

# THE KOBE STEEL CONUNDRUM

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RAMKI

PKF S&S LLP

OCT 17

# THE COMPANY

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- 112 years old!
- Third largest steel producer in Japan
- An icon in Japan- so far!

# WHAT HAPPENED?

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- Kobe steel admitted to falsifying data on quality of aluminium and copper parts supplied to many companies! (around 20000 MT in four plants)
- It systematically fabricated inspection data on strength and measurements of aluminium and copper products.
- The problem also extended to its group companies in Japan and other countries (Malaysia, Thailand, China) and iron and steel components also (Powdered steel used in moulded steel products and Target material-used in DVD's and other electronic equipment )
- Several dozen workers and managers were involved in the scam and it has been going on for over ten years!

# WHAT ELSE HAPPENED AND HOW DID IT COME TO LIGHT?

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- In Kobelco research institute, which tests products for the company, 70 cases of tampered data on materials used in optical disks and liquid crystal displays were found.
- Data in inspection certificates were improperly rewritten... and products were shipped as having met the specs.
- The alterations, it is stated by the Company, occurred in 4% of the production output from Sep 16.
- In some cases required checks were not done.
- The misconduct was discovered during internal inspections and emergency quality audits.

# GLOBALISATION MEANS EVERYTHING IS CONNECTED!

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- Boeing 787 Dreamliner wings and fuselage are made of carbon fibre but the 'shear ties' that connect them to one another are made from aluminium supplied to Subaru corp by Kobe
- There is a chain reaction in respect of anything done today in any part of the world as it ripples across the globe
- It is truly the Butterfly effect:
  - the power to **cause a hurricane** in China due to a **butterfly** flapping its wings in New Mexico!
- If a 1000 MW nuclear power plant has to be shut down due to safety concerns from items supplied by Kobe that would mean a revenue loss of anything between half to a full billion dollars p.a!

# THE FALL OUT-I

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- Kobe steel problem affects every mode of transportation!
- Affected are some 500 clients including some major Car manufacturers (including Mazda, Toyota, Mitsubishi, Nissan, Honda, Ford, GM, Daimler) , Bullet train manufacturers like Hitachi, Aircraft manufacturers like Boeing (and its suppliers like Nab Tesco and Kawasaki, who buy parts from Kobelco) Airbus (not direct), Mitsubishi jet, domestic rockets (H-IIA), Nuclear power plants, even equipment used by Self Defence forces!

# THE FALL OUT-2

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- Company lost a third of its market cap in just a week! ( Total drop to date 42% i.e. \$1.8B!)
- Cost to protect company bonds from failure rose 250 basis points!
- Law suits from investors, customers, regulators in many countries will follow
- Japanese Govt is obviously worried and has said:  
“We ask Kobe Steel to thoroughly look into the causes ... and take steps to prevent a recurrence as well as to make utmost efforts to restore the trust of not only its customers, but of society as a whole.”

# NOT THE FIRST TIME!

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- Previously also such fabrication of quality tests have surfaced
- Company had also falsified soot emission data to escape regulations on pollution
- In 1990's it was found out that the Company had paid off a corporate racketeer!
- Illegal political contributions had led to CEO resigning
- Its group company had sold wires which did not meet Japanese industrial standards



# REASONS WHY JAPANESE COMPANIES HAVE COME TO THIS PASS

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- Falling domestic demand leading to all round pressures
- High global competition from all over –mainly China , Korea and India (in steel making)
- Companies operate in silos which are supposed to ‘specialise’ and hence do not share data
- Concerns about timely delivery leading to short cuts
- The ‘keiretsu’ system of co-operation between manufacturers and suppliers led to less testing at manufacturer’s end
- Other Japanese scandals have surfaced showing this is not one-off (safety tests issue in Nissan and Japan Nuclear Fuel; fuel efficiency tests issue in Suzuki and Mitsubishi; Takata had huge quality issues with air bags and went bankrupt after defective products were linked to 16 deaths; Toyo Tire had falsified data regarding rubber supplied to earthquake proof buildings; Toshiba admitted to over stating profits)

# REASONS CONTD.

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- Outside agencies who do tests are not really independent
- The quality inspectors structurally fall under the factory directors. In addition, those working for production sections are often transferred to the quality assurance section, so it is “difficult to retain strict control over people they knew and to maintain their independence.”
- Middle managers of Japanese companies are not open to airing the problems.
- There is no formal protection for whistle-blowers in Japan and a culture of respect for hierarchy prevents many workers from speaking out.
- One reason could also be excessive quality standards and super stringent quality controls! Meeting these standards becomes a mere ‘formality’ and workers start to cheat
- While world has moved to ‘good enough’ quality supplied by Chinese , the Japanese companies are still living in the past of best in class quality

# ETHICS AND CORPORATE GOVERNANCE IN PAPER NOT IN PRACTICE?

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- Does any Company say in its Corporate governance report that they are working to improve it?
- See what Kobe says:
  - In May of 2017, Kobe Steel came out with a ‘core values report’, enshrining six pledges taken by all Kobe employees.
  - They can still be found on KOBELCO’s website.
  - The first of these is “heightened sense of ethics and professionalism”.
  - It states, “We not only follow the law, corporate rules and societal norms, but also conduct our corporate activity in fair and sound manner with the highest sense of ethics and professionalism.”

# PARALLELS WITH VOLKSWAGEN

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- Both falsified test reports. After VW many other companies (Including Suzuki and Mitsubishi) admitted to falsifying their data! How prevalent is this then?
- Both companies showed scant regard for human life –one leading to higher pollution and hence more healthcare related issues and other compromising on safety
- Both companies had a history of cheating!
- Both scams went on for a long time –VW for 8 years; Kobe for 10 plus years!
- Kobe can be said to be one level better as its own inspections revealed the problem and Company took action ; in VW this was found out by outsiders.

# FRAUD IS TRULY GLOBAL IN NATURE!

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- Fraud has no boundaries!
- Le Creusot Forge of France was accused of tampering data on supplies to nuclear plants!
- GM had to deal with Ignition defects leading to 124 deaths.
- So Fraud is global in nature and no country is immune
- As for us in India, we have our own fair share of scandals!
- The question is whether this will affect the Japanese /Indian Bullet train project?
- May be not – we need to wait and see if this blows over!

# SHOULD WE WORRY?

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- May be not?!
- The great bridge builder Roebling was told that suppliers had cheated on him.
- He said ‘no worries; I expected they would and designed accordingly!’
- When a German General was told that the bridge an army battalion was about to cross was built by British engineers but they suspected it may not hold the weight of the tanks, he is reported to have told them to go ahead, as he knew the British engineers always had a high margin for error in-built!
- Let’s hope all engineers do that! As cheating is not going to stop! We need to expect that and build it in!!

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