BUS422 INTERNATIONAL FINANCE II

## Chapter 9: Transaction Exposure

## MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1) exposure deals with cash flows that result from existing contractual obligations.				1)
A) Operating	B) Transaction	C) Economic	D) Translation	
2) exposure measures the change in the present value of the firm resulting from				
unexpected changes in exchange rates.				
A) Transaction	B) Translation	C) Accounting	D) Operating	
3) Each of the following is	s another name for operati	ing exposure EXCEPT:		3)
A) competitive expo	osure.	B) economic exposi	ure.	
C) accounting expos	sure.	D) strategic exposu	re.	
4) Transaction exposure a	and operating exposure ex	ist because of unexpected	changes in future cash	4)
flows. The difference b	etween the two is that	exposure deals wit	h cash flows already	·
contracted for, while _	exposure deals wi	ith future cash flows that	might change because of	
changes in exchange ra	ites.			
A) operating; transa	iction	B) transaction; oper	ating	
C) operating; accou	nting	D) none of the abov	e	
5) exposure is the	ne potential for accounting	g-derived changes in owr	er's equity to occur	5)
because of the need to	translate foreign currency	financial statements into	a single reporting	
currency.		-		
A) Economic	A) Economic B) Transaction			
C) Operating		D) Accounting (aka	translation)	
6) Losses from exposure generally reduce taxable income in the year they are realized.				
exposure loss	ses may reduce taxes over	a series of years.		
A) accounting; Ope	rating	<ul><li>B) operating; Trans</li></ul>	action	
C) transaction; Acco	punting	D) transaction; Ope	rating	
7) Losses from exposure generally reduce taxable income in the year they are realized.				7)
exposure losses are not cash losses and therefore, are not tax deductible.				
A) accounting; Oper	rating	B) transaction; Trar	nslation	
C) accounting; Tran	saction	D) transaction; Ope	rating	
8) MNE cash flows may be sensitive to changes in which of the following?				8)
A) interest rates B) exchange rates				
C) commodity price	es	D) all of the above		

Image: Internet i	9) Assuming no transaction costs (i.e., hedging is "free"), hedging currency exposures should the variability of expected cash flows to a firm and at the same time, the expected value			9)	
A) decrease; not change       B) increase: not change       10)         (C) not change; not change       D) not change; increase       10)         (10) Which of the following is NOT cited as a good reason for hedging currency exposures?       10)         (A) Reduced risk of future cash flows is a good planning tool.       B) Management is in a better position to assess firm currency risk than individual investors.       C) Currency risk management increases the expected cash flows to the firm.         (D) Reduced risk of future cash flows reduces the probability that the firm may not meet required cash flows.       11)         (11) Which of the following is cited as a good reason for NOT hedging currency exposures?       11)         (A) Shareholders are more capable of diversifying risk than management.       B) Hedging activities are often of greater benefit to management than to shareholders.         (C) Currency risk management through hedging does not increase expected cash flows.       D) All of the above are cited as reasons NOT to hedge.         (12) The stages in the life of a transaction exposure can be broken into three distinct time periods. The first time period is the time between quoting a price and reaching an actual sale agreement or contract. The next time period is the time lag between taking an order and actually filling or delivering it. Finally, the time it takes to get paid after delivering the product. In order, these stages of transaction exposure.       12)         (D) yuotation, backlog, and builling exposure.       D) billing, backlog, and quotation exposure.       13) <t< td=""><td>of the cash flows shou</td><td>lld</td><td></td><td></td><td></td></t<>	of the cash flows shou	lld			
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<ul> <li>is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. The U.S. firm is at risk today of a loss if: <ul> <li>A) the exchange rate doesn't change.</li> <li>B) the exchange rate changes to \$1.58/£.</li> <li>C) the exchange rate changes to \$1.52/£.</li> <li>D) all of the above</li> </ul> </li> <li>14) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate lis \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid avoid and hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid a</li></ul>	13) A U.S. firm sells merc	handise today to a British cor	npany for £150,000. The c	urrent exchange rate	13)
<ul> <li>A) the exchange rate doesn't change.</li> <li>B) the exchange rate changes to \$1.58/£.</li> <li>C) the exchange rate changes to \$1.52/£.</li> <li>D) all of the above</li> </ul> 14) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the exchange rate abanges to \$1.50/£ the U.S. firm will realize a second sec	is \$1.55/£ , the account techniques designed t	t is payable in three months, o reduce or eliminate the risk	and the firm chooses to av c of changes in the exchan	void any hedging ge rate. The U.S. firm	
<ul> <li>14) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate 14) is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avoid and the firm will realize a set of the firm will realize a set.</li> </ul>	A) the exchange ra	te doesn't change	B) the exchange rate (	changes to $$1.58/f$	
<ul> <li>14) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate 14) is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the avalance rate abanges to \$1.50/£ the U.S. firm will realize a set.</li> </ul>	(C) the exchange ra	to changes to \$1.52/f	D) all of the above	1111ges 10 \$1.50/L.	
14) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate 14) is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the		te Granges (0 \$1.32/E.			
techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the	14) A U.S. firm sells merc	handise today to a British cor	mpany for £150,000. The c	urrent exchange rate	14)
	IS \$1.55/£, the account techniques designed t	t is payable in three months, o reduce or eliminate the risk s to \$1.58/f the U.S. firm will	and the tirm chooses to av c of changes in the exchanges in the exchanges of	ge rate. If the	
A) loss; £4,500 B) gain; £4,500 C) loss; \$4,500 D) gain; \$4,500	A) loss; £4,500	B) gain; £4,500	C) loss; \$4,500	 D) gain; \$4,500	

15)	15) A U.S. firm sells merchandise today to a British company for £150,000. The current exchange rate is \$1.55/£, the account is payable in three months, and the firm chooses to avoid any hedging techniques designed to reduce or eliminate the risk of changes in the exchange rate. If the exchange rate changes to \$1.52/£ the U.S. firm will realize a of		15)		
	A) loss; \$4,500	B) loss; £4,500	C) gain; \$4,500	D) gain; £4,500	
16)	is NOT a com	monly used contractual l	nedge against foreign excl	nange transaction	16)
	A) Money market h	edge	B) Forward market	hedge	
	C) Options market h	nedge	D) All of the above	are contractual hedges.	
17)	A hedge refer conduct of business.	rs to an offsetting operati	ng cash flow such as a pay	vable arising from the	17)
	A) contractual	B) futures	C) natural	D) financial	
RUE/FA	ALSE. Write 'T' if t	he statement is true a	nd 'F' if the statemen	t is false.	
18)	As a generalized rule, o	only realized foreign exch	ange losses are deductible	e for tax purposes.	18)
19)	Many MNE s manage f	foreign exchange exposur try of origin	e centrally, thus gains or l	losses are always	19)
20)	Hedging, or reducing r	isk, is the same as adding	y value or return to the firm	n.	20)
21)	There is considerable q and necessary tool.	uestion among investors	and managers about whe	ther hedging is a good	21)
22)	The key arguments in o and diversification do r	opposition to currency he not have financial theory	dging such as market effic at their core.	ciency, agency theory,	22)
23)	The structure of a mon	ey market hedge is simila	r to a forward hedge. The	difference is the cost of	23)
	is a function of the forv	vard rates quotation.	inerential interest rates, w	nine the forward hedge	
24)	24) In efficient markets, interest rate parity should assure that the costs of a forward hedge and money market hedge should be approximately the same.			24)	
25)	25) Management often conducts hedging activities that benefit management at the expense of the shareholders. The field of finance called <i>agency theory</i> frequently argues that management is generally LESS risk averse than are shareholders.			25)	
26)	26) Managers CAN outguess the market. If and when markets are in equilibrium with respect to parity conditions, the expected net present value of hedging should be POSITIVE.			26)	
27)	Shareholders are LESS	capable of diversifying c	urrency risk than is the ma	anagement of the firm.	27)

28) Hedging can be advantageous to shareholders because management is in a better position than shareholders to recognize disequilibrium conditions and to take advantage of single opportunities to enhance firm value through <i>selective hedging</i> .	28)
29) TRANSACTION exposure measures gains or losses that arise from the settlement of existing financial obligations whose terms are stated in a foreign currency.	29)
30) Transaction exposure could arise when borrowing or lending funds when repayment is to be made in the firm's <i>domestic</i> currency.	30)

## ESSAY. Write your answer in the space provided or on a separate sheet of paper.

- 31) Does foreign currency exchange hedging both reduce risk and increase expected value? Explain, and list several arguments in favor of currency risk management and several against.
- 32) Currency risk management techniques include forward hedges, money market hedges, and option hedges. Draw a diagram showing the possible outcomes of these hedging alternatives for a foreign currency receivable contract. In your diagram, be sure to label the X and Y-axis, the put option strike price, and show the possible results for a money market hedge, a forward hedge, a put option hedge, and an uncovered position. (Note: Assume the forward currency receivable is British pounds and the put option strike price is \$1.50/£, the price of the option is \$0.04 the forward rate is \$1.52/£ and the current spot rate is \$1.48/£.)

## MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

Instruction 10.2:

Use the information for the following problem(s).

Central Valley Transit Inc. (CVT) has just signed a contract to purchase light rail cars from a manufacturer in Germany for eur 3,000,000. The purchase was made in June with payment due six months later in December. Because this is a sizable contract firm and because the contract is in euros rather than dollars, CVT is considering several hedging alternatives to reduce the exc rate risk arising from the sale. To help the firm make a hedging decision you have gathered the following information.

- The spot exchange rate is \$1.250/euro
- The six month forward rate is \$1.22/euro
- CVT's cost of capital is 11%
- The Euro zone 6-month borrowing rate is 9% (or 4.5% for 6 months)
- The Euro zone 6-month lending rate is 7% (or 3.5% for 6 months)
- The U.S. 6-month borrowing rate is 8% (or 4% for 6 months)
- The U.S. 6-month lending rate is 6% (or 3% for 6 months)
- December call options for euro 750,000; strike price \$1.28, premium price is 1.5%
- · CVT's forecast for 6-month spot rates is \$1.27/euro
- The budget rate, or the highest acceptable purchase price for this project, is
- \$3,900,000 or \$1.30/euro
  - 33) Refer to Instruction 10.2. If CVT chooses NOT to hedge their euro payable, the amount they pay in 33) six months will be:

A) \$3,500,000.	<b>B</b> ) \$3,900,000.
C) €3,000,000.	D) unknown today

A) buy: \$1,22	B) sell: \$1.22	 C) sell: €1.25	D) buy: \$1,25	
/ 000, 41122	-) 5511/ \$1.22	<i>c)</i> son, ch20	= / Saj/ + 1120	
35) Refer to Instruction 10.2	2. CVT chooses to hedge it	ts transaction exposure in	the forward market at	35)
the available forward ra	ate. The required amount	in dollars to pay off the a	ccounts payable in 6	
months will be:				
A) \$3,660,000.	<b>B</b> ) \$3,810,000.	C) \$3,750,000.	<b>D)</b> \$3,000,000.	
36) Refer to Instruction 10.3	2. If CVT locks in the forw	ard hedge at \$1.22/euro. a	and the spot rate when	36)
the transaction was rec	orded on the books was \$	1.25/euro, this will result i	in a "foreign exchange	/
accounting transaction	of			
A) loss; \$90,000.	B) gain; €90,000.	C) gain; \$90,000.	D) loss; €90,000.	
37) Refer to Instruction 10.	2. CVT would be	_ by an amount equal to _	with a forward	37)
hedge than if they had correct.	NOT hedged and their pr	edicted exchange rate for	6 months had been	
A) worse off; €150,0	00	B) better off; €150,0	00	
	20	D) better off: \$150.0	00	
C) worse off; \$150,0 38) Refer to Instruction 10. (Note: Calculate the cos appropriate interest rat	2. What is the cost of a cal st in future value dollars a e for calculating future va	I option hedge for CVT's e ind assume the firm's cost ilues.)	euro receivable contract?	38)
C) worse off; \$150,0 38) Refer to Instruction 10. (Note: Calculate the cost appropriate interest rat A) \$63,936	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208	euro receivable contract? of capital as the D) \$59,904	38)
C) worse off; \$150,0 38) Refer to Instruction 10.3 (Note: Calculate the cos appropriate interest rat A) \$63,936 39) Refer to Instruction 10 3	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208	euro receivable contract? of capital as the D) \$59,904	38)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest rattion A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275.</li> </ul>	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600 2. The cost of a put option	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208 to CVT would be:	euro receivable contract? of capital as the D) \$59,904	38) 39)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratted A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388.</li> </ul>	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600 2. The cost of a put option	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208 to CVT would be:	euro receivable contract? of capital as the D) \$59,904	38) 39)
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<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratt A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enous</li> <li>40) are transactio</li> </ul>	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600 2. The cost of a put option ngh information to answer	I option hedge for CVT's e ind assume the firm's cost ilues.) C) \$62,208 to CVT would be:	euro receivable contract? of capital as the D) \$59,904 greements between	38) 39) 40)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratted A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enous</li> <li>40) are transaction parties.</li> </ul>	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600 2. The cost of a put option ngh information to answer	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208 to CVT would be:	euro receivable contract? of capital as the D) \$59,904	38) 39) 40)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratted A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enous</li> <li>40) are transaction parties. A) Anticipated exposition</li> </ul>	2. What is the cost of a cal st in future value dollars a e for calculating future va B) \$57,600 2. The cost of a put option agh information to answer ns for which there are, at p	I option hedge for CVT's e ind assume the firm's cost ilues.) C) \$62,208 to CVT would be: this question. present, no contracts or ag B) Backlog exposur	euro receivable contract? of capital as the D) \$59,904 greements between	38) 39) 40)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratting A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enous</li> <li>40) are transaction parties. A) Anticipated exposed</li> <li>C) Quotation exposed</li> </ul>	<ol> <li>What is the cost of a callst in future value dollars a e for calculating future va B) \$57,600</li> <li>The cost of a put option</li> <li>The cost of a put option to answer ns for which there are, at psure ure</li> </ol>	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208 to CVT would be: this question. present, no contracts or ag B) Backlog exposur D) none of the abov	euro receivable contract? of capital as the D) \$59,904 greements between e	38) 39) 40)
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest ratt A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enou</li> <li>40) are transaction parties. A) Anticipated expose C) Quotation expose</li> <li>41) According to a survey by firms is:</li> </ul>	<ol> <li>What is the cost of a callst in future value dollars a e for calculating future va B) \$57,600</li> <li>The cost of a put option</li> <li>The cost of a put option to answer ns for which there are, at pusure ure</li> <li>Bank of America, the type of the state of the s</li></ol>	I option hedge for CVT's e ind assume the firm's cost alues.) C) \$62,208 to CVT would be: this question. present, no contracts or ag B) Backlog exposur D) none of the abov	euro receivable contract? of capital as the D) \$59,904 greements between e e sk most often hedged	<ul> <li>38)</li> <li>39)</li> <li>40)</li> <li>41)</li> </ul>
<ul> <li>C) worse off; \$150,00</li> <li>38) Refer to Instruction 10.3 (Note: Calculate the cost appropriate interest rat A) \$63,936</li> <li>39) Refer to Instruction 10.3 A) \$58,275. B) \$55,388. C) \$52,500. D) There is not enous</li> <li>40) are transaction parties. A) Anticipated exposes</li> <li>41) According to a survey by by firms is: A) contingent exposes</li> </ul>	<ol> <li>What is the cost of a callst in future value dollars a e for calculating future va B) \$57,600</li> <li>The cost of a put option</li> <li>The cost of a put option to answer ns for which there are, at psure ure</li> <li>Bank of America, the ty ure.</li> </ol>	I option hedge for CVT's e and assume the firm's cost alues.) C) \$62,208 to CVT would be: this question. present, no contracts or ag B) Backlog exposur D) none of the abov ype of foreign exchange ri B) transaction expo	euro receivable contract? of capital as the D) \$59,904 greements between e e sk most often hedged sure.	<ul> <li>38)</li> <li>39)</li> <li>40)</li> <li>41)</li> </ul>

42) When attempting to manage an account payable denominated in a foreign currency, the firm's	42)
only choice is to remain unhedged.	-

43) The treasury function of most firms, the group typically responsible for transaction exposure management, is NOT usually considered a profit center.	43)
44) According to the authors, firms that employ proportional hedges increase the percentage of forward-cover as the maturity of the exposure lengthens.	44)
45) Remaining unhedged is NOT an option when dealing with foreign exchange transaction exposure.	45)
46) A forward hedge involves a put or call option contract and a source of funds to fulfill that contract.	46)
47) Like a forward market hedge, a <i>money market hedge</i> also involves a contract and a source of funds to fulfill that contract. In this instance, the contract is a loan agreement.	47)
48) Hedging transaction exposure with option contracts allows the firm to benefit if exchange rates are favorable but protects the firm if exchange rates turn unfavorable.	48)
49) A firm's <i>risk tolerance</i> is a combination of management's philosophy toward transaction exposure and the specific goals of treasury activities.	49)
50) Although rarely acknowledged by the firms themselves, selective hedging is essentially speculation.	50)

Answer Key Testname: UNTITLED1

- 1) B
- 2) D
- 3) C
- 4) B
- 5) D 6) D
- 7) B
- 8) D
- 9) A
- 10) C
- 11) D
- 12) A
- 13) D
- 14) D
- 15) A
- 16) D
- 17) C
- 18) TRUE
- 19) FALSE
- 20) FALSE
- 21) TRUE
- 22) FALSE
- 23) TRUE
- 24) TRUE
- 25) FALSE
- 26) FALSE
- 27) FALSE
- 28) TRUE
- 29) TRUE
- 30) FALSE
- 31) Foreign exchange currency hedging can reduce the variability of foreign currency receivables or payables by locking in a specific exchange rate in the future via a forward contract, converting currency at the current spot rate using a money market hedge, or minimizing unfavorable exchange rate movement with a currency option. None of these hedging techniques, however, increases the expected value of the foreign currency exchange. In fact, expected value should fall by an amount equal to the cost of the hedge.

Generally, those in favor of currency risk management find value in the reduction of variability of uncertain cash flow: opposed to currency risk management argue the NPV of such activities are \$0 or less and that shareholders can reduce themselves more efficiently. For a more complete answer to this question, see page 4 where the author outlines several arguments for and against currency risk management.

32) The student should draw and label a diagram that looks similar to the one found in Exhibit 10.5.

- 33) D
- 34) A
- 35) A
- 36) C

Answer Key Testname: UNTITLED1

37) D
38) D
39) D
40) A
41) B
42) FALSE
43) TRUE
44) FALSE
45) FALSE
45) FALSE
46) FALSE
47) TRUE
48) TRUE
49) TRUE
50) TRUE