Block 4

FUNCTIONAL AREAS IN INTERNATIONAL BUSINESS

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BLOCK 4: FUNCTIONAL AREAS IN INTERNATIONAL BUSINESS

The fourth block to the course on International business deals with global research and development, global human resource management, global marketing and supply chain, accounting in international business, and financial management in international business. The block contains five units. The first unit gives an overview of global research and development. The second unit discusses human resource management in the global context. The third unit discusses globalization in international markets and how supply chains are globalized. The fourth unit discusses how accounting is carried out in international business. The fifth unit discusses the investment, financial, and money management decisions in the context of international business.

The first unit, *Global Research and Development* discusses the concept of globalizing R&D and the benefits and challenges of global R&D. It then goes on explaining the design and structure of global R&D activities. It then discusses how multinational enterprises (MNEs) manage their R&D operations. The unit finally discusses how technology transfer takes place across borders.

The second unit, *Global Human Resource Management* defines strategic international human resource management. It goes on to explain how staffing takes place in MNEs. It then discusses the concept of expatriates; their selection and failure; how they are trained and compensated; and recommendations on how expatriates should be compensated in different cultures. The unit finally discusses the human resource problems faced by MNEs in foreign affiliates.

The third unit, *Global Marketing and Supply Chain* discusses how the market potential of a foreign country can be determined. It goes on to explain the concepts of globalization and localization in international markets. The unit finally discusses how supply chains are globalized.

The fourth unit, *Accounting in the International Business* discusses accounting standards followed in different countries. It goes on to explain the national and international standards. It then discusses the significance of consolidated financial statements, the methods used for currency translation, and the concept of transaction exposure. It also explains the concept of economic exposure. The unit finally discusses the different aspects of accounting in control systems.

The fifth unit, *Financial Management in International Business* discusses the different investment decisions firms take in international business. It goes on to explain the various factors firms consider for financing in an international business. It then explains the money management decisions firms take in international business. It also explains how money management decisions help firms in achieving their tax objectives. It then discusses the techniques used by international businesses for moving liquid funds across borders. The unit finally discusses the techniques for global money management.

Unit 10

Global Research and Development

Structure

"Research is creating new knowledge."

- Neil Armstrong

10.1 Introduction

The previous block gave an overview of international strategy. It also dealt with the organization of international business. It finally discussed entry strategies and strategic alliances.

Many Multinational Enterprises (MNEs) are increasingly dedicating their human, financial, and technological resources to global research and development (R&D) in order to achieve sustained competitive advantages in the global marketplace. Many western MNEs are extending their R&D activities in developed as well as developing countries, especially emerging markets. Also MNEs from industrialized nations such as South Korea, Hong Kong, Taiwan, and Singapore have started relocating many R&D activities abroad.

This unit will discuss the concept of globalizing R&D and the benefits and challenges of global R&D. It then goes on explaining the design and structure of global R&D activities. It then discusses how multinational enterprises (MNEs) manage their R&D operations. The unit finally discusses how technology transfer takes place across borders.

10.2 Objectives

By the end of this unit, students should be able to:

- Explain the concept of globalizing R&D and the benefits and challenges of global R&D.

- Discuss the design and structuring of global R&D activities.
- Describe the global view of MNEs in managing their research operations.
- Outline the concept of technology transfer across borders.

10.3 Globalizing R&D

Globalizing R&D is "a process of locating and operating R&D laboratories in different countries, under a coordinated ad integrated system by the company's headquarters, in order to leverage the technical resources of each facility to further the company's overall technological capabilities and competitive advantage." Globalizing R&D differs from internalizing R&D. The former requires global integration of geographically dispersed R&D units while internalizing R&D is an early stage of globalizing R&D, which evolves as the international expansion of a firm grows larger and complex in scope and scale. The R&D function serves as the major avenue to build and sustain global competitive advantage of a company. MNEs having a well-defined strategy on globalizing R&D tend to achieve superior sales and profit performance.

R&D intensity has increased at a steady pace in many industries such as pharmaceuticals, electronics, chemicals, and medical equipment. While American MNEs lead in innovation in many high-technology industries such as computers, software, automobiles, healthcare, and advanced materials, MNEs from Europe, Japan, Canada, and newly industrialized countries such as Israel, Taiwan, and Korea also demonstrate high level of R&D and incentive productivity. Of late, the number of patents developed by MNEs worldwide has surged. The main thrust for global firms has been to increase the patent output per unit of R&D spending.

Managing global R&D receives greater attention by international business managers for three reasons: First, technology is recognized as a primary source of competitive advantage. International R&D augments and expands the overall R&D process of the firm. Second, the nature of technological innovation process has changed. Technological innovations are a result of integration of technologies from different disciplines. Countries differ in their competitive advantage and globalizing R&D enables firms to tap these sources of strength. Third, time is a critical competitive factor in many industries. R&D activities are decentralized for accelerating the process of innovation and adaptation. Finally, the growth of network and information exchange systems facilitates long-distance communication, which lowers the costs of coordination that are associated with globalization of R&D activities.

Globalizing R&D is a strategic response to changes in international markets. Foreign customers demand customized products and higher levels of technical service along with a shortened product life cycle in many industries. Targeting and developing regional markets such as the Latin American Free Trade

Association (LAFTA) and European Union may offer greater rewards to modify products for meeting market requirements. For gaining access to cutting-edge technologies developed by foreign companies or improving the adaptations of their own innovations, MNEs send their own scientists and engineers to onsite laboratories. The globalization process moves up the R&D value chain from technology support to product development and further to technology development. This indicates the important role assumed by foreign facilities in knowledge creation.

Example: Managing Global Research and Development at Nestle

Nestle SA (Nestle) is a research and development leader in the world's food industry. The company made substantial investments every year in R&D, which was carried out at the Nestle Research Center (NESTEC) at Lausanne, Switzerland and in 28 R&D centers worldwide.

The R&D activities were incorporated at NESTEC, which offered technical assistance to all operating units of Nestle throughout the world. The company has several researchers who worked in many disciplines such as bioscience, food science, plant science, food safety, food technology, and nutrition.

R&D management set some research priorities that helped in determining Nestle's long-term competencies (category I projects), while Nestle's strategic business units (SBUs) were responsible for prioritizing and monitoring R&D work linked to new process and product developments (category II projects). The SBUs had close working relationships with the R&D network as well as operating businesses, and take a multifunctional approach for setting priorities. The R&D coordinators at the SBUs were responsible for assigning the related research project to the most competent R&D group within the network and also monitor the progress.

The R&D centers were instructed by NESTEC to take on additional responsibility as product area managers for improving coordination across various R&D centers working in the same product area. The product area manager leads the R&D groups and also helped them in meeting their assigned tasks and deadlines.

Compiled from various sources

10.3.1 Benefits and Challenges of Global R&D

The following benefits may arise from globalizing R&D:

The first benefit of globalizing R&D is that it may offer a vehicle for accessing from extracting benefits from the technical resources local expertise, and scientific talent of the target country. MNEs may also receive benefits such as low interest financing and tax breaks offered by host governments when they establish R&D centers overseas.

Second, globalizing R&D may enhance the competitive advantage of a firm. Setting up R&D facilities in host countries signals long-term commitment of a firm to its local customers.

Finally, globalizing R&D may enable an MNE to enjoy benefits that arise from international division of labor in R&D among multiple foreign countries or regions. MNEs that are well-coordinated can allocate specific responsibilities to different but integrated R&D subsidiaries based on their knowledge, expertise, and external resources. This multilateral cooperation enables the firm to obtain a more diverse flow of new ideas, processes, and products, providing greater input into the innovation process of the firm. This also creates a synergy earned from comparative advantage in R&D resources from all the participating nations.

Example

Phillips, a major consumer electronics company, has R&D locations in Europe, the United States and Japan. The management wants them to be able to participate in Japanese growth. Phillips has employed Japanese experts and established relationships with Japanese businesses, universities and government research institutes. It benefits from learning from and partnering with extremely demanding Japanese customers and businesses. Here, multi-lateral cooperation is the aspect of Globalizing R & D is illustrated in the case of Phillips.

Multi-lateral cooperation enables Phillips to be benefitted from learning from and partnering with extremely demanding Japanese customers and businesses.

Source: ICFAI Research Center

Globalizing R&D is a complex process that involves several challenges and difficulties.

The first challenge of globalizing R&D is that maintaining minimum efficient scale in foreign R&D operations is not easy always. It may be difficult to staff the foreign laboratories with enough qualified people for achieving the minimum efficient scale. In addition, splitting up the most qualified people of an MNE over several international R&D sites may dilute the critical mass at the centralized R&D facility based in the home country. Further, government controls and political risks in the host country may increase the uncertainty of R&D operations. It may create a rift between the motivations of an MNE and those of the local government. In developing countries where import restrictions exist, it may not be easy to import the essential research materials. Hiring of local people can also be subject to government controls.

Second, the leakage of proprietary knowledge poses a serious threat when R&D is globalized. This arises because of the presence of a foreign joint venture partner, lax patent laws in the country, or due to foreign nationals being hired by indigenous firms after they acquire MNE's expertise. Maintaining the confidentiality of technical knowledge and information is difficult and costly.

Example
When it came to the F-15 Eagle Fighter and the Boeing 767 aircraft, McDonald Douglas and Boeing took chances by collaborating with Japanese companies. It is tough and expensive to keep technological information and knowledge private. Here, leakage of proprietary knowledge is the element of globalizing R&D is this case. In this case of F-15 & Boeing, maintaining the confidentiality of technical knowledge and information is difficult and costly.

Source: ICFAI Research Center

Finally, globalizing R&D inevitably increases coordination and control costs. MNEs may face coordination issues such as allocating research tasks among dispersed R&D centers, developing products that are responsive to market needs in different countries, and exchanging information among different R&D centers. The decentralized and distant MNE R&D facilities increase the coordination and control costs. Lack of coordination and control can lead to costly duplication of effort since different facilities may not be completely aware of what other facilities are doing. In addition, the cultural and business differences between home and host countries may intensify the difficulty in running R&D activities abroad.

Despite these challenges, there is an increased globalization of R&D activities as MNEs have become more internalized. The advantages of global R&D require well- prepared design and structuring in the building phase and well-established systems of coordination, management, communication, and control in the operational phase. Managing global R&D activities is complex and difficult while formulating strategies and policies that concern R&D dispersion and control. The global R&D system of a firm should be structured to fulfill organizational needs while taking advantage of external opportunities. Internally, the R&D function has to face the ongoing task of coordinating and controlling across the firm's international network of R&D laboratories. Externally, corporate R&D creates and manages technical cooperation with research consortia, universities, and even competitors to stay abreast of lading edge developments. A firm also has to essentially manage critical areas such as coordination and communication, technology transfer, human resource management, and collaboration with local firms. Without such management, the economic return of R&D dispersion cannot be ensured.

10.4 Design and Structure of Global R&D

10.4.1 Types of Foreign R&D Units

The first step in globalizing R&D is defining the type of a planned R&D program. With regard to the role of foreign R&D units, R&D subsidiaries can be categorized into corporate technology units specialized or regional technology units, global technology units, technology transfer units, and indigenous technology units.

A corporate technology unit is designed for generating basic, long-term technology of exploratory nature to use by the parent company. A specialized technology unit is set for developing specialized products, processes, or technologies predefined by headquarters for serving either the regional or the global market. A global technology unit is established to develop new products and processes for major world markets. A technology transfer unit facilitates the transfer of the corporate parent's technology to a subsidiary and providing local technical services. Finally, an indigenous technology is formed overseas for developing new products specifically for the local market.

Example

Samsung Research is the advanced research and development (R&D) hub of Samsung's Consumer Electronics (CE) Division and IT & Mobile Communications (IM) Division at its Corporate Head Quarters. Samsung Research leads the development of the future technologies for Samsung's products and services with more than 10,000 researchers and developers working in overseas R&D centers. However, the major decisions about the technology or exploring various product features were made primarily at Samsung's advanced research and development (R&D) hub. Here, Corporate Technology Unit is the type of R & D unit in this case.

In this case, Samsung Research is the advanced research and development (R&D) hub of Samsung's Consumer Electronics (CE) Division and IT & Mobile Communications (IM) Division at its Corporate Head Quarters is the corporate technology unit.

Source: ICFAI Research Center

Technology transfer units and indigenous technology units are locally adapting laboratories. The function of these units is to help the production and marketing facilities in a host country make use of the existing technology of the MNE. They may also assist the technology transfer process by advising on necessary adaption of the manufacturing technology. They may act as a technical service center where they examine why a product may not satisfy a local market and how it can be adapted to better meet the local needs. For instance Exxon used this technique for in the development of products in the European market. When indigenous technology units are designed for serving a foreign market, they become locally integrated laboratories and involve some of the basis developmental activities. The particular host-market may considerably be diverse, fast-growing, large, and may need a nationwide R&D office for coordinating and integrating host-country R&D activities.

Example

Labour arbitrage agreement between India and US made QuEST (US product-engineering design firm) to offshore its Airbus engine design services to India. An aircraft engine design supply chain cluster was set up in Karnataka, India, for making precision engineering equipment/services. Airbus offered its assistance along with approved component designs and integration procedures, to the Indian engineers at the cluster, helping them to design everything as per Airbus standards.

Source: ICFAI Research Center

Corporate technology units and global technology units are both globally interdependent laboratories. These two laboratories provide inputs into a centrally defined and coordinated R&D program with no essential connection with the production operations of the host-country. The function of these units is to focus on research and development as opposed to improvement and adaptation. They do not link to local manufacturing but to corporate and divisional R&D. Examples of successful corporate technology are Eastman Kodak's R&D unit in Australia and CPC International's R&D affiliates in Japan and Italy. IBM is known for establishing several global technology units worldwide for developing a product or process that will have universal applicability in all major local and foreign markets.

10.4.2 Selecting R&D Location

Selecting an R&D location is a crucial and complex decision because external parameters such as resource availability, market conditions, and government policies differ across countries and even at locations within a country. Once a laboratory is built, switching costs from one location to another are enormous.

First, location selection depends on the strategic role of an R&D subsidiary that is set by the parent company. If the subsidiary is designed to serve the home market, managers should take into consideration the availability of scientific knowledge and talent from foreign universities. For a subsidiary that targets the world market, location factors include availability of adequate infrastructure and universities and accessibility to foreign scientific communities. When the subsidiary serves just as center for technology transfer, it should be located in countries where the company already has made substantial investments in manufacturing and/or marketing. In general, R&D follows manufacturing and marketing in the globalization process. In cases where the laboratories are established for performing basic research or developing new products for the global market, they should be located in places in which there is a concentration of technology resources and advanced innovation. This concentration is a vital reason why MNEs tend to cluster their technology development centers into numerous hot spots.

Second, host government policies may have an influence on location decision. The policies include: work permit regulations for expatriate scientists, engineers, and managers; government requirements for increasing local technological content of the activities of the firm; tax subsidies for supporting the R&D activities of the foreign firm; and efficient patent laws.

Third, the local infrastructure and technological level of a foreign country are vital. Technological capability must exist in the country to permit R&D to take place. Some MNEs tap technologies that are more advanced. For instance, Germany is a world leader in areas of chemistry, physics, metallurgy, and medicine while Britain has spent heavily in pharmaceuticals and chemicals. The presence of research universities or local firms with advanced technologies becomes crucial in these circumstances.

Finally, sociocultural factors may affect location selection. MNEs prefer locating R&D facilities in nations with a similar culture and language, considering the difficulties associated with operating business in a different social and cultural environment. The decision makers at the headquarters should consider the attractiveness of the lifestyle of the foreign country to the staff assigned overseas. If the location is undesirable, it may be difficult to find qualified people willing to work abroad. As R&D largely depends on the creativity and efficiency of human resources the living and working conditions abroad may determine the incentives and commitments of the expatriates.

10.4.3 Structuring Global R&D Activities

To ensure global R&D success, MNEs should design an appropriate organizational structure governing R&D activities. The two crucial factors essential for structuring global R&D operations include (1) the level of authority an MNE plans to offer to its foreign R&D activities and (2) the scope of the geographical market to be covered. Based on these two axes (level of autonomy and market breadth), five models can be identified. They are ethnocentric centralized, polycentric decentralized, specialized lab, global central lab and the globally integrated network. These models serve an organizational framework in which different R&D units may be designed with different roles and types.

In the ethnocentric centralized R&D structure, all key R&D activities are concentrated in one home country. This structure has a corporate technology unit at home, and may also include a few technology transfer units for distributing centralized R&D results to local operations. In this model, the core technologies in the home country are viewed as national treasure, designing products that are manufactured subsequently at other locations and are distributed worldwide.

Its disadvantage is lack of sensitivity to signals from overseas markets and insufficient consideration of local market demands. MNEs select this structure only if they manufacture global, standardized products and do not take into consideration differentiating between foreign markets.

The polycentric decentralized R&D structure is characterized by a decentralized alliance of R&D sites with no corporate R&D center for supervision. This structure contains several indigenous technology units in major foreign markets. Foreign R&D laboratories are highly autonomous with little incentive for sharing information with central R&D or other R&D units. Foreign R&D laboratories emphasize process or product development process in response to local consumer demands and localization requests. In this structure efforts to preserve autonomy and national identity may hinder cross-border coordination, and thus lead to inefficiency on a corporate level and for duplication of R&D activities. The firm may also lose its focus on a particular technology.

In the specialized laboratory structure, foreign R&D units are assigned global directives. The aim is to enhance the global efficiency of the product development process, concentrating in a single location the resources related to development operations in a particular product category. This structure has specialized technology units in respective product areas. When a leading market exists in terms of size and presence of customers, the MNE assigns the global responsibility to develop and manufacture the product to the laboratories and plants in that country. This approach helps in achieving economies of scale in R&D and for placing the product development operations close to the key customers of the company. The global development laboratories are selected based on the proximity to the manufacturing plants because there are costs in transferring R&D to a manufacturing plant that is way from the R&D center.

Example

Due to poor quality, export of Vinca rosea (dry leaves) from India to Eli Lilly (US based pharmaceutical firm formulating anti-tumour cancer drugs), was stopped. Eli Lilly started its own plantation in Houston, US, resulting in pile up of Indian stocks. Avra Laboratories Pvt Ltd (ALPL), affiliated to Cipla-an Indian pharmaceutical firm, initiated a Government funded research unit, to develop a new Vinca rosea based formulation. The research unit under the guidance of Cipla developed an alternate formulation with a small team in a year. This innovation was commercialized at both domestic and export markets, by Cipla, giving a rare honour of entering the export market for the first time.

Source: ICFAI Research Center

The global center lab structure is used for leveraging company’s centralized technical resources for creating new global products. Though it is also centralized, R&D under this structure covers a broader market domain than R&D in the ethnocentric centralized model. In this structure, there can be more than one global technology unit for generating worldwide innovation. In this model, companies concentrate their technical resources in the country of origin. To make this structure work, it is crucial to create an effective market information network that provides an information flow from the decentralized marketing or production units to the parent company. This enables the central development laboratories for generating products suitable for the global market and/or to adapt different product versions to individual markets.

The globally integrated network structure may be filled with a number of foreign R&D units with different types and roles, such as corporate technology unit, indigenous technology unit, global technology unit, and specialized technology unit. In this model, home R&D is not the center of control for all R&D activities but rather one among many interdependent R&D units that are interconnected by means of varied and flexible coordination mechanisms. A central coordinating body exercises the needed supervision for preventing duplication and integrating the diverse contributions. Development processes which can be exploited across several markets involve resources from different facilities whose work is coordinated according to a common plan. Each unit in the network specializes in a particular component, product, or technology area, and set of core capabilities. At times this unit takes over a lead role as a competence center and is then responsible for the entire value generation process.

10.5 Management and Operations of Global R&D

The rapid dispersion of R&D laboratories in foreign markets have forced MNEs to take a global view in managing their research operations through areas such as human resource management, autonomy specification, global planning, and communications improvement.

10.5.1 Human Resource Management

R&D human resources needs to be managed in such a way that they fulfill the unique needs of global R&D. First, selection of key personnel must be linked to the role or type of foreign R&D unit. For instance, if the laboratory belongs to an indigenous technology then local talent that is well-qualified should be considered for both management and R&D positions. If the lab belongs to a specialized or global technology unit or is to accept technology from the parent company then qualified expatriates are preferred. Second, personnel policies for foreign lab should be standardized to the extent allowed by local customs and laws. Promotions, titles and rewards and recognition programs should be as same as possible. Because there needs to be frequent contact between home and overseas laboratory personnel this uniformity of management positions and titles can help make foreign laboratories feel that they are equal partners with parent laboratories. Reward and recognition programs instilled at the headquarters should be extended to include the global R&D personnel. Third, maintaining some regular visits and contacts between foreign R&D units and home la center is useful.

10.5.2 Autonomy Setting

Autonomy refers to the decision-making power of an R&D unit concerning R&D activities. The autonomy of a foreign R&D unit largely depends on the role it plays in the MNE network. For instance, managerial autonomy in a laboratory that serves as a specialized center for global competence must be delegate greater power. Generally autonomy should be higher if the technical resources in the laboratory are scarce, should be located together in a center of excellence or should be put to use where it could create more leverage for the company. When a foreign R&D unit serves as a unit for technology transfer for the MNE network, its autonomy will be low and the authority for decision making will be centralized at the headquarters. In this situation the unit plays the role of an effective adopter of new products and processes that are created by the parent company. If the unit is indigenous, specialized technology laboratory, or global technology center, it requires a low level of formalization (i.e. specifying the essential behaviors in the form of rules procedures or programs) and a high level of autonomy. The subsidiaries need increased degrees of freedom and more resources distributed by the parent companies. Some R&D subsidiaries of companies such as ITT, Philips, and Unilever enjoy considerable strategic and operational autonomy, though headquarters exercises administrative control through financial reporting and budgeting systems. These autonomous subsidiaries were found to be more productive than other R&D units in these companies.

Example

NASA's Space Shuttle Challenger (SSC), disintegrated over the Atlantic Ocean immediately after 73 seconds of its launch, killing all the astronauts onboard, due to O-ring failure. Allan McDonald, Director SSC, Rocket Motor Project, had to testify before a Presidential commission, to explain cause of the failure. During the hearing McDonald said, Morton Thiokol (Makers of O-rings) had recommended (prior to the launch) that NASA not launch the shuttle in temperatures below 53 degrees. But the advice was overruled and NASA went ahead with the launch at 29 degrees, as it was already delayed.

Source: ICFAI Research Center

The autonomy of a foreign R&D unit is subordinating the strategic needs of an MNE for global integration. There are positive associations between creating, adopting and diffusing innovations by a subsidiary and the degree to which the subsidiary is integrated with the parent company and shares its overall goals, strategy, and values. Such integration results from a high degree of organizational socialization and is achieved through extensive transfer and travel of managers between the headquarters and the subsidiary and through joint work-in teams committees, and task forces.

Resource allocation is a significant vehicle in balancing global integration and local autonomy to manage dispersed R&D units abroad. In general, resources allocated to specialized technology units or global technology units may be those involved in strategic and exploratory research core competency global market coverage, or significant areas of investment. Resources that are likely to be duplicated in regional R&D centers are the ones that focus chiefly on product development as opposed to technology development. In addition to technological factors geopolitical and financial factors play a major role in determining proper allocation of resources. Finally, in resource allocation it is important to consider the interface between physical resources and human resources in a new information technology environment. Networks connecting the facilities of a company worldwide enable researchers to work on one project from many locations.

10.5.3 Global Planning

The corporate R&D office has the crucial task of coordinating the dispersed global network of R&D laboratories. Global planning is a primary means of information exchange among decentralized R&D laboratories and projects. In the process of planning, corporate headquarters outline a strategic goal of globalizing R&D and communicating it to foreign R&D units. For instance, Matsushita build set up a three pillars blue print including:

- Construction of a tri-pole R&D network between laboratories in Europe and North America and domestic research laboratories for establishing advanced technological bases and creating products for the global market.
- Improved R&D efficiency through expansion of collaborative relationships with international research institutions.
- Increased speed of globalization of R&D through superior management and effective communication across borders.

R&D planning activities also contribute to learning throughout the MNE if they request participation from scientists and technicians on a routine basis. Planning can be transformed into an education process by the central R&D office. Planning activities also help in global integration. Though budgeting is considered to be difficult due to development cycles spanning five years or more, global planning is easier due to the ability to disseminate information and establish priorities.

Planning helps in the alignment of technological and business strategies of a company. Once the technology strategy is set, it can be carried into specific project areas. A key aspect of alignment of R&D on the business objectives is cross-functional planning and execution. With participation of manufacturing marketing, and sales, R&D groups can optimize the process of project assessment, selection, and project portfolio balancing. Progress on R&D projects can be assessed on a regular basis and can be reported to multi-functional teams.

10.5.4 Communication Improvement

A major communication challenge across a network of international R&D laboratories is posed by geographic distance. Cross-border communication breakdowns lower productivity. Moreover, the role of informal communication networks is important as much of the work can be accomplished in teams. An effective communication system is essential not only within the R&D function but also between R&D and other functional activities such as manufacturing, marketing, and sales. For improving communication within a global R&D network, international managers need to be aware of the following issues.

Rules and Procedures

For overseas laboratories, careful documentation and reporting of research progress can help the R&D personnel be aware of research activity across the company. Research progress reports supplement the communication flows related to the planning cycle which can also serve the purpose of education.

Electronic Communication

Videoconferencing images, electronic mail facsimiles of visual and written material and computer conferencing offer greater communication possibilities than a simple telephone call. They provide an essential infrastructure for communication across borders. However they cannot replace the informal face-to-face communication that builds trust.

Boundary Spanners

The R&D staff at the headquarters often perform the role of boundary spanners between the R&D laboratories that are dispersed. They travel to site location to share development somewhere else in the global R&D network and for discussing progress at the particular site. They may also divulge sensitive information across the network about developments with joint venture partners, customers, or suppliers.

Informal Network

Communicating through an informal network is an efficient means for teamwork. Informal networks can be stimulated through central R&D group, which may be created both inside and outside the company locally or internationally. An external local network comprising local suppliers, customers, and research institutions offer opportunity for learning from foreign environments. The central office R&D group can put in place an external international network of academics who work on company projects. Private conferences help in bringing these academics together for presenting their research and for exchanging information. The central office can supervise locating and funding outside academic researchers. The internal network of an MNE can be activated with international project teams. The project team members stay in their respective laboratories and collaborate on projects using personnel transfers and electronic means.

Cultural Adaptation

Global R&D projects need to overcome cultural differences. Though many researchers speak in English there is no assurance that the members of a multicultural R&D team understand each other. Research suggests that significant cross-cultural differences exist among R&D professionals on the dimension of power individualism risk avoidance and masculinity/feminity. An effective mean to minimize cultural differences is to socialize R&D professionals through a wide range of activities. International training seminars help in building in shared corporate culture as well as a network of colleagues who can communicate on an informal basis.

Example

Hanwang, a Chinese IT provider of pattern-recognition technology, licensed its embedded Handwriting Recognition System (HRS) to Microsoft for incorporation into Windows CE and Pocket PCs. As Chinese language characters are complex, a research project exclusively dealing with Chinese handwriting recognition was funded by the National Basic Science Foundation. The research project's firm was successful in developing pattern recognition technology which had a national patent. The firm was named as Hanwang Technologies Co. Ltd (HTCL). Most of the mobiles manufactured in China by firms like Nokia, Samsung and Sony Ericsson incorporate Hanwang's recognition technology for providing their global language translation needs.

Source: ICFAI Research Center

Activity 10.1

JJ Ltd., a pharmaceutical company has it head office in the US. The company had several R&D units that were spread across Europe and Asia. The headquarters staff often traveled to each R&D unit to share development and also monitor the progress at each site. Identify the role played by the headquarters staff in managing their cross-border R&D operations. Also discuss other issues international managers need to be aware of to improve communication within a global R&D network.

Answer:

10.6 Technology Transfer across Borders

A common alternative for setting up a foreign-based R&D center or laboratory is to collaborative agreements or technology transfers with foreign partners. This approach is attractive to firms or projects in need of large investments which may involve high uncertainties.

International technology transfer is “a process by which one firm’s technology or knowledge is passed on to another firm in a different country for economic benefits.” Technology transfer helps a firm acquire needed knowledge or technology from a foreign provider. The methods most often used for technology transfer include international licensing turnkey operations, non-equity or equity joint ventures and countertrade. In general firms that acquire technology through international transfer seek increasing competitiveness by reducing development costs increasing competitiveness, enhancing technological position in the market, or reducing prices while not compromising on quality. If firms want to transfer the technology they own to foreign firms, they need to consider factors such as protection of proprietary technology, impact on the existing market power of the firm, competition and earning royalties from remote markets.

Technology transfer is a complex and ongoing activity as demonstrated by the fact that the license relationships have been in operations for over 50 years. Moreover variations are prevalent across market lines, company or industry. Even within a MNE network management and policies of technology transfer vary according to subsidiaries, type of technologies, and stages of the technology life cycle. As such, it would be inappropriate for a firm to try controlling it through uniform rules.

A major problem with technology transfer across borders is that much of the technological capability cannot be transferred easily from one partner to another. This is because the successful operationalization of many technologies depends on the experiences acquired and expertise of critical personnel including engineers, equipment operators, key scientists suppliers, etc. The ways in which interdependent technologies are tuned for working effectively in a complex system are tacit or implicit in nature, relying on overall experiences understandings, and skills that have they internalized or learned over time. Due to this it is necessary to check the absorptive capability of a transferee. The absorptive capability concerns the ability of a firm to integrate, assimilate, acquire, and exploit skills and knowledge that are transferred from others. This capability depends on the level of firm’s related skill or technology that are already developed, the ability to combine the skills owned by the firm as well as acquired from others, and the effectiveness of organizational learning systems.

Effective technology transfer, especially through a joint venture requires coordinating mechanisms that link two parties which are labeled as bridges. Bridges are of three categories – procedural bridges, human bridges, and organizational bridges. Procedural bridges involve activities such as joint planning and joint staffing particularly during technology transfer. Here the emphasis is on collaboration through joint planning, problem solving, and implementation. Human bridges rely on establishing direct interaction between individuals belonging to different organizational areas typically through the transfer and rotation of personnel. The personal contacts allow enthusiasm and responsibility to be transferred from one person to another and it establishes a common work-related and social context that facilitates more learning and cooperation. Organizational bridges use dedicated transfer teams for establishing more formal ties between organizational areas. These groups are formed for building a more formal structure and common context for effective experience transfer.

Activity 10.2

Tel Ltd., a British telecom company entered into a joint venture with US-based AmPhones Ltd. for technology transfer. Both the companies noticed that there were communication problems between both the companies. The companies also had difficulty in finding who had the executive power in the company and with whom they had to negotiate to make decisions. What can the companies do for the teams to coordinate and make technology transfer? Also discuss the problems associated with technology transfer across borders.

Answer:

Check Your Progress - 1

1. _______________is a process of locating and operating R&D laboratories in different countries, under a coordinated ad integrated system by the company's headquarters, in order to leverage the technical resources of each facility to further the company's overall technological capabilities and competitive advantage.
   a. Globalizing R&D
   b. Internalizing R&D
   c. Externalizing R&D
   d. None of the above
2. The following benefits may generate from globalizing R&D:
   a. Globalizing R&D may offer a vehicle for accessing from extracting benefits from the technical resources local expertise, and scientific talent of the target country.
   b. Globalizing R&D may enhance the competitive advantage of a firm.
   c. Globalizing R&D may enable an MNE to enjoy benefits that arise from international division of labor in R&D among multiple foreign countries or regions.
   d. All of the above

3. Globalizing R&D creates the following challenges.
   a. Maintaining minimum efficient scale in foreign R&D operations is not easy always.
   b. The leakage of proprietary knowledge poses a serious threat when R&D is globalized.
   c. Globalizing R&D inevitably increases coordination and control costs.
   d. All of the above
4. A _____________ is designed for generating basic, long-term technology of exploratory nature to use by the parent company.
   a. Specialized technology unit
   b. Global technology unit
   c. Technology transfer unit
   d. Corporate technology unit
5. A/An __________ is set for developing specialized products, processes, or technologies predefined by headquarters for serving either the regional or the global market.
   a. Indigenous technology unit
   b. Specialized technology unit
   c. Technology transfer unit
   d. Corporate technology unit
6. A/An __________ is established to develop new products and processes for major world markets.
   a. Global technology unit
   b. Technology transfer unit
   c. Corporate technology unit
   d. Indigenous technology unit
7. A _____________ facilitates the transfer of the corporate parent's technology to a subsidiary and providing local technical services.
   a. Global technology unit
   b. Specialized technology unit
   c. Technology transfer unit
   d. Corporate technology unit
8. A/An __________ is formed overseas for developing new products specifically for the local market.
   a. Indigenous technology unit
   b. Specialized technology unit
   c. Global technology unit
   d. Corporate technology unit

9. Location selection of an R&D subsidiary depends on which of the following factors?
   a. Location selection depends on the strategic role of an R&D subsidiary that is set by the parent company.
   b. Host government policies may have an influence on location decision.
   c. The local infrastructure and technological level of a foreign country are vital and sociocultural factors.
   d. All of the above
10. In the _____ R&D structure, all key R&D activities are concentrated in one home country.
    a. Ethnocentric centralized
    b. Polycentric decentralized
    c. Specialized laboratory
    d. Global center lab
11. The ___________R&D structure is characterized by a decentralized alliance of R&D sites with no corporate R&D center for supervision.
    a. Ethnocentric centralized
    b. Global center lab
    c. Polycentric decentralized
    d. Specialized laboratory
12. In the _____structure, foreign R&D units are assigned global directives.
    a. Specialized laboratory
    b. Ethnocentric centralized
    c. Polycentric decentralized
    d. Global center lab
13. The _____structure is used for leveraging company's centralized technical resources for creating new global products.
    a. Ethnocentric centralized
    b. Specialized laboratory
    c. Global center lab
    d. Globally integrated network
14. In _____, home R&D is not the center of control for all R&D activities but rather one among many interdependent R&D units that are interconnected by means of varied and flexible coordination mechanisms.
    a. Globally integrated network
    b. Ethnocentric centralized
    c. Specialized laboratory
    d. Global center lab

15. The rapid dispersion of R&D laboratories in foreign markets have forced MNEs to take a global view in managing their research operations through areas such as

    i. Human resource management

    ii. Autonomy specification, global planning

    iii. Communications improvement

    iv. Financial management

    v. Coordinating mechanism

    a. i, ii and iii

    b. ii, iii and iv

    c. iii, iv, and v

    d. i, iv, and v

16. For improving communication within a global R&D network, international managers need to be aware of which of the following issues?

    i. Rules and procedures

    ii. Electronic communication

    iii. Boundary spanners, Informal network

    iv. Formal network

    v. Cultural adaptation

    a. i, ii, iii, and v

    b. ii, iii, iv, and v

    c. i, iii, iv, and v

    d. ii, iii, iv, and v

17. ______________________is a process by which one firm's technology or knowledge is passed on to another firm in a different country for economic benefits.

    a. International technology transfer

    b. External transfer

    c. Internal transfer

    d. None of the above

18. ______________________involve activities such as joint planning and joint staffing particularly during technology transfer.

    a. Organizational bridges

    b. Procedural bridges

    c. Human bridges

    d. International bridges

19. ______________________rely on establishing direct interaction between individuals belonging to different organizational areas typically through the transfer and rotation of personnel. Procedural
    a. Bridges Organizational
    b. Bridges International
    c. Bridges
    d. Human bridges
20. ______________________use dedicated transfer teams for establishing more formal ties between organizational areas.
    a. Organizational bridges
    b. Procedural bridges
    c. Human bridges
    d. None of the above

10.7 Summary

- Globalizing R&D involves several benefits. First, globalizing R&D may offer a vehicle for accessing from extracting benefits from the technical resources local expertise, and scientific talent of the target country. Second, globalizing R&D may enhance the competitive advantage of a firm. Finally, globalizing R&D may enable an MNE to enjoy benefits that arise from international division of labor in R&D among multiple foreign countries or regions.
- Globalizing R&D is a complex process that involves several challenges and difficulties. First, maintaining minimum efficient scale in foreign R&D operations is not easy always. Second, the leakage of proprietary knowledge poses a serious threat when R&D is globalized. Finally, globalizing R&D inevitably increases coordination and control costs.
- With regard to the role of foreign R&D units, R&D subsidiaries can be categorized into corporate technology units specialized or regional technology units, global technology units, technology transfer units, and indigenous technology units.
- Selecting an R&D location is a crucial and complex decision because external parameters such as resource availability, market conditions, and government policies differ across countries and even at locations within a country.
- The two crucial factors essential for structuring global R&D operations include
    i. The level of authority an MNE plans to offer to its foreign R&D activities and
    ii. The scope of the geographical market to be covered.

- The five models in structuring global R&D are ethnocentric centralized, polycentric decentralized, specialized lab, global central lab and the globally integrated network.
- The rapid dispersion of R&D laboratories in foreign markets have forced MNEs to take a global view in managing their research operations through areas such as human resource management, autonomy specification, global planning, and communications improvement.
- A common alternative for setting up a foreign-based R&D center or laboratory is to collaborative agreements or technology transfers with foreign partners. This approach is attractive to firms or projects in need of large investments which may involve high uncertainties.

10.8 Glossary

Autonomy setting - Refers to the decision-making power of an R&D unit concerning R&D activities.

Boundary spanners – Refers to R&D staff at the headquarters who travel to site locations to share development somewhere else in the global R&D network and for discussing progress at the particular site. They may also divulge sensitive information across the network about developments with joint venture partners, customers, or suppliers.

Corporate technology unit – An R&D unit that is designed for generating basic, long-term technology of exploratory nature to use by the parent company.

Ethnocentric centralized R&D structure – An R&D structure where all key R&D activities are concentrated in one home country. This structure has a corporate technology unit at home, and may also include a few technology transfer units for distributing centralized R&D results to local operations.

Global planning - Coordinating the dispersed global network of R&D laboratories to ensure information exchange among decentralized R&D laboratories and projects

Global technology unit – This unit is established to develop new products and processes for major world markets.

Globalizing R&D - It is a process of locating and operating R&D laboratories in different countries, under a coordinated and integrated system by the company's headquarters, in order to leverage the technical resources of each facility to further the company's overall technological capabilities and competitive advantage.

Globally integrated network structure - Filled with a number of foreign R&D units with different types and roles, such as corporate technology unit, indigenous technology unit, global technology unit, and specialized technology unit.

Indigenous technology unit – An R&D unit that is formed overseas for developing new products specifically for the local market.

International technology transfer - "A process by which one firm's technology or knowledge is passed on to another firm in a different country for economic benefits."

Polycentric decentralized R&D structure - It is characterized by a decentralized alliance of R&D sites with no corporate R&D center for supervision. This structure contains several indigenous technology units in major foreign markets.

Specialized laboratory structure – Global R&D structure that operates on specialized technology units in respective product areas

Specialized technology unit – An R&D unit that is set for developing specialized products, processes, or technologies predefined by headquarters for serving either the regional or the global market.

Technology transfer unit – An R&D unit that facilitates the transfer of the corporate parent's technology to a subsidiary and providing local technical services.

10.9 Self-Assessment Test

1. Define the concept of globalizing R&D. State the benefits and challenges of global R&D.
2. Discuss the type of foreign R&D units. Also explain the factors for selecting a location for global R&D.
3. Describe how the global R&D activities are structured.
4. Explain how the global R&D operations are managed.
5. Explain the concept of technology transfer across borders.

10.10 Suggested Readings/Reference Material

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5. Business Insider. Global ecommerce market report: ecommerce sales trends and growth statistics for 2021. https://www.businessinsider.com/global-ecommerce-2020-report?IR=T

10.11 Answers to Check Your Progress Questions

1. (a) Globalizing R&D

Globalizing R&D is a process of locating and operating R&D laboratories in different countries, under a coordinated ad integrated system by the company's headquarters, in order to leverage the technical resources of each facility to further the company's overall technological capabilities and competitive advantage.

2. (d) All of the above

The following benefits may generate from globalizing R&D:

- Globalizing R&D may offer a vehicle for accessing from extracting benefits from the technical resources local expertise, and scientific talent of the target country.
- Globalizing R&D may enhance the competitive advantage of a firm.
- Globalizing R&D may enable an MNE to enjoy benefits that arise from international division of labor in R&D among multiple foreign countries or regions.

3. (d) All of the above

Globalizing R&D creates the following challenges.

- Maintaining minimum efficient scale in foreign R&D operations is not easy always.

- The leakage of proprietary knowledge poses a serious threat when R&D is globalized.
- Globalizing R&D inevitably increases coordination and control costs.

4. (d) Corporate technology unit

A corporate technology unit is designed for generating basic, long-term technology of exploratory nature to use by the parent company.

5. (b) Specialized technology unit

A specialized technology unit is set for developing specialized products, processes, or technologies predefined by headquarters for serving either the regional or the global market.

6. (a) Global technology unit

A global technology unit is established to develop new products and processes for major world markets.

7. (c) Technology transfer units

A technology transfer unit facilitates the transfer of the corporate parent's technology to a subsidiary and providing local technical services.

8. (a) Indigenous technology units

An indigenous technology is formed overseas for developing new products specifically for the local market.

9. (d) All of the above

Location selection of an R&D subsidiary depends on the following factors:

- Location selection depends on the strategic role of an R&D subsidiary that is set by the parent company.
- Host government policies may have an influence on location decision.
- The local infrastructure and technological level of a foreign country are vital.
- Sociocultural factors may affect location selection.

10. (a) Ethnocentric centralized

In the ethnocentric centralized R&D structure, all key R&D activities are concentrated in one home country.

11. (c) Polycentric decentralized

The polycentric decentralized R&D structure is characterized by a decentralized alliance of R&D sites with no corporate R&D center for supervision.

12. (a) Specialized laboratory

In the specialized laboratory structure, foreign R&D units are assigned global directives.

13. (c) Global center lab

The global center lab structure is used for leveraging company's centralized technical resources for creating new global products.

14. (a) Globally integrated network

In globally integrated network structure, home R&D is not the center of control for all R&D activities but rather one among many interdependent R&D units that are interconnected by means of varied and flexible coordination mechanisms.

15. (a) i, ii, and iii

The rapid dispersion of R&D laboratories in foreign markets have forced MNEs to take a global view in managing their research operations through areas such as human resource management, autonomy specification, global planning, and communications improvement.

16. (a) i, ii iii, and v

For improving communication within a global R&D network, international managers need to be aware of the following issues:

- Rules and procedures
- Electronic communication
- Boundary spanners
- Informal network
- Cultural adaptation

17. (a) International technology transfer

International technology transfer is a process by which one firm's technology or knowledge is passed on to another firm in a different country for economic benefits.

18. (b) Procedural bridges

Procedural bridges involve activities such as joint planning and joint staffing particularly during technology transfer.

19. (d) Human bridges

Human bridges rely on establishing direct interaction between individuals belonging to different organizational areas typically through the transfer and rotation of personnel.

20. (a) Organizational bridges

Organizational bridges use dedicated transfer teams for establishing more formal ties between organizational areas.

Unit 11

Global Human Resource Management

Structure

“Human Resources isn’t a thing we do. It’s the thing that runs our business."

- Steve Wynn

11.1 Introduction

The previous unit discussed the concept of globalizing R&D and the benefits and challenges of global R&D. It then explained the design and structure of global R&D activities. It then discussed how multinational enterprises (MNEs) manage their R&D operations. The unit finally discussed how technology transfer takes place across borders.

International human resource management (IHRM) is “the procurement, allocation, utilization, and motivation of human resources in the international arena.” IHRM is crucial to the strategy and success of global operations. In international business, multinational enterprises (MNEs) from different home countries employ different strategies for staffing their subsidiaries. Expatriates play a vital role in the operations of MNEs. International joint ventures and wholly-owned subsidiaries face many staffing problems as any foreign venture.

This unit will define strategic international human resource management. It then goes on to explaining how staffing takes place in MNEs. It then discusses the concept of expatriates; their selection and failure; how they are trained and compensated; and recommendations on how expatriates should be compensated in different cultures. The unit finally discusses the human resource problems faced by MNEs in foreign affiliates.

11.2 Objectives

By the end of this unit, students should be able to:

- Define strategic international human resource management.
- Explain how an MNE staff its operations.
- Describe how expatriates are selected, trained, and compensated.
- Discuss human resource problems in foreign affiliates.

11.3 Strategic IHRM

Strategic international human resource management (SIHRM) is defined as "human resources, management issues, functions and policies and practices that result from the strategic activities of MNEs and that impact the international concerns and goals of these enterprises." SIHRM is more complex than strategic human resource management in a domestic context because it concerns multiple employee groups and environments and because it needs to be aligned with the multi-faceted considerations of the MNE. The SIHRM model has three orientations:

- The adaptive system that imitates local human resource management (HRM) practices.
- The exportive system that replicates the HRM system in the home country and other affiliates.
- The integrative system that emphasizes on global integration while allowing for some variations.

An optimal SIHRM has the capability to balance the different forces in the environment of the firm, particularly the tension between local responsiveness and global integration. The overall SIHRM strategy chosen by the parent in conjunction with the specific conditions of the affiliate (e.g. the cultural distance from the parent) determines the degree of similarity in SIHRM between the headquarters and the affiliate. This in association with the criticality of the group determines the similarity of HRM practices for each employee group.

11.4 Staffing the Multinational Enterprise

11.4.1 The Globalization of Board of Directors

In 1998-99, a survey was conducted by the Conference Board to assess how globalization affected the composition of board of directors. The survey revealed that between 1995 and 1998, the percentage of firms with non-national directors had increased from 39 percent to 60 percent. Companies with three or more non-national directors had an increase from 11 to 23 percent. By 1998, 10 percent of the directors surveyed firms were non-national.

The survey also revealed that entering new markets and exposure to new demands from investors and customers are the chief internal drivers to seek non-national board members. The initiative comes from new managers who wish to expand their international operations where the expertise and credibility of non-national directors makes a difference.

Selecting Global Board Members

Firms seeking to internalize their boards commence by selecting someone who is similar culturally to existing members but has an international perspective. In the next phase, firms look for individuals with in-depth business and cultural experience in a given part of the world. Even then, most of the appointments are made among those who have experience of living or working in the country in which the company is based.

Searches for non-national directors result on an average in 9 to 10 rejections for one accepted. The extra commitment, language and culture, different time zones are barriers to the appointment of non-national directors, as is the process of board evaluation. The Conference Board recommends accommodation of non-nationals by rotating locations, reducing the number of annual meetings, setting up orientation programs, and widening the definition of non-national director for including non-nationals living and working abroad who maintain closer ties with their home country.

Another obstacle for non-national directors is representation. US institutional investors are concerned with having non-national directors in domestic business as well as with national directors in the non-US firms. As these institutions have a fiduciary duty for protecting the interests of the shareholders, they need to consider limited shareholders‟ representation in the decision to elect directors. Representation is more difficult when vital shareholders sit on the board, especially with board member of companies with significant cross-share-holdings, board members of major suppliers, or labor or pension fund representatives. While US shareholders are dispersed relatively, shareholders with major control blocks are common in Asia, Latin America, and Europe.

11.4.2 Staffing the Ranks in an MNE

Factors affecting MNE staffing include strategy, organizational structure, and subsidiary-specific factors such as duration of operations, technology, production and marketing technologies, and host-country characteristics such as level of economic and technology development, political stability, regulation, and culture. MNEs can draw employees from the country where it is headquartered (parent company nationals or PCNs) where the foreign operations are located (host-country nationals or HCNs), or from a third country (third country nationals or TCNs). Alternative staffing philosophies abroad are ethnocentric, polycentric, regiocentric, and geocentric.

In ethnocentric staffing, PCNs are chosen for key positions regardless of the location. This approach is used by Japanese companies and Korean firms. For instance, at Samsung, an all Korean management existed until 1999.

Example

Coke's U.S. headquarters has HR policies related to labour, safety as well as compensation. Those are applied across Coke's affiliated country and regional operations, in the same manner. The leadership positions in each subsidiary of Coke have staff who are parent country nationals (PCNs). Local nationals are recruited for more junior positions in order to maintain headquarters' influence as the primary.

Source: ICFAI Research Center

In polycentric staffing, HCNs are hired at the subsidiaries of key positions but not at the corporate headquarters.

In regiocentric staffing, recruiting is done on a regional basis. In geocentric staffing, the best managers are recruited worldwide regardless of their nationality. The value of this approach is apparent in introducing new perspectives and modes of operation.

Most MNE employees abroad are „foreign employees" or HCNs, for several reasons. They are easier to employ administratively and legally. They are also knowledgeable about the local environment. In case of developing and emerging markets, HCNs are often cheaper to employ than home country nationals, even without adjusting for expatriate terms.

The availability of qualified candidates is a decisive factor in selection of HCNs. Foreign MNEs in Japan find it difficult to hire qualified Japanese employees. In some countries, hiring requires a government-controlled labor bureau that may assign employees to work for the MNE.

The cultural challenges go beyond staffing. A formal career planning system where individuals are evaluated in terms of abilities, skills, and traits that will be tested, scored, and computerized may appear to be impersonal in collective cultures. Individualistic societies use cognitive testing because they emphasize performance, individual rights, individual interests, whereas collective cultures emphasize organizational compatibility and loyalty that cannot be evaluated via cognitive tests.

Finally, the MNE is expected to monitor employment conditions at home as well as at its subsidiaries. For instance, Wal-Mart has been accused of buying from vendors that use child labor in Bangladesh.

11.4.3 Country Specific Issues

As in other functional realms, the need for adjustment in corporate practices and policies is anchored in the variation of employment conditions and labor markets.

In transition economies, older employees who are accustomed to a central planning system face difficulties adjusting to the higher productivity expected in an MNE. Despite, overall high employment in such economies, skilled are usually in short supply due to lack of educational infrastructure. For instance, in China, the biggest problem faced by MNEs is very high employee turnover, which undermines investment in recruitment and training. To overcome this problem, MNEs in China customize solutions. For instance, Ford Motor Company offered retention incentives to its Chinese workers such as tuition to pursue an MBA degree or a housing loan that is forgiven after a worker completes seven years of service. Ford also has deviated from its worldwide policy of not rehiring employees who had left the company.

Example

UNESCO pays Danger pay (a non-pensionable allowance) to staff members who are required to work in duty stations where very dangerous conditions prevail / non-protected environments where medical staff are specifically at risk to their life when deployed to deal with public health emergencies as declared by WHO. As per the UN Classification, the list of countries/duty stations where payment of danger pay has been approved, with effect from 1 July through 30 September 2015 - Afghanistan, Central African Republic, Congo, Democratic Republic of Katanga Province, North Kivu Province, South Kivu Province, ETHIOPIA (selected Somali Regions), GUINEA (to work in the Ebola Virus Disease (EVD) operations), Iraq - entire country excluding Kurdistan Region, Kenya, Republic North Eastern Province, LIBYA etc. The Chairman of International Civil Service Commission (ICSC) is responsible for authorizing the application of danger pay to a duty station based on the recommendations from the United Nations Department of Safety and Security (DSS) and WHO.

Source: ICFAI Research Center

Activity 11.1

ABC Auto Ltd. (ABC), an Indian automaker had its operations in Thailand and China. The company had to recruit staff for senior positions in Thailand. The company employed a senior manger from its Chinese operations to occupy the same level of positions in Thailand. The company at its headquarters in India continued to have parent country nationals at all managerial levels. Identify the staffing approach used by ABC. Also discuss other staffing approaches employed by multinational enterprises.

Answer:

11.5 The Expatriate Workforce

11.5.1 Expatriates: Types and Distribution

There are different types of expatriates. The traditional expatriate, older and experienced is selected for his/her managerial and technical skills for on to five years. International cadres are individuals moving from one foreign assignment to another. They seldom return to their home country and sometimes become permanent expatriates who stay in foreign assignments for extended periods of time or even permanently. Young, inexperienced expatriates are sent on local hire terms for six months to five years. Temporaries go on short on short assignments for up to a year. Another type is expatriate trainee, who is placed overseas for the purpose of training as part of initiation into an MNE. The virtual expatriate takes on foreign assignment without relocating physically. The virtual expatriate uses telecommunications and videoconferencing to stay in touch.

Example

Suresh has completed his MBA in 2021 and joined a Chennai-based IT company as an "Analyst" through Campus Recruitment. Prior to this, he had less than 6 - months of experience with a Fintech company. Suresh was deputed to the client office in the Philippines for a period of 3 years while continuing to be on the payroll of Chennai based company. He was not paid anything by the client company in the Philippines. In this case, Suresh is the inexperienced expatriate.

In this case, with less than 6 months of experience & having been deployed to the client in Office in the Philippines with the remuneration paid by the Chennai-based company reflects that Suresh is an inexperienced expatriate.

Source: ICFAI Research Center

115.2 Expatriates: Pros and Cons

MNEs use expatriates “to get the business off the ground, put in the infrastructure, and, more importantly, have a plan to change the mix of expatriates versus nationals.” Expatriates contribute essential knowledge and experience; serve as a mechanism for control, and as a way to transmit corporate culture and goals. Expatriation creates a global perspective and is necessary for knowledge and technology transfer.

Expatriates are not used by firms as they block promotion of the local workforce. The local workforce may also feel deprived due to their lower wage levels compared to that of the expatriates. An expatriate can also rob a company of its insights, skills, and initiative of local nationals. Another reason for not using expatriates is their high rates of failure.

11.5.3 Expatriate Failure

Expatriate failure occurs when the assignee returns prematurely to the home country or when his/her performance does not meet expectations. Japan and China show the highest failure rates for US expatriates.

The cost of expatriate failure is substantial, ranging from US$ 55,000 to US$ 150,000 in direct costs. However, the real cost of expatriate failure is considerably higher. It includes cost of selection, training, preparation, and moving, in addition to the consequences of poor performance in lower revenues, damage to the firm's reputation, and lost business opportunities. All these may undermine the future ventures in the host country.

There are numerous reasons for expatriate failure. They may include a spouse's unhappiness, inability to cope with the responsibilities and stress posed by overseas work, inability to adjust to an unfamiliar physical and cultural environment, personality or emotional immaturity, and lack of technical competence. Lack of motivation to work overseas when a firm attaches low value to an overseas assignment is also a problem.

Activity 11.2

JK Ltd., a chemical company based in India is considering setting up a subsidiary in Thailand. The company felt that training some of its employees would be better prior to it establishing a subsidiary in Thailand. Thus, the company placed some of its new executive recruits in Thailand for the purpose of training. Identify the type of expatriate. Also discuss other types of expatriates.

Answer:

11.5.4 Expatriates Selection

MNEs look for several attributes in an expatriate including cultural empathy, language skills, adaptability and flexibility, education, maturity, motivation, and leadership. Adler specifies these competencies: local responsiveness, a global perspective, transition and adaptation, synergetic learning, cross-cultural interaction, collaboration, and foreign experiences. The ability of exercising discretion in choosing when to engage in global integration and when to be locally responsive is another crucial factor.

Successful expatriates need three sets of skills – (1) personal skills, that facilitate emotional and mental well-being, for instance, reinforcement, stress orientation, substitution, technical competence, physical mobility, dealing with isolation, alienation, realistic expectation prior to departure; (2) people skills such as willingness to communicate, relational abilities, non-verbal communication, respect for others, and empathy for other; and (3) perception skills, namely the cognitive process that helps executives understand the foreigners‟ behaviors. Being culturally adventurous and extroversion are crucial for expatriate success in culturally distant cultures.

Example

PepsiCo uses a tool to help the employee and his family assess their ability to adapt to new cultures and environments. The cost and complexity of an international assignment makes it essential that PepsiCo selects the most suitable candidate. It encourages employee and spouse to take the SAGE (Self-Assessment for Global Endeavors) screening test which is available in the International Assignment track of the Cultural Wizard site: *http://pepsico.culturewizard.com.* This screening test assesses the employee and the spouse on aspects like cultural sensitivity, flexibility and desire for new experiences

Source: ICFAI Research Center

Expatriate Selection Instruments

Several instruments assist in expatriate selection. The Prospector evaluates the potential of aspiring international executives on 14 dimensions: cultural sensitivity, integrity, business knowledge, motivational ability, courage, insight, commitment, seeking feedback, using feedback, risk taking, culturally adventurous, seeking learning opportunities, flexibility, and open to criticism. Another instrument is the Overseas Assignment Inventory (OAI) developed by Tucker International. This instrument uses success predictors on a foreign assignment: open-mindedness, trust in people, expectations, respect for others‟ beliefs, locus of control, tolerance, patience, flexibility, social adaptability, initiative, risk taking, sense of humor, and spouse communication.

Another popular selection tool is role-based simulation. They are either generic or specific.

11.5.5 Preparing for Foreign Assignment

Expatriates entering a foreign country should adjust to the new environment, including a new culture, and job responsibilities. The first phase of adjustment is anticipatory and takes place before departure. This is followed by in-country adjustment. Adjustment varies by organizational culture, organization socialization, individual factors (self-efficacy, perception skills, and relation), job-related factors (role discretion, role novelty, role clarity, role conflict, and non-work factors such as culture novelty and family-spouse adjustment. Adjustment is also influenced by language fluency and previous assignments.

Five determinants of cross-cultural adjustment include: previous overseas experience; pre-departure cross-cultural training; multiple candidate, multiple-criteria selection; individual skills, and perceptual skills; and non-work factors such as cultural distance and spouse and family adjustment.

Expatriate Training

Training for an overseas assignment has two components – information giving and experiential learning. Information-giving consists of practical information on living conditions in the destination country, area studies, which includes facts about the country's macro-environment, and cultural awareness information. Experiential learning combines cognitive and behavioral techniques. The goal is to acquire intercultural effectiveness skills including relationship building, stress management, cross-cultural communication, and negotiation techniques.

Effective cross-cultural training requires an integrated approach which includes both general orientation and specific cultural development. Yoshida and Brislin list five guidelines for cultural training: (1) identify – become aware of the skills needed to function in the target culture; (2) understand – know why, where, when, to whom, and how the behavior is appropriate; (3) use cultural informants for understanding specifics – observe and consult people from the target culture to ensure that the behaviors are used in the proper context and are delivered appropriately, (4) practice –practice helps in gaining proficiency in a new skill; and (5) deal with emotions –trainees should anticipate new behaviors they use as well as strong emotional reactions to cultural differences.

Example

Fred is a Sales Team Manager working in the UK and the management has deputed him to Beijing to lead the new team over there. While there will be a translator to assist him, the question arose about whether Chinese clients think about working with a British without cultural fluency.

In this case, the guidelines of cultural training pertains to 'Identify target culture'. Language is the basic skill required to identify with the Chinese people. Fred does not know the Chinese language. Hence, it was felt how Chinese team members would identify with Fred.

Source: ICFAI Research Center

Harrison proposed a two-stage cultural orientation. The first stage focuses on trainees" attention and prepares them for cross-cultural encounters. This stage involves self- assessment of factors and cultural awareness. The second stage specific cultural orientation is designed to develop the ability of trainees to interact effectively within the specific culture he/she is assigned. This stage includes two phases: knowledge acquisitions and skill training.

Choosing a Training Method

Tung proposed a contingency framework to determine the nature and level of training rigor based on the cultural distance between the expatriate's native and new culture and the degree of interaction required in the overseas position. If the cultural distance is low and the expected interaction between the HCNs and expatriates is low, training should focus on task-related issues as opposed to cultural issues, and the level of rigor required is low. If the cultural distance and expected interaction is high, training should focus on cross-cultural skill development as well as on the new task and on the new culture, and the level of rigor should be moderate to high.

Another training model is based on social learning theory, where rigor is defined as the degree of cognitive involvement by the trainee. The model distinguishes between participative modeling, which involves observing and participating in the modeled behavior, and process-symbolic modeling, which involves observation of modeled behavior.

If the level of interaction and cultural distance is low, training should be less than a week. If the individual is going overseas for 2 to 12 months, the training should be for four weeks. If the individual is going for a novel culture and the expected degree of interaction is high, the level of training rigor should be high and training should be given for two months. Some field experiences and sensitivity training would be appropriate.

11.5.6 Compensation

MNE compensation programs focus on attracting and retaining qualified employees, facilitating transfer between the headquarters and the affiliates, and creating consistency and equity in compensation, and maintaining competitiveness. Compensation systems are derived from MNE international strategies as well as its organizational and/or product life cycle. They also reflect laws, regulations, and cultural traditions of the host country.

An effective compensation system begins with an accurate performance appraisal. In case of expatriates, difficulties include the choice of the evaluator, differences in performance perceptions between the home and host countries, inadequate recording of performance objectives, communication difficulties with headquarters, parent-country ethnocentrism, and indifference to the foreign experience of the expatriate. Other problems include difficulties in balancing local responsiveness and global integration, environmental variations across subsidiaries, and non-comparability of data from different regions/subsidiaries. Decisions are made related to raters' location, their expatriate experience, and regarding the use of standard, hybrid or customized evaluation forms.

Cost and Elements of Expatriate Compensation

The cost of hiring an expatriate is 3 to 5 times higher than the domestic salary of a local hire.

Expatriate compensation comprises the following elements:

Salary: Base pay plus incentives determined through competency-based plans or job evaluation. Incentives in the form of cash or deferred payment may be based on home-country plans or host-country plans or both.

Housing: Most MNEs offer housing allowances to expatriates for maintaining expatriates‟ living standards at their home country level.

Services allowance and premiums: These are paid to compensate for differences in expenditures between home and host countries. Allowances are offered for higher cost of living in the host country, home leave, education, and relocation. The purchasing power of the employees in the home and the host country can be equalized using the balance sheet approach. It also offsets qualitative differences between locations.

Tax equalization: Expatriates face income tax liability in the home and the host country. Tax equalization adjusts the expatriates pay to reflect taxes in the home country.

Example

Ragha Midhilesh is transferred to Denmark for a year to complete a project at the client location. His Indian employer assured him that he would continue to receive the same salary that he would have received had he not been relocated to Denmark. In the given case, the expatriate compensation is linked to tax equalization.

In this case, Ragha being assured of receiving the same salary as he gets in India is an indication that the tax liability beyond what he is liable in India will be taken care of by the company & this is tax equalization.

Source: ICFAI Research Center

Approaches to Expatriate Compensation

There are three approaches to expatriate compensation – home-based, host-based, and hybrid.

A home-country compensation system links base salary of an expatriate to the home country salary structure. For instance, the salary of a US executive transferred to Japan would be based on US as opposed to Japanese level.

In a host country-based compensation system, expatriate base salary is linked to the host country pay structure. However, supplemental compensation provisions are linked to the home-country salary structure.

A hybrid compensation system blends features from the home as well as host-based approaches. The purpose of this compensation system is to create an international expatriate workforce that while not coming from one location is paid as if it were. The simplest form of hybrid system assumes that all expatriates, regardless of the country f origin, belong to one nationality. Other forms include applying identical cost-of-living allowances to all nationalities, uniform housing, uniform premium, and other local allowances.

Other compensation approaches include lump-sum/cafeteria and negotiation approaches. In lump-sum/cafeteria approach, salary is set according to the home-country system. Firms allow a total allowance package instead of breaking compensation into component parts and expatriates make their own choices. The negotiation approach means that the employer and the employee find a mutually acceptable package. This approach is common in smaller firms with very few expatriates.

11.5.7 Culture and Compensation

The performance of a business improves when HRM practices are consistent with the national culture. In masculine cultures, work units with merit-based reward practices performed better while in feminine cultures, work units with fewer merit-based reward practices performed better. The propensity to use both skill-based and seniority-based compensation systems was positively correlated with uncertainty avoidance. Compensation practices based on individual performance were correlated with individualism. High masculinity is associated with lesser use of flexible benefits, career break schemes, child care programs, and maternity-leave programs. High collectivism is negatively related to equity-based and individual reward and merit- based promotion system.

The following recommendations are made vis-à-vis compensation in different cultures:

- In high-power distance cultures, MNEs need to pursue hierarchical compensation for local managers. Pay and benefits should be tied to the position of the local managers.
- In high individualism cultures, extrinsic and performance-based rewards are important. In low individualism cultures, group-based pay and compensation packages that reflect seniority and family needs are more acceptable.
- In cultures with high masculinity, MNEs need to pursue a compensation strategy for local managers that recognizes and rewards dominance, aggressiveness, and competitiveness. In cultures with low masculinity, compensation should focus on quality of work life, equity, and social benefits.
- In high uncertainty avoidance cultures, consistent and structured pay plans are preferable. In low uncertainty avoidance cultures, pay should be linked to performance.
- In masculine cultures with moderate to high uncertainty avoidance, policies designed to protect job security are preferred.

- In feminine cultures with moderate to high uncertainty avoidance, polices designed to protect income security are preferred.
- Employees in low-power distance and low individualistic cultures prefer flexible benefits program.
- Training and performance evaluation also varies across cultures. Management by objectives (MBO), where superiors and subordinates develop goals that can be measured, miserably fails in high-power distance culture.

11.5.8 Repatriation

Repatriation represents an adjustment equally if not more than the foreign assignment. Most returning employees are dissatisfied with the process of repatriation. Most of the US firms do not provide a written guarantee that the employee were reassigned prior to departure, and most returnees are not aware of what their next assignment will be prior to repatriation. Most of the firms do not offer spouse career counseling or other forms of family repatriation assistance. Thus it is evident from the fact that one quarter of repatriated employees leave their firm within a year of repatriation, and that many decline to accept subsequent foreign assignments.

Example

As of April 2017, Monsanto is a global provider of agricultural products with revenues in excess of $4 billion and 10,000 employees. At Monsanto, employees and their sending and receiving managers, or sponsors, develop an agreement about how this assignment will fit into the firm's business objectives. The focus is on why employees are going abroad to do the job, and what their contribution to Monsanto will be when they return. Sponsoring managers are expected to be explicit about the kind of job opportunities the expatriates will have once they return home. Once they arrive back in their home country, expatriate managers meet with cross-cultural trainers during debriefing sessions. They are also given the opportunity to showcase their experiences to their peers, subordinates, and superiors in special information exchange program that focuses on business as well as family's re-entry. This is why Monsanto offers returning employees an opportunity to work through personal difficulties. About three months after they return home, expatriates meet for three hours at work with several colleagues of their choice. The debriefing session is a conversation aided by a trained facilitator who allows the employee to share important experiences and to enlighten managers, colleagues and friends about his or her expertise so others within the organization can use some of the global knowledge.

Source: ICFAI Research Center

11.6 HRM in Foreign Affiliates

The issues and problems related to human resources (HR) vary depending on the type of foreign affiliate involved. Though wholly-owned subsidiaries (WOSs) employ three employee groups including host-country nationals (HCNs), third country nationals (TCNs), and expatriates; international joint ventures (IJVs) employ multiple groups such as (1) foreign parent(s) expatriates (i.e. nationals of the country where the headquarters of the foreign partner(s) are located, assigned by that parent to the affiliate; (2) host parent(s) transferees (i.e. HCNs employed by the host parents and transferred to the affiliated either through the host-parents headquarters or one of its subsidiaries); (3) HCNs (i.e. nationals of the host country employed by the affiliate; (4) Third-country expatriates of the host parents (i.e. TCNs assigned by the host parents to work in the affiliate); (5) Third-country expatriates of the foreign parents ((i.e. TCNs assigned by the foreign parents to work in the affiliate); (6) Third-country expatriates of the affiliate (i.e. TCNs recruited by the affiliate); (7) foreign headquarters executive (i.e. policymakers at foreign parents‟ headquarters who are board members of the affiliate or play a key role in the functioning of the affiliate at headquarters); and (8) Host headquarters executives (i.e. policymakers ate the host parents‟ headquarters, who are board members of the affiliate or play a key role in the functioning of the affiliate at headquarters).

11.6.1 HR Problems in Foreign Affiliates

The following HR problems can be expected in WOSs and IJVs:

Staffing friction: As a control measure, parent companies prefer to appoint their own transferees or expatriates for major positions in the affiliate. If the staffing policy is not specified contractually friction arises. Sometimes, friction develops regarding the level of staffing. In WOSs as well as IJVs, HCNs are deprived of opportunities for staffing the senior most positions.

Blocked promotion: In WOs and IJVs, the lack of promotion opportunities frustrate the local employees if senior positions are reserved for outsiders‟. The local employees may be reluctant to join, stay, or contribute their best to the affiliate, when such outsiders are abundant.

Exile syndrome and reentry difficulties: Feeling exiled in a foreign assignment due to fear of interruption in the career track in the home country occurs in both WOSs and IJVs. Exile syndrome can proved to be damaging for the foreign affiliate as employee may bypass their superiors in the affiliate, report only achievements leaving behind failures, and taking a short-term perspective.

Split loyalty: This problem is unique to IJVs. Employees recruited by the host or the foreign parent may remain loyal to that parent rather that shifting their loyalty to the IJV. This results in suspicion and low level of cooperation that prevents the IJV from attaining its goals.

Compensation gaps: The compensation gap problems (i.e. HCNs receiving much lower pay than expatriates) occurs in both WOSs and IJVs. For example, many US-based executives of foreign MNEs earn more than their seniors in Asia or Europe. IJVs face an additional problem of relative deprivation where employees are compensated based on affiliation with a particular parent or IJV rather than on universal criteria, such as skills, experience, etc. Every employee has a compensation policy where differences are significant. Moreover each employee group has a different perception about the desired compensation package. The result is a feeling of deprivation resulting in reduced morale and motivation.

Blocked communication: Effective communication between a parent and an affiliate and among parents can be hampered by cultural differences and varying organizational norms and procedures. Such communication blockages can impede decision making. This problem is serious in IJVs with a 50:50 equity distribution.

Limited delegation: Many parent companies maintain control of their affiliate by limiting the decision making power and scope of authority delegated by them. This is true when parents have conflicting goals, when they feel that the staff of the affiliate is loyal to the other parent, and when they depend on the affiliate for scarce and vital resources. Under these conditions, the management of the affiliate finds it difficult to operate effectively, especially in a fast-changing environment.

Information screening: Most of the firms hesitate to pass information and technology to an affiliate, especially in an IJV whose partner could be a current or future competitor. The venture may thus operate ineffectively.

Unfamiliarity: In most cases, expatriates joining a foreign affiliate are unfamiliar with the environment in which the venture operates. In case of IJVs, employees are unfamiliar with the unique organization structure and with its conflict-prone nature.

Research suggests that the HR problems can be alleviated by organization development training for working in an IJV, interpersonal and negotiation skills vital in IJV systems, identifying and rewarding leadership, opening up communication channels among parent and venture organizations, and career planning.

Check Your Progress - 1

1. __________________________is defined as human resources, management issues, functions and policies and practices that result from the strategic activities of MNEs and that impact the international concerns and goals of these enterprises.

   a. Strategic human resource management

   b. International human resource management

   c. Strategic international human resource management

   d. Performance management

2. The SIHRM model has which of the following orientations?
   i. The exportive system
   ii. The adaptive system
   iii. The integrative system
   iv. The effective system
   v. All of the above
   a. ii, iii, and iv
   b. i, ii, and iii
   c. v
   d. i, ii, and iv
3. Factors affecting MNE staffing include strategy, ___________________, and subsidiary-specific factors.
   a. Organizational structure
   b. Organization development
   c. Organizational culture
   d. Training and development
4. In _____________, PCNs are chosen for key positions regardless of the location.
   a. Polycentric
   b. Ethnocentric
   c. Regiocentric
   d. Geocentric
5. In _____________, HCNs are hired at the subsidiaries of key positions but not at the corporate headquarters.
   a. Ethnocentric
   b. Regiocentric
   c. Polycentric
   d. Geocentric
6. In _____________, recruiting is done on a regional basis.
   a. Regiocentric
   b. Geocentric
   c. Polycentric
   d. Ethnocentric
7. In _____________, the best managers are recruited worldwide regardless of their nationality.
   a. Polycentric
   b. Geocentric
   c. Ethnocentric
   d. Regiocentric

8. The ___________, older and experienced is selected for his/her managerial and technical skills for on to five years.
   a. Traditional expatriate
   b. International cadres
   c. Temporaries
   d. Expatriate trainee
9. ________are individuals moving from one foreign assignment to another.
   a. Virtual expatriate
   b. Temporaries
   c. International cadres
   d. expatriate Trainee
10. _______expatriates are sent on local hire terms for six months to five years.
    a. Temporaries
    b. Young, inexperienced
    c. Virtual
    d. Traditional
11. ___________go on short on short assignments for up to a year.
    a. Young, inexperienced expatriates
    b. Temporaries
    c. Virtual expatriates
    d. None of the above
12. _________is placed overseas for the purpose of training as part of initiation into an MNE.
    a. Traditional expatriate
    b. Virtual expatriate
    c. Expatriate trainee
    d. Young, experienced expatriates
13. The _____takes on foreign assignment without relocating physically.
    a. Temporaries
    b. Expatriate trainee
    c. Virtual expatriate
    d. None of the above
14. Successful expatriates need which sets of skills?
    a. Personal skills
    b. People skills
    c. Perception skills
    d. All of the above

15. Expatriate compensation comprises which of the following elements?
    - i. Salary
    - ii. Housing
    - iii. Services allowance and premiums
    - iv. Tax equalization
    - v. Fringe benefits
    - a. i, ii, iii, and iv
    - b. ii, iii, iv and v
    - c. i, ii, iv, and v
    - d. i, iii, iv and v
16. A _____________compensation system links base salary of an expatriate to the home country salary structure.
    - a. Host-country-based
    - b. Home-country-based
    - c. Hybrid
    - d. None of the above
17. In a _____compensation system, expatriate base salary is linked to the host country pay structure.
    - a. Hybrid
    - b. Host-country
    - c. Home-country
    - d. None of the above
18. A _____compensation system blends features from the home as well as host-based approaches.
    - a. Host-country
    - b. Hybrid
    - c. Home-country
    - d. None of the above
19. In _____approach, salary is set according to the home-country system.
    - a. Host-country
    - b. Lump-sum/cafeteria
    - c. Home-country
    - d. Negotiation
20. The ___________approach means that the employer and the employee find a mutually acceptable package.
    - a. Host-country
    - b. Negotiation
    - c. Lump/sum cafeteria
    - d. Home-country

21. HR problems that can be expected in WOSs and IJVs include
    i. Staffing friction, blocked promotion, exile syndrome and reentry difficulties
    ii. Split loyalty, compensation gaps, blocked communication
    iii. Limited delegation, information screening, and unfamiliarity
    iv. Data analysis
    v. Performance appraisal
    a. i, ii, and iv
    b. iii, iv, and v
    c. i, ii, and iii
    d. i, iv, and v

11.7 Summary

- Strategic International Human Resource Management (SIHRM) is defined as human resources, management issues, functions and policies and practices that result from the strategic activities of MNEs and that impact the international concerns and goals of these enterprises.
- Firms seeking to internalize their boards commence by selecting someone who is similar culturally to existing members but has an international perspective. In the next phase, firms look for individuals with in-depth business and cultural experience in a given part of the world.
- There are different types of expatriates such as the traditional expatriate; international cadres; young, inexperienced expatriates; temporaries; expatriate trainee; and virtual expatriate.
- MNEs use expatriates to get the business off the ground, put in the infrastructure, and, more importantly, have a plan to change the mix of expatriates versus nationals.
- Expatriate failure occurs when the assignee returns prematurely to the home country or when his/her performance does not meet expectations.
- MNEs look for several attributes in an expatriate including cultural empathy, language skills, adaptability and flexibility, education, maturity, motivation, and leadership.
- Five determinants of cross-cultural adjustment include: previous overseas experience; pre-departure cross-cultural training; multiple candidate, multiple-criteria selection; individual skills, and perceptual skills; and non-work factors such as cultural distance and spouse and family adjustment.

- MNE compensation programs focus on attracting and retaining qualified employees, facilitating transfer between the headquarters and the affiliates, and creating consistency and equity in compensation, and maintaining competitiveness.
- There are three approaches to expatriate compensation – home-based, host-based, and hybrid.
- HR problems that can be expected in WOSs and IJVs include staffing friction, blocked promotion, exile syndrome and reentry difficulties, split loyalty, compensation gaps, blocked communication, limited delegation, information screening, and unfamiliarity.

11.8 Glossary

Adaptive system – A SIHRM Model that imitates local human resource management (HRM) practices.

Ethnocentric staffing – Parent company nationals or PCNs) are chosen for key positions regardless of the location.

Expatriate failure – It occurs when the assignee returns prematurely to the home country or when his/her performance does not meet expectations.

Expatriate trainee – A trainee who is placed overseas for the purpose of training as part of initiation into an MNE.

Experiential learning training – It combines cognitive and behavioral techniques with the goal to acquire intercultural effectiveness skills including relationship building, stress management, cross-cultural communication, and negotiation techniques.

Exportive system - A SIHRM Model that that replicates the HRM system in the home country and other affiliates.

Geocentric staffing – Recruiting of best managers worldwide regardless of their nationality

Home-country compensation system – This form of expatriate compensation system links base salary of an expatriate to the home country salary structure.

Host country-based compensation system – In this form of expatriate compensation system expatriate base salary is linked to the host country pay structure.

Hybrid compensation system - Blends features from the home as well as host based approaches. The purpose of this compensation system is to create an international expatriate workforce that while not coming from one location is paid as if it were.

Information giving training - Consists of practical information on living conditions in the destination country, area studies, which includes facts about the country's macro-environment, and cultural awareness information.

Integrative system – A SIHRM Model that emphasizes on global integration while allowing for some variations.

International cadres - Individuals moving from one foreign assignment to another who seldom return to their home country and sometimes become permanent expatriates

International human resource management (IHRM) - Refers to the procurement, allocation, utilization, and motivation of human resources in the international arena.

Lump-sum/cafeteria approach - Salary is set according to the home country system. Firms allow a total allowance package instead of breaking compensation into component parts and expatriates make their own choices.

Optimal SIHRM - Strategy chosen by the parent in conjunction with the specific conditions of the affiliate that determines the degree of similarity in SIHRM between the headquarters and the affiliate.

Overseas Assignment Inventory (OAI) - Developed by Tucker International, this instrument uses success predictors on a foreign assignment: open-mindedness, trust in people, expectations, respect for others‟ beliefs, locus of control, tolerance, patience, flexibility, social adaptability, initiative, risk taking, sense of humor, and spouse communication.

Polycentric staffing – Host country nationals or HCNs are hired at the subsidiaries of key positions but not at the corporate headquarters.

Regiocentric staffing – In this type of staffing, recruiting is done on a regional basis

Strategic international human resource management (SIHRM) - Defined as "human resources, management issues, functions and policies and practices that result from the strategic activities of MNEs and that impact the international concerns and goals of these enterprises."

The negotiation approach - Means that the employer and the employee find a mutually acceptable package.

Traditional expatriate - Older and experienced expatriate selected for his/her managerial and technical skills for on to five years.

Virtual expatriate – Takes on foreign assignment without relocating physically. The virtual expatriate uses telecommunications and videoconferencing to stay in touch.

11.9 Self-Assessment Test

1. Define strategic international human resource management.
2. Explain how an MNE staff its operations.
3. Describe the concept of expatriate workforce.
4. Describe human resource problems in foreign affiliates.

11.10 Suggested Readings/Reference Material

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11.11 Answers to Check Your Progress Questions

1. (c) Strategic international human resource management

Strategic international human resource management (SIHRM) is defined as human resources, management issues, functions and policies and practices that result from the strategic activities of MNEs and that impact the international concerns and goals of these enterprises.

2. (b) **i, ii, and iii**

   The SIHRM model has three orientations:

   - The adaptive system
   - The exportive system
   - The integrative system

3. (a) **Organizational structure**

   Factors affecting MNE staffing include strategy, organizational structure, and subsidiary-specific factors

4. (a) **Ethnocentric**

   In ethnocentric staffing, PCNs are chosen for key positions regardless of the location.

5. (c) **Polycentric**

   In polycentric staffing, HCNs are hired at the subsidiaries of key positions but not at the corporate headquarters.

6. (a) **Regiocentric**

   In regiocentric staffing, recruiting is done on a regional basis.

7. (b) **Geocentric**

   In geocentric staffing, the best managers are recruited worldwide regardless of their nationality.

8. (a) **Traditional expatriate**

   The traditional expatriate, older and experienced is selected for his/her managerial and technical skills for on to five years.

9. (c) **International cadres**

   International cadres are individuals moving from one foreign assignment to another.

10. (b) **Young, inexperienced**

    Young, inexperienced expatriates are sent on local hire terms for six months to five years.

11. (b) **Temporaries**

    Temporaries go on short on short assignments for up to a year.

12. (c) **Expatriate trainee**

    Expatriate trainee is placed overseas for the purpose of training as part of initiation into an MNE.

13. (c) Virtual expatriate

The virtual expatriate takes on foreign assignment without relocating physically.

14. (d) All of the above

Successful expatriates need three sets of skills – personal skills, people skills, and perception skills.

15. (b) i, ii, iii, and iv

Expatriate compensation comprises the following elements:

Salary, housing services allowance and premiums, and tax equalization.

16. (b) Home country-based

A home-country compensation system links base salary of an expatriate to the home country salary structure.

17. (b) Host country-based

In a host country-based compensation system, expatriate base salary is linked to the host country pay structure.

18. (b) Hybrid

A hybrid compensation system blends features from the home as well as host-based approaches.

19. (b) Lump/sum cafeteria

In lump-sum/cafeteria approach, salary is set according to the home-country system.

20. (b) Negotiation

The negotiation approach means that the employer and the employee find a mutually acceptable package.

21. (c) i, ii, and iii

HR problems that can be expected in WOSs and IJVs include staffing friction, blocked promotion, exile syndrome and reentry difficulties, split loyalty, compensation gaps, blocked communication, limited delegation, information screening, and unfamiliarity.

Unit 12

Global Marketing and Supply Chain

Structure

"Good company will meet needs; great companies will create markets"

– Philip Kotler

12.1 Introduction

The previous unit defined strategic international human resource management. It then explained how staffing takes place in MNEs. It then discussed the concept of expatriates; their selection and failure; how they are trained and compensated; and recommendations on how expatriates should be compensated in different cultures. The unit finally discussed the human resource problems faced by MNEs in foreign affiliates.

International markets are more complex but offer vast opportunities for firms with a product or a service potentially in demand abroad. Newness, appropriate marketing strategies, and cultural attractiveness welcome a product in international markets.

Globalization forces include emergence of global brands, potential savings in costs, technological advances, and lower trade barriers. Localization forces include country level factors that affect product introduction and adaptation.

In recent years, supply chains have undergone substantial globalization with firms consolidating sourcing and distribution operations.

This unit will discuss how the market potential of a foreign country can be determined. It then goes on to explaining the concepts of globalization and localization in international markets. The unit finally discusses how supply chains are globalized.

12.2 Objectives

By the end of this unit, students should be able to:

- Discuss how market potential of a foreign country is assessed.
- Explain the concepts of globalization and localization in the context of international marketing.
- Outline how supply chains are globalized.

12.3 The International Marketing Challenge

The essence of international marketing, especially in global industries is that competition can come from anywhere on the globe. The country in which the product originates can help but is no guarantee of success.

Success in international markets depends on many skills such as accurate assessment of market potential; selection of the right product mix, and appropriate adjustments in pricing, packaging, advertising, and distribution. Cultural values and social customs, rules and regulations, economic conditions and political realities constitute the context within which international marketing takes place.

Example

According to a study conducted by KPMG, 85% of Indian consumers in post COVID-19 started saving money despite a 10% fall in income. 78% of Generation X (born between 1965 -1980) and 70% of millennials (born between 1980-1995) are more concerned about their finances. Here the international marketing challenge pointed out is economic conditions.

Source: ICFAI Research Center

12.3.1 Assessing Market Potential

For assessing market potential, firms seek to identify aggregate demand for a product or a service and estimate the costs associated with product introduction and distribution. In deciding market priority, profitability, accessibility, and market size play a major role. The size of the population reveals a little about short-term market potential.

Population growth offers a coarse estimate of future market potential. For instance, Japan and many European Union countries face low and negative population growth forecasts whereas most of the Asian countries show a rapid population growth. The single most indicator of market potential is economic development and its correlate of disposable income. The consumer's ability to afford certain products and services are found by nominal income figures. Purchasing power parity (PPP) is "an index used to adjust nominal figures to the purchasing power of local consumers."

Market potential is also influenced by consumption patterns. The French drink six times more wine than the British do. Consumption patterns are dynamic and current patterns need to be interpreted with caution. Often consumption is driven by factors different than those in domestic markets. For instance, BCG research indicates that in some developed economies such as Colombia or the Philippines, Coca-Cola is a substitute for non-drinkable water.

To assess market potential within the context of corporate strategy, firms carry out marketing research. The research aims at finding solutions to questions such as (a) what are the objectives to be pursued by firms in foreign markets?; (b) what foreign markets segments to be pursued?; (c) Which are the best product, distribution, pricing, and promotion strategies; and (d) what must be the product-market-company-mix be for taking advantage of the available foreign marketing opportunities?

12.4 Globalization and Localization in International Markets

Striking a balance between globalization and localization is a key challenge. Lack of marketing globalization had proved detrimental to performance, however, the same stands true for indiscriminate standardization of marketing practices without any attention to localization factors.

In the marketing sense, globalization is "the standardization of products (or services), brands, marketing, advertising, and the supply chain across countries and regions." In contrast, localization is "the adjustment of one or more of the above elements to be idiosyncratic characteristics of a given national market."

- The major challenge for the MNE is fine-tuning the globalization-localization balance.
- Globalization forces
- The function of marketing can be coordinated increasingly on a global basis.

12.4.1 Global Brands

Behind the trend of globalization, there is an assumption that many consumer and industrial products can be standardized. For instance, Kellogg designated Special K, Corn Flakes, Frosted Flakes, Nutri-Grain bars, and Fruit Loops as "global brands".

Global products are products that are recognized worldwide and are unaltered in terms of appearance and brand when sold abroad. To be designated global, products should be sold throughout the world under the same brand name with over US$ 1 billion in sales and over 5 percent of those sales coming from outside the home market.

The primary motivation toward product and service globalization is to gain scale economies. Selling the same product using the same distribution channel and promotional message reduces cost. Globalization allows firms to leverage the experience they gain in one market toward another, using communication technologies, for facilitating integration and coordination. Moreover, the appeal of a global product can be a crucial selling point for some customers.

12.4.2 Marketing Repercussions of a Global Approach

Some of the key ramifications of globalizing the marketing function are described below:

- Rapid roll-out of new products across major markets, preventing competitors from introducing similar products in new markets.

Example:

Nothing, a London-based TWS (True Wireless Stereo) company established in 2020, launched its first product ear (1) in 2021 in India. After getting the success, it planned to launch new products aggressively back-to-back in 2022 and thereby not giving room to its competitors to chase.

Rapid roll-out of new products is the key ramifications of globalizing marketing is highlighted in the given case. Here, the aggressive rollout of new products is the ramification for competitors, which prevent from introducing new products. The case of Nothing highlighted the ramification of globalizing marketing by rapid rollout of new products that prevent competitors from introducing similar products.

Source: ICFAI Research Center

- Prioritizing and targeting a product across markets, limiting local product offerings.
- Uniform branding and advertising globally creates a consistent message, reassures customers with global reach, and reducing cost and duplication. This enhances entering the crowded shelves of retailers that display only best-selling brands.
- Manufacturing relatively standardized products to scale economies. Transferring of marketing best practices across borders.

A by-product of the increased globalization of the function of marketing is erosion in the authority of country managers. Country managers have less control over pricing, marketing budget, and other key marketing decisions. Though they usually maintain control over local brands and have some say in new product development, their influence over the marketing of global brands in their country of jurisdiction is on the decline. National brand managers are rare, and frequently report directly to a global marketing group as opposed to the country manager.

While marketing globalization is evident worldwide, there are significant differences in how MNEs approach it from different countries.

12.4.3 Localization Forces

Localization forces represent pressures toward adjustment in product marketing or distribution for making it more appealing or for meeting requirements particular to a foreign market.

Following a spate of alleged product contamination in foreign markets, Coca-Cola executives noted that the firm's motto "think globally and act locally" need to be changed to "think locally and act locally". Despite globalization, local conditions and content remain vital.

Cross-national variations have a major impact on marketing. The income level differences create different consumer requirements. Diverse regulatory regimes put different constraints on product design, packaging and promotion. Even in the European Union, where trademarks and logotype are relatively standardized, pricing, promotion, and media-mix are far from uniform. Public opinion and social attitudes also make a difference. For instance, Kellogg's Nutri-Grain was successful in the US but did not do as well in the UK, where health consciousness was not strained at that time.

Another major influence is culture. Cultures on high uncertainty avoidance and power distance emphasizes on appearance for reaffirming one's status and for reducing uncertainty regarding others‟ positions. Culture also has an influence on sale practices. In high-power distance cultures, a sales pitch is made in a formal manner whereas it is likely to be personalized individualistic countries.

Cultural and social customs also shape the context in which the product is utilized. For instance, McDonald's restaurants in mainland China, Hong Kong, and Taiwan serve as bases for social activity in late mornings for seniors and in afternoons for school children.

12.4.4 Product Adaptation

Facing a foreign market with different characteristics, a firm may choose not to offer a product or a service in that market, to offer the same product it offers in other markets, or adapt it to country or regional markets. Firms use benefit/cost and user/needs for making decisions. Benefit/cost models evaluate the advantages and disadvantages of a product or a distribute mode in a given market. User/need models test the needs of prospective customers, including the circumstances in which the product or service may be used. The analysis yields a decision for customizing or standardizing the product and/or promotion and distribution.

For the MNE, a fine balance is required for global marketing. While making adjustments to local tastes and customs, it is equally important for the MNE to leverage its global reputation and name recognition.

The challenge of adaptation exceeds to all aspects of marketing. OfficeMax and Office Depot launched their outlets in Japan as replicas of their US-based large, warehouse type discount stores. They discovered that the global efficiencies derived were insufficient to compensate for local rents and unwillingness to buy in an impersonal, warehouse-type store. Accordingly, the firms changed their strategies.

12.4.5 Country-of-origin Effect

Country-of-origin effect is "the influence of the country of manufacturing image on the buying decision." The effect comprises dimensions such as innovativeness, namely using new technology and engineering advances; design, namely style, appearance, color, and variety; prestige, brand name reputation, status, and workmanship, including reliability, durability, craftsmanship, and manufacturing quality. The country-of-origin has an influence on the perception of the buyers. The impact has more to do with perception than reality. For instance, British firms are not associated with many strong products and innovations they have created actually.

Overtime, the country-of-origin effect changes. In the 1960s, Japanese products had a reputation of substandard quality and it was decades before the country set a reputation for quality manufacturing. As products from developed nations tend to receive higher evaluation, a country moving into the ranks of developed economies may also enhance their products‟ reputation. Firms from emerging economies also engage in activities that enhance reputation of their products.

Leveraging Positive Country Image

Country image differs across product categories. German automakers take advantage of the country's reputation for advanced engineering, reliability, and quality. Some countries may be noted for a single product. For instance, Russian caviar or Iranian carpets.

A positive country image minimizes customization that is not inherent to product use. To highlight the national origin of the product, the original appearance and packaging will be preserved to the extent permitted by law.

Leveraging Nationalist Sentiments

Country-of-origin might serve as a patriotic appeal for buying domestic products. Many countries carry out campaigns that urge customers to buy local products in order to support the local industry and employment.

At times, supporting domestic products may extend to disparagement of foreign products. Japanese farmers place ads in local newspapers accusing orange growers in the US of spreading Agent Orange on their fruit. (Agent Orange is a chemical used by the US armed forces in Vietnam for retarding vegetation growth).

Some foreign firms make attempts to disarm nationalist sentiment by emphasizing the local content in their product. Local content is "the portion of a product (or service) that includes locally made and procured inputs." For instance, Airbus in its ads outlines its US suppliers.

Others may downplay the foreign origin of the product, using packaging and brand names reflecting local heritage. In Russia, the "the beloved taste of real Russian butter" appears on the package of butter from New Zealand.

Often MNEs point out that local firms do not essentially suffer from entry. For instance, an Israeli burger chain, Burger Ranch, continued to prosper following the entry of Burger King and McDonald's, which greatly increased the overall market.

12.4.6 Branding

Branding is "the process of creating and supporting positive perceptions associated with a product or service." Branding is complex in global markets, especially given varying demand and environmental characteristics.

Example

Mercedes Benz attempted to promote its range of cars in China by translating its name into the Chinese language. By mistake, it translated the word Benz to Bensi. This made Chinese customers nervous as the word Bensi means 'rush to die'. Later, Mercedes changed the word from Bensi to Benchi, which means 'run quickly as flying'.

In the given case, branding as an element of globalization and localization is showcased. Mercedes Benz had a mistake while translating its brand into the Chinese language to give a local touch.

Source: ICFAI Research Center

12.4.7 Channel Decisions

Channel decisions involve the length (the number of intermediaries or levels employed in the process of distribution) and width (the number of firms in each level) of the channel used to link manufacturers to consumers. In business-to-business sales, channel decisions are more important than brand name, pricing, and advertising. Localization is pronounced especially among affiliates in the UK, perhaps due to the assumption of cultural similarity.

Intermediation

Most of the international sales are not made by firms directly but through export intermediaries. Export intermediaries are firms mediating between firms, especially Small and Medium Sized International Enterprises (SMIEs) and their export markets, by offering, logistics, documentation and related services. For smaller firms, intermediaries play a key role, though some MNEs prefer outsourcing of this function.

Direct Marketing

Direct marketing involves direct sales to customers through individual agents who make a commission on their sales, in addition on the sales by agents recruited by them. The pioneers of the direct marketing system are Avon and Mary Kay. It was adopted eventually by manufacturers of other products.

The image of direct selling is quite low especially in Asia. In Japan, Avon found that its system of making sales to random groups was ineffective as people were reluctant to invite strangers into their home. However, the direct marketing prospered after it started relying on groups of friends or acquaintances.

Niche Marketing

Niche marketing is directed in a narrow manner toward a pre-defined market segment. In international markets, niche marketing maybe directed toward not only to a product category but also to a geographical or an ethnic segment. Convencao, a small soft-drink company in Brazil cut into the market share of beverage industry giants Coca-Cola and Pepsi, by offering lower-priced products in its home market. A niche may also serve as a base for expansion, however, Timberland, originally known for its weather-proofed boots, exported casual wear to over 50 countries, including Italy.

12.4.8 Pricing

Pricing is the process and decision to set a price for a product or a service. In international markets, pricing is more complex due to varying cost structures (e.g. tariffs, transportation costs) and market positioning.

Price differentials facilitate market segmentation that allows firms to position their products differentially in different markets. Where there is little competition and consumer resistance to price increases is low, firms increase the price of their products. Or firms may price a brand higher so they can position it as “premium”.

Price consistency is not easy to achieve. For example, some subsidiaries offer a higher service level than others. Host government decisions also have an influence over price. The Turkish government imposes an 80 percent import tax on all vehicle imports thus protecting domestic manufacturers as well as the international firms manufacturing in Turkey.

Predatory Pricing

Predatory pricing is the selling of goods at prices that are below the real cost in order to drive competition out of the market. For instance, it was alleged that Matsushita priced its Panasonic TV sets below cost in the US, subsidizing sales with its high margins in the Japanese market and driving US manufacturers out of business.

12.4.9 Promotion

Globalization can yield substantial savings in promotion. General Motors Europe uses a unified promotional approach to drive brand identity. However, the company recognizes the need for adaptation in some markets.

Advertising

Advertising needs to be adjusted to local tastes, regulations, and norms to make it effective in international markets. When Lego exported its successful advertising in the US to Japan, it flopped. Lego discovered that moving advertising across borders is difficult linguistically, socially, and culturally.

The standardization of advertising can be considerable. Standardization provides a consistent and coherent message and greatly reduces production cost by spreading it across multiple markets. For instance, Coca-Cola, Benetton, and Ford have launched global advertising campaigns.

As the firms globalize their marketing, firms increasingly seek advertising agencies with global reach for providing a one-stop shop. For instance, Kellogg assigned responsibilities for of its global brands to J Walter Thompson and Leo Burnett.

Activity 12.1

RS Steel Ltd. (RS Steel), a Brazilian steel company is a leading player in the steel industry. Of late, the company faced competition from a local steel manufacturer, XYZ Steel Co. To add to its troubles, a US-based steel company, ABC Steels was also capturing a significant share in the Brazilian steel market. To regain its market share, RS Steel decreased the price of its steel below the real cost. Identify the practice adopted by RS Steel. Also discuss other channel decisions taken by firms.

Answer:

12.4.10 Marketing Alliances

International strategic alliances are a major venue for market entry. Such alliances and mergers and acquisitions allow a firm to quickly establish itself in a foreign market. Interbrew based in Leuven, Belgium grew from a smaller family-owned brewery to the second largest brewer in the world and the owner of hundreds of brands though acquisitions. Marketing alliances can also be formed between large firms.

All marketing alliances do not prosper. For instance, Timex established an alliance with Titan in India. Timex offered low-end watches, whereas Titan offered high-end luxury watches. Titan shops serviced Timex watches while Timex had access to Titan‟s dealers and showrooms. In return, Titan has access to low-cost mass production market through Timex. With the changing of market conditions, the firms decided to enter other segments and in 1997 they eventually decided to break up the alliance.

12.5 The Global Supply Chain

Global supply chain covers both logistics and operations. It includes activities such as sourcing, procurement, order processing, manufacturing, warehousing, inventory control, servicing and warranty, custom cleaning, wholesaling, and distribution. In a firm‟s global strategy, supply chain management plays a key component, influencing key decisions such as plant and service location.

The costs of logistics have declined in recent years. The decline reflects increasing efficiencies such as the incorporation of Just-in-time and the resulting decrease in inventory levels.

Issues such as international shipping costs, currency translation, language, customs documentation, and cross-border financial settlement are beginning to be addressed.

12.5.1 The Globalization of Supply Chains

Firms increasingly consolidate production and distribution in some strategic locations for ensuring effective delivery of a product or a service. The shift from domestic to global supply chains is due rapidly escalating capital costs and enhanced technologies as well as regional integration. The evolution of flexible manufacturing systems had enabled mass customization for meeting demands of the consumers at reasonable costs. Consolidation of transport industry facilitates seamless transportation. Developments in management information systems permit accurate tracking of material flow and variable customer demands.

Where integration has progressed as in the EU, standardized regulations have replaced local rules, enhancing consolidation. With nations being increasingly served with logistic centers in other countries, geographic designs become less of an option for MNEs. Other repercussions of globalization of supply chain are increased transportation from and to transportation centers, extended supply and distribution chains, and more small-volume transactions.

Box 1: The Challenge for SMIEs

SMIEs do not have the necessary economies for justifying a specialized facility. Mutualization is one solution where the logistic facilities are shared by two or more partners. Some SMIEs form alliances with local firms as the local partner may already have the logistic component or a long-term logistic provider, which makes the foreign firms to consolidate its supply chain locally. Another solution for SMIEs is sourcing logistic services from third parties. In such alliances, the shipper leads strategy formulation while the provider leads day-to-day operations. There exists a sole key provider with whom the manufacturers establish a close working relationship.

Compiled from various sources.

12.5.2 Global Sourcing

Global sourcing is "the procurement of production or service inputs or components in international markets." Global sourcing provides an opportunity to the MNE for leveraging its scale and competitive advantage in spotting opportunities for procurement worldwide for use in its various locations and divisions. For instance, Wal-Mart, because of its scale, uses its huge volume for extracting lower prices from its customers.

MNEs are also increasingly using outsourcing or buying the inputs outside their network. Some firms may even outsource the logistic function itself.

Logistic Providers

While one-stop international provision of logistic provision continues to be the ultimate goal, national services may be replaced by regional providers. For instance, Texas Instruments Semiconductors Group contracts with a key logistic provider for managing forwarding and distribution in each region of the world.

12.5.3 Customizing the Supply Chain

As the globalization of supply chain proceeds, several factors require continuous attention to localization and customization. Localization is supported by three factors – variation among national environments, product customization that triggers logistic adjustments, and existence of national borders that impede the free flow of goods and services thus limiting global solutions. Advantages such as the incorporation of suppliers‟ input at the phase of product design heighten dependencies and logistic challenges accompanying the need to control and coordinate them.

National Variation

World regions vary in size, terrain, and other characteristics that have an impact on the supply chain. For instance, the land area of NAFTA is over six time than that of the EU. Quality of supplies, skill level, availability of process equipment and technologies, and the level of transportation and communications differ substantially among regions. Asia, large parts of the Middle East, Africa, and Latin America suffer from poor infrastructure. Though Asian infrastructure is relatively weak, Singapore has superb infrastructure in terms of both shipping and air.

Conditions often vary even among developed nations. For instance, in the US, it takes three weeks for breakfast cereals to reach the retailers‟ shelves from the time of manufacturing but it takes eleven weeks in France. This explains why domestic supply chains continue to dominate the transfer of goods. In addition, increased foreign direct investment in local production base creates even more reliance on domestic supply chains. A great number of intermediaries and fragmented supply chains add to the problem.

Product and Logistic Customization

Product customization challenges the characteristics of supply chain management as it impacts modularity, packaging, transportation, shipping, tracking, and distribution. A postponement strategy designed for delaying customization to the latest value-adding phase is not feasible always without compromising on product variety. For instance, Meritor which used to provide several automotive parts in North America, now manufactures only suspension systems, roofs, and doors but provides them to car manufacturers across the globe.

12.5.4 Packaging

Standardization in packaging appeals for logistics ease and also promotes brand recognition. Coca-Cola uses similar color and logo to enhance its brands. Standardization in packaging results in savings in design and promotion costs. Packaging size must also be adapted as well. Where space is scarce, bulk packaging is less attractive, for instance, Japanese households.

Some adaptations are essential for logistic reasons. For instance, sturdier packaging is required to shield the product from outside elements in a harsh environment. Other adaptations are needed to meet legal requirements. Various laws govern safety requirements.

The new German Packaging Act (VerpackG) entered into force on 1st January 2019. The aim of the law is to reduce the negative impacts of packaging waste on the environment and to significantly increase recycling rates. *(Source: https://deutsche-recycling.com/packaging-regulation/)*

In most of the countries, labels should be printed in the local language, adding time and cost to distribution. The US requires all food products to carry labels indicating their nutritional value. Many countries also require clear labeling of the product's country source. In the US, US content should be disclosed on textiles, cars, wool, and fur products.

Some packaging adaptations are essential for cultural or religious reasons. For instance, Hogla-Kimberly, a joint venture between an Israeli manufacturer and Kimberly Clark, sell diaper to the orthodox segment in Israel in a specially designed, easy-to-prop open packaging that met the religious requirements for doing no work on the Sabbath.

Activity 12.2

KK Foods Ltd., a US-based snacks company has operations in many countries throughout the world. In order to save costs, the company standardized its packaging while printing labels in the local language where it distributed its food products. However, in the US, the company had display nutritional value of each food item. Explain why packaging cannot be standardized in some countries and also state various reasons why adaptations in packaging are needed.

Answer:

12.5.5 Transportation Modes

Customer demands can be met in a timely and cost-effective manner by effective modes of transportation. One of the driving forces behind intermodal transportation is globalization. Intermodal transportation is a term that denotes "the combination of ocean vessels (including short sea shipping), river transport, rail, road links, and air transport within a seamless supply chain." However, intermodality represents many challenges. Comparing prices of alternative modes of transportation is difficult because price is based on several products (e.g. value, weight, space) and non-product (e.g. custom administrative procedures, port of the shipment) factors. Intermodality also requires standardization and modularity to permit frequent transfer of goods from one mode to another. Other obstacles to intermodality and seamless logistics lie at the political and legal level. For instance, regulations in Thailand require warehousing and transport to be handled by separate companies.

Maritime Transportation

Over 90 percent of the international trade is served by maritime transportation. Most of the US-Mexico trade was handled by 9 ports, of the 29 border crossing points between the US and Mexico.

Impediments to further globalization of maritime transport include the issuance of "flags of convenience" that is registering ships in countries with less stringent regulations such as Panama and Liberia. Such registries less stringent safety standards and confer labor and tax benefits but they do not raise opposition in some of the countries in which the MNEs operate.

Port Facilities

Port facilities represent a vital ingredient in the convenience and cost of maritime transport. According to a report by Conference Board, the most competitive ports offer low cost, speed processing, and superb intermodal links. Ports are of four types –

(1) The maritime hub – dedicated to transshipment from an ocean vessel to a feeder or another vessel; (2) The gateway port – an interchange between the maritime hub and maritime and/or land transport; (3) The logistic-industrial port – interchange between modes of transport combined with logistic support; and (4) The trade port – logistic activities together with other value-added international trade services.

Singapore and Hong Kong are the two largest container ports in the world, which together have 44 percent of the container lifts in the world. Non-hub ports can compete by adopting niche strategies. One port strategy is to specialize in a particular product line in order to achieve economies of scale.

Ports as key links in the global supply chain face the challenge to accommodate local distribution. For instance, to integrate domestic and international shipping for accommodating situations such as when the final destination is closer to the port as opposed to rail transportation.

The Inland Port

In central Ohio, "Port Columbus" is an inland port. It utilizes 86 million square feet of warehousing and distribution facilities on the grounds of a former air force base. The port has arteries to highways, airports, and rail and coastal port access through agreements with the ports of Los Angeles, New York/New Jersey, and Virginia. Countries with vast underdeveloped hinterland show immense interest in the inland port concept in a bid to improve access to less developed regions.

Trucking

Trucking plays an important role in international trade in geographically contiguous areas such as Texas/Mexico and Hong Kong/Shenzhen in southern China as in Europe, where distances are relatively short. Trucks are also vital in the domestic distribution of products delivered internationally by rail, air, or ship. The utilization of containers had made such intermodality substantially easier.

While Europe, the US, and other developed countries have standardized safety and other regulations related to motor vehicles, there remained substantial impediments to the globalization and standardization of truck transportation. For example, there are different conventions regarding the use of rentals, manufacturers' fleet, and so forth.

Traffic congestion is costly to trucking in terms of high energy costs, delayed shipments, deteriorating service quality, and lower productivity of vehicles and workforce. Developing countries such as Iran and China have less congestion problems but a higher proportion of unpaved roads in the US and other developed countries impose serious constraints on the domestic transportation of goods.

Rail

Rail transportation is considered to be an attractive mode of transportation domestically and internationally due to its competitive time to cost ratio as well as road and sky congestion. For instance, nearly half of the grain exports from the US are transported to Mexico by rail. Where rails are not contiguous, railways can still play a crucial role as part of intermodal transportation.

Air Transport

Air transportation was initially confined to high value or perishable items. It is now increasingly used when logistics infrastructure is in place and speed of transportation is vital. A major impediment to globalization of air transport is the stringent safety standards imposed by developed nations, especially the EU and the US, vis-à-vis the lax regimes common in most of the developing countries. If the safety standards are not complied, the US does not permit the landing of foreign aircraft.

Crossing National Borders

A seamless supply chain spanning national borders is difficult to be established. Customs inspection, processing, and other barriers associated with crossing borders create unpredictable and costly delays.

The NAFTA agreement offers for substantial non-tariff movement of goods across the US, Canada, and Mexico, on the condition that goods originate from one of these three countries. For this to take place, substantial documentation is essential for establishing country-of-origin source. Moreover, shortage of border-crossing points, rails, docks, and bridges undermine traffic expansion.

In the aftermath of the September 11, 2001 terrorist attacks in the US, border delays have worsened considerably in many parts of the world, including major borders such as the US and Canada. Though the delays since then have shortened, they show that global logistics is vulnerable to the problem of overlapping international boundaries and the expected contingencies that characterize the global supply chain and other facets of international business.

Check Your Progress - 1

1. _______________ is an index used to adjust nominal figures to the purchasing power of local consumers.
   a. Purchasing power parity
   b. Income levels
   c. Consumption patterns
   d. National income
2. _______________is the standardization of products (or services), brands, marketing, advertising, and the supply chain across countries and regions.
   a. Localization
   b. Globalization
   c. Customization
   d. Standardization
3. _______________ is the adjustment of one or more of the above elements to be idiosyncratic characteristics of a given national market.
   a. Globalization
   b. Glocalization
   c. Localization
   d. None of the above

4. _______________evaluate the advantages and disadvantages of a product or a distribute mode in a given market.
   a. User/need models
   b. Benefit/cost model
   c. Customized model
   d. Standardized model
5. _______________test the needs of prospective customers, including the circumstances in which the product or service may be used.
   a. Customized model
   b. User/need models
   c. Benefit/cost model
   d. None of the above
6. Branding is the process of creating and supporting positive perceptions associated with a product or service.
   a. Pricing
   b. Packaging
   c. Branding
   d. Promotion
7. _______________involves direct sales to customers through individual agents who make a commission on their sales, in addition on the sales by agents recruited by them.
   a. Niche marketing
   b. Direct marketing
   c. Online marketing
   d. None of the above
8. _______________is directed in a narrow manner toward a pre-defined market segment.
   a. Online marketing
   b. Niche marketing
   c. Direct marketing
   d. Advertising
9. _______________is the process and decision to set a price for a product or a service.
   a. Marketing
   b. Packaging
   c. Promotion
   d. Pricing

10. ______________________is the selling of goods at prices that are below the real cost in order to drive competition out of the market.
    a. Pricing
    b. Niche marketing
    c. Predatory pricing
    d. None of the above
11. ______________________activities such as sourcing, procurement, order processing, manufacturing, warehousing, inventory control, servicing and warranty, custom cleaning, wholesaling, and distribution.
    a. Global sourcing
    b. Domestic supply chain
    c. Local sourcing
    d. Global supply chain
12. ______________________is the procurement of production or service inputs or components in international markets.
    a. Global supply chain
    b. Local sourcing
    c. Niche marketing
    d. Global sourcing
13. Localization is supported by which of the following factors?
    i. Variation among national environments
    ii. Product customization that triggers logistic adjustments
    iii. Variation among regional environments
    iv. Existence of national borders that impede the free flow of goods and services
    v. All of the above

    a. v
    b. i, iii, and iv
    c. ii, iii, and iv
    d. i, ii, and iv
14. Which of the following are types of ports?
    i. The maritime hub
    ii. The gateway port
    iii. The logistic-industrial port
    iv. The trade port
    v. The customized port

a. i, iii, iv, and v
b. ii, iii, iv, and v
c. i, ii, iii and iv
d. i, ii, iv, and v

15. _______________________is considered to be an attractive mode of transportation domestically and internationally.

a. Air
b. Trucking
c. Rail
d. None of the above

12.6 Summary

- Success in international markets depends on many skills such as accurate assessment of market potential; selection of the right product mix, and appropriate adjustments in pricing, packaging, advertising, and distribution.
- For assessing market potential, firms seek to identify aggregate demand for a product or a service and estimate the costs associated with product introduction and distribution.
- Globalization is the standardization of products (or services), brands, marketing, advertising, and the supply chain across countries and regions. In contrast, localization is the adjustment of one or more of the above elements to be idiosyncratic characteristics of a given national market.
- Country-of-origin effect comprises dimensions such as innovativeness, namely using new technology and engineering advances; design, namely style, appearance, color, and variety; prestige, brand name reputation, status, and workmanship, including reliability, durability, craftsmanship, and manufacturing quality.
- Channel decisions involve the length (the number of intermediaries or levels employed in the process of distribution) and width (the number of firms in each level) of the channel used to link manufacturers to consumers.
- Pricing is the process and decision to set a price for a product or a service.
- Advertising needs to be adjusted to local tastes, regulations, and norms to make it effective in international markets.
- International strategic alliances are a major venue for market entry. Such alliances and mergers and acquisitions allow a firm to quickly establish itself in a foreign market.

- Global supply chain covers both logistics and operations. It includes activities such as sourcing, procurement, order processing, manufacturing, warehousing, inventory control, servicing and warranty, custom cleaning, wholesaling, and distribution.
- Global sourcing provides an opportunity to the MNE for leveraging its scale and competitive advantage in spotting opportunities for procurement worldwide for use in its various locations and divisions.
- As the globalization of supply chain proceeds, several factors require continuous attention to localization and customization. Localization is supported by three factors – variation among national environments, product customization that triggers logistic adjustments, and existence of national borders that impede the free flow of goods and services thus limiting global solutions.
- Standardization in packaging appeals for logistics ease and also promotes brand recognition.
- Customer demands can be met in a timely and cost-effective manner by effective modes of transportation.
- A seamless supply chain spanning national borders is difficult to be established. Customs inspection, processing, and other barriers associated with crossing borders create unpredictable and costly delays.

12.7 Glossary

Branding - Branding is the process of creating and supporting positive perceptions associated with a product or service.

Country-of-origin effect - Country-of-origin effect is the influence of the country of manufacturing image on the buying decision.

Direct marketing - Direct marketing involves direct sales to customers through individual agents who make a commission on their sales, in addition on the sales by agents recruited by them.

Global sourcing - Global sourcing is the procurement of production or service inputs or components in international markets.

Intermodal transportation - Intermodal transportation is a term that denotes the combination of ocean vessels (including short sea shipping), river transport, rail, road links, and air transport within a seamless supply chain.

Pricing - Pricing is the process and decision to set a price for a product or a service.

Predatory pricing - Predatory pricing is the selling of goods at prices that are below the real cost in order to drive competition out of the market.

Purchasing power parity - Purchasing power parity (PPP) is an index used to adjust nominal figures to the purchasing power of local consumers

Global supply chain - Covers both logistics and operations. It includes activities such as sourcing, procurement, order processing, manufacturing, warehousing, inventory control, servicing and warranty, custom cleaning, wholesaling, and distribution.

Niche marketing - Marketing directed in a narrow manner toward a pre-defined market segment. In international markets, niche marketing maybe directed toward not only to a product category but also to a geographical or an ethnic segment.

Channel decisions - Involve the length and width of the channel used to link manufacturers to consumers.

Globalization - In marketing sense, it is "the standardization of products (or services), brands, marketing, advertising, and the supply chain across countries and regions."

Localization - In marketing sense, it is "the adjustment of one or more of the marketing elements to be idiosyncratic characteristics of a given national market."

12.8 Self-Assessment Test

1. Explain the need for assessing market potential in the context of international marketing.
2. Briefly explain the various concepts involved in globalization and localization in international markets.
3. Describe in brief how supply chains are globalized and customized in international marketing.
4. Explain the different types of intermodal transportation.

12.9 Suggested Readings/Reference Material

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4. IFC. Social and Green Bonds. https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/investor+relations/ir-products/socialbonds
5. Business Insider. Global ecommerce market report: ecommerce sales trends and growth statistics for 2021. https://www.businessinsider.com/global-ecommerce-2020-report?IR=T

12.10 Answers to Check Your Progress Questions

1. (a) Purchasing power parity

Purchasing power parity (PPP) is an index used to adjust nominal figures to the purchasing power of local consumers.

2. (b) Globalization

Globalization is the standardization of products (or services), brands, marketing, advertising, and the supply chain across countries and regions.

3. (c) Localization

Localization is the adjustment of one or more of the above elements to be idiosyncratic characteristics of a given national market.

4. (b) Benefit/cost models

Benefit/cost models evaluate the advantages and disadvantages of a product or a distribute mode in a given market.

5. (b) User/need models

User/need models test the needs of prospective customers, including the circumstances in which the product or service may be used.

6. (c) Branding

Branding is the process of creating and supporting positive perceptions associated with a product or service.

7. (b) Direct marketing

Direct marketing involves direct sales to customers through individual agents who make a commission on their sales, in addition on the sales by agents recruited by them.

8. (b) Niche marketing

Niche marketing is directed in a narrow manner toward a pre-defined market segment.

9. (d) Ricing

Pricing is the process and decision to set a price for a product or a service.

10. (c) Predatory pricing

Predatory pricing is the selling of goods at prices that are below the real cost in order to drive competition out of the market.

11. (d) Global supply chain

Global supply chain activities such as sourcing, procurement, order processing, manufacturing, warehousing, inventory control, servicing and warranty, custom cleaning, wholesaling, and distribution.

12. (d) Global sourcing

Global sourcing is the procurement of production or service inputs or components in international markets.

13. (d) i, ii, and iv

Localization is supported by three factors – variation among national environments, product customization that triggers logistic adjustments, and existence of national borders that impede the free flow of goods and services thus limiting global solutions.

14. (c) i, ii, iii, and iv

Ports are of four types the maritime hub, the gateway port, the logistic-industrial port, the trade port.

15. (c) Rail transportation

Rail transportation is considered to be an attractive mode of transportation domestically and internationally.

Unit 13

Accounting in the International Business

Structure

"Don't ever let your business get ahead of the financial side of your business. Accounting, accounting, accounting. Know your numbers."

- Tilman J. Fertitta

13.1 Introduction

The previous unit discussed how the market potential of a foreign country can be determined. It then explained the concepts of globalization and localization in international markets. The unit finally discussed how supply chains are globalized.

Accounting information is the means by which firms communicate their financial position to the providers of capital, investors, creditors, and government. It enables the capital providers to evaluate the value of their investments or the security of their loans and for making decisions about future resource allocations.

International businesses confront many accounting problems that are not confronted in domestic businesses. The lack of consistency in accounting standards of different countries is a major problem. Thus international standards are formed to standardize accounting practices. Multinational enterprises (MNEs) make use of consolidated financial statements and methods of foreign currency translation to correctly report their financials. Control system is also a crucial aspect of accounting in international business.

This unit will discuss country differences in accounting standards. It then goes on to explaining the national and international standards. It then discusses the significance of consolidated financial statements, the methods used for currency translation, and the concept of transaction exposure. It also explains the concept of economic exposure. The unit finally discusses the different aspects of accounting in control systems.

13.2 Objectives

By the end of this unit, students should be able to:

- Discuss differences in accounting standards in different countries. understand why national and international standards are established.
- Explain the significance of consolidated financial statements, the methods used for currency translation, and the concept of transaction exposure.
- Outline the concept of economic exposure.
- Discuss the different aspects of accounting in control systems.

13.3 Accounting Standards: Country Differences

Accounting is shaped by the environment in which it operates. Countries have different accounting systems just as they have different economic systems, political systems, and cultures. The accounting system has evolved in each country in response to the demands for accounting information.

An example of differences in accounting conventions concerns employee disclosures. In many European countries, government regulations require firms to publish detailed information about their employment and training policies. Such requirement does not exist in the US. Another difference is treatment of goodwill. The goodwill of a firm is any advantage such as brand name or a trademark that enables firms to earn profits higher than its competitors. When one company acquires another company, the goodwill value is calculated as the amount paid for a firm above its book value, which is often substantial. Under accounting rules that are prevalent in many countries, acquiring firms have been allowed to deduct the goodwill value from the amount of equity or net worth reported on their balance sheet.

Despite several attempts to harmonize standards by developing internationally acceptable conventions differences between national accounting systems still remain. Though many factors can influence the development of an accounting system in a country, there appear five main variables:

- The relationship between business and capital providers;
- Political and economic ties with countries;
- The inflation level;
- The level of economic development of a country;
- The prevailing culture in a country.

13.3.1 Relationship between Business and Capital Providers

The three main sources of external capital for business enterprises are individual investors, banks, and government. In most advanced countries, all three sources are crucial. For instance, in the US, business firms can raise capital by selling shares and bonds to individual investors through the bond market and stock market. They can borrow capital from banks and in some cases from the government. The importance of each capital source varies from country to country. In some countries, such as the US, individual investors are the major capital source; in others; banks play a greater role; in still others, the government is the major capital provider. The accounting system of a country tends to reflect the relative importance of these three constituencies as capital providers.

Example

A report in Statista dated 18th March 2022 has reported that in 2020, 55% of adults in the United States invested in the stock market. This figure has remained steady over the last few years and is the highest across the developed countries. The accounting system of the USA tends to reflect relative importance and is oriented toward offering individual investors the information they require to make decisions about selling or purchasing corporate stocks or bonds. The factor that influenced the development of the accounting system in the USA is the relationship between business and capital providers.

The USA has well-developed stock and bond markets in which firms can raise capital by selling stocks and bonds to individual investors. The accounting system of the USA tends to reflect relative importance and is oriented toward offering individual investors the information they require to make decisions and so is the accounting system as well.

Source: ICFAI Research Center

Consider the case of Britain and the US. Both have well-developed stock and bond markets in which firms can raise capital by selling stocks and bonds to individual investors. Most individual investors purchase a very small proportion of the total outstanding stocks or bonds of a firm. The investors leave the task to professional managers. But due to their lack of contact with the management of the firms in which they invest, individual investors may not have the information needed for evaluating how well the companies are performing. Individual investors generally lack the ability to get information on management demand because of their small stake in firms. The financial accounting system in both Britain and the US evolved to cope with this problem. In both countries, the financial accounting system is oriented toward offering individual investors with the information they require to make decisions about selling or purchasing corporate stocks or bonds.

In countries such as Japan, Switzerland, and Germany, a few large banks satisfy most of the capital needs of business enterprises. In these countries, the role of the banks has been so important that a bank's officers often have seats on the boards of firms to which it lends capital. In such circumstances, the information needs of the providers of capital are satisfied in a straightforward manner through direct visits, personal contacts, and information provided at board meetings. Consequently, though firms do prepare financial reports, as government regulations in these countries mandate some public disclosure of the financial position of the firm, the reports historically tend to contain less information than those of the US or British firms. Because banks are major capital providers, financial accounting practices are oriented toward protecting a bank's investment. Hence, assets are valued conservatively and liabilities are overvalued to offer a cushion for the bank in the event of default.

In still other countries, the national government has been a crucial capital provider, and this has influenced accounting practices. This is the case in Sweden and France, where the national government has often stepped in to make loans or invest in firms whose activities are deemed in national interest. In these countries, financial accounting practices are oriented toward the needs of government planners.

13.3.2 Political and Economic Ties with Countries

Similarities in the accounting systems of countries are sometimes due to the close political and economic ties between countries. For instance, the accounting system in the US has influenced the accounting practices in Mexico and Canada, and since passage of NAFTA, the accounting systems in these countries has converged on a common set of norms. Another significant force in accounting worldwide has been the British system. A majority of former colonies of the British Empire have accounting practices modeled after Britain's. Similarly, the European Union (EU) has also made attempts to harmonize accounting practices in its member countries. The accounting systems of EU members have converged to the norms of the International Accounting Standards Board.

13.3.3 Inflation Accounting

In many countries, including the US, Japan, and Germany, accounting is based on the historic cost principle. This principle assumes "the currency unit used to report financial results is not losing its value due to inflation." Firms record sales, purchases, and the like at original price of the transaction and make no adjustments in the amounts later. The historic cost principle affects accounting most significantly in the area of asset valuation. If the inflation is high, the historic cost principle underestimates the assets of a firm so the depreciation charges based on these underestimates can be inadequate for replacing worn out or obsolete assets.

The appropriateness of this principle inversely varies with the inflation level in a country. During the 1970s and 1980s, the high level of price inflation in many industrialized countries created a need for new accounting methods that could adjust inflation. Many industrialized countries adopted new practices. In 1980, an approach called current cost accounting was adopted in Britain. Current cost accounting adjusts all items in a financial statement – assets, liabilities, revenues, and costs in order to factor out the effects of inflation. The method makes use of a general price index for converting historic figures into current values. However, the standard was not made compulsory and once the inflation rate fell in the 1980s in Britain, most of the firms stopped proving the data.

13.3.4 Level of Development

Developed nations have large, complex organizations, whose accounting problems are complicated than those of small organizations. They also have sophisticated capital markets in which business organizations raise funds from investors and banks. The capital providers require comprehensive reports of the financial activities of an organization they invest in. The workforces of developed nations tend to be highly skilled and educated and can perform complex accounting functions. These reasons make accounting in developed countries more sophisticated than accounting in less developed countries, where the accounting standards may be moderately primitive. In most of the developed nations, the accounting system used is inherited from colonial powers. For instance, many African nations have accounting practices based on either the French or British models. These models may not be applicable to small businesses in a poorly developed economy. Another problem in poorer countries of the world is lack of trained accountants.

13.3.5 Culture

The culture of a country has a major impact upon the nature of its accounting system. Researchers have found that the degree to which a culture is characterized by uncertainty avoidance has an impact on the accounting system. Uncertainty avoidance refers to "the extent to which cultures socialize their members to accept ambiguous situations and tolerate uncertainty." Members belonging to a high uncertainty avoidance cultures give importance to career patterns, job security, retirement benefits, etc. They also have a strong need for rules and regulations; the manager is expected to give clear instructions and the initiatives of the subordinates are controlled tightly. Lower uncertainty avoidance cultures are characterized by an increase readiness to take risks and less emotional resistance to change. Research indicates that countries with low uncertainty avoidance cultures tend to have strong independent auditing professions that audit the accounts of the firms to ensure that they comply with generally accepted accounting regulations.

13.4 National and International Standards

Accounting standards are "rules for preparing financial statements." They define what is useful accounting information. Auditing standards specify the rules for performing an audit – the technical process through which an independent person (the auditor) gathers evidence to determine if financial accounts conform to required accounting standards and also if they are reliable.

13.4.1 Lack of Comparability

An adverse result of national differences in accounting and auditing standards has been a general lack of comparability of financial reports from one country to another. For example, Dutch standards favored the use of current value for replacement assets; Japanese law prescribed historic cost and generally prohibited revaluation; in Britain, capitalization of financial leases was a required practice, but was not practiced in France; in the US, R&D costs must be written off in the year they were incurred but in Spain it could deferred as an asset and may not be amortized as long as benefits covering them were expected to arise in the future.

Such differences would not have mattered much if there was a little need for a firm headquartered in one country for reporting its financial results to citizens of another country. However, a striking development has been the growth of the capital markets. A growth of both transnational financing and transnational investment has also been noticed.

Transnational financing takes place when a firm based in one country enters the capital market of another country for raising capital from the sale of stocks or bonds. A German firm raising capital by selling stock through the London Stock Exchange is an example of transnational financing. Large firms have been increasingly making use of transnational financing by gaining listings, and ultimately issuing stock, on foreign stock exchanges, particularly the London and the New York stock exchanges.

Example

Live mint dated 6th January 2022 has reported that Reliance Industries Ltd., (RIL) has raised $4 billion through transnational financing, the largest ever foreign currency bond issuance.

Source: ICFAI Research Center

Transnational investment takes place when an investor based in one country enters another nation's capital market for making investments in stocks or bonds of a firm based in that country. An investor based in Britain buying stock of General Motors through the New York stock exchange is an example of transnational investment.

The rapid expansion of transnational financing and transnational investment is accompanied by a corresponding growth in transnational financial reporting. For instance, a Danish firm raising capital in London should issue Danish financial reports, in addition to the financial reports that serve the needs of its British investors. However, a lack of comparability between accounting standards in different nations can cause confusion. For instance, the German firm that issues two sets of financial reports, one prepared under German standards and the other under US standards, may find that its financial position shows a significant difference in the two reports, and its investors may have difficulty in identifying the true worth of a firm.

In addition to problems related to lack of incomparability, faced by the investors, the firm has to explain its investors why its financial position looks so different in the two accountings. Also, an international business may find it difficult to evaluate the financial positions of key foreign suppliers, customers, and competitors.

13.4.2 International Standards

Many companies raise money from capital providers across national borders. The providers demand consistency in the way in which financial reports are reported for making informed decisions. Also adoption of common accounting standards will facilitate the development of global capital markets, since more investors will be willing to make investments across borders, and the end result will be to lower the cost of capital and stimulate economic growth. Thus, accounting standards were standardized across national borders in the best interests of the participants in the world economy.

Formed in March 2001, the International Accounting Standards Board (IASB) has emerged as a proponent of standardization. The IASB replaced the International Accounting Standards Committee (IASC), which was established in 1973. The IASB is responsible for formulating new international financial reporting standards. By 2005, the IASC and the IASB had issued 41 international accounting standards. For issuing a new standard, 75 percent of the members of the IASB must agree. It can be difficult to get three-quarters agreement as members come from different cultures and legal systems. The IASB offers two acceptable alternatives to get around this problem.

Another hindrance to the development of international accounting standards is that compliance is voluntary; the IASB has no power to enforce the standards. Despite this, the support for IASB and recognition of its standards has been growing.

The impact of IASB standards has been least noticeable in the US as most of the IASB standards were consistent with opinions already articulated by the US Financial Accounting Standards Board (FASB). The FASB writes the generally accepted accounting principles (GAAP) by which the financial statements of US firms should be prepared. By contrast, the IASB standards had a significant impact in many other countries as they eliminated a commonly used alternative.

EU also has substantial influence on the harmonization of accounting standards. The EU mandates its accounting principles in its member countries.

13.5 Multinational Consolidation, Currency Translation, and Transaction Exposure

A consolidated financial statement combines the different financial statements of two or more firms to yield a single set of financial statements as if the individual companies were a single entity. Most of the multinational firms comprise a parent company with several foreign subsidiaries located in various countries. Such firms issue consolidated financial statements, which merge the accounts of the parent company as well as its subsidiaries as opposed to issuing individual financial statements for the parent company and each subsidiary.

13.5.1 Consolidated Financial Statements

Many firms find it beneficial to organize as a set of separate legal entities. For example, a firm may incorporate the various business components separately for limiting its total legal liability or for taking advantage of corporate tax regulations. Multinationals often required by the countries in which they carry out their business to set up a separate company. Thus a Multinational comprises a parent company and several subsidiaries located in different countries, most of which are wholly-owned by the parent company. Though the subsidiaries may be separate legal entities, they are not separate economic entities. Economically, all the companies in a corporate group are interdependent. For instance, if the Brazilian subsidiary of a US parent company experiences considerable losses that drain off the corporate funds, the cash available for investment in that subsidiary, the parent company in the US, and other subsidiary companies will be limited. Hence, the purpose of consolidated financial statements is to provide accounting information about a group of companies that recognize their economic interdependence.

Transactions that take place among members of the corporate family are not included in consolidated financial statements; only assets, liabilities, revenues, and expenses with external third parties are shown. However, by law, separate legal entities need to maintain their own accounting records and prepare their own financial statements. Thus transactions with other members of a corporate group should be identified in separate statements so they can be excluded during the preparation of consolidated statements. The process involves adding up individual assets, liabilities, revenues, and expenses reported on the separate financial statements and then eliminating the ones in the intragroup.

Preparing consolidated statements has become a norm for multinational firms. Investors realize that in the absence of a consolidated financial statement, a multinational can conceal losses in an unconsolidated subsidiary, thereby hiding the economic status of the entire corporate group.

13.5.2 Currency Translation

The concept of exposure refers to "the degree to which the company is affected by exchange rate changes." Accounting exposure arises from the need, for the purpose of reporting and consolidation, to convert the financial statements of foreign operations from the local currencies to the home currencies. If the exchange rates change since the last reporting period, this translation or restatement, of the revenues, expenses, assets, liabilities, gains, and losses, that are denominated in foreign currencies would result in foreign exchange gains or losses. The extent of these gains or losses is measured by the translation exposure figures. The rules governing these translations are devised by the FASB in association with the government of the parent company or by the company itself.

Normally, foreign subsidiaries keep their accounting records and prepare their financial statements in the currency of the country in which they are located. When an MNE prepares its consolidated records, it should convert all these financial statements in the home country's currency. If the currency value changes, gains or losses in the foreign exchange translation may result. Assets and liabilities translated at the current (postchange) exchange rate are considered to be exposed while those translated at a historical (prechange) exchange rate will maintain their historic home currency values and therefore are regarded as not exposed. Translation exposure is "the difference between exposed assets and exposed liabilities." The controversies among accountants center on which assets and liabilities are exposed and on when the foreign exchange accounting-derived gains or losses should be recognized. A vital point to realize is that the gains or losses are of an accounting nature and no cash flows are necessarily involved. Four main methods that determine what exchange rate should be used by firms when translating financial statement currencies are the current/noncurrent method, monetary/non monetary method, the current rate method, and the temporal method.

Current/Noncurrent Method

In the current/noncurrent method, all the assets and liabilities of the foreign subsidiary are translated into the home currency at the current exchange rate. The noncurrent assets and liabilities are translated at the historical exchange rate; i.e. at the rate that was in effect when the asset was acquired or the liability incurred. Hence a foreign subsidiary with positive-currency working capital will result in a translation loss (gain) from a devaluation (revaluation) with the current/noncurrent method and vice versa when the working capital is negative.

Example

Bharat Apparels Pvt. Ltd. (BAPL) is a decade-old garment manufacturing company in Ahmedabad. The company has set up a subsidiary in London in 2020.

Contd….

While finalizing the consolidated financial statement, BAPL has converted the inventories, working capital finance, receivables, etc., at its London subsidiary into ₹ at the spot rate and fixed assets, long-term loans at the historical exchange rate for the year ended 2021-22. Here, current/noncurrent method is the exchange rate method that was adopted by BAPL while translating the assets and liabilities of its London subsidiary.

Source: ICFAI Research Center

Monetary/Nonmonetary Method

The monetary/nonmonetary method differentiates between differentiates between monetary assets and liabilities i.e. those items that represent an obligation to pay, a claim to receive, a fixed amount of foreign currency units and nonmonetary, or physical assets and liabilities. Monetary items such as cash, long-term debt, accounts receivable and payable are translated at the current rate and nonmonetary items such as long-term investments, fixed assets, and inventory are translated at historical rates.

Current rate Method

In the current rate method, the exchange rate at the balance sheet date is used for translating the foreign subsidiary's financial statements into the MNE‟s home currency. Though this seems logical, it is incompatible with the historic cost principle, which is a generally accepted principle in accounting followed in many countries. For instance, a US firm invests US$ 100,000 in a subsidiary in Malaysia. Assume the exchange rate at that time is 1 US$ = 5 Malaysian ringgit. The subsidiary converts the US$ 100,000 into ringgit to make it 500,000 ringgits and buys land with this money. Subsequently, if the dollar rate depreciates against the ringgit, so that by year end 1US$ = 4 ringgit. If this exchange rate is used for converting the value of the land in dollars for preparing consolidated accounts, the land will be valued at US$ 125,000. The land value appears to be increased by US$ 25,000, though in reality the increase will be a function of change in the exchange rate. Therefore, the consolidated accounts present a misleading picture.

Temporal Method

Under the temporal method, inventory is usually translated at the historical rate but it can be translated at the current rate if the inventor is shown on the balance sheet at market values. The temporal method avoids the problem encountered in the current rate method. The temporal method translates the value of the assets in a foreign currency into the currency of the home country using the exchange rate that exists when the assets are purchased. Though the temporal method ensures that the dollar value of the land does not fluctuate due to changes in exchange rates, it has its own problems. As the various assets of the subsidiary will in all probability be acquired at different points of time and because exchange rates rarely remain stable for a long time, different exchange rates would need to be used for translating the foreign assets into the MNE‟s home currency.

Example

As per a report in ET dated 11th April 2019, Amazon Inc, a US based e-commerce giant. has invested $631 million (₹4,472.50 crore) into its Indian subsidiaries, which includes Amazon Seller Services, Amazon Pay and Amazon Retail for the year 2018-19 at an exchange rate of ₹ 70.88/USD. As on the date of balance sheet (31.03.2019) of the subsidiary, the exchange rate stood at 71.20 and in terms of Indian currency, the investments stood at ₹ 4492.72 crores showing an increased investment of 20.22 crores in the consolidated financials of Amazon Inc .

Source: ICFAI Research Center

13.5.3 Current US Practice

On January 1, 1976, Statement of Financial Accounting Standards No. 8 (FASB-8), which was based on the temporal method became effective. Immediately after adoption a controversy ensued over FASB-8 that all reserves for currency losses be disallowed. Thus in 1981, a new translation standard was established - Statement of Financial Accounting Standards No. 52 (FASB-52). According to FASB-52, firms should use the current rate method to translate foreign-currency denominated assets and liabilities into dollars. US-based multinationals should follow the requirements of FASB-52. Under FASB-52, a foreign subsidiary is classified as either as an autonomous, self-sustaining subsidiary or as integral to the activities of the parent firm.

Example

As per a report in Business Standard dated 02.08.2019, there has been a spurt in imports of aluminum scap by 2.3 million tonnes from SE Asian countries as India has free trade agreements (FTAs) with them. Vedanta, one of the largest aluminum manufacturers imports over 2 million tonnes a year for its two smelters. The Company on import converts the value of the imported stock from foreign currency into INR based on the exchange rate on the date of import in its books.

Source: ICFAI Research Center

FASB-52 differentiates between the functional currency and the reporting currency. The functional currency of an affiliate is the currency of the primary economic environment in which case is generated and expended by an affiliate. If the operations of an enterprise are self-contained and integrated within a particular country, the functional currency would generally be the currency of that country.

An instance of this case is an English affiliate manufacturing and selling most of its output in England. On the other hand, if the operations of a foreign affiliate are a direct and integral component or extension of the operations of the parent company, the functional currency would be the US dollar. An instance of this case would be a China assembly plant for radios that sources the components in the US and sells the assembled radios in the US. The functional currency sometimes may not be a local currency nor the dollar but rather a third currency.

The reporting currency is the currency in which the parent company prepares its own financial statements i.e. US dollars for a US firm. FASB-52 requires that the foreign unit's financial statements be first stated in the functional currency using the GAAP. At each balance-sheet date, any assets and liabilities denominated in any currency other than the functional currency of the recording entity should be adjusted to reflect the current exchange rate on that date. Transactions gains and losses resulting from the adjustment of assets and liabilities denominated in a currency other than the functional currency or from settlement of such items, should generally appear on the income statement of the foreign unit.

13.5.4 Transaction Exposure

As part of their accounting exposure, companies often include transaction exposure. Transaction exposure stems from the prospects of incurring future exchange gains or losses on transactions that are already entered into and are denominated in a foreign currency. For instance, if Dell sells a computer to some company in England, it will not be paid until a later date. If that sale is priced in pounds, Dell has a pound transaction exposure.

The transaction exposure of a company is measured currency by currency and equals the difference between contractually fixed future cash inflows and outflows in each currency.

13.6 Accounting Practice and Economic Reality

To respond to increased currency volatility, many multinationals have devoted more resources to the foreign exchange risk management. For developing an effective strategy for managing currency risk, management needs to first determine what is at risk. This determination requires an appropriate definition of foreign exchange risk. however, a major discrepancy exists between accounting practice and economic reality in terms of measuring exposure.

Accounting measures of exposure have their focus on the effect of currency changes on the firm's previous decisions as reflected in the book values of the assets acquired and liabilities incurred in the past. However, book values representing historical costs and market values reflecting future cash flows – of assets and liabilities differ. Hence retrospective accounting techniques cannot truly account for the economic effects of the revaluation or devaluation of a firm as these effects are prospective in nature.

Since the change in accounting net worth produced by movements in exchange rates has little relationship to the changes in the firm's market value, information derived from a historical method of cost accounting can offer a misleading picture about the true economic exposure of a firm. Here, economic exposure is defined as "the extent to which the value of the firm – as measured by the present value of its expected cash flows – will change when exchange rates change." Though items on the balance sheet of a firm represent cash flows, not all future flows appear here. In addition, these items are not adjusted for reflecting the distorting effect of inflation and relative changes in price on their associated with future cash flows.

Based on the market value, the definition of exposure assumes that the goal of the management is to maximize the firm's value. Whether management believes in this has been debated vigorously. Some managers may want to pursue other objectives. Nevertheless, the assumption that management aims to maximize (risk-adjusted) cash flows remains standard in the financial literature. Moreover, the principle of maximizing wealth of the stock holders offers a rational guide to financial decision making.

Activity 13.1

XYZ Oil Ltd., a petroleum company has its subsidiary in Japan. The company's financial year ended on December 31. At the end of the year, the company had to prepare its consolidated accounts. While preparing this account, the company converted its earnings from the Japanese subsidiary from Yen to US dollars using the exchange rate when the consolidated account is prepared. Which method is the company using? What problems would it encounter using that method? How can the company overcome these problems?

Answer:

13.7 Accounting Aspects of Control Systems

The role of corporate headquarters is to control subunits within the organization in order to ensure that they achieve the best possible performance. Typically, the control process is annual and involves three steps:

- The head office in conjunction with the subunit management determines subunits goals for the coming year.
- The head office monitors the performance of the subunit against the agreed goals.
- In case any subunit fails to achieve its goals, the head office intervenes to learn the reason for the shortfall and also takes corrective action when appropriate.

In this process, the accounting function plays a critical role. Most of the subunit goals are expressed in financial terms and are embodied in budget of the subunit for the coming year. The main instrument for financial control is the budget. The budget is usually prepared by the subunit but has to be approved by the management at the headquarters.

During the budget approval process, the managements at the headquarters as well as the subunit debate the goals that need to be incorporated in the budget. A function of the headquarters" management is to ensure that the budget of the subunit contains challenging but realistic goals. After the budget is approved, accounting information systems collect the data throughout the year in order to evaluate the sub-units performance against the goals set in the budget.

In international business, most of the subunits of the firm are foreign subsidiaries. Thus the performance goals for the coming year are set by negotiation between corporate management and the managers of foreign subsidiaries. The most important criterion for evaluating foreign subsidiary's performance is comparing the actual profits with the budgeted profits. This is closely followed by a comparison of actual sales to budgeted sales and its return on investment. The same criteria can be used for evaluating the performance of the subsidiary managers.

13.7.1 Exchange Rate Changes and Control Systems

Most of the international businesses require all budgets and performance data within the firm to be expressed in the corporate currency, which is normally the home currency. For instance, the Malaysian subsidiary of a multinational firm in the US would submit its budget in US dollars as opposed to the Malaysian ringgit and performance data would be reported to the headquarters in US dollars. This enables comparisons between subsidiaries in different countries and makes things easier for the management at the headquarters. However, it also allows changes in exchange rates to introduce substantial distortions. For instance, the profit goals may not be achieved by the Malaysian subsidiary not due to any problems in performance but merely due to a decline in the value of ringgit against the dollar. The opposite can also occur making the performance of the foreign subsidiary look better than it actually is.

The Lessard-Lorange Model

A research by Donald Lessard and Peter Lorange suggest that several methods are available to international businesses for dealing with this problem. Lessard and Lorange point out three exchange rates for translating foreign currencies into the corporate currency in setting budgets and in performance tracking:

- The initial rate, which is the spot exchange rate when the budget is adopted.
- The projected rate, which is the spot exchange rate forecast for the end of the budget period (i.e. forward rate).
- The ending rate, which is the spot exchange rate when the budget is compared with performance.

Lessard and Lorange recommend firms to use the projected spot exchange rate for translating both the budget and the performance figures into the corporate currency. The projected rate will be the forward exchange rate as determined by the foreign exchange market or some company-generated forecast of future spot rates, referred to as the internal forward rate. The internal forward rate might vary from the forward rate quoted by the foreign exchange market if the firm wishes to bias its business against or in favor of the particular foreign currency.

13.7.2 Transfer Pricing and Control Systems

The global strategy and the transnational strategy give rise to a globally dispersed web of productive activities. Firms that pursue these strategies disperse each value creation activity to its optimal location in the world. Thus a product can be designed in one country, some of its components can be manufactured in a second country, other components can be manufactured in a third country, assembled in a fourth country, and then sold across the globe.

The intra-firm transaction volumes will be very high in such companies. The firms ship component parts and finished goods between subsidiaries in different countries on a continuous basis. "The price at which such goods and services are transferred is referred to as the transfer price."

Example

Royal Pens Pvt., Ltd., (RPPL) an Indian pen company manufacturing pens located in Kolkata, has its subsidiary in Dacca Bangladesh namely Royal Pens (Bangladesh) Pvt., Ltd. The parent company manufactures the pens at Rs. 3 per piece and bills it at Rs 8 each to its subsidiary in Bangladesh, which in turn sells the pens at Rs. 15 per piece after incurring Rs. 2 per pen as marketing and distribution expenses. Thus the company's total profit amounts to Rs. 10 per pen. Transfer Pricing is the pricing policy adopted by the parent company with its subsidiary in Bangladesh.

Transfer pricing is the price at which goods and services are transferred between entities within the firm is referred to as the transfer price which is what we see in case of RPPL.

Source: ICFAI Research Center

The choice of transfer price may have a critical affect on the performance of two subsidiaries that exchange goods or services. When budgets are set and performance of the subsidiary is reviewed, corporate headquarters need to keep in mind the distorting effect of transfer prices.

International businesses manipulate their transfer prices often for minimizing import duties, for minimizing their worldwide tax liability, and for avoiding government restrictions on capital flows.

13.7.3 Separating Subsidiary and Manager Performance

In many international businesses, the same quantitative criteria are used for evaluating the performance of both the foreign subsidiary and its managers. However, many accountants argue that while it is legitimate to compare subsidiaries against each other based on return on investment (ROI) or other indicators of profitability, it may not be suitable to use these to compare and evaluate the managers belonging to different subsidiaries. Foreign subsidiaries operate in an environment that has different political, social, and economic conditions that have an influence on the costs of doing business in a country and the profitability of the subsidiary. Thus it is suggested that evaluation of a subsidiary should be separated from the evaluation of its managers. The evaluation of the managers should take into consideration how benign or hostile the country's environment is for that business. Also, managers should be evaluated in terms of local currency after making allowances for items over which they do not have any control (e.g. tax rates, interest rates, transfer prices, inflation rates, and exchange rates).

Activity 13.2

AS Pharma Co. Ltd. (AS Pharma), a US-based pharmaceutical company has its subsidiaries in several parts of India. The Indian subsidiary AS India Pharma Ltd. reported its performance after converting Indian National Rupees (INR) into US dollars. This was done so that the parent company can report its financials in the form of consolidated financial statements. The slowdown in the US market had affected the company's business in the US and thus the dollar value decreased against the INR. The accountants at AS Pharma noted that the Indian subsidiary's performance declined not due to any shortage in performance but due to the decline in dollar value against the INR. Suggest some methods that are available to international businesses for dealing with this problem. Also discuss them in detail.

Answer:

<u>Check Your Progress - 1</u>

1. Which of these variables can influence the development of an accounting system in a country?
   i. The relationship between business and capital providers
   ii. Political and economic ties with countries

iii. The inflation level

iv. Social ties in a country

v. The level of economic development of a country; the prevailing culture in a country

a. i, ii, iii, and iv

b. ii, iii, iv, and v

c. i, ii, iii, and v

d. i, iii, iv, and v

2. The main sources of external capital for business enterprises include:

   a. Individual investors

   b. Banks,

   c. Government

   d. All of the above

3. _______________adjusts all items in a financial statement – assets, liabilities, revenues, and costs in order to factor out the effects of inflation.

   a. Current cost accounting

   b. Future cost accounting

   c. Financial accounting

   d. Budget

4. _______________refers to the extent to which cultures socialize their members to accept ambiguous situations and tolerate uncertainty.

a. Accounting system

b. Power distance

c. Cultural issues

d. Uncertainty avoidance

5. _______________are rules for preparing financial statements.

   a. Financial standards

   b. Auditing standards

   c. National standards

   d. Accounting standards

6. _______________specify the rules for performing an audit.

   a. Auditing standards

   b. Accounting standards

   c. Control systems

   d. None of the above

7. _______________takes place when a firm based in one country enters the capital market of another country for raising capital from the sale of stocks or bonds.
   a. Transnational investment
   b. Transnational financing
   c. Capital investment
   d. Capital growth
8. _______________________takes place when an investor based in one country enters another nation's capital market for making investments in stocks or bonds of a firm based in that country.
   a. Transnational financing
   b. Capital market
   c. Transnational investment
   d. None of the above
9. The ___________is responsible for formulating new international financial reporting standards.
   a. International Accounting Standards Committee
   b. International Accounting Standards Board
   c. Financial Accounting Standards Board
   d. None of the above
10. A _____________combines the different financial statements of two or more firms to yield a single set of financial statements as if the individual companies were a single entity.
    a. Consolidated income statement
    b. Consolidated financial statement
    c. Consolidated profit and loss statement
    d. Budget
11. The concept of __ refers to the degree to which the company is affected by exchange rate changes.
    a. Transaction currency
    b. Fluctuation
    c. Exposure
    d. Financial management
12. In the ____, the exchange rate at the balance sheet date is used for translating the foreign subsidiary's financial statements into the MNE‟s home currency.
    a. Temporal method
    b. Current rate method
    c. Capital rate method
    d. None of the above

13. The _____translates the value of the assets in a foreign currency into the currency of the home country using the exchange rate that exists when the assets are purchased. capital
    a. Rate method temporal
    b. Rate method current
    c. Rate method
    d. None of the above
14. In the __________ method, all the assets and liabilities of the foreign subsidiary are translated into the home currency at the current exchange rate.
    a. Current rate
    b. Current/noncurrent
    c. Temporal
    d. None of the above
15. Which currency translation method differentiates between differentiates between monetary assets and liabilities?
    a. Current/noncurrent
    b. Temporal
    c. Monetary/nonmonetary
    d. Current rate
16. The ___________of a company is measured currency by currency and equals the difference between contractually fixed future cash inflows and outflows in each currency.
    a. Economic exposure
    b. Translation exposure
    c. Transaction exposure
    d. None of the above
17. ______________________is defined as the extent to which the value of the firm – as measured by the present value of its expected cash flows – will change when exchange rates change.
    a. Transaction exposure
    b. Economic exposure
    c. Financial exposure
    d. Translation exposure
18. The main instrument for financial control is the _______.
    a. Assets
    b. Liabilities
    c. Revenues and expenses
    d. Budget

19. The _____is the spot exchange rate when the budget is adopted.
    a. projected rate
    b. ending rate
    c. final rate
    d. initial rate
20. The ____is the spot exchange rate forecast for the end of the budget period.\
    a. Initial rate
    b. Ending rate
    c. Projected rate
    d. None of the above
21. The ___________is the spot exchange rate when the budget is compared with performance.
    a. Ending rate
    b. Projected rate
    c. Initial rate
    d. None of the above
22. The price at which such goods and services are transferred is referred to as the____________.
    a. Cost price
    b. Market price
    c. Selling price
    d. Transfer price

13.8 Summary

- Accounting is shaped by the environment in which it operates. Countries have different accounting systems just as they have different economic systems, political systems, and cultures.
- An adverse result of national differences in accounting and auditing standards has been a general lack of comparability of financial reports from one country to another.
- Adoption of common accounting standards facilitates the development of global capital markets, since more investors will be willing to make investments across borders, and the end result will be to lower the cost of capital and stimulate economic growth. Thus, accounting standards were standardized across national borders in the best interests of the participants in the world economy.

- A consolidated financial statement combines the different financial statements of two or more firms to yield a single set of financial statements as if the individual companies were a single entity.
- Two main methods that determine what exchange rate should be used by firms when translating financial statement currencies are the current rate method and the temporal method.
- The role of corporate headquarters is to control subunits within the organization in order to ensure that they achieve the best possible performance.

13.9 Glossary

Accounting information - It is the means by which firms communicate their financial position to the providers of capital, investors, creditors, and government.

Accounting standards - A set of rules, practices and policies that are used to systematize bookkeeping and other accounting functions across firms and over time.

Auditing standards: Auditing standards specify the rules for performing an audit – the technical process through which an independent person (the auditor) gathers evidence to determine if financial accounts conform to required accounting standards and also if they are reliable.

Consolidated financial statement - It combines the different financial statements of two or more firms to yield a single set of financial statements as if the individual companies were a single entity.

Current rate method - the exchange rate at the balance sheet date is used for translating the foreign subsidiary's financial statements into the MNE"s home currency.

Current/noncurrent method – Under this method, all the assets and liabilities of the foreign subsidiary are translated into the home currency at the current exchange rate.

Exposure - The concept of exposure refers to "the degree to which the company is affected by exchange rate changes.

Historic cost principle - This principle assumes "the currency unit used to report financial results is not losing its value due to inflation."

Inflation Accounting - The method makes use of a general price index for converting historic figures into current values.

Lessard-Lorange model – This model points out three exchange rates for translating foreign currencies into the corporate currency in setting budgets and in performance tracking: The initial rate, which is the spot exchange rate when the budget is adopted. The projected rate, which is the spot exchange rate forecast for the end of the budget period (i.e. forward rate) and the ending rate, which is the spot exchange rate when the budget is compared with performance.

Monetary/Nonmonetary method - differentiates between monetary assets and liabilities i.e. those items that represent an obligation to pay, a claim to receive, a fixed amount of foreign currency units and nonmonetary, or physical assets and liabilities.

Temporal method - inventory is usually translated at the historical rate but it can be translated at the current rate if the inventory is shown on the balance sheet at market values.

Transaction exposure – This exposure stems from the prospects of incurring future exchange gains or losses on transactions that are already entered into and are denominated in a foreign currency.

Transfer price - The price at which such goods and services are transferred between entities within a firm

Translation exposure - It is "the difference between exposed assets and exposed liabilities."

13.10 Self-Assessment Test

1. Explain country differences in accounting standards.
2. Define accounting standards. Explain why there is lack of comparability of financial reports from one country to another.
3. State the reasons for establishing international standards.
4. Explain why multinationals make use of consolidated financial statements to report their financials.
5. Explain the methods used by multinationals for currency translation.
6. Explain the different aspects of accounting in control systems.

13.11 Suggested Readings/Reference Material

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13.12 Answers to Check Your Progress Questions

1. (c) i, ii, iii, and v

The following variables can influence the development of an accounting system in a country:

- The relationship between business and capital providers;
- Political and economic ties with countries;
- The inflation level;
- The level of economic development of a country;
- The prevailing culture in a country.

2. (d) All of the above

The three main sources of external capital for business enterprises are individual investors, banks, and government.

3. (a) Current cost accounting

Current cost accounting adjusts all items in a financial statement – assets, liabilities, revenues, and costs in order to factor out the effects of inflation.

4. (d) Uncertainty avoidance

Uncertainty avoidance refers to the extent to which cultures socialize their members to accept ambiguous situations and tolerate uncertainty.

5. (d) Accounting standards

Accounting standards are rules for preparing financial statements.

6. (a) Auditing standards

Auditing standards specify the rules for performing an audit – the technical process through which an independent person (the auditor) gathers evidence to determine if financial accounts conform to required accounting standards and also if they are reliable.

7. (b) Transnational financing

Transnational financing takes place when a firm based in one country enters the capital market of another country for raising capital from the sale of stocks or bonds.

8. (a) Transnational investment

Transnational investment takes place when an investor based in one country enters another nation's capital market for making investments in stocks or bonds of a firm based in that country.

9. (b) International Accounting Standards Board

The IASB is responsible for formulating new international financial reporting standards.

10. (b) Consolidated financial statement

A consolidated financial statement combines the different financial statements of two or more firms to yield a single set of financial statements as if the individual companies were a single entity.

11. (c) Exposure

The concept of exposure refers to the degree to which the company is affected by exchange rate changes.

12. (b) Current rate method

In the current rate method, the exchange rate at the balance sheet date is used for translating the foreign subsidiary's financial statements into the MNE‟s home currency.

13. (b) Temporal method

The temporal method translates the value of the assets in a foreign currency into the currency of the home country using the exchange rate that exists when the assets are purchased.

14. (b) Current/noncurrent

In the current/noncurrent method, all the assets and liabilities of the foreign subsidiary are translated into the home currency at the current exchange rate.

15. (c) Monetary/nonmonetary method

The monetary/nonmonetary method differentiates between differentiates between monetary assets and liabilities.

16. (c) Transaction exposure

The transaction exposure of a company is measured currency by currency and equals the difference between contractually fixed future cash inflows and outflows in each currency.

17. (b) Economic exposure

Economic exposure is defined as the extent to which the value of the firm – as measured by the present value of its expected cash flows – will change when exchange rates change.

18. (b) Budgets

The main instrument for financial control is the budget.

19. (d) Initial rate

The initial rate is the spot exchange rate when the budget is adopted.

20. (c) Projected rate

The projected rate, which is the spot exchange rate forecast for the end of the budget period (i.e. forward rate).

21. (a) Ending rate

The ending rate is the spot exchange rate when the budget is compared with performance.

22. (d) Transfer price

The price at which such goods and services are transferred is referred to as the transfer price.

Unit 14

Financial Management in International Business

Structure

"Stop thinking about what your money can buy. Start thinking about what your money can earn."

- J. L. Collins

14.1 Introduction

The previous unit discussed country differences in accounting standards. It then explained the national and international standards. It then discusses the significance of consolidated financial statements, the methods used for currency translation and the concept of transaction exposure. It also explained the concept of economic exposure. The unit finally discussed the different aspects of accounting in control systems.

The financial management in international business includes three sets of decisions –investment decisions, decisions regarding what activities are to be financed; financing decisions; decisions regarding how to finance those activities; and money management decisions; decisions regarding how to efficiently manage the financial resources of a firm.

Good financial management enables a firm to both reduce costs of value creation and add value by improving customer service.

This unit will discuss the different investment decisions firms take in international business. It then goes on to explaining the various factors firms consider for financing in an international business. It then explains the money management decisions firms take in international business. It also explains how money management decisions help firms in achieving their tax objectives. It then discusses the techniques used by international businesses for moving across borders. The unit finally discusses the techniques for global money management.

14.2 Objectives

By the end of this unit, students should be able to:

- Explain how investment decisions are taken in international business.
- Describe how financing decisions are taken in international business.
- Discuss the money management decisions taken by firms in international business.
- Describe the techniques used by international businesses to transfer liquid funds across borders.
- Discuss the money management techniques that help firms in managing their global cash resources.

14.3 Investment Decisions

A decision to make investment in activities in any country should consider many political, economic, cultural, and strategic variables. A significant role of the financial managers in international business is to make attempts to quantify the various benefits, costs, and risks that may flow from an investment in a given location. This can be done by making use of capital budgeting techniques.

14.3.1 Capital Budgeting

The benefits, costs, and risks of an investment can be quantified using capital budgeting techniques. This helps managers to compare different alternatives of investment within and across countries in order to make informed choices about where the firm should invest its scarce financial resources. The theoretical framework used in capital budgeting for a foreign project is as same as that of the domestic project, that is, the firm should estimate the cash flows with the project over time. In most cases, the cash flows will be negative first because the firm heavily invests in production facilities. However, after some time period, the cash flows will become positive as revenues grow and investment costs decline. After estimating the cash flows, they should be discounted in order to know the net present value using an appropriate discount rate. The commonly used discount rate is either the cost of capital of the firm or some other required rate of return. If the net present value of the discounted cash flows is greater than zero, the firm should go ahead with the project.

Capital budgeting is a complex process. The factors complicating the process for international businesses include:

- A distinction should be made between cash flows to the parent company and cash flows to the project.
- Economic and political risks, including risks associated with foreign exchange, can significantly change the foreign investment value.
- The connection between the source of financing and cash flows to the parent company needs to be recognized.

14.3.2 Parent and Project Cash Flows

A theoretical argument exists for analyzing any foreign project from the parent company's perspective because cash flows to the project are essentially not the same thing as cash flows to the parent company. The project may not have the ability to remit all the cash flows to the parent company for several reasons. For instance, cash flows may be blocked from repatriation by the government of the host-country, they must be taxed at an unfavorable rate, or, the host government may require a certain percentage of the cash flows from the project to be reinvested within the host country. Though these restrictions do not affect the project's net present value, they do affect the net present value of the project to the parent company as they limit the cash flows that can be remitted to it from the project.

When a parent firm evaluates a foreign investment opportunity, it should be interested in the cash flows it would receive as opposed to the cash flows generated by the project because those are the basis for dividends to stockholders, repayment of worldwide corporate debt, investment somewhere else in the world, etc. Stockholders do not perceive blocked earnings as contributing to the value of the firm, and creditors do not count those earnings when calculating the ability of the parent to service its debt.

The issue of blocked earnings is not very serious. The greater acceptance of free market economics has reduced the number of countries in which governments may prohibit the foreign multinational's affiliates from remitting cash flows to their parent companies.

14.3.3 Adjusting for Political and Economic Risk

When analyzing a foreign investment opportunity, firms should consider the politic and economic risks stemming from the foreign location.

Political Risk

Political risk is defined as "the likelihood that political forces will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise." Political risk is greater in countries that experience social unrest or disorder and in countries where the fundamental nature of the society makes the probability of high social unrest. When political risk is high, there is a high probability that change will take place in the political environment of a country that will endanger the foreign firms there.

Political and social unrest may sometimes result in economic collapse, which can render assets of a firm to be worthless. In less extreme cases, political changes may result in increased tax rates, the imposition of price controls, the imposition of exchange controls that limit or block the ability of a subsidiary for remitting earnings to its parent company, and interference of government in existing contracts.

Many firms pay considerable attention to political risk analysis and to quantify political risk. The problem with forecasting political risk is that the firms try to predict a future and in most cases the guesses are wrong.

Economic Risk

Economic risk can be defined as "the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise." The biggest problem arising from economic mismanagement is inflation. Price inflation leads to a drop in the value of the currency of a country on the foreign exchange market. This can be a major problem for foreign firms with assets in that country as the value of the cash flows the firm receives from those assets will fall as the currency of the country depreciates on the foreign exchange market. This decreases the attractiveness of foreign investment in that country.

Example

As per a report in Bloomberg news dated October 15, 2019, China faced a precarious situation where its factory output slowed, falling raw material prices and its domestic slowdown further added its owes. Further the increased price of pork has propped up its consumer inflation higher thereby affecting the household spending power adding to the already uncertainty caused by the U.S.-China dispute.

Source: ICFAI Research Center

There have been many attempts to quantify the economic risk of a country and longterm movements in their exchange rates. There have been several empirical studies of the relationship between inflation rates of countries and their currencies' exchange rates. The studies showed a long-run relationship between the country's relative rates of inflation and exchange rate changes. However, the relationship is not reliable in the short-run and totally unreliable in the long-run. So as with political risks, the attempts to quantify economic risk were tempered with healthy skepticism.

13.3.4 Risk and Capital Budgeting

When analyzing a foreign investment opportunity, the additional risk stemming from its location can be handled in at least two ways. The first method is to treat all kinds of risks as one problem by increasing the discount rate that is applicable to foreign projects in countries where political and economic risk are perceived to be high. The higher the discount rate, the higher the projected net cash flows should be for any investment to have a positive net present value.

The second method is adjusting discount rates for reflecting the riskiness of a location. For instance, several studies of large US multinationals have found that many of them add a premium percentage for risk to the discount rate they used in the evaluation of potential foreign investment projects. For any investment decisions, the political and economic risk being evaluated is not of immediate possibilities, but rather at some discount in the future. Thus, it can be argued that rather than using a high discount rate to evaluate such risky projects, it is better to revise future cash flows from the project downward to reflect the possibility of adverse political or economic changes sometime in the future.

Activity 14.1

CH Mobile, a China-based mobile company is planning to make investments in the Indian telecom industry. Before making any investment, the managers of the company conducted some research in order to quantify the benefits, risks, and costs ensuing from the investments in the country. What are the decisions the company is planning to take? Suggest the technique the company can take when taking such decisions in international business. Also explain the benefits of that technique.

Answer:

14.4 Financing Decisions

An international business should take into consideration some factors when considering its options for financing. The first factor is how the foreign investment will be financed. If the firm requires external financing, it should decide whether to borrow from host-country's sources or tap the global capital market for funds. The second factor is how to configure the financial structure of the foreign affiliate.

14.4.1 Financing Decisions and the Global Capital Market

A capital market brings together those who want to make investments and those who want to borrow money. Corporations with surplus cash, non-bank financial institutions, and individuals make investments in the capital market. Individuals, companies, and governments borrow money from the capital market. The global capital market benefits borrowers by increasing the supply of funds available for borrowing, which lowers the cost of capital of the firm.

Capital market loans offered to corporations are either equity loans or debt loans. An equity loan is made when a corporation sells its stock to investors. The money the corporation receives in return for its stock can be used for purchasing plants and equipment, pay wages, fund R&D projects, etc. A share of stock gives a holder a claim to the profit stream of the firm. The claim is honored by corporations by paying dividends to stockholders. The dividend amount is not fixed in advance rather it is determined by management based on the profits made by the corporation. Investors purchase stock for yielding dividends and in anticipation of gains in the stock price, which in theory reflects future dividend yields. Thus investors purchase equity in firms that do not currently issue dividends to stockholders because they anticipate that the firm will do at some point. Stock prices increase when a corporation is projected to have higher earnings in the future, which increases the probability that it will increase dividend payments in future.

A debt loan requires the corporation to repay a predetermined portion of the loan amount at regular intervals regardless of how much profit the corporation is making. Management has no discretion as to the amount it will pay its investors. Debt loans include cash loans from banks and funds raised from the sale of corporate bonds to investors. When a corporate bond is purchased by an investor, he/she purchases the right to receive a specified fixed income stream from a corporation for some specific number of years i.e. until the bond matures.

Lowering Capital Costs

In a domestic capital market, the pool investors are limited to the country residents. This places an upper limit on the funds supply available to borrowers i.e. the liquidity of the market is limited. A global capital market, which has a larger pool of investors, offers a larger supply of funds for borrowers to draw on.

Perhaps the most crucial drawback of the limited liquidity of a domestic capital market is that the cost of capital tends to be higher than it is in an international market. The cost of capital is “the price of borrowing money, which is the rate of return that borrowers must pay investors.” This is the rate of interest on debt loans and the dividend yield and expected capital gains on equity loans. The limited pool of investors in a domestic market implies that borrowers should pay more in order to persuade investors to lend them their money. The larger pool of investors in an international market implies that borrowers will be able to pay less. The greater pool of resources in the global capital market leads to greater liquidity. Thus the global capital market lowers the cost of capital for borrowers.

Growth of the Global Capital Market

The global capital market is growing rapidly increasing the opportunities for firms to lower their capital costs by accessing the market.

The international capital market boomed in the 1980s due to advances in information technology and government deregulation. The financial services industry is information-intensive, drawing on large volumes of information about markets, risks, interest rates, exchange rates, credit worthiness, etc. This information is used by the financial services industry to make decisions about what to invest where, how much the borrowers should be charged, how much interest should be paid to the depositors, and the value and riskiness of several financial assets including stocks, corporate bonds, currencies, and government securities.

Financial services industry is the most tightly regulated industry of all industries. Governments worldwide have kept financial services firms of other countries from entering capital markets. In some cases, they also have restricted the overseas expansion of their domestic financial services firms. In many countries, the domestic financial services industry is segmented by law. For instance, in the US commercial banks were prohibited to perform the functions of investment banks and vice versa. Historically, many countries have limited foreign investors' ability to purchase significant equity positions in domestic companies.

Many of these restrictions have been reducing since the early 1980s with a series of changes that allowed foreign banks to enter the US capital market and domestic banks to expand to expand their operations overseas.

14.4.2 Source of Financing

When a firm seeks external financing for a project, it will want to borrow funds from the lowest-cost capital source available. Firms are increasingly moving toward the global capital market to finance their investments. The cost of capital in global capital markets is low by virtue of its size and liquidity, than in domestic capital markets, especially those that are small and relatively illiquid. For instance, a US firm making an investment in Denmark may finance the investment by borrowing through the London-based Eurobond market as opposed to the Danish capital market.

Despite the trends toward deregulation of financial services, in some cases, the restrictions of the host-country's government may rule out this option. The governments of some countries prefer foreign multinationals to finance projects in their country by local sales of equity or local debt financing. In countries where there is limited liquidity, this increases the cost of capital used for financing a project. Thus, in capital budgeting decisions, the discount rate needs to be adjusted in order to reflect this. However, some governments court foreign investment by providing foreign firms low-interest loans, lowering the capital cost. Accordingly, in capital budgeting decisions, the discount rate should be revised downward in such cases.

In addition to the impact of host-government policies on financing decisions and the cost of capital, the firm may consider local debt financing for investments in countries where the local currency is expected to depreciate on the foreign exchange market. When a country's currency depreciates, the amount of local currency needed to meet interest payments and retire principal on local debt obligations is not affected. However, if the foreign debt obligations have to be served, the amount of local currency needed for doing this will increase as the currency depreciates, and this effectively raises the cost of capital. Thus, though the initial capital costs may be greater with local borrowing, it might be better to borrow locally in case the local currency is expected to be depreciated on the foreign exchange market.

14.4.3 Financial Structure

Different countries have a different financial structure for firms. Financial structure refers to "the mix of debt and equity used to finance a business." For instance, Japanese firms rely more on debt financing than most of the US firms.

A possible explanation for why financial structures of firms vary across countries is that different tax regimes determine the relative attractiveness of equity and debt in a country. However, empirical research shows that country differences in financial structure are not related to systematically to country differences in tax structure. Another possibility is that the country differences may reflect cultural norms.

International businesses should decide whether it should conform to local capital structure norms. A significant advantage for conforming to debt norms of the host-country is that management can more easily evaluate its return on equity relative to local competitors in the same industry. Conforming to host-country debt norms can also enhance the foreign affiliates' image that operates with too little debt and thus appearing sensitive to local monetary policy. The best recommendation is that an international business needs to adopt a financial structure for each foreign affiliate that minimizes its cost of capital irrespective of whether that structure is consistent with local practice.

14.5 Global Money Management: The Efficiency Objective

Money management decisions make attempts to manage the global cash resources of a firm – most efficiently its working capital. This involves minimizing cash balances and reducing transaction costs.

14.5.1 Minimizing Cash Balances

A firm should hold certain cash balances for any given period. This is essential for serving any accounts and notes payable during that period and as a contingency against unexpected cash demands. The firm invests its cash reserves in money market accounts in order to earn interest on them. However, it should be easily able to withdraw money freely from those accounts. Such accounts offer low rates of interest. In contrast, a firm can earn higher interest rate if it invests its cash resources in longer-term financial instruments. However, the problem with longer-term financial instrument is that the firm cannot withdraw its money before the instruments mature without bearing a financial penalty.

14.5.2 Reducing Transaction Costs

Transaction costs are "the cost of exchange." Every time a firm changes cash from one currency to another, it bears a transaction cost – the commission fee a firm pays to foreign exchange dealers to perform the transaction. Most banks also charge a transfer fee for moving cash from one location to another. This is another transaction cost.

14.6 Global Money Management: The Tax Objective

Different countries have different tax regimes. Many nations follow the worldwide principle that they have the right to tax income earned outside their boundaries by entities based in their country. When the income of a foreign subsidiary is taxed by the host country's government and by the parent company's home country, double taxation occurs. Double taxation can be mitigated to some extent by tax credits, tax treaties, and the deferral principle.

A tax credit "allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government. A tax treaty is "an agreement between two countries specifying what items of income will be taxed by the authorities of the country where the income is earned." A deferral principle "specifies that parent companies are not taxed on foreign source income until they actually receive a dividend."

Example

Standertrade.com dated 15th January 2022 has reported that there has been a robust investment through acquisitions in ICT (software and hardware) and construction-supported FDI. Cross-border mergers and acquisitions increased by 83% to USD 27 billion, with large deals involving ICT, healthcare, infrastructure and energy. Major transactions included the acquisition of Jio Platforms by Jaadhu (US) for USD 5.7 billion, the acquisition of Tower Infrastructure Trust by Brookfield (Canada) and GIC (Singapore) for USD 3.7 billion and the sale of Larsen & Toubro India's electrical and automation division for USD 2.1 billion. The merger of Unilever India with GlaxoSmithKline Consumer Healthcare India for USD 4.6 billion also contributed. In case these investors have not been taxed in their respective foreign countries till they receive the dividends, then 'deferral principle' will be used to depict the transaction.

Source: ICFAI Research Center

For the international business with activities spread across many countries, the various tax regimes and tax treaties have crucial implications for how the firm should structure its internal payments system among the parent company and the foreign subsidiaries. Firms can use transfer prices and fronting loans for minimizing its global tax liability. In addition, the form in which income is remitted from a foreign subsidiary to the parent company can be structured in order to minimize the global tax liability of the firm.

Some firms use tax havens such as the Bermuda and Bahamas for minimizing their tax liability. A tax haven is "a country with exceptionally low, or even no, income tax." International businesses avoid or defer income taxes by setting up a wholly- owned non-operating subsidiary in the tax haven. The tax haven subsidiary owns the common stock of the operating foreign subsidiaries, which allows for transferring funds from foreign subsidiaries to the parent company by funneling through the tax haven subsidiary. The tax levied on foreign source income by the home government of the firm can be deferred under the deferral principle until the tax haven subsidiary pays the dividend to the parent. This dividend payment can be indefinitely postponed if foreign subsidiaries continue to grow and require new internal financing from the tax haven affiliate.

14.7 Moving Money across Borders

Pursuing the objectives of utilizing the cash resources of a firm efficiently and minimizing the global tax liability requires the firm to be able to transfer funds from one location to another across the globe. International businesses use many techniques for transferring liquid funds across borders. These include dividend remittances, royalty payments and fees, transfer prices, and fronting loans. Some firms rely on more than one of these techniques for transferring funds across borders – a practice known as unbundling. Unbundling helps international businesses to recover funds from its foreign subsidiaries without piquing sensitivities of the host-country with large "dividend drains."

A firm's ability to select a particular policy is limited when a foreign subsidiary is partly-owned either by a local joint venture or by local stakeholders.

14.7.1 Dividend Remittances

The most common method for transferring funds from foreign subsidiaries to the parent company is payment of dividends. The dividend policy differs in each subsidiary depending on factors such as tax regulations, age of the subsidiary, extent of local equity participation, and foreign exchange risk.

14.7.2 Royalty Payments and Fees

Royalties represent remuneration paid to the owners of patents, trade names, or technology for the right to manufacture/sell products under those patens or trade names or use that technology. Parent companies charge its foreign subsidiaries royalties for patents, trade names, or technology as it transfers them. Royalties may be levied as a fixed monetary amount per unit of the product sold by the subsidiary or a percentage of the gross revenues of the subsidiary.

A fee is compensation for expertise or professional services supplied by the parent company or another subsidiary to a foreign subsidiary. Fees are differentiated into "technical fees" for guidance in technical matters and "management fees" for advice and general expertise. Fees are levied as fixed charges for the services provided.

Royalties and fees have some tax advantages over dividends, particularly when the corporate tax rate is higher in the host country than in the home country. Royalties and fees are tax-deductible locally, so arranging for payments in royalties and fees educes the tax liability of the foreign subsidiary. If a foreign subsidiary provides the parent company dividend payments as compensation, local income taxes need to be paid before the dividend distribution, and withholding taxes should be paid on the dividend itself. Though the parent company can offer a tax credit for the local withholding and income taxes it has paid, a portion of the benefit would be lost is the combined tax rate of the subsidiary is higher than the parent's.

14.7.3 Transfer Prices

In any international business, a large number of goods and services transfer between the parent company and foreign subsidiaries and between subsidiaries. This usually happens in firms pursuing global and transnational strategies because these firms are likely to have dispersed their value creation activities to various locations around the globe. "The price at which goods and services are transferred between entities within the firm is referred to as the transfer price."

Example

As per a report in Economic Times dated 6th January 2020, the largest Chinese automobile company manufacturing SUV's, "The Great Wall Motors" has entered into a formal agreement with General Motors, in Pune India and is acquiring the manufacturing facility of General Motors for about $ 250 to 300 million. The company has plans to shift its manufacturing operations and the Pune facility will become its subsidiary. The company may face higher import duty in shifting the semi finished components from China to India for final assembly of the SUV. To avoid this, the company can adopt transfer pricing technique while pricing such semi finished products?

Source: ICFAI Research Center

Transfer prices can be used for positioning funds within an international business. For instance, funds can be moved out of a country by setting high transfer prices for goods and services that are supplied to a subsidiary in that country and by setting low transfer prices for the goods and services sourced from that subsidiary. On the other hand, funds can be positioned in a country by setting low transfer prices for goods and services sourced from that subsidiary and setting high transfer prices for the goods and services sourced from that subsidiary. This movement of funds takes place between the subsidiaries of the firm or between the parent company and a subsidiary.

Benefits of Manipulating Transfer Prices

The benefits derived from manipulating transfer prices include:

1. The firm can reduce its tax liabilities by making use of transfer prices for shifting earnings from a high-tax country to a low-tax country.
2. Firms use transfer prices for moving funds out of a country where significant devaluation in currency is expected, thereby reducing its exposure to foreign exchange risk.
3. Firms use transfer prices for moving funds from a subsidiary to the parent company when financial transfers in the form of dividends are blocked or restricted by polices of the host government.
4. Firms can use transfer prices for reducing the import duties it has to pay when an ad valorem tariff is in force – tariff that is assessed as a percentage of value. In such cases, low transfer prices on goods and services being imported into the country are required. Since this lowers the value of the goods or services, it lowers the tariff.

Problems of Transfer Pricing

Significant problems are associated with transfer pricing policies. When transfer prices are used for reducing the tax liabilities or import duties for a firm, governments feel that they are being cheated of their legitimate income. When transfer prices are manipulated for circumventing government restrictions on capital flows, governments perceive this as breaking the spirit if not the law. Many governments impose limits on the ability of international businesses to manipulate transfer prices. The US has strict regulations governing transfer prices. According to Section 482 of the Internal Revenue Code, the Internal Revenue Service (IRS) can reallocate gross income, credits, deductions, or allowances between related corporations for preventing tax evasion or for reflecting proper income allocation. According to IRS guidelines, the correct transfer price is arm's-length price – "the price that would prevail between unrelated firms in a market setting."

Another problem associated with transfer pricing is that it is inconsistent with a policy of treating each subsidiary in a firm as a profit center. When transfer prices are manipulated and deviate from the arm's-length price significantly, the performance of the subsidiary depends much on transfer prices. A subsidiary told to charge a higher transfer price on goods supplied to another subsidiary appear to do better than it actually does while the subsidiary purchasing the good appears to be doing worse. Unless this is recognized during performance evaluation, serious distortions in management incentives can occur.

Despite these problems, research indicates that all international businesses do not use arm's-length pricing but instead use some cost-based system for transfer pricing among their subunits.

14.7.4 Fronting Loans

A fronting loan is "a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large multinational bank." In a direct intrafirm loan, the parent company lends cash to the foreign subsidiary directly, and the subsidiary later repays the loan. In a fronting loan, the parent company deposits funds in an international bank, and the bank lends the same amount deposited to the foreign subsidiary. From the bank's viewpoint, the loan is free from risks as it has 100 percent collateral in the form of deposit of the parent company. The bank "fronts" for the parent, hence the name. The bank profits by paying the parent company a lower interest rate on its deposit than it charges the foreign subsidiary on the funds borrowed.

Fronting loans are used by firms for two reasons. First, fronting loans can circumvent restrictions of the host-country on funds remittance from a foreign subsidiary to the parent company. A host government may impose restrictions on a foreign subsidiary regarding loan repayment to its parent for preventing the foreign exchange reserves of a country, but it is less likely to restrict the ability of a subsidiary to repay a loan to a large international bank. International businesses sometimes make use of fronting loans when they want to lend funds to a subsidiary based in a country with high probability of political turmoil that may lead to capital flow restrictions. A fronting loan also provides tax advantages.

Example

Central banking.com dated 30th July 2021 has reported that China's capital controls will continue as it is critical for China to grow economically. The report adds that while domestic households are restricted from investing abroad and foreign investors are restricted from accessing financial markets, funds are kept safe within China's borders. Further, there are restrictions on funds remittance from a foreign subsidiary in its country to the parent company. Assuming that Lorvin Power (India) Pvt., Ltd., has established its subsidiary in China Lorvin Power (China). The company wants to expand its activities and the parent company deposits funds in an international bank and the bank lends the same amount deposited to its foreign subsidiary. The subsidiary repays the loans to the bank thereby overcoming the regulatory restrictions of the host government. Here, fronting loan is the method adopted by Lorvin Power (India) through its banker.

The parent company can circumvent restrictions of the host country on funds remittance from a foreign subsidiary to the parent company which is the policy adopted by Lorvin Power (India) Pvt. Ltd.

Source: ICFAI Research Center

Activity 14.2

XYZ Ltd., a US-based company sold vacuum cleaners under the brand name "Power Cleaners". The company achieved huge sales due to its unique vacuum cleaning technology. This prompted the company to expand its operations in other countries. After conducting some market research, the company found that there was lot of demand for vacuum cleaners in the UK. Subsequently, the company started its operations in the UK. As the foreign subsidiary use XYZ's technology and expertise, the subsidiary had to compensate the parent company for using its technology patent and brand name. Which technique can the foreign subsidiary use in order to transfer funds from the UK to the US? Also discuss other techniques used in international business for transferring funds across national borders.

Answer:

14.8 Techniques for Global Money Management

Firms make use of several money management techniques for managing their global cash resources efficiently. They are discussed below:

14.8.1 Centralized Cash Management versus Decentralized Cash Management

Multinationals with different subsidiaries in different parts of the world have cash flows in several currencies and countries. It can either leave cash management to an individual subsidiary, which may be called decentralized cash management. When the cash management is left to the affiliates, each subsidiary has to take on the entire responsibility of cash management, including short-term borrowing, short-term investment and currency exposure management. In other words, the entire cash management is from the view of the subsidiary. Thus there is no need to monitor cash flows between affiliates and between an affiliate and the parent company for ensuring the success of the MNCs cash management system.

Under the centralized cash management, the cash management of the entire MNC is vested in a centralized cash depository. The centralized cash depository acts as a netting center as well as a repository of surplus funds of a subsidiary unit. The depository pools the excess cash from all the subsidiaries and pays it to the subsidiary units as when a need arises. As different subsidiaries have excess cash in different currencies, the centralized cash management maintains a separate cash pool for each currency. When an affiliate needs cash in a particular currency, the cash pool can pay to the affiliate in that currency. The centralized cash management also undertakes market borrowing or undertakes investment of surplus funds on behalf of the entire MNC. This system takes on the responsibility of exchange risk management for the entire MNC. Thus the centralized cash management reduces the burden of cash management at each subsidiary and this in turn helps the subsidiaries to concentrate on their major operations.

Why Centralized Depositories are Preferred?

Firms generally prefer to hold cash balances at a centralized depository for three reasons. First, by centrally pooling the cash reserves, the firm can deposit larger amounts. Usually cash balances are deposited in liquid accounts such as overnight money market accounts. As interest rates on such deposits increase with the size of the deposit, the firm should be able to earn a higher interest rate than it would if each subsidiary managed its own cash balances.

Second, if the centralized depository is located in a major financial center such as in London, Tokyo, or New York, it should have access to information about good short-term investment opportunities that are lacking in a typical foreign subsidiary. The financial experts at the centralized depository must have the ability to develop investment skills and know-how that are lacking in managers in a typical foreign subsidiary. Hence, the firm should make better investment decisions if it pools its cash reserves at a centralized depository.

Third, pooling cash reserves helps a firm in reducing the total size of the cash pool it should hold in highly liquid accounts, which enables the firm to invest cash reserves in large amounts in longer-term, less liquid financial instruments that earn a high rate of interest.

The ability of a firm to set up a centralized depository that can serve short-term cash needs may be limited by restrictions imposed by governments on flow of capital across borders. The advantages of this system are also limited by transaction costs of moving money into and out of different currencies. Despite this, many firms hold precautionary cash reserves at the centralized depository, having each subsidiary hold its own day-to-day-needs cash balance. The trends likely to increase the use of centralized depositories are globalization of the world capital market and the general removal of barriers for free cash flow across borders.

Advantages of Centralized Cash Management

A major advantage of a centralized cash management is that the cash balances of all the affiliates can be pooled and the excess cash can be invested at advantageous rates. Another advantage is that cash deficits can be taken care of by undertaking market borrowing at favorable rates. The centralized cash management can ensure adequate liquid funds in the system with smaller cash holdings in comparison to a decentralized cash management system. The funds are also maintained in currencies which are highly needed. The centralized cash management has an investment policy for investing surplus funds in marketable securities that are denominated in international currencies. This also helps in meeting payables in future. Under the centralized cash management, foreign exchange risk could be easily diversified by holding cash or marketable securities in different currencies.

Disadvantages of Centralized Cash Management

The centralized cash management also has some disadvantages. There can be unpredictable delays in moving funds to affiliates. This may pose a serious problem if an affiliate has to meet an unforeseen expenditure on an immediate basis. To meet such needs, affiliates may need to keep some excess cash with them but this goes against the principle of centralized cash management. Thus the MNC has to decide the appropriate degree of centralization of cash management. It can also clearly state which aspects of cash management can be centralized or decentralized. The system should also take into consideration taxes, political risks, and liquidity preferences while deciding the currencies in which the cash balances should be held and also the quantum of such cash balances. It should also keep in view the nature of operations of the subsidiaries and their locations. Information technology helps centralized cash management to receive timely information about each subsidiary's cash position. This continual information facilitates the centralized cash management to take right and timely decisions regarding borrowing, investment, and exposure coverage.

14.8.2 Multilateral Netting

Multilateral netting allows a multinational firm to reduce its cost of transaction that arises when many transactions take place between its subsidiaries. These transaction costs are the commissions paid to foreign exchange dealers for foreign exchange transactions and the fees charged by banks for transferring cash between locations. The volume of such transactions is high in firms that have a globally dispersed web of independent value creation activities. Multilateral netting reduces the costs of transaction by reducing the number of transactions.

Multilateral netting is an extension of bilateral netting. Under bilateral netting, if a French subsidiary owes US$ 6 million to a Mexican subsidiary and the Mexican subsidiary owes US$ 4 million to the French subsidiary, a bilateral settlement will be made with a single payment of US$ 2 million from the French subsidiary to the Mexican subsidiary cancelling the remaining debt.

Example

As per a report in Economic Times dated 31.12.2019, there has been an increase of global sales of Toyota's cars by 2 % in November 2019 at 9,24,352 units. Toyota, one of the largest Japanese car manufacturer has plants across the world notably in Australia, Brazil, Canada, Bangladesh, India and USA.

Contd….

Due to global operations, there can be high volume transactions across the various subsidiaries globally and the company has to incur commissions paid to foreign exchange dealers for foreign exchange transactions and the fees charged by banks for transferring cash between locations. Such costs can be reduced through multilateral netting.

Source: ICFAI Research Center

Under multilateral netting, the transactions take place between multiple subsidiaries within an international business. Consider a firm establishing multilateral netting among four Asian subsidiaries based in China, Taiwan, South Korea, and Japan. These subsidiaries trade with each other and at the end of the month a large transaction volume needs to be settled. If US$ 43,000 is required to flow among the subsidiaries, the amount can be reduced by multilateral netting. The firm can determine the payments to be made among its subsidiaries for settling these obligations. Multilateral netting reduces the transactions to just three; the Korean subsidiary pays US3 million to the subsidiary in Taiwan; and the Chinese subsidiary pays US$ 1 million to the Japanese subsidiary and US$ 1 million to the Taiwanese subsidiary. The total funds are reduced to just US$ 5 million from US$ 43 million, and the transaction costs are reduced to US$ 50,000, a savings of US$ 380,000 is achieved through multilateral netting.

Check Your Progress - 1

1. The benefits, costs, and risks of an investment can be quantified using _____.
   a. Political risks
   b. Economic risks
   c. Project cash flows
   d. Capital budgeting techniques
2. When analyzing a foreign investment opportunity, firms should consider the _______and economic risks stemming from the foreign location.
   a. Social
   b. Political
   c. Technical
   d. None of the above
3. ________is the likelihood that political forces will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.
   a. Economic risk
   b. Social unrest
   c. Technical issues
   d. Political risk

4. _______is the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.
   a. Economic slowdown
   b. Political risk
   c. Economic risk
   d. None of the above
5. Which of the following make investments in the capital market?
   a. Corporations with surplus cash
   b. Individuals
   c. Non-bank financial institutions
   d. All of the above
6. Which of the following borrow money from the capital market?
   a. Individuals
   b. Companies
   c. Governments
   d. All of the above
7. Capital market loans offered to corporations are either equity loans or______.
   a. Debt loans
   b. Mortgage loans
   c. Personal loans
   d. None of the above
8. A/An __________is made when a corporation sells its stock to investors.
   a. Debt loan
   b. Equity loan
   c. Auto loan
   d. Mortgage loan
9. A/An __________ requires the corporation to repay a predetermined portion of the loan amount at regular intervals regardless of how much profit the corporation is making. equity
   a. Loan unsecured
   b. Loan secured
   c. Loan
   d. Debt loan
10. ___________include cash loans from banks and funds raised from the sale of corporate bonds to investors.
    a. Credit card debt
    b. Debt loans

   c. Equity loans
   d. None of the above

11. The ___________ is the price of borrowing money, which is the rate of return that borrowers pay investors.
    a. Cost of capital
    b. Financial structure
    c. Financial assets
    d. Financing costs
12. _______________ including stocks, corporate bonds, currencies, and government securities.
    a. Financial structure
    b. Liabilities
    c. Financial assets
    d. Loans
13. _________refers to the mix of debt and equity used to finance a business.
    a. Equity loans
    b. Debt loans
    c. External financing
    d. Financial structure
14. Under the ______, the cash management of the entire MNC is vested in a centralized cash depository.
    a. Decentralized cash management
    b. Netting
    c. Centralized cash management
    d. None of the above
15. ___________involve minimizing cash balances and reducing transaction costs.
    a. Investment decisions
    b. Money management decisions
    c. Financial decisions
    d. None of the above
16. A _____________allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government.
    a. Tax haven
    b. Tax treaty
    c. Deferral principle
    d. Tax credit

17. A _____________is an agreement between two countries specifying what items of income will be taxed by the authorities of the country where the income is earned.
    a. Tax treaty
    b. Tax credit
    c. Tax haven
    d. None of the above
18. A _____specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.
    a. Dividends remittance
    b. Deferral principle
    c. Arm's length price
    d. Tax treaty
19. A _____is a country with exceptionally low, or even no, income tax.
    a. Tax treaty
    b. Tax credit
    c. Tax haven
    d. Deferral principle
20. The most common method for transferring funds from foreign subsidiaries to the parent company is ___________.
    a. Fronting loans
    b. Dividend payments
    c. Royalties
    d. Fees
21. ___________represent remuneration paid to the owners of patents, trade names, or technology for the right to manufacture/sell products under those patens or trade names or use that technology.
    a. Royalties
    b. Dividend payments
    c. Fronting loans
    d. Transfer price
22. A _____is compensation for expertise or professional services supplied by the parent company or another subsidiary to a foreign subsidiary.
    a. Royalty
    b. Fee
    c. Transfer price
    d. None of the above

23. The price at which goods and services are transferred between entities within the firm is referred to as the .
    a. Transfer price
    b. Arm's-length price
    c. Tax credit
    d. Bilateral netting
24. ________is the price that would prevail between unrelated firms in a market setting.
    a. Deferral principle
    b. Transfer price
    c. Royalties
    d. Arm's-length price
25. A _____ is a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large multinational bank.
    a. Fronting loan
    b. Fee
    c. Dividend
    d. None of the above
26. Firms make use of two money management techniques for managing their global cash resources efficiently – centralized depositories and _________.
    a. Bilateral netting
    b. Multilateral netting
    c. Royalties and fees
    d. Transfer price

14.9 Summary

- A decision to make investment in activities in any country should consider many political, economic, cultural, and strategic variables.
- An international business should take into consideration some factors when considering its options for financing. The first factor is how the foreign investment will be financed. The second factor is how to configure the financial structure of the foreign affiliate.
- Money management decisions make attempts to manage the global cash resources of a firm – most efficiently its working capital. This involves minimizing cash balances and reducing transaction costs.
- Different countries have different tax regimes. Many nations follow the worldwide principle that they have the right to tax income earned outside their boundaries by entities based in their country.

- International businesses use many techniques for transferring liquid funds across borders. These include dividend remittances, royalty payments and fees, transfer prices, and fronting loans.
- Multinationals with different subsidiaries in different parts of the world have cash flows in several currencies and countries. It can either leave cash management to an individual subsidiary, which may be called decentralized cash management.
- Under the centralized cash management, the cash management of the entire MNC is vested in a centralized cash depository. The centralized cash depository acts as a netting center as well as a repository of surplus funds of a subsidiary unit.
- Multilateral netting allows a multinational firm to reduce its cost of transaction that arises when many transactions take place between its subsidiaries.

14.10 Glossary

Arm's-length price - Arm's-length price is the price that would prevail between unrelated firms in a market setting.

Cost of capital - The cost of capital is the price of borrowing money, which is the rate of return that borrowers must pay investors.

Deferral principle - A deferral principle specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.

Economic risk - "the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise."

Economic risk - Economic risk is the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.

Financial structure - Financial structure refers to the mix of debt and equity used to finance a business.

Fronting loan: - A fronting loan is a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large multinational bank.

Multilateral netting - It allows a multinational firm to reduce its cost of transaction that arises when many transactions take place between its subsidiaries.

Political risk - Political risk is the likelihood that political forces will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.

Tax credit - A tax credit allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government.

Tax haven - A tax haven is a country with exceptionally low, or even no, income tax.

Tax treaty - A tax treaty is an agreement between two countries specifying what items of income will be taxed by the authorities of the country where the income is earned.

14.11 Self-Assessment Test

1. Explain in detail the factors complicating the capital budgeting process for an international business.
2. Explain in detail the factors an international business should take into consideration when considering its options for financing.
3. Money management decisions involve minimizing cash balances and reducing transaction costs. Explain them in detail.
4. Explain how the money management decisions help firms in achieving their tax objective.
5. International businesses use many techniques for transferring liquid funds across borders. Explain those techniques in detail.
6. Describe the money management techniques that help firms in managing their global cash resources.

14.12 Suggested Readings/Reference Material

1. Charles W L Hill and G Thomas M Hult (2021). International Business – Competing in the Global Marketplace. 12th edition, McGraw Hill India.
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7. John Wild and Kenneth Wild (2019). International Business – The Challenges of Globalization. Pearson Education

Additional References:

1. Serenity Gibbons. How to expand your business internationally without compromising your core model. Forbes (2020). https://www.forbes.com/sites/serenitygibbons/2020/03/24/how-to-expand-a-business-internationally-without-compromising-your-core-model/?sh=66335a6f741d

2. IFRS Foundation. Use of IFRS standards around the world. 2018. https://cdn.ifrs.org/-/media/feature/around-the-world/adoption/use-of-ifrs-around-the-world-overview-sept-2018.pdf
3. Brett Steenbarger. Why diversity matters in the world of Finance. 2020. https://www.forbes.com/sites/brettsteenbarger/2020/06/15/why-diversity-matters-in-the-world-of-finance/?sh=36dba0637913
4. IFC. Social and Green Bonds. https://www.ifc.org/wps/wcm/connect/corp_ext_content/ifc_external_corporate_site/about+ifc_new/investor+relations/ir-products/socialbonds
5. Business Insider. Global ecommerce market report: ecommerce sales trends and growth statistics for 2021. https://www.businessinsider.com/global-ecommerce-2020-report?IR=T

14.13 Answers to Check Your Progress Questions

1. (d) Capital budgeting techniques

The benefits, costs, and risks of an investment can be quantified using capital budgeting techniques.

2. (b) Political risks

When analyzing a foreign investment opportunity, firms should consider the political and economic risks stemming from the foreign location.

3. (d) Political risk

Political risk is the likelihood that political forces will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.

4. (c) Economic risk

Economic risk is the likelihood that economic mismanagement will cause drastic changes in a country's business environment that hurt the profit and other goals of a business enterprise.

5. (d) All of the above

Corporations with surplus cash, non-bank financial institutions, and individuals make investments in the capital market.

6. (d) All of the above

Individuals, companies, and governments borrow money from the capital market.

7. (a) Debt loans

Capital market loans offered to corporations are either equity loans or debt loans.

8. (b) **Equity loan**

An equity loan is made when a corporation sells its stock to investors.

9. (d) **Debt loan**

A debt loan requires the corporation to repay a predetermined portion of the loan amount at regular intervals regardless of how much profit the corporation is making.

10. (b) **Debt loans**

Debt loans include cash loans from banks and funds raised from the sale of corporate bonds to investors.

11. (a) **Cost of capital**

The cost of capital is the price of borrowing money, which is the rate of return that borrowers must pay investors.

12. (c) **Financial assets**

Financial assets including stocks, corporate bonds, currencies, and government securities.

13. (d) **Financial structure**

Financial structure refers to the mix of debt and equity used to finance a business.

14. (c) **Centralized cash management**

Under the centralized cash management, the cash management of the entire MNC is vested in a centralized cash depository.

15. (b) **Money management decisions**

Money management decisions involves minimizing cash balances and reducing transaction costs.

16. (d) **Tax credit**

A tax credit allows an entity to reduce the taxes paid to the home government by the amount of taxes paid to the foreign government.

17. (a) **Tax treaty**

A tax treaty is an agreement between two countries specifying what items of income will be taxed by the authorities of the country where the income is earned.

18. (b) **Deferral principle**

A deferral principle specifies that parent companies are not taxed on foreign source income until they actually receive a dividend.

19. (c) Tax haven

A tax haven is a country with exceptionally low, or even no, income tax.

20. (b) Dividend payments

The most common method for transferring funds from foreign subsidiaries to the parent company is payment of dividends.

21. (a) Royalties

Royalties represent remuneration paid to the owners of patents, trade names, or technology for the right to manufacture/sell products under those patens or trade names or use that technology.

22. (b) Fee

A fee is compensation for expertise or professional services supplied by the parent company or another subsidiary to a foreign subsidiary.

23. (a) Transfer price

The price at which goods and services are transferred between entities within the firm is referred to as the transfer price.

24. (d) Arm's-length price

Arm's-length price is the price that would prevail between unrelated firms in a market setting.

25. (a) Fronting loan

A fronting loan is a loan between a parent and its subsidiary channeled through a financial intermediary, usually a large multinational bank.

26. (b) Multilateral netting

Firms make use of two money management techniques for managing their global cash resources efficiently – centralized depositories and multilateral netting.

International Business

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