OUTLINE FOR CHAPTER 21

- Understand Repositioning of Funds
  - Constraints on Moving of Funds
  - Ways to Transfer Funds
  - Unbundling
  - What to do if Funds are blocked
- Aspects of Working Capital Management
  - Advantages and Disadvantages of a Centralized Depository
  - Netting (bilateral and multilateral)
  - Accounts Payable vs. Short-Term Debt

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Chapter 21 – Working Capital Management

- Managing current assets and current liabilities as well repositioning funds.
- Repositioning funds - Moving Funds from one country to another or from one currency to another

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Why Reposition Funds

- For tax Reasons- locate profits in low-tax environments
- To move funds to areas with greater profit potential
- To move funds out of areas of economic or political problems
- To move funds from countries that have exchange controls

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Constraints on Positioning Funds

- Usually assumed for a domestic firm there is no problem in moving funds from one affiliate to another
- However for multinational firms there are often problems in moving funds

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Constraints - Continued

- 1) Political (examples - inconvertible currency, exchange controls and dividends and other remittances heavily taxed or limited in amount)
- 2) Taxes (example withholding)
- 3) Transaction costs (small / unit but add up over a year)
- 4) Liquidity needs (banks want firms to keep a portion of their funds at their banks)

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Unbundling

- Many firms transfer funds in many ways (unbundle the package) as opposed to transferring funds in only one way (often through dividends)
- It may be more acceptable politically to transfer funds in multiple ways (a firm would not want to make too large of a dividend payment)

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Ways to Transfer Funds

- 1) Dividends
- 2) License fees, royalties, overhead and loans
- 3) Transfer pricing
- 4) Leads and lags (discussed earlier)

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Dividends - Considerations

- 1) Taxes - complicated
  - withholding taxes
  - in Germany, different tax rates on retained vs. distributed earnings (which are lower)
  - countries have different tax rates
  - countries often give tax credits for foreign income taxes

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Dividend Considerations - Continued

- 2) Political risk (for example, if a host country is very risky the parent may want more dividends declared by the subsidiary)
- 3) Impending devaluation (would want subsidiary to speed up payables to the parent)
- 4) Availability of funds (are the funds available to declare a dividend)

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Dividend Considerations - Continued

- 5) Joint venture partner (presence of a partner may dictate a defendable dividend policy - joint venture partner will want his/her proper share of the profits)

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Royalties, Fees, Overhead and Loans - Considerations

- A parent can charge its subsidiaries for the use of technology, patents, trade names etc.
- Funds can effectively be transferred by over or undercharging from their true cost
- Royalties, fees, etc. are usually locally tax deductible while dividends are not tax deductible

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Transfer Pricing

- Price one unit of a company charges another unit of the company for goods or services
- The higher the price the more money the unit keeps and if the amount is above the “true” price this would amount to a transfer of funds
- A major consideration for transfer pricing in addition to positioning of funds is the income tax effect

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Example of Income Tax Effect on Transfer Pricing

- Parent's tax rate - 40%
- Sub's tax rate - 30%
- Parent buys finished goods from the sub
- Parent sells one good for $200
- Cost of goods sold for one unit is $100

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Example - Transfer Price of $200 (amounts in dollars)

	Sub	Parent	Total
Sales	200	200	200
CGS	100	200	100
EBT	100	0	100
Tax	30	0	30
EAT	70	0	70

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Example Transfer Price - $100 (amounts in dollars)

	Sub	Parent	Total
Sales	100	200	200
CGS	100	100	100
EBT	0	100	100
Tax	0	40	40
EAT	0	60	60

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Transfer Price Examples

- Principle: All things being equal, want to show as much profit as possible in country with the lowest tax rates

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Transfer Pricing - Tax Considerations

- U.S. Section 482 “suggest” using an arm’s-length price (price one independent unit would charge another independent unit)
- IRS - 3 methods to establish arm’s-length price (in order)
  - Comparable uncontrolled prices (market price)
  - Resale price method (final price - markup)
  - Cost-Plus method (full cost + markup)

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Other Considerations on Transfer Pricing

- 1) Tariffs (if a company pays a percentage of the transfer price would want, all things being equal, a low transfer price)
- 2) Transfer pricing may make it difficult to judge performance of subsidiaries
- 3) Transfer price should be fair to joint venture partner

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Blocked Funds

- Governments can limit transfers of foreign exchange of the country (examples - prior approval is needed to transfer and governments can make a currency inconvertible)

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Moving Blocked Funds

- 1) Use techniques discussed earlier for moving funds
- 2) Fronting loans
- 3) Creating unrelated exports
- 4) Obtaining special dispensation (bargain for a special deal with the local government)

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Fronting Loan

- Instead of Parent —loan→ Sub

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Fronting Loan - Continued

- Bank “fronts” for the company (note bank has 100% collateral)
- A government will more likely allow payment under the fronting loan than under the straight loan because its reputation will be hurt more if it does not allow a company to repay a major international bank
- In many cases bank may be from a neutral country

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Creating Unrelated Exports

- Examples:
  - Locate a R&D facility in a country that blocks funds (in this case pay expenses in local currency)
  - Have a big party (again pay expenses in local currency)

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Primary Purposes for Holding Cash Balances

- 1) Transaction needs
- 2) Precautionary reasons

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Centralized Depository

- Affiliates hold minimum cash for transactions and none for precautionary purposes
- Excess cash for each affiliate is remitted to depository
- Central depository invests excess funds for all subs and borrows if needed

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Advantages of a Depository

- Information advantage
  - the staff should know more about investment and borrowing opportunities worldwide than the financial manager at local subsidiary.
  - Also the more money they handle the better the information they should be able to obtain.
  - Also being located in a major financial center, it should have in general access to good and timely information.

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Advantages - Continued

- Total precautionary balance for company as a whole will be less than if each subsidiary holds its own balances (portfolio effect)
- With a depository should not run into the situation that one sub is borrowing money (at a high rate) while another sub is investing money at a bank (at a low rate)
- The depositories should locate in major money centers or other places that have major advantages.

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Disadvantage to the Centralized Depository

- It would require funds to set up and also to continually maintain

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Netting

- The table on the next slide represents the payment schedule for a month for a company with four subsidiaries or one parent and three subsidiaries
- In this case sub C owes sub A $2 and sub A owes sub C $3

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Paying Subsidiaries

Receiving Subsidiaries

	A	B	C	D	Total
A	-	1	2	3	6
B	0	-	1	1	2
C	3	2	-	1	6
D	2	0	1	-	3
Total	5	3	4	5	17

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Netting - Continued

- The worst system would be for each sub to pay the gross amount to all of the other subs (for example sub A pays $3 to sub C and sub C pays $2 to sub A) - this would result in a total of 12 transactions
- Better to have bilateral netting - for example, sub A would pay sub C $1 (6 transactions)

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Netting - Continued

- If every sub paid or received from a central pool there would be only four transactions - for example, sub A would receive $1 from the pool
- The best arrangement would be for the director of the pool to tell sub B to pay sub A $1 and sub D to pay sub C $2. This would involve only 2 transactions

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Netting - Continued

- Multilateral netting cuts down on the number of transactions as well as the $ amount of each transaction
- Some countries don’t allow netting (want to help local banks)

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Accounts Payable vs. Short-Term Debt

- Many times a company (domestic or foreign) will get a discount if it pays early.
- For example, credit terms of 5/10 net 50 means that if you pay in the first 10 days you only pay 95% of the bill or if you wait and pay in 50 days the entire amount of the bill is due.

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Accounts Payable vs. Short-Term Debt - Continued

- So if you don't take the discount, you would in effect be borrowing $95 and agree to payback $100, an interest rate of 5.26% (5/95) for 40 days (50-10). Assuming 365 days in a year, the number of times 40 goes into 365 is 9.125
- The yearly interest rate would be $(1.0526)^{9.125} - 1 = 59.6$ %

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Accounts Payable - Continued

- So take the discount even if short-term rates are lower than 59.6 % p.a.

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