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COMPANY: ITOCHU Corporation | Tokyo: 8001
INDUSTRY: Trading

On July 27, 2016, we published our investment opinion (the "Report") on Itochu Corporation (Tokyo: 8001) ("Itochu" or the "Company").[1] In our Report we presented 42 pages of detailed analysis of Itochu's financial statements and public disclosures, which highlighted a number of corporate governance and accounting deficiencies. That same day, Itochu issued a perfunctory 1-page response (the "Response"), which was so short and cursory that it failed to address the issues raised by our Report in any meaningful way.

1. **Hiding Behind Deloitte, Touche & Tohmatsu**

Time and again, Itochu has hidden behind Deloitte, Touche & Tohmatsu ("DTT"), trying to reassure investors by reminding them that DDT "issued an unqualified opinion for our Consolidated financial statement." But having a well-known auditor sign off on Itochu's financial statements is no guarantee that the Company will not be engulfed in an accounting scandal.

Ernst & Young ShinNihon gave Toshiba an unqualified audit opinion, but the auditor was fined **¥2.1 billion (USD 17.4 million)** by Japanese regulators for a "grave breach of duty" in failing to spot irregularities in Toshiba's accounts. KPMG signed off with an unqualified opinion on the accounts of Olympus. Enron, one of the biggest corporate scandals in American history, was notable because renowned accounting firm Arthur Anderson gave an unqualified opinion on Enron's accounts.

Furthermore, DTT does not have the best reputation for detecting accounting irregularities. DTT acted as the auditor for Hong Kong listed China Metal Recycling (HK: 773), which Glaucus exposed as a fraud in 2013. In the US, DTT came under intense scrutiny for giving an unqualified opinion on the accounts of Chinese accounting frauds such as Longtop Financial and China Media Express.[2]

The point is that an unqualified opinion from a famous auditor is no protection against accounting impropriety. That is why we firmly believe that Itochu should nominate an independent committee to retain an independent auditor to investigate the integrity of Itochu's financial statements and the issues raised in our detailed Report.

2. **Itochu's Failed Investment in the Drummond Mine**

In our Report, we presented an extensive analysis into Itochu's disastrous 2011 investment in Drummond's Colombian coal mine ("the Drummond JV"). By any economic measure, Itochu's investment was a failure. Since the investment date, coal prices were down 57% and production at the mine was 26% less than forecast. Accounting rules dictate that Itochu should have taken a write-down or impairment to the carrying value of the Drummond JV. It did not. Instead, Itochu reclassified its investment, an accounting gimmick that we believe was clearly inappropriate under prevailing accounting standards.

[1] Our Report is available for download in English and Japanese at https://glaucusresearch.com/japan/
[2] http://www.law360.com/articles/652106/deloitte-unit-to-pay-12m-to-china-mediaexpress-investors.

Itochu's Response is oddly contradictory. First, the Company claims (as it did in Q3 FY 2015) that the JV agreement was revised at the time of the issuance of preferred shares (potential voting rights). But it is important to note that although Itochu claims its share might be diluted, such a dilution did not happen.[3] Indeed, in Itochu's Response, the Company mentioned potential dilution but again failed to clarify if such a dilution took place.

Itochu claims that reclassification was justified because it "**lost the approval right on important resolutions** of Drummond such as budget and capital expenditures." But as we discussed in detail in our Report, "approval authority" over capital expenditures and budget **is irrelevant under prevailing accounting standards**. "Approval authority" appears to be an accounting standard made up by Itochu. In reality, the test is "significant influence." Under, IAS 28, a holding of 20% or more of the voting equity of an entity creates a **presumption of significant influence** and generally **requires that the investment be treated as an investment in an associate**.

Itochu owns a 20% stake in the Drummond JV, **therefore the presumption** is that its stake in the Drummond JV should be accounted for as an investment in an associate. This presumption is even stronger in this case because from FY 2012 through FY 2014, Itochu followed the rule and **classified the Drummond JV as an investment in an associate**.

Further, in our Report, we provided a detailed analysis of the "five factors" under IAS 28 which clearly showed that Itochu's investment in the Drummond JV easily meets all the requirements to be considered an investment in an associate under prevailing accounting rules. Itochu fails to even acknowledge the correct accounting standard, let alone provide any detailed explanation over why it lacks sufficient influence over the Drummond JV to justify deconsolidation.

But the larger point is this. Even if Itochu was right and deconsolidation was appropriate in FY 2015, **accounting rules required Itochu to perform a revaluation of its investment at the time of reclassification**. Itochu were happy to recognize a ¥60 billion gain when it reclassified its investment in Ting Hsin from an associate to an "other investment." Why wasn't a similar revaluation taken for the Drummond JV?

We believe that any such revaluation of the Drummond JV would have meant recognizing major losses in Itochu's consolidated accounts, and that Itochu inappropriately avoided recognizing such impairments in order to overstate its reported profitability.

Do not just take our word for it. Bloomberg independently valued Itochu's share of the Drummond mines at ¥60 billion in July 2013, and coal prices continued to decline from there.[4]

By our valuation, we estimate that Itochu's stake was worth only **<u>¥45 billion in FY 2015</u>**. As a result, we believe that instead of inappropriately reclassifying the investment, Itochu **<u>should have taken an impairment in FY 2015 of at least ¥153 billion</u>**. Itochu's reported net income was ¥300 billion in FY 2015, so this restatement would have reduced net profits by **<u>51%</u>**! We continue believe that this misconduct should trigger a regulatory investigation and that Itochu should be forced to restate at least its FY 2015 financial statements.

3. **Erroneous Consolidation of CITIC**

Itochu fails to address this issue, falling back on the fact that it holds a 10% stake in CITIC through a 50:50 JV with Charoen Pokphand Group ("CP"). The JV, CT Holdings, holds 20% of CITIC's voting equity. But this is all form over substance

In order to be deemed an investment in an associate, accounting rules dictate that Itochu must have "significant influence" over the investee. As we state in our Report, the fact that the JV holds a 20% interest is no guarantee of "significant influence," especially in this case.

CITIC is 58.13% owned by CITIC Group Corp ("<u>CITIC Parent</u>")– a company wholly-owned by the Chinese government. According to its website, "the national interests represent CITIC Group's **core interests**. CITIC Group follows the excellent tradition in **putting the national interests above all else**." Given that CITIC is majority owned and controlled

[3] To our knowledge, although Itochu fails to disclose any details, Itochu still owns 20% of the voting equity of the Drummond JV.
[4] http://www.bloomberg.com/news/articles/2013-07-16/alabama-billionaire-battles-murder-suits-as-prices-ebb

by the Chinese government, we think it is extremely unlikely that Itochu can have "significant influence" on CITIC's policies and financial decisions. Our analysis of the five factors supports our opinion that consolidation is inappropriate as Itochu fails to meet any of them.

Applying the Objective Significant Influence Criteria to Drummond and CITIC		
IAS 28 Guideline	Drummond	CITIC
Holding of 20%	Yes	No
Representation on the board of directors or equivalent governing body of the investee	Yes	No
Participation in the policy-making process	Yes	No
Material transactions between the investor and the investee	Yes	No
Interchange of managerial personnel	Yes	No
Provision of essential technical information	Yes	No
Does Itochu have significant influence	**Yes**	**No**
Should the investment be considered an associate	**Yes**	**No**

Source: Glaucus

It is also worth mentioning that if the test was "approval authority" over capital expenditures and the budget, as Itochu claims with respect to the Drummond JV, then Itochu obviously lacks any such approval authority over CITIC and thus should not be consolidating its investment in CITIC as an equity method associate.

4. **Dubious Reclassification of Ting Hsin**

In our Report, we highlighted that Itochu looked set to miss earnings in FY 2015 by ¥60 billion. **Yet just four weeks before the end of the fiscal year**, Itochu reclassified its investment in Ting Hsin and recognized a one-time, (**after-tax**) non-cash gain from the reclassification of ¥60 billion, just enough so that Itochu hit its target.

Itochu responded that it "partially sold [its] share of Ting Hsin," which justified a reclassification and a recognition of a gain. Again, this is all form over substance. Itochu's effective stake in Ting Hsin was 18.7% in 2010 and remained almost unchanged (17.8%)[5] when Itochu reclassified its investment. Itochu has yet to provide any evidence that its level of influence substantively changed at FYE 2015.

Itochu fails to address the suspicious timing of its reclassification. We do not have enough information to value Itochu's stake in Ting Hsin, but we find it highly suspicious that the amount of the after-tax gain (¥60.5 billion) was just enough to allow Itochu hit its earnings forecast and make up a ¥60 billion profit shortfall in the last four weeks of FY 2015. Are Itochu's shareholders supposed to believe in such coincidences?

Itochu also misses the larger point. If it performed a revaluation of Ting Hsin upon reclassification, why did Itochu not perform a similar revaluation of its Drummond investment upon reclassification? We believe the answer is that the result would have been inconvenient: a revaluation of Ting Hsin allowed the recognition of a gain whereas any revaluation of the Drummond JV would have resulted in a significant loss and would have adversely affected earnings. But accounting standards do not permit Itochu to selectively follow the rules only when the results are positive.

[5] http://www.hkexnews.hk/listedco/listconews/SEHK/2015/0416/LTN20150416256.pdf

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