

Chapter 6
Political and Legal Systems in National Environments
International Business
Strategy, Management & the New Realities
by
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Learning Objectives

1. What is country risk?
2. What are political and legal system?
3. Political systems
4. Legal systems
5. Actors in political and legal systems
6. Types of country risk produced by the political system
7. Types of country risk produced by the legal system
8. Managing country risk

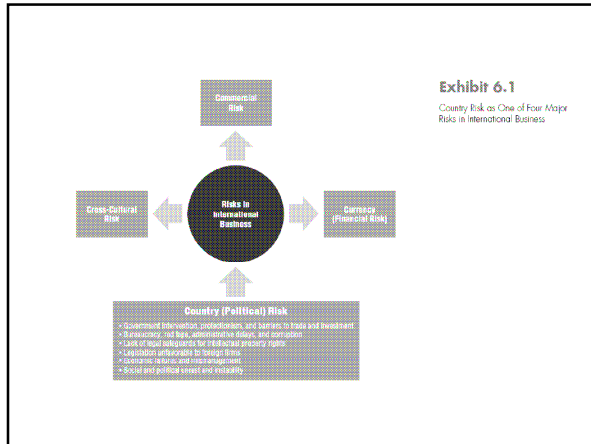
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What is Country (Political) Risk?

Exposure to potential loss or adverse effects on company operations and profitability caused by developments in a country's political and/or legal environments.

- Every country is characterized by diverse political and legal systems that pose significant challenges for company strategy and performance, as managers must adhere to business laws and regulations.
- Preferential subsidies, government incentives, and protection from competition reduce business costs and influence strategic decision making.
- Governments encourage domestic investment from foreign MNEs by offering tax holidays and cash incentives to employ local workers.

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What Gives Rise to Country Risk?

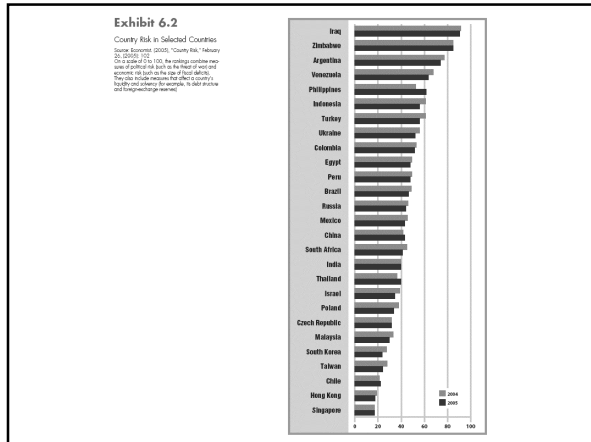
- While the immediate cause of country risk is a political or legal factor, underlying such factors may be economic, social, or technological developments.
- Unintended consequences- Laws may be unexpectedly strict, political/ legislative actions may harm business, even though not the intent.
- Host-country favoritism- interests in foreign countries where the firm has direct operations.
- **Example-** In China, the government censors material that criticizes the government. Yahoo must monitor the information that appears on its Web site to prevent the Chinese government from shutting down its China operations.
- Weak enforcement of laws and regulations poses challenges.
- Regulations to protect intellectual property may exist on paper but are not adequately enforced.

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How Prevalent is Country Risk?

- Risk is measured using various indicators, such as government debt, fiscal and monetary policy, and political stability.
- **Risky countries:** Iraq (war), Zimbabwe (corruption, bribery, fraud and political turmoil), India (Hindu nationalists that came to political power in 1996 openly opposed foreign investment and foreign influence on Indian society- despite a series of economic reforms and markets liberalization efforts in 1991).
- **Stable countries:** Singapore, Hong Kong.
- Systematic Country Risk- affects all industries, all firms in a country.

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Examples of How Country Risk Influences Firms and Industries

- **Systematic Country Risk**- affects all industries, all firms in a country.
 - **Example**- the civil war that occurred in the former Yugoslavia and several African countries in the 1990s impacted all firms.
- **Unsystematic Country Risk**- affects only a subset of firms.
 - **Example**- the Russian government targeted only Yukos with politically motivated persecution, despite competitors in the Russian oil industry—Conoco-Phillips, Exxon Mobil, and Royal Dutch Shell.
- As countries develop stronger economic ties with foreign trading partners, and become better integrated with the global economy, they tend to liberalize their markets and eliminate restrictions on foreign business.

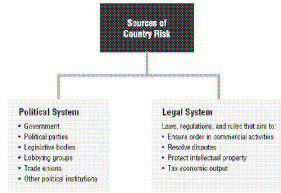
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What are Political and Legal Systems?

- **Political system** - a set of formal institutions that constitute a government. It includes legislative bodies, political parties, lobbying groups, and trade unions. A political system also defines how these groups interact with each other.
- **Legal system** - a system for interpreting and enforcing laws. The laws, regulations, and rules establish norms for conduct. A legal system incorporates institutions and procedures for ensuring order and resolving disputes in commercial activities, as well as protecting intellectual property and taxing economic output.

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Exhibit 6.3
Sources of Country Risk



Political and Legal Systems are Dynamic

- Political and legal systems are dynamic, constantly changing and interdependent.
- **Examples**- new government, shifting values or priorities in political parties, new directions from special interest groups, and new laws or regulations
- Change may be gradual or sudden.
- Country risk is *always* present, but its nature and intensity vary over time and from country to country.
- **Example**- China is in the process of overhauling the national legal system, making it increasingly consistent with Western systems. Piecemeal regulations have been poorly formulated, are confusing, and/or contradictory.

Political Systems

- The principal functions of a political system are to establish stability based on laws, provide protection from external threats, and govern the allocation of valued resources.
- Emerging from a specific historical, economic, and cultural context, amidst constituent demands, and the evolution of the national and international environments, country political systems are relatively unique.
- The continuum runs from state ownership and control of economic enterprises to minimal government intervention in business activities.

Three Major Types of Political Systems

- Totalitarianism, socialism, and democracy.
- These categories are not mutually exclusive. Most democracies also include some elements of socialism. Most of the totalitarian regimes of the 20th century now embrace a mix of socialism and democracy.
- Totalitarian states from the past include **China** (1949–1980s), **Germany** (1933–1945), the **Soviet Union** (1918–1991), and **Spain** (1939–1975).
- Today, some states in the **Middle East** and **Africa** employ totalitarianism.



Elements of Totalitarianism Found in	Elements of Socialism Found in	Elements of Democracy Found in	Exhibit 6.4 Examples of Countries under Various Political Systems
Cuba North Korea Several countries in Africa (Sierra Leone, Libya, Sudan, Equatorial Guinea, Zimbabwe)	Soviet China Egypt India Romania Russia Venezuela	Australia Canada Japan New Zealand United States Most European countries Most Latin American countries	

Totalitarianism

- Government controls all economic and political matters.
- Totalitarian states are generally either **theocratic** (religion-based) or **secular** (non-religion-based).
- A state party is led by a dictator, such as Kim Jong-il in North Korea. Party membership is mandatory for those who wish to advance.
- Power is sustained via secret police, propaganda disseminated through state-controlled mass media, regulation of free discussion and criticism.
- Totalitarian states do not tolerate criticism by individuals or groups such as churches, labor unions, or political parties.
- Transition- most of the world's totalitarian states have either disappeared or shifted their political and economic systems toward democracy and capitalism. China initiated major reforms in the **1980s**, and the Soviet Union collapsed in **1991**.
- Transition- not easy- former Soviet states and China are still characterized by government intervention, red tape, bureaucratic accounting and tax regulations, inadequate legal systems to protect business interests.



Socialism

- Capital and wealth should be vested in the state and used primarily as a means of production for use rather than for profit.
- Based on a collectivist ideology where group welfare outweighs individual welfare.
- Socialists argue that capitalists receive a disproportionate amount of society's wealth relative to workers. Government should control the basic means of production, distribution, and commercial activity.
- Socialism has manifested itself in much of the world as *social democracy*, and has been most successful in Western Europe, and playing a role in Brazil and India.
- In social democratic regimes, such as France and Norway, government does intervene in the private sector and in business activities. Corporate income tax rates are higher.

Two Key Features of Democracy

- **Private property rights:** The ability to own property and assets and to increase one's asset base by accumulating private wealth.
- **Property** includes tangibles: land and buildings, and intangibles: stocks, contracts, and patent rights.
- Democratic governments devise laws that protect property rights. People and firms can acquire property, use it, buy or sell it, and bequeath it to whomever they want. These rights are important because they encourage individual initiative, ambition, and innovation, as well as thrift.
- **Limited government:** The government performs only essential functions that serve all citizens, such as national defense, maintaining law and order, diplomatic relations, and the construction and maintenance of infrastructure such as roads, schools, and public works.

Social Democracy

- Exemplified by Japan, Germany, and Sweden, where the individual rights and freedoms are balanced with broader social goals.
- **Social democracy-** virtually all democracies include elements of socialism, such as government intervention in the affairs of individuals and firms. Socialistic tendencies emerge because of abuses or negative externalities that occur in purely democratic systems.
- **Example-** Japan has been striving to achieve the right balance between democracy and socialism. In the 1990s, poor management practices and an economic recession led to the bankruptcy of thousands of Japanese firms. To maintain jobs and economic stability, the Japanese government intervened to support numerous large firms and banks that, in a pure democracy, would have failed. Nevertheless, such policies have also led to inflexibility in the Japanese economy and a delay of needed structural improvements.

Mixed Political Systems

Many countries, including Australia, Canada, the United States, and those in Europe, are best described as having a *mixed* political system -- characterized by a strong private sector *and* a strong public sector (with considerable government regulation and control).

Democracy's Link to Economic Freedom

- There is sufficient empirical evidence suggesting that democracy -- greater economic freedom -- leads to higher economic living standards.
- Economic freedom flourishes in free market and rule of law systems.
- **Characteristics:** free and fair elections, the right to form political parties, fair electoral laws, existence of a parliament or other legislative body, freedom from military domination, foreign powers, or religious hierarchies, and self-determination for cultural, ethnic, and religious minorities.
- Economic freedom is related to the extent of government interference in business, the strictness of the regulatory environment, and the ease with which commercial activity is carried out according to market forces (www.freedomhouse.org).

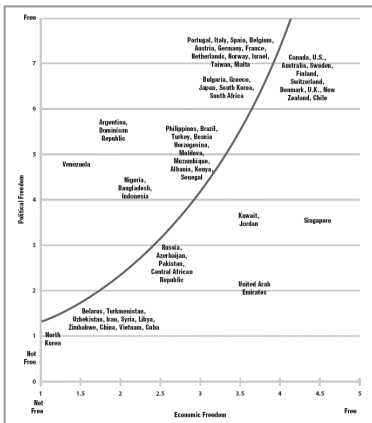


Exhibit 6.5
Relationship between Political Freedom and Economic Freedom for a Sample of Countries
SOURCE: Freedom House. Accessed at www.freedomhouse.org

How Political Systems Influence Economic Systems

In general:

- Totalitarianism is associated with command economies
- Democracy with market economies
- Socialism with mixed economies



Command (Centrally Planned) Economies

- The state is responsible for making all decisions:
- What goods and services the country produces; Quantity of production; Prices at which they are sold; and Distribution
- The state owns all wealth, land, and capital, and allocates resources based on which industries they want to develop.
- Command economies were common in the 20th century; they proved so inefficient that most have gradually died out.
- Central planning is less efficient than market forces in synchronizing supply and demand.
- Today many countries exhibit some characteristics of command economies- **examples**- China, India, Russia, and certain countries in Central Asia, Eastern Europe, and the Middle East.



Market Economies

- Decisions regarding production levels, consumption, investment, and savings resulting from the interaction of supply and demand (*market forces*).
- Economic decisions are left to individuals and firms.
- Government intervention in the marketplace is limited.
- Capitalism (private ownership of production) is closely aligned with market economies.
- State should establish a legal system that protects private property and contractual agreements.
- Government may also intervene to address the inequalities that market economies sometimes produce.



Mixed Economies

- Exhibits market and command economy features, thus combining state intervention *and* market mechanisms.
- Most industries are under private ownership, and entrepreneurs freely establish, own, and operate corporations- but the government also controls certain functions, such as pension programs, labor regulation, minimum wage levels, and environmental regulation.
- The state usually funds public education, health care, and other vital services and owns enterprises in transportation, telecommunications, and energy.
- **Examples- France, Germany, Japan, Norway, Singapore, and Sweden,** government often works closely with business and labor interests to determine industrial policy, regulate wage rates, and/or provide subsidies to support specific industries.



Legal Systems

- Legal systems provide a framework of rules and norms of conduct that mandate, limit, or permit specified relationships among people and organizations, and provide punishments for those who violate these rules and norms.
- Laws empower citizens to enter into contracts and seek remedies for contract violations.
- Legal systems are dynamic- they evolve over time to represent each nation's changing social values and the evolution of their social, political, economic, and technological environments.



Rule of Law Signals Existence of a Legal System

- Political systems—totalitarianism, socialism, and democracy—influence their respective legal systems.
- In Australia, Canada, Japan, the United States, and most European countries, laws are widely known and understood. Such well-developed legal systems are effective and legitimate because they are applied to all citizens equally, issued by means of formal procedures applied by recognized government authorities, and enforced systematically and fairly by police forces and formally organized judicial bodies.
- **Rule of law** (businesses flourish) the existence of a legal system where rules are clear, publicly disclosed, fairly enforced, and widely respected by individuals, organizations, and the government.
- Legal systems can be eroded by declining respect for the law- in the absence of the rule of law, economic activity can be impeded and firms have to contend with great uncertainty.



Five Types of Legal Systems

The five legal systems are the foundation for laws and regulations:

- Common law
- Civil law
- Religious law
- Socialist law
- Mixed systems



Primarily Common Law	Primarily Civil Law	Primarily Religious Law	Primarily Socialist Law	Mixed Systems
Australia	Much of western Europe, and Latin America,	Middle East, North Africa, and a few countries in Asia	Russia	Much of eastern Europe,
Ireland			China	Philippines
New Zealand			Cuba	Puerto Rico
United Kingdom	Turkey		North Korea	South Africa
Canada	Japan		Kazakhstan	Thailand
United States	Mexico		Uzbekistan	Sri Lanka
India			Ukraine	Ethiopia
Pakistan			Azerbaijan	Hong Kong
Ghana			Moldova	Bahrain
Nigeria			Tajikistan	Qatar
Zimbabwe			Kyrgyzstan	Singapore
Malaysia				Morocco
				Tunisia
				Vietnam
				Egypt

Exhibit 6.6 Dominant Legal Systems in Selected Countries

SOURCE: Accessed at wikipedia.org/wiki/legal_systems_of_the_world and www.droitofculture.ca/worldlegal/systems/legaltable.php

Common (Case) Law

- *Common law* (also known as case law) is a legal system that originated in England and spread to Australia, Canada, the United States, and former members of the British Commonwealth.
- The basis of common law is tradition, past practices, and legal precedents set by the nation's courts through interpretation of statutes, legislation, and past rulings.
- Common law is open to interpretation by courts- it is more flexible than other legal systems.
- Judges have substantial power to *interpret* laws based on the unique circumstances of individual cases.



Civil (Code) Law

- *Civil law* is found in France, Germany, Italy, Japan, Turkey, Mexico, and in Latin America.
- Its origins go back to Roman law and the Napoleonic Code- based on an all-inclusive system of laws that have been “codified”—clearly written and accessible.
- Civil law divides the legal system into three separate codes: commercial, civil, and criminal.
- Rules and principles form the starting point- the codified rules emerge as specific laws and codes of conduct produced by a legislative body or some other supreme authority.
- Both common law and civil law systems originated in western Europe and both represent the common values of western Europeans.
- A key difference is that **common law** is primarily **judicial** in origin and based on court decisions, whereas **civil law** is primarily **legislative** in origin and is based on laws passed by legislatures.



<i>Legal Issues</i>	<i>Civil Law</i>	<i>Common Law</i>
Ownership of intellectual property	Determined by registration.	Determined by prior use.
Enforcing agreements	Commercial agreements become enforceable only if properly notarized or registered.	Proof of agreement is sufficient for enforcing contracts.
Specificity of contracts	Contracts tend to be brief because many potential problems are already covered in the civil code.	Contracts tend to be very detailed, with all possible contingencies spelled out. Usually more costly to draft a contract.
Compliance with contracts	Noncompliance is extended to include unforeseeable human acts such as labor strikes and riots.	Acts of God (floods, lightning, hurricanes, etc.) are the only justifiable excuses for noncompliance with the provisions of contracts.

Exhibit 6.7

Examples of Differences between Common Law and Civil Law

Religious Law

- *Religious law* is strongly influenced by religious beliefs, ethical codes, and moral values, viewed as mandated by a supreme being.
- Most important religious legal systems are based on Hindu, Jewish, and Islamic law- the most widespread is Islamic law, found mainly in the Middle East, North Africa, and Indonesia.
- Islamic law (also known as shariah law) is derived from interpretations of the Qur'an, and the teachings of the Prophet Mohammed.
- Islamic law is nonsecular and spells out norms of behavior regarding politics, economics, banking, contracts, marriage, and many other social issues.
- Most Muslim countries maintain both religious and secular courts.
- Indonesia, Bangladesh, Turkey and Pakistan have secular constitutions and laws. Saudi Arabia and Iran use religious courts as authority over all aspects of jurisprudence.
- Strict interpretation of Islamic law prohibits the giving and receiving of interest on loans or investments.



Socialist Law

- *Socialist law* is a legal system found mainly in the independent states of the former Soviet Union, China, and a few states in Africa.
- It is based on civil law, with elements of socialist principles that emphasize state ownership of property- state rights take precedence over individuals'.
- Socialist law countries tend to view property and intellectual property rights more loosely.
- As China and Russia adopt free-market principles, their legal systems increasingly incorporate additional elements of civil law.



Mixed Systems

- *Mixed systems*- variation of two or more legal systems operating together.
- The contrast between civil law and common law has become particularly blurred as many countries combine both systems. Legal systems in Eastern Europe mix elements of civil law and socialist law. Legal systems in Lebanon, Morocco, and Tunisia share elements of civil law and Islamic law.
- Socialism is most associated with socialist law, but may include elements of common law and civil law.
- Totalitarianism is most associated with religious law and socialist law.
- Democracy is associated with common law, civil law, mixed systems, and, occasionally, socialist law.



Actors in Political and Legal Systems

Political and legal systems evolve from the interplay among various societal institutions, at both the national and international levels:

- Government
- International organizations
- Regional economic blocs
- Special interest groups
- Competing firms



Government and International Organizations

- The **government**, or the public sector, is the most important actor, operating at national, state, and local levels.
- Governments have the power to enact and enforce laws. They are influential in how firms enter host countries and how they conduct business there.
- Governments regulate international business activity through institutions, agencies, and public officials.
- **Supranational agencies** such as the World Trade Organization (www.wto.org), United Nations (www.un.org), and the World Bank (www.worldbank.org) have a strong influence on international business activities.
- Such organizations help facilitate free and fair trade by providing administrative guidance, governing frameworks, and, occasionally, financial support.



Regional Trade Organizations and Special Interest Groups

- **Regional trade organizations**, such as the European Union (EU), the North American Free Trade Agreement (NAFTA), and the Association of Southeast Asian Nations (ASEAN), advance the economic and political interests of their members.
- The EU organization is especially well developed, with its own executive, legislative, and bureaucratic bodies.
- **Special Interest Groups** are formed to serve the interests of particular countries, industries, or causes.
- The Organization of Petroleum Exporting Countries (OPEC) is a powerful cartel that controls global oil prices, which, in turn, affect the cost of doing business and consumer prices. (Saudi Arabia, Kuwait, Iran, Venezuela, Nigeria, and Indonesia.)
- Other special interest groups control sugar, coffee, and iron ore.
- Special interest groups engage in political activity to advance specific causes, ranging from labor rights to environmental protection.



Organization or Group	Issues of Concern
Organized religious groups	Perceive moral violations by foreign firms
Labor organizations	Oppose imported goods and offshoring
Competing businesses	Concerned about local resource consumption
Customers	Perceived price gouging by firms
Minority groups	Perceived discrimination/sexual harassment
Conservationists	Concerned about environmental degradation
General public	Concerned about the impact of foreign firms on national culture

Exhibit 6.8

Issues of Concern to Special Interest Organizations and Groups

Competing Firms

- Rival domestic firms with a strong presence in the host country naturally have an interest in opposing the entry of foreign firms into the local market and may lobby their government for protection.
- Host-country competitors often complain when foreign firms receive financial support from the parent or host-country governments.

Examples:

- Asterix, a French theme park, opposed French government support for the U.S.-based Disney when Disneyland Paris was established.
- U.S. automakers in Detroit opposed BMW's construction of a factory in South Carolina.



Country Risk Produced by the Political System: Government Takeover of Corporate Assets

- **Confiscation** refers to the seizure of foreign assets *without* compensation. For example, in Venezuela, President Hugo Chavez confiscated a major oil field owned by the French petroleum firm Total.
- **Expropriation** refers to the seizure of corporate assets *with* compensation.
- **Nationalization** refers to government takeover of an entire industry, with or without compensation. In 2006, the government of Bolivia nationalized much of the oil and gas industry in that country.
- **Privatization** - selling of state-owned enterprises to private interests. The trend has been especially notable in China and Eastern Europe.



Embargoes and Sanctions

Governments may resort to sanctions and embargoes to respond to offensive activities of foreign countries.

- **Sanctions** are a type of ban on international trade, usually undertaken by a country, or a group of countries, against another judged to have jeopardized peace and security.
- **Embargoes** are official bans on exports or imports that forbid trade in specific goods with specific countries. For example, the U.S. has enforced embargoes against Cuba, Iran, and North Korea, all at times labeled as state sponsors of terrorism.



Boycotts and Conflict

- **Boycott**- voluntary refusal to engage in commercial dealings with a nation or a company
- **Examples**- Disneyland Paris and McDonald's- targets of boycotts by French farmers, who view these firms as symbols for venting their anger against U.S. agricultural policies and globalization.
- **War, insurrection, and revolution**- indirect effects- can be disastrous.

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Terrorism

Terrorism is the threat or actual use of force or violence to attain a political goal through fear, coercion, or intimidation.

- Much terrorism is sponsored by national governments, making it a particularly hazardous form of country risk.
- Terrorism has escalated in much of the world, as exemplified by the 9/11 attacks on the United States.
- In addition to causing tremendous loss of life, the financial markets were severely damaged following the 9/11 attacks, the value of the U.S. stock market dropped some 14 percent.
- Hospitality, aviation, entertainment, and retailing industries may be particularly affected by terrorism.

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**Country Risk Produced by the Legal System:
Foreign Investment Laws**

- These laws affect the type of entry strategy firms choose, as well as their operations and performance.
- Many nations impose restrictions on inward FDI.

Examples:

- Japan- *daitenhoo* (large-scale retail store law) restricted foreigners from opening warehouse-style stores such as Wal-Mart or Toys'R'Us.
- Malaysia- firms that want to invest in local businesses must obtain permission from the Malaysian Industrial Development Authority, which screens proposed investments to ensure they fit with national policy goals.
- U.S. restricts foreign investments that are seen to affect national security. In 2006, the U.S. Congress fiercely opposed a pending deal granting operational control at several U.S. ports to Dubai Ports World, a firm based in the United Arab Emirates.

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Controls on Operating Forms and Practices

- Governments impose laws and regulations on how firms should conduct production, marketing, and distribution activities within their borders.
- **Example-** In China, a huge telecommunications market, government requires foreign investors to seek joint ventures with local firms; local operations cannot be wholly owned by foreigners. This is to ensure that China maintains control of its telecommunications industry and obtains inward transfer of technology, knowledge, and capital.



Marketing and Distribution Laws

Determine which practices are allowed in advertising, promotion, and distribution.

- Finland, France, Norway, and New Zealand prohibit cigarette advertising on television.
- Germany largely prohibits comparative advertising, in which one brand is touted as superior to a specific competitor.
- Many countries cap the pricing of critical goods and services, such as food and health care.
- Product safety and liability laws hold manufacturers and sellers responsible for damage, injury, or death caused by defective products.
- Product liability laws are generally weak in developing economies, as litigants pursued tobacco companies in Europe and the United States, these companies shifted their marketing of cigarettes to developing economies.



Restrictions on Income Repatriation and Environmental Laws

Laws regarding Income Repatriation. MNEs earn profits in various countries and typically seek ways to transfer these funds back to their home country.

- Repatriation restrictions limit the amount of net income or dividends that firms can remit to their home-country headquarters-aiming to preserve hard currencies, such as euros, U.S. dollars, or Japanese yen.

Environmental laws. Governments enact laws to preserve natural resources, combat pollution and the abuse of air, earth, and water resources, and ensure health and safety.

- Germany- companies must follow strict recycling regulations.
- Mexico- environmental standards- less well-enforced due to the fear of foreign MNEs reducing their investment.



Contract Laws

Five types of Contracts:

1. Sale of goods or services;
2. Distribution of the firm's products through foreign distributors;
3. Licensing and franchising-that is, a contractual relationships;
4. FDI, especially where this is done in collaboration with a foreign entity; and
5. Joint ventures.

Some convergence- More than 70 countries are now party to the U.N. convention on Contracts for the International Sale of Goods (CISG), a uniform text of law for international sales contracts.



Country Risk Arising from the Home Country Legal Environment

Extraterritoriality - the application of home-country laws to persons or conduct outside of national borders

- Typically, laws are applied in an attempt to prosecute individuals or firms located abroad for some type of wrongdoing.
- French court recently ordered Yahoo! to bar access to Nazi-related items on its website in France and to remove related messages, images, and literature from its sites.
- 2001- U.S. enacted the Patriot Act, authorizing the U.S. government to seize funds held by non-U.S. banks in the U.S.
- EU has pursued Microsoft for perceived monopolistic practices in the development and sale of its operating system software.
- Businesses oppose extraterritoriality- increases transaction costs, compliance, regulatory costs, and causes considerable uncertainty.



Foreign Corrupt Practices Act (1977)

The FCPA made it illegal for a firm to offer bribes to foreign parties for the purpose of securing business.

- 1998- FCPA strengthened with additional antibribery stipulations for foreign firms while in the U.S.
- The definition of a "bribe" is not clearly specified in the FCPA. Is there a distinction between bribery and "facilitation" payments?
- **Competitive disadvantage**- U.S. managers have argued that the FCPA harms their interests because foreign competitors are not so constrained.
- FCPA penalties- firms- \$2 million; individuals- \$100,000 and imprisonment



Antiboycott Regulations

- Home-country regulations prevent companies from participating in restrictive trade practices or boycotts imposed by foreign countries against other countries.
- The antiboycott regulations (1977) prohibit U.S. firms from participating in the boycott of Israel when operating in Arab nations because discrimination based on race, religion, gender, or national origin is prohibited.
- Some Arab countries require such a boycott as a condition of business.



Accounting and Reporting Laws

- Stocks/securities valuation- most countries use the lower of cost or market value. **Brazil** - firms to adjust their portfolio valuations because of historically high inflation there.
- Physical asset valuations (plant and equipment): **Canada** and the **U.S.** use historical costs. **Latin American** countries use inflation-adjusted market value.
- Uncollectible accounts allowance: in the **U.S.** – yes; **France, Spain, and South Africa** – no
- Research and development costs are: expensed as incurred in most of the world; Capitalized in **South Korea** and **Spain**; **Belgium, Malaysia, and Italy** use both conventions.



Transparency in Financial Reporting

Transparency -- the degree to which firms regularly reveal substantial financial & accounting information.

- The timing and transparency of financial reporting vary widely around the world. U.S.-every quarter; much of the world-once a year/less often.
- **2002** Sarbanes-Oxley Act (SOX) promotes greater transparency in accounting practices- emerged in the wake of accounting-fraud scandals at firms such as Enron and Worldcom.
- The act makes corporate CEOs and CFOs personally responsible for the accuracy of annual reports & financial data.
- Foreign affiliates of U.S. firms, and foreign firms with significant U.S. operations (e.g. listed on a U.S. stock exchange), are required to comply with SOX.
- **Cost of compliance**—High- some European firms are reducing their business investments in the U.S. and several have deregistered from U.S. stock markets.



Ethical Values and Practices

Ethics refers to the moral behavior of people, firms, or governments- issues often arise, or may be exacerbated, by deficiencies in legal systems.

- **Corruption** is an extreme form of unethical behavior- involving the use of illegal or unethical practices, especially bribery and fraud, to achieve business objectives- is particularly common in developing economies.
- One study found that over 30 percent of MNEs believe that corruption is a major or very severe concern to them in their worldwide investment decisions.



Combating Corruption in Cross-Border Business

- 1996- the International Chamber of Commerce adopted "Rules of Conduct to Combat Extortion and Bribery," and the United Nations issued a "Declaration against Corruption and Bribery in International Commercial Transactions."
- 1998-Organization for Economic Cooperation and Development (OECD) crafted its own antibribery agreement.
- United Nations, the World Bank, and the International Monetary Fund have launched programs to minimize corruption.



Transparency International's Corruption Perceptions Index

Transparency International (www.transparency.org), an organization that tracks illicit behavior worldwide.

- Countries with the highest scores have the lowest levels of corruption, such as Canada, Finland, New Zealand, and Denmark.
- Countries with the lowest scores have the highest levels of corruption, such as most countries in Africa and former Soviet Union states.
- Corruption and economic development appear to be correlated.
- Corruption poses a threat to national development, internal stability, FDI levels and is more prevalent where transparency is lacking.



Managing Country Risk: Environmental Scanning

- Develop a comprehensive understanding of the political and legal environment in target countries.
- **Scanning**- assess potential risks/threats to the firm- good sources of intelligence:
 - Employees working in the host country
 - Embassy and trade association officials
 - Consulting firms, such as PRS Group (www.prsgroup.com/) and Business Entrepreneurial Risk Intelligence (www.beri.com/)
- Firm then takes steps to minimize its exposure to country risks that threaten its performance.



Adherence to Ethical Standards

- Ethical behavior is essential not only for its own sake, but also because it helps insulate the firm from country risks.
- **Corporate social responsibility (CSR)** -- operating a business in a manner that meets or exceeds the ethical, legal, commercial, and public expectations of stakeholders (customers, shareholders, employees, and communities).
- **Trend**- good corporate citizenship implies that firms should behave not just to maximize their profits but in ways that benefit society.
- **Examples** of such behavior include: complying with local and international laws; not discriminating in hiring or promoting; providing fair and adequate wages; ensuring health and safety in the workplace; instituting a fair system of regular and overtime work hours; avoiding the use of child labor; providing adequate protection of the environment.



Allying with Qualified Local Partners

- A practical approach to reducing country risk is to enter target markets in collaboration with a knowledgeable and reliable local partner.
- **Examples** –due to various challenges in China and Russia, Western firms often enter these countries by partnering with local firms who assist in navigating the complex legal and political landscape.



Protection through Legal Contracts

- A legal contract spells out the rights and obligations of each party and is especially important when relationships go awry.
- Contract law varies widely from country to country, and firms must adhere to local standards.
- Three approaches for resolving contractual disputes:
 1. **Conciliation** is the least adversarial method. It is a formal process of negotiation whose objective is to resolve differences in a friendly manner.
 2. **Arbitration** is a process in which a neutral third party hears both sides of a case and decides in favor of one party or the other, based on an objective assessment of the facts. Compared to litigation, arbitration saves time and expense.
 3. **Litigation** is the most adversarial approach, and occurs when one party files a lawsuit against another- it is most common in the U.S.



Safeguarding Intellectual Property Rights (IPRs)

- Intellectual property (often the basis for competitive advantage) consists of *industrial property*—patents, inventions, trademarks, industrial designs, and copyrights for works of literature, music, art, books, films, and TV shows.
- Despite protections by the WTO, the World Intellectual Property Organization (WIPO) and various international treaties, the protection of intellectual property rights—the legal claim that firms and individuals hold on their proprietary assets and are protected from unauthorized use by other parties—is not guaranteed in much of the world.
- Laws enacted in one country are enforceable only within that country.
- Enforcement is a challenge.
- Individual country laws and practices differ widely.



Losses from Copyright Piracy are Substantial

- Legitimate Disney DVDs of films like *Finding Nemo* and *The Lion King* cost up to 10 times as much as knockoffs, restricting sales to a trickle.
- Protection of IPR is a perennial problem
- Particularly susceptible are firms in the pharmaceuticals, software, publishing, and music industries



Country	Records and Music		Business Software		Entertainment Software		Books	Totals
	Losses	Levels	Losses	Levels	Losses	Levels	Losses	Loss
Brazil	\$177	48%	\$487	62%	\$159	88%	\$18	\$851
China	203	83%	1,486	90%	310	90%	00	2,021
India	53	55%	318	70%	86	82%	40	497
Italy	48	27%	716	60%	648	40%	20	1,432
Mexico	487	67%	286	63%	182	85%	41	1,006
Philippines	50	62%	35	72%	NA	NA	49	134
Poland	24	33%	264	58%	NA	75%	NA	288
Russia	423	65%	1403	83%	282	72%	42	2,180
Saudi Arabia	20	50%	112	51%	NA	NA	8	140
Ukraine	30	60%	260	83%	NA	NA	NA	320

Exhibit 6.10

Estimated Losses from Copyright Piracy (Millions of U.S. Dollars) and Piracy Levels (Percentages) in Selected Countries, 2005
