Foreign currency exchange rates, interest rates, and inflation are the three major external factors that affect multinationals’ budgets. Chief financial officers know they have no influence or control over this “Bermuda Triangle” of outside forces. Nonetheless, these elements must be estimated, evaluated, and examined as part of a multinational’s strategic plan. Although these variables are interrelated (for example, higher inflation in a specific country tends to drive down the value of its currency, which impacts the exchange rate, and price inflation would drive up interest rates), the changes in currency exchange rates have the most direct effect on the budgeting process for a multinational corporation.
We will show you 19 company examples so you can see the broad range of issues involved. (Some of the company names are hypothetical.)

**Example 1**

The uncertainty introduced by the volatility of foreign currency exchange rates has been evident in recent years. In the span of one year, the value of the euro went from $1.48 on February 25, 2008, to $1.27 exactly a year later, a decrease of 14%. A similar significant change was observed in other major currencies (e.g., the value of the British pound went from $1.97 to $1.42, and the Canadian dollar depreciated from $1.00 to $0.80 during the 12 months ending on February 25, 2009). The general strengthening of the U.S. dollar was expected to negatively impact the already weak trading position of U.S. exporters. On the other hand, the June 2010 decision of the Chinese government to allow more flexibility to the yuan did provide export opportunities for U.S. companies.

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, organizational procedures, 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 exist, such as political turmoil, competition, labor quality, and cultural or religious orientation of the local populace, 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, the strategic plans of 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**

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 they 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 and on the strategic marketing and operating decisions.

**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 operations budgets. Throughout the budgetary period, the actual exchange rates likely will 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 solely because of 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, partly because of exchange rate movements that influenced the preference for products or taste trends in the marketplace.

**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/or 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.
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 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; or “an artificial hedge” that is created with foreign exchange contracts or derivative instruments such as options and swaps futures.5

Hedging involves additional transactions and expenses that must be recognized in the budgeting process. As part of their strategic plan, corporate finance executives should develop a hedging policy that identifies the minimum amount of cash flow to be hedged, the hedging mechanisms 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.6

**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.7

Companies can prepare a separate budget for international cash flows if the volume is significant. This budget will facilitate planning, controlling, and evaluating hedging activities and policies that are included in the organization’s strategic plan. Finally, hedging expense should be included in the Other Income and Expenses budget.8

**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. Strategic planning activities should consider policy decisions that include:

1. Selecting and segmenting markets that minimize the effects of foreign currency fluctuation while maximizing long-term cash flows.
2. 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.
3. Adjusting promotional budgets to take advantage of improved price positioning in the event of a currency devaluation.
4. Developing a mix of sales strategies for both currency devaluations and revaluations.
5. Switching between imported and domestic input suppliers to achieve lower costs.
6. Shifting production among plants to locations where the currency has devalued, thereby achieving lower production costs.
7. Locating plants in countries that tend to minimize the negative consequences of exchange rate changes.
8. Raising capital in the foreign country’s currency instead of using capital provided in the parent company’s currency.

The marketing-related policies above (1 through 4) will dictate the manner in which the tactical sales budget will vary according to changes in the exchange rate. The production policy considerations (5 through 7) indicate that the budget must be able to handle severe production changes. Because of the recent economic downturn affecting the United States and its major trading partners, companies are reallocating and adjusting...
their productive resources and supply chains. As the markets retract and consumer spending drops, multinational corporations redirect their efforts toward cost containment and reduction to maintain at least a survival level of profitability. The management policies resulting from these changes will become part of the strategic planning effort while being incorporated in the budgetary planning and control process.

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. Because of the impact of interest rates, an organization’s strategic planning must address this key financial component. Ignoring it or assuming it will remain stable is a hazardous move. 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 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 help to 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, 96.80 yen/dollar, 6%, and 7%. Assuming that the interest rate parity holds, the forward exchange rate will be 97.28 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 2,432,000,000 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 97.7680 yen/dollar. This would establish a minimum contract price of 2,444,200,000 yen. The difference of 12,200,000 yen (i.e., 2,444,200,000 minus 2,432,000,000) or $124,785 (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 2,444,200,000 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 97.7680 yen/dollar forward exchange rate.

Inflation

The inflation rate differential between countries affects multinationals through purchasing power parity and the Fisher Effect.11 Purchasing power parity is the expected inflation differential between countries. It is inversely proportional to the spot market foreign exchange rate. This theory usually 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 but has more meaning as part of an entity’s strategic plan.

The Fisher Effect is useful when evaluating an important component of an organization’s strategic plan (i.e., capital budget 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 Oui R ND Enterprises is examining a pair of projects in foreign subsidiaries:

- The Holtz project offers a 14% return in a country with a 3% inflation rate.
- The Weiss project is expected to produce a 23% return in an economy that has a 12% inflation rate.

Because of limited resources, only one project will be funded.

- The real expected rate of return on the projects is:
  - Holtz: $10.68\% = \frac{14\% - 3\%}{1.03}$
  - Weiss: $9.82\% = \frac{23\% - 12\%}{1.12}$

In general, the differential in the nominal rate of return for two identical 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 before it is implemented.12 Despite this lead-time reduction, budgets often will be revised immediately before they are implemented to accommodate inflation changes that have occurred since the budgeting process started. When someone is analyzing variances, he or she should recognize the uncontrollable effect of inflation 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 and/or sudden changes in foreign exchange rates because the impact may not apply equally to all revenue and expense categories, such as those that are tied to long-term contracts.
Example 6
In 2008, a U.S. parent company with a subsidiary in Argentina accelerated remittances of profits from the Argentine operation. This action:
1. Was to preserve the U.S. dollar value of the cash flow and
2. Reflected the crisis of confidence when the Argentinean government imposed a new and burdensome export tax on agricultural products and threatened to appropriate the moneys from the national pension funds.

These conditions generated a great deal of pressure on the value of the Argentine peso relative to the U.S. dollar as the peso slid from a value of $0.37 on June 30, 2008, to $0.29 on December 31, 2008.

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, the impact of substitutes, and market characteristics may be similar throughout a particular region—or different in each country. Extraordinary disruptive events such as the September 11 terrorist acts and the recent Japanese earthquake and resulting tsunami 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.

Example 7
A multinational company with a significant retail and wholesale operation in Bangladesh establishes its sales budget each year based on the following weather conditions:
• Minor disruptions caused by flooding,
• Major disruptions caused by flooding, and
• Extraordinary disruptions caused by flooding.

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. Organizations 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 strategic plan and sales budgets.

Many of these factors arise from a specific nation's characteristics, and 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 merely be 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 strategic plan.

**Example 8**
In some countries, brief or surprise strikes must be expected and should be worked into the expense budgets. For instance, as a result of a surprise strike by workers in India’s Port of Mumbai, shipments of pharmaceutical products were unable to depart. In order to meet the time-sensitive launch of a new product, a company had to retrieve the product from the Port and ship it by air from Mumbai to its U.S. operation. Fortunately, the company was prepared for this type of event, had a backup plan in place, and had included funds in its budget to cover just such an occurrence.

The resulting expenses should be monitored carefully to ensure that they do not exceed what is necessary to operate the foreign unit successfully, given its organizational structure, target markets, input sources, and coordination efforts.

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.

**Example 9**
An appliance manufacturer that had been shipping its products to Brazil for a long time discovered that the packaging used for the Brazil shipments was inadequate when items were being sent to India. Thus, the initial shipments to India wound up with a 100% damaged-delivery record because of the unique shipping and handling challenges encountered in India.

An unskilled, unmotivated workforce usually 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.

Some U.S. companies adapt and alter their strategic plan and adjust to new international conditions in a practical and functional manner. The operating budgets reflect this flexibility.

**Example 10**
The need for U.S. companies to quickly adjust and adapt to new conditions in the international and domestic markets is evident in recent events. For example, the drastic worldwide decrease in demand for cars forced GM to temporarily close its three assembly plants it owns in Mexico during the months of December 2008 to February 2009.

**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 signif-
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 payments, dividends transfer pricing regimes), the foreign income tax rate, withholding taxes, and the form of business established in the foreign country.

**Example 11**

Go Irish Organization (GI) is a U.S. corporation in the 35% tax bracket. GI has a pair of foreign operations:
- Knute, organized as a branch of GI in a country with a 25% tax rate, and
- Rockne, organized as a subsidiary of GI in a country with a 30% tax rate.

GI’s approach is to reinvest the after-tax earnings in both Knute and Rockne. Knute and Rockne earn $700,000 each, but the after-tax earnings will differ, as shown below:

<table>
<thead>
<tr>
<th></th>
<th>Knute (foreign branch)</th>
<th>Rockne (foreign subsidiary)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign source income</td>
<td>$700,000</td>
<td>$700,000</td>
</tr>
<tr>
<td>Foreign taxes</td>
<td>$175,000</td>
<td>$210,000</td>
</tr>
<tr>
<td>Domestic taxes</td>
<td>$70,000 (a)</td>
<td>None (b)</td>
</tr>
<tr>
<td>After-tax earnings</td>
<td>$455,000</td>
<td>$490,000</td>
</tr>
</tbody>
</table>

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

(b) No domestic taxes because the foreign subsidiary pays no dividend to GI.

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 12**

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.13

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 will 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 discussed previously.

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 involve:

1. Reducing the minimum payback period,
2. Raising the required rate of return, and
3. Adjusting the cash flows for the level of risk.14

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 interna-
tional operation is the measure of the cost savings the capital expenditure may generate for the U.S. entity.

**Example 13**
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 initially should 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 14**
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:

\[ \$400,000 \times (6.145) - \$1,800,000 = \$2,458,000 - \$1,800,000 = \$658,000 \]

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 \( \$123,200 \):

\[ \$400,000 \times (4.192) - \$1,800,000 = \$1,676,800 - \$1,800,000 = \$123,200 \]

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 objectives stated in its strategic plan, a global business must also manage short-term cash flows from foreign operations.

**Example 15**
What appears to be obvious to some managers (i.e., local employees prefer to be paid in local currency) was not taken into consideration by the CFO of a company making its initial move into an international operation. The first pay period (which found the payroll being met in U.S. dollars) created confusion and generated an extra cost for the company as it rectified this oversight. Additional expenses continued for a while because of some changeover charges that the company incurred.

The international entity 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 to be examined as part of strategic planning include:

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

The final cash budget must be developed in accordance with the selected policies but also must reflect potential government regulations. When developing the cash budget, planners must consider currency exchange controls that foreign governments 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 in their strategic plans 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 U.S.S.R. 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 16
The overwhelming use of the euro as the official common currency by 17 (Belgium, Germany, Ireland, Greece, Spain, France, Italy, Cyprus, Luxembourg, Malta, The Netherlands, Austria, Portugal, Slovenia, Finland, Estonia, and Slovakia) of the 27 European Union countries 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.
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 components, which results in higher costs for a foreign operation. Corporate policymakers must be aware that the benefits of transfer pricing, while satisfying the multinational company and reflecting its strategic planning strategy, must also suit 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. As part of their strategic planning, policymakers must consider the effects that different policies would have on investment performance when establishing a stance toward transfer pricing.

**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 17**

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 each. 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, or $50 as analyzed below:

<table>
<thead>
<tr>
<th>Transfer Price</th>
<th>Payton Production</th>
<th>Zurich Organization (25% tax rate)</th>
<th>Zorich Organization (35% tax rate)</th>
<th>Dabears Corporation (Total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$20</td>
<td>0</td>
<td>$5,000,000</td>
<td>$0</td>
<td>$1,750,000,000</td>
</tr>
<tr>
<td>$35</td>
<td>$2,500,000</td>
<td>$625,000</td>
<td>$875,000</td>
<td>$1,500,000</td>
</tr>
<tr>
<td>$50</td>
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<td>$1,250,000</td>
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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.

**Example 18**

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 above example and in the wake of extraordinary events (such as 9/11 and the 2011 Japanese earthquake), the inventory policy of a multinational 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; they lengthen the time required to develop the budget effectively 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 that 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 for a multinational’s strategic plan 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 already have 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. An overly complex system may result in suspicion 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 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 19**

A multinational entity that operates a seafood export operation in Norway (one of the world’s largest exporters of seafood) will prepare flexible budgets for the upcoming fiscal year (July 1, 2012, to June 30, 2013) based on 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, 2013.

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. Therefore, performance standards should be tailored to the foreign segment’s operating environment.

AN ESSENTIAL MANAGEMENT TOOL
In current times, any business—large or small—whether acting as a buyer, supplier, distributor, producer, or provider of services—is prone to be impacted by the effects of international factors. These variables, such as foreign currency, interest rates, and inflation, can singly or jointly affect the level of profits and cash flows sought by companies engaged in global operations.

The recent indicators that presage periods of decreased global economic growth make it more imperative for business entities to rely on cost containment and to closely monitor their strategic plans and operational budgets. A well-designed, functional, and comprehensive budgeting system is an essential management tool for a multinational corporation. Companies must forecast the impact of global external variables as well as internal variables. All in all, the budgeting system should be effective not only in monitoring progress compared to plan, but also in adapting and adjusting to unpredictable events and circumstances that occur as the operations of the business unfold.

Juan Rivera, Ph.D., CPA, is an associate professor in the Department of Accountancy at the Mendoza College of Business at the University of Notre Dame in Notre Dame, Ind. An IMA Member-at-Large, he can be reached at (574) 631-5195 or jrivera@nd.edu.

Ken Milani, Ph.D., is a professor in Notre Dame’s Department of Accountancy and a member of IMA’s Mishiana Chapter. He can be contacted at (574) 631-5296 or milani.1@nd.edu.

ENDNOTES
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. Rudebaugh, Global Accounting and Control: A Managerial Emphasis, John Wiley & Sons, Hoboken, N.J., 2001.
2 Except for the Canadian dollar, which was quoted at about par with the U.S. dollar on June 21, 2010, the strengthening of the U.S. dollar persisted in the first half of 2010 as the euro and the British pound were equivalent to $1.2318 and $1.475 in the current markets on that date. See Currencies Table, June 21, 2010, The Wall Street Journal, June 21, 2010, p. C2.
4 The methodology of SFAS No. 52, “Foreign Currency Translation,” provides the normal framework that firms follow when preparing budgetary data for financial statements denominated in foreign currencies. Thus, income statement items are translated at the expected average (usually monthly) exchange rates, and 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.
6 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: 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.
7 Shapiro, 1999.
8 As an extension of the subject that SFAS No. 52 had not addressed, for the first time the FASB permitted and prescribed accounting treatment for foreign currency cash flow hedges (including forecast transactions) and hedges of foreign net investments in SFAS No. 133, paragraph 40.
9 Shapiro, 1999.
10 Significant changes in the interest rates have introduced another element of risk and uncertainty in the budgeting process. For example, the annual yield on a commercial one-month CD in the U.S. financial markets went from 3.11% to 0.29% during the 52 weeks ending on February 20, 2009. Likewise, the yield on U.S. treasury bonds went from 2.04% to 0.64% for the same period.
11 Shapiro, 1999.
12 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.
14 Shapiro, 1999.