

12.5: Financial Management in International Business

Learning Objectives

1. Understand the factors that underlie political risk and volatility.
2. Identify two ways in which the financial organization of a multinational firm can be structured.
3. Recognize how religion can influence financial practices in some countries.

Accounting for Political and Economic Risk

Companies that locate operations in foreign countries face a set of unavoidable risks, chief among which are political and economic risks. Political risks arise from decisions that foreign governments make, including changes in government that result from wars and coups. Economic risks are often paired with political risks but can also arise from international money markets. Both risks are exacerbated by increased volatility and changes in laws.

Increased Volatility

In the 2010 *McKinsey Global Survey* of 1,416 executives from around the world, 63 percent of respondents “expect increased overall volatility to become a permanent feature of the global economy.” Renée Dye and Elizabeth Stephenson, “Five Forces Reshaping the Global Economy: McKinsey Global Survey Results,” *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_resaping_the_global_economy_McKinsey_Global_Survey_results_2581. For example, the most important growing economy in the world, China, is a force that must be reckoned with. The volatility arises because this major economy isn’t a developed state with commitment to the rule of law and strong institutions. Rather, it’s an emerging market where political insecurities are the ultimate driver, according to Ian Bremmer, president of the Eurasia Group and author of *The End of the Free Market*. Rik Kirkland, “China’s State Capitalism and Multinationals: An Interview with the President of Eurasia Group,” *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Chinas_state_capitalism_and_multinationals_An_interview_with_the_president_of_Eurasia_Group_2583.

To prepare for volatility, multinational companies may want to plan contingencies or at least think through how they might react to events that are currently “unthinkable,” such as significant, rapid shifts in currency values (e.g., a 30 percent decline of the dollar versus an emerging-market currency); an exit from the euro by some nations; dramatic, rapid changes in commodity prices (e.g., oil prices spiking to \$200 a barrel); or defaults on debt by major nations. Lowell Bryan, “Globalization’s Critical Imbalances,” *McKinsey Quarterly*, June 2010, accessed October 28, 2010, www.mckinseyquarterly.com/Globalizations_critical_imbalances_2624. These events seem highly improbable now, but, if they come to pass, executives who have thought about how to respond to them will be better positioned to react effectively.

Legal Infrastructure: Challenges of Nascent Laws

Variations in contract law, bankruptcy law, real estate law, intellectual property rights, and liability are just some of the legal issues that companies face when operating or making investments in emerging-market countries. Slow civil judicial processes, corrupt judges, and potential biases against foreigners can affect a company’s ability to operate effectively, recover losses, or collect bad debts. For example, General Motors (GM) often uses a contractual structure with suppliers in which GM owns the proprietary tooling used in their supplier’s factory. In most countries, if the supplier goes bankrupt, GM can easily take the tooling back. But GM noted that this isn’t possible in China due to the nascent state of the country’s bankruptcy law, which was created only in 1988. Harjeet S. Bhabra, Tong Liu, and Dogan Tirtiroglu, “Capital Structure Choice in a Nascent Market,” *Financial Management*, June 22, 2008, accessed November 25, 2010, www.allbusiness.com/company-activities-management/company-structures-ownership/11673477-1.html. As a result, GM uses contracts to mitigate these risks.

Financial Organizational Structure in International Business

Multinational companies can choose to manage their financial operations centrally or via a decentralized organizational structure.

Centralized Structures

The advantages of a **centralized structure** are that the company can afford to hire and retain specialized staff with deep expertise who can bring savings to the company through centralized cash management and more efficient capital investment. Centralization

can improve control and compliance with corporate policies. This structure enables the firm to gain economies of scale for investment and borrowing activities that can reduce transaction costs and provide the firm with the most competitive pricing.

Decentralized Structures

Alternatively, multinational firms may choose a **decentralized financial organization structure** due to variations in language, consumers, cultures, business practices, and government rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty. The downsides of a decentralized approach are higher costs (due to having to hire more employees), some unavoidable duplication of effort, and a diminishment of control.

Communication with Headquarters

If a company uses a decentralized financial structure, it's vital for regional chief financial officers (CFOs) in the different countries to keep regular contact with their superiors at headquarters. Rebecca Norton, vice president of finance, Asia-Pacific, at Business Objects (a unit of SAP), makes it a point to participate in global conference calls as often as possible, in order to "wave the Asia-Pacific flag." She notes that this is necessary to ensure that her overseas colleagues understand the conditions under which the Asian business operates. Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219. The reason for the frequent communication is to help the home office better understand the opportunities and risks of the foreign country. For example, if headquarters is focused on short-term performance indicators, the head office is more likely to allocate funds to developed markets where returns are quick. But this approach neglects emerging markets, which have more future potential.

According to a 2010 McKinsey study, global economic activity is shifting from developed to developing nations with populations that are young and growing. Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results 2581. The growth in the number of consumers in these emerging markets make them not only a focus for rising consumption and production but also major providers of talent, capital, and innovation. This makes it vital for US companies to succeed in these emerging markets. Despite identifying this trend as the most important trend for business in the next five years, only 40 percent of executives are taking action and fully 20 percent are taking no action at all to capture emerging-market growth. Renée Dye and Elizabeth Stephenson, "Five Forces Reshaping the Global Economy: McKinsey Global Survey Results," *McKinsey Quarterly*, May 2010, accessed November 23, 2010, www.mckinseyquarterly.com/Five_forces_reshaping_the_global_economy_McKinsey_Global_Survey_results 2581. This is where communication with headquarters becomes imperative. Regional CFOs must spur actions, such as developing partnerships or joint ventures with local companies, recruiting talent from emerging markets, and developing new business models.

One company taking action is the Luxottica Group, a \$6.6 billion eyewear company based in Italy. Although Luxottica sells its products online, it remains solidly committed to brick-and-mortar retail stores and is rapidly expanding its retail presence in China. Describing the role of retail stores, Chris Beer, CEO of Asia Pacific, greater China, and South Africa for Luxottica, said, "You need to create a connection, create a personal experience, and that's what we've done." Sheila Shayon, "Luxottica Envisions Future of Retail," *Brand Channel*, July 22, 2010, accessed November 26, 2010, www.brandchannel.com/home/post/2010/07/22/Luxottica-Eye-Hub-Retail-Concept.aspx. On the finance side, Kevin Zhou, retail CFO for Luxottica, closely follows the regulatory environment in China and actively communicates with headquarters to explain evolving legislation and help them understand local financial issues. "You have to always tell them the truth about what's happening in China, and keep updating them," he says. "Keep explaining, and before long, people at headquarters will really understand what's going on in this market." Don Durfee, "Local Knowledge," *CFO*, November 1, 2008, accessed August 12, 2010, www.cfo.com/printable/article.cfm/12465219.

Hybrid Financial Organization Structures

Finally, multinational companies follow a hybrid of centralized financial operations for some tasks and regional operations for others. Before it was acquired by Hewlett-Packard (HP) in April 2010, network switching and routing solutions company 3Com had centralized specific operations in its North America shared service center (SSC). The North America SSC provided a number of accounting services globally. Although the US-based SSC had a much higher cost of labor than Singapore (where 3Com offshored transaction-based processes), 3Com decided to keep higher-value services in the North America SSC due to 3Com's assessment of the risk and complexity in comparison to the anticipated benefit of moving these from one global center to another.

Some of the tasks retained by the North American SSC were worldwide consolidation, worldwide intercompany accounting, and external reporting.

The following processes have been performed in each region (i.e., Europe, the Middle East, and Africa [EMEA]; North America; Latin America; and Asia-Pacific) due to language and local knowledge issues:

- Regional general ledger
- Regional revenue accounting
- Local field finance accounting
- Regional and local payroll
- Regional and local value-added tax (VAT) and good-and-services tax (GST) compliance and reportingPhil Searle and Fraser Kirk, “Expanding Geographic Scope and Setting Up a Truly Global Process Model,” *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

3Com also assigned local field finance managers to be key shared accounting services team members located in the company’s higher-risk countries to help ensure compliance with local legal, statutory, tax, and reporting requirements and to help with enforcement and communication of corporate policies locally. Their responsibilities include the following:

- Ensuring all statutory and tax (direct and indirect) filings are completed in accordance with local country requirements
- Liaising with local external auditors, tax authorities, and outsource agencies to ensure the proper execution of payroll and employee disbursements
- Communicating and enforcing corporate accounting policies to local employees
- Ensuring appropriate accounting for local accruals by liaising with local marketing and sales teams to determine if services related to outstanding purchase orders have been providedPhil Searle and Fraser Kirk, “Expanding Geographic Scope and Setting Up a Truly Global Process Model,” *Shared Services & Outsourcing Network* 5, no. 9 (January 2004), accessed November 23, 2010, www.ssonetwork.co.uk/topic_detail.aspx?id=194&ekfrm=50.

Did You Know?

What does the job description for a treasury operations manager look like? The tasks of a manager overseeing international-unit financial management include

- managing foreign exchange exposures, hedging, accounting compliance, multilateral netting, and multilateral cash pool;
- driving collection, disbursement, concentration and cash accounting, and domestic debt-portfolio management;
- performing cost review and analysis of monthly cash management;
- assisting the treasurer in bank coordination, agreement negotiations, and renewals;
- modeling financial transaction scenarios for capital budgeting and planning analysis (i.e., debt, equity, and other capital market transactions);
- preparing, reviewing, and maintaining Sarbanes-Oxley controls; and
- delivering and coordinating cash forecasts with bank-funding needs and regulatory capital requirements.

The Impact of Religion: Islamic Finance

Companies operating in countries where Islam is the official religion, such as Malaysia, Saudi Arabia, Kuwait, Bahrain, and Yemen, must adhere to Islamic finance laws. Islamic law prohibits certain financial practices that are common in other countries. For example, Islamic law (called **Sharia**) prohibits charging interest on money. No interest can be charged, including fixed-rate, floating, simple, or compounded interest, at whatever rate. The Sharia also prohibits financial practices like speculation, conventional insurance, and derivatives, because they’re considered gambling in the Islamic tradition. Sharia also prohibits *gharar*, which means “uncertainty” and includes conventional practices like short selling.

To overcome these prohibitions, financial products must be Sharia compliant. There are approved alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It’s a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner. A *mudarabah* is an investment partnership, whereby the investor provides capital to another party or entrepreneur in order to undertake a business or investment activity. While profits are shared on an agreed-on ratio, loss of investment is born only by the investor. The entrepreneurs only lose their share of the expected income.“Introduction to Islamic

Financing,” HSBC Amanah, accessed August 14, 2010, www.assetmanagement.hsbc.com/gam/attachments/mena/amanah/islamic_invest.pdf.

These investment arrangements demonstrate the Sharia’s risk-sharing philosophy—the lender must share in the borrower’s risk. Since fixed, predetermined interest rates guarantee a return to the lender and fall disproportionately on the borrower, they are seen as exploitative, socially unproductive, and economically wasteful. The preferred mode of financing is profit and loss sharing.

Islamic finance law extends to mutual funds, securities firms, insurance companies, and other nonbanks. A growing number of conventional financial institutions, both inside and outside the Islamic world, have in recent years created Islamic subsidiaries or have been offering Islamic “windows” or products in addition to conventional ones. Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh, UK: Edinburgh University Press, 2000).

KEY TAKEAWAYS

- Political and economic risks arise when a country lacks a long history or commitment to the rule of law. Companies can prepare for volatility by thinking through “unthinkable” scenarios and planning how they would respond if such situations occurred.
- Multinational firms can organize their financial operations in a centralized, decentralized, or hybrid organization structure. The advantages of a centralized structure are that the company can afford to hire and retain specialized staff who have deep expertise and can bring savings to the company through centralized cash management and more efficient capital investment. Centralization also enables the firm to gain economies of scale for investment and borrowing activities that will reduce transaction costs and get the firm the most competitive pricing. On the other hand, a decentralized financial organization structure allows the firm to recognize the variations in language, customs, cultures, business practices, rules, laws, and regulations among different countries. A decentralized structure lets multinational firms exploit local knowledge and business conditions to deal with uncertainty.
- It’s important for regional CFOs to stay in regular contact with corporate headquarters to alert headquarters to opportunities (or warn them of dangers) in their countries.
- Islamic countries practice Sharia—the prohibition of charging interest on money. There are approved, Sharia-compliant alternatives to interest and speculative investments. For example, instead of lending money and charging interest, banks can lend money and earn profits by charging rentals on the asset leased to the customer. One alternative investment strategy, *musharakah*, allows profit and loss sharing. It’s a partnership wherein profits are shared per an agreed-on ratio and losses are shared in proportion to the capital or investment of each partner.

EXERCISES

(AACSB: Reflective Thinking, Analytical Skills)

1. Name two ways that companies can prepare or deal with political risk or volatility in a country.
2. What advantages does a decentralized financial organization structure bring to a multinational firm?
3. What advantages does a centralized financial organization structure bring?
4. Why are frequent communications between a regional CFO and headquarters important?
5. How might religion impact financing operations?

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