Deep Roots of Fraud at Olympus

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Published: December 8, 2011

Blame it on James A. Baker III. The “Plaza Accord” that halted the appreciation of the United States dollar in 1985 was largely his doing, as Ronald Reagan’s Treasury secretary. It set in motion a series of events that led to a huge fraud at the Olympus Corporation, the Japanese maker of cameras and medical imaging equipment, that lasted more than two decades.

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James Baker III, left, then Treasury secretary, with finance ministers from other nations at the Plaza Hotel in 1985.

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It turns out that it was an effort to make the company’s books accurate — at least in terms of its balance sheet — that led to the suspicious transactions noticed by Michael C. Woodford, at the time the newly appointed president and chief executive. He thought they showed theft from the company by its chairman, and he confronted him.

It now appears the chairman reacted with righteous indignation. He had not stolen; he had only tried to clean up a mess without damaging the reputation of generations of Olympus executives.

From his point of view, I infer from a new report by an investigating committee, there had been no need to tell Mr. Woodford about what had happened because the fraud was finally behind the company when Mr. Woodford took the job.

The report, released by Olympus this week, shows that two changes in accounting rules, one caused by the Enron scandal, eventually led to the collapse of the scheme.

It shows that KPMG AZSA, the Japanese affiliate of the international accounting group, failed to notice what was going on for years but balked at the somewhat clumsy transactions intended to finally, if misleadingly, put the losses on Olympus’s books.

Ernst & Young Sjin Nihon, a Japanese affiliate of that network, was brought in and did sign off.

The scandal also highlights the need for mark-to-market accounting. Until accounting rule makers finally started to require it for some financial instruments in 1997 — seven years after the fraud began — covering up the losses was easy. A decade later, efforts to force companies to stop hiding things in off-balance-sheet entities led to the transactions that ended up exposing the fraud. The collapse of Lehman Brothers in 2008 also played a role.

To understand this scandal fully, remember what life was like for a Japanese company before the Plaza Accord. The dollar had been rising at a good clip and by the end of 1984 was worth more than 250 yen. That was heavenly for Japanese exporters, who could reap large profits exporting to the United States, and it led to a gaping Japanese trade surplus with the United States.

The Plaza Accord was reached by what was then the Group of Five — Japan, the United States, West Germany, France and Britain — at the Plaza Hotel in New York. They agreed on concerted action to bring down the value of the dollar, and to the surprise of many it worked. By the end of the year, the rate was down to 200 yen, and by the end of 1987 it was only 121 yen. It was no longer as much fun to be a Japanese exporter.

But the Japanese bubble was still expanding. In the final four years of the decade, stock prices tripled. In 1985, Olympus — not alone among Japanese companies — introduced zaiteku, or speculative investment, as a major business strategy.

The strategy worked until the Japanese bubble burst in 1990. That year, the company chose to hide losses of nearly 100 billion yen, or about $730 million at the exchange rate at the time. The report does not detail exactly how those losses came, only saying that they involved financial instruments.

How could such a loss be hidden? At the time, accounting rules in Japan, as well as in other countries, allowed investments to be carried at cost. Theoretically, there should eventually have been a write-down, but there never was.

There seems to have been some hope that with additional risky investments, the losses could somehow be made up. They were not. Over time, the company tried securities speculation and private equity, investing in what it thought were promising start-up companies. None of it worked. Eventually, the losses evidently grew to more than $1 billion.

Olympus seems to have been content to sit on the losses until 1997, when accounting rules changed and some investments had to be marked to market. To do so would reveal the entire sordid tale.

So a plan was developed to "sell" the losing investments, at original cost, to shell companies set up by Olympus for that purpose. The sales were financed with loans from banks, which received cash from Olympus to secure the loans. Under lenient accounting rules, those shell companies would not have to be consolidated with Olympus, so the losses could remain hidden.

The plan was to get out of the losses eventually, either by more investments or through overpriced acquisitions, with the extra cost of the acquisitions going to the off-balance-sheet subsidiaries to make them whole. That was done through a variety of means, one of which was retaining the phony companies as high-priced investment advisers. That "cost" would be put on the company's balance sheet as good will, and eventually written off. When that was done, the balance sheet would show an accurate value for Olympus.

From 1999 to 2003, Olympus managed to get out of some losses, or at least to convert them to good will. No one outside the company was the wiser. KPMG, the auditor, did not notice, the report says, in part because some of the information it received was false.

Perhaps the company could have gradually accomplished the goal, had it not been for Enron.

But in 2001, Enron went broke. One of the ways it had concocted phony profits was to "sell" assets to off-balance-sheet entities it controlled, and to book profits on those sales.

Accounting rule makers do not move rapidly, so it took years to do anything about that in the United States, and even longer in Japan. But in 2007, the Japanese rules were changed. Those shell companies would have to be consolidated. Olympus had until March 31, 2008, the end of its fiscal year, to clean up its books. Some deals were quickly closed in March.

One complicated transaction in 2008 fell apart almost immediately. A company that had accepted some securities from Olympus in September, with the promise they would be exchanged for cash in two years, suddenly demanded immediate payment. That company, the report states, "seemed to be in need of cash due to the impact of Lehman," which failed in mid-September.

That transaction could not be completed immediately, however, because KPMG was reluctant to sign off on the accounting. It went through only after Ernst & Young became the auditors.

All this might have gone unnoticed but for a Japanese magazine, which reported in July that the company had overpaid spectacularly for the acquisitions that Olympus made to avoid the Enron-related accounting deadline. Olympus denied the allegations.

Mr. Woodford, a British citizen who had run the company's European operations, became president in April and chief executive in September. He was told to not worry about such history when the magazine article appeared. But he did. With the assistance of PricewaterhouseCoopers, he unraveled the transactions but not their purpose, and concluded that company money was being stolen. He confronted the chairman and was fired. He forced an investigation, which resulted in this week's report.

The investigating committee reported that it had been assisted by two affiliates of Deloitte Touche Tohmatsu. That makes all members of the Big Four involved in some way.

The committee says the top officers of Olympus knew what was going on throughout and that new presidents always accepted the decisions made by their predecessors. It does not say why Mr. Woodford evidently was not told, but it seems reasonable to think that it was some combination of not trusting a foreigner who had not worked in Japan and a belief that, with the balance sheet now reflecting reality, there was no need to involve him.

Now Olympus is experiencing a mass departure of tainted executives and directors. It is not clear whether a new board will bring Mr. Woodford back.

More than 20 years after the scandal began, the valuation of financial assets for which there is no ready market remains a subject of controversy. This week, the Public Company Accounting Oversight Board, which regulates audit firms in the United States, issued an "audit practice alert" that made clear it was concerned that American auditors were now — like Japanese auditors in the past — too willing to believe whatever management said.

"Auditors are reminded," the board said, "that audit evidence consists of both information that supports and corroborates management's assertions and information that contradicts such assertions, including assertions regarding fair values, estimates and related disclosures."

There is a certain symmetry here. The Olympus scandal might never have been uncovered if reforms had not been forced by the Enron debacle. The accounting oversight board owes its very existence to outrage over Enron, which led Congress to establish the agency in 2002.

Floyd Norris comments on finance and the economy at nytimes.com/economix.