

Xerox restates billions in revenue: yet another case of accounting fraud

Joseph Kay
1 July 2002

In the latest scandal involving a prominent American corporation, Xerox revealed last week that over the past five years it has improperly classified over \$6 billion in revenue, leading to an overstatement of earnings by nearly \$2 billion.

The announcement of Xerox is not entirely new. The Securities and Exchange Commission (SEC) began an investigation that ended in April of this year. The SEC had charged the producer of copiers and related services with accounting manipulations. It was estimated at the time, however, that the amount involved was about half that which is now stated, or about \$3 billion. A settlement was eventually reached that included a \$10 million fine, as well as an agreement to conduct a further audit. It was this audit that produced the \$6 billion figure.

According to Paul Berger, the SEC's associate director of enforcement, Friday's announcement "falls under the scope of our original investigation.... We found what we considered to be a pattern of pervasive fraud."

There were two basic manipulations that formed the basis for the SEC investigation. The first was the so-called "cookie jar" method. This involved improperly storing revenue off the balance sheet and then releasing the stored funds at strategic times in order to boost lagging earnings for a particular quarter. This is a widely used manipulation. Earlier this year Microsoft settled an investigation by the SEC into similar practices at the software giant.

The second method—and what accounted for the larger part of the fraudulent earnings—was the acceleration of revenue from short-term equipment rentals, which were improperly classified as long-term leases. The difference was significant because according to the Generally Accepted Accounting Principles (GAAP)—the standards by which a company's books are supposed to be measured—the entire value of a long-term lease can be included as revenue in the first year of the agreement. The value of a rental, on the other hand, is spread out over the duration of the contract.

The effect of the manipulation was that Xerox could count as earnings what was essentially future revenue. This boosted short-term profits and allowed the company to meet

profit expectations in 1997, 1998 and 1999, though it had the effect of reducing earnings during the past two years. In 1998 Xerox reported a pretax income of \$579 million, while it should have reported a loss of \$13 million. On the other hand, the \$137 million loss for 2001 will become a \$365 million gain after the manipulation is reversed. The \$1.9 billion total that will now be subtracted from revenue reported from 1997-2001 will be added to future reports.

Thus, unlike some of the other scandals that have emerged over the past several months, Xerox has not been accused of falsely creating unearned income. Rather it spread its income out in a fraudulent manner. To the same end, WorldCom improperly capitalized about \$4 billion in ordinary expenses in order to allow the company to deduct the expense over a period of decades rather than writing it off all at once. Both these methods serve to boost short-term profits.

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. 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 that "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.

Xerox stock rose to a peak of \$60 a share in mid-1999, when the company was carrying out the accounting fraud. It has since declined sharply and is now trading at about \$7.

Confronted with declining revenue during the late 1990s that should have led to lower than expected earnings reports—thereby reflecting the true nature of the company's deepening problems—Xerox decided to cook the books. This was done quite methodically. Internal documents have recorded discussions among top officials at Xerox

concerning ways to manipulate accounting to allow the company to meet Wall Street expectations. Executives apparently calculated the exact amount that would have to be altered in order to allow the company to just meet or slightly exceed “first call consensus” expectations on Wall Street, which are determined prior to a company’s release of earnings data.

In 1997, for example, expected earnings were at \$1.99 a share, while reported earnings were \$2.02. Actual earnings, correcting for the accounting manipulations, were at \$1.65. Using its earlier underestimate of \$3 billion in improperly classified revenue, the SEC calculated these actual earnings. In 1998, expected and reported earnings were both at \$2.33 while actual earnings were only \$1.72 a share. In 1999, reported earnings beat expected earnings by one cent, while actual earnings fell short by almost 50 cents.

This is a striking example of a company fitting earnings to expectations in order to prevent a run on stock. It is, however, a fairly common practice. Many companies, like General Electric for example, always seem to come out just barely ahead of expectations. Indeed, recent studies have found the distribution of reported earnings of major companies around expectations was skewed to the positive side. That is, it is more likely for a company to beat than to fall short of expectations, suggesting that there are many companies that have been following the same accounting practices as Xerox.

Like the WorldCom fraud, Xerox’s manipulation should have been easy to detect if there was anyone interested in looking. As former SEC chief accountant Lynn Turner noted, “These numbers have gotten so large that it’s akin to auditors driving past Mt. Everest and saying they never saw it... Corporate America has somehow gotten into the mindset that this is OK.” Xerox’s auditor during the period in question was KPMG, one of the “big four” accounting firms that dominate the profession. KPMG was fired in October and replaced by PricewaterhouseCoopers.

KPMG was also part of the SEC investigation that began last year. The evidence suggests that the auditing firm knew what was going on and decided to allow it to continue. An internal document obtained by the SEC contained a statement by a KPMG official acknowledging that Xerox’s schemes constituted “half-baked revenue recognition.” When the KPMG auditor in charge of the Xerox account began to raise some concerns about the company’s improper techniques, he was replaced with someone else.

Earlier this year, the SEC considered filing civil charges against top executives at both KPMG and Xerox. The accounting firm is currently facing lawsuits from shareholders charging the company with failing to audit Xerox properly. KPMG is also under scrutiny for its role in

approving the books of the drug store chain Rite Aid, which recently acknowledged that it inflated its income by more than \$1 billion over a two-year period. It also approved the books of the collapsed Belgian software company Lernout & Hauspie Speech Products NV, which has admitted to fabricating 70 percent of sales at its largest unit.

The Xerox case has focused attention on the role of the SEC and its chairman, Harvey Pitt. Pitt, a former lawyer for the big accounting firms including KPMG, met with KPMG’s new chairman, Gene O’Kelly, in April. O’Kelly issued a statement declaring he told Pitt at this meeting that any SEC action against KPMG would be “unfounded” and “would pose serious disruption ... in the capital markets.” Pitt denied that the two discussed Xerox at all during the meeting. Such a discussion, if it took place, would be a serious violation of norms of independence. The SEC, having failed to raise any flags while the fraud was being carried out, appears complicit in the scandal.

Because of its protracted crisis, Xerox has been forced to sell off some of its assets. It managed to renegotiate its credit earlier this month, but at higher interest rates. If the company had failed to renegotiate its credit line, it may have been unable to meet its obligations, forcing it into bankruptcy. This almost happened once before, in late 2000.

In an attempt to cut back on costs, Xerox has laid off thousands of workers in the past two years and may well make further retrenchments in the future. On the other hand, as Xerox’s troubles grew more severe, the company’s CEO Anne Mulchay received a pay package in 2001 that could be worth as much as \$25 million.



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