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. 2) ______
A) Transaction B) Translation C) Accounting D) Operating

3) Each of the following is another name for operating exposure EXCEPT: 3) ______
A) competitive exposure.
B) economic exposure.
C) accounting exposure.
D) strategic exposure.

4) Transaction exposure and operating exposure exist because of unexpected changes in future cash flows. The difference between the two is that _______ exposure deals with cash flows already contracted for, while _______ exposure deals with future cash flows that might change because of changes in exchange rates. 4) ______
A) operating; transaction
B) transaction; operating
C) operating; accounting
D) none of the above

5) _______ exposure is the potential for accounting-derived changes in owner's equity to occur because of the need to translate foreign currency financial statements into a single reporting currency. 5) ______
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 losses may reduce taxes over a series of years. 6) ______
A) accounting; Operating
B) operating; Transaction
C) transaction; Accounting
D) transaction; Operating

7) Losses from _______ exposure generally reduce taxable income in the year they are realized. _______ exposure losses are not cash losses and therefore, are not tax deductible. 7) ______
A) accounting; Operating
B) transaction; Translation
C) accounting; Transaction
D) transaction; Operating

8) MNE cash flows may be sensitive to changes in which of the following? 8) ______
A) interest rates
B) exchange rates
C) commodity prices
D) all of the above

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 of the cash flows should ________. 9) ______

A) decrease; not change
B) increase; not change
C) not change; not change
D) not change; increase

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) 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 may be identified as: 12) ______

A) quotation, backlog, and billing exposure.
B) backlog, quotation, and billing exposure.
C) quotation, billing, and backlog exposure.
D) billing, backlog, and quotation exposure.

13) 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. The U.S. firm is at risk today of a loss if: 13) ______

A) the exchange rate doesn't change.
B) the exchange rate changes to $1.58/£.
C) the exchange rate changes to $1.52/£.
D) all of the above

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 changes to $1.58/£ the U.S. firm will realize a ________ of ________. 14) ______

A) loss; £4,500
B) gain; £4,500
C) loss; $4,500
D) gain; $4,500

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 commonly used contractual hedge against foreign exchange transaction exposure. 16) ______

A) Money market hedge B) Forward market hedge
C) Options market hedge D) All of the above are contractual hedges.

17) A ________ hedge refers to an offsetting operating cash flow such as a payable arising from the conduct of business. 17) ______

A) contractual B) futures C) natural D) financial

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

18) As a generalized rule, only realized foreign exchange losses are deductible for tax purposes. 18) ______

19) Many MNE s manage foreign exchange exposure centrally, thus gains or losses are always matched with the country of origin. 19) ______

20) Hedging, or reducing risk, is the same as adding value or return to the firm. 20) ______

21) There is considerable question among investors and managers about whether hedging is a good and necessary tool. 21) ______

22) The key arguments in opposition to currency hedging such as market efficiency, agency theory, and diversification do not have financial theory at their core. 22) ______

23) The structure of a money market hedge is similar to a forward hedge. The difference is the cost of the money market hedge is determined by the differential interest rates, while the forward hedge is a function of the forward rates quotation. 23) ______

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) Management often conducts hedging activities that benefit management at the expense of the shareholders. The field of finance called *agency theory* frequently argues that management is generally LESS risk averse than are shareholders. 25) ______

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 currency risk than is the management 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 *selective hedging.* 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 *domestic* 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 f 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 six months will be: 33) ______

A) $3,500,000.
B) $3,900,000.
C) €3,000,000.
D) unknown today

34) Refer to Instruction 10.2. If CVT chooses to hedge its transaction exposure in the forward market, it will _______ euro 3,000,000 forward at a rate of _______. 34) _____

A) buy; $1.22 B) sell; $1.22 C) sell; €1.25 D) buy; $1.25

35) Refer to Instruction 10.2. CVT chooses to hedge its transaction exposure in the forward market at the available forward rate. The required amount in dollars to pay off the accounts payable in 6 months will be: 35) _____

A) $3,660,000. B) $3,810,000. C) $3,750,000. D) $3,000,000.

36) Refer to Instruction 10.2. If CVT locks in the forward hedge at $1.22/euro, and the spot rate when the transaction was recorded on the books was $1.25/euro, this will result in a "foreign exchange accounting transaction _______ of _______. 36) _____

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 hedge than if they had NOT hedged and their predicted exchange rate for 6 months had been correct. 37) _____

A) worse off; €150,000
B) better off; €150,000
C) worse off; $150,000
D) better off; $150,000

38) Refer to Instruction 10.2. What is the cost of a call option hedge for CVT's euro receivable contract? (Note: Calculate the cost in future value dollars and assume the firm's cost of capital as the appropriate interest rate for calculating future values.) 38) _____

A) $63,936 B) $57,600 C) $62,208 D) $59,904

39) Refer to Instruction 10.2. The cost of a put option to CVT would be: 39) _____

A) $58,275.
B) $55,388.
C) $52,500.
D) There is not enough information to answer this question.

40) _______ are transactions for which there are, at present, no contracts or agreements between parties. 40) _____

A) Anticipated exposure
B) Backlog exposure
C) Quotation exposure
D) none of the above

41) According to a survey by Bank of America, the type of foreign exchange risk most often hedged by firms is: 41) _____

A) contingent exposure.
B) transaction exposure.
C) economic exposure.
D) translation exposure.

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

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

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 *money market hedge* 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 *risk tolerance* 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) ______

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 flows 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

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