



# Module 7

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## International Financial Management

### Introduction

In the economic times we are working in today, understanding the rigours of the international organisation is important. Over the last decade we have seen a growth in companies that do business internationally. No longer are our investment and growth strategies only concerned with domestic markets or markets in our own continent. More and more growth is achieved by entering new markets in new countries. These growth strategies bring much excitement and new opportunities but they also bring a more complex environment in which to work and to manage. Consequently we cannot study finance without looking at international markets and their impacts on operations and corporate decisions. For our purposes we define an international company as one that has subsidiary or joint venture operations in a country other than the country the parent company calls home.

While many of the decisions made in a domestic company and an international company are the same, the risks involved may be quite different and how one manages these risks may differ. Hence we focus on what differences exist when dealing in an international market versus a domestic market. What the financial manager and really any manager in an international organisation needs to be aware of is what those risks are and how they impact any decisions that need to be made. You cannot apply the same criteria to decisions in foreign countries that you do to domestic decisions without evaluating the different business environments. This module will concentrate on highlighting what areas need to be examined more closely when making financial management decisions across international borders.

Upon completion of this module you will be able to:



### Outcomes

- *describe* various ways to enter into borderless trading
- *narrate* the various risks involved in international trade
- *explain* exchange risk in the context of international companies
- *describe* the basic relationships and the theories of international financial management
- *describe* concerns that face international organisations and the impact these concerns have on the financial manager
- *explain* the political risk faced by doing business in foreign countries.



### Terminology

International trade:	Buying or selling of goods across the borders
Exchange rate:	A rate which measures the value of one currency in terms of other currency
Purchasing power parity:	The theory describes the relationship between exchange rate and purchasing power of currency

## Borderless trading

As a result of demand from corporations and their growth needs, we have seen international trade agreements formed to make doing business in foreign countries easier. In 1988, Canada and the United States negotiated the North American Free Trade Agreement (NAFTA) which later included Mexico as well. The goal of this agreement was to allow for trading across the borders of these countries as if they were one country.

Of course things are not quite that simple and NAFTA does have guidelines and restrictions with special incidents being debated as they are faced. A big issue is the softwood lumber debate. The U.S. has made it prohibitive for Canadian lumber companies to export softwood to the U.S. Canada protested that this violates NAFTA and the issue is still in the resolution stage.

In 2003-04 United States signed a bilateral trade deal with Chile and five central American countries (Costa Rica, El Salvador, Guatemala, Nicaragua) known as Central America Free Trade Agreement (CAFTA). At a very different level in Europe is the European Union, which has been in place since 1956. The EU is a significant global economic force with a series of major economic, monetary, financial and legal provisions set by the member countries during the 1980s.



At the end of 1992, Western Europe opened a new era of free trade within the union called European open market. Although the EU has managed most of these provisions, there are still debates relating to motor vehicle production and imports, monetary union, taxes and workers' rights. In January 1999, most EU nations adopted a single currency, the euro, as a continent wide medium of exchange. In January 2002, EU nations switched to a single set of euro bills and coins.

At the same time the EU implemented monetary union which also involved creating new European Central bank. The EU had to deal with a wave of new applicants in May 2004 for the admission of 10 new members from Eastern Europe and Mediterranean region. In South America in 1991 the Mercosur Group was formed by Argentina, Paraguay and Uruguay. This group was taking the same initiative by attempting to remove barriers to trade among the member countries. The Mercosur countries represent more than half of the Total Latin American GDP that wishes to access the growth market of this region.

### Various modes of borderless trading

- International trade
  - Import
  - Export
- Contractual entry modes
  - Licensing
  - Franchising
  - Joint venture
  - Foreign investment
  - Multinational corporation

### International trade

Buying or selling of goods across the borders is called international trade. Many companies move towards international trade to gain foreign exchange and to get international recognition. Following are the ways to trade internationally:

- **Import**

Literally, import means to bring the things in your country from another one. From a business point of view it means buying the goods from another country to fulfill domestic needs in return of foreign exchange. It involves the issues like balance of payments, exchange rate risks etc.

- **Export**

Literally, export means to sell something to some other country. In business scenario export means to sell goods to foreign countries to earn foreign exchange. It also faces the same issues as imports.

### Contractual entry modes

One of the ways to cross the border for business purpose is contractual entry mode. Through this way, before entering you have to make a contract with a local company of that specific country where you want to go by either licensing or franchising. It is known as contractual entry modes. Following are the demonstrations of contractual entry modes:

- *Licensing*

In case of intellectual property, brands, patents and copyright licensing is common. Licensing means to give permission or transfer own right to some other party. If a party gives permission to some other party to use their copyright or brand it is known as licensing. If this right is transferred across the borders, it becomes a way to go international.

- *Franchising*

Franchising means acquire the right to use a successful business model of a well established organisation. It's a very common strategy to do business across the borders. Businesses that want rapid expansion use this strategy intensively. The best example of franchising is MacDonald's.

- *Joint venture*

A temporary partnership between two companies across the borders for performing of a specific venture is called a joint venture. The host country company can ask a foreign company to hire its services. For example, a Pakistani company asks a Japanese for help in the construction of roads in Pakistan. If it is agreed it's known as joint venture.

- *Foreign investment*

In addition, companies having excess funds can go across the border for direct investment. The companies invest money with foreign setup, culture and human power. It is called foreign direct investment.

- *Multinational corporation*

A multinational corporation is an organisation that manages production or delivers services outside the country in which it is based. Multinational corporations face a lot of challenges while going across the borders. These challenges may be



social, cultural, language difference, political or demographic.

### Risks involved in international trade

The difference between expected and actual outcomes is known as risk. When companies go across the borders these have to face many challenges and risks.

Following risks may be faced:

- Economic risk
- Exchange rate risk
- Political risk
- Buyer country risk
- Commercial risk
- Other risk

#### Economic risk

The risk associated with the economic conditions of the country where you want to do business. Economic conditions of one country are different from another country. So before entering into another country to trade, companies analyse deeply economic conditions. Economic risk may be elaborated with the help of following sub headings:

- Risk of insolvency of the buyer
- Risk of concession in economic control
- Risk of non-acceptance
- Risk of protracted default (the failure of the buyer to pay due amount after six months of due date).

#### Exchange rate risk

Exchange rate is a crucial and important factor in international trade. If the rates are not favourable for trading countries, these may suffer heavy loss instead of gains. Exchange rate determines whether you should go for imports or exports. International traders must avoid the risks of exchange rate.

#### Political risk

Political risk is the implementation of specific rules and regulations or restrictions by the host country or by any country's government where you want to go for business purposes. These are the restrictions imposed by a government either to promote domestic trade or to reduce foreign trade in its country. For example, when the revolutionary government came to power in

Libya, it seized American oil investments. Political risk may be in one of following forms:

- Risk of non-renewal of export and import licences
- Risks due to war
- Risk of imposition of an import ban after the delivery of goods.

### **Types of political risk**

- Micro political risk
- Macro political risk.

#### *Micro political risk*

Micro political risk is project specific. The level or intensity of risk may vary from project to project. At the same time one project may produce very good returns while another may be at risk of exposing lower returns. Governments may prohibit operation of a specific project or may attach many risks with the operation of that specific project. This is known as micro political risk.

#### *Macro political risk*

Macro political risk is not project-specific. It affects all the participants in a country. In this case, government may impose restrictions which equally affect all organisations working in a country. For example, restrictions on the import of wheat in a country will affect all the countries supplying/exporting wheat.

### **Buyer country risks**

Sometimes a buyer country has to face risks in understated forms:

- Changes in the policies of the government
- Exchange control regulations
- Lack of foreign currency
- Freezing of bank accounts
- Trade embargo.

### **Commercial risk**

Commercial risk may involve:

- Failure of a bank to honour its responsibilities
- A buyer's failure pertaining to payment due to financial limitations
- A seller's failure to provide required quality or quantity.



## Other risks

Other than above, the following risks are also involved:

- Cultural differences
- Lack of knowledge of overseas markets
- Language barriers
- Logistical and transport risk
- Project risks
- Natural risk
- Low legal protection.

## Exchange rate

Exchange rate is a rate which measures the value of one currency in terms of other currency. This is the measurement of value of foreign currency in terms of home currency of any nation or country. For example, if one US dollar is equal to 85 rupees of Pakistani currency then this is exchange rate of U.S. currency with Pakistani currency. Exchange rate is the amount of one country's currency needed to buy another country's currency. Simply, the ratio between two currencies is exchange rate. e.g., one dollar is equal to Rs. 85. This ratio of 1 to 85 is the exchange rate.

### Factors affecting exchange rate

Exchange rate is determined and affected by following factors:

- Interest rate
- Inflation rate
- Trade balance
- Internal harmony
- Political instability
- General state of economy
- Quality of governance.

### Types of exchange rate

- Direct exchange rate
- Indirect exchange rate
- Spot exchange rate
- Forward exchange rate
- Cross exchange rate

- Nominal exchange rate
- Real exchange rate
- Effective exchange rate
- Foreign exchange rate.

### **Direct exchange rate**

The home currency price of one unit of a foreign currency is the direct exchange rate. In simple words it means how many units of home currency you have to pay to buy one unit of foreign currency. For example in Pakistan for dollars direct quotation is Rs 85/USD.

### **Indirect exchange rate**

The foreign currency price of one unit of home currency is indirect exchange rate. Simply it is the value of a foreign currency against one unit of home currency. For example, in Pakistan for U.S. dollars the indirect quotation would be \$0.0117647/ PKR.

### **Spot exchange rate**

The rate of foreign exchange contract for immediate delivery is termed as spot exchange rate. It is also known as benchmark rate, straightforward rate or outright rate. Spot exchange rate refers to the current market price of a foreign currency.

### **Forward exchange rate**

The exchange rate set today for a foreign currency transaction with delivery or payment at some future date. Opposite to spot exchange rate, its payment is to be done at some future time period. A contract is signed between buyer and seller for future transaction. The rate will be determined at future date. It is known as the forward exchange rate.

### **Cross exchange rate**

Sometimes one currency cannot be directly converted into another foreign currency. In this situation, the first currency is converted into some common currency and this common currency is converted for the desired currency. This is known as cross exchange rate.

### **Nominal exchange rate**

The other name for nominal exchange rate is bilateral exchange rate. This is the rate of currencies without any adjustment. The rate of currencies quoted in the market at any specific slice of time is the nominal exchange rate.





### **Real exchange rate**

Real exchange rate is the price-adjusted nominal exchange rate. There are some adjustments made regarding price indexes in both the home and foreign currencies. The rate you get in this way is the real exchange rate. It shows really how many units you have to pay to convert one currency into another currency.

### **Effective exchange rate**

Effective exchange rate is the measure of the average value of a currency relative to two or more other currencies. It is determined by taking the weighted average of the currencies for which you want to determine the exchange rate. This whole is done in the form of an index.

### **Foreign exchange rate**

A foreign exchange rate is the value of two currencies with respect to each other. A foreign exchange rate is a concept of exchange in the value of currency with respect to the Australian dollar, for example, or any other currency. In foreign exchange rate, changes in the value are called an appreciation or depreciation. For fixed currencies, changes in the value are called official revaluation or devaluation.

### **Relationship between currencies**

Every country has its own currency with its unique characteristics, but there is no country in the world which may survive independently. As countries correlate with each other to fulfill their needs, in the same way currencies of those countries have some relationship with each other. This relation may be fixed or floating.

### **Floating relationship**

The relationship in which the value of any two currencies with respect to each other fluctuates on daily basis is floating relationship.

### **Fixed (or semi-fixed) relationship**

The constant relationship of the values of two currencies with respect to one another is a fixed relationship. This type of relationship is a combination of major currencies or some type of an international foreign standard.

### **Illustration**

Since the mid 1970s, major currencies of the world have had a floating as opposed to fixed relationship with respect to the US dollar and to one another. Among the currencies regarded as being major (or 'hard') are the British pound (£) the Swiss Franc (SF), the Euro (€) the Japanese Yen (¥), the

Canadian dollar(C\$) and the U.S. dollar (USD). The value of two currencies with respect to each other is expressed as follow:

$$\text{A\$ 1.00} = \text{SF 1.18}$$

$$\text{SF 1.00} = \text{A \$ 0.847}$$

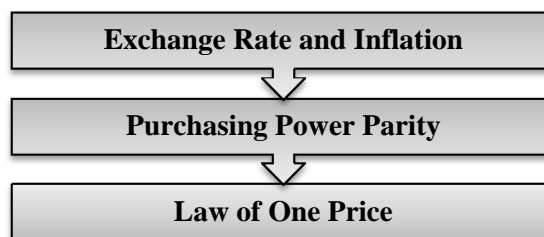
The exchange quotation in the international market is given as SF 1.18/A\$, where the unit of account is the Swiss Franc and the unit of currency priced is one Australian dollar. Exchange rate is always quoted from the dealer's point of view. That is, buying rates are those at which the local currency will buy a foreign currency, and selling rates are those at which the local currency will sell a foreign currency. Here, we discussed briefly the existences of relationship for the major currencies.

### Off setting of return by exchange rate differential

There are some theories of parity positions which occur due to the ultimate impact of exchange rate differences of spot and forward exchange of currencies. There are many theories of parity position. This module will only cover two main theories of equilibrium position of a buyer or an investor.

### Purchasing power parity

This theory describes the relationship between exchange rate and purchasing power of currency. Another name for this relationship is law of one price. Inflation is defined as the general increase in price level. This relationship will tell how an exchange rate adjusts itself when the price level shows an increase or decrease. When prices rise or fall the exchange rate adjusts itself to maintain the purchasing power as equal. The basic concept behind this theory is that "exchange rate adjusts to offset inflation differences across the countries to keep cost of living at same level".



Simply, exchange rate is an adjustable factor which adjusts itself according to the changing financial and economic conditions of countries. The word parity means equality so to keep the purchasing power equal exchange rate adjusts. This is purchasing power parity.

### Kinds of purchasing power parity

- Absolute purchasing power parity
- Relative purchasing power parity



### **Absolute purchasing power parity**

The word absolute means complete, total or utter. The idea behind absolute purchasing power parity is that purchasing power of a currency remains the same regardless of location and type of currency. With \$1 you can buy the same number of commodities all over the world due to adjustments of the exchange rate.

#### **Example**

If a commodity costs \$2 in the United States and the exchange rate is Rs85 per dollar, then this commodity costs  $\$2 / \text{Rs } 85 = \$0.023529$  in Pakistan. So, in this way the exchange rate adjusts itself to keep the parity among purchasing power.

### **Assumptions of absolute purchasing power parity**

Following factors are considered constant to hold PPP absolutely

- The transaction cost of trading commodities must be zero.
- There are no barriers to trading in the countries. Trade is totally free from barriers.
- The commodities you are trading are identical in both the countries.

### **Relative purchasing power parity**

This version of theory tells that the exchange rate will not show an absolute change regarding inflation rather than the change in exchange rate being determined by the differences between the inflation rates in two countries. So this concept is relative to the inflation differential between the two countries.

#### **Example**

If inflation rate in the U.S. increases by 10 per cent and in Pakistan by 5 per cent the exchange rate will adjust according to the difference – by  $10 - 5 = 5\%$ . This is relative adjustment of exchange rate in relative PPP.

### **Interest rate parity**

Interest rate is a factor that can influence the exchange rate significantly. Investors keep an eye on interest rates over different countries to take advantage of the differential. But if the exchange rate adjusts to avoid exceeding margins and to keep the net interest benefits same, it is interest rate parity. This concept can be defined as: The interest differential between the countries is equal to the difference between the spot and forward exchange rates.

When in two countries, there is a difference between interest rates on investment, investors borrow at a lower interest rate, convert this currency to another currency at a spot exchange rate with a forward hedging contract, and invest this currency at a higher interest rate. At the maturity, the exchange rate adjusts itself equaling the difference between interest rates and exchange rates by which investor earns the same as if it was invested in the first currency.

### Factors affecting exchange rate to change

Various economic and political factors influence exchange rate movements, but the most important factor is a differing inflation rate between two countries. High inflation rates in countries will see their currencies depreciate relative to the currencies of countries with lower inflation rates.

Assume that the current exchange rates between Australia and new nation of Farland, and 2 Farland guineas (FG) equal to per Australian dollar (A\$),  $FG\ 2.00/A\$,$  and which is also equal to  $A\ \$\ 0.50/FG.$  This exchange rate means that a basket of goods worth \$100.00 in Australia sells for  $\$100.00 * FG2.00/\$ = FG200.00$  Farland, and vice versa goods worth  $FG200.00$  in Farland sell for \$100.00 In Australia.

Now assume that inflation rate in Farland is 25 per cent and 2 per cent in Australia. In one year, the same basket of goods mentioned above will sell for  $1.25 * FG200.00 = FG250.00$  in Farland and for  $1.02 * \$100.00 = \$102.00$  in Australia. These relative prices imply that in one year, so the exchange rate in one year should change to  $FG250.00/\$102.00 = FG2.45/\$,$  or  $\$0.41/FG.$  In other words, the Farland guinea will depreciate from  $FG2.00/\$$  to  $FG2.45/\$$  while the dollar will appreciate from  $\$0.50/FG$  to  $\$0.41/FG.$

### Currency appreciation and depreciation

In economics and finance the two terms currency appreciation and depreciation are very common.

Whenever you hear currency appreciation it means the increase in the value of a currency as compared to other currencies. Let us take the example of dollars and rupees. If it is said that the dollar is appreciated it means that value of the dollar has increased as compared to the rupee. Clearly it implies that now the dollar is more expensive. You have to pay more rupees than before to buy one dollar. It is appreciation of the dollar.

Depreciation is the opposite to appreciation; depreciation means reduction in the value of a currency. If we hear dollar is depreciated it means that value of dollar has decreased. When one currency appreciates, another observed currency depreciates.



## Impact of currency fluctuations

Multinational companies face foreign exchange risks under both floating and fixed arrangements. Floating currencies can be used to illustrate these risks. Returning to the dollar-Swiss Franc relationship, we note that the forces of international supply and demand, as well as internal political and economic elements, help to shape both the spot and forward rates between these two currencies. Since the multinationals face potential changes in exchange rates in the form of appreciation or depreciation, these changes can in turn affect those companies' revenues, costs and profits as measured in dollars. For currencies fixed in relation to each other, the risk comes from the same set of elements. Again, these official changes in case of floating currencies, can affect the multinational's operation and its dollar-based financial position.

## Financing decisions

As mentioned in Module 6, international mergers and acquisitions in foreign countries provide access to more investors and lenders. Because of these increased markets, companies may have access to cheaper sources of debt. If debt is a cheaper alternative then you will see international companies with more debt loads than national organisations. If debt is cheaper then the company won't have to raise as much in equity funds, which carry a higher cost. Just as with national firms, the ideal mix of debt and equity financing differs among international companies. International companies have the same corporate goal as national companies –maximising shareholder wealth. Therefore the mix they choose should be based on this overall goal. This means taking both risk and return into consideration.

It is very common for countries to have some type of requirement for local ownership in a foreign country. Some countries require that any foreign company entering the market form a joint venture with a local company in order to operate. Often there is a requirement that the foreign company must hold less than 50 per cent of the shares of the company. This means that foreign companies cannot control the operations of the local company.

## Impact on capital projects

In MS4 Accounting and Finance you learned about weighted average cost of capital and its use in calculating net present value for projects and potential investments of an organisation. In international organisations it is important that you assess changes that need to be made to the weighted average cost of capital that you would use in investment decisions. There must be an adjustment for the increase in risk to the discount factor you would apply in estimating net present value. You would not want to apply the same discount factor to projects in Canada and in Brazil without some adjustment for political risk and currency risk.

In today's business environment you may often be faced with ranking projects for investment that are not local. If you did discount a project in Canada at the same rate as a project in Brazil, you would be saying that doing

business in both these countries has the same level of risk, which is not the case. Your starting point for a discount rate should be the weighted average cost of capital plus a risk factor for foreign exchange fluctuations, plus a risk factor for the level of political risk. As companies grow and become more versed in doing business in different markets they will also become more sophisticated in their risk assessment adjustments.

## Taxation

Taxes always have an important position with a financial manager. Taxation rules are complex and continuously changing. When you add different countries you are only adding to this complexity. When you are operating in more than one country you need to understand the rules within that country and any states that have taxing authority as well. You need to answer these questions:

- What income does my company need to include in the tax calculations?
- In what countries is my company subject to tax?
- If I pay taxes in a foreign country, how does this impact taxes in my home county?
- Are there any other levels of governments that can charge tax other than the federal government?

Answering these questions is complex and, in the world of change, the answers to these questions today may not be the same answers in the future. Companies need to ensure that they have the right experts looking at these issues whether they are internal or external experts. While we will not enter the world of calculating income taxes for the international company we will explain why these questions are important.

In some jurisdictions you will only pay taxes on the income earned within that taxing jurisdiction. In others you are required to pay taxes on your world income regardless of where it was earned. This can make a significant difference to the overall tax bill of an organisation. In the U.S. for example, companies must pay taxes on their consolidated income. Therefore they will include the income from all domestic and internationally operated companies they own. They will also be subject to the taxes according to the regulations in all of the countries where they have subsidiaries. Therefore the same income may be subject to tax in more than one country. Depending on the tax treaties in place among the various countries there may be some relief for foreign taxes paid.

In some countries, companies will be subject to both a federal tax and a state or local tax. In Canada, for example, companies must pay a federal tax as well as a provincial tax. Therefore, even domestically it is important to know whom you need to pay taxes to. In some provinces in Canada there is a capital tax, which is based on your asset size rather than income. Canada is



just one example of a country that has various levels of taxation. It shows that taxation rules can be more costly than an organisation might estimate if they look at only one level of tax authority.

### Accounting

As with taxation, international organisations add another level of complexity to accounting. Domestically, when you purchase a company you need to create consolidated financial statements and calculate goodwill and fair value; however, you are dealing with companies that are subject to the same accounting principles. With international companies you will have to prepare consolidated financial statements but you are adding the fact that the subsidiary company may not be subject to the same accounting principles and therefore; differences must be explained and adjusted for as required. Not only is the accounting different, the currency that the statements are presented in, for use in the consolidation process, is different as well. A company must therefore follow the accounting principles in the country of the parent company with respect to translating the financial statements to local currency.

The methods used in these translations from one currency to the local currency can have some impact on the consolidated income of the parent company. The impact depends on the methods used for translating and the changes in the underlying currency versus the parent company currency. As a financial manager concerned with shareholder wealth it is important that you take these impacts into consideration when making financial decisions and when using the financial information.

### Personnel and management

The people side of any organisation is critical. With an international organisation people management is even more critical as you are likely expanding as an organisation into areas/cultures that are unfamiliar. Simple issues, such as do you have the language skills required to do business in the various countries? Often you will find management meetings difficult even when all participants speak the same language. In meetings where you now have a language difference adding to the mix, you must have a plan of how to deal with this difference. Meetings may have to include translators. This is not without risk as when somebody is taking our words and transmitting them to another person there are bound to be differences in nuances and the technical level of explanations. This increases the chances of messages being misunderstood or taken to have a different meaning than originally intended. Also, finding translators with the necessary technical terminology required for certain businesses might not be easy or inexpensive.

The organisation will also have to deal with different social customs to survive in the international market. This means gaining an understanding of the customs in each of the countries that you will be operating in and respecting those customs. If an organisation enters a new market with thoughts that it will force its current organisation culture into its newly acquired international company, it will face great resistance.

Is the senior management of the current organisation prepared to handle the demands of these new complexities? Does that company have to look at restructuring its management team and/or expand the management team to ensure that the international environment is understood and issues are handled appropriately both from the corporate perspective and the cultural perspective in the new market? An organisation has to be prepared that similar problems may not have one easy solution in all the countries they do business in.

In international business you are working with multiple time zones, customs, laws and religions, all of which impact personnel. And all must be given the appropriate level of consideration in managing all the people in your new organisation. One way that an international organisation does not differ from a purely domestic one is that the people who work for the organisation are a great part of its success or failure. Therefore, to overlook this key area could cause the downfall of an expanded organisation.

### **World Trade Organization (WTO)**

The World Trade Organization (WTO) is a relatively new international body. It was established in 1994 under the General Agreement on Tariffs and Trade (GATT). GATT is a United Nations associated international treaty organisation with headquarters in Geneva and is in place to reduce barriers to international trade through reduction of tariffs, enhancing copyright protection internationally, and other efforts that encourage international trade.

WTO is an independent agency operating since January 1995 with an objective to promote trade between members, to resolve trading disputes between members, and to assist in the development of new trading agreements. In other words it helps facilitate the GATT. The formation of this type of organisation and the various trading agreements is a definite sign that international trade is becoming more commonplace every year and crucial to companies in all countries.

### **Other international organisations**

In Module 1 we discussed the various legal forms of business. In most countries there exist rules regarding the forms; which various businesses must take. It is important to understand what legal forms of businesses are available in any country you are dealing with, and what the impact of the different forms will be to your investments plans. In both your accounting and finance course and this course we have stressed that you need to have an understanding of what the different forms of business are, what are their differences, and this is even more important internationally. We may sometimes falsely assume that a corporation is a corporation; however, not all corporations are created equally. There could be different regulations from one country to another with respect to routine items like financial reporting to crucial items such as ownership requirements.



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## Module summary



### Summary

In this module you learned:

- International finance is a growing area of finance due to the slow elimination of trading barriers between countries.
- Several countries have established trading agreements to ease the import/export of products and services between their major trading partners, for example, North American Free Trade Agreement (NAFTA) and the General Agreement on Tariffs and Trade (GATT). And new global institutions are being formed to help manage international activities.
- There are three modes to become international from national. These are international trade, contractual entry modes and foreign investment.
- The increase in international activities does not change the main objective of the financial manager of shareholder wealth maximisation, but it does add complexity to the manager's job.
- In addition to different tax systems and regulations, an organisation must ensure that it reports the correct income to the correct taxing authority. In some instances the income reported may include more than the income earned only within one country. The key accounting implications are the fact that statements will be prepared on a consolidated basis which means combining statements with different currencies and different accounting principles.
- As an organisation expands its operations into different countries there is an increase in political risk as there are more levels of government to deal with and varying government regulations and policies. It is important that a company understand the risk that exists in all countries they operate in.
- As full operations are now in foreign countries there is an increased exposure to foreign exchange risk. This increases hedging activities and monitoring of this risk.
- There is an opportunity to expand your potential investors and debtors as you expand into new countries. A financial manager must carefully assess what financing sources are the best in these countries and not apply the same 'formula' used in the home country.
- In project evaluation, a financial manager and those who prepare project proposals must ensure that they make changes to the

discount factor used in the net present value calculations for political risk. The discount used domestically should not be used without some consideration of an increase due to the riskier environment that the project is taking place in.



## Assignment



### Assignment

1. If China had an inflation rate of 6 per cent while the United States had an inflation rate of 3.5 per cent, the exchange rate was 7.45 yuan per U.S. dollar. How would you have expected the exchange rate to change in that particular year?
2. What factors can prevent arbitrage opportunities if purchasing power parity (PPP) does not hold?
3. How does interest rate parity differ from purchasing power parity?
4. Is it possible PPP holds for some goods but other others?
5. If a Canadian investor in the domestic stock market experiences a negative rate of return, is it possible for a Singapore investor with the same investment to experience a positive rate of return? Discuss.
6. What methods of foreign currency hedging can firms consider?
7. How can foreign currency hedging create firm value?

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# Assessment



## Assessment

1. All of the following are factors that can influence the operations of a multinational corporation, EXCEPT:
  - a. Foreign ownership of portions of equity.
  - b. Existence of multinational capital markets.
  - c. Foreign currency fluctuations.
  - d. Consolidation of financial statements based on only one currency.
2. The risk resulting from the effects of changes in foreign exchange rates on the translated value of a firm's accounts denominated in a given foreign currency is:
  - a. Economic exposure.
  - b. Macro political risk.
  - c. Accounting exposure.
  - d. Micro political risk.
3. All of the following are positive approaches of coping with political risk EXCEPT:
  - a. Use of locals in management.
  - b. Joint venture with local banks.
  - c. Licence or patent restrictions under international agreement.
  - d. Local sourcing.
4. Foreign exchange risk refers to the risk created by
  - a. The potential seizure of a multinational company's operations in a host country.
  - b. The varying exchange rate between two currencies.
  - c. The fixed exchange rate between two currencies.
  - d. The potential nationalisation of the multinational company's operations by a host government.
5. Relative to cash flows of domestic firms, by diversifying internationally, multinationals:
  - a. Can increase cash flows.
  - b. Can achieve further risk reduction.
  - c. Are unable to change the risk.



- d. Are not attempting to change risk.
6. In terms of inventory management, multinational firms:
    - a. Must deal mainly with exchange rate fluctuations and tariffs.
    - b. Must deal with a wide number of factors, including exchange rate fluctuations, tariffs, and non-tariff barriers, integration schemes such as the EEC, and other rules and regulations.
    - c. Have only economic factors to consider, since this is a current asset and is minimally affected by political factors.
    - d. Have only political factors to consider, since inventory is minimally affected by foreign economic factors.
  7. A group of European countries have formed a union and created a common currency known as:
    - a. The EU currency
    - b. The European Union
    - c. The EMU
    - d. The EURO.
  8. The forward exchange rate is:
    - a. The rate today for exchanging one currency for another for immediate delivery.
    - b. The rate today for exchanging one currency for another at a specific future date.
    - c. The rate today for exchanging one currency for another at a specific location on a specific date.
    - d. The rate today for exchanging one currency to another at a specific location for immediate delivery.
  9. The spot exchange rate is:
    - a. The rate today for exchanging one currency for another for immediate delivery.
    - b. The rate today for exchanging one currency for another at a specific future date.
    - c. The rate today for exchanging one currency for another at a specific location on a specific date.
    - d. The rate today for exchanging one currency for another at a specific location for immediate delivery.
  10. When you have to pay more units of local currency to buy one unit of foreign currency as compared to earlier then your home currency is:
    - a. Appreciated

- b. Depreciated
- c. Overvalued
- d. Devalued



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## Answer Key to Review Questions

1. d
2. c
3. c
4. b
5. c
6. b
7. b
8. b
9. a
10. d

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