

Olympus case essay sample



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What is Fraud?

Fraud occurs when individuals purposely materially misstate facts with the intent of coercing someone to believe these misrepresentations. Upon believing the misrepresentation, individuals will act upon them and suffer a loss or damages.

Fraud occurs in various forms:

1. Misappropriation of assets
2. Fraudulent financial reporting
3. Employee fraud
4. Management fraud

The Fraud Triangle

* Motive/Incentive: a reason to commit the fraud

* Opportunity: the chance for an individual to violate a trust. *

Attitudes/Rationalizations: an individual has a lapse in ethical and moral values. When combined with motive and an opportunity, fraud occurs

Corporate Governance and Reducing Fraud Risks

* Management and the board of directors are responsible for implementing control procedures and corporate governance to minimize or prevent fraud. *

Therefore, programs implemented by management include:

Creating a Culture of Honesty and High Ethics:

- * Embraces its core values.
- * Tone with management
- * Positive workplace environment
- * Hire and promote appropriate employees

- * Train all new employees on ethical conduct
- * Reconfirm that employees understand their responsibilities * Discipline

Responsibility to Manage Risks of Fraud:

- * An effective fraud risk management process should include the following principles: 1. Written policy clarifying board of directors/management's expectations regarding fraud risk 2. Fraud risk exposures should be assessed
- 3. Establish controls and actions to prevent or mitigate fraud risks 4. If prevention or mitigation fails, controls and actions to detect fraud are present 5. Communication, reporting and monitoring used to update the fraud management process organization-wide and on a timely basis. * Senior managers and the board of directors are responsible for oversight; management must identify, measure and reduce existing fraud risks. * Management should regularly evaluate the effectiveness of antifraud programs and controls. Audit Committee Oversight:

- * Responsibility to oversee financial reporting and internal control processes.
- * Must be aware of the potential for management to override internal controls * The audit committee itself is a deterrent to fraud

The Auditor's Role in Assessing Fraud Risks

- * The most important thing an auditor can maintain is professional skepticism. * All members of the audit team must discuss their opinions and insights regarding the likelihood of a client to fraud or error. * In every audit, the auditor must inquire about fraud risks.

The Auditor and Responding to the Risk of Fraud

- * When material misstatements are identified, findings are discussed with management. * Auditor's response to fraud generally includes:
- * Change the overall conduct of the audit
- * Design and perform procedures to address risks that have been identified * Design and perform procedures to address the risk of management controls override * There are a variety of ways to respond to an increased risk of fraud – more experienced individuals, fraud expert, etc. * Auditors should be conscious of management's accounting policy selection * Unpredictability should be incorporated into audit plans.

Fraud Detection

- * Although fraud is often very difficult to detect, there are generally some red flags * Employee fraud:
- * Any changes in lifestyle and habits
- * Specific characteristics
- * Telltale hints of cover up in the accounting records
- * Fraudulent financial reporting:
- * Specific circumstances within the company

Why Do Auditors Fail to Detect Fraud?

- * Over reliance on client representations
- * Failure to maintain an appropriate level of professional skepticism
- * Failure to recognize signs that may indicate a material fraud
- * Lack of experience
- * Personal relationship with the client
- * Failing to employ various fraud detective techniques during the audit

Sources for the information above:

* <http://www.thebottomlinenews.ca/index.php?section=article&articleid=317> * Auditing: The Art and Science of Assurance Engagement

* Auditing an International Approach (5th Edition)

Japan and the Financial World in the ' 80s and ' 90s 1980s

* Japanese companies were in cash rich positions

* U. S dollar was greatly overvalued

* 1985 - Plaza Accord

* Put in place to devalue the U. S dollar against other G5 currencies including the Yen * By 1987, the U. S. dollar fell in value approximately 50% * Made it harder for Japanese companies to export to the United States * Japanese economy slowed; government decreased interest rates to restart the economy * Japan became a large creditor nation to the rest of the world * As a result, its citizens stopped spending

* Property values skyrocketed

Early 1990s

* Bank noticed high prices and raised interest rates to combat them * Equity markets took a hit but property market didn't fall * Bank kept raising interest rates until property values started to fall * By then, the equity market and economy as a whole was in a downward spiral * Bank tried lowering interest rates to stop the spiral, but soon after the Japanese Stock Markets crashed

Zaitech and its Role in the Financial Collapse

* Zaitech aka " Financial Engineering" is a financial strategy used by

corporations. It uses gains from speculative investments as a key part of income growth * Used by most large Japanese corporations in the 1980s

* One of the leading drivers of price inflation in Japan during the ' 80s * When interest rates were low, corporations would use the low rates to borrow large sums of money and then use that money as leverage to raise capital from the market * The zaitech strategy is estimated to have accounted for almost half the profits reported by the largest Japanese corporations in the latter half of the ' 80s * When prices fell in the late ' 80s/ early ' 90s, most of the corporations using the strategy suffered huge losses

Japanese Business Culture and Customs

In Japan, the business culture is very different from many Western countries. There are many points in which the two cultures are different. Some of these main points in which Japan is very different from the West include: * The need for consensus when making decisions

* The strong respect for elders and predecessors and the decisions they made during their time at the company * The low presence of independent directors in Japanese corporations * The rarity of shareholder activism

In Japan, most of the directors on the board are from within the company. On average among public Japanese corporations, only 1 director will be external to the company. In the West, this would be considered as going against best practices since most companies have weak shareholder independence. In Japan, it is uncommon for shareholders to be vocal about their requests or demands of the company that they own a part of. Shareholders are willing to

accept that management of the company knows best how to push the company forward.

Michael Woodford: Michael first joined Olympus in 1981 as a salesman for Olympus' medical equipment business. He then headed the businesses in the UK, Middle East and Africa, and Europe for Olympus. In April, Kikukawa appointed him as president and COO of Olympus Corp. He was later appointed CEO on October 1, 2011. Michael Woodford was terminated as CEO on October 14, 2011. He eventually then stepped down from the BOD as well.

Tsuyoshi Kikukawa: Joined Olympus in 1964. He was appointed main BOD, in charge of finance in 1999. In 2001, he became president and representative director. He handed over the role of president to Michael Woodford in April 2011 and later handed over the title of CEO to him as well on October 1, 2011. Tsuyoshi eventually stepped down as president, chairman, and CEO on October 26, 2011. He later resigned from the BODs on November 24, 2011.

Hisashi Mori: Joined the Olympus team in 1981. He worked his way up to be an executive vice-president and main BOD in 2006. He was eventually terminated from his duties as an executive vice-president on November 8, 2011. He also stepped down from the board on November 24, 2011.

Hajime “ Jim” Sagawa: Hajime was a banker who set up Axes America and was president. He also had ownership in Axes (Japan) Securities. It was also determined that he had signed off on documents, as director, for Axam Investments Ltd. of the Cayman Islands.

Akio Nakagawa: Akio had worked with Hajime Sagawa in the financial world in the 1990s. He then joined Hajime and helped out with Axes America.

Source for the information above:

* Exposure: Inside the Olympus Scandal: How I Went from CEO to Whistleblower

Setting Up for Fraud (Phase 1)

* During 1990s, no need to report investments at FMV.

* In 1997-1998, the idea of FMV accounting in Japan was rumoured. *

Olympus executives contact Axes Japan Securities and Axes America LLC (run by Sagawa and Nakagawa) * Both experienced in finance. The plan was to get their help to hide the large losses, as FMV accounting approached. *

Devised a plan to sell investments to shell companies, called Receiver Funds.

* Steps involved (see Appendix 1 for visual):

1) Olympus gives collateral to bank

2) Axes Japan Securities and Axes America LLC set up receiver funds 3)

Banks loan to receiver funds (backed by collateral from Olympus) and buy losing investments from Olympus. 4) Receiver funds pay money back to

bank, bank unlocks Olympus' collateral. * Important character note: Tsuyoshi Kikukawa takes over in June 1999 as managing executive director (oversees accounting/finance) and allows the scandal.

The Scandal, As Seen Per Receiver Fund

Three main routes: Europe, Singapore, and Domestic

Europe Route (see Appendix 2. 12, 2. 2):

* 1997-1998: Receiver Funds, Central Forest Corp. (CF) and Quick Progress

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Co. (QP) established. Eventually roughly 96 billion Japanese Yen in losses were transferred to CF and QP. * Olympus Asset Management (OAM) group gives funds to Lichtenstein bank LGT, who managed three class funds with the cash flow on OAM's behalf (TEAO Ltd., Neo Strategic Venture, and Quick Progress). * Class funds essentially supplied funds to receiver funds.

Singapore Route (see Appendix 2. 3):

* In 2000, Olympus gave Commerzbank of Singapore a Credit of Deposit as collateral. * Commerzbank lends money to three Special Purpose Companies (Twenty First Century Global Fixed Income Ltd., SG Plus Fund, and Easterside Investments Ltd.). Domestic Route (see Appendix 2. 4):

* Created March 2000, with no bank involved.

* Olympus created a fund – G. C. New Vision Venture LP.

* Olympus puts 30 billion Japanese Yen into Quick Progress Co. (receiver fund, see Europe route) through G. C. New Vision Venture LP. * At this point, all funds were set and ready to purchase losing investment from Olympus.

The Scandal Builds

* G. C. New Vision Venture LP (Created in Domestic Route), created three new companies – Altis, Humalabo, and News Chef (see Appendix 3. 1). * The plan was to have the created funds purchase shares in these three companies. From 2000-2005, Neo and Class Fund IT Venture did this for roughly 700 million Japanese Yen (see Appendix 3. 2). * G. C. New vision Ventures LP, Dragon Dynamic II SPC, and Global Targets SPC (all funds created for/by Olympus) purchase shares in the three created companies

from Neo and Class Fund IT Venture for roughly 18.8 billion Japanese Yen in total (see Appendix 3. 2)... huge markup!

Wrapping it up (see Appendix 4)

- * 2007: Consolidation was now becoming a possibility in Japanese accounting standards.
- * September 2007: G. C. New Vision Venture LP is terminated. Shares in the three new companies revert to Olympus at book values.
- * March 2008: Olympus buys shares in the three companies from Neo, Class Fund IT Venture, Dragon Dynamic II SPC, and Global Targets SPC.
- * In the end, the three companies are now on Olympus' books for 73.2 billion Japanese Yen (far from 700 million Japanese Yen).
- * Olympus could now hide losses on original investments through Goodwill impairment of the three companies (Altis, Humalabo, and News Chef).
- * March 2009: External auditor tells Olympus that shares in the three companies are way over valued.
- * 2009: Impairment loss of 55.7 billion Japanese Yen
- * 2010: impairment loss of 1.3 billion Japanese Yen.
- * Write downs help cover original losses.

Side Story: Axes America

- * Brought on by Olympus to help cover up losses in risky investments in 1990s.
- * In mid 2000s, Axes America reappears for advisory services with regards to M&A activities.
- * Olympus acquires Gyrus, most likely under Axes America guidance.
- * 2006: Olympus paid fees to Axes America (\$12 million in share options and warrants were also given) (see Appendix 5. 1).
- * 2008: Axes America sells options to Axam Investments Ltd. in Cayman Islands for \$24 million.
- * September 2008: Olympus goes to Axam Investments Ltd. and

exchanges preferred shares in Gyrus for share options in Gyrus (originally acquired from Axes America) (see Appendix 5. 2). * Axiom Investments Ltd. went to Olympus in November 2008 saying they needed to buy back the preferred shares of Gyrus, due to financial issues. Olympus' external auditor, KPMG, denies buyback, stating "unusually large finder's fees" (see Appendix 5. 3). * KPMG was released of their duties at Olympus and replaced by Ernst & Young who would go on to accept the buyback of the preferred shares at \$620 million (significantly higher than original \$12 million share option value). * Axiom Investments Ltd. eventually wired the money to multiple Olympus funds, helping them pay off their loans and allowing the banks to unlock Olympus' original collateral. Sources for the information above:

* Exposure: Inside the Olympus Scandal: How I Went from CEO to

Whistleblower * Investigation Report Summary (Dec. 6, 2011):

<http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf>

The Whistleblower (Michael Woodford)

* Michael started with Olympus in 1981 as a salesman.

* In April 2011 promoted to COO and president.

* Uncommon for a Japanese company to have a western (Michael was from Liverpool, UK) in charge. The Story

* Tsuyoshi Kikukawa was in charge and promoted Michael to COO and president in April 2011. * Michael quickly realized his authority as COO and president meant nothing; people were still reporting to Kikukawa (CEO at the time). * Not uncommon for Japanese business culture.

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* Michael first got word of the scandal in July 2011.

* Was sent an e-mail from a friend in Japan who had translated a Japanese article for Michael, which claimed Olympus was hiding some dirty business involving large sums of money. * The article was published in Facta magazine – uncommon journalism for Japan. * Article also left the reader hanging, telling them to stay tuned for details. * Michael knew if these facts were true, they were coming from the inside. His biggest fear was a large media outlet getting a hold of the story. * Michael knew nothing of the allegations and sent multiple e-mails to executives demanding answers (including Kikukawa). Those answers were insufficient in his eyes. * Eventually, after much dialogue with Kikukawa, Michael was appointed CEO in October 2011 at a board meeting. * He was set up, as he faced many tough questions.

* Shortly after October 11, 2011, Michael sent out a sixth e-mail demanding answers. * E-mail accused Kikukawa and others of poor corporate governance. * Unknown to the recipients, Michael had contacted PwC to look into the scandal in early October. * Following that e-mail, Michael sent one to all Olympus employees accusing Kikukawa and others of poor corporate governance and he also attached the PwC report. * After hearing of the PwC report, the board unanimously voted Michael out as president and CEO on October. 14, 2011. * From there, Michael went public talking to media outlets, police, federal agents, regulators, etc. He was now a whistleblower. * The case grew as the media picked up coverage

* Kikukawa's lies continued

* Evidence became overwhelming.

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* Olympus officials admit to the scandal.

* Olympus almost delisted.

Source for the information above:

* Exposure: Inside the Olympus Scandal: How I Went from CEO to Whistleblower

What Role Did the Auditor Play as the Fraud Unraveled?

KPMG

* Most of the unrealized losses from the speculative investing was hidden in financial derivatives * Very hard to detect; not surprising that KPMG did not discover the losses. * Fair market value of the investments was monitored based on figures submitted to KPMG from the management of Olympus. * These figures were manipulated before they were given to KPMG. * KPMG never asked Olympus' management for collateral related information when looking into foreign related bank accounts. They always took the word of the foreign banks. * Foreign banks were instructed to supply KPMG with information that would not make them suspicious * KPMG gave Olympus' financial statements an unqualified opinion even though there was a conflict of opinion over the accounting treatments Olympus made over the year. * A qualified opinion should have been given

* It is apparent that there was very little, if anything, that KPMG could have done to detect the fraud

Ernst & Young

* Ernst & Young allowed Olympus to record a questionable fee as Goodwill without knowing whether or not the fee was acceptable * Ernst & Young had

just become the auditor and did not fully understand Olympus' regular transactions * The transaction between the two auditors was mainly just a formality. Hardly any information was exchanged. * As KPMG had concerns about Olympus, Ernst & Young should have discussed concerns * Ernst & Young could have been more skeptical and potentially catch signs of the fraud * Fraud was very well concealed and still would have been difficult to uncover

PricewaterhouseCoopers

* Hired by Woodford to look into issues regarding potential fraud * " We were unable to confirm that there has been improper conduct, however, given the sums of money involved and some of the unusual decisions that have decisions that have been made it cannot be ruled out at this stage... It is important that Olympus takes appropriate steps to fully investigate and understand the acquisitions of Gyrus and the arrangement made between Olympus, AXES and AXAM and whether there are wider regulatory issues such as money laundering and, if so, considering what action and remedial steps it should take" (Exposure p. 54).

Role of Japanese Business Culture in Preventing the Auditors from Catching the Fraud * Audit fees in Japan are substantially smaller than those in North America * Auditors may not be as thorough

* Auditors lack the ability to uncover fraud, even if it's suspected * It would have been very hard for either of the auditors to prevent the Olympus fraud * Social and economic conditions

What Could the Auditors have Done to Detect the Fraud?

1) A proper assessment of the corporate culture

* Olympus' atmosphere did not allow anyone to speak up or make objections

* Employees fired for making objections

* No investigation of large fund transfers or losses

2) Ensure corporate bodies functioned as required by the Companies Act *

The large fees paid to Gyrus should have sparked sufficient discussion *

Board of Directors appeared to be more of a formality

* The BOD had become far more formality, appropriate auditor including an appropriate outside director was not elected, there was no trail of objection from the board of auditors against the company's business policy, and the top management endorsed it, and disliked to be pointed out"

3) Follow a proper succession process

* There was not enough discussion between KPMG and Ernst & Young *

Unreasonable transactions were not noticed

4) Verify that the committee functions sufficiently

* Reports were incomplete

* Committee attempted to avoid misconduct - obtained reports in line with top management's intentions

5) Ensure proper disclosures

* Olympus' disclosures were partial and fragmented

* Only minimum disclosures were present with respect to Gyrus 6) Check to see that HR rotation functions properly

- * Lack of rotation

- * Same individual responsible for the management of important assets for a long period of time

7) Red flags

- * Unfavourable industry conditions

- * Related party transactions

- * Strong foreign capital

- * Profit squeeze

- * Employees acting out of character

8) Look for unusual transactions

- * Extremely high advisory fees for the acquisition of Gyrus

9) Perform confirmations

- * There were no confirmations made regarding accounts in the Cayman Islands and the AXAM Investments Ltd. Group * There were no confirmations performed upon the creation of three new companies: News Chef, Humalabo and

Altis

Sources for the information above:

- * http://graphics.thomsonreuters.com/11/11/7733/7733_FLW.swf *

<http://www.olympus-global.com/en/info/2011b/if111206corpe.pdf>

What Happened After the Fraud?

- * Michael Woodford continued to advocate that change was needed in management * He went on to write a book about his experience at Olympus

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and was also granted a \$15 million USD settlement for being wrongfully dismissed from his position as CEO * Tsuyoshi Kikukawa was forced to resign from his position as President of Olympus * He is currently being prosecuted for his role in the fraud and faces up to 5 years in prison * Bankers involved with the fraud are facing penalties for their participation * Some bankers, such as Chan Ming Fon (Banker at Commerzbank and Société Générale) are facing trial and jail time for their roles in the fraud * Share prices of Olympus fell dramatically