Business briefing series

20 issues for businesses expanding internationally
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Our global network of Strategic Growth Markets professionals are dedicated to serving the changing needs of fast-growth companies. Whether working with dynamic mid-cap companies or early stage venture-backed businesses, our professionals around the world draw upon their extensive experience, insight and global resources to help growing businesses reach their full potential.

As well as providing traditional assurance, advisory, tax and transaction advisory services, our professionals work with you to reduce the complexity of legislation, help align your tax strategy with your business goals, expand into new markets and pursue mergers, acquisitions or other strategy transactions to take your business to the next level. We can provide guidance around how to manage and control your risks, so that you can approach the future with confidence.

So whether your business thrives on entrepreneurial spirit, innovation or superior customer service – and regardless of your stage of growth – our Strategic Growth Markets team can help you take the next step. It’s not luck that makes leaders.

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Anyone who has made the bold step of starting their own business has at some stage dreamed about taking that business offshore in a bid for increased expansion and to generate additional revenue.

Although ambitious and potentially very lucrative, such a move could also prove very costly if not done correctly.

To assist business leaders with the process of taking on globalisation, the Institute of Chartered Accountants in Australia (the Institute), in conjunction with Ernst & Young (EY) has produced this thought leadership paper entitled Business briefing: 20 issues for businesses expanding internationally.

The publication is the third part of the Institute’s Business Briefing series designed to help businesses to successfully navigate challenging issues. The commentary in the report is divided into three key phases of an international expansion project:

- Planning for expansion
- Choosing your location
- Conducting business overseas.

Business briefing: 20 issues for businesses expanding internationally has been written and presented in such a way as to maximise the reader’s understanding of the issues. Each of the three sections contains a series of pull-out boxes which guide the reader as to the types of questions that they should be asking with regard to the business. These questions are consolidated into a detachable checklist at the back of the publication which can be used when consulting the paper.

I trust that you will find this thought leadership paper interesting and worthwhile reading.

Michael Spinks FCA
President
Institute of Chartered Accountants in Australia
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Introduction

In August 2010, China overtook Japan as the second largest economy in the world, and it is closing the gap on the United States. The world is changing at a fast pace, driven by globalisation. Throughout the global financial crisis, agile organisations continued their quest to participate in and prosper from the tremendous growth in the emerging markets. Very few Australian organisations can afford to ignore this growth momentum, nor the other benefits that can be achieved from investing in emerging and international markets.

The Globalization Index supports many market indicators that the trend towards ambitious international expansion will continue. This research depicts a global landscape where organisations execute their international expansion strategies at a rapid pace. This speed of expansion may indicate the strong desire by companies to be the first-to-market and/or the imperative to capitalise on new market developments.

The survey was conducted in August 2009, with 520 senior executives worldwide. 38% of respondents indicated that they currently derive over half of their revenue from overseas operations. As indicated in the chart below, by 2012 more than half of the respondents expect this to be the case, with one in four respondents expecting to derive more than three quarters of their revenue from overseas.

Only one in 50 executives surveyed believes containing their operations within their home country or earning less than 10% of their revenue from overseas by 2012, to be a viable option.

Regardless of the size of their international footprint, the research identified the top five drivers for businesses expanding internationally as overall growth opportunities, profitability, access to materials, access to human resources, and the ability to innovate.

Benefits for international companies from globalisation

In which of the following ways has globalisation had a positive impact on your business over the past three years?

<table>
<thead>
<tr>
<th>Overall growth</th>
<th>Profitability</th>
<th>Access to materials</th>
<th>Access to human resources</th>
<th>Ability to innovate</th>
<th>Investment opportunities</th>
<th>Access to finance</th>
</tr>
</thead>
<tbody>
<tr>
<td>86%</td>
<td>68%</td>
<td>35%</td>
<td>42%</td>
<td>37%</td>
<td>36%</td>
<td>16%</td>
</tr>
</tbody>
</table>

Proportion of revenue from international clients:
- 25% – 75%
- 10% – 24%
- 0% – 9%

Source: The Globalization Index Survey 2009

* Figures may not add up to exactly 100%, due to rounding.

1. The Globalization Index 2009 is a report written by Ernst & Young with the Economist Intelligence Unit. The 2010 edition of the report is expected to be released in January 2011.
This report, the 20 issues for businesses expanding internationally, focuses on the core issues that you should consider when formulating and executing your international expansion strategy. It does not provide country specific analysis, however, common themes have been identified that can be applied regardless of your target location.

The commentary in this report is divided into the three key phases of an international expansion project:
1. Planning for expansion
2. Choosing your location
3. Conducting business overseas.

The planning funnel

The diagram above depicts the importance of funnelling your efforts to ensure the bulk of your energy and resources are spent setting up successful operations. The first two phases focus on identifying potential locations and selecting the most appropriate for your operations.

In the ‘planning for expansion’ section we examine the importance of a clearly defined strategy, global trends driven by changing demographics and market research. The planning phase is vital to avoid wasting resources in assessing investment locations that should never have been considered in the first place.

The detailed assessment under the major heading ‘choosing your location’ involves looking at the political and social climate, the local tax and regulatory environment, the legal system, innovation and incentives, location and infrastructure, cultural compatibility and the local workforce. These issues are looked at from a strategic point of view rather than a country specific angle. Whilst for example legal systems are not examined in any detail, we raise the question whether your business is equipped to deal with a legal system based on civil or Muslim law.

The last section deals with issues associated with doing business overseas. An existing global management team would make it easier to set up your footprint in a foreign location. Would your management team know how to deal with a request by a high ranking official asking for a facilitation fee? Does your global workforce need security protection in addition to other incentive payments? Will your business be funded by an intercompany loan or do you need to consider more innovative funding arrangements such as Islamic finance? Will you acquire an existing local business to reach a certain market share quickly? Foreign exchange management and currency risk/controls, business and international tax, supply chain and intellectual property and risk management issues are also looked at in more detail.

Finally, we consider exit and wind down issues. Agile organisations will go through the process described above at regular intervals. Based on the findings they may decide to wind down operations in one location and commence operations in another. This may make perfect commercial sense, however, broader brand and reputation issues must be considered. For example, if you have become an important employer in a particular country or region your exit must be carefully planned to mitigate social backlash.
Planning for expansion

1. Strategy
   - Clearly define and stress test your strategy
   - What are the implications of international expansion for your existing business operations?

Very few organisations can afford to ignore the increasing trend towards globalisation. Entrepreneurial organisations that are the first to move often have the most startling success stories. However, those organisations that do not stress test the financial and operational impact on their existing business, may lose more than their dream of becoming a global player.

Before expanding internationally, you should have a clear picture of what you are trying to achieve. Are you searching for a new and cheaper source of capital, market leading talent, more cost effective production, new markets, or all of the above? Can you execute your strategy alone or do you need strong partners both from an advisory as well as a business perspective? You should consider the pressure global expansion may have on your domestic operations in terms of finance, management time and human resources. Will you enter the identified market(s) through acquisition, joint venture, a partnership or a green field development? Ensure you test your assumptions and have a clear understanding of how long it will take to turn a profit.

2. Global trends
   - Is your organisation exposed to new and emerging markets?
   - Has the composition of your major competitors changed?
   - Is foreign direct investment in your industry sector clustered in locations where you do not have a presence?

It is important to monitor and to be aware of global trends, particularly in relation to demographic changes. Australia’s population is estimated to grow to 36 million by 2050. To put this into perspective, that is equivalent to the bi-monthly combined population growth of China and India. World population growth is not a new phenomenon; however it is the demographic changes that arise from this growth that will affect business practices and profitability in the future. In countries such as China and India, population growth is accompanied by increasing affluence and a growing middle class consumer base. Therefore, the traditional characterisation and perception of emerging markets as predominantly low cost manufacturing centres is quickly changing. Emerging markets are also becoming strong consumer driven societies where the demand for products and services is increasing faster than in more established and mature markets.

The implications for your business are clear. You can become a participant in these markets and tap into an ever increasing consumer base to help secure your future profitability, or you can watch others fill that space. Those business leaders that do not act risk watching others reap the benefits and may be challenged when those first-movers turn their attention to Australia. Seen from this perspective, international expansion is also an opportunity to help strengthen your business at home in the medium to long term.

The flow of foreign direct investment (FDI) into a country is an important indicator of the economic viability of that location. Similarly, demographic trends such as the age and education profile of the population may also indicate future economic vitality and the growth of a consumer base. An example of this is Vietnam, where more than 70% of the population is 30 years or younger. Vietnam is currently attracting significant FDI in certain industry sectors.

‘Global foreign direct investment witnessed a modest, but uneven recovery in the first half of 2010. Developing and transition economies now absorb more than half of global FDI.’

*World Investment Report 2010*
*United Nations Conference on Trade and Development*
3. **Market research**

☐ What research is available to provide you with information on market and industry conditions?

☐ Is this information up-to-date and what is the future outlook?

☐ Create a short list of new and emerging markets, tap into existing networks, talk to your advisors and visit your short listed locations.

Market research is very important but can be costly; however there are numerous resources available free of charge to help you uncover useful information about the strengths and challenges of global markets. Much of this research can be done from your home base and will help you in generating a short list of potential locations for expansion.

Reliable statistical data or reference material can supplement but should not replace a field trip. The world is moving and changing fast. What may have been a good investment location historically, may not present the same opportunities in the future. Tap into existing networks via chambers of industry and commerce or other organisations representing an investment location, visit trade fairs, talk to your advisors, visit your target locations and meet the local people. This will greatly assist you to make an educated and informed decision about whether that market is right for your business.
Choosing the location

4. Political and social climate

☐ Is the political system stable? How do you assess sovereign risk?
☐ Does the country suffer under high levels of sovereign debt?
☐ Is there likely to be social unrest or are workers organised in powerful unions?

The pace of change of the global political landscape is accelerating due to globalisation. Political decisions in one country may have far reaching implications for trading partners or the globalised business community at large. The response to the global financial crisis with stimulus programs around the globe illustrated this. Most governments appreciate that globalisation is the motor of economic expansion.

However, as the graph below illustrates, concerns are now emerging about new protectionism, regulations and trade issues. More than 50% of Globalization Index respondents believe that major economies will adopt limited protectionist measures in certain key sectors. Furthermore, the burden of sovereign debt may force a country to abandon business friendly programs.

An assessment of your target location’s political environment, including the potential for social unrest or regional instability is relevant for determining the risk of any potential investment. This has been an important issue in South East Asia, where various countries have been affected by social unrest in recent years.

To support this, the graph below illustrates the importance investors place on political stability in assessing emerging market locations. Almost 60% of respondents rated political stability as the most important government-related factor to consider when deploying FDI. Before entering a new market, you should evaluate the risk based on the future outlook for the country or the region, not just the status quo or historic events. Ensure that you take note of any early signs of social unrest.

If you were to plan a foreign direct investment in developed or emerging markets over the next year, which of the following would you consider to be the most important government related-factors?

- Political stability
- Macroeconomic stability
- Currency stability
- Host government support for inward foreign investment
- Host government attitude towards domestic enterprises
- Corporate and other relevant taxes
- Clarity and predictability of the legal system
- Strength and fairness of legal system
- Risk of nationalisation or expropriation

Which of the following assertions about the impact of protectionism in coming years most closely reflects your view? (% who agree with each statement)

- Major economies will adopt limited protectionist measures in certain key sectors
- Global markets will remain or become more open as governments try to restore economic growth
- Domestic political expediency will override claims by world leaders to resist protectionism
- ‘Tit-for-tat’ protectionism will trigger a dangerous downward spiral in global trade
- The world economy will repeat the protectionist errors of the 1930s
- Don’t know

Source: The Globalization Index Survey 2009

Source: The Globalization Index Survey 2009
5. Local tax and regulatory environment

- Is the tax regime business friendly and/or competitive?
- Does the country have free trade agreements or double tax treaties?
- Does the regulatory regime set the scene for a sound corporate governance framework?

A low headline corporate tax rate is always appealing. However, this can also be deceptive due to many factors including the existence of state based taxes, withholding taxes and consumption taxes such as a value added tax (VAT). Your market analysis should include commercial discussions with a local market tax expert taking into account your specific facts and circumstances where possible.

Free trade agreements generally indicate an open and investment friendly economy. However, their existence does not rule out the possibility of government support for certain industries to protect domestic markets against foreign competition, through subsidies or other forms of protection. An extensive double tax treaty network may likewise look impressive; however it is necessary to look beyond withholding tax rates and test how the treaties deal with mutual agreement procedures and arbitration around transfer pricing, permanent establishment issues and a global work force. Not all double tax treaties are the same and some countries may try to assert taxing rights beyond what investors would ordinarily expect under OECD guidelines.

A country’s regulatory framework will be considered open to FDI, if it can strike the right balance between creating a secure environment for effective corporate governance across all industry sectors, without stifling entrepreneurial freedom or discriminating against foreign investors.

![Legal systems around the world](https://www.juriglobe.ca/eng/index.php)

Source: Legal systems around the world, University of Ottawa: [www.juriglobe.ca/eng/index.php](http://www.juriglobe.ca/eng/index.php)

2. Ernst & Young Passport (includes the 2010 Worldwide Corporate Tax Guide, the 2010 VAT Guide, the 2009 Global Executive and the 2009 Transfer Pricing Global Reference Guide)
6. Legal system

- Is it a common law system? If not, are you sure you understand the outcomes?
- Do the laws and the legal and judicial system provide support for and protection of commercial activities?

An effective legal system that provides a balance between protecting the commercial interests of business, whilst also protecting the consumer, can provide you with a level of confidence that you can legally enforce your commercial agreements.

A common law legal system can be a huge advantage as you will be much more likely to understand the framework and outcomes. The map on page 11 shows however that the number of countries with a pure common law system is limited.

Civil law is the prevailing system in much of Europe and in many of the emerging markets, while Muslim law may be encountered when doing business in the Gulf States, the Middle East and parts of Africa and Asia.

The legal system will affect every aspect of your international expansion. For example:

- It will affect merger and acquisition activity itself and will set boundaries through anti-trust or competition law
- It will be instrumental for the protection of trademarks, commercial design or plant innovations (including copyright or distribution law, data protection and privacy)
- It will set the scene for litigation, arbitration or mediation
- It will provide guidance with respect to information technology
- Labour law will regulate employment matters
- There is real estate, planning and construction law to consider.

7. Innovation and incentives

- Should you develop your products in emerging or fast growth markets?
- Should you have a presence at global innovation clusters?
- Are generous grants and incentives available for innovative organisations?

Maintaining an environment that supports innovation is critical for future business growth. Innovation can be centralised, or decentralised and driven locally. As demonstrated in the chart below, organisations with a centralised strategy are just about as likely as those with a decentralised approach to regard it as essential to apply innovative ideas from local markets.

For many businesses, the decision to relocate research and development activities to an emerging market will be influenced by a number of strategic and business drivers. These may include using the target location as a strategic hub for market expansion into that region. Conducting research in emerging and fast growth markets can drive new ideas by tapping into a new pool of innovative and market leading talent.
An understanding of the various government incentive regimes ranging from tax holidays and incentives, to discretionary government grant support may help sweeten the deal for many organisations. In addition to any formal programs, the host country’s government may be interested in attracting your investment in order to boost the local economy and create jobs in strategic sectors. In most jurisdictions, governments may be receptive to specific negotiated concessions and incentives, depending on the circumstances and the nature of the investment. It is important to consider these possibilities at an early stage before committing to the target location. This ensures that an effective strategy can be developed that places your organisation in a strong bargaining position.

8. Location and infrastructure
- Is economic infrastructure secure and reliable?
- How would you deal with power outages, telecommunication down time or traffic congestion?
- Is the location central to your regional markets, suppliers of goods and services?

It is important to understand the infrastructure that will be at your disposal in the target country and assess its reliability and the positive or detrimental impact it may have on achieving success in your target market.

Particular attention should be paid to the target country’s communications infrastructure. In the digital age this is arguably more critical than ever before, given the importance of information technology to the effective operation of modern businesses. You should consider the capacity and efficiency of telephone and mobile networks, and also data delivery mechanisms such as fibre optic cable and broadband internet. Is the infrastructure modern, reliable and safe? How vulnerable is it to being compromised for example from power failures and cyber attacks, and are there emergency systems and disaster recovery plans in place?

When expanding into the target location, consider whether the attributes which have made you successful at home can be leveraged to drive success abroad. Your ability to shift wealth, products, people and information, will be heavily dependent on accessing adequate social and commercial infrastructure. There are a wide range of potential considerations such as the target location’s size and accessibility, transport, utilities and information systems, access to financial services and other factors.

9. Cultural compatibility
- Are there significant cultural differences that may impact the way you conduct your business?
- Are there likely to be language barriers?

Entrepreneurial organisations through their very nature can achieve growth and develop a global footprint relatively quickly. However, it can take a long time to create a diverse workforce that reflects the variety of markets in which the organisation operates, and cultural customs can impact significantly on business practices in the chosen location.

Without early attention to these issues, your management team may be left behind in terms of cultural awareness and diversity. This can generate a competitive disadvantage as the management team will be required to make rapid decisions, while at the same time ensuring that they have a clear understanding of the local customs and operating conditions.

Cultural business etiquette
- Bringing your host in Tokyo a bottle of American whiskey is a thoughtful gift. It’s a major offense in Dubai. American whiskey is revered in China and Japan. But in the Islamic Middle East, and among Muslim hosts in Asia, alcohol is strictly taboo.
- In the Middle East and Asia, gifts must always be given at the end of the meeting so they are not regarded as bribes. In Latin America, however, gifts are a great icebreaker and can be given at the start of a meeting.
- Business cards in Japan, China and other parts of Asia are considered a representation of one’s self – offer and receive cards with both hands, and always look at it as if you’re studying it carefully.
- In most of the Islamic Middle East, it’s the norm to keep visitors waiting. This is not considered rude, but an extension of the Middle Eastern custom to mix business with pleasure. It is also acceptable to ask about your host’s children, especially sons, but never their wives.


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3. Ernst & Young, R&D incentives in the new tax landscape.
Choosing the location (continued)

In this respect, the importance of language cannot be overstated, as it will underpin everything the business does in the target location. Effective communication (or the lack thereof) has the ability to make or break the business. It is a key foundation upon which the success of the business may be built. Your management team will need the language skills to communicate effectively with those who will interact with your business including government, regulators, financiers, suppliers, staff and customers. Even in countries where English is commonly spoken or is the language of business, regional nuances can be a source of misunderstanding and can lead to more serious problems.

As demonstrated in the diagram below, the level of tolerance and understanding of cultural and ethnic differences and language barriers in foreign markets ranks highly amongst Globalization Index respondents when asked about the most important cultural factors when conducting business internationally. The top ranked issue related to the level of international experience of the workforce is discussed below.

10. Local workforce

What is the availability, skill-set and cost structure of the local work force?

When expanding into a global market, your human resources can mean the difference between success and failure. As your organisation grows off-shore, getting the right people in the right location can provide a vital competitive advantage. The quality of the local workforce may often be the deciding factor in determining whether to expand your business to that location and also in determining how successful such an expansion will be.

‘Companies are viewing the labour market more through a global lens, and in many cases, off-shoring decisions, especially in higher, value-added functions, are being driven by talent shortages at home as much as by cost-cutting.’

A.T Kearney, Global Services Location Index 2009

When setting up a local workforce in your target location, there are numerous practical issues to consider. You will need to think about the education level and experience of your prospective workers and how much you will need to invest in training. You will need to determine the terms and conditions of employment and you may need to negotiate with individuals, labour unions or other bargaining agents. There may be local legislation or regulations concerning working hours, weekends and public holidays and there may also be local customs or practices that will impact on the operation and activities of your workforce. In addition you will need to consider your global remuneration approach and whether short term and long term incentive programs will be offered to your overseas employees, as well as the tax and regulatory implications associated with this.
11. Global management team

- Who will negotiate with government, customers, suppliers and business partners? How should you manage risks such as bribery and corruption?
- Who will be responsible for the recruitment of staff?
- Do you have an international management team or do you need to build one?

Commencing business operations in a new market can involve significant risks, and therefore it is important to have a strong management team that understands the challenges ahead. Having established the business in a new country, a variety of issues may present themselves such as:

- How to ensure that your business operations run smoothly?
- How much hands on involvement is required by your management team?
- How much time and resources will it consume setting up your operations?
- Will some members of your management team be required to spend a lot of personal time in the new location?
- Will Australian expatriates be sent to run the business or can the services of local managers be relied upon?

To be prepared, you must consider the challenges your business will face during the start-up phase, and who from a management perspective is best placed to deal with those challenges. In determining this, consider any potential negotiations with the government or other local officials in the host country. Negotiations might be required over issues such as licensing arrangements, tax concessions, labour conditions and local joint venture partners. The right negotiating technique will be essential.

Does your organisation have sufficient knowledge of the host country and expertise to conduct negotiations or will you need specialists with expert local knowledge to negotiate on your behalf? The graph on page 16 shows that organisations that operate in more than 10 countries...
are highly likely to have a diverse management team whilst those with only domestic operations are unlikely to have a significant proportion of senior management from another country.

**12. Global human resources considerations**

- What benefits will you provide to expatriates and what are the tax consequences? Do your employees require security protection?
- Do you have a team that can deal with assignment management, immigration and tax compliance?
- Should these functions be outsourced?

Although expatriates know your business and may enjoy the opportunity to work overseas; they may also lack local knowledge. Relocating and remunerating expatriates can be more expensive than local hires, so you should first consider the objectives of the assignment and your desired return on investment. If you decide to use expatriates rather than local hires, you must also consider what happens when the assignment is finished. A repatriation plan should be implemented so the knowledge and skills gained on assignment are retained within your organisation. You must also ensure that you have the resources to manage the related local and international compliance obligations, particularly if you are expanding into more than one country.

To ensure your expatriate staff are not distracted from the job at hand, organisational support will be required to deal with relocation and immigration issues. This level of support will vary from organisation to organisation; however this along with the development of an incentive plan should be factored in, even if the new host location is attractive. Generally, most organisations develop formal mobility policies that consider issues such as the level of remuneration, relocation benefits and other incentives. Increasingly organisations are also linking their mobility programs with their talent management strategy. The tax affairs of your employees will also get more complicated with tax exposure in more than one location, specifically due to the revised rules in Australia for the taxation of employment income. Benefits provided to your Australian workforce whilst working overseas could potentially be assessable both abroad and domestically. Tax equalisation arrangements are a common mechanism used for employees who work abroad for a period of time.

Another important consideration (and cost) will be that of security for your employees. In some countries, expatriate employees may be the target of extortion threats, kidnapping attempts or other forms of violence. They will need to be assured of their safety, which may include specific accommodation, transport and protection arrangements as part of their overall remuneration and benefits package.

Have you also considered the possibility of corruption in your host country? Is it common for local officials or business people to demand bribes, facilitation fees or kick-back payments? How will you deal with such demands while protecting the interests and integrity of your business? Will the local authorities be of assistance or will they be complicit in the process? Failing to identify and deal with such risks can bring serious consequences; as such practices may be criminal offences under the laws of both Australia and the host country and punishable with heavy fines and/or prison sentences.

The map on page 15 illustrates the perceived levels of corruption in countries around the world.

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**Doing business overseas (continued)**

**More global companies are more likely to have international management**

Roughly what proportion of senior management are nationals of another country?

<table>
<thead>
<tr>
<th>Foreign operations in 11 or more countries</th>
<th>30%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign operations in 1 – 10 countries</td>
<td>16%</td>
</tr>
<tr>
<td>Domestic operations only</td>
<td>13%</td>
</tr>
</tbody>
</table>

Senior management from another country:

- Less than 5%
- 5 – 14%
- 15 – 24%
- 25 – 49%
- 50%+

Source: The Globalization Index Survey 2009

* Figures may not add up to exactly 100%, due to rounding.
13. Financing

☐ What are the cash flow needs of your business? What is your projected revenue growth? Are your financial models sound or overly optimistic?

☐ Do you need strong partners to finance your expansion? Have you considered Islamic finance as a source of funds?

☐ What is the debt equity mix of funding? What are the tax consequences?

It is important to stress test your financial models and revenue targets to ensure you can service your debt. This testing should involve hypothetical parameters such as an interest rate hike, currency deflation or difficult market conditions. During the global financial crisis, successful businesses continued their growth path due to the establishment and implementation of realistic and effective business models that had been stress tested.

There are many options available for raising finance for your global expansion. There are, of course, well established conservative options including bank or intercompany loans, however, you may wish to consider emerging financing options such as Islamic finance.

The map below depicts how Islamic finance is available worldwide.

How you manage your ongoing finance raises significant taxation considerations both in Australia and your target country. You should test your assumptions by using financial modelling to determine if you can achieve the desired debt to equity ratio recommended by your financial advisors. You should confirm that your treasury function is permitted under local and Australian law to ensure that the terms of your finance arrangements do not breach the transfer pricing rules or thin capitalisation thresholds. Hybrid financing arrangements, changes to the non-portfolio dividend exemption and withholding tax implications, need to be reviewed carefully from a tax perspective.

You should stress test assumptions made in financial models to ensure that you can still service the recommended debt levels if certain factors turn to the worse. You should also confirm that the proposed debt to equity ratio on both the Australian and foreign entity balance sheet is permitted under the relevant taxation law as potential breaches of the transfer pricing or thin capitalisation rules can result in the denial of tax deductions.

Global Islamic Funds by Home Country of Asset Manager (QI 2010)

<table>
<thead>
<tr>
<th>Country</th>
<th>Islamic AuM by Country (US$ billion):</th>
</tr>
</thead>
<tbody>
<tr>
<td>Malaysia</td>
<td>27.1</td>
</tr>
<tr>
<td>USA</td>
<td>17.7</td>
</tr>
<tr>
<td>KSA</td>
<td>22.8</td>
</tr>
<tr>
<td>Bahrain</td>
<td>1.2</td>
</tr>
<tr>
<td>UAE</td>
<td>6.1</td>
</tr>
<tr>
<td>Kuwait</td>
<td>4.0</td>
</tr>
</tbody>
</table>

Note: Funds per country include those managed by players headquartered in that respective jurisdiction.

- **Dark grey**: Indicates total AuM of Islamic funds in US$ billion
- **Light grey**: Indicates the number of funds

Source: Eurekahedge, Zawya Funds Monitor, Ernst & Young analysis
14. Choosing the operating structure

- Are you looking for slow organic growth?
  Will you start out with a sales office or are you looking for a green field development?
- Are you looking to establish an immediate local presence? If so, will you set up a joint venture or will you acquire an existing local business?

There are a number of factors that will determine the method of entry into your chosen location. The market conditions and the opportunities to capture immediate market share will impact the design of your initial business model and structure. For example, you may have time to establish various operating entities and build up your infrastructure such as factories or, you may only have time to set-up a simple representative office from which you can immediately negotiate customer contracts. These factors may in turn drive your choice of legal operating structure and also the method you adopt to gain a foothold in the market. For example, will you establish a joint venture with a host country partner or operative and/or set-up various contracts to establish your operations? There will be costs and benefits associated with these choices which must be considered, including those concerning commercial, legal, regulatory and tax issues.

15. Implementing the operating structure

- What are the legal and administrative procedures and regulatory requirements for setting up the operating structure and starting the business?
- Should you outsource the set-up to corporate secretarial service providers?

How easy is it to start-up your business in the host country? What is the level of red tape and how will you go about cutting through it? You may have local accounting and reporting obligations and other legal statutes that you must comply with at start-up and on an ongoing basis. Penalties for non-compliance may be severe, including criminal prosecutions and prison sentences. How will you make sure that you have identified all obligations and how will you satisfy them? It may be cost effective to outsource your corporate secretarial, accounting and tax functions to local experts.

16. Foreign exchange management and currency risk/controls

- Is the local currency stable or volatile?
- Is currency hedging available at a reasonable cost?
- Could currency restrictions inhibit or even prohibit the flow of international funds?

Organisations generally can hedge international internal transactions effectively without adverse outcomes, although the tax and accounting treatment can be complicated. The risk and commercial exposure rises exponentially where transactions with external suppliers and customers are involved.

The diagram below illustrates the fall of the Euro against the US Dollar initially triggered by the sovereign debt crisis in Greece. The fall of the Euro accelerated when the crisis spread to other European countries. The rise and fall of a currency can impact the economics of an entire project or production set-up. It can significantly alter the margins of goods sold on the world market, as well as the cost of overseas sourced inputs. The hedging of cross currency supply or loan contracts may remove some of the risk but will also come at a cost.

In addition to foreign exchange management, you need to ensure that the target location does not impose limitations on the movement of currency in and out of the country.
17. Business and international taxation

☐ Are you aware of how the new Australian attribution regime in relation to controlled foreign companies may allow you to take better advantage of efficiencies overseas?

☐ How will profits be taxed in your target location? What is the treatment of losses?

Consider how tax is assessed and paid in the host country. The timing and quantum of tax payments will impact your cash flow. Ensure that start up losses can be carried forward to reduce future tax liabilities. Payment of withholding taxes will typically be required on cross-border payments of interest, dividends and royalties. In certain jurisdictions, taxes will be triggered on the payment of technical services fees and other payments to non residents. Double taxation agreements may operate to allocate taxing rights between the host country and Australia. Detailed tax due diligence is recommended if you are acquiring a foreign business.

‘The reform of the Australian CFC rules will improve the competitiveness of Australian businesses expanding overseas. Overall it will be the catalyst for better efficiencies in foreign operations.’

Daryn Moore, Ernst & Young Australia, Partner Oceania Leader – International Tax Services

Australian international tax rules such as the controlled foreign company (CFC), thin capitalisation and transfer pricing rules must also be considered. Australia has and is continuing to reform the CFC rules to ensure that Australian organisations are not disadvantaged in competing overseas. Non-portfolio dividends paid by the foreign organisation to Australian corporate shareholders are not taxable in Australia at the corporate level and also do not generate franking credits. Australia does allow for certain tax deductions for a loss or outgoing incurred in deriving foreign dividend income.

18. Supply chain, transfer pricing and intellectual property

☐ Have you identified all possible supply chain efficiencies?

☐ Have you considered potential Australian tax issues as you move functions, intellectual property and risk offshore? Is your intellectual property and data protected?

The development of an effective supply chain process is vital to establishing efficient operations and achieving maximum profitability. You should consider local and international commercial contracts, the adequacy of local physical infrastructure beyond that which was assessed during start-up and the reliability of associated services on which the business will rely.

You could also explore the possibility of vertical integration such as the acquisition of key suppliers or distributors. However in doing this, you should give consideration to any potential infrastructure, regulatory or other constraints that may hinder such an expansion. If you have operations in multiple countries, you may consider the suitability of the target location for a shared services centre. An example may be moving your existing production or other business functions from Australia and/or other locations to your target location. Such decisions may result in the shifting of risk and/or intellectual property from the target location to another location. This may have an impact on the cost structure and profitability of your business from an international perspective and give rise to transfer pricing and other tax issues. Revenue authorities often focus on these types of transactions.
19. Risk management

☐ Have you identified areas of risk and how you will address them?
☐ Are your foreign operations susceptible to fraud?

There are a number of business risks that should be considered when entering an emerging or international market. To identify these risks, Ernst & Young conducted research to ascertain the top 10 business risks facing multinational firms. 

*The Ernst & Young Business Risk Report 2010* is based on interviews with industry executives and analysts representing 14 industry sectors. The survey asked each interviewee to identify and rank the top business risks for 2010. Aggregating the results worldwide and across industry sectors, resulted in the following top 10 business risks for multinational firms ranked by importance:

1. Uncertainty around regulation and compliance
2. Access to credit and the impact of rising levels of government debt
3. The withdrawal of global stimulus programs
4. The global war for talent and compensation structures
5. The strategic imperative of succeeding in an emerging market, as these markets continue to drive global growth
6. Increased cost pressures as the result of commodity price inflation and low cost competitors
7. Incumbent firms in transitional sectors adjusting to non-traditional entrants
8. Staying ahead of consumer preferences and government regulation on environmental issues
9. Political backlash and reputational risks triggered by corporate social responsibility breaches
10. Rescue mergers and regulatory changes that may force new transactions.

The above list has changed considerably in both order and content from the 2009 report, which demonstrates that businesses operate in a dynamic, ever-changing global environment that requires constant monitoring. The business risk associated with not succeeding in an emerging market for example, moved from rank 12 in 2009 to rank 5 in 2010. You should also recognise that in such an environment, to manage existing and newly emerging risks, an effective risk management strategy and process should be implemented. Obtaining appropriate insurance in your selected host country is an important consideration to mitigate against potential business risks.

You should also consider your organisation’s exposure to potential fraud. Are you at greater risk if the control of your organisation resides in only a handful of managers, rather than a structure with a board of directors and policy and process around corporate governance, internal/external audit and other external controls?

20. Exit or wind-down

☐ Will you continue to maintain a presence in this location?
☐ What are the legal and commercial issues associated with terminating business and employment contracts?
☐ What is your strategy for redeploying your resources?

There are different ways to exit or wind-down your operations in a host country. You will need to take into account local laws, tax and financial issues. You must also determine if you wish to maintain a presence in the host country. Options may include liquidation, the sale of shares or even floating the business. The exit strategy should be part of your overall business plan.

There are also reputational risks to consider, particularly if your business was an important employer in a country or region. To avoid costly litigation or compensation payments you must also be aware of the industrial relations environment. Consider whether local regulations restrict the transfer of funds overseas.
## 20 issues for businesses expanding internationally

Table based on the top 20 issues and related questions.

### Planning for expansion

<table>
<thead>
<tr>
<th>Planning for expansion</th>
<th>Yes</th>
<th>No</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>1. Strategy</strong></td>
<td></td>
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<tr>
<td>• Clearly define and stress test your strategy</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td>• What are the implications of your international expansion for your existing business operations?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td><strong>2. Global trends</strong></td>
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<tr>
<td>• Is your organisation exposed to new and emerging markets?</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td>• Has the composition of your major competitors changed?</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td>• Is foreign direct investment in your industry sector clustered in locations where you do not have a presence?</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td><strong>3. Market research</strong></td>
<td></td>
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<tr>
<td>• What research is available to provide you with information on market and industry conditions?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• Is this information up-to-date and what is the future outlook?</td>
<td>☐</td>
<td>☐</td>
</tr>
<tr>
<td>• Create a short list of new and emerging markets, tap into existing networks, talk to your advisors and visit your short listed locations</td>
<td>☐</td>
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</table>

### Choosing the location

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<tr>
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<tbody>
<tr>
<td><strong>4. Political and social climate</strong></td>
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<tr>
<td>• Is the political system stable? How do you assess sovereign risk?</td>
<td>☐</td>
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<tr>
<td>• Does the country suffer under high levels of sovereign debt?</td>
<td>☐</td>
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<tr>
<td>• Is there likely to be social unrest or are workers organised in powerful unions?</td>
<td>☐</td>
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<tr>
<td><strong>5. Local tax and regulatory environment</strong></td>
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<tr>
<td>• Is the tax regime business friendly and/or competitive?</td>
<td>☐</td>
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<tr>
<td>• Does the country have free trade agreements or double tax treaties?</td>
<td>☐</td>
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<tr>
<td>• Does the regulatory regime set the scene for a sound corporate governance framework?</td>
<td>☐</td>
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<tr>
<td><strong>6. Legal system</strong></td>
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<tr>
<td>• Is it a common law system? If not, do you understand the outcomes?</td>
<td>☐</td>
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<tr>
<td>• Do the laws and the legal and judicial system provide support for and protection of commercial activities?</td>
<td>☐</td>
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<tr>
<td><strong>7. Innovation and incentives</strong></td>
<td></td>
<td></td>
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<tr>
<td>• Should you develop your products in emerging or fast growth markets?</td>
<td>☐</td>
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<tr>
<td>• Should you have a presence at global innovation clusters?</td>
<td>☐</td>
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<tr>
<td>• Are grants and incentives available for innovative organisations?</td>
<td>☐</td>
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<tr>
<td><strong>8 Location and infrastructure</strong></td>
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<tr>
<td>• Is economic infrastructure secure and reliable?</td>
<td>☐</td>
<td>☐</td>
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<tr>
<td>• How would you deal with power outages, telecommunication down-time or traffic congestion?</td>
<td>☐</td>
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<td>• Is the location central to your regional markets and suppliers of goods and services?</td>
<td>☐</td>
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<td><strong>9. Cultural compatibility</strong></td>
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<tr>
<td>• Are there significant cultural differences that may impact the way you conduct your business?</td>
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<tr>
<td>• Are there likely to be language barriers?</td>
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<td><strong>10. Local workforce</strong></td>
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<tr>
<td>• What is the availability, skill-set and cost structure of the local work force?</td>
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20 issues checklist (continued)

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<td><strong>11. Global management team</strong></td>
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<tr>
<td>• Who will negotiate with government, customers, suppliers and business partners? How should you manage risks such as bribery and corruption?</td>
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<td>• Who will be responsible for the recruitment of staff?</td>
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<td>• Do you have an international management team or do you need to build one?</td>
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<td><strong>12. Global human resources considerations</strong></td>
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<td>• What benefits will you provide to expatriates and what are the tax consequences? Do your employees require security protection?</td>
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<td>• Do you have a team that can deal with assignment management, immigration and tax compliance?</td>
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<td>• Should these functions be outsourced?</td>
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<td><strong>13. Financing</strong></td>
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<td>• What are the cash flow needs of your business? What is your projected revenue growth? Are your financial models sound or overly optimistic?</td>
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<td>• Do you need strong partners to finance your expansion? Have you considered Islamic finance as a source of funds?</td>
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<td>• What is the debt equity mix of funding? What are the tax consequences?</td>
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