Journal of Forensic & Investigative Accounting
Vol. 6, Issue 3, Special International Issue, 2014

ZAITEKU + TOBASHI = OLYMPUS ACCOUNTING FRAUD

Michael C. Knapp
Carol A. Knapp*

On the morning of October 14, 2011, Michael Woodford met with the fifteen-member board of directors of Tokyo-based Olympus Corporation. Woodford, a native of Great Britain who had been appointed Olympus's chief executive officer (CEO) just two weeks earlier, expected that the meeting would be eventful. Why? Because the day before, Woodford had sent a letter to Tsuyoshi Kikukawa, Olympus's former CEO, demanding that he resign his position as the chairman of the company's board of directors. Woodford and Kikukawa had been quarreling for months over a series of suspicious transactions that Woodford had discovered in Olympus's accounting records. Woodford was convinced that the transactions had been recorded improperly and that they might involve criminal activity.

Instead of tendering his resignation, Kikukawa, began the October 14th board meeting by making a motion to have Woodford dismissed as Olympus's CEO. Kikukawa's motion was unanimously approved by the board, which then ratified a second motion to reappoint him CEO. After the board meeting ended—it lasted exactly eight minutes, an Olympus senior executive approached Woodford and told him to vacate his office immediately and leave the country. When the executive attempted to take Woodford's company cell phone, Woodford resisted by backing away and clenching his fist. A short time later, Woodford was in a taxi en route to a Tokyo airport. Because Woodford believed that members of the *yakuza*, Japan's notorious organized crime organization, were linked to the suspicious transactions he had uncovered, he feared for his life.

* Michael C. Knapp is David Ross Boyd Professor of Accounting and Glen McLaughlin Chair in Business Ethics, Price College of Business, University of Oklahoma. Carol A. Knapp is John Mertes, Jr. Presidential Professor and Assistant Professor of Accounting, Price College of Business, University of Oklahoma.

Corporate Cover-Up

Michael Woodford became the first foreign-born chief executive of a Nikkei 225[1] firm when he was appointed Olympus's CEO. Being selected as Olympus's CEO was the culmination of Woodford's 30-year career with the company. Woodford was born into a working-class family in 1960 in a small city in central England. At age seven, after his parents divorced, Woodford moved to nearly Liverpool where he and his mother and two siblings lived with his maternal grandparents in a small house that lacked indoor plumbing. To help support his family, Woodford went to work as a small child doing various odd jobs after school. Eventually, the young man found his true calling: sales. As a teenager, Woodford sold snacks to classmates from his school locker between classes. A few years later, he helped finance his college degree in business by working as a salesman for the large British company Cadbury Schweppes.

At the age of 21, Woodford accepted an entry-level position as a salesman with a British subsidiary of Olympus that sold medical equipment—although best known for its digital cameras, Olympus has long been the dominant company in the endoscopic segment of the medical equipment industry.[2] Over the next decade, the outgoing and hard-working Brit worked his way up the company's employment hierarchy. In his early 30s, Woodford became friends with Kikukawa, a fast-track junior executive with Olympus. Kikukawa was appointed Olympus's CEO in 2001 and seven years later chose Woodford to oversee Olympus's foreign operations.

In early 2011, Kikukawa promoted Woodford to chief operating officer (COO). At the time, Olympus was struggling financially because the growing popularity of smart phones was undercutting sales of the company's digital cameras. Woodford immediately transferred to

[1] The Nikkei 225 is a price-weighted stock index that is widely used to monitor Japanese stock prices. The 225 companies included in this market index are among the largest firms in Japan.
[2] Endoscopic devices produced by Olympus are used to "look inside" the human body.

Olympus's Tokyo headquarters and began an intensive study of Olympus's financial affairs as a prelude to developing a comprehensive turnaround plan to revitalize the company's operations.

Woodford soon uncovered a series of large and unusual transactions that included several acquisitions unrelated to the company's two primary lines of business. Among those acquisitions were the purchase of a mail-order cosmetics company and a manufacturer of microwave ovens.

Woodford could not understand why Olympus would purchase companies that had no connection to the company's other lines of business. More troubling to Woodford was the fact that by any conventional standard Olympus had paid grossly more than the companies were worth, which was readily confirmed by the two companies' extremely weak operating results subsequent to their acquisition. The gross overpayments for the companies suggested to Woodford that Olympus management was covertly conveying corporate assets to third parties, a serious violation of their fiduciary responsibilities to company stockholders.

Woodford also discovered that Olympus had recently purchased a well-known British medical equipment manufacturer. While investigating that acquisition, Woodford was shocked when he learned that Olympus had paid a nearly $700 million fee to an obscure investment advisory firm that had supposedly helped arrange the deal. That amount represented one-third of the total cost of the acquisition. Woodford realized that investment advisory firms typically receive a fee of approximately one percent of the value of an M&A (merger and acquisition) transaction that they help arrange, which meant that the Cayman Islands firm had been paid a fee thirty times greater than normal.

After discovering the series of questionable business deals, Woodford arranged a meeting with Kikukawa, his longtime friend and mentor. During this meeting, Kikukawa stonewalled Woodford when he asked probing questions about those transactions. When Woodford continued to pressure him to discuss them, Kikukawa suggested that Woodford's responsibility was to focus on the future of the company's operations while ignoring any less than optimal decisions that the company had made in the past.

Kikukawa's lack of candor surprised and frustrated Woodford. Woodford told Kikukawa that it was impossible for him to overlook more than $1.5 billion of bad investments and suspicious third-party payments when Olympus's total profit the previous year had been only $350 million—at the time, Olympus had total assets of approximately $10 billion. When Kikukawa continued to stonewall him, Woodford came up with an even more pragmatic reason why he needed to have a complete understanding of the questionable transactions. He told Kikukawa that he had to be fully knowledgeable of the transactions because, "I'm the one who signs the letter of representations with the auditors."[3]

After Kikukawa refused to discuss the series of questionable transactions, Woodford retained PricewaterhouseCoopers (PwC) to investigate them. The report that PwC subsequently provided to Woodford convinced him that he had stumbled upon a fraudulent scheme being engineered by company insiders. PwC indicated that the given transactions appeared to have been recorded improperly and that they may have involved "unlawful" activity.[4] While he was doggedly pursuing the suspicious transactions, Woodford wrote six letters to the members of Olympus's board, including Kikukawa, in which he documented his concerns. Woodford sent copies of each of those letters to Ernst & Young ShinNihon, the Japanese affiliate of Ernst & Young that Olympus had chosen in 2010 to replace its previous audit firm, KPMG Azsa.

Upon returning to London after being dismissed as Olympus's CEO, Woodford was unsure how to proceed. He later told a newspaper reporter that the situation he faced was similar

[3] K. T. Greenfield, "The Story Behind the Olympus Scandal," www.businessweek.com, 16 February 2012.
[4] D. Carozza, "The Real Cost of 'Choosing Truth Over Self," www.fraud-magazine.com, March/April 2012.

to an innocent bystander on a deserted city street who observes a crime and realizes that he has a moral responsibility to report it. Complicating matters was the fact that, despite having left Japan, Woodford still feared for his safety. Woodford was concerned that if the *yakuza* was involved in the mysterious transactions that he had discovered, he might be targeted for assassination to prevent him from reporting those transactions to law enforcement authorities or the media.[5]

On October 17, 2011, three days after he was fired, Woodford told a *New York Times* reporter that Olympus needed a thorough forensic accounting investigation because he believed that there was something "sinister"[6] about the company's recent corporate acquisitions. On that same day, Woodford delivered a file of information to British law enforcement authorities and requested police protection for himself and his family. The information he turned over to law enforcement authorities documented the suspicious $700 million investment advisory fee paid by Olympus. That transaction fell within the legal jurisdiction of British law enforcement authorities since the company acquired was a British company and since the alleged investment advisory firm was based in the Cayman Islands, a British territory.

An Olympus spokesperson responded to Woodford's allegations by insisting that "All our mergers and acquisitions have been carried out with proper accounting and through appropriate procedures and processes."[7] Another company representative suggested that Woodford had made the false allegations to retaliate against Olympus after he was dismissed.

Although the Japanese press downplayed Woodford's claims, reporters of international news organizations pressured the company to investigate those claims. As the pressure mounted

---

[5] Subsequent investigations never established that the *yakuza* had profited from, or were directly involved in, those transactions.
[6] H. Tabuchi, "Ex-Chief Executive of Olympus Ties Ouster to His Claim of Fraud by the Company," *New York Times* (online), 17 October 2011.
[7] *Ibid*.

on Olympus, Kikukawa resigned as the chairman of the company's board of directors. The company's board then organized an independent panel, chaired by a former Japan Supreme Court Justice, to investigate Woodford's allegations.

In early November 2011, less than one month after Woodford was dismissed as Olympus's CEO, a company spokesperson publicly admitted that Olympus had engaged in, and attempted to conceal, a fraudulent accounting scheme that would prove to be one of the largest in Japan's history. Although Kikukawa was not one of the original participants in the long-running fraud, he had become aware of it in 2000, shortly before he was initially appointed Olympus's CEO. Over the next decade, he closely monitored the elaborate efforts of company insiders to conceal the fraud from the investment community, regulatory authorities, and other parties.

***Zaiteku* + *Tobashi* = Trouble**

On December 6, 2011, the six-member panel appointed by Olympus to investigate Michael Woodford's allegations released a report of its findings. The forty-page report provided a chronological summary of the company's accounting fraud. The series of events that sparked the fraud actually began in the mid-1980s. To compensate for an earnings shortfall, Olympus's top management decided to implement what is known in the Japanese business culture as a *zaiteku* strategy. This strategy involves liquidating underperforming corporate assets and investing the proceeds in high-risk but potentially lucrative investments.

Olympus's senior management created a secretive team consisting of three executives that would be responsible for deciding how to invest the cash resources devoted to the new *zaiteku* strategy. Collectively, this team was referred to within the company as the "few and proud group." Hideo Yamada, an accountant by training who had previously been assigned to one of Olympus's finance divisions, was placed in charge of this team.

Initially, the *zaiteku* strategy proved successful. Yamada and his subordinates produced sizable gains that bolstered the company's reported operating results. But then, in the early 1990s, the speculative "bubble" in Japan's securities markets burst. Over the two-year period 1991-1992 alone, major Japanese stock indices declined by more than 50 percent. When the market values of Japanese securities collapsed, Yamada's team suffered large losses on its investment portfolio. As the losses continued to mount, Yamada's team made increasingly speculative investments, which, in turn, produced even larger losses. By the late 1990s, the *zaiteku* strategy had piled up cumulative losses exceeding $1.5 billion, losses that were concealed from the users of Olympus's periodic financial statements. Yamada hid those losses by simply maintaining the *zaiteku* investments at their historical cost basis in the company's accounting records.

Yamada realized that Olympus could not conceal the investment losses indefinitely. At the time, there was pressure on Japan to adopt fair value or "mark-to-market" accounting for investments similar to the United States and other developed countries. Once Japan adopted fair value accounting, Yamada knew the large investment losses would have to be reported by Olympus—one way or another.

Many large Japanese companies in addition to Olympus accumulated huge unrealized investment losses during the 1990s as the nation's securities markets imploded. With the help of creative investment firms, principal among them Yamaichi Securities, several of these companies employed innovative *tobashi* schemes to make those losses disappear—*tobashi* is a Japanese term that means "to fly away." The global investing community initially became aware of these *tobashi* schemes when Yamaichi Securities collapsed into bankruptcy in 1999. Although

Yamaichi had served as Olympus's primary investment broker, published reports did not link Olympus directly to any of the *tobashi* schemes engineered by the brokerage firm.

The independent panel appointed by Olympus's board to investigate the company's financial affairs following the dismissal of Michael Woodford discovered that Yamada's team had used a two-prong *tobashi* plan to conceal the company's investment losses. The first element of the plan was referred to by Yamada and his fellow conspirators as the "loss separation scheme," while the second element was known as the "loss disposition scheme." This plan forced Olympus to ultimately record the losses stemming from the company's ill-fated *zaiteku* strategy but concealed the true nature of the losses and allowed the company to write them off gradually.

The loss separation scheme involved Olympus selling its impaired investments at their recorded book values to unconsolidated "dummy" corporations that it created and financed. These bogus, multinational companies then sold the assets among themselves in "cross-border" transactions to erase any apparent link between the assets and Olympus and, just as importantly, to make it difficult, if not impossible, for the company's auditors to track those transactions.[8] Years later, Olympus implemented the loss disposition scheme by reacquiring those assets at inflated prices from the dummy entities holding them. Olympus then amortized the goodwill recorded for those acquisitions over a period of ten to twenty years.

Again, this sleight of hand forced Olympus to recognize the investment losses that resulted from the *zaiteku* strategy, but it allowed the company to diminish their impact on its reported operating results by spreading them over an extended period of time. Just as importantly, the *tobashi* plan allowed Olympus to both conceal the original source of those

[8] During the late 1990s, Enron Corporation, a large U.S. energy company, used a similar strategy to conceal more than $1 billion of losses that it had incurred. The unconsolidated subsidiaries created by Enron's accountants to hide the company's investment losses were known as special purpose entities (SPEs) or special purpose vehicles (SPVs).

losses and to conceal the fact that the company had intentionally hidden the losses for years from its stockholders, creditors, regulatory authorities, and other interested parties.

Olympus used Yamada's *tobashi* plan to "separate" and "dispose" of approximately two-thirds of the more than $1.5 billion of investment losses due its *zaiteku* strategy. In 2009, Yamada initiated a related but more expedient—and sloppy—method to rid Olympus of the remaining portion of those losses. This diversion involved Olympus purchasing Gyrus, a legitimate British company that complemented Olympus's endoscopic line of business. Similar to the earlier scams, Yamada intended to record a large amount of bogus goodwill for the Gyrus acquisition, which Olympus would then amortize over an extended period of time.

Yamada and his co-conspirators realized that the Gyrus acquisition posed challenges that they had not faced on the previous *tobashi* scams. Because those transactions had not been genuine, the conspirators had easily controlled all aspects of them, which allowed them to conceal their true nature from third parties, including Olympus's KPMG Azsa auditors.

To produce goodwill on the Gyrus acquisition roughly equal to Olympus's remaining investment losses, Yamada needed to inflate the purchase price for that acquisition by approximately one-third. He accomplished that goal by allegedly paying the huge consulting fee to the Cayman Islands firm that had supposedly arranged the transaction. That advisory fee proved to be a "red flag" for third parties, most notably Michael Woodford. A related red flag was the fact that the Cayman Islands advisory firm was unknown in the global M&A financial services market.

The sloppy method used by Yamada and his associates to dispose of Olympus's remaining investment losses proved to be their undoing. The conspirators could not conceal the paper trail of documents prepared for the Gyrus acquisition from British law enforcement authorities and media representatives who had been alerted to the suspicious nature of the transaction by Woodford. Ultimately, the investigation of the Gyrus transaction by those parties forced Olympus's senior executives to reveal all of the *tobashi* schemes that had been used to misrepresent their company's reported financial data.[9]

Spotlight on Japan's Independent Audit Function

When Michael Woodford blew the whistle on the Olympus accounting fraud in mid-October 2011, many parties immediately questioned how such a large-scale and long-running fraud could go undetected by the company's auditors. The most vocal critic of Olympus's auditors was arguably Woodford himself. A few months after the details of the fraud were revealed, Woodford told a reporter, "I still find it hard to fathom how the auditors missed the fraudulent nature of these bizarre and sizeable transactions."[10] Woodford had earlier characterized the audits performed by Olympus's independent auditors and the series of unqualified opinions they issued on the company's financial statements as "hollow," "shallow," and completely meaningless."[11]

While criticizing Olympus's auditors, Woodford also suggested that their failure to uncover the accounting fraud was linked to systemic weaknesses in Japan's independent audit function. Among those systemic weaknesses, Woodford singled out the modest audit fees paid by Japanese companies. Those fees, which are typically less than one-half those paid by

---

[9] This case provides only a concise overview of the *tobashi* schemes used by Olympus to conceal its massive investment losses. Many features of those schemes have been simplified for purposes of this case. For a more elaborate discussion of those schemes and an analysis of the "debit and credits" used in recording the various features of those schemes, please see the following source: F. McKenna, "How Do You Hide A Multibillion Loss? Accounting for the Olympus Fraud," http://retheauditors.com, 2 January 2012.
[10] C. Quick, "Olympus Post-Mortem: Interview With a Fired CEO," www.cfoinnovation.com, 17 April 2013.
[11] A. Sawers, "Michael Woodford on the Olympus Scandal, Auditors, and Capitalism," http://economia.icaew.com, 31 January 2012.

comparable U.S. companies, limit the scope and rigor of independent audits performed by Japanese accounting firms.[12]

Even more problematic for independent auditing in Japan is a deferential culture that pervades the nation's business community, a culture that places an emphasis on "relationships and harmonious working practices."[13] This cultural norm allegedly spawns cordial relationships between auditors and their clients and causes auditors to routinely subordinate their judgment to the wishes and demands of client executives. "Even when corporate clients ask the auditors to do something that isn't allowed under the law, they just do it."[14]

The close ties between Japanese auditors and their clients are also manifested by Japanese companies rarely changing their audit firms and by individual auditors often remaining on client engagement teams for decades. Prior to the Olympus scandal, the highest profile accounting fraud in Japan involved Kanebo, Ltd., a large conglomerate. In August 2006, three of Kanebo's former independent auditors were convicted of helping conceal material errors in the company's financial statements. One of those auditors had served for more than 30 years on the Kanebo audit engagement team.[15]

Critics of Japan's independent audit function point out that the systemic weaknesses in that function have been perpetuated by ineffective regulatory and judicial oversight of the nation's public accounting profession. As an example, for a period of more than twenty years, the regulatory body overseeing Japan's public accounting profession did not revoke a single CPA license or otherwise severely sanction a CPA.[16] Likewise, Japanese courts have been

[12] N. Kasai and T. Takada, "How Do Regulation and Deregulation on Audit Fees Influence Audit Quality: Empirical Evidence from Japan," Kobe University, December 2012.
[13] D. Reilly and A. Morse, "Japan Leans On Auditors to Be More Independent," *post-gazette.com*, 18 May 2006.
[14] *Ibid*.
[15] M. Knapp, "Case 8.3, Kansayaku," In *Contemporary Auditing: Real Issues and Cases*, 9th Edition (Stamford, Connecticut: Cengage Learning, 2013).
[16] *Ibid*.

extremely reluctant to hand down punitive sentences to auditors who abrogate their professional responsibilities. Consider the three auditors convicted of participating in the Kanebo accounting fraud—the auditors actually recommended methods to help mask the company's deteriorating financial condition. Those three individuals received only suspended prison sentences, the same punishment given the former Kanebo executives who were the masterminds behind the fraud.

One feature of Japan's financial regulatory structure designed to bolster the integrity of the nation's financial reporting system is the requirement that large public companies have at least three "statutory" auditors. The role and responsibilities of statutory auditors in Japan correspond closely to those of corporate audit committees in the United States. Statutory auditors attend board of directors meetings, review accounting and financial reporting matters with a company's independent auditors, and monitor their company's internal controls. Statutory auditors have one important responsibility that is not shared with U.S. corporate audit committees. If a Japanese company's board of directors violates its fiduciary responsibilities to the company's stockholders, statutory auditors may bring civil actions (lawsuits) against the board on behalf of the stockholders.

Despite the important responsibilities delegated to Japanese statutory auditors, they have not been an effective deterrent to misconduct by corporate executives. Why? Because statutory auditors are typically longtime friends or "cronies" of a company's senior executives who are handpicked for their positions by those same executives. During the course of Olympus's accounting fraud, Hideo Yamada, one of the fraud's primary architects and a close associate of top Olympus executives, served as a statutory auditor for the company.

Spotlight on Olympus's Independent Auditors

Throughout the nearly two decades that the Olympic accounting fraud was taking place, the company received an unqualified audit opinion each year from a series of three accounting firms. Those firms included the Japanese affiliates of Arthur Andersen & Co., KPMG, and Ernst & Young. When Andersen was forced to cease operations in 2002 following the Enron scandal, Olympus's senior management chose KMPG Azsa as the company's new audit firm. In 2010, Olympus management retained Ernst & Young ShinNihon, Japan's largest public accounting firm, to replace KPMG Azsa.

Because Japanese companies rarely change their auditors, Olympus's decision to replace KPMG Azsa with Ernst & Young ShinNihon shocked Japan's business community. When a reporter asked an Olympus executive why the change was made, the executive explained matter-of-factly that the contract between the accounting firm and Olympus had simply "expired." In fact, a disagreement stemming from the goodwill recorded for the Gyrus acquisition prompted Olympus's senior management to dismiss KPMG Azsa. The KPMG Azsa auditors questioned that goodwill because it was a direct product of the enormous fee paid to the Cayman Islands investment advisory firm. The size of that fee and the fact that the Cayman Islands firm was not known in the global investment community caused the auditors to question whether the fee was legitimate. Although Olympus executives insisted that the Cayman Islands firm was not a "related party," they refused to respond to the auditors' request for information regarding that firm.

Senior members of the KPMG Azsa audit team were so concerned by the Gyrus acquisition and the client's refusal to respond fully to their inquiries regarding the transaction that they took the unusual step of suggesting that the Olympus executives involved in the business deal resign. KPMG Azsa also attempted to persuade Olympus's statutory auditors, who were led by none other than Hideo Yamada, to file a civil complaint against Olympus management to force the company to cooperate with the team of independent auditors. In one final, desperate attempt to gain the client's cooperation, the audit firm threatened to resign and to notify Japanese regulatory authorities of their concerns regarding the Gyrus acquisition.[17]

The tense standoff between KPMG Azsa and Olympus management ended abruptly when Olympus produced an outside "experts" report indicating that the Gyrus acquisition was legitimate and had been properly accounted for by Olympus. KPMG Azsa accepted that report and then issued an unqualified opinion on Olympus's 2009 financial statements. The independent investigative panel appointed by Olympus subsequently criticized KPMG Azsa for "carelessly" relying on the experts report since it was "incomplete" and not prepared by an independent third party.[18]

KPMG Azsa was also criticized for failing to communicate fully with the banks involved in the Gyrus and other *tobashi* transactions orchestrated by Hamada. "KPMG could have been more dogged in asking foreign banks . . . for information when confirming foreign account balances"[19] related to those transactions. In defense of the accounting firm, Olympus executives instructed their foreign banks to be evasive when responding to audit inquiries regarding the *tobashi* transactions.

Shortly after KPMG Azsa issued a clean opinion on Olympus's 2009 financial statements, Tsuyoshi Kikukawa, Olympus's CEO at the time, went to the accounting firm's Tokyo office. Kikukawa told a KPMG Azsa partner that Olympus would be retaining another accounting firm to audit the company's 2010 financial statements. He indicated that Olympus

[17] P. Dvorak and K. Inagaki, "Olympus Auditors Get New Scrutiny," *Wall Street Journal* (online) 9 December 2011.
[18] C. Bacani, "The Olympus Scandal: Now It All Makes Sense," www.cfoinnovation.com, 12 December 2011.
[19] *Ibid*.

was replacing KMPG Azsa because the firm had interfered with "management decisions" [20] during the 2009 audit.

Similar to the United States, Japan's professional auditing standards require successor and predecessor audit firms to communicate when a company changes auditors. This rule is intended to ensure that successor audit firms are made aware of important matters, such as disputes over accounting issues, that precede a change in auditors. The independent panel appointed to investigate the accounting fraud found that the communication between KPMG Azsa and Ernst & Young ShinNihon during the change of audit firms was a "mere formality" [21] and that KPMG Azsa never told Ernst & Young ShinNihon about the goodwill dispute that prompted the auditor change.

The independent panel also criticized Ernst & Young ShinNihon for its 2010 Olympus audit that ended with an unqualified opinion on the company's financial statements. The panel questioned why the auditors did not more rigorously investigate the huge amount of goodwill linked to the Gyrus deal. Despite the fact that the Gyrus transaction had taken place the prior year, the panel concluded that the new audit firm's decision not to more rigorously audit that goodwill "was inappropriate."[22]

The Financial Services Agency (FSA) is the Japanese government agency comparable to the U.S. Securities and Exchange Commission. The FSA has the ultimate responsibility for policing Japan's financial reporting system, including the accounting firms that audit publicly owned companies. In July 2012, the FSA issued the results of its investigation of the Olympus accounting scandal. The FSA concluded that both KPMG Azsa and Ernst & Young ShinNihon "lacked operational management systems to ensure" that "dubious" client transactions were

[20] C. S. Verschoor, "Olympus Scandal Shows Need for U.S. Standards," *Strategic Finance*, February 2012, 14.
[21] The Third Party Committee, "Investigation Report," Olympus Corporation,(Tokyo, 2011).
[22] Bacani, "The Olympus Scandal."

identified and required each firm to develop and submit an "improvement plan" to strengthen their audit processes.[23] The FSA also criticized KPMG Azsa for failing to inform Ernst & Young ShinNihon of the circumstances that preceded Olympus's decision to change audit firms.

Despite the FSA's criticism of KPMG Azsa and Ernst & Young ShinNihon, the agency did not sanction the accounting firms. An FSA official subsequently justified that decision. The official explained that even if the two firms had "proper operational management systems"[24] while auditing Olympus, it was unlikely they would have uncovered the fraud given its complexity and the extensive measures Olympus executives used to conceal it from the two firms.

Epilogue

Michael Woodford felt vindicated in late 2001 when Tsuyoshi Kikukawa admitted that Olympus had intentionally misrepresented its operating results and financial condition for two decades. That vindication convinced Woodford to launch a campaign to regain the CEO position at Olympus. His campaign ended after a few weeks when Olympus's major stockholders, which were primarily other large Japanese corporations, refused to support him. Olympus's major stockholders reportedly viewed Woodford as an outsider who did not understand that the most important trait of Japanese corporate executives is absolute loyalty to their companies. In their view, Woodford should have resolved the concerns he had privately rather than sharing them with the media and law enforcement authorities. After realizing that he would not be invited to return to Olympus, Woodford negotiated a $10 million financial settlement with the company. In late 2012, Woodford published a memoir entitled *Exposure: Inside the Olympus Scandal; How I went from CEO to Whistleblower* (Penguin Books).

[23] BBC News, "Japan FSA Imposes Improvement Plans on Olympus Auditors," www.bbc.com, 6 July 2012.
[24] *Ibid*.

KPMG Azsa and Ernst & Young ShinNihon, which still serves as Olympus's audit firm, emerged relatively unscathed from the Olympus accounting scandal. The FSA's decision not to sanction the two firms apparently discouraged third-party plaintiffs from naming the firms as defendants in the approximately two dozen civil lawsuits prompted by Olympus's accounting fraud.

The Olympus scandal did re-ignite the debate over the role of the Big Four firms' global networks. "The Olympus scandal also renews long-standing questions about the structure of audit firms, which brand themselves as global networks but in fact are made up of legally separate firms."[25] Each Big Four firm has long maintained that its international network of affiliates operates as one unified firm offering a uniformly high quality of professional services across the globe. Critics point to scandals such as the Olympus debacle as evidence that the Big Four firms' global organizations have a limited ability to control their national practice units even in developed countries such as Japan. A major focus of the PCAOB in recent years has been investigating the global networks of the major accounting firms to ensure that they are "properly supervising their disparate arms and ensuring quality."[26]

Olympus has also weathered the firestorm of controversy stemming from the disclosure of its accounting fraud. The company was fined $7 million for violating Japan's federal securities laws and paid another $1.2 million fine for violating the listing rules and regulations of the Tokyo Stock Exchange. Within a few weeks of the disclosure of its accounting fraud, Olympus's stock price declined by approximately 75 percent. However, two years later, in December 2013, the stock price had fully recovered and was at a record high—nearly 40 percent higher than the price when the scandal first broke.

---

[25] D. Aubin and T. Uranaka, "Analysis: Olympus Scandal Puts Auditors Under Scrutiny," www.reuters.com, 10 November 2011.
[26] *Ibid*.

More than one dozen Olympus executives faced criminal charges as a result of their roles in the accounting fraud. Those executives included Tsuyoshi Kikukawa and Hideo Yamada who pled guilty in July 2012 to violating Japanese securities laws. Two months later, a Japanese judge gave each of them a three-year suspended prison sentence, meaning that neither of them would spend time in jail.

The nominal "wrist-slap" criminal penalties imposed on Kikukawa, Yamada, and their fellow conspirators shocked and angered media representatives and corporate watchdog groups outside of Japan. According to *The Economist*, a prominent British publication, the Olympus accounting scandal demonstrated that the company's corporate governance was a "laughable failure"[27] and that the nation's regulatory infrastructure was just as ineffective. To regain the trust of the international business community and international investors, *The Economist* insisted that Japan's corporate governance institutions had to undergo radical change. "Until Japan's institutions of governance—those internal to the corporations as well as external regulators and prosecutors—change, Japan cannot change."[28]

[27] The Economist, "Arrested Development: The Olympus Scandal," www.economist.com, 16 February 2012.
[28] *Ibid*.

Questions

1. In both Japan and the United States, external auditors have frequently been accused of failing to maintain a proper degree of independence from their clients. What measures have and should be taken to promote the independence of auditors from their clients?

2. KPMG Azsa ultimately agreed to accept Olympus's accounting decisions for the Gyrus acquisition after being given an "experts" report that corroborated those decisions. In the United States, what measures should auditors take in deciding whether or not to seek (and rely on) an "expert's" opinion?

3. What responsibility do auditors in the U.S. have to determine whether or not "related parties" exist for a given audit client? What types of audit procedures should be applied to related party transactions?

4. Michael Woodford pointed out correctly that he had to sign the "letter of representations" to be provided by Olympus to its independent auditors. What is the nature and purpose of a letter of representations? Comment on the quality or strength of the audit evidence yielded by a letter of representations.

5. In the United States, which audit firm has the responsibility for initiating predecessor-successor auditor communications? Briefly summarize the information that a successor auditor should obtain from a predecessor auditor under U.S. auditing standards.

6. Cultural norms and nuances affect the operations of large companies worldwide. Identify examples of distinctive cultural norms and nuances specific to three countries or regions of the world. Explain how those cultural traits likely impact the performance of independent audits.

7. In both Japan and the United States, a small number of accounting firms audit the great majority of large public companies. Identify the advantages and disadvantages of this oligopolistic market structure for independent audit services.