

Blurred Vision, Perilous Future: Management Fraud at Olympus

Saurav K. Dutta, Dennis H. Caplan, and David J. Marcinko

ABSTRACT: In 2011, Japan was shocked by the revelation of a fraud at one of its most prominent companies, Olympus. What was more shocking was that the fraud was perpetrated by its Chairman of the Board and past president, Tsuyoshi Kikukawa, in collusion with several other Board members and officers. The whistleblower was Michael Woodford, a British citizen and the Company's first non-Japanese president and CEO. Woodford had held the post of president for just six months before he was precipitously fired at a Board of Director's meeting on October 14, 2011.

The case has been successfully used in both undergraduate and graduate courses that include intermediate financial accounting, advanced accounting, auditing, and forensic accounting. It demonstrates how poor governance structures allowed company executives and directors to circumvent accounting rules and hide investment losses for over two decades. The accounting topics include (1) methods of accounting for investments in financial instruments, (2) recognition and measurement of goodwill at the time of acquisition, and (3) consolidation accounting. The case requires students to link economic events to business decisions, and understand the financial reporting ramifications of those decisions. The case also requires students to critically analyze corporate governance mechanisms, and to consider the external auditor's responsibility for detecting and communicating financial statement fraud.

Keywords: Olympus; goodwill; fair-value accounting; corporate governance; financial reporting fraud; auditing.

INTRODUCTION

Michael Woodford had made the trip from Olympus's Tokyo headquarters to Haneda Airport countless times before. He enjoyed the comfortable confines of the company's Lexus sedan, and the ride usually gave him time to chat with his driver and friend, Nick. Today, however, neither Nick nor the Lexus were anywhere in sight, and he found himself in the back seat of a Tokyo cab. Only moments before, he concluded a meeting at a popular cafe with a

Saurav K. Dutta is an Associate Professor and Dennis H. Caplan is an Assistant Professor, both at the University at Albany, SUNY; and David J. Marcinko is an Associate Professor at Skidmore College.

We thank the editor, associate editor, and two anonymous reviewers for their helpful insights, comments, and suggestions. We acknowledge our students and, in particular, Jim Halley, who completed the case and provided us with valuable feedback. We are also grateful to Jennifer Pickett for teaching this case and allowing us to administer the post-case questionnaire to her class.

Published Online: April 2014

reporter for the *Financial Times*, to whom he had explained the circumstances surrounding his abrupt dismissal from his position as president and CEO of Olympus. Woodford himself could scarcely believe the series of events that had unfolded since his appointment as Olympus's president in April 2011. Now, only six months later, the Board had suddenly terminated his employment with the company for which he had worked for 30 years. Despite the lack of a formal university education, Woodford had risen to prominence in Olympus, culminating in his appointment as Olympus's first non-Japanese president. He had explained to the *Financial Times* reporter how he had disclosed to the Board the details of a massive fraud perpetrated by Olympus executives, including Chairman of the Board Tsuyoshi Kikukawa and Executive Vice President Hisashi Mori. Among the documents he provided to the *Financial Times* was the following letter he had sent to Kikukawa three days earlier:

In putting the company first, the honourable way forward would be for you and Mori-san to face the consequences of what has taken place, which is a shameful saga by any stretch of the imagination. It is clear that the current situation is now untenable and to move forward positively the necessary course of action is for you both to tender your resignations from the Board. This approach would allow the situation to be managed in a discreet manner and minimise the reputational damage to both Olympus and yourselves. If your resignations are not forthcoming, then there is a principal obligation upon me in respecting my fiduciary duties, to raise, with the appropriate parties, my fundamental concerns in relation to the governance of the company. (Woodford 2011, 12)

Woodford's revelations to the press were partly motivated by concerns for his personal safety. Recent Japanese press coverage of the emerging scandal suggested connections between Olympus and the notorious organized crime syndicate Yakuza. As long as he remained in Japan, Woodford felt that he had good reason to be concerned, so the private taxi and the waiting flight to Hong Kong offered welcome relief from the circumstances of the past several hours.

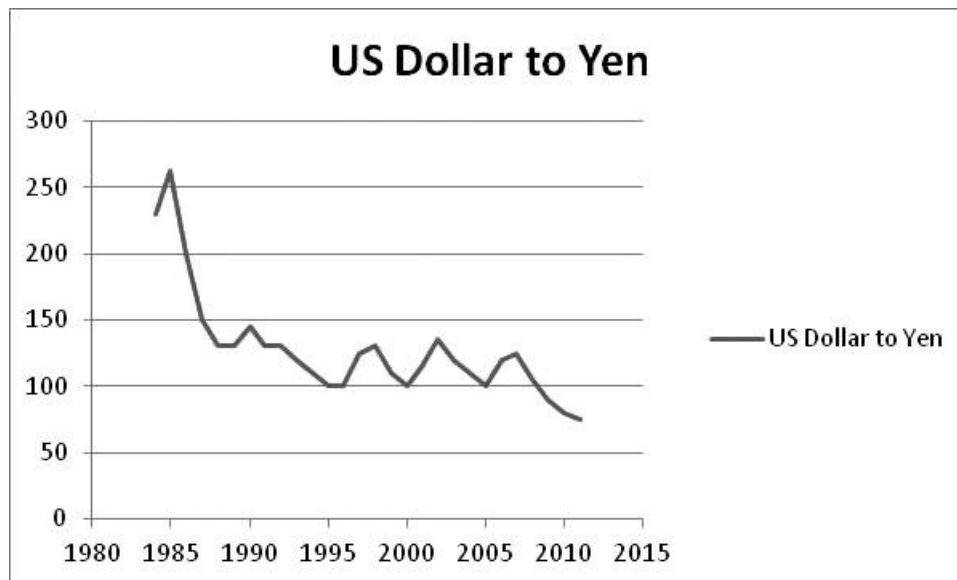
ECONOMIC BACKDROP AND THE GENESIS OF PROBLEMS AT OLYMPUS

Established in 1919, Olympus currently has over 30,000 employees in its five business segments. Of the five segments, its Medical division is the most profitable, and controls over 70 percent of the worldwide endoscope market. The Imaging segment manufactures digital cameras and, in recent years, has been the poorest performing division of the company. The other three segments are Life Science, Information Communication, and Others.

The underlying causes of Olympus's problems in 2011 were rooted in macroeconomic events that transpired in the 1980s.¹ At the time, Japan was one of the world's fastest growing economies. Along with Germany, Japan was running large trade surpluses. A pivotal event occurred in September 1985, when representatives from France, Germany, Japan, the United Kingdom, and the United States developed a plan to begin weakening the overvalued U.S. dollar. It was agreed that Japan and Germany would stimulate domestic demand and allow their currencies to appreciate. At the same time, the U.S. Federal Reserve would ease monetary policy and allow the dollar to decline. The policies formulated at the New York Plaza Hotel, hence known as the Plaza Accord, triggered an exceptional appreciation in the value of the yen against the dollar (see Figure 1). Consequently, Japan's export growth largely came to a halt in 1986, causing a slump in the Japanese economy. The Japanese government responded aggressively to the recessionary pressures. The macroeconomic stimulus featured extraordinarily low interest rates that were sustained until 1989. In the late

¹ The discussion in this and the following paragraph relies heavily on a report issued by the International Monetary Fund (IMF 2011).

FIGURE 1
Exchange Rate



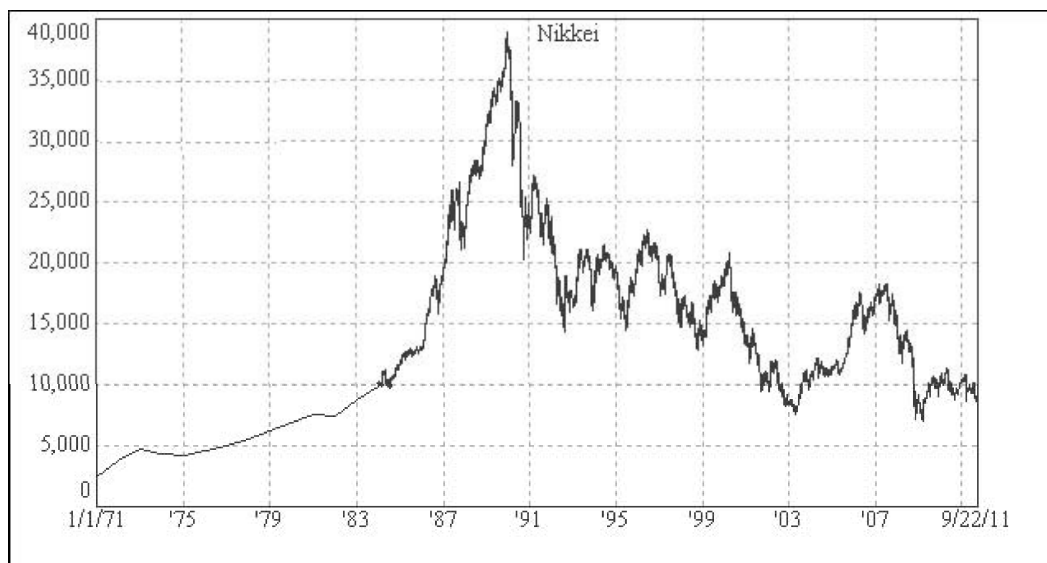
The graph shows the exchange rate on December 31.

1980s, the Japanese economy began to experience significant credit growth and increasing asset prices.

The rising value of the yen put pressure on profitability of companies like Olympus, which were largely dependent on exports. Goods such as Olympus cameras, when sold in the U.S., yielded far fewer yen, leading to a decline in the company's income. Olympus's net income fell from ¥6.8 billion in 1985 to ¥3.1 billion in 1986. Rather than respond strategically within its core businesses, Olympus's president, Shimoyama, sought earnings from speculative investments in financial products (Woodford 2012, 182). That change in direction worked well in the mid-1980s because stock prices tripled between 1985 and 1989. However, in 1990, the bubble in Japanese asset prices burst and the Nikkei stock index lost half its value in less than a year (see Figure 2). Olympus incurred significant losses in its investment portfolio. Instead of liquidating the financial assets and disclosing the losses, Olympus took a strategy of "doubling down" and started investing in even riskier financial instruments. This high-risk strategy failed spectacularly, and by 1995 the amount of unrealized losses had grown to tens of billions of yen (Olympus Corporation—Third Party Committee 2011, 11; hereafter, Investigation Report).

In 1993, Masatoshi Kishimoto succeeded Shimoyama as president of Olympus and, like his predecessor, continued to resist disclosing the mounting losses. He commented to the finance group leader Hideo Yamada: "We will wait because the losses will decrease when the market recovers and then we can turn things around" (Woodford 2012, 183). Kishimoto and Yamada were unaware that a coming change in Japanese accounting standards would deny Olympus the opportunity to wait for the losses to reverse.

FIGURE 2
Nikkei Price Chart



JAPANESE GAAP FOR INVESTMENTS: A STANDARD IN FLUX

When Olympus started making investments in financial assets in the mid-1980s, Japanese Generally Accepted Accounting Principles (GAAP) allowed these investments to be valued at either historical cost or the lower of cost or market (LCM), at the company's discretion. The cost method requires that gains and losses on investments are recorded only when realized, at the time the investments are sold. There is no accounting for unrealized gains or losses. The LCM method, on the other hand, requires early recognition of unrealized losses, but prohibits the recognition of unrealized gains. In the case of losses, investments are marked down to market value, and a corresponding reduction is made to the "unrealized gains and losses on investments" in the net assets section of the balance sheet.² At the time, about half of all firms listed on Japanese exchanges opted for the cost method (Inoue and Thomas 1996). Olympus was among those firms. Reporting investments at cost enabled Olympus to avoid disclosing the massive unrealized losses it had suffered due to the sharp decline in the Japanese stock market. This allowed Olympus the luxury of waiting for prices to rebound, at which time Olympus would be able to recoup its losses.

Throughout the 1990s, pressure began to mount on Japan's Business Accounting Council (BAC) to revise its accounting standards for financial products and require that such instruments be reported at their market values and not historical costs. The BAC succumbed to pressures to reform accounting for marketable securities and signaled its intent in 1997 by issuing *Discussion Points for Accounting Disposition Standards for Financial Products*. In January 1999, the BAC issued Statement No. 10, *Accounting Standards for Financial Products*. The new standards became effective for all fiscal years beginning on or after April 1, 2000. Olympus would be required to apply the new standards in the fiscal year that would end on March 31, 2001 (Investigation Report 2011, 14).

² The balance sheet under Japanese GAAP labels the equity section as net assets.

Similar to U.S. GAAP, the new standard classified investments into categories based on the intent for holding the securities. Different accounting methods were applied to each category. Trading securities held by a company are for the purpose of earning profits on market movements. They must be presented in the balance sheet at market value, with gains and losses included in income of the current period. Held-to-maturity securities are debt securities that the company purchases with the intent to hold until maturity. They are valued at amortized cost. Equity investments in subsidiaries and associated companies are valued at historical cost. “Other securities” are all other securities that are not trading securities, held-to-maturity securities, or investments in subsidiaries and associated companies. They are presented in the balance sheet at market value. Changes in market value for “other securities” are accounted for by either of the following two methods (Koga and Yao 2011, 55–58):

- **Full Fair Value Method:** The total valuation difference is credited or charged directly to unrealized gains and losses in the net assets section of the balance sheet.
- **Partial Fair Value Method:** While valuation profits are credited directly to net assets, valuation losses are included in income (profit or loss) for the period.

The classification of the investments as trading or other made little difference to the valuation. If the investments were classified as trading securities, the balance sheet would record the decline in value and the associated loss would appear in the income statement. If the investments were classified as “other securities,” the balance sheet would still reveal the losses. Even though there would be no income effect in the current period, the losses would be clearly evident in the net assets section of the balance sheet. Olympus decided that neither option was acceptable, and embarked instead on a “loss separation scheme.”

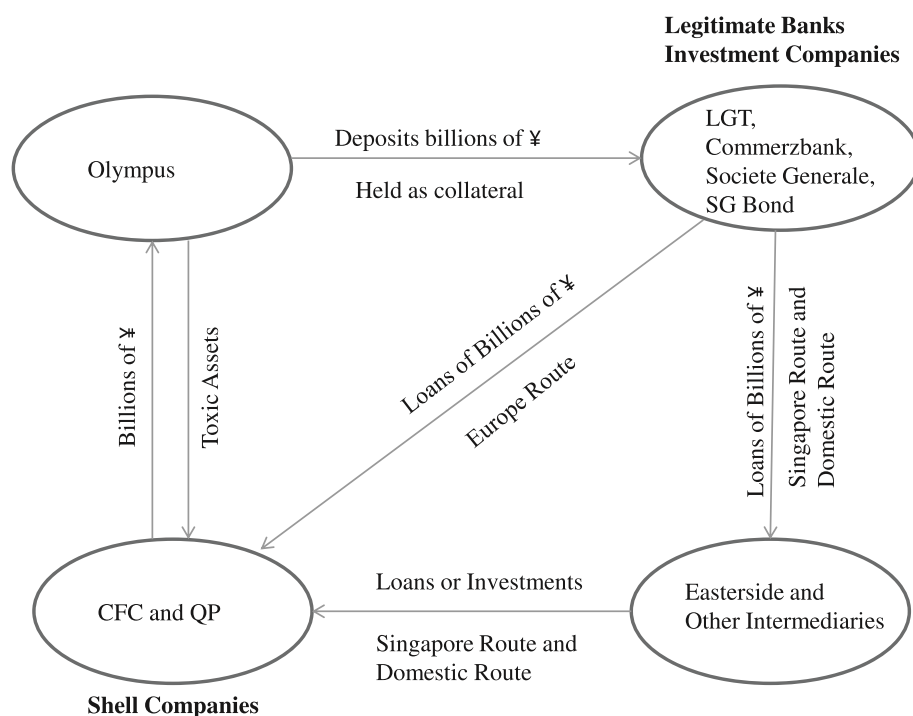
LOSS SEPARATION SCHEME

The change in accounting standards that required investments to be marked to market implied that Olympus could no longer avoid reporting the unrealized losses in its investment portfolio. These losses, according to some estimates, had ballooned to almost 100 billion yen by 1998 (Investigation Report 2011, 15). Olympus’s executives believed there was no recourse but to remove these “underwater” investments and the corresponding unrealized losses from Olympus’s books. To do so, Olympus would have to find a buyer willing to purchase these toxic assets at their original cost, which far exceeded their market value. Obviously unable to find such a buyer, Yamada and Mori, senior officers at Olympus, devised the loss separation scheme described below.

Yamada and Mori created two shell companies, Central Forest Corporation (CFC) and Quick Progress Company (QP), which would buy Olympus’s toxic investments. The two new companies were set up as “*tobashi*,” or receiver funds that did not have to be consolidated on Olympus’s financial statements.³ The next problem was to channel funds to these companies, enabling them to purchase the investments. Olympus could not directly provide CFC and QP the needed funds, since doing so would raise red flags if CFC and QP were to engage in transactions favorable to Olympus. Instead, Olympus deposited Japanese government bonds with LGT Bank in Liechtenstein, and arranged for the bank to use these bonds as collateral for a loan to CFC. CFC used the borrowed funds to buy the investments from Olympus at Olympus’s original acquisition cost. Olympus, thus, recovered the amount it deposited with LGT and the toxic assets were considered “sold” to the shell corporations. Olympus thereby avoided recognizing losses on these underwater securities. CFC

³ “*Tobashi*” was the Japanese practice of shifting losses off a company’s books to a subsidiary or outside funds, which led to reforms such as consolidation accounting and marking to market for securities investments.

FIGURE 3
Loss Separation Scheme



now owned the toxic assets and owed money to LGT. The scheme is illustrated in Figure 3, labeled as the “Europe Route,” and the requisite journal entries for Olympus and CFC are shown below.

Olympus purchased Japanese government bonds worth ¥21 billion and deposited them with LGT Bank. The journal entry for Olympus (in millions of yen) would have been:

Government Bonds	¥21,000	
Cash		¥21,000

CFC would record the loan from LGT as follows:

Cash	¥21,000	
Loan Payable		¥21,000

CFC used the borrowed funds to purchase the toxic assets from Olympus and recorded the transaction with the following journal entry:

Financial Assets	¥21,000	
Cash		¥21,000

Olympus’s side of the transaction would be recorded as follows:

Cash	¥21,000	
Financial Assets		¥21,000

At the end of the sequence of transactions, Olympus has effectively swapped underwater investments originally purchased for ¥21 billion for Japanese government bonds, and recorded no loss. The unconsolidated shell company, or “tobashi,” now holds the underwater investments that it purchased for ¥21 billion. Transactions with LGT bank commenced with the deposit of ¥21 billion and by 2000 had increased to ¥35 billion. Equivalent funds were transferred to CFC to enable it to purchase additional underwater investments of Olympus at cost.

LGT Bank was not the only conduit used to transfer funds from Olympus to CFC and QP. Two additional schemes were devised. In the second scheme, called the Singapore Route, Olympus arranged for Commerzbank to provide loans to CFC and QP through a chain of intermediaries located in the Cayman Islands and British Virgin Islands. The chain of intermediaries was deliberately made complex in order to conceal the original source of the funds.⁴ These loans were collateralized through Olympus’s deposits at Commerzbank. When Olympus’s main contact at Commerzbank, Mr. Chan, moved to the Singapore branch of the bank Société Générale, Olympus transferred the loans and collateral from Commerzbank to Société Générale. Later, Mr. Chan left Société Générale and created a bond fund named SG Bond. Olympus invested ¥60 billion in SG Bond, which loaned those funds to another Olympus shell named Easterside. Easterside used the money to repay the loan with Société Générale, which, in turn, returned the collateral to Olympus. Thus, CFC and QP’s loan with Société Générale was shifted to Easterside’s loan from SG Bond, and Olympus’s collateral at Société Générale converted to its investment in SG Bond.

The third scheme, called the Domestic Route, involved a business investment fund named Global Company New Vision Ventures (GCNVV). Olympus created this fund in 2000 for the purpose of identifying new business and strategic growth opportunities. However, GCNVV was also used as a conduit to transfer ¥30 billion to QP. Similar to CFC, QP used these funds to purchase underwater investments from Olympus.

The postmortem investigation revealed that several senior officers at Olympus, including Yamada, Mori, Kishimoto, and Kikukawa, were aware of these funds and helped create them. In fact, Kishimoto and Kikukawa signed an agreement with LGT to extend the term of the account-collateralized ¥30 billion loan made to CFC up to mid-2008. Further, a staffer from the finance group was involved with day-to-day practicalities, including bank transmission instructions and fund management reports (Investigation Report 2011, 22).

Through the execution of this scheme, Olympus was able to transfer losses of approximately ¥64 billion to CFC, and losses of ¥32 billion to QP. This enabled Olympus to separate unrealized losses from its consolidated financial statements. Note that there was no real cash outlay for this scheme, and the cash position of Olympus did not change, because the amount it would provide as collateral to the banks would be returned by CFC and QP once they purchased the investments from Olympus. Effectively, Olympus was able to swap the toxic assets for high-quality Japanese government bonds held as collateral by the lender. The underwater investments were held by “tobashi,” or unconsolidated receiver funds that could bide time and wait for the value of these investments to rebound. If that were to happen, CFC and QP were to liquidate these investments and repay the loans to the lenders, thereby releasing Olympus’s collateral at the banks. For this elaborate scheme to work, there was one element outside of Olympus’s control: the market value of these investments had to rebound. Unfortunately for Olympus and its senior officers, that was not to be!

⁴ Transactions between Olympus and the shell companies were often channeled through multiple intermediaries. To simplify the exposition, we do not detail all of those transactions.

LOSS DISPOSITION SCHEME—ACQUISITION OF DOMESTIC COMPANIES

The successful loss separation scheme permanently removed the toxic assets from Olympus's books, permitting Olympus to avoid recognizing the associated investment losses. Olympus now faced a different problem. After years of carrying the loans to CFC and QP, the lenders demanded repayment. CFC and QP would have been able to satisfy these liabilities if the market values of the toxic assets had recovered. They would have sold these assets and repaid the loans. LGT and SG Bond, in turn, would have released the collateral to Olympus. However, even seven years after transferring the toxic assets to CFC and QP, their values had not rebounded. Hence, sufficient cash had to be transferred to CFC prior to 2008. Kikukawa and Mori devised two schemes to provide cash to CFC and QP: one involved acquisition of domestic companies, and the other involved the acquisition of a foreign company. The former is discussed in the remainder of this section and the latter in the next section.

The essence of the "domestic acquisition" scheme involved two shell companies, Neo and ITV, acquiring legitimate businesses at market prices, which they would sell to Olympus at greatly inflated prices. The proceeds from these sales would then be transferred to CFC, providing it with sufficient cash to repay the loans. A consequence of this scheme was that Olympus would record significant goodwill on its balance sheet, which it intended to amortize over a period of 20 years as permitted under Japanese GAAP (Koga and Yao 2011, 313).

The scheme began with Global Company New Vision Ventures (GCNVV) identifying three Japanese companies as attractive investment opportunities. The first, Altis, was a recycling business specializing in medical waste. The second, News Chef, made cookware for microwave ovens. The third, Humalabo, developed health supplements with ingredients extracted from fungus. These companies were relatively new and had yet to turn a profit (Tabuchi 2011). The scheme proceeded as follows:

- Neo and ITV were created by Olympus as unconsolidated shell companies. These two companies purchased shares of the three domestic companies at a price of 50,000 to 200,000 yen per share.
- Neo and ITV prepared extensive business plans that projected high growth for each of the three companies. Based on these projections, Kikukawa and Mori were able to convince Olympus's Board of Directors that these were excellent investment opportunities. Thus, Olympus purchased the shares of these three companies from Neo and ITV at exorbitant prices. Some of these purchases were made directly and others through its affiliates, as shown in Table 1.
- Upon purchasing shares of the three domestic companies at prices far exceeding the fair value of their net assets, Olympus recorded the difference as goodwill.

Neo and ITV, in turn, channeled the proceeds from the sale of the shares to CFC, which was then able to repay its loan to LGT. The bank, having received repayment of its loan, released the collateral to Olympus. That completed the full circle for Olympus. Initial cash outlays to purchase the shares of three domestic companies from Neo and ITV were effectively returned by the bank when it released the collateral of Japanese government bonds. The scheme is illustrated in Figure 4.

LOSS DISPOSITION SCHEME PART DEUX—GYRUS ACQUISITION

Overpayment for the purchase of target companies was not the only mechanism used to divert cash to the shell companies. In another scheme, Olympus overpaid for financial advisory services in connection with a corporate acquisition. In 2008, Olympus acquired Gyrus, a British company. Axes, a Japanese-owned financial advisory firm, assisted Olympus with the transaction.

TABLE 1
Stock Transactions in Loss Disposal Scheme

Panel A: March 2006

Target Company	Date Acquired	Cost Per Share	Selling Surrogate	Selling Price Per Share	Total Amount	Buying Surrogate
Altis	Dec. 2005	¥50,000	Neo	¥5,790,000	¥7.35 B	GCNVV
Humalabo	July 2005	200,000	Neo	14,100,000	6.54 B	GCNVV
News Chef	Dec. 2003– Dec. 2005	200,000	Neo and ITV	4,450,000	3.78 B	GCNVV

Panel B: March 2008

Target Company	Date Acquired	Cost per Share	Selling Surrogate	Selling Price Per Share	Total Amount	Buying Company
Altis	Dec. 2005	¥50,000	Neo	¥11,000,000	¥18.2 B	Olympus
Altis	Mar. 2006	5,790,000	DD	10,500,000	5.56 B	OFH
Humalabo	July 2005	200,000	Neo	20,500,000	13.7 B	Olympus
Humalabo	Mar. 2006	14,100,000	GT	19,500,000	3.9 B	OFH
News Chef	Dec. 2003– Dec. 2005	200,000	ITV	9,500,000	15.2 B	Olympus
News Chef	Mar. 2005	4,450,000	DD	9,000,000	4.0 B	OFH

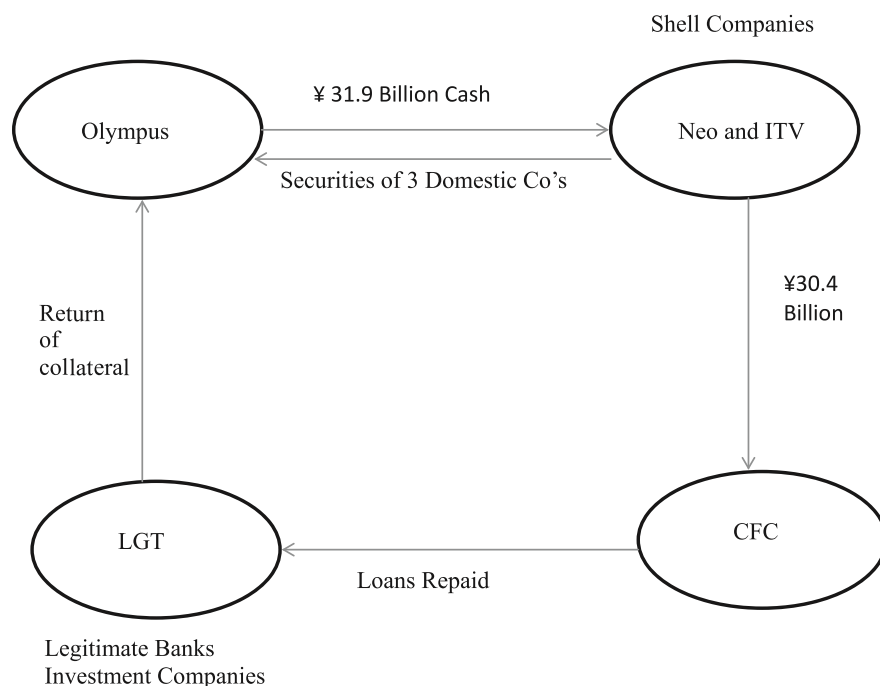
This table shows successive purchases of the shares of the three domestic companies. Panel A shows the purchases made in March 2006 and Panel B shows those made in March 2008.

Upon completion of its purchase of Gyrus, Olympus paid Axes a fee of \$12 million in cash, in addition to an unspecified amount in stock options and warrants of Gyrus. Axes subsequently sold the stock warrants and options for \$24 million to Axam, a Cayman-based investment fund. Seven months later, Olympus reacquired the options and warrants from Axam in exchange for dividend preferred shares of Gyrus with a face value of \$177 million (17.7 billion yen).⁵ This amount was capitalized as an incidental cost of the Gyrus acquisition.

About three months later, Axam demanded that Olympus purchase the same preferred shares for a sum in the range of \$530 to \$590 million, and threatened to transfer those shares to a third party if Olympus failed to do so. Axam provided no justification as to why the value had increased significantly in the three-month period, concurrent with the global financial crisis. Regardless, Olympus's Board unanimously approved the purchase of the preferred shares and no Board members objected to the significant increase in price. However, the purchase was not consummated because in the U.K., preferred stock is regarded as a liability, and settlement of a liability at a price greater than the book value (\$530 million compared to \$177 million) would result in reporting a loss, which was unacceptable to Kikukawa and Mori. Thereafter, Mori directed the Accounting Department to examine whether it would be possible to reclassify the dividend preferred shares as equity (Investigation Report 2011, 66). In early 2010, as dividends were never paid to Axam, a case

⁵ Payment of preferred shares was contrary to the advice of two outside experts, KPMG and Weil, Gotshal & Manges LLP (a New York-based law firm), both of which independently recommended a settlement in cash of the \$177 million, noting that it was "Clearly the 'cleanest' way for Olympus to deal with [Axam]" (Investigation Report 2011, 62).

FIGURE 4
Loss Disposition Scheme



was made to reclassify the dividend preferred shares from a liability to shareholders' equity. Olympus's legal counsel advised:

Although there exist no provisions in English law that permit conversion to common stock, there is also a possibility that there will be no choice but to accede in the event that the other party has asserted this. In addition, although there still exist no precedents in English law that permit conversion to common stock that does not mean that there is absolutely no possibility of this in the future. (Investigation Report 2011, 68)

Olympus management regarded the above opinion positively and engaged in discussions with Ernst & Young ShinNihon LLC, the incoming auditors, to reclassify the dividend preferred stock from a liability to shareholders' equity. This was accomplished by Gyrus through the following journal entry:

Long-term borrowing	\$177M	
Capital (preferred stock)		\$177M

Interestingly, after 16 months of silence, on March 17, 2010, an email was received from Axam, again demanding the buyback of the dividend preferred stock, but now at a price of \$724 million. For a second time, Olympus's Board unanimously approved the buyback from Axam, this time at a negotiated price of \$620 million. The transaction was executed through the fully owned British subsidiary Olympus Finance UK Ltd., which purchased the dividend preferred stock from Axam for \$620 million (57.9 billion yen) in cash and recorded the transaction as:

Shares of affiliated company	\$620M	
Cash		\$620M

At the time of consolidation, the elimination of the “shares of affiliated company” account led to recording additional goodwill:

Capital (preferred stock)	\$177M	
Goodwill	\$443M	
Shares of affiliated company		\$620M

The debit to Capital removed from the consolidated financial statements the preferred stock recorded in Gyrus’s financial statements. Thus, to help facilitate a \$2 billion purchase of Gyrus, Axes and Axam received a fee of \$632 million (¥65 billion), or 31 percent of the purchase price. Industry standard for such advisory fees are about 1 to 2 percent of the purchase price, or \$20 to \$40 million.

Axam, for its part, having received \$620 million in cash, transferred \$623 million to an intermediary on March 31, 2010. Within three months, Axam’s registration in the Cayman Islands was revoked due to non-payment of license fees. The funds were transferred through a chain of intermediaries, and eventually \$622 million was received by Easterside, one of Olympus’s unconsolidated subsidiaries (as noted in the previous section). Easterside used \$622 million cash to repay SG Bond, which, in turn, redeemed Olympus’s initial investment in two equal installments of ¥31.569 billion on September 21, 2010, and March 24, 2011. Thus, of the ¥65 billion Olympus paid Axes and Axam, it recouped ¥63 billion from SG Bond through a circuitous path.

Although this flow of funds ultimately had minimal impact on Olympus’s cash balance, it had significant accounting ramifications. The inflated purchase price of the acquisitions and the exorbitant fees paid for M&A advisory services were capitalized. The purchase price was recorded as goodwill through the journal entries shown above. Under Japanese GAAP, the goodwill could be amortized over a period of 20 years while periodically tested for impairment. Olympus resorted to a series of convoluted transactions for the sole purpose of converting unrealized investment losses to goodwill, thereby not having to recognize these losses in a single year.

CORPORATE GOVERNANCE EFFECTIVENESS

Various parties involved in the financial reporting process have complementary and overlapping responsibilities for deterring and detecting fraud (Dutta 2013). The Investigation Report (2011) examined corporate governance at Olympus and found numerous flaws, some of which are summarized here.

Internal Controls

Company management is responsible for implementing and maintaining an effective system of internal controls. Two important and common features of good internal control are segregation of duties and job rotation. For transactions involving external funding, the Treasury Group both executed and approved those transactions. Furthermore, Yamada oversaw the Finance Department while concurrently serving other roles at various times, including Head of the Audit Office, Head of the Administration Management Division, Corporate Center Manager, and the Officer in charge of audits. This created an unusual concentration of power. Additionally, there was minimal job rotation at high levels in the finance and accounting departments, allegedly because at Olympus, there was a perception that these functions required a high level of expertise and long-term operational experience.

Internal Audit Function

The Institute of Internal Auditors (IIA) recommends that the internal audit function have a direct line of communication to the Audit Committee and the Board of Directors and be independent, in substance and in form, from the rest of the organization. At Olympus, from 2002 to 2009, Yamada, in his role as the Head of the Finance Department, supervised the Head of the Internal Audit Department. Arguably, the independence of the internal audit function is compromised when it is supervised by the same person who is in charge of the accounting and finance functions. The Internal Audit Department did not conduct a single audit of the finance function over a period of seven years.

Board of Directors

In April 2001, there was an overhaul of the corporate governance system that affected the Board of Directors and top-level management committees. In June 2005, outside directors were elected at the regular shareholder meeting for the first time. However, the addition of outside directors did not have much impact on governance insofar as these individuals seldom asked questions at board meetings⁶ (Investigation Report 2011, 125).

As part of the overhaul, the Board of Managing Directors and the Management Committee were eliminated. Instead, a Management Implementation Committee, comprised of seven to eight members, was established. The members of this Committee were all insiders and included the chairman, president, vice president, and presidents of the subsidiaries. The tasks of the committee were related to operational matters to be decided by the president, and the Committee was to support the president's decision-making (Investigation Report 2011, 116). The Management Implementation Committee, comprised of officers, had essentially become the highest decision-making body in Olympus for operating decisions, and the Board of Directors had become a formality.

Even when there was relatively active questioning and debate in the Board of Directors meetings, the final resolution was made by the chairman without opposition. As a general rule, there was no adoption of a voting method, such as by a show of hands, where approval and disapproval would be clearly evidenced. Matters related to the M&A projects were introduced through replacement of agenda items, and relevant material was distributed and recovered on the same day, thereby undercutting the ability of directors to study or understand the issues. Concern expressed about these changes and lack of adequate deliberations on these issues was assuaged through management's assertion that the "item was adequately discussed at the Management Implementation Committee" (Investigation Report 2011, 125).

The Investigation Report (2011) pointed out three structural deficiencies in the Board of Directors that contributed to the problems at Olympus. First, there was a lack of diversity of expertise on the Board. For example, with the exception of the director in charge of finance and accounting, there were no other directors with experience or working knowledge of finance and accounting. Second, the directors were generally apathetic to matters that were not in their individual area of expertise. As noted in the report: "each director . . . reviewed only areas that they were in charge of, and were indifferent to the areas charged to others" (Investigation Report 2011, 144). Apathy on the part of directors was evident in both the acquisition of the three domestic

⁶ The Board of Directors met about 20 times annually before the overhaul, and attendance was generally in the range of 90 to 100 percent. After the overhaul, there were 26 to 36 meetings annually, and attendance was generally between 90 and 100 percent. One exception was an outside director, elected in 2005, whose attendance was 4 percent. After 2006, the meetings were reduced to 17 to 19 times a year, and with the exception of one outside director whose attendance was between 11 and 16 percent, attendance was generally between 90 and 100 percent.

companies and the advisory fees paid in connection with the Gyrus acquisition. While thorough discussion and questioning of these transactions would occur in most organizations, at Olympus there was none. Third, the directors were not sufficiently independent of the president, because the president exercised exclusive decision-making authority on director compensation and personnel matters. Consequently, once approved by the president, the Board rubber-stamped all corporate actions, including deferral of losses in 1999, acquisition of the three domestic companies, and the advisory fees related to the acquisition of Gyrus. When Woodford finally pointed out the obvious scandal, the directors failed to investigate the substance of the allegations and, in deference to Kikukawa, agreed to Woodford's dismissal.

The Investigation Report (2011) concludes: "unless those with professional knowledge and high independence are elected as outside directors, they would not be able to exercise the role that they would be expected to fulfill," and due to the lack of this attribute, "the supervisory responsibility that the Board of Directors had to fulfill as the center of the corporate governance had not been fulfilled" (Investigation Report 2011, 146).

Audit Committee

At Olympus, the Board of Auditors was composed of two standing auditors and two outside auditors. The two standing auditors were longtime employees of the company. One of the outside auditors was a classmate of the president from high school (Investigation Report 2011, 129), and the other was from a corporation that had a supplier relationship with Olympus. Moreover, from 2000 to 2012, among those who were appointed to this committee, only Yamada had professional knowledge in accounting, auditing, and law. Hence, the directors deferred to Yamada's judgment on items involving accounting and finance issues.

External Auditors

KPMG AZSA LLC had been Olympus's auditors since 1974, and in 2008, they raised concerns to the Board of Auditors about the acquisition of the three domestic companies and also about the exorbitant financial advisory fees paid for the Gyrus acquisition. Specifically, KPMG AZSA informed the Board of Auditors that the prices paid for the three domestic companies and the financial advisory fees paid for the Gyrus acquisition were extremely high. After many consultations, in April 2009, KPMG AZSA requested the Board of Auditors to consider the following (Investigation Report 2011, 151):

- The reasonableness of the share prices paid for the three domestic companies.
 - The shares were purchased in two installments: March 2006 and March 2008. The latter purchase was made at unit prices 1.4 to 2.1 times higher than the 2006 purchase, even though earnings growth had fallen short of projections.
- The reasonableness of the advisory fee connected with the acquisition of Gyrus.
 - Normally, the percentage of fees of foreign-capitalized investment banks is within 1 percent of the transaction amount. An amount exceeding 12 percent of the acquisition price is abnormally high. (This was the estimate of the advisory fees as of April 2009, when preferred shares were issued. Ultimately, the fees rose to 31 percent of the acquisition price.)
 - Axes, the advisory firm hired, is extremely small and outsourced the actual advisory services to other firms. Why, then, was a large amount paid to Axes, and no competing bids sought?

Subsequent to this request, there were numerous consultations between KPMG AZSA and senior Olympus executives, culminating in the following statement by KPMG AZSA:

There are doubts about the propriety and reasonableness ... If the same kind of explanation as before were going to be repeated, then it would be difficult to continue the auditing agreement in the future. Also, the same applies to transactions with securities firms and investment funds whose backgrounds are not known. (Investigation Report 2011, 164–165)

Two weeks later, on May 21, 2009, Kikukawa visited the offices of KPMG AZSA to inform them that Olympus would be replacing them with Ernst & Young ShinNihon as of June 2009. The reason given was the conflict of opinion over the accounting treatment of the business valuation of the three domestic companies and the payment of advisory fees for Gyrus. Also, Olympus management regarded KPMG AZSA's questioning of these issues as overstepping their duties and meddling in the management of the company (Investigation Report 2011, 175).

The succession of auditors was performed in accordance with relevant Japanese guidelines requiring communication between the incoming and outgoing auditors. At a meeting between the two auditors held on June 11, 2009, the exchange between the two firms was limited to KPMG AZSA asking Ernst & Young ShinNihon, "Have you heard the reason for the dismissal?" to which Ernst & Young ShinNihon responded that they had heard there were two accounting issues. This was the final exchange between the auditors (Investigation Report 2011, 175) and the succession was completed without further discussion. Japan's Financial Service Agency, the country's top financial watchdog, "did not find 'any intentional acts or grave negligence' by the two firms," but faulted them for not having communicated fully when Ernst & Young ShinNihon took over the audit (Uranaka 2012).

EPILOGUE

On July 3, 2013, Kikukawa was found guilty by a Tokyo court of abetting a \$1.7 billion fraud and cover-up. Yamada and Mori were also found guilty. Each received a suspended three-year sentence, meaning that they are likely to avoid prison. Olympus was ordered to pay fines of ¥700 million for falsifying its financial reports. Mr. Chan, of Commerzbank, Société Générale, and SG Bond, had received in excess of \$10 million from Olympus for abetting the fraud. He was arrested in the U.S. and pled guilty in September 2013 in federal court to charges that carry a maximum five-year prison term. An attempt by Mr. Woodford to get his job back at Olympus was unsuccessful. However, he won a multi-million dollar settlement for unfair dismissal.

CASE REQUIREMENTS

1. Provide a brief synopsis of economic events occurring in Japan and how they affected Olympus's business strategy and risks. Discuss, in context of Olympus, how economic events lead to business risk, which leads to financial reporting risk and, ultimately, audit risk.
2. Olympus had made significant investments in the late 1980s that lost substantial value in the 1990s. Since Japanese GAAP allowed these investments to be valued at cost, Olympus was able to hide unrealized losses by not selling these investments. Under U.S. GAAP, investments in marketable securities have been reported at fair value since the adoption of SFAS No. 115 in 1993.
 - a. Discuss the pros and cons of valuing investments at cost versus fair value from the perspective of decision-usefulness in financial reporting.

- b. Do you think managerial decision-making related to the operations of a company is affected by accounting rules? Discuss in the context of valuation of investments at Olympus.
 - c. Discuss the impact of divergence in accounting rules across various jurisdictions (U.S. GAAP, IFRS, Japanese GAAP) on global investing. Is there a need for a single set of high-quality accounting standards, worldwide? (Hint: See [Shibata \[1996\]](#).)
3. Research the FASB Codification on accounting for goodwill. Olympus used Japanese GAAP to compute goodwill. Specifically, the fees paid to advisers and M&A consultants (\$660 million) were capitalized as part of the acquisition cost, and would be amortized over a period of 20 years under Japanese GAAP. Would the accounting treatment be similar or different under (a) U.S. GAAP, and (b) IFRS?
4. With regard to the loss separation scheme and the loss disposal schemes at Olympus:
 - a. What corporate governance weaknesses allowed these schemes to go undetected for so long? Be specific.
 - b. In addition to the corporate governance weaknesses identified in (a), were there “red flags” that the auditors should have pursued? What routine audit procedures might have led the auditors to detect and investigate these schemes?
5. Olympus acted as a guarantor of loans made by the banks to CFC and QP by depositing funds at the banks equal to the amount loaned. Do you think this creates a related-party relationship? Review the auditing standards pertaining to related parties. Why are transactions with related parties subject to particular scrutiny?
6. Subsequent to the discovery of fraud, Olympus changed the entire leadership team and appointed a new president, CEO, and chairman of the board. The new management team instituted many changes in the corporate governance structure, as specified in the Annual Report of 2012 ([Olympus Corporation 2012](#)). Describe three key features of the new corporate governance structure and explain how these are necessary and sufficient to detect and deter management fraud.
7. Despite their concerns, on May 20, 2009, KPMG AZSA issued a clean opinion on the 2009 financial statements. The very next day, Kikukawa informed KPMG AZSA that they would not be renewed as Olympus’s auditors. This was primarily due to the difference in opinion between KPMG AZSA and Olympus management about the appropriate accounting treatment of various acquisition-related costs, which was perceived as “overstepping” the auditors’ role and “meddling” in the company’s affairs.
 - a. Summarize the concerns that KPMG AZSA had regarding Olympus’s acquisition-related costs. How did these affect audit risk?
 - b. The Japanese regulator noted that the exchange between KPMG AZSA and Ernst & Young ShinNihon did not comply with the spirit of Japanese guidance on auditor communications. Discuss the exchange between KPMG AZSA and Ernst & Young ShinNihon in the context of U.S. Generally Accepted Auditing Standards specifying the responsibilities of the predecessor and successor auditors.

REFERENCES

- Dutta, S. K. 2013. *Statistical Techniques for Forensic Accounting: Understanding the Theory and Application of Data Analysis*. New York, NY: FT Press.
- Inoue, T., and W. B. Thomas. 1996. The choice of accounting policy in Japan. *Journal of International Financial Management and Accounting* 7 (1): 1–23.

- International Monetary Fund. 2011. *Global Prospects and Policies*. Chapter 1 (April). Available at: http://www.imf.org/external/pubs/ft/weo/2011/01/c1/box1_4.pdf
- Koga, C., and J. Yao. 2011. *Japan GAAP Guide*. Tokyo, Japan: CCH Japan Limited.
- Olympus Corporation. 2012. Annual Report 2012. Available at: http://www.olympus-global.com/en/common/pdf/ar2012e_20.pdf
- Olympus Corporation—Third Party Committee. 2011. *Investigation Report*. (December 6). Available at: http://www.olympus-global.com/en/common/pdf/if111206corpe_2.pdf
- Shibata, Y. 1996. On the way out: Japan's "hidden profit management." *Global Finance* 10 (8): 18–20.
- Tabuchi, H. 2011. Acquisitions at Olympus scrutinized. *New York Times* (October 24). Available at: <http://www.nytimes.com/2011/10/25/business/global/acquisitions-at-olympus-scrutinized.html?ref=global-home>
- Uranaka, T. 2012. Japan regulator raps KPMG, Ernst & Young for Olympus work. *Reuters* (July 6). Available at: <http://www.reuters.com/article/2012/07/06/us-auditing-olympus-idUSBRE86508G20120706>
- Woodford, M. 2011. Personal Correspondence to Mr. Tsuyoshi Kikukawa (October 11). Available at: <http://graphics8.nytimes.com/packages/pdf/business/20111018/letter-text.pdf>
- Woodford, M. 2012. *Exposure: Inside the Olympus Scandal: How I Went from CEO to Whistleblower*. New York, NY: Penguin Group.