Accounting Fraud at Xerox Corporation: Ethical Considerations[1]

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Management at Xerox Corporation faced with strategic mistakes and tough economic environment resorted to creative accounting to meet financial targets and Wall Street expectations. This case presents a brief history of Xerox Corporation, followed by Xerox's corporate culture in the 1980s & 90s, and the SEC investigation. The focus of the case is the actions of an assistant treasurer that top management used to guide Xerox through tough economic times and help make financial results appear more favorable. A teaching note is included. The case may also be used for exploring strategic issues or accounting issues and the mechanics of GAAP violations.

Keywords: Xerox, Accounting Fraud, Ethical Issues, Code of Ethics, Professional Behavior

XEROX HISTORY

Xerox Corporation (Xerox) was founded in 1906 in Rochester, New York as The Haloid Company. It started making and selling photographic paper. Chester Carlson made the first xerographic image in his lab in Astoria, Queens, New York City in 1938 and was granted a patent for his electro-photography technology, which was later, changed to xerography (for the ancient Greek words for "dry and "writing"). In 1942 Carlson perfected a process for transferring electrostatic images from a photoconductive surface to paper.

In 1948 the word "Xerox" was trademarked. Haloid commercialized xerography in1949 with the Model A copier and the Xerox Copyflo in 1956. By that time xerographic products represented 40% of sales. The company name was changed to Haloid Xerox in 1958. In 1959 the first simplified office photocopier was developed, called the Xerox 914, bringing the company major recognition. The Xerox 914 was soon beating competing technologies, such as mimeograph (A.B. Dick), thermal paper (3M), and damp copy (Kodak) (Gehani, 1998). The Xerox 914 was so popular that by the end of 1961, Xerox had almost $60 million in revenues; by 1965 revenues had grown to over $500 million.

In 1961 the company changed its name to Xerox Corporation, and its common stock was listed on the New York Stock Exchange. Xerox decided to branch out into other ventures starting in the 1960s by buying three publishing companies and a computer unit. All of these were later sold or disbanded. By 1963 Xerox had introduced the Xerox 813, which was the first desktop plain-paper copier, fulfilling Carlson's vision of having a copier that could fit on anyone's office desk. In 1973, Xerox introduced its first color copier. In the 1970s, Xerox bought printer, plotter, and disk drive businesses. In 1974 the FTC decided that Xerox dominated the market, and they were forced to license their technology.

Also during the 1970's, Xerox began to face its first real threat to its copier market, which came from the Japanese, who started to penetrate the market with their low-cost products. Japanese manufacturers Canon and Ricoh started to gain a reputation for good quality low cost copiers and they soon began to impact Xerox's once dominant copier market share. Xerox responded by developing the laser printer, which was actually a modified version of a Xerox copier. Xerox introduced the first laser printer, the Xerox 9700 in 1977. Laser printing today is a multibillion dollar business with Hewlett Packard as the market leader. Xerox continued to revive itself throughout the 1980's and into the 1990's by improving quality, design and realigning its product line.

In the 1980s Xerox bought companies specializing in optical character recognition, scanning, faxing, and desktop publishing. The company experienced a revival in the 1980s and 1990s, through their improvement in quality design and the realignment of its product line. By the mid-1990s they had developed digital technology that they were sure would lead them into the next century. The expectations were that the new digital technology would once again give Xerox a technical edge over its competitors. In 1993-94, Xerox Corporation was adding a new line and a new dimension to its business complete with a new logo, "The Document Company." The first product that was developed for their new digital age was known as the DocuTech. These were huge machines costing $250,000-plus that could rapidly scan paper documents into digital format where they would be stored. The digital images and text could then be manipulated, printed, or transmitted over networks to other DocuTechs. There were also different scanners, image processors, and printers that could be run from different locations over PC networks. The software for the additional equipment would allow the PC networks to be used regardless of the differences in the computer's software. Xerox Corporation reasoned that digitized documents needed little physical storage space and they could also be manipulated at will. They also hoped to gain an entry into the low end of the professional printing market with these new machines. Colin O'Brien, head of Xerox's document-production unit, expected that by the year 2000, 80% of the firm's revenues would be digital.

XEROX CORPORATE CULTURE

Xerox based its business on the belief that, "documents represent the knowledge base of an organization and play a dynamic and central role in business, government, education, and other organizations" (Xerox, 2001, p. 8). Their principle strategy had been to focus the core of their business on the most profitable and highest growth segments of the document market. They put particular emphasis on color across their product lines and services. Their belief was that their customer's demands would increasingly move toward a higher demand for color documents. They also believed that the document industry would undergo a transformation toward digital technology, with documents being increasingly created and stored in digital electronic form. With the internet increasing the amount of information that could be accessed in the form of electronic documents, Xerox believed that they had the strengths and technology to take advantage of these trends that represented opportunities for future growth for the company.

Paul Allaire, Xerox chairman and chief executive officer (CEO) since 1986, proudly introduced an initiative to his senior managers in 1994 that he believed would ensure Xerox's continued success into the next century and beyond. What he introduced to them was the outline for Xerox 2000, which was actually a planned update of a total quality strategy plan that the company had in place since 1983 that was called Leadership through Quality. This program was originally designed to provide "Xerox employees a working knowledge of total quality and the tools and techniques to achieve it" (Leo, 1996, p. 65). Leadership Through Quality was credited with helping Xerox regain some of its market share in a highly competitive market (Leo, 1996). Allaire had taken a look at the original program and decided that some adjustments were needed to integrate quality into all aspects of business operations. Two objectives that were most critical for Xerox to focus on were profitable revenue growth and world-class productivity. It would be up to Xerox's management to clarify the company's vision, focus on essential objectives, and organize and allocate its resources accordingly. Allaire felt that the mid 1990's and the early part of the next century would be a time of crisis for the company, calling for the need to set aggressive productivity and revenue goals and use its quality process to achieve them.

Barry D. Romeril was Xerox's chief financial officer (CFO) since 1993 and was credited, along with then chairman and chief executive, Paul Allaire, of leading Xerox through a difficult period in the late 1990's. During this time Xerox was faced with stiff competition from foreign markets while losing a considerable portion of their core small copier business to desktop printers. In addition, a new internal reorganization had been poorly implemented, putting salespeople in unfamiliar territory and tying the billing department up in knots. During this period, Xerox also lost millions of dollars on their diversification effort into insurance and financial services. Yet, through all of this, Mr. Allaire and Mr. Romeril seemingly managed to keep Xerox headed in the right direction, and meeting Wall Street earnings expectations every quarter, keeping their stock price rising and keeping investors happy.

However, Allaire's prediction of an impending crisis turned out to be truer than most people would have expected. Unknown to outsiders, Xerox's top executives had adopted an attitude of win at any cost, and they turned to their accounting department to help them achieve this goal. By the mid-1990s, Xerox management had decided they were going to have their accountants come up with some significant creative accounting if they were going to be able to keep showing Wall Street and their stockholders that they were able to meet their earnings expectations.

SEC INVESTIGATION

For Xerox it all started to publicly unravel in May 2000, when Xerox made its first public announcement that they had discovered accounting irregularities associated with its Xerox-Mexico operations. As the problems at Xerox-Mexico became public in June of 2000, the Securities and Exchange Commission (SEC) launched an investigation into what was happening at the Xerox-Mexico subsidiary. At the same time, Xerox's audit committee hired the Washington DC law firm of Akin, Gump, Strauss, Hauer, & Feld to conduct an independent investigation about what was happening at the Mexican subsidiary, with explicit instructions to limit the scope of their investigation to the Mexico division. When the law firm found indications that aggressive accounting practices may have been used in other areas, they were told by internal Xerox lawyers to stick with Mexico only and that Xerox management, including CFO Mr. Romeril, would look into accounting issues outside of Mexico.

In February 2001, the SEC started to look beyond the Mexican unit. In an effort to reassure company investors, Mr. Allaire presented the conclusions of the Akin, Gump, Strauss, Hauer, & Feld investigation. He announced that some of the problems found during the investigation in Mexico included failures to write off their mounting bad debts and improper classification of transactions. Mr. Allaire went out of his way to distance corporate executives from the problems in Mexico by blaming a small group of Xerox Mexico and Latin American executives, accusing them of acting in collusion to circumvent company policies and procedures. As a result of the investigation, 13 managers were fired or removed, and Xerox had to write-off $120 million in 2000.

Shortly after Xerox released the results of the Akin, Gump, Strauss, Hauer, & Feld report, Xerox also released results of the internal world-wide investigation. For the first time, Xerox said that some of the problems went beyond Mexico, forcing it to increase reserves in some smaller Latin American countries, while at the same time suggesting there were no accounting issues found in any other major units. Following closely, Mr. Romeril also publicly announced for the first time that the SEC had widened its investigation beyond Mexico.

FROM LOYAL ACCOUNTANT TO WHISTLEBLOWER

James F Bingham, a 15 year Xerox veteran, and assistant treasurer at Xerox, was one of the several finance managers that top management called on to guide them through some of these tough economic times and help make the numbers go their way. He was more than willing to help shore up deteriorating economic results by practicing some creative accounting. According to Bingham, Xerox executives frequently assigned accountants numerical goals to produce profits through accounting actions. It just became standard operating procedure to look to the accountants to find income.

It appears that Mr. Bingham was doing this since the mid-1990s, and often he even enjoyed the challenges placed before him. However, after working on one particular deal, he began to realize that all he was doing was to help mask a bigger and bigger problem. He could see that Xerox's underlying business was deteriorating, and no one was doing anything to try to fix it, except using accounting trickery. He began to get rather depressed about the situation, and after the news of the scandal in Mexico went public, Mr. Bingham decided something needed to be done. He was convinced that the problems found in Mexico were part of a larger Xerox culture where managers were being pressed to reach financial targets using aggressive accounting. A few weeks after the Mexico scandal went public, Mr. Bingham sent an e-mail to his boss, then Treasurer Eunice Filter, warning her that the recent accounting problems found in Mexico were not limited to Mexico alone. He was told not to send that memo to anyone else. However, he sent the memo to Anne Mulcahy, the new Xerox chairwoman and CEO, and Mr. Romeril, the CFO.

Mr. Bingham found himself extremely frustrated by the responses he was receiving, because he truly wanted to help set the company back on the right course. He had always considered himself a loyal Xerox employee and he was just trying to do what he believed to be the right thing. For the next few weeks, Mr. Bingham spent a considerable amount of time preparing a presentation that he hoped would finally get the attention of top Xerox executives. On August 28, 2000, Mr. Bingham met with Barry Romeril and two other senior executives. Over the course of an hour, Mr. Bingham laid out his own comprehensive critique of the company's accounting practices and corporate culture. He felt he had a responsibility to speak out because he saw that what was happening was leading the company toward bankruptcy. He concluded his presentation by saying there was a high likelihood the company had issued misleading financial statements and public disclosures.

Mr. Bingham naively felt that the logic of his arguments would make it clear to the executives that things needed to change in order to save the company. Two days later, he was fired. Xerox offered a settlement roughly equal to a year's pay, which he rejected. Instead, he had his lawyer file a lawsuit against Xerox in November 2000 in Connecticut Superior Court in Stamford. The suit claimed, among other things, that Mr. Bingham was wrongfully terminated for preventing Xerox's fraudulent activities. The filing of the lawsuit brought Mr. Bingham to the attention of the SEC, where he would soon become a star witness against Xerox. In December 2000, Mr. Bingham spent two days in Washington DC being deposed by the SEC. The SEC also obtained a copy of the August 28th presentation he gave to Xerox executives, along with some other documents.

While part of Mr. Bingham's August 28th presentation contained criticism of the change in booking for services and supplies as part of the company's leasing agreements, his bigger concern was how the company was making overly inflated assumptions about the value of future leases in developing countries. According to Mr. Bingham, Xerox would rapidly reduce the discount rate too far below the local interest rate, allowing them to book more revenue. While this doesn't fabricate revenue, it shifts revenue to current period from future periods. Mr. Bingham said that Xerox was using the lower rates because there was no other way that the managers in developing markets were going to meet their revenue goals for 2000. He told the SEC that he had estimated that Xerox had improperly booked $447 million in pretax income over the previous six years, using the understated discount-rate assumptions when booking leases, primarily in Latin America. He also spoke about several other one-time accounting actions that had been used, including the use of "cookie jar" reserves, which were not in accordance with GAAP standards in order to boost quarterly income throughout the late 1990s.

TEACHING NOTE - ACCOUNTING FRAUD AT XEROX CORPORATION: ETHICAL CONSIDERATIONS

Introduction

This teaching resource presents a case study. Case studies have several advantages. Case studies provide context-dependent knowledge, enhance learning process, are closest to practical experience, have more student involvement, helpful for students preferring inductive reasoning, promote problem solving, analytical skills, complex decision-making and deal with ambiguity, among others[2]. Stewart and Dougherty (1993) report significant pre-to post-test improvement in essay exam performance for students using case study approach. A case study may be effectively used by instructors favoring Problem Based Learning approach (Milne & McConnell, 2001). Case studies may also be used to develop soft skills along with discipline specific skills (Boyce, et.al., 2001).

While there has been no reported survey of the extent of case studies used in accounting education, anecdotal evidence suggests that cases are not widely used by accountings instructors. Given the many advantages of using cases one might wonder why case studies are not widely used by accounting instructors. There are many reasons for the lack of widespread use of cases in accounting education. The authors experience is that it is not easy to find good case studies that an instructor may use in his/her course; thus the motivation to provide an additional resource.

Ethics Education

The many incidences of accounting and management fraud are widely documented in the popular press and literature. It is not practical to provide a comprehensive review of the many frauds; still one can list the well-publicized accounting scandals in the United States in recent years. These include ethical and legal violations at WorldCom, Xerox, Adelphia, Dynergy, Tyco, Rite Aid, and Enron. In just 26 years The Association of Certified Fraud Examiners (ACFE) has become the world's largest anti-fraud organization with more than 70,000 members. The many calls for more emphasis on ethics education by professional accounting bodies are well known. The American Institute of Certified Public Accountants (AICPA), Institute of management Accountants (IMA), and ACFE all have specific ethics related Continuing Professional Education (CPE) requirements.

Like other professional organizations, such as Law, Medicine, etc., accounting professional organizations all have a code of ethics. The success of the accounting profession depends upon public trust. Besides competence, integrity and credibility are key components of such code of ethics for professional accountants. Accountants should not only avoid conflicts of interest but also any appearance of conflict of interest. As such, the focus of this teaching note is on ethics.

Accounting Fraud at Xerox

This case was originally written for the IMA's Carl Menconi Ethics Case Writing Competition and received an honorable mention in the competition. An earlier draft of the case was uploaded on the SSRN network as a working paper. The case was very popular at the Social Science Research Network (SSRN) where it was listed in the top ten downloads with current overall statistics of more than 3,000 downloads. Given the statistics and feedback, one could say that the Accounting Fraud at Xerox case is a popular resource.

As stated below, the events and issues at Xerox were many and diverse. Writing a comprehensive case dealing with all the issues is not practical. As noted above, this case was originally written for an ethics case competition, hence the focus on ethical issues. However, the choice of issues to include in any particular case is to some extant a personal choice and always open to criticism by others.

The issues at Xerox in the late 1990s were many and highly interesting for both undergraduate and graduate accounting and business students. A very interesting strategic issue that could be explored is: how did Xerox, who invented great technologies, such as the first personal computer and the laser printer, fail to commercialize and benefit from these inventions. George William and Andrew McLean of the Harvard Business School have written a very popular case about Leadership focusing on Ann Mulcahy's leadership at Xerox[3]. Then there are the accounting issues reported but not detailed in the case or the teaching note that enterprising instructors with some effort can use to focus on the mechanics of GAAP violations[4].

However, this case mainly deals with ethical issues and particularly the actions of assistant treasurer, James F. Bingham. The case can be used in both the undergraduate accounting class and/or a professional CPE seminar. A standalone ethics course or a capstone course would be ideal places to use the course. The case can also be used in a professional ethics course or a seminar. While some knowledge of professional ethics would be helpful, the case does not require any prior preparation besides reading to benefit from and participate in class discussion.

In short, the case describes a very interesting, though unfortunate, situation at a leading American Corporation that should be of interest to both students and professionals.

Suggested Question

This is a rich case and the instructor could probably come up with many different questions, however, the following questions are suggested:

1) Discuss the IMA's Statement of Ethical Professional Practice and explain which of the four standards appear to be violated by James Bingham?
2) Discuss James Bingham's efforts in relation to the IMA's Statement of Ethical Professional Practice, resolution of ethical conflict.
3) To comply with the IMA's Statement of Ethical Professional Practice, what should James Bingham have done?
4) Assuming that the IMA's Statement of Ethical Professional Practice is applicable to all Xerox accountants, discuss who else may have violated the standards.
5) What are the ethical issues in the case?
6) What factors contribute to the ethical problems at Xerox?

Discussion

While detailed analysis and discussion of all the questions will require a lot of time and space, in the interest of keeping this short, only the major points are highlighted below:

Q1: The instructor can lead the discussion about the IMA's Statement of Ethical Professional Practice and write down the standards on the board or flipchart as the participants talk about them. If the participants are not expected to be knowledgeable about the Statement, the instructor can write or project the IMA's Statement of Ethical Professional Practice as below[5]:

I. COMPETENCE

Each member has a responsibility to:

1. Maintain an appropriate level of professional leadership and expertise by enhancing knowledge and skills.
2. Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3. Provide decision support information and recommendations that are accurate, clear, concise, and timely. Recognize and help manage risk.

II. CONFIDENTIALITY

Each member has a responsibility to:

1. Keep information confidential except when disclosure is authorized or legally required.
2. Inform all relevant parties regarding appropriate use of confidential information. Monitor to ensure compliance.
3. Refrain from using confidential information for unethical or illegal advantage.

III. INTEGRITY

Each member has a responsibility to:

1. Mitigate actual conflicts of interest. Regularly communicate with business associates to avoid apparent conflicts of interest. Advise all parties of any potential conflicts.
2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
3. Abstain from engaging in or supporting any activity that might discredit the profession.
4. Contribute to a positive ethical culture and place integrity of the profession above personal interests.

IV. CREDIBILITY

Each member has a responsibility to:

1. Communicate information fairly and objectively.
2. Provide all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3. Report any delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.
4. Communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

The discussion can then move on to specific violations. The consensus from the discussion should be that most, if not all, the standards are violated. Some may argue that he did not violate the confidentiality standard. Also, participants may point out positive aspects of James Bingham's behavior. Which could be used as a teaching moment to emphasize that in the real world things are not always all good or bad but often a mix-shades of grey.

Q2: The IMA's resolution of conflict states that[6]:

- The resolution process could include a discussion with the member's immediate supervisor. If the supervisor appears to be involved, the issue could be presented to the next level of management.
- IMA offers an anonymous helpline that the member may call to request how key elements of the IMA Statement of Ethical Professional Practice could be applied to the ethical issue.
- The member should consider consulting his or her own attorney to learn of any legal obligations, rights, and risks concerning the issue.

If resolution efforts are not successful, the member may wish to consider disassociating from the organization.

Going over the steps taken by James Bingham in chronological order, one can see that he probably followed the resolution of Ethical Conflict guidelines pretty closely. Some students will argue that James Bingham did not consult an ethics counselor. While the observation is technically correct, such facility was probably not available in the 1990s. The instructor can walk the participants through each step in the resolution process. However, the interesting thing is that for quite some time James Bingham viewed as a challenge and was himself involved with the creative accounting in order to report higher earnings. This point would not be missed by the students who are truly engaged in the case discussion. Again, it may be worthwhile to emphasize real world issues. Early on, James Bingham probably did not realize that the management requests were unethical or in violation of existing standards and regulations but came to that realization subsequently.

Q3: is an open ended question and there are many things that James Bingham could have done to comply with the standards. Students likely mention a diverse list of actions that the instructor can write down on the chalk board or flip chart. However, the main thing that should come out in the discussion is performing professional duties in accordance with relevant laws, regulations, and technical standards. Another item is to abstain from engaging in or supporting any activity that might discredit the profession. And of course, there are other issues.

Q4: If you look at it, it seems that almost all the accounting and finance personnel involved are culpable to some extent, starting with the CFO Barry Romeril. Based on instructor discretion, the discussion can progress to the nature of violation for each individual vis-à-vis the IMA Statement of Ethical Professional Practice.

Q5: There are numerous ethical issues in this case. These include earnings management, GAAP violations, financial misstatement, deception, and outright fraud. Not all students will list all the violations. Based on experience with teaching similar cases, this should lead to a very active and interesting discussion.

Q6: What factors contributed to the ethical problems at Xerox? A review of the many cases that deal with similar situation shows that in almost all cases, it is the same common scenario. A company faced with strategic mistakes, operational problems, stiff competition, etc., and faced with poor financial performance takes recourse to aggressive accounting practices[7]. Often it starts as a one shot deal to meet short term financial expectations that escalates to ongoing fraudulent activity, until someone blows the whistle. Other contributing factors include good past performance and managements desire to continue to show high performance by whatever means necessary; setting not only aggressive performance standards but often unrealistic standards that fail to take into account the business environment; poor internal controls; tone at the top; poor corporate governance; and of course, unethical individuals.

Eventual Outcome

Most students are interested in the eventual outcome. A few often look up current information about the company. They or the instructor can present the information to rest of the class.

The SEC investigation and review by KPMG, the auditors, revealed internal memos in which senior Xerox management actually discussed accounting practices that could be used to increase earnings in line with Wall Street expectations. While Xerox officials dismissed this as simple "brainstorming" that was encouraged at Xerox, KPMG insisted that fake transactions and illegal revenue recognition should never be discussed and refused to sign the 2000 annual report despite threats from Mr. Allaire that this could lead to bankruptcy.

In 2002 the SEC filed suit against Xerox accusing management of fraud and imposed a $10 million fine. Xerox settled the case without admitting any wrong doing, restated 1997-2000 financial results and paid the $10 million fine.

With regard to James Bingham, information available indicated that he was shunned by the employees at Xerox, and he and his family had to make do with less because of the loss of his $350,000 annual pay package. He was offered a job by a friend, but had to resign because of his obsession with the wrongdoings at Xerox. He was in a way vindicated by Xerox's settlement with the SEC.

While not discussed in this case/teaching note, the adverse impact on whistle blowers could be the subject of further discussion.

ENDNOTES

1. This case is based mostly on information from Xerox Corporation's annual reports, annual form 10-K, SEC complaints and cases, Xerox on Wikipedia, and several investigative reports published by James Bandler and Mark Maremont in the Wall Street Journal during 2001 & 2002. This case is developed for class discussion and the purpose is not to depict effective or ineffective management practices and behavior.
2. "Using case studies to teach," Boston University Center for Excellence and Innovation in Teaching http://www.bu.edu/ctl/teaching-resources/using-case-studies-to-teach/ and "Teaching with case studies," Stanford University Newsletter on Teaching, Winter 1994, 5, (2).
3. There are several Harvard Business School cases about various aspects of Xerox.
4. Students may be asked to research the GAAP issues highlighted in the case.
5. IMA Statement of Ethical professional Practice. https://www.imanet.org//media/b6fbeeb74d964e6c9fe654c48456e61f.ashx
6. Ibid.
7. There are many examples, such as IBM, WorldCom, Bausch & Lomb, etc.

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