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The Rigorous Business of **Budgeting for International Operations**

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MANAGING GLOBAL RISK IS AT THE CENTER OF BUDGETING FOR OVERSEAS SUBSIDIARIES. BUT TRANSFER PRICING AND INVENTORY POLICY ALSO WEIGH HEAVILY ON INTERNATIONAL BUDGETING.

Multinational companies contend with an array of external factors, internal considerations, and other forces that influence budget policies, composition, and control. Budgeting in a global business environment calls for an enhanced level of coordination and communication because of the variety of powerful components that impact organization performance. In this article, we examine and describe how international issues influence the budgeting process of multinational companies that are headquartered in the United States and that control foreign affiliates.[1]

EXTERNAL FACTORS

Foreign currency exchange rates, interest rates, and inflation are the three major external factors that affect multinationals and their markets. Although these variables are interrelated—for example, higher inflation in a specific country tends to drive the value of its currency down, which impacts the exchange rate—changes in currency exchange rates have the most effect on the budgeting process.

Example 1. In June 2001, the value of the U.S. dollar was at a 15-year high when compared to the British pound and other currencies of the major U.S. trading partners. This caused John T. Dillon, CEO of International Paper and head of the Business Roundtable, to complain to U.S. Treasury Secretary Paul O'Neill that the dollar's strength made it difficult for U.S. companies to compete with imports and penetrate foreign markets.[2]

Changes in these three external factors stem from several sources, including economic conditions, government policies, monetary systems, and political risks. Each factor is a significant external variable affecting areas such as policy decisions, strategic planning, profit planning, and budget control. To minimize the possible negative impact of these factors, multinational corporate management must establish and implement policies and practices that recognize and respond to them. Other external forces such as political turmoil, competition, labor quality, and cultural or religious orientation of the local populace exist, but they tend to be related specifically to one country or particular region of the world.

For example, the events of September 11, 2001, have been significant to U.S.-based multinational corporations. Since 9/11, many international entities have focused on security measures, employee counseling, and other special training that they had not paid much attention to in the past. All of these efforts must be addressed in budgeting for an international operation.

Foreign Currency Exchange Rates

But of all factors influencing international budgeting, foreign exchange rates have the most significant and pervasive effect.

Changes in foreign exchange rates are explained by different theories but essentially are based on the underlying demand for assets denominated in a particular currency. Foreign exchange rate fluctuations affect a multinational through translation exposure, transaction exposure, and economic exposure. Each of these exposures has a different effect on the entire budgeting process.

Translation Exposure

Translation exposure influences financial statements during the development of a budget and/or while the budget is being used for control purposes. Specific exchange rates, usually based on forecasted values, must be determined and applied when preparing the budgeted financial statements from the applicable operating budgets.[3] Throughout the budgetary period, the actual exchange rates will likely vary from the anticipated exchange rates. The differences can generate unpredictable—often uncontrollable—results during interim and final budget performance reviews. Because management cannot control shifting exchange rates, the effects of the fluctuations can be removed from the budgeting control process by setting aside the variations from the budget that are due to changes between the budgeted and actual exchange rates. After removing these effects, however, there still may be some variances between the forecasted and actual budget due—in part—to exchange rates.

Example 2. Translation exposure influences include: (1) pricing policies being modified to compete with either higher- or lower-priced goods that are not produced in the same country, usually price-sensitive goods such as consumer electronic items, table wines, and textiles; (2) positive or negative changes in sales volume resulting from lower- or higher-priced competing goods and services either in a domestic or foreign market; and (3) deviations from standard input efficiencies because of alternate domestic or foreign suppliers who become more price competitive as a result of changes in the foreign exchange rate.

To remove all of the effects of foreign exchange rate fluctuations, a different exchange rate would be required for each revenue and expense category. Because this process would be cumbersome and time-consuming, it is not utilized.

Transaction Exposure

Transaction exposure results from international transactions such as unhedged contracted cash flows that characterize international trade, repatriation of profits, and acquisition or disposal of foreign assets. The principle of applying an expected future exchange rate can be employed when comparing the actual cash flows with the expected cash flows between foreign units of a multinational corporation. Because of transaction exposure, multinationals hedge their international cash flows. The hedging usually occurs in two basic modes: a "natural hedge" mechanism, such as pricing decisions, risk shifting, exposure netting, or currency risk sharing, and an "artificial hedge" that is created with foreign exchange contracts or derivative instruments such as options, swaps, and futures.[4]

Hedging involves additional transactions and expenses that must be recognized in the budgeting process. Corporate finance executives should develop a hedging policy that identifies the minimum amount of cash flow to be hedged, the hedging methods to be employed, and the conditions for using such methods. Managers involved in planning cash flows should identify transactions that require hedging during the upcoming budget period.[5]

Example 3. In 1985, the Toronto Blue Jays baseball team budgeted a loss for the season despite the team's on-field success. The majority of team expenses were paid in U.S. dollars, in contrast to their revenue, which was earned in Canadian dollars. To protect themselves against adverse changes in the exchange rate, the Blue Jays made forward purchases of U.S. dollars in late 1984 at $0.75 per Canadian dollar to cover a large portion of their budgeted 1985 U.S. dollar-denominated expenses. In 1985, the Blue Jays benefited from their hedged position when the Canadian dollar depreciated, which helped offset exchange losses on their U.S. dollar-denominated expenses during the same period.[6]

A separate budget for international cash flows may be prepared if the volume is significant. This budget will facilitate planning, controlling, and evaluating hedging activities and policies. Finally, hedging expenses should be included in the other income and expenses budget.

Economic Exposure

A third impact of foreign exchange rate variations is uncontracted future cash flows from foreign operations or investments. This is considered economic exposure and requires policy decisions that are important to the budgeting process. Some policy decisions to be considered include:

a) Selecting and segmenting markets that minimize the effects of foreign currency fluctuation while maximizing long-term cash flows;

b) Establishing a pricing strategy that is based on either market share for products with a high price elasticity or profit margin for those with a low price elasticity;

c) Adjusting promotional budgets to take advantage of improved price positioning in the event of a currency devaluation;

d) Developing a mix of sales strategies for both currency devaluations and revaluations;

e) Switching between imported and domestic input suppliers to achieve lower costs;

f) Shifting production among plants to locations where the currency has devalued, thereby achieving lower production costs;

g) Locating plants in countries that tend to minimize the negative consequences of exchange rate changes;

h) Raising capital in the foreign country's currency instead of using capital provided in the parent company's currency.

The marketing-related policies above—a through d—will dictate the manner in which the tactical sales budget will vary according to changes in the exchange rate. The production policy considerations—e and f—indicate that the budget must be able to handle severe production changes. The events of September 11 may continue to have a direct impact on production policy considerations because a multinational company located in the United States may find it more difficult and time-consuming to switch between imported and domestic input suppliers. The anticipated cost savings may not materialize because of the added expense involved.

Likewise, shifting production between plants may run into costly hurdles erected as a result of the September 11 tragedy. Flexible budgeting will assist in implementing and controlling marketing and production changes. The final two policies attempt to assist multinationals in matching cash outflows (production and financing costs) with cash inflows (revenue and capital proceeds) in the same currency to minimize the cash flows between countries and ultimately reduce economic exposure. Once established, these policies will be part of the budgeting process and will be used to evaluate the actual performance of foreign operations that are subject to exchange rate fluctuations.

Interest Rates

Interest rates affect the multinational corporation through the Fisher Effect, the International Fisher Effect, and interest rate parity relationships.[8] The Fisher Effect maintains that the nominal interest rate is a function of the real interest rate and the inflation rate. Furthermore, it contends that real returns are balanced between countries through arbitrage and that the resulting inflation rate and interest rate differentials are approximately equal between two countries.

The International Fisher Effect is based on the Fisher Effect and indicates that a change in the interest rate differential between any two countries will objectively predict future movements in the spot exchange rate. In reality, however, changes in the interest rate differential must be examined carefully to determine if a change in the inflation rate or real interest rates is the cause. These two underlying factors in an interest rate differential change will have opposite effects on the future movements of the spot exchange rate.

Interest rate parity asserts that, under realistic conditions, the forward premium or discount on a currency is approximately equal to the interest rate differential between the two countries. A complete understanding of the past, present, and future real interest rates and inflation rates will help multinationals forecast future changes in nominal interest rates and subsequent changes in the spot and forward exchange rates. Such changes would impact budgets that include the flow of goods and capital across international borders.

In the short term, accurate interest rate forecasting can help determine potential changes in the forward exchange rates. In more efficient markets, such as the Eurocurrency markets, forward exchange rates are based on both current and future expectations of the interest rate differential. Forward rates—instead of the spot exchange rate—will play an important role in sales and purchases budgets because of their use in determining prices for international transactions. When engaging in such transactions, each entity will determine an acceptable price based on the forward exchange rate that coincides with the payment date. Accurate short-term interest rate forecasts will permit the sales manager to determine the appropriate price or converted amount for the transaction, depending on the budget currency. Forward exchange rate predictions are only as good as the underlying nominal interest rate forecasts that are used to predict them. Inflation rate changes, real interest rate alterations, and changes in people's expectations can have varying effects on the nominal interest rate differential between countries. This makes interest rate forecasting difficult.

Example 4. A U.S. aerospace manufacturer is negotiating a $25 million contract with a Japanese airline. The items are scheduled for delivery and payment in six months (i.e., during the next budgetary period). The current spot rate, U.S. interest rate, and Japanese interest rate are, respectively, 140 yen/dollar, 6%, and 7%. Assuming that the interest rate parity holds, the forward exchange rate will be 140.70 yen/dollar. The contract will be priced in yen and coordinated through the U.S. firm's Tokyo sales operation.

The minimum contract price that the U.S. firm should accept is 3,517,500,000 yen using the forward exchange rate that coincides with the payment. Because leading Japanese economists predict that the Japanese interest rate will increase to 8% within the next six months, however, the forward exchange rate should adjust to 141.40 yen/dollar. This would establish a minimum contract price of 3,535,000,000 yen. The difference of 17,500,000 yen (i.e., 3,535,000,000 minus 3,517,500,000) or $123,762 (calculated at the new, expected forward exchange rate) would be lost if the new exchange rate were not used to price the contract.

When developing the Tokyo sales budget for the next budgetary period, this specific contract would be valued at 3,535,000,000 yen, and the U.S. aerospace manufacturing firm's comprehensive budget would reflect a $25 million contract for the Tokyo sales operation. The cash budget would translate any resulting cash flow from the Tokyo office to the U.S. operation at a 141.40 yen/dollar forward exchange rate.

Inflation

The inflation rate differential between countries affects multinationals through purchasing power parity and the Fisher Effect.[9] Purchasing power parity is the expected inflation differential between countries. It is inversely proportional to the spot market foreign exchange rate. Usually this theory is valid in the long run because the prices of goods do not move as freely as exchange rates. Also, different goods are used to determine inflation in different countries. Because of its long-run nature, purchasing power parity has limited application in the budgeting process.

The Fisher Effect is useful when evaluating capital budgeting alternatives. It permits multinationals to determine the real rate of return that a market demands given a country's rate of inflation and the nominal rate of return required. This is especially useful when comparing investment opportunities between different countries.

Example 5. The management of SBUC Enterprises is examining a pair of projects in foreign subsidiaries:

- The Waveland project offers a 15% return in a country with a 4% inflation rate.
- The Sheffield project is expected to produce a 21% return in an economy that has a 10% inflation rate.

Due to limited resources, only one project will be funded.

- The real expected rate of return on the projects is:

$$\text{Waveland:} \quad 10.58\% = \frac{15\% - 4\%}{1.04}$$

$$\text{Sheffield:} \quad 10.00\% = \frac{21\% - 10\%}{1.10}$$

In general, the differential in the nominal rate of return for two identical capital budgeting opportunities in two different countries should be approximately equal to the inflation differential between the countries.

In some countries, the inflation rate may exceed 100% over a three-year period. This condition, termed hyperinflation per the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 52, "Foreign Currency Translation," makes the budgeting process in local foreign currency extremely difficult. The lead time for developing a budget under hyperinflation conditions must be reduced to minimize the effect of inflation on the budget prior to its implementation.[10] Despite this lead-time reduction, budgets often will be revised immediately before implementation to accommodate inflation changes that have occurred since the budgeting process started. When analyzing variances, the uncontrollable effect of inflation should be recognized by applying the actual inflation rates in the flexible budgeting process before determining the revenue and expense variances. Management must be careful when analyzing and interpreting the effect of hyperinflation because the impact may not apply equally to all revenue and expense categories, such as those that are tied to long-term contracts.

Hyperinflation also complicates the foreign currency risk exposure for those cash flows that are translated into the hyperinflationary country's currency. In these instances, the multinational must establish a policy that preserves the purchasing power of its future cash flows.

Example 6. In 2001, a U.S. parent company with a subsidiary in Argentina accelerated remittances of profits from the Argentinian operation. This action was taken to preserve the U.S. dollar value of the cash flow and reflected the crisis of confidence that occurred when Argentina was denied access to international credit markets and the International Monetary Fund (IMF) had to intervene. Argentinians made significant bank withdrawals, which created a great deal of uncertainty about the value of the Argentine peso relative to the U.S. dollar.[11]

Specific Budgets

Each budget is impacted by conditions tied to a multinational's international business operations. This section examines specific budgets and describes external, internal, and other forces that influence the preparation and/or use of the budget.

Sales Budgets

When a global business is developing a sales budget, external factors can affect which products to market and the product mix. Depending on the type of product, the market potential, competition, and the impact of substitutes, market characteristics may be similar throughout a particular region or different in each country. Extraordinary events such as the September 11 terrorist acts can trigger uncertain and unfavorable business conditions that would affect the nature and volume of international operations. While these unpredictable events are impossible to incorporate into the annual profit plan, a company must be ready to introduce the appropriate adjustments to the approved budget that would reasonably flow from the altered circumstances.

The sales budget for a foreign operation is sensitive to the targeted sales territory. Sales budgets for international operations that produce products only for intracompany sales are controlled by transfer pricing policies that we will discuss later. Foreign concerns that produce goods solely for the country in which they reside are similar to most national operations except for the differences in market characteristics, competition, and government regulations. Operations that market their products in multiple countries, however, must contend with considerations such as international trade agreements, import restrictions, and other potential legal constraints.

Multinationals must be aware of and respond to the conditions of each market they serve. Conditions to be considered include the level of economic development, degree of government price control, cost of sales in each market, product pricing decisions for each market (e.g., standard markup and market prices), available channels of distribution and promotion, and import/export controls. Although these factors are present in every market, selling in multiple markets requires examining each one in order to incorporate its unique characteristics into the sales budgets.

Example 7. Oui R ND Enterprise is a multinational entity that does business in several areas of the world. In preparing its sales budget, it might perform the following analysis:

Region/Country	Dominant and Distinctive Market Characteristic(s)
Argentina	Precarious economic conditions are resulting from the government's defaulting on its foreign debt. Persistent and growing unemployment is causing social unrest, while the government is unable to restore investor confidence. Convertibility of foreign currency has been suspended or limited.
Brazil	With a population second only to the United States in the Western Hemisphere, its market potential is huge. Repercussions of economic downturn in Argentina, Brazil's neighbor and major trade partner, stifles demand for the short and medium term.
Canada	U.S./Canada Free Trade Agreement, a relatively weak currency, and strong economic ties to the United States.
Chile	An expanding middle class. Strong agricultural and fishing export sector. Governmental control of the economy is good and favors foreign investment and free trade.
China	Enormous market potential and an increasing propensity to acquire Western consumer goods, fueled by one of the fastest GDP growth rates in the world. All of this is tempered by continuing state controls and an extensive bureaucracy.
Eastern Europe	True democratization in place, but there is still a need to upgrade economic institutions. Potential future incorporation into the European Union.
European Union	Ongoing economic integration activities, including use of the euro as the official common currency for most member countries. Concern about high unemployment and spillover effects from the conflict in the Middle East.
India	An ever-expanding population that is predicted to be the world's largest by the end of the decade. Presence of high-tech computer expertise. Growing uncertainty from territorial conflicts with neighboring Pakistan.
Japan	Complex, government-protected distribution system and the fourth recession in the last 10 years.
Mexico	A more democratic, participative environment and strong economic ties to the United States.
Pacific Rim	An area with many developing countries offering a growing consumer base.
Russia	Reemergence as an economic power as a result of the policies pushed by a popular leader. Willingness to apply Western-based economic programs and policies to start exploiting its abundant mineral and natural resources.

Many of these factors arise from a specific nation's characteristics, while others stem from international or regional forces. Whatever their origin, they dictate that sales budgets be developed separately for each market. The existence of these differences indicates that marketing strategies and the resulting sales budget cannot be merely transplanted from domestic operations to a foreign operation.

Expense Budgets

Managing direct labor, direct materials, overhead costs, and distribution and administrative expenses in an international environment requires additional considerations. Foreign operations that only serve the local market require expenses similar to those of a U.S. firm's domestic-oriented operations. Most of the production, distribution, and selling expenses will be incurred within one country and may not be adversely affected by foreign currency exchange rate considerations. External factors, however, and specific government policies controlling economic growth, inflation, interest rates, prices, and/or costs can influence expense budgets despite the narrow orientation of these foreign operations. Expense budgets must incorporate external forces to depict operations accurately. Native or local managers often will have a better understanding of the foreign market potential, available input sources, local economy, and government policies. Using these personnel could result in more accurate expense budgets than those generated by a nonresident manager.

For foreign operations that serve regional (e.g., Southeast Asia, South America) or global markets instead of local markets, expense budgets must reflect both internal and external factors. A feasible approach to developing expense budgets would be to assign the budget preparation for individual countries to each of the local country managers and let the regional managers coordinate and modify the resulting budgets to reflect regional factors and the global entity's overall objectives. The resulting expenses should be monitored carefully to ensure that they do not exceed what is necessary to successfully operate the foreign unit, given its organizational structure, target markets, input sources, and coordination efforts.

In the aftermath of September 11, several expense budgets have been increased. For example, travel costs and/or travel time have risen because government-mandated security measures have increased. Also, as companies have replaced workers who are serving in the U.S. armed forces, employment agency fees, training, and other costs related to bringing temporary or new people into a company have increased.

Additionally, cultural factors can create the need for significant spending in areas such as marketing, as shown in the next example.

Example 8. Procter & Gamble's Mexican operation initiated a strong and unique marketing campaign in 2000 to promote Tampax tampons in an area of the world where only 2% of the women used this type of product. In gatherings resembling Tupperware parties, female P&G promoters assume roles of teachers and friends about the uses and benefits of the product.[12]

From a budgeting standpoint, it is likely that the promotional expenses for the Mexican affiliate would seem out of line when compared to the domestic marketing effort.

When considering its foreign operations, a U.S. company—usually a multinational parent—must recognize how external factors drive the internal expense policies and decisions. For example, an unskilled, unmotivated workforce normally means higher turnover, excessive costs, and lower labor productivity. When comparing direct labor budgets between operations in different countries, it is important to review relative characteristics, such as productivity, rather than actual characteristics, such as total direct labor costs. For example, countries such as the United States and Canada that lead in labor rates also lead in labor productivity by approximately the same percentage.[13]

On the other hand, some U.S. companies adapt and adjust to the new international conditions in a functional manner, and the operating budgets reflect this flexibility.

Example 9. The fact that U.S. companies quickly adapt and adjust to new international conditions is evident in border-area towns between the United States and Mexico. An example is the fluid economic and cultural interconnection between neighboring cities like Juarez, Mexico, and El Paso, Texas.[14] The North American Free Trade Agreement has enhanced production opportunities in Mexico. Proximity to the U.S. market and comparatively lower operating costs have fueled this trend, especially in labor-intensive industries. Thus, the minimum salary in Mexico in 2002 was the equivalent of $4 per day, while more skilled workers in the manufacturing sector earned an average of $2.60

per *hour*. In addition, labor productivity in the Mexican manufacturing sector is not significantly different from that in the United States.[15]

Capital Budgeting

The capital budgeting process becomes more complex in a global business environment because additional considerations arise. The first area of concern involves developing pro forma cash flows that can be viewed from the perspectives of both the U.S. firm and the foreign operation. Developing and evaluating investments using the foreign viewpoint will be especially useful when foreign banks, third parties, and foreign governments are considering investing in the potential project or are evaluating its performance. When assessing a potential foreign investment, the projected net incremental after-tax cash flows that will accrue to the U.S. firm are derived from those that will accrue to the foreign operation by adjusting the cash flows for fees, royalties, and tax considerations.

Tax effects between different countries have a significant impact on an investment's cash flows. The actual amount of taxes paid by the U.S. business is affected by the timing of the cash remittance, the manner of the remittance (e.g., loan repayments, dividends, transfer pricing advantages), the foreign income tax rate, withholding taxes, and the form of business established in the foreign country.

Example 10. TyWill Organization (TWO) is a U.S. corporation in the 35% tax bracket. TWO has a pair of foreign operations: Cardinal, organized as a branch of TWO in a country with a 25% tax rate, and Spartan, organized as a subsidiary of TWO in a country with a 30% tax rate.

TWO's approach is to reinvest the after-tax earnings in both Cardinal and Spartan. Cardinal and Spartan earn $700,000 each, but the after-tax earnings will differ, as shown below:

	Cardinal (foreign branch)	Spartan (foreign subsidiary)
Foreign source income	$ 700,000	$ 700,000
Foreign taxes	$ 175,000	$ 210,000
Domestic taxes	$ 70,000 (a)	None (b)
After-tax earnings	$ 455,000	$ 490,000

(a) 35% x $700,000 =	$245,000
Less: Foreign tax credit	(175,000)
	$ 70,000

(b) No domestic taxes because the foreign subsidiary pays no dividends to TWO.

Usually, the U.S. company will pay taxes on any dividends, fees, and royalties it receives from its foreign concerns, but tax treaties between countries may provide for lower taxes and/or tax credits.

Example 11. In 2001, a new income tax treaty between the United States and the U.K. was hailed as a landmark agreement. Under the treaty, most dividends received by a company in one country from its subsidiary in the other country will be exempt from tax in the subsidiary's home country. In the past, a maximum withholding tax of 5% was allowed. The U.S. Treasury noted that this represented the first treaty to provide a zero rate of withholding tax on dividends from subsidiaries.[16]

A final financial consideration to be addressed in the capital budgeting process is the weighted average cost of capital used when evaluating international investments. The cost of capital used in evaluating an international investment for the U.S. company differs from that used when evaluating the investment from the foreign operation point of view because foreign debtors and equity investors will usually seek different rates of return than the U.S. company. To accommodate for this, the cost of equity capital used should include: (1) the return required by foreign investors weighted according to the percent of their investment and (2) the cost of retaining earnings from the foreign investment, including the tax implications previously discussed. The cost of debt capital must be modified to include the after-tax cost of borrowing foreign currency if such a source of funds will be used. These cost-of-capital modifications must be included when developing the weighted average cost of capital used to assess investments in the foreign operation. When evaluating potential foreign investments from the U.S. company's perspective, however, the U.S. firm's weighted average cost of capital can be used to calculate the net present value.

In addition to the financial aspects of capital budgeting, the threat of political disturbances or social conflicts adds risk to an international investment. Although this type of risk is present in a domestic setting, management has fewer instruments for prevention and control in a foreign investment. Ways to include such risks in the investment analysis include: (1) reducing the minimum payback period, (2) raising the required rate of return, and (3) adjusting the cash flows for the level of risk.[17] The first two approaches are easier to apply, but they average the effects of the potential risk over the entire life of the project. The third approach requires more effort but results in the most realistic projected cash flows.

Another factor in capital budgeting for an international operation is the measure of the cost savings the capital expenditure may generate for the U.S. entity.

Example 12. A U.S. musical instrument manufacturer was importing instruments in a semi-finished state from its foreign subsidiary in Europe. When the instruments were received, they were disassembled and reprocessed to meet American standards. Direct labor costs in the United States became prohibitive. Capital spending at the European operation enabled the production of an instrument in Europe that met American standards and cut the U.S. direct labor costs dramatically.

We recommend that the capital budgeting approach should be to initially develop the net incremental after-tax cash flows for the foreign operations, then consider the cash flows between the U.S. and foreign firms, and finally develop the pro forma cash flows for the U.S. company. The net present value calculation using the appropriate weighted average cost of capital provides an accurate evaluation of the foreign investment opportunity from the perspectives of the U.S. firm and the foreign firm.

Example 13. The U.S. musical instrument manufacturer in the previous example determined that it would save $400,000 of direct labor per year—for 10 years—by making an investment of $1.8 million in the European operation. Using a weighted cost of capital of 10% (if the funds were borrowed), the investment has a net present value of $658,000, as calculated below:

$400,000 (6.145) - 1,800,000 = $2,458,000 - $1,800,000 = $658,000

On the other hand, a weighted cost of capital of 20% (if the funds were provided internally by the U.S. operation) generates a negative net present value of $(123,200):

$400,000 (4.192) - $1,800,000 = $1,676,800 - $1,800,000 = $(123,200)

Thus, the sourcing of the funds for the investment will be an integral factor in the capital budgeting deliberations the U.S. musical instrument manufacturer conducts.

Cash Budgeting

The long-term objective of cash planning in an international environment is to match cash inflows with cash outflows, thereby limiting the multinational's foreign currency exposure to only those cash flows (e.g., profits, royalties, fees) that will be repatriated from a foreign operation to the multinational. Cash budgeting in combination with capital budgeting approaches can be used to evaluate investments that will manage the long-run economic exposure and match the cash inflows and cash outflows in the same currency.

While seeking to attain the long-term objective, a global business must also manage short-term cash flows from foreign operations. It must develop policies to maximize long-term profits and minimize overall income tax payments for the U.S. company when repatriating cash. Some of the policy options that are available include:

- Transfer pricing,
- Reinvoicing centers,
- Fees and royalty adjustments,
- Dividend policy adjustments, and
- Intra-corporate loans.

The final cash budget must be developed in accordance with the selected policies but must also reflect potential government regulations. When developing the cash budget, planners must consider currency exchange controls that the foreign government may impose. Such controls may limit the amount of local or other currency leaving or entering the country during a specific time period. These controls use multiple exchange rates for different categories of goods or services, impose limitations or taxes on specific bank deposits, limit the amount of credit extended to particular firms, control transfer pricing policies, and/or restrict imports. Some multinationals establish consistent policies that are used throughout the global corporation to indicate an established financial program rather than a speculative repatriation policy that foreign governments may resent.

On occasion some multinationals may be required to use nonconvertible currencies in order to do business in certain localities. Countries with this type of currency usually prefer or require hard-currency inflows and/or countertrade outflows from multinationals to build up their supply of hard currency. For example, PepsiCo sold soft drinks to the USSR and received Soviet vodka in place of a hard currency payment. Sometimes countries impose penalties, as Indonesia has in the past, for companies that do not participate in countertrade practices. After determining the size and timing of the cash flow for a hard-currency transaction, a multinational must adjust the cash budget to reflect either the penalty imposed or the time lag and discount required for the sale of the goods received. Multinationals may offset the effects of countertrade by charging a premium for their products or adjusting the manufacturing and delivery schedules to coincide with the actual sale of the countertrade goods. Planned adjustments such as these are reflected in the sales, production, and other related budgets.

Example 14. The historic shift to the euro as the official common currency by 12 European Union countries (Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, and Spain) has cash budgeting implications. Working with a common currency should make the cash budgeting process smoother and more predictable because currency barriers are no longer a factor.

Finally, an effective reporting system is the key to implementing a multinational's cash budget. Frequent and accurate operation reports will permit managers to adhere to budget policies, monitor the company's liquidity position, and meet performance targets.

Other Considerations

Several other critical elements need to be examined when the international dimension of a business represents a significant portion of its activity. These elements are commonly encountered, but the global environment adds a unique twist.

Transfer Pricing

Transfer pricing plays a significant role when budgeting in an international environment. Similar to domestic budgeting, transfer pricing is a policy decision that influences the profitability of different foreign operations within a global corporation. Although the transfer price of goods and services traded internally may be a noncontrollable factor at the division level, it eventually becomes controllable at a higher responsibility center. Therefore, foreign subsidiary managers should not be held accountable for the profitability of their operations if they cannot control this factor.

In international budgeting, transfer pricing can be used to the company's benefit in a wide variety of situations including taxes, tariffs, exchange controls, credit status of affiliates, profitability of parent and foreign subsidiaries, and reduction of exchange risks. The most frequent abuse of transfer pricing policies involves companies that manipulate the price of internally traded goods to reduce taxes in high-tax jurisdictions, thereby shifting profits to a country with lower tax rates.

Example 15. Dabears Corporation, a U.S. company in the 35% tax bracket, produces a product in a foreign operation, Payton Production, at a cost of $20. The tax rate in the country is 25%. The product is transferred to a U.S division, Zorich Organization, which sells the product for $50. Dabears Corporation management is exploring transfer pricing strategies based on a transfer price of $20, $35, and $50 as analyzed below:

	PROFIT REPORTED		INCOME TAX PAID		
Transfer Price	Payton Production	Zorich Organization	Payton Production (25% tax rate)	Zorich Organization (35% tax rate)	Dabears Corporation (total)
$20	$0	$5,000,000	$0	$1,750,000	$1,750,000
$35	$2,500,000	$2,500,000	$625,000	$875,000	$1,500,000
$50	$5,000,000	-0-	$1,250,000	-0-	$1,250,000

The $50 transfer price would generate the lowest tax liability for Dabears Corporation, but it also might draw added scrutiny from the Internal Revenue Service. A transfer price of $35 would be prudent in this instance.

Governments have continued to increase their efforts to enforce arm's-length pricing between foreign and domestic operations of multinationals by applying their own estimates for the value of the traded goods or by imposing minimum value-added requirements for production. This usually requires using more expensive local inputs, which results in higher costs for a foreign operation. Corporate policy makers must be aware of the benefits of transfer pricing while establishing a policy that satisfies the multinational company, its subsidiaries, and the foreign government guidelines.

A multinational company's transfer pricing policy impacts the sales budget, cost-of-goods-sold budgets, and the capital budgeting process. Policy makers must consider the effects that different policies would have on investment performance when establishing a transfer pricing policy.

Inventory Policy Decisions

To meet the sales plan, a manufacturing operation will manage and monitor its manufacturing process through the production budget. A variety of decisions enter into the production plan, including the level of inventory required to minimize costs and stockouts.

Example 16. A multinational corporation involved in inventory planning decisions must consider and examine the following factors:

- Transportation,
- Customs procedures,
- Import restrictions,
- Supply problems (e.g., dock strikes, embargoes),
- Duties, and
- Foreign exchange rate changes.

Because of external factors, such as those listed in the example and in the wake of the September 11 events, a multinational's inventory policy may have to be changed to permit advance inventory purchases or higher-than-usual levels of inventory. There will be a trade-off between the benefits of these policies and the additional inventory holding costs. Using multiple domestic and foreign input sources may be an attractive alternative to counteract the negative consequences of the external factors. For example, consider a U.S. computer manufacturer, who purchases memory chips from a Japanese firm, and its U.S. competitor, who purchases similar chips from a U.S. supplier. The computer producer who uses the Japanese vendor may maintain a higher level of inventory based on events that have occurred in the past (e.g., import restrictions, dumping penalties imposed on Japanese suppliers, and devaluation of the U.S. dollar with respect to the Japanese yen) while maintaining an ongoing relationship with other memory chip providers.

Timing Issues

Although current communication techniques have reduced the time-lag factor, barriers such as language, different accounting practices, and time-zone changes still exist and lengthen the time required to effectively develop the budget in a multinational entity. The planning process will be more difficult to coordinate because there are multiple operations in different countries with different cultures, priorities, and objectives instead of a more homogeneous group of people from a single country who can be managed more easily. Coordinating an international planning process will require a great degree of vertical and horizontal communication and coordination. When implementing the budget, the time required to distribute its components and conduct the corresponding budget conferences with the appropriate parties will be greater than that required for a domestic company because of the additional distance and barriers. All of these complications underline the importance of complete support and involvement at all levels of a multinational organization engaged in budgeting. This further necessitates the use of some technique to simplify and coordinate the budgeting process.

Budget Control

We have already discussed many budget control issues. This section focuses on a general overview of budget control instead of specific control issues.

In a global enterprise, steps must be taken to ensure that the control system implemented does not become more complicated than the operation itself. An overly complex system may result in suspicion on the part of the multinational's executives, frustration among middle management, and wasted management time. In conjunction with this, a U.S. parent company must not request information simply because it is provided at the foreign subsidiary's expense. The amount of positive and negative feedback to the subsidiary must be commensurate with the level of information requested from it to maintain a successful long-term relationship. One possible approach involves a simple, decentralized control system while centrally monitoring other important information that is readily available.

Flexible budgeting is useful for budget control in a foreign environment where a large degree of uncertainty exists. Many of the uncontrollable influences of the international environment can be isolated to provide a better picture of management's actual performance. Flexible budgeting allows management to forecast the effects of a variety of scenarios so alternative strategies can be considered and implemented if necessary.

Example 17. A multinational entity that operates a seafood export operation in Norway (Norway recently became the world's largest exporter of seafood) will prepare flexible budgets for its upcoming fiscal year (July 1, 2004, to June 30, 2005), each, for instance, based on one of the following assumptions:

(1) Trade barriers (e.g., punitive duties and import regulations) will not become more restrictive.

(2) More restrictive trade barriers will be put into place prior to the start of the fiscal year.

(3) Implementation of restrictive trade barriers will occur on or after January 1, 2005.

When evaluating a foreign operation, performance measurement must be based only on areas that a manager controls. If a foreign segment's management does not control long-term profitability because of organizational or government policies, an alternative evaluation criterion that is consistent with the multinational's overall objectives must be selected. Other potential performance measures include market share, sales growth, contribution margins, production costs, inventory turnover, accounts receivable turnover, quality control, or labor turnover.

This balanced scorecard approach must be consistent with the policies that have been established as a result of discussions with management. When evaluating the performance of a foreign segment, a manager should recognize that the foreign operation can incur higher-than-expected costs, such as those from above-normal inventory requirements, the effect of different inflation rates on accounts receivable turnover, and local value-added requirements. Performance standards should, therefore, be tailored to the foreign segment's operating environment.

Uncertainty of International Budgeting

International issues have a strong impact on the budgeting activities of global companies. In particular, we identified several volatile external factors such as foreign currency, interest rates, and inflation rates and described how these factors influence overall and specific budget preparation and use. We also addressed other considerations such as transfer pricing and inventory policy decisions. As multinational companies undertake the rigorous business of budgeting for international operations, they must be constantly vigilant and aware of the uncertainty that is a common—and unwelcome—characteristic of any budgetary activity. ■

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1 When a U.S. firm conducts international business through joint ventures or noncontrolling equity participation, the nature of the budgetary process is expected to differ from the model discussed here. For these types of situations and other issues of international accounting and management control, see Sidney J. Gray, Stephen B. Salter, and Lee H. Radebaugh, *Global Accounting and Control: A Managerial Emphasis*, John Wiley & Sons, Hoboken, N.J., 2001.

2 Michael M. Phillips, "Executives Try to Persuade Bush to Drop Strong Dollar Policy," *The Wall Street Journal*, June 21, 2001, p. B14. It should be noted that this trend in foreign exchange markets can change in a short period of time. For instance, the value of the British pound appreciated substantially from $1.372 to $1.58 in one month from June to July 2001.

3 The methodology of the Financial Accounting Standards Board's (FASB) Statement of Financial Accounting Standards (SFAS) No. 52, "Foreign Currency Translation," provides the normal framework that firms follow when preparing budgetary data for financial statements denominated in foreign curren-

cies. Thus, income statement items are translated at the expected average (usually monthly) exchange rates, while balance sheet accounts are translated at expected exchange rates at year end, except capital stock and beginning retained earnings, which are translated at historical exchange rates. The available rates for forward and futures contracts negotiated in the international foreign exchange markets could serve as a basis for forecasting exchange rates to use in the preparation of budgets.

4 Alan C. Shapiro, *Multinational Financial Management*, Allyn & Bacon, Boston, Mass., 1996, pp. 253-260.

5 The need to document and disclose the hedging relationship, the firm's risk management objectives, and the strategy behind the hedge became more prominent under the new accounting principle focusing on derivatives: FASB's SFAS No. 133, "Accounting for Derivative Instruments and Hedging." This standard requires management to periodically assess the effectiveness of the hedging instrument used in offsetting the exposure to changes in value of the item being hedged.

6 Shapiro, pp. 271-272.

7 As an extension of the subject that SFAS No. 52 had not addressed, for the first time the FASB has permitted and prescribed accounting treatment for foreign currency cash flow hedges (including forecast transactions) and hedges of foreign net investments, outlined in SFAS No. 133, paragraph 40.

8 Shapiro, pp. 194-209.

9 *Ibid*.

10 In this case of hyperinflation conditions for the local currency, budgets should be translated at the expected "historical temporal" exchange rates. This makes it more imperative to rapidly adjust the local revenue and expense components in order to preserve an acceptable profit differential in U.S. dollars and preclude an erosion of the value of incoming cash flows.

11 Pamela Druckerman, Jonathan Karp, Michael Phillips, and Hugh Pope, "IMF Acts to Pre-empt Emerging Market Crisis," *The Wall Street Journal*, August 6, 2001, p. A9. The expectations of unfavorable business conditions in Argentina became reality. As a direct consequence of an economic crisis, the Argentine peso started to slide in January 2002, going from its previous parity with the U.S. dollar to $0.27 at the end of July 2002.

12 Emily Nelson and Miriam Jordan, "Sensitive Exports. Seeking New Markets for Tampons, P&G Faces Cultural Barriers," *The Wall Street Journal*, December 8, 2000, p. A1.

13 Peter H. Lindert, *International Economics*, Eighth Edition, Richard D. Irwin Inc., Homewood, Ill., 1986, pp. 113-114.

14 Joel Millman, "In America's Most Mexican City, Hockey and Kielbasa," *The Wall Street Journal*, March 31, 1999, p. B1.

15 For these labor statistics, see National Institute of General Statistics and Information at http://www.inegi.gob.mx/est/.

16 Tom Herman, "Business Leaders Applaud a New Income-Tax Pact with the U.K.," *The Wall Street Journal*, August 1, 2001, p. A1.

17 Shapiro, pp. 626-627.