A Fraud Case As Reported through SEC Documents: Revisiting Its Relevance in Today's Regulatory Environment

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This case highlights accounting manipulations, in areas of reserves and lease accounting, as viewed through SEC documents related to the KPMG audit failure of Xerox 1997-2000. Referenced online citations provide flexibility in the use of the case. We present the original causes and eventual consequences, and update for enacted changes in auditing standards and authoritative guidance, including current efforts to address lease accounting in the IFRS and US GAAP convergence. A set of questions are included; teaching notes contain the actual outcome of the case. The case is appropriate for anyone who wishes to review a well-documented audit failure.

CASE OVERVIEW

This audit failure case reviews readily available evidence from SEC Administrative Proceedings and Litigation Releases that indicate there was plenty of blame to go around for the parties: Xerox and KPMG. The case events from 1997-2000 are viewed in the actual historical context as well as recent changes in authoritative pronouncements and Sarbanes Oxley. The eventual outcome in terms of penalties to the company, audit firm, and all related parties are discussed, as the investor lawsuit finally settled in 2008. The evolution of accounting and auditing guidance updates related matters, and a discussion illustrates how inherent complexities within the situation enabled the fraud. The case is set forth with questions proposed by each section, and concludes with a set of teaching notes with answers for interested readers to review the context of this fraud.

BACKGROUND

History of Xerox

Xerox Corporation, while incorporated in New York, is headquartered in Norwalk Connecticut, and competes in the industry of document management technology and services (Xerox, n.d.). It offers leading technology in digital systems including color, black and white printing, publishing systems, digital presses, copiers, and fax machines. Beginning in 1906 in Rochester, NY, the company's rebound from heavy R& D costs was slow; but in the 1960's revenues increased into the millions due to the introduction and prominence of the model 914, first demonstrated to the public via television Sep. 19,

1959. This revolution in the industry was the first plain paper photocopier (Xerox timeline, n.d.). Investors of the company benefitted handsomely in this timeframe.

The industry market for Xerox remained competitive, particularly with international market developments. In the 1990's competitive factors increased, and Xerox began to have trouble sustaining revenue growth. The emphasis was on making benchmarked goals, using lead competitors as benchmarks. In addition, Wall Street placed great emphasis on the company to reach certain goals, or else suffer a severe decrease in value (SEC No. 3-11905, April 19, 2005). Such high competition and pressure led Xerox officials to turn to fraudulent and manipulative reporting practices. to conceal the true financial performance from 1997 to the year 2000. In 2002, an initial SEC complaint was issued against Xerox (SEC Civil Action No. 02-272789, April 11, 2002). Company management had used measures to accelerate the recognition of equipment revenue by over $3 billion and increase pretax earnings by around $1.5 million (SEC Immediate Release 2005-59, April 19, 2005). Misstatements and violations were enabled by the external audit firm KPMG, who was lax in its audit.

The Environment

From 1997-2000, in response to competitive pressures, Xerox enacted several "topside" accounting actions in order to increase reported revenue and build a more favorable representation of the company. A red flag is evident in the discussion of events and facts which depicts the impact of the change in accounting treatment from the historical treatment for each quarter and year during that time period (SEC Administrative Proceeding File No. 3-11905, April 19, 2005). The accounting changes show that the earnings per share consensus estimates 'get met' to the penny through such manipulations (SEC Civil Action No. 03-CV-0671, para. 28- 29, January 29, 2003). It is important to note that KPMG had been Xerox's auditor for forty years and a "cozy" relationship existed (Morgenson, April 20, 2005). While familiar with the accounting used by Xerox, KPMG auditors allowed several departures and manipulations of GAAP to occur. "By 1998, nearly three out of every ten dollars of Xerox's annual reported pretax earnings and up to 37 percent of its reported quarterly pre-tax earnings came from undisclosed changes to its historic accounting practices and estimates" (SEC Litigation Release No. 18174, June 5, 2003).

> Question 1. What is meant by the term "topside" accounting actions? In general, what audit procedures would assist in detecting these actions?
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> Question 2. Since the time of these events, Sarbanes Oxley has enacted changes oriented to prevent "cozy" relationships. What are some of the changes?

METHODS OF COOKING THE BOOKS

Role of Capital Leases

For equipment leases, Xerox said it was unable to assign a fair value to the equipment sold under a sales type lease as required by FAS13; however, it had figured a fair value for other leases of similar nature in the past. The leases included the bundling of the equipment (the box) and financing, service and repairs, which previously had been accounted for on a consistent basis until 1997. In 1997 when growing competition levels necessitated higher revenue levels, Xerox management devised a formula to "calculate" the value for reporting in which manipulations could be easily executed. At no time did Xerox test the accuracy of the formula and method of valuation.

Furthermore during this time, Xerox increased the amount of lease revenues reported immediately at the beginning of a lease while, correspondingly, reducing the amount recognized over its lifetime. Company managers enacted two separate types of manipulations pertaining to this area that both employed subjective and unreasonable methods for estimating revenues. The first method was the Return on Equity Method while the second method was the Margin Normalization Method.

Return on Equity Method (ROE)

Xerox began to manipulate the ROE model in order to discount lease payments at a finance rate that did not relate to the market interest rates, the financing of Xerox, or the actual price of the equipment sold (SEC No. 3-11905, page 12, April 19, 2005). These manipulations were carefully orchestrated to ensure that financing operations did not generate more than 15% of the ROE to avoid increased suspicion and questioning.

Such low discount rates, some even below Xerox's own incremental borrowing costs, became apparent to the KPMG auditors in comparing operational markets. However, Xerox's management defended the use of such rates and made the argument that relying on operational markets was setting the rate too high. To solidify this point with the auditors, Xerox employed its marketing department to find and present rates to the auditors that were no more than two or three percentage points different from its own.

KPMG accepted Xerox's claim's of impossibility of calculation without further inquiry. The auditors signed off on the procedures related to the test of the ROE calculation without testing or requiring others to test the accuracy of the claims. KPMG's Rochester office and other foreign firm members had warned members of the Xerox audit team as to the potential problems and deviations involving topside adjustments. Specifically, a KPMG partner from the Rochester office wrote a letter to the President of Xerox Corporation explaining the departure from GAAP, the needed changes, and recommendations for implementation. Xerox management disregarded the letter, and KPMG auditors did not attempt to make sufficient follow-up. KPMG Canada and Brazil were among the first entities to challenge the ROE practice, but the practice ensued and was not further investigated, tested, or communicated.

Question 3. Discuss the adequacy of management representation as audit evidence.

Question 4. Discuss using a COSO control perspective, any deficiencies in KPMG's attitude. Include any relevant auditing and/or quality control standards that pertain.

Margin Normalization Method

In response to the highly competitive nature of the industry's markets in the 1990's, Xerox found that its margins declined as foreign market competitors were able to offer lower prices. In response, Xerox turned to manipulate its margin through "margin normalization" of the equipment portion in countries below the US margin, (not complying with GAAP) and created artificially high revenues and earnings for Xerox. Margins were manipulated to present management's wishes for improved company performance instead of transparently revealing the true amounts. Xerox took this method of manipulation further by retroactively applying the allocations. This action accelerated revenues into current reporting periods instead of properly waiting until future reporting periods. Manipulations were such that they "did not accurately reflect economic realities as recorded directly by those [foreign] regions at the inception of the lease" (SEC No. 3-11905, page 16, April 19, 2005).

KPMG knew of Xerox's use of margin normalization since the company had implemented its use; however, KPMG incorrectly accepted the company's representation that it could not reasonably estimate the true value. To compound matters, Xerox made last minute changes to procedural methods in order to limit the auditors' ability to review the changes (SEC No. 3-11905, page 17, April 19, 2005). KPMG made no substantial effort to test the methodology of the margin normalization. The KPMG audit partner continued to receive warning information pertaining to the use of this process from other foreign segments; however, even with these warnings, none of the entities, even while taking note of the issues involved, enacted any action against the policies.

In the next year's audit (1998), KPMG faced the same issues with margin normalization as had been present in 1997. Finally the audit partner identified the issue as one needing adjustment due to past warnings and pressures received from other segments of KPMG. The true level of manipulation on the part of Xerox to stay ahead of the competition was coming into full light.

KPMG failed to enforce a remedy to this issue and in 1999 the Brazilian KPMG auditors were told by Xerox that "the Brazilian auditors were wrong and that they were not to discuss margin normalization with local Xerox personnel" (SEC No. 3-11905, page 18, April 19, 2005). The KPMG auditors complied with this request. The U.S. audit partner for 1998 and 1999, Ronald Safran, went to KPMG's relationship partner for Xerox in addition to KPMG's senior partner within the Department of Professional Practice ("DPP"), Joseph T. Boyle, with concerns of the practice and of the continued last minute changes that Xerox continued to enact to the process. The DPP told the audit partner to follow GAAS and take the concerns the Audit Committee; however, no such follow through transpired (SEC Civil Action No. 03-CV-0671 (DLC), January 29, 2003). KPMG continued to bend to the will of the officers and management of Xerox. After Xerox complained in 1999 to KPMG's chairman about Ronald Safran's questioning on the KMPG audit engagement, KPMG, instead of investigating the issues involved, prematurely replaced the audit partner on the Xerox engagement.

Michael A. Conway was the new partner assigned to the 2000 Xerox audit; he was warned by several related KPMG entities of the potential problems and high risk of margin normalization. In his own audit however, he only required that Xerox restate the retroactive application of the practice. KMPG "abandoned professional skepticism and failed to perform audit procedures to assess whether margin normalization resulted in recognizing the fair value of the equipment at the inception of the lease…Xerox never demonstrated --nor did KPMG require it to demonstrate-- how margin normalization corrected any distortions of revenue allocations" (SEC No. 3-11905, page 20, April 19, 2005).

> Question 5. The matter with leases described is very technical in nature. Does the complexity of the matter constitute a risk factor? What other real world factors may have complicated the situation?
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> Question 6. Personnel worldwide were trying to alert others within the audit firm to improprieties. When presenting, they were either ignored (as in the case of Mr. Rochester in the previous section), or they were told to remain silent. Address in your opinion, the options that an individual has in trying to speak truth to power. Next, what are the costs and the benefits of speaking up? What options existed at the point that the Brazilian auditors were told that they were wrong and not to discuss the matter with client personnel?
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> Question 7. Read the actual account of lease manipulations (page 10 to page 21) from the Accounting and Auditing Enforcement Release No. 2234 in the matter of KPMG: Administrative Proceeding No. 3-11905, U.S. Securities and Exchange Commission. Located at www.sec.gov/litigation/admin/34-51574.pdf. Your professor will advise you of additional updates in terms of lease accounting that you should consider in addressing the issues.

Other Lease Shenanigans: Extensions, Residual Values, and Portfolio Asset Strategy

Xerox manipulated revenue with acceleration techniques of prices increases and extension of leases from 1997 to the third quarter of 1999 for a net impact of $58 million dollars even after reversals and adjustments (SEC No. 3-11905, page 20, April 19, 2005). This was in violation of GAAP with price increases and lease extensions negotiated earlier than the end of the lease term, but immediately recognized before the old established lease term had passed. Additionally, Xerox did not disclose such changes as required by FAS 5. Instead, KPMG regarded the practice as an immaterial misapplications while Xerox insisted that such a practice was appropriate and fair. Eventually, in 1999 the lead audit partner communicated the violations associated with this practice to the Chair of the Audit Committee; however, Xerox's reaction was not to stop the practices, but only to reduce the amount to ensure that it continued to be immaterial (less than 5% of profit) to KPMG (SEC No. 3-11905, page 20, April 19, 2005). In the third quarter of 1999, Xerox US finally stopped this practice due to increased pressure from KPMG, but the foreign segments, particularly those in Latin America, continued the practice. In 2000, KPMG insisted that the audit committee enact a special investigation of the practice in all worldwide segments and correct the financials. No retroactive corrections resulted but current year (2000) representations were corrected.

Xerox also manipulated to increase residual values of leased equipment between 1997 and 1999 in several of its operating units, some up to 50% of the value, in order to achieve a more favorable balance sheet presentation (SEC No. 3-11905, page 21, April 19, 2005). Many of these write ups occurred near the end of the quarter in order to reach benchmarked goals. KPMG was well aware of this practice during the 1997 to 1999 period.

Xerox accelerated revenues further through engaging in Portfolio Asset Strategy transactions in which it sold rights to future revenue streams from existing leases. These rights were sold at deep discount in order to meet immediate short term goals and benchmarks. Under GAAP, Xerox would have recognized the revenue stream over the life of the leases, but such a practice led Xerox to immediately recognize increases in revenue. While such transactions were engaged to some degree prior to 1999, the majority of the manipulation occurred throughout the year in 1999 and existed as a vital way to meet the year's benchmarks. Such transactions were also coupled with a change in business model, particularly with Xerox-Brazil, to a rental contract model from a sales-type lease model. KMPG was aware of the manipulations but took no corrective actions.

Role of Creative Reserve Accounting

Xerox manipulated the creation and use of reserves continually through 1997 to 2000. Such manipulation allowed Xerox to create a "cushion" to meet benchmarked targets. Specifically, Xerox established a reserve of $100 million when purchasing a European subsidiary, Rank Xerox Inc. The reserve was for "unknown risks" (SEC No. 3-11905, page 23, April 19, 2005) while KPMG's audit partner promoted the reserve even though proper evaluation of the tax situation revealed associated risk as "remote to low". Further, Xerox depleted the reserve for unrelated expenses, labeling this an "interdivisional opportunity". KPMG did not require disclosure of the reserve; nor did it require adjustment or restatement.

Beyond the Rank reserve, 20 other reserves existed that totaled in amount to $396 million and were manipulated to gain more favorable earnings between 1997 and 2000. Controller staff tracked this with schedule labeled "List of unencumbered and other reserves" or "Interdivisional opportunities" (SEC No. 3-11905, page 23, April 19, 2005). Such reserves are examples of creative accounting. For example, a FAS 106 reserve existed when no further post retirement benefit liabilities existed; and a "Whiskers Reserve" remained on the books that had been there so long that no one in the company even knew what is was for, nor was there any type of supporting documentation for the reserve. KMPG knew of the actions occurring and continued to allow them. Instead of questioning the manipulation and lack of disclosure, the auditors simply classified it as "unspecified excess reserves" or "opportunities" in the work papers (SEC No. 3-11905, page 24, April 19, 2005).

The Role Played by the Concurring Audit Partner

An inadequate concurring partner review by Thomas J. Yoho contributed to the overall audit failure. Yoho failed in maintaining proper skepticism and care while "in-depth" review and documentation procedures were undertaken. Although Yoho had conducted an investigation focusing on areas of manipulated practices and concerns as raised by workers, Yoho did not (beyond a telephone conversation) pursue documentation of concerns that surfaced. Yoho did not follow up on missing work papers. Also the partner responsible for reviewing the work at the KPMG Rochester office had stated that ROE policy put in place several years earlier had not been subjected to annual testing to determine if topside adjustments were appropriately handled (SEC Administrative Proceeding File No. 3-12215, page 5, February 22, 2006). Yoho's brief report did not disclose the issues that had arisen. KPMG gave unqualified opinions to Xerox for 1997-2000.

> Question 8. Discuss where KPMG failed to comply with GAAS. What GAAP violations are noted in this section?

Question 9. What changes in GAAP and GAAS have been implemented since these events unfolded?

Question 10. Assume that you were the SEC Commission who must determine the type of punishment. Who in your opinion is most culpable and what punishments would you consider?

TEACHING NOTE

Case Objectives

- To review the lease aspects of the fraud, and current updates in the joint FASB and IASB project.
- To understand the "creative accounting" techniques of reserve manipulation.
- To evaluate whether then-existing audit standards were utilized.
- To understand the various provisions of Sarbanes Oxley (which was not in effect at the time of the case events).
- To understand audit standards and GAAP enacted since the events of the case.
- To comprehend the role of complexity in obscuring salient issues in decision making.
- To provide an opportunity for deliberation of ethical issues in which students role play circumstances where instructed to ignore their better judgment.
- To expose students to SEC Administrative Proceedings, litigation releases, and complaints, including the resulting sanctions and penalties that can ensue.

Methods of Classroom Use

The case is intended for use primarily as classroom discussion. However, in some courses, the sections of the case might be appropriate to include as a comprehensive assessment exercise, to test student knowledge. Alternatively, the case could enable written analysis or subsequent research by teams or individuals. Any of the sections or questions may be emphasized or eliminated to enhance the instructor's specific objectives, without overall detriment. The reference page might separately be provided to students if the learning objective was to facilitate student's ability to research SEC documents.

Suggested Answers to Case Questions

(Note: the actual penalties and outcomes of the case are included within the answer to Question 10)

Question 1. What is meant by the term "topside" accounting actions? In general, what audit procedures would assist in detecting these actions?

"Topside" is the manipulation of accounting practices to close gaps between actual operating results and results reported to the investors. There are two chart illustrations in the Administrative Proceeding that depict this exact annual match where the actual EPS figures meet the forecast to the penny for 1998 and 1999 (SEC No. 3-11905, April 19, 2005). For earlier quarters, the estimates were either met or surpassed.

Audit procedures to facilitate detection and awareness include understanding the client, which includes analytical procedures in the preliminary phase of the audit. Such analysis for those two years does not yield many obvious red flags, but is still a required auditing procedure in the planning phase of the audit, and may be appropriate for those professors who wish to emphasize this. In looking at the quarterly changes in revenues, acceleration of revenues for the fourth quarters of both 1996 and 1997 is obvious (with hindsight). Overall risk assessment is imperative in being aware of the possibility of schemes. Attention to appropriate cutoff is one procedure aimed at this type of manipulation. Fraud brainstorming as currently required by SAS 99 is helpful to alert staff to improper actions that might be relevant.

Question 2. Since the time of these events, Sarbanes Oxley has enacted changes oriented to prevent "cozy" relationships. What are some of the changes?

Sarbanes Oxley Act of 2002 provisions to increase independence is the primary discussion point. This includes improvements in the role of the audit committee, mandatory audit partner rotation, and the cooling off period related to subsequent employment with clients. An overview of SOX major provisions include more complete internal controls (Section 302), assessment of internal controls (Section 404), tighter penalties for violators of established accounting practices, while concentrating on violators of SOX (Section 802), and enacting criminal penalties for violations (Title XI, Section 1107). The Act established more involvement of the audit committee, which would have added both more independence and safeguards in relation to the Xerox audit (Title III). Additionally, there was a mandate for more disclosure (Title IV). Whistleblowing and an anti-fraud attitude became mandated by the Act (Title VIII). The Sarbanes Oxley Act further increased the responsibility of a company's head fiscal officers, as it required signatures in certification of disclosure. The SEC further enforced such messages of increased responsibility by issuing a Final Ruling on this requirement (SEC Release Nos. 33-8124, 34-46427, IC-25722, August 30, 2002).

Question 3. Discuss the adequacy of management representation as audit evidence.

Management representation is internal evidence and is not sufficient. Overall, KPMG failed to perform audit procedures and testing to obtain sufficient competent evidence that the ROE was both a necessary and appropriate means of reporting revenue. Proper professional skepticism, given the high risk of the area, was not employed.

Question 4. Discuss using a COSO control perspective, any deficiencies in KPMG's attitude. Include any relevant auditing and/or quality control standards that pertain.

COSO, released in 1992, was only a few years old at the time of this case, and the internal control directives were not fully integrated into the Xerox audit. KPMG simply accepted the claim by Xerox management for the need for changes in accounting methods without considering the issues related to control environment (example: the tone at the top). Aspects of risk assessment were missing from the audit. Information and communication systems broke down within KPMG. Monitoring and follow-up techniques were not consistently used within the audit firm. The basic quality control elements associated with SQCS 2-6, which were in place at the time, did not appear to be operating.

Consider in today's environment the PCAOB inspection process and inspection report that specifically addresses the firm's quality control aspects. Under the current quality control standard SQCS7 effective January 1, 2009, basically every element of quality control was absent. These currently include: leadership responsibilities for quality within the firm (the "tone at the top"), relevant ethical requirements, acceptance and continuance of client relationships and specific engagements, human resources, engagement performance, and monitoring.

Updated auditing standards seek to enhance audit effectiveness and efficiency while integrating elements of the COSO framework. SAS 115 issued in October 2008 and effective October 2009 replaces SAS 112 from 2006 and the much earlier SAS 60. SAS 115 sets standards and guidelines dealing with communicating internal control related matters identified in an audit. Such communication was absent in the Xerox audit and duly noted by the SEC in its undertakings. Thus, SAS 115 attempts to establish preventive control of increased communication.

Question 5. The matter with leases described is very technical in nature. Does the complexity of the matter constitute a risk factor? What other real world factors may have complicated the situation?

Leases and financing arrangements are a complex area. Research has indicated that SOX 404 disclosed that material weaknesses have been attributed to situations involving complex structures and arrangements (Zhang and Pany, 2008). The new risk auditing standards lend some guidance and caution. Additional aspects related to human nature apply: complexity in terms of human ability to comprehend the matters being discussed, being able to fully grasp the nuances, and the emotional reaction of "saving face" are a few barriers to full understanding. The incentives held by different parties in terms of client retention issues and long-standing relationships are relevant factors. The international dimension of communicating across time zones and with individuals of different cultures contributed to complications. The time element and scheduled audit hours are relevant factors from a cost benefit standpoint in the goal to achieve full understanding. Also the human dimension related to conflict avoidance for situations with disagreements between auditors and clients is notable, as something that individuals, unless trained for, are ill equipped for and might tend to avoid conflict-prone situations.

Question 6. Personnel worldwide were trying to alert others within the audit firm to improprieties. When presenting, they were either ignored (as in the case of Mr. Rochester in the previous section), or they were told to remain silent. Address in your opinion, the options that an individual has in trying to speak truth to power. Next, what are the costs and the benefits of speaking up? What options existed at the point that the Brazilian auditors were told that they were wrong and not to discuss the matter with client personnel?

This question opens the door for discussion of ethical decision making. This includes consideration of alternatives and the tradeoffs and consequences that exist in every action taken, or not, by an individual. Several ethical models might be discussed. For example, see the excellent free resources of seven different ethical models from the Markkulla Center for Applied Ethics at St. Clara University in the Silicon Valley. These materials are accessible online, but also include separate pdf files for the models. http://www.scu.edu/ethics/practicing/decision/ The AICPA Code of Conduct is clearly relevant. Also relevant to the discussion are aspects of the culture inherent with a large firm; what are students' perceptions of the norms of behavior in large audit firms. In this case involving international dimensions, there are challenges that ensue in multinational communication (time zones, different economic realities, different accounting standards, various cultural norms and taboos). Classroom options include discussion, demonstration through role play, or analysis through written reflection.

Question 7. Read the actual account of lease manipulations (page 10 to page 21) from the Accounting and Auditing Enforcement Release No. 2234 in the matter of KPMG: Administrative Proceeding No. 3-11905, U.S. Securities and Exchange Commission. Located at www.sec.gov/litigation/admin/34-51574.pdf . Your professor will advise you of additional updates in terms of lease accounting that you should consider in addressing the issues.

If used in a Financial Accounting or Theory course, extensive analysis of the lease concepts is relevant. FASB and IASB have been working jointly on leases, and issued an exposure draft in 2010, that generated much comment. Students can be directed to the websites for either or both organizations to review the matters that were considered, as well as the final outcome of accounting treatment in this area.
http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB%2FFASBContent_C%2FProjectUpdatePage&cid=900000011123 is the FASB url.
The IASB url is http://www.iasb.org/Current+Projects/IASB+Projects/Leases/Leases.htm

For professors who do not wish to delve as deeply into the lease concepts, and prefer to keep case discussion along the auditing perspective solely, there is still one useful resource of interest gleaned from the ongoing joint deliberations. This resource is the KPMG IFRG comment letter received in response to the discussion paper Leases: Preliminary Views in 2009 (the KPMG letter is #270 on the 6th page of that site). The letter is 20 pages long, and includes a number of examples of lessons learned the hard way for KPMG. Reading some of the facts of the lease manipulations from the case is clearly relevant, and if linked to the firm's comment letter would prove beneficial as to processes inherent in standard setting. Especially enlightening and relevant is to review KPMG's subsequent comments in light of this specific fraud context. One example from page 7 of that comment letter follows. "For example, many entities routinely carry out multiple leasing arrangements on a regular basis during their day to day operations, while other entities utilise leasing for complex structured transactions in order to achieve a particular financial statement effect. However, we also recognise that such requirements should, at the same time, be robust and principles-based to address the more complex scenarios seen in practice. We believe that a new model that is not sufficiently comprehensive will, over time, become subject to the structuring as has

been the case under the existing lease accounting standards." Having first reviewed the egregious behavior in the actual words of the administrative proceedings, and subsequently following it up with KPMG applying some of its hard-earned lessons in its own words speaks volumes. The letter is located at the following url
http://www.ifrs.org/Current+Projects/IASB+Projects/Leases/DPMar09/Comment+Letters/CL270.htm

Presently the lease accounting issue is tentatively scheduled to have a final standard released in June 2011, with an effective date still to be determined (BKD, March 2011). One letter does not begin to surface the issues involved in looking at alternative accounting treatments for leases. From the release of the 2010 exposure draft, there have been at least 760 comment letters received and posted related to the comment letter deadline of December 15, 2010. The IASB decided its site couldn't post all of the letters and deferred to FASB to post them. While this is not the largest number of comment letters for an exposure draft of an accounting topic, 760 is a significant number as pointed out compared to a summary of other accounting topics presented on the Lease Accounting Blog (Smith, January 11, 2011). The next steps of digesting the discussions are currently underway. A blog resource for ongoing deliberations of lease accounting is located at http://financialcomputer.blogspot.com/

Of special interest for present purposes is a 33-page letter from KPMG IFRG Limited (numbered as 367 and dated December 15, 2010, the last date of the comment period). The conclusion by KPMG is that significant further work is necessary to refine the joint proposal. The letter expresses "we do not believe that the objective of a less complex single approach has yet been achieved for either lessee or lessor accounting". When one reviews the monetary penalties that KPMG paid related to shirked duties in its handling of leases, this particular comment letter becomes interesting and relevant.
http://www.fasb.org/cs/BlobServer?blobcol=urldata&blobtable=MungoBlobs&blobkey=id&blobwhere=1175821950849&blobheader=application%2Fpdf

Question 8. Discuss where KPMG failed to comply with GAAS. What GAAP violations are noted in this section?

Emphasis of due professional care, due diligence, and professional skepticism would have helped prevent the audit failure. A mindset of independence emphasizes procedural and professional integrity over simply pleasing the client. The auditors needed to be more objective in their review while implementing such a critique at every level of supervision within the audit.

Overall, the conduct of KPMG during its audit of Xerox failed to comply with GAAS in gathering sufficient competent evidence (both in terms of documentation and testing), exercising professional skepticism and enforcing the requirements of GAAP. Instead of insisting on disclosure KPMG allowed the improper accounting and reporting practices to occur year after year, even though various warnings and issues had been brought to the auditors' attention from various affiliated sources. Clearly, KPMG did not have a reasonable basis for the unqualified opinions that it rendered to Xerox in the years 1997-2000.

The auditors of KPMG needed to pay more specific attention, care, and skepticism toward results and analysis that deviated from prior practices, and for financial results that were too close to budgeted forecasts. The results of analytical procedures subsequently computed indicate a need for further investigation; these include the income before taxes to total assets ratio, the long term assets to owner's equity ratio, and the total assets to owner's equity ratio. These ratios showed a percentage change that contradicted the struggling trend and low revenues that Xerox had previously held. While the ratios do not indicate sweeping patterns, in hindsight, closer scrutiny the auditors of the required analytical review procedures was merited.

Procedures and findings needed more prudent and thorough follow- through with Xerox management. Certainly, more complete documentation of noted concerns would have also proved beneficial. Complete and accurate testing of valuations and formulas would have also proved highly beneficial while providing solid competent evidence of the situation and manipulations occurring.

Proper mentality towards audit procedures was absent. From the top down, KPMG partners should have conveyed the importance of upholding GAAS and GAAP, while maintaining the norms of honesty, fairness, compassion, integrity, predictability, and responsibility (Brooks, 2007). GAAP violations noted in this section pertain to the treatment of contingencies and materiality.

Question 9 What changes in GAAP and GAAS have been implemented since these events unfolded?

Since these events of and other audit failures FASB, in 2008, proposed changes to FAS 5 in order to enhance disclosure requirements (FASB, June 5, 2008). While the proposed changes concentrated heavily on disclosure requirements of litigation, other changes were integrated to require more details while integrating quantitative information for all liability disclosure. As Xerox's management had taken a lax care attitude about the consequences of manipulation, such an enactment sends a clear message for increased responsibility throughout the business and accounting professions.

FAS 13, as violated by Xerox involving lease disclosures, has been amended since the issues with Xerox (FASB Status of Statement No. 13, n.d.). It has been expanded to include many technical issues. SAS 99 places an emphasis on finding and dealing with fraud. As the KPMG auditors had ignored the fraudulent manipulation occurring at Xerox, this standard now emphasizes dealing with fraudulent matters known and/or found in the course of an audit. SAS 103 deals with audit documentation. The KPMG auditors did not keep or obtain sufficient documentation; this SAS seeks to amend such problems. Audit quality is to be emphasized. The nature, timing, and extent of procedures should be transparent and openly communicated through the documentation. Any significant findings must be documented clearly while being given proper attention.

SAS 105 amends SAS 1, placing more detailed emphasis on due professional care. SAS 106 was enacted in 2006 to further specify appropriate types of audit evidence to be used while employing due professional care. Also, SAS 110 provides guidelines for the integration of consideration of risk with audit evidence and due professional care. As Xerox was in a fast-changing and competitive technology industry, integration of such risk factors would have proven beneficial. Standard setters in the implementation of the subsequent set of audit risk standards re-emphasized a more clearly defined consideration of key audit elements.

In many audit failures, materiality is often a manipulated factor on the part of the auditor(s). Often, adjustments and confrontations are waived with the reasoning that they are not material to the company and the financial statements. However, while some issues in the Xerox audit were not material, the issues involved elements of fraudulent misrepresentation that should have been addressed. As a result of the relationship between audit failure and materially concepts and manipulation, the AICPA enacted SAS 107 to set more complete guidelines for Audit Risk and Materiality in Conducting an Audit to aim to reduce such manipulation. Students should review all AICPA Audit Standards and the PCAOB that have been enacted in the time frame for those related to the facts of the case. For example, SAS 114 pertains to auditor communications with those charged with governance; case facts indicate that this was a relevant concern. This standard addresses the documentation and communication processes.

In 2000, while seeing the problems with communications that occurred with KPMG and Xerox that were manifesting in audits of other businesses, the SEC enacted a final ruling to increase audit committee disclosure. The rules were enacted in order to improve disclosures and communication with the audit committee while aiming to enhance reliability and credibility of the financial statements through these enactments (SEC Release No. 34-42266, January 10, 2000).

Question 10. Assume that you were the SEC Commission who must determine the type of punishment. Who in your opinion is most culpable and what punishments would you consider?

The Rest of the SEC Story for KPMG

The SEC found several legal implications involving the lax actions of KPMG on the Xerox audit. In its analysis of the legal impact, the SEC found the following violations:

* Violation of Section 17(a) (2) of the Securities Act as KPMG obtained money by allowing untrue statements of material facts or omission of material fact while knowing that such statements would be used in the sale of securities.

* Violation of Section 17(a) (3) as KMPG perpetuated fraud and deceit involving statements to be used in the sale of securities.

* Violation of Section 12 of the Exchange Rule Act as KPMG allowed misleading information to be filed in the quarterly reports.

* Violation of Section 13(b) (2) (A) of the Exchange Act as KPMG did not employ reasonable detail to accurately reflect the transactions occurring and the position of the company.

* Violation of Section 13(b) (2) (B) of the Exchange Act as KPMG did not properly investigate and maintain sufficient skepticism and documentation as to the effectiveness of internal control; nor did the company properly assess the appropriateness of internal control to uphold GAAP requirements.

* Violation of Rule 13b2-1 of the Exchange Act as KPMG both directly and indirectly falsified/ caused to be falsified information within accounts to be presented in financial statements.

* Violation of Section 10A of the Exchange Act as KPMG was aware of manipulations, illegal acts, and departures from GAAP occurring.

The ruling of the SEC was that KPMG willfully aided and abetted the fraudulent and misrepresentative accounting recording and reporting of Xerox. The SEC stated that within ninety days after final judgment, KMPG would designate a senior partner with substantial experience (who had not been involved with the Xerox audit) to further investigate and complete documentation of the violating circumstances. Evidence contrary to or supporting of maintenance of independence of the audit from undue client influence was to be sought and documented. From this evidence, corrective action and preventative implementation would be enacted (SEC No. 3-11905, page 27, April 19, 2005).

The SEC also undertook to create additional lines of communication within KPMG in order to prevent further occurrence of such issues. These were to allow confidential and/or anonymous reporting of problematic issues by anyone at the firm at any level. The Ombudsman receiving the reports was then to report directly to the Chairman of KPMG while having full authority to investigate reported matters.

The SEC also enacted that KMPG should provide sufficient documentation of all matters raised and brought to KPMG's Department of Professional Practice. Additionally, increased training measures, particularly involving justified material period-end adjustments, was mandated to be further implemented; obtaining and keeping more complete evidence of matters pertaining to the audit was also emphasized. Thus, the SEC took measures to ensure that KPMG auditors were skillfully trained to appropriately deal with complex accounting measures and manipulative accounting. Additionally, the SEC placed emphasis and requirement on increased documentation with audit work papers of consultations of individuals outside of the audit engagement team. While the SEC recognized that a departure from GAAP can be reasonable and non-material, such items need to be further documented, investigated, and assessed so that these departures are not purely manipulations for a more favorable decision on the part of the company.

The SEC placed the Chairman of KPMG in charge of fully enacting all of these stated undertakings. Commission review was to reassess compliance with the undertakings two years after the Chairman certifies that all of the undertakings were appropriately enacted (SEC No. 3-11905, page 29, April 19, 2005). In addition to these undertakings, the SEC issued a general order to KPMG to

> …cease and desist from committing any violations and future violations of Section A of the Exchange Act; from committing or causing any violations or future violations of Section 17(a)(2) and (3) of the Securities Act and Rule 13b2-1 promulgated under the exchange Act; and from causing any violations and future violations of Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder. (SEC No. 3-11905, page 30, April 19, 2005)

Additionally, the SEC was to censure KPMG according the Commission's Rules of Practice, specifically, Rule 102(e) (1) (iii). In addition to the SEC's orders and undertakings, a separate federal court litigation was held in which a final judgment KPMG was ordered to pay $9,800,000 of disgorgement fees that represented the audit fees for the 1997-2000 audits of Xerox, $2,675,000 of prejudgment interest, and a $10,000,000 civil penalty (SEC Immediate Release 2005-59, April 19, 2005). Thus, total monetary penalties were $22,475,000 and represented the largest SEC required payments by an audit firm (Taub, March 27, 2008).

In SEC's proceedings against KPMG the following four specific partners were named as defendants, and faces the penalties noted:

* Michael A. Conway- Worldwide Xerox engagement partner for the 2000 audit; and member of the KPMG board and Chairman of the KPMG Audit and Finance Committee (SEC For Immediate Release 2003-16, January 29, 2003). Additionally, Conway, at the time, had served on advisory boards for FASB and FASB's Emerging Issues Task Force (writing accounting rules) and the IASB (Norris, 2003). In addition to the monetary fine, Conway was suspended from appearing or practicing before the commission as an accountant for two years, after which time he could appeal for reinstatement (SEC Administrative Proceeding File No. 3-12225, March 1, 2006).
* Joseph T. Boyle- "Relationship Partner" (liaison) of the Xerox audit between 1999 and 2000; and managing partner of the New York KPMG (SEC For Immediate Release 2003-16, January 29, 2003). In addition to monetary penalties, Boyle was suspended from appearing or practicing before the Commission as an accountant for one year after which he could appeal for reinstatement (SEC Administrative Proceeding File No. 3-12120, December 2, 2005).
* Anthony Dolanski- Lead engagement partner on the 1995-1997 Xerox audit; he left KPMG in 1998 to become CFO of the Internet Capital Group (SEC For Immediate Release 2003-16, January 29, 2003). In addition to the monetary penalties, Dolanski was suspended from appearing or practicing before the Commission as an accountant for one year, after which he could petition for reinstatement (SEC Administrative Proceeding File No. 3-12240, March 1, 2006).
* Ronald Safran- Lead engagement partner of the 1998 and 1999 Xerox audit; he was removed from the engagement after the 1999 audit (at Xerox's request) and replaced by Conway (SEC For Immediate Release 2003-16, January 29, 2003). In addition to monetary penalties, Safran was suspended from appearing or practicing before the Commission as an accountant for three years, after which he could petition for reinstatement (SEC Administrative Proceeding File No. 3-12226, March 1, 2006).

Additionally, the SEC brought Administrative Proceedings against Thomas J. Yoho who was the SEC concurring reviewing partner for KMPG on the 1994-2000 Xerox audits. While not charged as extremely as the above named partners, Yoho was found to be in violation of Section 12(b) of the Securities Act of 1934. No monetary penalties were pursued, but Yoho was censured pursuant to Rule 102 (a) (1) (ii) of the Commission's Rules of Practice (SEC Administrative Proceeding File No. 3-12215, page 5, February 22, 2006).

The Rest of the SEC Story for Xerox

A prior judgment against Xerox presented allegations of fraud that were not denied. Xerox Corporation in 2002 accepted a final judgment of a $10 million penalty, restatement of its financial statements, and was required to hire a consultant to review internal controls and policies (SEC Litigation Release No. 17465, April 11, 2002). Those six executives separately named by the SEC in 2003 settled the fraud enforcement by paying disgorgement amounts, and prejudgment interest as well as civil penalties, for a combined total of 22 million dollars. The individual fines and the corresponding civil penalties are listed below (SEC Litigation Release No. 18174, June 5, 2003*)*.

* Paul A. Allaire- Former CEO of the company until April 1999 and again from May 2000 to April 2001; former Chairman of Xerox's Board of Directors during the period of the fraud (1997-2000). A five year officer and director bar was imposed against him while civil penalties were assessed in the amount of $1 million.

* G. Richard Thoman- former President and Chief Operating Officer from July 1997 - April 1999, CEO from April 1999- May 2000; a Director of the company from July 1997- May 2000. A three year officer and director bar was imposed against him while civil penalties were assessed in the amount of $750,000.
* Barry D. Romeril- former CFO from 1993 - December 2001; Executive Vice President from 1997 through early 1999 and then Vice Chairman. A permanent officer and director bar was imposed against him while civil penalties were assessed in the amount of $1million.
* Philip D. Fishbach- former Controller until retirement from Xerox in April 2000. A five year officer and director bar was imposed against him while civil penalties were assessed in the amount of $100,000 while relinquishing rights to deferred bonuses.
* Daniel S. Marchibroda- former Assistant Controller until January 2000; Civil penalties against him were assessed in the amount of $75,000 while relinquishing rights to deferred bonuses.
* Gregory B. Tayler- former Director of Accounting Policy (March 1997-April 1999), Assistant Treasurer (May 1999-March 2000) and Controller (April 2000-November 2001). Civil penalties were assessed in the amount of $75,000.

CONCLUSION AND FINAL OUTCOME

The results of the SEC investigations yielded a fairly similar result for both the auditors and the company itself, if one looks only at the monetary penalties of approximately 22 million dollars for each. However this was just one of the fraud cases that at the time seemed to keep occurring at the turn of the century. This case is one factor in the result of new legislative requirements, at least one regulatory board (PCAOB), and skepticism of the “business as usual” mentality. Accordingly further legal proceedings were brought by shareholders against both KPMG and Xerox. The class- action settlement agreement resulted in that KPMG would pay $80 million to the settlement fund while Xerox would pay $670 million (WebCPA, 2008). KPMG, despite the numerous enacted penalties and suits, continued to hold that such actions were “‘clearly unjustified’…[and] that “at the very worst this [was] a disagreement over complex professional judgments’” (KPMG, 2003). Xerox’s posture was that it settled without admitting to any wrongdoing.

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