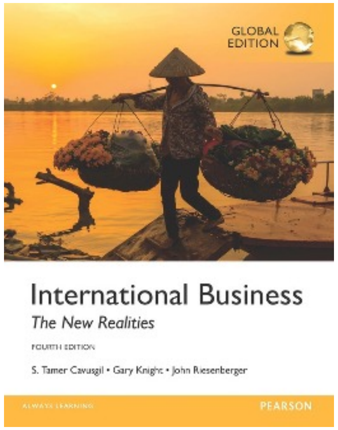
Chapter 10



Financial Management and Accounting in the Global Firm

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International Financial Management

- It is the acquisition and use of funds for cross-border trade, investment, and other commercial activities.
- MNEs must carry out transactions in a multitude of foreign currencies and diverse environments characterized by restrictions on capital flows, country risk, and varying accounting and tax systems.
- Firms access funds from a variety of sources – foreign bond markets, stock exchanges, banks, venture capital firms, and intra-corporate financing – based on wherever in the world capital is cheapest.

Typical International Financial Activities

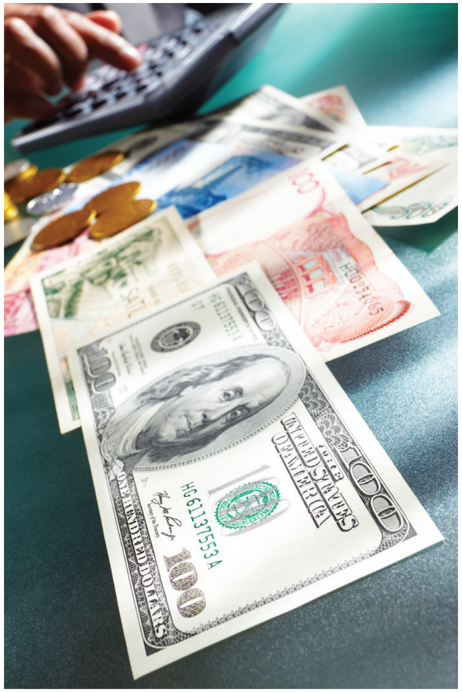
- Motorola, has facilities in nearly 50 countries and raises funds in financial markets worldwide.
- Its managers are familiar with the laws and regulations that govern the financial exchanges worldwide.
- The financial dimensions of Motorola's activities are managed globally, through a network of subsidiaries and strategic business units.
- The units are a complex web of financial coordination and control processes supplemented by investment analysis, capital structure optimization, risk reduction, and the mobilization of global financial resources.

International Financial Management Tasks

1. **Choose a capital structure** – Determine the ideal long-term mix of debt versus equity financing.

2. **Raise funds for the firm** – Acquire equity, debt, or intracorporate financing for funding activities and investments.

3. **Working capital and cash flow management** – Manage funds passing in and out of the firm's value-adding activities.



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International Financial Management Tasks (cont'd)

4. **Capital budgeting** – Assess financial attractiveness of major investment projects (e.g., Foreign market expansion and entry).

5. **Managing currency risk** – Manage the multiple-currency transactions of the firm and the exposure to exchange-rate fluctuations.

6. **Manage the diversity of international accounting and tax practices** – Learn to operate in a global environment with diverse accounting practices and international tax regimes.

Task One: Choose a Capital Structure

- **Capital structure**: The mix of long-term equity and debt financing firms use to support their activities.
- The firm obtains equity financing by selling stock to investors or by retaining earnings, which is profit reinvested in the firm rather than paid to investors.
- Shares of stock provide investors with an ownership interest – *equity* – in the firm. In new firms, founders may provide equity from their personal savings.
- Debt financing comes from either loans from banks and other financial intermediaries or money raised by selling corporate bonds to individuals or institutions.

Task Two: Raising Funds

- **Global money market**: Financial markets where firms and governments raise short-term financing. It is the meeting point of those who want to invest money and those who want to raise funds.

- **Global capital market**: Financial markets where firms and governments raise intermediate-term and long-term financing.

- Participating in the global capital market allows firms to access funds from a larger pool of capital at competitive interest rates. International investors access a much wider range of investment opportunities than available in the domestic capital market.

Financial Centers

- New York, London, and Tokyo are the major centers.
- Frankfurt, Hong Kong, Paris, San Francisco, Sydney, Singapore, and Zurich are secondary centers.
- Firms access major capital suppliers – banks, stock exchanges, venture capitalists – at such centers.
- In 2011, international issues of equity in world securities markets were about $500 billion, up from $83 billion in 1996.
- In 2011, the stock of cross-national bank loans and deposits exceeded $23,000 billion, up from $12,000 billion 10 years earlier.

Advantages of the Global Capital Markets for the Firm

1. Compared to being restricted to financial markets in the home country, the global market provides a broader base from which the firm can draw funds.
2. Greater breadth of financing sources means firms can often access funds at substantially lower cost.
3. The market provides a variety of investment opportunities for MNEs, professional investment firms, and individuals.

China: An Emergent Banking Center

- China is rapidly becoming the world’s largest economy and a center of global banking.
- The country’s big trade surplus and foreign investment inflows together have created massive reserves of foreign exchange.
- Now home to several of the world’s largest banks, the Chinese government is positioning Shanghai as a global financial hub.

The Eurocurrency Market

- The **Eurocurrency Market**, representing money deposited in banks outside its country of origin, is a key source of loanable funds. U.S. dollars account for the largest share of such funds.
- **Eurodollars** are U.S. dollars held in banks outside the United States, including foreign branches of U.S. banks.
- Other Eurocurrencies include euros, yen, and British pounds, as long as they are banked outside their home country.

Bonds: A Major Source of Debt Financing

- A bond is a debt instrument that enables the issuer (borrower) to raise capital by promising to repay the principal along with the interest on a specified date (maturity).
- Along with firms, governments, states, and other institutions also sell bonds. Investors purchase bonds and redeem them at face value in the future.
- The **global bond market** is the international marketplace in which bonds are bought and sold, primarily through banks and stockbrokers.

Task Three:
Working Capital and Cash Flow Management

- Cash flow needs arise from everyday business activities, such as paying for labor and materials or resources, servicing interest payments on debt, paying taxes, or paying dividends to shareholders.
- Cash flow management ensures cash is available where and when it is needed.
- Cash is generated from various sources and needs to be transferred from one part of the MNE to another.
- International financial managers devise strategies for transferring funds within the firm's worldwide operations to optimize global operations.

Task Four: Capital Budgeting

- Managers use capital budgeting to decide which international projects are economically desirable.
- The net present value (NPV) of a project depends on the initial investment, cost of capital, and the amount of incremental cash flow or other advantages the proposed project is expected to provide over time.
- Internationally, such decisions are complex because managers must consider many variables, each of which can strongly affect the potential profitability of a venture.

Task Five: Currency Risk Management

- *Currency risk* concerns exchange rate fluctuations that harm business profits.
- **Transaction exposure** is currency risk that firms face when outstanding accounts receivable or payable are denominated in foreign currencies.
- **Translation exposure** is currency risk that results when a firm translates financial statements denominated in a foreign currency into the functional currency of the parent firm.
- **Economic exposure** is currency risk that results from exchange rate fluctuations affecting the pricing of products, the cost of inputs, and the value of foreign investments.

Hedging Instruments

- **Forward contract**: A financial instrument to buy or sell a currency at an agreed-upon exchange rate at the initiation of the contract for future delivery.
- **Futures contract**: An agreement to buy or sell a currency in exchange for another at a pre-specified price and on a pre-specified date.
- **Currency option**: Gives the purchaser the right, but not the obligation, to buy a certain amount of foreign currency at a set exchange rate within a specified amount of time.
- **Currency swap**: The exchange of one currency for another currency, according to a specified schedule.

Task Six: Manage International Accounting and Tax Practices

- Developing accounting systems to identify, measure, and communicate financial information is especially challenging in firms with multi-country operations.
- Dozens of approaches are used to determine cost of goods sold, return on assets, R&D expenditures, net profits, and other outcomes, in different countries.
- Balance sheets and income statements vary mainly regarding language, currency, format, and underlying accounting principles.
- Financial statements prepared in one country may be difficult to compare with those prepared in another.

International Taxation

- A **direct tax** is imposed on income derived from business profits, intra-corporate transactions, capital gains, and sometimes royalties, interest and dividends.
- An **indirect tax** applies to firms that license or franchise products and services, or who charge interest. The government withholds some percentage of royalty payments or interest charges as tax.
- A **sales tax** is a flat percentage tax on the value of goods or services sold, and paid by the ultimate user.

International Taxation (cont'd)

- A **value-added tax** is payable at each stage of processing in the value chain of a product or service.
- **VAT** is calculated as a percentage of the difference between the sale and purchase price of a good.
- **VAT** is common in Canada, Europe, and Latin America.
- Each business in a product's value chain is required to bill the **VAT** to its customers and pay the tax on its purchases, crediting the amounts it paid against the amounts due on its own activities. The net result is a tax on the added value of the good.

Tax Havens

- **Tax havens** are countries hospitable to business and inward investment because of their low corporate income taxes.
- Bahamas, Luxembourg, Monaco, Singapore, and Switzerland are examples.
- Tax havens exist in part because tax systems vary greatly worldwide. Thus, MNEs have an incentive to structure their global activities to minimize taxes.
- MNEs take advantage of tax havens either by establishing operations in them or by funneling business transactions through them.