International Accounting and Financial Management

Quick decisions are unsafe decisions.

—*Sophocles, 496–406 B.C.*

Arrange whatever pieces come your way.

—*Virginia Woolf*

18

Sovereign Wealth Funds: Globalization at Work

Sovereign wealth funds are investment funds that are controlled by governments. The funds themselves may be from national reserves, pension funds, and other monies controlled by the government. Recently, the growth of sovereign wealth funds in China and the oil-rich states has created pools of dollars so large, in the range of $4 trillion, that they can influence the market and readily acquire assets in the developed world. The Sovereign Wealth Funds Institute, an organization that tracks these funds, lists the United Arab Emirates as having the largest fund or group of funds, at $738.9 billion. China follows at $732.5 billion, then Saudi Arabia weighs in at $436.3 billion.[a]

Governments invest to get a return on their assets for their citizens and to diversify their national risk. For example, if the country's main earnings are in the oil sector, investments in nonrelated industries will protect it from a down oil market (if we can imagine such a thing).

"What's the problem?" you might ask. Why not use Arab, Chinese, and Brazilian wealth to leverage growth in the developed world? There are a couple of interesting issues connected to sovereign wealth funds. First of all, it is an odd twist on the prevalent trend toward privatization. Except for dire situations such as the recent financial crisis in which governments bailed out some private companies, the developed nations tend to preach that business should be controlled by private risk takers. Keep the government out. Yet sovereign wealth funds are government owned, so their investments actually represent a foreign government's ownership.

In addition to the counter-trend aspect of sovereign wealth funds, there's the issue that they are not purely commercial in their interests and might choose objectives other than to maximize return to the shareholder. For example, the Chinese Investment Corporation, one of the major Chinese sovereign wealth funds, might choose to influence procurement decisions, favoring China's companies over less costly suppliers, on the basis of self-interest. Or Chinese government economic policy could favor job creation over profitability. Or a foreign government might invest in a firm that's important to national defense. Once government ownership is established, the business decisions may be influenced by political objectives or other objectives not in the best interest of the firm's economic results. Besides, these are

learning objectives

After reading this chapter, you should be able to:

- **LO18-1** **Identify** the major international accounting issues that international firms face when operating in foreign currencies.
- **LO18-2** **Describe** the relationship between accounting and culture.
- **LO18-3** **Describe** the international accounting standards' convergence process and its importance to international firms.
- **LO18-4** **Outline** the arguments for and against 3BL.
- **LO18-5** **Explain** the capital structure choices open to international firms and their significance.
- **LO18-6** **Describe** why ICs move funds.
- **LO18-7** **Explain** the utility of an international finance center.
- **LO18-8** **Describe** multilateral netting and its benefits.
- **LO18-9** **Categorize** foreign exchange risks faced by the international firm into transaction exposure, translation exposure, and economic exposure.
- **LO18-10** **Describe** ways to hedge transaction exposure.

private funds and have limited transparency, so what the fund is doing is difficult to assess.

Many of these concerns can be answered by government legislation that limits foreign investment directly, requires disclosure or requires approval of foreign investments. By and large, these processes have been legislated. There are many examples of government-owned businesses, both domestic and foreign. In the United States, public pension funds constitute more than 40 percent of all institutional investment. More than a whopping 80 percent of all the oil pumped in the world is pumped by government-owned firms. CITGO is owned by the Venezuelan government.[b] (Don't you wonder what the Red Sox Nation thinks of that?[c])

There's still another noteworthy point to be made about sovereign wealth funds. They represent a global shift—a trend toward a transfer of ownership away from the United States, Europe, and Japan and toward developing nations. Sovereign wealth funds represent globalization at work. In addition, for the developed world, they provide benefits because they leverage continued growth and provide an ability to cushion financial crises. Remember, developing country assets are growing around twice as fast as those in the developed nations.[d] A McKinsey study predicts that by 2020, more than half of the world's saving and investment will take place in developing markets![e]

[a]Sovereign Wealth Funds, www.swfinstitute.org (accessed April 16, 2011).

[b]James Surowiecki, "The Financial Page: Sovereign Wealth World," *The New Yorker,* November 26, 2007, p. 70; and Alan Murray, "The Outlook: Ascent of Sovereign Wealth Funds Illustrates New World Order," *The Wall Street Journal,* January 28, 2008.

[c]See www.redsoxconnection.com/citgo.html for explanation.

[d]Diana Farrell and Susan Lund, "Power Brokers," McKinsey Global Institute, October 2007, referenced by Murray, "The Outlook," www.mckinsey.com/mgi/mginews/powerbrokers.asp (accessed April 16, 2010).

[e]"Farewell to Cheap Capital? Implications of Long-Term Shifts in Global Investment and Saving," McKinsey, October 2010 (accessed April 16, 2011).

In Chapter 8, we reviewed some of the major financial forces international managers face in their daily operations. These forces include fluctuating currency values, currency exchange controls, taxation, and inflation and interest rates. Managers are not helpless before these forces, and now we look at methods these managers have developed to deal with them, some of which are imaginative and elegant, and, of course, all of them are legal. *A word here about the general area.* Some find these topics uninteresting or perhaps too complex. One of our goals in this chapter is to help you see that these issues are at the core of how companies work, they often make the difference between moderate and outstanding results, and they can be exciting and interesting. True, there's no doubt; international finance is complex. Our approach is to help you gain access to the major issues, assuming that you do not have an advanced background in finance.

We'll begin with accounting because it is a fundamental tool of financial management and because accounting practices and standards change across national borders. First, we look at the differences in how countries record stored value (the essence of accounting). Fortunately, there is a strong movement toward a convergence of accounting standards, which will make the process much easier for the international company. In our discussion, we'll use the U.S.-based international company (IC) for the sake of simplicity, remembering that ICs can be any nationality. Note, too, that increasingly major ICs are headquartered in emerging-market economies such as China, India and Brazil.

That's the first half of our job in this chapter, to address issues of international accounting. The second half is to review the major issues in IC financial management. If you are concerned that this material is too complex, rest assured that we are not condensing an international finance course into a chapter. We begin with how the IC's capital is structured and then move on to cash management, including techniques such as multilateral netting and approaches to currency fluctuations. Finally, we discuss some aspects of taxation. Our goal is to describe these areas in an understandable way so that you can appreciate their contributions to the IC's success.

International Accounting

The purpose of accounting in all countries is to provide managers with financial data for use in their decision making and to provide external constituencies (investors, governments, lenders, suppliers, and others) the quantitative information they seek to inform their decisions. Accounting also provides the data governments need to levy taxes. If you think back to Chapter 4's coverage of cultural values that vary across nations, the idea that the basic concept of what useful accounting data is varies from country to country shouldn't surprise you. For example, in Germany, the primary users of financial information have been creditors, so accounting focuses on the balance sheet and the company's assets. By contrast, in the United States, investors are major users of financial information, and they look to the income statement as a sign of the company's future and are less interested in the balance sheet than are the Germans.[1]

An international company such as the Indian Tata Group, the Chinese household appliance company Haier Group, or the American consumer goods company Procter & Gamble has to address transactions in foreign currencies, with an obvious impact on the practice of accounting. And, as mentioned in our contrast of the Germans and Americans, different needs in different countries have led to large variations in financial statements across the globe. There is one additional source of variation, and this goes more directly to cultural differences: assumptions that underlie the country's legal, political, and economic systems, as well as the country's history, influence the commonly shared understanding of the purpose of accounting. That is to say, culture plays a significant role in the practice of accounting. In this section, we examine both transactions in foreign currencies and the role of culture in accounting, and then we go on to look at possible convergence among the main accounting approaches.

ACCOUNTING AND FOREIGN CURRENCY

LO18-1 **Identify** the major international accounting issues that international firms face when operating in foreign currencies.

There are only two points at which operating in a foreign currency raises issues from an accounting perspective: when transactions are made in foreign currencies and when branches and subsidiaries operate in foreign currencies and their results need to be made a part of the parent company's financial reports. We look first at transactions and then at translation and consolidation, the two processes involved in merging subsidiary financial results with those of the parent company.

When the U.S.-based company has foreign currency–based transactions such as sales, purchases, and loans (made and taken), they need to be recorded as revenues, expenses, assets, or liabilities. Here's an example.

Suppose the U.S.-based company buys Swiss watches in Geneva for 25,000 Swiss francs (CHFs) on June 1. Because the company's books are in U.S. dollars, the transaction is entered in dollars at the exchange rate on June 1. Let's say it's $0.963149/CHF. That is, 1 CHF buys $0.963149. The purchase entry would be $24,078.73. Accounts payable would also be $24,078.73 and the exchange rate notation "CHF 25,000 @ $0.963149" would be made.

Now, if the payment is immediate or stipulated in U.S. dollars (US$), that would be the end of it. But suppose there is a time lag, the payment is made on August 1 and in the meantime, the exchange rate has changed. If the transaction is in CHF, the underlying dollar value of the purchase would change. Let's say the Swiss franc weakens against the dollar, moving to $0.94300/CHF on August 1, when the payable is due. Now the U.S. company has to pay $23,575, or less than their original purchase entry. The $503.73 difference constitutes a foreign exchange gain. In this case, the journal entries would remain the same, and the gain (or loss) would be recorded in the income statement. This process is described by U.S. Financial Accounting Standards Board Statement 52 (FASB 52), which requires that companies record foreign currency–based transactions at the spot rate at the time of the transaction. Any gains or losses from changes in exchange rates for items carried as payables or receivables are posted in the income statement. The International Accounting Standards Board (IASB), the international accounting standards organization that we'll soon discuss when we look at the convergence of accounting standards, has the same rule.

consolidation The process of translating subsidiary results and aggregating them into one financial report

current rate method An approach in foreign currency translation in which assets and liabilities are valued at current spot rates

temporal method An approach in foreign currency translation in which monetary accounts are valued at the spot rate and accounts carried at historical cost are translated at their historic exchange rates

functional currency The primary currency of a business

LO18-2 **Describe** the relationship between accounting and culture.

Now to our second concern about foreign currencies in accounting operations. When a U.S. IC's foreign subsidiary reports results, these results need to be translated into the parent company's operating currency, in our discussion, dollars, and made to conform to U.S. generally accepted accounting principles (GAAP). Then these various results from foreign subsidiaries are aggregated into one financial report. This process is called **consolidation.**

So the question arises, what exchange rate should be used, today's or the one in effect on the day of the transaction? As you can see, there are two basic approaches to translation, and these are called the current rate method and the temporal method. They both have as their objectives to accurately reflect business results. By the **current rate method,** assets and liabilities are translated at the rate in effect the day the balance sheet is produced. By the **temporal method,** monetary items such as cash, receivables, and payables are translated at the current exchange rate. Fixed assets and long-term liabilities are translated at the rates in effect the date they were acquired or incurred.

So when is each of these translation methods used? The choice hinges on which currency the operation uses, its **functional currency**. The functional currency is the primary currency of the operation, the currency in which cash flows, pricing, expenses, and financing are denominated. Usually the functional currency is the local one, but every once in a while, an IC will operate in its parent currency in a foreign location. You can find all the details for the translation process in FASB 52 and IASB 21. Figure 18.1 summarizes implications of using the local or parent company currency as the functional currency.

ACCOUNTING AND CULTURE

We know that accounting follows different patterns in different parts of the world. Sidney Gray's research measures how two accounting functions, what information companies provide and how companies value assets, are influenced by culture. Accounting terms for these functions are disclosure practices and accounting measurement. His study, summarized in Figure 18.2, classifies countries on two dimensions, secrecy–transparency and optimism–conservatism.[2]

The dimension of secrecy–transparency measures the degree to which companies disclose information to the public. Germany, Japan, and Switzerland tend to value secrecy or privacy over transparency. In the United Kingdom and the United States, there is more disclosure and less privacy. The dimension of optimism–conservatism measures the degree to which a company is cautious in its valuing of assets and measuring of income. Accounting reports in countries with more conservative asset-valuing approaches tend to understate assets and income, while those in countries whose asset-valuing approach is more optimistic

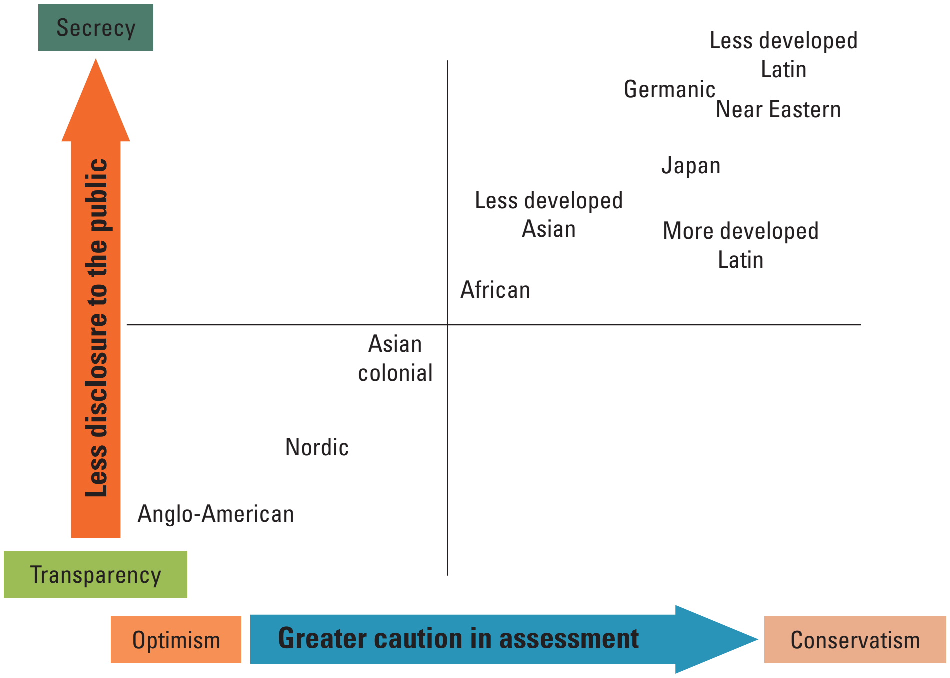
FIGURE 18.1

Functional Currency and Translation Methods

When Functional Currency Is:	Local Currency	Parent Company Currency
Translation method is:	Current method	Temporal method
Assets are translated at:	Spot rate on date balance sheet prepared	Spot rate for monetary assets Historic cost for fixed assets
Income statement is translated at:	Average exchange rate for reporting period	Cost of goods sold and depreciation at historic rates Average exchange rate for reporting period Other items at average rate for period
Owner's equity is translated at:	Rates in effect when stock issued	Rates in effect when stock issued
Retained earnings are translated at:	Rates in effect when earnings posted	Rates in effect when earnings posted

FIGURE 18.2

Cultural Differences in Measurement and Disclosure for Accounting Systems



Source: Adapted from Lee Radebaugh and Sidney J. Gray, *Accounting and Multinational Enterprises,* 5th ed. (New York: John Wiley & Sons, 2002).

tend toward overstatement. In France, Germany, and Japan, public companies' capital structure tends to depend more on debt rather than equity, with banks being a major source of the debt. Banks are concerned with liquidity. A conservative statement of profits may reduce tax exposure and dividend payouts, contributing to cash reserves that can be tapped for debt service. On the optimism measure, U.S. and, in a more restrained way, U.K. companies want to show impressive earnings that will attract investors and raise the share value sooner rather than later.

CONVERGENCE OF ACCOUNTING STANDARDS

LO18-3 **Describe** the international accounting standards' convergence process and its importance to international firms.

There are now two main accounting standards at play in the global arena. The private organization that establishes accounting standards in the United States is the Financial Accounting Standards Board. The FASB's standards are the U.S. generally accepted accounting principles. The international body is the International Accounting Standards Board, whose standards are the International Financial Reporting Standards (IFRS). In 2002, FASB and IASB agreed in principle to harmonize standards and converge. Convergence would create a standard for a global market and allow ICs to list stock in foreign markets, so they could tap into their potential as a source of shareholders. There is general political agreement to move toward the principles-based IASB standards (IFRS) from the rules-based FASB standards, but as we approached and then saw the initial 2011 deadline reset, some U.S. companies voiced their dissatisfaction with IFRS standards, especially in the cost area. The recession has also slowed down progress toward convergence. Significant progress has been made on this commitment by a negotiating group, with a target date of June 2011, a date later extended to 2015, but the negotiations are complex. With two very different basic sets of assumptions and so many important and heavily detailed aspects of specific standards to be reconciled, the progress so far toward convergence is impressive.

On the path of convergence, the EU Parliament and the Council of Europe decided to require IASB standards for financial reporting as of 2005. Australia and New Zealand have joined the EU in this step forward. The transition seems to have gone smoothly. Presently there are more than 90 countries that require public companies to list using IFRS and another 30 that permit it. Many other countries, including those in the EU, have adopted IFRS with

WORLD VIEW

The Ongoing Effects of SOX as a Symptom, Not a Cause

When the U.S. Congress passed the Sarbanes-Oxley Act (SOX) in the wake of the corporate scandals of 2001, Harvey Pitt, former chairman of the Securities and Exchange Commission (SEC) (2001–2003), lashed out at Congress for its required export of a hastily written and poorly conceptualized law. Its "one size-fits-all" approach to regulation stifles innovation, creativity, risk taking, and competitiveness. All foreign companies listing in the United States had to conform to SOX listing requirements, which are seen to be overly complex, until 2007, when the SEC changed its regulation. Worse, Pitt says, "Congress's exportation of SOX's standards has created huge difficulties for multinational companies and produced scorn for U.S. standards." He suggests that the scorn is justified, that there are better standards out there.[a]

What Pitt characterizes as "American geocentrism" has resulted in the loss of foreign listings on U.S. exchanges and the movement of IPOs to non-U.S. sites. In fact, London overtook New York as the world's top financial center in 2007.[b] A 2011 report on the top financial centers by the Qatar Financial Centre Authority lists London as the foremost city in the world economy, followed by New York, Hong Kong, Singapore and Shanghai.[c] Many financial reporters note that financial business has fallen off in New York due to "heavy-handed regulations." John Ross, director of economic and business policy for London's former mayor, Ken Livingstone, said that "the predictability and clarity of regulations were obvious advantages for London over New York. . . . I don't think Sarbanes-Oxley is even the worst aspect of it, nor do the companies I have talked to. It is the litigious and apparently arbitrary culture of regulation and policy." Ross mentioned the political opposition to the takeover of P&O Ports by Dubai Ports World, owned by the United Arab Emirates, as an example of the uncertainty found in the United States.

Faced with evidence that they are increasingly irrelevant in the global economy, largely due to SOX-like approaches to regulation and enforcement, U.S. stock exchanges made a gallant effort to change their position. They went out to the market, trying to buy into foreign exchanges. Instead, following the old "buy on weakness; sell on strength" approach, Belgian Euronext merged with the NYSE in 2007. In 2011, the German Deutsche Börse made a $9.53 billion all stock purchase of the NYSE that is awaiting approval.

Questions:

1. Explain the goals of SOX legislation.
2. Why is SOX a symptom?

[a]Harvey Pitt, "Sarbanes-Oxley Is an Unhealthy Export," *Financial Times*, June 21, 2006, p. 15.

[b]Alan Beattie, "London Named Top Financial Centre," *Financial Times*, June 12, 2007, p. 3.

[c]Qatar Financial Centre Authority, Financial Centre Futures, "The Global Financial Index 9," www.zyen.com/GFCI/GFCI%209.pdf (accessed April 21, 2011).

minor modifications, called *carve-outs,* on the path to full IFRS acceptance. As of 2007, the U.S. Securities and Exchange Commission (SEC) decided that foreign companies listing their shares in the United States no longer needed to restate their financial statements to comply with FASB standards. As of April, 2011, the SEC had yet to decide whether to require or allow a switch to IFRS for U.S. public companies Incidentally, in 2002, when the U.S. Congress passed the Sarbanes-Oxley Act (SOX), in response to the corporate scandals in which accounting practices were at the center (Tyco, Enron, and WorldCom among them), it also noted in the legislation its desire for convergence in accounting standards. SOX named the SEC as the responsible party for recognizing the IASB.

One of the largest differences between GAAP and the IFRS has to do with their general approach. Thinking back to new institutional theory (Chapter 3) will help us here. GAAP relies on rules and regulations; we can think of it as a formal institution, with compliance based on expedience. The IFRS has greater reliance on principles, a normative institution, with compliance based on social obligation. Shared principles suggest the need for reasoned judgment because they allow for interpretations, unlike the application of rules, so accountants with GAAP approaches will have to get used to a new way of thinking. At this point, the United States is the only major nation that follows GAAP.

With convergence, financial markets around the world will become more integrated because the statements will be directly comparable. Investors and other interested parties will be able to see company performance across borders, companies will no longer have to restate their financials, and the complex process of consolidation will be much less so. These features of standardization mean substantial cost reductions for companies and better information for everyone.

TRIPLE-BOTTOM-LINE ACCOUNTING

LO18-4 **Outline** the arguments for and against 3BL.

As mentioned in Chapter 5 in our sustainability discussion, increasingly, companies have made efforts to report on their environmental, social, and financial results. This reporting framework has been termed triple bottom line (3BL), a term credited to John Elkington in his 1997 book, *Cannibals with Forks: The Triple Bottom Line of 21st Century Business.*[3] The book's argument is that capitalism can become civilized; capitalists can be taught to eat with forks, due to consumer pressure and other social forces. Corporate capitalism can become sustainable capitalism. Elkington describes seven drivers of this transformation: markets, values, transparency, life-cycle technology, partnerships, time, and corporate governance. This approach supports sustainability and corporate social responsibility (CSR). As we have seen in our earlier discussion, *sustainability* is a systems concept that has three major aspects: the environmental or ecological, the social, and the economic. Currently, we measure at the economic level and, where required by government or social pressure, we measure at the environmental level (as with emission controls and hazardous waste) and at the social level (as with the Equal Employment Opportunity Commission's enforcement of the federal civil rights laws). Yet even in the environmental and social areas, we tend to know more about the problems—what is reported in the media—than about the company-level thinking on these important issues. Companies should measure and make public the environmental and social effects of their decisions. These are, in summary, the major argument for 3BL.

The major argument against 3BL is neither a substantive disagreement with the desirability of ecologically responsible business practices that support sustainability nor a disagreement with the idea of business being socially responsible; rather, it is the claim that measurement will not get us closer to the desired state. Wayne Norman and Chris MacDonald argue that social performance and environmental impact cannot be objectively measured in ways that are comparable to our economic measurements of a firm's activities.[4] They point out that the rhetoric may be appealing, but no widely implementable framework exists for measuring a company's performance in environmental and social areas, although there are high levels of consulting in these areas. In fact, they suggest that a focus on the measurement of these activities may well detract from efforts to figure out ways to combine sustainability and social responsibility with positive economic results, which is a more difficult challenge. There is a parallel with codes of ethics: what matters is what a company actually does, not whether a code of ethics is hanging on the wall of every office. The poster is rhetoric. Posting it is not ethical action. Decisions in the field that have to do with implementation are what matter, as well as how the organization's members understand the company's values and what those values say about their duties to stakeholders.[5]

Perhaps such reporting requires a reframing of how we think about organizational outcomes, a process that is incremental and subtle. Notable efforts to develop a framework that supports substantive reporting on the environmental, social, and financial aspects of business have been made by the Global Reporting Initiative (GRI), an international network of stakeholders from thousands of organizations, including private sector businesses, nongovernmental organizations, and government organizations, both local and international. There are more than 20,000 stakeholders from more than 80 countries. GRI is independent and collaborates with the United Nations Environmental Program (UNEP). Details can be accessed at www.globalreporting.org.

International Financial Management

We now look at how the firm manages funds across borders. This process of transferring value internationally is interesting and complex because it involves many variables, among them, exchange rates among currencies, varying restrictions on the movement of funds, differing tax systems, and differing economic environments. You might think of this challenge as an exceedingly complex game that involves managing risk, opportunity and complexity.

We begin our financial management review with a focus on the capital structure of the firm. Then we move on to cash flow management across borders, looking at both the financial flows themselves and the techniques used to move them. Foreign exchange (FX) risk management follows. We also look at taxation issues. This review's goal is to introduce you to the type of challenges international financial managers face and how they resolve them.

LO18-5 **Explain** the capital structure choices open to international firms and their significance.

Capital Structure of the Firm

We have seen that firms are becoming increasingly international in their markets and their sourcing in order to exploit attractive opportunities. Such an opportunity is also available for the capital structure of the firm, and, increasingly, chief financial officers (CFOs) have been tapping international financial markets, both public and private. Because financial markets are not globally integrated, though they are increasingly interconnected, varying opportunities arise among them with varying costs. If a CFO can raise capital in a foreign market at a lower cost than in the home market, such an opportunity may be attractive as a way to increase shareholder value.

The firm raises capital internally through its retained earnings and then, externally, through either equity (the issuing of shares) or debt (leveraging). Many firms choose the equity approach, to issue stocks in foreign markets, in part to tap into a broader investor pool, which can raise the stock price and reduce the cost of capital. Selling stock in foreign markets may have a significant marketing advantage, too, raising the profile of the brand name abroad. Foreign companies that have issued shares in the United States include Unilever, Fuji Film, Canadian Pacific, KLM, Sony, Toyota, and Cemex. Sometimes, foreign shares are directly traded in the American stock markets, but many times, they are traded in the form of **American depository receipts (ADRs).** These receipts represent shares that are held by a custodian, usually an American bank, in the stock's home market. They are denominated in dollars and traded on the U.S. exchange, eliminating the need to have a broker in the country of issue and the need for currency exchange.

American depository receipts (ADRs)
Foreign shares held by a custodian, usually a U.S. bank, in the issuer's home market and traded in dollars on the U.S. exchange

The sale of increasingly more shares of a company in foreign stock markets may raise concerns about foreigners having control of domestic assets, especially when the sectors involved are perceived as essential to national security. In these cases, governments restrict foreign ownership of equity. These restrictions are more prevalent in developing countries. For example, in China, India, Mexico, and Indonesia, foreign ownership in specific sectors is limited. Some sectors in developed nations are also protected from foreign ownership, often through an approval process. Such an example in the United States is found with airlines, which must be directed and operationally controlled by a U.S. citizen.[6] In addition, foreign acquisitions are approved by the U.S. Treasury's Committee on Foreign Investment in the United States, with final decision made by the president. In 2008, CFIUS investigated just under 2,000 proposed acquisitions. In 2005, this committee refused approval of China National Offshore Oil Corporation's acquisition of the California oil company UNOCAL, which later merged with Chevron.

Debt markets are the other source of capital for the firm, and increasingly the tendency is to tap local markets first. That may mean that a foreign subsidiary of the Japanese firm Toyota would look first to its market in the United States for funds to use in their U.S. operations. Multinational corporations, in addition to obtaining funds at the corporate level, can explore borrowing in their domestic and international debt markets, increasing the opportunities to reduce the cost of capital. They also have access to **offshore financial centers,** locations that specialize in financing by nonresidents, where the taxation levels are low and the banking regulations are slim. Switzerland, the Cayman Islands, Hong Kong, and the Bahamas are examples of offshore financial centers.

offshore financial center
Location that specializes in financing nonresidents, with low taxes and few banking regulations

Debt financing is thought to be less expensive than is equity financing, because the interest paid on the debt is usually tax deductible, while dividends paid out to investors are not. Yet the choice of debt or equity financing is also influenced by local practice. Companies in the United States, the United Kingdom, and Canada tend to rely on equity more heavily than do companies in many other countries. In both Japan and Germany, banks traditionally play a more central role than do the stock markets in the financing picture. In Japan, we find the interlocking relationships of the *keiretsu,* where related companies in a larger family—such as Mitsubishi, Sumitomo, or C. Itoh—are connected with interlocking ownership of stocks and bonds, with the company bank at their center. Essentially, this structure eliminates the stakeholder conflicts between bondholders and stockholders, an appropriate characteristic for a national culture where harmony is an important cultural value.

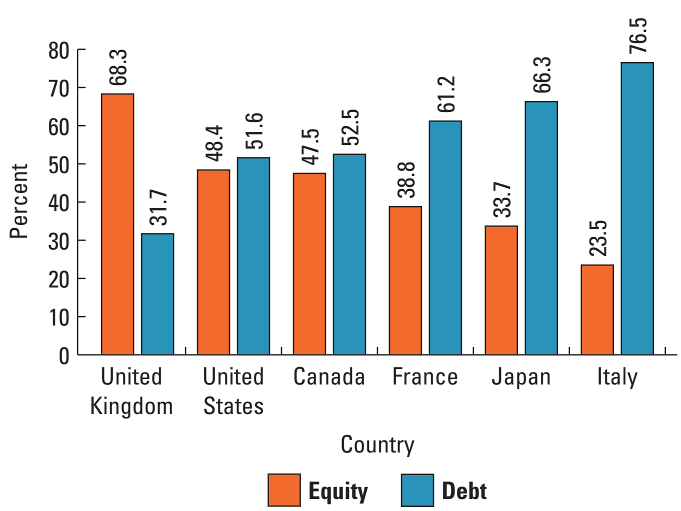
How the local government treats taxes may also influence how the IC structures its capital. If the local tax rate is high, and interest paid on debt is tax deductible, debt may be a way to partially protect profits from taxes. National policies also influence this decision. For example, exchange controls may limit dividend payments to foreign equity holders, and national policies designed to encourage local reinvestment may control the remission of dividends. In summary, local practices, taxation and other country-level policies may influence the firm's capital structure. Figure 18.3 illustrates capital structure percentages for selected countries.

Decisions a financial manager would make in the process of raising capital are as follows:

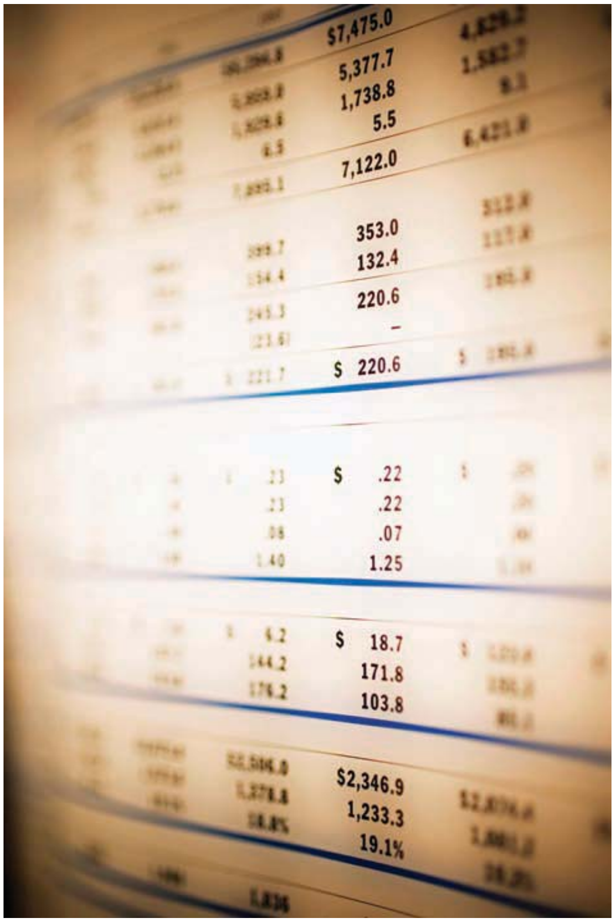
1. In what currency should the capital be raised, considering an estimate of its long-term strength or weakness?
2. How should the capital raised be structured between equity and debt?[7]
3. What are the sources of capital available? Should money be borrowed from a commercial bank by an ordinary loan; a bank as part of a swap; another company as part of a swap; another part of the MNC; or a public offering in one of the world's capital markets, for example, in the New York or eurobond market?
4. If the decision is made to use one of the world's capital markets, management must then decide in which of those markets it can achieve its objectives at the lowest cost.
5. Are there other sources of money available? For example, a joint venture partner, private capital, or a host government may be some sources. A host government may be a source of funds or tax abatement if the move is expected to bring the IC's technology, management knowledge, or the jobs that will be created.
6. How much money does the company need and for how long? For instance, if the company is moving into a new market or product, there will probably be a period during product introduction or plant construction when the new venture will need more capital than it can generate.

FIGURE 18.3

Capital Structure Percentages for Selected Countries



Source: Data extracted from S. Besley and E. Brigham, *Essentials of Managerial Finance* (Oklahoma City, OK: Southwestern Publishing, 2008, Table 12.7.



Cash Flow Management

The management of cash flows is an important part of international financial management that builds on the activities of domestic financial management. For example, both purely domestic and international firms would want to source funds in low-cost markets and place excess funds where they would get the best return. The global cash management picture is more complex than that of a domestic firm due to the number of different markets involved, each with its own economic characteristics, currency, and regulations. Operating in 25 local currencies is not uncommon for the international firm. The overall goal of cash flow management is to reduce risks and position the firm so it can benefit from opportunities. Some of the sources of these risks and opportunities are foreign exchange movements, interest rates, inflation, government regulation, and taxes. We first look at the major reasons for which an international company moves funds and then at its international finance center's activities.

WHY FUNDS ARE MOVED AND USEFUL TECHNIQUES

LO18-6 **Describe** why ICs move funds.

Firms move funds for many reasons, among them dividends, royalties, and fees from the subsidiary to the parent company; loans from the parent to the subsidiary or among subsidiaries; and transfer pricing of sales between subsidiaries and the parent company. Dividends result from the parent company's equity interest in the subsidiary, while royalties and fees are payments made for the use of company assets such as trade names, technology, consulting, and management systems. These payments are important to the business in and of themselves and are additionally are useful in cash flow management in several ways. They may serve as vehicles for moving profits from subsidiaries in high-tax environments to lower-tax environments. They may be a way to move profits out of countries where repatriation of profits is blocked or limited. They may also be a way to reduce FX risk by moving currency from environments that have a high risk of devaluation to lower risk ones. Note, too, that these payments are business expenses, so they may be used to impact tax liability.

fronting loan
A loan made through an intermediary, usually a bank, from parent company to subsidiary

transfer price
The bookkeeping cost of goods transferred from one unit of a business to another in another country

Loans also may be useful in cash flow management. Parent companies may loan funds directly to the subsidiary, yet these direct loans face some risk because the host government is able to restrict the subsidiary's remittances, including the loan payments, back to the parent. A **fronting loan** is an approach that achieves the same objective for the firm, with much less risk. In a fronting loan, the parent company deposits money in an international bank, which then lends to the subsidiary, *fronting* for the parent company. The host government is not inclined to restrict subsidiary loan payments, especially to a major international bank. There is a small cost to the parent company, while the bank has no risk because it is holding a fully collateralized loan. If the deposit is made from a tax haven, there will be tax advantages as well. Such loans may also be a way to get around blocked funds. Such funds may be blocked because the host government is making an effort to protect its balance of payments position.

One additional method of transferring funds within the firm that may serve as a cash management technique is transfer pricing. The **transfer price** is the bookkeeping cost of goods transferred (sold) from one unit of a business to another in another country.

Such transfers are common with globally dispersed firms, making up 60 percent of world trade. Because the sale that creates the transfer is internal, its cost can be seen as somewhat flexible. In this flexibility lies the potential to move funds from high-tax, weak-currency environments in ways that are beneficial to the firm. Transfer pricing may also be used to circumvent host-country currency transfer controls and tariffs. Because it may often represent lost tax revenues for host governments, transfer pricing is carefully reviewed by host-government authorities. Transfer pricing can be seen to raise ethical issues, too, because the maneuvers, although they may be legal, are often not in the spirit of the host-country tax and monetary laws. The OECD and the U.S. Internal Revenue Service have issued guidelines on transfer pricing. Some firms now voluntarily agree in advance with the host country on their approach to internal pricing. Such agreements, in addition to offering ethical guidelines to decision makers, reduce the firm's legal and tax audit risks.

INTERNATIONAL FINANCE CENTER

LO18-7 **Explain** the utility of an international finance center.

The increasing complexity of global financing, combined with increasing global competition, has encouraged firms to pay more attention to financial management. In many firms, the finance operation has become centralized and established as a profit center, a bit like a company bank. Developments that lead to the establishment of finance centers are (1) floating exchange rates, whose fluctuations are sometimes volatile; (2) growth in the number of capital and foreign exchange markets, where the firm can shop for lower interest costs and better currency rates; (3) different and changing inflation rates from country to country; (4) advances in electronic cash management systems; (5) realization by financial managers that through innovative management of temporarily idle cash balances of the subsidiaries, they can increase yields and, thereby, profit; and (6) the explosive growth of derivatives to protect against commodity, currency, interest rate, and other risks. These centralized finance centers can balance and **hedge** currency exposures, tap capital markets, manage inflation rate risk, manage cash management technological innovation, manage derivatives use, handle internal and external invoicing, help a weak-currency subsidiary, and strengthen subsidiary evaluation and reporting systems. Hedging is the process of taking a position in one market in order to offset exposure to price changes in an opposite position. Hedging is widely used to cover risk. We now move to cash flow management and look at multilateral netting and leading and lagging as two approaches the firm's finance center may use to manage cash flows.

hedge
To take a position in one market in order to offset exposure to price changes in an opposite position

MULTILATERAL NETTING

LO18-8 **Describe** multilateral netting and its benefits.

There are many possible types of cash flows between subsidiaries and the parent company and among subsidiaries. The parent company makes loans to the subsidiary and may increase investment in the form of equity capital. In the other direction, cash from sales, dividends, royalties, and fees move from the subsidiary to the parent. Flows also exist among subsidiaries. One common strategy finance centers use to manage and optimize these flows is **multilateral netting.** This is a centralized approach in which subsidiaries transfer their net cash flows within the company to a cash center that disperses cash to net receivers. A single transaction to or from each member settles the net result of all cash flows. The structure is essentially the wheel-and-spoke model.

multilateral netting
Strategy in which subsidiaries transfer net intracompany cash flows through a centralized clearing center

Why do companies consider multilateral netting? First of all, the transfer of funds has a cost attached to it, the *transaction cost,* and at the same time, the funds while in transit present an opportunity cost: they are not working for the company. In addition, FX costs are incurred. By reducing the transfer transactions, there is less inactive time for funds, the actual transfer costs are reduced, and there are fewer FX transactions, as well. As an example, consider multilateral netting among the European and Middle Eastern subsidiaries of a firm. Each subsidiary with a net payable position would transfer its funds to a central

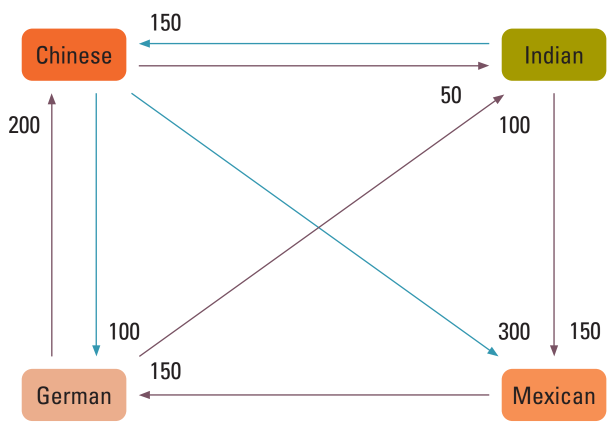
FIGURE 18.4

Advantages of Multilateral Netting

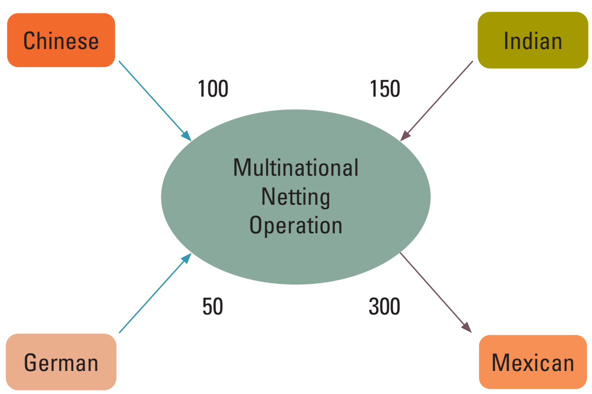
	US$-000		
Subsidiary	**Receivables**	**Payables**	**Net**
Chinese	350	450	(100)
German	250	300	(50)
Indian	150	300	(150)
Mexican	450	150	300

MNC, Inc. intra-subsidiary cash positions

(a) MNC Inc., intrasubsidiary cash flows (US$-000)



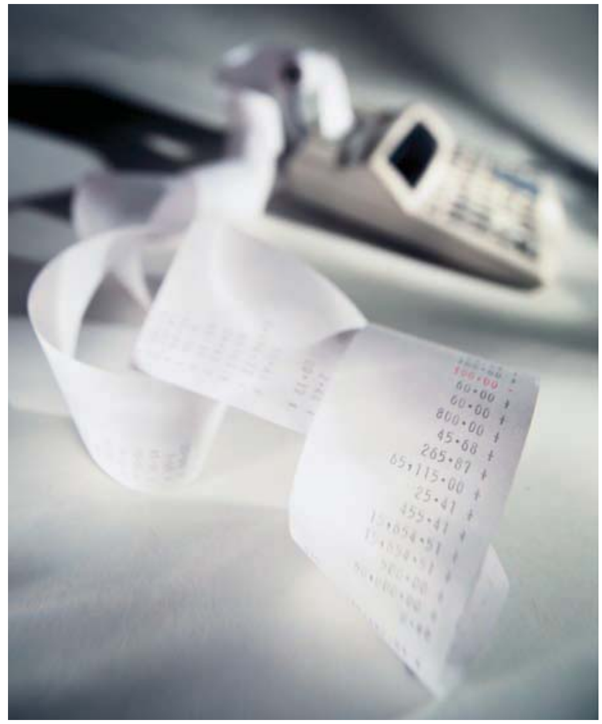
(b) MNC Inc., intrasubsidiary cash flows with netting (US$- 000)



account once a month, where the central account manager would then transfer funds to the net receivers. Compare the two approaches in Figure 18.4. Without netting, reconciling the positions would require eight transactions and $1.2 million in transit. With netting, there are four transactions, and $600,000 in transit. Plus, the foreign exchange transaction costs are reduced.

LEADING AND LAGGING

Currency exchange rates that float, as do today's, create a risk for the multinational firm. To minimize such a risk, one useful technique is **leading and lagging,** which involves the timing of payments. This is actually a simple technique that you may practice already: collect payments as early as possible (lead) and pay out as late as possible (lag). In the international arena, leading and lagging also can be used to limit FX risk. A *lead* approach is to collect receivables early when the foreign currency is expected to weaken and fund payables early when the foreign currency is expected to strengthen. A *lag* approach is to collect receivables late when the currency is expected to strengthen and fund payables late when the currency is expected to weaken. If we now think about combining the multilateral netting approach, leading and lagging can be coordinated among IC subsidiaries to reposition funds and help to compensate for blocked funds or funds about to be blocked.



Foreign Exchange Risk Management

When operating across different currencies, MNC managers regularly encounter currency exchange rate movements. These unanticipated shifts present risks to the international business because they represent unplanned-for changes in the value of assets and liabilities. These significant risks are usually categorized into three types: transaction exposure, translation exposure, and economic exposure. These exposures describe positions that are either uncovered or covered, that is, hedged.

leading and lagging
Timing payments early (lead) or late (lag), depending on anticipated currency movements, so that they have the most favorable impact for company

TRANSACTION EXPOSURE

Transaction exposure occurs when the firm has transactions denominated in a foreign currency. The exposure is due to currency exchange rate fluctuations between the time the commitment is made and the time it is payable. For example, an order for German diesel truck engines is placed by a Massachusetts company, for payment in 180 days in euros, €150,000 (US$189,000 at the then-prevailing exchange rate of $1.26 per euro). This agreement to buy in a foreign currency creates a transaction exposure for the buyer in Massachusetts. If the euro strengthens against the dollar to $1.38 when the company converts its dollars to euros, the engines' price in dollar terms would increase by $18,000 to US$207,000. In this case, there would be a cash flow effect for the importer but no effect for the exporter. Had the exporter quoted the engines' price in U.S. dollars, the situation would have been reversed.

LO18-9 **Categorize** foreign exchange risks faced by the international firm into transaction exposure, translation exposure, and economic exposure.

LO18-10 **Describe** ways to hedge transaction exposure.

There are many ways to cover the risk a transaction exposure creates. An initial observation is that the company could avoid transaction exposure altogether by refusing to enter into foreign currency contracts. That's true, yet the desire to conduct business across currency borders suggests a willingness to accept this risk. Besides, one party will always have to, and doing so might be a part of the contract negotiation strategy. There are other approaches to dealing with eliminating the risk of a transaction exposure, or hedging, at the firm's operations level. Remember our discussion of leading and lagging? Let's look at an example.

transaction exposure
Change in the value of a financial position created by foreign currency changes between the establishment and the settlement of a contract

The U.S. company Nucor is exporting to Spain a €20 million boutique steel order, made from recycled steel, payable in euros. Nucor has accepted the foreign exchange risk as a part

GLOBAL DEBATE

Microloan Bankers: Charity or For-Profit Business Model?

This is Sophia Maimu, a melon stand owner and microloan client of ACCION Tanzanian partner, Akiba Commercial Bank.

You might think it would be utter folly to lend money to the poor in a developing country. What about a loan to a new small business or entrepreneur such as a vegetable peddler, tailor, or candle maker? Worldwide, development organizations are finding that some of the world's poorest entrepreneurs repay their debts at rates approaching 100 percent. To encourage grassroots private business in Latin America, Asia, and Africa, microlending organizations are expanding programs that already lend thousands of small entrepreneurs amounts ranging from $50 to several hundred dollars. Tiny businesses in developing countries commonly repay these microloans faithfully because of community pressure and the security of a favorable credit rating. Microloans give them small spurts of working capital when they need it, allow them to establish credit, and let them borrow again in hard times. The money helps them start or expand their businesses—selling vegetables, sewing, repairing shoes, making furniture, and the like—and boosts the local economy.

The microcredit concept was developed by Professor Muhammad Yunus, a U.S.-trained Bangladeshi PhD economist, through the Grameen Bank in Bangladesh (which he established to administer his program), and ACCION, a U.S. microcredit organization. Dr. Yunus was awarded the Nobel Peace Prize in 2006 for his work fighting poverty.

The microloan repayment performance shines when compared with that of some sovereign nations. It also looks very good compared with a default rate of 13.8 percent among U.S. recipients of federally guaranteed student loans. ACCION reports a repayment rate over the life of its program of 97 percent. A Mexican program, Compatramos, reports a 1 percent default rate.

Critics point out, though, that one microloan is not going to pull a budding entrepreneur out of poverty, let alone a whole country. When Tufts University received an endowment to set up a microloan program, specialists were ready to warn Tufts of the ethical aspects of microloans: its program needs to be much more than banking. A series of loans is probably necessary, combined with training and support.

Recently, several not-for-profit microloan operations have changed. Because of their success, they have become banks, and in one case, Mexico's Banco Compartamos sold 30 percent of its shares to the public, with the IPO share price moving up 34 percent. Their 2007 IPO also brought a lot of difficult issues forward. Compartamos began as a charity grant program, then became a bank, and then a publicly listed bank. The move to private ownership that seeks a return on investment changes the microloan business model substantially, from *charity* to *business.* The charity model uses donated funds and funds from international financial institutions such as the World Bank and the European Bank for Reconstruction and Development, and they have low interest rates. Some of the microcredit organizations even make profits, but they are cooperatives, such as Grameen Bank, so their profit moves back into their stakeholder community. Compartamos, in contrast, now charges its credit customers in the range of 100 percent (on an annualized basis) to cover loan interest, fees, and taxes. That is three times the cost of borrowing from other microcredit lenders. To make matters a little more complicated, many of the shareholders who profited greatly from the Compartamos IPO are themselves microlenders, such as ACCION. Tufts University splits the revenues from its microloans 50–50 with the loan program and the university itself. In 2008, the university reported a $6.60 million payout from its share of the microlending operations.[a]

Is it right to profit from loans to the poor? Dr. Yunis thinks definitely not, and "refuses to mention the words *Compartamos* and *microfinance* in the same breath."[b] At the same time, here's an explanation from the two friends who founded Compartamos in 1990. They suggest that, much like food crisis and famine, the issue isn't the existence of the needed good; both food and money exist. The issue is one of distribution: the food and money frequently are not where they are needed most desperately. The argument is that a profit potential brings private capital in touch with the people who need it, the world's poor, quickly and efficiently. It is a way to align the world's wealth with the world's poor. Big investment firms and banks have begun to participate in profitable microlending. Firms such as CITI Group, Morgan Stanley, TIAA-CREF, and Deutsche Bank are active in the sector now. With returns like Compartamos has, at 53 percent, investors are interested. Here's how the loans work: they are small, usually to women, guaranteed by peers, paid off on time, and often followed immediately by another loan.[c]

(continued)

In a disagreement over this very issue, Dr. Younis was ousted from his directorship of Grameen Bank in 2011. View a PBS video that explores this issue further at www.pbs.org/now/shows/338/.

Questions:

1. So, what do you think, is profiting from microloans to the poor ethical?
2. Is the movement from charity to profit an evolution or a devolution?

[a] www.tufts.edu/microfinancefund/?pid=13 (accessed April 21, 2011).

[b] "Yunus Blasts Compartamos," *BusinessWeek,* December 13, 2007, www.businessweek.com/magazine/content/07_52/b4064045920958.htm (accessed April 21, 2011).

[c] Haley Dillan, November 4, 2009, www.globalenvision.org/2009/10/20/microfinance-update-interview (accessed April 20, 2011); www.ACCION.org (accessed April 21, 2011); and Maria Otero, "Microfinance at the Crossroads," *Forbes.com,* May 19, 2008, www.forbes.com/opinions/2008/05/19/micro-finance-accion-oped-cx_mot_0519accion.html (accessed April 21, 2011).

of its marketing strategy. It may also even have factored a currency shift expectation into its euro pricing. Here are the foreign exchange and interest data. They are hypothetical:

EU interest rate:	4.00
U.S. interest rate:	5.00
Spot rate	$1.534
Forward rate	$1.527 (one year forward)

Nucor faces transaction exposure in its receivable. The markets have figured out clever ways to reduce the risks, and we look briefly at six of these maneuvers, leading and lagging, exposure netting, forward market hedge, currency option hedge, money market hedge, and a swap contract. These maneuvers may sound complex, but they are simply ways Nucor has to cover its risk because it made a sale in a foreign currency.

First, Nucor could lead its receivable, because the market indicates that the dollar may well strengthen against the euro. (Moving from a spot rate of $1.534 to a forward rate of $1.527 means that the market expects the euro to buy fewer dollars a year out. So the dollar is strengthening against the euro.) The Spanish customer may well want to lag the payment, though, if there is no incentive for early payment.

In another way to hedge on transaction exposure through company actions, Nucor could follow a centralized practice similar to multilateral netting: *exposure netting.* The firm will run a centralized clearing account that matches and nets out foreign exchange exposures across currencies or across currency families. Working with currency families recognizes that some currencies tend to move in lockstep with one another. Many ICs follow this approach.

There are also ways to hedge foreign currency exposure by engaging in contracts known simply as *hedges*. A **forward market hedge** involves a quite simple transaction: the company sells forward its foreign currency receivables for its home currency, matching the time forward to the due date of the receivables. When the Spanish company pays, Nucor will deliver the amount to its bank, the partner in the forward market hedge contract. Nucor will not have been exposed to currency risk in the Spanish sale. Because the forward market hedge is a way to cover the complete exposure in a given transaction, it is the most widely used approach. Yet, because the forward market hedge assumes all of the foreign exchange risk, it eliminates the chance of gaining from a currency move in the company's favor.

forward market hedge
Foreign currency contract sold or bought forward in order to protect against foreign currency movement

An approach to hedging an exposure but not losing the opportunity to gain from a currency appreciation is a *foreign currency option.* With a **currency option hedge,** you purchase an option to buy or sell a specific amount of currency at a specific time, but the option can be exercised or not. These hedges are *calls*—or contracts with an option to buy—for foreign currency payables and *puts*—or contracts to sell—for foreign currency receivables. Because these are options, if the market works against you, you can exercise the contract. If the market works for you, you don't need to exercise the option.

currency option hedge
An option to buy or sell a specific amount of foreign currency at a specific time in order to protect against foreign currency risk

money market hedge
A method to hedge foreign currency exposure by borrowing and lending in the domestic and foreign money markets

The money markets also afford an opportunity to hedge a foreign transaction. In a **money market hedge,** Nucor would borrow euros in the European money market in the amount of the receivables from the Spanish sale. The basic idea here is to match the balance sheet asset with a liability in the same currency. Here's how the money market hedge works: Nucor borrows the equivalent of $20 million in euros, or €13,035,300, for a period that matches the receivable's due date. Nucor then converts the euros to dollars at the spot rate and then invests them. The euros that are received from the Spanish company will be used to close out the euro loan. Then the invested dollars plus their interest provide Nucor the dollar amount for the Spanish sale.

swap contract
A spot sale/purchase of an asset against a future purchase/sale of an equal amount in order to hedge a financial position

Swap contracts are also used to hedge foreign currency exposure. A swap is an agreement to exchange currencies at specified rates and on a specified date or sequence of dates. Swaps are quite flexible and may be undertaken for long periods, much longer than in the forward market. So if Nucor had a series of sales in the EU over the next 10 years, all denominated in euros, it could enter into a series of swaps so that the exchange rate or series of exchange rates would be known in advance.

TRANSLATION EXPOSURE

translation exposure
Potential change in the value of a company's financial position due to exposure created during the consolidation process

Translation exposure occurs when subsidiary financial statements are consolidated at the corporate level for the companywide financial reports. Because the foreign subsidiaries operate in non-dollar currencies, there is a need to translate subsidiary financial reports to the parent company's currency during the corporate consolidation process. Exchange rate movements can have substantial impact on the value of these financial statements, which may affect per-share earnings and stock price. Take a U.S. company that has subsidiaries in Brazil, Japan, Spain, and the United Kingdom. Each subsidiary will prepare financial reports in its own currency, so amounts in four currencies will need to be translated. Any changes in the exchange rates will affect the dollar values or these results. Such changes, either gains or losses, are not reflected in cash flow; they are paper or unrealized changes.

The key question related to translation exposure is what currency exchange rate to use for the translation. The two basic approaches to translation, the current rate method and the temporal method, and their exchange rate use rules are reviewed earlier in this chapter in our discussion of international accounting. Approaches to translation exposure differ by country.

Many organizations do not hedge translation exposure because hedging a translation exposure can actually increase transaction exposure. For example, if the translation exposure is hedged through a matching foreign exchange liability, such as a debt, then that debt is an exposure at the transaction level. Transaction exposure is fundamental to a corporation's value.

ECONOMIC EXPOSURE

economic exposure
The potential for the value of future cash flows to be affected by unanticipated exchange rate movements

Economic exposure occurs at the operations level and results from exchange rate changes on projected cash flows. Unlike transaction exposure, which addresses the individual transaction, economic exposure is firm-wide and long term. For example, when the dollar strengthens, as it did in the 1990s, U.S. export prices increased in terms of other currencies. U.S. exported goods became less price-competitive in foreign markets, so sales plummeted. Yet when the dollar weakens, U.S. export prices become more attractive in foreign markets. These changes are examples of the possible effects of economic exposure. Economic exposure can affect both the dollar value of the company's foreign assets and liabilities and the company's cash flow, because it has an impact on foreign sales. Asset exposure includes the firm's fixed assets as well as their financial assets. The exposure of cash flow to currency fluctuation is known as *operating exposure.* Operating exposure is difficult to measure because it involves both the cash flows and the larger commercial context, the competitive conditions connected to obtaining inputs and selling. The management of economic exposure draws on the hedging and swap contracts we have discussed as ways to manage transaction exposure, on flexibility in sourcing, and on a portfolio approach to foreign market involvement.

Taxation

In Chapter 8, we discussed taxation as a financial force and outlined three major types of taxation that governments around the world use—income tax, value-added tax, and withholding tax. **Income tax** is a direct tax levied on earnings. **Value-added tax (VAT)** is an indirect tax, in that the tax authority collects it from the person or firm that adds value during the production and marketing process, not from the owner of the item taxed. The ultimate user of the product pays the full amount of tax that is rebated to the others in the value chain. Thus, the government is collecting the tax on the value added in the process. The **withholding tax** is also an indirect tax, in that it is paid not by the person whose labor generates the income but by the business that makes the payment for the labor. Usually, the withholding tax is levied on passive income such as royalties, dividends, and interest.

income tax
Direct tax levied on earnings

value-added tax (VAT)
Indirect tax collected from the parties as they add value to the product

withholding tax
Indirect tax paid by the payor, usually on passive income

As for what territories a government's tax covers, we find two approaches to this jurisdiction issue, either worldwide or territorial. A worldwide approach taxes residents of the country on their worldwide income. The United States follows a policy of worldwide taxation, and it can be argued convincingly that, despite tax treaties, such taxation puts U.S. firms operating foreign subsidiaries at a disadvantage compared with their foreign domestic competitors.[8] A territorial taxation policy taxes income earned within the nation's borders. There are tax credits, based on treaties that reduce or eliminate double taxation for U.S. residents and companies, as long as the foreign tax liability is less than the U.S. equivalent would be.

How the foreign operations of a company are organized is key to its U.S. tax liability on foreign earnings. If the operation is a **branch,** that is, an extension of the parent company, not a separate legal entity incorporated in the foreign country, its losses may be deducted by the parent company from its U.S. taxable income. If the foreign entity is a **subsidiary,** that is, a separate legal entity incorporated in the foreign country, its ownership by the IC may be minority, that is, between 10 and 50 percent. Such minority company income, both active and passive, is taxed only when it is remitted to the parent company. If the foreign subsidiary is actually controlled by the parent company, with more than 50 percent ownership, it is known as a *controlled foreign corporation (CFC),* and its active income is taxed in the United States when that income is remitted to the parent company, but its passive income (royalties, licensing fees, dividends, service fees) is taxed as it occurs. When deciding where to locate and how to structure a foreign operation, IC managers review the tax rates of possible locations and also consider what legal form their operations should take. Often, startups have several years of losses, so establishment of a branch rather than a subsidiary might generate valuable losses, from a tax point of view, for the parent company. Transfer pricing, which we discussed earlier, offers international businesses a way to reduce tax liability. Some ICs are remarkable in their ability to manage their tax exposure. A recent *New York Times* article reported that GE paid no U.S. taxes in 2010 on U.S. profits of $5.1 billion and actually claimed a tax benefit of $3.2 billion.[9]

branch
Legal extension of the parent company

subsidiary
Separate legal entity owned by the parent company

In Chapter 18, we have examined two basic areas that are fundamental to the financial management of an international business, international accounting and the process of financial management. Our review of accounting looked at accounting issues related to foreign currency, culture, convergence of accounting standards, and 3BL accounting efforts. In financial management, we reviewed the capital structure of the international firm, cash flow management, foreign exchange risk, and taxation. Financial management is becoming increasingly central to capturing efficiencies in the international firm. The green eyeshades are passé—it's an exciting area in which to develop a career.

THE GLOBAL PATH AHEAD

Bryan Goldfinger: Microfinance in Latin America with Kiva

I was born and raised in San Diego, California, surfing, playing soccer, and generally living a pretty stereotypical California life. My first two years at Cal Poly, San Luis Obispo, I was a business administration major with an undeclared concentration. I spent my third year of university studying abroad in Puntarenas, Costa Rica, where I lived with a Spanish-speaking host family and completed primarily Spanish classes. During this year, I became infatuated with travel and the Latin people and culture and gained fluency in Spanish and a desire to in some way help those less fortunate. Upon my return, I declared a concentration in international business management and later that same year, also declared a concentration in accounting. I graduated in June 2007 with a minor in Spanish and a contract to begin auditing with KPMG in January 2008. The months between graduation and entering the "real world," I spent taking an overland trip from Nicaragua to Argentina. This travel experience proved to be more valuable than I could have imagined.

I began my time at KPMG with high hopes of completing the CPA examinations, spending a minimum of two years auditing and hopefully being able to complete an international rotation at one of its overseas offices. My time at KPMG was extremely valuable, although not quite what I had expected. I had the opportunity to work with clients in the roofing and construction, real estate, telecommunications, insurance, and agriculture industries. However, at the end of my first year, I began feeling as though the work I was doing did not satisfy my goals of helping others, and the lifestyle of public accounting was not consistent with one I desired to live. Just after completing my first year, I left KPMG.

During this time, a friend asked me what my ideal dream job would entail. The dream job that I conjured up would involve international business travel, allow me to utilize my Spanish skills, involve more time in the field and less in an office, and be more socially fulfilling than my previous work. Two days later, he sent me an e-mail about a friend who was currently working in Paraguay with a company called Kiva, and he included a link to the website (www.kiva.org). Kiva's mission is to connect people through lending to help alleviate poverty. Individuals like you or me provide funds in increments of $25, via the organization's website, to entrepreneurs in developing countries and the United States. Kiva then sends the funds to their partner microfinance institutions (MFIs), which provide loans to the selected entrepreneurs.

The work of a Kiva Fellow varies greatly, depending on his or her experience, skill set, and which partner institution he or she is assigned to work with. Kiva Fellows are volunteers who work closely with the partner institutions to help them implement Kiva policies, meet and interview borrowers, and complete verifications of the information the MFIs provide to Kiva. Essentially, the Kiva Fellows are Kiva's eyes and ears in the field and connect all four stakeholders involved with Kiva: the borrowers, the lenders, the MFIs and Kiva headquarters.

I completed two placements as a Kiva Fellow, the first as a roaming Fellow in Peru, and the second in Managua, Nicaragua. The primary objective of my placement in Peru was borrower verification. I would select a small sample of loans from several MFIs, visit the borrowers, and verify that the information Kiva had on the website was consistent with what was actually taking place in the field. During these visits, I would also write a short journal entry on the progress of the borrowers. This journal entry would then be uploaded to the Kiva website and sent out to everyone who had lent money to that particular borrower. In Nicaragua, I worked primarily with one MFI to complete a review of its social performance. Social performance monitoring is a new and growing subject in microfinance. There are a variety of tools and companies whose sole purpose is social performance monitoring. The goal is to review and identify strengths and weaknesses of an MFI's social performance. More specifically, what is the mission statement of the MFI and is the mission being applied in the field? Kiva has recently begun administering social performance questionnaires to many of its partner MFIs and utilizing Kiva Fellows to assist MFIs in filling out and reviewing the questionnaires.

Due to the vastly different locations and duties Kiva Fellows are assigned, each Fellow tends to have wildly different experiences, challenges and rewards. In my opinion, the most rewarding part of being a Kiva Fellow was visiting and interviewing borrowers and having the opportunity to witness, firsthand, the effects of microfinance. To trek out into the field with a loan officer to a place you would likely never go otherwise, meet people you would likely never meet otherwise, ask them in-depth questions about their business and life, and at the end ask, "what are your hopes and dreams?" is quite a unique and rewarding experience.

Aside from the small frustrations of working in and learning the work culture of a new country and MFI, I was lucky to have very few, if any, difficulties in relation to my work as a Kiva Fellow. Reflecting on both of my placements, as a Kiva Fellow, the biggest challenge I experienced, particularly

(continued)

during my placement in Peru and the first half of my placement in Nicaragua, was loneliness and lack of a social network. Although an incredibly rewarding and equally valuable experience, work travel is not the same as tourist travel or a study abroad experience. One does not necessarily have the built-in support group that is often present in a study abroad program or the free time and lodging situations that "tourist" travel provides—which are helpful in facilitating social interactions. That said, by the end of each placement, I found myself wishing I did not have to leave so soon. In my experience, the most important thing to do when in such a situation is to not resort to crawling into a ball and secluding yourself. The Internet and comforts of home can easily become a crutch to lean on, which ultimately serve no purpose in alleviating the situation. Go out by yourself, put your pride on the line, meet random people, and be willing to experience situations you normally would never dream of.

As far as Kiva is concerned, one of the most important aspects of an applicant is his or her experience living, working, studying, and traveling abroad. Obviously, work experience and study background weigh in heavily, but with no experience abroad, Kiva will likely not even consider your application. The reasoning behind this is that there are a multitude of applicants who are qualified to do the work of a Kiva Fellow. The reality is that Kiva trains the Fellows on what they need to know once in the field. They realize that cultural sensitivity, adaptability, and general decision making when abroad are knowledge abilities primarily gained through experience and travel, and they cannot be taught in a classroom at Kiva Headquarters.

My advice to anyone who wishes to pursue international work opportunities is to get as much international experience as possible before entering the "workforce." Whether it is through study abroad, international internships, small jobs abroad like working at a restaurant, bar, or hostel, or just flat out travel, one gains knowledge and experience that cannot be taught in any classroom.

Resources for Your Global Career

Careers in International Accounting

- http://career-advice.monster.com/job-search/company-industry-research/global-accounting-careers/article.aspx
- www.ehow.com/how_7451915_plan-international-career.html
- www.internationalaccountingjobs.com/a/jobs/find-jobs

Sustainability and Triple-Bottom-Line Accounting

- www.green2sustainable.com/media/docs/TripleBottomLine.pdf
- http://globaledge.msu.edu/resourcedesk/gbr/gbr4-6.pdf
- www.businessethics.ca/3bl/triple-bottom-line.pdf

Careers in International Finance

- www.expatfinancejobs.com/
- http://bx.businessweek.com/international-finance/jobs/
- www.guidetoonlineschools.com/careers/international-business

Jobs and Careers in Foreign Exchange Currency Analysis and Trade

- www.princetonreview.com/Careers.aspx?cid=70
- www.jobmonkey.com/forex/traders-analysts.html
- www.job-search-engine.com/keyword/currency-exchange/

International Microlending Issues, Resources, and Job Opportunities

- www.microfinancefocus.com/
- www.kiva.org/
- www.accion.org/

Summary

LO18-1 Identify the major international accounting issues that international firms face when operating in foreign currencies.

International accounting has to deal with many major issues. The chapter discusses issues related to foreign currency, such as which values to be used to translate currencies during consolidation, the current rate or the temporal rate; the influence of national culture on assumptions we make in the process of accounting; issues related to differing accounting standards; and issues related to accounting for social and environmental impacts of business decisions, in additional to the economic impacts.

LO18-2 Describe the relationship between accounting and culture.

Accounting is a product of assumptions about human behavior and the need to control. These assumptions are influenced by culture.

LO18-3 Describe the international accounting standards' convergence process and its importance to international firms.

The body that establishes accounting standards in the United States is a private organization, the Financial Accounting

Standards Board (FASB), whose standards are the generally accepted accounting principles (GAAP). The more international body is the International Accounting Standards Board (IASB), whose standards are the International Financial Reporting Standards (IFRS). Convergence requires harmonization of many standards and procedures, and it is a time-consuming process. With so many important and heavily detailed aspects of specific standards to be reconciled, the progress toward convergence is impressive. The EU Parliament and the Council of Europe requires IASB standards for financial reporting, along with Australia and New Zealand. There are more than 75 countries that require public companies to list using IFRS and another 50 countries, including those in the EU, that have adopted IFRS with minor modifications. In 2007, the U.S. Securities and Exchange Commission (SEC) decided that foreign companies listing their shares in the United States no longer needed to restate their financial statements to comply with FASB standards. In the United States, the SEC is the responsible party for recognizing the IASB. One of the largest differences between GAAP and the IFRS is their general approach. GAAP relies on rules and regulations; the IFRS has greater reliance on principles.

LO18-4 Outline the arguments for and against 3BL.

Currently, we measure at the economic level and, where required by government or social pressure, we measure at the environmental level (as with emission controls and hazardous waste) and at the social level (as with the Equal Employment Opportunity Commission's enforcement of the federal civil rights laws). Yet in the environmental and social areas, we tend to know more about the problems—what is reported in the media—than about the company-level thinking on these important issues. Companies should measure and make public the environmental and social effects of their decisions. These are, in summary, the major argument for 3BL. The major argument against 3BL is neither a substantive disagreement with the desirability of ecologically responsible business practices that support sustainability nor a disagreement with the idea of business being socially responsible; rather, it is the claim that measurement will not get us closer to the desired state.

LO18-5 Explain the capital structure choices open to international firms and their significance.

The firm raises capital through its retained earnings, and then, externally, through equity, the issuing of shares, or debt (leveraging). Firms may choose to issue stocks in foreign markets, in part to tap into a broader investor pool, which can raise the stock price and reduce the cost of capital. Such local issues may also have a significant marketing advantage. Debt markets are the other source of capital for the firm, and increasingly the tendency is to tap local markets first. Offshore financial centers, where taxation is low and banking regulations are slim, are also a source of debt financing. Debt financing is thought to be less expensive than equity financing, but local practices and taxation are some of the factors that are considered in making decisions about the capital structure of the firm.

LO18-6 Describe why ICs move funds.

Firms move funds for many reasons, among them dividends, royalties, and fees from the subsidiary to the parent company; loans from the parent to the subsidiary or among subsidiaries; and transfer pricing of sales between subsidiaries and the parent company.

LO18-7 Explain the utility of an international finance center.

Centralized finance centers offer ICs a way to address the increasingly complex financial environment. They can balance and hedge currency exposures, tap capital markets, manage inflation rate risk, manage cash management technological innovation, manage derivatives use, handle internal and external invoicing, help a weak-currency subsidiary, and strengthen subsidiary evaluation and reporting systems. Developments that increase complexity and often lead to the establishment of finance centers are (1) floating exchange rates, whose fluctuations are sometimes volatile; (2) growth in the number of capital and foreign exchange markets, where the firm can shop for lower interest costs and better currency rates; (3) different and changing inflation rates from country to country; (4) advances in electronic cash management systems; (5) realization by financial managers that through innovative management of temporarily idle cash balances of the subsidiaries, they can increase yields and, thereby, profit; and (6) the explosive growth of derivatives to protect against commodity, currency, interest rate, and other risks.

LO18-8 Describe multilateral netting and its benefits.

Multilateral netting is a centralized approach in which subsidiaries transfer their net cash flows within the company to a cash center that disperses cash to net receivers. A single transaction to or from each member settles the net result of all cash flows. The structure is essentially the wheel-and-spoke model. The advantages are that it reduces transaction costs and, at the same time, avoids the opportunity cost that would be incurred by the funds in transit.

LO18-9 Categorize foreign exchange risks faced by the international firm into transaction exposure, translation exposure, and economic exposure.

Transaction exposure occurs when the firm has transactions denominated in a foreign currency. The exposure is due to currency exchange rate fluctuations between the time the commitment is made and when it is payable. Translation exposure occurs when subsidiary financial statements are consolidated at the corporate level for the companywide financial reports. Because the foreign subsidiaries operate in non-dollar currencies, there is a need to translate subsidiary financial reports to the parent company's currency during the corporate consolidation process. Economic exposure is at the operations level and results from exchange rate changes on projected cash flows. Unlike transaction exposure, which addresses the individual transaction, economic exposure is firmwide and long term.

LO18-10 Describe ways to hedge transaction exposure.

There are many ways to cover the risk a transaction exposure creates. (The company could avoid transaction exposure altogether by refusing to enter into foreign currency contracts.) The company could hedge through leading and lagging, through exposure netting, or through a currency option, a forward market hedge, a money market hedge, or a swap. The key goal is to cover the exposure to foreign currency.

Key Words

consolidation (p. 458)
current rate method (p. 458)
temporal method (p. 458)
functional currency (p. 458)
American depositary receipt (ADR) (p. 462)
offshore financial center (p. 462)
fronting loan (p. 464)
transfer price (p. 464)
hedge (p. 465)
multilateral netting (p. 465)
leading and lagging (p. 467)
transaction exposure (p. 467)
forward market hedge (p. 469)
currency option hedge (p. 469)
money market hedge (p. 470)
swap contract (p. 470)
translation exposure (p. 470)
economic exposure (p. 470)
income tax (p. 471)
value-added tax (VAT) (p. 471)
withholding tax (p. 471)
branch (p. 471)
subsidiary (p. 471)

Questions

1. The cultural analysis of accounting Gray presents suggests that transparency is the result of a cultural characteristic of some countries and secrecy of others. Could the same attributes be explained by the hypothesis that transparent cultures are less trusting and need the transparency to satisfy their cultural distrust? What do you think?
2. How might Sarbanes-Oxley influence the progress of the convergence of international accounting standards?
3. How might triple-bottom-line accounting improve the social and environmental behavior of companies?
4. What is your assessment of the movement pushing for 3BL? Explain your thinking.
5. You are establishing your first overseas subsidiary. As you consider how to capitalize your business, what are your concerns about using the local and home-country debt and equity markets?
6. A local exporter has signed a sales contract that specifies payment of $3 million in Saudi riyals in six months. Discuss the hedge options you would advise the exporter to consider.
7. One of the characteristics of centralized structures is that they are slow and reduce innovation. Why would an MNC set up a centralized cash management operation?
8. What aspect of how foreign operations of a company are organized is key to its U.S. tax liability?
9. What are the differences between transaction and translation exposure?
10. Describe how mircolending has developed as a result of its success.

Research Task

globalEDGE globalEDGE.msu.edu

Use the globalEDGE site (http://globalEDGE.msu.edu/) to complete the following exercises:

1. Deloitte Touche Tohmatsu hosts an *International Accounting Standards* (IAS) webpage that provides information and guidelines regarding accounting guidelines approved by IASC. Locate the website, go to the section on standards, and prepare a short description of the international accounting standards for recording intangible assets.
2. The top management of your company has requested information on the tax policies of Denmark. Using the Denmark business guide on *Deloitte International Tax and Business Guides*—a resource that provides information on the investment climate, operating conditions, and tax system of the major trading countries—prepare a short report summarizing your findings on Denmark's business taxation.

Minicase: Dealing with Transaction Risk in a Renminbi Contract

You are the finance manager of an American multinational that has sold US$6 million of your high-tech product to a Chinese importer. Because of stiff competition for the contract against European and other American companies, you agreed that the negotiators could sign a renminbi-based contract, although this is not standard practice for the firm. This concession may have won you the deal, actually.

The sales contract calls for the Chinese importer to make three equal payments at 6, 12, and 18 months from the date of delivery, which is in 60 days. Your plan is to translate the renminbi to dollars on their receipt; your company has no operations in China and no need for the currency. You realize, though, that this arrangement involves transaction exposure. How could you cover this risk?