Multinational Intercompany Funds Flow Mechanisms Exposure

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Introduction:

Funds flow mechanism for both domestic and multinational firm is part of the financial management of a going concern. The purpose of financial management for both domestic and a global firm is to maximize shareholder wealth. In many cases, a firm may be considered a domestic firm; but, could still be involved with doing international business like import and export of service, products, components, or even licensing. Moreover, the two types of businesses are not mutually exclusive. The domestic firm has also to deal with all the risk exposures (operational cash flow) through their customer relationships, credit risks related to trade and even the exchange rate risk as related to all the above.

Efforts to create firm value, in light of the rapid pace of globalization, is a complicated undertaking. In creating value globally one needs to define globalization by producing where it is most cost – effective. What is more important the effective sourcing of capital strictly on the bases of cost of funds globally without reference to which nations are involved. National boundaries are slowly but surely becoming irrelevant under globalization pressures. Financial management of corporation is all about maximizing firm value. Financial manager need to gage opportunities ahead of the crowed and grab the opportunities and run with them. As long as they are able to make followers out of the competition, they are bound to win in the trade. The management skill of create developing and plan and implementing way ahead of the crowd is an assurance that the joint

effort will create that value that is required by investors. Investors are basically interested in maximizing their earnings per share, more than anything else.

Creating Firm Value in Global Markets

Figure I: Moffett, et al 2008.

Multinational Access to Capital:

One of the glaring differences between a domestic and a multinational firm is on access to capital. By definition, the domestic firm has access to a limited source of capital, mainly domestic capital. Though severity of the limitations is varied depending on the development of the capital market in the countries involved,

these limitations still exist and do affect the domestic firm. The multinational firm, however, is limited only by its own ability to find and hook up with capital. The funds are out there. Figure I display the extent of the global capital accessible by the global firm. For example, Proctor and Gamble, General Electric, and IBM may be considered Level III global firms. These concerns are household name companies to the global capital market place and have management expertise that use such global capital market place with high level of sophistication The global capital market places high level trust on the management abilities of these companies to obtain the required knowhow and the technology and implement their strategy. What is more, the competitive position of these companies in their global core business and in their global market place matters a great deal. Level I corporate concerns would be firms that are not to the required level of management skills. They have no easy access to the international capital market place. A great number of these firms are located countries with less developed capital markets. Similar difficulties or bottlenecks happen even in the rapidly growing emerging nations. The pyramid in figure I, nevertheless, indicates that a large number of firms are being formed in these emerging market countries. Studies show that these firms being created in great numbers are evolving as the multinational firms companies thereby maximizing shareholder value. In the mechanics of capital flow in a global market place, there are important approaches, especially in the area of short term funding. Multinationals need to make specially careful decisions about those important approaches. (1) The global concern needs to form and implement special mechanisms for situating its global operational funds. (2) These multinational firms need to attempt to minimize and monitor its transactions costs incurred related simply to the special funds flow mechanism adopted. And (3) multinationals with special funds flow mechanism need to be concerned regarding blockages that prevent the use of certain special funds flow channels it adopted. In this paper, we attempt to present each of these in at least a short order and draw conclusions on the efficiency of global funds flow as a direct contribution to the efficiency of multinational financial management.

The Mechanics For Global funds flow Mechansim:

The mechanics for global funds flow strategy is a part of global funds flow that focuses in the specially on operational funds (working capital management) (i.e. management of current assets and current liability and their relationships). A main consideration for decision about global funds flow mechanism and its management is the decision to centralize or decentralize the cash management function. Normally, a multinational has a concentrated pool of financial expertise at its head quarter (centralized). In order to maximize the utility of such pool of skills, the global concern would decided to concentrate funds at the central office. The central office is also usually the sit for all other policy decisions. Planning including capital budgeting decisions on the various investment project opportunities are also made at the centre office. Such concentration would render efficiency of funds management and it would be efficient in its allocation of the funds to the most productive projects globally. Any other office different from the centre office, for instance, should it be designated to a subsidiary, the scope of such allocation of resources would have hindered the objective of shareholder wealth maximization, according to some studies. Some of the obvious advantages of the central office are: (1) The research and development department, (2) the finance office with market expertise, (3) the accounting office with expertise in various accounting standards around the globe, (4) the various experience to the insurance, (5) the local and global banking sources of funds. (6) the local and global brokerage houses, and (7) the other concerns in the local and global financial markets like brokers, specialists in the industry and in various countries. Moreover, management expertise that the company is also normally situated at the central office.

Since the central office is the main concentration of the various skills and expertise, all policy market decisions are strategically made at the center office. It has the marketing skills to play market differentiation. It can play all sort of product differentiation, advertising, and the diversification games. Nevertheless, integrating global operating working capital and its management is not an easy sale. The global market financial market place invites in the various cultural,

economic, political, and social issues into global business decisions, a complex process because it involves several factors like ever changing tax laws in the various countries and their varied regulations on ethics. Other exogenous factors like risk exposures due to exchange rate changes and political risk require exposure risk management skills that the central office normally possess. Centralizing working capital management of a multinational concern would enable the firm to have a funds flow mechanism that is most efficient and effective in that it can dispatch its funds whenever and as desired. Such position for funds flow mechanism would be cost effective, since company data center and other important information and research expertise are located at the central office.

Multinational firms may move funds globally across nations in two categories. The first category is funds related to investing, sometimes called long term related funds transfer done mostly for capital infusion. Such infusion may be equity infusion by investors or the central office or else where acceptable, could be long term debt sold in the global capital market including and not limited to the euro-market. Normally, countries like such new funding addition formed elsewhere. The second category is funds related to daily operational short-term related flow mechanisms. Such global flow of funds mechanisms used by multinationals are in the current assets and current liabilities categories. Some of the types of global funds flow mechanism in the two categories being discussed as utilized by multinational corporations are:

Figure II: **Global funds flow Mechanisms**

Long-term Related Funds Transfer	Short-term Funds Transfer
Equity investment by others	Administrative overhead
Equity investment by parent	Management fees paid
External loan	
Paid license fees	
Loans among subsidiaries	Payment for external goods/services
Payment of dividends	Payment for internal goods/services

Principal repayment	Repayment of equity invested
Repayment of interest	Receipts for external sales
Repayment of equity and interest	Receipt for internal sales
Principal repayment	
Royalties paid/received	
Other capital transfers	Other short-term trades of funds

There are others that are not listed here but would affect company funds flow mechanism. A good example may be funds flow due tariff, taxes and fees related to exchange rates. Each global production location requires what is termed 'the minimal and necessary funds flow' to run it. The sum of all of each of the minimal and necessary funds flow would make up the "required to run operations minimal and necessary funds flow for the company. The cost of capital and all transaction cost and fees are important consideration when managing funds flow mechanisms. Multinationals and their affiliates need to be able to obtain resources quickly and readily as needed at a minimal cost. Therefore the cost of funds is a factor that needs to be seriously looked at by market experts. Moving funds among affiliates of a multinational firm is a popular means of funds flow mechanism. Even moving funds among affiliates is not free; but it is expected to minimize fund cost for these costs are significantly lower than if an external market sources are utilized instead. If affiliates also happen to trade with each other, they can reduce the over all cost of transaction and increase the efficiency of receivables and payable management.

Figure III: An example of funds flow mechanism (affiliates' "**netting**") for **cost savings:**

Part R: Total Company Example:

Account Receivable from Affiliates

	Brazil	Chile	Japan	Mexico	Total A/P
Brazil	--	$400	$100	$100	$600
Chile	$400	--	300	100	800
Japan	200	100	--	100	400
Mexico	200	100	200	--	500
Total A/R	$800	$600	$600	$300	$2,300

Part S: Inter-affiliates Netting Example (Bilateral Netting):

Account Receivable From Affiliates

Brazil	---	0	0	0	0
		400	100	100	
Chile	0	---	200	0	200
	400	---	100	100	
Japan	100	0	---	100	200
	100	100	---	100	
Mexico	100	0	100	---	200
	100	100	100	--	
Total A/R	$200	$ 0	$300	$100	$600

Part T: Multinational Netting Example:

Accounts Receivable

Brazil	**---**	**0**	**0**	**0**	**0**
Chile	**0**	**---**	**200**		**200**
Japan	**200**	**0**	**---**	**0**	**200**

Mexico	**0**	**0**	**0**	**---**	**0**
Total A/R	**$ 200**	**$ 0**	**$200**	**$ 0**	**$400**

Figure III depicts account receivables and the account payables among affiliates of multinational firms. In Part R, the columns are individual subsidiary's account receivables from the various other affiliates. The rows are account payables to the various other affiliates. The total account receivable for Brazilian affiliate is $500 as shown at the end of its column. The Brazilian affiliate also expect $300 from Chile, and $100 each from Japan and Mexico. On the other hand, the Brazilian affiliate's account payable is shown, on far right column, a total of $800 with $400 payable to Chile, and $200 to both Japan and Mexico. Its focus is that each pair of affiliates, for instance, Brazil and Chile, have receivables and payables to each other: Brazil owes $400 to Chile, and Chile owes $300 to Brazil. It would have been necessary for each affiliate to acquire foreign exchange and physically remit payments to one another. That would have been a serious transaction cost depending on its frequency of need for the funds transfer, and more importantly over a longer time period. It goes to show that it is important to design and use affiliate netting funds flow mechanism as frequently as possible.

Blockages in Funds Flow:

Blockages in funds flow is any hindrance to free market mechanism to the flow of resources including capital. A good example is usually government regulations on the way of free flow of multinational funds. Blockages are usually manifested in the form of price controls and show up in the form of restrictions on repatriating funds. Such restrictions often show in the form of limit on foreign currency remittance, numerical limit on dividend payments to company shareholders, and on other forms of investment returns. Multinationals attempt to get by using the less intensive blockages i.e. where blockages exist, by designing ways of getting money out and by financing operations using local currencies. Dealing with blockages needs certain strategies and to formulate any strategy, a multinational needs to be knowledgeable with why countries put up blockages. Countries put up blockages for multiple reasons few of which are as follows: (1) One major reason most countries often give for putting up serious blockages to international funds flow is "efficient management of the highly limited foreign reserves". These particular line of reasoning is certainly prevalent among countries that possess only extremely limited means of earning foreign currency. (2) The second reasoning is normally based on protectionist philosophies of supporting domestic industries as opposed to multinationals by enhancing investments locally and attempt stimulating the economies though local industries. Nevertheless, external capital is critical to purchase fuel and parts and other input needed to support the local infant industries. (3) The third line of reasoning to justify funds flow restrictions is for enhancing export earnings and foreign funds are used to attract firms that are particular in promoting the export sector of that economy; and (4) another reason for restriction of global funds flow is meant for increasing the multinational company's commitment to the local economy. In several situations, local suppliers are developed and utilized. Multinationals are then invited to adopt to the social system that has supplier net work already developed. Infrastructure, workers training, housing and medical facilities are routinely included in agreements multinationals. In many agreements schools and other packages are

also included. The normal five-year, ten-year, and fifteen year development plans of many nations would also include such fundamental agreements with foreign concerns and nations.

There several means of handling blockages by multinational concerns: (a) pre-arrangement where blockage issues could be negotiated long before the scarce capital is invested. (b) day to day or week to week company strategies in its operations to establish the ability to shift funds internationally such that funds are moved from weak currencies to more stronger ones. (c) Multinational need to set up means of non- capital contributions in financing foreign affiliates. A strategy of developing and utilizing local currencies extensively needs to be adopted and (d) exit strategy must be already thought of by the time agreement is signed. Moreover, it is widely suggested that the effect of blockage may be minimized by first, for instance, using the funds under blockage the firm may make purchases of the multiple local goods and services and export. That is called the unrelated export strategy against blockage. Second, another affective strategy against blockage may outsourcing of production, service and supplies and get paid there. If funds are blocked for this firm, other necessary affiliates may be able to use the restricted funds. Blocked funds could also be used to purchase the various special services companies regularly need lime data processing services, accounting services, market research services, back office paper duties marketing services, customer service call centers, consulting services, product support services, R&D, software development and maintaining. Third, loans to unaffiliated external bank or firm that in turn would serve the company affiliates.

Conclusions:

The objective of a firm is to maximize shareholder value. One may maximize value by maximizing revenues and/or by minimizing cost. Funds flow in global operations is an area that need attention and expertise to help minimize funds transfer costs. The paper attempted to show some of the effective means of minimizing funds movements and lessening the cost of doing so. The netting mechanism is shown to be one effective means to cut cost of funds management.

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