Chapter 15

Understanding the Roles of Finance and Accounting in Global Competitive Advantage

WHAT'S IN IT FOR ME?

1. What are the role of accounting in business and the impact of international standards?
2. What are the nature of currency risk and the methods of currency translation?
3. What are the sources of financing available to firms?
4. What are capital budgeting and the factors that influence international investment decisions?
5. What are global money management methods that reduce corporate transaction costs and taxes?

In this chapter, you'll learn the principles and techniques of global finance and accounting. In the opening case study, you'll see the increased role that governments are playing in the business finance arena. In a flat world, access to capital (i.e., part of the finance function) is uniform across countries, as are accounting standards. However, access to capital varies significantly across countries and between small and large firms. Accounting standards also vary, though these differences are decreasing.

In Section 15.1 "International Accounting Standards", you'll get a glimpse into why countries developed different accounting rules in the past and how new international accounting standards have emerged to create smoother capital markets functioning in our increasingly global world.

In Section 15.2 "Accounting in International Business", you'll learn the importance of consolidated financial statements, and the challenges they present in currency translation. You'll also explore two techniques of currency translation and two ways to mitigate the risks of currency exposure.

In Section 15.3 "Fundamentals of Finance", you'll learn the sources of financing available to international firms and see how firms like L'Occitane, IBM, Hewlett-

Packard, Kimberly-Clark, SAP, and McDonald's are making financing and investment decisions.

In Section 15.4 "Financial Management in International Business", you'll see the factors underlying political risk and economic volatility and learn three ways that multinational firms are structuring their financial organizations to deal with those risks. You'll also find out how religion can impact the financial laws of some countries.

Finally, in Section 15.5 "Global Money Management: Moving Money across Borders", you'll delve into global money management and how firms like Colgate move money across borders to minimize costs and taxes, while gaining maximum returns on their capital.

Opening Case: Bucyrus and Ex-Im Bank

Among the many changes taking place in the international business landscape, numerous leading management consultants predict that government will play an increasingly active role. Governments will no longer simply be an external regulator but will be a direct participant in particular strategic choices and actions. The *new normal*, in terms of government involvement in business, is one in which government's hand in strategy and strategy execution will be highly visible and significant. Part of this governmental activism is a result of the growing scale and reach of global firms. For instance, even before the global financial meltdown in 2009, McKinsey & Company consultancy noted the following:

As businesses expand their global reach, and as the economic demands on the environment intensify, the level of societal suspicion about big business is likely to increase. The tenets of current global business ideology—for example, shareholder value, free trade, intellectual-property rights, and profit repatriation—are not understood, let alone accepted, in many parts of the world. Scandals and environmental mishaps seem as inevitable as the likelihood that these incidents will be subsequently blown out of proportion, thereby fueling resentment and creating a political and regulatory backlash. This trend is not just of the past 5 years but of the past 250 years. The increasing pace and extent of global business, and the emergence of truly giant global corporations, will exacerbate the pressures over the next 10 years.Ian Davis and Elizabeth Stephenson, "Ten Trends to Watch in 2006," *McKinsey Quarterly*, January 2006, accessed July 24, 2010, https://www.mckinseyquarterly.com/Ten_trends_to_watch_in_2006_1734.

Unfortunately for big (and small) business, the apparent systematic risk, managerial excesses, and imprudence that led to the global financial meltdown in 2008 and 2009 have only exacerbated the interest of government in business matters. Let's look at the example of Bucyrus International for how to survive and thrive in this new normal of governmental activism.Compiled based on reports in Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html; James R. Hagerty, "U.S. Ex-Im Bank Reconsiders India Coal Project," *Wall Street Journal*, June 30, 2010, accessed July 23, 2010, http://online.wsj.com/article/SB10001424052748704334604575338791530127472.html?mod=WSJ_hps_LEFTWhatsNews; Rich Rovito, "Bucyrus' Sullivan Wants Vote, and Sleep," *Milwaukee*

(WI) Business Journal, July 6, 2010, accessed July 23, 2010, http://milwaukee.bizjournals.com/milwaukee/blog/2010/07/bucyrus_sullivan_wants_vote_and_some_sleep.html?t=printable; Rick Barrett, "Export-Import Bank May Reconsider Bucyrus Decision," *Milwaukee (WI) Journal Sentinel*, June 28, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97319564.html.

Meet Bucyrus

Bucyrus caters to those who *mine* their own business.Bucyrus website, accessed July 23, 2010, http://www.bucyrus.com. To be precise, the company designs and manufactures surface and subsurface mining equipment and aftermarket replacement parts, as well as servicing its equipment. Its mining products are used for unearthing coal, gold, iron ore, oil sands, and other raw materials. The company sells products to customers worldwide, from large companies to small ones to quasi-governmental agencies operating largely in South America, Australia, Canada, China, India, South Africa, and the United States. Even though Bucyrus is a US-based company, international sales account for more than 70 percent of its revenues.

Bucyrus in Emerging Markets

Like many successful multinationals, much of Bucyrus's new work takes place in emerging markets where the growth and need is greatest. For instance, Bucyrus struck a deal in which its mining shovels would be used to dig coal to fire a giant, new power plant being built by Reliance Industries in India. Reliance, with nearly 25,000 employees, is India's largest private-sector conglomerate, with business interests in energy, retailing, chemicals, textiles, and communications."10 Years Highlight: Financial Highlights," Reliance

Industries Limited, accessed July 23, 2010, http://www.ril.com/html/investor/10_yearshighlight.html.

Although Bucyrus and Reliance had agreed on the deal, the involvement of the Export-Import Bank of the United States (Ex-Im Bank) as a loan guarantor complicated things. Ex-Im Bank is the principal government agency responsible for aiding the export of American goods and services—thereby creating and sustaining US jobs—through a variety of loan, guarantee, and insurance programs. Although supporting US exports is its primary mission, the bank was sued by Friends of the Earth, Greenpeace and four American cities that brought a global warming lawsuit against the bank as well as the Overseas Private Investment Corporation (OPIC), contending that the agencies provided financial assistance to projects without first evaluating the projects' global warming impacts.Friends of the Earth, "Landmark Global Warming Lawsuit Settled," press release, February 6, 2009, accessed December 12, 2010, http://action.foe.org/t/6545/pressRelease.jsp?press_release_KEY=486. The lawsuit took seven years to resolve, but in the end the courts ruled that Ex-Im Bank and OPIC must consider the environmental effect of the projects they fund."Settlement Agreement: Export-Import Bank of the United States," Friends of the Earth, February 6, 2009, accessed December 12, 2010, http://www.foe.org/pdf/Ex-Im_Settlement.pdf; "Victory!," *ClimateLawsuit.org*, accessed December 12, 2010, http://www.foe.org/climate/climatelawsuit/index.htm.

In reviewing Bucyrus's loan-guarantee application, Ex-Im Bank expressed concerns about the project's environmental impact.Bob Hague, "Ex-Im Bank Moves Forward on Bucyrus Deal," *Wisconsin Radio Network*, July 14, 2010, accessed December 12, 2010, http://www.wrn.com/2010/07/ex-im-bank-moves-forward-on-bucyrus-deal. In the end, the bank rejected the application. It stated that the coal-fired power plant that would be fed by the mine conflicted with the Obama administration's environmental goals.Mark Drajem, "Reliance Power's India Plan Rejected by U.S. Export-Import Bank," *BusinessWeek*, June 26, 2010, accessed December 12, 2010, http://www.businessweek.com/news/2010-06-26/reliance-power-s-india-plan-rejected-by-u-s-export-import-bank.html. The guarantees would have backed loans that Reliance would have used to purchase mining equipment from Bucyrus. If the bank's rejection of the financing stood, Reliance could turn to another country, most likely China, for financing and equipment.James R. Hagerty and Amol Sharma, "Employment, Environment at Odds," *Wall Street Journal*, June 28, 2010, accessed December 12, 2010, http://online.wsj.com/

article/SB10001424052748704846004575332810145193160.html. The bank's ruling was not appealable, but within hours of hearing about it, Bucyrus CEO Tim Sullivan launched an intense campaign aimed at getting Ex-Im Bank to reverse course before the Indian project's equipment orders went to Chinese companies. Sullivan argued that the rejection could result in a loss of $600 million in equipment sales for Bucyrus and up to 1,000 US jobs could be at stake.Patrick McIlheran, "Reprieve for Bucyrus in Era of Mojo," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/news/opinion/97521434.html.

Preparation + Reaching Out to Stakeholders…and a Little Luck

Sullivan fumed at the bank's rejection of his loan application. He had recently gone out on a limb and made the bold move of convincing his board of directors to spend $250 million to expand and refurbish Bucyrus's South Milwaukee operations, while the company's competitors were moving work to China.Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html. Instead of accepting defeat with the bank's decision, he went on the attack. Sullivan notified elected officials, many of whom were engaged in reelection campaigns. Given the prevailing tough US economic atmosphere, the officials would likely back an initiative that would retain or increase US jobs. Sullivan also called business and labor union leaders and enlisted support from Bucyrus's hundreds of suppliers. The president of the United Steelworkers of America, Leo Gerard, appealed to the public to participate in a letter-writing campaign to protest Ex-Im Bank's refusal to finance mining equipment that would be made by union members. "At a time when we are losing good-paying jobs, and at a time when President Obama wants to double US exports, how can the Export-Import Bank deny a loan that would create and protect jobs at Bucyrus International? It was a dumb decision," Gerard told the *Journal Sentinel*.Rick Barrett, "Obama Visit to Racine Wednesday May Be Pushing Review," *Milwaukee (WI) Journal Sentinel*, June 28, 2010, http://www.jsonline.com/business/97319564.html accessed November 28, 2010.

As Sullivan rallied potential supporters, luck played its role: President Barack Obama was planning for a town hall meeting in Racine, Wisconsin, just a few miles from Bucyrus's headquarters. Even better, the town hall meeting topic was the economy. A local business association took out full-page advertisements in the local newspapers asking the president to help reverse the bank's decision and save US jobs. Sullivan was astute in pushing the right political hot buttons, but getting Obama's attention would have been much harder had he not been coming to Racine.

All-Night Negotiations and a Surprise Reversal of the Ex-Im Bank Decision

It is important to remember that Bucyrus is not a coal miner but instead a supplier to that industry, so Ex-Im Bank's complaint was really with Bucyrus's customer, Reliance. After all-night negotiations, still prior to President Obama's visit to Wisconsin, Reliance and Ex-Im Bank remained in disagreement. The bank's primary mission is to support US exports,Carter Wood, "Ex-Im Bank: Starting to Get Things Right, Slowly," *Shop Floor*, July 15, 2010, accessed December 12, 2010, http://shopfloor.org/tag/export-import-bank. but it still wanted Reliance to commit to buying US equipment for renewable energy projects as a condition of its approving the loan guarantees.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html. Reliance, however, stated that making such a promise would violate World Trade Organization rules. The impasse was finally settled when Reliance agreed to pursue renewable energy projects in addition to the coal-fired power plant.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html. In an Export-Import Bank news release, Ex-Im Bank chairman and president Fred P. Hochberg said, "We are pleased that Reliance is making this commitment to renewable energy, which allows us to sustain U.S. jobs and promote both conventional and renewable energy exports."Export-Import Bank of the United States, "Ex-Im Bank Approves Preliminary Review of Export Financing Application for India's Sasan Power Plant," press release, July 14, 2010, accessed December 12, 2010, http://www.exim.gov/pressrelease.cfm/D25FB2CF-D13D-

A3B0-A324873AFCC72DC7. Renewable energy sources only account for about 12 percent of India's power,Prashant Bawankule, "Renewable Energy Sources: What Will Work for India?," *Chilli Breeze*, November 2010, accessed December 12, 2010, http://www.chillibreeze.com/articles_various/Renewable-Energy.asp. while 50 percent comes from coal-fired plants and the rest from oil and gas.Prashant Bawankule, "Renewable Energy Sources: What Will Work for India?," *Chilli Breeze*, November 2010, accessed December 12, 2010, http://www.chillibreeze.com/articles_various/Renewable-Energy.asp. Therefore, progress on alternative energy sources in India was seen as a victory (or at least a face-saving reason) for Ex-Im Bank's reversing its original decision.

A few of hours before Obama landed in Wisconsin, therefore, Ex-Im Bank announced it would reconsider its rejection of the loan guarantees and would review the application again, taking "into account Reliance's expressed commitment to invest in the renewable energy sector" in its review.Mark Drajem, "U.S. Export-Import Bank Reconsiders India Coal Financing Deal," *BusinessWeek*, July 1, 2010, accessed December 12, 2010, http://www.businessweek.com/news/2010-07-01/u-s-export-import-bank-reconsiders-india-coal-financing-deal.html. In a letter to Reliance chairman Anil Ambani, Hochberg asked Reliance to consider building renewable-energy power plants capable of producing at least 250 megawatts of power, which would be among the largest renewable projects built in India to date.Fred P. Hochberg, letter to Anil Ambani, Chairman, Reliance ADAG, June 30, 2010, accessed December 12, 2010, http://media.journalinteractive.com/documents/EI-bank-ltr_062010.pdf. The letter did not, however, make the loan guarantees contingent on a fixed amount of renewable energy nor did it impose a deadline for those projects.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html.

Nonetheless, Reliance's agreement to support renewable energy projects was the key factor in the bank's reversed decision. "If we can encourage India to move faster toward renewable energy as part of this project, and to increase opportunities for U.S. exporters, and to finalize the deal with Bucyrus and save jobs, that's a big victory for everyone," an Ex-Im Bank official said.Rick Barrett, "Reversal Revives Bucyrus' Big Deal," *Milwaukee (WI) Journal Sentinel*, June 30, 2010, accessed December 12, 2010, http://www.jsonline.com/business/97484379.html.

Although experts agree that Obama's involvement was vital to the bank's reverse decision, many think Bucyrus would have prevailed in the long run anyway, because the bank's decision would not prevent the plant from being built but merely result in the equipment contract going to a foreign competitor.

Experts said Bucyrus's reaction to the bank's initial decision could be a great example of how a company should behave when a deal is threatened by a government agency.Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html. Sullivan may have been lucky with Obama's pending visit to Racine, but he also had courage and knew how to seize the moment, enlisting the help of business leaders, union officials, and elected officials alike. "If you are going to be aggressive, the way Bucyrus was in this case, then you had better have the facts on your side," said University of Wisconsin–Madison professor Mason Carpenter. Bucyrus took risks and expended much political capital. "The stakes were big here," Carpenter said. "To me, this was a case of how to respond to a crisis in our new, more political world."Rick Barrett, "Bucyrus Chief Dug Deep for Support," *Milwaukee (WI) Journal Sentinel*, July 3, 2010, accessed July 23, 2010, http://www.jsonline.com/business/97745649.html.

Opening Case Exercises

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. How was the deal between Bucyrus and Reliance threatened by a government agency?
2. What do you think of how Bucyrus's CEO handled the situation?
3. Do you think governmental agencies will become more involved in business matters? Why or why not?

15.1 International Accounting Standards

LEARNING OBJECTIVES

1. Learn the value of accounting in international business.
2. Describe the role of accounting standards.
3. Recognize the difficulties caused by countries using different accounting standards.

The Role of Accounting in International Business

The purpose of accounting is to communicate the organization's financial position to company managers, investors, banks, and the government. **Accounting standards**[1] provide a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a firm's managers and investors can assess the financial health of the firm. Accounting standards cover topics such as how to account for inventories, depreciation, research and development costs, income taxes, investments, intangible assets, and employee benefits. Investors and banks use these financial statements to determine whether to invest in or loan capital to the firm, while governments use the statements to ensure that the companies are paying their fair share of taxes.

As countries developed different cultures, languages, and social and economic traditions, they developed different accounting practices as well. In an increasingly globalized world, however, these differences are not optimal for the smooth functioning of international business.

The Emergence of New International Accounting Standards

The International Accounting Standards Board (IASB) is the major entity proposing international standards of accounting. Originally formed in 1973 as the International Accounting Standards Committee (IASC) and renamed the International Accounting Standards Board in 2001, the IASB is an independent agency that develops accounting standards known as **international financial reporting standards (IFRS)**[2].“History,” International Accounting Standards Board, accessed November 26, 2010, http://www.ifrs.org/Home.htm.

The IASB is composed of fifteen representatives from professional accounting firms from many countries.“About the IFRS Foundation and the IASB,” IFRS Foundation,

1. A system of rules and principles that prescribe the format and content of financial statements.

2. Standards that are developed by the International Accounting Standards Board (IASB) for reporting company financial results and that are followed by over one hundred nations throughout the world.

accessed November 25, 2010, http://www.ifrs.org/The+organisation/IASCF+and+IASB.htm. These board members formulate the international reporting standards. For a standard to be approved, 75 percent of the board members must agree. Often, getting agreement is difficult given the social, economic, legal, and cultural differences among countries. As a result, most IASB statements provide two acceptable alternatives. Two alternatives aren't as solid or straightforward as one, but it's better than having a dozen different options.

Adherence to the IASB's standards is voluntary, but many countries have mandated use of IFRS. For example, all companies listed on EU stock exchanges are required to use IFRS.European Commission, "Report to the European Securities Committee and to the European Parliament," April 6, 2010, accessed November 26, 2010, http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=com:2010:0292:fin:en:html. The same is true for all companies listed on South Africa's Johannesburg Stock Exchange and Turkey's Istanbul Stock Exchange. In all, over one hundred nations have adopted or permitted companies to use the IASB's standards to report their financial results.Neil Baker, "IFAC Calls for Crucial Reporting Roadmap," *Compliance Week*, July 27, 2009, accessed November 26, 2010, http://www.complianceweek.com/blog/glimpses/2009/07/27/ifac-calls-for-reporting-roadmap.

The United States doesn't mandate using the IFRS. Instead, the United States has the Financial Accounting Standards Board (FASB), which issues standards known as **generally accepted accounting principles (GAAP)**[3]. The US currently mandates following GAAP. However, the FASB and IASB are working on harmonizing the accounting standards; many IASB standards are similar to FASB ones. The United States is moving toward adopting the IFRS but hasn't committed to a specific time frame.Marie Leone, "Harvey Goldschmid Named IASB Trustee," *CFO*, December 11, 2009, accessed November 26, 2010, http://www.cfo.com/printable/article.cfm/14461503.

The primary reason for adopting one standard internationally is that if different accounting standards are used, it's difficult for investors or lenders to compare the financial health of two companies. In addition, if a single international standard is used, multinational firms won't have to prepare different reports for the different countries in which they operate.

Accounting standards can be complex; and this makes modification of standards difficult. In addition, differing practices among various nations add to the complications of a unified accounting format. For example, in the United States and Great Britain, individual investors provide a substantial source of capital to companies, so accounting rules are designed to help individual investors.CIRCA, "International Accounting Norms: Background and Recent Developments in the

3. Standards that are developed by the US Financial Accounting Standards Board (FASB) for reporting company financial results and that all US companies or companies operating in the US must follow.

EU," accessed November 26, 2010, http://circa.europa.eu/irc/dsis/accstat/info/data/en/accounting%20for%20website.htm. In contrast, the tradition in Switzerland, Germany, and Japan is for companies to rely more on banks for funding. Companies in these countries have a tighter relationship with banks. This means that less information is disclosed to the public. It also results in accounting rules that value assets conservatively to protect a bank's investment. In other countries, the government steps in to make loans or invest in companies whose activities are in the "national interest."

Finally, accounting rules in China follow neither IFRS nor GAAP, which makes it hard for investors to gauge the true value of a company.Doug McIntyre, "Chinese Accounting: Greek to Many," *Forbes*, June 18, 2007, accessed November 26, 2010, http://www.forbes.com/2007/06/18/china-accounting-gaap-pf-education-in_dm_0618investopedia_inl.html. To address this issue, some large Chinese companies report results in both Chinese accounting standards and the IASB's standards. The two accounting standards can show quite different results for the same company, which is why convergence proponents advocate using one global accounting standard.

Characteristics of International Accounting Standards and Their Implications for International Business

On one hand, having to adhere to GAAP rules as well as IFRS rules creates extra labor and paperwork for multinational firms. For example, a US company seeking to raise funds in Germany has to prepare a financial report according to IFRS accounting rules as well as US GAAP rules. Further problems arise when different country accounting rules make the financial statements look different. If the same transaction is accounted for in different ways based on different country accounting rules, the comparability of financial reports is undermined.

In some instances, the differences between US GAAP rules and IFRS are significant. For example, the last-in, first-out (LIFO) accounting method is allowed by GAAP but banned by IFRS. Some firms, such as aluminum company Alcoa, receive a tax benefit from using the LIFO method.Marie Leone, "Unfazed by IFRS," *CFO*, April 30, 2010, accessed August 10, 2010, http://www.cfo.com/article.cfm/14495043. If IFRS is mandated for all US companies, firms like Alcoa may need to make significant cash-tax payments. This is why US adoption of IFRS is taking time, and why the FASB and IASB are working hard to harmonize the standards.

On the positive side, other companies, like IBM, may gain greater efficiencies and stronger controls from a move to IFRS. For example, converting to IFRS would make it possible for IBM to create a globally shared service center for accounting, rather than having accounting departments in different regions.Marie Leone, "Unfazed by IFRS," *CFO*, April 30, 2010, accessed August 10, 2010, http://www.cfo.com/article.cfm/14495043.

US adoption of the IASB's global accounting standards would be useful to big multinational companies. Tyco International, for example, is the parent of 1,200 legal entities, 900 of them outside the United States. For Tyco, having to follow only IFRS rules would be positive, because it would enable Tyco to prepare financials on the same basis worldwide and to more freely move accounting staff from country to country and business to business. Nonetheless, given Tyco's massive network of information systems, making the switch would still be "a tremendous amount of work," according to John Davidson, the company's controller and chief accounting officer.David McCann, "IFRS: Jekyll or Hyde?," *CFO*, November 20, 2009, accessed October 28, 2010, http://www.cfo.com/article.cfm/14456597/c_14457492.

Some smaller public companies, however, would see only costs from a move to IFRS. Davey Tree Expert Company, for example, which only does business in the United States and Canada, sees no benefits. Because the company is unlikely to ever list on any national exchange, the argument that unified standards would allow comparability of financials has no value.David McCann, "IFRS: Jekyll or Hyde?," *CFO*, November 20, 2009, accessed October 28, 2010, http://www.cfo.com/article.cfm/14456597/c_14457492.

An interim step toward the United States adopting IFRS is to permit US firms that operate globally to file only under IFRS, rather than under both GAAP and IFRS, thereby reducing their financial-statement preparation costs.

KEY TAKEAWAYS

- The purpose of accounting is to communicate an organization's financial position to company managers, investors, banks, and the government. Accounting provides a system of rules and principles that prescribe the format and content of financial statements. Through this consistent reporting, a company's managers and investors can assess the financial health of the firm.
- Historically, countries have followed different accounting standards. If different accounting standards are used, however, it's difficult for investors or lenders to compare two companies or determine their financial condition. US firms and any listed on a US stock exchange must prepare financial statements in accordance with the US Financial Accounting Standards Board (FASB) standards, which are known as generally accepted accounting principles (GAAP). Firms based in the European Union (EU) follow standards adopted by the International Accounting Standards Board (IASB) known as international financial reporting standards (IFRS). Over one hundred nations have adopted or permit companies to use IFRS to report their financial results. The United States is moving toward adopting IFRS but hasn't committed to a time frame. The FASB and IASB are working on harmonizing the two accounting standards.
- The three main advantages of a single set of international accounting standards are (1) an increased comparability between firms, which reduces investor risk and facilitates cross-border financing and investment; (2) a reduction in the cost of preparing consolidated financial statements for multinational firms; and (3) the improved reliability and credibility of financial reports.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What is the purpose of accounting?
2. Why do countries have different accounting standards?
3. What are the advantages of a single set of international accounting standards?
4. Which set of accounting standards does the United States follow?
5. Why are some governments reluctant to follow IFRS?

15.2 Accounting in International Business

LEARNING OBJECTIVES

1. Describe what consolidated financial statements are.
2. Understand the risk of currency fluctuations.
3. Explain two methods that firms use for currency translation.

Financial Statements in International Business

Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages, such as limiting liability or taking advantage of local corporate tax regulations. Also, many countries mandate that companies that do business in their country set up a separate company in that country. As a result, a multinational company may have numerous foreign subsidiaries, all owned by the parent. A **consolidated financial statement**[4] brings together all the financial statements of a parent and its subsidiaries into a single financial statement. The consolidated financial statement must reconcile all the investment and capital accounts as well as the assets, liabilities, and operating accounts of the firms. Consolidated financial statements demonstrate that firms—although legally separate from the parent and each other—are in fact economically interdependent. Most of the developed nations require consolidated statements so that losses can't be hidden under an unconsolidated subsidiary. The International Accounting Standards Board (IASB) standards mandate the use of consolidated financial statements.

Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries. Companies must decide on what basis they will translate those different currencies into the home currency of the parent company.

Currency Risk

Currency values fluctuate from day to day relative to each other, which poses a risk for firms that operate internationally. Currency risk is the risk of a change in the exchange rate that will adversely affect the company. Companies face this risk because they typically price their products and services in the local currency of each country in which they operate, to make it easy for local customers to understand the pricing and make the purchase. This practice exposes companies to

4. A single financial statement that brings together all the financial statements of a parent company and its subsidiaries.

currency risk. For example, the US dollar fluctuated from 1.501 dollars per euro in October 2009 to 1.19440 in June 2010."Historical Exchange Rates," *OANDA*, accessed October 28, 2010, http://www.oanda.com/currency/historical-rates?date_fmt=us&date=10/26/09&date1=02/25/09&exch=EUR&exch2=EUR&expr=USD&expr2=USD&format=HTML&margin_fixed=0. This means that if a US company were selling a product for 1,000 euros, the company would receive $1,501 dollars for it in October 2009 but only $1,194 for it in June 2010. To preserve profits, the company might raise the euro-denominated price of its products, but the company would risk a drop in sales due to the increased price.

In a simple example, currency fluctuations mean that if a US-based company sold its product in Germany at a 10 percent profit and the currency value of the dollar dropped 10 percent relative to the euro, then the profit would be wiped out.

Companies can mitigate currency risk by engaging in hedging. **Hedging**[5] refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In the **forward contract**[6], the firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date. Thus, the firm will pay the agreed-on exchange rate regardless of what the current exchange rate is at the date of the final settlement. There are costs associated with using these instruments, such as premium pricing, bank fees, and interest payments. But companies often prefer to protect themselves against a potential larger downside loss, even if they have to pay extra to avoid that bigger loss.

Currency Translation

When multinational companies consolidate their subsidiaries' financial statements, they must translate all the currencies into the currency used by the parent company in its home country. There are two methods which a company can use for currency translation—the current-rate method or the temporal method.

Current-Rate Method

The **current-rate method**[7] is a method of foreign-currency translation in which items in the subsidiaries' financial statements are translated into the currency of the parent corporation at the current exchange rate (i.e., the rate on the date when the statements are prepared). In this case, the current value may be different on the day it's translated than on the date when the assets were originally purchased. Although this difference is only a paper gain or loss, it nonetheless affects the

5. Using financial instruments to reduce adverse price movements by taking an offsetting position.
6. An agreement in which a firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date. Thus, the firm will pay that rate regardless of what the current exchange rate is at the date of the final settlement.
7. A method of foreign currency translation in which items in the subsidiaries' financial statements are translated at the current exchange rate (i.e., the rate on the date when the statements are prepared) into the currency of the parent corporation.

valuation of the firm. This method is the most widely used currency-translation method.

Temporal Method

The **temporal method**[8] is a method of foreign-currency translation that uses exchange rates based on the rate in place when the assets and liabilities were originally acquired or incurred. The temporal method avoids the paper gains or losses problem of the current-rate method. But because subsidiaries purchase assets at different times throughout the year, the multinational firm's balance sheet may not balance if the temporal method is used.

Currency Fluctuations

When the Chinese government announced in 2010 that it would allow its currency, the yuan, to float more freely in relation to other world currencies, US CFOs knew that the change would affect their currency-risk picture. When the yuan was pegged to the dollar (from 2008 to 2010), China's currency had less value, which gave China an advantage in global trade. China's goods were cheaper in world markets. Once the yuan floats more freely, it's expected to appreciate against the dollar.

The yuan's appreciation against the dollar will most likely bring two results. First, it will bring Chinese consumers' purchasing power closer to parity around the world. Second, manufacturing in China will be more expensive than it was in the past, which brings about two results of its own. Foreign firms may move their manufacturing operations out of China (or not open them there in the first place) as they search for the lowest costs elsewhere, and the yuan's value appreciation in the long term means that Chinese products will become more expensive for other countries to buy, which will force China to move from manufacturing lower-margin products like toys and shoes to higher-end businesses. These higher-end areas will bring China into more direct competition with the United States and Europe.Kate O'Sullivan, "Freeing the Yuan," *CFO*, June 23, 2010, accessed October 28, 2010, http://www.cfo.com/article.cfm/14506658.

Forward Exchange Rate

One way to deal with the problem of currency fluctuations is to use the forward-exchange-rate method. The **forward exchange rate**[9] is the rate at which two parties agree to exchange currency and execute a deal at some specific point in the future, usually 30 days, 60 days, 90 days, or 180 days in the future. The firms agree up front on the rate at which they'll exchange currencies, although the actual

8. A method of foreign currency translation that uses exchange rates based on the rate at which the assets and liabilities were originally acquired or incurred.

9. The rate at which two parties agree to exchange currency and execute a deal at some specific point in the future, usually 30 days, 60 days, 90 days, or 180 days in the future.

delivery of the foreign currency will be at a future specified date. For example, a multinational firm based in Spain might sign a contract with a US bank to buy US dollars for euros 90 days from now at a specified exchange rate. The Spanish corporation would use the forward exchange rate as a way to reduce exchange-rate risk if the value of the euro decreases substantially relative to the US dollar.

If two subsidiaries of the same multinational firm do a currency exchange, then they can use an internal forward rate. The **internal forward rate**[10] is a company-generated forecast of future **spot exchange rates**[11]. The internal forward rate may differ from the forward rate quoted by the foreign exchange market. The advantage of this agreement between the parent and foreign subsidiaries is that if the exchange rate changes, the subsidiary will be not be blamed or credited for the change.

KEY TAKEAWAYS

- Multinational firms often organize as separate legal entities (i.e., companies) in different countries to gain advantages such as limiting liability or taking advantage of local corporate tax regulations. A consolidated financial statement brings together all the financial statements of a parent and its subsidiaries into a single financial statement. Consolidating financial statements of subsidiaries located in different countries poses problems because of the different currencies used in different countries.
- Currency values fluctuate from day to day relative to each other. Companies can mitigate currency risk by engaging in hedging. Hedging refers to using financial instruments to reduce adverse price movements by taking an offsetting position. Specifically, a firm can lock in a guaranteed foreign exchange rate through a forward contract. In a forward contract, a firm agrees to pay a specific rate at the beginning of the contract for delivery at a future date.
- Companies must decide what method they'll use to translate different currencies into the home currency of the parent company. Under the current-rate method of currency translation, items in the subsidiaries' financial statements are translated at the current exchange rate (i.e., the rate on the date when the statements are prepared) into the currency of the parent corporation. Under the temporal method, firms use the exchange rate based on the rate in place when the assets and liabilities were originally acquired or incurred.

10. Company-generated forecast of future spot exchange rates. This rate may differ from the forward exchange rate quoted by the foreign exchange market.

11. The exchange rate for trades that take place immediately (i.e., "on the spot").

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Why do most developed nations require consolidated financial statements?
2. What does currency risk mean?
3. What are some ways that companies can reduce the currency risk they face?
4. Compare the current-rate method of currency translation with the temporal method.
5. Explain the difference between the foreign exchange rate and the internal forward rate.

15.3 Fundamentals of Finance

LEARNING OBJECTIVES

1. Know the various financing options available to international firms.
2. Explain the value of capital budgeting.
3. Understand the role of governments in affecting investment decisions.

Financial Structure and Sources of Financing

As demonstrated in the opening case study, governments, banks, and individuals all play a role in international financing. Businesses get external capital from these sources—capital that lets them build, expand, and grow.

Financial structure[12] refers to the ways in which a multinational firm's assets are financed—from short-term borrowing to long-term debt and equity. Managing a multinational firm's financial structure involves asking: *What is the ideal mix of debt versus equity to finance international operations? Where should these funds be invested?* Multinational firms engage in both **transnational financing**[13] (i.e., seeking capital from a foreign sources) and **transnational investment**[14] (i.e., investing capital in foreign markets).

Sources of financing available to firms include foreign stock exchanges, foreign bond markets, foreign banks, venture-capital firms, and funding from the parent company. Although global equity and debt markets offer firms a new way to get funding—often at lower cost than US markets—they are also complicated by foreign currency and exchange rates.

Equity financing[15] refers to raising capital by selling shares of stock. The **stock market**[16] refers to the organized trading of securities through exchanges. An individual or entity can purchase partial ownership in a corporation, buying shares of stock in the company. The **global equity market**[17] refers to all stock exchanges worldwide where firms can buy and sell stock for financing an investment.

12. The ways in which a multinational firm's assets are financed, including short-term borrowing as well as long-term debt and equity.
13. Seeking capital from a foreign sources.
14. Investing capital in foreign markets.
15. Raising capital by selling shares of stock.
16. The organized trading of securities through exchanges.
17. All the stock exchanges worldwide where firms can buy and sell stock for financing an investment.

The New York Stock Exchange is now part of the NYSE Euronext corporation, which operates multiple stock exchanges.

© 2011, NYSE

The largest exchanges in the world include the New York Stock Exchange (NYSE) Euronext, the Tokyo Stock Exchange, NASDAQ (National Association of Securities Dealers Automated Quotations) stock exchange, and the London Stock Exchange. The advantage of raising capital in equity markets is that the firm doesn't have to repay the money at a specific time or at a specific interest rate, as it does with bank loans. The disadvantage is that each time a firm offers stock, the firm's management loses some control of the company because shareholders can now vote to approve or disallow management actions.

Debt financing[18] refers to raising capital by borrowing the money and agreeing to repay the entire amount plus agreed-on interest at a specific date in the future. Firms can borrow money from banks or by selling bonds. The advantage of raising money through debt financing is that company management doesn't give up any ownership of the firm.

Firms can also obtain funding via intrafirm loans or trade credits. A **trade credit**[19] lets the customer (in this case, the subsidiary buying the goods or services) defer payment on the good or service for a specified period of time, typically thirty or

18. Raising capital by borrowing the money and agreeing to repay the entire amount plus agreed-on interest at a specific date in the future.

19. Lets the customer (in this case, the subsidiary buying the goods or services) defer payment on the good or services for a specified period of time, typically thirty or ninety days.

ninety days. By borrowing capital from a parent, both the subsidiary and the parent eliminate paying transaction costs to an outside entity such as a bank, which would charge fees to make the transaction.

Financing Options Available to Subsidiaries

Subsidiaries can choose between two major ways to finance their operations through external sources: overseas equity markets and overseas debt markets. Let's look at each in turn.

Raising Money in Overseas Equity Markets

Multinational firms choose to raise money in foreign markets for a number of reasons. For example, French luxury beauty products company L'Occitane conducted its initial public offering (IPO) on Hong Kong's stock exchange, rather than on the stock exchange in its home country—the NYSE Euronext in Paris.Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, "The Great Rebalancing," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, http://www.mckinseyquarterly.com/The_great_rebalancing_2627. L'Occitane made this decision because emerging-market consumers are its fastest-growing segment. Listing on Hong Kong's exchange makes the company more visible in these growing markets and lets locals participate in the growth of the firm by buying shares.

Some multinational firms raise money in both their home-country and overseas stock exchanges. One of the reasons for listing on multiple exchanges is a lower cost of capital as shares become available to global investors who might not otherwise be able to purchase shares due to international investment barriers.

Emerging markets are also opening stock exchanges. For example, the Shanghai and Shenzhen Stock Exchanges in China opened in 1990. In July 2010, the Shanghai Stock Exchange became the sixth-largest stock exchange in the world based on market capitalization.

Figure 15.1 *Shanghai Stock Exchange*

Courtesy of Jindao Floors Inc.

Public share ownership in China remains complex with three classes of shares: A, B, and H. A-shares are local shares denominated in China's local currency for domestic investors. B-shares are denominated in Hong Kong dollars or US dollars and are generally owned by foreigners. H-shares are for China-incorporated companies traded in Hong Kong. Chinese authorities (the China Securities Regulatory Commission, the People's Bank of China, and the State Administration of Foreign Exchange) closely regulate the Shanghai and Shenzhen Stock Exchanges. Indeed, the Chinese government actively intervenes in its capital markets. For example, it didn't allow any new equity funds to be established in 2007. The government also owns a relatively high number of shares in many listed companies. China's low transparency, poor implementation of securities regulations, and restrictions on hedging and risk-management tools are warning signs to foreign investment-fund executives. At the same time, the government lacks many regulations related to educating or protecting investors. A brokerage firm can allow an investor to buy and sell any amount of any security after the investor answers three questions in the following areas: name, health, and risk tolerance.Matt Anderson, Daniel Curtis, Derek Lin, and Ian Van Reepinghen, "Coming of Age: A Look at China's New Generation of Investors," in The Lauder Institute, *Lauder Global Business Insight Report 2010: First-Hand Perspectives on the Global Economy* (Philadelphia: Wharton, University of Pennsylvania, 2010), 69–73, accessed October 28, 2010, http://knowledge.wharton.upenn.edu/papers/download/021710_GlobalBiz_2010.pdf.

Raising Money in Overseas Debt Markets

Multinational firms can issue bonds in overseas markets as well as in their home countries. Even China now has an active bond market. Before April 2008, Chinese state-owned enterprises were about the only ones issuing corporate debt in China because corporate bonds were so costly and time-consuming to issue there. Corporate bonds had to be listed on the stock exchange and approved by exchange regulators, making the process subject to political whims. State-owned enterprises raised money in the bond market to finance big infrastructure projects, and the bonds had state guarantees. In 2008, new rules simplified the issuing process, and the Chinese government began letting foreign companies issue yuan-denominated bonds through Hong Kong in 2010. The attraction of the Chinese bond market, according to Chris Zhou, director of debt capital markets at UBS Securities in Beijing, is that "the bond market is a relatively easy and cost-effective way to get money."Frederik Balfour, "In China, A Burst of Corporate Bonds," *BusinessWeek,* July 6, 2009, 25.

McDonald's was the first foreign company to issue yuan-denominated bonds, selling 200 million yuan (or $29 million) of 3 percent notes due in September 2013. As Donald Straszheim, senior managing director and head of China research at the International Strategy & Investment Group observed, "There are hundreds of global companies wanting to do more business in China, and they will want to be involved in the country's evolving credit market."Patricia Kuo and Shelley Smith, "McDonald's Sets Benchmark for China With Yuan Bond Sale," *Bloomberg*, August 20, 2010, accessed August 23, 2010, http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html.

According to McDonald's spokesperson Lisa Howard, issuing bonds in China "gives us access to new funding to support growth in China. We are very confident in the Chinese market and have a strong plan to grow our business in China."Patricia Kuo and Shelley Smith, "McDonald's Sets Benchmark for China with Yuan Bond Sale," *Bloomberg*, August 20, 2010, accessed August 23, 2010, http://www.bloomberg.com/news/2010-08-19/mcdonald-s-yuan-bonds-set-standard-as-china-promotes-debt-credit-markets.html. McDonald's will use the money it has raised in the bond market to provide working capital for expansion in China, including opening as many as 175 restaurants in 2010, adding to the 1,000 restaurants it already has there.

Innovation and Entrepreneurship

WaterHealth: Financing for Entrepreneurs in Developing Countries

WaterHealth is a company that sells and leases water purification systems for use in developing countries. The company also sells and leases special sanitary water containers that reduce the spread of waterborne diseases from contaminated ladles. WaterHealth developed ultraviolet technology to sanitize water. The technology doesn't require large-scale operations or equipment, which enables local entrepreneurs in developing countries to use the technology to open their own water shops to sell water to local customers. The result? Consumers gain access to cheaper, cleaner water, while the local economy gains new businesses. WaterHealth's innovative financing doesn't require high up-front payments for its technology. Instead, the company collects user fees, allowing the repayment of financing costs over time.WaterHealth International, "Frequently Asked Questions," accessed August 14, 2010, http://www.waterhealth.com/.

Investment Decisions

Capital Budgeting

Capital budgeting[20] refers to the process of financing long-term outlays for major projects such as plant expansion, entry into new markets, or research and development. The process of capital budgeting helps a firm decide which major investment projects will be most economically advantageous for the firm by assessing each project's benefits, costs, and risks. When making capital-investment decisions, firms examine the initial investment that will be required, the cost of capital, and the amount of cash flow or other gains which the project will provide. The **cost of capital**[21] is the rate of return that a company could earn if it chose a different investment of equivalent risk. The cost of capital comes into play because firms have choices in how to put their capital to use; using the capital for one purpose precludes using it for a different purpose.

Some governments court foreign borrowers by offering low-interest loans or by offering lower corporate income tax to attract investment in their countries. For example, Poland created special tax breaks for companies. These tax breaks make the country attractive for firms such as Hewlett-Packard and IBM to locate operations there. Similarly, Singapore's government has invested heavily in education and training in an effort to attract investment by leading multinational

20. The process of financing long-term outlays such as are used for plant expansion or research and development. During the capital-budgeting process, firms examine the initial investment that will be required, the cost of capital, and the amount of cash flow or other gains which the project will provide.
21. The rate of return that a company could earn if it chose a different investment of equivalent risk.

firms. Singapore also offers subsidies to companies locating there. As corporations think about where to invest, build factories, locate offices, and source talent, they explore such opportunities actively.Peter Bisson, Rik Kirkland, and Elizabeth Stephenson, "The Market State," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, http://www.mckinseyquarterly.com/The_market_state_2628.

How Government Actions Affect Investment Decisions

Government policy affects foreign investment and innovation. According to Jeffrey Sachs, a leading international economic advisor and Columbia University professor, the near-term prospects for Brazil are bright, and it's poised to do the best among Latin American countries.

Brazil

For the last fifteen years, Brazil has been investing heavily in education. In particular, Brazil made high school available to all citizens and invested in higher education, science, and technology. The result of these government investments is that not only does Brazil have a more educated workforce, but it has also narrowed off the gap between rich and poor and between ethnically divided segments of Brazilian society. In contrast, countries with deep ethnic and racial inequities aren't unified societies, which leads to mediocre economic performance. Brazil plans to invest another $22 billion in science and technology innovation in 2010 and seeks corporations to join in additional investments in the country.Jeffrey Sachs, "Economics for a Crowded Planet" (webinar, HSM Global, 2009), accessed October 28, 2010, http://us.hsmglobal.com/contenidos/hsm-webinars-sachs.html; Jeffrey Sachs, *The End of Poverty: Economic Possibilities for Our Time* (New York: Penguin, 2005).

IBM is one of the companies investing in Brazil. CEO Sam Palmisano met with Brazilian President Luiz Inacio Lula Da Silva to discuss the creation of a "collaboratory" in Brazil. IBM's collaboratories match IBM researchers with local experts from governments, universities and companies. IBM's Palmisano praised Brazil's strategy: "Investments in innovation are critical, especially in a downturn. They can help Brazil and other countries, including the US, realize an economic expansion." Among the BRIC countries (Brazil, Russia, India, and China), Brazil is seeing the highest growth in business partners that IBM works with, averaging 150 percent year over year, according to Claudia Fan Munce, managing director of IBM Venture Capital Group.Steve Hamm, "Big Blue's Global Lab," *BusinessWeek*, August 27, 2009, accessed October 28, 2010, http://www.businessweek.com/magazine/content/09_36/b4145040683083.htm; Spencer E. Ante, "IBM Bets on Brazilian Innovation," *BusinessWeek*, August 17, 2009, accessed October 28, 2010, http://www.businessweek.com/technology/content/aug2009/tc20090817_998497.htm.

The IBM Rio Operations Center, located in Cidade Nova, integrates and interconnects information from multiple government departments and public agencies in the municipality to improve city safety and responsiveness to various types of incidents, such as flash floods and landslides.

As the above example illustrates, Brazil is attracting foreign business. Companies making foreign investments, however, must be aware of the total financial picture, including the tax environment. Brazil has a very complex tax system. "If it's not the most complicated tax system in the world, it's certainly right up there," said Mark Buthman, finance chief at Kimberly-Clark, the consumer packaged goods giant, which has approximately 3,000 people in its Brazilian operation. "It's not uncommon to have disagreements with the taxing authorities that you have to work through over time."Kate O'Sullivan, "Brazil Is Booming (and Maddening)," *CFO*, July 15, 2010, accessed October 28, 2010, http://www.cfo.com/printable/article.cfm/14508833. What makes doing business in Brazil challenging is that the tax laws have not kept pace with the progress of modern products or services; that is, the categories of taxes do not correspond to modern-day categories of products and services. The lack of parallelism leads to confusion and misinterpretation. To deal with the difficulties, Kimberly-Clark, for example, employs seventy people—most of them native Brazilians—in its finance group in Brazil.

In addition to federal taxes, Brazilian states assess their own taxes as well. Thack Brown, CFO of SAP Latin America, says that any misstep regarding a labor or tax regulation can prove costly. "If you do have an issue, not only can the penalties be large, but you can spend three or four or even 10 years working through the judicial system."Kate O'Sullivan, "Brazil Is Booming (and Maddening)," *CFO*, July 15, 2010, accessed October 28, 2010, http://www.cfo.com/printable/article.cfm/14508833. Despite the difficulties, Brown says that compared to China, the Brazilian system is still more structured and capable of dealing with issues.Kate O'Sullivan, "Brazil Is Booming (and Maddening)," *CFO*, July 15, 2010, accessed October 28, 2010, http://www.cfo.com/printable/article.cfm/14508833.

Indonesia

Indonesia is the third-largest democracy in the world and the largest economy in Southeast Asia. The country recently created an investment coordinating board to attract foreign direct investment into Indonesia. How is Indonesia making itself attractive to foreign investors?

1. It's touting its young population—half of the population is under thirty years of age, which bodes well for a skilled workforce and growing consumer base.
2. It's touting its political stability of twelve years after democratization, and monetary stability for the last five to six years.
3. It's investing in infrastructure. "We are committing $50 billion from a budgetary standpoint for the development of infrastructure as part of a $150 billion five-year program," said Gita Wirjawan, Indonesia's chairman of Badan Koordinasi Penanaman Modal (BKPM), the country's newly created investment coordinating board. "That will produce 20,000 kilometers of new roads and an additional 15,000 megawatts of power generation. That is going to create a much higher degree of connectivity than what we have today."“Why Gita Wirjawan Wants to Open Indonesia to International Investors," *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553.

Despite these advances, Indonesia still restricts which industries foreign investors can invest in. For example, investors can't invest in telecommunications towers. Nonetheless, Indonesia has attracted some major investors, such as a large Middle Eastern investor who will build an integrated infrastructure project including a port, a rail track, and new power-generation capability. The total investment will be about $5.2 billion. Indonesia has also convinced the Swiss firm Holcim to expand its cement capabilities in Indonesia.“Why Gita Wirjawan Wants to Open Indonesia to International Investors,” *Knowledge@Wharton*, July 21, 2010, accessed August 9, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2553.

The Role of Government

The role of government in terms of international business and finance includes

- passing laws and setting policies (e.g., regulating stock and bond markets and setting tax codes),
- enforcing laws (laws laxly enforced have little value),
- providing infrastructure (e.g., fast communications infrastructure and reliable electricity are important to the smooth functioning of capital markets), and
- providing capital (e.g., providing or guaranteeing loans, as the US government does through the Export-Import Bank of the United States).Scott Leibs, “A Force to Be Reckoned With,” *CFO*, February 1, 2010, accessed August 7, 2010, http://www.cfo.com/printable/article.cfm/14470883.

KEY TAKEAWAYS

- Multinational firms have a choice in how they finance international operations. Some choose to raise capital through equity markets, issuing stock on domestic or overseas stock exchanges. Others opt for debt financing through banks or bond markets in order to not give up ownership in the firm.
- Capital budgeting is the process by which firms assess the relative merits of different investment choices, weighing the cost of capital and the expected returns of different investment options.
- Governments can play an active role in attracting firms to invest in their countries or enticing foreign borrowers by offering low-interest loans or lower corporate income taxes. When evaluating countries for investment potential, companies consider a government’s economic policies (e.g., business environment, trade policy, investment policy, and infrastructure) as well as any cultural issues (e.g., ethnic, religious, and gender inequalities) that may be a barrier.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. What sources of financing are available to a company's subsidiaries?
2. What is the advantage of equity financing over debt financing?
3. When might a company choose debt financing?
4. Name two advantages of raising money on a foreign stock exchange.
5. Why is capital budgeting important to a multinational company?

15.4 Financial Management in International Business

LEARNING OBJECTIVES

1. Understand the factors that underlie political risk and volatility.
2. Identify two ways in which the financial organization of a multinational firm can be structured.
3. Recognize how religion can influence financial practices in some countries.

Accounting for Political and Economic Risk

Companies that locate operations in foreign countries face a set of unavoidable risks, chief among which are political and economic risks. Political risks arise from decisions that foreign governments make, including changes in government that result from wars and coups. Economic risks are often paired with political risks but can also arise from international money markets. Both risks are exacerbated by increased volatility and changes in laws.

Increased Volatility

In the 2010 *McKinsey Global Survey* of 1,416 executives from around the world, 63 percent of respondents "expect increased overall volatility to become a permanent feature of the global economy."Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, http://www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. For example, the most important growing economy in the world, China, is a force that must be reckoned with. The volatility arises because this major economy isn't a developed state with commitment to the rule of law and strong institutions. Rather, it's an emerging market where political insecurities are the ultimate driver, according to Ian Bremmer, president of the Eurasia Group and author of *The End of the Free Market*.Rik Kirkland, "China's State Capitalism and Multinationals: An Interview with the President of Eurasia Group," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, http://www.mckinseyquarterly.com/Chinas_state_capitalism_and_multinationals_An_interview_with_the_president_of_Eurasia_Group_2583.

To prepare for volatility, multinational companies may want to plan contingencies or at least think through how they might react to events that are currently "unthinkable," such as significant, rapid shifts in currency values (e.g., a 30 percent decline of the dollar versus an emerging-market currency); an exit from the euro by some nations; dramatic, rapid changes in commodity prices (e.g., oil prices spiking to $200 a barrel); or defaults on debt by major nations.Lowell Bryan, "Globalization's Critical Imbalances," *McKinsey Quarterly*, June 2010, accessed October 28, 2010, http://www.mckinseyquarterly.com/Globalizations_critical_imbalances_2624. These events seem highly improbable now, but, if they come to pass, executives who have thought about how to respond to them will be better positioned to react effectively.

Legal Infrastructure: Challenges of Nascent Laws

Variations in contract law, bankruptcy law, real estate law, intellectual property rights, and liability are just some of the legal issues that companies face when operating or making investments in emerging-market countries. Slow civil judicial processes, corrupt judges, and potential biases against foreigners can affect a company's ability to operate effectively, recover losses, or collect bad debts. For example, General Motors (GM) often uses a contractual structure with suppliers in which GM owns the proprietary tooling used in their supplier's factory. In most countries, if the supplier goes bankrupt, GM can easily take the tooling back. But GM noted that this isn't possible in China due to the nascent state of the country's bankruptcy law, which was created only in 1988.Harjeet S. Bhabra, Tong Liu, and Dogan Tirtiroglu, "Capital Structure Choice in a Nascent Market," *Financial Management*, June 22, 2008, accessed November 25, 2010, http://www.allbusiness.com/company-activities-management/company-structures-ownership/11673477-1.html. As a result, GM uses contracts to mitigate these risks.

Financial Organizational Structure in International Business

Multinational companies can choose to manage their financial operations centrally or via a decentralized organizational structure.

Centralized Structures

The advantages of a **centralized structure**[22] are that the company can afford to hire and retain specialized staff with deep expertise who can bring savings to the company through centralized cash management and more efficient capital investment. Centralization can improve control and compliance with corporate policies. This structure enables the firm to gain economies of scale for investment

22. All finance decisions are performed at headquarters, which sets guidelines for subsidiaries to follow, pools funds, leverages the benefits of scale for investment and borrowing, and hires knowledgeable staff to make the most effective, firm-wide decisions.

and borrowing activities that can reduce transaction costs and provide the firm with the most competitive pricing.

Decentralized Structures

Alternatively, multinational firms may choose a **decentralized financial organization structure**[23] due to variations in language, consumers, cultures, business practices, and government rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty. The downsides of a decentralized approach are higher costs (due to having to hire more employees), some unavoidable duplication of effort, and a diminishment of control.

Communication with Headquarters

If a company uses a decentralized financial structure, it's vital for regional chief financial officers (CFOs) in the different countries to keep regular contact with their superiors at headquarters. Rebecca Norton, vice president of finance, Asia-Pacific, at Business Objects (a unit of SAP), makes it a point to participate in global conference calls as often as possible, in order to "wave the Asia-Pacific flag." She notes that this is necessary to ensure that her overseas colleagues understand the conditions under which the Asian business operates.Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, http://www.cfo.com/printable/article.cfm/12465219. The reason for the frequent communication is to help the home office better understand the opportunities and risks of the foreign country. For example, if headquarters is focused on short-term performance indicators, the head office is more likely to allocate funds to developed markets where returns are quick. But this approach neglects emerging markets, which have more future potential.

According to a 2010 McKinsey study, global economic activity is shifting from developed to developing nations with populations that are young and growing.Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, http://www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. The growth in the number of consumers in these emerging markets make them not only a focus for rising consumption and production but also major providers of talent, capital, and innovation. This makes it vital for US companies to succeed in these emerging markets. Despite identifying this trend as the most important trend for business in the next five years, only 40 percent of executives are taking action and fully 20 percent are taking no action at all to capture emerging-market growth.Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global

23. Subsidiaries or regions make financing or investment decisions for their region, taking advantage of local knowledge and moving quickly to respond to opportunities or uncertainties.

Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, http://www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results_2581. This is where communication with headquarters becomes imperative. Regional CFOs must spur actions, such as developing partnerships or joint ventures with local companies, recruiting talent from emerging markets, and developing new business models.

One company taking action is the Luxottica Group, a $6.6 billon eyewear company based in Italy. Although Luxottica sells its products online, it remains solidly committed to brick-and-mortar retail stores and is rapidly expanding its retail presence in China. Describing the role of retail stores, Chris Beer, CEO of Asia Pacific, greater China, and South Africa for Luxoticca, said, "You need to create a connection, create a personal experience, and that's what we've done."Sheila Shayon, "Luxottica Envisions Future of Retail," *Brand Channel*, July 22, 2010, accessed November 26, 2010, http://www.brandchannel.com/home/post/2010/07/22/Luxottica-Eye-Hub-Retail-Concept.aspx On the finance side, Kevin Zhou, retail CFO for Luxottica, closely follows the regulatory environment in China and actively communicates with headquarters to explain evolving legislation and help them understand local financial issues. "You have to always tell them the truth about what's happening in China, and keep updating them," he says. "Keep explaining, and before long, people at headquarters will really understand what's going on in this market."Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, http://www.cfo.com/printable/article.cfm/12465219.

Hybrid Financial Organization Structures

Finally, multinational companies follow a hybrid of centralized financial operations for some tasks and regional operations for others. Before it was acquired by Hewlett-Packard (HP) in April 2010, network switching and routing solutions company 3Com had centralized specific operations in its North America shared service center (SSC). The North America SSC provided a number of accounting services globally. Although the US-based SSC had a much higher cost of labor than Singapore (where 3Com offshored transaction-based processes), 3Com decided to keep higher-value services in the North America SSC due to 3Com's assessment of the risk and complexity in comparison to the anticipated benefit of moving these from one global center to another. Some of the tasks retained by the North American SSC were worldwide consolidation, worldwide intercompany accounting, and external reporting.

The following processes have been performed in each region (i.e., Europe, the Middle East, and Africa [EMEA]; North America; Latin America; and Asia-Pacific) due to language and local knowledge issues:

- Regional general ledger
- Regional revenue accounting
- Local field finance accounting
- Regional and local payroll
- Regional and local value-added tax (VAT) and good-and-services tax (GST) compliance and reportingPhil Searle and Fraser Kirk, "Expanding Geographic Scope and Setting Up a Truly Global Process Model," *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, http://www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

3Com also assigned local field finance managers to be key shared accounting services team members located in the company's higher-risk countries to help ensure compliance with local legal, statutory, tax, and reporting requirements and to help with enforcement and communication of corporate policies locally. Their responsibilities include the following:

- Ensuring all statutory and tax (direct and indirect) filings are completed in accordance with local country requirements
- Liaising with local external auditors, tax authorities, and outsource agencies to ensure the proper execution of payroll and employee disbursements
- Communicating and enforcing corporate accounting policies to local employees
- Ensuring appropriate accounting for local accruals by liaising with local marketing and sales teams to determine if services related to outstanding purchase orders have been providedPhil Searle and Fraser Kirk, "Expanding Geographic Scope and Setting Up a Truly Global Process Model," *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, http://www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

Did You Know?

What does the job description for a treasury operations manager look like? The tasks of a manager overseeing international-unit financial management include

- managing foreign exchange exposures, hedging, accounting compliance, multilateral netting, and multilateral cash pool;
- driving collection, disbursement, concentration and cash accounting, and domestic debt-portfolio management;
- performing cost review and analysis of monthly cash management;
- assisting the treasurer in bank coordination, agreement negotiations, and renewals;
- modeling financial transaction scenarios for capital budgeting and planning analysis (i.e., debt, equity, and other capital market transactions);
- preparing, reviewing, and maintaining Sarbanes-Oxley controls; and
- delivering and coordinating cash forecasts with bank-funding needs and regulatory capital requirements.

The Impact of Religion: Islamic Finance

Companies operating in countries where Islam is the official religion, such as Malaysia, Saudi Arabia, Kuwait, Bahrain, and Yemen, must adhere to Islamic finance laws. Islamic law prohibits certain financial practices that are common in other countries. For example, Islamic law (called **Sharia**[24]) prohibits charging interest on money. No interest can be charged, including fixed-rate, floating, simple, or compounded interest, at whatever rate. The Sharia also prohibits financial practices like speculation, conventional insurance, and derivatives, because they're considered gambling in the Islamic tradition. Sharia also prohibits *gharar*, which means "uncertainty" and includes conventional practices like short selling.

To overcome these prohibitions, financial products must be Sharia compliant. There are approved alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It's a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner. A *mudarabah* is an

24. Islamic law; in terms of finance, prohibits charging interest on money and other common business activities, including short selling.

investment partnership, whereby the investor provides capital to another party or entrepreneur in order to undertake a business or investment activity. While profits are shared on an agreed-on ratio, loss of investment is born only by the investor. The entrepreneurs only lose their share of the expected income.“Introduction to Islamic Financing,” HSBC Amanah, accessed August 14, 2010, http://www.assetmanagement.hsbc.com/gam/attachments/mena/amanah/islamic_invest.pdf.

These investment arrangements demonstrate the Sharia’s risk-sharing philosophy—the lender must share in the borrower’s risk. Since fixed, predetermined interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive, and economically wasteful. The preferred mode of financing is profit and loss sharing.

Islamic finance law extends to mutual funds, securities firms, insurance companies, and other nonbanks. A growing number of conventional financial institutions, both inside and outside the Islamic world, have in recent years created Islamic subsidiaries or have been offering Islamic “windows” or products in addition to conventional ones.Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000).

KEY TAKEAWAYS

- Political and economic risks arise when a country lacks a long history or commitment to the rule of law. Companies can prepare for volatility by thinking through “unthinkable” scenarios and planning how they would respond if such situations occurred.
- Multinational firms can organize their financial operations in a centralized, decentralized, or hybrid organization structure. The advantages of a centralized structure are that the company can afford to hire and retain specialized staff who have deep expertise and can bring savings to the company through centralized cash management and more efficient capital investment. Centralization also enables the firm to gain economies of scale for investment and borrowing activities that will reduce transaction costs and get the firm the most competitive pricing. On the other hand, a decentralized financial organization structure allows the firm to recognize the variations in language, customs, cultures, business practices, rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty.
- It’s important for regional CFOs to stay in regular contact with corporate headquarters to alert headquarters to opportunities (or warn them of dangers) in their countries.
- Islamic countries practice Sharia—the prohibition of charging interest on money. There are approved, Sharia-compliant alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It’s a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Name two ways that companies can prepare or deal with political risk or volatility in a country.
2. What advantages does a decentralized financial organization structure bring to a multinational firm?
3. What advantages does a centralized financial organization structure bring?
4. Why are frequent communications between a regional CFO and headquarters important?
5. How might religion impact financing operations?

15.5 Global Money Management: Moving Money across Borders

LEARNING OBJECTIVES

1. Understand the role of global money management in a multinational firm.
2. Know how multilateral netting and transfer pricing can be used to minimize transaction costs and taxes for the firm.
3. Appreciate the efficiencies and savings that result from centralized depositories.

Global Money Management and Centralized Depositories

Global money management involves moving money across borders and managing the firm's financial resources in a way that minimizes taxes and transaction fees while maximizing the firm's returns.

A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a **centralized depository**[25]. There are two main advantages of centralized depositories:

1. The company earns a higher interest on higher amounts of cash, because cash from across the company is pooled.
2. Pooling cash reserves reduces the total amount of cash that the company needs to hold, because the amount of cash held on hand as a precautionary measure against the unexpected can be pooled and thus reduced—it's unlikely that all the worst cases will happen simultaneously.

Centralized money management also lets a company trade currencies between its subsidiaries and thereby eliminate intermediaries like banks. This practice saves the firm transaction costs. Centralization also means that the company can buy currencies in larger lot sizes, which gives it a better price.

Two facts are important to keep in mind when using the centralized depository technique for global cash management. First, a government can restrict how much capital can flow out of the country (governments do this to preserve foreign

25. A central location where the cash balances of a parent and its subsidiaries are pooled.

exchange reserves). Second, there are transaction costs associated with moving money across borders, and these costs are incurred each time the money is moved.

Cash Management

Companies need to be aware of differences in local cash practices. For example, business customers in Asia often pay their invoices via bank draft—a common method there, but almost unheard of in the United States. This approach typically means a company gets its cash slowly, creating potential working-capital problems. "If you sell to a customer on 30-day terms and on day 29 they give you a bank draft, that's three months more you'll have to wait," said Brian Kenny, CFO of specialty chemicals materials company W. R. Grace's Asia-Pacific division.Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, http://www.cfo.com/printable/article.cfm/12465219.

Multilateral Netting

Multilateral netting[26] is a technique which companies use to reduce the costs of cross-border payments between subsidiaries. Three or more subsidiaries must participate. (If only two participate, the technique is known as bilateral netting.)

For example, let's say a firm's subsidiary in the Czech Republic owes the Australian subsidiary $4 million, while the Australian subsidiary owes the Czech subsidiary $10 million. Rather than the Czech subsidiary transferring $4 million and the Australian transferring $10 million, the parties agree to one payment in which the Australian subsidiary pays the Czech $6 million. Both payments are thus satisfied. The total funds that flowed between the subsidiaries are reduced from $14 million to $6 million, reducing costs. For example, if the transaction costs (i.e., the foreign exchange commission plus the transfer fees) are 1 percent of the total funds transferred, the transaction costs in this example drop from $140,000 to $60,000. In cases where multiple subsidiaries trade amongst each other, the savings are even more significant. For example, if four subsidiaries each trade with three other subsidiaries, the total number of transactions can be reduced from twelve to three, which reduces transaction costs substantially.

In a real-life example, Colgate-Palmolive operates in 218 countries. Much of its manufacturing operations are centralized rather than being located in numerous countries around the world. As a result, subsidiaries do a lot of business with each other. Colgate headquarters requires that all subsidiaries submit and settle their payments to each other on the same day. By directing all settlements to one day, Colgate maximizes the benefits of multilateral netting and saves on the spread. This reduces the transaction costs as well as the risk of currency fluctuations.Kabir

26. A technique that companies use to reduce the costs of cross-border payments between three or more subsidiaries; if only two participate, the technique is known as bilateral netting.

Masson, "'Managing International Financial Risk': A Presentation by Hans L. Pohlschroeder," *Columbia Business School Chazen Web Journal of International Business*, February 24, 2009, accessed November 23, 2010, http://www1.gsb.columbia.edu/mygsb/faculty/research/pubfiles/3386/Managing%20International%20Financial%20Risk%2Epdf.

Did You Know?

According to a survey of almost five hundred CFOs and controllers from US-based companies, the following are the top concerns regarding international taxes:

- Cost of complying with international taxes (31 percent of respondents)
- Transfer pricing (28 percent)
- Repatriation of offshore earnings (21 percent)
- Risk management in developing countries (14 percent)
- Mergers and acquisitions transactions (5 percent)Marie Leone, "Tax Sticklers, Not Schemers," *CFO*, May 26, 2010, accessed October 28, 2010, http://www.cfo.com/printable/article.cfm/14501223.

Tax Advantages of Fronting Loans

A **fronting loan**[27] is a loan made between a parent company and its subsidiary through a financial intermediary such as a bank. The advantage of using fronting loans as a way to lend money, rather than the parent lending the money directly to the subsidiary, is that the parent can gain some tax benefits and bypass local laws that restrict the amount of funds that can be transferred abroad. With a fronting loan, the parent deposits the total amount of the loan in the bank. The bank then lends the money to the subsidiary. For the bank, the loan is risk free, because the parent has provided the money to the bank. The bank charges the subsidiary a slightly higher interest rate on the loan than it pays to the parent, thus making a profit.

The tax advantages of fronting loans come into play if the loan is made by a subsidiary located in a tax haven. A **tax haven**[28] is a country that has very advantageous (i.e., low) corporate income taxes. Bermuda is a well-known tax haven. The bank pays interest to the tax-haven subsidiary. The subsidiary doesn't

27. A loan made between a parent company and its subsidiary through a financial intermediary such as a bank.

28. A country that has very advantageous (i.e., low) corporate income taxes.

pay taxes on that interest because of the tax-haven laws. At the same time, the interest paid by the subsidiary receiving the loan is tax deductible.

Transfer Pricing

Multinational firms that conduct business among their cross-border subsidiaries can use tax-advantageous transfer pricing. Transfers occur when a company transfers goods or services between its subsidiaries in different countries. For example, a firm might design a product in one country, manufacture it in a second country, assemble it in a third country, and then sell it around the world. Each time the good or service is transferred between subsidiaries, one subsidiary sells it to the other. The question is, what price should be paid? The **transfer price**[29] is the price that one subsidiary (or subunit of the company) charges another subsidiary (or subunit) for a product or service supplied to that subsidiary.

Since the pricing taking place is between entities owned by the same parent firm, there's an opportunity for pricing an item or service at significantly above or below cost in order to gain advantages for the firm overall. For example, transfer pricing can be a way to bring profits back to the home country from countries that restrict the amount of earnings that multinational firms can take out of the country. In this case, the firm may charge its foreign subsidiary a high price, thus extracting more money out of the country. The firm would use a cost-plus markup method for arriving at the transfer price, rather than using market prices.

Although this practice optimizes results for the company as a whole, it may bring morale problems for the subsidiaries whose profits are impacted negatively from such manipulation. In addition, the pricing makes it harder to determine the actual profit which the favored subsidiary would bring to the company *without* such favored treatment. Finally, all the price manipulations need to remain compliant with local regulations. In fact, to combat such potential losses of income tax revenue, more than forty countries have adopted transfer-pricing rules and requirements.“Driving Indirect Tax Performance—Managing the Global Reform Challenge,” KPMG, April 2010, accessed October 28, 2010, http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

Generally, compliance with local tax regulations means setting prices such that they satisfy the “arm's length principle.” That is, the prices must be consistent with third-party market results. The test of fairness is, “What would an independent company, operating in a competitive market, charge for performing comparable services or selling similar products?”Alfredo (Jay) Urquidi and David R. Jarczyk, “The Importance of Economics in the Practice of Transfer Pricing,” *Transfer Pricing*

29. The price that one subsidiary (or subunit of the company) charges another subsidiary (or subunit) for a product or service supplied to that subsidiary.

International Journal, May 26, 2010, accessed November 23, 2010, http://www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Nonetheless, even within these guidelines, multinational firms can adjust prices to shift income from a higher-tax country to a lower-tax one. Governments, of course, are instituting or revising legislation to ensure maximum taxes are collected in their own countries. As a result, multinational firms must monitor compliance with local transfer-pricing regulations.Alfredo (Jay) Urquidi and David R. Jarczyk, "The Importance of Economics in the Practice of Transfer Pricing," *Transfer Pricing International Journal*, May 26, 2010, accessed November 23, 2010, http://www.ceterisgroup.com/files/Articles/Urquidi-Jarczyk-Economics_May10.pdf.

Indirect Taxes

One way that governments respond to budget shortfalls is by imposing or increasing **indirect taxes**[30] like the value-added tax (VAT) and goods-and-services tax (GST). The reach of these indirect taxes is extending into new areas of the global economy. "The slow economy and falling direct-tax rates are causing many governments worldwide to tighten their existing indirect-tax regimes or introduce new ones," said Frank Sangster, a principal in KPMG's US Indirect Tax practice. "Finance and tax directors must be proactive in considering how their organizations are responding to the global VAT changes, which are already affecting their markets, operations and internal systems."“U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT," *SmartPros*, May 3, 2010, accessed October 28, 2010, http://accounting.smartpros.com/x69387.xml.

More countries are coming to rely on VAT as a significant and stable source of tax revenue, so these taxes are unlikely to diminish. China and India are considering introducing national VAT systems for the first time, while European Union (EU) countries might be looking at ways to raise more revenue through VAT. International companies can assess and manage the risks and opportunities of new VAT systems by using merging technologies to increase automation of the indirect tax process, deciding whether to insource or outsource new compliance obligations, and using modeling techniques to assess the impact of local VAT changes.“U.S. Multinationals Expected to Feel Impact of Accelerated Global Move to VAT," *SmartPros*, May 3, 2010, accessed October 28, 2010, http://accounting.smartpros.com/x69387.xml; "Driving Indirect Tax Performance—Managing the Global Reform Challenge," KPMG, April 2010, accessed October 28, 2010, http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Pages/Driving-indirect-tax-performance-Global-reform.aspx.

30. Taxes that are shifted to another person or entity, like the value-added tax (VAT) and goods-and services tax (GST), which are levied on the seller but are passed on and paid by buyers.

Manufacturing shoes in China for the Chinese market is subject to a 17 percent VAT, for example, but shoes for export aren't subject to this tax. In some cases, it may be cheaper to make the shoes in China, export them to Hong Kong, reimport them into China, and pay import duties instead of VAT. Local import/export regulations can also impact where companies decide to locate specific functions of the supply chain, such as distribution centers or warehouses. In Fujian province, one can import materials one day and export the output the next day. In Guangdong province, in contrast, the local authorities insist on thirty days' notice for reexported materials. The point is that each emerging-market country and even each region in an emerging-market country can have its own interplay of taxes, duties, and regulatory delays that affect how companies design their operations and the margins they're able achieve.

Did You Know?

Colombia and Indirect Taxes

To attract business process outsourcing (BPO) vendors to Colombia, the country eliminated the VAT tax on BPO service exports. This makes it more attractive to locate offshoring services in Colombia. Local governments also created two free-trade zones in Bogotá and Medellín specifically for BPO, providing state-of-the-art infrastructure and services to companies that settle there.Luis Andrade and Andres Cadena, "Colombia's Lesson in Economic Development," *McKinsey Quarterly*, July 2010, accessed August 14, 2010, https://www.mckinseyquarterly.com/Economic_Studies/Productivity_Performance/Colombias_lesson_in_economic_development_2642.

KEY TAKEAWAYS

- Global money management involves moving money across borders and managing the firm's financial resources in a way that minimizes taxes and transaction fees while maximizing the firm's returns.
- Companies can use multilateral netting as a way to reduce the costs of cross-border payments between subsidiaries. They can also use fronting loans to gain tax advantages.
- The transfer price is the prices at which subsidiaries or affiliates of the same firm sell goods or services to each other. When subsidiaries are located in countries with different tax rates, opportunities exist to move income to a lower-taxing jurisdiction. Firms can manipulate transfer prices to reduce global tax liabilities
- A multinational company can make the most of its cash reserves by holding cash balances at a central location, called a centralized depository, thus earning higher interest and being able to reduce the total amount of cash reserves held on hand. However, the two downsides of centralized depositories are that governments can restrict how much capital flows out of their country and transaction costs are incurred each time money is moved across borders.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. How can local cash practices in a country affect a subsidiary's cash flow?
2. What are some advantages that multinational firms gain from centralized depositories?
3. Explain multilateral netting and how it can reduce transaction costs.
4. Why would a company choose to do a fronting loan?
5. What are the challenges of transfer pricing?

15.6 End-of-Chapter Questions and Exercises

These exercises are designed to ensure that the knowledge you gain from this book about international business meets the learning standards set out by the international Association to Advance Collegiate Schools of Business (AACSB International).Association to Advance Collegiate Schools of Business website, accessed January 26, 2010, http://www.aacsb.edu. AACSB is the premier accrediting agency of collegiate business schools and accounting programs worldwide. It expects that you will gain knowledge in the areas of communication, ethical reasoning, analytical skills, use of information technology, multiculturalism and diversity, and reflective thinking.

EXPERIENTIAL EXERCISES

(AACSB: Communication, Use of Information Technology, Analytical Skills)

1. You've been tasked with obtaining financing for your subsidiary in Brazil. Of all the sources of financing you've learned about in this chapter, which sources of financing would you explore? Would you consider equity financing in the Brazilian stock exchange? What factors would you research before making this financing decision?
2. Go to http://www.oanda.com to check the current value of the US dollar relative to the euro. Compare this exchange rate to the exchange rate one year ago. Imagine that you are an executive in a multinational firm that will be manufacturing components at a Chinese subsidiary and selling those components to a US subsidiary that will assemble the components into finished goods and then sell them to a Portuguese subsidiary to sell to European markets. What actions would you take to mitigate currency risk?
3. You are the treasury operations manager for a multinational company. You've been tasked with recommending a cash-investment strategy that will maximize a return on the cash and maintain the liquidity needed for emergencies. Using what you've learned about centralized depositories, multilateral netting, fronting loans, tax havens, and transnational investment, what recommendations would you make?

Ethical Dilemmas

(AACSB: Ethical Reasoning, Multiculturalism, Reflective Thinking, Analytical Skills)

1. Coca-Cola operates thirty-nine bottling plants in China.“Coca-Cola on the Yangtze: A Corporate Campaign for Clean Water in China,” *Knowledge@Wharton*, August 18, 2010, accessed August 25, 2010, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2568. China is an important market for Coca-Cola. The company’s sales in volume grew 19 percent in China in 2009 while declining 1 percent in the United States. Coca-Cola also hopes to expand its business into the juice, dairy, and ready-to-drink markets. It had offered $2.3 billion to buy Chinese company China Huiyuan Juice to get a strong (20 percent) share in China’s juice market. Chinese regulators, however, rejected the deal. In 2004, Coca-Cola was forced to shut down one of its bottling plants in south India after community organizers blamed it for causing water shortages there. (A year earlier PepsiCo’s plant in the same state also lost its operating license for similar reasons.) Coca-Cola is now partnered with the World Wildlife Fund (WWF) to improve the water quality of the Yangtze River, which is the longest river in Asia and supplies 35 percent of China’s water but is now the most threatened river in the world due to pollution. Coca-Cola is working with rural farmers, for example, to reduce runoff from animal waste into the river by turning it into biogas for cooking and heating instead. The company has pledged $24 million over seven years to support fresh-water programs globally. It’s also striving to be “water neutral” by making its “waste” water pure enough for agricultural irrigation and completely offsetting the amount of water it uses in its soft-drink products by funding clean-water projects and watershed preservation efforts around the world. What do you think of these moves by Coca-Cola? On the one hand, as the world’s largest beverage company, its water-neutral plan could make a big difference, and its clout brings attention to the world water issue. On the other hand, bringing attention to the issue could put the spotlight on the company itself, which uses 2.5 liters of water to make a liter of Coke. In fact, when looking across the whole supply chain, 200 liters of water go into making a single liter of Coke (due to water-intensive sugar cane crops). However, looked at from an

entire-chain perspective, it takes 140 liters of water to make a cup of coffee and 800 to 1,000 gallons of water to get a single gallon of milk.Peter M. Senge, *The Necessary Revolution* (New York: Doubleday, 2008), 77–92. If you were a Chinese consumer, would you be more likely to buy Coca-Cola products given the company's efforts to clean up the Yangtze River? If you were an executive at Coca-Cola, what actions or programs would you recommend or support?

2. As you learned in Section 15.5 "Global Money Management: Moving Money across Borders", transfer pricing is legal, and firms can manipulate transfer prices to avoid taxes. The practice, however, violates the spirit of the law in some countries. Should firms engage in this practice? On the other hand, by not taking advantage of these opportunities, would firms be shortchanging their investors?