

OPPORTUNITIES FOR DECREASING EXCHANGE RISKS OF FOREIGN CURRENCY TRANSACTIONS IN ENTERPRISES WITH A SPECIAL REGARD ON CHANGING-OVER FOREIGN CURRENCY BOOKING

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Abstract: The profitability of the operation of an enterprise is influenced by several factors. Besides the tendency of market demand and supply, taking the changes of inflation, interest rate and exchange rate into consideration is necessary, as all these are risks. Since the start of the economic crisis in the autumn of 2008, changes in the exchange rate have been more and more emphasized. The article deals with methods for decreasing exchange risks of foreign currency transactions, without the need of completeness. In international trade due to the growth of the number of currency loans the significance of managing financial risks coming from the changes in exchange rates has increased. One of its tools is the currency based booking, which may make the effect of the change more predictable.

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Exchange gain or loss coming from the changes in the exchanges rate may be caused by the change between the completion and the financial completion and in case of the conversion of these items as well as may appear in year end evaluation.

When translating the foreign exchange items of the enterprise, the following opportunities may arise on the bases of the Act C of 2000 on Accounting: "60. § (4) *The HUF value of foreign currency holdings, whether on hand or on account, and receivables, financial investments, securities denominated in foreign currencies (jointly referred to as "assets denominated in foreign currencies"), and liabilities shall be determined - as defined under Subsections (1)-(2) - by the average of the buying and selling rate of a credit institution of the undertaking's choice, or by the official foreign exchange rate published by the National Bank of Hungary.*"

"60. § (6) *When determining the HUF value of assets and liabilities denominated in foreign currencies, instead of the average of the buying and selling rate of foreign exchange, all assets and liabilities denominated in foreign currencies may be uniformly valued at buying and at selling rates, provided the difference resulting from the use of a valuation method other than the one described under Subsection (4) is illustrated in the notes on the accounts, if the difference resulting from the valuation method described under Subsection (4) carries a substantial impact in the assets and liabilities, or on the profit and loss figure, because of which the true and fair view requirement would not be satisfied if valued according to Subsection (4).*"

If the revenues and the expenses of an enterprise occur mainly in currency, it is worth finding a solution for avoiding the exchange risks. Exchange risk management has both internal and external techniques as well.

Internal methods of risk management use tools which constitute the part of the financial management of the entity, and do not require establishing any special contractual relationship with a third party. Such tools are for example:

- **Delaying payments:** this time the early completion or delaying the deadline happens by which the opportunities of under or overvaluation may be utilized.
- **Internal compensation** or offsetting: the enterprise group nets the debts in its certain interest and accounts only the remaining net debt.
- **Cash-flow harmonization**, the enterprise harmonizes its revenues in foreign currency to the expenses in foreign currency on the basis of the amounts and timing, thus the contribution of certain currencies happens in the same currency.
- The next possible technique for exchange risk management is **changing the price**. In this case the change in the exchange rate is calculated in advance and built in the increasing selling price.
- It is possible for an enterprise to decrease the exchange risk by giving an **account in a foreign currency** after its products or service (BUCKLEY-ADRIAN, 1998).

These opportunities may partly be solutions for risk management for a company. However, they may be used only in a limited way, and do not serve an all-rounded solution for certain cases.

The external techniques utilize contractual solutions to avoid potential exchange losses. The most often used risk management techniques in the domestic companies are **futures, options, swap, hedge and arbitrage** transactions.

Survey on Foreign Exchange Risk

The Deloitte made a survey relating to foreign exchange risks, by which the unrealized exchange loss resulted the most common negative effects evolved due to the exchange risk. In the given year end evaluation significant losses were generated in companies in the earnings if the enterprise used foreign currency credit, has suppliers of foreign currency, maybe contracted futures transactions, as exchange risk appears in these transactions, which may significantly affect the earnings (I1).

The survey dealt with even the risk decreasing methods utilized by enterprises. According to this, most of the companies chose using futures, options and swap transactions during the past years and even relating to the future. Rather few enterprises consider changing-over foreign currency booking; only 10% of the respondents would choose it.

The Role and Effects of Functional Booking

Changing-over booking in functional foreign currency has both advantages and disadvantages. It is a significant ease for those who change-over as significant exchange fluctuation is not expected in the prices of either the sold products or the purchased inventory, in this way the significant part of the income statement is not affected by the unfavourable tendency of the exchange rates. Thus, it is a good opportunity and method for decreasing the exchange risk, though in the previously introduced survey of Deloitte in September of 2012 only 10% of the asked enterprises consider it as an effective solution. It is a further advantage that the translation of an international statement package in case of a parent of foreign operation does not require the use of a newer exchange rate, thus the enterprise ensures the real and reliable introduction of its statement. Besides these for example a review made in EUR is better understandable for international investors, in this way there is a greater chance to involve new investors, by which the company may develop and step forward from the competitors.

The introduction of booking in foreign currency needs a thorough preparation and work, and further extra payables have to be coped with such as inner work expenses, IT costs and expert fees. All these may cause difficulties for enterprises. Besides the wages, taxes and contributions relating to wages as well as every other tax connection should be registered and paid in HUF.

There are strict conditions for changing-over booking in foreign currency, which will not be detailed due to length limitations.

Illustrating the Risk of Changes in Exchange Rates through a Practical Example

The change in the exchange rates may have significant, often extreme effects on the economic events, which is illustrated in the next Figure.



Figure 1: Changes in the Exchanges Rates of HUF and EUR between November 2011 and October 2012

Source: [http://finance.yahoo.com/q/bc?s=eurhuf=X&t=1y&l=on&z=m&q=l&c=\(12\)](http://finance.yahoo.com/q/bc?s=eurhuf=X&t=1y&l=on&z=m&q=l&c=(12))

The Figure illustrates clearly, that nowadays the exchange rate of EUR declined from 320 HUF to 280 HUF comparing it to the beginning of 2012. The fluctuation of exchange rate may be significant per days, or even per hours. Considering the fact that an enterprise pays its account using a 60-day-deadline, it can be concluded that significant fluctuation may occur regarding a period of two months.

About 80% of the revenues of the examined enterprise dealing with trade are in EUR, but the majority of its costs payable are in HUF. In many cases conversion is necessary in order to pay the account in HUF by converting the revenues in EUR into HUF.

Significant losses may arise during conversion, if the exchange rate of HUF becomes stronger. In case of the exchange rate of 300 HUF/EUR, one can receive 300 HUF for 1 EUR, while after the strengthening of the HUF one receives only 280 HUF in case of the exchange rate of 280 HUF/EUR.

In case of HUF booking, strengthening of HUF causes loss in case of the accounts going out, while liabilities and loans in EUR at the same time cause an (unrealized) profit. Weakening of HUF would make an opposite process.

As it is illustrated in the Figure, comparing to the earlier years there was an extra high exchange rate of 311,13 HUF/EUR on the 31st of December, 2011, thus foreign currency items had to be evaluated on a very high exchange rate, which caused a financially unrealized exchange rate loss, coming from long-term and great value of loans. In this way the profitable results of operating activities due to the effect of financial operations decreased to such a degree that the annual earnings became negative.

Opportunity of Changing-Over Booking in Foreign Currency in case of Kereskedő Ltd. Company

The company faced with the ratio of the unrealized exchange rate loss during the evaluation and making the statement at the end of 2011. As it was very significant, introducing other alternatives for decreasing the exchange loss became necessary. For the managers of the company it was the opportunity of booking in foreign currency.

Effect of Booking in Foreign Currency for the Decrease of Exchange Loss

It is important to examine the earnings of the company for financial decisions, in case of booking in EUR as a functional currency. In case of accounts coming into the company or trade receivables the official exchange rate on the date of the account of the Hungarian National Bank gives the value of the account in EUR. All this calculated to the date of financial completion, regarding the difference between the two values, it can be concluded that what rate of exchange loss or exchange gain could realize in EUR during the exchange rate fluctuation between the time of completion and financial completion. Table 1 contains the result of the calculation.

Table 1: Exchange Loss and Gain of Kereskedő Ltd Company at the End of 2011 in Cases of HUF and EUR Booking

A Data: in HUF

Ledger account No.	Description	Balance in HUF 31.12.2011	Calculated balance with EUR booking converted into HUF
8761	Expenditures for foreign exchange reserves converted into HUF	-103 345 485	0
8763	Expenditures for assets and liabilities in foreign currency financial (receivables from customers exchange rate)	-92 165 047	-52 912 244
8764	Expenditures for assets and liabilities in foreign currency (Year End evaluation)	-203 907 326	-1 352 283
9761	Incomes for foreign exchange reserves converted into HUF	3 427 331	0
9763	Incomes for assets and liabilities in foreign currency financial (receivables from customers exchange rate)	161 503 271	45 438 271
9764	Incomes from assets and liabilities in foreign currency (Year End evaluation)	59 305 973	2 670 121
	Total:	-175 181 283	-6 156 135
Differences:			-169 025 148

Source: Data of „Kereskedő” Ltd. Company

From the view of the company, the positive effect of booking in foreign currency mainly reveals during the conversions. In case of EUR booking, exchange rate differences do not arise because payments happen in the same currency. As 80% of the revenues of the company are realized in EUR, it is obvious, that neglecting the conversion during booking in EUR would decrease the ratio of exchange rate fluctuation affecting mostly the company at present (in case of HUF booking). This ensures significant savings even in case of the loan repayment as both borrowing and repayment happens in EUR.

There are several external factors affecting the exchange rate as well, which mean that EUR booking alone cannot prevent the company from realizing exchange rate losses. Functional booking makes the change of exchange rates more predictable for entities, because the ratio of the accounts on foreign currency and HUF turns around. Until now changes in exchange rates affected foreign currency accounts constituting 80% of

revenues; after changing the booking this would have effects only on the account of HUF, representing 20%.

References

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ACT C of 2000 on Accounting

Links of WebPages:

(I1)http://www.deloitte.com/view/hu_HU/hu/sajtoszoba/sajtkozlomenyek/9d8f215f5d3e9310VgnVCM1000003156f70aRCRD.htm, Time of download: 2012.09.23

(I2) <http://finance.yahoo.com/q/bc?s=eurhuf=X&t=1y&l=on&z=m&q=l&c=>, Time of download: 2011.10.10