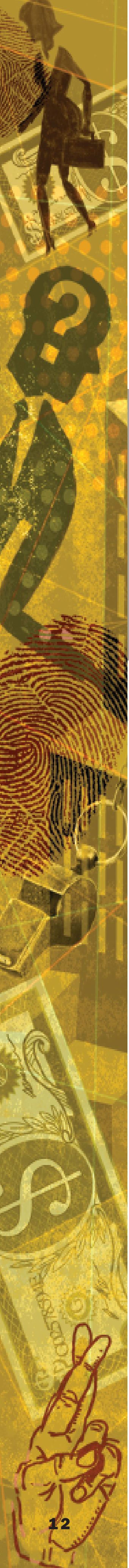

Curtis C. Verschoor, CMA, Editor

Olympus Scandal Shows Need for U.S. Standards

The misdeeds by Japanese manufacturer Olympus Corporation demonstrate the immense dangers of lax compliance with the weaker global standards of ethics, governance, accounting, and auditing that seem to be acceptable in an advanced industrial country like Japan.

Olympus Corporation, with sales of $10.6 billion for the fiscal year ended March 31, 2011, is a leading manufacturer of endoscopic medical devices as well as cameras and other imaging devices, microscopes, and information and communications equipment. Olympus is listed on the Tokyo Stock Exchange, and American Depository Receipts are traded in the U.S. over-the-counter market and listed on the "Pink Sheets." Thomson Reuters even named Olympus Optical one of the world's 100 most innovative companies.

In April 2011, Olympus named Michael Woodford its first non-Japanese president. A U.K. citizen, Woodford had worked for the company for more than 30 years, including as head of European operations. In a July 5 article in the *Financial Times* (*FT*), Woodford noted that part of his mission was to change Olympus's culture, saying, "Harmony and consensus have their place and time but scrutiny and challenging—devil's advocate, whatever you want to call it—leads to better decision making." Whether or not Woodford knew the details at the time, Olympus's stifling ethical culture—where employees were afraid to speak up—appears to be the single most important cause of events that almost took the company down.

In Olympus's fiscal 2011 annual report, Woodford outlined his plans to maintain innovation while cutting costs through changes to a more centralized organizational structure. Under the slogan of "Advancing to the Next Stage of Globalization," the annual report also related specific goals in the strategic plan for the company. Woodford saw his mandate as: "Do what you did in Europe, and do that around the world."

Woodford became CEO of Olympus on October 1, 2011, but was summarily dismissed from the company on October 14. The corporate termination announcement stated the reason for his firing was that he had "largely diverted from the rest of the management team in regard to the management direction and method, and it is now causing problems for decision making by the management team." On the day the news was published, Olympus's share price plunged 18%, followed by a 24% decline on the next trading day.

Woodford's side of the story came out in an October 15 *FT* story. Since July, he had been strongly questioning members of the board about large payments to "financial advisors" relating to the 2008 purchase of Gyrus Group, a U.K. medical device manufacturer, and about details of the acquisition of three other Japanese companies, some in totally unrelated businesses.

In an October 11 letter to Olympus's chairman, Woodford described "a catalogue of calamitous errors and exceptionally poor judgment which...has resulted in the destruction of shareholder value of $1.3 billion." Payments of $687 million, about a third of the Gyrus acquisition cost, and estimated to be the largest M&A fee ever paid, were made to a Cayman Islands special purpose investment vehicle that disappeared from view shortly after receiving the final payment. This information was based on an investigation by Pricewaterhouse-Coopers, which had been hired by Woodford. The recipients of the payments were said to be a U.S. brokerage house and its subsidiary.

The Olympus audit board in

2009 commissioned an investigation about the advisor payments, but its report found no illegality in the transaction. The October 15 *FT* story said that Olympus had declined to comment further about the Woodford accusations, stating, "We have disclosed everything we are required to disclose." An Olympus press release dated October 19 notes, "By unanimous resolution of the board of corporate auditors, their conclusion is that 'No dishonesty or illegality is found in the transaction itself, nor any breach of obligation to good management or any systematic errors by the directors recognized.'"

Olympus's governance structure regarding auditing is based on Japanese law. According to the 2011 annual report, a Board of Auditors reports to the General Meeting of Shareholders for appointment/dismissal and also provides audits to the president and board of directors. Under Japanese law, having such a board eliminates the need for outsiders on the board of directors. An Office of the Auditor reports to the Board of Auditors. Also reporting to the General Meeting for appointment/dismissal is the independent auditor, Ernst & Young ShinNihon (E&Y). The firm is shown reporting to the Board of Auditors and providing accounting audits to the Board and Representative Director. An Internal Audit Department reports to the Representative Director and provides audits of the various business units. In 2010, E&Y was described as Accounting Auditor and reported to the president, as did the Internal Audit Department.

An October 28 letter to the *FT* editors noted that the scandal had wiped $3.2 billion off Olympus's share value, and "its reputation for ethics went down the same tube." Reacting to pressures from institutional investors in the United States and Japan, Olympus announced on November 1, 2011, that it had appointed a third-party special committee to conduct an independent inquiry. Consisting of five attorneys and one CPA, the group employed Deloitte Touche Tomatsu LLC, among others, to assist. Within a week, Olympus admitted that it "had been engaged in deferring the posting of losses on investment securities since around the 1990s" and that the fees paid to financial advisors "had been used in part to resolve unrealized losses."

With amazing speed, the special committee report was made public on December 6. It described the cause of the massive losses as the result of "zaiteku," or highly speculative investments. This strategy was undertaken to offset reductions in operating income because of the rise in the Japanese yen after 1985. As investment losses were ballooning in the late 1990s, unrealized investment losses became recognizable under fair value accounting. To avoid having to reveal these losses in the Olympus financial statements, management created a Loss Disposition Scheme, deciding to adopt a strategy that was apparently so well known in Japan that it had a name, "tobashi," or making something bad fly away. Loss-making assets were sold to dummy corporations that didn't have to be included in the consolidated results. This is reminiscent of the Enron strategy of burying losses in special purpose entities that weren't consolidated. The fact that tobashi was declared illegal soon after the company employed the tactic didn't stop the Olympus senior executives.

The 2011 special committee report described the implementation of the cover-up strategy, relating that Olympus placed money or guaranteed borrowings into a secret nonconsolidated Receiver Fund corporation and then used those funds to buy overpriced companies at book value, thus recovering the original cash. Another method was to overpay for an acquisition or service fees, resulting in huge amounts of goodwill, but release the excess funds back to Olympus. In other words, none of the financial advisor's huge fee paid in connection with the Gyrus purchase described earlier actually stayed with the "advisor."

E&Y became the external auditor of Olympus for fiscal 2010, relying on the unqualified report of its predecessor, KPMG AZSA, LLC (KPMG) for 2009 and 2008. As questions about the involvement of auditors began to arise, the company's former president was quoted in a December 12 article saying that, in 2009, he personally went "to the KPMG firm's offices to say it would not be rehired by Olympus, accusing it of 'interfering in management decisions.'" Nevertheless, KPMG didn't insist on disclosing their concerns and gave a clean opinion on 2009, possibly relying on the audit board's report noted above. The firm noted that both the accounting principles and audit standards followed were acceptable in Japan.

In mid-December, the company restated its results for fiscal years ended March 2007 through 2011. The corrections resulted in accumulated retained earnings that were more than $15 billion less than at the beginning of 2007, triggering a capital shortfall. E&Y provided an unqualified opinion on 2010 and 2011, but KPMG's opinion on the earlier period restatement was qualified because, according to KPMG, "information on the investment funds that were used to conceal losses has not been properly kept…Therefore, we could not obtain evidence to support the value of assets held by those funds."

The 2011 special committee report presented 10 causes or conditions that allowed the fraud to take place. These are violations of corporate behavior that would never be countenanced in the U.S. and must be corrected in all Japanese companies that want to be considered to have world-class management:

1. It was handled and concealed by the top management.
2. There was a problem in the corporate culture and mind (ethics).
3. The method used to conceal was tactical (no evidentiary matter was kept).
4. Each corporate body didn't function as required under the Companies Act.
5. The auditing firm didn't function sufficiently.
6. The committee composed of outside experts didn't function sufficiently.
7. Disclosure of information was insufficient (less rigorous accounting principles).
8. HR rotation of the company didn't function (same people did same jobs for years).
9. The sense of compliance was lacking (inadequate governance).
10. There were outside collaborators (banks who handled the money flows).

Admitting guilt and facing possible criminal charges, Tsuyoshi Kikukawa, the chairman and former CEO; Hisashi Mori, director and executive vice president; and Hideo Yamada, standing corporate auditor, have all resigned. Michael Woodford hopes to return to lead the corporation with an entirely new board of directors. The com-

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pany is looking for a "white knight" to invest in it. Dozens of lawsuits are being filed in the U.S.

It may be years before the entire story about the enormous Olympus fraud will become public. What is already very obvious is that the U.S. should continue to lead the way toward developing, maintaining, and enforcing the highest, strongest, and most effective standards of business ethics, corporate governance, accounting principles, and auditing standards. There should be praise for and pride in virtually all of the contents of the Sarbanes-Oxley Act. Implementation of its provisions in Japan almost certainly would have prevented the sad Olympus events from occurring or remaining undetected for so many years. **SF**

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