UNIVERSITI SAINS MALAYSIA

Master of Business Administration
(On Line Mode)

Second Semester Examination
Academic Session 2007/2008

April 2008

ADU613 - International Accounting

Duration: 3 hours

Please check that this examination paper consists of **NINE** pages of printed material before you begin the examination.

Answer **ALL** questions.

Question 1

In its 4th quarter 2007 earnings announcement, Nokia, the Finnish cell phone giant, reported a three percent increase in sales to €9.06 billion due to strong demand for new phone models and sales of network gear. However, Nokia management noted that sales would have been higher if it hadn't been for the adverse impact of currency exchange rates.

Nokia is the world's largest manufacturer of mobile devices and a leader in mobile networks. Its business is divided into four business groups and two horizontal groups that support the business groups. The four business groups are mobile phones, multimedia, enterprise solutions, and networks. The two horizontal groups are customer and market operations and technology platforms. Nokia was founded in 1967 through the merger of three Finnish companies. In the early 1980s, Nokia began a big push into telecommunications and consumer electronics markets through the acquisition of three Swedish companies. After some other acquisitions, it became the largest Scandinavian information technology company and then expanded its cable business into Continental Europe. However, it decided to divest its information technology and basic industry operations in the beginning of the 1990s so that it could focus on telecommunications.

Even though the sale of handsets increased by 16 percent in 2007, competition and low prices actually pushed revenues down by 3 percent and global market share fell 20 percent. The stock price was pushed down 52 percent by investors between March and August 2007. Nokia's management was able to turn around the company by the end of the year, but sales were still flat.

In order to move the company forward, CEO Jorma Ollila is putting a lot of money into R&D. Nokia generates 63 percent of its revenues and 87 percent of its operating profits from basic cell phones, a market that isn't expected to expand significantly in the developed markets. As a result, Nokia is putting more emphasis into the developing markets of China, India, Brazil, and Russia and moving into even higher technology areas.

Nokia is the biggest mobile phone manufacturer in the world, and only one percent of its sales comes from Finland. It makes twice as many handsets as its closest rival, Motorola. Nokia employs 22,000 workers in Finland and has relationships with some 6,000 Finnish suppliers and subcontractors. In addition, it has about 51,000 employees worldwide. It had 15 manufacturing facilities in nine different countries as of December 31, 2007. Only a small percentage of its cell phone manufacturing takes place in Finland. Manufacturing facilities in the U.S., Mexico, and Brazil supply the North and South American markets. Plants located in Finland, Germany, the United Kingdom, and Hungary supply the European market and non-European markets that have adopted the GSM technology standard. Plants in China and South Korea service Asia. In 2005, Nokia announced that it was going to set up a manufacturing facility in India.

In 2007, Nokia generated 55 percent of its sales in Europe, the Middle East, and Africa; 25 percent in China and the rest of Asia; and 20 percent in North and South America. However, the largest market for Nokia in 2007 was the United States, followed by China, the United Kingdom, Germany, India, and Brazil.

...3/-

Nokia reports in euros and keeps its financial statements according to IFRS. Its shares are traded on stock exchanges in Helsinki, Stockholm, Frankfurt, Paris, and New York. Because it lists in New York it must disclose form 20-F reconciling the financial statement from Finnish Accounting legislation and IFRS to U.S. GAAP.

In discussing its risk factors, Nokia management noted the following:

> "We operate globally and are therefore exposed to foreign exchange risks in the form of both transaction risks and translation risks. Our policy is to monitor and hedge exchange rate exposure, and we manage our operations to mitigate, but not eliminate, the impacts of exchange rate fluctuations. Our sales and results may be materially affected by exchange rate fluctuations. Similarly, exchange rate fluctuations may also materially affect the U.S. dollar value of any dividends or other distributions that are paid in euro."

Talking about the risk in more detail, management noted,

> "Nokia's business and results of operations are from time to time affected by changes in exchange rates, particularly between the euro and other currencies such as the U.S. dollar, the Japanese yen, and the U.K. pound sterling... Foreign currency-denominated assets and liabilities, together with highly probable purchase and sale commitments, give rise to foreign exchange exposure."

In most countries where it does business, Nokia has more sales than purchases, with the exception of Japan where it has more purchases than sales. During 2007, 2006, and 2005, both the U.S. dollar and the Japanese yen depreciated against the euro. In 2007, the British pound appreciated against the euro, but in 2006 and 2005, the pound fell against the euro. The importance of the dollar is significant, because in 2007, more than 50 percent of Nokia's net sales were generated in dollars or currencies that closely followed the dollar. In addition, about 50 percent of the components that Nokia uses are sourced in U.S. dollars.

The company is highly centralized in establishing its hedging strategy. In its discussion on risk, Nokia notes that foreign currency-denominated assets and liabilities as well as expected cash flows from highly probable purchases and sales give rise to foreign exchange exposures. Due to a high degree of production and sales outside of the Eurozone, transaction exposures are managed against the different national currencies. Material transaction hedges are hedged, and most of the derivatives it uses mature in less than one year.

Required:

(i) Identify the different types of foreign exchange exposure Nokia faces.

[5 marks]

(ii) Given the discussion of the movements of the U.S. dollar, Japanese yen, and British pound against the euro in 2005-2007, what is your guess on how the exchange rates should have affected the different types of exposure of Nokia?

[10 marks]

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(iii) What types of hedging devices do you think Nokia might have used against its different exposures?

[5 marks]

(iv) Discuss whether or not Nokia's manufacturing strategy was an effective hedging strategy.

[10 marks]

Question 2

Willowmill Clothing, a multinational clothing chain, has operations that span around the world. The jeans-making process starts in Bermuda, where they spin natural fibers into cloth that is used to make jeans. They purchase raw material for $3.00 per jean and incur a cost of $7.00 per jean to spin the cloth. As such, total cost of the spinning process equals $10.00 per jean. The second phase of the jeans-making process occurs at two manufacturing plants, one in China and one in Hong Kong. There, they manufacture the jeans for distribution. Generally, 75% of the jeans are manufactured in China and 25% are manufactured in Hong Kong. The cost incurred to make the jeans, not including the price paid to purchase the cloth made in Bermuda, is $20.00 at each location. The jeans are then sent to the distribution center in France, where they sell the jeans to retailers around the world for $45 per pair of jeans. An additional cost of $5.00 is incurred at the distribution center.

Willowmill has called you in as a tax consultant to help them minimize its tax burden on the production of jeans. You are aware of the following tax information about the countries in which Willowmill operates.

Bermuda	No Income Tax
Hong Kong	25% income tax
China	37% income tax
France	30% income tax

Additionally, you researched the clothing industry to determine the standard markup for each phase of production to ensure that transfer prices are not set at levels which would be not be considered arm's length.

Cloth Spinning	15-25%
Manufacturing	5-15%
Distribution	5-10%

In order for Willowmill to set transfer prices to its advantage without committing tax evasion, the prices need to be set so that the markup at each stage is between the standard values found in the industry. Additionally, the prices set to and from the two distribution centers need to be identical. The company must also continue to produce 75% in China and 25% in Hong Kong.

Required:

(i) Create a diagram that illustrates Willowmill's operations around the world. Include the tax rates in each country and the cost to manufacture the products in each area.

[10 marks]

(ii) Determine the transfer price that should be set at each stage in order to minimize the tax burden for Willowmill. Remember that at the end, the distribution center needs to be able to sell the product for $45.00. Round your answers to the nearest cent. *Hint: to determine whether you should minimize or maximize income at the distribution centers, weight the tax rates by the amount of jeans manufactured there and compare the effective manufacturing tax rate to the distribution tax rate.*

[10 marks]

(iii) Assume Willowmill produces 1,000 pairs of jeans. Calculate the income recognized under your transfer pricing structure and the overall tax burden. The income recognized should be the same under any scenario, but the tax burden should differ according to your transfer pricing structure.

[10 marks]

(iv) Compare your answer to what the income tax would have been if you used a 15% markup at the cloth spinning stage, a 15% markup at the manufacturing stage, and a 9.1% markup at the distribution stage. Note the difference between the two tax burdens.

[10 marks]

Question 3

Chances are you've heard of "the document company". Xerox Corporation is a U.S. MNE based in Connecticut. Xerox manufactures, sells, and leases document imaging products, services and supplies in over 130 countries. In 2000, Xerox employed approximately 92,500 people worldwide.

Xerox was a leading technological innovator for several decades, but by the late 1990s, the company was confronting intense product and price competition from its overseas rivals. The investment climate of the 1990s added to pressures on Xerox. Companies that failed to meet Wall Street's earnings estimates by even a penny often were punished by significant declines in stock price. In addition, compensation of Xerox senior management depended significantly on their ability to meet increasing revenue and earnings targets. Between the first quarter of 1997 and the fourth quarter of 1999, Xerox met analysts' expectations every quarter. However, the reported results were fraudulent. In June 2002, Xerox reported restated revenues of $18.8 billion and a restated net loss of $273 million for the year ended December 31, 2000.

Although Xerox management used many accounting tricks to increase earnings, the bulk of the fraud was based on improper revenue recognition from it sales-type leases of equipment and services. When a client purchased equipment from Xerox (e.g. a copy machine), it signed a contract to pay a fixed monthly fee covering the cost of the equipment, service, and financing. Under U.S. GAAP, the portion of the lease attributed to the sale of equipment can be recognized immediately as revenue (Xerox called this portion "the box"). The other portion, attributable to the sale of ongoing services and financing of the lease, must be recognized throughout the life of the lease. Between 1997 and 2000, Xerox improperly pulled forward nearly $3.1 billion in equipment revenue and pre-tax earnings of $717 million by reallocating revenue to "the box" to accelerate its recognition. This was done in two ways. First, Xerox reduced the discount rate used to get the value of the equipment—a technique called ROE. By reducing the discount rate, the present value of the equipment, which can be recognized immediately as revenue, was increased. Second, revenue was increased by a process called "margin normalization." Suppose the U.S. market provided Xerox with the highest gross margin, say 20%. At the end of a reporting period, Xerox management would take the sales in Brazil, with a margin of less than 20%, and adjust it up to 20% to increase sales and income. These manipulations were directed by top management, including the CFO of Xerox.

Although accounting for lease revenues requires a significant amount of judgment and is prone to periodic adjustments to discount rates other inputs, Xerox management made these adjustments without any rationale other than to meet quarter-end targets. For example, the typical discount rate to price similar equipment in Brazil was 20%. However, management at headquarters would adjust the rate down to 6% to increase the value of the equipment, which could be recognized as revenue in the present period. The motive behind all these accounting manipulations was simple: to "bridge the gap" between actual performance and analyst expectations. The chart below shows the difference between EPS by proper standards and what earnings were by using fraudulent accounting.

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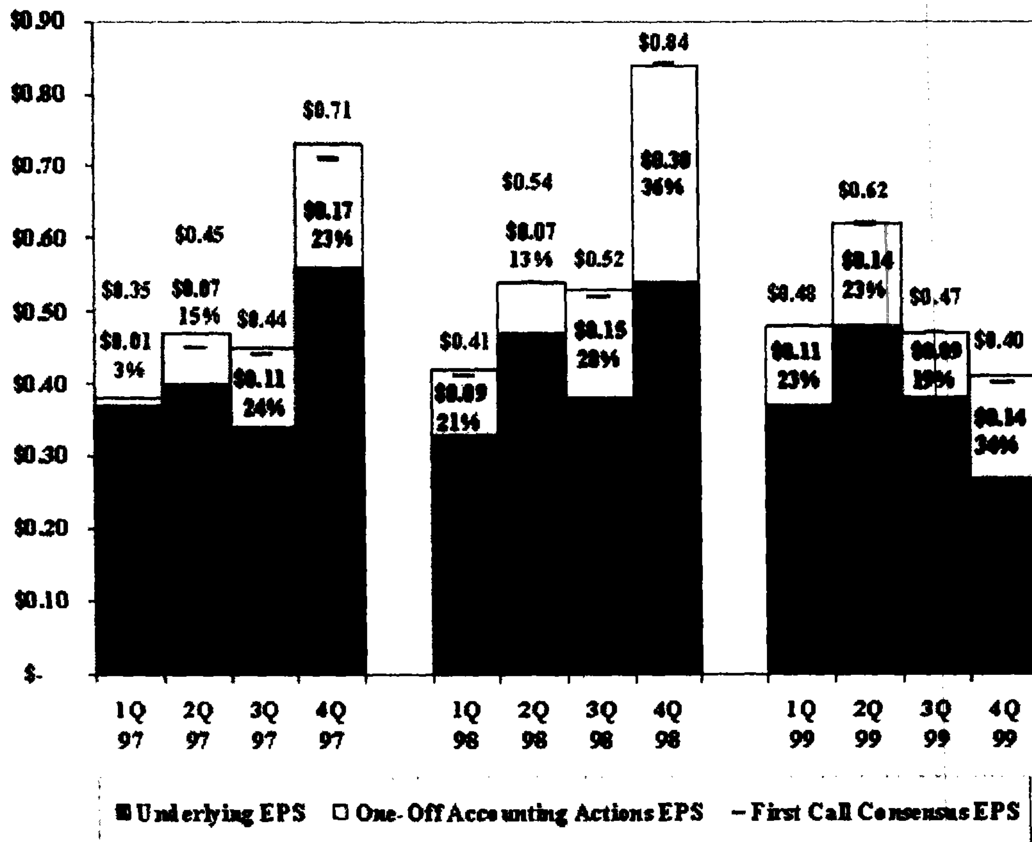

Xerox's auditor during this period was KPMG. KPMG International is one of the largest public accounting firms in the world, with over 700 offices in 152 countries. KPMG International employed over 100,000 people in 2002 and had worldwide revenues of $10.7 billion. The firm was Xerox's auditor for approximately 40 years, through the 2000 audit. KPMG was paid $26 million for auditing Xerox's financial results for fiscal years 1997 through 2000. It was paid $56 million for non-audit services during that period.

While Xerox management was deceiving the public through accounting manipulations, KPMG apparently had many opportunities to uncover the fraud—yet year after year the auditor issued a clean opinion on the financial statements. Of particular interest are the many red flags raised by the auditors of Xerox's foreign subsidiaries.

For example, KPMG Canada told the managing partner that the ROE model was "not supportable" and posed an "unnecessary control risk with regard to accounting records." In addition, KPMG's Brazilian affiliate warned that the manipulation of discount rates to value equipment was using rates that were significantly below the market rates actually realized in Brazil.

KPMG Brazil 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. KPMG Brazil also informed the partner that Xerox in Brazil did not adequately document how accounting estimates were calculated. Similarly, 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. KPMG U.K. warned in 1998 that that use of a 15% ROE was not appropriate for Europe. Despite these warning, the engagement partner never required Xerox to formulate and apply a valid method of estimating its discount rate.

In connection with margin normalization, KPMG U.K. voiced numerous concerns about implementing margin normalization on Xerox lease accounting in Europe because there was no objective basis for equalizing margins based on "little hard evidence." The U.K. office told the partner that Xerox was "playing 'follow my leader'—whoever has the highest sales margins being the leader." In 1999, KPMG Brazil insisted 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 at headquarters said that the Brazilian auditors were wrong and that they were not to discuss margin normalization with local Xerox personnel. By the end of 1999, Xerox had imposed restrictions on KPMG discussions of margin normalization with local managers in both Brazil and Europe.

When the managing partner finally decided to confront Xerox management about these issues, the CFO asked KPMG to remove the partner from the Xerox audit team. KPMG complied with the CFO's request. It was not until 2001, when the SEC had already begun its investigation of the irregularities, that the auditor requested Xerox's audit committee to investigate the companies accounting practices.

In 2002, after the SEC filed a complaint accusing Xerox management of fraud, the company settled with the SEC for $10 million, the largest fined imposed to a company up to that date. In 2003, the SEC filed a complaint against KPMG accusing several of the engagement partners of fraud. As of the writing of this case, the complaint hadn't been resolved.

(Sources: SEC Complaint 17465 vs. Xerox Corporation, and SEC Complaint 17954 vs. KPMG)

Required:

(i) Explain in your own words the accounting manipulations used by Xerox to accelerate revenue recognition from its sales-type leases.

[5 marks]

(ii) Although hindsight is 20/20, do you think it was easy for the auditor to detect the fraud? What are some of the difficulties the auditor may have faced in doing so?

[5 marks]

(iii) Why do you think the engagement partner ignored the repeated issues raised by KPMG's foreign affiliates? How does this reflect the difficulty of conducting an MNE audit?

[5 marks]

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(iv) Do you think the risks involved in auditing Xerox are unique, or do they apply to all MNE audits? Justify your answer.

[5 marks]

(v) Many of the issues involved in the Xerox fraud were related to internal controls. Section 404 now requires the auditor to specifically audit internal controls and issue an opinion on their effectiveness. Do you think auditing internal controls would have prevented the fraud from occurring? Why or why not?

[10 marks]

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