Sixth Edition

INTERNATIONAL FINANCIAL MANAGEMENT

Jeff MADURA | Roland FOX

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Jeff Madura | Roland Fox

Australia • Brazil • Canada • Mexico • Singapore • United Kingdom • United States

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Jeff Madura:
To my mother Irene

Roland Fox:
To Marlene, Anna and Joe

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Online additional reading

1 Multinational restructuring
2 Multinational cost of capital and capital structure
3 Multinational capital budgeting

See the online resources.

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PREFACE

Multinational corporations (MNCs) continue to expand their operations globally. They must not only be properly managed to apply their comparative advantages in foreign countries, but they must also manage their exposure to many forms and sources of risk. It can be said that all companies from large to SMEs (small and medium-sized enterprises) are in some sense multinational, not least due to the internet. As international conditions change, so do opportunities and risks. Those MNCs that are most capable of responding to changes in the international financial environment will be rewarded. The same can be said for today's students who become the MNC managers of the future.

Lecturer notes

Textbook contribution

The role of this textbook is primarily to interest the reader in this very important topic not just by informing and explaining but also by being critical and reflective. We try to explain the first steps in a topic as simply as possible, and once that has been covered we move more quickly to the higher levels. It is a learning curve after all. The topics range from the ethical issues in Chapter 4, to exotic options in Chapter 11, to letters of credit in Chapter 17. Most modules would have to be selective. One of the problems from experience is that for some, once they have grasped a theory or technical issue the rest is seen as unimportant. We try to emphasize the shortcomings of theory and the failings of parametric analysis in looking at topics such as market price behaviour. To be more persuasive in this regard we encourage learners in the questions to go to the internet and analyze real data and review real reporting as opposed to scenario-type questions which can appear rather too tidy in having an answer. These questions have been highlighted with an icon and have appropriate links to the internet. The Blades Case Study and the Small Business Dilemma further encourage learners to contrast theory and practice.

Allied to the textbook are PowerPoint slides including the exhibits from the book, an Instructor Manual, and Discussion in the Boardroom as well as Running Your Own MNC activities. An additional test bank offers additional multiple-choice questions for students to put their knowledge to the test.

Finally, our overall focus is on management and the multinational company, aware that for most readers it is the use of finance that is important rather than the complexities of some of the formulae.

Sixth edition

This edition represents something of a completion of a style updating. Previous editions have stressed the need to treat theory as no more than an attempt to discern what happens in practice, not to define practice. We continue with that approach but this time fully extend the treatment to the questions. We have moved the existing questions to the internet and replaced them with questions that more directly address the real world. We ask the student to go on the internet and look at the real data. Creating frequency histograms of 10 years' worth of daily data is *not* a big task if shown the right free downloadable source and the basic Excel commands. We do this. We hope it will excite students. Modern accounting and information systems produce masses of information that need to be managed and interpreted using much the same skills as we

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address here. To support this change, we have added a guide to relevant Excel commands and a note on data presentation in Appendix B. The number of questions in each chapter has been limited to around 15 with the expectation that it is feasible, certainly at higher levels, for all questions to be answered.

There have also been a number of further changes to what has amounted to a considerable updating. First, the level of difficulty is problematic for a text that supports both final year and postgraduate classes. To be helpful, we have asterisked sections that we feel are more advanced. Second, we have updated events and taken out some of the older examples leaving in those that have not been superseded. Third, some of the longer explanations have been made shorter and more to the point, recognizing that textbooks are part reference and part that uniquely 'bigger space' where issues can be considered in a more holistic manner without being overlong. Finally, at the time of writing, interest rates have been very low. To avoid excessive decimal places we have used higher rates in illustrations and similarly so for exchange rates.

We hope that these changes will keep the subject fresh and relevant to the big questions of the day through the lens of MNCs and finance.

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Roland Fox

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PART I

The international financial environment

We start with a look at the international environment as it affects a multinational corporation (MNC). Chapter 1 explains the goals of the MNC along with the motives and risks of international business. Chapter 2 looks at how international trade and investment are recorded in the balance of payments and the economic theories and practices relevant to the economic effect of international trade. Chapter 3 describes the international financial markets and the theory and practice of currency price movements. Chapter 4 addresses non-financial pressures that lead to regulatory changes that can have a dramatic impact on MNCs. Together these chapters show how the economic and socio-political environment affects MNCs.

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CHAPTER 1

Multinational financial management: an overview

LEARNING OBJECTIVES

The specific objectives of this chapter are to:

- Identify the main goal of the multinational corporation (MNC) and potential conflicts with that goal.
- Describe the key theories that seek to explain international business.
- Outline the common methods used to conduct international business.

Understanding the context

The main focus of this text is on the MNC and the effect of the international environment on financial management. Where once it was thought that MNC referred only to large companies, the growth of the internet has meant that the international dimension is now open to all businesses. Understanding the financial aspect of this environment and its impact on pricing, investment and trade in goods and services is now a central part of finance.

The common view of multinational development is that initially, firms attempt to export products to a particular country or import supplies from a foreign manufacturer. Over time, however, many recognize additional foreign opportunities and eventually establish subsidiaries in foreign countries (foreign direct investment). Large European MNCs such as BP plc (UK), Renault (France), Koninklijke Philips Electronics NV (the Netherlands) and many other firms have more than half of their assets in foreign (non-euro) countries. Businesses such as Diageo (UK), ThyssenKrupp Group (Germany),

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Alcatel (France), Tesco (UK) and adidas (Germany) commonly generate more than a third of their sales outside Europe. In the Middle East, Forbes magazine in 2021 quoted the top 100 companies were making $670 billion in sales and $148 billion in net profits. Not just oil companies and banking feature in the top 20 but also industrial, telecommunications, logistics and construction. In Africa, the African Business Magazine quoted in 2021 the top 20 companies by capitalization and country as South Africa (16), Morocco (2), and one each from Kenya and Egypt, their total market capitalization being about $365 billion and ranging from technology, media and luxury goods to mining.

An understanding of international financial management is crucial not only for the largest MNCs with numerous foreign subsidiaries but also for small and medium-sized enterprises (SMEs). Smaller firms often serve speciality markets where they will not have to compete with large firms that could capitalize on ***economies of scale****. While some SMEs have established subsidiaries, many of them penetrate foreign markets through exports. In May 2018 Reuters reported that 'Around 1,000 German Mittelstand (SME) firms have business ties to Iran and 1,340 firms have set up branches in the country'; larger firms may feel more exposed to government control. International financial management is important even to companies that have no international business because these companies must recognize how their foreign competitors will be affected by movements in exchange rates, foreign interest rates, labour costs and inflation. Such economic characteristics can affect the foreign competitors' costs of production and pricing policies.*

Companies must also recognize how domestic competitors that obtain foreign supplies or foreign financing will be affected by economic conditions in foreign countries. If these domestic competitors are able to reduce their costs by capitalizing on opportunities in international markets, they may be able to reduce their prices without reducing their profit margins. This could allow them to increase market share at the expense of the purely domestic companies.

This chapter provides a background to the goals of an MNC and the potential risk and returns from engaging in international business.

Goal of the MNC

The commonly accepted goal of an MNC is to maximize shareholder wealth. Some MNCs are former state-owned companies where governments remain an important shareholder (e.g. Renault and Petro China). Such companies seek stock market quotes to raise finance and therefore have to demonstrate by means of the annual report and accounts that they are maximizing shareholder wealth in the same way as a wholly privately owned company. Such companies may benefit more from government support, but in all other respects there is little to suggest that they are in any way different from other MNCs.

Shareholder influence is another major difference between MNCs. Continental Europe has what has been termed the blockholder system consisting of fewer, larger stakeholders in companies with an emphasis on corporate governance laws that seek to protect creditors and employees. The UK–US market-based approach has far more dispersed ownership and much greater emphasis on shareholders' rights.[1] In offering greater non-shareholder participation, the Continental system in theory gives greater emphasis to long-term profitability as shareholders have the shortest time horizon: they want returns in one or two years, whereas employees' and governments' interests are long term. In a questionnaire survey of UK, Dutch, French and German respondents, Brouenen *et al.*[2] found that customers, employees and management were all rated more highly than shareholders; the German respondents even rated their suppliers as more important and the French respondents gave a higher ranking to the general public! Surveys have to be treated with caution; all respondents would recognize that the need to earn a surplus is critical in any capitalist system.[3]

Conflicts with the MNC goal

Agency theory

The formal relationship between the employees of a company (including the directors) and the shareholders is part of the concept of **corporate governance**. Quite simply, corporate governance is defined as 'the system by which companies are directed and controlled'.[4] A basic concept of governance is **stewardship**. This arose from the accounting function whereby in medieval times the steward of an estate (often a

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collection of farms) had to account for the financial transactions to the lord of the manor, the owner, who was often an absentee landlord. There was a formal duty for the steward of the estate to act on behalf of the landlord and to take decisions in his best interests. The accounts were a way of checking that this was indeed the case. This concept has been translated to modern times whereby the board of directors, as the steward, reports to the shareholders who replace landlords. There is therefore a strong underlying assumption that the directors, and hence all whom they employ, act in the best interests of the shareholders. For traditional modelling, this implies that a model need only take into account the goals of the shareholders, namely wealth maximization, in analyzing the decision-making function within a firm.

This unanimity between directors and shareholders, the assumption that directors *always* act in the best interests of shareholders, is seen by many as being unrealistic. **Agency theory** drops this assumption and accepts that managers of a firm may make decisions that conflict with the firm's goal to maximize shareholder wealth. For example, a decision to establish a subsidiary in one location versus another may be based on the location's appeal to a particular manager rather than on its potential benefits to shareholders. A decision to expand may be determined by a manager's desire to make the division grow in order to receive more responsibility and remuneration. When a firm has only one owner who is also the sole manager, such a conflict of goals does not occur. However, when a company's shareholders differ from its managers, a conflict of goals can exist. This conflict is often referred to as the **agency problem**.

The costs of ensuring that managers maximize shareholder wealth (referred to as *agency costs*) are normally larger for MNCs than for purely domestic firms for several reasons. *First*, MNCs with subsidiaries scattered around the world may experience larger agency problems because monitoring managers of distant subsidiaries in foreign countries is more difficult. Financial managers of an MNC with several subsidiaries may be tempted to make decisions that maximize the values of their respective subsidiaries. This objective will not necessarily coincide with maximizing the value of the overall MNC. *Second*, foreign subsidiary managers raised in different cultures may treat the goals of their MNC in a different way from that intended by the senior management. *Third*, the sheer size of the larger MNCs can also create communication problems. *Fourth*, the complexity of operations may result in decisions for foreign subsidiaries of the MNCs that are inconsistent with maximizing shareholder wealth for the company as a whole.

EXAMPLE

A subsidiary manager obtained financing from the parent firm (headquarters) to develop and sell a new product. The manager estimated the costs and benefits of the project from the subsidiary's perspective and determined that the project was feasible. However, the manager neglected to realize that any earnings from this project remitted to the parent would be heavily taxed by the host government. The estimated after-tax benefits received by the parent were more than offset by the cost of financing the project. While the subsidiary's individual value was enhanced, the MNC's overall value was reduced.

USING THE WEB

An excellent site for comparing cultures based on the work of Hofstede is: www.hofstede-insights.com/country-comparison.

If financial managers are to maximize the wealth of their MNC's shareholders, they must implement policies that maximize the value of the overall MNC rather than the value of their respective subsidiaries. The temptation to pursue their own goals, either personal or that of a subsidiary at the expense of the overall goal, is referred to as **moral hazard**. To counteract moral hazard, companies will often have bonus

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schemes linked to the overall share price performance of the company (such as share option schemes) for the senior executives, but this does not solve the moral hazard problem at lower levels. Rules and regulations in part are implemented to ensure that managers' actions conform to company goals. Many MNCs require major decisions by subsidiary managers to be approved by the parent. However, it is difficult for the parent to monitor all decisions made by subsidiary managers, particularly in an international context.

At times it can appear that the headquarters of an MNC (the parent) is pursuing goals not in the shareholders' interests: for example, environmental concerns, funding community projects or maximizing market share or directors' bonuses. The counter argument is that these are really a proxy for operational goals necessary for long-term profit maximization. Motives can always be questioned and there will always be the view that shareholders' interests could be more vigorously pursued. In some respects it is reassuring to note that the US company Enron's demise (the most recent major case of corporate misbehaviour where shareholders' wealth was being sacrificed for managerial rewards) involved misleading shareholders by false accounting and deception. If there had been a more honest disclosure of information, as is required, the abuses would most likely not have taken place. The same can be said of the Italian food giant Parmalat which collapsed in December 2003 with a €14.3 billion hole in its accounts. As with Enron the accounts had been materially misstated. The need for proper implementation of the rules and regulations both internally and externally is driven by moral hazard. To this end both internal and external auditing are essential, especially for an MNC.

Agency theory itself is an abstraction of all relationships between levels in an organization. The higher level is that of the **principal** who sets the goals and monitors the actions of the **agent** who carries out the tasks either directly or indirectly. The principal is also responsible for the rewards which are geared towards encouraging the agent to meet the principal's goals. Moral hazard occurs as the personal goals of the agent are not the same as those of the principal. Where an agent consumes resources to meet their own ends, this is referred to as **consumption of perquisites**; this can be directly in the form of high expenses or indirectly by substituting leisure for work. Monitoring is necessary to reduce moral hazard, particularly where the principal does not have a good knowledge of the agent's actions. The term used in cases where the agent knows more than the principal, which is almost always the case, is **information asymmetry**. An organization can be characterized as a network of principal–agent relationships being director–senior managers, senior managers–middle managers, middle managers–junior managers and so on. At the top of the organization for a publicly quoted MNC, the shareholders are the principal to the managing director or CEO, who is the agent. There is a very high level of information asymmetry between the shareholders and the managing director, hence the use of independent auditors to check the accounts and the high degree of regulation in the form of Companies Acts and accounting standards to control the content of the annual report.

In the language of agency theory, we can say that information asymmetry and moral hazard are likely to present particular difficulties for a company developing from a national company into an MNC. In this way agency theory, first developed in the 1970s, has contributed to the language of business by neatly encapsulating the problem of control in an organization. Its contribution to formal analysis has, however, been hampered by the difficulty in developing tractable models.[5] Despite the early promise of the greater realism of agency theory, formal modelling still assumes a properly regulated stewardship function to support the single aim of profit maximization. The role of agency analysis is more as a critique of academic models rather than an alternative.

Impact of management control. The magnitude of agency costs can vary with the management style of the MNC. A centralized management style, as illustrated in the top section of Exhibit 1.1, can reduce agency costs because it allows managers of the parent direct control of foreign subsidiaries and therefore reduces the power of subsidiary managers. However, the parent's managers may make poor decisions for the subsidiary if they are not as informed as subsidiary managers about local financial conditions.

Alternatively, an MNC can use a decentralized management style, as illustrated in the bottom section of Exhibit 1.1. This style is more likely to result in higher agency costs because subsidiary managers may make decisions that do not focus on maximizing the value of the entire MNC. Yet, this style gives more control to those managers who are closer to the subsidiary's operations and environment.

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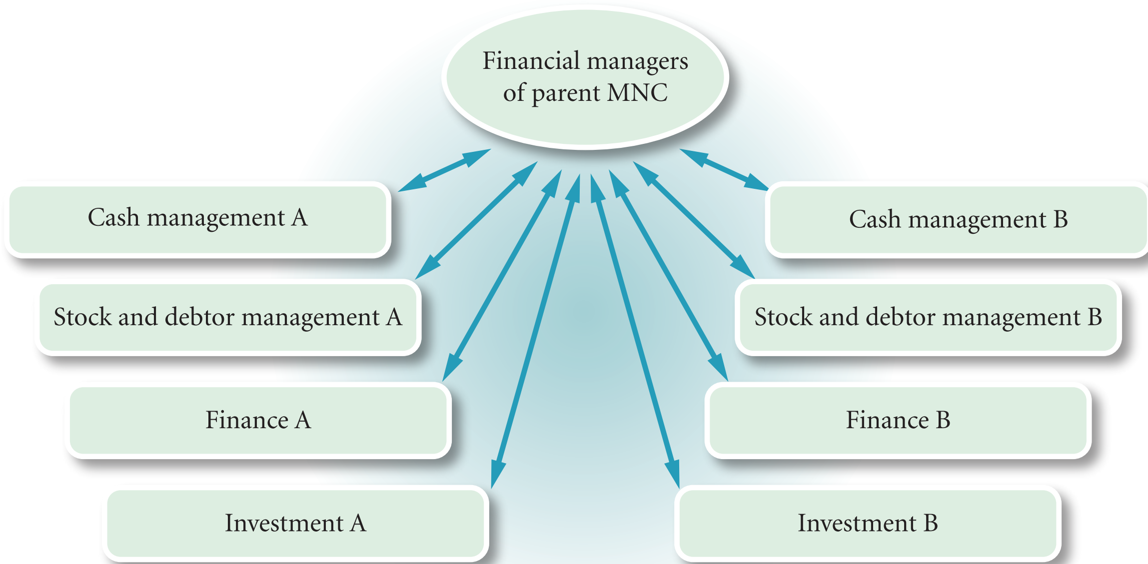
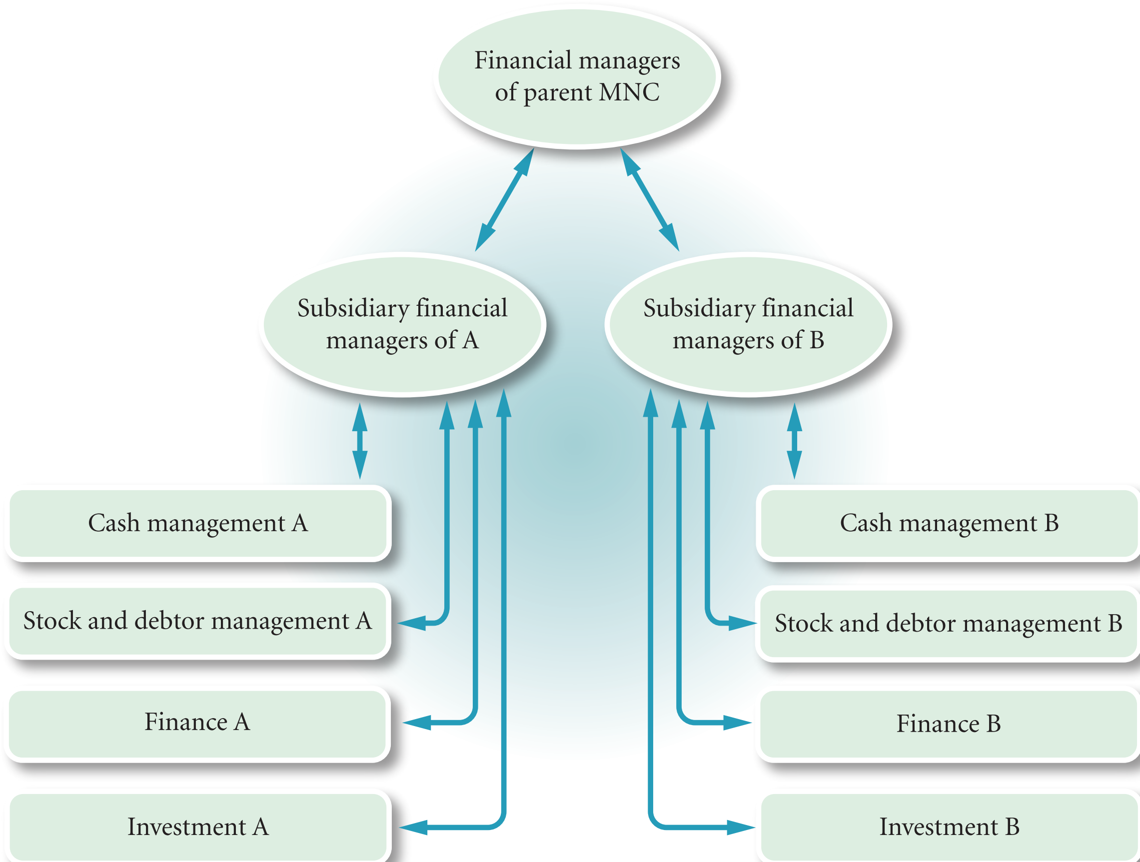
EXHIBIT 1.1 Financial management structures of MNCs





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To the extent that subsidiary managers recognize the goal of maximizing the value of the overall MNC and are compensated in accordance with that goal, the decentralized management style can be more effective.

Given the obvious trade-off between centralized and decentralized management styles, some MNCs attempt to achieve the advantages of both styles. That is, they allow subsidiary managers to make the key decisions about their respective operations, but the parent's management monitors the decisions to ensure that they are in the best interests of the entire MNC. That this is not always a harmonious relationship is perhaps not surprising.[6]

Internet facilities and software. The internet is making it easier for the parent to monitor the actions and performance of its foreign subsidiaries. Before the advent of computerized systems much middle management was concerned with preparing reports and budgets. Now a spreadsheet can automate much of this work; a single worksheet has 250 columns and hundreds of thousands of rows. This enables a wider span of control in an organization and potential de-layering (loss) of middle management in many organizations. Whether this is contributing to the greater inequality of pay in organizations and wealth in society is a current concern. What is not disputed is that wealth inequality is increasing around the world as measured by the **Gini coefficient**.[7]

EXAMPLE

The parent of Jersey plc has subsidiaries in India and Australia. The subsidiaries are in different time zones, so communicating frequently by telephone is inconvenient and expensive. In addition, financial reports and designs of new products or plant sites cannot be easily communicated over the telephone. The internet allows the foreign subsidiaries to email updated information in a standardized format to avoid language problems and to send images of financial reports and product designs. The parent can easily track inventory, sales, expenses and earnings of each subsidiary on a weekly or monthly basis. Thus, the use of the internet can reduce agency costs due to international business.

USING THE WEB

Internet millionaires

For those who manage to exploit the new trading conditions the rewards are high. Anecdotes are provided at: www.entrepreneur.com/article/244808.

External influences

An important motive for internal control is to be able to manage threats to a company from the competitive environment.

Hostile takeover threat. A major threat to both the company and its employees is the threat of a hostile takeover if the MNC is inefficiently managed. Stock market analysts and shareholders will sell the shares of companies they believe to be badly run. If this view is widespread in the market, the share price will fall. Another firm might then acquire the MNC at a low price and is likely to terminate the contracts of the existing directors who have not already resigned. Reorganizations involving extensive redundancies are also common.[8] In theory, this threat is supposed to encourage directors to make decisions that enhance the value of MNCs. It is also in the interests of the directors to ensure good motivation and control of

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lower levels of management. In the past, this threat was not so positive for managers of subsidiaries in many countries because their governments commonly protected employees, thereby effectively eliminating the potential benefits from a takeover – France and Germany being notable examples. Recently, however, governments have recognized that such protectionism may promote inefficiencies, and they are now more willing to accept takeovers and the subsequent layoffs that occur. In Europe there is currently much debate about the extent to which employee rights can be maintained in a world economy where production has to compete with goods made in countries with poor employee rights. In France, President Macron signed a series of decrees making it easier for firms to hire and fire and reducing the power of collective bargaining. An important motivation was the unemployment rate standing at more than double that of Germany, which was 3.8 per cent in 2017. In 2019 there was little change to French unemployment. **Hostile takeovers** are governed by the Thirteenth Directive of the European Union (EU). Generally, it imposes more restrictions on both the raider and the target compared to the equivalent US legislation.

Investor monitoring. A second form of external influence is the monitoring by individuals, pressure groups and institutions, including investment trusts, pension funds and insurance companies, all of whom are major shareholders in the stock market. Their monitoring by means of the financial press, annual and interim reports and, rather more controversially, by investor briefings given by companies, tends to focus on broad issues such as: motivation packages, use of excess cash for repurchasing shares, investing in questionable projects, ethical behaviour and attempts by MNCs to insulate themselves from the threat of a takeover (by implementing anti-takeover amendments, for example). An MNC whose decisions appear inconsistent with maximizing shareholder wealth will be subjected to shareholder activism as pension funds and other large institutional shareholders lobby for management changes and threaten votes of no confidence at the MNC's annual general meeting (AGM). MNCs that have been subjected to various forms of shareholder activism include Eastman Kodak, adidas, Shell, IBM and, more recently, Rolls Royce.

Non-US banks also maintain large share portfolios (unlike US commercial banks, which do not use deposited funds to purchase shares). Such banks are large and hold a sufficient proportion of shares of numerous firms (including some US-based MNCs) to have some influence on key corporate policies. In Germany, banks are often represented on the supervisory board of companies and will play a part in their management. The concern is that either as lender, or as a member of the management, banks will have access to private or insider information. The relationship is uneasy in that stock markets around the world forbid the use of such information when taking investment decisions. If some investors used private information, other investors would be disadvantaged and may sell shares to the informed investor at a price that the informed investor knows for sure is undervalued. It would be like playing poker against someone who knew which cards were going to be dealt next. The banks are supposed to have 'Chinese walls' inside the organization so that insider information cannot be used to make investment decisions. Nevertheless, there is evidence that banks and other institutions use private information. In the literature this is termed information asymmetry (as discussed earlier). **Order flow models** (Chapter 5), that is the buy and sell orders in the market, are viewed as evidence of possible insider information and hence information asymmetry. In international finance, the intervention of central banks in the foreign exchange market is a source of insider information; prior knowledge of a central bank's intention to buy a currency to raise its value would lead to speculative purchasing. A study by Peiers[9] found that the Deutsche Bank adjusted its rates up to one hour before public release through Reuters of the news that the German Central Bank (the Bundesbank) had intervened. In this way, certain traders are taken to be market leaders; in this case, other banks were estimated to follow some 35 minutes after the Deutsche Bank's trading activities.

Private information is not limited to banks. Rating agencies will be informed about important moves so that they can adjust their ratings immediately on announcement. Printing companies have the accounts prior to publication. Research findings may be shared with universities. The opportunity for leaks is extensive. Legal cases, such as the conviction of Raj Rajaratnam for insider trading in 2009, have led to allegations against employees of many major companies. The general consensus, despite these cases, is that private information revealed through unusual trades leads to gains that are relatively small and short lived.

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Constraints interfering with the MNC's goal

When financial managers of MNCs attempt to maximize their firm's value, they are confronted with various constraints that can be classified as environmental, regulatory or ethical in nature.

Environmental constraints. Each country enforces its own environmental constraints. Building codes, disposal of production waste materials and pollution controls are examples of restrictions that force subsidiaries to incur additional costs. The threat by MNCs to locate elsewhere in the face of overly harsh local environmental laws acts as a significant restraint to countries wishing to pursue a strong environmental policy. The failure of the US and Australia to sign the Kyoto Protocol on global warming further weakens the environmental movement.

Regulatory constraints. Each country also enforces its own regulatory constraints pertaining to taxes, currency convertibility, earnings remittance, employee rights and other policies that can affect cash flows of a subsidiary established there. Because these regulations can influence cash flows, financial managers must consider them when assessing policies. Also, any change in these regulations may require revision of existing financial policies, so financial managers should monitor the regulations for any potential changes over time.

To recognize the potential impact of regulations, consider the regulation of employee rights. Although it is understandable that every country attempts to ensure employee rights, countries are limited by the threat of multinationals investing elsewhere.

EXAMPLE

Apple diversifies its supply chain

In September 2021 Forbes reported that Apple was moving 20 per cent of its China-based manufacturing to India thus reducing its exposure to the Chinese economy. A more diversified geographic production base is also seen as a response to the uncertain effects of the coronavirus pandemic.

Source: Jennings, R. (2020) 'Apple's assemblers are looking to shift some operations from China to India'. Available at: www.forbes.com/sites/ralphjennings/2020/09/18/apples-assemblers-are-looking-to-shift-some-operations-from-china-to-india/ [Accessed 27 April 2022].

Ethical constraints. There is no consensus standard of business conduct that applies to all countries. A business practice that is perceived to be unethical in one country may be totally ethical in another. For example, MNCs are well aware that certain business practices that are accepted in some less developed countries would be illegal in their home country. Bribes to governments in order to receive special tax breaks or other favours are common in some countries. Dieter Frisch, a former director-general of development at the European Commission, estimates that on average at least 10–20 per cent of total government contract costs are bribes.[10] The dilemma facing MNCs can be seen as whether standards should be *relative* (conforming to the law and practices of each country separately) or *absolute* (one set of values applied worldwide). If they do not participate in such practices, they may be at a competitive disadvantage. Yet, if they do participate, their reputations will suffer in countries that do not approve of such practices. One solution to this dilemma is to adopt a set of ethical conventions for all MNCs and countries to adhere to, thus eliminating the competitive disadvantage and conforming to morally acceptable practice. The Equator Principles,[11] a voluntary set of relatively loosely defined commitments, represents one such initiative. But it remains voluntary and limited in scope to project finance. International organizations such as the UN and the International Monetary Fund (IMF) have as yet failed to develop a regulatory framework with a strong ethical foundation.

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