

## CHAPTER 3

# Legal, Technological, Accounting, and Political Environments



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### AFTER STUDYING THIS CHAPTER, YOU SHOULD BE ABLE TO:

1. Describe the major types of legal systems confronting international businesses.
2. Explain how domestic laws affect the ability of firms to conduct international business.
3. List the ways firms can resolve international business disputes.
4. Describe the impact of the host country's technological environment on international business.
5. Identify the factors that influence national accounting systems.
6. Explain how firms can protect themselves from political risk.

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## WHEN IS AN IPHONE NOT AN IPHONE?

The global market offers numerous opportunities for companies large and small to boost their revenues and profits by introducing new, innovative products. Surprisingly, one of the most important and complex issues in launching such products globally is finding the right name, particularly if the firm wishes to use the same brand name to represent the new product in every market it serves. Care needs to be taken to avoid names that might inadvertently be sending the wrong message about the product. For instance, Clairol's Mist Stick curling iron, Rolls-Royce's Silver Mist, and Irish Mist liquor had problems entering the German market under their original names because *mist* is the German word for dung.

Although cultural or language issues have tripped up many would-be global brands, legal issues are equally troublesome. Consider the travails of Apple. The most valuable assets of many multinational corporations (MNCs) is their intellectual property—trademarks, brand names, patents, etc. These firms' legal departments aggressively protect these assets by constantly monitoring markets around the world to make sure no one is infringing on their intellectual property. When Apple introduced the iPhone in 2007 and the iPad in 2010, its lawyers filed for trademark protection in every country Apple anticipated selling the products. Yet despite the sophistication of Apple's lawyers, the company has run into a series of legal problems over the use of those names. In Mexico, for instance, iFone, a Mexican telecommunications company, filed for a trademark under that name in 2003. Apple sued iFone in 2009 to invalidate iFone's trademark. iFone countersued;

in 2012, a Mexican court found in its favor, reasoning that iFone trademark was validly granted four years before Apple sold its first iPhone. The Mexican company is now suing Apple for trademark infringement. Under Mexican law, it can ask for damages equivalent to 40 percent of Apple's iPhone sales in Mexico.

Apple ran into similar problems in Brazil. IGB Eletronica SA, selling under the brand name Gradiente, applied for the iPhone trademark in Brazil in 2000. Brazil's National Institute of Industrial Property granted the application in 2008. Apple attempted to invalidate the trademark, but the effort proved unsuccessful. Under Brazilian law, Gradiente would lose the rights to the trademark if it went unused for five years; the Brazilian firm beat the deadline by one month, introducing the IPHONE Neo One in December 2012. To make matters worse, the Neo One uses the Android operating system, owned by Apple's bitter rival Google. Needless to say, Apple's ability to market its phones in the Brazilian market has been harmed.

Securing rights to the iPad trademark has also bedeviled Apple's lawyers. A bankrupt Chinese firm, Proview Technology, sued Apple over use of the name iPad in China. Apple had purchased the right to use the iPad trademark in 10 countries from Proview's Taiwanese subsidiary for \$55,000. The Chinese parent, however, claimed that its Taiwanese subsidiary did not own, and therefore could not sell, the iPad trademark in China. Facing a ban on iPad sales in parts of China, Apple agreed to pay Proview Technology an additional \$60 million for the rights to the iPad trademark in China.<sup>1</sup> ■

Virtually all decisions facing international managers—whom to hire, how to market their company's goods in the host market, which technologies to adopt, and so forth—are affected by the national environment of the country in which the transaction occurs, as Apple painfully discovered. The goal of this and the next chapter is to understand the impact of the various dimensions of a country's environment on the management of a firm's international business. This chapter discusses the legal, technological, accounting, and political dimensions, and Chapter 4 focuses on the cultural.

### The Legal Environment

A domestic firm must follow the laws and customs of its home country. An international business faces a more complex task: It must obey the laws not only of its home country but also the laws of all the host countries in which it operates. Both home and host country laws can critically affect the way international firms conduct their business. These laws determine the markets firms may serve, the prices they can charge for their goods, and the cost of necessary inputs such as labor, raw materials, and technology. The laws may also affect the location of economic activity. For example, some Internet companies have chosen to base their operations outside the People's Republic of China because of the seemingly arbitrary rules imposed by its government. "E-World" discusses some additional effects the rapid growth of the Internet has had on the legal systems of various countries.

## E-WORLD

## LAW AND THE INTERNET

Most existing laws predate the World Wide Web. Adjusting these laws to the needs of the Internet age is a massive undertaking, to say the least. One basic issue is deciding which country's laws should oversee e-commerce transactions. Activities sponsored by a website may be legal in its home country yet violate the laws of other countries. For example, Yahoo! Inc. was found guilty of allowing neo-Nazi paraphernalia to be sold on its websites in violation of a French law that prohibits the sale of anything that incites racism. Although Yahoo! had carefully excluded such goods from its French portal, it had not done so for its U.S. sites. Because French citizens had access to the U.S. websites over the Internet, Yahoo! was fined \$2,800 and given two months to make the site inaccessible to French Internet users.

The responsibility for enforcing intellectual property rights is similarly unresolved. For example, in June 2008, in a lawsuit filed by Hermès a French court ruled that eBay participated in the fraudulent sale of counterfeit goods because it provided a variety of services that facilitated such transactions. Later that month, a different French court ordered eBay to pay LVMH Moët Hennessy Louis Vuitton €40 million in damages, after finding that eBay failed to take sufficient steps to prevent the sale of unauthorized or counterfeit products that damaged the company's brand names. A month later, a U.S. court found in favor of eBay, in a similar lawsuit filed by Tiffany & Co. In August 2008, a Belgian court reached the same conclusion, siding with eBay in a suit filed by L'Oréal SA, as did a third French court and a British court in 2009. In 2011, the European Court of Justice added its opinion, ruling that if an online operator played an "active role" in sale of a fake product it could be held liable for trademark infringements.

National policies toward consumer privacy also need to be taken into account. Many U.S. companies routinely collect information from their customers that the companies then use internally to cross-sell other products or that they sell to third parties. For instance, many websites produce "cookies" that help facilitate repeat online transactions. Cookies allow an online travel vendor to remember customers' frequent flyer numbers, whether the customers prefer an aisle or a window seat, and the billing addresses of their credit cards. However, European laws provide consumers with stronger privacy protection than do U.S. laws. The European Union (EU) regulates the ability of companies to use cookies without obtaining permission from customers. U.S.-based web companies must thus alter their marketing and information-gathering practices to accommodate European privacy laws. In a similar vein, Switzerland has demanded



that Google obscure every face visible in its Street View mapping application to preserve individual's privacy. In 2013, the EU launched an investigation to determine whether Google sufficiently discloses to consumers how the company uses personal data it has collected.

Another issue is what to do with "cybersquatters"—people or firms who try to register domain names of established organizations or famous people and then sell back the names to their owners at inflated prices. For example, when Apple launched the iPhone for the British market in 2007, it discovered that cybersquatters had claimed web addresses such as [www.ukiphone.co.uk](http://www.ukiphone.co.uk), which featured nothing more than pay-per-click advertisements for other companies' products. The World Intellectual Property Organization (WIPO) operates an arbitration program to reduce this problem. Although victims are usually successful in reclaiming their property—they win about 85 percent of the cases adjudicated by WIPO—cybersquatting has not gone away. In 2010, for example, 2,696 complaints were filed with WIPO, up 80 percent from their 2006 level.

*Sources:* Based on "Ebay faces liability on fake goods," *Financial Times*, July 13, 2011, p. 22; "Ebay may be liable for counterfeit goods," *Wall Street Journal*, July 12, 2011 (online); "Cookie laws threaten to unravel web sales," *Financial Times*, May 26, 2011, p. 18; "EU to say location data is private," *Wall Street Journal*, May 13, 2011, p. B6; "Google plans to challenge Swiss ruling on mapping," *Wall Street Journal*, May 12, 2011, p. B5; "Ebay wins trademark-infringement case," *Wall Street Journal*, May 22, 2009; "French court says eBay not accountable for sale of L'Oréal fakes," *Wall Street Journal*, May 13, 2009; "L'Oréal loses suit on fakes sold on eBay," *Wall Street Journal*, August 13, 2008, p. B6; "Ebay wins fight over Tiffany counterfeits," *Wall Street Journal*, July 15, 2008, p. B1; "E Bay fined over selling counterfeits," *Wall Street Journal*, July 1, 2008, p. B1; "Domain-name complaints rise," *Wall Street Journal*, March 28, 2008, p. B6; "Cybersquatters target iPhone," *Financial Times*, September 27, 2007 (online); "Court setback for French buyers at web auctions," *Financial Times*, May 4, 2000, p. 3; "U.S. in tentative pact protecting Europeans' privacy," *Wall Street Journal*, February 24, 2000, p. B6; "Cybersquatters squeezed as Internet arbitration takes off," *Financial Times*, February 23, 2000, p. 18; "Land of laptops and lederhosen," *Financial Times*, February 17, 2000, p. 14; "Cross-border regulations create hurdle for cyber-shoppers," *Financial Times*, February 16, 2000, p. 7; "Border crossings," *Wall Street Journal*, November 22, 1999, p. R41; "In Europe, surfing a web of red tape," *Wall Street Journal*, October 29, 1999, p. B1; "Judge fines Yahoo! for neo-Nazi auction," *Houston Chronicle*, May 23, 2000, p. A4; [www.wipo.int](http://www.wipo.int).

### Differences in Legal Systems

National legal systems vary dramatically for historical, cultural, political, and religious reasons. The rule of law, the role of lawyers, the burden of proof, the right to judicial review, and, of course, the laws themselves differ from country to country. In the United States, for instance, in times of economic distress firms can lay off workers with minimal notice and severance pay. In Belgium, however, firms wishing to trim their workforces must provide each worker with three months' notice, three months' severance pay, or some combination of the two for every five years (or fraction of five years) the employee has worked for the firm. Brink's, for example, ran afoul of these laws when its Belgian subsidiary declared bankruptcy as a result of its high labor costs. Affected unions promptly sued the company for failure to negotiate severance pay, as the

and financial institutions have had to develop alternative financing arrangements to acquire and finance capital. Muslim businesses often rely on leasing arrangements, rather than borrowing money, to obtain long-term assets. In Iran banks often charge up-front fees that act as a substitute for loan interest payments, and owners of bank deposits receive shares of the bank's profits rather than interest payments. Family-owned firms are often influential in countries in which legal systems are based on the *Koran* because members of an owner's extended family may be the best available source of capital, given the costs of circumventing the prohibition on interest.

Countries relying on religious law often have other features, such as an absence of due process and appeals procedures, which should make outsiders cautious. In Saudi Arabia, for example, all foreign firms must have a local representative or sponsor, typically a government agency or a person well connected to the royal family. Should a commercial dispute arise between a foreign businessperson and the local representative, the local representative can have the foreigner detained by the local police. Because no independent judiciary exists in the country to protect the foreigner's rights, the foreigner is in a weak bargaining position.

**BUREAUCRATIC LAW** The legal system in communist countries and in dictatorships is often described as bureaucratic law. **Bureaucratic law** is whatever the country's bureaucrats say it is, regardless of the formal law of the land. Contracts can be made or broken at the whim of those in power. The collapse of Zairean dictator Mobutu Sese Seko's government in 1997, for example, threatened the viability of all existing contracts signed by foreign companies and triggered a mad scramble to revalidate old contracts and negotiate new ones with the government of his successor.<sup>5</sup> Protections that may appear in the country's constitution—such as the right to an attorney and the right to hear witnesses against one—may be ignored if government officials find them inconvenient. For instance, the formalities of Ugandan law afforded Ugandans and foreigners little protection under dictator Idi Amin's regime of terror during the 1970s. Similarly, the elaborate protections detailed in the constitution of the former Soviet Union offered little solace to the victims of Joseph Stalin's political purges during the 1930s. "Venturing Abroad" discusses a contemporary example of this phenomenon.

## VENTURING ABROAD

### HOW IMPORTANT IS THE RULE OF LAW?

As the eminent scholar and jurist Richard Posner has defined it, the rule of law means "that judges decide cases 'without respect to persons', that is, without considering the social status, attractiveness, etc. of the parties or of their lawyers." A well-functioning legal system with clearly defined rules and procedures often encourages foreign firms to invest in a country. But the opposite may also be true.

One country in which a lack of the rule of law appears to be affecting foreign direct investment (FDI) is Russia. Russian authorities are notorious for manipulating the Russian legal system to promote their personal agendas. For example, despite a constitutional guarantee for freedom of assembly, Russian officials arrested Brian Nemtsov, a former deputy prime minister, for attending a rally promoting freedom of assembly on New Year's Eve 2010. According to some human rights activists, the motive for his arrest was simply to demonstrate to political dissidents that the authorities could do what they wish.

Perhaps the most brazen example of the deficiency of the Russian rule of law is the second trial and conviction of former oil magnate Mikhail Khodorkovsky. He was the founder of OAO Yukos, once Russia's largest oil company. Yukos was a creation of the privatization process that followed the collapse of the Soviet Union. The selling off of state-owned assets created much controversy because critics charged that favored insiders benefited from a lack of transparency that characterized this privatization process. Khodorkovsky, once the richest man in the new Russia and the most powerful



of the new oligarchs (the term used to describe the business leaders made rich by the privatization process), committed the fatal mistake of making a political enemy of Vladimir Putin, the Russian Federation's second president and its most powerful political force. Khodorkovsky provided financing for political parties not friendly to Putin and argued for a strong, independent media. Khodorkovsky was arrested in 2003, convicted in 2005 of tax evasion, and sentenced to eight years in a Siberian prison. After the conviction, Yukos was forced into bankruptcy. Most of its assets were sold off at bargain basement prices to state-owned companies controlled by political allies of Putin to pay for the alleged unpaid taxes.

As his release date from prison drew nearer, Khodorkovsky and his partner Platon Lebedev were charged with stealing all the oil that Yukos produced. Khodorkovsky was convicted in December 2010 and sentenced to another six years in prison. Many observers viewed this second trial as a clear case of double jeopardy. They also viewed it as logically inconsistent with the charges filed in his first trial. If Khodorkovsky stole the oil, then Yukos would not have had any profits in the first place and thus could not have underpaid its taxes. If Yukos was guilty of tax evasion, then it must have owned the oil and then Khodorkovsky could not have stolen the oil. The suspicion that his original and subsequent arrest were politically motivated was heightened when in February 2011 an assistant to the presiding judge in the second trial claimed that the judge was pressured by his superior to deliver a guilty verdict and a harsh sentence. The Obama

(Continued)

administration denounced the verdict as an “abusive use of the legal system for improper ends.”

Many Russian citizens viewed Khodorkovsky's first conviction favorably. The oligarchs who rose to prominence in the 1990s after the breakup of the Soviet Union were perceived as benefiting from insider deals as state-owned assets were transferred to the private sector. But in the 2000s economic power appears to have been transferred from the oligarchs to bureaucrat-entrepreneurs, that is, government officials who used their government positions to enrich themselves and their friends. Administrative power, rather than property rights, became the basis of wealth. The concern is that firms, foreign and domestic, in such an environment will fail to make the long-term investments that are the basis of economic growth in developed economies. Other investors fear that if their investments

become too profitable they will attract the attention of state authorities, who will then use their positions to loot those assets: Such a fate befell Hermitage Capital, a foreign-financed firm that at one time was the largest investor in the Russian stock market.

*Sources:* Based on “Khodorkovsky derides reforms,” *Financial Times*, May 25, 2011, p. 2; “Russian tycoon’s sentence is upheld,” *Wall Street Journal*, May 25, 2011, p. A11; “Sergei Magnitsky and the rule of law in Russia,” *Wall Street Journal*, February 24, 2011; Dafna Linzer, “The problem with question 36,” *Slate*, February 23, 2011 (online); “Mikhail B. Khodorkovsky,” *New York Times*, February 15, 2011 (online); “Opposition battles repression in Russia,” *Washington Post*, January 28, 2011; “Doing things the Putin way,” *The Economist*, January 1, 2011; “White House criticizes Moscow court,” *Wall Street Journal*, December 27, 2010; “Frost at the core,” *The Economist*, December 11, 2010; “The trial, part two,” *The Economist*, April 24, 2010.

In countries relying on bureaucratic law, the ability of an international business to manage its operations is often compromised by bureaucrats. International managers are often confronted with arbitrary rules or decisions that have the force of law. This is often the case in China, for example. One study notes:

Chinese bureaucracies have sometimes been accused of selectively applying regulations. China has many strict rules that are usually ignored in practice until a person or entity falls out of official favor. Governmental authorities can wield their discretionary power to “crack down” on foreign or disfavored investors or make special demands on such investors simply by threatening to wield such power.<sup>6</sup>

Many international managers have learned the hard way that an unfortunate by-product of bureaucratic law is the lack of consistency, predictability, and appeal procedures.

International businesspeople must be aware of these general differences in legal systems to avoid costly misunderstandings. They should also rely on the expertise of local lawyers in each country in which they operate to help them comply with the specific requirements of local laws and to counsel them on substantive differences in due process, legal liabilities, and procedural safeguards.

### Domestically Oriented Laws

The laws of the countries in which an international business operates play a major role in shaping the opportunities available to that firm. Some of these laws are primarily designed to regulate the domestic economic environment. Such laws affect all facets of a firm’s domestic operations: managing its workforce (recruitment, compensation, and labor relations laws); financing its operations (securities, banking, and credit laws); marketing its products (advertising, distribution, and consumer protection laws); and developing and using technology (patent, copyright, and trademark laws). Although such laws are primarily focused on the domestic marketplace, they may indirectly affect the ability of domestic firms to compete internationally by increasing their costs, thus reducing their price competitiveness relative to foreign firms. For example, labor costs for manufacturers in Germany, France, and Belgium are among the world’s highest as a result of government-mandated benefits packages. These manufacturers, therefore, find that their products are less price competitive in export markets; many of them that compete internationally stress their products’ quality rather than their price.

Domestically oriented laws may also inadvertently affect the business practices of foreign firms operating outside the country’s borders. Often firms whose products are geared to the export market alter their production techniques to meet the regulations of the importing countries, even though the firms’ operations are legal within their home country. For example, Grupo Herdez chose to alter its production processes in Mexico to sell its goods in the U.S. market. Grupo Herdez is one of Mexico’s largest producers of *mole* (pronounced mo-lay), a spicy but sweet sauce made from chocolate and chili peppers. The firm’s traditional way of preparing the chilies for production—laying them out to dry in the sun for several days—failed to meet hygiene standards of the U.S. Food and Drug Administration (FDA). To receive the

necessary FDA approval and benefit from the growing U.S. market for Mexican foods, Grupo Herdez had to develop a new technology that uses electronic dryers to prepare the chilies for mole production.<sup>7</sup>

### Laws Directly Affecting International Business Transactions

Other national laws are explicitly designed to regulate international business activities. Such laws are often politically motivated and designed to promote the country's foreign policy or military objectives. A country may attempt to induce a second country to change an undesirable policy by imposing **sanctions**—restraints against commerce with that country. Sanctions may take many forms, such as restricting access to high-technology goods, withdrawing preferential tariff treatment, boycotting the country's goods, and denying new loans. For instance, the United Nations imposed financial sanctions against Sierra Leone and Liberia to cut the flow of arms to their war-torn countries, and the United States levied sanctions against Sudan and Myanmar (Burma) for human rights violations and against Iran for nuclear proliferation policy violations.<sup>8</sup>

An **embargo**—a comprehensive sanction against all commerce with a given country—may be imposed by countries acting in unison or alone. For example, the United Nations embargoed all trade with Iraq after Iraq's 1990 invasion of Kuwait. Most countries embargoed goods to or from South Africa during the 1980s to protest its apartheid policies. The United States has unilaterally embargoed trade with Cuba since 1961, when the attempted U.S.-supported overthrow of Fidel Castro died on the beaches of the Bay of Pigs.

A particularly important form of export control involves high-technology goods. Many technologically advanced countries limit the export of so-called **dual-use** products that may be used for both civilian and military purposes. McDonnell Douglas ran afoul of U.S. dual-use controls when it sold sophisticated machine tools to the China National Aero-Technology Import and Export Company, which claimed that the equipment would be used to build civilian aircraft. However, the tools were instead shipped to a military factory that builds ballistic and cruise missiles.<sup>9</sup> Similarly, Boeing agreed to pay a \$15 million fine because it sold China 94 commercial airliners whose avionics systems contained a tiny gyrochip that could be used to guide air-to-surface missiles, without receiving an export license, in violation of the Arms Control Export Act.<sup>10</sup>

Countries may also attempt to regulate business activities that are conducted outside their borders, a practice known as **extraterritoriality**. For example, firms are vulnerable to U.S. antitrust lawsuits if they engage in activities outside the United States that diminish competition in the U.S. market. In one such case the United States successfully sued Pilkington PLC, the British owner of the most important patents for producing flat glass, for limiting the ability of its U.S. licensees to use the technology in international markets. U.S. authorities claimed that Pilkington's policies hurt U.S. exports and reduced the incentive of U.S. flat glass producers to invest in research and development, thereby lessening competition.<sup>11</sup>

Antiboycott provisions in U.S. trade law also have extraterritorial reach. U.S. antiboycott law prohibits U.S. firms from complying with any boycott ordered by a foreign country that prohibits trade with a country friendly to the United States. This law is primarily directed against a 1954 resolution adopted by the League of Arab States that calls for a boycott of any firm that does business with Israel. Baxter International found itself in deep trouble after a U.S. grand jury investigated it for selling discounted hospital supplies to Syria, allegedly as a bribe for the Arab states terminating their boycott of the company. Baxter pleaded guilty to violating the antiboycott law and paid a fine of \$6.6 million.<sup>12</sup>

The Helms-Burton Act is probably the most controversial application of extraterritoriality affecting international business today. This act is directed against international firms that "traffic" in the assets of U.S. companies that were confiscated by the Cuban government when Castro assumed control in 1959. Over time the Cuban government has leased or sold many of these confiscated assets to foreign companies. The Helms-Burton Act authorizes the U.S. government and the former U.S. owners of the confiscated assets to take action against their new foreign owners. The U.S. government can deny entrance to the United States of officers of companies that benefit from the use of these confiscated assets; such a fate has befallen executives of Canada's Sherritt Corporation, which is producing nickel and cobalt from a mine formerly owned by Freeport McMoRan, a New Orleans-based natural resources company.

In the eyes of the U.S. government the Helms-Burton Act is simply designed to ensure that foreign companies do not profit from Cuban property that was stolen from U.S. owners. In the view of many other countries, such as Canada and the EU, the Helms-Burton Act is an ill-conceived policy of trying to bludgeon them into joining the U.S. anti-Castro crusade. By some estimates 85 percent of all foreign-owned private property in pre-Castro Cuba was owned by U.S. interests, so it is easy to see why the disposition of confiscated property in Cuba is more important to the United States than to other countries.<sup>13</sup>

### Laws Directed against Foreign Firms

On other occasions countries may pass laws that are explicitly directed against foreign-owned firms. Ownership issues are a particular area of concern. In most countries there is ongoing debate between the political left and right regarding the appropriate balance between governmental control of the economy and reliance on market forces to allocate resources. Often when leftist governments obtain power, they choose to transfer ownership of resources from the private to the public sector, a process known as **nationalization**. Most vulnerable to such actions are industries that lack mobility: natural resource industries such as crude oil production and mining, and capital-intensive industries such as steel, chemicals, and oil refining. For example, in 2008 Hugo Chávez, the then president of Venezuela, nationalized the steel and cement industries on grounds that they constituted “strategic sectors” of the economy. The previous year he nationalized private firms in the oil, power, and telecommunications industries.<sup>14</sup> Similarly, Zimbabwe is mandating that foreign-owned mining companies must divest majority ownership of their local subsidiaries to government entities or employee-owned groups.<sup>15</sup>

When the host government compensates the private owners for their losses, the transfer is called **expropriation**. When the host government offers no compensation, the transfer is called **confiscation**. Most governments, including that of the United States, recognize the right of other national governments to mandate the transfer of private property within their borders to the public sector, although nonhost governments do expect that foreign owners will receive suitable compensation for their lost property. For example, many Arab oil-producing countries nationalized the properties of Western oil firms after 1973. These countries, however, offered the Western firms a combination of compensation, continuing operating agreements, and future drilling rights that the firms found acceptable. Conversely, a key element in the U.S. conflict with Cuba is Cuba's lack of compensation for assets seized from U.S. firms.

**PRIVATIZATION** The conversion of state-owned property to privately owned property is called **privatization**. Although not strictly an issue of host country control, privatization is the opposite of nationalization and creates opportunities for international businesses. Most state-owned enterprises sold to the private sector are unprofitable, undercapitalized, and overstaffed. Nevertheless, they are often attractive to international businesses seeking to expand their operations into new markets located in key sectors of a national economy, such as telecommunications, transportation, and manufacturing.

Privatization, which gained momentum in the 1980s, stems from two primary forces: political ideology and economic pressure. Political ideology prompted Margaret Thatcher, the prime minister of the United Kingdom from 1979 to 1990, to call for diminishing the role of the state in the economy. During the 1980s the British government sold its interests in British Airways, British Telecom, the British Airport Authority, and British Petroleum. Brian Mulroney, head of Canada's Progressive Conservative Party, followed a similar agenda during his tenure as Canada's prime minister from 1984 to 1993, as did the leaders of Argentina, Brazil, Chile, Mexico, and many other countries during the 1990s.

Privatization has also resulted from competitive pressures that firms face in global markets. The telecommunications industry provides a perfect example of this phenomenon. That industry has benefited from rapid technological change, yet many national governments, facing enormous budgetary pressures and deficits, have found it difficult to raise the capital required to upgrade and expand state-owned telecommunications systems. As a result, countries such as Argentina, Mexico, Chile, and the United Kingdom have privatized telecommunications services.

**CONSTRAINTS ON FOREIGN OWNERSHIP** Many governments limit foreign ownership of domestic firms to avoid having their economies or key industries controlled by foreigners.

For example, Mexico restricts foreign ownership in its energy industry, believing that the benefits of its oil reserves, which it views as part of its “national patrimony,” should accrue only to its citizens. Canada effectively limits foreign ownership of newspapers to 25 percent as part of its program to protect the country’s culture from being inundated by its neighbor to the south. Foreign firms are often excluded from the radio and television broadcasting industries. For example, the United States limits foreigners to 25 percent ownership of U.S. television and radio stations. Similar rules exist in Europe.

Countries can also constrain foreign MNCs by imposing restrictions on their ability to **repatriate** (return to their home countries) the profits earned in the host country. Such restrictions were common in the 1980s, but many countries, such as Botswana and Ethiopia, abolished their repatriation controls during the 1990s as they adopted more free-market-oriented policies.

### The Impacts of MNCs on Host Countries

Firms establishing operations beyond the borders of their home country affect and are affected by the political, economic, social, and cultural environments of the host countries in which the firms operate. To compete effectively in these markets and maintain productive relationships with the governments of the host countries, managers of MNCs must recognize how they and their firms should interact with the national and local environments.

**ECONOMIC AND POLITICAL IMPACTS** MNCs affect every local economy in which they compete and operate. Many of the effects are positive. For instance, as Western supermarket chains such as France’s Carrefour enter the Chinese market, they offer Chinese consumers greater selection, national brands, and high standards of hygiene. MNCs may make direct investments in new plants and factories, thereby creating local jobs. Such investments provide work for local contractors, builders, and suppliers. MNCs also pay taxes, which benefit the local economy and help to improve educational, transportation, and other municipal services. Technology transfer can also have positive local effects. An important benefit to the Shanghai Automotive Industry Corporation of its joint venture with Volkswagen was access to the latest German automotive technology. Similarly, General Electric raised the productivity of Hungary’s largest lightbulb manufacturer by transferring technological knowledge to the Hungarian firm.

MNCs may also have negative effects on the local economy. To the extent that MNCs compete directly with local firms, the MNCs may cause these firms to lose both jobs and profits. For instance, Carrefour’s entry into the Chinese market makes it more difficult for mom-and-pop operators in China’s open-air food markets to eke out a living.<sup>16</sup> Also, as a local economy becomes more dependent on the economic health of an MNC, the financial fortunes of the firm take on increasing significance. When retrenchment by an MNC is accompanied by layoffs, cutbacks, or a total shutdown of local operations, the effects can be devastating to a local economy.

MNCs also may have a significant political impact, either intentionally or unintentionally. Their sheer size often gives them tremendous power in each country in which they operate. Furthermore, there is always the possibility that this power may be misused. Even when it is not, MNCs are often able to counter efforts by host governments to restrict their activities. The MNCs simply threaten to shift production and jobs to other locations.

**CULTURAL IMPACTS** MNCs also can exert a major influence on the cultures in which they operate. As they raise local standards of living and introduce new products and services previously unavailable, people in the host cultures develop new norms, standards, and behaviors. Some of these changes are positive, such as the introduction of safer equipment and machinery, better health care and pharmaceuticals, and purer and more sanitary food products. Other changes are not positive. Nestlé, for example, has received much criticism for its promotion of infant formula in the world’s developing countries. Mothers in these countries were allegedly enticed into buying the formula but were not trained in its proper use. The mothers diluted the formula to make it go further and often were unable to follow adequate sanitation procedures. As a result, critics argue, infant mortality in these countries increased significantly.

The entry of Western retailers like Carrefour into the Chinese market has increased the selection and quality of goods available to the country's consumers. But competition from foreign MNCs makes it harder for mom-and-pop vendors in China's open-air markets to stay in business.



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### Dispute Resolution in International Business

Disputes in international commerce can be complicated. Typically, four questions must be answered for an international dispute to be resolved:

1. Which country's law applies?
2. In which country should the issue be resolved?
3. Which technique should be used to resolve the conflict: litigation, arbitration, mediation, or negotiation?
4. How will the settlement be enforced?

Many international business contracts specify answers to these questions to reduce uncertainty and expense in resolving disputes. The courts of most major trading countries will honor and enforce the provisions of these contracts, as long as they are not contrary to other aspects of the country's public policy.

If a contract does not contain answers to the first two questions, each party to the transaction may seek to have the case heard in the court system most favorable to its own interests, a process known as **forum shopping**. Forum shopping allegedly places U.S. manufacturers at a disadvantage in international markets. Monetary awards are higher in U.S. courts, so many plaintiffs' lawyers attempt to use these courts to adjudicate foreign lawsuits for product defects in U.S.-made goods sold internationally. In contrast, a foreign manufacturer of a good sold outside the United States would not face the threat of having to defend its product in a U.S. court because the manufacturer lacked a tie to that forum.

Whether a foreign court order is enforced is determined by the **principle of comity**. The principle of comity provides that a country will honor and enforce within its own territory the judgments and decisions of foreign courts, with certain limitations. For the principle to apply, countries commonly require three conditions to be met:

1. Reciprocity is extended between the countries; that is, country A and country B mutually agree to honor each other's court decisions.
2. The defendant is given proper notice.
3. The foreign court judgment does not violate domestic statutes or treaty obligations.<sup>17</sup>

Because of the costs and uncertainties of litigation, many international businesses seek less expensive means of settling disputes over international transactions. Often business conflicts will be resolved through alternative dispute resolution techniques, such as arbitration. **Arbitration** is

the process by which both parties to a conflict agree to submit their cases to a private individual or body whose decision they will honor. Because of the speed, privacy, and informality of such proceedings, disputes can often be resolved more cheaply than through the court system. For example, a five-year-old conflict between IBM and Fujitsu over the latter's unauthorized use of proprietary IBM software that was moving slowly through the U.S. judicial system was settled quickly with the help of two neutral arbitrators from the American Arbitration Association.<sup>18</sup> Similarly, 16 francophone African nations have established a regional commercial arbitration court in Abidjan, Côte d'Ivoire. By providing a site for resolving commercial disputes independent of behind-the-scenes politicking or pressures from a host government, this court should encourage more international trade and investment in the 16 countries.<sup>19</sup>

Another set of issues arises when an international business is in a dispute with a national government. The legal recourse available to international businesses in such disputes is often limited. For example, the U.S. **Foreign Sovereign Immunities Act of 1976** provides that the actions of foreign governments against U.S. firms are generally beyond the jurisdiction of U.S. courts. Thus, if France chose to nationalize IBM's French operations or to impose arbitrary taxes on IBM computers, IBM could not use U.S. courts to seek redress against the sovereign nation of France. However, the Foreign Sovereign Immunities Act does not grant immunity for the commercial activities of a sovereign state. If the French government contracted to purchase 2,000 servers from IBM and then repudiated the contract, IBM could sue France in U.S. courts.

Countries often negotiate bilateral treaties to protect their firms from arbitrary actions by host country governments. These treaties commonly require the host country to agree to arbitrate investment disputes involving the host country and citizens of the other country. The United States and Jamaica have such a treaty. When the Jamaican government announced a tax increase on Alcoa's aluminum refining plant despite a contract between the two parties that prohibited such an increase, Alcoa was able to force the Jamaican government to submit its decision to arbitration.<sup>20</sup>

### In Practice

- Laws and legal systems vary widely among the nations of the world. Savvy international business practitioners always seek local counsel to help them navigate the requirements of the host country's laws.
- Because the Internet so easily spans national boundaries, e-commerce is particularly vulnerable to inadvertently violating local laws.

*For further consideration:* What could Apple have done to reduce its legal problems after deciding to market the iPhone and iPad using a global brand name?

## The Technological Environment

Another important dimension of a country is its technological environment. The foundation of a country's technological environment is its resource base. Some countries, such as Australia, Argentina, and Thailand, are blessed with much fertile agricultural land. Other countries, like Saudi Arabia, South Africa, and Russia, are endowed with rich natural resources such as oil, gold, and diamonds. Countries like Bangladesh and Indonesia have abundant labor supplies, whereas other countries, such as Iceland and New Zealand, do not. The availability or unavailability of resources affects what products are made in a given country. Because of their abundance of fertile land, Australia, Argentina, and Thailand are major exporters of agricultural goods. Similarly, the easy availability of low-cost labor allows firms in Bangladesh and Indonesia to produce labor-intensive products for the world market. Conversely, firms in Iceland and New Zealand are net importers of such products because these firms lack low-cost labor, which hinders their ability to manufacture labor-intensive goods profitably.

Countries may change or shape their technological environments through investments. Many countries, such as Canada, Germany, and Japan, have invested heavily in their infrastructures—highways, communications systems, waterworks, and so forth—to make producing and distributing products easier. Similarly, many countries have invested heavily in human capital.

be in violation of Yamaha's patents if they purchased CyberOptics' services. Consequently, the Minneapolis firm sued Yamaha for breach of contract and infringement of its patents. The case was later settled out of court.<sup>23</sup>

Registration of trademarks and brand names can also cause problems for international businesses. Generally, most countries follow a first-to-file approach, which often lends itself to abuses against foreigners. A firm may popularize a brand name or trademark in its home market, only to find, when it attempts to export its product to a second country, that an opportunistic entrepreneur has already applied for the intellectual property rights in that country. Some countries adopt a use-it-or-lose-it philosophy, which can prove troublesome to foreign firms. For example, J.C. Penney, which had registered its trademark in most markets to establish its first-to-file claim, lost the rights to its name in Singapore to a small entrepreneur who adopted the name "JC Penney Collections" for her two clothing stores. The High Court of Singapore, although acknowledging that J.C. Penney had validly registered its trademark in that country, determined that the U.S. firm had lost the right to its company name for failure to exercise its use in Singapore.<sup>24</sup> And Starbucks' entry into the Russian market was delayed for several years while it struggled to regain the rights to use its brand name from a trademark squatter. The delay allowed local and foreign rivals to gain a foothold in the Russian market and tie up the best sites for coffeehouses.<sup>25</sup>

Administrative delays may also hurt the rights of intellectual property owners. In Japan approval of a trademark application often takes four times as long for a foreign firm as for a Japanese firm. Approval of foreign patent applications may also take a long time. For example, three decades elapsed before Japanese courts recognized Texas Instruments' (TI) original patents on integrated circuits in 1989, substantially reducing TI's royalty payments from Japanese licensees. Some firms, such as Fujitsu, were able to avoid paying TI any royalties, arguing that Fujitsu's circuit designs rely on newer, more improved technology rather than on TI's original patents. In essence the slowness of Japan's judicial process allowed companies like Fujitsu to benefit from TI's technology during the early days of the semiconductor industry without having to compensate TI for its intellectual property.<sup>26</sup>

### In Practice

- Intellectual property is an important asset for most multinational companies. Protecting their rights to this property is thus a matter of the highest priority for firms from both legal and strategic perspectives.
- Laws protecting intellectual property vary dramatically from country to country, making it critical that international businesses deal with knowledgeable local attorneys to secure their rights in each country that they do or may want to do business in.

*For further consideration:* What can software firms do to reduce the piracy rate in developed markets? In emerging markets like China?

## The Accounting Environment

Differences in the policies and procedures of national accounting systems can create significant operational and control problems for an international business, which must develop an accounting system that provides both the internal information required by its managers to run the firm and the external information needed by shareholders, lenders, investors, and government officials in all the countries in which the firm operates.

### The Roots of National Differences

A country's accounting standards and practices reflect the influence of legal, cultural, political, and economic factors, as Figure 3.1 indicates.<sup>27</sup> Because these factors vary by country, the underlying goals and philosophy of national accounting systems also vary dramatically.

Consider first the difference between common law and code law countries. In common law countries such as the United Kingdom and the United States, accounting procedures normally

procedures of the United Kingdom, whereas former colonies of France and the Netherlands have adopted those of their colonial rulers. Similarly, the accounting procedures of the Philippines follow those of the United States, which controlled that country from 1898 to 1946.

A country's economic system also influences its accounting practices. In a centrally planned economy the accounting system is driven by the need to provide output-oriented information to the state planners. Such accounting systems focus on documenting how state funds are used and whether state-mandated production quotas are being met.<sup>30</sup> In market-oriented systems, on the other hand, managers and investors require profit- and cost-oriented information.

Capital markets also may affect national accounting standards. U.S. firms historically have raised capital by relying on public investors. U.S. accounting standards therefore emphasize the provision of accurate and useful information to help outsiders—private shareholders and bondholders—make appropriate investment decisions. As part of this goal, publicly owned firms must satisfy all the disclosure regulations of the Securities and Exchange Commission (SEC). Unfortunately, these disclosure regulations were not perfect, as Enron's bankruptcy demonstrates. To remedy the problems uncovered by the Enron debacle, the Sarbanes-Oxley Act of 2002 (see "Bringing the World into Focus") imposes new corporate governance and financial reporting requirements on companies publicly traded in the United States. The SEC has also issued new regulations addressing these issues, with the goal of making the accounting statements and governance of these companies clearer and more understandable to investors. In contrast, in Germany the dominant role of a few large banks in providing capital results in accounting practices that focus on the needs of creditors, for example, by tending to undervalue

## BRINGING THE WORLD INTO FOCUS

### THE SARBANES-OXLEY ACT

The accounting scandals surrounding Enron, Tyco, and WorldCom threatened more than the accounting profession. The U.S. Congress feared that investors could lose faith in the U.S. capital market if they no longer trusted public accountants or corporate accounting statements. If so, the cost to U.S. firms of acquiring capital could rise, which would lessen their competitiveness in world markets. To restore the public's trust in the capital market, Congress passed the Public Company Accounting Reform and Investor Protection Act of 2002, more commonly known as the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act has several objectives. First, it addresses perceived public accounting problems. The act establishes the Public Company Accounting Oversight Board, which is tasked with developing and enforcing ethical and auditing standards for auditors of public companies. The act forbids accounting firms from providing certain consulting services to firms that they audit. This requirement is a direct response to conflicts of interest that arose between Arthur Andersen and Enron, for Arthur Andersen earned far more from Enron for providing consulting services than auditing services. Many critics believed that Arthur Andersen's willingness to challenge Enron's more dubious accounting practices was compromised by its fear of losing its lucrative consulting business with Enron.

Second, the act strengthens corporate governance of publicly owned corporations by imposing new requirements on corporate executives, auditors, and the company's board of directors. No corporate executive can serve on the audit committee of the board of directors, and any disagreement over accounting procedures between the auditors and company executives must be reported to the audit committee. The chief executive officer (CEO) and chief financial officer (CFO) are required to certify that the corporation's financial statements "fairly present, in all material respects, the operations and financial condition" of the corporation. This requirement is designed



to eliminate the "I didn't know" defense used by corporate officers in several recent high-profile court cases.

A critical component of the Sarbanes-Oxley Act is Section 404, which mandates that the managers of a publicly traded corporation must create "adequate internal control structure and procedures for financial reporting," which then must be reviewed by the firm's auditor. The CEO, the CFO, and the auditors are required to certify to the company's shareholders and to the SEC their assessment of the quality and adequacy of the company's internal controls.

The act has proven to be highly controversial, particularly because the high costs of complying with Section 404's requirements fall more heavily on small companies than larger ones. The act's passage has also negatively affected the competitiveness of U.S. stock exchanges. Many foreign firms are choosing not to list their shares in the U.S. public capital market, thereby avoiding the costs of complying with Sarbanes-Oxley. In 2000, for example, the New York Stock Exchange was capturing almost 90 percent of the market for new listings of foreign companies when competing against the London and Luxembourg stock exchanges. By 2005, 90 percent of the new listings were acquired by those rivals. The number of stocks listed on U.S. exchanges has fallen by 43 percent since 1997; during that span, listings outside the United States have more than doubled. Ironically, the main beneficiaries of the act—which was passed in part because of their poor performance—are the surviving Big Four accounting firms, whose business is booming because of the additional workload demanded by Sarbanes-Oxley.

Sources: Based on "U.S. falls behind in stock listings," *Wall Street Journal*, May 26, 2011, p. A1; "Please be patient," *Wall Street Journal*, May 25, 2006, p. A14; "Taking their business elsewhere," *Businessweek*, May 22, 2006 (online); "New York loses edge in snagging foreign listings," *Wall Street Journal*, January 26, 2006, p. C1; "A price worth paying?" *The Economist*, May 21, 2005, p. 71; "Teething troubles," *The Economist*, May 21, 2005, p. 72.

assets and overvalue liabilities. This conservative approach is favored by the lending banks. The public capital market has been much less important in Germany than in the United States, and German accounting practices provide less information to public investors than do U.S. methods.<sup>31</sup>

The situation is similar in Japan. Most publicly traded Japanese firms are members of a *keiretsu*. They have relatively few public shareholders because of the pervasive cross-ownership of shares among keiretsu members and the extensive share ownership by banks and other financial institutions. Most Japanese firms also have large debt-to-equity ratios by Western standards. Thus, Japanese accounting standards are geared toward meeting the needs of a firm's lenders and keiretsu partners, both of which already have privileged access to the firm's financial records, rather than the needs of outside investors. However, the lack of transparent accounting standards often affects the ability of firms in less developed countries to raise capital.

### Differences in Accounting Practices

Political, cultural, legal, and economic forces affect each country's philosophy and attitude toward its accounting system. They also affect the way a country's accountants treat different accounting issues. These different treatments in turn impact a firm's reported profits, the value of its assets, its tax bill, and its decision to begin or continue operating in a country. International businesses that rely on foreign accounting records but fail to recognize these differences may make expensive, perhaps fatal, strategic errors and operating mistakes, as "Venturing Abroad" suggests. Let U.S. look at some of the more important national accounting differences that affect international business.

**VALUATION AND REVALUATION OF ASSETS** Most countries' accounting systems begin with the assumption that a firm's assets should be valued on a historical cost basis. That is, an asset is carried on the firm's books according to the asset's original cost, less depreciation. Because of inflation, however, the market value of an asset is often higher than its historical cost. The resolution of this problem differs among national accounting systems. Dutch firms are permitted to raise the value of such assets on their balance sheets to reflect the assets' true replacement value. British accountants may exercise their professional discretion and value assets on a historical cost basis, a current cost basis, or a mixture of the two. Australia, an inheritor of British accounting philosophy, similarly grants a firm's accountants a great degree of professional discretion. Australian firms may alter the value of long-term assets on their balance sheets to take into account inflation or improved economic conditions. In the United States and Japan, however,

## VENTURING ABROAD

### CHINESE ACCOUNTING BURIES CATERPILLAR'S INVESTMENT

Caterpillar, a leading global provider of earth-moving equipment, excavators, and specialized mining vehicles, provides a vivid example of the costs of not understanding accounting differences among nations. Company executives were eager to increase Caterpillar's presence in the booming Chinese market, which currently accounts for half of the world's construction equipment market. Although world-renown for the quality and durability of its rugged equipment, Caterpillar found it hard to compete in the Chinese market, which emphasized low prices, political connections, and "good enough" products. To bolster its presence in China, in June 2012 it purchased ERA Mining Machinery Ltd, one of the leading domestic suppliers of roof support equipment for underground coal mines in China, for \$700 million. But within nine months of the transaction, Caterpillar was forced to write off \$580 million of its investment in ERA, attributing the action to the discovery of "deliberate, multiyear, coordinated



accounting misconduct." At issue were ERA's revenue recognition procedures and discrepancies between actual and reported inventory levels. At least one senior Caterpillar executive departed the company, presumably for failure to conduct appropriate levels of due diligence for the transaction. While the write-off of 83 percent of its investment is embarrassing enough for the Illinois-based company, even more troubling is the setback in Caterpillar's plans to boost its market share in the China market. Currently, Caterpillar earns only 3 percent of its revenues from the huge Chinese market, despite having 23 factories, 4 R&D centers, and 15,000 employees in China.

*Sources:* Based on "Caterpillar Chief Faults China Unit," *Wall Street Journal*, January 28, 2013, p. B2; "Deal Trips up Caterpillar in China," *Wall Street Journal*, January 22, 2013, p. B1; "Caterpillar Finds Accounting Misconduct at Chinese Unit," *Wall Street Journal*, January 9, 2013, p. B4.

The use of such reserves hampers outside investors' ability to assess German firms' performance. Often these firms use reserve accounts to smooth out fluctuations in their earning flows by adding large sums to their reserves in good years and dipping into their reserves in poor years. Because of their use of accounting reserves, the reported earnings of German firms often fluctuate less than those of comparable U.S. firms, giving the misleading appearance that the former are less risky than the latter. These accounting differences complicate investors' decision making regarding how to diversify their portfolios internationally to reduce overall investment risk.

**OTHER DIFFERENCES** Many other differences exist in the way countries treat accounting issues. The following are a few examples:

- *Capitalization of financial leases*: U.S., British, and Canadian firms must capitalize financial leases, whereas Swiss firms may do so but are not required to do so.
- *Capitalization of research and development (R&D) expenses*: Most countries permit firms to capitalize R&D expenses, but this practice is forbidden in the United States except in limited circumstances.
- *Treatment of goodwill*: A firm that acquires a second firm often pays more than the book value of the acquired firm's stock. The excess payment is called **goodwill**. In the Netherlands firms typically amortize goodwill over a 5-year period, although they may write it off instantaneously or over a period of up to 20 years. UK firms also are allowed to choose between immediately writing off goodwill or capitalizing it on their balance sheets and amortizing it over a period of time. Japanese and French firms may amortize goodwill as well.

### Impact on Capital Markets

The various national differences in accounting practices would be little more than a curiosity were it not for international businesspeople's need for information to make decisions. These differences can distort the measured performance of firms incorporated in different countries. As already noted, the earnings of German and French firms often are understated because of the congruency between financial reporting and tax reporting. The price-to-earnings ratios of Japanese firms are frequently higher than those of U.S. firms, primarily because Japanese accounting practices often substantially reduce reported profits. For example, Japanese firms report depreciation expenses on an accelerated basis to their shareholders and are allowed to create generous reserve funds for future pension liabilities. The overall impact of these accounting differences is clear: Comparing the financial reports of firms from different countries is exceedingly complex, making it more difficult for international investors to assess the performance of the world's businesses.

These differences can affect the global capital market in other ways. The New York Stock Exchange (NYSE), for example, is concerned about SEC-mandated accounting rules that must be followed by publicly traded corporations under the SEC's jurisdiction. Those rules emphasize full and comprehensive disclosure of a firm's financial performance information, and the NYSE fears that the rules discourage foreign firms from listing on the exchange, thereby threatening the exchange's global competitiveness.<sup>34</sup> The Sarbanes-Oxley Act of 2002 has worsened this problem, as "Bringing the World into Focus" on page 94 indicated; increasingly, foreign firms are choosing to list their stocks on European or Asian stock exchanges, rather than the NYSE.<sup>35</sup> Consider the plight of Philips NV. As a Dutch company, it must first comply with Dutch accounting standards. To list its stock on the NYSE, Philips must then undergo the expense of reworking its financial statements to meet SEC requirements as well as comply with the requirements of Sarbanes-Oxley.<sup>36</sup>

The information-laden accounting practices used by U.S. firms do offer them certain advantages, however. Many foreign bankers believe that the United States is the easiest foreign locale in which to lend because of U.S. public disclosure policies. Those policies result in reliable numbers for assessing the riskiness of potential loans. In contrast, the German accounting system, which allows firms to lump together various cost categories and establish a variety of reserves, is much less helpful for a potential foreign lender. As one investment manager has noted, "The poor quality of financial information available from many German companies makes it difficult for investors to buy a stock with confidence, since valuations cannot be clearly established."<sup>37</sup> In hopes of improving their standing with institutional investors, many German MNCs adopted either U.S. GAAP or the **International Financial Reporting Standards (IFRS)**, an alternative

transparent approach to financial reporting issued by the International Accounting Standards Board (IASB). The FASB, which establishes U.S. accounting standards, and the IASB have been negotiating to standardize their treatment of accounting issues, but progress has been slow.<sup>38</sup>

### In Practice

- Every nation establishes its own accounting standards and procedures. These differences complicate the tasks of interpreting and comparing the financial statements of firms domiciled in different countries.
  - The U.S. Securities and Exchange Commission's policies promote transparency in the financial statements of firms wishing to rely on the U.S. public capital markets. This transparency helps investors in evaluating the performance and riskiness of such firms.
- For further consideration:* The Sarbanes-Oxley Act has imposed new corporate governance and disclosure requirements on firms accessing the U.S. public capital market. What are the benefits of Sarbanes-Oxley? What are its costs? Should the law be modified or repealed?

## The Political Environment

An important part of any business decision is assessing the political environment in which a firm operates. Laws and regulations passed by any level of government can affect the viability of a firm's operations in the host country. Minimum-wage laws affect the price a firm must pay for labor; zoning regulations affect the way it can use its property; and environmental protection laws affect the production technology it can use as well as the costs of disposing of waste materials. Adverse changes in tax laws can slowly destroy a firm's profitability. Civil wars, assassinations, or kidnappings of foreign businesspeople and expropriation of a firm's property are equally dangerous to the viability of a firm's foreign operations.

### Political Risk

Most firms are comfortable assessing the political climates in their home countries. However, assessing the political climates in other countries is far more problematic. Experienced international businesses engage in **political risk assessment**, a systematic analysis of the political risks they face in foreign countries. **Political risks** are any changes in the political environment that may adversely affect the value of a firm's business activities. Most political risks can be divided into three categories:

- Ownership risk, in which the property of a firm is threatened through confiscation or expropriation
- Operating risk, in which the ongoing operations of a firm or the safety of its employees are threatened through changes in laws, environmental standards, tax codes, terrorism, armed insurrection, and so forth
- Transfer risk, in which the government interferes with a firm's ability to shift funds into and out of the country

As Table 3.2 shows, political risks may result from governmental actions, such as passage of laws that expropriate private property, raise operating costs, devalue the currency, or constrain the repatriation of profits. Political risks may also arise from nongovernmental actions, such as kidnappings, extortion, and acts of terrorism.

Political risks may affect all firms equally or focus on only a handful. A **macropolitical risk** affects all firms in a country; examples are the civil wars that tore apart Sierra Leone, Zaire, Bosnia, and Rwanda in the 1990s or the recent conflicts in Afghanistan, Iraq, Libya, and Syria. A **micropolitical risk** affects only a specific firm or firms within a specific industry. Saudi Arabia's nationalization of its oil industry in the 1970s is an example of a governmentally imposed micropolitical risk, as is the Venezuelan government's recent requirements that foreign oil companies renegotiate their contracts with the government.<sup>39</sup> Nongovernmental micropolitical risks are also important. Disneyland Paris and McDonald's have been the target of numerous

River, so earning the goodwill of local residents is money well spent.<sup>41</sup> Similarly, Vale and Rio Tinto agreed to support educational, agricultural, and infrastructure projects to ensure that Guinea's newly elected president would honor the licenses granted by his predecessor allowing the two companies to mine the high-quality iron ore, worth an estimated \$2.5 billion, found in Guinea's Simandou field.<sup>42</sup>

To reduce the risk of foreign operations, most developed countries have created government-owned or government-sponsored organizations to insure firms against political risks. For instance, the **Overseas Private Investment Corporation (OPIC)** insures U.S. overseas investments against nationalization, insurrections or revolutions, and foreign-exchange inconvertibility. In a typical transaction, OPIC sold Plant-Tech Concrete Solutions, a Maryland building supply company, \$2.8 million of political risk insurance, allowing it to construct a facility producing low-cost concrete products in Angola.<sup>43</sup> However, OPIC insurance is limited to firms operating in countries with which the United States has signed bilateral investment treaties. The **Multilateral Investment Guarantee Agency (MIGA)**, a subsidiary of the World Bank, provides similar insurance against political risks. Private insurance firms, such as Lloyd's of London, also underwrite political risk insurance.<sup>44</sup>

### In Practice

- The definition of political risk is broad. Political risk is everywhere, but some risks are manageable and foreseeable, others are not. Some political risks are mere annoyances; others threaten the viability of the firm.
- Firms have multiple sources of information about political risks. Employees, embassy officials, and political risk consultants are available to help firms manage their political risks.

*For further consideration:* Does the CAGE model (page 29) provide any insights into assessing and managing political risk?

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## CHAPTER REVIEW

### Summary

The legal systems used by the world's countries vary dramatically. The former British colonies follow the common law tradition of the United Kingdom, whereas most other Western countries use the civil law system that originated with the Romans. A few countries, such as Iran and Saudi Arabia, use religious law, while centrally planned economies use bureaucratic law.

Laws adopted by national governments can influence the global marketplace in many ways. A country can impose restrictions on the ability of firms to conduct business internationally and can indirectly affect their competitiveness by raising their costs of doing business. A country's laws may also

have extraterritorial reach, affecting transactions conducted beyond the country's borders.

MNCs operating in a host country can influence the country's economic, political, and cultural environments. Often these changes are positive. For example, FDI generates new employment opportunities and raises the productivity of local workers. MNCs can also impact the host country negatively by increasing competition for workers or by introducing products or practices incompatible with the local culture.

Resolution of international disputes is an important dimension of the legal environment. Because of the costliness

of international litigation, firms often attempt to resolve disputes through dispute resolution techniques such as arbitration. When U.S. MNCs are dealing with sovereign countries, however, their ability to resolve conflicts is often hindered by the terms of the Foreign Sovereign Immunities Act.

The technological environment is an important facet of the national environment. A country's natural resources, as well as its investments in physical and human capital, affect the country's attractiveness as a location for international business activities. A country's willingness (or unwillingness) to enforce intellectual property rights of foreign firms often plays a major role in their location decisions.

The accounting tasks international businesses confront are more complex than those faced by purely domestic firms. An international firm must meet the accounting requirements of both its home country and all the countries in which it operates. Unfortunately, significant philosophical and operational differences exist in the accounting standards and procedures of the world's countries.

International businesses operating in foreign environments are subject to political risks. To protect themselves from changes in the political environment, firms should continually monitor

the political situations in the countries in which they operate by consulting with local staff, embassy officials, and, where appropriate, firms specializing in political risk assessment.

## Review Questions

- 3-1. Describe the four different types of legal systems with which international businesses must deal.
- 3-2. What is extraterritoriality?
- 3-3. How can an MNC affect its host country?
- 3-4. How do expropriation and confiscation differ?
- 3-5. Why do countries impose restrictions on foreign ownership of domestic firms?
- 3-6. How do restrictions on repatriation of profits affect MNCs?
- 3-7. What factors influence the accounting procedures a country adopts?
- 3-8. How do German firms use accounting reserves?
- 3-9. What is the impact of differing accounting standards on the international capital market?
- 3-10. What is political risk? What forms can it take?
- 3-11. What is OPIC's role in promoting international business activity?

## Questions for Discussion

- ★ 3-12. What options do firms have when caught in conflicts between home country and host country laws?
- ★ 3-13. What is the impact of vigorous enforcement of intellectual property rights on the world economy? Who gains and who loses from strict enforcement of these laws?
- 3-14. Does your country impose restrictions on the export of dual-use items? Have other countries imposed restrictions on your country importing dual-use items? What do these restrictions include and why might the restrictions be in place?
- ★ 3-15. What is the impact on the global economy if governments fail to restore investors' faith in firms' accounting statements?
- 3-16. What impact would harmonization of national accounting standards have on international businesses?
- 3-17. What is meant by "aggressive accounting," and is it used by any businesses in your own country?

## Building Global Skills

Both government and competitors can have a marked impact on the ability of a new business to break into the market. There will be numerous regulatory controls and limitations imposed on a new business by different layers of government. The more complex the government structure, the more permissions and potential delays. At the same time, existing businesses will have a vested interest in preventing, or at least delaying, new potential competitors. They will have distinct advantages from being already established, but will also have existing contacts at various levels of government. If they feel threatened by the prospect of additional competition, they may use their leverage to influence decision-makers.

Problems such as these exist in varying degrees in different countries. As a group, choose either an existing, highly competitive market in your country or pick a business intending to manufacture or distribute products and services that could be conceived as being contentious. A good example would be an alcohol manufacturer in a country that has strict

laws (or bans) on alcohol consumption. Alternatively, choose a business type that is concerned about its impact on the environment. Your group should aim to pick a type of business that is more likely to run into serious opposition, either from the levels of government, the competition or resistance from local communities, activists or other groups.

- 3-18. Identify the key groups or organizations that are likely to oppose the setting up of the business. How strong are they and what kind of influence do they exert?
- 3-19. What power and influence do the different branches of government have? Which is likely to be the most resistant?
- 3-20. Assess the probability that the right to establish the business is going to be denied, regardless of any safeguards you promise to make.
- 3-21. What are the existing regulations that could impact the potential setting up of the business? Can they be circumvented in some way?

## CLOSING CASE Tiny Islands, Big Trouble

The South China Sea has long been a critical waterway in international commerce. Stretching from the Straits of Taiwan in the north to Singapore and the Straits of Malacca in the south, its fecund waters yield a tenth of the world's commercial fish catch. It is transited by vessels accounting for half the tonnage of ocean-borne intercontinental trade. Yet squabbling over three small island chains—the Spratly Islands, the Paracel Islands, and the Pinnacle Islands—and two submerged shoals and reefs—the Macclesfield Bank and the Scarborough Shoal—threaten to undermine trade relations and escalate political conflicts among Brunei, China, Japan, Malaysia, Taiwan, the Philippines, and Vietnam, which have staked claims to part or all of these areas (Map 3.2).

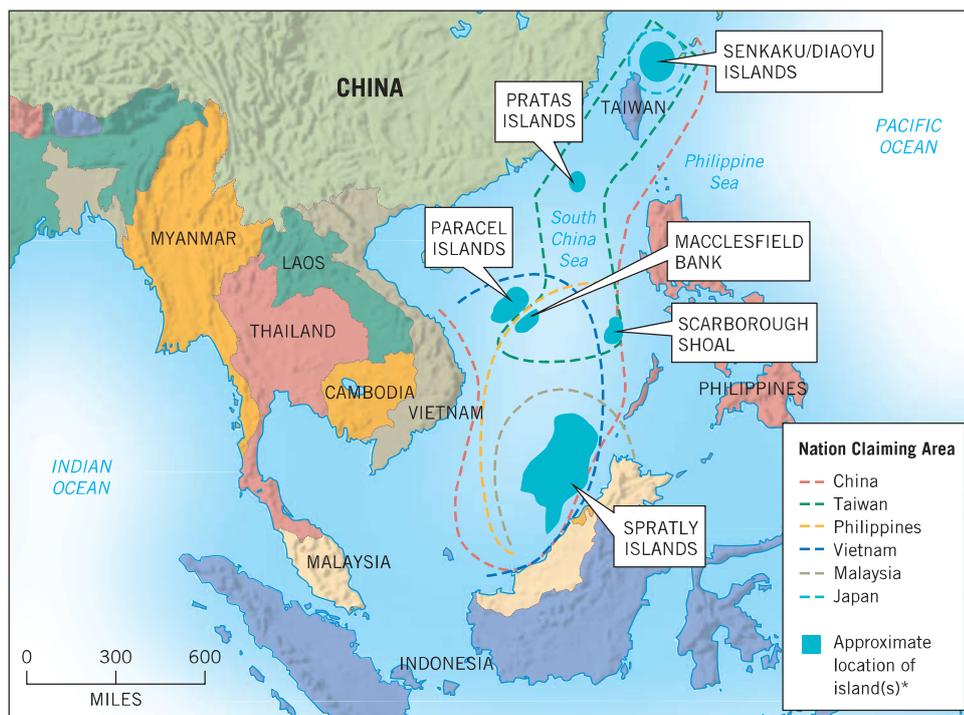
The size of the territory at stake is small: no more than 10 square miles of land spread throughout the 1.4-million-square-mile South China Sea. But the size of the islands underestimates their economic, strategic, and political importance. Under the 1982 United Nations Convention on the Law of the Sea (UNCLOS), a nation's territorial waters consist of those within 12 nautical miles of its coastal shores. These territorial waters are considered to be part of its sovereign territory, although foreign vessels are permitted innocent passage through them. UNCLOS also grants a nation an exclusive economic zone (EEZ) extending a

maximum of 200 nautical miles from its coastal shores. The presence of a continental shelf may also influence the boundaries of an EEZ. Each country controls all economic resources within its EEZ. However, Article 121 (3) of UNCLOS indicates that rocks “which cannot sustain human habitation or economic life of their own shall have no exclusive economic zone.” It is not obvious that the island groups in dispute meet this threshold.

The Macclesfield Bank, a series of submerged shoals and reefs, is claimed by Vietnam, China, and Taiwan. (To complicate matters, as we discussed in Chapter 2, China believes that Taiwan is part of its sovereign territory.) The Scarborough Shoal, an underwater formation claimed by China, Taiwan, and the Philippines, has triggered commercial conflicts between China and the Philippines. Incidents involving surveillance of Chinese fishing boats by the Philippine navy have led to boycotts of Chinese goods by Philippine consumers, alleged cyber attacks on Philippine universities by Chinese hackers, stricter regulations on Philippine banana exports to China, and suspension of Chinese tours to the Philippines.

The struggles over the disputed island chains are even more intense than over the two submerged formations. Ownership of the island chains impacts a country's

**MAP 3.2**  
South China Sea



million Chinese workers are employed in 4,600 Japanese-controlled factories. Should the Chinese market turn hostile to them, Japanese investors could redirect their investments to other parts of Asia, such as Vietnam or the Philippines. Moreover, the United States and Japan have a mutual defense treaty, which would escalate the significance of any armed conflict between China and Japan.

Resolving these territorial disputes will be complex. National pride may need to be balanced against the economic benefits of peaceful resolution. Philippine leaders have proposed that Association of Southeast Nations (ASEAN, discussed in more detail in Chapter 10) and China negotiate a binding code of conduct that would regulate commercial activities in the region. Others experts propose that the squabbling nations agree to binding arbitration under the aegis of the UNCLOS. China has rejected arbitration, preferring to engage in bilateral negotiations over the disputed areas. Cynics suggest that given the unequal economic and military power of China vis-à-vis its neighbors, bilateral negotiations will inevitably favor China.

### Case Questions

- 3-22. Pick one of the island chains (Paracel, Spratly, Pinnacle/Senkaku/Diaoyu/Tiaoyutai) under dispute. Research the claims of the parties asserting ownership of the island chain. Prepare a short memo

summarizing the ownership claims, the basis of those claims, and a possible solution to the dispute. Are bilateral negotiations, arbitration under UNCLOS, or a region-wide code of conduct the best way to resolve the conflicts? What are the advantages and disadvantages of each approach?

- 3-23. Suppose you are an executive for Forum Energy PLC, which was granted exploration rights in the Spratlys by the Philippines. What political risks do you face? What can you do to lessen these political risks?
- 3-24. Suppose you are an executive for Toyota, which has extensive FDI in China and has targeted the Chinese market as critical to the company's future growth. What political risks do you face? What can you do to lessen these political risks?

Sources: Based on "In South China Sea, a dispute over energy," *Washington Post*, January 25, 2013; "Senkaku row raises militarization fears," *Financial Times*, February 6, 2013; "Dangerous shoals," *The Economist*, January 19, 2013; "China Dispute Casts Pall Over Japan Growth," *Wall Street Journal*, October 14, 2012; "Japanese car sales down in China," *Japan Times*, October 14, 2012; "Roiling the waters," *The Economist*, July 7, 2012; "Vietnam Protests CNOOC's Plans in Disputed South China Sea," *Wall Street Journal Asia*, March 16, 2012; "Beijing in Fresh Sea Row with Hanoi," *Wall Street Journal*, March 1, 2012; "The devil in the deep blue detail," *The Economist*, February 4, 2012; "Carp among the Spratlys," *The Economist*, March 10, 2011; U.S. Energy Information Administration report on the South China Sea, accessible at <http://www.eia.gov/countries/regions-topics.cfm?fips=SCS>.

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- 3-26. What is political risk? How can companies protect themselves from political risk?
- 3-27. Mymanagementlab Only—comprehensive writing assignment for this chapter.

### Endnotes

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