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Xerox Corporation is a document management company that manufactures, sells and leases document imaging products, services and supplies. They are based out of Norwalk, Connecticut and currently do business in over 160 countries. They were founded in 1906 in Rochester, New York as The Haloid Photographic Company ("Articlesbase"), and their first products were manufactured photographic equipment and paper. In 1959, they invented and manufactured the first plain paper photocopier in the world, which really put Xerox on the map. This photocopier would increase their revenues by over \$500 million within the first six years of its creation ("Articlesbase"), making Xerox a staple in the photocopy business for the next 50 years. Within the next 10 years, they would go on to create the first ever desktop copier, laser printer and color copier which would contribute to helping Xerox become the standard when it came to photocopying. They were even the first company to invent the computer mouse and the first Graphical User Interface (GUI), combining them to create the Xerox Alto, the first personal computer ever created ("Articlesbase"). Unfortunately for them, they couldn't see the sales potential of the computer and wanted to focus their company on the photocopying business, so they agreed to let Apple use their GUI and mouse technology as they went on to build their personal computer systems. In the late 80's and early 90's, Xerox added a services division to their company after management changed their focus to realigning the product line and improving the quality design of their products. The service was known as a "complete document service" ("Articlesbase") as they provided companies with supplies, maintenance and user support of all copiers their clients would buy or lease. By the late 1990's, they were the

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largest supplier of photocopier machines in the world. Unfortunately, this wasn't enough to meet the expectations placed on Xerox by analysts, so from 1997-2000 they orchestrated accounting manipulations to increase their earnings, margins and revenues, making their company worth a whole lot more than it actually was. In the mid 1990's, Xerox was losing a big portion of their revenues from stiff competition faced in foreign markets as well as personal desktop printers. So, the CEO, CFO and other important executives decided to paint a façade of their financial statements for investors to look at, making them believe that Xerox was doing better than they ever had. They did this by claiming they were increasing their revenues and earnings every quarter from the first quarter of 1997 until the last of 2000, which allowed them to exceed Wall Street's expectations every single reporting period during that time frame. Unfortunately they became more and more dependent on these fraudulent methods in order to attempt to "close the gap" between their actual financial results and what was reported to investors ("Xerox Accounting Scandal"). By the end of 1998, undisclosed changes to their historical estimates and practices made up almost 37% of all of their 'reported' earnings. Xerox senior management and executives used a number of tools in order to increase their earnings and revenues without actually earning anything. The most significant method they used to commit this fraud was to accelerate the recognition of their leasing revenues through non-GAAP accounting. Xerox would lease products to companies and then recognize all of the revenues made from the sale as soon as the contract was signed in the current period, instead of spacing the revenues out over the time period specified by the lease as GAAP suggests. GAAP states that companies are to only recognize the payments owed to them in

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the current period as revenue, not the entire sale in the same period ("Xerox Accounting Scandal"). By Xerox using accounting methods they called "one-time actions or one-offs" ("Civil Action No. 02-272789 (DLC)"), they were illegally accelerating their recognition of equipment revenue by over \$6 billion while increasing their earnings by another \$2 billion over the 4 year span this was occurring. This method alone made it almost impossible for them to continuously meet their future expectations and would hurt them in the long run. Now, if they are using all these accounting methods and estimates that are not sanctioned by GAAP, why didn't the auditors catch them as soon as they started changing their historical accounting practices? Their auditor at the time this fraud was occurring and for the 40 years prior to this was KPMG. KPMG and Xerox had a fantastic working relationship throughout that time and KPMG didn't want anything to change, especially the \$82 million in auditing fees they would bring in over the 4 year span the fraud was occurring ("Xerox Accounting Scandal"). Because of this, KPMG didn't say a word about the fraudulent financial statements and instead just collected their paychecks. Their relationship with Xerox was so comfortable that whenever the lead KPMG engagement partner would challenge Xerox's use of non-GAAP accounting practices, Xerox executives would tell KPMG they wanted a new engagement partner and the firm would comply without question. Other accounting methods they used to mislead investors include: overstating earnings using "Cookie Jar" reserves and interest from tax refunds, improper increases in the residual values of leased equipment, acceleration of revenue from portfolio asset strategy transactions and failing to disclose factoring transactions. Xerox used "cookie jar" reserves with various accounts, including Accrued Vacation pay and post retirement

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benefits reserve (FAS 106), to overstate their earnings in the late 90's by almost \$500 million (" Civil Action No. 02-272789 (DLC)"). They also increased the residual value of their most of their leased machines by up to 50% more than they should've been. They made many of these residual value adjustments near the ends of the quarters and ended up increasing the residual value of these machines by over \$95 million, solely from 1997-1999 (" Civil Action No. 02-272789 (DLC)"). Another method they used to meet expectations was to accelerate their revenue from portfolio asset strategy transactions by selling the revenue streams from their portfolios of leases to investors, which allowed them to immediately recognize the revenue from those transactions in the current period. In doing this, Xerox pulled forward over \$400 million solely in 1999 (" Civil Action No. 02-272789 (DLC)"). Also in 1999, they also failed to disclose factoring transactions of over \$288 million, which allowed the company to report a positive cash balance at year-end. When looking at the financial statements and all of these departures from GAAP as a whole, we see that these methods not only heavily misstated their revenues, margins and earnings, but also lead to a significant departure from past accounting estimates methods, while misleading investors into thinking the company was worth much more than they actually were. Why carry out these manipulations when the extra money earned in one year would have to be subtracted from future years? This was necessary because corporations are under enormous pressure from Wall Street investors to keep up short-term earnings (representing the incentives/pressures third of the fraud triangle). Otherwise, their share values will drop, which not only threatens companies heavily reliant on share values to finance debt, but also has financial consequences for top

executives, whose astronomical incomes are bound up with stock options. The SEC investigation noted " compensation of Xerox senior management depended significantly on their ability to meet [earnings] targets." Because of the accounting manipulations, top Xerox executives were able to cash in on stock options valued at an estimated \$35 million (In mid-1999, Xerox stock peaked at \$60 a share, in 2013 they're worth \$8. 65). These stock options were the main motivation of executives and senior management to use non-GAAP accounting methods that would allow them to make their revenue and earnings just slightly exceed the expectations given to them by Wall Street each quarter, thus increasing the value of the stock held by management. Senior management was a key part of the fraud considering they were informed of everything regarding the accounting actions taking place and they were using these non-GAAP methods on purpose in an attempt to close the gap between the financial expectations and the actual financial statements of Xerox. Throughout this time, there were many occurrences of managers protesting the use of these methods because they knew their investors were being misled, however no manager ever came forward before the fraud became known to the public (" CNN Money"). Senior management also always reassured their investors and analysts that their performance would continue to improve and analysts never questioned that since their financial statements had been audited by the " big five" firm KPMG without any indication of wrongdoing. This made KPMG another main player in the Xerox fraud since they never blew the whistle on Xerox for these non-GAAP principles that clearly lead to material misstatements on the financials. They allowed Xerox to ' cook the books' and fill a \$6 billion gap in revenue as well as a \$2 billion gap in pre-tax earnings (" Xerox Accounting <https://assignbuster.com/the-data-analytical-procedures-finance-essay/>

Scandal"), as well as use all those historical accounting methods not allowed by GAAP, which means KPMG represents another third of Xerox's fraud triangle, opportunity. The final third of the fraud triangle is the rationalization factor, which is evident as senior executives thought that the non-GAAP recognition of revenue would just be a short-term thing and eventually fixed in the long run. Some of these senior executives were very important to the success of this fraud, especially Paul Allaire (CEO), G. Richard Thoman (COO) and Barry Romeril (CFO). Allaire was responsible for rebranding Xerox from a photocopier leasing business into "The Document Company", increasing their range of products and services. He did this because personal computers and virtual documents took off, decreasing the need for photocopiers but increasing the need for other products and services he added to Xerox's product line ("Litigation Release No. 18174"). He served as CEO of Xerox from 1990 until Thoman succeeded him in 1999. Allaire hired Thoman as CFO in 1997 after he was the President and COO of IBM in prior years. Thoman became CEO in 1999 but stepped down after just one year amid all the fraud coming to the surface. Romeril was the CFO from 1993 until 2001 and also served as an executive vice president from 1997 until 1999 ("Litigation Release No. 18174"). Midway through 1999, Xerox management realized that they couldn't continue to recognize income at the rate they were. Their revenues were starting to heavily drop, mainly because all the deferred revenue from leases and sales that should have been recognized in these periods had already been recognized in the past, leaving them with no revenue to recognize in those periods. Their illegal accounting actions of the past made their current reported results suffer and they couldn't meet the financial expectations of Wall Street, leading them to their eventual downfall.

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All the fraud finally came to the eye of the SEC in May 2000, when Xerox made a public announcement that they had discovered accounting irregularities in its Mexico office (" CNN Money"). One month later, the SEC launched an investigation into Xerox, starting with the Mexico office but expanding their investigation to the US, specifically looking at how the company accounted for the leasing of their equipment (" CNN Money"). After a two-year probe, civil fraud charges were filed against Xerox. The investigation, starting in mid-2000, was conducted by the SEC and did not end until April 2002 when charges were filed against Xerox in the U. S. District Court for the Southern District of New York. For the two years, the investigation was headed by Stephen Cutler, Director of Enforcement for the SEC. Other key players in the investigation for the SEC included Charles D. Niemeier, Chief Accountant for the Division of Enforcement, and Paul R. Berger, Associate Director of Enforcement. After Xerox's internal investigation uncovered irregular accounting practices in their Mexico division, the SEC dug further primarily using review of internal documents. This was the only procedure they really needed due to the clear departure from GAAP on the financial statements of Xerox. The SEC reviewed both the long-term and short-term lease contracts of the company and concluded that their accounting for them did not comply with GAAP. They were accelerating revenue recognition from their long-term leases when they should have been recognizing those revenues over a period of time. The SEC found their " smoking gun" when they uncovered internal documents that recorded discussions among top officials concerning ways to manipulate accounting to allow the company to meet Wall Street expectations. They actually found that executives were calculating the exact amount of additional earnings

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that would need to be altered in order to allow the company to meet or slightly beat those analyst expectations. For example, in 1997, the analyst estimate for Xerox's earnings was \$1.99 per share. If the company had followed GAAP like they should have, earnings for that period would have been reported at \$1.65/share. Xerox calculated exactly how much they would need to alter their revenue from leases and other accounting manipulations and they eventually did so just enough to beat the estimate and report earnings per share of \$2.02 for that year (Kay, 2002). In addition to the investigation into Xerox internal documents, the SEC took a look at the corresponding KPMG documentation. Internal communications found at KPMG indicates that the auditors knew exactly what was going on at Xerox with respect to the departure from GAAP and allowed it to continue. A document from KPMG had a partner acknowledge that Xerox was performing "half-baked revenue recognition". Although once the auditor that was in charge of the engagement brought up concerns regarding the departure from GAAP, they were replaced by KPMG with another auditor (Kay, 2002). In our opinion, if we were the investigating party, there is not much that we could have done differently. One thing that could have prevented or ultimately detected the fraud on the SEC's part would be the review and oversight of the KPMG auditors. Oversight and review of the auditor's documentation would have indicated early on that Xerox was incorrectly applying GAAP to their financial statements and in turn, KPMG was allowing this to happen and incorrectly giving the financials clean audit opinions. Review over the KPMG audit by the SEC could have recognized that Xerox was incorrectly recognizing lease revenue as well as their development of cookie jar accounts. The fraud may have also been detected by the

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investigators by performing a simple swing calculation. It becomes suspicious when a company consistently meets or just beats analyst expectations for a considerable number of quarters back to back. The use of a swing calculation could have possibly detected the fraud sooner and not allowed it to continue for the span of four years. The data analytical procedures that could have been used in order to detect this fraud include a swing calculation, recognition of hockey stick patterns, and manual journal entry examination and testing. As talked about before, a swing calculation would calculate the difference between an analyst estimate for earnings per share for a quarter and the reported earnings per share for the quarter by the company. When a company just meets or barely beats estimates quarter after quarter and year after year, this is a clear red flag that they may be managing earnings in order to keep their stock price at a consistent level or to keep it rising. Hockey stick patterns are another red flag indicator of earnings management. Hockey stick patterns show a consistent level of revenues or income through a quarter until at the end of the quarter when there is a large or unusual uptick. Management of Xerox was calculating how much additional revenue was needed in order to meet or just beat those analyst estimates and then recording top side journal entries from their "cookie jar" reserves at the end of the quarter in order to do so. This relates to another procedure that could have been performed, testing of those top side or manual journal entries. Testing large or unusual journal entries may have exposed even more red flags that may have uncovered the fraud. Large journal entries at the end of each quarter would have been a clear indicator of fraudulent revenue recognition. Examples of unusual manual journal entries that would have raised suspicion include journal entries made

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by top executives, back-posted journal entries, entries made late at night or on a weekend/holiday, and any entries with "restate" or other unusual descriptions. These data analytic tools would have made it extremely easy for an auditor or investigator to uncover that Xerox was managing their earnings and fraudulently reporting their financials. At the end of the two year investigation into Xerox, the situation was ultimately resolved in April 2002 with a settlement between the United States and Xerox in which the company neither admitted nor denied the fraud allegations brought about by the SEC. Xerox was fined \$10 million which was, at the time, the largest fine for fraudulent financial reporting. The company also had to restate their financial results from 1997-2000 in addition to an agreement to conduct a further audit and special review of their accounting controls ("Civil Action No. 02-272789 (DLC)"). Xerox was forced to sell off assets, renegotiate its credit line at higher interest rates, and lay off thousands of workers in order to cut costs (Kay, 2002). In our opinion, the fraud was corrected, for the most part, in the proper way. The financial results of Xerox clearly needed to be restated for the years of fraudulent reporting and an audit of their controls over accounting would hopefully prevent an event such as this from occurring in the future. On the other hand, we acknowledge that the \$10 million fine was the largest at the time for a fraudulent financial reporting matter, but this is just a slap on the wrist for the company when compared to the difference of \$6 billion and \$2 million false amounts reported for revenue and income, respectively. The consequences of the case is that the federal regulators charged six former Xerox Corp. executives, including two past chief executives, with securities fraud Thursday and extracted more than \$22.4 million in penalties to settle the case. The key player involved in this

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case are Former Chairman and CEO, Paul Allaire, Former Chief Financial Officer, Barry Romeril and KPMG partner, Michael Conway, in a statement reported that they are the main person whom in charged by the SEC way back year's of 1999." The six were accused of participating in an elaborate effort to boost revenues and earnings over four years to allow the company to meet Wall Street earnings estimates."(Andrew Countryman, 2003)

Spokeswoman Christa Carone said " because the six were not found guilty of any wrongdoing--they settled the case without admitting or denying the allegations--the company's bylaws require it to pay most of the penalties".

The six former executives will be responsible for a combined \$3 million in fines, but Xerox will pay \$14. 4 million in disgorgement of stock-sale profits and performance bonuses and just over \$5 million in interest. The company already had disclosed that it would pay \$4. 8 million in legal fees and other expenses for the former officials. (Andrew Countryman, 2003)Among those settling were former CEOs Paul Allaire and G. Richard Thoman, who agreed to penalties totaling a combined \$15. 5 million in fines, disgorgement and interest. Allaire agreed to be barred from serving as an officer or director of a public company for five years, while Thoman received a three-year ban.

(Andrew Countryman, 2003)The new guidelines should be adopted on constituting director independence. Proactively integrated Sarbanes-Oxley Act and proposed NYSE rules into their governance processes. Moreover, The board of directors' committees should have a more revised and strengthened the charters. A comprehensive Whistleblowers Act to provide wide-ranging protection for whistleblowers can help encourage whistle blowing. Xerox scandal indicates it is necessary to change its corporate governance system, regulations on accounting professions and analysts as <https://assignbuster.com/the-data-analytical-procedures-finance-essay/>

well as regulators. The values and ethical behaviors of these board directors have continuously been called into question. The motivation of these individual to commit the fraud is to acquire personal interest. Because of the senior executives' individual failures and greed, they distorted the financial statements. Their immoral decision on their company impacted the all parties with interests in the company. The top management used unethical practices to ensure that the accountant of the Corporation is able to make up the financial statement reporting. In order to show the public that the company was on a good position, the top management manipulated the accounting practices no matter how much it needs to cost. This is the main reasons lead to the accountant in that organizational unable to perform as an independent parties. Accountants are required to adhere to strict and highly complex professional standards. However, The auditors just followed the command from the top management with misleading accounting practices. The highly visible accounting scandal in Xerox Corp showed us one significant fact: the most important two parts: the corporate governance and internal controls is failed in the corporations. As we all known, the most serious fraud are usually committed by insiders, among whom those executives figure prominently who are assigned to manage and control their organizations. After the scandal happened, corporations are now focus on the effectiveness and efficiency of their boards of directors can be implemented. As a result, Xerox Corp has made a good progress on corporate governance and control issues arising from the company's experience. In order to ensure the effectiveness of corporate governance, the company should hold regular executive sessions of outside directors without Xerox management present, launched a massive effort to strengthen

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internal controls, train their people, and apply a clear and strong Code of Conduct. The independent board and auditor is the best safeguard to prevent committing fraud, no laws or policies will ever be sufficient to end all corporate misbehavior. Fraud has a negative impact on the whole society. It can reduce the degree of faith in the integrity of senior managers, erosion in the confidence in the free market system, including its political institutions, processes, and leaders, and a general growth of cynicism in a society. The failure of accounting firms to detect managerial fraud has also led to less faith in audited financial statements. Worse still, many believe that the accounting firms have compromised their own integrity because of the lure of lucrative consulting contracts from firms they were auditing. In Xerox's case, their auditor, KPMG complied with management at Xerox to allow the accounting irregularities to continue. The negative impact of Xerox's fraud was that Xerox has laid off thousand of workers in the past two years and may make further retrenchments in the future. The primary reason of the scandal is the failure of the board of direct. It is perceived that most of the fraud was committed by top management. The final result is to cause more and more people to question the ability and integrity of the board of directors. At the same time, shareholders and senior executives suspect whether their wealth can be protected well. In summary, corporation needs to comply the conduct of code and ensure independent accountants exist.