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UNIVERSITY OF WOLLONGONG

DEPARTMENT OF ACCOUNTANCY



**FINANCING PATTERN OF MULTINATIONAL
ENTERPRISES IN A DEVELOPING COUNTRY -
THE SRI LANKAN EXPERIENCE**

by

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FINANCING PATTERN OF MULTINATIONAL ENTERPRISES IN A DEVELOPING HOST COUNTRY

- The Sri Lankan Experience

by

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Abstract

Multinational enterprises (MNEs) have played a vital role in the economies of developing countries. However, empirical studies on some crucial aspects of MNE involvement in these economies appear to be inadequate. One such aspect is their financing pattern. This paper attempts to shed some light on this aspect through an analysis of balance sheet data of a sample of MNE affiliates operating in the manufacturing sector of Sri Lanka. The findings do not support the generally held view that MNEs gear themselves more highly than local firms and that they make use of a greater degree of domestic commercial bank credit. Further, the study reveals that the direct financial contributions of parent companies to equity capital of their affiliates are very small, indicating a low level of direct foreign inflow of capital into the host country.

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FINANCING PATTERN OF MULTINATIONAL ENTERPRISES IN A DEVELOPING HOST COUNTRY

- The Sri Lankan Experience

1. INTRODUCTION

A striking development in the economic activities of developing countries from about the turn of this century has been the growing importance of multinational enterprises (MNEs)¹. They were originally concentrated largely in the primary sector.² The rapid industrial development taken place after World War II brought about an unprecedented expansion of MNE activity and the most rapidly growing sector of this activity in developing countries during this period was manufacturing. Many nations followed import substitution policies in the 1950s and 1960s and often a major beneficiary of these policies was the multinational enterprise. In the late 1960s and 1970s a number of developing countries adopted more export-oriented industrialisation strategies, the manifestation of which was the mushrooming of export processing zones around the world (Jenkins, 1987, 7). Enticing MNE participation in export production was again a prime objective of such a strategy. Consequently, by 1985 about one fourth of overseas investment by MNEs was concentrated in developing countries (UNCTC, 1988, 25).

Over the last two decades there has been an enormous amount of academic discussion on the MNE activity in developing countries. In spite of the flood of literature, empirical evidence on some crucial aspects of MNE activity is still sparse (Lall and Streeten, 1977, 5). One such aspect is the financing pattern of MNEs *vis a vis* indigenous enterprises in developing countries. Therefore, undertaking more empirical investigations

¹ In line with usual practice in this area of study the multinational enterprise (MNE) is defined here as an enterprise that owns or controls income-generating assets in one or more countries other than the one in which it is based.

² By the outbreak of World War I over 60 per cent of all direct foreign investment was located in developing countries and 55 per cent of them were in the primary sector (Dunning, 1983, 89).

covering a wider spectrum of individual country situations is needed in order to broaden our understanding of this aspect of MNE operations. The present study is an attempt in this direction.

2. REVIEW OF PREVIOUS WORK

A widely held view regarding the operations of MNE subsidiaries in developing host countries is that in establishing an affiliate abroad, they usually prefer to commit only a small amount of their own capital for initial investment and raise bulk of their financial requirements locally (Lall and Streeten, 1977, 41). Such a policy not only minimises the parent company's exposure to various forms of risk in an unfamiliar environment, but also enables it to "gear" its capital very highly to local borrowing so that global returns on capital are maximised. As far as this author is aware, the only comprehensive empirical investigation made to verify this view is an UNCTAD study by Lall and Streeten. Their study, based on a sample of 109 MNE affiliates in India and Colombia, did not, however, support the original hypothesis. The authors concluded, "Our data do not provide any support for a general statement that transnational corporations³ gear themselves more highly than other firms or that they obtain greater access to commercial bank credit. It appears that they tend to conform to local patterns of financing or regulation rather than use their superior borrowing strength to procure an extraordinary degree of external financing" (*ibid*, 119).

The empirical analysis of Lall and Streeten (1977) is based primarily on eleven financial ratios computed from the balance sheet data of 109 sample firms. Surprisingly, one set of data used for computing the ratios on direct foreign inflow and direct foreign long-term inflow⁴ seems to be inappropriate, although the above conclusion has not been

³ The term, 'transnational' is used in UN publications as a preferred substitute to 'multinational'.

⁴ Direct foreign inflow = Foreign equity + foreign long- and short-term loans/Total sources;
Direct foreign long-term inflow = Foreign equity + foreign long-term loans/Total sources

based on any of these two specific ratios. Obviously, in most MNEs a very considerable portion of 'foreign equity' consists of revenue and capital reserves that have been capitalised in the form of 'bonus' shares. In company balance sheets this component of 'equity' is not disclosed separately and therefore a researcher has to rely on other sources. However, it is necessary to deduct the nominal value of total 'bonus' shares issued to foreign shareholders in order to derive the correct computation of the direct foreign inflow of capital. Since no adjustment has been made in respect of 'bonus' shares the figures represented by the above two ratios in the Indian and Colombian study could lead to distorted conclusions.

In a more recent study on the operations of Transnational Trading Corporations in Sri Lanka, Athukorala and Lakshman (1985, 339-44) found that the reliance of these companies on external sources of finance is noticeably higher than that of their local counterparts. A study based on in-depth interviews with 90 MNEs in Western Europe, Japan and Australia by Frank (1979) found that there is no consistency in the financial pattern of subsidiaries except in the case of Japanese MNEs which had raised significant part of their capital in the host country by taking local partners. This study also reports that financing policies of MNEs vary from country to country as well as from firm to firm depending on the area of operation.

According to a study by the US Department of Commerce (as cited by Hood and Young, 1979, 38-41), the affiliates of US MNEs have access to a much wider range of financing sources than the equivalent local firms and their growth through reinvested earnings and local borrowing was significantly high. Hood and Young also stated that the actual inflow of capital from MNEs into host countries is often fairly small, with most of funds coming from reinvested profits and local savings. For example, the net capital flow from US MNEs to their affiliates in host countries during 1966-70 have only been

about 12 per cent of the total sources of finance (Dunning, 1981, 122). The possibility of affiliate growth through reinvested earnings is claimed to reduce the balance of payments advantages derived from capital inflows from parent companies (Hood and Young, 39).

3. MULTINATIONAL ENTERPRISE INVOLVEMENT IN SRI LANKAN MANUFACTURING

As in many other developing countries, import control was the major factor which triggered the entry of direct foreign investment into Sri Lankan manufacturing (Athukorala and Jayasuriya, 1987, 411). In the early 1960s in response to a severe balance of payments crisis, Sri Lanka moved rapidly to a regime of stringent import and exchange restrictions, placing heavy emphasis on an import substitution strategy. When their market shares were threatened by import controls many foreign firms set up affiliates within Sri Lanka to undertake the domestic production and/or assembly of product lines which had hitherto been supplied from their overseas production centres. During the 1960s, facilitated by a favourable government policy stance, MNEs expanded their role in the domestic manufacturing sector. By the end of the decade, there were 51 MNE affiliates in operation, and they accounted for about 28 per cent (38 per cent if the public sector is excluded) of total manufacturing output (Fernando 1971, 84).

As evident from Table 1, the period from 1970 to 1977 witnessed a notable reduction in the tempo of direct foreign capital participation in the economy. The commitment to socialism by the government in power during this period led to the introduction of a new industrialisation policy aimed at expanding the role of the public sector by setting up new public corporations and nationalising some of the privately owned enterprises (Betancourt, 1981, 33). This policy apparently had considerable

Table 1
MNEs in Sri Lankan Manufacturing

Period of establishment	Total number of affiliates
Prior to 1950	3
1950 - 1959	8
1960 - 1969	40
1970 - 1977	20
1978 - 1985 ¹	222
Total	293

¹ Figures in this period include firms in trial production and under construction.

Source: Athukorala and Jayasuriya (1988), Table 1

adverse effect on the expansion of MNE activity in the economy. The change in political leadership in 1977 brought about a liberalised economic environment with a marked shift in the industrialisation policy. The promotion of foreign capital participation in manufacturing, notably in export-oriented industries, was a pivotal element of the development strategy of the new "right-of-centre" government (Lal and Rajapatirana, 1988, 45). Setting up of an export processing zone (the Katunayake Investment Promotion Zone) in 1978 was one of the major steps taken in this direction. Despite the political uncertainty that resulted from the worsening of the country's ethnic conflict since 1983 the new policy orientation proved to be very attractive to foreign investors over the post-liberalisation period (Table 1).

4. FINANCING PATTERN

Against this background, we proceed in this section to highlight some salient features of the financing aspect of MNE subsidiaries *vis a vis* local firms operating in the manufacturing sector of Sri Lanka through a comparative analysis of their balance sheets.

The sample firms used for this analysis consisted of 15 MNE affiliates and 15 local firms operating in the manufacturing sector. To avoid distortion from possible random variations, the analysis is based on average published account figures for the three years from 1981 to 1983.⁵

At the outset, a few words of caution are warranted regarding the limitations of published accounts. Published balance sheet data are not completely reliable indicators of the true financial position of a company, and much less so when some of the 'values' are determined directly by the companies concerned. Profit figures, particularly in the case of multinational companies, may be liable to various manipulations through practices such as transfer pricing (Robbins and Stobaugh, 1974, 91). Some items, such as fixed assets and inventories are subject to arbitrary valuations within a fairly wide range. Furthermore, particularly in respect of fixed assets, accounting figures based on the historical cost concept may not represent realistic values in a period of inflation. Finally, there is the difficulty of comparing and interpreting balance sheet data which represent the financial position at one particular point in time of the lives of firms having different ages and facing different market conditions. There is little we can do to resolve these problems which pervade all studies of this type. In any case, economic policies relating to the business sector and also the existing debate on the financing pattern of MNEs are largely based on the available published data. As such, an analysis based on published balance sheet data is considered relevant and useful in a developing country context.

The financial structure of the sample firms is summarised in Table 2. All balance sheet figures are presented in the form of a common-size 'sources' and 'uses' of funds statement. It should be noted that this is different from the accounting-type sources and

⁵ Published data are available for the years from 1977 to 1986. However, the years 1984 to 1986 are not "representative" because developments in the manufacturing sector (and also other economic sectors) were severely affected by ethnic disturbances which took serious proportions since 1983. The period 1977-80 was excluded since the entire business sector was in a process of extensive transformation during early years of the 1977 policy reforms. For these reasons, 1981-83 was selected as the study period.

uses of funds statement prepared for a specified period of time. Rather, our statement shows total accumulated sources of funds and how they have been used in various types of assets. Such a historical treatment seems more appropriate in testing and analysing the financing pattern of firms (Lall and Streeten, 1977). Table 3 further summarises the information presented in Table 2 in terms of selected financial ratios. These two tables taken together portray a number of important features of the financing behaviour of MNEs.

First, it appears that the level of internal financing of MNEs (45%) is slightly higher than that of the local firms. This seems to have resulted from their relatively stronger position in equity financing and the lower level of loan financing. The percentage contribution of equity finance to total sources of funds is 22 for MNEs as compared to 16 for local firms. The reason for this higher contribution of MNEs is not clear from the available data, but one tentative explanation would be their very high rate of capitalisation of reserves created mainly by revaluation of fixed assets. According to the available data, these capitalised reserves account for almost 90 per cent of the equity capital of MNEs. Unfortunately, the limitation of data prevents us from examining the comparative situation in local firms.

In the category of external sources of finance for MNE subsidiaries and local firms, the highest component is represented by current liabilities, other than bank overdrafts. The most prominent item in these liabilities is the trade credit available from suppliers. In the case of MNEs, trade credit accounts for 70 per cent of total external finance as compared to 52 for local firms. This difference reflects, in part, the advantageous position of MNEs in obtaining trade credit on the purchase of raw materials, merchandise and supplies from their parent companies on relatively easy credit terms.

Table 2
**Financial Structure (%) of MNEs and Local Firms
operating in the manufacturing sector of Sri Lanka
(1981-83 Annual Averages)**

	MNEs	Local Firms
<u>Sources of Finance</u>		
Equity	22.32	15.47
(a) Local	2.48	15.47
(b) Foreign	19.84	
Reserves	12.97	16.04
Depreciation	10.18	11.32
Long-term Loans	6.64	16.08
Bank Overdrafts	8.18	11.14
Other Current Liabilities	38.71	29.95
	----- 100.00 =====	----- 100.00 =====
<u>Uses of Finance</u>		
Gross Fixed Assets	42.83	55.49
(a) Depreciation	10.17	11.32
(b) Net Fixed Assets	32.66	44.17
Investment	2.01	1.01
Current Assets	55.16	43.50
	----- 100.00 =====	----- 100.00 =====

Sources: Compiled using company accounts obtained from Colombo Brokers Association, *Handbook of Rupee Companies: 1981-83*; Company Annual Reports; and Records of the Registrar of Companies, Sri Lanka.

Table 3
**Selected Financial Ratios of MNEs and Local Firms
operating in the manufacturing sector of Sri Lanka**

	MNEs	Local Firms
(1) Total internal finance	45.47	42.83
(a) Equity finance	22.32	15.47
(b) Other internal finance	23.15	27.36
(2) Total external finance	55.53	57.17
(3) Total loan finance	26.69	46.79
(4) Trade credit and accruals	69.71	52.39
(5) Total gearing	42.00	86.39
(6) Total foreign finance	39.86	
(7) Direct foreign inflow	1.47	

Sources: As for Table 2.

Explanation of ratios:

- (1) $(\text{Equity} + \text{reserves} + \text{depreciation}) / \text{Total sources}$
 - (a) $\text{Equity} / \text{Total sources}$
 - (b) $(\text{Reserves} + \text{depreciation}) / \text{Total sources}$
- (2) $(\text{Long-term loans} + \text{bank overdrafts} + \text{other current liabilities}) / \text{Total sources}$
- (3) $(\text{Long-term loans} + \text{bank overdrafts}) / \text{Total external sources}$
- (4) $\text{Other current liabilities} / (\text{Long-term loans} + \text{bank overdrafts} + \text{other current liabilities})$
- (5) $(\text{Long-term loans} + \text{bank overdrafts}) / (\text{Equity} + \text{reserves})$
- (6) $(\text{Foreign equity} + \text{foreign share of reserves} + \text{foreign share of depreciation}) / \text{Total resources}$
- (7) $(\text{Foreign equity} - \text{'bonus' shares component in foreign equity}) / \text{Total sources}$

Loan financing consisting mainly of bank overdrafts and long-term bank loans is much lower in MNEs (27%) in relation to that in local firms (47%). This indicates a tendency on the part of local firms to rely largely on loan financing, which could be partly due to their weaker position in raising funds through share issues and other external sources. In the case of using long-term bank loans the predominance of local firms is particularly noteworthy. This is to be expected in view of the various loan schemes initiated by the government through the state banks and other financial institutions for the promotion of local industries. It should also be noted that even though the bank overdraft is customarily a short-term source of finance, it is common practice among many Sri Lankan business firms to use it as a kind of long-term financing source because of the possibility to "roll over" from year to year (Lakshman and Athukorala, 344).

It is seen from the total gearing ratio that MNEs are much less geared (42%) than local firms (86%). This situation in Sri Lanka confirms the Indian experience reported by Lall and Streeten in respect of gearing and commercial bank financing. However, a comparison of our estimates with those of the Indian and Colombian study shows a surprisingly large variation in respect of direct foreign inflow of capital. The total foreign finance in relation to total sources in our sample is 40 per cent which is not substantially different from that for India (36%). But, the direct foreign inflow of capital, according to our data, is as low as 1.47 per cent of the total sources, whereas it is shown as 17.3 per cent for the Indian sample. As pointed out in Section 3, this wide variation appears to be attributed to the use of inappropriate data for the computation of direct foreign inflow in the Indian and Colombian study. In our study this ratio was computed using only the amount of actual capital contributions to MNE affiliates by their parent companies. We obtained this figure by deducting the nominal value of total 'bonus'

issues from the total equity capital shown in the balance sheets. Our data indicate that only about 10 per cent of the total equity capital of MNEs comprises actual capital contributions. In the Indian and Colombian study, the foreign equity figure used for the computation of direct foreign inflow and direct foreign long-term inflow should obviously include actual capital contributions and capitalised reserves with the latter as high as the figure in the Sri Lankan sample.

5. Conclusions

The empirical analysis of this study does not support the generally held view that MNEs gear themselves more highly than local firms or that they make use of a greater degree of commercial bank credit. This confirms the finding of Lall and Streeten (1977, 119) for India and Columbia. Local firms in our sample tend to have much greater degree of reliance on loan financing than MNEs. On the other hand, MNEs seem to rely more heavily on trade credit as a source of finance than their local counterparts. This suggests that they are in an advantageous position in procuring raw materials, supplies and merchandise on relatively easy credit terms since the suppliers, in most cases, are their parent companies themselves. Finally, the share of total equity capital in total sources of finance of MNEs is higher than that of local firms. However, the direct financial contributions of parent companies to equity capital of their affiliates are very small in relation to the total sources of finance, indicating a low level of direct foreign inflow of capital into the host country as an outcome of MNE involvement.

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