ABSTRACT: This audit case examines an interesting real-life instance of financial statement manipulation by a client (Xerox, Inc.) and the related audit failure by the audit firm (KPMG). The facts of this case are drawn from several SEC Accounting Enforcement and Administrative Proceedings Releases. Learning objectives specific to this case include an increased awareness of the importance of reserves, including when their use is appropriate or inappropriate; better understanding of the role of a concurring partner; improved perception of when departures from GAAP are improper; a heightened awareness of the importance of professional skepticism; the identification of audit risk factors; exposure to International Financial Reporting Standards (IFRS); and identification of illegal acts by a client's management.

Keywords: Xerox; KPMG; accounting reserves; concurring partner; capital leases; audit quality; professional skepticism.

We have determined that certain accounting practices including some that involve complex accounting issues, which we had previously believed to comply with generally accepted accounting principles (GAAP), in fact, misapplied GAAP. In addition, we have made period adjustments to certain previously recorded charges for errors and irregularities resulting from the accounting issues in Mexico. The impact is a cumulative reduction of common Shareholders' Equity and Consolidated Tangible Net Worth of $137 and $76 million, respectively. Amendments to revenue in each of the three years 1998–2000, were insignificant. (Xerox 2001a)

INTRODUCTION

The above statement appeared in a letter sent to shareholders along with Xerox Inc.’s (hereafter referred to as Xerox) 2000 Annual Report. In reality, when the dust had finally settled, it was determined that the errors and irregularities encompassed far more than accounting issues in Mexico. In July 2002, Xerox issued a restatement that resulted in a decrease of revenues of over $3.8 billion and a decrease in pretax earnings of $1.2 billion for the period 1997–2000 (SEC 2002a). These errors and irregularities ultimately cost Xerox, six Xerox executives, Xerox’s independent auditors, and five partners of the auditing firm nearly $800 million in penalties, interest, and settlement of a class action shareholders’ lawsuit.

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Editor’s note: Accepted by Kent St. Pierre.

1 The material presented in this case was drawn from several SEC accounting and auditing enforcement releases, litigation releases, and administrative proceedings; since some of the information from these sources is overlapping, references provided in the text of this case will be to the primary source where the information was located.

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MAKING THE NUMBERS LOOK GOOD

Xerox is the leading manufacturer of photocopy equipment in the world. Over the years, Xerox developed many new products and became known for its high-quality products. In its 2000 Annual Report, Xerox reported annual sales of $18.7 billion. Xerox was ranked 87th in the Fortune 500 and had 92,500 employees worldwide (CNNMoney.com 2000). Xerox, like many technology companies, faced significant competition from overseas, especially in Japan, in the late 1990s. They faced competition in the copy machine business from the likes of Canon, Minolta, and Ricoh. Because of the increased competition, Xerox was confronted with declining revenues, which should have led to lower than expected earnings (SEC 2005a).

Failing to meet the investment community’s expectations can have a dramatic negative impact on the price of the company’s stock. It appears that Xerox’s senior management was obsessed with meeting quarterly earnings expectations (SEC 2002a). According to complaints filed by the SEC in 2000, Paul Allaire and G. Richard Thoman (each of whom were the CEO during portions of the period investigated by the SEC), and Barry Romeril, the CFO, set a negative “tone at the top” (SEC 2003a). This tone measured the success of Xerox by the company’s ability to meet analysts’ expectations. This meant meeting quarterly earnings targets estimated by stock analysts and reported by First Call, a service that reports a consensus earnings projection based on estimates prepared by various analysts (SEC 2005a).

Xerox, as shown in Figure 1, met or exceeded First Call’s estimated quarterly earnings in every quarter for the period 1997–1999. As is also shown in the chart, if Xerox had not resorted to various accounting devices (i.e., manipulation schemes), the company would have missed the quarterly estimates in 11 of the 12 quarters. Senior management knew about these schemes, and kept track of each of these manipulations to quantify their impact on the corporate financial results.

The manipulation schemes initially added only a penny or two to the quarterly earnings per share. At their worst, however, these schemes added 30 cents per share to the fourth quarter of 1998 earnings per share, and 61 cents to the 1998 annual earnings per share. In the fourth quarter of 1998, 36 percent of the earnings per share came from the accounting devices. Management referred to the process of manipulating the quarterly earnings per share as “closing the gap” (SEC 2005a).

Cookie Jar Reserves

Over the years, Xerox developed a “cookie jar” of financial reserves that were released into income, as needed, to meet quarterly expectations. During the period 1997–1999, Romeril, Philip Fishbach, Xerox’s corporate Controller, and Daniel Marchibroda, the Assistant Controller who reported to Fishbach, released $415 million of reserves held in the cookie jar to “close the gap” between actual results and analysts’ expectations (SEC 2003a). Gregory Tayler, who served in various capacities of Xerox management during this time, participated in the release of $100 million of these reserves. Exhibit 1 summarizes the key personnel involved in this case for both Xerox and KPMG.

Reserves were tracked on schedules prepared by employees in Fishbach’s office. Marchibroda and Fishbach reviewed these schedules quarterly and released the reserves, as needed, to meet the projected earnings for the quarter. Romeril received copies of these schedules as well as schedules prepared by the independent auditors that tracked the reserve balances on a quarterly and annual basis. The “cookie jar” contained 22 reserves (SEC 2005a), including:
The Rank Reserve. In 1997, Xerox purchased the remaining 20 percent interest that the Rank Group plc held in Rank Xerox Ltd., making Xerox the sole owner. At the time of the purchase and at KPMG’s suggestion, Romeril, Marchibroda, Fishbach, and Tayler created a $100 million reserve for “unknown risks” related to the purchase. However, the Rank Group had indemnified Xerox for any liabilities resulting from the sale, making this reserve unnecessary. In addition, KPMG U.K., which had performed the due diligence for Xerox before the purchase, had assessed the tax exposure related to the purchase as remote to low. Romeril, in notes he had made about the purchase, acknowledged that the unknown risks were remote. However, with the encouragement of KPMG, Xerox established the reserve. Starting in mid-1998, Xerox began charging unrelated expenses against this reserve each quarter until the reserve was depleted at the end of 1999.2


- The Rank Reserve. In 1997, Xerox purchased the remaining 20 percent interest that the Rank Group plc held in Rank Xerox Ltd., making Xerox the sole owner. At the time of the purchase and at KPMG’s suggestion, Romeril, Marchibroda, Fishbach, and Tayler created a $100 million reserve for “unknown risks” related to the purchase. However, the Rank Group had indemnified Xerox for any liabilities resulting from the sale, making this reserve unnecessary. In addition, KPMG U.K., which had performed the due diligence for Xerox before the purchase, had assessed the tax exposure related to the purchase as remote to low. Romeril, in notes he had made about the purchase, acknowledged that the unknown risks were remote. However, with the encouragement of KPMG, Xerox established the reserve. Starting in mid-1998, Xerox began charging unrelated expenses against this reserve each quarter until the reserve was depleted at the end of 1999 (SEC 2005a).

2 The Rank Group plc is a leading European gaming business company. It is organized as a public limited company, with headquarters in the United Kingdom.
Vacation Pay Accrual Reserve. In 1993, Xerox changed its corporate vacation policy by limiting the amount of vacation an employee could carry over to subsequent periods. By the end of 1996, this policy change had resulted in an over-accrual of $30 million. Instead of releasing this reserve immediately, Xerox released $7.5 million in each of the four quarters of 1997. In June 1998, this reserve had an additional $41.9 million balance from vacations not taken. Rather than release it all in the second quarter, Xerox released $23.4 million in the fourth quarter of 1998 and the remainder in the first quarter of 1999 in order to "close the gap" on earnings (SEC 2005a).

FAS 106 Reserve. This reserve, which relates to post-retirement benefits, was created in 1993 when Xerox adopted FAS 106. At the end of 1996, this reserve had an excess balance of $40 million. Rather than release the reserve and recognize the income in 1996, Xerox management released the reserve at the rate of $5 million per quarter at the end of each of the quarters of 1997 and 1998 (SEC 2005a).

The Whiskers Reserve. This reserve had been on the books so long that Xerox could not identify what it was for or produce any documentation to support its existence (SEC 2005a). Rather than eliminate the reserve immediately, Romeril, Fishbach, and Marchibroda used it to increase 1997–1999 income by $31 million (SEC 2003a).

Most, if not all, of the reserves maintained by Xerox to manage earnings were reviewed on a quarterly and annual basis by KPMG’s audit partners. According to the SEC complaint, these reserves were identified in KPMG work papers as “unspecified excess” reserves or as “opportunities” (SEC 2005a).

Return on Equity and Equipment Leases

Certain types of leases were considered sales-type leases; accordingly, GAAP required the revenue from the sale of such equipment to be immediately recognized as earned. The revenue

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EXHIBIT 1
Xerox, Inc.
Key Personnel

Xerox

Fishbach, Philip. Xerox Controller until his retirement in April 2000.
Romeril, Barry. Xerox CFO from 1993 through December 2001, Executive Vice President from 1997 through early 1999, and then Vice Chairman.

KPMG

Conway, Michael. Most Senior Partner of KPMG’s Department of Professional Practice, Senior engagement partner for 2000 audit.
Dolanski, Anthony. KPMG engagement partner for the 1997 audit.
Yoho, Thomas. KPMG concurring partner for the 1997–2000 audits.
from the equipment portion of the lease was to be recognized immediately; but the revenue from the service, supplies, and financing portion of the lease had to be recognized over the term of the lease. The amount of revenue that should have been immediately recognized was the fair value of the equipment (FASB 1976, 1978).

In 1997, Xerox switched to a different methodology because management felt that the allocation being used was misleading. A new approach was developed, rather than determining the fair value of the equipment, a GAAP requirement. The company determined the value of the ancillary items and backed into the fair value of the equipment. The company set a maximum return on equity (ROE) of the ancillary services, regardless of the ROE used to determine the monthly lease payment. As a result, excess ROE was shifted to the fair value of the equipment, causing immediate revenue recognition. The corporate treasury department along with Romeril, Fishbach, Marchibroda, and Tayler regularly adjusted the ROE. In some cases, the ROE rate used was lower than the three-year Treasury Bill rates. In other instances, the rate was lower than the corporate 30-day borrowing rate. The change in methodology and subsequent changes in the ROE factor resulted in the acceleration of $2.2 billion in revenue recognition and $301 million in pretax earnings increases for 1997–2000 (SEC 2003a).

Audit partners at KPMG were aware of the manipulation that Xerox made to the underlying assumptions of ROE. The audit firm also accepted Xerox’s claim that they were unable to directly calculate the fair value of their products. KPMG, in effect, signed off on each accounting adjustment without testing or requiring Xerox to test whether the results were accurate.

KPMG Canada stated in 1997 that the model of ROE was “not supportable” and posed an “unnecessary control risk with regard to accounting records.” KPMG Brazil expressed concern for the accounting practice in both 1997 and 1998. KPMG identified a $40 million audit difference in connection with the use of a 6 percent discount rate in Brazil (the market rates exceeded 20 percent at that time). KPMG did not require the client to record any adjustment to its books in connection with the difference. Two years later, KPMG Tokyo objected to the ROE formula’s use by Fuji Xerox because the formula “did not match the actual status” of Fuji’s business and no procedures had been performed to determine if it might (SEC 2005a).

Despite these objections, KPMG accepted the representations of Xerox’s management as justification for the procedure. The appropriate degree of professional skepticism was not evident in the actions of KPMG’s engagement team. In connection with a special investigation ordered by Xerox’s Audit Committee in 2000, the true purpose of the ROE formula became apparent. Xerox used the ROE lease calculations to retroactively “close the gap” between actual and planned financial results (SEC 2005a).

**Profit Margin Normalization**

If the ROE adjustments failed to achieve the desired result, management would dig deeper into their manipulation toolbox and pull out the “margin normalization” device. Although it sounds complicated, the way margin normalization worked was relatively simple. The operating units would report their results, and management would make the ROE adjustment (SEC 2002a). Management would review the consolidated results and make a “topside adjustment” to reallocate the profit margin differential from service to equipment so that the consolidated results met the profit margins for service and equipment that were identical to those of the United States. This meant movement of revenues from service, which had to be deferred, to the equipment, which was recognized immediately. This resulted, for 1997 through 2000, in additional revenue recognition of $617 million and additional pretax earnings of $358 million (SEC 2005a).

It was noted in KPMG’s audit partner’s work papers that margin normalization was a high-risk accounting practice. The audit team noted that with respect to margin normalization, “in our
view, central adjustments of this nature should be strongly discouraged. We would also expect this change to be fully implemented at a local level by the end of 1998” (SEC 2005a).

KPMG U.K. noted in their local working papers in 1997 that margin normalization carried a “high risk of significant misstatement...were potentially arbitrary...based on little hard evidence.” Consequently, Xerox restricted KPMG U.K. from discussing margin normalization adjustments with local Xerox management (SEC 2005a).

In 1998, KPMG U.K. informed KPMG’s U.S. audit partners that margin normalization was an area for audit adjustment due to the lack of support for the procedure and because the practice was being used as a vehicle for managing earnings. The U.K. office told KPMG that Xerox was “playing follow the leader— whoever has the highest sales margins being the leader” when Xerox applied a margin differential based on U.S. leases. An unidentified U.S. audit partner agreed with the KPMG U.K. work papers stating, “In the absence of objective evidence of fair value pricing, I am concerned that there is too much judgment applied in the process, and the habit of periodic adjustment of the formula when needed is driven by the wrong motives” (SEC 2005a).

During the 1999 audit, KPMG Brazil reported to a U.S. audit partner that there were sufficient stand-alone service contracts in Brazil to calculate actual margins on service, rather than accepting margins based on U.S. leases. Xerox’s headquarters told the Brazilian auditors that they were wrong and that they were not to discuss the practice of margin normalization with local Xerox personnel. Consequently, by the end of 1999, Xerox had imposed restrictions on KPMG’s discussions about margin normalization with local staff in both Brazil and Europe (SEC 2005a).

KPMG acknowledged that the use of the margin normalization practice, combined with the ROE model, could result in a “significant accounting surprise.” The audit partner’s completion memo for the 1999 audit noted, “The accounting was at risk because of the absence of objective data to support Xerox’s assumption—that relative margins around the world should be comparable to U.S. margins.” Safran told the most senior partner of the audit firm’s Department of Professional Practice (DPP), Michael Conway, that the client’s proposed expansion of the practice to countries that were in Xerox’s developing markets organization in 1999 was “half-baked revenue recognition” (SEC 2005a).

Safran also told both Conway and Charles Boyle, the relationship manager for the 1999 and 2000 audits, that KPMG had a “professional obligation” under GAAS to communicate his concerns to the Xerox Audit Committee. At the next meeting of the Audit Committee, however, none of these concerns were raised and Safran signed off on the 1999 audit without qualification (SEC 2005a).

Anthony Dolanski was the engagement partner for 1997. Because KPMG had a policy of replacing audit engagement partners every five years, Ronald Safran replaced Dolanski as engagement partner for the 1998 and 1999 audits. After the 1999 audit, Xerox complained about Safran’s performance as engagement partner to the Chairman of KPMG. As a direct result of the complaint, Safran was replaced three years before his term was over (SEC 2005a).

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3 This restriction was, in effect, a scope limitation placed on obtaining audit evidence; if considered significant, a qualified audit report should have been issued as a result of the scope limitation; and if considered to be highly significant, a disclaimer of opinion could have been expressed.

4 It should be noted that the case gives only the SEC’s point of view, since, as previously noted, the majority of the facts and circumstances presented in the case are drawn from SEC enforcement releases, litigation releases, and enforcement proceedings. Accordingly, Xerox’s management team and the auditors would likely have different perspectives and alternative points of view from those presented in the case. Readers should bear in mind that following GAAP often requires assumptions to be made and involves judgment regarding complex issues. Similarly, auditors use professional judgment to determine the materiality of amounts related to the audit, auditing procedures to be performed, etc.

5 This infers that there was a five-year rotation policy in place for the audits of public companies, even though the Sarbanes-Oxley Act, which requires such a policy, had not yet been passed.
Michael Conway was the senior engagement partner for the 2000 audit. KPMG U.K. warned him in April 2000 that Xerox Europe “has little empirical data to evidence commercial sales prices or service rates” and that the use of margin normalization “might override/disguise genuine commercial trends” (SEC 2005a).

In October of 2000, Conway sent the Xerox Audit Committee an analysis of Xerox’s revenue allocation methods. The analysis did not mention the skepticism of KPMG U.K., and accepted, without question, management representations that the margin normalization model was appropriate (SEC 2005a).

In spite of the numerous concerns raised by KPMG members in both the United Kingdom and Brazil, the risks and concerns documented by KPMG’s audit partners in the United States, the limitations on audit scope imposed by Xerox in the United Kingdom and Brazil, the apparent absence of any testing by Xerox or KPMG to determine whether the use of margin normalization resulted in recognizing the fair value of the equipment at the inception of the lease, and the lack of evidence to support the assertion that margin normalization corrected distortions of revenue allocations, KPMG issued unqualified opinions for audits from 1997–2000. Thomas Yoho was the concurring partner for the Xerox engagement from 1997–2000. He signed off on the clean reports (SEC 2005a).6

Price Increase/Lease Term Extensions

Xerox also improperly accelerated revenue recognition due to price increases and lease period extensions. GAAP requires, in most cases, that additional price increases and term extensions be recognized over the remaining lease period. Xerox chose to recognize the revenue immediately. From 1997 thru mid-1999, this action resulted in overreporting $300 million in revenue and $200 million in pretax earnings (SEC 2002a).

Xerox’s management knew this practice violated GAAP. In a memo to Marchibroda, the Assistant Controller, in February 1999, Tayler (as Director of Accounting Policy) informed him that the company was violating GAAP (SEC 2005a).

Conway, Yoho, Boyle, and Safran (KPMG’s partners) were also aware of these violations of GAAP, no later than the first quarter of 1999. When Xerox was confronted about this material deviation from GAAP, the client’s management asserted that despite the differing requirements of GAAP, Xerox’s accounting treatment was appropriate since it was “pragmatic” and “a fairer representation of the results” of its business (SEC 2005a).

KPMG’s Safran told Xerox that on a “going forward” basis the treatment should conform to GAAP’s requirements. This position was also communicated to Xerox’s Audit Committee in a meeting that included the CFO of Xerox after the close of the first quarter of 1999 (SEC 2005a).

Instead of discontinuing this practice, Xerox arbitrarily reduced the amount of adjustment to an amount that would be quantitatively immaterial to KPMG (less than 5 percent of Xerox’s consolidated profit before tax). Thus, KPMG knew that Xerox recognized $84 million of non-GAAP equipment revenue, which resulted in a $68 million increase to pretax earnings. This was approximately 14 percent (not 5 percent) of first quarter pretax earnings in 1999.7 Using this practice, Xerox recognized an additional $47 million of equipment revenue and $32 million in pretax earnings in the second quarter of 1999 (SEC 2005a).

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6 It should be noted that the Public Company Accounting Oversight Board (PCAOB) was not yet in existence during this period; in 2009, the PCAOB issued Engagement Quality Review, Auditing Standard No. 7, which gives specific guidance regarding the role of a concurring partner.

7 At the time of this case neither Interim Financial Information, SAS 100, nor the PCAOB’s Engagement Quality Review, Auditing Standard 7, had been issued; these standards include guidance on materiality judgments for interim (quarterly) financial information.
The practice continued into the second half of 1999, until Safran insisted that the $89 million of equipment revenue earned in the third and fourth quarter be reversed. Xerox’s Latin American operating units continued with the practice into 2000 but, because of an Audit Committee investigation, was required to reverse the 2000 adjustment (SEC 2005a).

**Residual Value Increases**

Xerox’s management also manipulated the residual values of the leased equipment. GAAP requires the establishment of an estimate of the residual value of equipment at the inception of the lease. Once established, FAS 13 (as amended by FAS 23) prohibits any adjustment to the value of the equipment. Nevertheless, Fishbach and Marchibroda established a corporate policy that permitted upward adjustments (SEC 2002a). From 1997 through 1999, Xerox adjusted the estimated residual value of equipment leased by its operating units in Europe, Brazil, Argentina, Mexico, and the United States. In some instances, the adjustment would increase the residual value by 50 percent. The overall impact was a $95 million overstatement of revenues and an overstatement of earnings of $43 million during 1997–2000 (SEC 2005a).

Safran informed Yoho and Boyle in 1999 that he believed that this violation of GAAP heightened the risk of fraud in the financial statements. In addition, KPMG’s legal counsel advised Marchibroda that the practice was unacceptable, but Marchibroda persuaded KPMG to accept the practice anyway. KPMG did not require Xerox to change this practice, or disclose this departure from GAAP in the footnotes (SEC 2005a).

**THE SEC AND INVESTORS SPEAK**

On April 11, 2002, the SEC filed a civil action against Xerox in the U.S. District Court for the Southern District of New York (SEC 2002b). The complaint charged that Xerox had violated the Securities Act of 1933 and the Exchange Act of 1934. Specific charges were that:

1. Xerox knowingly violated these laws by failing to disclose the impact of all of the accounting devices discussed above. Theses accounting actions:
   a. Increased 1997–2000 pretax earnings by $1.5 billion;
   b. Failed to disclose that between 4 and 37 percent of quarterly pretax earnings, and between 19 percent and 29 percent of annual pretax earnings came from these actions;
   c. Increased equipment sales revenue by over $3 billion and significantly increased quarterly gross revenues;
   d. Resulted in false periodic reports filed with the SEC, including 12 quarterly reports, four annual reports, and seven registration statements;
   e. Caused a misleading portrayal of meeting analysts’ projections for each quarter from 1997 to 1999; and
   f. Painted a false appearance that the 1999 financial statements had a positive cash balance, when in fact, they would have had a negative balance if the manipulative transactions were excluded;
2. Xerox failed to disclose certain leasing practices related to the sales-type leases; and
3. Xerox failed to maintain a system of internal controls that permit the preparation of financial statements in accordance with GAAP (SEC 2002b).

On June 5, 2003, the SEC filed a complaint against the six Xerox executives (Allaire, Thoman, Romeril, Fishbach, Marchibroda, and Tayler; SEC 2003b). The specific charges against them were:

8 The Sarbanes-Oxley Act was not cited in the allegations by the SEC, since it was not in effect during the time frame of the case.
1. All six executives failed to disclose the impact that ROE and margin normalization transactions had on the reported financial results;

2. Romeril, Fishbach, Marchibroda, and Tayler knew that the ROE and margin normalization violated GAAP;

3. Romeril, Fishbach, and Marchibroda knowingly failed to disclose the material impact the residual value adjustments, price increases, lease extensions, the use of the cushion reserves and the accounting method used for tax-related income had on the financial results. They also knew these transactions did not comply with GAAP; and

4. Allaire, Thoman and Romeril made false statements about the company’s performance in public disclosures including releases to shareholders and analysts (SEC 2003b).

On October 3, 2003, the SEC filed an amended complaint against KPMG and the five partners connected to the Xerox audit (Boyle, Conway, Dolanski, Safran, and Yoho) (SEC 2003c). The specific charges were:

1. KPMG and the partners knew that for each year, 1997–2000, in which they were responsible for the Xerox audit, Xerox’s annual report was false and misleading, and their publication constituted a scheme to defraud;

2. The five partners aided and abetted KPMG’s violations of securities laws by permitting Xerox to represent that KPMG had concluded in its audit that internal controls were satisfactory, when the defendant partners knew that no controls were in place to prevent or correct topside adjustments by Xerox to reach revenue and earnings targets;

3. KPMG, Dolanski, Safran, Conway, and Boyle did not report likely violations to the Xerox Audit Committee or take other steps required by statute when Xerox management and its board failed to correct the violations;

4. KPMG, Dolanski, Safran, Conway, and Boyle aided and abetted Xerox’s violations of not filing factually accurate annual and quarterly reports and not including additional information expressly required to be included to make the required statements not misleading; and

5. KPMG, Dolanski, Safran, Conway, and Boyle aided and abetted Xerox in violating requirements that Xerox make and keep books, records, and accounts that accurately and fairly reflect the transactions and dispositions of assets of the issuer.

In addition, several class action lawsuits were filed on behalf of stockholders against Xerox and KPMG.10

EPILOGUE

Xerox settled the fraud suit with the SEC on April 11, 2002. Without admitting or denying the SEC allegations, Xerox agreed to a $10 million fine and to restate company earnings from 1997–2000. Xerox also agreed to have the Board of Directors appoint a committee comprised only of outside directors to review the company’s material internal accounting controls and policies (SEC 2002a).

The six Xerox executives charged in the SEC suit settled with the SEC on June 5, 2003. As a group, they paid a total of $3 million in civil penalties. They were also required to surrender nearly $14.4 million in stock profits and bonuses and another $5 million in interest. Fishbach and Marchibroda were also required to relinquish $177,000 in deferred bonuses plus interest. In addition, the SEC imposed a permanent officer and director ban against Romeril, a five-year ban

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9 As previously noted, the time periods included in the SEC allegations preceded the requirements of the Sarbanes-Oxley Act. Accordingly, the requirement for management and the independent auditor to separately opine as to the effectiveness of internal controls over financial reporting was not yet in effect.

10 One example of the class action lawsuits can be seen in Carlson v. Xerox et al. (2008).
against Allaire and Fishbach, and a three-year ban against Thoman. Finally, Romeril was permanently suspended from practicing before the SEC as an accountant; Tayler was suspended for three years with the right to apply for reinstatement after the three-year period (SEC 2003a).

On April 19, 2005, the SEC announced a settlement agreement with KPMG (SEC 2005c). KPMG was required to forfeit to the SEC $9.8 million in audit fees it received from Xerox for 1997-2000, pay $2.675 million in interest on the forfeited audit fees, and pay a $10 million civil penalty. In addition, KPMG was required to institute reforms to audit procedures and policies to prevent future securities law violations (SEC 2005a). Included in the reforms were:

- Requirement for examination of a client’s justification for GAAP departures;
- Requirement for work paper documentation of consultations with individuals outside the audit engagement team;
- Requirement to review and document the reasons for changing an audit engagement partner; and
- Requirement to establish a “whistle blower” process within KPMG so an engagement team member can anonymously express concerns about an audit (SEC 2005c).

The five KPMG partners settled with the SEC by February 26, 2006. Safran and Conway were each fined $150,000—the largest penalty ever imposed by the SEC on an individual auditor. Dolanski and Boyle were each fined $100,000. All four were prohibited from practicing before the SEC. Safran can apply for reinstatement after three years, Conway after two years, and Dolanski and Boyle after one year. Yoho was censured by the SEC (2005b, 2006).

Additionally, all KPMG partners were permanently enjoined from violating the federal securities laws that requires reporting likely illegal acts to a company’s audit committee, its board of directors, and ultimately the commission (Section 10A of the 1934 Securities Exchange Act; SEC 2005b, 2006).

On March 28, 2008, Xerox and KPMG settled a class action lawsuit filed on behalf of Xerox investors. Xerox agreed to pay $670 million and KPMG agreed to pay $80 million.

Xerox changed its independent auditor to PricewaterhouseCoopers beginning with the 2002 fiscal year. KPMG had been Xerox’s auditors for approximately 40 years. KPMG had received $26 million in audit fees and $55.8 million for non-audit services for the fiscal years 1997 through 2000. The vote of the stockholders approving the change in audit firms was approximately 654 million votes for and approximately 15 million votes against (Xerox 2001b).

QUESTIONS

1a. What is meant by the terms “Cookie Jar,” “Rainy Day,” or “Piggy Bank” reserves?
1b. Under U.S. GAAP, when is it appropriate to accumulate reserves, including those for contingent liabilities?
1c. What is the appropriate treatment for an accumulated reserve that is no longer necessary? (Provide authoritative support for your answers to 1b. and 1c.).
1d. How does accounting for contingent liabilities under International Financial Reporting Standards (IFRS) compare to U.S. GAAP?
2a. What may have motivated the auditors to allow Xerox to perpetrate this fraud?
2b. Is KPMG guilty of violating the public’s trust? Defend your position.
3. What is the appropriate action, or series of actions, for an audit firm of a publicly traded company that becomes aware of illegal acts of the client’s management?

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11 Readers who are interested in reading the exhibit entitled “Changes in Registrant’s Certifying Accountant” included in Xerox’s Form 8-K can do so online at http://sec.gov/Archives/edgar/data/108772/000010877201500018/0000108772-01-500018.txt.
4a. Xerox’s management asserted that the departures from GAAP were justified. What type of opinion should auditors issue when there is a justified departure from GAAP?

4b. What type of opinion should auditors issue when there is an unjustified departure from GAAP? (Provide authoritative support for your answers to 4a. and 4b.).

4c. Should an audit firm be required to validate the propriety of these types of departures? Defend your answer.

5. Did the KPMG team exhibit the appropriate degree of professional skepticism in its audit of Xerox, Inc. during the fiscal periods noted in the case? Defend your answer, providing specific examples from the case.

6a. A major criticism of the engagement partners was that they did not exert adequate pressure on Xerox to change the illegal accounting practices. What methods of exerting pressure should an audit partner use to avoid exposing the audit firm to litigation liability?

6b. An “Advisory Committee on the Auditing Profession” has issued a Draft Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury, available at: http://www.federalregister.gov/articles/2008/05/15/E8-10818/draft-report-of-the-advisory-committee-on-the-auditing-profession (Advisory Committee on the Auditing Profession 2008). Among other things, one of the recommendations of the report is that the SEC amend Form 8-K disclosure requirements to notify the PCAOB of any premature engagement partner changes on public company audit clients. If this requirement had been in effect during the time period of this case, what effect may it have had on the replacement of Safran as partner after only three years? (Your answer should include a discussion of arguments both for and against the proposed disclosure of a premature change in audit engagement partners.)

7a. The engagement partners of KPMG received warnings from other KPMG offices in New York, Canada, Brazil, Europe, and Japan. Concurring partner review requirements were in place at the time of this case for audit firms that were members of the AICPA’s SEC Practice Section. Further, subsequent to the events described in this case, the PCAOB issued Engagement Quality Review, Auditing Standard No. 7 (PCAOB 2009). Discuss the key provisions of this standard, and how the implementation of a proper “concurring partner” review could have potentially averted the Xerox, Inc. crisis.

7b. What processes, procedures, or safeguards other than a concurring partner review should an audit firm implement to limit the firm’s exposure to litigation liability?

8. KPMG and Xerox both faced criminal charges initiated for violating Rule 10b-5 of the Securities Exchange Act of 1934. What does a violation of this rule mean? Your answer should include an explanation of the concept of scienter and of gross negligence and the relationship of these concepts to Rule 10b-5.