MNB 3701

GLOBAL BUSINESS MANAGEMENT

EXAM PACK (FIRST PAPER) MAY/JUNE 2018

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SECTION B

1.1. Explain fully what “transfer pricing” means

Transfer pricing is an amount charged by one subsidiary for an operational resources transfer to another subsidiary of an MNC. In short, it is the pricing of internal resources within a multinational company networks. It moves from one subsidiary to another within the foreign subsidiaries of an organisation, that’s from the parent company or headquarters of the subsidiaries. Goods from the parent company is sold to foreign subsidiaries at a fixed price, which is arbitrary fixed by the MNC itself. The approach has been used extensively by MNC to reduce cost on input tax and excise duties to be paid. The method is popular among MNC and it’s regarded as a strategic tool for maximum earning. The argument over the practice is that it leads to tax manipulation and evasion. The concern of fiscal authorities is that MNC might set transfer price on cross-border transaction to reduce taxable profit. It’s noted that some MNC use the transfer pricing to move fund abroad, in cost paddling and also monopolistic tendencies. However, where there is an established truth it could be termed a crime and lead to prosecution.

1.2 Contrast forward exchange contracts with foreign currency options provide example to substantiate your answer.

Forward exchange contract is a form of financial issuance taken to keep exchange rate at a fixed price for a specific date in future whiles foreign currency option is a form issuance that grants the purchaser or the buyer the right or privilege to buy or sell a specific amount of foreign currency within a specific period.

In foreign currency options the buyer may decide to buy and sell at a will whereas in forward exchange contract, the request is lock-in agreement that guarantees the settle of foreign denominated account at a later date at a pre- agreed exchange rate.

In forward exchange contracts, the contract may be activated at a forward premium or a forward discount while in currency options, there is flexibility of trading that is accorded to the option buyer.

With currency option the buyer is shield against any possible exchange rate volatility whereas in forward exchange contract, the contract is activated at forward premium, if the contract assumed that domestic currency will depreciate against the foreign currency and discounted on converse premise assumptions.

1.3 Critically discuss the three types of foreign exchange exposure the Multinational Corporation (MNC) can encounter in the foreign exchange market.

The three types of foreign exchange exposure that an MNC can encounter in foreign exchange market include transactional exposure, translation exposure and economic exposure.

In the first place, transactional exposure, this exposure occurs as a result of exchange volatility on outstanding obligation that existed before the exchange rate changed and which have to be settled after the exchange rate had changed. In most instant monetary transaction are meant to earn profits that's basically the end result. In most cases there are possibility that final objective may be hampered if the transaction involves uses of foreign currency and the rate of exchange tend to be unfavourable. This risk is common in international business transaction because most of the execution date of transactions negotiated by MNC are set in future date. For example South Africa Edcon Group has ordered school material from a manufacturer in India, the deal was seal in July 2015, for delivery in December of the same year. Payment will be effected sometimes after delivery. The rand equivalent to India rupee might have change either favourably or unfavourably. This change may affect the profitability of Edcon Group as far as import is concerned. For instance the India rupee was 0.08 of South Africa rand. By the time of delivery the India rupee has appreciated greatly against the rand to 0.13. The Edcon Group will be paying more for the import than they should have paid if the currency conversion had remain the same. The profit margin of the Group would have increase if the rand had strengthen against the rupee.

Secondly, translation exposure, this risk like transactional exposure deals with the possible loss of financial value on the accounting books of the organisation in the course of converting operational finances of organisations subsidiaries. Translation exposure is often termed accounting exposure. The exposure occurs when an MNC compiles its corporate balance sheet, through the translation of its books of account into the home currency. The translation is carried out as a result of conformity with regulatory requirement of reporting corporate financial reports to shareholders or stakeholders. And this is done in home currency to show the position of the company.

Finally, economic exposure, this exposure have higher impact as compare to the other two. It has direct impact on the value of the firm. The economic exposure is the extent to which the economic value of the company can decline due to changes in exchange rate due to negative swing in the macro economy. The impact of the exchange could be felt on the overall book value of the firm. The implication of the negative exchange rate behaviour could show the company profititablity, survival and growth. Significant exchange volatility could affect the operational cost of the firm. The extent of volatility recorded between input and output stage of production process may greatly influence the company competitive position. Economic exposure can also have bearing effect on overall book value of company assets. Since MNC are more concern with profit maximisation foreign exchange

exposure more time hurt their operation especially where value of future cash flow is dependent on the value of foreign currency or currency where the MNC operates.

1.4 Discuss the role of the capital market in the economy

The capital market of an economy is made of financial market and capital market. Financial market is market where short-term financial instrument are traded that's sold and bought whereas capital market on the other hand is a virtual monetary space where long term financial instruments are traded that's sold and bought. The capital market provides a cheap platform for corporations to raise fund for capital intensive projects. The main component of a country capital market are equity market and credit market. The equity market comprises of stock market, investment bank and other related equity market whiles credit market includes development and assets - backed commercial banks, bond market, insurance houses and other financial instrument of intermediation. The capital market play a very significant role in enhancing economic growth of a country. It provides an alternative source of finance for project which required long term repayment period. It helps bridge the capital gap in long term financing through the stock market and development banks. It provides businesses with the opportunity to raised cheaper funding through initial public offering or secondary offering. The market provide an access for international and domestic portfolio investors. This enhances the supplementations of low domestic savings, which make it possible for governments and other deficit units to seek funding that's critical for growth- inducing activities.

2.1 Fully explain the "four attribute" that Porters theory of competitive advantage is based on

Porter's theory of competitive advantage is based on the following four attributes, demand conditions, factor conditions, related and supporting industries and firm strategy, structure and rivalry.

Demand conditions - here companies set up their production operation in close proximity to a potential market which is sustainable enough to drive strong demand for the manufacturing operation.

Factor conditions - this view absolute advantage of the availability of natural resource that may influence the ability of the firm to meet specific consumer demand within the scope of the firm production facility. Thus is it look at the absolute advantage with regard to the natural resource availability and the relative availability of factors of production as compare to other international locations.

Related and supporting industries - this examine the importance of related and supporting industries in close proximity to the firm production facility and compare their competitive advantage from supporting industries in similar industries.

The firm strategy, structures and rivalry – while demand condition, factor condition, and related and supporting industries influence decision regarding availability of factors of production. The firm

sustainability generally depends on strategy, structure rivalry activities. Example, if barriers to marketing entry are low, one will expect increasingly intensive rivalry activities among competitive firms.

2.2 Fully discuss the characteristics of an emerging industry and relevant strategies that an MNC should consider.

An emerging industry is an entirely new industry or restructured industry that is growing at a faster rate than an overall economy. It can also be described as a group of companies in line of business formed around new product or idea that is at early stage of development. The main characteristic of emerging industry is that the industry is new and unproven which leaves much speculation and many opinions about how it will function, how fast it will grow and how big it will become. There is often uncertainty as to how the industry will attract customers for the product and the willingness of customers to pay value for the product. In most cases the technological know-how underlying production in the industry are proprietary base and are close guarded. There are no much competition in the industries. Product attributes play major factor in winning buyers favour. Entry barriers to the industry is relatively low, it only become competitive when the market shows promising signs of growth. In emerging industries, all buyers are first time users who might be more concern with product performance, reliability and conflict claim of rivalry firms. Organisations in an emerging industry more times have problem of securing ample suppliers of raw materials and components to support production. Sometimes they even find themselves short of fund to support the needed research and development for the product to catch attention. The most critical issues confronting most organisation in an emerging industry is how to pre-finance their initial operation before sales and revenue take off and which market segment to target and what specific competitive advantage is important to secure a leading position. It's believe that organisation with solid resource capabilities and good strategy has greater advantage. As an MNC considering entering an emerging industry it is important to pursue one or more of the following strategic avenues.

In the first place, it's important to try to win the early race of the industry leadership with risk- taking entrepreneurship culture and value.

Secondly, it is important to perfect the technology know- how to improve product quality and to develop additional attractive performance features.

Thirdly, it is also important to form strategic alliance with key supplies to gain access to specialised skills, technology capabilities and critical materials or component. The alliance form with companies that have related or complementary technological expertise will out- compete competitors on technological superiority.

Furthermore, there should be constant focus on gaining new customer groups, new user's applications and new entry into new geographical areas

Finally, it is important to make it cheap for first time buyers to try the new product.

2.3 Discuss what is meant by the “rights theories” as a theory of business ethics

The right theories assumed that every human being have a fundamental rights and privilege that goes beyond national boundaries and culture. The theories was based on moral norms and the principle that state that “all human beings are permitted or empowered to do something or have something done for them”. The moral right is considered as a universal right and represent all right of human being. The rights are not limited to particular area. It’s applicable to all human being in any location or a country. Example the right to freedom of speech, movement, right not to be tortured regardless of nationality or legal system is enshrine and must be always upheld regardless of interest of state. The assertion that the fundamental human right goes beyond boundaries and culture prompted the adoption by the United Nation Declarations of Human Right. The declaration exposes the basic principle that must be applied regardless of culture in the context of international business. The declaration state that “All human beings are born free and equal in dignity and right. They are endowed with reason and conscience and should act towards one another in spirit of brotherhood. This principle translate into

Everyone one has the right to work, the right to equal pay for same work done, entitles to just and favourable remuneration , the right to form and join trade union for protection of their interest.

The implication of these right lead to the assumptions that it’s unethical to engage a child labour and also pay less than subsistence wage. Giving the framework of the theory of the right, certain stakeholder are obligated to provide benefits or services that secure

3.1 Explain what the concept of Foreign Direct Investment (FDI) entails

The concept of FDI can be explain through many different perspective, thus economic, environmental and socio political. From economic perspective, what constitute FDI is toward the effect rather than investment. The financial value is more important that the effect of investment on the economy. From environmental point of view FDI is more on ecological impact, while from political leaders stand FDI is view from socio political and economic point. However, from institutional perspective, the most robust definition according to IMF, FDI is the category of international investment that reflects the objective of resident entity in one economy obtaining a lasting interest in an enterprise resident in another country. From the fund definition, that resident entity is a direct investor while the enterprise is the direct investment enterprise that is locate in the host country. The resident entities are largely Multinational Corporation that invest huge sum of capital and commit valuable resources into their offshore presence for the sole purpose of non-easily reversible business interest.

According to Organisation for Economic Cooperation and Development (OECD), FDI is a reflection of the objective of obtaining a lasting interest by resident entity in one economic (the MNC) in an entity economy other than that of the investor (the offshore investment). This definition clear implies that FDI is only possible when the intent to commit lasting interest is in the form of a long term business relationship. However, United Nations Conference on Trade and Development (UNCTAD) also share the same definition presented by OECD but try to expanded scope by including lasting and

controlling interest in the offshore subsidiary. The controlling and ownership structure introduce by UNCTAD consider a very important view point that includes not only the lasting nature of the FDI in the host nation but also appropriate shareholding in the foreign subsidiary. The relevance of the ownership structure is the possibility for the domestic investor to ultimately participate and hold equity stake in the subsidiary through participation in the stock market or any other similar platform. From above explanation FDI focus on lasting nature of foreign investment in the host country and the ownership of the investment.

3.2 Discuss the four major types of FDI mergers, acquisitions, brownfield investment and wholly-owned subsidiaries.

The four major types of FDIs are mergers, acquisitions, brownfield and wholly –owned subsidiaries.

MERGERS

Mergers as FDI occurs when an MNC decides to partner with a foreign organisation on equal footing basis. Through this arrangement the partner organisation share equal stake in the business as well as in management and control.

ACQUISITIONS

Acquisition as FDI occurs when a strong MNC absorbs a weak organisation in the host country. This forms of arrangement often occurs among organisation in the same industry or related industries. Acquisition is best if the government in the host country favours outright ownership of assets by the foreign investor. In this case, the foreign investor takes over the existing business fully including assets and management.

BROWNFIELD INVESTMENT

This form of FDI occurs through acquisition or lease of an existing operational facilities with the purpose of utilizing the facilities to deliver or render specific services or produce certain product. Brownfield generally occur when a company or government establishment take over the controlling share in an offshore organisation for the purpose of rending certain services or production of certain product. It is mainly done through lease arrangement with the aim of acquiring the operation

WHOLLY –OWENED SUBSIDAIRY

This form of FDI occurs, when MNC invest and build production or operation facilities in an offshore market from the scratch. Wholly owned subsidiaries usually occurred as result of foreign expansion corporate strategy of a firm, which might identify fully project with the foreign community. Thereby winning the people loyalty. It could also be adopted as a strategy of circumventing restriction on ownership of asset by foreign organisation.

3.3 Elaborate on the advantage FDI has for the host country

The advantage of FDI to the host country include among others the following.

1. It creates production and system linkage and synergy within the industry. In most country of foreign subsidiaries, the MNC try to annex the sources that supply the input materials through backward integration or the distribution network using forward integration. This strategy is very important to MNC

2. It facilitates access to bigger international market. The MNC that invest in offshore market, choose a market that provides opportunities for low cost production with the capability to produce in a very large quantity. The MNC uses that create international network to penetrate both nearby and distance market.

3. Technology spill over, the MNC penetrating foreign market with superior technology capabilities and state of the act production that enables efficiency and efficacy, this occur because the MNC originate from technological advance economies , importing the technology to the host economy not only to improve the level of technology advancement of the industry but the country as well

4. Employment opportunities, the FDI inflows into the host country create the possibility of absorbing more labour. Given the fact that production capacity is enlarged and the production system is optimise, more human resources may be required to create the necessary interaction between input materials and machines.