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Olympus Corporation financial statement fraud case study

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Olympus Corporation, founded on October 12, 1919, by Takeshi Yamashita, is a business enterprise listed on the Tokyo Stock Exchange as a prominent Japanese optical and medical device manufacturer, with headquarters in Tokyo, Japan (Morgan & Burnside, 2014). The name Olympus is derived from Mount Olympus; the home of the twelve Greek gods. It represents the desire to create incredible merchandise.

Problem statement.

In the 1980s, countless Japanese firms skilled monetary challenges as they depended on investments to raise their declining earnings (Woodford, 2012). One of the important motives was once that the country's export had been damaged through the power of its currency against other currencies, particularly the US Dollar. Olympus became one of the number one victims of Japan's economic situation (Kuroda, 2011). Because the company was struggling with its business operations, Olympus's top management decided to use a Japanese concept known as zaitech, which refers to financial engineering in salvaging the situation (Morgan & Burnside, 2014). Consequently, the company decided to invest in risky businesses and financial derivatives

in order to boost its profits. Olympus used the receiver funds to buy shares from the target firms. Afterwards, Olympus would buy the shares from the receiver funds at inflated prices. Nevertheless, the business ventures caused huge losses of about 2.1 billion Yen in the early 1990s (Norris, 2011). This fraud used to be hidden using off-balance sheet reconciliations. Again, the company's property has been booked at historic value instead of honest market values (Morgan & Burnside, 2014).

Literature Review

Culture refers to ideals that people in a group share and that tend to survive through time, even when group membership changes (Schein & Scheiner, 2016). Corporate cultures exist in all businesses, albeit some have far "stronger" cultures than others. Particularly in a setting of competition, these cultures can have a significant impact on people and their performance (Schein & Scheiner, 2016). Olympus' board of directors (BOD) chose to hide the fraud at Olympus because the Japanese ethos of loyalty over propriety discourages internal debates and impedes efficient accounting procedures (Cohen et al., 2010).

According to Hofstede, two elements that impact business culture are power distance and uncertainty avoidance (2010). In contrast to most European businesses, most Asian firms tend to have high power distance and moderate uncertainty avoidance, according to his research on the corporate cultures of various countries. Power distance does, however, have an impact on a person's personality. Michael Woodford, the CEO of Olympus, was from a different nation and background than Olympus, yet this did not stop him from behaving morally and disclosing the fraud operations that had been hidden for the preceding thirteen years.

Developed by Jensen and Meckling in 1976, agency theory elaborates governance of a company is based on the conflicts of interest between the company's owners (Eisenhardt, 1989).

This is in line with stewardship theory which states that if managers are left on their own, they will act as responsible stewards of the assets they control (Davis et al., 1997). It was developed to study situations where managers act as stewards whose actions do not deviate from the interests of the organization (Davis et al., 1997). The theory describes the existence of a strong relationship between satisfaction and organizational success. Motivated employees will contribute positively to the achievement of the goals of organizational principals. These theories can explain how culture affects organizational behavior. The reason for choosing these theories is because the occurrence of fraudulent accounting is due to the judgment of top management only acting for their best interests and not factoring in their stakeholders and investors (Ghoshal, 2005).

Both theories emphasize principal agents and principal stewards. However, former Olympus executives hid the losses with the help of corporate auditors (Friedman, 1970). According to these theories, management is inherently intended to be a good steward of the company's assets. As a result, the stewardship idea asserts that inspiring leaders is okay. However, the structural environment in which managers operate determines organizational performance (Davis et al., 1997). In light of this, there are pressures, opportunities, and justifications when examining the variables that contribute to accounting fraud (the fraud triangle). However, beyond austerity, the inefficiencies of good corporate culture will reinforce the existence of three factors.

The Olympus case study focuses on management financial fraud (Aronson, 2012). Executives commit fraud on behalf of the organizations. They falsified financial statements at Olympus by implementing Zaiteku (loss disposition scheme), understating liabilities, and improper asset valuation (Kiradoo, 2020). The top management committed fraud to make the company appear better than it is, as well as to serve its own needs, which caused problems in the

agency (Morgan & Burnside, 2014). Other similar frauds are the Enron scandal, Parmalat, WorldCom, and Satyam, among others.

There have been numerous studies conducted to detect and predict the occurrence of financial reporting fraud. Beneish (1999) developed a model to detect financial statements that have been manipulated. Meanwhile, Spathis (2002) identified factors associated with financial reporting fraud in a study. Similarly to Beneish, the researcher compared a matched sample of fraudulent and non-fraudulent firms using financial ratios to detect fraud in financial statements. Currently, the machine learning (ML) model is useful in recognizing fraud patterns.

Large losses result from financial statements that misrepresent the company's genuine circumstances (Aronson, 2012). Over 50% of American corporations had average losses of more than US$500,000 in the year 2000. (Kranacher et al., 2011). Market capitalization has decreased by US$70 billion as a result of Enron's implosion (Kranacher et al., 2011). The 21,000 Enron employees who lost their jobs—and more significantly, their life pensions and savings—felt the impact in addition to the investors.

Such malpractices eroded public trust in the reliability and authenticity of financial statements, which is enormously expensive (Kranacher et al., 2011). It also raises regulatory costs because of increased supervision, monitoring, and control. The Sarbanes-Oxley Act of 2002, passed by the United States Congress in 2002, increased the compliance costs incurred by companies by an average of US$5.1 million (Kranacher et al., 2011). The agency cost accounts for the incremental value in monitoring and control of the company in order to improve transparency within the company.

Financial reporting fraud not only affects stakeholders but also puts professionals at risk. In this Olympus case, professionals such as accountants, board of directors (BOD) and auditors were asked about their integrity in carrying out their professional duties (Kuroda, 2011). Kenya is also not spared having also been affected by fraudulent transactions involving government

officials, and Covid-19 millionaires. In the USA, “Telemedicine schemes commanded significant attention because they involved the largest share of alleged losses — $1.1 billion — after 43 people were arrested for such offences” (Liebman, 2022). These scandals put every stakeholder at risk (Aronson, 2012). Olympus directors were arrested, risked delisting from the Tokyo exchange and destroyed their reputation.

It can be challenging for even well-known organizations to alter their corporate cultures in order to improve performance. Employers must adopt an ethics training program for their workforce in order to establish an ethical business culture and lower the frequency of financial fraud (Paine, 2000). This is crucial since a company's traits are influenced by the personalities of the individuals who make up the organization. To strengthen the ethical culture, personnel should address it. Another recommendation is to use remuneration tools to reward staff members and make them glad to work for the organization.

Case Elements.

Olympus reportedly had several decades of excellent performance before hiring a new non-Japanese Vice President, Michael Woodford, in early 2011 (Meadors, 2012). In October 2011, Woodford made headlines after he was fired from Olympus for questioning large financial deals made during the acquisition of the Gyrus Group in 2008 ($2,2 billion), and three small Japanese companies for $ 940,1 million (Morgan & Burnside, 2014). Woodford exposed the company's nefarious plans to cover massive losses totalling $1.7 billion over 20 years. The collapse of the Japanese bubble economy in the early 1990s marked the beginning of this cover-up (Woodford, 2012). He explained that Olympus used "financial engineering" to deceive investors and make it appear that the company was profitable (Coney, 2016). Michael C. Woodford said the transaction in question cost Olympus shareholders $1.3 billion in value.

Tsuyoshi Kikukawa called an emergency board meeting in reaction to the Woodford’s pesrsistent queries (Woodford, 2012). On a unanimous vote, Woodford was dismissed by the

Olympus board (Morgan & Burnside, 2014). Woodford claimed that despite knowing about the accounting firm's report, the entire board took no action. Olympus said the payments were "appropriate" and that it would form an independent panel to review its past merger payments. Woodford became a whistleblower and exposed the fraudulent dealings which led to Olympus Corporation backlash (Woodford, 2012).

Unable to hide the scheme from irate investors anymore, Olympus executives in Japan admitted that the massive payoff had been used to cover losses extending back decades. They admitted that since the bubble boom broke 20 years ago, the company deferred losses without alerting investors (Coney. 2016; Woodford, 2012). This left former Olympus chairman Tsuyoshi Kikukawa and 15 other employees accountable for large-scale accounting fraud. Kikukawa and other executives pleaded guilty in 2013 to the Tokyo District Court and were charged with suspended prison terms (Coney, 2016).

The root cause of Olympus Corporation's problems.

According to Morgan & Burnside (2014), “a corporate culture of secrets, centralized control, and a lack of transparency can provide the opportunity for fraud to be concealed” (p.176). According to Morgan and Burnside (2014), Japanese employees may be " reluctant to disclose improper behaviours of others in positions of authority " (p. 117). According to Morgan & Burnside (2014), Japanese employees are careful not to say or do anything that could lead others into problems. So, it makes sense that Olympus would disguise its huge losses by handing over worthless financial assets to shell companies and manipulating the numbers on its balance sheet.

The capacity of the CEO to choose future successors and company directors is Olympus' biggest internal control issue (Aronson, 2012). This resulted in Macro-level Management fraud due to the circumvention of the governance system, which was possible due to the independence

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of the Board of Directors (BOD) (Kuroda, 2011). Olympus long ago implemented a one-man system and an environment that discouraged internal disagreement (Ghoshal, 2005).

Lorsch et al. (2012) reveal the group thinking of Olympus board members. Another feature of Japanese corporate culture is team thinking, in which team goals are given priority over individual goals and responsibilities. This can also be attributed to groupthink, which is one of the building blocks of Japanese corporate culture (Woodford, 2012). Employees may be hesitant to disclose inappropriate behaviour by others in positions of authority. They should not do or say anything outside their position (Morgan & Burnside, 2014). Thus, the Olympus fraud remained hidden for more than a decade due to the creativity of top management, poor external scrutiny, and the national character of Japanese companies.

Olympus' corporate culture is stifling. People cannot express themselves freely (Ghoshal, 2005). The idea of individualizing the company was dominant. The internal audit team was hampered by the Japanese business culture of not disclosing inappropriate accounting techniques. KPMG questioned Olympus management about the value of goodwill on its balance sheet and huge consulting costs. After persistent questioning, KPMG discovered that Olympus had manipulated the accounting (loss disposition scheme (Tobashi) (Norris, 2011), but management found an excuse to change the auditor's concerns. Olympus replaced KPMG with Ernst & Young as an external auditor when questionable transactions were challenged. Olympus has hindered a proper audit by submitting incomplete documents and false declarations.

Possible Alternatives

The PricewaterhouseCoopers (PwC) interim report concluded that there were significant flaws in Olympus' governance on issues such as due diligence and decision-making procedures (Aronson, 2012). Management must always work for the best interests of the organization (Ghoshal, 2005). Olympus's management hid losses with aid of company auditors (Friedman, 1970).

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No single employee should be given too much control (Ghoshal, 2005). Yamada only had knowledge about the financial and audit processes. Kikukawa being a CEO and a chairman at once should not be allowed (Morgan & Burnside). It makes it easy to concealment of illegal practices within an organization. CEO and should not be the chairman (Kuroda, 2011). Hiring qualified staff and training should be done to ensure that different employees have the same knowledge. Making decisions will be aided by this. Directors should be selected externally and management replaced with prudent individuals.

Olympus and Japanese culture should encourage people to avoid secrets and report fraudulent activities (Schein & Scheiner, 2016). This can be done by encouraging teamwork. According to Thomas (2021), effective teams do not keep secrets. Changing auditors removes the familiarity threat as Olympus auditors seem not to uncover the losses as they have become conversant with the processes (Hussey, 1999). Employees can also be empowered with incentives and training. This will bridge the gap in the concealment of fraud.

Recommended Plan of Action.

A good corporate culture should encourage transparency and accountability as a way of developing genuine business entities. Improving organizations' current internal control and governance system is critical to ensuring success (Paine, 2000).

Transaction authorizations and allocation of duties.

Financial stewardship is important to the employee delegated on behalf of the company (Friedman, 1970). For day-to-day procedures, decision rules for approving transactions should be established in advance. There should be a maximum amount for internal authorizations different from authorizations exceeding one million. This will increase levels of accountability and transparency reducing illegal and illegitimate authorizations (Hillman & Dalziel, 2003).

Hideo should not have all the authority to authorize transactions. It is undesirable to have a single process under the total control of a single person (Kuroda, 2011). At the very basis of

sound corporate governance is the requirement to prevent conflicts of interest between shareholders and business executives (Kuroda, 2011). Olympus should therefore think about how independent stockholders and company executives are from one another (Cohen et al., 2010). It is advisable to put into practice the concept of separating asset custody from asset recording. This will serve as the watchdog for the prevention of fraud.

Management approach

The management should consider incorporating different management systems to be more effective (Cohen et al., 2010; Ghoshal, 2005). A democratic approach will create an environment where employees are allowed to think critically and rationally without bias (Hillman & Dalziel, 2003). Empowering employees with incentives will motivate them to be good stewards of the company. This will encourage a culture of ethical behaviours and deep business ethics (Ghoshal, 2005). To ensure this is successful, the human resource department should focus on integrity and personal ethics when recruiting. Shareholders should participate in the selection of board members, attend the annual general meeting and contribute to the decision-making (Lorsch, et al, 2012).

Corporate Culture and employee training

One of the problems Olympus had with Woodford is that he was a foreigner who was not conversant with Japanese culture, so he could not earn the loyalty of the Board of Directors like Kikukawa (Morgan & Burnside). This hindered disclosure processes as staff could not disclose anything to him (Morgan & Burnside). Cultural norms are important as they dictate what is right or wrong within an organization (Donnithorne, 2013). Management must organize training for employees in Japanese culture to smoothly integrate into the company (Schein & Scheiner, 2016). Japanese corporate culture of avoiding, denying and ignoring crisis should be eliminated.

The hiring of external BOD members

According to Aronson (2012), "only half of the publicly listed companies have outside directors" (p. 87). The majority of the BOD should be made up of outsiders to avoid the agency theory issues of management prioritizing their interests over those of the company (Kuroda, 2011). These individuals may then make decisions based on what is best for the business and its stakeholders.

Changing the mindset of the organisation

The company must focus on the morality and ethic of management, auditors and directors; reminding them of their duties to comply with the policy could be a solution. As can be seen from the view of Ghoshal, (2005), directors and auditors should protect their opinion and protest top management's decisions, which they think, could negatively affect the company. They should be prepared to risk their positions, and not quickly compromise with the board's activities that he cannot agree on. In the long term, this will bring great benefit to the cooperation. Also, when voting for leadership, it is necessary to focus on moral values and high compliance of the candidates. Moreover, encouraging employees to raise their ideas will help create a better working environment.

Reforming all systems.

Olympus should restructure its organization. For example, the human resource department can be reformed by enhancing the process of selecting personnel by concentrating on potential employees' attributes such as honesty. Auditors, as well as the BOD, should be changed to eliminate poor management issues (Ghoshal, 2005).

Change of Auditors.

A new audit department with honest professionals should be employed to identify the gaps and provide long-term solutions (Ghoshal, 2005). They should show professionalism and

trust which was missing in internal auditors. Different external auditors will reduce familiarity threats (Hussey, 1999).

Case Solution.

According to Paine (2000), ethical behaviour in companies enhances corporate value. Ethics pays in so many ways but. the reverse is also true, "unethical behaviour can destroy a company's innate value" (Paine, 2000). Olympus' unethical behaviour has already diminished stakeholder confidence, reduced stock price and investor ownership interests, resulted in potential delisting from stock markets and instigated investigations by local and foreign concerns. This is a wake-up call for corporations to improve internal compliance and ethical issues within organizations (Thomas, 2021).

Culture should be prioritized while working to improve internal controls and governance because it significantly affects how people perceive an organization. Management should be able to change approaches and train their staff on how to deal with cultural divides (Schein & Scheiner, 2016). Empowering employees will motivate them to be good stewards of the company and disclose unethical activities (Ghoshal, 2005). There will be no secrecy and group thinking will be different which will make everyone act without bias and avoiding of conflict. Olympus should ensure that their BOD has the majority of external stakeholders and no staff has a lot of power. This will reduce management fraud as all stakeholders will be working for the best interest of the company (Cohen et al., 2010).

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