xerox®

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Agenda

1. Introduction
2. Background
3. Accounting Manipulations
4. Question and Answers

1. Introduction

- Xerox Corporation was once “a star in the technology sector of economy“

- Accounting scandal in the year 2000

- 1997-2000: Overstated revenues by $3 billion
  pre-tax earnings by $1.5 billion

- KPMG responsible auditor

2. Background

- Fundamental changes in the industry:

  - Black and white → Color capable devices
  - Analog → Digital technology
  - Paper → Electronic documents

	1997	1999
=	0.35	0.53

2. Background

- No growth in revenues or earnings
- Pressure was built up by:
  - High Wall Street expectations
  - Maintain strong credit rating
  - Compensation system
- Restructuring program as an answer to challenges

3. Accounting Manipulations

Acceleration of Lease Revenue Recognition from Bundled Leases

Bundled Leases consist of: Equipment, service, supplies & financing

GAAP (sales-type lease): - Equipment revenues recognized immediately

- Non-equipment revenues recognized over term of the lease

→reallocation of revenues from finance and service to equipment

Finance activities → equipment: „return on equity"

Service activities → equipment: „margin normalization"

3. Accounting Manipulations

Acceleration of Lease Revenue from Lease Price Increase and Extensions

Renegotiation of contracts

GAAP: increases of price and length recognized over the remaining life of a lease

Xerox recognized them immediately.

3. Accounting Maipulations

Increase in the Residual Values of Leased Equipment

Cost of sales for leased equipment = equipment cost – expected residual value

GAAP: no upward adjustment of estimated residual value allowed after inception

Xerox periodically increased the expected residual value (previously recorded equipment)

→ reduction of cost of sales

3. Accounting Manipulations

Acceleration of Revenues from Portfolio Asset Strategy Transactions

Difficulties with sales lease agreements in Brazil → rental contracts

GAAP: revenues from rental contracts not recognized immediately

Xerox sold those contracts to investors → immidiate recognition of revenue

Problem: no disclosure of that approach in reports (filed with SEC)

3. Accounting Manipulations

Manipulation of Reserves

GAAP: reserves for identifiable, probable and estimable loss contigencies

Xerox: 1. Reserve for unknown business risks established

2. unrelated business expenses recorded and claimed the reserve account

→ reducing operating expenses → increasing net income

3. Accounting Manipulations

Manipulation of Other Income

Tax dispute: Xerox won a tax dispute in 1996 → taxes and interest payments on disputed amount were refunded

GAAP: Recognize the interest income in period the dispute is finalized and interest is due

→ in Xerox case: 1995 & 1996

Xerox recognized them in the periods 1997-2000.

3. Accounting Manipulations

Failure to Disclose Factoring Transactions

Cash position: Concerns about the very low cash position

(1999: **$126 millions** of cash compared to **28.814 billions** of assets)

Factoring transactions: Xerox sold future cash flows(receivables) to banks

→ immediate cash

Problem: Again no disclosure in the reports filed with SEC

4. Questions

1. Comparison of Hewlett Packard and Xerox in the period 1997-2000.

How were Xerox´s and Hewlett Packards businesses similar and disssimilar during the relevant time periods?

How did the two companies financial performance compare?

Both companies had to challenge the same competition, technology and especially the same changes in that time.

4. Questions

Revenues (in $):

Xerox:

	1997	1998	1999	2000
Revenues(in mio)	18,144	19,447	19,228	18,632
Annual growth		7.2%	-1.1%	-3.1%

Hewlett Packard:

	1997	1998	1999	2000
Revenues(in mio)	35,465	39,419	42,370	48,782
Annual growth		11.1%	7.5%	15.1%

https://www.sec.gov/Archives/edgar/data/47217/000091205701002796/a2032630z10-k.txt

4. Questions

Net Earnings (in million $):

	1998	1999	2000
Xerox	395	1,424	-384
Hewlett Packard	2,945	3,491	3,697

In the year 2000:

	Assets/Liabilites and Equity	Equity-Ratio	Cash-ratio
Xerox	$29,687 (mio)	0.12	0.06
Hewlett Packard	$34,009 (mio)	0.41	0.22

4. Questions

2. a) What responsibility does an auditor have to detect material misstatements due to error and fraud?

- Auditor has to find and disclose all misstatments
- Ensure that reports and balance sheets are completly correct and legal represented
- Auditors of KPMG haven‘t acted resposibly in that case

4. Questions

b) What two main categories of fraud affect financial reporting?

1. “Misstatements arising from fraudulent financial reporting” (SAS No. 99.06)

→ Manipulation, falsification, misrepresentation or omission of records or financial information

2. “Misstatements arising from misappropriation of assets” (SAS No. 99.06)

→Misappropriation of assets, for example: stealing assets, company pays for goods or other benefits which are destined for you

4. Questions

3. Using hindsight, indentify factors present at Xerox that are indicative of each of the three fraud conditions.

1. Incentive or „under pressure“ → reason to commit fraud
2. Opportunity for a fraud → lack of controls or ineffective controls
3. Ability to rationalize the fraud → depends on the attitude and ethical values of a person

(SAS No. 99.07)

4. Questions

1. Incentives: Compensation system of senior management linked to presented results

   Under pressure: Wall Street expectations, strong competition

2. Opportunity for a fraud: lack of controls by KPMG, they were not firm but approving

3. Ability to rationalize the fraud: Senior managers were resolute, called them „Accounting Opportunities

4. Questions

a) For each accounting manipulation identified, indicate the financial statement accounts affected.

Bundled Leases Recognition:

→greater revenues in the profit and loss statement→ greater profit/earnings

→ Bigger position of Equity or profit for shareholders through dividends

Price Increases and Extensions through renegotiations:

Basically the same

4. Questions

<u>Increase in Residual Values:</u>

→ Higher valuation of the assets (equipment) → increase in the asset position land, building and equipment

→reduction of cost of sales→ increase in the profit→ increase in equity or shareholders wealth

<u>Portfolio Asset Strategy Transactions:</u>

Effect of immediate revenues the same (like first two examples)

4. Questions

<u>Manipulation of Reserves:</u>

→ First increase of Reserves (reserve for unknown business risk)

→ Periodically reduction of that account by unrelated business expenses

→reduction of operation expenses → increase in net income

<u>Manipulation of other Income/tax dispute:</u>

→Effect of the interes payments on the other income were delayed

→ Again effect on the equity (increase was delayed)

→ Income in the years 1997-2000 again inflated

4. Questions

Factoring Transactions:

- No effect on revenues (asset exchange)

→ Cash position increased→ financial receivables decreased

Sources

Case 4.5: „Xerox Corporation: Evaluating Risk of Financial Statement Fraud“ by Mark S. Beasley, Frank A. Buckless, Steven M. Glover, Douglas F. Prawitt (2015 Pearson Education)

„Annual report of Hewlett Packard“, published by the Securities and Exchange Comission:

https://www.sec.gov/Archives/edgar/data/47217/000091205701002796/a2032630z10-k.txt

(Filing date: 25/01/2001)

„Consideration of Fraud in a Financial Statement Audit“, AU Section 316, SAS No. 99:

http://www.aicpa.org/Research/Standards/AuditAttest/DownloadableDocuments/AU-00316.pdf