Chapter 1
Financial Goals and Corporate Governance

Why it is important to study the MNEs?
- MNEs face significant foreign exposure and risk.
- Firms with total domestic operations may not have to face direct foreign exposure still they face indirect financial risk through their relationship with customers and suppliers.
- It has, therefore, became increasingly important even for the managers of a totally domestic operations to also learn about international financial risk, especially those related to foreign exchange rates and the credit risks related to trade payments.

The Globalization Process
- The globalization process is the structural and managerial changes and challenges experienced by a firm as it moves from domestic to global in operations
- We will examine the case of Trident, a young firm that manufactures and distributes an array of telecommunication devices
  - Trident’s initial strategy is to develop a sustainable competitive advantage in the U.S. market
  - Trident is currently constrained by its small size, other competitors, and lack of access to cheap capital

The Globalization Process
- In Phase One, Trident is not itself international or global in its operations
- However, some of its competitors, suppliers or buyers may be
  - This is one of the key drivers pushing Trident into Phase Two, the first transition of the globalization process
  - The above was Global Transition I: **The Domestic Phase to The International Trade Phase**
The Globalization Process

**Phase Two: Expansion into International Trade**

Trident Corporation
(Los Angeles, USA)

Mexican Suppliers

Canadian Buyers

Are Mexican suppliers dependable? WILL Trident pay US$ or Mexican pesos?

Are Canadian buyers creditworthy? WILL payment be made in US$ or C$?

**Trident Corp: Phases Combined**

**Phase One: Domestic Operations**

U.S. Suppliers (domestic) All payments in US dollars; All credit risk under U.S. law

Mexican Suppliers

Trident Corporation (Los Angeles, USA)

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Canadian Buyers

Mexican Suppliers

Canadian Buyers

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Are Canadian buyers creditworthy? WILL payment be made in US$ or C$?

**Phase Two: Expansion into International Trade**

**The Globalization Process**

- In the International Trade Phase, Trident responds to globalization factors by importing inputs from Mexican suppliers and making exports sales to Canadian buyers.
- Exporting and importing products and services increases the demands of financial management over and above the traditional requirements of the domestic-only business.

**The Globalization Process**

- First, direct foreign exchange risks are now borne by the firm:
  - Pricing and payments may be in different currencies.
  - The value of these foreign currency receipts and payments can change, creating a new source of risk.
- Second, the evaluation of the credit quality of foreign buyers and sellers is now more important than ever; this is known as credit risk management:
  - Potential for non-payment of exports and non-delivery of imports.
  - Differences in business and legal systems and practices.

**The Globalization Process**

- If Trident is successful in its international trade activities, it will soon need to establish foreign sales and service affiliates:
  - This step is often followed by establishing manufacturing operations abroad or by licensing foreign firms to produce and service Trident’s products.
  - This is Global Transition II: The International Trade Phase to The Multinational Phase.

**The Globalization Process**

- Trident’s continued globalization will require it to identify the sources of its competitive advantages:
- This variety of strategic alternatives available to Trident is called the foreign direct investment sequence which include the creation of foreign sales offices, licensing agreements, manufacturing, etc.
- Once Trident owns assets and enterprises in foreign countries it has entered the multinational phase of globalization.
Foreign Direct Investment Sequence

- Trident and its Competitive Advantage
- Greater Foreign Presence
- Change Competitive Advantage
- Exploit Existing Competitive Advantage Abroad
- Production at Home Exposing
- Production Abroad
- Licensing
- Management Contract
- Control Assets Abroad
- Joint Ventures
- wholly-owned
- subsidiary
- Acquisition of a Foreign Enterprise
- Greenfield Investment
- Greater Foreign Investment

Foreign Direct Investment

- As Trident increases its foreign presence and level of foreign investment, its management team must:
  - Develop knowledge of the global financial environment
  - Understand foreign exchange theory and markets
  - Manage foreign exchange exposures including transaction, operating, and translation exposures
  - Gain access to global equity and debt markets by globalizing the cost and availability of capital
  - Continue to make strategic and financial foreign investment decisions
  - Manage multinational operations

Foreign Investment Decisions

Trident Corporation (Los Angeles, USA)  
Trident Europe (Hamburg, Germany)  
Trident Brasil (Sao Paulo, Brazil)  
Trident China (Shanghai, China)  

Trident Corporation

- Greenfield Investment
  - A long-term physical investment in productive capability in that country
- Cross-Border Acquisition
  - Identification, valuation, tender, and post-acquisition management of an existing going-concern
- Joint Venture Investment
  - Combining investment capital and managerial know-how to reach specific opportunities

Foreign Investment Decisions

Trident Corporation (Los Angeles, USA)  
Trident USA (Los Angeles, USA)

- Currency: US dollar ($)
- Tax rate: 35%
- 2004 Earnings before tax (EBT): $ 4.5 million

Trident Europe (Hamburg, Germany)

- Currency: Euros (€)
- Tax rate: 45%
- 2004 EBT: € 4.5 million
- Avg exchange rate: $ 1.20/€
- 2004 EBT in US$: $ 5.4 million

Trident Brasil (Sao Paulo, Brazil)

- Currency: Brazilian real (R$)
- Tax rate: 25%
- 2004 EBT: R$ 6.25 million
- Avg exchange rate: R$ 3.00/$
- 2004 EBT in US$: $ 2.083 million

Trident China (Shanghai, China)

- Currency: Chinese renminbi (Rmb)
- Tax rate: 30%
- 2004 EBT: (Rmb 2.5 million)
- Avg exchange rate: Rmb 8.20/$
- 2004 EBT in US$: ($ 0.305 million)

What is the Goal of Management?

- As Trident becomes more deeply committed to multinational operations, a new constraint develops – one that springs from divergent worldwide opinions and practices as to just what the firms’ overall goal should be:
  - Shareholder Wealth Maximization – As characterized by Anglo-American markets
  - Corporate Wealth Maximization – As characterized by Continental European and Japanese markets
The Goal of Management

- Shareholder Wealth Maximization
  - A firm should strive to maximize the return to shareholders (those individuals owning equity shares in the firm)
  - This view defines risk in a very strict financial sense
  - Risk is defined as the added risk a firm’s shares bring to a diversified portfolio (a fully diversified portfolio represents systemic risk)
  - The added firm-specific risk is known as unsystematic risk

- Corporate Wealth Maximization
  - A view that all a corporation’s stakeholders (employees, management, suppliers, local community, local/national government and creditors) need to be considered in addition to the equity holders
  - The goal is to earn as much as possible in the long run, but to retain enough to increase the corporate wealth for the benefit of all
  - The definition of corporate wealth is much broader than just financial wealth, it includes technical, market and human resources as well

The Goal of Management

- Corporate Wealth Maximization

The Anglo-American Model has been frequently criticized as focusing on short-term profitability rather than long-term growth.

The Non-Anglo-American Model has come under increasing criticism for its lack of accountability to equity investors – its shareholders – while focusing on the demands of too diffuse a group of stakeholders.

Corporate Governance

- The way stakeholders determine and control the strategic direction and performance of an organization is termed corporate governance

The single overriding objective of corporate governance in the shareholder wealth model is the optimization over time of the returns to shareholders

The most widely accepted statement of good corporate governance (established by the OECD) focuses on the following principles:
  - The rights and equitable treatment of shareholders
  - The role of stakeholders in corporate governance
  - Disclosure and transparency
  - The responsibilities of the board

Goal of Corporate Governance

- The Anglo-American Model

The Non-Anglo-American Model

The Structure of Corporate Governance

<table>
<thead>
<tr>
<th>The Marketplace (external)</th>
<th>The Corporation (internal)</th>
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<tbody>
<tr>
<td>Equity Markets Analyze and other market agents evaluate the performance of the firm on a daily basis</td>
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<tr>
<td>Debt Markets Ratings agencies and other analysts review the ability of the firm to service debt</td>
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<tr>
<td>Auditors Provide an external opinion on the fairness of presentation and conformity to standards of financial statements</td>
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<tr>
<td>Regulators, SEC, the NYSE, or other regulatory bodies by country</td>
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Management

Chief Executive Officer (CEO) and his team run the company

Board of Directors

Chairman of the Board and members are accountable for the organization

Corporate governance represents the relationship among stakeholders that is used to determine and control the strategic direction and performance of the organization.
Corporate Governance

- The origins of the need for a corporate governance process arise from the separation of ownership from management, and from the varying views by culture of who the stakeholders are and of what significance.
- A governance regime (system) is a function of:
  - Financial market development
  - The degree of separation between management and ownership
  - The concept of disclosure and transparency

Corporate Governance

- Market-based regimes (U.S. and U.K.) are characterized by relatively efficient capital markets with dispersed ownership.
- Family-based regimes (Asia, Latin America) involve strong concentrations of family ownership.
- Bank-based and government-based regimes result in only marginal public ownership and sometimes significant restrictions on business practices.

Corporate Governance

- Does good governance matter?
- Certainly, as in the case of Enron, many of the improprieties were overlooked as long as the company's share price continued to rise.
- However, after the fall of Enron, and the substantial losses sustained by investors, employees and society as a whole, many would say that corporate governance matters a lot.

The Value of Good Governance

How much more (what premium) would you be willing to pay for a share in a 'good governance' company in the following countries?

Potential Responses to Shareholder Dissatisfaction

- Shareholder Dissatisfaction
- Possible Action: Remain Quietly Disgruntled
  - Popular Term: The Post
- Possible Action: Sell the Shares
  - Popular Term: Walk-Away
- Possible Action: Change Management
  - Popular Term: Shareholder Activism
- Possible Action: Initiate a Takeover
  - Popular Term: Maximum Threat

Mini Case: The Failure of Corporate Governance at Enron

- Enron failed as a result of a complex combination of business and governance failures.
- How did the system allow this to happen?
- Why did the many structures and safeguards within the U.S. corporate governance system not catch, stop, or prevent the failure of Enron?
- Please review the case, and the following exhibit in preparation for the case questions.
Mini Case Questions: The Failure of Corporate Governance at Enron

- Which parts of the corporate governance system (internal and external) failed Enron the most?
- How could individual stakeholders and/or components of the corporate governance system have prevented the problems at Enron? How could they have acted to resolve these problems?
- Do you believe this was an isolated incident, or are we to expect more collapses like Enron's in the future? Why?
- Will recent changes in Corporate Governance law help?