LECTURE NOTES
(Краткий конспект лекций)

Part 1. Background of International Business

Globalization refers to the widening set of interdependent relationships among people from different parts of a world that happens to be divided into nations. The term sometimes refers to the elimination of barriers to international movements of goods, services, capital, technology, and people that influence the integration of world economies.

Throughout history, wider human connections have expanded people's access to more varied resources, products, services, and markets. We've altered the way we want and expect to live, and we've become more deeply affected (positively and negatively) by conditions outside our immediate domains. The opening case shows how far-flung global contact allows the world's best sports talent to compete, and their fans to watch them, just about anywhere. Likewise, managers in almost

every industry consider ever more distant places as sources of supplies and markets. As consumers we know from "Made in" labels that we commonly buy products from all over the world, but these labels do not tell us everything. So many different components, ingredients, and specialized business activities from different countries go into products that it's often a challenge to say exactly where they were made. Belgium is renowned for its chocolate, but a Belgian Neuhaus bonbon includes ingredients from the Ivory Coast, Philippines, Ecuador, Sao Tome˙, and Venezuela. Because Apple ships its iPhones from China, they appear to be Chinese products, but less than 4 percent of their value is created in China.

HOW DOES *INTERNATIONAL BUSINESS* FIT IN?

Globalization enables us to get more variety, better quality, or lower prices. Our daily meals contain spices that aren't grown domestically and fresh produce that's out of season in one local climate or another. Our cars cost less than they would if all the parts were made and the labor performed in one place. All of these connections between supplies and markets result from the activities of **international business,** defined as all commercial transactions, including sales, investments, and transportation, that take place between two or more countries. Private companies undertake such transactions for profit; governments may undertake them either for profit or for other reasons. The Study of International Business Why should you study international business?

Simply, it makes up a large and growing portion of the world's business. Global events and competition affect almost all companies, large and small, regardless of industry. They sell output and secure supplies and resources abroad, and they compete against products, services, and companies from foreign countries. Thus, most managers need to take into account international business when setting

their operating strategies and practices. Like the NBA teams in the opening case, which search globally for talent and additional markets, as a manager in almost any industry you'll need to consider (1) where you can obtain the best required inputs at the best possible price and (2) where you can best sell the product or service you've put together from those inputs.

Understanding the Environment/Operations Relationship The best way to do business abroad may not be the same as the best way at home. Why? First, when your company operates internationally, it will engage in *modes* of business, such as exporting and importing, which differ from those it uses domestically. Second, physical, social, and competitive conditions differ among countries and affect the optimum ways to conduct business. Thus, international companies have more diverse and complex operating environments than purely domestic ones.

Even if you never have direct international business responsibilities, understanding some of the complexities may be useful to you. Companies' international operations and their governmental regulations affect overall national conditions—economic growth, employment, consumer prices, national security—as well as the success of individual industries and firms.

A better understanding of international business will help you make more informed decisions,such as where you want to work and what governmental policies you want to support.

THE FORCES DRIVING GLOBALIZATION

Measuring globalization is problematic, especially for historical comparisons. First, a country's interdependence must be measured indirectly.5 Second, when national boundaries shift, such as in the breakup of the former Soviet Union or the reunification of East and West Changes in Political Situations and Government Policies For nearly half a century after World War II, business between Communist countries and the rest of the world was minimal. Today, only a few countries do business almost entirely within a political bloc.

In fact, political changes sometimes open new frontiers for international business, such as Myanmar's cessation of military rule that has influenced international companies to seek footholds there. Nevertheless, governments still prefer international business with certain countries and even deny such business with others for political reasons, such as many countries' sanctions against doing business with Iran because of its efforts to develop nuclear capabilities.

Governments seem more willing to support programs, such as improving airport and seaport facilities to foster speed and cost efficiencies for delivering goods internationally. They also now provide an array of services to help domestic companies sell more abroad, such as collecting information about foreign markets, furnishing contacts with potential buyers, and offering insurance against nonpayment in the home-country currency.

Expansion of Cross-National Cooperation Governments have come to realize that their own interests can be addressed through international cooperation by means of treaties, agreements, and consultation. The willingness to pursue such policies is due largely to these three needs:

1. To gain reciprocal advantages
2. To attack problems jointly that one country acting alone cannot solve
3. To deal with areas of concern that lie outside the territory of any nation

Gain Reciprocal Advantages Essentially, companies don’t want to be at a disadvantage when operating internationally, so they petition their governments to act on their behalf.

Thus, governments join international organizations and sign treaties and agreements for a variety of commercial activities.

Some treaties and agreements allow countries’ commercial ships and planes to use certain of each others’ seaports and airports. Some cover commercial-aircraft safety standards and flyover rights; some protect property, such as foreign-owned investments, patents, trademarks, and copyrights. Countries also enact treaties for reciprocal reductions of import restrictions (remaining prepared, of course, to retaliate when another party interferes with trade flows by raising trade barriers or cutting diplomatic ties).

Multinational Problem Solving Governments often act to coordinate activities along their mutual borders by building highways, railroads, and hydroelectric dams that serve the interests of all parties. The adjacent photo shows a dam between Brazil and Paraguay. (However, there are still border inefficiencies. For instance, trains between Italy and Sweden must change locomotives three or four times because of different national systems.) They also cooperate to solve problems that they either cannot or will not solve by themselves. First, the resources needed to solve a problem may be too great for one country to manage; sometimes no single country is willing to pay for a project that will also benefit another country, as witnessed by Japan and the United States sharing the costs of ballistic-missile defense technology. In any case, many problems are inherently global—think of global climate change or nuclear proliferation—and can’t be easily addressed by a single country. That’s why cooperative efforts have developed to fight the spread of diseases such as mal aria, to set warning systems against such natural disasters as tsunamis, and to take action on environmental problems such as global warming.

Second, one country’s policies may affect those of others. Higher real-interest rates in one country, for example, can attract funds very quickly from individuals and firms in countries with lower rates, thus creating a shortage of investment funds in the latter. Similarly, a country may manipulate the value of its currency so that companies abandon suppliers in one country for those in another, with an undervalued currency thus contributing to unemployment in the abandoned country. To coordinate economic policies in these and other areas, the Changes in Political Situations and Government Policies For nearly half a century after World War II, business between Communist countries and the rest of the world was minimal. Today, only a few countries do business almost entirely within a political bloc.

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Unemployed Brazilian workers have felt that job creation in the logging industry is more important than climate protection outside Brazil.

GROWING INCOME INEQUALITY AND PERSONAL STRESS

In measuring economic well-being, we not only look at our absolute situations but also compare ourselves to others. We generally don't find our economic status satisfactory unless we're doing better and keeping up with others.

Income Inequality By various measurements, income inequality, with some notable exceptions, has been growing both among and within a number of countries. Critics claim that globalization has affected this disparity by helping to develop a global superstar system, creating access to a greater supply of low-cost labor, and developing competition that leads to winners and losers.

The superstar system is especially apparent in sports, where global stars earn far more than the average professional player or professionals in sports with a more limited worldwide following. It also carries over to other professions, such as business, where charismatic top people can command many times what others can.

Although globalization has brought unprecedented opportunities for firms to profit by gaining more sales and cheaper or better supplies, critics argue that profits have gone disproportionately to the top executives rather than to the rank and file. Nobel economist Robert Solow supports this criticism by arguing that greater access to low-cost labor in poor countries has reduced the real wage growth of labor in rich countries. And even if overall worldwide gains from globalization are positive, there are bound to be some losers in either an absolute or relative sense (who will probably become critics of globalization). The speed with which technology and competition expand globally affects the number of winners and losers along with the relative positions of individuals, companies, and countries. As an example, relocation of U.S. manufacturing jobs to China and India has helped the latter grow more rapidly than the United States, thus lessening the U.S.'s relative economic leadership over those countries. Likewise, some displaced workers have lost economic and social standing relative to workers whose jobs were not moved. The challenge, therefore, is to maximize the gains from globalization while simultaneously minimizing the costs borne by the losers.

Personal Stress Certain repercussions of globalization can't be measured in strictly economic terms. What about the stress imposed on the people whose relative economic and social status suffers, or those who fear the loss of their jobs? There is some evidence that the growth in globalization goes hand in hand not only with increased insecurity about job and social status but also with costly social unrest.

Further, although few of the world's problems are brand new, we may worry about them more now because globalized communications bring exotic sagas of misery into living rooms everywhere

EXPANDING SALES

A company's sales depend on the desire and ability of consumers to buy its goods or services. Obviously, there are more potential consumers in the world than found in any single country. Now, higher sales ordinarily create value, but only if the costs of making the additional sales don't increase disproportionately. Recall, for instance, the opening case. Televising sports competitions to multiple countries generates advertising revenue in excess of the increased transmission costs. In fact, additional sales from abroad may enable a company to reduce its per-unit costs by covering its fixed costs—say, up-front research costs—over a larger number of sales. Because of lower unit costs, it can boost sales even more.

So increased sales are a major motive for expanding into international markets, and many of the world's largest companies—such as Volkswagen (Germany), Ericsson (Sweden), IBM (United States), Michelin (France), Nestlé (Switzerland), and Sony (Japan)—derive more than half their sales outside their home countries. Bear in mind, though, that international business is not the purview only of large companies. In the United States, 97 percent of exporters are small and mid-sized firms (SMMs), which account for about a third of U.S. direct export value. Further, many sell products to large companies, which install them in finished products slated for sale abroad.

ACQUIRING RESOURCES

Producers and distributors seek out products, services, resources, and components from foreign countries—sometimes because domestic supplies are inadequate (as with crude oil shipped to the United States). They're also looking for anything that will create a competitive advantage. This may mean acquiring a resource that cuts costs, such as Rawlings's reliance on labor in Costa Rica—a country that hardly plays baseball—to produce baseballs.

Sometimes firms gain competitive advantage by improving product quality or differentiating their products from those of competitors; in both cases, they're potentially increasing market share and profits. Most automobile manufacturers, for example, hire design companies in northern Italy to help with styling. Many companies establish foreign R&D facilities to tap additional scientific resources.42 They also learn while operating abroad, and they acquire product knowledge for entering new markets at home, such as what PepsiCo is doing in order to enter the fast-growth U.S. yogurt market.43 Further, the diversity of employees and operations bring companies new perspectives.

REDUCING RISK

Operating in countries with different business cycles can minimize swings in sales and profits. The key is the fact that sales decrease or grow more slowly in a country that's in a recession and increase or grow more rapidly in one that's expanding economically. During 2011, for example, Gap's North American sales fell 5 percent, but this was mainly offset by its sales growth of 11 percent

elsewhere.44 Moreover, by obtaining supplies of products or components both domestically and internationally, companies may be able to soften the impact of price swings or shortages in any one country.

Finally, companies often go international for defensive reasons. Perhaps they want to counter competitors' advantages in foreign markets that might hurt them elsewhere. By operating in Japan, for instance, Procter & Gamble (P&G) delayed foreign expansion on the part of potential Japanese rivals by slowing their amassment of resources needed to enter into other international markets where P&G was active. Similarly, British-based Natures Way Foods followed a customer, the grocery chain Tesco, into the U.S. market. This move expanded its sales and its relationship with Tesco. Moreover, it reduced the risk that Tesco would find an alternative supplier who might then threaten Natures Way's relationship with Tesco in the U.K. market.

Asset Use When one company allows another to use its assets—such as trademarks, patents, copyrights, or expertise—under contracts known as licensing agreements, they receive earnings called royalties. For example, Adidas pays a royalty for the use of the Real Madrid football team's logo on jackets it sells. Royalties also come from franchise contracts.

Franchising is a mode of business in which one party (the franchisor) allows another (the franchisee) to use a trademark as an essential asset of the franchisee's business. As a rule, the franchisor (say, McDonald's) also assists continuously in the operation of the franchisee's business, perhaps by providing supplies, management services, or technology.

INVESTMENTS

Dividends and interest paid on foreign investments are also considered service exports and imports because they represent the use of assets (capital). The investments themselves, however, are treated in national statistics as separate forms of service exports and imports. Note that foreign investment means ownership of foreign property in exchange for a financial return, such as interest and dividends, and it may take two forms: direct and portfolio.

Direct Investment In foreign direct investment (FDI), sometimes referred to simply as direct investment, the investor takes a controlling interest in a foreign company. When, for example, U.S. investors bought the Liverpool Football Club, it became a U.S. FDI in the United Kingdom. Control need not be a 100 percent or even a 50 percent interest; if a foreign investor holds a minority stake and the remaining ownership is widely dispersed, no other owner may effectively counter the investor's decisions. When two or more companies share ownership of an FDI, the operation is a joint venture. (There are also non-equity joint ventures.)

Portfolio Investment A portfolio investment is a noncontrolling financial interest in another entity. It usually takes one of two forms: stock in a company or loans to a company (or country) in the form of bonds, bills, or notes purchased by the investor. They're important for most companies with extensive international operations, which routinely move funds from country to country for short-term financial gain.

TYPES OF INTERNATIONAL ORGANIZATIONS

Basically, an "international company" is any company that operates in more than one country, but we have a variety of terms to designate different types of operations. Highly committed international companies usually draw on multiple operating types. Companies work together—in joint ventures, licensing agreements, management contracts, minority ownership, and long-term contractual arrangements—all of which are known as collaborative arrangements.

The term strategic alliance is sometimes used to mean the same, but it usually refers either to an agreement that is of critical importance to one or more partners or to an agreement that does not involve joint ownership.

Multinational Enterprise A multinational enterprise (MNE) usually refers to any company with foreign direct investments. This is the definition we use in this text. However, some writers reason that a company must have direct investments in some minimum number of countries to be an MNE. The term multinational corporation or multinational company (MNC) is often used as a synonym for MNE, while the United Nations uses the term transnational company (TNC).

Does Size Matter? Some definitions require a certain size—usually giant. However, a small company, usually described within the United States as having fewer than 500 employees, can have foreign direct investments and adopt any of the operating modes we've discussed. recent melting of Arctic ice floes along with new ship technologies have allowed more ships to use a Northwest Passage to cut transport costs by saving as much as 15 days at sea. Finally, population distribution and the impact of human activity on the environment may exert strong future influences on international business, particularly if ecological changes or regulations cause companies to move or alter operations.

Political Policies Not surprisingly, a nation's political policies influence how international business takes place within its borders (indeed, whether it will take place). For instance, Cuba once had a minor-league baseball franchise, which went the way of diplomatic relations between Cuba and the United States back in the 1960s. Several Cuban baseball players are now members of professional U.S. teams, although most of them had to defect from Cuba to play abroad. (Even more Cuban boxers than baseball players have defected.)

Obviously, political disputes—particularly military confrontations—can disrupt trade and investment. Even conflicts that directly affect only small areas can have far-reaching effects.

The 2002 and 2009 terrorist hotel bombings in Indonesia resulted in a decrease in the country's international tourism revenue and investment capital because individuals and businesses abroad perceived it as too risky.

Legal Policies Domestic and international laws play a big role in determining how a company can operate abroad. Domestic law includes both home- and host-country regulations on such matters as taxation, employment, and foreign-exchange transactions. British law, for example, determines how the U.S.-investor-owned Liverpool Football Club is taxed and which nationalities of people it employs in the

U.K. Meanwhile, U.S. law determines how and when the earnings from the operation are taxed in the United States.

International law—in the form of legal agreements between countries—determines how earnings are taxed by all jurisdictions. International law may also determine how (and whether) companies can operate in certain places. As we point out in our closing case, agreements permit ships' crews to move about virtually anywhere without harassment. When transactions between countries involve disputes, such as whether a French football team must pay Nike for imported uniforms when it questions the quality, the contract usually specifies the country's law that will make the determination.

Finally, the ways in which laws are enforced also affect a firm's foreign operations. In the realm of trademarks, patented knowledge, and copyrights, most countries have joined in international treaties and enacted domestic laws dealing with violations. Many, however, do very little to enforce either the agreements or their own laws. This is why companies not only must understand agreements and laws but also must determine how fastidiously they're enforced in different countries.

Behavioral Factors The related disciplines of anthropology, psychology, and sociology can help managers better understand different values, attitudes, and beliefs. In turn, such understanding can help managers make operational decisions abroad. Let's return once again to the opening case. Although professional sports are spreading internationally, the popularity of specific sports differs among countries, while rules and the customary way of play for the same sport sometimes differ as well. Because of tradition, tennis's grand slam tournaments are played on hard courts in Australia and the United States, on clay in France, and on grass in England. A baseball game in the United States continues until there is a winner, while Japanese games end with a tie if neither team is ahead after 12 innings. Presumably the reason for the baseball difference is that the culture of Japan values harmony more than U.S. culture does, whereas U.S. culture values competitiveness more than the Japanese culture does.

Economic Forces Economics explains why countries exchange goods and services, why capital and people travel among countries in the course of business, and why one country's currency has a certain value compared to another's. Recall from our opening case that the percentage of non-U.S.-born players on major-league rosters has been on the rise.

IB TRENDS AND THEORY IN THE INFORMATION AGE

The Pervasiveness of the Digital Economy

The digital economy – the application of internet-based digital technologies to the production and trade of goods and services – is becoming an ever more important part of the global economy (Schwab, 2016).

• It is affecting the lives of growing numbers of people: according to the International Telecommunication Union, three quarters of the population in most developed and emerging economies use the internet, and the penetration rate is approaching 50 per cent across developing countries — exceeding 25 per cent in Africa.

• It is a growing part of people's economic lives: in developed countries and emerging economies, up to two-thirds of people now shop online.

• It is pervasive in doing business: business-to-business transactions are worth a multiple of business-to-consumer (B2C) transactions; even considering only web-based sales (excluding closed digital networks between firms), they are still about a third higher (UNCTAD , 2015).

• It is encompassing an ever-greater part of the global economy: the value of B2C transactions has tripled from 0.5 per cent of global gross domestic product (GDP) in 2010 to 1.5 per cent today, and the internet industry contributes almost 4 per cent points to GDP in the largest economies, those that generate 70 per cent of global GDP.

• It is increasingly used by governments to interact with citizens and deliver services: according to the UN's e-Government Development Index, 90 countries now offer one or more one-stop portals for public information or online services, and 148 countries provide at least one form of online transactional services.

With the rapid growth of the digital economy, the importance of multinational enterprises (MNEs) in digital and technology sectors in international production has increased dramatically. The rapid rise of tech MNEs represents one of the most noteworthy trends in the world of global megacorporations in recent years.

This phenomenon has attracted increasing attention not only at the research and policy levels, but also in the broader public. In 2010, the relevance of tech companies in the top 100 MNE ranking compiled by UNCTAD was still limited and not significantly different than 10 years earlier. From 2010 to 2015, in contrast, the number of tech companies in the ranking more than doubled, from 4 to 10, and their share in total assets and operating revenues followed a similar, and even more pronounced, trend. It has not stopped there; in the last two years, five more digital MNEs entered the top 100, signalling a further acceleration of the trend United States, entering the ranking. Some of these companies, such as Alphabet (Google) and Microsoft, are leading the digital revolution; others, such as Oracle, heavily rely on and benefit from the acceleration of the internet to deliver theirvalue proposition. When including telecom MNEs, other important enablers of the digital economy, 22

MNEs in the top 100 are information and communication technology (ICT) companies – a sizeable portion of megacorporations.

1.2. The Analytical Framework and Scope of the Chapter

The digital economy is characterised by three building blocks At its foundation are firms in the IT and telecom industries that provide the infrastructure and tools that make the internet accessible to individuals and businesses. Its core is represented by digital firms, characterised by the central role of the internet in their operating and delivery model. Finally, the broad economy rests on digital infrastructure and digital content in the process of the digitalisation of traditional activities.

This analytical framework approaches the analysis of the relationship between digitalisation and international production at two levels. The first level (item 1 in figure 2) deals with the changes in international production patterns and behaviours brought by the players at the frontiers of the digital revolution, ICT and digital MNEs. The second level (item 2) expands the scope to include the broader impact of the adoption of digital technologies on the internationalisation of traditional players . These two levels are addressed (respectively) in Sections 2 and 3, the analytical core of this chapter. Section 4 elaborates on the policy challenges resulting from the fundamental changes in international production patterns described in Sections 2 and 3. Section 5 sets out an ambitious (and provocative) agenda for future research. It questions some of the common ways of thinking about the relationship between globalisation and digitalisation and argues that deep re-thinking of the MNE internationalisation theory is needed to explain the transformations at work in international production.

2. Digital Mnes: Challenging Traditional Investment Patterns

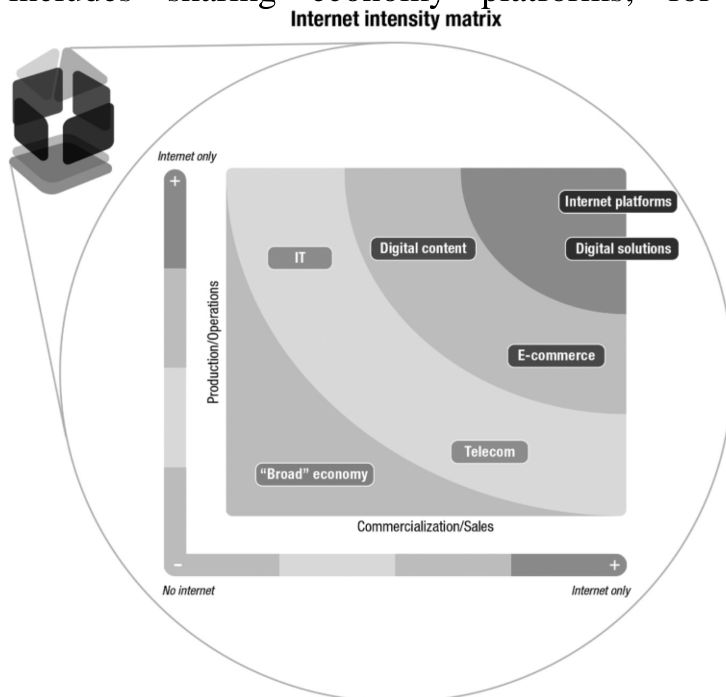
2.1. Mapping Digital MNEs: The Internet Intensity Matrix

To assess the potential impact of digitalisation on international production more broadly, that is, on international investment patterns of all MNEs, it is useful to re-think the analytical framework above more explicitly in terms of exposure to the internet.

At the top end of the matrix are the purely digital MNEs, the group of internet platforms and providers of digital solutions, where both operations and sales are digital. At the lower end of the matrix is the heterogeneous group of non-ICT and non-digital firms, some of which are gradually moving towards digital adoption in operations and sales, as confirmed, for example, by the growing importance of e-commerce in traditional business. An intermediate position is covered by digital MNEs with mixed models (digital content and e-commerce) and the group of ICT MNEs (IT and telecom), whose core business activities combine physical and digital elements.

Specifically, internet platforms (search engines, social networks and other platforms) are companies providing digital services through internet and cloudbased platforms; for example, search engines and social networks. ‘Other platforms’

includes sharing economy platforms; for example, transaction platforms



(eBay) and open-source platforms (Red Hat). The category digital solutions describes a variety of players with core activities based on, or strictly linked to, internet technologies. Among them: cloud hosting and computing, web hosting and email services, electronic and online payments and digital solutions for business management and for financial applications (fintech).

Among the mixed players, e-commerce (internet retailers and other e-commerce) consists of specialised and non-specialised online stores and online travel and booking agencies, focussing on fully online and online-born retailers.

It also includes agencies specialised in online marketing and advertising. The last category in the scope of digital MNEs, digital content (digital media and entertainment, information and data providers) includes producers and providers of digital content, such as media (music, video, e-books and online magazines and online courses) and games ('classic' video games, online games, mobile games and multiplayer interactive games). It also captures 'big data' providers, and providers This feature is described by the FDI lightness ratio, an indicator of the extent to which a company is able to generate sales abroad given its stock of foreign assets.

Specifically, it is defined at the level of the individual MNE, as the ratio between the share of sales generated by foreign affiliates and the corresponding share of foreign assets. It is low (between 0 and 1) when the share of foreign assets is higher than the share of foreign sales (a 'heavy' footprint); it equals 1 when the two shares are the same; it is high (above 1) when the share of foreign assets is lower than the share of foreign sales (a 'light' footprint).

The more MNEs rely on the internet, the better they can leverage their foreign assets, obtaining a higher share of foreign sales with relatively fewer foreign assets (Fig. 5). This pattern is not driven by a few large companies, but rather applies across

the board: the results are consistent when replacing categories' weighted averages with median values.

The foreign asset configuration of digital MNEs reflects the different degrees of exposure to, and usage of, internet and digital technologies.

• Purely digital MNEs, including internet platforms and providers of digital solutions, show the highest gap between (low) foreign assets and (high) foreign sales. These are companies that operate almost entirely in a virtual environment, characterised by limited physical ties with their markets. Tangible foreign assets in foreign markets are often limited to corporate offices and data centre hubs.

• Digital MNEs with mixed models, including providers of digital content and e-commerce, also exhibit lighter foreign asset footprint than traditional MNEs, but the gap is significantly reduced. Both groups combine a digital core business with a physical component instrumental to the delivery of their value proposition.

Internet retailers consist mainly of e-commerce multinationals, such as Amazon or Rakuten, where marketing and commercial activities are online, but delivery requires logistic assets and operations.

Digital content providers include large media companies, such as Twenty-First Century or Sky. These companies operate in an inherently digital environment with digital products and digital technologies. However, they still reach their mass customer base in traditional ways, for example, through cable or satellite television. With some notable exceptions such as Netflix, their online distribution segment, although growing rapidly, is still smaller than their traditional distribution segments.

MNE business models more suited to online operations and delivery, such as online travel agencies (in the e-commerce category) and information and data providers (in the digital content category), are characterised by lighter foreign asset footprint.

The group of ICT MNEs is highly polarised between IT MNEs (hardware and software) and telecom MNEs.

• IT MNEs exhibit a light foreign asset footprint overall, with a ratio between the share of foreign sales and the share of foreign assets almost equivalent to that of purely digital players. However, this group is quite heterogeneous, and reasons other than digitalisation may contribute to a light foreign asset configuration.

The leading IT companies, such as Apple and Samsung, and the leading software companies, such as Microsoft and Oracle, have strong digital footprints.

Conversely, smaller and specialised IT manufacturers have more limited digital exposure. Several of these MNEs are suppliers of IT components from East and South-East Asia. These companies tend to locate their production investment choices (Fig. 6). In other words, digitalization tends to "break" the operational nexus between foreign sales and foreign assets. Conversely, for MNEs in telecom and in digital content, which have relatively heavier foreign asset footprint, the share of foreign sales correlates highly with the share of foreign assets. This suggests that physical presence in a foreign market is a critical condition for sales.

FDI by Digital MNEs: Intangibles and Cash

Also the nature of foreign investment of digital MNEs differs from traditional ones, as the sources of value are moving from tangible assets to intangibles and cash.

The average market capitalisation of tech megacorporations is almost three times higher than that of other MNEs. At the end of 2015, 10 tech MNEs made up about 26 per cent of the total market capitalisation of the top 100 MNEs in the ranking. Such market capitalisation can be largely attributed to highly valuable unrecorded intangibles, such as brand, know-how and intellectual facilities at home, where production costs are lower, and then to export. This clearly contributes to a high ratio between the share of foreign sales and the share of foreign assets.

• Telecom MNEs exhibit a high share of foreign assets relative to foreign share. They tend to establish a heavy, tangible presence in the foreign countries where they operate. This is intrinsic to their business and operating model, which requires telecommunication infrastructure to achieve capillary coverage.

Finally, non-digital MNEs exhibit on average the same share of foreign assetsand foreign sales (FDI lightness indicator equal to 1). However, there is significant variability across industries. MNEs in automotive and aircraft, a highly technological industrial sector, are comparatively lighter, typically resorting to contract manufacturing for more asset and labour intensive operations (average FDI lightness indicator at 1.3). At the other extreme, are industries that rely either on local infrastructure (utilities) or natural resources (mining and petroleum refining), with FDI lightness indicator below 1.

Not only do highly digital MNEs tend to realise more foreign sales with fewer foreign assets, but there is also little correlation between the two, suggesting that commercial presence in foreign markets has no apparent bearing on international cash consists of unremitted foreign earnings, retained abroad for tax optimization purposes. In the group of 2015 UNCTAD Top 100 MNEs, tech megacorporations from the United States in the 2015 ranking of the top 100 MNEs kept 62 per cent of their total foreign earnings unremitted, a share almost three times higher than that of the other United States MNEs (Fig. 8). Furthermore, total foreign earnings retained abroad by tech MNEs from the United States are growing faster, at an average annual rate of 28 per cent between 2010 and 2015, against 8 per cent for other MNEs. As a result, tech megacorporations each retained about $75 billion abroad on average in 2015, against $45 billion for other MNEs. The fact that unremitted foreign earnings are equivalent to about six times the estimated value of foreign tangible assets suggests that these resources are only in small part used to finance foreign productive capacity. The main objective is rather to minimise the tax burden by (indefinitely) deferring the payment of the tax adjustment upon repatriation of foreign earnings to the United States. Accordingly, tech MNEs incurred an average effective tax rate of 19 per cent in 2015 – almost half of the statutory corporate tax rate in the United States and lower than the tax rate paid by other United States MNEs. These patterns are likely to apply to digital MNEs as well, given the common characteristics they share with tech MNEs. This phenomenon of high retained foreign earnings, however, is strictly linked to the United States territorial tax system and likely to be less relevant for MNEs from other countries.

Furthermore, the very recent reform of the United States tax system may radically change the picture on this aspect.

The Geography of Digital FDI: Concentration in Developed Economies

The opportunity to operate globally with limited foreign investment may slow down the globalisation of international production, at least from the perspective of tangible assets. This trend is further exacerbated by the fact that most digital MNEs are from developed countries, in particular the United States. The share of digital MNEs based in the United States is high, at almost two-thirds

The predominance of digital MNEs that are based in the United States, coupled with the tendency of these companies to retain most productive assets at home, results in a geographic distribution of subsidiaries that is highly skewed towards domestic companies based in the United States. Just above 50 per cent of digital MNEs' subsidiaries are foreign, compared with almost 80 per cent of other MNEs' subsidiaries; conversely, about 40 per cent of digital MNEs' subsidiaries are based in the United States, almost twice the share for other MNEs. As result, the growth of digital economy MNEs could reverse the trend in outward FDI observed in the last decade towards 'democratisation' – back towards concentration in a few large home countries.

FINANCIAL MANAGEMENT IN INTERNATIONAL BUSINESS

THE CROSSROADS OF ACCOUNTING AND FINANCE

The accounting and finance functions are closely related, with each relying on the other to fulfill its responsibilities. The CFO of any company is responsible for procuring and managing the company's financial resources. Usually a member of the top management team, the CFO relies on the controller, or chief accountant, to provide the right information for making decisions, while the internal audit staff ensures that corporate policies and procedures are followed. The internal auditors, the controller, and the CFO work closely with the external auditor to try to safeguard the assets of the business. As you can see from our opening case on the Parmalat scandal, however, things can go wrong, especially when topmost management is willing to shirk its fiduciary responsibility and the external auditor may see a different sort of value in the company's assets.

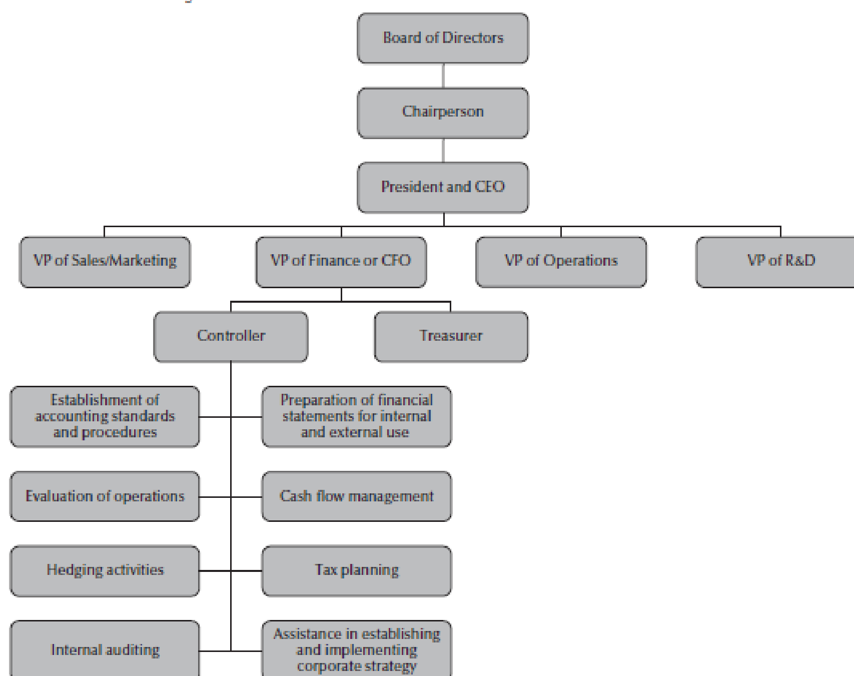
The actual and potential flow of assets across national boundaries complicates the finance and accounting functions. So MNEs must learn to cope with differing inflation rates, exchange-rate changes, currency controls, expropriation risks, customs duties, tax rates and methods of determining taxable income, levels of sophistication of local accounting personnel, and local as well as home-country reporting requirements.

What Does the Controller Control? The role of the company controller is critical to providing useful and timely information to management and external stakeholders. Figure illustrates some of the key responsibilities of the controller as part of a firm's financial team.

Today's controller is engaged in a variety of activities outside the typical accounting and reporting functions that support the firm's general strategy. These can include managing the supply chain, evaluating potential acquisitions abroad, disposing of a subsidiary or a division, managing cash flow, hedging currency and interest-rate risks, tax planning, internal auditing, and helping to plan corporate strategy. In fact, today's accountants overall must have a much broader perspective of business in general—and international business in particular, for our purposes—than the old stereotypes of accountants as bean counters (see Figure)

he Responsibilities of the Controller

We have our controller reporting to either a VP of finance or a chief financial officer. Note that our controller's area of responsibility, like that of many contemporary controllers, is twofold. He or she oversees not only activities in accounting, but also those in financial management as well.



As noted elaborated here, foreign managers and subsidiaries are usually evaluated at headquarters on the basis of data generated in the company's reporting system as set up and coordinated by the controller's office. The controller generates reports for internal consideration, local government needs, creditors, employees, suppliers, stockholders, and prospective investors while handling the effect of many different currencies and inflation rates on the statements and becoming familiar with different countries' accounting systems.

In discussing some key accounting issues facing MNEs, this chapter initially examines how accounting differs around the world and how global capital markets are forcing countries to consider converging their accounting and reporting standards in the attempt to move to one set of globally accepted standards. It then examines some unique issues facing MNEs, such as accounting for foreign-currency transactions, translating foreign-currency financial statements, reporting on foreign operations to shareholders and potential investors, and evaluating the performance of foreign operations and managers.

Although the focus here is on MNEs' problems, many of these issues affect any company doing business overseas, even a small importer or exporter. Foreign-currency transactions, such as denominating a sale or purchase in a foreign currency, must be accounted for in the currency of the parent company. This is true of both large and small companies, as well as service and manufacturing firms.

The balance sheet for British retailer Marks and Spencer uses the following format, which is very different from both the traditional U.S. format as well as the one used by Parmalat:

Noncurrent assets + Current assets − Current liabilities − Noncurrent liabilities = Total equity

Some of the terminology used in presenting financial statements varies for companies around the world. What is referred to by U.S. companies as inventories is called stocks in other English-speaking countries, whereas stocks in the U.S. are called shares elsewhere. U.S. firms, for example, present only a set of consolidated financial statements (also called group statements by European companies), whereas European firms like Marks & Spencer present both company (also called parent company) and group financial statements.

DIFFERENCES IN THE PRESENTATION OF FINANCIAL INFORMATION

The types of financial information required in different countries can differ, while companies also have to consider who their audience is: are they providing financial information only for the local market (such as Brazilian firms for users in Brazil), or also for users from the broader global capital markets? Companies that list on stock exchanges usually provide an income statement, a balance sheet (also known as a statement of financial position), a statement of shareowners' equity, a cash-flow statement, and detailed footnotes in their annual report. Providers of financial information for the broader investing community need to consider the following four factors:

1. Language
2. Currency
3. Statement type (including format and extent of footnote disclosure)
4. Underlying GAAP on which the statements are based

Language Differences English tends to be the first choice of companies choosing to raise capital abroad. For example, German company Daimler issues financial statements in both German and English, while Sweden's H&M provides its annual reports in Swedish and English. Parmalat is interesting because its registered office is in Italy, its shares are traded on the Online Stock Market operated by the Borsa Italiana, and it is controlled by a French company that is part of the Lactalis Group, a French multinational dairy products company. It provides an annual report in English, although its financial statements are in euros, its major reporting currency.

Many companies also provide a significant amount of information on their Internet home pages. Managers can just click on the desired language button and all the information is provided in that language. Parmalat's home page is full of information for people all over the world. It even has a link, www.parmalat.com.br, that gives general information in Portuguese for Brazilian readers.

Currency Differences Companies around the world prepare their financial statements in different currencies—Daimler's are in euros, H&M's in Swedish kronor, Coca-Cola in U.S. dollars, and so on. In its 2012 annual report, Adidas provided its financial information in euros, disclosed information on the firm's currency-translation policies, and gave average exchange rates for the U.S. dollar, the British pound, the Japanese yen, the Russian ruble, and the Chinese yuan to allow investors to make convenient translations from euros.2

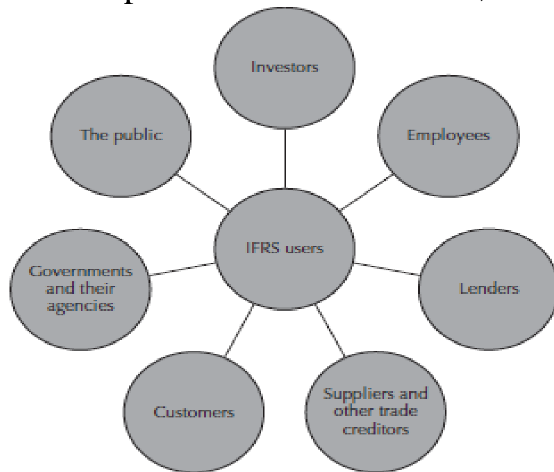
Differences in Types of Statements As noted earlier in the chapter, financial-statement format is not a big issue, but it can be confusing to read a balance sheet prepared in an analytical format when one is used to seeing it in the balance format. A major area of differenceis the use of footnotes. Footnote disclosures in countries with strong equity markets such as the United States, tend to be very comprehensive. Greater transparency is synonymous with more extensive footnote disclosures. Companies that list on multiple stock exchanges, such as Daimler AG, have extensive footnotes as well because they have to comply with the reporting requirements of a global investing community.

GAAP Usage Differences A major hurdle in raising capital in different countries is dealing with widely varying accounting and disclosure requirements. Although this problem is decreasing as more stock exchanges and countries allow the use of IFRS, some countries care more about those differences than others. Most countries also may apply one set of accounting standards for consolidated groups while using another set for the individual companies in the group. In this situation, the individual companies must use local accounting standards that are usually tied to legal requirements and are the basis for tax accounting. Consolidated financial statements, which are used for capital markets and not for tax purposes, are prepared by a different set of standards, such as IFRS. U.S. companies do not have the same situation. They disclose only consolidated financial statements, not individual company financial statements. There are some differences for tax accounting, but those differences are reconciled in the financial statements rather than as separate statements for each company in a group.

ACCOUNTING OBJECTIVES

It is important in the accounting process to identify, record, and interpret economic events. Every country needs to determine the objectives of the accounting system it has put into place. According to the Financial Accounting Standards Board (FASB), the private- sector body that establishes accounting standards in the United States, and the International Accounting Standards Board, a London-based organization that sets accounting standards for the broader global community, general purpose financial reporting should "provide financial information about the reporting entity that is useful for potential investors, lenders, and other creditors in making decisions about providing resources to the entity." As noted in Figure there are many users of general financial information, but the primary users are existing

and potential investors, lenders, and other creditors.



GLOBAL BUSINESS STRATEGY AND ORGANIZATION

Licensing—granting the right to others to use a legally protected property (a name, trademark, logo, design, etc.) —has grown enormously in international business. Such transactions imply a contractual relationship between those who own the property and those given permission to use it. For companies that own licensable properties such as technology, artistic works, logos, and business systems, licensing can be a very lucrative business around the world.

In this chapter, we address licensing, franchising, and other types of cross-border contractual relationships. Contractual entry strategies in international business are cross-border exchanges in which the relationship between the focal firm and its foreign partner is governed by an explicit contract. Intellectual property describes ideas or works that individuals or firms create, including discoveries and inventions; artistic, musical, and literary works; and words, phrases, symbols, and designs. Harry Potter is a leading example. As explained in Chapter 4, intellectual property is safeguarded through intellectual property rights, the legal claim through which proprietary assets are protected from unauthorized use by other

Contractual Entry Strategies

Two common types of contractual entry strategies are licensing and franchising. Licensing is an arrangement by which the owner of intellectual property grants another firm the right to use that property for a specific time period in exchange for royalties or other compensation. As described in the opening case, a royalty is a fee paid periodically to compensate a licensor for the temporary use of its intellectual property. The royalty is usually a percentage of the gross sales generated from use of the licensed asset. As an entry strategy, licensing requires neither substantial capital investment nor extensive involvement of the licensor in the foreign market. Licensing is a relatively inexpensive way for the firm to establish

a presence in foreign markets. Firms that use licensing often can avoid expensive entry as is usually required in foreign direct investment (FDI).

Franchising is an advanced form of licensing in which the firm allows another the right to use an entire business system in exchange for fees, royalties, or other forms of compensation.

The preceding types of contractual relationships are common in international business and allow companies to transfer their knowledge assets to foreign partners routinely. Professional service firms such as those in architecture, engineering, advertising, and consulting extend their Intellectual property rights derive from legally protected patents, trademarks, copyrights, and other protections associated with intellectual property. Such rights provide inventors with a monopoly advantage for a specified period of time, so they can exploit their inventions not only to recoup their investment costs and create commercial advantage, but also to acquire power and market dominance free of direct competition. The availability and enforcement of these rights vary from country to country. Without such legal protection and the assurance of commercial rewards, most firms and individuals would have little incentive to invent.3

Licensing as an Entry Strategy

A licensing agreement specifies the nature of the relationship between the owner of intellectual property, the licensor, and the user of the property, the licensee. High-technology firms routinely license their patents and know-how to foreign companies. For example, Germany’s Cognitec licensed the use of its face recognition technology to U.S. chip manufacturer Intel, which will use the technology to control access to laptops, tablets, and similar devices.4

Warner licenses images from the Harry Potter books and movies to companies worldwide. Disney (www.disney.com) licenses the right to use its cartoon characters to shirt and hat manufacturers in China. It also licenses its trademark names and logos to manufacturers of apparel, toys, and watches for sale worldwide. Licensing allows Disney to create synergies wth foreign partners, who can then adapt materials, colors, and other design elements to suit local tastes and market a product similar to one Disney already may offer in the United States.

Upon signing a licensing contract, the licensee pays the licensor a fixed amount up front and an ongoing royalty of covers the licensor’s initial costs of transferring the licensed asset to the licensee, including consultation, training in how to deploy the asset, engineering, or adaptation. Certain types of licensable assets, such as copyrights and trademarks, may have lower transfer costs. The royalty percentage may escalate with increasing sales.

A typical licensing contract runs five to seven years and is renewable at the option of the parties. Initially, the licensor provides technical information and assistance to the licensee. Once the relationship has been established and the licensee fully understands its role, the licensor usually plays an advisory role but usually has no direct involvement in the market and provides no ongoing managerial guidance. Most firms enter into exclusive agreements, in which the licensee is not permitted to share the licensed asset with any other company within a prescribed territory.

In addition to operating in its domestic market, the licensee also may be permitted to export to other countries.

If the licensor is an MNE, it may enter a licensing arrangement with its own wholly or partly owned foreign affiliate. In this case, licensing is an efficient way to compensate the foreign affiliate, especially when it is a separate legal entity, and transfer intellectual property to it within a formal legal framework.

In the fashion industry, Hugo Boss, Pierre Cardin, and other strong brands generate substantial profits from licensing deals for jeans, fragrances, and watches. Saks Inc. entered China by licensing its Saks Fifth Avenue name for a flagship department store in Shanghai. Saks generates revenue from the agreement and controls which merchandise is sold in China but has no other involvement. Licensing brings greater awareness of Saks Fifth Avenue to Asia without requiring Saks itself to operate the store, thereby reducing its risk.

The national origin of some popular brands might surprise you. Planters and Sunkist are food and beverage brands owned by U.S. companies and sold in Singapore and the United Kingdom through licensing agreements with local companies. Kit Kat chocolate bars are owned by Switzerland's Nestlé and distributed in the United States through a licensing agreement with Nestlé's competitor, Hershey. Game shows such as Price Is Right and Family Feud are owned by FremantleMedia, a United Kingdom company that licenses these programs for broadcast around the world.

There are two major types of licensing agreements: (1) trademark and copyright licensing and (2) know-how licensing. Let's review each.

Trademark and Copyright Licensing

Trademark licensing grants a firm permission to use another firm's proprietary names, characters, or logos for a specified period of time in exchange for a royalty. Trademarks appear on such merchandise as clothing, games, food, beverages, gifts, novelties, toys, and home furnishings. Organizations and individuals with name-brand appeal benefit from trademark licensing, such as Disney, Nickelodeon, FIFA, Harley-Davidson, LeBron James, and even your favorite university. A famous

trademark such as Harry Potter can generate millions of dollars for the owner. Worldwide retail sales of licensed merchandise exceed $175 billion annually.

In Canada, the United States, and numerous other countries, firms acquire rights to trademarks through first use and continuous usage. In other countries, however, rights to trademarks are acquired through registration with government authorities. Many firms register their trademarks in the countries where they do business to protect the asset. When a firm registers its trademark, it formally notifies government authorities that it owns the trademark and is entitled to intellectual property protection. Many countries require local use of the registered mark to maintain the registration.

The convention of gaining ownership to a trademark simply through registration has caused concerns for many firms. When it sought to enter South Africa, McDonald's was frustrated to learn a local businessperson had already registered the McDonald's trademark for his own use. In a court case, the South African Supreme Court ruled in favor of the local entrepreneur.

McDonald's eventually won on appeal but only after spending a significant sum in legal fees. In China, French apparel company Hermes lost the right to the Chinese version of its name because a local company had already registered it.

Winnie the Pooh (winniethepooh.disney.com) is one of the biggest success stories of trademark licensing. Introduced as a character in children's literature in 1926, Pooh evolved into a multibillion-dollar licensing property. Disney acquired it in 1961. Pooh is the second-highest earning fictional character of all time, behind only Mickey Mouse. The Pooh image is licensed to many manufacturers for inclusion on a range of products from baby merchandise to textiles to gardening products. There are roughly 1,000 Pooh licensees in Europe alone

In many countries, a copyright gives the owner the exclusive right to reproduce the work, prepare derivative works, distribute copies, or perform or display the work publiccly. Original works include art, music, and literature as well as computer software. The term of protection varies by country, but the creator's life plus 50 years is typical. Because many countries offer little or no copyright protection, it is wise to investigate local copyright laws before publishing a work abroad.

Know-How Licensing

Gaining access to technology is an important rationale for licensing. A know-how agreement is a contract in which the focal firm provides technological or management knowledge about how to design, manufacture, or deliver a product or a service to a licensee in exchange for a royalty.

The royalty may be a lump sum, a running royalty based on the volume of products produced from the know-how, or a combination of both.

In some industries, such as pharmaceuticals and semiconductors, inventions and other intellectual property are acquired in reciprocal licensing arrangements between firms in the same or similar industries. Known as cross-licensing, the practice is common in industries with rapid technological advances that often build on each other. Technology licensing from competitors reduces the cost of innovation by avoiding duplication of research while reducing the risk of excluding any one firm from access to new developments.

AT&T (www.att.com) once held most of the key patents in the semiconductor industry. As more firms entered the industry and the pace of research and development (R&D) quickened, AT&T risked being surpassed by competitors in Europe, Japan, and the United States, where thousands of semiconductor patents were being awarded. In such a complex network of patents, few firms would have succeeded without obtaining licenses from competitors. AT&T, Intel, Siemens, and numerous other competitors began licensing their patents to each other, creatingsynergies that greatly accelerated innovation in semiconductors.

In the pharmaceutical industry, the R&D expense to develop new drugs can reach billions of dollars. Pharmaceutical firms want to launch new medicines as quickly as possible to recoup these costs and to expedite product development. Thus, the firms frequently crosslicense technologies to each other, exchanging scientific knowledge about producing specific products as well as the right to distribute them in certain geographic regions.11 In other industries, firms may license technology and know-how from competitors to compensate for insufficient knowledge, fill gaps in their product lineups, enter new businesses, or save timeand money.

The World’s Top Licensing Firms

The world’s leading licensing firms by annual revenues. The greatest amountof licensing occurs in the apparel, games, and toy industries. In 2009, Disney acquired Marvel Entertainment for $4 billion, greatly expanding Disney’s inventory of licensed assets. Licensing sales have benefited immensely from the emergence of large-scale retailers such as Carrefour, Walmart, and Amazon.com.

Advantages and Disadvantages of Licensing

Let’s highlight some key points.

Licensing can be used as a low-cost strategy to test the viability of foreign markets. By establishing a relationship with a local licensee, the foreign firm can learn about the target market and devise the best future strategy for establishing a more durable presence there. For example, Swiss pharmaceutical manufacturer Roche entered a licensing agreement with Chugai Pharmaceuticals in Japan, where

success requires substantial knowledge of the local market and the drug approval process. The relationship accelerated Roche's penetration of the huge Japanese market.13 Licensing can also help the firm develop its brand name in a target marketand preempt the later entry of competitors.

Disadvantages of Licensing

From the licensor's standpoint, licensing is a relatively passive entry strategy. However, the licensor must take steps to enforce the licensing agreement. The licensor needs to ensure that licensees are paying the appropriate royalties and are not violating the licensor's intellectual property.

Profits tend to be lower than those from exporting or FDI. Licensing does not guarantee a basis for future expansion. To earn royalties, the licensor must rely on the licensee's sales and marketing prowess. A weak partner will generate only meager royalties. Also, licensing provides limited control over how the licensor's asset is used. If the licensee produces a substandard product, the licensor's reputation can be harmed. To avoid such problems, experienced firms require foreign licensees to meet minimum quality and performance standards. For example, Budweiser beer is made and distributed in Japan through a licensing arrangement with Kirin (www.kirin. co.jp/company/english). Kirin is one of Japan's most reputable brewers and produces the beer according to Budweiser's strict standards.

If the licensee is very successful, the licensor may regret not entering the market through a more lucrative entry strategy. This happened to Disney, which developed Disneyland Tokyo through a licensing arrangement with a Japanese partner. When the theme park proved more successful than originally forecast, Disney management wished it had used FDI to develop Disneyland Tokyo itself. In Mexico, Televisa (www.televisa.com), the largest producer of Spanish-language TV programming, opted for a licensing arrangement with California-based Univision to enter the U.S. market. Although there are approximately 40 million native Spanish speakers in the United States, Televisa received only a fraction of Univision's Spanish market advertising revenue.

Because licensing requires sharing intellectual property with other firms, the risk of creating a future competitor is substantial.14 The rival might exploit the licensor's intellectual property by entering third countries or creating products based on knowledge gained in the relationship. This has occurred in the automobile, computer chip, and consumer electronics industries in Asia as Western firms have transferred process technologies to firms in China, Japan, and South Korea. Japan's Sony (www.sony. com) originally licensed transistor technology from U.S. inventor Bell Laboratories to make hearing aids. But instead, Sony used the technology to create small, battery-powered transistor radios and soon grew to become a global leader in this product category.

The U.S. toymaker Mattel licensed rights to distribute the Barbie doll to the Brazilian toymaker Estrela (www.estrela.com.br). Once the agreement expired, Estrela developed its own Barbie lookalike— Susi—which surpassed sales of Barbie dolls in Brazil. Estrela then launched the Susi doll throughout South America to great success. In Japan, Mattel entered a licensing agreement with local toymaker Takara (www.takaratomy.co.jp), which adapted the Barbie doll for Japanese girls.

When the agreement expired, Takara continued to sell the doll under the name "Jenny," becoming a competitor to Mattel in the world's second-biggest toy market.

Franchising as an Entry Strategy

Franchising is an advanced form of licensing in which the focal firm, the franchisor, allows an entrepreneur, the franchisee, the right to use an entire business system in exchange for compensation.

As with licensing, an explicit contract defines the terms of the relationship. McDonald's, Subway, Hertz, and FedEx are well-established international franchisors. Others that use franchising to expand abroad include Benetton, Body Shop, Yves Rocher, and Marks & Spencer.

Franchising is common in international retailing. However, some retailers such as IKEA and Starbucks favor direct investment and internationalize through company-owned outlets.

Ownership provides these firms with greater control over foreign operations but also typically restricts their ability to expand more rapidly abroad.

Franchises generate the biggest volume of sales in advanced economies such as the United States, Europe, and Japan. However, a large number of franchises are found in countries that are less economically developed in Asia. Many of these are micro-franchises, operated by one or two people. Franchising is a major job creator in developing economies in Asia and Latin America, helping to raise living standards. A large proportion of franchises in Africa and lessdeveloped Asia are international.

The nature of the franchising agreement. Most firms undertake business format franchising (sometimes called system franchising). The franchisor transfers to the franchisee a total business method, including production and marketing methods, sales systems, procedures, and management know-how, as well as the use of its name and usage rights for products, patents, and trademarks. The franchisor also provides the franchisee with training, ongoing support, incentive programs, and the right to participate in cooperative marketing programs.

In return, the franchisee pays some type of compensation to the franchisor, usually a royalty representing a percentage of the franchisee's revenues. The

franchisee may be required to purchase certain equipment and supplies from the franchisor to ensure standardized products and consistent quality. Burger King and Subway require franchisees to buy food preparation equipment from specified suppliers.

Whereas licensing relationships are often short-lived, franchising parties normally establish an ongoing relationship that may last many years. This results in a more stable long-term entry strategy. In addition, franchisors often combine franchising with other entry strategies. For example, about 70 percent of Body Shop's approximately 2,500 stores in some 60 countries are operated by franchisees. Body Shop (www.thebodyshop.com) headquarters owns the rest. Large retailers such as Carrefour often employ both franchising and FDI when expanding abroad.

Franchising is more comprehensive than licensing because the franchisor prescribes virtually all of the business activities of the franchisee. The franchisor tightly controls the business system to ensure consistent standards. International franchisors employ globally recognized trademarks and attempt to guarantee the customer a uniform retail experience and consistent product quality.

Completely standardized business activities, however, are difficult to replicate across diverse markets. Differences in local tastes, available ingredients, and physical space may necessitate changes to the franchise formula. McDonald's offers teriyaki burgers in Japan, wine in France, and a McPork sandwich in Spain. In China, KFC offers shredded carrots, fungus, and bamboo shoots instead of the coleslaw it sells in Western countries.20 Limited land in Japan forced KFC to reconfigure its cooking equipment from a wide horizontal design to a narrower, more vertical design that saves space. Japanese KFCs are often multistoried restaurants to save on the high cost of land. The challenge is to strike the right balance, adapting the format to respond to local markets without affecting the overall image and service of the franchise.

Some focal firms may choose to work with a single, coordinating franchisee in a particular country or region. In this master franchise arrangement, an independent company is licensed to establish, develop, and manage the entire franchising network in its market. The master franchisee has the right to sub-franchise to other independent businesses and thus assume the role of the local franchisor. McDonald's is organized this way in Japan. By delegating the responsibilities of identifying and working with its franchisees directly, the focal firm gives up considerable control over its foreign market operations. From the focal firm's perspective, however, the arrangement isthe least capital- and time-intensive.

Master franchisees prefer this arrangement because it provides them with an exclusive, large, predefined territory (often an entire country) and substantial scale economies from operating numerous sales outlets simultaneously. They gain access

to a proven retailing and marketing concept and partnership with a corporate headquarters and master franchisees in other territories, which typically provide support, know-how, and the latest innovations in the field. Master franchising accounts for as much as 80 percent of international franchising deals. Sbarro, Inc., the pizza chain, operates through master franchises in Belgium, Canada, Guatemala, Kuwait, the Philippines, and the United Kingdom.

Who Are the Top Global Franchisors?

Franchising is a global phenomenon and accounts for a large proportion of international trade in services, especially fast-food outlets, professional business services, home improvement, and various types of retailers. Yum! Brands, Inc., owns the KFC, Pizza Hut, and Taco Bell brands of franchised restaurants. KFC has approximately 5,000 stores in China, and Pizza Hut has roughly 1,600 stores in China, making Yum! one of the largest retail developers in China.23 profiles several other leading global franchisors.

The United States is home to the largest number of franchisors and dominates international franchising. U.S. franchisors and their franchisees employ 21 million people, generate $2.3 trillion of economic activity, and account for nearly 50 percent of total U.S. retail sales. The United Kingdom is home to numerous home-grown franchisors such as Eden Delicious and Perfect Pizza. Annual franchised sales of fast food in the United Kingdom are said to account for 30 percent of all food eaten outside the home.

The ability to exchange information instantaneously through the Internet enhances the franchisor's ability to control international operations and saves time and money. Some franchisees use electronic point-of-sale equipment that links their sales and inventory data to the franchisor's central warehouse and distribution network. Information technology also allows the franchisor to serve customers or franchisees with central accounting and other business process functions.

As markets in Europe and other advanced economies become saturated, franchisors are expanding to emerging markets. Subway is doing big business in Eastern Europe. Avis car rental enjoys much success in Latin America. Ben & Jerry's ice cream is a favorite in Thailand and Turkey. About 70 percent of the countries where KFC does business are developing economies.

Estimates suggest international franchised companies provide more than 2.4 million jobs in developing economies. Franchises help provide needed modernization in business methods, distribution networks, and commercial infrastructure. They help build local capabilities and skills by both bringing in expatriate staff and training local personnel. Because franchising is less risky, it is often preferred over FDI for entering developing economies.

Advantages and Disadvantages of Franchising

In an ideal relationship, franchisor and franchisee complement each other. The franchisor possesses economies of scale, a wealth of intellectual property, and know-how about its industry; the franchisee has entrepreneurial drive and substantial knowledge about the local market and how to run a business there. A large pool of well-chosen franchisees greatly enhances the speed and quality of the franchisor's performance abroad.26 For example, KFC internationalized quickly and performed well worldwide by developing franchisees in more than 115 countries with some 17,000 restaurants serving more than 12 million customers per day.

The Franchisor Perspective

The advantages and disadvantages of franchising to the franchisor. Firms prefer franchising when they lack the capital or international experience to establish themselves abroad through FDI or when offering the product through exporting or basic licensing is ineffective as an internationalization strategy. Foreign markets often provide greater profitabilitythan the home market. For example, the Beijing KFC store has generated more sales than any other KFC outlet worldwide partly due to the novelty and popularity of the offering and the lack of direct competition. Governments in host countries often encourage franchising by foreign entrants because most of the profits and investment remain in the local economy.

For the franchisor, franchising is a low-risk, low-cost entry strategy. It offers the ability to develop international markets relatively quickly and on a larger scale than possible for most nonfranchise firms. The franchisor can generate profit with only incremental investments in capital, staff, production, and distribution.

The major disadvantages include the need to maintain control over potentially thousands of outlets worldwide an the risk of creating competitors. When the franchising agreement is terminated, some franchisees leverage their newly acquired knowledge to remain in business, often by slightly altering the franchisor's brand name or trademark. Franchisees may also jeopardize the franchisor's image by not upholding its standards. Dunkin' Donuts experienced problems in Russia when it discovered some franchisees were selling vodka along with donuts.

When the franchisor depends heavily on a foreign partner as master franchisee, it is critical to cultivate friendly, durable relationship ps. However, even experienced franchisors encounter major problems. In 2010, nearly 30 years after opening its first outlet in Japan, restaurant chain Wendy's could not reach a new agreement with its Japanese master franchisee, Zensho Company, and chose to close its restaurants there. The move disappointed countless Japanese fans, who formed long lines in front of Wendy's outlets in the days before the chain shut down.

Another major challenge is to become familiar with foreign laws and regulations. The European Union has strict laws that favor the franchisee, sometimes hampering the franchisor's ability to maintain control over operations. Laws and foreign exchange circumstances affect the payment of royalties.