

## CHAPTER 20

# Corporate Performance of Foreign Operations

### ***Opening Case 20: Offshore Workers Increase IBM's Profits***

Until a few years ago, multinational companies (MNCs) used to export only lowly waged jobs, but relentless pressure to cut costs is now compelling many MNCs to export highly paid positions. In one of the largest moves to “offshore” highly paid software jobs, *The Wall Street Journal* reported on December 14, 2003, that IBM would move 4,730 programmers from the United States to India, China, and elsewhere. Unlike the salaries for low-wage manufacturing jobs, IBM typically paid \$75,000 to \$100,000 or more a year for the US computer-services work. In contrast, hiring a software engineer with a bachelor's or even a master's degree from a top technology university in India may cost \$10,000 to \$20,000 annually.

Offshore workers account for more than half of IBM's 315,000 employees. IBM has been a multinational company since the 1920s, with operations in India for 50 years. Until recently, however, most of the software has been designed in the USA and exported to other countries. Apparently, IBM's effort to export highly paid jobs has recently enabled IBM to be profitable and to gain market share, despite the technology slump in the past few years. No wonder IBM intends to increase the number of its employees in India from 9,000 at the present time to 20,000 by the end of 2005.

The trend looms as one of the most serious long-term threats to US employment and labor. Countries with lower-salaried occupations are no longer siphoning only unskilled or blue-collar jobs from US workers; they now are scooping up skilled work from US companies on a large scale. By the end of 2004, one out of every 10 jobs within US-based computer companies will move to emerging markets, as will one of every 20 technology jobs in other corporations, according to tech-industry researcher

Gartner Inc. The International Data Corporation recently estimated that by 2007, 23 percent of all information technology jobs would be offshore, up from 5 percent in 2003.

*Source:* "IBM to Export Highly Paid Jobs to India, China," *The Wall Street Journal*, Dec. 15, 2003, pp. B1, B3.

Chapter 1 presented hard evidence that companies earn more money as they boost their presence in foreign markets. Furthermore, the first chapter discussed eight principles of global finance that help MNCs perform better than domestic companies. In fact, the entire text of this sixth edition has attempted to cover those financial concepts and techniques that would boost the corporate performance of foreign operations. We conclude this book by discussing how MNCs can use international accounting, taxation, and transfer pricing to improve their overall performance even further.

This chapter consists of three major sections. The first section examines global control systems and performance evaluation of foreign operations. Accurate financial data and an effective control system are especially important in international business, where operations are typically supervised from a distance. The second section considers the significance of national tax systems on international business operations. Perhaps multinational taxation has the most pervasive effect on all aspects of multinational operations. Where to invest, how to finance, and where to remit liquid funds are just a few examples of management actions affected by multinational taxation. The third section covers international transfer pricing. Because transfers between business entities account for approximately one-third of total world trade, the multinational company must try to satisfy a number of objectives. This chapter examines some of these objectives, such as taxes, tariffs, competition, inflation rates, exchange rates, and restrictions on fund transfers.

## ● 20.1 The Global Control System and Performance Evaluation

In order to achieve the firm's primary goal of maximizing stockholder wealth, the financial manager performs three major functions: (1) financial planning and control, (2) investment decision-making, and (3) financing decision-making. These financial functions cannot be performed effectively without adequate, timely accounting information. The two fundamental financial statements of any company are the balance sheet and the income statement. The **balance sheet** measures the assets, liabilities, and owners' equity of a business at a particular time. The **income statement** matches expenses to revenues in order to determine the net income or net loss for a period of time. In addition to these two financial statements, a control system is used to relate actual performance to some predetermined goal.

The actual and potential flows of assets across national boundaries complicate the accounting functions of an MNC. The MNC must learn to deal with environmental differences, such as different rates of inflation and changes in exchange rates. If an MNC is to function in a coordinated manner, it must also measure the performance of its foreign affiliates. Equally important, managers of the affiliates must run operations with clearly defined objectives in mind.

An MNC consists of the parent and its subsidiaries in foreign countries. To operate the MNC as a system, the parent and its subsidiaries need continuing flows of data. Hence, the key element in the control system is the company's system for collection and dissemination of data on a world-wide basis. The company's information system between the parent and its subsidiaries generally consists of: (1) impersonal communications such as budgets, plans, programs, electronic messages, and regular reports; and (2) personal communications such as meetings, visits, and telephone conversations.

Communications essential to evaluating the performance of an enterprise usually follow established organizational channels. An effective communication system requires an efficient reporting system for collecting information on the results of actual operations and for disclosing deviations from predetermined standards. The more efficient the system, the more quickly managers may take corrective action.

Financial results of profitability have traditionally provided a standard to evaluate the performance of business operations. However, as MNCs expand their operations across national boundaries, the standard itself is affected by the environment in which they operate. Inflation and foreign-exchange fluctuations affect all the financial measures of performance for MNCs. To compare the results of various affiliates of an MNC, multinational financial managers must understand the various ways in which inflation and exchange fluctuations affect operations as measured by traditional financial statements.

### 20.1.1 *Inflation and exchange rate fluctuations*

Every control system establishes a standard of performance and compares actual performance with the standard. The most widely used standards are budgeted financial statements. The preparation of the statements is a planning function, but their administration is a controlling function. We will compare budgeted financial statements with actual financial statements to determine the impact of inflation and exchange rate fluctuations on financial statements. Budgeted statements are prepared without anticipated inflation or exchange rate fluctuations, but the actual statements are prepared after these phenomena have occurred.

**THE IMPACT OF INFLATION ON FINANCIAL STATEMENTS** Table 20.1 presents the effects of a 10 percent and a 20 percent rate of inflation on the major accounts of the balance sheet and the income statement. If we assume that one unit is sold every month and that prices increase at an even rate throughout the year, the annual inflation rates reflected on sales would be 5 percent and 10 percent instead of 10 percent and 20 percent.

If we follow the results of a case having a total annual inflation rate of 10 percent, or 0.83 percent per month, annual sales increase to 2,100 – a 5 percent increase over the budgeted price. The cost of goods sold increases by only 4 percent from the budgeted cost of 1,500 to the actual cost of 1,560, because the cost of goods sold is based on historical costs. We assumed that interest expenses remain constant. The budgeted depreciation charges are based on historical costs. The combination of higher prices in sales and the use of historical costs in the two major accounts will increase the profits after taxes by 20 percent from 100 to 120.

The effects of inflation on the balance-sheet accounts depend on the date when assets were acquired or liabilities incurred. Fixed assets and inventory are carried at cost, but accounts receiv-

**Table 20.1** The impact of inflation on financial statements

	<i>Budget</i>	<i>Actual, with annual inflation rate of:</i>		
		<i>10%</i>	<i>20%</i>	
<b>Income statement (in foreign currency)</b>				
Sales	2,000	2,100	2,200	
Cost of goods sold	<u>1,500</u>	<u>1,560</u>	<u>1,620</u>	
Gross margin	500	540	580	
Depreciation	<u>200</u>	<u>200</u>	<u>200</u>	
Operating income	300	340	380	
Interest expense	<u>100</u>	<u>100</u>	<u>100</u>	
Profit before taxes	200	240	280	
Taxes (50%)	<u>100</u>	<u>120</u>	<u>140</u>	
Profit after taxes	100	120	140	
<hr/>				
	<i>Initial</i>	<i>Budget</i>	<i>Actual, with annual inflation rate of:</i>	
			<i>10%</i>	<i>20%</i>
<b>Balance sheet (in foreign currency)</b>				
Cash	0	400	440	480
Accounts receivable	200	200	220	240
Inventory	<u>100</u>	<u>100</u>	<u>110</u>	<u>120</u>
Total current assets	300	700	770	840
Plant and equipment	350	350	350	350
Less: Depreciation	<u>—</u>	<u>(200)</u>	<u>(200)</u>	<u>(200)</u>
Total assets	650	850	920	990
Accounts payable	300	300	330	360
Notes payable	300	300	300	300
Taxes payable	<u>—</u>	<u>100</u>	<u>120</u>	<u>140</u>
Total current liabilities	600	700	750	800
Equity	50	50	50	50
Retained earnings	<u>—</u>	<u>100</u>	<u>120</u>	<u>140</u>
Total liabilities & equity	650	850	920	990

able and accounts payable are carried at the prices prevailing at the time of the transactions. The budgeted cash of 400 consists of profits after taxes (100), taxes payable (100), and depreciation (200).

**THE IMPACT OF EXCHANGE RATE FLUCTUATION ON FINANCIAL STATEMENTS** Let us assume that a subsidiary purchases its raw materials from country A and sells its finished products to country B. Thus, both exports and imports are denominated in foreign currencies. In this case, exchange rate fluctuations affect the level of both revenues and costs measured in terms of the domestic currency. Table 20.2 shows that an appreciation in the revenue currency (country B's

**Table 20.2** The impact of currency fluctuations on profits

	<i>Budget</i>	<i>B's currency appreciates 10%</i>	<i>A's currency appreciates 10%</i>	<i>Both currencies appreciate 10%</i>
Sales	2,000	2,100	2,000	2,100
Cost of goods sold	<u>1,500</u>	<u>1,500</u>	<u>1,560</u>	<u>1,560</u>
Gross margin	500	600	440	540
Depreciation	<u>200</u>	<u>200</u>	<u>200</u>	<u>200</u>
Operating income	300	400	240	340
Interest expense	<u>100</u>	<u>100</u>	<u>100</u>	<u>100</u>
Profit before tax	200	300	140	240
Taxes (50%)	<u>100</u>	<u>150</u>	<u>70</u>	<u>120</u>
Profit after tax	100	150	70	120

currency) raises profits, assuming that costs remain constant. In contrast, an appreciation in the cost currency (country A's currency) reduces profits after taxes unless selling prices are adjusted to reflect the increase in costs.

There are similarities between the effect of inflation and the effect of exchange rate fluctuations on reported profits. If prices in the local currencies are increased by the same percentage as the increase in the cost of imports, the effect of exchange rate fluctuations on profits is identical with the effect of a comparable local inflation rate. A 10 percent increase in export prices, accompanied by a proportional increase in import prices, produces profits of 120; this is identical to the profit obtained when the local inflation rate was 10 percent in the example from table 20.1.

We cannot determine the true impact of exchange rate fluctuations on foreign operations unless a parent's accounts and those of its subsidiaries are expressed in terms of a homogeneous currency unit. Any changes in the value of the local currency relative to the parent currency will affect the reported profits when financial statements expressed in the local currency are translated into the currency of the parent company. The translation procedure, already discussed in chapter 10, is regulated by the accounting profession.

### 20.1.2 Performance evaluation

Performance evaluation is a central feature of an effective management information system. A management information system is a comprehensive system to provide all levels of management in a firm with information so that production, marketing, and financial functions can be effectively performed to achieve the objectives of the firm. Management must plan its economic activities in advance, carry out its plans, and make sure that deviations are properly evaluated and handled. Thus, performance evaluation based on the concept of the management information system relates to the fundamentals of the management process: planning, execution, and control.

Because every subsidiary is unique in many respects, each subsidiary should be evaluated on the basis of specific targets and individual objectives set for each. A survey of 125 MNCs by Person and Lessig (1979) identified four purposes of an internal evaluation system: (1) to ensure adequate profitability; (2) to have an early warning system if something goes wrong; (3) to have a basis for the allocation of resources; and (4) to evaluate individual managers. The study also

revealed that MNCs always use more than one criterion to evaluate the results of their foreign subsidiaries. Of course, the performance evaluation system is designed to measure actual performance against budgeted objectives as well as the prior year's results. In the best of situations, the evaluation system should monitor and control performance on a year-to-date and regular basis.

**PERFORMANCE CRITERIA** MNCs use multiple performance evaluation criteria because no single criterion can capture all facets of performance that interest management at the main headquarters. Moreover, no single basis of measurement is equally appropriate for all units of an MNC. For example, companies can appropriately evaluate their production unit on the basis of such measures as cost reduction, quality control, and meeting shipment targets. For a sales unit, however, cost reduction and quality control may be less appropriate than such measures as market share and number of new customers. Thus, it is highly desirable for companies to use multiple bases for performance measurement; that is, different ones for different kinds of operations in different countries.

Two broad groups of performance evaluation criteria – financial criteria and nonfinancial criteria – are used most widely by companies for evaluating their overseas operations. The **return on investment** relates enterprise income to some specified investment base such as total assets. Many companies compare their actual operating performance with their budgeted performance; budgets are pre-established standards against which operations are evaluated, compared, and adjusted by the exercise of control. Abdallah and Keller (1985) surveyed 64 MNCs to identify the financial criteria that they used to evaluate the performance of foreign subsidiaries. According to Abdallah and Keller, the four most important criteria were: (1) return on investment (ROI), (2) profits, (3) budgeted ROI compared to actual ROI, and (4) budgeted profit compared to actual profit.

Many MNCs do not confine their performance criteria to mere financial considerations. Non-financial criteria complement financial measures because they account for actions that may not contribute directly to profits in the short run but may contribute significantly to profits in the long run. The market share is measured by sales or orders received as a percentage of total sales in a market. The sales growth is measured by unit volume gains, selling price increases, and exchange variations. Other important nonfinancial criteria include quality control, productivity improvement, the relationship with the host-country government, cooperation with the parent company, employment development, employee safety, and community service.

Once questions of performance criteria have been resolved, companies should ascertain whether their criteria could be useful in comparing a foreign unit's performance against its competitors' performance, either in the same country or across different borders. However, there are many pitfalls in such comparisons. For example, it is almost impossible to determine the transfer pricing of competitors as well as their accounting principles. Certainly, cross-border comparisons would compound the problem even further. Companies with many affiliates – at home or abroad – must also take caution whenever questions of comparability arise. Differences in subsidiaries would automatically distort performance comparisons unless they are directly accounted for. Even if subsidiary objectives are the same, differences in country risk profiles, such as exchange controls and export subsidies, could distort performance comparisons.

**PERFORMANCE MEASUREMENT ISSUES** There are many crucial, yet perplexing, elements in the performance evaluation process. As described earlier, two measurement problems unique to MNCs are exchange rates and inflation.

Perhaps the most critical element in the evaluation process is how to deal with results that are denominated in currencies other than that of the parent company. The financial performance of overseas operations can be measured in terms of local currency, home-country currency, or both. If major changes occur in the exchange rates, the choice of currency can have a significant effect on the assessment of a foreign subsidiary's performance. For example, a subsidiary could make a profit in local currency but could incur a loss in the parent company's currency. Most US companies analyze the operating results of their foreign operations in dollar terms. However, several of these companies also use different rates for budgeting and performance tracking, because they recognize variations between actual and expected results, which arise purely from exchange rate changes.

Fluctuating exchange rates may pose the most significant obstacle to proper evaluation, but this is certainly not the only environmental factor. Wide variations and rapid changes in inflation rates from country to country also complicate the evaluation process. Generally, accepted accounting principles in the United States are based on the assumption of price stability. However, other countries have runaway inflation, thus making it essential to adjust local asset values for changing prices. Such restatements directly affect the measurement of various ROI components and performance statistics for budgeting purposes. Because failure to account for inflation may result in an overstatement of return on investment, company resources may not be channeled to their most promising use. Unfortunately, solutions to these problems are not readily formulated. Furthermore, MNCs must consider two sets of laws, two competitive markets, and two governments. As a result, pricing considerations in international business are more numerous, more complex, and more risky than those in purely domestic business.

### 20.1.3 *Organizational structure*

As strictly domestic companies evolve into MNCs, many internal and external pressures strain a firm's existing organizational structure. Some responsibilities are changed, new ones are created, and some existing ones are eliminated. Furthermore, control and finance functions change over time as changes occur in countries' socioeconomic environments. Companies must constantly adjust their organizational structure to deal with new opportunities and challenges as they grow, diversify, and internationalize.

How should the financial staff of a company with foreign operations organize itself to carry out tasks that require the specialized expertise of multinational finance? There are three basic forms of organizational structure: centralization, decentralization, and hybrid structure.

A centralized financial function has a strong staff at the parent company level, which controls virtually all treasury decisions. The subsidiary financial staff only implements the decisions of its parent company. In a decentralized financial function, parent-company executives issue a few guidelines, but most financial decisions are made at the subsidiary level. Many companies split responsibilities for international financial management between the corporate level and the regional level. The corporate level typically determines policy and grants ultimate approval on major financial decisions. However, day-to-day decisions to implement policy are made at regional headquarters.

Both centralization and decentralization carry advantages. The advantages of a centralized financial function include close control of financial issues at headquarters, attention of top management to key issues, and an emphasis on parent-company goals. A decentralized company may argue that these advantages could be disadvantages. Data collection costs may be enormous,

centralized decision-making may stifle flexibility, and many opportunities may be lost because of slow actions.

**DECISION VARIABLES** The ultimate choice of a particular organizational structure depends largely upon the types of decisions one must make: (1) transfer pricing and performance evaluation, (2) tax planning, (3) exchange exposure management, (4) acquisition of funds, and (5) positioning of funds.

First, transfer pricing decisions made to minimize taxes may ruin the performance evaluation system for foreign subsidiaries. This problem sometimes forces a company to keep a second set of books for evaluation purposes. Many MNCs may, in fact, keep three or more sets of books: one for taxes, one for financial reporting, and one for evaluation purposes. There may be a need for two transfer prices: one for tax purposes made at headquarters and one for evaluation purposes decided by direct negotiations between affiliates.

Second, the centralized organization usually works well to minimize worldwide taxes. When tax planning is centralized, it is easier to use tax-haven countries, tax-saving holding companies, and transfer pricing. Thus, it is more efficient for MNCs to centralize their tax planning function rather than allow each region to create its own layer of tax havens and holding companies.

Third, most companies centralize their foreign-exchange exposure management, because it is difficult for regional or country managers to know how their foreign-exchange exposure relates to other affiliates.

Fourth, many MNCs borrow money from local sources for their working capital. On the other hand, cheap sources of funds depend upon alternatives in all capital markets and the cost of exchange gains or losses. Regional managers can hardly know all alternative sources of funds outside a local market.

Fifth, positioning funds involves paying dividends and making intracompany loans, thereby reducing consideration of total corporate tax liabilities, foreign-exchange exposure, and the availability of capital. Consequently, most companies tend to control positioning of funds from a centralized vantage point rather than from a regional viewpoint.

#### 20.1.4 *The Foreign Corrupt Practices Act*

The US Securities and Exchange Commission (SEC) first investigated illegal foreign payments in 1974, with its probe of questionable contributions by US companies to the reelection campaign of former President Nixon. Subsequent inquiries by the SEC, the Department of Justice, and the Senate Foreign Relations Committee disclosed questionable payments of \$300 million by 450 companies. Revelations of such dubious payments by US firms to foreign officials rocked governments in Japan and the Netherlands.

Congress felt that the US corporate bribery (1) tarnished the credibility of American business operations, (2) caused embarrassment with allies and foes alike, (3) created foreign-policy difficulties, and (4) generally tarnished the world's image of the USA. Consequently, they passed and signed the **Foreign Corrupt Practices Act (FCPA)** on December 19, 1977, as an amendment to the Securities Exchange Act of 1934. In 1988, the FCPA was modified in an effort to address its perceived deficiencies. In December 1997, members of the Organization for Economic Development and Cooperation (OECD) with five other nations signed a binding convention to outlaw bribery in international business dealings.

**THE CONTENT OF THE FCPA** The FCPA consists of two separate sections, antibribery and accounting. The antibribery section was the first piece of legislation in US history to make it a criminal offense for US companies to corruptly influence foreign officials or to make payments to any person when they have “reason to know” that part of these payments will go to a foreign official. In other words, the FCPA applies only to US companies and not to their agents or subsidiaries. US companies or citizens could, however, be held in violation of the law if they had “reason to know” that their subsidiaries or agents would pay bribes on their behalf.

The accounting section establishes two interrelated accounting requirements. First, public companies must “keep books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions” of their assets. Second, corporations are also required to “devise and maintain a system of internal accounting controls sufficient to provide reasonable assurance” that transactions have been executed in accordance with management’s authorized procedures or policies.

Congress concluded that the antibribery and accounting sections would effectively prevent payments of foreign bribes and off-the-book slush funds. Penalties for violations include fines and jail time. Thus, both the antibribery section and the accounting section are enforced through civil and criminal liabilities.

**MODIFYING THE FCPA** President Reagan signed the FCPA amendment of 1988 into law as part of an omnibus trade bill. Most proponents of its changes affirmed the original purposes of the FCPA. They found that the FCPA had been effective in curtailing bribes, kickbacks, and other unethical activities by US companies. Still, the 1988 amendment removed one of the statute’s strongest export disincentives: the threat of statutory criminal liability based on accidental or unknowing negligence in the retention of certain accounting records. So, only corporate employees who “knowingly” circumvent corporate accounting controls or falsify records of corporate payments are now subject to criminal liability. In fact, the old law and the new law differ in notable ways:

- 1 The old law assessed both civil and criminal sanctions against both deliberate and negligent violators of the accounting section. The new law assesses only civil (no criminal) penalties against negligent or unintentional violators of the accounting section. Violators convicted of an intent to deceive still face criminal penalties.
- 2 The old law did not define “reasonable detail” in the accounting section and “reason to know” in the antibribery section. The new law defines them as those that would satisfy a “prudent individual” under similar circumstances.
- 3 The old law did not define “grease payments” and virtually precluded all forms of grease payments to foreign officials. In fact, grease payments were enforced via both civil and criminal sanctions. The new law specifically permits such grease payments if: (1) they help expedite routine governmental action; (2) they are legal in that foreign country; or (3) they demonstrate gratitude or reimbursement for expenses incurred in connection with a contract.
- 4 The old law had been severely criticized from its inception on the ground that it was vague and difficult to interpret. Still, no government agency issued interpretive guidelines. The new law specifies that the government will issue a set of clear guidelines if the business community wants further clarification.
- 5 The old law did not require any government agency to give its opinion on the legality of a contemplated transaction. The new law requires the Department of Justice to give its

opinion on the legality of a planned transaction within 30 days after receiving the necessary information.

- 6 Penalties for violations increased from \$1 million to \$2 million for corporations and from \$10,000 to \$100,000 and/or 5 years in jail for individuals. The Internal Revenue Service will not allow a firm to treat a foreign bribe as a business expense for tax purposes: such bribes are treated as profits currently subject to US taxation. A company is not allowed to reimburse individuals for fines paid as a consequence of violating the FCPA.
- 7 Enforcement of the antibribery provisions for all jurisdictions has been consolidated within the Justice Department. The SEC retains the responsibility to enforce the provisions of the accounting section.

## ● 20.2 International Taxation

Usually, one of the most important variables in multinational operations is taxation. Perhaps no environmental variable, with the possible exception of foreign exchange, has such a pervasive influence on all aspects of multinational operations as taxation: (1) the choice of location in the investment decision, (2) the form of the new enterprise, (3) the method of finance, and (4) the method of transfer pricing.

International taxation is complicated because tax laws differ among countries and are constantly changing. Hence, it is not accidental that international taxation still remains somewhat of a mystery for many international executives. For example, multinational financial managers need to understand the following:

- 1 Shareholders of foreign and domestic corporations are subject to different rules.
- 2 Accounting for foreign taxes on foreign operations is not identical to that on domestic operations.
- 3 Bilateral tax treaties and foreign tax credits exist to avoid double taxation of income.
- 4 Many countries offer a number of tax incentives to attract foreign capital and know-how.
- 5 Tax savings realized in low-tax countries may be offset by taxes on undistributed earnings.

There are many such added complexities because governments have failed to come to any general agreement on tax policies. Each country has its own tax philosophies, tax incentives, transfer pricing policies, and the like. Multinational financial managers must sort them out in order to maximize profitability and cash flow. To attain this end, they must acquaint themselves with the overall tax environment.

### 20.2.1 *Types of taxes*

MNCs face a variety of direct and indirect taxes. **Direct taxes** include corporate income taxes and capital gains taxes. **Indirect taxes** include value-added taxes, tariffs, and withholding taxes. In addition to these direct and indirect taxes, MNCs may have to pay property taxes, payroll taxes, stamp and registration taxes, taxes on registrations of agreements of various types, sales and excise taxes (excluding value-added taxes), and taxes on undistributed earnings.

**INCOME AND CAPITAL GAINS** As with individual income taxes, corporate income taxes are an important source of revenue for many countries. Because most developing countries have low per capita income, individual income taxes or sales taxes are not very appropriate. Thus, developing countries obtain a larger share of government revenues from corporate income taxes than industrial countries.

Gains and losses on sales of capital assets are called **capital gains and losses**. Capital assets are those assets that are not primarily for resale and not acquired in the ordinary course of business. These assets include stocks and bonds. If capital assets are held longer than a specified period of time, gains on sales of these assets may be subject to preferential tax treatment:

- **Value-added taxes** are a special type of sales tax. Sales taxes are those taxes assessed at one or more stages in the production process. In Canada, sales taxes are levied when production is complete; in England, when products are wholesaled; in the USA, when products are retailed; and in some European countries, at all stages in the production cycle. Many European countries have adopted the value-added tax as the major source of revenue to avoid the compounding effect of sales taxes. For example, if a car dealer purchased a car for \$10,000 from a car manufacturing company and then sold it for \$15,000, the value added would be \$5,000 and the tax would be levied on this \$5,000 increment.
- **Tariffs** are simply taxes assessed on imported goods, which parallel excise and other indirect taxes paid by domestic producers of similar goods. They may be imposed for purposes of revenue or protection. When tariffs are employed to increase revenues, they are usually modest. However, when tariffs are used to protect domestic companies from foreign competition, they are typically high. Although protective tariffs do not eliminate the importation of foreign products completely, they clearly put foreign sellers at a comparative disadvantage. In this instance, consumers must pay more for foreign goods, which in turn would reduce their consumption of imported commodities.
- **Withholding taxes** are those taxes imposed by host governments on dividend and interest payments to foreign investors and debt holders. These taxes are collected before receipt of the income. In other words, they are usually withheld at the source by the paying corporation. For example, a 20 percent withholding tax on \$10,000 interest payments to foreigners means that the tax proceeds of \$2,000 are deducted from the interest payment made to the lender and collected by the borrower on behalf of the government. Hence, the purchaser of the bonds would receive only \$8,000, or 80 percent of the \$10,000 interest payment. Withholding taxes are generally modified by bilateral tax treaties, because they frequently restrict the international movement of long-term investment capital.

### 20.2.2 *Tax morality*

The issue at stake is the conflict between economics (profits) and ethics (corporate morality). Some business executives think that profits are one thing and corporate morality is another; thus, they conclude that they have to make a choice. It is well known that in many countries both corporate and individual taxpayers are not completely honest with their tax authorities. MNCs must decide whether to comply with the tax laws voluntarily. Although most MNCs comply fully with the tax laws, some companies feel that they should evade taxes to the same extent as their competitors in order to protect their competitive position. Ethical standards vary greatly

among people, companies, and societies because business ethics are partly a function of cultural patterns and historical development. Therefore, there is obviously no universally accepted answer to the problem.

Host governments also have a similar moral problem. Two basic tax principles are that taxes should be equitable and neutral. In other words, taxes should be fair to everyone, and they should not affect decisions in the economic system. Nevertheless, many countries have imposed some arbitrary tax penalties on MNCs for presumed violations of local tax laws. Many developing countries have various tax incentive programs for private foreign investments. These tax incentive programs abandon the principle of an economically neutral system. Under a neutral tax system, if we want the most efficient economic system, supply and demand should be left alone to determine prices and economic activity.

### 20.2.3 Tax burdens

Because different countries have varying statutory rates of income tax, differences in overall tax burdens are another natural feature of international business operations. The corporate tax rate ranges from zero in such tax-haven countries as the Bahamas to 60 percent in such countries as Libya.

Differences in definitions of taxable corporate income create greater disparities than differences in nominal corporate tax rates. Thus, differential tax rates tell us only part of the story. In one country, taxable income may be computed on a cash basis, while in another country it may be determined on an accrual basis. Investment allowances and credits, reserves, the timing of depreciation deductions, and asset valuations vary greatly from country to country. Some countries provide companies with full credit for taxes on the income paid in other countries.

Tax systems also affect relative tax burdens internationally. In general, there are three classes of systems: single tax, double tax, and partial double tax. Under the single tax system, income is taxed only once. If corporations pay no taxes, their stockholders pay taxes on dividends. Under the double tax system, corporations pay taxes on profits at a given rate and dividends are then taxed as income to stockholders at their personal income tax rates. Under the partial double tax system, taxes are levied on corporate income, but dividends are taxed at a lower rate than other forms of personal income, or distributed corporate earnings are taxed at a lower rate than undistributed earnings (retained earnings).

**CARRYBACKS AND CARRYFORWARDS** An operating loss is the excess of deductible expenses over gross income. Operating losses can often be carried back or forward to offset earnings in other years. Tax provisions for carrybacks and carryforwards vary among countries. Most countries do not permit operating losses to be carried back. However, virtually all countries allow companies to carry their losses forward for a limited number of years.

US companies may carry their excess foreign tax credit back 3 years and carry it forward 15 years to offset US tax on foreign-source income. The choice depends largely upon whether a company has had foreign-source income in the 2 years immediately prior to the excess foreign tax credit. If this is the case, the company must carry the excess foreign tax credit back in order to expedite the refund of tax payment.

The purpose of this provision is to allow corporations to average their operating results, which fluctuate widely from year to year. However, some profitable MNCs have used the carryback and carryforward feature as a means of reducing their taxable income by merging with other firms that have considerable operating losses or excess foreign tax credits.

#### 20.2.4 *Parent-country taxation of multinational operations*

Countries differ with respect to their tax treatment of foreign-source income earned by their MNCs. Major differences include varying interpretations of tax neutrality, the method of granting credit for foreign-income taxes already paid, and concessions gained in bilateral tax treaties.

**TAX NEUTRALITY** A **neutral tax** is one that would not affect the location of the investment or the nationality of the investor. Tax neutrality is justified on the ground that world welfare would be increased if capital were free to move from countries whose rate of return is low to those whose rate of return is high.

Tax neutrality consists of domestic neutrality and foreign neutrality. Domestic neutrality means the equal treatment of Americans who invest at home and Americans who invest abroad. This neutrality involves equalization of all taxes on profits.

Foreign neutrality indicates that the tax burden imposed on each foreign subsidiary of a US company should equal the tax burden placed on its competitors in the same country. The firm owned by residents of the host country and the foreign subsidiary of a non-US company are the two basic types of competitors faced by the foreign subsidiary of a US firm.

Tax neutrality is designed to achieve a status of equality within the tax system. In practice, however, it is difficult to define and measure tax neutrality. The issue of tax equality is also difficult to define and measure. Many governments claim that they tax foreign income at the same rate as domestic income. However, most countries in the world have many important departures from the theoretical norm of tax neutrality.

**TAX TREATIES** Countries enter into bilateral tax treaties to avoid double taxation and thus to encourage the free flow of investments internationally. Treaty countries agree on how taxes will be imposed, shared, or otherwise eliminated on business income earned in one taxing jurisdiction by nationals of another.

Tax treaties are designed to serve the following four purposes:

- 1 To prevent double taxation on the same income.
- 2 To prevent national tax discrimination against foreign nationals of the other treaty country.
- 3 To increase predictability for the nationals of the treaty nations by specifying taxable obligations. Predictability also tends to reduce opportunities for tax evasion or tax fraud.
- 4 To specify the type of tax subsidies that will be mutually acceptable to both treaty nations.

The provisions of most tax treaties override the provisions of national income tax laws. For example, Section 8894 of the US Internal Revenue Code states that “income of any kind, to the extent required by any treaty obligation of the United States, shall not be included in gross income and shall be exempt from taxation under this subtitle.” Thus, US tax treaties provide that profits earned by US companies in a foreign country are exempt from taxation unless they have

permanent establishment in the foreign country. Tax treaties also reduce withholding taxes on dividends, interest, and royalties.

**FOREIGN TAX CREDITS** The purpose of the foreign tax credit is to avoid international double taxation when profits earned abroad become subject to the full tax levies of two or more countries. Under the **foreign tax credit** system, the USA relinquishes tax on profits earned abroad up to the amount of the foreign tax. Thus, the foreign government takes the first bite of profits earned in its jurisdiction. In addition, taxes subject to these credit provisions include withholding taxes on dividends, interest, and other income.

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## Example 20.1

Assume that a US corporation has \$1,000 of foreign income earned in the United Kingdom. The US tax rate is 35 percent and the UK tax rate is 30 percent. The net US tax of \$50 is computed as follows:

Foreign income	\$1,000
Foreign tax (30%)	<u>300</u>
Net income after tax	\$ 700
US taxable income	\$1,000
US tax (35%)	\$ 350
Foreign tax credit	<u>300</u>
US tax payable	\$ 50
Total foreign and US taxes	\$ 350
Effective tax rate	35%

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As this example illustrates, the purpose of the foreign tax credit is to limit the total tax on foreign income to the higher tax rate of the two countries. If the foreign tax on income earned abroad and remitted to the USA is less than or equal to the US tax rate, that income will be subject to a total tax of 35 percent. Thus, if the foreign tax rate is lower than the US rate, the US government receives some tax revenues on the foreign income. If the foreign tax rate is higher than the US rate, the US government receives no tax revenues on the foreign income.

As an alternative to the foreign tax credit, US companies can treat any foreign tax paid directly as a deductible expense. Because both a credit and deduction cannot be claimed in the same year, the US company must decide whether to claim the credit or deduction for foreign income taxes. In general, it is advantageous to claim a credit against federal income tax rather than a deduction.

## Example 20.2

Assume that a US corporation has \$1,000 of foreign income earned in Spain. Spain and the USA have an identical tax rate of 35 percent. The following computation shows that the credit is better than the deduction:

	Foreign tax credit	Foreign tax deduction
Foreign income	\$1,000	\$1,000
Foreign tax (35%)	<u>350</u>	<u>350</u>
Net income after tax	650	650
US taxable income	\$1,000	\$ 650
US tax (35%)	\$ 350	\$ 227
Foreign tax credit	<u>350</u>	<u>0</u>
US tax payable	\$ 0	\$ 227
Total foreign and US taxes	\$ 350	\$ 577
Effective tax rate	35%	57.7%

### 20.2.5 Tax incentives for foreign investment

The location of foreign investment is influenced by three major tax factors: tax incentives, tax rates, and tax treaties. The existence of tax incentives can significantly reduce the cash outflow required for an investment project, which will increase the net present value of the project. It is important to be familiar with local tax laws, because the determination of revenues and expenses for tax purposes is a function of tax laws in most countries. Tax treaties are essential in terms of how they affect the cash flows related to withholding taxes on dividends, interest, and royalties. Paying close attention to tax treaties can help investors to wisely choose the location of their legal operations.

Many countries, especially developing countries, offer tax incentives to attract foreign capital and know-how to their countries. The four basic forms of tax incentive programs are government concessions, tax havens, foreign trade zones, and other tax incentives.

**GOVERNMENT CONCESSIONS** Developing countries offer many concessions to attract MNCs. Most concessions are in the form of a complete tax exemption for the first few years, known as “tax holidays.” Some other forms of temporary tax concessions include reduced income tax rates, tax credits on new investments, tax deferrals, and reduction or elimination of various indirect taxes. These concessions, along with lower labor costs in relation to developed countries, have made many developing countries attractive for assembly and manufacturing operations.

**TAX HAVENS** Those countries that offer strict bank-secrecy laws and zero or low taxation in order to attract foreign investors and depositors are known as **tax havens**. These nations have few natural resources. In addition to low tax rates, tax havens must have (1) a stable government, (2) good communication facilities, (3) freedom of currency movements, and (4) the availability of financial services. Tax havens may be classified into four broad categories:

- 1 Countries with no income taxes, such as the Bahamas, Bermuda, and the Cayman Islands.
- 2 Countries with very low taxes, such as Switzerland, Liechtenstein, and the Channel Islands.
- 3 Countries that tax income from domestic sources but exempt income from foreign sources, such as Liberia and Panama.
- 4 Countries that allow special privileges to make them suitable as tax havens for very limited purposes.

A large number of MNCs have foreign affiliates that act as tax havens for corporate funds. These corporate funds are held in the tax havens until they are reinvested or repatriated elsewhere. Tax-haven affiliates are the outgrowth of tax-deferral features on foreign earnings allowed by some parent countries to their MNCs. Normally, parent companies could defer taxes on their foreign earnings until these earnings are received as dividends.

Increasing capital flows across countries have many benefits, but they pose policy challenges, such as tax avoidance and tax evasion. The vast increase in global capital flows has made it tougher for countries to monitor their taxpayers for compliance: “Nobody really knows how much tax revenue is lost to offshore schemes, but everybody agrees it is huge – by one estimate about \$70 billion a year in the US alone” (Allen 2000). Thus, industrialized countries have recently pressured tax havens to adopt international standards for banking regulation and safeguards against money laundering activities.

**THE FOREIGN TRADE ZONE (FTZ)** A foreign trade zone is an enclosed area where domestic and imported merchandise can be stored, inspected, and manufactured without being subject to formal customs procedures until the goods leave the zone. There are thousands of these areas in most countries around the world.

FTZs have operated in the USA since the passage of the Foreign Trade Zone Act of 1934. This law also created the Foreign Trade Zone Board, which authorizes and regulates activities within the FTZs. Over the years, the law and administration have been liberalized to permit more activities within the FTZs and more flexibility in the location of FTZs. The number of FTZs has increased from less than a dozen before 1970 to well over 600 today.

Goods in FTZs have not entered the country so far as import documentation, collection of customs duties, and the allocation of quotas or other import restrictions are concerned. Federal and local excise taxes are not levied on goods while they are located in FTZs. Except for customs and excise taxes, products and firms in FTZs are subject to the same local and federal laws and regulations, such as immigration laws, safety laws, and regulation of carriers.

FTZs must be located adjacent to US customs “ports of entry,” but these are no longer located adjacent to “inland ports of entry.” Within FTZs, companies may store and assemble imported goods. They may also use imported parts and raw materials to conduct manufacturing operations in FTZs.

Although the advantages of the FTZ to importers are well known, its benefits to exporters appear to have been overlooked. FTZs can provide accelerated export status for purposes of excise

tax rebates and customs drawbacks. Manufacturers of such items as tires, trucks, and tobacco products are required to pay federal excise taxes when these items are produced, but the taxes are rebated if the items are exported. Companies must pay duty on the imports, but this duty is returned when the product is exported (custom drawback). Because the recovery of this money takes time, the exporter can have considerable capital tied up in excise taxes and import duties. The use of FTZs resolves this problem. A product is considered exported as soon as it enters an FTZ and thus the exporter can immediately apply for a rebate or a drawback while waiting to make an export sale.

## ● 20.3 Transfer Pricing and Tax Planning

**Transfer prices** are prices of goods and services bought and sold between parent companies and subsidiaries. Internal transfers include raw materials, semifinished goods, finished goods, allocation of fixed costs, loans, fees, royalties for use of trademarks, and copyrights. International transfer pricing policies become increasingly complex as companies increase their involvement in international transactions through foreign subsidiaries, joint ventures, and parent-owned distribution systems. Discrepancies between transfer pricing methods used by companies and those allowed by taxing agencies take place because taxing agencies and companies have different objectives. For example, MNCs try to maximize profits and improve performance evaluation by manipulating internal transfer prices. Taxing authorities, on the other hand, try – through fair market prices – to allocate the profit of a sale between their country and other countries. Thus, multinational financial managers must understand transfer pricing objectives and their impact on transfer prices.

### 20.3.1 *Transfer pricing objectives*

Transfer pricing strategies are sensitive internal corporate issues, because successful pricing is a key element in achieving profits. Transfer pricing also helps MNCs determine how company profits are allocated across divisions. Governments show interest in transfer pricing because these prices will decide tax revenues and other benefits. So, many host governments have policing mechanisms to review the transfer pricing policies of MNCs.

Transfer pricing has the following objectives:

- 1 Income tax minimization.
- 2 Import duty minimization.
- 3 Avoidance of financial problems.
- 4 Adjustment for currency fluctuations.

**INCOME TAX MINIMIZATION** Many researchers have singled out tax minimization as an important variable influencing international transfer pricing decisions. Their finding is not surprising, because transfers between related business entities account for approximately 35 percent of total world trade. Economic benefits are immediate if transfer prices can shift profits from a country with a higher tax rate to a country with a lower tax rate. Yet a company using transfer pricing for maximizing profits must balance this approach by having prices that are consistent with the regulations of taxing authorities.

## Example 20.3

To illustrate the tax effects of a change in transfer prices on corporate earnings, assume the following. (1) Affiliate A is in a low-tax country (20 percent tax rate) and affiliate B is in a high-tax country (50 percent tax rate). (2) Affiliate A produces 100 radios for \$5 per unit and sells them to affiliate B. (3) Affiliate B sells these radios for \$20 per unit to an unrelated customer. Table 20.3 shows the tax effects of low (\$10 per unit) versus high (\$15 per unit) transfer price on company earnings.

**Table 20.3** The tax effects of low versus high transfer prices

	<i>Low tax, A</i>	<i>High tax, B</i>	<i>Combined, A + B</i>
<b>Low transfer price</b>			
Sales price	\$1,000	\$2,000	\$2,000
Cost of goods sold	<u>500</u>	<u>1,000</u>	<u>500</u>
Gross profit	\$ 500	\$1,000	\$1,500
Operating expenses	<u>200</u>	<u>400</u>	<u>600</u>
Earnings before taxes	\$ 300	\$ 600	\$ 900
Taxes (20%/50%)	<u>60</u>	<u>300</u>	<u>360</u>
Net income	\$ 240	\$ 300	\$ 540
<b>High transfer price</b>			
Sales price	\$1,500	\$2,000	\$2,000
Cost of goods sold	<u>500</u>	<u>1,500</u>	<u>500</u>
Gross profit	\$1,000	\$ 500	\$1,500
Operating expense	<u>200</u>	<u>400</u>	<u>600</u>
Earnings before taxes	\$ 800	\$ 100	\$ 900
Taxes (20%/50%)	<u>160</u>	<u>50</u>	<u>210</u>
Net income	\$ 640	\$ 50	\$ 690

Under the low transfer price, A pays taxes of \$60 and B pays taxes of \$300 for a total tax bill of \$360 and a consolidated net income of \$540. Under the high transfer price, A pays taxes of \$160 and B pays taxes of \$50 for a total tax bill of \$210 and a consolidated net income of \$690. Earnings before taxes are the same at \$900, despite the different prices at which the radios transfer from A to B. Still, the higher transfer price reduces total taxes by \$150 (\$360 – \$210) and increases consolidated net income by the same amount (\$690 – \$540).

**IMPORT DUTY MINIMIZATION** Affiliate A sells goods to affiliate B. The rule of thumb for income tax minimization is: (1) set the transfer price as high as possible if A's tax rate is lower than B's tax rate; and (2) set the transfer price as low as possible if A's tax rate is higher than B's tax rate. The introduction of import duties complicates this rule, because multiple objectives could conflict. For example, a lower transfer price reduces import duties, but it increases income taxes. A higher transfer price reduces income taxes, but it increases import duties. Suppose that B must pay import duties at the rate of 10 percent. Import duties are normally levied on the invoice (transfer) price. The higher transfer price raises tariffs by \$50 ( $\$1,500 \times 0.10 - \$1,000 \times 0.10$ ), thus offsetting tax effects of \$50 in terms of increased tariffs.

Import duty minimization is easy, but tax reductions, which have offsetting effects, may complicate it. Also, a country with low import duties may have high income taxes, while a country with high import duties may have low income taxes. If MNCs use low or high transfer prices in certain countries, they have to balance import duties and income taxes to maximize a combined benefit from tariff and income tax reductions.

**AVOIDANCE OF FINANCIAL PROBLEMS** Transfer prices can be used to avoid financial problems or to improve financial conditions. Transfer pricing often avoids economic restrictions and exchange controls that host countries place on MNCs. For example, some developing countries restrict the amount of profits that can leave the country. An obvious way around this restriction is to charge high prices for imports. Therefore, countries with such restrictions watch import and export prices closely.

Some countries do not allow MNCs to charge certain expenses against taxable income. For instance, they do not permit expenses for research and development done elsewhere. Royalty fees a parent company charges against its subsidiary income are often not allowed. Because the host country does not allow them, they can be recaptured by increasing the transfer price of goods shipped into the country.

Transfer prices can also channel profits into an affiliate to bolster its financial condition, thus presenting a favorable profit picture to satisfy earnings criteria set by foreign lenders. Therefore, the parent company does not need to commit much capital to its foreign subsidiary, even though the subsidiary may be required to secure the loan. Besides, low transfer prices give the subsidiary a competitive edge that it might need when starting a new venture or when reacting to an economic downturn.

**ADJUSTMENT FOR CURRENCY FLUCTUATIONS** A wide range of currency fluctuations may influence the performance reports of foreign subsidiaries. Many US MNCs evaluate the performance of foreign subsidiaries with reports stated in US dollars. If currency exchange rates fluctuate, it may be difficult to evaluate the performance of the subsidiary. The management of the subsidiary often prefers to evaluate its performance with reports stated in local currency rather than in US dollars. Adjusting transfer prices for currency fluctuations can solve this performance evaluation problem. Performance evaluation, however, is difficult when the objective is tax minimization or when currency fluctuates. One subsidiary's profit in one country may be greater than another subsidiary's profit in another country, not because of better management but because of the transfer price. One way to solve this problem is to maintain two sets of books: one for foreign authorities and another set for performance evaluation purposes.

## SUMMARY

Multinational accounting has become increasingly important in recent years because of a great increase in foreign investment, capital flows, and trade. Accurate financial reports on operations must be prepared for stockholders and creditors to make decisions about the value of existing operations. They are especially important in international business where operations are typically supervised from a distance. This chapter has discussed major issues in multinational accounting, control system and performance evaluation, and the Foreign Corrupt Practices Act of 1977. Financial control systems must fit international circumstances to check performance against standards on a worldwide basis. The Foreign Corrupt Practices Act of 1977 intended to stop the erosion of international confidence in US business and institutions. The FCPA made it unlawful for US companies to influence foreign officials through payments and required these firms to maintain strict accounting controls over their assets. For many years, a large number of US business executives had regarded the FCPA as one of the statute's strongest export disincentives. Thus, Congress amended the FCPA in 1988 to make US companies more competitive in the world market. In addition, by the end of 1998, countries around the world had adopted tough laws of their own to crack down on companies that bribe to win foreign contracts.

For multinational operations, taxation has a significant impact on the choice of location in the initial investment decision, the form of the new enterprise, the method of finance, and many other international financial decisions. Tax planning for multinational operations involves complex problems such as national tax environments, double taxation, and various tax incentive programs. Thus, it is highly desirable that MNCs seek the inputs of experienced tax and legal counsel in both parent and host countries. Nevertheless, to preserve profit opportunities abroad and to receive special tax incentives, it is important for the financial manager of an MNC to be acquainted with the national tax environments and other tax problems in the host countries in which the company operates.

**Transfer prices** are prices of goods and services bought and sold between parent companies and subsidiaries. Internal transfers include raw materials, semifinished goods, finished goods, allocation of fixed costs, loans, fees, royalties for use of trademarks, and copyrights. International transfer pricing policies become increasingly complex as companies increase their involvement in international transactions through foreign subsidiaries, joint ventures, and parent-owned distribution systems. Discrepancies between transfer pricing methods used by companies and those allowed by taxing agencies take place because taxing agencies and companies have different objectives. For example, multinational companies try to maximize profits and improve performance evaluation by manipulating internal transfer prices. Taxing authorities, on the other hand, try – through fair market prices – to allocate the profit of a sale between their country and other countries. Thus, multinational financial managers must understand transfer pricing objectives and their impact on transfer prices.

## Questions

- 1 Explain two major problems that make multinational accounting complicated.
- 2 Why are budgets and the return on investment in performance evaluation systems more frequently used than any other indicators?
- 3 Discuss centralization versus decentralization as it impinges on decisions relating to transfer pricing and performance evaluation, exchange exposure management, acquisitions of funds, positioning of funds, and tax planning.
- 4 What is the Foreign Corrupt Practices Act? What are the two sections of this law?
- 5 Why is taxation one of the most important variables in multinational operations?
- 6 In what general ways do countries differ with regard to their tax systems?
- 7 Explain tax morality from the viewpoints of both multinational companies and host governments.
- 8 What is double taxation? How can its effect be lessened?
- 9 List some key objectives of transfer pricing policies.
- 10 Is it possible for a multinational company to minimize both income taxes and import duties simultaneously?
- 11 How do multinational companies use transfer prices to avoid financial problems faced by their subsidiary?

## Problems

- 1 AT&T purchases its raw materials from Germany and sells its finished products to Japan. Both exports and imports with terms "net 60 days" are denominated in foreign currencies (the yen and the euro), but the levels of both revenues and costs are measured in the US dollar. AT&T has: sales = \$4,000; cost of goods sold = \$3,000; depreciation = \$400; interest expenses = \$200, and tax rate = 50 percent. Assume that the euro and the Japanese yen appreciate by 10 percent before these credit transactions are settled.
  - (a) Use the above information to prepare an income statement such as table 20.2.
  - (b) Under what condition will a 10 percent appreciation in the yen raise AT&T's profits?
  - (c) Under what condition will a 10 percent appreciation in the euro reduce AT&T's profits?
  - (d) What will happen to AT&T's profits if selling prices and costs are adjusted to reflect the 10 percent appreciation in both the yen and the euro?
- 2 The following selected amounts are from the separate financial statements of a US parent company and its foreign subsidiary:

	Parent	Subsidiary
Cash	\$ 180	\$ 80
Accounts receivable	380	200
Accounts payable	245	110
Retained earnings	790	680
Revenues	4,980	3,520
Rent income	0	200
Dividend income	250	0
Expenses	4,160	2,960

Additional assumptions are as follows: (1) the parent owes the subsidiary \$70; (2) the parent owns 100 percent of the subsidiary; (3) during the year, the subsidiary paid the parent a dividend of \$250; (4) the subsidiary owns the building that the parent rents for \$200; and (5) during the year, the parent sold some inventory to the subsidiary for \$2,200, whose cost was \$1,500 to the parent, and in turn, the subsidiary sold the inventory to an unrelated party for \$3,200.

- (a) What is the parent's unconsolidated net income?
  - (b) What is the subsidiary's net income?
  - (c) What is the consolidated profit on the inventory that the parent originally sold to the subsidiary?
  - (d) What are the amounts of the following items, on a consolidated basis?
    - cash
    - accounts receivables
    - accounts payable
    - revenues
    - expenses
    - dividend income
    - rent income
    - retained earnings.
- 3 Assume that: (a) a multinational corporation has \$1,000 of foreign income; (b) the foreign country's tax rate is 40 percent; and (c) the domestic tax rate is 50 percent. What is the domestic tax liability?
  - 4 Assume that: (a) a multinational corporation has \$1,000 of foreign income; (b) the foreign country's tax rate is 50 percent; and (c) the domestic tax rate is 50 percent. The multinational company can treat any foreign tax paid directly as a deductible expense or as a tax credit. What are the effective tax rates of the multinational corporation under the credit and the deduction?
  - 5 A US company has \$100 of foreign income earned in Belgium. Assume that the US tax rate is 35 percent and the Belgium tax rate is 33 percent. Demonstrate the difference in US tax liability that arises from double taxation, a tax deduction, and a tax credit.

- 6 Assume a value-added tax of 10 percent. What would be the selling price and taxes at each stage if the following were the values added?

Seller	Value added by seller
Extractor	\$300
Processor	500
Wholesaler	75
Retailer	75

- 7 Eurowide Corporation has two foreign affiliates: A is in a low-tax country (30 percent tax rate) and B is in a high-tax country (50 percent tax rate). Affiliate A produces partially finished products and sells them to affiliate B, where the production process is completed. The *pro forma* income statements of these two affiliates are shown in the following table. Assume that the company increases its transfer price from \$3,000 to \$3,600. Determine the tax effect of this high transfer price on the company's consolidated net income.

*Pro forma* income statements for two affiliates

	Low tax A	High tax B	Combined A + B
<b>Low transfer prices</b>			
Sales price	\$3,000	\$4,400	\$4,400
Cost of goods sold	<u>2,000</u>	<u>3,000</u>	<u>2,000</u>
Gross profit	\$1,000	\$1,400	\$2,400
Operating expenses	<u>200</u>	<u>200</u>	<u>400</u>
Earnings before taxes	\$ 800	\$1,200	\$2,000
Taxes (30%/50%)	<u>240</u>	<u>600</u>	<u>840</u>
Net income	\$ 560	\$ 600	\$1,160

- 8 Eurowide Corporation has two foreign affiliates: A is in a low-tax country (30 percent tax rate) and B is in a high-tax country (50 percent tax rate). Affiliate A produces partially finished products and sells them to affiliate B, where the production process is completed. Affiliate B must pay import duties at the rate of 10 percent – 10 percent of the value of the imported goods. These tariffs are tax deductible. The *pro forma* income statements of these two affiliates are shown in the following table. Assume that the company increases its transfer price from \$3,000 to \$3,600. Determine the tax-plus-tariff effect of this high transfer price on the company's consolidated net income.

*Pro forma* income statements for two affiliates

	Low tax A	High tax B	Combined A + B
<b>Low transfer prices</b>			
Sales price	\$3,000	\$4,400	\$4,400
Cost of goods sold	2,000	3,000	2,000
Import duty (10%)	—	300	300
Gross profit	\$1,000	\$1,100	\$2,100
Operating expenses	200	200	400
Earnings before taxes	\$ 800	\$ 900	\$1,700
Taxes (30%/50%)	240	450	690
Net income	\$ 560	\$ 450	\$1,010

- 9 Assume that IBM's Canadian subsidiary sells 1,500 personal computers per month to the German affiliate at a transfer price of \$2,700 per unit. The tax rates are 45 percent for Canada and 50 percent for Germany. The transfer price can be set at any level between \$2,500 and \$3,000.
- At what transfer price will IBM taxes be minimized? Explain.
  - If the German government imposes an import duty of 15 percent on imported personal computers, at what transfer price will IBM tariffs be minimized? Explain.
- 10 Suppose that Ford Motor sells 100 trucks per month to its Mexican subsidiary at a transfer price of \$27,000 per unit. Ford Motor is allowed to set its transfer price at any level between \$25,000 and \$30,000.
- At what transfer price will Ford Motor move the maximum amount of funds from Mexico? Explain.
  - At what transfer price will Ford Motor bolster the subsidiary's financial condition most? Explain.

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## Case Problem 20: Advanced Technology’s Ethical Dilemma

The Executive Committee of Advanced Technology (AT) – Robert Smith, President; Linda Humphrey, Vice President of Finance; Sam Miller, Vice President of Marketing; and Susan Crum, Vice President of Production – scheduled a luncheon meeting on September 1, 1996, to discuss two major problems for the welfare of the company: (1) how to finance the rapid expansion of its production facilities and (2) how to cope with a growing competition in its major overseas markets. In addition, the Department of Justice requested AT to answer several questions about bribes, gifts, slush funds, and grease payments in relation to its foreign sales. This inquiry began in response to a 100-page complaint by its overseas competitor, which alleged that AT had violated the Foreign Corrupt Practices Act of 1977.

AT has recently enjoyed a rapid growth in business. The company is anticipating substantial increases in sales for the next few years. However, it must solve two major problems – capacity and strong competition in foreign operations – if it is to maintain fast sales growth for years to come.

AT produces office automation systems and equipment. In addition to introducing a newly designed mainframe computer, the company has aggressively increased research in mini-computers and word processors. These products are in high growth markets, and the firm’s expenditures for these projects have more than proved their worth. In fact, the company’s major problem has been to increase production fast enough to meet demand of its Asian customers. The company’s capacity has expanded steadily since 1980, but it has often lost sales because of insufficient production.

The industry recognizes AT as one of the fastest growing companies in the market. Experts in the high-tech industry have projected for the next 10 years a potential bonanza for mini-computers and word processors. Thus, the company plans to invest heavily in research and development for the next 5 years. It also plans to increase production quickly by acquiring existing computer manufacturing firms and by establishing new production facilities.

AT is a multinational company with headquarters in Los Angeles, California. The company has five manufacturing locations in the USA and three abroad, with offices in 13 countries. In 1995, approximately 40 percent of its sales came from foreign operations – primarily South America and Asia, where the company has recently faced stiff competition from its larger rivals, such as IBM, Digital Equipment, and Olivetti. The company has depended on distributors for most of its overseas sales.

### **Conflict of Interest in Financial Affairs**

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Thomas Nickerson is a Special Assistant to the Vice President of Finance, Linda Humphrey. He graduated from a major university in St. Louis, Missouri, with an MBA in Finance. After 2 years of experience with Ernst & Young, a major CPA firm in St. Louis, he joined the accounting staff and served in a variety of accounting and finance positions for 5 years. Two years ago, he was appointed Special Assistant to Ms Humphrey at an unusually high salary, mainly because of his outstanding financial and communication talents. Thomas Nickerson has a large family and a home with a \$450,000 mortgage. His deep debt and huge financial needs hardly matter to him, because he has a promising future at the company.

Ms Humphrey approached Thomas with a special task on August 1, 1996. She informed him that she had met with other vice presidents and decided to purchase Computer Engineering to alleviate the capacity problem. She further stated that the acquisition would be highly advantageous for AT, but she needed to convince two members of the board of directors. Then she instructed him to prepare a report justifying the acquisition of the company. Under the terms, AT would offer Computer Engineering two million shares of its stock. The market price of the stock was \$20 per share.

Normally, Thomas would have welcomed the assignment, but this one made him uneasy. Computer Engineering's financial statements indicated poor performance as compared with comparable companies in the field. He knew that Ms Humphrey and other vice presidents had helped the current top executives of Computer Engineering set up their company. He suspected that vice presidents of AT owned sizable blocks of Computer Engineering stock, which was not publicly traded. To establish a fair market price for Computer Engineering, he compiled the statistics presented in table 20.4. High Tech is more similar to Computer Engineering than any other company whose stock is traded in the public market.

### **Ethics Versus Profits in Global Business**

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The Foreign Corrupt Practices Act of 1977 (FCPA) has encouraged US companies to introduce policies against corrupt foreign payments and to improve internal controls. The FCPA bans illegal payments to foreign officials, monitors accounting procedures, and levies heavy penalties for violations. The FCPA forced AT to think about its way of doing business overseas. The company had expanded its foreign operations very quickly. In the 1960s, less than 2 percent of its sales came from foreign operations, but by the late 1970s its foreign operations accounted for 30 percent of total sales.

Just like many other companies, AT had undertaken positive steps to prevent illegal payments to foreign officials and to improve internal control. In 1980, the company published its

**Table 20.4** Key statistics for Computer Engineering and High Tech

<i>Variables</i>	<i>Computer Engineering</i>	<i>High Tech</i>
Earnings per share	\$1.00	\$ 2.00
Dividend per share in year 1	\$0.75	\$ 1.00
Annual dividend growth rate	0.04	0.09
Price per share	?	\$20.00
Book value per share	\$8.00	\$10.00
Cost of equity	?	0.14
Number of shares outstanding	1 million	1.2 million

first corporate code, along with two separate area codes: one for the USA and another one for the foreign area. The code of business conduct for overseas employees reflected most provisions of the FCPA, so that the company would not have any trouble with the law.

Marketing Vice President Miller had been under heavy pressure from President Smith to increase the company's foreign sales by 30 percent per year for the next 5 years. Mr Miller thought that when in Rome, some do as the Romans do. In other words, he did not hesitate to call the FCPA "bad business" and "unnecessary." Miller felt that the FCPA should be repealed for several reasons. First, it forced US companies to increase audit costs substantially. Second, the Department of Justice and the SEC failed to establish clear guidelines. Third, it put US companies at a competitive disadvantage. Fourth, in many countries, foreign payments are not outlawed, but they are encouraged. Fifth, the FCPA was unnecessary because US law enforcement agencies already had many statutes to prevent illegal foreign payments by US companies.

Mr Miller reflected on the report he would present to the Executive Committee. The purpose of this report was to make certain that AT was complying with its corporate code of conduct. There was, however, one situation that required a tough decision. This particular situation was considered an acceptable practice in the countries where they occurred, but he did not know how he would handle specific questions if they should come up.

Kevin Hart was the exclusive distributor for Advanced Technology products in South American countries. He had a reputation for reliability and efficiency. However, the most recent audit suggested that he had corruptly influenced customs officials to obtain lower duty rates for AT's products. In doing so, he had violated both the FCPA and the company's code of conduct.

AT had asked Kevin to agree in writing to abide by the code, but he had refused to do so. He had argued that these "grease payments" were customary in these countries. He had insisted that he could not compete effectively without them. Kevin had represented AT for many years and generated approximately \$10 million worth of business per year for the company. His exclusive dealership contract would be up for renewal in a few months. AT had suggested that it might refuse to renew its contract unless he agreed to abide by the code. Mr Miller knew that it would be difficult to resolve this problem while he was under heavy pressure to increase the company's overseas sales by 30 percent per year.

## Case Questions

- 1 Use the data in table 20.4 to estimate the market value of Computer Engineering in the following three ways: (1) price–earnings ratio, (2) market value/book value, and (3) the dividend growth model.
- 2 List and discuss the options available to Thomas Nickerson.
- 3 Discuss the two major sections of the FCPA – antibribery and accounting.
- 4 List and discuss the pros and cons concerning corporate codes of conduct.
- 5 If you were Sam Miller, what would you do about the situation in these South American countries?
- 6 The Internet Center for Corruption Research provides the transparency international perceptions index and a comprehensive assessment of countries' integrity performance. Use the website of this organization, [www.gwdg.de/~uwww/icr.htm](http://www.gwdg.de/~uwww/icr.htm), to identify the five most corrupt countries and the five least corrupt countries.

*Sources:* Arthur Aronoff, "Complying with the Foreign Corrupt Practices Act," *Business America*, Feb. 11, 1991, pp. 10–11; Suk H. Kim, "On Repealing the Foreign Corrupt Practices Act: Survey and Assessment," *Columbia Journal of World Business*, Fall 1981, pp. 16–21; Catherine C. Langlois and Bodo B. Schlegelmilch, "Do Corporate Codes of Ethics Reflect National Character?" *Journal of International Business Studies*, Fourth Quarter 1990, pp. 519–40; Manuel Velasquez, "Unicomp, Inc.," St Charles, IL: Center for Professional Education, Arthur Anderson & Co., 1990; and David Whiteside and Kenneth E. Goodpaster, "Dow Corning Corporation: Business Conduct and Global Values," in Kenneth E. Goodpaster and Thomas R. Piper, eds., *Managerial Decision Making and Ethical Values*, Boston, MA: Publishing Division/Marketing Department, Harvard Business School, 1991.