Olympus: what have we learnt?

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In October 2011, Olympus Corporation, a global consumer electronics and healthcare company headquartered in Tokyo, Japan sacked its then Chief Executive Officer and President, Michael Woodford. Only two weeks earlier, Woodford had been promoted to CEO, but he was now persona non grata. His crime was to help uncover accounting fraud on an unprecedented scale. This led to the resignation of the entire board and global investigations culminating in the arrest and successful prosecution of several directors. Here, we recap Woodford's thoughts on the scandal, which he revealed at Aberdeen's London Investment Conference, and discuss what governance lessons can be learnt.

Cause and effect

When asked how Olympus ended up in such a mess, Woodford explained that the shady activities at the company had actually been going on for some time. Twenty years earlier, President Toshiro Shimayama engaged in a series of risky, casino-style investments to enhance Olympus's financial results. These investments became worthless and the imminent introduction of mark-to-market accounting rules in Japan meant the losses would soon be visible on Olympus' financial statements.

To achieve the objective of hiding these massive losses, beginning in 2008, Olympus purchased three companies for $1bn in areas completely unrelated to its core optical-digital and healthcare business. It had put up a façade that these were excellent investments. The money was then suspiciously paid to the Cayman Islands. Olympus had also paid a further $700m to an unknown consultant in the Cayman Islands. The Thomson Reuters news agency said that the $700m fee was the largest to any mergers and acquisition advisor in the history of capitalism. Olympus later admitted that these acquisitions had been used to cover up prior investment losses.

Within a month of the scandal, Olympus' share price had fallen 82% and $7bn had been wiped off the company's value. As Woodford recounted, the company had become bloated and bureaucratic, and one of the most indebted in Japan. It was haemorrhaging money in its consumer electronics business and there was insufficient capital for investment in its healthcare business.

The truth will out

Of the fourteen board directors, including three non-executive directors, all voted for Woodford's dismissal. Rather than criticising the Olympus board, the four largest shareholders (three banks and one large insurance company) seemed more "annoyed" that Woodford had brought attention to the fraud.

Woodford noted that for almost two weeks after the scandal broke, much of the mainline Japanese media was supportive of Olympus. Eight weeks on, an independent committee found Olympus had a board of Yes men. Olympus' board had three non-executive directors, including one doctor and a former executive of a Nikkei TV channel. In a later interview on the scandal, the doctor openly admitted to not knowing the ins and outs of boardroom discussions.

Having informed the board of his concerns without success, Woodford secretly commissioned a leading international accounting firm to evidence the exchange of letters between himself and the board. He circulated the report to his board colleagues and Olympus' lawyers outlining the scale of money laundering and other criminal activities. Woodford recommended bringing in forensic accountants, without success.

In 2011, Olympus changed its auditors – something Woodford noted as a clear red flag. But neither of the auditors had noticed the massive fraud that took place: "It is incomprehensible how they could not know about this scandal" said Woodford.

Better governance

Woodford believes that, in the UK to an extent, lessons have been learnt from Olympus and similar scandals. For example, the Financial Conduct Authority now has a whistleblowing line. Companies are realising that if they don't address governance concerns then the consequences could be catastrophic. However, he believes more needs to be done. In the US for example, some of the country's most impressive legal minds work in the earlier part of their careers for the Department of Justice, whereas the same can't be said for the UK's Serious Fraud Office, whose investigators are competing with some of the country's top lawyers at the companies they are probing.

In Japan, privately owned small to medium-sized enterprises (SMEs) often have strong governance. More than 99% of all businesses in Japan are SMEs. They employ a majority of the working population and account for a large proportion of economic output[A], several of them being leaders in material sciences, ceramics and other areas. But larger companies making up the Nikkei index have more room for improvement.

The encouraging news for investors is that the Japanese government and companies themselves are taking concrete steps to improve their governance standards. Japan now has its first corporate governance code that will hold companies accountable to shareholders. Another development is the formulation of the JPX-Nikkei 400 index – a new equity benchmark highlighting better-performing companies through metrics valued by shareholders.

The Olympus scandal clearly underlines the importance of good governance as a safeguard against corporate misdemeanour. Unlike Olympus, successful companies create a culture that encourages accountable, transparent and inclusive decision-making. Aberdeen places good corporate governance at the heart of its investment decision-making and will not invest if governance standards are not sufficiently high.

The only positive to emerge from corporate scandals like Olympus is that they accelerate the trend towards better governance.

[A] Economist Intelligence Unit, 2010.

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