**How Do You Hide A Multibillion Dollar Loss? Accounting For The Olympus Fraud**

By [Francine](http://retheauditors.com/author/admin/) • Jan 2nd, 2012 • Category: [Latest](http://retheauditors.com/category/latest/), [Pure Content](http://retheauditors.com/category/default/), [The Big 4 And Globalization](http://retheauditors.com/category/global_or_no/)

I asked [Jim Ulvog](http://www.ulvogcpa.com) to write a guest post on the Olympus scandal because he was the only one to explain it to me from an accounting perspective. Major media often regurgitate the latest news updates about accounting scandals with no explanation of how or why fraudulent transactions take place.

Journalists throw in terms like [***tobashi***](http://blogs.wsj.com/japanrealtime/2011/11/08/at-olympus-high-times-dark-shadow/) to sound knowledgeable. There’s talk about the potential complicity of other parties without understanding or seeking to understand the theory and practice underlying the fraud.

How are we to prevent future frauds if we focus only on the sensational?

Japan is ripe for fraud. PwC seems to be the only Big Four auditor – well, they are not that big in Japan any more – not implicated by the fraud. PwC was hired by the Olympus ex-CEO Woodford to support his side of the story after he blew the whistle on the fraud after being fired.



PwC, who seem to be getting [a lot of investigation whitewash jobs](http://ftalphaville.ft.com/blog/2011/11/15/747801/sino-forest-still-has-many-questions-to-answer/) lately, was [almost kicked out of Japan](http://retheauditors.com/2007/08/01/old-pwc-japan-fades-like-lotus-blossom/) a few years ago for their own involvement in a major fraud. Some of the firm’s partners went to jail along with the executives.

The old Pwc Japan (Misuzu, formerly ChuoAoyama Pricewaterhouse) calls it quits. The new PwC Japan still going, [although in a small way](http://www.amesrgi.com/psmtoday/?p=77). Even they were not excited to take on any of their former colleagues accounts, for fear of the ghosts hidden behind the walls.

[Misuzu operations formally halt in Japan](http://www.accountancyage.com/aa/news/1788528/misuzu-operations-formally-halt-japan)
The 2,400 remaining employees to go to KPMG, Deloitte and Ernst & Young

“Operations of the Japanese firm, Misuzu Audit Corp, formally terminated yesterday after a 39-year-history which included several major accounting scandals involving its own employees.

Deloitte has its own scandal in Japan with [Daio Paper.](http://e.nikkei.com/e/fr/tnks/Nni20111213D1212A09.htm)

And, like PwC experienced in [Russia with the Yukos scandal](http://retheauditors.com/2010/09/10/yukos-slicks-accuse-pricewaterhousecoopers-of-succumbing-to-kremlin-pressure/), Olympus’ most recent and former auditors, Ernst & Young and KPMG, now have to worry about what might be found after a [raid of their client’s offices by government officials.](http://www.bloomberg.com/news/2011-12-21/olympus-tokyo-offices-searched-by-japan-prosecutors-amid-accounting-fraud.html)

Japanese prosecutors raided offices of [Olympus Corp. (7733)](http://www.bloomberg.com/apps/quote?ticker=7733:JP) in[Tokyo](http://topics.bloomberg.com/tokyo/), more than a month after the camera maker admitted to a $1.7 billion accounting fraud that hid investment losses over more than a decade.

Officials from the Tokyo District Public Prosecutors Office and police entered Olympus offices in Tokyo today, the company confirmed in a statement. Footage from public broadcaster NHK showed investigators entering the building of three companies Olympus used in its scheme.

Olympus last week restated more than five years of earnings to avoid being automatically delisted from the [Tokyo Stock Exchange](http://www.bloomberg.com/apps/quote?ticker=TOEZ:JP) after admitting to the 13-year cover-up.

I will keep following the story, along with Jim Ulvog, and bring you updates as they emerge.

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**How Do You Hide a $1.7 Billion Loss?**

**Summary of the Olympus Scandal in Journal Entry Format**

Olympus’ investigative committee’s report on the fraud at Olympus was released December 6. The description of the fraud, causes, and recommendations in the report are a scathing indictment of the company.

This post is a thumbnail description of the fraud based on my reading of the investigative committee’s report.  The summary report is available [here](http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf).

My goal is to provide more accounting detail than shows up in the general news reports.

The report’s conclusion on page 30 compares management to a cancer:

Olympus had originally been a sound company, with diligent employees and high technical strength. Not all part (sic) of the company was involved in this misconduct. Olympus should remove its malignant tumor and literally renew itself.

Ouch. That’s gotta’ hurt.

Here are just a few of the news articles discussing the company’s report:

* The Wall Street Journal, [Panel Calls Olympus ‘Rotten’ at Core](http://online.wsj.com/article/SB10001424052970204083204577082163172106608.html?mod=ITP_marketplace_0). (article behind paywall),
* Bloomberg, [Olympus faces Tokyo delisting after management hid $1.7 billion of losses](http://www.bloomberg.com/news/2011-12-06/olympus-management-rotten-to-the-core-panel.html).,
* New York Times, [The Culture Was Corrupt at Olympus, Panel Finds](http://www.nytimes.com/2011/12/07/business/global/banks-aided-in-olympus-cover-up-report-finds.html).

*What is the amount of the fraud and time frame?*

According to the report, the company had incurred substantial losses on financial investments by 1990. The report indicates that through 1998 very large losses were incurred, but the investments were never written down.

The whole project got started as 2000 approached and new accounting rules would require writing down the investments from book value to market  value.

In 1998 through 2000, approximately ¥96B (~$US1.2B by my calculation) of unrealized investment losses were moved off the books. In 2003 approximately ¥118B (~$US1.5B) of unrealized losses were moved off the books. The scheme blew up this year. Losses are reported at ¥137B (~$US1.7B).

There was ¥214B/ $2.7B moved off the books according to the report, which represents the book value of the investments that were underwater.  The current loss being reported is $1.7B.  If I get the picture right, the difference between those amounts represents the market value of the investments that were moved out, plus some smaller losses incurred while the investments were held in subsidiaries.

For perspective, the March 31, 2011 audited [financial statements](http://www.olympus-global.com/en/corc/ir/annualreport/) report total assets are $US13.3B, equity is $US2.08B, net sales are $US10.59B, net income is $US92M.

The WSJ article says the losses were apparently off the books by March 31, 2010, so those amounts are after $1.7B had all been written off.

Sure seems to me that $1.7B of hidden losses is rather material.  I doubt anyone will be advancing the immateriality argument.  Compared to March 31, 2011 amounts (which is after write-off, I believe), the loss is equal to 13% of total assets, 81% of net worth, 16% of total revenue, and 18 times net income. Some amount of the loss was hidden off the books from 2010 back to at least 1998.

Also, since those losses were primarily hidden in goodwill according to the report , that loss constitutes 78% of goodwill, after the write-off.

I think several audit firms are going to be on the receiving end of some tough questions.

Arthur Andersen was the external auditor through 3-31-02. Then KPMG AZSA LLC was the auditor through 3-31-09.  The 2010 and 2011 fiscal years were audited by Ernst & Young ShinNihon LLC.

Just to complicate the picture, the report lists staff persons as assistant commissioners, which includes lots of attorneys plus 18 staff from Deloitte Tohmatsu FAS Co., Ltd. and 17 staff from Deloitte Touche Tohmatsu LLC.

On the other hand, the report also mentions the fraud was hidden quite well. Three banks were also involved by hiding information from the auditors. The summary report says all three of them agreed not to tell auditors the information that would normally be provided on an audit confirmation.

*How do you hide a $1.7B loss?*

Now I’d like to discuss the debits and credits.

Since reading the first reports, I’ve been wondering how you can hide investments that are underwater by $1.7B.

[Here](http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf) is a one paragraph summary from page 5 of the report:

The lost disposition scheme is featured in that Olympus sold the assets that incurred loss to the funds etc. set up by Olympus itself, and later provided the finance needed to settle the loss under the cover of the company acquisitions. More specifically, Olympus circulated money either by flowing money into the funds etc. by acquiring the entrepreneurial ventures owned by the funds at the substantially higher price than the real values, or by paying a substantially high fees to the third party who acted as the intermediate in the acquisition, resulting in recognition of large amount of goodwill, and subsequently amortized goodwill recognized impairment loss, which created substantial loss.

(Grammar issues are in the original, which is understandable because this is the English translation from the Japanese report.)

Here’s my understanding in one sentence:

**Olympus indirectly loaned money to an off-the-books subsidiary and then sold the investments that had the huge losses to the subsidiary at historical cost, eventually paying a huge premium to buy some other small companies and writing off the underwater investments as if they were goodwill impairments.**

*Journal entries*

I’m going to walk through what I think the summary journal entries would be. Think of the old t-account analysis you learned in school. This will be in accounting shorthand, so only accountants will likely appreciate it.

If you want the long version, the last two pages of the report have diagrams showing the flows of money. Be forewarned that there are 17 different entities on each graph with lots of arrows, so it’s a bit complicated.

So, here goes the simple version. Let’s look at the Olympus entries in highly condensed form. I’ll condense the story into 8 journal entries.

* DR Certificate of deposit that was in turn loaned to unconsol sub
* CR Cash
* Transfer cash to new, unconsolidated sub

This is a summary of a complex move – it involved making a CD deposit at several banks, who were asked to loan the money back to an apparently unrelated entity, with the CD as collateral, so the sub can buy investments from Olympus.

According to the investigative committee’s report and the New York Times article, three banks were involved through the course of the whole project:  Commerzbank, LGT, and Société Générale  The committee’s report and NYT article both indicate that all three banks  agreed to Olympus’ request to not tell the auditors  about the CDs being collateral for a loan.

* DR Cash
* CR Financial assets that are seriously underwater (probably not the actual general ledger account they used)
* Proceeds from selling underwater investments to new, unconsolidated sub

Eventually the CDs would have to be rolled over and brought back. In addition, the unrealized losses would have to be written down eventually, so the second phase was launched.

Olympus bought some tiny companies. They paid humongously more than they were worth and paid big dollars for consultants for their service as finders and intermediaries.

The effect of these transactions was to transfer money into the newest consolidated subsidiary, which used the money to buy the bad investments from the older, unconsolidated subsidiary. The unconsolidated sub then repaid the note payable to the bank and Olympus pulled back their CD.

The investment in the consolidated subsidiary shows huge goodwill, which could then be either written off over time or written down completely when it was determined to be impaired.

Here’s my understanding of the journal entries on Olympus’ books for phase 2:

* DR Investments in startup subsidiary
* DR Goodwill – tons of it, since the subs have minimal FMV that can be identified, so there must be lots of goodwill
* CR Cash
* Make several investments in new subs – note these have minor revenue and assets
* DR Cash
* CR Certificate of deposit (that had in turn been loaned to unconsol sub)
* This is for the cash coming back from the unconsol sub repaying their loan, which was used to transfer out the underwater investments

Here’s the entries on the newly formed consolidated subsidiary:

* DR Cash
* CR Common stock
* Cash investment from Olympus used to buy 3 little companies
* DR Financial assets that are seriously underwater (bought from unconsol sub)
* CR Cash
* Buy underwater investments from unconsol sub at book value

Here’s the entries on the older, unconsolidated subsidiary:

* DR Cash (from consolidated sub)
* CR Financial assets that are seriously underwater
* Proceeds from selling underwater investments to newly formed consol sub
* DR Note payable to intermediary bank
* CR Cash
* Repay loan to European and Asian banks

Therefore the net effect is the bad investments were moved into a new subsidiary, converted into goodwill, then written off as a goodwill impairment. You can guess what the press releases could then say: That investment in new technology or start-up or cutting edge idea or other-excuse-given-for-unsuccessful-subsidiary just didn’t work out and those accounting rules required the goodwill to be written off.

And thus the tanked investments would be off the books with the unrecognized loss written off as goodwill amortization or impairment.

*Hiding losses was legal and normal*

Apparently, moving underwater investments off the books was so common in Japan that it had a nickname, tobashi. The investigative committee’s report uses the phrase but does not explain it.  The [Wall Street Journal](http://online.wsj.com/article/SB10001424052970204083204577082163172106608.html?mod=ITP_marketplace_0) article reports that senior leaders:

…devised a plan to transfer the bad assets off Olympus’s books to firms that weren’t officially connected with the company and so wouldn’t appear in Olympus’s accounts, the report said. The intention was to unwind those transactions gradually, allowing Olympus to take the losses secretly, over time. This type of operation had been employed by so many Japanese companies in the 1990s that it was widely known in Japanese as tobashi, meaning, to send something flying away.

KPMG did tumble to one of the tobashi schemes carried out through one of the three different routes that had been set up. I’m not sure if this is the only scheme through that particular bank or just one of several.  The WSJ article continues:

Not everything was going smoothly. The report said that in 1999, Olympus’s then-auditor, KPMG AZSA LLC, came across information that indicated the company was engaged in tobashi, which recently had become illegal in Japan. Messrs. Mori and Yamada initially denied KPMG’s assertion, but the auditor pushed them that same year to admit to the presence of one fund and unwind it, booking a loss of ¥16.8 billion. The executives assured KPMG that was the only such deal, the report said.

Looks like there was quite a nasty fight over that write-down.  Notice that tobashi was finally made illegal sometime before the 1999 audit. That means it was an acceptable approach previously.

A few thoughts here on the auditors’ actions:

How do you perform an audit for a global investor audience in a local economy where intentionally hiding losses is legal? How do you function in a business environment where that is acceptable and normative?

On the other hand, notice how one audit team, from KPMG in 1999, did find one part of the scheme.  Management lied bv denying it even existed. After agreeing to write it off, Olympus senior management lied again and said it was the only one.

On the other hand, the scheme expanded, without detection, for another 6 years or so and was in place, without detection, until the last component was unwound at the end of fiscal year 2010.

I’ve run out of hands, so back to the story.

*When did the scheme finally get unwound?*

The last part of the bad investments was finally written off in March 2010, according to the WSJ article. That month, by the way, would have been the last month of the fiscal year when Ernst & Young took over the audit from KPMG :

Messrs. Mori and Yamada decided to unwind and write off the whole thing, using three small Japanese companies: …. Olympus bought the trio in 2008 for the highly inflated price of ¥73.2 billion and wrote the bulk of that amount off the next year, an arrangement that allowed it to repay the loans it had borrowed from LGT and close down the European route in 2008, the report said.

Note: LGT is one of the three banks used to hide the money flow.

That left only the funds in the Singapore route still operating, the report said. Olympus internal documents said Messrs. Mori and Yamada wrote off those losses using $687 million in fees attached to Olympus’s acquisition of U.K. medical-technology firm Gyrus Group PLC as cover. The last bit of that deal was completed in March 2010. Those fees were paid to the company run by Mr. Sagawa, one of the brokers who first proposed the loss-covering operation to Olympus 12 years earlier.

Note: There were three different ‘routes’ set up to get the bad investments off the books.

*When did this mess get started?*

A bit more detail on the front end of this mess. The WSJ article points out the fiasco started back in about 1985 with management pushing aggressive investments that didn’t work out too well.

Exchange rates started generating losses on those investments in the late 80s. Thus the fraud was running from about 1985 through 2010, when it was all written off. The fraud blew up in October of this year.

That is why you will see comments that this fraud was running for 20 years. That is also why the WSJ article leads with:

The secret held for a quarter-century, quietly passed among senior executives.

*Causes of the fraud*

The report was harsh in identifying the causes, starting at page 23. Just a few causes that were mentioned:

* Collusion and intentional fraud by management
* Very poor corporate culture which punished dissent
* No document trail (this is something to remember in the long discussion of auditors’ work that we will have later)
* Poor corporate governance
* Poor follow-up by the CPA – this obviously requires lots more follow-up by the committee and others.
* Outside collaborators (this could eventually include three banks and a host of attorneys, intermediaries, finders, and consultants)

The [New York Times](http://www.nytimes.com/2011/12/07/business/global/banks-aided-in-olympus-cover-up-report-finds.html) article comments about cooperation from the outside banks who did not give full answers to the audit confirmations:

[The report](http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf) says that Olympus had persuaded several banks, including Société Générale of France, to submit incomplete financial statements to auditors, apparently in an effort to conceal financial maneuvers that the report says involved at least $1.7 billion and were meant to hide failed investments during the 1990s. There is no indication the banks knew of Olympus’s cover-up, the report said.

According to the report, Olympus told the banks that they did not need to respond to KPMG queries about collateral, which was used to finance loans to investment funds involved in the loss cover-up.

Keep that bit of trivia in mind as we read the soon-to-arrive avalanche of articles saying it was all the auditors’ fault.

*Recommendations*

The recommended changes are extensive and harsh. Here are a few of the committee’s recommendations, starting on page 27:

* Replace management who did nothing about the issues identified by the auditor in 2009 and 2010. Replace the board members who addressed those issues in a mere 15 minutes.
* Remind the current auditor, who missed things in their first audit in 2010, of “…the importance of its duties…” Ouch. Think that will be a painful meeting with the board?
* Don’t hire the president’s buddies or business partners.
* Change the attitude and mindset of management. Also, make sure management, directors, and auditors know they have a responsibility to society in carrying out their duties. Ouch. Slam in the last sentence – new members of management should have “…moral value and sense of compliance”.

Ouch again.

* Change corporate culture to one that is focused on compliance with policy, not just following orders.
* Reform many of the systems of the company. Corporate culture overhaul, HR system reform, periodic rotation of duties, and lack of whistleblower system all need to be addressed.

Like I said, a rather harsh report.

One final idea. Think about the sheer size of the fraud.

Picture a company that can absorb $1.7B of losses and keep going as if nothing happened. Then they have enough cash ($2.7B) to fund some round-about loans to buy the assets and return the cash to Olympus.  That leaves $2.7B sitting on the books as an unusable CD.

After that, they have enough cash sitting around to float $2.7B again, but this time it’s sent to the consolidated sub, which passes the money to the unconsolidated sub, on to the various banks, and then back to Olympus.

Imaging having enough spare cash after absorbing the loss, enough cooperation from enough people, and sufficient skill to discretely push $2.7B in a meandering trip through the world’s banking system, twice.

Finally, in what will generate lots of discussion, picture that the whole thing was hidden well enough that dozens of audit teams from three different audit firms over 25 years stumbled onto only one part of the fraud in only one year, and that was toward the beginning.

I think we will be talking about this a lot. I hope my comments in this post move the discussion forward.

Many thanks to Francine for the opportunity to be a guest blogger!