

**UNITED STATES OF AMERICA**  
**Before the**  
**SECURITIES AND EXCHANGE COMMISSION**

**SECURITIES EXCHANGE ACT OF 1934**  
**Release No. 51574 / April 19, 2005**

**ACCOUNTING AND AUDITING ENFORCEMENT**  
**Release No. 2234 / April 19, 2005**

**ADMINISTRATIVE PROCEEDING**  
**File No. 3-11905**

**In the Matter of**

**KPMG LLP,**

**Respondent.**

**ORDER INSTITUTING PUBLIC  
ADMINISTRATIVE AND CEASE-  
AND-DESIST PROCEEDINGS  
PURSUANT TO SECTION 8A OF THE  
SECURITIES ACT OF 1933, SECTION  
21C OF THE SECURITIES EXCHANGE  
ACT OF 1934 AND RULE 102(e) OF THE  
COMMISSION'S RULES OF PRACTICE,  
MAKING FINDINGS, AND IMPOSING  
REMEDIAL SANCTIONS AND A  
CEASE-AND-DESIST ORDER**

**I.**

The Securities and Exchange Commission (“Commission”) deems it appropriate that public administrative and cease-and-desist proceedings be, and hereby are, instituted against KPMG LLP (“KPMG” or “Respondent”) pursuant to Section 8A of the Securities Act of 1933 (“Securities Act”), Section 21C of the Securities Exchange Act of 1934 (“Exchange Act”) and Rule 102(e)(1)(iii) of the Commission’s Rules of Practice.<sup>1</sup>

**II.**

In anticipation of the institution of these proceedings, Respondent has submitted an Offer of Settlement (the “Offer”) which the Commission has determined to accept. Solely for the purpose of these proceedings and any other proceedings brought by or on behalf of the Commission, or to which the Commission is a party, and without admitting or denying the

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<sup>1</sup> Rule 102(e)(1)(iii) provides, in pertinent part, that:

The Commission may . . . deny, temporarily or permanently, the privilege of appearing or practicing before it . . . to any person who is found . . . to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws or the rules and regulations thereunder.

findings herein, except as to the Commission's jurisdiction over it and the subject matter of these proceedings, Respondent consents to the entry of this Order Instituting Public Administrative and Cease-and-Desist Proceedings Pursuant to Section 8A of the Securities Act of 1933, Section 21C of the Securities Exchange Act of 1934 and Rule 102(e) of the Commission's Rules of Practice, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order ("Order"), as set forth below.<sup>2</sup>

### III.

On the basis of this Order and Respondent's Offer, the Commission finds<sup>3</sup> that:

#### A. RESPONDENT AND ISSUER

**KPMG LLP**, the fourth largest public accounting firm in the United States, is a Delaware limited liability partnership and headquartered in New York City. KPMG was Xerox Corporation's auditor for approximately 40 years, through the audit of Xerox's fiscal 2000 financial statements. KPMG was paid \$26 million for auditing Xerox's financial statements for fiscal years 1997 through 2000. It was paid \$55.8 million for non-audit services during that period. KPMG maintained offices at Xerox's Stamford location and its partners regularly met with the company's financial managers, attended meetings of the Audit Committee of the Board of Directors and had access to Xerox financial records.

**Xerox Corporation** ("Xerox") is a Stamford, Connecticut based company incorporated in New York, which manufactures, sells and leases document imaging products, services and supplies in the United States and 130 other countries. In 2000, Xerox employed approximately 92,500 people worldwide, 50,000 of them in the United States. In June 2002, Xerox reported restated revenues of \$18.8 billion (as compared to \$18.7 billion originally reported) and a restated net loss of \$273 million (as compared to a net loss of \$257 million originally reported) for the year ended December 31, 2000. Xerox's common stock is registered with the Commission pursuant to Section 12(b) of the Exchange Act. Throughout the relevant time period, Xerox's stock was listed on the New York and Chicago Stock Exchanges and also was traded on the Boston, Cincinnati, Pacific Coast, Philadelphia, London and Switzerland exchanges. On April 18, 2002, the U.S. District Court for the Southern District of New York enjoined Xerox from future violations of antifraud and other provisions of the securities laws and rules alleged to have been violated in a Complaint filed by the Commission on April 11, 2002 [*SEC v. Xerox Corporation*, 02 CV 2780 (DLC)]. Pursuant to a consent to settlement by Xerox,

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<sup>2</sup> Simultaneously with this proceeding, KPMG consented in the separate, previously filed civil action against KPMG to the entry of a final judgment by the U.S. District Court for the Southern District of New York pursuant to Section 20(d) of the Securities Act and Section 21(d) of the Exchange Act that: finds that KPMG violated Section 10A of the Exchange Act; orders KPMG to pay a \$10 million civil penalty; orders KPMG to pay disgorgement of its 1997-2000 audit fees in the amount of \$9.8 million and to pay prejudgment interest thereon in the amount of \$2,675,000; and orders KPMG to undertake to alter or amend its audit practices in certain respects. *SEC v. KPMG LLP*, 03 CV 671 (S.D.N.Y.) (DLC).

<sup>3</sup> The findings herein are made pursuant to Respondent's Offer of Settlement and are not binding on any other person or entity in this or any other proceeding.

the company also was assessed a civil penalty of \$10 million. In consenting to settlement, Xerox neither admitted nor denied the allegations of the Commission's Complaint.

## **B. SUMMARY**

From 1997 through 2000, Xerox engaged in a fraudulent scheme that disguised Xerox's true operating performance through the use of accounting actions that accelerated the recognition of equipment revenue by over \$3 billion and increased pre-tax earnings by approximately \$1.5 billion. Most of these accounting actions violated generally accepted accounting principles ("GAAP") and all of them should have been disclosed because they distorted the true picture of its business performance. The scheme allowed Xerox to "close the gap" between actual operating results and results reported to the investing public, and to claim that it met performance expectations of Wall Street analysts, to mislead investors and, consequently, to boost the company's stock price.

As part of its fraudulent scheme, Xerox included false and misleading financial statements and information in quarterly and annual reports it filed with the Commission from 1997-2000 and in registration statements that were in effect or filed with the Commission during this period through which Xerox registered billions of dollars of debt securities. As a result, Xerox violated the anti-fraud, reporting, recordkeeping and internal controls provisions of the federal securities laws.

KPMG's failure to comply with generally accepted auditing standards ("GAAS") caused<sup>4</sup> and willfully<sup>5</sup> aided and abetted Xerox's violations. In each of the years 1997-2000, KPMG audited the company's annual financial statements and issued audit reports containing unqualified opinions stating that KPMG had applied GAAS to its review of Xerox's accounting, that Xerox's financial reporting was consistent with GAAP and that Xerox's reported results fairly represented the financial condition of the company. However, throughout this period KPMG's failure to comply with GAAS allowed Xerox to utilize accounting devices that did not comply with GAAP. By doing so, KPMG allowed Xerox to manipulate its accounting practices to distort the company's financial results, failed to insist that Xerox disclose those practices and their financial impacts in the company's annual and quarterly reports, and allowed Xerox to falsify its books and records and to fail to maintain adequate internal controls over its accounting. KPMG's failure to comply with GAAS therefore caused and willfully aided and abetted Xerox's violations of Sections 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13 and 13b2-1 promulgated thereunder.

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<sup>4</sup> As described in this Order, the standard of liability as "a cause of" a violation under Section 21C of the Exchange Act is negligence. *See KPMG LLP v. SEC*, 289 F.3d 109, 112 (DC Cir. 2002). In this instance, the respondent engaged in an act or omission that it knew or should have known would contribute to the primary violation. *See* Section 8A(a) of the Securities Act; Section 21C(a) of the Exchange Act.

<sup>5</sup> "Willfully" as used in this Order means knowingly committing the act which constitutes the violation, *see Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

KPMG also willfully violated Section 10A of the Exchange Act. During its audits of Xerox's 1997-2000 financial statements, KPMG became aware of information indicating that illegal acts had or may have occurred as a result of Xerox's use of accounting actions. Although KPMG at times raised concerns to Xerox's management about certain of these accounting actions, KPMG failed prior to the SEC's investigation in this matter to inform Xerox's board of directors or its audit committee about the illegal acts that had or may have occurred or that otherwise came to its attention.

## **C. FACTS**

### **1. Background and Impact of Xerox's Manipulative Accounting**

Xerox was a leading technological innovator for most of the last half of the 20th century. But by the late 1990s, the company was confronting intense product and price competition from its overseas rivals. As a result, increasing revenues and earnings became more difficult to achieve. Xerox also faced additional pressures from the investment climate of the 1990s in which companies that failed to meet Wall Street's earnings estimates by even a penny often were punished by significant declines in stock price.

From at least 1997 through publication of the company's 2000 financial report, Xerox addressed these competitive business challenges and succumbed to Wall Street pressures by using manipulative accounting actions at the end of each financial reporting period. These actions (hereinafter referred to generally as "topside accounting adjustments" or "topside accounting actions") increased equipment revenue and earnings through the improper acceleration of revenue from long term leases of Xerox copiers. These actions involved manipulating Xerox's historic accounting estimates and methods through changes that were unsupported by economic or business circumstances which allowed immediate recognition of revenue that otherwise would have been recognized over the term of the lease. In addition, Xerox inflated earnings through the use of excess or "cookie jar" reserves.

Most of Xerox's topside accounting actions violated GAAP by inflating Xerox's current business performance. Their impact and that of other manipulative accounting actions should have been disclosed to the public in a timely fashion. By violating GAAP and ignoring disclosure obligations, Xerox's financial reporting for the period 1997-2000 misled investors about the quantity and quality of Xerox's earnings. These undisclosed actions overstated Xerox's true equipment revenues by at least \$3 billion and overstated its true earnings by approximately \$1.5 billion during the four-year period (before taxes, minority interest and equity income -- hereinafter, "pre-tax earnings"). When Xerox finally restated its financial results for 1997-2000, it restated \$6.1 billion in equipment revenues and \$1.9 billion in pre-tax earnings -- the largest restatement in U.S. history to that time. As discussed further below, KPMG's conduct allowed Xerox to inflate equipment revenues by approximately \$3 billion and inflate earnings by approximately \$1.2 billion in the company's 1997-2000 financial results.

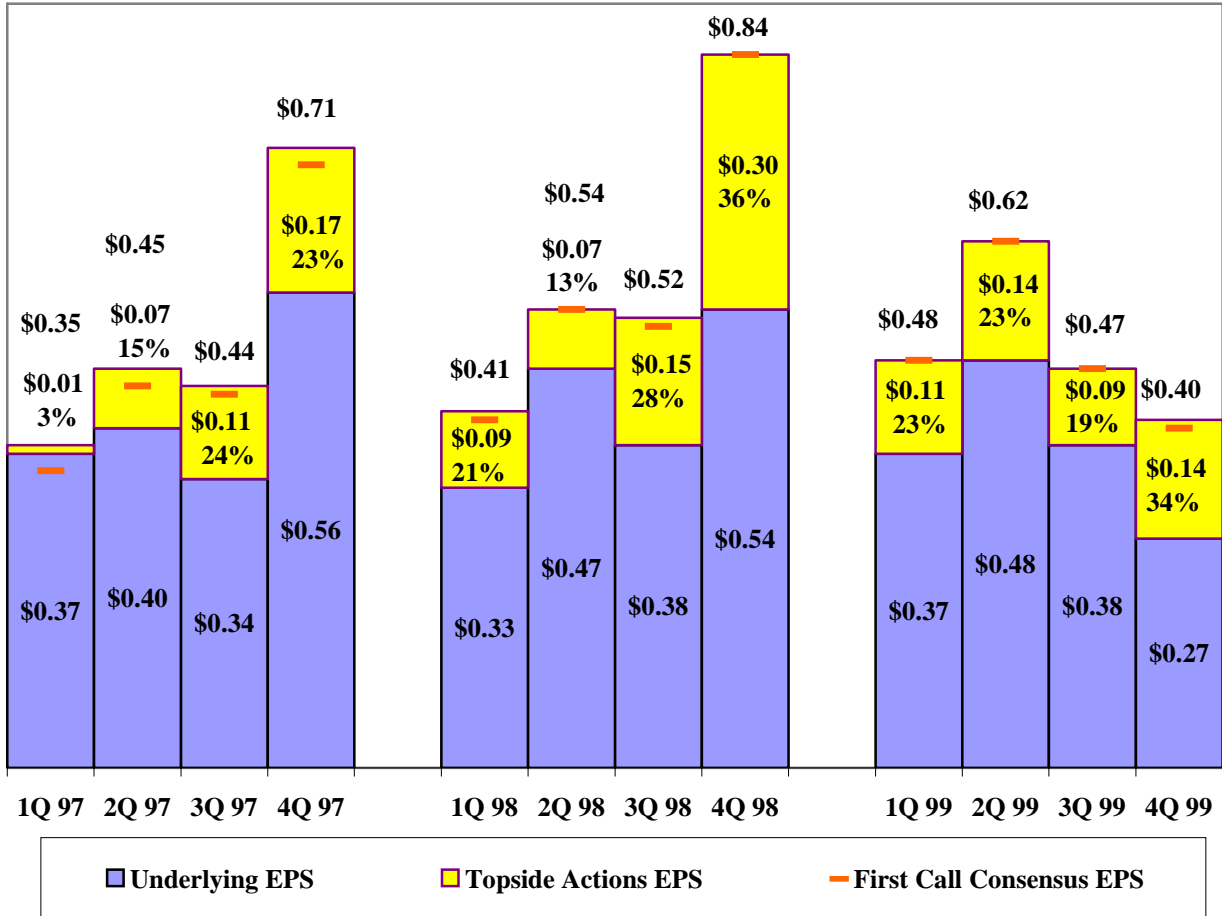
The undisclosed use of topside accounting actions accounted for 4 percent of Xerox's reported first quarter pre-tax earnings in 1997 and between 14 percent and 37 percent of reported quarterly pre-tax earnings thereafter through 1999. Similarly, the impact of these accounting

actions on Xerox's reported annual pre-tax earnings grew from 19 percent in 1997 to 27 percent in 1998, and constituted 25 percent of 1999 reported pre-tax earnings. Moreover, as illustrated in the two charts below, had Xerox reported its revenues and earnings consistent with its accounting in earlier years, Xerox would have failed to meet Wall Street earnings per share ("EPS") expectations in all quarters in 1997-1999 except the first quarter of 1997 and in all three years 1997-1999.<sup>6</sup> The blue or darker portion of each bar represents EPS as historically calculated by Xerox. The yellow or lighter portion represents the additional reported EPS that resulted from undisclosed topside accounting actions, most of which did not comply with GAAP. Black numbers reflect EPS accounted for by each color of each column, and the percentage each method of calculation represented of total reported earnings for each period. The red numbers (the number above each column) represent Wall Street's consensus earnings estimates.

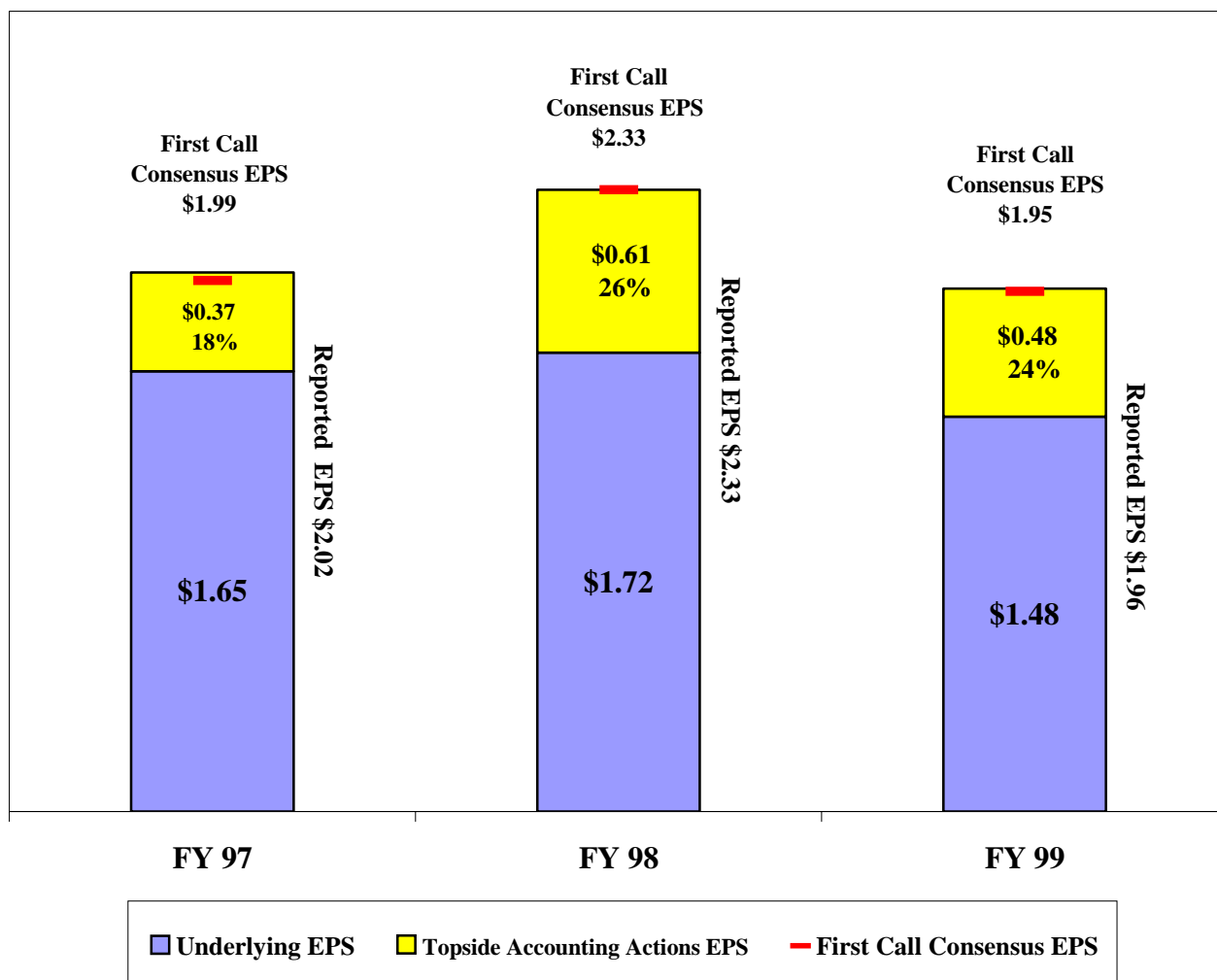
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<sup>6</sup> The percentage impact on EPS reflected in the charts may be slightly lower than the percentage impact on pre-tax earnings because pre-tax earnings exclude equity income, minority interests and other adjustments, while EPS calculations do not.

**Impact of Topside Accounting Actions on Quarterly  
Reported EPS Compared to First Call Consensus Estimates  
During 1997-1999 (In Dollars)  
(First Call consensus EPS estimates are shown in red)**



**Impact of Topside Accounting Actions on Annual Reported EPS and  
Compared to First Call Consensus Estimates  
For 1997-1999 (In Dollars)**



**2. Summary of KPMG’s Role in Xerox’s Manipulative Accounting**

KPMG was intimately familiar with Xerox’s accounting actions it used on a quarterly and annual basis to increase reported revenues and earnings during 1997-2000. KPMG had served as Xerox’s auditor for approximately 40 years and considered Xerox one of its largest and most important clients, generating revenues for the firm of \$26 million in audit fees and over \$55.8 million in non-audit fees during 1997-2000. But from 1997-2000, KPMG failed to conclude that topside accounting actions were unnecessary and distorted the true operating performance of the company. KPMG’s audit partners received many warnings from member firms of KPMG International in Europe, Brazil, Canada and Japan that methods adopted by Xerox to “close the gap” between actual and desired results were not based on adequate

evidentiary support. Even KPMG's U.S. office in Rochester, N.Y., where Xerox had a major manufacturing and administrative center, warned that topside adjustments were creating unnecessary internal accounting control weaknesses.

Nevertheless, from at least 1997 through 2000, KPMG ignored these warnings and did not demand evidence sufficient to establish that these accounting actions and the assumptions Xerox asserted to justify their use were in fact grounded in business realities or fairly reflected the company's performance. KPMG at times suggested to Xerox management that it test the assumptions underlying its accounting and test the resulting accounting adjustments to ensure they accurately portrayed Xerox's business. But year after year, Xerox management ignored KPMG's requests, and KPMG exerted no pressure on its client to perform such testing. KPMG did not demand that Xerox test, and KPMG itself never adequately tested, the assumptions Xerox used to justify its topside accounting actions. Nor did KPMG test -- or demand that Xerox test -- to determine if the topside accounting actions Xerox used resulted in financial statements which fairly presented Xerox's financial results. Further, despite Xerox's claimed inability to reasonably estimate the fair value of its products without resort to topside estimates, KPMG failed to identify those topside accounting actions as material internal accounting control weaknesses.

Among other things, KPMG failed to perform the Xerox audits with the due care required by Section 230 of the *Codification of Statements on Auditing Standards* ("AU"), which is issued by the Auditing Standards Board, whose interpretations of the Statements on Auditing Standards constitute an essential component of GAAS. KPMG also failed to obtain, or demand that Xerox produce, sufficient competent corroborating evidence of the need for, or adequacy of, topside accounting actions (AU Section 326, *Evidential Matter*) that would satisfy an auditor applying an appropriately professional degree of skepticism in any audit (AU Section 316, *Consideration of Fraud in a Financial Statement Audit*). Nor did KPMG adequately analyze and assess the control weaknesses inherent in permitting senior managers at Xerox who were compensated based, in part, on financial results, to regularly increase revenue and earnings reported from the field at the close of each reporting period. (AU Section 319, *Consideration of Internal Control in a Financial Statement Audit*). Nor did KPMG adequately assess the quantitative and qualitative aspects of misstatements they identified during their audits. (AU Section 312, *Audit Risk and Materiality in Conducting an Audit*).

Had KPMG performed an audit of Xerox's financial statements with due professional care as it represented, Xerox could not have filed with the Commission or distributed to the public quarterly and audited annual financial reports which were not prepared in accordance with GAAP in material respects and which contained material misstatements and omissions fraudulently representing that Xerox's revenue and earnings growth was due entirely to business performance.

In addition, despite its knowledge of the nature and impact of topside accounting actions on Xerox's financial reporting, KPMG failed to require that Xerox disclose that it had changed its methods of accounting in material respects from year to year and disclose the financial impacts resulting from those changes and the accounting actions Xerox employed. KPMG did not insist that Xerox include these disclosures in its financial statements or in the Management's



Discussion and Analysis (“MD&A”) section of its quarterly or annual reports, which KPMG auditors reviewed during 1997-2000 to insure they were not materially inconsistent with the company’s financial statements. KPMG’s failure in this regard also violated GAAP provisions -- Opinions 20 and 28 of the Accounting Principles Board (“APB”) -- that require disclosure in financial statements of material changes in accounting estimates or accounting methods.

In the summer or early fall of 1999, Xerox complained to KPMG’s chairman about the performance of KPMG’s audit engagement partner. That partner had questioned Xerox management about several of the topside accounting actions that formed Xerox’s fraudulent scheme. Although KPMG policy was to limit assignments of an engagement partner on public company audits to five years, and the partner had been assigned to Xerox less than two years, KPMG replaced the partner after completion of the 1999 audit.

In each of the years 1997-2000, KPMG issued audit reports containing unqualified opinions on Xerox’s annual financial statements which were misleading. Each of those reports represented that KPMG had conducted its audits in accordance with GAAS, that, in its opinion, the consolidated financial statements of Xerox “present fairly, in all material respects, the financial position of Xerox Corporation” as of year-end and that for those years and each of the preceding three-year periods the financial results were presented “in conformity with generally accepted accounting principles.” In fact, KPMG failed to perform its audit in accordance with GAAS and Xerox’s financial statements did not comply with GAAP in material respects and omitted to disclose that earnings were materially increased by the numerous accounting actions described below, rather than by operating success. KPMG consented to the inclusion of these audit reports in Xerox’s 1997-2000 Forms 10-K and in registration statements that were in effect or were filed with the Commission during this period, including four offerings that registered nearly \$9 billion dollars worth of debt securities. KPMG additionally permitted Xerox to invoke its name and audit work in Xerox’s 1997-1999 annual reports to assure shareholders that KPMG had conducted a professional audit, had found that the company’s financial reports were prepared in accordance with GAAP.

### **3. The Accounting Actions and KPMG’s Acts or Omissions that Caused and Willfully Aided and Abetted Xerox’s Securities Violations**

Although Xerox had resorted to a variety of accounting actions on a more modest scale earlier, these tools grew more central to the company’s financial reporting strategy during the period 1997-2000. By 1997, Xerox had substantially departed from GAAP to improperly manage its earnings, to accelerate recognition of equipment revenue, to report higher earnings growth and to meet Wall Street analyst expectations. Despite the material impact of these accounting actions, none was disclosed in Xerox’s quarterly and annual financial reports or in registration statements filed with the Commission in 1997-2000.

Xerox adopted or increased its reliance upon the following accounting actions which caused a material increase in the company’s reported equipment revenues and earnings, and which made the company appear to have generated more revenue from its long term leases of equipment than it would have reported under its prior accounting practices: (1) return on equity (ROE); (2) margin normalization; (3) price increases and lease extensions; (4) retroactive

increases to residual values of leased equipment; (5) undisclosed dramatic increases in the sale of future revenue streams; and (6) manipulation of reserves. All but practice (5) constituted, individually or in the aggregate, material GAAP violations.

KPMG's failure to comply with its obligations under GAAS caused and aided and abetted the misstatements of Xerox's equipment revenues and earnings during 1997-2000 with respect to these actions. It also caused and aided and abetted Xerox's misleading disclosures of its financial performance. The table below illustrates the annual gross and net impact on pre-tax earnings from each of the actions that KPMG caused Xerox to misstate. The net effect turns negative for 2000 because of Xerox's improper acceleration of revenues in earlier years, making revenues unavailable in later years, when they should have been recognized. (The hyphens in the table indicate accounting actions that are not the subject of this Order.)

<b>Xerox's Topside Accounting Actions</b>					
<b>Gross and Net Impact on Pre-Tax Earnings</b>					
<b>(In Millions)</b>					
	<u>1997</u>	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>Total</u>
<b>ROE</b>	<b>\$ 455</b>	<b>\$ 720</b>	<b>\$ 569</b>	<b>\$ 459</b>	<b>\$ 2,203</b>
<b>Margin Normalization</b>	<b>55</b>	<b>168</b>	<b>202</b>	<b>192</b>	<b>617</b>
<b>Price Increases/Extensions</b>	<b>-</b>	<b>-</b>	<b>131</b>	<b>7</b>	<b>138</b> *
<b>Residual Value Increases</b>	<b>36</b>	<b>45</b>	<b>15</b>	<b>0</b>	<b>96</b>
<b>PAS Transactions</b>	<b>-</b>	<b>-</b>	<b>400</b>	<b>-</b>	<b>400</b>
<b>Cushion Reserve Releases</b>	<b>90</b>	<b>115</b>	<b>196</b>	<b>23</b>	<b>424</b> **
<b>Total Gross Impact</b>	<b><u>\$ 636</u></b>	<b><u>\$ 1,048</u></b>	<b><u>\$ 1,513</u></b>	<b><u>\$ 681</u></b>	<b><u>\$ 3,878</u></b>
<b>Total Net Impact</b>	<b>\$ 258</b>	<b>\$ 510</b>	<b>\$ 481</b>	<b>\$ (60)</b>	<b>\$ 1,189</b>

\* This gross amount does not reflect the reversal of \$89 million made during the second half of 1999.

\*\* Included in the gross amounts are the effects of improperly timed reserve releases of \$78 million which affected only interim periods within a fiscal year.

(a) **Xerox's Fraudulent Lease Accounting**

Xerox sells copiers and other office equipment outright to its customers for cash, but more frequently enters into long-term lease agreements in which customers pay a single negotiated monthly fee in return for the equipment, service, supplies and financing. Xerox refers

to these arrangements as “bundled leases.” Beginning at least in the early 1990s, bundled lease transactions constituted the majority of Xerox’s sales revenue.

Financial Accounting Standard (“FAS”) 13, an Original Pronouncement of the Financial Accounting Standards Board (“FASB”), sets forth the rules accountants must follow in accounting for leases. Under FAS 13, monthly payments due under ordinary leases are recognized only as they become due during the term of the lease. But FAS 13 requires equipment leases meeting certain criteria to be accounted for as if the lessor sold the equipment and provided financing for the sale. This “sales-type” lease accounting results in immediate recognition of the fair value of the equipment in the quarter in which the equipment is delivered, less any residual value the equipment is expected to retain once the lease expires. Revenues from financing, repair services and copier supplies, however, are recognized under FAS 13 over the term of the lease.

Until the mid-1990s, Xerox had an accounting system in place which, with only minor adjustments, assigned fair value to the equipment portion (“the box”) as each sales-type lease was entered into and assigned remaining anticipated lease revenues to financing, service and supplies according to internal calculations made at the inception of the lease based on terms of the contract, competitive conditions and market finance rates. The fair value of the equipment was recognized immediately as revenue in Xerox’s books and records, while revenue from financing, service and supplies was recognized gradually over the life of the lease. This book entry system, which continued to be used at the operational level at Xerox, was deemed satisfactory for accounting for sales revenues with only minor adjustments until the mid-1990s.

By 1997, Xerox management claimed the operating level allocation of box, service and financing revenues was unreliable and misleading. Despite the fact that it had been manufacturing, selling and leasing copiers for decades, Xerox told KPMG throughout the 1997-2000 period that it was unable reasonably to assign a fair value to equipment sold under a sales-type lease, as it had in the past. Instead, for public financial reporting purposes, but not for internal operating purposes, the company abandoned the value determinations made at the inception of the lease and substituted a formula which management could, and did when it encountered growing competition around the world and a perceived need to continue reporting earnings increases in the 1997-2000 period, manipulate at will. Xerox did no testing to determine if in fact its traditional manner of allocation was unreliable or if the new methodology did a better job of accurately reflecting the fair value of its equipment.

Xerox’s topside lease accounting actions consistently increased the amount of lease revenues which Xerox recognized at the inception of the lease and reduced the amount it recognized over the life of the lease. One method was called “ROE” (for “return on equity”), which pulled forward a portion of finance income and recognized it immediately as equipment revenue. The second, called “margin normalization,” pulled forward a portion of service income and recognized it immediately as equipment revenue, too. ROE and margin normalization ignored GAAP’s FAS 13 requirement that leasing revenue allocations begin by identifying the fair value of the equipment. Instead, the ROE and margin normalization methods employed subjective and defective procedures for estimating revenues from the finance and service

elements of the lease agreement. The supposed fair value of the equipment was the remaining value of the lease, after deductions for finance, service and supplies.

(i) **The ROE Model**

(1) **Xerox's Manipulation of ROE to Accelerate Revenues and Earnings**

Xerox began in 1995 to exploit accounting opportunities inherent in the ROE method and to use the ROE methodology in violation of GAAP. A desired return on the finance division's equity always had been a factor in Xerox's accounting for its finance charges. In 1995, however, Xerox formalized its ROE model in a manner that mechanically discounted lease payments at a finance rate that had little relation to market interest rates available to the customer, the actual return on financing to Xerox, or the price at which the equipment actually sold. Between 1995 and 2000, Xerox always assumed a 15 percent return for its ROE formula, everywhere in the world and under all financial and economic conditions, despite significant volatility in the returns actually earned by leasing companies in this period.

In most cases, application of ROE was a topside adjustment directed by the Xerox corporate office. Operating units allocated lease cash flows to the box, service and finance components according to established prices set by management. Xerox then recalculated these allocations to insure that financing operations realized no more than a 15 percent return on equity. This practice ignored the real interest rates prevailing where the equipment was leased and the interest rates available to the customer wishing to lease a copier over a 3-6 year term. It also artificially eliminated the volatility in Xerox's wholly-owned credit subsidiaries' return on equity that a competitive market inevitably produces. Initially, use of the ROE formula was limited to the United States and to Xerox Brazil, where the formula was implemented by at least 1995. As the pressure to meet earnings targets grew, and competition made selling copiers more difficult, ROE was expanded to Xerox in Europe.

Topside adjustments grew larger and larger from 1997 through 2000. Altering assumptions in the ROE formula produced lower and lower assumed finance, or "discount," rates, which enabled Xerox to account for more and more of the lease payments up front as equipment revenue. But the use of such lower discount rates was unsupported by either verifiable objective evidence or economic reality. Neither Xerox nor KPMG tested the company's claim that the topside adjustments were necessary to arrive at the actual fair value of the equipment leased to the customer. Thus, the effect of the topside adjustment on any individual lease transaction's interest rate or equipment price was never calculated and compared to market rates or market prices. Yet, the unrealistic discount rates produced by the ROE formula were increasingly apparent in the operational markets in which ROE was used. For example, the discount rates that were applied to leases in the United States at times fell below Xerox's own incremental borrowing costs.

Continuous changes in underlying assumptions used to calculate the ROE formula and expansion of the formula to new geographic areas resulted in larger and larger portions of finance income being reallocated to equipment revenue for immediate recognition. For example,

a lease recorded as generating \$15,000 in immediately recognized equipment revenue at the operational level was increased at the corporate level for financial reporting purposes by 6 percent in 1997 and 13 percent in 2000. In this way, additional millions of dollars of equipment revenues and earnings were reported each quarter -- none of which necessarily resulted from the sale of a single additional copier or other Xerox product. Compared to the equipment revenues that would have been reported based on allocations recorded at the operational level, Xerox's ROE formula pulled forward \$2.2 billion in equipment revenue and \$301 million in pre-tax earnings in the period 1997 through 2000.

Xerox management defended its substitution of lower interest rates produced by the ROE formula by arguing that the rates entered and relied upon at the operational level were too high. But Xerox's own marketing department monitored rates available from other sources and concluded that the rates entered at the operational level were competitive or no more than 2 or 3 percentage points higher than competitor rates. But the ROE formula reduced rates used to prepare the public financial statements by as much as 6 percentage points. In some reporting periods, discount rates on five-year leases to some customers were recorded for financial reporting purposes at a rate below that for which the U.S. government could borrow money for 90 days.

The failure of the ROE method to produce realistic market finance rates was particularly pronounced in Brazil. For example, Xerox recorded all of its Brazilian leases in early 1997 assuming a finance rate of 8 percent, then dropped the rate to 7 percent in the third quarter of 1997, and then reduced the rate again to no more than 6 percent beginning in the first quarter of 1998 and continuing through the second quarter of 2000. The ROE formula generated rates even as low as zero percent in certain periods in 1999. These ROE-derived finance rates were based on the costs of Xerox's U.S. finance operations, rather than the currency and costs which were dictating the economic reality of Xerox's lease contracts in Brazil. By comparison even to the short-term inter-bank rates in Brazil, which during the relevant period exceeded 20 percent until the last few months of 1999, Xerox's ROE formula produced clearly absurd results. Had Xerox used even the short-term inter-bank rates in Brazil as an estimate of prevailing finance rates, the company's equipment revenues reported for Brazil would have been reduced by an estimated total of approximately \$757 million during 1997-2000.

## **(2) KPMG Permits The Use Of ROE**

KPMG's audit partners were aware that Xerox changed the underlying assumptions of ROE, that the changes were sometimes made by management at the ends of financial reporting periods, that Xerox expanded ROE to foreign markets and that each change in the ROE method accelerated recognition of more revenues and earnings. They accepted Xerox's claim that it could not directly calculate the fair value of its products and they signed off on each resulting accounting adjustment without testing, or requiring others to test, whether the results were accurate. Nor did they carefully analyze the claimed need for topside adjustments as a material internal controls deficiency.

KPMG allowed Xerox management to use ROE despite numerous warnings from KPMG's Rochester office and foreign member firms of KPMG International that the method

was unreliable, was not sufficiently tested and posed an unnecessary internal accounting control risk in financial reporting.

For example, KPMG audit partners knew of the following information and received the following warnings during the 1997 and 1998 audits or quarterly reviews of Xerox's financial statements:

- In a letter to the president of Xerox's United States Customer Operations in Rochester ("USCO"), dated February 7, 1997, a KPMG partner addressed the growing reliance on ROE adjustments:

[W]e do not believe that the recognition of sale revenue and the related asset without specific identification to a customer is an appropriate and prudent accounting practice. Leases should be recorded in the detail accounting records and the consolidated financial statements of the company based upon a single fair market interest rate without adjustment for the intercompany transfer of the leases to XCC [Xerox Credit Corporation, Xerox's financing arm]. We recommend that USCO discontinue the financing sale revenue adjustment in 1997 to strengthen its revenue recognition policies, simplify its accounting procedures and maximize cash collections in the event of early settlement of a lease.

- KPMG Canada stated in 1997, in connection with the 1996 audit, that the ROE model was "not supportable" and posed an "unnecessary control risk with regard to accounting records".
- In 1998, when Xerox expanded the use of the ROE model to Europe, KPMG-UK had neither tested nor reached any conclusion as to whether the assumptions underlying the ROE model in Europe were appropriate.
- In 1998, KPMG Brazil warned that Xerox was "constantly 'fine tuning' its accounting policies in order to increase" profits and that "this 'fine tuning' [was] carried out with the full knowledge (and often at the suggestion of)" Xerox corporate headquarters in Connecticut. KPMG Brazil also warned that this "fine tuning" increased the risk of fraudulent financial reporting and that the pressure imposed on Xerox Brazil by headquarters to meet revenue and profit goals increased audit risk.
- In 1998, KPMG Brazil repeated the concern it identified in 1997: that implied interest rates generated by ROE were significantly below prevailing interest rates and that ROE "did not consider all of the uncertainties inherent in [Xerox Brazil's] business and, consequently, on its cash flow." Although KPMG identified a \$40 million audit difference in 1998 in connection with the use of a 6 percent discount rate in Brazil (where market rates exceeded 20 percent), KPMG did not require Xerox to record any adjustment to its books and records.

Similar warnings were provided to KPMG's audit partners during the 1999 and 2000 audits or quarterly reviews of Xerox's financial statements:

- In 1999, KPMG Brazil warned that the ROE model resulted in recording zero percent interest rates for leases in the first and second quarters and urged that use of the ROE model needed to be examined by KPMG in Stamford.
- KPMG Tokyo in 1999 objected to the use of the ROE formula by Fuji Xerox because it did "not match the actual status" of Fuji's business and no procedures had been performed to determine if it might.
- KPMG-UK stated in 1999 (as it had in 1998) that it could not conclude that use of a 15 percent ROE target was appropriate for Europe.
- In 2000, the lead KPMG engagement partner concluded that the ROE model was flawed because it generated discount rates that did not reflect the uncertainties inherent in Xerox's business, such as cancellations, bad debts and lease renegotiations.
- In connection with Xerox's audit committee's special investigation related to the 2000 audit, KPMG learned what was or should have been apparent in prior years: that Xerox had used ROE retroactively to close the gap between actual and planned results.

Despite all of this and other information, KPMG failed to perform audit procedures -- and failed to require that Xerox test -- to obtain competent evidence that ROE was necessary and resulted in correctly reported revenue. Instead, KPMG accepted the representations of Xerox management to justify application of ROE without maintaining the appropriate degree of professional skepticism in the light of higher than normal risk of financial misstatement and without assessing the effectiveness of the company's internal control systems.

(ii) **Margin Normalization**

(1) **Xerox Manipulation of Margin Normalization to Accelerate Revenues and Earnings**

Competition in Xerox's markets increased in the 1990s, as foreign manufacturers were able to match Xerox technology at lower prices. As a result, margins on Xerox equipment declined, especially outside the United States. Observing this margin slippage in equipment sales, Xerox reallocated anticipated leasing revenues outside the United States using an accounting device referred to as "margin normalization." This "margin normalization" method, which Xerox used to derive the equipment revenue for sales-type leases, did not comply with GAAP and resulted in artificially high revenue and earnings reported by Xerox.

Margin normalization, like ROE, was a topside adjustment directed by the Xerox accounting department in Connecticut near the end of reporting periods. Sales and allocation of revenues were initially booked by operating units, which did not use margin normalization. Then, on a consolidated basis, management in Stamford, Connecticut directed that revenue from service be reallocated to the box based upon what management asserted the margins ought to be, not as they were calculated locally. Xerox even made these reallocations retroactively to transactions that had already been reported in its quarterly financial statements, also in violation of GAAP. The result of these accounting actions was to reclassify anticipated service revenues, which were required to be recognized over the life of the lease, as equipment revenues, which Xerox recognized immediately. Xerox was therefore able immediately to increase the revenues and earnings it reported to meet internal goals and Wall Street estimates. In addition to misrepresenting the true financial picture of Xerox, use of this non-GAAP accounting procedure accelerated into current reporting periods revenues and earnings which properly should have been recognized in future reporting periods.

When the methodology was first implemented in Europe in 1997, management reallocated revenue from service to the box so as to achieve equal gross margins on those two components. By the end of 1999, however, Xerox had changed the methodology so that its reallocation of revenue resulted in a 17 percentage point gross margin differential between box and service with no economic or business circumstances justifying such changes. Margin normalization, in essence, meant that Xerox recalculated its revenues in Europe, Brazil, Canada, Mexico and Argentina to achieve relative profit margins on the service and box portions of its bundled leases modeled, in large part, on margins realized in the United States. Xerox ignored regional economic and business factors in making these calculations and, therefore, reported revenues and earnings that did not accurately reflect economic realities as recorded directly by those regions at the inception of a lease. The total equipment revenues pulled forward during 1997 through 2000 as a result of margin normalization was \$617 million. Of that amount, \$358 million was recognized as pre-tax earnings.

## (2) **KPMG Permits the Use of Margin Normalization**

KPMG knew about Xerox's use of margin normalization from its inception in 1997. As it did with respect to the ROE model, Xerox management justified margin normalization by representing to KPMG that it could not reasonably estimate the fair value of its equipment and, therefore, could not allocate revenue appropriately among equipment, finance and service at the inception of a lease. KPMG accepted this proposition without performing procedures sufficient to verify it.

As was the case with the ROE model, Xerox regularly changed the assumptions underlying the methodology and expanded its application to new regions. From 1997 to 1999, the margin normalization methodology changed more than a dozen times. With small exceptions, each time the methodology changed, Xerox recognized an increasing amount of revenue immediately and deferred less and less revenue to the future.

KPMG's audit partners received numerous warning and concerns from foreign member firms of KPMG International about the risk and appropriateness of using margin normalization.



The partners themselves reached conclusions during 1997-2000 that adequate corroborative evidence did not exist to support management's assumptions, that the methodology presented a high risk of misstatement or fraud, that it should be controlled at the local level to avoid risk, and that Xerox was engaged in quarter-end transactions to "bridge the gap" and made last minute changes to the method to limit KPMG's ability to review changes. Nevertheless, KPMG's engagement partners signed off on the resulting accounting adjustments without any effort to test whether the methodology was justified or produced results that reflected economic reality.

During the 1997 audit or quarterly reviews, for example, KPMG's audit partner received the following warnings and information from foreign member firms of KPMG International and reached their own conclusions indicating that margin normalization was inappropriate under GAAP.

- When Xerox implemented margin normalization in Europe to achieve equal gross margins on the service and equipment components of its leases -- which Xerox corporate represented was necessary because the margin on service exceeded the margin on equipment in Europe -- KPMG UK informed KPMG's audit partner that there was no objective basis for equalizing margins and noted in their 1997 local work papers that margin normalization carried a "high risk of significant misstatement," that reported margins on bundled contracts were "potentially arbitrary" and that they were based on "little hard evidence." KPMG-UK also raised the possibility of identifying an audit difference for the amount that Xerox had booked due to margin normalization.
- Xerox restricted KPMG auditors in Europe from discussing margin normalization adjustments with local Xerox management.
- KPMG's audit partner, in planning the audit, concluded in his work papers that margin normalization was a high risk accounting practice.
- KPMG's audit team concluded with respect to margin normalization that "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."

Nevertheless, Xerox's senior management never implemented margin normalization at the local level and KPMG never required them to do so. KPMG's audit procedures were inadequate to determine whether the diverging margins between the U.S. and Europe or Brazil were economically justified or whether it was economically appropriate to equalize margins on service and equipment.

During the 1998 audit or quarterly reviews, KPMG's audit partner received similar warnings and reached additional conclusions concerning margin normalization:

- KPMG-UK identified margin normalization as a matter for audit adjustment because there was no support for the procedure and because it was applied in the fourth quarter retroactively to the beginning of the year. The UK auditors told KPMG that

Xerox was “playing follow my leader -- whoever has the highest sales margins being the leader” when it applied a margin differential based on U.S. leases.

- When Xerox corporate headquarters required Xerox Europe to calculate its margins based on the relative margins between equipment and service achieved in the U.S., KPMG-UK informed the KPMG audit partner that it was concerned about management’s motives underlying that methodology, and recommended that Xerox corporate headquarters be required to make a stronger defense of the accounting methods imposed on Europe. KPMG-UK also recommended that Xerox in London carry out “a major exercise testing the U.S. allocation model on its leases to see what differences arise.” KPMG, however, demanded no such defense or testing.
- In still other communications, KPMG-UK advised the KPMG audit partner that it was concerned that the 1998 margin normalization change was driven by “pressure to deliver budget.” The audit partner agreed, 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.

In 1999, additional admonitions were received from foreign member firms of KPMG International and the KPMG audit partner himself identified and raised concerns about the use of margin normalization, the lack of evidence justifying its application and the risks of material misstatement of the financial statements, including from fraud.

- KPMG Brazil informed the KPMG audit partner that there were sufficient stand-alone service contracts in Brazil to calculate actual margins on service, rather than accept for reporting purposes margins based on U.S. leases. Xerox officers in Stamford, however, told the partner that the Brazilian auditors were wrong and that they were not to discuss margin normalization with local Xerox personnel. Thus, by the end of 1999, Xerox had imposed restrictions on KPMG discussions of margin normalization with local managers in both Brazil and Europe.
- KPMG-UK again raised audit differences over use of margin normalization in Europe in 1999 and urged that the procedure be studied to determine if it reflected commercial realities.
- KPMG-UK told KPMG that Xerox Europe continued to make retroactive adjustments to margin normalization for prior quarters despite KPMG-UK’s admonition that such practices cease.
- KPMG acknowledged that the use of margin normalization and the ROE model could result in a “significant accounting surprise” like those that had recently been experienced by Cendant Corporation and Sunbeam, companies sued for financial fraud.

- KPMG’s audit partner also observed in his completion memorandum for the 1999 audit, which was circulated within the KPMG audit team, that the accounting was at risk because of the absence of objective data to support management’s assumption that relative margins around the world should be comparable to U.S. margins.
- KPMG’s audit partner also told both KPMG’s relationship partner (“relationship partner”) for Xerox and KPMG’s most senior partner with the firm’s Department of Professional Practice (“DPP”) that he regarded the proposed 1999 expansion of margin normalization to countries in Xerox’s developing markets organization as “half-baked revenue recognition.”

In fact, shortly after the close of the third quarter of 1999, the KPMG audit partner contacted the head of DPP and advised him about his heightened concern of the risk of fraudulent financial reporting at Xerox. The audit partner informed him that he was concerned specifically about the “last minute” nature of Xerox’s changes to the margin normalization method, and more generally about Xerox’s tendency to apply changes in estimates frequently and at the end of reporting periods. The audit partner also later informed the head of DPP and the relationship partner that the problems at Xerox were getting worse. He told them that Xerox was engaged in “quarter-end transactions to ‘bridge the gap,’” and that Xerox intentionally brought accounting changes or issues to KPMG’s attention at the last minute to limit the time available for KPMG to complete the appropriate review. Finally, the partner informed them (and the KPMG concurring partner for the Xerox audit) that KPMG had a “professional obligation” under GAAS to communicate his concerns to the Xerox Audit Committee. However, KPMG raised none of these issues at the next Audit Committee meeting and the audit partner signed off on the 1999 audit without any qualification.

In 2000, the new lead engagement partner on the Xerox audit -- the head of DPP, who was assigned to the audit after KPMG replaced the 1998-99 engagement partner at Xerox’s request -- received further warnings about margin normalization. When the audit partner visited KPMG-UK in April 2000, the Xerox Europe audit team warned him 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.” The audit partner, however, ignored these and other warnings about the use of margin normalization. Instead, in October 2000, he sent the Xerox Audit Committee an analysis of Xerox’s revenue allocation methods which did not mention the skepticism of KPMG auditors in Europe and accepted without question management representations that the margin normalization device was appropriate:

These adjustments were made to obtain greater consistency in the worldwide process of revenue allocation and because local and Corporate management collectively concluded that changes occurring in pricing and competitive factors in the marketplace had caused a distortion of revenue allocations from fair value.

KPMG signed off on Xerox’s 2000 financial statements, only requiring that Xerox restate to correct the “retroactive” application of margin normalization.

Despite the concerns raised by foreign member firms of KPMG International during 1997-2000 and the risks identified and acknowledged by the KPMG audit partners, including the increased risk of misstatements in Xerox financials, and despite the limitations Xerox imposed on KPMG's ability to discuss the methodology with local Xerox managers in both Brazil and Europe, KPMG abandoned its 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. Moreover, since it was adopted in Europe in 1997, Xerox never demonstrated -- nor did KPMG require it to demonstrate -- how margin normalization corrected any distortions of revenue allocations.

**(iii) Price Increase and Lease Extensions**

In addition to ROE and margin normalization, Xerox used non-GAAP accounting to accelerate the recognition of revenues and earnings through price increases and extensions of existing leases. From 1997 through the second quarter of 1999, Xerox pulled forward approximately \$300 million in equipment revenue and \$200 million in pre-tax earnings in this manner to close the gap between actual and expected financial performance. The net impact on pre-tax earnings for 1997-2000, even after accounting for the reversal of certain of these adjustments in 1999 and the reversing impact of the adjustments made in earlier periods, was \$58 million.

In certain regions, principally Brazil, Xerox negotiated or unilaterally imposed price increases and lease extensions on existing lease customers. GAAP, including FAS 13 and FAS 27, requires that additional income realized from renegotiation of existing leases be recognized over the remaining life of the lease (except when the renegotiation occurs in the last few months of the lease term). Xerox violated these GAAP provisions by recognizing immediately the revenue from price increases and lease extensions negotiated much earlier than the last few months of the lease term and failed to disclose in its public reports that this, rather than increased sales, was another non-GAAP adjustment contributing to increased revenues and earnings.

KPMG, through the audit engagement and concurring partners, and the head of DPP and relationship partner, knew about Xerox's improper accounting for price increases and lease extensions by at least the first quarter of 1999. Xerox told KPMG that, despite the contrary requirements of GAAP, Xerox's accounting treatment was appropriate because it was "pragmatic" and "a fairer representation of the results" of its business. KPMG accepted Xerox's position as it related to the company's pre-1999 accounting, because it concluded it was "an immaterial misapplication of GAAP." However, KPMG's audit partner told Xerox's CFO, controller and other senior financial managers that, on a going forward basis, Xerox's accounting for these extensions and uplifts was wrong, and the company should discontinue the practices. KPMG's audit partner also communicated KPMG's position to the head of Xerox's Chairman of the Audit Committee in a meeting with the CFO shortly after the first quarter close in 1999. Xerox, however, did not stop using the accounting actions. Instead, in the first quarter of 1999, Xerox recognized revenue from these actions but arbitrarily reduced the amount to that which KPMG deemed as quantitatively immaterial -- less than 5 percent of Xerox's consolidated profit before tax. Thus, KPMG knew that Xerox still recognized \$84 million of non-GAAP equipment revenue from these intentional and improper actions that resulted in a \$68 million increase to

Xerox's pre-tax earnings -- which constituted approximately 14 percent (not 5 percent) of first quarter pre-tax earnings.

Xerox's non-GAAP accounting for price increases and lease extensions continued in 1999. During the second quarter of 1999, KPMG allowed Xerox to prematurely recognize \$47 million equipment revenue that resulted in \$32 million of pre-tax earnings from these accounting actions. Xerox committed to cease the practice altogether in the third quarter of 1999, when KPMG learned in connection with the third quarter review that Xerox Brazil was still improperly accounting for revenue from lease extensions and price increases.

At year-end 1999, although he had not objected in prior periods, the engagement partner insisted that Xerox reverse the entire amount that KPMG had counted as improperly reported in connection with price uplifts and lease extensions. But, apparently undaunted by KPMG's repeated admonishments, several of Xerox's Latin American operating units returned to improperly accounting for price increases and lease extensions in 2000, which was corrected for the 2000 financials as a result of Xerox's audit committee's special investigation and KPMG's expanded audit that year.

(iv) **Improper Increases in Residual Values of Leased Equipment**

GAAP requires that at the inception of a lease, the lessor must establish and record the "estimated residual value" of the leased equipment, *i.e.*, the estimated fair value of the equipment, if any, at the end of the lease term. FAS 13, as amended by FAS 23, prohibits increasing the estimated residual value after it is first established.

Despite this prohibition, from 1997 to 1999, Xerox recorded adjustments of more than \$95 million in retroactive upward revisions to the net residual values of machines leased by its Europe, Brazil, United States, Argentina and Mexico operating units. These write-ups, which had the effect of reducing the cost of sales, were often recorded close to the end of quarterly reporting periods as a gap-closing measure to help Xerox meet or exceed internal and external earnings expectations. In some instances, the revisions increased the residual value of the machines by as much as 50 percent. In total, the revisions inflated Xerox's reported pre-tax earnings by a net of \$43 million during 1997-2000.

Notwithstanding the clear requirements of FAS 13, Xerox created an internal accounting policy in late 1996 that permitted retroactive write-ups of net residual values for leases originated in the same year as the write-up. KPMG's audit partner knew that such write-ups were expressly prohibited by GAAP and he communicated this to Xerox. However, KPMG ultimately bowed to Xerox management's pressure and approved its implementation in 1997.

In 1997-1999, KPMG was aware that Xerox was retroactively increasing residual values and that those increases boosted Xerox's reported financial performance. This violation of GAAP contributed to Xerox materially misstating its financial results in numerous public filings, including its second and third quarter reports in 1997, its annual report for 1997, its third quarter report in 1998, and its annual report for 1998. Despite the acceptance of this practice by KPMG, the KPMG auditors of Xerox's U.S. operations repeatedly noted in their 1997 completion

memoranda that retroactively raising residual values violated GAAP. KPMG knew that these write-ups were frequently recorded near the end of reporting periods and KPMG's audit partner in 1999 believed that this heightened the risk of fraud in the financial statements, a belief he communicated to the head of DPP and to KPMG's concurring partner. Nevertheless, Xerox did not disclose, and KPMG did not require Xerox to disclose, this intentional violation of GAAP or its impact.

**(b) Undisclosed Dramatic Increases in Sales of Future Revenues in 1999**

In 1999, Xerox pulled forward approximately \$398 million in revenue and \$182 million in profit before taxes by selling at a discount rights to future revenue streams from existing lease portfolios. This allowed Xerox to immediately recognize revenues which, under GAAP, the company otherwise would have had to recognize over the life of the leases. These transactions were known as "PAS" ("Portfolio Asset Strategy") transactions.

Although Xerox had entered into PAS transactions prior to 1999, that year it quintupled the amount of those transactions compared to 1998. The dramatic and material increase in Xerox's 1999 PAS transactions resulted, in large part, from Xerox's inability to sustain a business model in Brazil that relied on sales-type leases. In 1999, Xerox Brazil changed its business model from its traditional sales-type lease model to one based on rental contracts. Because, under GAAP, the revenue from rental contracts cannot be recognized immediately, Xerox entered into PAS transactions to allow such immediate revenue recognition.

All of the 1999 PAS transactions were crucial to Xerox's ability to close the gap between actual and expected results, and they had a material impact on Xerox's reported results in 1999. The substantial increase in the amount of PAS transactions used to close the gap was material and should have been disclosed to shareholders.

KPMG was aware of and tracked Xerox's use of PAS transactions. KPMG knew that in 1999 Xerox materially increased use of those transactions to recognize \$398 million in revenue that otherwise would have been recognized in later periods under GAAP. However, KPMG failed to require that Xerox disclose the impact from these 1999 transactions, which disclosure should have been required given the dramatic increase in revenues from these transactions compared with earlier periods.

**(c) Improper Creation and Use of Reserves**

Xerox also pumped up its earnings by nearly \$500 million through the release into income of excess or "cushion" reserves. The practice provided a "bank account" to help Xerox meet earnings targets when necessary. Xerox's use of these reserves violated GAAP, and its knowing or reckless use of reserves for this purpose without disclosure was fraudulent.

FAS 5, "Accounting for Contingencies," allows a company to establish reserves only for identifiable, probable and estimable risks and precludes the use of reserves, including excess reserves, for general or unknown business risks because they do not meet the accrual requirements of FAS 5. When a reserve ceases to meet the accrual requirements of FAS 5, it

must be immediately released into income. The systematic or timed release of excess reserves into income violates GAAP.

From 1997 through publication of its fiscal 2000 financial report, Xerox violated GAAP by repeatedly manipulating the release of approximately \$496 million of reserves to close the gap between actual results and earnings targets. This amount includes \$78 million of improperly timed reserve releases, which affected interim periods within a fiscal year. The undisclosed manipulation of these reserves caused Xerox's financial reports to be materially false and misleading.

**i) The Rank Reserve**

In June 1997, Xerox purchased the Rank Group plc's 20 percent stake in Rank Xerox Ltd., Xerox's European subsidiary. In connection with this purchase, Xerox fraudulently established a \$100 million reserve for "unknown risks" arising out of the transaction. In establishing the reserve, Xerox violated GAAP by failing to comply with FAS 5.

Senior management at Xerox knew that the Rank reserve was created for "unknown risks associated with" the transaction, as was documented in a memo by Xerox accounting. In fact, the Rank Group indemnified Xerox for any liabilities arising from the sale.

KPMG-UK, which performed the due diligence on behalf of Xerox preceding the acquisition, advised the company and KPMG's audit partner that the potential tax exposure arising out of the transaction was "remote to low." KPMG's audit partner at the time nevertheless recommended that Xerox book a \$100 million reserve in violation of FAS 5.

Beginning in mid-1998, Xerox began charging expenses against the Rank reserve for items unrelated to the acquisition. The accounting department continued to draw on the reserve each quarter for expenses unrelated to the acquisition until it was exhausted at the end of 1999. Internally, Xerox referred to the reserve as an "interdivisional opportunity" that Xerox Europe used to boost its reported results as needed. Xerox knew its use of the Rank reserve was not in conformity with GAAP and caused its financial reporting to be false and misleading.

In 1999, KPMG learned or should have known that Xerox had improperly established the Rank reserve in 1997 and released the reserve in 1998 and 1999 for expenses unrelated to the purpose for which the reserve ostensibly had been established. However, KPMG did not require Xerox to make any disclosures on the subject or restate its financial statement to correct the improperly accounted income.

**ii) Excess or Cushion Reserves**

Xerox fraudulently released into income approximately 20 other excess reserves totaling \$396 million to improve earnings from 1997 through 2000. Staff in the controller's office tracked excess corporate reserves by preparing schedules called "Interdivisional Opportunities" and "List of Unencumbered & Other Reserves." The controller's office reviewed these excess reserve schedules on a quarterly basis and released the reserves when they were needed to close

the gap between operational earnings and Wall Street expectations. Two of the larger reserves used to manipulate earnings are described below.

FAS 106 Reserve: Xerox created this reserve in 1993 when it adopted FAS 106, which relates to accounting for post-retirement benefits for employees. The balance of Xerox's FAS 106 reserve was \$40 million at the end of 1996, when no additional liabilities remained. During 1997 and 1998, Xerox systematically released the reserve into income at the rate of \$5 million per quarter until the reserve was exhausted.

Whiskers Reserve: The Whiskers reserve had been on Xerox's books so long that neither the controller nor the assistant controller could identify its original purpose and Xerox could not produce any documentation to support it. Rather than reverse Whiskers, as was required by FAS 5, Xerox used \$2 million from the reserve to cover operating and litigation expenses in 1998. In the third quarter of 1999, the controller's office released \$16 million of the Whiskers reserve to cover taxes for Brazilian contract extension issues. Because the controller's office failed to immediately release this reserve at the time it could no longer determine its purpose, Xerox artificially inflated its income from 1997 through 1999 by \$31 million.

Some of the \$396 million in reserves were maintained at the operational level, but a substantial number -- \$225 million as of December 31, 1996 -- were maintained on Xerox's corporate books by senior corporate financial management. Most of these excess reserves were quantified and reviewed by KPMG's audit partners in 1997-1999, often on a quarterly basis. In fact, many of these reserves were identified in KPMG audit differences work papers as either "unspecified excess" reserves or as "opportunities." As with the Rank reserve, however, KPMG did not require Xerox to disclose the use of this improper accounting or to restate its accounting.

#### **D. LEGAL ANALYSIS**

Section 17(a)(2) of the Securities Act prohibits obtaining money or property by means of untrue statements of material fact or misleading omissions of material fact in the offer or sale of securities. Section 17(a)(3) of the Securities Act prohibits engaging in transactions, practices or courses of business which operate or would operate as a fraud or deceit upon the purchaser in the offer or sale of securities. Information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. *Basic, Inc. v. Levinson*, 485 U.S. 224, 231-32 (1988). Establishing violations of Section 17(a)(2) and 17(a)(3) does not require a showing of scienter. *Aaron v. SEC*, 446 U.S. 680, 697 (1980).

Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13 thereunder require all issuers with securities registered under Section 12 of the Exchange Act to file annual and quarterly reports on Form 10-K and Form 10-Q, respectively. Exchange Act Rule 12b-20 further requires that, in addition to the information expressly required to be included in such reports, the issuer must include such additional material information as may be necessary to make the required statements, in light of the circumstances under which they were made, not misleading. The obligation to file these periodic reports includes the obligation that they be complete and accurate in all material respects. *See, e.g., SEC v. Savoy Indus., Inc.*, 587 F.2d 1149, 1165 (D.C. Cir. 1978), *cert. denied*, 440 U.S. 913 (1979); *United States v. Bilzerian*, 926 F.2d 1285, 1298 (2d Cir.), *cert. denied*, 502 U.S. 813 (1991). No showing of scienter is necessary to establish a



violation of Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20. See *Savoy Indus., Inc.*, 587 F.2d at 1167; *SEC v. Wills*, 472 F. Supp. 1250, 1268 (D.D.C. 1978).

Section 13(b)(2)(A) of the Exchange Act requires issuers to “make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” Section 13(b)(2)(B) of the Exchange Act requires issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP and to maintain the accountability of assets. Scienter and materiality are not elements of primary violations of these provisions. See *SEC v. McNulty*, 137 F.3d 732, 740-741 (2d Cir. 1998); *SEC v. WorldWide Coin Investments, Ltd.*, 567 F.Supp. 724, 749-50 (N.D. Ga. 1983).

Rule 13b2-1 of the Exchange Act prohibits any person from directly or indirectly falsifying, or causing to be falsified, any book, record or account subject to Section 13(b)(2)(A) of the Exchange Act. Scienter is not an element of a violation of Rule 13b2-1. *McNulty*, 137 F.3d at 740-741.

Xerox violated these provisions of the securities laws by, among other things, including false and misleading financial statements and information in quarterly and annual reports filed with the Commission from 1997 through the publication of its 2000 financial statements and in registration statements that incorporated these periodic reports and financial information. Xerox failed to disclose in these reports the use and effect of the accounting actions described above, most of which violated GAAP, that accelerated the recognition of equipment revenues by over \$3 billion and increased pre-tax earnings by approximately \$1.5 billion. This misconduct allowed Xerox to “close the gap” between its true operating results and the financial results it reported to the public; to improve earnings, revenues and margins in each quarter and year during 1997-2000; to falsely portray its business and growth as far more robust in 1997-1999 than it actually was, including the false appearance of meeting or exceeding Wall Street earnings estimates in 11 out of 12 quarters from 1997-1999; and to increase its underlying stock price which in turn affected the ability of its executives to obtain performance based compensation and reap profits from the sale of stock.

KPMG’s failure to comply with GAAS caused and willfully aided and abetted Xerox’s violations. See footnotes 4 and 5, *supra*. For each of the years 1997-2000, KPMG issued audit reports containing unqualified opinions stating that KPMG had conducted an audit of the company’s annual financial statements in accordance with GAAS, that Xerox’s financial reporting was consistent with GAAP and that Xerox’s reported results fairly represented the financial condition of the company. KPMG consented to the inclusion of these audit reports in the company’s annual reports on Form 10-K for 1997-2000 and in registration statements filed or in effect during that period. However, KPMG’s 1997-2000 audit reports were misleading because KPMG failed to conduct its audits in accordance with GAAS. KPMG also knew or should have known that Xerox was engaged in non-GAAP and other accounting actions that were not disclosed to investors and prevented Xerox’s reported financial results from fairly representing the company’s financial condition.

In auditing Xerox's accounting practices and methods for recognizing lease revenues, including the ROE and margin normalization methods, KPMG failed under GAAS to exercise due professional care and skepticism, failed to obtain sufficient competent evidential matter justifying their use or verifying their results, substituted managements' representations for competent evidence supporting the accounting, failed to assess the claimed need for the practices (that Xerox could not reliably determine the fair value of its own equipment) as a material internal control weakness, and failed to properly plan or expand its procedures in the face of risk of material misstatement of the financial statements including due to fraudulent accounting. In fact, although KPMG at times urged Xerox management to conduct testing of these methods, KPMG never insisted that Xerox undertake such testing when it failed to do so, nor did KPMG itself perform audit procedures to test and determine whether these accounting actions were necessary or resulted in appropriate revenue allocations. Had it done so, it would have reasonably determined that these were arbitrary, non-GAAP accounting actions. KPMG also failed to assess adequately (or require Xerox to assess) the need to disclose in the MD&A or financial statements the nature of and the impacts from these accounting actions, which materially deviated from the company's historical accounting and financial reporting and accelerated \$2.8 billion of equipment revenues and \$659 million in pre-tax earnings that otherwise would not have been recorded under GAAP.

In addition, KPMG permitted Xerox to use other accounting actions that KPMG knew or reasonably should have known did not comply with GAAP and should have been disclosed to investors because they materially increased and distorted the company's financial results. These actions included price increases and lease extensions, retroactive increases to residual values of leased equipment and manipulation of reserves. KPMG also failed to require that Xerox disclose the material increase in revenues and earnings in 1999 from PAS transactions as compared to prior periods.

Despite these accounting and audit failures, and in further violation of GAAS, KPMG did not express a qualified or adverse audit opinion, or refuse by disclaimer to express any opinion at all, but instead issued audit reports that contained unqualified opinions on Xerox's 1997-2000 financial statements. Nor did KPMG require that Xerox correct its improper accounting or disclose the use of and impacts from the accounting actions in the quarterly (unaudited) financial statements and reports that KPMG reviewed during 1997-2000. Accordingly, KPMG's failure to comply with GAAS caused and willfully aided and abetted Xerox's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13 and 13b2-1 promulgated thereunder.

KPMG also willfully violated Section 10A of the Exchange Act. As discussed above, during its audits of Xerox's 1997-2000 financial statements, KPMG became aware of information indicating that illegal acts had or may have occurred as a result of Xerox's use of numerous material accounting actions, most of which violated GAAP and were not disclosed to investors. Although KPMG at times raised concerns to Xerox's management about certain of these accounting actions, KPMG failed to inform Xerox's board of directors or its audit committee about the illegal acts it detected or that otherwise came to its attention.

## **E. FINDINGS**

Based on the foregoing, the Commission finds that KPMG willfully violated Section 10A of the Exchange Act and caused and willfully aided and abetted Xerox's violations of Section 17(a)(2) and (3) of the Securities Act and Sections 13(a) and 13(b)(2)(A) and (B) of the Exchange Act and Rules 12b-20, 13a-1, 13a-13 and 13b2-1 promulgated thereunder.

## **F. UNDERTAKINGS**

As stated above in Footnote 2, simultaneously with this proceeding, KPMG consented in a separate, previously filed civil action against KPMG to the entry of a final judgment ("Final Judgment") by the U.S. District Court for the Southern District of New York pursuant to Section 20(d) of the Securities Act and Section 21(d) of the Exchange Act that, among other things, orders KPMG to undertake to alter or amend its audit practices in the manner described as follows.

1. Oversight of Engagement Partner Changes. The goal of this undertaking is for KPMG to avoid circumstances where a client may improperly influence the firm's assignment of engagement partners, and for KPMG to reasonably document its consideration of these circumstances if it is presented with a client's attempt to influence the assignment of an engagement partner. Among the procedures to be implemented to effectuate this goal, KPMG shall designate one or more senior partners with substantial audit and management experience ("Senior Partner") to investigate and document the circumstances surrounding any changes in authority, reassignment or termination of an audit partner responsible for issuing the firm's audit report on the financial statements of a public company, other than changes to comply with rules of the Commission concerning independence and partner rotation or by reason of retirement in the ordinary course ("Change in Partner Review"). Such procedures shall be implemented within a reasonable time after the Final Judgment, but in no event later than ninety days after the date of the Final Judgment. The Senior Partner shall not have previously been a member of the audit engagement team for the client in question and shall not be in a position of supervising directly the engagement partner who is the subject of the Change in Partner Review. The Senior Partner shall interview the engagement partner and any KPMG partner or employee who participated in or was consulted regarding the change in assignment, and make any other inquiries and review any documents he or she deems appropriate under the circumstances. The purpose of the Change in Partner Review shall be to identify and document the reasons for the change in the engagement partner's assignment and to determine whether those reasons are consistent with maintaining the independence of the audit from undue client influence. If, in the course of the Change in Partner Review, information comes to the attention of the Senior Partner indicating that there may be a material error in previously issued financial statements by the client, or that the client may have engaged in an illegal act (as that term is used in Section 10A of the Securities Exchange Act of 1934), and such issues had not been previously addressed by the engagement team, the Senior Partner shall take such steps as are reasonable and necessary to have those issues addressed in a timely and appropriate manner and to have such information and such actions documented in the audit workpapers. Additionally, if, as a result of the Change in Partner Review, any disciplinary action against any member of the firm is warranted, or if any changes in KPMG policies and practices are warranted, such actions and changes also shall be

documented. Documents prepared or collected during this review shall be retained for seven years, and shall be produced on request to the Commission staff and to the consultant to be appointed by KPMG pursuant to these undertakings.

2. “Whistle-blower” Channels of Communication. The goal of this undertaking is for KPMG to create additional lines of communication within the firm to allow KPMG professionals to raise issues, which they may believe have not been adequately addressed at the engagement team level, to a more senior level within the firm. KPMG shall establish appropriate policies and procedures to effectuate the goal, including those described herein. KPMG shall establish and publicize, on a regular basis, to its partners and employees (and to all partners and employees of KPMG International member firms engaged to assist KPMG LLP in the audit of foreign operations of publicly reporting U.S. companies upon whose financial statement’s KPMG LLP is reporting) channels of communication that would enable engagement personnel to raise any such issues or concerns to higher levels within the firm and with the option of doing so in a confidential or anonymous manner. The initial designated recipient of such communications shall be an ombudsman or similarly designated senior partner (“Ombudsman”). The Ombudsman shall not be in a direct line of supervision over any member of any audit engagement team nor may the Ombudsman be compensated based on the revenue generated with respect to any specific audit engagement. The Ombudsman, as a partner in the firm, however, shall continue to share in the profits and the losses of the firm. The Ombudsman shall have full authority to conduct his or her own investigation of any matter identified to him or her, and may not be required to identify the origin of the inquiry (except pursuant to a subpoena issued by a law enforcement agency or demand by the Public Company Accounting Oversight Board (“PCAOB”). The Ombudsman, in that role, shall report directly to the Chairman of KPMG. KPMG shall retain written records of Ombudsman communications and of the Ombudsman’s investigation and results of such investigation, for a period of seven years. These documents shall be made available on request to the Commission staff and subject to inspection by the PCAOB and to the consultant to be appointed by KPMG pursuant to these undertakings.

3. Consultation Documentation. The goal of this undertaking is for KPMG to ensure that KPMG has policies and procedures designed to provide reasonable assurance that workpapers prepared in connection with the audits of the financial statements of public companies include documentation of significant consultations with KPMG’s Department of Professional Practice, firm specialists or others within or without the firm. The documentation of such consultations should include a description of the issue considered, any action taken with respect to the issue, and the basis for conclusion with respect to the issue. Such documentation shall be made available on request to the Commission staff and subject to inspection by the PCAOB. The policies and procedures also should provide reasonable assurance that significant inquiries of employees of public audit clients are documented in the audit working papers.

4. Audit Evidence Training. The goal of this undertaking is for KPMG to provide reasonable training to its audit professionals concerning evaluation of audit evidence in a situation involving period-ending material adjustments by management to a company’s original accounting system entries. To implement this goal, KPMG shall develop and furnish to all audit professionals, and incorporate in its training for new audit professionals, procedures for evaluation of purportedly sufficient and competent evidence offered by management of public

company clients to justify departure from journal entries prepared within the client's existing accounting systems in favor of period-ending adjustments to the original accounting system entries. The training shall address audit strategies for verifying the need for the adjustments, to assess whether the adjustments fairly state the accounts which have been adjusted and whether the adjustments might be manipulative to achieve or disguise financial results.

5. Reassessing Departures from GAAP. It is recognized that from time to time an entity may conclude that it need not account for transactions in accordance with GAAP because the effect is not material to investors. The goal of this undertaking is for KPMG to evaluate the continued reasonableness of conclusions concerning a client's prior departures from GAAP, to the extent that the client continues to utilize the non-GAAP accounting in later years. To implement this goal, KPMG shall disseminate to all audit professionals, and incorporate in its training for new audit professionals, requirements that auditors of public company clients at least annually reassess a client's justification for accounting practices which are not in accordance with GAAP and assess the materiality of such departures. The auditor should obtain competent evidential material and document, consistent with auditing standards promulgated by PCAOB, each quarter and at year end, that the departure from GAAP is reasonable and is not employed to distort or present a materially false presentation in the financial statements. A prior determination about the appropriateness of the departure from GAAP or the materiality of the departure may not, alone, be relied upon in subsequent audits. This undertaking shall not relate to items that are clearly inconsequential as that expression is used in Section 10A of the Exchange Act.

The chairman of KPMG shall certify compliance with each of the above undertakings. The certification shall identify each of the above undertakings with which KPMG believes it has complied by establishing appropriate policies, procedures and training, and shall provide written evidence of compliance in the form of a narrative which is supported by exhibits sufficient to establish compliance. The Commission staff may request such further evidence of compliance as is reasonable, and KPMG agrees to provide such evidence. The certification and supporting material shall be submitted to the Director of the Division of Enforcement, or to such person designated by him. Certification of the satisfactory completion of all of the above undertakings and sufficient evidence of completion shall be submitted to the Commission staff not later than one year after the entry of the Final Judgment.

KPMG further undertakes to retain a consultant qualified to examine and assess compliance with these undertakings two years after successfully certifying to the Commission that all of the above undertakings have been completed. Said consultant shall be selected by KPMG, but shall be a person acceptable to the Commission staff in advance of the consultant's retention by KPMG. The limited purpose of the consultant shall be to certify to the Commission that the undertakings continue to be in effect, are being complied with and appear to be effective in achieving their overall goals. If the consultant cannot so certify, the consultant shall make such recommendations to KPMG, as he or she deems appropriate, for the purpose of bringing KPMG into effective compliance with the goals of the Undertakings. A copy of his or her certifications, conclusions and recommendation (the "Certification") shall be submitted to the Division of Enforcement. Once such Certification has been submitted, the limited role of the consultant shall be concluded. KPMG consents to adoption of any recommendations of the

consultant unless it is able to establish to the satisfaction of the Division of Enforcement that adoption of a particular recommendation is unnecessary or unreasonably onerous. If the Division requires that KPMG adopt a recommendation to which it objects, KPMG may request that the Division present the issue to the Office of the Chief Accountant of the Commission in a written memorandum, setting forth reasons why the recommended procedure is necessary together with KPMG's written objection, for which KPMG may request confidential treatment under the Freedom of Information Act. Until the Office of the Chief Accountant resolves the objection, KPMG shall be under no obligation to accept the recommendation. KPMG agrees that the Office of the Chief Accountant's decision shall be final and shall not be subject to any appeal or other legal challenge by KPMG.

#### IV.

In view of the foregoing, the Commission deems it appropriate to impose the sanctions agreed to in Respondent KPMG's Offer.

Accordingly, it is hereby ORDERED, effective immediately, that:

A. KPMG shall cease and desist from committing any violations and any future violations of Section 10A of the Exchange Act; from committing or causing any violations or any 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 any 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.

B. KPMG is censured pursuant to Rule 102(e)(1)(iii) of the Commission's Rules of Practice.

By the Commission.

Jonathan G. Katz  
Secretary