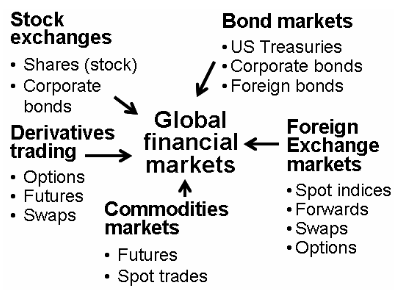
Finance and Accounting

Learning Objectives:

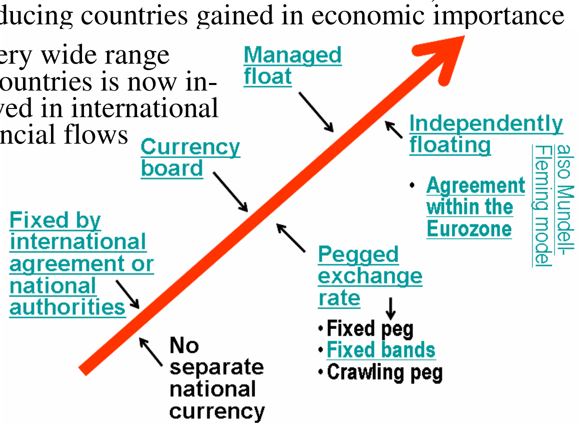
- *To gain an overview of the principles and workings of the international monetary system*
- *To become familiar with foreign exchange risks, and the tools available to manage them*
- *To understand the role of global financial markets in international business*
- *To evaluate the corporate financing options which allow firms to function internationally, together with their impacts on decision-makers, shareholders and other stakeholders*
- *To highlight key international accounting issues which impact on businesses at the international level and in diverse national environments*

The global financial markets

- Internationalization of investment and operations has made finance, once treated as subordinate to the core business activities, central to any corporate decision-making. The wider opportunities for international financial strategies are now available. This has also enhanced exposure to market risk and volatility.

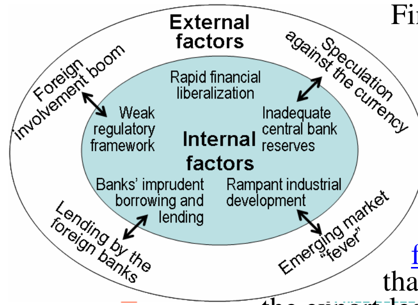


- **International monetary system**
  - Gold standard prevailed from 1870 to 1944.
  - As a result of the 1944 Bretton Woods agreement
    - Every currency fixed to the US$ that was fixed to gold
    - Reflected US status as the world's strongest economy
    - IMF founded to oversee global financial system
  - Bretton Woods broke down in the 1970s, when oil-producing countries gained in economic importance
  - A very wide range of countries is now involved in international financial flows



- **Lessons from the financial crises**

  1990s saw growth of emerging economies, with liberalized markets and high growth rates which attracted investors. Improved financial systems in these economies facilitated localization of financing foreign operations. These benefits provide the means to manage currency risk and associated political and legal risk. But this globalization of financial markets has brought interdependence and the risk that any market turmoil will create ripple effects world-wide. The underlying weaknesses here include (1) build-up of debt, often in dollars, (2) weak banking systems, etc.



Financial crises have external as well as internal origins, e.g., the 1997-98 **Asian Financial Crisis** that raised fears of a global economic melt-down was a [financial contagion] that occurred because the export-led economic growth of Southeast Asian countries piled huge dollar-denominated debt and strains on local currencies.

The need for (1) independent regulation of banks, and (2) monetary policy to support confidence in the currency are the two lessons that could be drawn from this crisis.

How about the current global financial crisis that started in 2007? In all probability, it reflects three problems that need to be addressed: (1) excessive quantification without adequate basis in the world of real finance, (2) increasing innumeracy of the corporate world, regulators and of public at large, and (3) excessive liquidity in the economy.

- **Global financial strategies:**
  - Transaction risks occur where a firm buys or sells in a foreign currency, payment can fluctuate with the currency. Hedging strategy is helpful in these situations, but longer term strategies are needed if these transactions are frequent. Global sourcing must consider currency risk, for instance, but where a local subsidiary deals in the local currency, this can act as a natural hedge.
  - Transfer pricing – managing pricing of products between subsidiaries, to maximize financial benefits.
  - The **hedge** is the tool that insures against adverse currency movement and includes spot contracts (settled on the day), forward contracts (for transaction on a set future date), options (they give the right, not the obligation, to sell/purchase on a future date at a specific rate) and swaps (instruments by which firms can customize terms by swapping them with another party).
  - Trading in **equities** is carried out on **stock exchanges** that are regulated by the national authorities and are becoming internationalized because of increasing numbers of foreign IPOs and investors.
  - Debt instruments, or **bonds**, are issued by both companies and governments.
  - **Debt/equity ratio** – balance between debt financing and equity financing (*where debt financing prevails, creditor's interests matter the most; when equity financing prevails, shareholder interests are the key*). It is the public companies that can issue shares or bonds.

Private company	Public company
• Few share-holders & shares not traded • Reliant on lenders such as banks & private equity	• Diverse shareholders & shares traded • Can issue corporate bonds