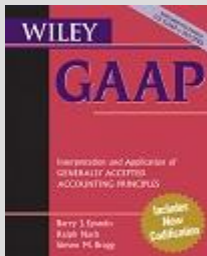
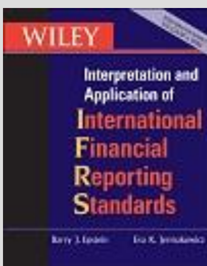
Russell Novak & Company

Dr. Barry Jay Epstein

Dr. Epstein is the author of **The Handbook of Accounting and Auditing**, published by RIA, the tax and accounting business of Thomson Reuters.





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

The Olympus Fraud: Enron-esque Off-Balance-Sheet Entities Combined with a New Twist on Abusive Business Acquisitions Accounting

Eight Lessons for Auditor Accountability

by
Barry Jay Epstein, Ph.D., CPA, CFF
Russell Novak & Company, LLP
Chicago, Illinois

Barely two months ago, allegations of financial reporting fraud at Japan's Olympus Corp. first surfaced, and it was immediately apparent that there had been gross failures to properly account for long-since-incurred investment losses as well as more recent business acquisitions, coupled inevitably with intimations about a range of audit, control, governance and other failures.

Now that an investigative report (by outside attorneys and auditors styled as The Third Party Committee) has been issued, those surmises have been fully corroborated, with additional insights regarding Olympus' blatant and widespread use of Enron-esque off-the-books entities (which were commonly cited as "partnerships" in that earlier fraud) to unashamedly disguise and defer recognition of losses. Once again, lessons that should have been well (and expensively) learned by the auditing profession from the epidemic of frauds in the late 1990s and early 2000s (Enron, WorldCom, Global Crossing, Adelphia, and scores of others) now need to again be taught.

The Olympus fraud can be distinguished, to some modest degree, from the others perpetrated by U.S. and some European companies (e.g., Royal Ahold, Parmalat) by cultural and business environmental factors unique to Japan. To the extent these are generalizable to other Japanese corporations, these could imply that there are other scandals waiting to be uncovered. Perhaps more importantly, however, the lessons of Olympus may be seen as illuminating the audit risk factors that need to be addressed universally, across all cultures and industries.

Japanese Cultural and Economic Concerns

The cultural and national economic concerns will be discussed initially, followed by consideration of specific Olympus fraud issues.

First, as constituent parts of an export-dependent economy, Japanese companies are exposed not only to the usual business risks, but also to exchange rate risk. The Third Party Committee Report cites the significant earnings declines suffered when the value of the yen sharply appreciated in the latter half of the 1980s, making products more expensive and thus less attractive to foreign customers. (For example, the yen rose from about 255 to the dollar at the start of 1985 to 133 to the dollar by the end of 1990: *ceteris paribus*, demand from American consumers of Olympus' products would have sharply declined as a consequence.)

Apparently some companies, including Olympus, chose to respond by aggressively pursuing speculative investments as a way to compensate for earnings lost due to falling demand for their main products – a phenomenon the Japanese called *zaiteku*.

Lesson one for auditors: when a client is scrambling for profits, risks increase even absent actual fraud risk, as management reaches beyond its sphere of competency.

Lesson two: when the reporting entity has already demonstrated desperation for earnings, there almost inevitably is increased risk of accounting rule-bending, if not financial reporting fraud, per se. Audit procedures and scope have to be adjusted accordingly.

Second, even if the *zaiteku*–era investments had been successful in the short term, the crash of Japan's widely touted "bubble economy" in 1990 meant that the values of many such tangential investments had or would shortly suffer declines in values, all the more so if these were speculative in nature. These would have warranted careful scrutiny by the auditors, even absent any hint of intent to commit fraud.

Lesson three for the auditors is that, in changing or unsettled economic environments, valuation assertions must be given much closer attention.

Lesson four: the auditors must be fully conversant with their clients' business strategies, tone at the top, the overall decision-making structures and processes, and the quality of controls over major strategic business decisions. Auditors must also remain alert to exogenous factors such as changes in the economic, legal, and regulatory environment.

A third factor in the Olympus situation, which is not unique to Japan but may be more common there than elsewhere (inferred because this phenomenon has been given a Japanese name), is *tobashi* ("fly away" in English), whereby losses are hidden by being transferred among portfolios or entities. In the Olympus instance, losses incurred on failed *zaiteku* were hidden by being moved to off-balance sheet entities controlled by Olympus but not subject to consolidated financial statement requirements at the time (this changed in 2007, which is what precipitated the belated recognition of the losses that had been incurred a decade or more prior). Olympus' management arranged to have the losses that had been incurred, but not reported, from its failed portfolio investments concealed by selling those investments at *book value* (which greatly exceeded fair values – which in some instances were effectively zero) to newly established entities that were capitalized by loans secured by Olympus' other assets.

We thus come to **lesson five for the auditors**: even if non-consolidation of related or special purpose entities (which today are known as variable interest entities) is technically allowed, never, ever forget that substance must rule over form. The Olympus SPEs, like the Enron SPEs before them, existed only to engage in specific transactions with the sponsor/parent entity, a circumstance always pregnant with fraudulent possibilities, even if valid reasons (e.g., legal segregation and asset protection) also are present. Even cursory examination of the Olympus

tobashi transactions should have triggered fraud alerts for the auditors, particularly concerning the ostensible "book value" trades being conducted during a time of market turmoil and decline. Throw in the related party character of those transactions (another fact the auditors were professionally charged with discovering) and there should have been more red flags visible than are found at a Chinese Communist politburo meeting.

Lesson six: although disclosure is no substitute for proper recognition and measurement in the financial statements, disclosure, particularly of such "soft" phenomena as related party transactions, is extremely important since it gives the financial statement users a fighting chance to press management for more information or to simply unload the investments that are increasingly burdened with unusual and perhaps implausible relationships and transactions. Olympus, abetted by its auditors, had few or no disclosures about these transactions.

How the Olympus Accounting Fraud Worked

The Olympus scheme worked as follows, in two easy steps: In phase one (referred to as the "loss separation scheme"), unrealized losses (i.e., value declines) on portfolio investments made during the *zaiteku* era and still held after the "bubble economy" crash were moved to Olympus controlled and funded non-consolidated entities that were created to receive them as part of the *tobashi* maneuvers engineered by Olympus management. In phase two (the "loss settlement scheme"), other business acquisitions were consummated, with the hidden losses from the earlier investments re-characterized as financial advisory fees or other acquisition costs. In some instances, these costs constituted improbably large portions of the entire purchase prices. Since these costs could not be allocated to productive assets, they could only find a home hidden in goodwill – the unidentifiable intangible representing excess purchase cost usually assumed to reflect surplus earnings power when arising from arm's-length business combinations.

Under then-extant rules, amortization over extended periods would have permitted Olympus to "trickle out" these charges against earnings, tempering the pain of the postponed recognition of these improperly deferred investment losses. When financial reporting rules changed to require that impairment assessments be made annually of goodwill, Olympus could no longer hide these historical losses nor could it hope to surreptitiously slip them into operating costs over an extended time horizon. Thus, Olympus had to take large impairment charges which were fraudulently misrepresented as being associated with value declines on recently completed business acquisitions – a suspicion-fostering turn of events that got freshly appointed CEO Michael Woodford's attention. Shortly thereafter – once Mr. Woodford had been dismissed by a Board of Directors embarrassed by this incriminating discovery, and he went public with his concerns – this captured the attention of the world's financial press and numerous regulatory agencies.

Lesson seven for the auditors: major, episodic transactions and events, such as business acquisitions, need to be thoroughly examined, because not only are these infrequent transactions more likely to be accounted for erroneously, but also they offer tempting occasions for financial reporting fraud for those so inclined. Historically, the most common abuse of accounting for business combinations was to see them as opportunities to create so-called "cookie jar reserves" by overstating assumed liabilities, establishing unneeded accruals (e.g., for future restructuring charges) that could later be reversed piecemeal and used to boost earnings. In the Olympus situation, on the other hand, it was the assets acquired, not the liabilities assumed, that were overstated, by including previously deferred losses on unrelated

investments. Whether the financial reporting irregularity is of the mainstream variety, or the more unusual strain employed here, the risk is high and auditor vigilance must accordingly be enhanced.

Lesson eight is straightforward: when accounting rules call for some variant of fair value measurement – be it lower of cost or market, net realizable value, or the currently ascendant exit value – there must be rigorous independent appraisal of the reporting entity's methodology for making such determinations. Clearly, at Olympus the dubious investments were not evaluated in any critical way, and the so-called sales at book value to newly-created entities were apparently not even understood or investigated by the auditors. Had the requisite level of professional skepticism been brought to bear, these sales should have been seen as not credible by the auditors, which in turn would have led to other revelations.

Concluding Thoughts on Auditor Responsibility for the Olympus Fraud

With specific reference to the Olympus situation, there were multiple opportunities for the auditors to have meaningfully scrutinized the now-condemned transactions. For example, about $200 million of goodwill was purportedly recorded from the Gyrus transaction alone, and there were reportedly 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 long been concealed on its balance sheet. From failing to identify the value declines in the *zaiteku* investments, to the creation of off-the-books special purpose entities, to bogus accounting for massive but fictitious financial advisory fees, to the large and almost-immediate write-downs in carrying values of acquired companies, at every step the auditors (two different major firms, in succession) seemingly confused their client with the mythological Mt. Olympus, home of the gods, rather than as mere mortals susceptible to such earthly temptations as accounting fraud.

The auditing literature has long cautioned that audits cannot be depended upon to uncover collusive fraud. The Olympus fraud was quite clearly of the collusive variety, with multiple and successive top officers actively concealing the investment losses, and with a board that was either asleep at the switch or willingly compliant in that fraud. Notwithstanding the profession's self-serving mantra that collusive frauds *might not* be detected during audit examinations, investors demand and expect that textbook-simple frauds such as these will be observed by auditors, if not during the maiden year of its perpetration, then surely after several successive audits have been completed. Given that the Olympus fraud consisted of only a few basic elements, perpetrated repeatedly over many years, there were multiple opportunities for the auditors to have uncovered and put a halt to these improper actions. They failed to do so, and a blatant fraud persisted for thirteen years.

Barry Jay Epstein, Ph.D., CPA, CFF (BEpstein@RNCO.com), is a partner of Russell Novak & Company, LLP, where his practice is concentrated on technical consultations on GAAP and IFRS, and as a consulting and testifying expert on civil and white collar criminal litigation matters. Dr. Epstein is the co-author of Wiley GAAP 2010, Wiley IFRS 2010, Wiley IFRS Policies and Procedures, *the WG&L* Handbook of Accounting and Auditing, *and other books.*