Recommendation
Approved by
Commission
With Revisions

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Tara Sussan
Program Information Specialist

Circ. 4/8 for 4/9

PRIVILEGED AND CONFIDENTIAL

To include info on lit release and "co. was uncooperative," note "investigation is ongoing."

ACTION MEMORANDUM

April 8, 2002

TO: The Commission

FROM: Division of Enforcement PRB

RE: In the Matter of Xerox Corporation,
File No. HO-9013

SUBJECT: Proposed Enforcement Action

RECOMMENDATION: That the Commission:

(1) authorize the staff to file a civil injunctive action that:

(a) permanently restrains and enjoins Xerox Corporation ("Xerox") from violating Section 17(a) of the Securities Act of 1933 ("Securities Act"), Sections 10(b), 13(a) and 13(b) of the Securities Exchange Act of 1934 ("Exchange Act"), and Exchange Act Rules 10b-5, 12b-20, 13a-1, 13a-13 and 13b2-1;

(b) requires Xerox's Board of Directors to appoint a special committee comprised entirely of outside directors which shall retain a qualified consultant, not unacceptable to the Commission, to perform a complete review of Xerox's material internal accounting controls and policies; and

(c) imposes on Xerox a money penalty pursuant to Section 21(d)(3) of the Exchange Act and Section 20(d) of the Securities Act;

(2) extend the due date for the Form 10-K for the fiscal year ended December 31, 2001 until June 30, 2002 and extend the due date for the Form 10-Q for the fiscal quarter ending March 31, 2002 until June 30, 2002, pursuant to the Commission's authority under Section 36 of the

Exchange Act, for Xerox and its wholly owned financing subsidiary, Xerox Credit Corporation (See Order attached as Exhibit A); and

(3) accept Xerox's offer to settle this matter by consenting to the entry of an injunction. (See the settled Complaint attached as Exhibit B, the Consent and Undertakings attached as Exhibit C, and the Final Judgment of Permanent Injunction and Other Relief attached as Exhibit D.

ACTION REQUESTED BY:	Regular Calendar
PRIOR COMMISSION ACTION:	On June 22, 2000, the Commission issued a Formal Order of Private Investigation.
OTHER DIVISIONS AND OFFICES CONSULTED:	Office of General Counsel (copy provided) David R. Fredrickson (942-0968) Office of Corporation Finance (copy provided) Alan L. Beller (942-2800) Martin P. Dunn (942-2890) Carol A. Stacey (942-1863) Todd E. Hardiman (942-2874) Mary J. Kosterlitz (942-2843) Office of the Chief Accountant (copy provided) Robert K. Herdman (942-4400) Jane D. Poulin (942-4400)
OTHER INTERESTED GOVERNMENT AGENCIES:	U.S. Attorney for the District of Connecticut Federal Bureau of Investigation
SOURCE OF CASE:	News Media (June 16, 2000)
TENTATIVE SUNSHINE ACT STATUS:	Closed pursuant to 17 C.F.R. 200.402(a)(5), (7) and (10)
SMALL ENTITY STATUS:	Xerox is not a small business entity.

NOVEL, UNIQUE, OR COMPLEX ISSUES:	It is unprecedented for the staff to request that the Commission exercise its exemptive authority pursuant to Section 36 of the Exchange Act to grant Xerox a 75-day exemption from filing a Form 10-K and Form 10-Q under the reporting requirements of Section 13(a) of the Exchange Act.

PERSONS TO CONTACT: Financial Fraud Task Force

Paul R. Berger	942-4854
Charles D. Niemeier	942-4594
Timothy N. England	942-7109
C. Hunter Wiggins	942-4850
Charles F. Wright	942-4673
David M. Stuart	942-4810
Fiona A. Philip	942-4708
Robert Bayless	942-2892
Susan Markel	942-4871
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I. SUMMARY

Xerox, one of the most storied businesses in American corporate history, engaged in a financial fraud unprecedented in scope and impact. From at least 1997 through 2000, Xerox senior management disguised its true operating performance by using undisclosed accounting maneuvers -- most of which were improper -- that accelerated the recognition of equipment revenue by over $3 billion and increased earnings by approximately $1.5 billion.

Relying on what it called "one-time actions," "one-offs," "accounting opportunities" and "accounting tricks" to achieve earnings targets that it otherwise could not have met, Xerox falsely portrayed itself as a business meeting its competitive challenges and increasing its earnings every quarter. Many of these accounting actions violated the established standards of generally accepted accounting principles ("GAAP"). All of them should have been disclosed to investors in a timely fashion because, singly and collectively, they constituted a significant departure from Xerox's past accounting practices and misled investors about the quality of the earnings being reported. The accounting actions improved Xerox's earnings, revenues and margins in each quarter and year during 1997 through 2000, and allowed Xerox to meet or exceed Wall Street expectations in virtually every reporting period from 1997 through 1999.

In the face of intense competition and a market demanding stellar earnings performance, Xerox grew progressively dependent on these accounting actions to "close the gap" between its actual operating and financial results and the numbers it wished to and did report to the investing public. By 1998, nearly three out of every ten dollars of Xerox's annual reported pre-tax earnings and up to 37 percent of its reported quarterly pre-tax earnings came from undisclosed changes to its historic accounting practices and estimates.

Xerox employed a wide range of tools to enhance its revenue and earnings picture, using them as required to meet Wall Street earnings expectations. Xerox knowingly or recklessly increased revenues and earnings by accelerating the recognition of revenues through mostly non-GAAP accounting actions, overstated its earnings by using so-called "cookie jar" reserves and interest income from tax refunds, disguised loans as asset sales, and otherwise manipulated its accounting in violation of GAAP. Xerox separately tracked these accounting actions to quantify their impact on the financial results reported to the public as compared to the company's underlying operating results, but knowingly or recklessly failed to disclose that its underlying financial performance was dramatically different from what it reported to investors.

The most significant and pervasive of these accounting actions were used to pull forward and recognize immediately revenues from leases of Xerox equipment that, under Xerox's historical accounting practices, would have been recognized in future years. As a result, Xerox portrayed its business and growth as far more robust in 1997-99 than it in fact was. Moreover, by accelerating future revenues and profits into the present, Xerox made the prospect of achieving future expectations even more difficult and increased the company's vulnerability to future business downturns. As it happened, underlying sales and business conditions worsened in 1999 and later periods, and Xerox's prior-year accounting actions began to negatively affect its reported results. Xerox could no longer rely in lean times on deferred financing and service revenue from its leases because some of that revenue already had been recognized as income to make the company's financial statements more robust in earlier years.

The staff recommends that the Commission institute a civil injunctive action against Xerox for violations of the antifraud, reporting and recordkeeping provisions of the Exchange Act and Securities Act.[1] Xerox has offered to settle this matter by agreeing to the entry of a fraud, reporting and recordkeeping injunction. In addition, Xerox has agreed to pay a $10 million civil penalty and provide ancillary relief as described below. The staff recommends that the Commission accept the proposed settlement.[2]

II. THE PROPOSED DEFENDANT

Xerox is a Stamford, Connecticut-based company incorporated in New York that 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. For the year ending December 31, 2000, Xerox reported revenues of $18.7 billion and a loss of $257 million. Xerox is a public company whose securities are registered with the Commission pursuant to Section 12(b) of the Exchange Act and it is required to file periodic reports with the Commission pursuant to Section 13 of the Act. Its securities are listed on the New York and Chicago Stock Exchanges and also are traded on the Boston, Cincinnati, Pacific Coast, Philadelphia, London and Switzerland exchanges. Throughout the relevant time period, Xerox's stock was covered by Wall Street analysts who routinely issued quarterly and annual earnings estimates.

III. XEROX'S PROPOSED SETTLEMENT OFFER

There are five components to Xerox's settlement offer. The settlement includes an injunction, restatement, monetary penalty, ancillary relief and a request that the Commission exercise its exemptive authority under the Exchange Act. Each will be discussed in turn.

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1 Because Xerox seeks to resolve this matter as expeditiously as possible, in part to satisfy its creditor obligations, the staff has not drafted the standard action memorandum describing the issuer's misconduct. Instead, the staff requests that the Commission accept the settled complaint as a predicate for its enforcement recommendation. Of course, the staff will answer any questions the Commission may have regarding our recommendation.

2 The staff also has provided Wells notices to six current and former Xerox officers, four members of Xerox's outside audit firm KPMG LLP, and KPMG itself. Once Wells submissions have been made, the staff will evaluate the arguments and determine whether further enforcement recommendations are appropriate.

A. **Injunction**

Xerox has agreed to the entry of an injunction finding that it violated:

(1) Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder by:

(a) using certain accounting actions that fraudulently accelerated revenue such as retroactively writing up residual values on equipment subject to lease and recognizing up front revenues associated with lease modifications;

(b) failing to disclose adequately that it was repeatedly changing its method of accounting for leases such that more and more revenue was recognized at lease inception rather than over the life of the lease;

(c) failing to disclose adequately that it had entered into transactions that had the effect of pulling forward substantial revenue;

(d) establishing and releasing cushion or "cookie jar" reserves; and

(e) reporting loans as asset sales.

(2) Section 13(a) of the Exchange Act and Rules 13a-1, 13a-13, 12b-20 thereunder by:

(a) engaging in all of the foregoing accounting actions;

(b) using the accounting actions that repeatedly changed its method of accounting for leases such that more and more revenue was recognized at lease inception rather than over the life of the lease; and

(c) failing to disclose certain leasing practices that materially affected an understanding of the operating and financial risks related to the economically usable lives of equipment conveyed to customers under Xerox's leases.

(3) Section 13(b) and Rule 13b2-1 by:

(a) engaging in all of the foregoing accounting actions; and

(b) improperly accounting for transactions at its Mexican subsidiary.

B. **Restatement**

Xerox has agreed to restate its financial results for the periods 1997, 1998, 1999 and 2000. The restatement will address issues related to (i) the acceleration of over $3 billion in revenues that were prematurely recognized from 1997 to 2000 and (ii) the fraudulent use of reserves. PwC, Xerox's outside audit firm, will provide an audit opinion on Xerox's restatement.

C. Monetary Penalty

Xerox has agreed to pay a $10 million penalty. The staff recognizes the substantial nature of this fine. Indeed, it is our understanding that such a penalty, if imposed, would be the largest ever levied by the Commission in a financial fraud case. We also recognize that historically the Commission has refrained from imposing monetary penalties against issuers so as not to punish current shareholders. This case, however, dictates a different approach. First, the staff does not believe that current shareholders will otherwise be punished by this action. Indeed, when Xerox publicly announced its agreement in principle with the staff, the stock reacted favorably. In fact, the ultimate impact of Xerox's improper acceleration of revenue will be to push revenue from back years into current and future reporting periods. As a result, Xerox will report much-improved financial results for 2001. Shareholders stand to benefit from this result.

Second, Xerox's conduct throughout the course of the staff's investigation stands as a marked contrast to the ideal identified in the Commission's recent 21(a) report on cooperation. The staff began its investigation of Xerox after the company announced that it was examining certain accounting irregularities in Mexico. Five months into the staff's investigation of that conduct, we uncovered a much larger, systemic fraud concerning the one-offs that had nothing to do with the Mexico conduct that the company had publicized. Xerox insisted that the staff's focus, which had shifted to Xerox worldwide, was inappropriate and proceeded to delay the investigation. For example, Xerox failed to cooperate with the staff's efforts to obtain documents and, to this day, has not provided information necessary to calculate the impact of Xerox's improper accounting actions.

Xerox's lack of cooperation is also manifest in its failure to remove all of the individuals responsible for the fraud. While some were removed, and others have retired, Xerox still retains one individual who has received a Wells notice from the staff. That individual was Xerox's Controller until the company's predecessor outside auditor demanded that he be removed from a financial reporting position. In response to the auditor's demand, the Controller was promoted to Treasurer. Xerox claims that this individual is important to the future of the company.

Accordingly, the staff recommends that the Commission accept Xerox's offer to pay a $10 million penalty.

D. Ancillary Relief

Xerox also has agreed to include as part of the relief ordered in the injunctive action certain remedial measures. Specifically, Xerox has agreed to appoint a special committee drawn from independent members of the Board of Directors which shall retain a qualified consultant, not unacceptable to the Commission, to perform a complete review of Xerox's internal accounting controls and policies. Within 180 days after appointment, the consultant shall complete its review and submit to the committee a report fully documenting the findings of its review and proposing recommendations. Within 60 days after receipt of the consultant's report, the committee shall submit the report to Xerox's Board of Directors, as well as to the Commission, and within 60 days thereafter, the Board of Directors shall report to the Commission the decisions taken as a result of the consultant's proposed recommendations

The ancillary relief offered by Xerox represents a significant step in the right direction. Such an undertaking will provide some visibility to the accounting processes and allow the company to establish clear, consistent and correct controls and policies going forward. The staff recommends that the Commission accept Xerox's offer.

E. Exemptive Authority

A critical component to Xerox's settlement offer is its request that the Commission exercise its exemptive authority under Section 36 of the Exchange Act. Section 36 provides that:

> . . . the Commission, by rule, regulation, or order, may conditionally or unconditionally exempt any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any provision or provisions of this title or of any rule or regulation thereunder, to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors.

Xerox and its wholly-owned financing subsidiary, Xerox Credit Corporation ("XCC")[3] request that the Commission exercise its exemptive authority under Section 36 with respect to the timing of the required filing of its Form 10-K for the fiscal year ended December 31, 2001 and its Form 10-Q for the fiscal quarter ending March 31, 2002. Without Commission action, the Forms 10-K and 10-Q, which are required by Section 13(a) of the Exchange Act and the Commission's rules thereunder, would be required to be filed no later than March 30, 2002 and May 14, 2002, respectively. Xerox requests that the Commission use its exemptive authority to, effectively, extend the due dates for these reports because the filing of the Form 10-K at this time would be deemed deficient by the Commission since the filing would not contain audited financial statements and it cannot begin preparation of the Form 10-Q until it has the audited financial statements required to complete the Form 10-K.[4] Xerox seeks the exemption so that its outside auditor can complete its 2001 audit, which will include providing an audit opinion on Xerox's restatement of its financial results for 1997, 1998, 1999 and 2000.

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[3] XCC's sole business is the purchase of long-term contract receivables arising from installment sales and sales-type leases originated by the domestic marketing operations of Xerox. XCC is a '34 Act filer and always files its periodic reports at the same time as Xerox.

[4] As discussed below, Xerox has informed the staff that a deficient filing may trigger a default in the company's loan covenants and precipitate a bankruptcy filing.

Enforcement has conferred with the Division of Corporation Finance and the Office of the Chief Accountant on this issue. The Division of Corporation Finance and the Office of the Chief Accountant concur with Enforcement's view that exercising such authority to allow the outside auditor to conduct an appropriate audit is both in the public interest and necessary to the protection of investors. Xerox's Chairwoman and CEO has advised the staff that Xerox is on the verge of bankruptcy and that the consequences of a deficient filing will jeopardize the company's survival. The consequences include defaulting under its current loan covenants, delisting by the New York Stock Exchange, an inability to refinance a $7 billion line of credit and an inability to attract a new Chief Financial Officer (Xerox is currently operating without a CFO). The staff believes that providing this unusual extension of time to comply with the periodic reporting requirements of Section 13 of the Exchange Act is warranted under these unique circumstances.

The staff also believes that the Commission's exercise of its exemptive authority under these circumstances will not set a dangerous precedent. Xerox requests this relief on terms that are highly favorable to the Commission. Xerox is agreeing to: (1) a settlement that includes a fraud injunction; (2) issuance of a restatement of earnings; (3) payment of a $10 million penalty; and (4) significant ancillary relief. The exemptive order would make clear that the resolution of the Commission's enforcement action is a condition of the exemptive relief. As a result, the staff, with the concurrence of the Division of Corporation Finance and the Office of the Chief Accountant, believes that the facts warrant the use of the Commission's exemptive authority.

IV. RECOMMENDATION

Based on the foregoing, the staff recommends that the Commission authorize the foregoing proposed enforcement action.