Chapter 18
International Managerial Finance

■ Learning Goals

1. Understand the major factors that influence the financial operations of multinational companies (MNCs).
2. Describe the key differences between purely domestic and international financial statements—consolidation, translation of individual accounts, and international profits.
3. Discuss exchange rate risk and political risk, and explain how MNCs manage them.
4. Describe foreign direct investment, investment cash flows and decisions, the MNCs' capital structure, and the international debt and equity instruments available to MNCs.
5. Discuss the role of the Eurocurrency market in short-term borrowing and investing (lending) and the basics of international cash, credit, and inventory.
6. Review recent trends in international mergers and joint ventures.

■ True/False

1. NAFTA is a treaty establishing free trade and open markets between Europe and the United States.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: North American Free Trade Area

2. The World Trade Organization is a new international body established to police world trading practices and to mediate disputes between member countries.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: World Trade Organization

3. Offshore Centers are cities or states that have achieved prominence as major centers for Euromarket business.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Offshore Centers

4. NAFTA is an international financial market that provides for borrowing and lending currencies outside their country of origin.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: North American Free Trade Area

5. Fluctuations in foreign exchange markets can affect foreign revenues and profits of a multinational company, but they have no impact on its overall value.

   Answer: FALSE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Foreign Exchange Risk

6. The Euromarket is the international financial market that provides for borrowing and lending currencies outside their country of origin.

   Answer: TRUE
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: The Euromarket

7. The existence of specific regulations and controls on dollar deposits in the United States, including interest rate ceiling imposed by the government, have contributed to the growth of the Euromarket.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: The Euromarket

8. A joint venture is a partnership under which the participants have contractually agreed to contribute specified amounts of money and expertise in exchange for stated proportions of ownership and profit.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Joint Ventures

9. FASB No. 52 requires U.S. multinationals first to convert the financial statement accounts of foreign subsidiaries into their functional currency and then to translate the accounts into the parent firm's currency using the all-current-rate method.

   Answer: TRUE
   Level of Difficulty: 2
   Learning Goal: 2
   Topic: FASB No. 52

10. The all-current-rate method is the method by which the functional currency-denominated financial statements of an MNC's subsidiary are translated into the parent company's currency.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: FASB No. 52 and the Current Rate Method

11. The spot exchange rate is the rate of exchange between two currencies at some specified future date.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: FASB No. 52 and the Current Rate Method

12. The forward exchange rate is the rate of exchange between two currencies on any given day.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Forward Exchange Rates

13. The functional currency is the currency of the economic environment in which a business entity primarily generates and expends cash, and in which its accounts are maintained.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 3
    Topic: Functional Currency

14. Accounting exposure is the risk resulting from the effects of changes in foreign exchange rates on the translated value of a firm's financial statement accounts denominated in a given foreign currency.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Accounting Exposure

15. Economic exposure is the risk resulting from the effects of changes in foreign exchange rates on the firm's value.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Economic Exposure

16. The three basic types of risk associated with international cash flows are 1) business and financial risks, 2) inflation and foreign exchange risks, and 3) political risks.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Types of Risk in International Cash Flows

17. Countries that experience high inflation rates will see their currencies decline in value relative to the currencies of countries with lower inflation rates.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Inflation Risk and International Cash Flows

18. When more units of a foreign currency are required to buy one dollar, the currency is said to have appreciated with respect to the dollar.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 3
Topic: Foreign Exchange Risk and International Cash Flows

19. Foreign bond is an international bond that is sold primarily in countries other than the country of the currency in which the issue is denominated.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: Foreign Bonds

20. In general, an international bond is one that is initially sold in the country of the borrower and, then, often distributed in several countries.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 4
Topic: International Bonds

21. Because of their access to the international bond and equity markets, MNCs may have lower costs of various sources of long-term financing, thus resulting in differences between the capital structures of these firms and those of purely domestic companies.

Answer: TRUE
Level of Difficulty: 3
Learning Goal: 4
Topic: Cost of Capital for MNCs

22. The foreign direct investment (FDI) is a multi-national corporation's transfer of capital, managerial, and technical assets from a host country to its home country.

Answer: FALSE
Level of Difficulty: 3
Learning Goal: 4
Topic: Foreign Direct Investment

23. A multi-national corporation (MNC) can give some protection to international cash flows by reducing its liabilities if the currency is appreciating, or by reducing its financial assets if the currency is depreciating.

Answer: TRUE
Level of Difficulty: 4
Learning Goal: 4
Topic: MNCs and International Cash Flows

24. In the international context, the nominal interest rate is the stated interest rate charged on financing when only the MNC parent's currency is involved.

Answer: TRUE
Level of Difficulty: 1
Learning Goal: 5
Topic: MNCs and Interest Rates

25. In the case of short-term financing, the forces of supply and demand are among the main factors determining exchange rates in Eurocurrency markets.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Eurocurrency Markets

26. Hedging strategies are techniques used to offset or protect against risk; in the international context these include borrowing or lending in different currencies, undertaking contracts in the forward, futures, and/or options markets, and also swapping assets/liabilities with other parties.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal:
    Topic: Hedging Foreign Exchange Risk

27. The interest rates offered in the Euromarket on the U.S. dollar are greatly affected by the prime rate inside the United States.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Euromarket Interest Rates

28. In the international context, the effective interest rate equals to the nominal rate plus (or minus) any forecast appreciation (or depreciation) of a foreign currency relative to the currency of the MNC parent.

    Answer: TRUE
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: MNCs and Interest Rates

29. The official melding of the national currencies of the European Union into one currency, the Euro, created the European Monetary Union in 2002.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: European Union

30. The Mercosur Group is a major South American trading bloc that includes countries that account for more than half of the total of Latin America's GDP.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Mercosur Group

31. The Mercosur Group is a major European trading bloc made up of former Soviet bloc countries in Eastern Europe.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Mercosur Group

32. Disagreements among European Union country members over the disposition of garbage and manufacturing refuse generated primarily by Eastern European countries have come to be known as the Euro Trash Issue.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: European Union

33. In 2003–2004, the United States signed a regional trade pact with the Dominican Republic, Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua called the Central American Free Trade Agreement or CAFTA.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Central American Free Trade Agreement

34. In 2003–2004, the United States signed a regional trade pact with south pacific countries including the Philippines, Indonesia, Malaysia called the South Pacific American Trade Agreement or SPAMTA.

    Answer: FALSE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: Free Trade Agreements

35. The World Trade Organization has in recent years admitted current and former communist countries as members including the Russian Federation and the Peoples Republic of China.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 1
    Topic: World Trade Organization

36. Current U.S. tax laws require the consolidation of financial statements of subsidiaries according to the percentage of ownership by the parent company.

    Answer: TRUE
    Level of Difficulty: 1
    Learning Goal: 2
    Topic: Taxes Issues Related to MNCs

37. Current U.S. tax laws require the separation of financial statements of subsidiaries and the operating results for some subsidiaries are excluded from the parent entirely for some countries such as China and India.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Taxes Issues Related to MNCs

38. A functional currency is the currency of the parent company's country.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 2
    Topic: Functional Currency

39. A functional currency is the currency of the host country in which a subsidiary primarily generates and expends cash and in which its accounts are maintained.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal:
    Topic: Functional Currency

40. Although several economic and political factors can influence foreign exchange rate movements, by far the most important explanation for long-term changes in exchange rates is a differing inflation rate between two countries.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Foreign Exchange Rates

41. Although several economic and political factors can influence foreign exchange rate movements, by far the most important explanation for long-term changes in exchange rates is fiscal policy that a country adopts.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Foreign Exchange Rates

42. Macro political risk is the risk faced by all foreign firms in a host country related to political change, revolution, and the adoption of new policies of a government that may result in changes in ownership structure, closure or expropriation.

    Answer: TRUE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Political Risk

43. Micro political risk is the risk faced by all foreign firms in a host country related to political change, revolution, and the adoption of new policies of a government that may result in changes in ownership structure, closure or expropriation.

    Answer: FALSE
    Level of Difficulty: 2
    Learning Goal: 3
    Topic: Political Risk

44. National entry control systems are comprehensive rules, regulations, and incentives introduced by host governments to regulate inflows of foreign direct investment from MNCs and at the same time extract more benefits from their presence.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 3
Topic: National Entry Control Systems

45. National entry control systems are comprehensive rules, regulations, and immigration policies introduced by xenophobic host governments to regulate inflows of foreign workers.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 3
Topic: National Entry Control Systems

46. Both theory and empirical evidence indicate that the capital structures of MNCs differ from those of purely domestic firms.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 3
Topic: MNC Capital Structure

47. Both theory and empirical evidence indicate that the capital structures of MNCs are no different from those of purely domestic firms.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 3
Topic: MNC Capital Structure

48. Exchange rate risk hedging tools include forward contracts, options, interest rate swaps, currency swaps, and hybrid securities.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 5
Topic: Hedging Exchange Rate Risk

49. Exchange rate risk hedging tools include Monte Carlo swaps, synthetic insurance contracts, and inventory swaps.

Answer: FALSE
Level of Difficulty: 2
Learning Goal: 5
Topic: Hedging Exchange Rate Risk

50. The creation of international joint ventures has increased substantially during the past two decades.

Answer: TRUE
Level of Difficulty: 2
Learning Goal: 6
Topic: International Joint Ventures

■ Multiple Choice Questions

1. A partnership between a multinational company and a foreign investor in which contractually specified amounts of money and expertise are contributed by the participants for stated proportions of ownership and profit is a

   (a) multinational corporation.
   (b) floating relationship.
   (c) joint venture.
   (d) consolidation.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Joint Ventures

2. The _________ is the taxation technique that increases the U.S. income of an MNC by the amount of foreign income (before foreign taxes). The U.S. tax calculation is then based on that higher level.

   (a) unitary tax law
   (b) grossing up procedure
   (c) GmbH
   (d) nationalization procedure

   Answer: B
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Grossing Up Procedure

3. Several U.S. states have imposed _________, which tax MNCs on a percentage of their total worldwide income.

   (a) grossing up procedures
   (b) joint ventures
   (c) unitary tax laws
   (d) national entry control systems

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Unitary Tax Laws

4. All of the following are considered offshore centers EXCEPT

   (a) Cuba.
   (b) Singapore.
   (c) London.
   (d) Nassau.

   Answer: A
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Offshore Centers

5. A partnership under which the participants have contractually agreed to contribute specified amounts of money and expertise in exchange for stated proportions of ownership and profit is called
   (a) limited partnership.
   (b) GmbH.
   (c) S.A.R.L.
   (d) joint venture.

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 1
   Topic: Joint Ventures

6. Laws in some U.S. states that tax multinationals (both American and foreign) on a percentage of their total worldwide income rather than the usual taxation of the MNCs' earnings arising within their jurisdiction are called
   (a) multinational tax laws.
   (b) state corporate tax laws.
   (c) unitary tax laws.
   (d) universal tax laws.

   Answer: C
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Unitary Tax Laws

7. All of the following are factors that can influence the operations of an MNC EXCEPT
   (a) foreign ownership of portions of equity.
   (b) existence of multinational capital markets.
   (c) foreign currency fluctuations.
   (d) consolidation of financial statements based on only one currency.

   Answer: D
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: International Accounting and MNCs

8. The Euromarket is dominated by the
   (a) French franc.
   (b) Japanese yen.
   (c) Deutsche mark.
   (d) U.S. dollar.

   Answer: D
   Level of Difficulty: 2
   Learning Goal: 1
   Topic: Euromarket

9. Joint venture laws and restrictions may result in any of the following negative implications for the operation of a foreign-based subsidiary EXCEPT
   (a) foreign ownership may result in disagreement among the partners regarding the distribution of profits.
   (b) operating in foreign countries may result in difficulties obtaining the remission of profits.
   (c) joint venture agreements may stem a certain degree of risk due to political hostility.
   (d) foreign management policies may be detrimental to the usual policies of the MNC.

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 1
   Topic: Joint Ventures

10. FASB No. 52 is a statement issued by the Financial Accounting Standards Board requiring American MNCs to first convert the financial statement accounts of foreign subsidiaries into the country’s _________ currency and then translate the accounts into the parent firm’s currency using the _________ method.
   (a) spot; historical rate
   (b) functional; all-current-rate
   (c) principal; average rate
   (d) forward rate; weighted average

   Answer: B
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: FASB No. 52 and the Current Rate Method

11. The all-current-rate method dictated by the FASB No. 52 statement requires the translation of all balance sheet accounts at the ______ rate and all income statement items at the _________ rates.
   (a) closing; average
   (b) average; closing
   (c) historical; current
   (d) average; historical

   Answer: A
   Level of Difficulty: 3
   Learning Goal: 2
   Topic: FASB No. 52 and the Current Rate Method

12. All of the following are considered to be major or “hard” currencies EXCEPT
   (a) the Japanese yen.
   (b) the British pound.
   (c) the Mexican peso.
   (d) the U.S. dollar.

   Answer: C
   Level of Difficulty: 1
   Learning Goal: 3
   Topic: Foreign Exchange

13. When fewer units of a foreign currency are required to buy one dollar, the currency is said to have _________ with respect to the dollar.
(a) appreciated
(b) depreciated
(c) consolidated
(d) remained fixed

Answer: A
Level of Difficulty: 2
Learning Goal: 3
Topic: Foreign Exchange

14. The risk resulting from the effects of changes in foreign exchange rates on the translated value of a firm's accounts denominated in a given foreign currency is
(a) economic exposure.
(b) macro political risk.
(c) accounting exposure.
(d) micro political risk.

Answer: C
Level of Difficulty: 2
Learning Goal: 3
Topic: Accounting Exposure

15. The risk resulting from the effects of changes in foreign exchange rates on the firm's value is
(a) economic exposure.
(b) macro political risk.
(c) accounting exposure.
(d) micro political risk.

Answer: A
Level of Difficulty: 2
Learning Goal: 3
Topic: Economic Exposure

16. The risk attached to international cash flows are all of the following EXCEPT
(a) business and financial risks.
(b) inflation and foreign exchange risks.
(c) political risks.
(d) risk of local management.

Answer: D
Level of Difficulty: 3
Learning Goal: 3
Topic: Types of Risk in International Cash Flows

17. Macro political risk and micro political risk in international business refer to the risk
    (a) that will affect all foreign firms and the risk that will affect an individual firm or specific industry, respectively.
    (b) of nationalization of the oil industry and the risk of a political revolution, respectively.
    (c) that will affect an individual firm or specific industry and the risk that will affect all foreign firms, respectively.
    (d) of sudden taxes on exporting the manufactured goods of a particular industry and the risk of the devaluation of the host country's currency, respectively.

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Political Risk

18. A political risk that might affect all foreign firms in a host country is termed a _________ risk; a political risk that might affect only an individual firm or specific industry in a host country is termed a _________ risk.
    (a) macro political; micro political
    (b) micro political; macro political
    (c) micro political; foreign exchange
    (d) foreign exchange; micro political

    Answer: A
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Political Risk

19. All of the following are positive approaches of coping with political risk EXCEPT
    (a) use of locals in management.
    (b) joint venture with local banks.
    (c) license or patent restrictions under international agreement.
    (d) local sourcing.

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Political Risk

20. For _________ currencies, changes in the value of foreign exchange rates are called _________.
    (a) floating; appreciation
    (b) floating; revaluation or devaluation
    (c) fixed; revaluation or devaluation
    (d) fixed; appreciation or depreciation

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Fixed versus Floating Rate Currencies

21. Between two major currencies, the spot exchange rate is the rate _________ and the forward exchange rate is the rate _________.
    (a) on that date; today
    (b) at some specified future date; today
    (c) today; on that date
    (d) on that date; at some specified future date

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Spot and Forward Exchange Rates

22. Foreign exchange risk refers to the risk created by _________
    (a) the potential seizure of an MNC's operations in a host country.
    (b) the varying exchange rate between two currencies.
    (c) the fixed exchange rate between two currencies.
    (d) the potential nationalization of the MNC's operations by a host government.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Foreign Exchange Risk

23. Comprehensive rules, regulations, and incentives aimed at regulating the inflow of direct foreign investments involving MNCs and at extracting more benefits from their presence are termed
    (a) unitary tax laws.
    (b) foreign direct investments.
    (c) Eurocurrency markets.
    (d) national entry control systems.

    Answer: D
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: National Entry Control Systems

24. The transfer by a multinational firm of capital, managerial, and technical assets from its home country to a host country is termed
    (a) an MNC.
    (b) an SDI.
    (c) an FDI.
    (d) a CAPM.

    Answer: C
    Level of Difficulty: 1
    Learning Goal: 4
    Topic: Foreign Direct Investment

25. An international bond that is sold primarily in countries other than the country of the currency in which the issue is denominated is called
    (a) international bond.
    (b) foreign bond.
    (c) Eurobond.
    (d) None of the above.

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Eurobonds

26. In capital budgeting for a multinational, the starting discount rate to which risks stemming from foreign exchange and political factors can be added, and from which benefits reflecting the parent's lower capital costs may be subtracted is
    (a) the cost of capital of the parent (multinational) company.
    (b) the risk-free rate of the parent company, adjusted for risk relevant to the foreign subsidiary.
    (c) the local cost of equity capital applicable to the local business and financial environments within which a subsidiary operates.
    (d) the weighted average cost of capital applicable to all foreign subsidiaries combined.

    Answer: C
    Level of Difficulty: 4
    Learning Goal:
    Topic: Multinational Capital Budgeting

27. Theory and empirical evidence indicate that the capital structures of multinational companies
    (a) are basically the same as those of domestic firms.
    (b) differ, but all multinationals are similar no matter the domicile country.
    (c) not only differ from domestic firms, but differ also based upon the country in which they are domiciled.
    (d) differ only because of their operating structure.

    Answer: C
    Level of Difficulty: 4
    Learning Goal: 4
    Topic: Multinational Capital Structures

28. Relative to cash flows of domestic firms, by diversifying internationally, multinationals
    (a) can increase cash flows.
    (b) can achieve further risk reduction.
    (c) are unable to change the risk.
    (d) are not attempting to change risk.

    Answer: B
    Level of Difficulty: 4
    Learning Goal: 4
    Topic: Multinationals and Diversification

29. The center of the Euro-equity market, which deals in international equity issues is
   (a) New York.
   (b) Geneva.
   (c) Tokyo.
   (d) London.

   Answer: D
   Level of Difficulty: 1
   Learning Goal: 5
   Topic: Euro-Equity Market

30. The usual capital markets used by U.S.-based MNCs that desire international ownership of their equity are
   (a) Western Europe and Japan.
   (b) Mexico and Canada.
   (c) Saudi Arabia and South Africa.
   (d) Liechtenstein and Panama.

   Answer: A
   Level of Difficulty: 2
   Learning Goal: 5
   Topic: MNCs and Capital Markets

31. A Eurobond is
   (a) a bond sold primarily to Europeans.
   (b) a bond sold primarily in countries other than the country of the currency in which the issue is denominated.
   (c) a debt instrument sold exclusively in Europe.
   (d) a bond issued in Liechtenstein.

   Answer: B
   Level of Difficulty: 2
   Learning Goal: 5
   Topic: Eurobonds

32. The existence of _________ allows multinationals to take advantage of unregulated financial markets to invest and raise short-term funds in a variety of countries and to protect themselves from foreign exchange exposure.
   (a) a strong U.S. dollar
   (b) the International Monetary Fund
   (c) Eurocurrency markets
   (d) European Economic Council

   Answer: C
   Level of Difficulty: 3
   Learning Goal: 5
   Topic: Eurocurrency Markets

33. In the international context, the _________ interest rate involves only the MNC parent's currency, while the _________ interest rate includes any forecast appreciation or depreciation of a foreign currency relative to that of the MNC parent.
    (a) effective; nominal
    (b) macro; nominal
    (c) nominal; effective
    (d) nominal; micro

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: MNCs and Interest Rates

34. A short-term financial decision based on an MNC management's expectation that the local foreign currency will appreciate may be
    (a) increasing local customers' accounts receivable and increasing local notes payable.
    (b) decreasing local notes receivable and decreasing accruals.
    (c) increasing local inventories and increasing local notes payable.
    (d) increasing local accounts receivable and decreasing local accounts payable.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: MNCs and Short-term Finance

35. As a foreign exchange hedging tool, options have all of the following characteristics EXCEPT
    (a) the right to buy or sell an amount of foreign currency.
    (b) specifies price.
    (c) specifies time period.
    (d) represents an obligation to buy or sell.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Hedging Foreign Exchange Risk

36. As a foreign exchange hedge, currency swaps have all of the following characteristics EXCEPT
    (a) an initial exchange by two parties of two principal amounts in two different currencies.
    (b) principal amounts are reversed at the spot rate at maturity.
    (c) each party pays the other's interest payment.
    (d) principal amounts are reversed at a pre-agreed rate at maturity.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Hedging Foreign Exchange Risk

37. In terms of inventory management multinational firms
    (a) must deal mainly with exchange rate fluctuations and tariffs.
    (b) must deal with a wide number of factors, including exchange rate fluctuations, tariffs, non-tariff barriers, integration schemes such as the EEC, and other rules and regulations.
    (c) have only economic factors to consider, since this is a current asset and is minimally affected by political factors.
    (d) have only political factors to consider, since inventory is minimally affected by foreign economic factors.

    Answer: B
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: MNCs and Inventory Management

38. Foreign bonds are sold primarily in
    (a) countries other than the country in which the issue is denominated.
    (b) Western Europe.
    (c) Japan.
    (d) the country of the currency of issue.

    Answer: D
    Level of Difficulty: 3
    Learning Goal: 5
    Topic: Foreign Bonds

39. The _________ is a significant economic force currently made up of 25 nations with a population of more than 295 million that permits free trade within the countries that make up this group.
    (a) North American Free Trade Agreement (NAFTA)
    (b) Mercosur Group
    (c) Asian Economic Area Network (ASEAN)
    (d) European Union (EU)

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: European Union

40. The _________ is a major South American trading bloc that includes countries that account for more than half of total Latin American GDP.
    (a) North American Free Trade Agreement (NAFTA)
    (b) Mercosur Group
    (c) Latin and South American Free Trade Area (LASTA)
    (d) Group of Seven

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Mercosur Group

41. The _________ is a major trade agreement signed by the United States and five Central American Countries.
    (a) North American Free Trade Agreement (NAFTA)
    (b) Mercosur Group
    (c) Latin and South American Free Trade Area (LASTA)
    (d) Central American Free Trade Agreement (CAFTA)

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: Central American Free Trade Agreement

42. _________ is an international body that polices world commercial trading practices and that mediates disputes between two or more member countries.
    (a) NAFTA
    (b) GATT
    (c) WTO
    (d) CAFTA

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: World Trade Organization

43. _________ is a treaty that has governed world trade throughout most of the post World War II era.
    (a) NAFTA
    (b) GATT
    (c) WTO
    (d) CAFTA

    Answer: B
    Level of Difficulty: 2
    Learning Goal: 1
    Topic: General Agreement on Tariffs and Trade

44. Nico Mining, a U.S.-based MNC has a foreign subsidiary that earns $1,050,000 before local taxes, with all the after tax funds to be available to the parent in the form of dividends. The foreign income tax rate is 30 percent, the foreign dividend withholding tax rate is 15 percent, and the firm's U.S. tax rate is 35 percent. What are the funds available to the parent MNC if foreign taxes can be applied as a credit against the MNC's U.S. tax liability?
    (a) $624,750.
    (b) $425,250.
    (c) $257,250.
    (d) $735,000.

    Answer: A
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Tax Credits and MNCs

45. Nico Mining, a U.S.-based MNC has a foreign subsidiary that earns $1,050,000 before local taxes, with all the after tax funds to be available to the parent in the form of dividends. The foreign income tax rate is 30 percent, the foreign dividend withholding tax rate is 15 percent, and the firm's U.S. tax rate is 35 percent. What are the funds available to the parent MNC if no tax credits are allowed?
    (a) $624,750
    (b) $425,250
    (c) $257,250
    (d) $735,000

    Answer: C
    Level of Difficulty: 4
    Learning Goal: 2
    Topic: Tax Credits and MNCs

46. If the exchange rate between the U.S. dollar and the Euro is $1.20 per Euro and the exchange rate between the U.S. dollar and the Japanese yet is 120 Yen per dollar, then what is the Euro per Yen exchange rate?
    (a) 0.0100
    (b) 144.00
    (c) 0.0069
    (d) 100.00

    Answer: C
    Level of Difficulty: 3
    Learning Goal: 3
    Topic: Exchange Rates

47. If the exchange rate between the U.S. dollar and the Euro is $1.20 per Euro and the annual rate of inflation is 5 percent in the United States and 10 percent in Europe, what will be U.S. dollar per Euro exchange rate in one year?
    (a) 1.145
    (b) 0.8730
    (c) 1.257
    (d) 0.7955

    Answer: A
    Level of Difficulty: 4
    Learning Goal: 3
    Topic: Exchange Rates and Inflation

48. The capital structures of MNCs are influenced by all of the factors below EXCEPT
    (a) international capital markets.
    (b) international diversification.
    (c) country factors.
    (d) All of the above.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: Capital Structure and MNCs

49. The first international capital market, a market with uniform rules and regulations governing major stock exchanges, was finally established and began operations in 2002
    (a) at The Hague.
    (b) in New York.
    (c) in London.
    (d) None of the above.

    Answer: D
    Level of Difficulty: 2
    Learning Goal: 4
    Topic: International Capital Market

50. A bond that is initially sold primarily in countries other than the country of the currency in which the issue is denominated is called
    (a) an international bond
    (b) a foreign bond
    (c) a Eurobond
    (d) a double Dutch bond

    Answer: C
    Level of Difficulty: 2
    Learning Goal: 5
    Topic: Eurobonds

■ Essay Questions

1. A U.S.-based MNC has three subsidiaries: S1 (40 percent owned by the MNC); S2 (33 percent owned by S1), and S3 (20 percent owned by S2). The taxable income for each firm is $100 million. The local taxes for each firm are $15 million, $20 million, and $10 million, respectively. The MNC's tax rate is 40 percent.
    (a) Can the MNC apply all of its local taxes as a credit against its U.S. taxes?
    (b) Based on the "grossing up" concept, calculate all tax credits applicable to the MNC.

    Answers:

    (a) Determine the degree of ownership of each subsidiary:
    S1: 40% directly owned by the MNC.
    S2: (40% × 33%) = 13.2% owned by the MNC.
    S3: (40% × 33% × 20%) = 2.6% owned by the MNC.
    Based on these results, S1 and S2 can be included but S3 cannot.

    (b) The maximum credit against U.S. taxes = 40% × ($100 million + $100 million) = $80 million. The local taxes paid by S1 and S2, or $35 million, can be used as a U.S. tax credit by the MNC.

    Level of Difficulty: 4
    Learning Goal: 2
    Topic: MNCs and Taxes

2. A multinational company has two subsidiaries, one in Ireland (local currency, Irish pound) and the other in West Germany (local currency, Deutsche mark). Pro forma statements of operations indicate the following short-term financial needs for each subsidiary (in equivalent U.S. dollars): Ireland: $25 million excess cash to be invested (lent); West Germany: $10 million funds to be raised (borrowed)

The following financial data is also available:

	Currency		
Item	**U.S. Dollars**	**Irish Pound**	**Deutsche Mark**
Spot exchange rates		0.7418/U.S.$	2.0138/U.S.$
Forecast %		+1%	–1.5%
Interest rates			
Nominal Euromarket	7.5%	6%	5%
Domestic	6.5	6.25	5.5
Effective			
Euromarket	7.5%		
Domestic	6.5		

(a) Determine the effective rates of interest for Irish pound and Deutsche mark in both the Euromarket and the domestic market.

(b) Where should the funds be invested?

(c) Where should the funds be raised?

Answers:

(a)

Effective Rates	U.S. Dollar	Irish pound	Deutsche Mark
Euromarket	7.5%	7%	3.5%
Domestic	6.5	7.25%	4.0

(b) $25 million should be invested in U.S. dollars in the Euromarket.

(c) $10 million should be raised in Deutsche marks in the Euromarket.

Level of Difficulty: 4
Learning Goal: 4
Topic: MNCs and Financing Decisions

3. A U.S-based MNC has a subsidiary in China where the local currency is the Renminbi (RMB). The balance sheets and income statements of the subsidiary are presented in the table below. On December 31, 2005, the exchange rate was 8.27 RMB/US$. Assume the local currency figures in the statement below remain the same on December 31, 2006. Calculate the U.S. dollar translated figures for the two ending time periods assuming that between December 31, 2005 and December 31, 2006, the Chinese government revalues (appreciates) the RMB by 20 percent.

Translation of Income Statement

	December 31, 2005		**December 31, 2006**
	RMB	**US$**	**US$**
Sales	1,800,000		
Cost of Goods Sold	1,650,000		
Operating Profits	150,000		

Translation of Balance Sheet

	December 31, 2005		**December 31, 2006**
Assets	**RMB**	**US$**	**US$**
Cash	24,000		
Inventory	180,000		
Plant and Equipment	96,000		
Total	300,000		
Liabilities and Stockholders Equity			
Debt	144,000		
Paid in Capital	120,000		
Retained Earnings	36,000		
Total	300,000		

Answer: This shows that an appreciation of the foreign currency against the dollar for a subsidiary in that country will result in higher values on both the balance sheet and income statement once those values are translated into dollars even if the local currency values didn't change at all. The opposite would be the case if the foreign currency depreciates against the dollar.

Translation of Income Statement

	December 31, 2005		December 31, 2006
	RMB	US$ (8.27 RMB = US$1)	US$ (6.89 RMB = US$1)
Sales	1,800,000	217,654	261,248
Cost of Goods Sold	1,650,000	199,516	239,478
Operating Profits	150,000	18,138	21,770

Translation of Balance Sheet

	December 31, 2005		December 31, 2006
Assets	**RMB**	**US$ (8.27 RMB = US$1)**	**US$ (6.89 RMB = US$1)**
Cash	24,000	2,02	3,483
Inventory	180,000	21,766	26,125
Plant and Equipment	96,000	11,608	13,933
Total	300,000	36,276	43,541
Liabilities and Stockholders Equity			
Debt	144,000	17,412	20,900
Paid in Capital	120,000	14,510	17,417
Retained Earnings	36,000	4,353	5,225
Total	300,000	36,276	43,541

Level of Difficulty: 4
Learning Goal: 2
Topic: Translation of Financial Statements