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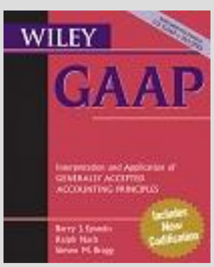

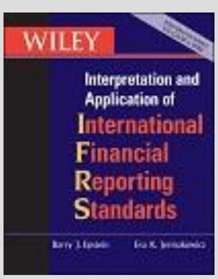

Dr. Epstein served as the lead author of **Wiley GAAP** and **Wiley IFRS** for 26 and 14 annual editions, respectively.

Alleged Olympus Fraud
Latest Example of Common Accounting Scam: Using Business Acquisitions to Effect Profit Manipulations

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The recent revelations about the financial reporting fraud at Japan's Olympus Corp. are only the latest manifestation of the use of business combinations accounting as a device to further financial reporting irregularities. Business acquisitions have long provided opportunities for companies to perpetrate various schemes for smoothing earnings or concealing losses, albeit the Olympus machinations were a more unusual wrinkle than those more commonly observed.

In accounting for a business combination under current U.S. and international financial reporting requirements (which are now universally mandated but which are similar to the purchase accounting methods formerly most often applied), the cost of the acquisition must be allocated or assigned to the various assets acquired and liabilities assumed. To the extent that the aggregate purchase cost exceeds the amounts assignable to identifiable net assets – a common phenomenon since the value of a going business acquired as a whole typically is greater than the sum of its parts – this excess is assigned to the always-problematic asset called "goodwill." Investors and lenders often look askance at this intangible, unsalable and often ephemeral asset, and indeed the common measure of financial strength employed by lenders, *tangible net assets*, explicitly zeroes-out goodwill from borrower balance sheets, thereby reducing the entity's net stockholders' equity to a "real" amount represented by substantive items.

Under current GAAP and IFRS, goodwill is not systematically amortized, but must be tested annually for impairment, and written down or off if impairment is detected. Prior to about 2002, goodwill was to be amortized, but with the expense spread typically over as long as 40 years, the annual charge against earnings was generally small. Now that write-offs of goodwill are episodic in nature, investors and analysts are seemingly less sensitive to them, in common with reactions to other varieties of non-recurring charges, which are viewed as being of mere historical interest and not indicative of future operating results.

Historically, the most common abuse of accounting for business combinations was to use them as opportunities to create so-called "cookie jar reserves." By overstating liabilities assumed in an acquisition, unneeded accrued liabilities (e.g., for future restructuring charges) could be booked, to be reversed piecemeal and used to boost earnings in later periods, such as when anticipated post-merger profits fell short. This was explained, if at all, as being the consequence of enjoying lower-than-expected costs of integrating the acquired business – a claim notoriously difficult to disprove since based on very subjective assessments made by management and often beyond independent auditors' skills to verify. (Auditors have, however, frequently been held accountable for such failures both by the SEC and in investor lawsuits.)

The Olympus matter, if proven consistent with current allegations and admissions, did not use business combination accounting to create such reserves, but rather as an excuse to write off previously concealed losses. Apparently, and remarkably, Olympus had incurred multi-hundred-million dollar losses over as long as several decades, ostensibly resulting from various failed investments. Rather than reporting such losses as incurred, as required under all financial reporting regimes, prior management somehow buried these losses in the balance sheet, where they remained unexamined or unchallenged by the outside auditors, financial analysts and investors. (Precisely where on the balance sheet these were concealed has yet to be fully explicated, although there are allegations that offshore entities and investments were employed, which would suggest certain Enron-esque elements to the scheme.) Reportedly, these undetected deferred losses ultimately grew to a staggering \$687 million by the time an opportunity presented itself to remove these worthless assets from the consolidated Olympus balance sheet.

Using what were apparently dummy companies as ostensible advisors for several real business acquisitions made around 2008 (most significantly, the purchase of British medical implement maker Gyrus Group in that year), Olympus overstated the cost of the purchases by seemingly exaggerating advisory fees paid, in part by issuing value-inflated Olympus preferred shares later reacquired by the issuer for some or all of those fees. The fees ostensibly being paid to those advisors amounted to as much as 35% of the acquisition cost, which itself should have been a "red flag" for auditors, one might think.

Precise details of the workings of this fraud have yet to surface. In general, however, one consequence would likely have been to overstate the resultant goodwill reported on the consolidated Olympus balance sheet, since the nominal costs of these acquisitions would have greatly exceeded the fair values of net identifiable assets obtained. This inflated goodwill could later be found impaired, and accordingly written down in what has become both commonplace (particularly during the current financial crisis, which has seen a great many such charges reported) and innocuous-sounding.

About \$200 million of goodwill was purportedly recorded from the Gyrus transaction alone, and there were apparently several other similar transactions. Ultimately, by writing down the carrying value of these acquired companies, Olympus would finally eliminate the \$687 million of water that had been concealed on its balance sheet for many years, and do so in a way that would mischaracterize this as being the rather innocent end product of recent acquisitions gone awry, rather than being the final resting place for losses that had been fraudulently concealed (although quite possible also innocently incurred, originally) bad investment decisions of years gone by.

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For auditors, this again underscores the need to closely scrutinize all major, non-routine transactions such as business acquisitions, which have repeatedly been shown to be tempting, "one-time" opportunities for management to provide mechanisms for income smoothing or, as with Olympus, taking "big bath" write-offs that may or may not have anything to do with the transactions cited. Not only can value assignments and contingency accruals not be treated as mere "givens" received from management, but also the structural components of the transactions, including the roles of outside parties, must be fully vetted and understood. Absent this, the independent auditors cannot sign off on the accounting for such transactions – the consequences of which may affect the reporting entity's financial statements for decades to come.

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