Management of Transaction Exposure: A Comparative Analysis of MNCs in India

Manisha Goel, YMCA University of Science & Technology, Faridabad, India

ABSTRACT

In an era of globalization, thousands of transactions of international trade take place among companies of different countries. But the profitability of these transactions can be completely wiped out by adverse movements in the exchange rate during this time gap. Transaction exposure is a measure of effect of exchange rate fluctuations on these transactions. Unmanaged transaction exposure can paralyze not only financial position but also competitive position of companies in market. The present study portrays transaction exposure management as practiced by various multinational companies in India. And compares management of transaction exposure by banking and non-banking and foreign and Indian MNCs. The effect of various factors on their management policy is also investigated. The results of the study evidence that the majority of firms make efforts to measure their transaction exposure. There is no significant effect of level of transaction exposure on estimation policy and decision to develop separate management system for management of transaction exposure of companies. Significant difference exists between management policies of companies of different sectors toward management of their transaction exposure. Companies are actively using various hedging strategies for managing their transaction exposure.

Keywords: Estimation Policy, Exposure Management System, Financial Derivatives, Hedging Strategies, Transaction Exposure

1. INTRODUCTION

With globalization and liberalization being adopted by almost all countries, scope as well as sphere of international business has become much larger. There has been vast expansion of business beyond national boundaries all over the world. All of the business firms make efforts to acquire the required inputs from the cheapest source in the world and sell their output in the markets where they can get maximum return.

Cross border trade transactions and financial flows involve exchange of one currency into other currency at some future date. But the continuous fluctuations in exchange rate results in risk in these activities. This risk is known as transaction exposure. Transaction exposure is a measure of adverse effect of movements of the exchange rate from the time foreign currency denominated transactions are initiated till the time of their final settlement. In other words, it measures the sensitivity of “realized” domestic currency values at the time of settling of outstanding, fixed priced contracted

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transactions resulting in future cash inflows and outflows denominated in foreign currencies to unexpected exchange rate changes. A real devaluation or revaluation of a particular currency can strongly affect the competitive position of local firms and their foreign competitors. Longer the time lag between entering into a sales/purchase contract, shipment of goods and final payment higher is the risk of adverse movements in exchange rates which can convert a profitable deal into a loss. No doubt, it is not possible for any company to say that it has measured and covered all its transaction exposure. That is why efficient management of transaction exposure has become an alarming need. Usually it is stated that success of any MNC largely depends on how effectively it manages its transaction exposure.

Source of currency risk from transaction exposure for multinational companies could be either export/import activities, or borrowing/lending activities - anytime when future cash flows (to be paid or received) are fixed in a foreign currency. As a result of change in exchange rate, importers may require to pay extra for their imports, exporters may get lesser value for their exports, borrowers may required to pay extra and lenders may recover lesser amount. The resource-based companies face the uncertainty associated with the fact that while the commodities markets of the world are denominated in US Dollars or pounds sterling, their costs are denominated in local currencies. Exchange rate volatility is compounded by the fact that all factors that influence a currency’s value have to be evaluated relative to every other currency – or at least every other major currency that is actively traded. While the commodity price cycle tends to be highly correlated with the world economic cycle – which stands to reason given that demand for commodities is based on demand for global production – there is no corresponding currency cycle, which makes it that much more difficult to anticipate what will be the value of any particular currency after one month, six months or twelve months.

In India, the major sources of transaction exposure are imports and exports. But an Indian importer sourcing products from abroad typically pays for them in the currency of the supplier, and then sells them in Indian Rupee at home. If the local currency appreciates relative to the Rupee, the importer must either raise prices at home to maintain margins, or contend with a reduction in profit. If the product faces competition in India from other importers or domestic producers, raising prices is not always an option. Similarly, if selling prices are contracted in advance, there is no opportunity to recover the foreign exchange loss that would result from an appreciation of the local currency. The Indian exporters face the same risk. A depreciating Indian Rupee is beneficial for them when they receive their funds in foreign currency. But any depreciation in foreign currency will erode their margins at the time of conversion of their foreign currency revenues into Rupee. The risk extends beyond the volatility of revenues and gross margins.

It is not only companies who have sales and costs in overseas currencies who are affected by exchange rate movements but also those companies whose competitors are based internationally. The major reason of foreign currency inflow is export of goods. Many of the MNCs in India are also enjoying foreign currency inflow in form of commission, interest on lending, dividend on their foreign investments, royalty, fee for their technical know-how, agency commission and other overseas contracts. The major reason of foreign currency outflow is imports of raw material, stores and spares and capital goods. There are many other transactions which are resulting in foreign currency outflow such as payment for royalty, research and development, trade mark fees, legal fees, professional and project consultancy fees, technical consultancy fees, supervision charges, subscriptions, membership fees, overseas contracts, overseas office and branches, software development of foreign branches, dividend to shareholders, international borrowings, interest on foreign currency term loans, foreign travel, issue of foreign currency convertible notes, foreign bank charges and commission on exports and discount, etc. Moreover, majority of their
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