all cases covered in this book. Collectively, these cases show the following:

(1) Wrongdoing in Operating Divisions can be traced back to pressure from the management team.
(2) When independence among departments is not ensured, interdepartmental checks do not function properly, which increases the difficulty of identifying fraud in the company.
(3) In all of the cases examined here, the three lines of defense failed to prevent fraud.

Table 10.1 Summary of corporate fraud incidents

	Toyo Tire & Rubber	Fukumusume Sake Brewery	Kobe Steel	JX Mizushima Refinery
Revealed (year)	2015	2013	2017	2012
Department of Fraud	Development	Manufacturing	Inspection	Inspection
Fraud Type	Data Falsification	Misrepresentation	Data fabrication	Falsified inspection
Factor	Lack of development capability	Lack of technological capability	Lack of technological capability	Attempt to improve operating ratio
Pressure by Management		Improve operating ratio. Raw material rice designated by the holding company.	Attached importance of profitability	Improve operating ratio
Independence Among Departments	Manufacturing Department controls Inspection Department		Inspection data falsification is possible	Inspection Department is not independent from Maintenance Department
Three Lines of Defense	The first and second lines did not function	The first and second lines did not function	The second line was not present	The first and second lines didnot function
Internal Control	The inspection data were not shared with all related departments	Ingredient use was not checked	Inspection process tolerated falsification and fabrication of data	Weak compliance. Opaque disclosure.

Table 10.1 (Continued)

	Mitsubishi Motors	Tsubakimoto Kogyo	Olympus	Toshiba
Revealed (year)	2016	2014	2011	2015
Department of Fraud	Inspection	Sales	Finance /Director	Director /Company
Fraud Type	Data fabrication (fuel efficiency)	Circular transaction	Accounting fraud	Accounting fraud
Factor	Lack of development capability	Greed	Concealing loss	Raising profit
Pressure by Management	Raised the target fuel economy		Dismissal of new president	Pressure from CEO
Independence Among Departments	Development Department involved in inspection function and audit function	Ordering, stocking, checking and payment all done by one person	Kansayaku controls internal audit	Checking function among departments is not active
Three Lines of Defense	The first defense line was involved in the fraud. The second and third defense lines did not have checking functions.	The first and second lines did not function	The first and second lines did not exist. The third defense line did not function.	The first defense line did not function. The second and third defense lines were intentionally prevented from functioning.
Internal Control	Whistle-blowing was not used	Self-decision. Job rotation was not properly used.	Director and Kansayaku engaged in wrongdoing. Bad whistle-blower system.	Corporate governance and internal control system were controlled to prevent them from functioning

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