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Analysis of Market Failure Theories Based on Toshiba's Business Ethic Issue: Earnings Overstatement Scandal

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Abstract

As a controversial topic, business ethic is becoming significantly important in today's business world. Business unethical behaviors such as fraud scandal and other accounting manipulation will bring reputation risks for organizations, which may lead to serious consequences and even severe administrative penalties. Therefore, responsible firms should have senses of good behavior and prevent themselves from committing unethical behaviors, which causing negative externalities for other organizations and people. This research paper mainly conducts research through investigation, literature review and other methods, aiming at demonstrating responsible global citizenship implications by analyzing related market failure theories based on Toshiba's business ethic issue: earnings overstatement scandal.

Keywords

Business Ethic, Market Failure, Fraud Scandal

1. Background

1.1. Reasons Why We Choose This Topic

Earnings overstatement fraud is always the focus of capital market. COSO had conducted researches about financial statement fraud cases in the American capital market during the period of 1999 to 2010. According to the research, annual losses caused by fraud account for about 5% of the revenues of the surveyed organizations and the global fraud losses are estimated to be close to $3.7 trillion every year. This paper intends to sort out the Toshiba fraud scandal in the Japanese capital market to help market participants understand the methods and motives of fraud and draw lessons from them.

1.2. Toshiba's Earnings Overstatement Scandal Synopsis

Founded in 1875, Toshiba Corporation is a Japanese diversified electric/electronic manufacturer and provides its products and services on a global basis (Verschoor, 2015) [1]. It was once the world's fifth-largest personal computer vendor and the company's reported revenues were $55.5 billion in fiscal 2014. In the 2008 global financial crisis, Toshiba was struggled to survive, its truthful year-end profits were "too embarrassing" to report to the public (negative ¥340 billion yen). In order to maintain a good market image, the President Atsutoshi Nishida set unrealistic performance targets. Under such pressure, business department failed to achieve the set goal through normal operation. Thus, methods such as stockpiling, accounting estimation and manipulation were adopted to inflate the profits. Meanwhile accounting department turned a blind eye and even helped to inappropriately change accounting techniques (Kirk, 2015) [2]. Without effective monitoring from board of directors, audit committee, internal and external audit, the improper practices continued under the next two company leaders, Norio Sasaki and Hisao Tanaka (Kang & Bang, 2015) [3]. In February 2015, Toshiba received a notice from Japan's Securities and Exchange Surveillance Commission (SESC) asking Toshiba to investigate accounting issues (net profit overstatement) reported by employees (Jennings, 2015) [4]. After setting up special investigation committee and conducting self-examination, Toshiba found several manipulations related to accounting treatment (accounting treatment related to operating expenses of recording video product business, accounting treatment related to inventory valuation of semiconductor business, accounting treatment related to transactions in PC business components). Further investigation results indicated that Toshiba had been involved in overstating at least $1.2 billion for 7 years since 2008 and significantly misled investors. Later Japan's SESC fined Toshiba almost $60 million for its unethical business behavior, which is the largest ever in Japan for accounting-related violations.

2. Related Business Ethic Issue and Ethical Theory Frameworks

Toshiba's business ethic issue related to the fraud is the manipulation of accounting techniques in order to overstate earnings (accounting fraud), which misleads outside investors. Following are theory frameworks we will use to analyze Toshiba's business ethic issue: market failure, corporate social responsibility, professional ethics and Pareto efficiency.

2.1. Market Failure

In economics, market failure refers to inefficient allocation of goods and services. Market failures can be viewed as scenarios where individuals' pursuit of pure self-interest leads to results that are not efficient—that can be improved upon from the societal point of view. Information asymmetries (one party in transactions has more or better information than the other) can lead to market failure because one party can take advantage of it to pursuit self-interest, which is an inefficient outcome for the whole society.

2.2. Corporate Social Responsibility

A firm's implementation of CSR goes beyond compliance and engages in "actions that appear to further some social good, beyond the interests of the firm and that which is required by law". Thus, the concept of CSR is underpinned by the idea that corporations can no longer act as isolated economic entities operating in detachment from broader society. CSR can be used as insurance against market failure because it creates win-win situations for all stakeholders, which is efficient for whole society (Heath, 2006) [5].

2.3. Professional Ethics

Professional ethics refer to specific duties derived from the purpose of the profession. For example, duties as an accountant and manager. Business organizations need it because of the following reasons. Firstly, profit is not a good to be pursued at all costs—some constraints are needed. Secondly, staffs with good professional ethics will reduce information asymmetry gap between their jobs and outsiders. Finally, it is the internal code of conduct for trust. Moreover, professional ethical conduct is an effective response to market failure when the regulation does not work.

2.4. Pareto Efficiency

Pareto efficiency is a state of allocation of resources in which it is impossible to make any one individual better off while making at least one individual worse off (Babichenko, 2014) [6]. A Pareto improvement is defined to be a change to a different allocation that makes at least one individual better off without making any other individual worse off. Actual business market is not efficient because it is always criticized for moral hazards and negative externalities. Moral hazard often arises in a principal–agent problem, where the agent usually has more information about his actions or intentions than the principal does (Gürtler, 2014) [7]. The agent may have an incentive to act inappropriately if the interests of the agent and the principal are not aligned (Stone, 2011) [8].

3. Toshiba's Fraud Scandal Analysis Based on Ethical Theories

There are several parties significantly involved in or affected by Toshiba's earnings overstatement scandal: Toshiba itself, managers (Atsutoshi, Norio, Hisao), accountants, investors and the whole market. In addition, there are also some issues related to this fraud: information asymmetry and moral hazard. In this part, we will make analysis for Toshiba's business ethical issues and evaluate different parties based on four theoretical frameworks: market failure, corporate social responsibility, professional ethics and Pareto efficiency.

3.1. Toshiba's Scandal Is a Market Failure

Obviously, Toshiba's accounting scandal is a market failure. In order to provide good-looked financial results, Toshiba manipulates the accounting techniques to inflate earnings. The result is considered to be inefficient because from the whole society's perspective, outside investors are misled by their financial statements and make wrong decisions. Toshiba's market failure is mainly caused by information asymmetries. Managers including Atsutoshi, Norio, Hisao and accountants within the company know the real situation about Toshiba's financial performance, but they choose to cover up it rather than revealing it to public. Without knowing the real financial situation of Toshiba, external investors are misled by the provided financial statements, therefore they keep investing the company.

3.2. Toshiba Does Not Take Proper Corporate Social Responsibility

Toshiba's market failure indicates it does not take proper corporate social responsibility. As a global diversified electric/electronic manufacturer, Toshiba should not only comply commercial and law requirements such as maximizing profits and do not make hostile acquisitions, but also need to take proper corporate social responsibility to benefit the society and environment. However, Toshiba's earnings overstatement does not satisfy its corporate social responsibility because the scandal harms investors' interests, which is inefficient from societal perspective and lead to market failure. Toshiba should have taken its CSR, which create win-win situations for all stakeholders to prevent the market failure from occurring.

3.3. Violation of Professional Ethics for Personnel Involved

Managers and accountants within Toshiba do not behave professional ethics. Specifically, as managers, Atsutoshi, Norio and Hisao have duties to act in the best interest of Toshiba and avoid any conflicts of interest between themselves and the company (Kaufman, 2002) [9]. However, they breach their duties through manipulating accounting techniques, may be in order to get much more pay. Besides, as accountants within Toshiba, they have responsibilities to provide fair and faithful represented financial reports for investors. But they breach their code of conducts (integrity and honesty) through helping managers cook the books. If managers and accountants within Toshiba behave proper professional ethics, it will help to reduce the information asymmetry for external investors and make the organization more transparent, which should have prevented the Toshiba accounting scandal from happening.

3.4. Toshiba's Fraud Scandal Lead to Pareto Efficiency

Toshiba's market failure is a form of Pareto efficiency because it overstates its profits to make its financial performance better but make other investors worse off through misleading them to make the wrong investment decisions. Toshiba should make a Pareto improvement which not only make Toshiba itself earning profits but also do not affect other investors' interests. Toshiba is criticized for moral hazard, in which managers including Atsutoshi, Norio and Hisao have more information about his actions or intentions than Toshiba's shareholders do, therefore when interests are not aligned between "Toshiba is struggled with a low profit" and "managers want high financial performance to improve their remuneration", Atsutoshi, Norio and Hisao decide to inappropriately overstate the financial results.

4. Implications for Business Practice

Toshiba's accounting fraud reflects a typical business ethical issue in today's business world. With intense competition around the business world, companies are under huge pressures to make profits or even survive. Thus, they commit unethical behaviors such as overstating profits and utilizing rebates to manipulate financial performance. Often these fraudulent behaviors are related to managers, accountants or insiders because they are the people who can take advantage of information asymmetry, which finally harm investors and lead to market failure. However, these unethical issues could have been prevented if companies take some proactive actions.

4.1. Set Restrictions for Management

Set restrictions for management, especially when management is under pressures to achieve target profits. Vast majority of fraud cases (*i.e.* Enron and WorldCom) are caused by companies facing great pressures to maintain or improve their performance. In this case, after fully recognizing and understanding management pressures, Toshiba should have established a strong balance system in the board of directors, internal and external audit and other aspects, and then strengthened monitoring to prevent the scandal from happening. As for how to recognize the management's pressures in a timely manner and keep balance between each other, it needs further consideration.

4.2. Regularly Check the Fraud Risk Assessment Mechanisms

According to nearly 30 years fraud investigations, it reveals a startling fact that fraud cases are not eliminated at all; instead it shows an increasing trend and almost all types of organizations face the threat of fraud risk. Toshiba is just one example of the fraud cases of many listed companies. Therefore, listed companies should integrate fraud risk into the radar system when setting goals and evaluating risks, and maintain the healthy operation of the company through regularly checking the risk assessment mechanisms and fraud prevention measures.

4.3. Enhance Awareness of Accounting Compliance

Management and governance of the listed companies should have strong awareness of accounting compliance. In the Toshiba's fraud case, follow-up investigation indicated 98 executives involved in the fraud. What's worse, it also found that senior executives turned a blind eye to and even encouraged the improper accounting practices. However, with the rapid development of capital market and legal system, listed company executives should understand accounting compliance has increasingly become the mainstream of consciousness. They should enhance awareness of accounting compliance through personnel daily training and teaching programs.

4.4. Make Full Use of Whistle-Blowing System

According to research, whistle-blowing system is an important way to detect fraud in large sample studies. Nearly 48.9% fraud cases are found through the whistle-blowing system of employees, customers and suppliers (ACFE, 2014) [10]. Relevant laws have even introduced to encourage tip-offs and those who provide valuable tips would be offered huge rewards. Toshiba was also brought to the attention of regulators by employee reports, revealing nearly seven years of accounting misconduct to the public.

4.5. Be Aware of Earnings Manipulation Tools

Companies should enhance the awareness of earnings manipulation tools and prevent accounting tools from adopting as earnings manipulation method. In the case of the Toshiba's fraud, it used accounting estimates to inflate the profits, which was hard to find by external stakeholders. However, it cannot say that the above manipulations are violation of accounting standards because accounting estimate is a subjective judgement for different accountants. Relevant standards give accountants the right to make determinations according to their own companies' situations, but it will cause the false inflation of profits and influence investors' judgements if accounting estimates are used inappropriately.

5. Conclusion

In conclusion, from a responsible global citizenship's perspective, Toshiba's accounting scandal is an obvious violation of business ethic. In order to cover up its poor earnings and present a good-look financial report, Toshiba manipulates accounting techniques to overstate earnings. Later, such unethical behavior draws Toshiba intense fines. Toshiba's accounting scandal results in the market failure because managers and accountants utilize information asymmetry to harm investors' benefits, which leads to an inefficient situation from societal perspective. Moreover, Toshiba's violation of CSR and managers/accountants' violation of professional ethics also contribute to the market failure. There are some implications for Toshiba's future business practice and other companies. For example, companies should set restrictions for management, conduct regularly check of fraud risk assessment mechanisms and make full use of whistle-blowing system. Besides, management and staff should also enhance their awareness of accounting compliance and be aware of earnings manipulation tools.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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