INDIRA GANDHI NATIONAL OPEN UNIVERSITY

SCHOOL OF MANAGEMENT STUDIES

MASTERS THESIS

MANAGEMENT OF FOREIGN EXCHANGE TRANSLATION EXPOSURE: THE CASE OF SOS SAHEL ETHIOPIA

A THESIS SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUREMENT FOR THE DEGREE OF MASTERS OF BUSINESS ADMINISTRATION IN FINANCE

PREPARED BY
Tesfu Nega
Enrolment No. ID1217853

May 2015
Addis Ababa
ETHIOPIA

CERTIFICATE OF ORIGINALITY

This is to certify that the project titled "Management of Foreign Exchange Translation Exposure: The Case of SOS Sahel Ethiopia" is an original work of the Student and is being submitted in partial fulfillment for the award of the Master's Degree in Business Administration of Indira Gandhi National Open University. This report has not been submitted earlier either to this University or to any other University/Institution for the fulfillment of the requirement of a course of study.

SIGNATURE OF SUPERVISOR	**SIGNATURE OF STUDENT**
Place:	Place:
Date:	Date:

ACKNOWLEDGEMENT

I would like to express my deepest gratitude and appreciation to my advisor, Dr. Zenegnaw Abiy, for his constructive comments on my work and assistance at all times in preparing this paper.

I owe a debt of gratitude to the staffs of SOS Sahel Ethiopia who have helped me in gathering information.

It would have been a very formidable task for me to complete this study without the active help and whole hearted cooperation of my family and friends. Particularly my mother and my wife who helped me a lot even to do this job, well wishers and positive thinkers.

On top of that, my due respect is to the Almighty God for giving me strength, patience and for the grace he has bestowed upon me to accomplish my study.

TABLE OF CONTENTS

CERTIFICATE OF ORIGINALITY i

ACKNOWLEDGEMENT ii

LIST OF FIGURES v

LIST OF TABLES vi

ACRONYMS.. vii

ABSTRACT viii

CHAPTER ONE: INTRODUCTION 1

1.1 Background of the Study 1

1.2 Statement of the Problem 4

1.3 Objective of the Study 6

1.4 Significance of the Study 6

1.5 Methodology 6

1.6 Scope and Limitation of the Study 7

1.7 Organization of the Study 8

CHAPTER TWO: LITERATURE REVIEW 9

2.1 Introduction 9

2.2 Foreign Exchange 10

2.3 Foreign Exchange Risk 10

2.4 Foreign Exchange Exposure 11

2.4.1 Types of Foreign Exchange Exposure 12

2.4.2 Translation Exposure 15

2.4.3 Translation Method 18

2.4.3.1 Current / Noncurrent Method 18

2.4.3.2 Monetary / Nonmonetary Method 19

2.4.3.3 Temporal Method 20

2.4.3.4 Current Rate Method 20

2.4.4 Management of Translation Exposure 22

2.5 Foreign Exchange Transaction and Translation 23

2.6 Translation Exposure vs. Transaction Exposure........ 24
2.7 Hedging Translation Exposure........ 25
2.7.1 Balance Sheet Hedge........ 26
2.7.2 Derivative Hedge........ 27
2.8 Critique of Translation Exposure........ 28

CHAPTER THREE: RESEARCH DESIGN AND METHODOLOGY 31
3.1 Introduction........ 31
3.2 Research Design........ 31
3.3 Data Sources........ 33
3.4 Study Population and Sample Size........ 33
3.5 Data Collection Instruments........ 34
3.8 Data Analysis Methods........ 34

CHAPTER FOUR: DATA PRESENTATION AND ANALYSIS 36
4.1 Introduction........ 36
4.2 Response Rate........ 36
4.3 General Information........ 36
4.4 Foreign Exchange Exposure Management Policy........ 38
4.5 Review of Financial Statements........ 43
4.6 Foreign Exchange Translation Impact........ 53
4.7 Gaps in Managing Translation Exposure........ 58

CHAPTER FIVE: SUMMARY, CONCLUSIONS AND RECOMMENDATION.. 60
5.1 Introduction........ 60
5.2 Summary........ 60
5.3 Conclusion........ 64
5.4 Recommendations........ 65

REFERENCES........ 67

APPENDICES........ 69
Appendix 1: Research Questionnaire........ 69
Appendix 2: Research Interview Questions........ 74

LIST OF FIGURES

Figure 1: SOS Sahel Ethiopia Income and Expenditure Trend....................................... 43

Figure 2: SOS Sahel Ethiopia Income and Expenditure vs. Translation Loss Trend…... 44

Figure 3: SOS Sahel Ethiopia UK Debtor vs. Transaction Gain Trend………………….... 45

Figure 4: SOS Sahel Ethiopia Transaction Gain (Loss) Trend……………….................... 46

Figure 5: SOS Sahel Ethiopia Translation Gain (Loss) Trend ………….......................... 47

Figure 6: SOS Sahel Ethiopia Exchange Rate Trend... 48

LIST OF TABLES

Table 1: Response rate……………………………………………………………. 36

Table 2: Level of education ………………………………………………………. 37

Table 3: Work experience…………………………………………………………. 37

Table 4: Exchange rate policy…………………………………………………… 38

Table 5: Foreign exchange policy………………………………………………….. 38

Table 6: Foreign exchange translation exposure management……………………….. 39

Table 7: Foreign exchange transaction exposure position tracking…………………… 40

Table 8: Foreign exchange translation exposure position tracking…………………… 40

Table 9: Management of translation exposure………………………………………… 41

Table 10: Foreign exchange translation exposure hedging method…………………….. 42

Table 11: Internal hedging method……………………………………………………42

Table 12: Donor reporting currency……………………………………………………. 49

Table 13: Translation method……………………………………………………………49

Table 14: Foreign exchange risk…………………………………………………………53

Table 15: Foreign exchange translation clause in the donor's contract………………… 54

Table 16: Foreign exchange translation method………………………………………54

Table 17: Foreign exchange transaction loss…………………………………………… 55

Table 18: Foreign exchange translation loss …………………………………………… 56

Table 19: Donors willingness to receive fund balance in local currency………………. 56

Table 20: Currency used to refund the unspent balance of a project fund……………… 57

Table 21: Absence of foreign exchange translation clause in the donor's contract…….. 58

ACRONYMS

AAFM	–	American Academy of Financial Management
CAD	–	Canadian Dollar
ETB	–	Ethiopian Birr
EU	–	European Union
FAS	–	Financial Accounting Standards
FX	–	Foreign Exchange
GAAP	–	Generally Accepted Accounting Standards
GBP	–	Great Britain Pound
IFRS	–	International Financial Reporting Standards
MNC	–	Multi National Corporations
MOFA	–	Ministry of Foreign Affair
NBE	–	National Bank of Ethiopia
NGO	–	Non-Governmental Organization
NOK	–	Norwegian Kroner
UK	–	United Kingdom
US	–	United States
USAID	–	United States Agency for International Development
USD	–	United States Dollar
WU	–	Western Union

ABSTRACT

A gradual increase in foreign exchange market volatility in recent years has increased the need for management of foreign exchange exposure. Charities and nongovernmental organisations were not participated in foreign exchange market in the past decades. But as their foreign exchange volume and intervention countries increased their hedging needs are becoming more important and it leads them to exercise hedging strategies. Accordingly management of foreign exchange translation exposure has helped many nongovernmental organizations to implement projects without compromising their quality and equity. The objective of the study was to examine the management of foreign exchange translation exposure in the case of SOS Sahel Ethiopia. In this study exploratory research design approach was adopted. The target population of this study included management team of the organization both in Addis Ababa and project sites in different regions of the country. Simple random sampling technique was used to select 35 respondents. This study used questionnaires and interview questions for primary data collection and secondary data collected from financial records of the organization. Quantitative data was analyzed using descriptive analysis. Data collected through open ended questions and interviews was analyzed qualitatively through content analysis. The study summarized and concluded that management of foreign exchange translation exposure contributes a lot to the financial sustainability of the organization and it has to be backed up with workable policies, procedures and systems. It also required well experienced and qualified personnel's to formulate workable financial strategies and prevent the organization from extraordinary losses. In order to prevent the organization from foreign exchange translation exposure and stayed sustainable, the study recommended to adopt a well designed foreign exchange translation exposure management policy, proven translation methods and hedging techniques.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The Ethiopian government issued Charities and Societies Proclamation No. 621/2009 in 2009 in order to support and facilitate the role of Non-Governmental Organizations (NGOs) in the overall development of the Ethiopian people (MOFA). Accordingly the NGO sector played an important role in the poverty alleviation and socio economic development activities in collaboration with the Ethiopian government (MOFA website).

As per the National Bank of Ethiopia (NBE) annual report the total amount of foreign currency cash transfer to the country through NGOs in 2011/12 is amounting USD 1.3725 billion and it is 23.1% of the total unrequited transfers. When we compare the 2011/12 receipt with 2010/11 it increased by 32.8 % and the 2010/11 receipt increased by 3.8% as compared with 2009/10 (NBE Annual Report 2011-2012). This shows an increasing trend of foreign currency transfer to Ethiopia through NGOs. The sources of this huge amount of money are multilateral, bilateral and institutional funding agencies represented by NGOs.

Charities and not-for-profit organisations might not be the most typical participants in the foreign exchange market. But as their foreign exchange volume increased their hedging needs are becoming as important as any other business organizations and it leads them to exercise their hedging strategies.

A gradual increase in foreign exchange market volatility in recent years has boosted the need for strategic risk management, and managers say charities and NGOs increasingly now hedge their positions with forwards as well as spot contracts.

NGOs are becoming more sophisticated in their fund raising and more aware of the risks they face. The sophistication is mainly to do with the assessment of asset and liability foreign exchange exposures. An international NGOs will now think about where it raises funds, what currencies it holds, including foreign exchange of assets, in what currency its income naturally arises, how its liabilities will be paid out and how these liabilities might vary as currencies move (Albanese, 2011).

Exposure refers to the degree to which a company is affected by exchange rate changes. Exchange rate risk is defined as the variability of a firm’s value due to uncertain changes in the rate of exchange (DeMaskey, 2011).

At the firm level, currency risk is called exposure. The globalization of the business environment has turned exposure into a general management responsibility. In analyzing the foreign exchange exposure three types of foreign exchange exposure should be considered (Moffett, 2009). These are: transaction exposure, economic exposure, and translation exposure (balance sheet exposure).

Transaction exposure refers to the currency risk of transactions denominated in foreign currency (John, 2001). Economic exposure measures the degree to which a firm's expected cash flows are affected by unexpected changes in exchange rates (Maurice, 2005). Translation exposure

measures potential accounting-based changes in a firm's consolidated statements that result from a change in exchange rates (Frederick, 2003).

In relation to the above background information foreign currency exchange exposure directly affected NGOs and the rationale of this study is to assess the hedging practices of SOS Sahel Ethiopia and identify the management gap if any.

SOS Sahel International (UK) started work in the Sahelian Dry lands Zone, both in Western and Eastern Africa in 1984. In Ethiopia, it began rural development projects focusing on food security and community based resource management five years after its establishment in 1989.

In 2005, SOS Sahel Ethiopia was registered (No. 1986) as an independent national NGO by the Ethiopian Ministry of Justice and reregistered (No. 0320) in 2012 as Ethiopian Residents Charities as per the charities and societies proclamation no. 621/2009. SOS Sahel Ethiopia is a national NGO and has more than 24 years of rural development experience in Ethiopia.

SOS Sahel Ethiopia envisions a world without poverty and it is dedicated to improve the living standards of smallholder farmers and marginalized pastoralists through better management of their environment. The work of SOS Sahel focuses on community-based natural resources management, food security, agriculture, policy analysis, value chain analysis and development, pro-poor value chain development.

SOS Sahel Ethiopia based in Addis Ababa, the capital city of Ethiopia, and operating in three regional states of Ethiopia: namely Amhara, Oromia and Southern Nations Nationalities and Peoples Region (SNNPR). Currently the organization has 19 projects and 182 staffs.

1.2 Statement of the Problem

The statement that 'most international charities are currency speculators' may at first glance appear somewhat controversial; surely such behavior is the sole purview of hedge funds and investment banks (Andrew, 2009). But, unfortunately, this statement is accurate. Many non-governmental organisations find themselves with income and expenditures denominated in different currencies (Andrew, 2009).

NGOs typically derive income from countries in the developed world, but have program expenditures in the developing world. Any such NGO is therefore naturally exposed to movements on the foreign exchange markets. Changes in exchange rates between their revenue currencies and those in which their expenditures are denominated will either positively or negatively impact their ability to fund their programs. An NGO will benefit if the currencies of developed world countries appreciate versus the rest of the world, and of course vice versa (Andrew, 2009).

As per charities and societies proclamation no. 621/2009 article 2 sub article 3 Ethiopian residents charities should have receive more than ten percent of their fund from foreign sources. Accordingly SOS Sahel Ethiopia received funds from local as well as international funding agencies denominated in different foreign currencies, such as USD, GBP, CAD, EURO, NOK,

etc. The local currency Ethiopian Birr (ETB) is used as a base currency in the budget preparation process and it converted to donor currency at the prevailing rate of that currency.

For example in the year 2013 SOS Sahel Ethiopia received Euro 2.1 million, USD 0.56 million, GBP 0.32 million, CAD 0.15 million and NOK 0.69 million as part of the annual income of ETB 81 million, which is equivalent to GBP 2.8 million. The organization has also incurred a currency translation loss of GBP 65,689, which was GBP 81,208 in 2012. This loss arises due to currency translation during cash transfer from the funding agency i.e. donor currency translated in to ETB at the date of transfer and the balance sheet closing rate used at the end of the year to translate ETB in to GBP as per the organization policy.

The fund transferred to the organization is converted to the local currency by the official rate of the bank at date of transfer. On the other hand the expenditures are converted in to foreign currency using the rate predetermined by the funder (e.g. EU) or weight average of the cash transfer rates. This change in exchange rate affects the operation of the project as well as organization as a whole.

Based on the above gap this study analyzes foreign exchange translation practices of SOS Sahel Ethiopia and identifies how it affects the operation of the organization. In contrast with the related literatures it recommends the best hedging technique to minimize foreign exchange translation exposure.

1.3 Objective of the Study

The overall objective of this study is to assess foreign exchange translation exposure management practices and to provide general idea to the management of the organization. The specific objectives are as follows:

1. To assess policies of the organization if any with regard to foreign exchange translation exposure.
2. To review financial statements in line with foreign exchange translation exposure.
3. To investigate the foreign exchange translation impact
4. To identify the major gaps in managing translation exposure.

1.4 Significance of the Study

The output of this study will give information about the implication of foreign exchange translation exposure, and the hedging mechanisms used by SOS Sahel Ethiopia in order to protect the resulting risk. It gives an insight to the management of the organization and it is their decision how to use the output of this study. It also helps researchers for further investigation and gives highlight to the policy makers to review their working policies.

1.5 Methodology

Both qualitative and quantitative research design methods will be used in this study. The study will use cross-sectional survey method as starting point.

This study considers both primary and secondary data. Primary data will be collected through questionnaire and interview.

The questionnaire will include few open ended questions to capture the qualitative aspect or explanations for some responses. This questionnaire will be distributed to all project managers and finance and admin officers at project site.

The interview questions will be semi-structured to ensure the necessary data is collected. Interviews will be conducted with directors, program managers and the senior finance team at Addis Ababa.

Secondary data will be gathered from annual financial reports, donor reports, books, periodicals, internet, government publications, company flyers and previous studies.

The study focuses on those who have direct relationship with the financial management of projects and the organization as a whole. These are directors, program managers and the senior finance team at head office, project managers and finance officers at project sites. This comprises of 35 staffs and the study will incorporate all of them.

Tables and graphs will be used to present the collected data and analyzed using both qualitative and quantitative methods.

1.6 Scope and Limitation of the Study

This study will be conducted specifically in SOS Sahel Ethiopia. It is difficult to conclude that this study represents the overall NGO sector in Ethiopia. Due to resource (money and time)

limitation it is not possible to study the Ethiopian NGO sector as a whole. Therefore it is important to state that the study is limited to SOS Sahel Ethiopia only.

1.7 Organization of the Study

The study will have five chapters. Chapter one will contain background of the study, statement of the problem, objective of the study and significance of the study. Chapter two will contains literature review. Chapter three will contains methodology. Chapter four will be data presentation and analysis. Chapter five, the last chapter of the study will be summary, conclusion and recommendation.

CHAPTER TWO

LITERATURE REVIEW

2.1 Introduction

Poor understanding of the impact of exchange rates on accounting and reporting can create additional losses and gains. The translation of foreign currency transactions and financial statements should produce results which are generally compatible with the effects of rate changes on an organizations cash flows and its award; and also ensure that the financial statements present a true and fair view of the results of management actions (USAID website).

As the euro exchange rate to the US dollar reached new record highs in the summer and autumn of 2007, concerns about the impact of the appreciation on euro-area exports have been voiced in the media. Earlier in 2007, then Airbus chairman Gallois famously estimated that a euro appreciation of 10 cent against the US dollar cost his company one billion euro due to the fact that a large share of the company's costs are denominated in euro, whereas the bulk of its revenues is in US dollar (Döhring, 2008). This clearly shows how companies affect by a small change in exchange rate.

Some U.S. based charities generate significant donation revenue from abroad and with the currency market proving highly volatile, a select few are looking to manage their exchange-rate risk exposure (WU website).

The Wall Street Journal reported on the trend on March 17, 2011, noting that organizations like

World Vision - a relief and development group based in Washington State - are devising the kind of advanced currency risk management strategies that were once exclusive to the private sector (WU website).

2.2 Foreign Exchange

Foreign exchange is the mechanism by which the currency of one country gets converted into the currency of another country. The conversion is done by banks who deal in foreign exchange. These banks maintain stocks of foreign currencies in the form of balances with banks abroad.

Exchange rate is the rate at which one currency is converted into another currency is the rate of exchange between the currencies concerned. The rate of exchange for a currency is known from the quotation in the foreign exchange market.

2.3 Foreign Exchange Risk

Foreign exchange risk refers to the adverse effects that unanticipated exchange rate changes can have on the value of the organization. If foreign exchange risk is an issue that organizations have to deal with, we need to know how they identify and measure their currency exposure. Based on the nature of the exposure and the organization's ability to forecast currencies, we have to deal with what exchange risk management strategy they should employ (Frederick, 2003).

Exchange risk originates from the random fluctuations of foreign exchange rates. It can be measured by the variance of the value of monetary as well as real assets and liabilities and the

operating income and expenditure of a company that is caused by unanticipated changes in the exchange rates. The emphasis here is on unexpected changes, as anticipated changes in the foreign exchange rate as well as all other available information are already reflected in market prices. In most currencies there exist futures or forward exchange contracts whose prices give organizations an indication of where the market expects currencies to go. And these contracts offer the ability to lock in the anticipated change (Frederick, 2003).

Exchange rate volatility is a necessary but not sufficient condition for foreign exchange risk. Some organizations may not be affected by foreign exchange rate changes at all. Thus, what is required is to assess foreign exchange exposure that quantifies the sensitivity of the value of assets, liabilities, operating income and expenditure with respect to exchange rate variations. The concept of exposure describes the effect that exchange rate changes have on these values. It is the value at risk. Therefore, it is ultimately foreign exchange exposure that is relevant for each individual organization. One of the consequences of this conclusion is that An organization may decide to take operating measures that alter its exposure as one way to manage the underlying exchange risk (Levi, 1996).

2.4 Foreign Exchange Exposure

Foreign currency exposure is the extent to which the future cash flows of an enterprise, arising from domestic and foreign currency denominated transactions involving assets and liabilities and generating revenues and expenses are susceptible to variations in foreign currency exchange rates. It involves the identification of existing and/or potential currency relationships which arise

from the activities of an organization, including hedging and other risk management activities (Malaysian Institute of Accountants, 2009).

Foreign exchange exposure is defined as the assessment of potential of a firm's profitability, net cash flows, and market value to change due to unpredictable changes of foreign exchange rates, which can be financially unfavorable to the global organization. In addition to this it also affects the smooth operation of nongovernmental organizations. In today's ever growing global economies, one should expect a great degree of foreign exchange risk, which if not addressed can have major adverse effect to the operating organization (Harris & Kaurs, 2013).

2.4.1 Types of Foreign Exchange Exposure

There are three types of foreign exchange exposure and described below (Harris & Kaurs, 2013).

1. **Transaction exposure**. The typical illustration of transaction exposure involves an export or import contract giving rise to a foreign currency receivable or payable. On the surface, when the exchange rate changes, the value of this export or import transaction will be affected in terms of the domestic currency. However, when analyzed carefully, it becomes apparent that the exchange risk results from a financial investment (the foreign currency receivable) or a foreign currency liability (the loan from a supplier) that is purely incidental to the underlying export or import transaction; it could have arisen in and of itself through independent foreign borrowing and lending. Thus, what is

involved here are simply foreign currency assets and liabilities, whose value is contractually fixed in nominal terms. While this traditional analysis of transactions exposure is correct in a narrow, formal sense, it is really relevant for financial institutions only. With returns from financial assets and liabilities being fixed in nominal terms, they can be shielded from losses with relative ease through cash payments in advance (with appropriate discounts), through the factoring of receivables, or more conveniently via the use of forward exchange contracts, unless unexpected exchange rate changes have a systematic effect on credit risk. However, the essential assets of nonfinancial firms have non contractual returns, that is, revenue and cost streams from the production and sale of their goods and services that can respond to exchange rate changes in very different ways. Consequently, they are characterized by foreign exchange exposure very different from that of firms with contractual returns (Harris & Kaurs, 2013).

2. **Translation exposure**. The concept of accounting exposure arises from the need to translate accounts that are denominated in foreign currencies into the home currency of the reporting entity. Most commonly the problem arises when an enterprise has foreign affiliates keeping books in the respective local currency. For purposes of consolidation, these accounts must somehow be translated into the reporting currency of the parent company. In doing this, a decision must be made as to the exchange rate that is to be used for the translation of the various accounts. While income statements of foreign affiliates are typically translated at a periodic average rate, balance sheets pose a more serious challenge (Harris & Kaurs, 2013).

To a certain extent this difficulty is revealed by the struggle of the accounting profession to agree on appropriate translation rules and the treatment of the resulting gains and losses.

3. **Economic exposure**. Economic exposure or operational exposure moves outside of the accounting context and has to do with the strategic evaluation of foreign transactions and relationships. It concerns the implications of any changes in future cash flows which may arise on particular transactions of an enterprise because of changes in exchange rates, or on its operating position within its chosen markets. Its determination requires an understanding of the structure of the markets in which an enterprise and its competitors obtain capital, labour, materials, services and customers. Identification of this exposure focuses attention on that component of an enterprise's value that is dependent on or vulnerable to future exchange rate movements. This has bearing on a corporation's commitment, competitiveness and viability in its involvement in both foreign and domestic markets. Thus, economic exposure refers to the possibility that the value of the enterprise, defined as the net present value of future after tax cash flows, will change when exchange rates change (Harris & Kaurs, 2013).

It will almost certainly be many times more significant than either transaction or translation exposure for the long term well-being of the enterprise. By its very nature, it is subjective and variable, due *in part* to the need to estimate future cash flows in foreign currencies. The enterprise needs to plan its strategy, and to make operational decisions in

the best way possible, to optimize its position in anticipation of changes in economic conditions.

All the three exposures have significant impact on organizations using dual currencies on their reporting, but this study mainly focused on translation exposure.

2.4.2 Translation Exposure

Translation exposure, also frequently called accounting exposure or balance sheet exposure, refers to the effect that an unanticipated change in exchange rates will have on the consolidated financial reports of an MNC. When exchange rates change, the value of a foreign subsidiary's assets and liabilities denominated in a foreign currency change when they are viewed from the perspective of the parent firm. Consequently, there must be a mechanical means for handling the consolidation process for MNCs that logically deals with exchange rate changes (Eun-Resnick, 2007).

Translation exposure is the possibility of a change in the equity section (common stock, retained earnings, and equity reserves) of a multinational company's consolidated balance sheet, caused by a change (expected or not expected) in foreign exchange rates. As such it is not a cash flow change, but is rather the result of consolidating into one parent company's financial statement the individual financial statements of related subsidiaries and affiliates (Dumitrescu, 2009).

Translation exposure is a risk of loss that perhaps will ascend because of the variations of revenue, assets, stock, or liabilities of a business because of the unexpected movement

of the foreign exchange rate. A business undergoes translation exposure when a small portion of its revenue, assets, and liabilities are denominated in a foreign rate and it becomes necessary to convert it back to the base currency due to accounting purposes. The economic value of translation exposure which is put at risk by using cash transactions to hedge accounting valuations is not completely understood. There are disadvantages and few complications associated with hedging the translation exposure (Harris & Kaurs, 2013).

Due to the internationalization of business and frequent fluctuations in exchange rates, information about the impact of changes in exchange rates on individual organizations' and multinational groups' financial position and profitability has become increasingly important. Data on the translation effects of foreign currency transactions and financial statements, a company's exposure to different types of foreign exchange risks and taken currency hedging measures enable many users of accounting contents to obtain a better picture of an entity's financial position and its profitability (Bogicevic, 2013).

The key issues relate to the choice of the exchange rate to be used in accounting data translation and the financial reporting presentation of translation effects. While the effects of the foreign subsidiaries' financial statements translation can be shown in the balance sheet and the income statement, the effects of foreign currency transactions translation are incorporated in the income statement (Bogicevic, 2013).

The key international accounting pragmatic aspects are related to the consolidation, segmental

reporting, foreign currency translation and foreign currency hedging. The importance of studying the two latter interactive international accounting areas has particularly been evident in the recent years due to the expansion of international business, financial, investment and developmental activities, and the expressed flexibility in exchange rates (Bogicevic, 2013).

In an accounting context, foreign currency translation is the restatement of accounting data expressed in one currency into another. The necessity of foreign currency translation accounting is particularly evident in the recording of foreign currency transactions in the books of accounts and the preparation of an individual organization's financial statements as well as the consolidation of financial statements in foreign currency on condition that they are not expressed in a common currency (Nobes & Parker, 2010).

Due to the impact of fluctuations in exchange rates on foreign currency transactions, organizations face transaction exposure to exchange-rate risk, which directly affects their cash flows and profitability when they are settling a monetary transaction. In order to hedge against transaction exposure to foreign exchange risk, organizations mainly enter into financial currency hedging arrangements. This type of hedging connects gains and losses on foreign currency financial derivatives (hedging instruments) with losses or gains on items that are the subject of currency hedging.

In the accounting context, foreign currency translation is a process of expressing financial data presented in one currency into another one using appropriate exchange rates. Additionally, historical, current or average rates can be used in the process of the monetary expression of the

change in the foreign-currency denominated amount against the domestic currency equivalent.

Therefore, the subject of this study will be focused on the analysis of the interaction of foreign currency translation and a company's exposure to various types of foreign exchange risk. More specifically, the study focuses on the analysis of the aspects of foreign currency transaction translation and their currency risk hedging in terms of fluctuations in exchange rates.

2.4.3 Translation Methods

Four methods of foreign currency translation have been used in recent years: the current/noncurrent method, the monetary/nonmonetary method, the temporal method, and the current rate method (Eun-Resnick, 2007). These methods described as follows:

2.4.3.1 Current/Noncurrent Method

This method of foreign currency translation was generally accepted in the United States from 1930 until 1975. The underlying principle of this method is that assets and liabilities should be translated based on their maturity. Current assets and liabilities, which by definition have a maturity of one year or less, are converted at the current exchange rate. Non-current assets and liabilities are translated at the historical exchange rate in effect at the time the asset or liability was first recorded on the books (Eun-Resnick, 2007).

Under this method, a foreign subsidiary with current assets in excess of current liabilities will cause a translation gain or loss if the local currency appreciates or depreciates. The opposite will happen if there is negative net working capital in local terms in the foreign subsidiary.

Most income statement items under this method are translated at the average exchange rate for the accounting period. However, revenue and expense items that are associated with noncurrent assets or liabilities, such as depreciation expense, are translated at the historical rate that applies to the applicable balance sheet item.

2.4.3.2 Monetary/Nonmonetary Method

According to the monetary/nonmonetary method, all monetary balance sheet accounts (such as cash, marketable securities, accounts receivable, notes payable, accounts payable) of a foreign subsidiary are translated at the current exchange rate. All other (nonmonetary) balance sheet accounts, including stockholders' equity, are translated at the historical exchange rate in effect when the account was first recorded (Eun-Resnick, 2007).

In comparison to the current/noncurrent method, this method differs substantially with respect to accounts such as inventory, long-term receivables, and long-term debt. The underlying philosophy of the monetary/nonmonetary method is that monetary accounts have a similarity because their value represents a sum of money whose currency equivalent after translation changes each time the exchange rate changes. This method classifies accounts on the basis of similarity of attributes rather than similarity of maturities.

Under this method, most income statement accounts are translated at the average exchange rate for the period. However, revenue and expense items associated with nonmonetary accounts, such as cost of goods sold and depreciation, are translated at the historical rate

associated with the balance sheet account.

2.4.3.3 Temporal Method

Under the temporal method, monetary accounts such as cash, receivables, and payables (both current and noncurrent) are translated at the current exchange rate. Other balance sheet accounts are translated at the current rate, if they are carried on the books at current value; if they are carried at historical costs, they are translated at the rate of exchange on the date the item was placed on the books (Eun-Resnick, 2007).

Since fixed assets and inventory are usually carried at historical costs, the temporal method and the monetary/nonmonetary method will typically provide the same translation. Nevertheless, the underlying philosophies of the two methods are entirely different. Under current value accounting, all balance sheet accounts are translated at the current exchange rate.

Under the temporal method, most income statement items are translated at the average exchange rate for the period. Depreciation and cost of goods sold, however, are translated at historical rates if the associated balance sheet accounts are carried at historical costs.

2.4.3.4 Current Rate Method

Under the current rate method, all balance sheet accounts are translated at the current exchange rate, except for stockholders' equity. This is the simplest of all translation methods to apply. The common stock account and any additional paid-in capital are carried

at the exchange rates in effect on the respective dates of issuance (Eun-Resnick, 2007).

Year end retained earnings equal the opening balance of retained earnings plus any additions for the year. An equity account named cumulative translation adjustment is used to make the balance sheet balance, since translation gains or losses do not go through the income statement according to this method.

Under the current rate method, income statement items are to be translated at the exchange rate at the dates the items are recognized. Since this is generally impractical an appropriately weighted average exchange rate for the period may be used for the translation.

Which Translation Method is Suitable?

This is, in fact, a key issue from financial theory point of view. If compared, the current / non-current method seems to be less realistic as it values long-term debt at historical cost. However, other methods justify the translation as monetary assets and liabilities are valued at the current exchange rate (AAFM website).

If global scenario is reviewed US MNCs accepted current / non-current method of foreign currency translation from 1930 to 1975. After 1976 US MNCs adopted FASB 8 which was based on temporal method. But, this method faced criticisms from various spheres. The dominant issue was whether the real assets of a foreign subsidiary should be translated at historical exchange rate or at the current exchange rate. A number of empirical studies were conducted to compare the historical exchange rate and the current rate method. The current rate method assumes that

real assets are exposed one for one to exchange rate changes. Some of the renowned researchers like Collins and Salatka, and Bartov found that earnings response co-efficient of US MNC with foreign operations improved when FASB 52 was adopted (AAFM website).

It will be of great concern to quote the findings of surveys conducted by Arthur Anderson & Co.; Coopers and Lybrand; Deloitte and Touch, Earnst & Young; KPMG Peat Marwick, and Price Waterhouse (1991) and to learn which method is preferred and adopted by various developed nations. The MNCs have been categorized as 'Integrated Foreign Entity' and 'Self-sustaining Foreign Entity'. At international level, temporal method is used in the case of former while current rate method is used in case of latter. In the countries like USA, Canada, Australia, Netherlands, France & UK, the temporal and current rate methods are used in case of 'integrated' and 'self-sustaining' foreign entities respectively. But Japan and Germany use the same method i.e. temporal method in both the cases (AAFM website).

2.4.4 Management of Translation Exposure

The approach of an enterprise to the management of foreign currency exposure and risk is ultimately based on the costs and benefits of alternative strategies. Some enterprises may adopt a comprehensive system of risk management, particularly where the extent of exposure is large, or where management has a defensive attitude to risk. On the other hand, the costs of a comprehensive risk management strategy may outweigh the benefits where the extent of exposure is small, or where management chooses to adopt a speculative approach to exchange rate movements.

Whatever approach is adopted, it is absolutely necessary that the basic philosophy, policies, objectives and organization structure of the enterprise concerning the management of foreign currency exposure and risk are set at the highest level, formally recorded and communicated, as well as regularly reviewed and modified (Malaysian Institute of Accountants, 2009).

2.5 Foreign Currency Transaction and Translation

Foreign currency denominated monetary assets and liabilities are translated into the relevant functional currency at exchange rates in effect at the balance sheet date. The gains or losses resulting from such translations are included in net profit in the statement of comprehensive income. Nonmonetary assets and nonmonetary liabilities denominated in a foreign currency and measured at fair value are translated at the exchange rate prevalent at the date when the fair value was determined. Nonmonetary assets and nonmonetary liabilities denominated in a foreign currency and measured at historical cost are translated at the exchange rate prevalent at the date of transaction (Mehtab, 2013).

Transaction gains or losses realized upon settlement of foreign currency transactions are included in determining net profit for the period in which the transaction is settled. Revenue, expense and cash-flow items denominated in foreign currencies are translated into the relevant functional currencies using the exchange rate in effect on the date of the transaction (Mehtab, 2013).

The translation of financial statements of the foreign subsidiaries to the functional currency of the company is performed for assets and liabilities using the exchange rate in effect at the balance sheet date and for revenue, expense and cash flow items using the average exchange rate

for the respective periods. The gains or losses resulting from such translation are included in currency translation reserves under other components of equity. When a subsidiary is disposed off, in part or in full, the relevant amount is transferred to net profit in the statement of comprehensive income (Mehtab, 2013)

2.6 Translation Exposure vs. Transaction Exposure

It is interesting to note that some items that are a source of transaction exposure are also a source of translation exposure, and some are not. Items that create transaction exposure are receivables or payables that are denominated in a currency other than the currency in which the unit transacts its business, or cash holdings denominated in a foreign currency (Eun-Resnick, 2007).

In general it is not possible to eliminate both translation and transaction exposure. In some cases, the elimination of one exposure will also eliminate the other. But in other cases the elimination of one exposure actually creates the other. Since transaction exposure involves real cash flows, we believe it should be considered more important of the two. That is, the financial manager would not want to legitimately create transaction exposure at the expense of minimizing or eliminating translation exposure. As noted before the translation process has no direct effect on reporting currency cash flows, and will only have a realizable effect on net investment upon the sale or liquidation of the assets. In a recent survey of exchange risk management practices of UK., US, and Asia Pacific multinational firms, Marshall (2000) found that 83 percent rated a significant amount of emphasis on managing transaction exposure, whereas 37 percent rated that much emphasis on managing translation exposure

(Eun-Resnick, 2007).

2.7 Hedging Translation Exposure

The US GAAP rules and IFRS principles are in general agreement as to the handling of foreign currency accounting the assets and liabilities of a self-sustaining operation to be translated at the prevailing year end exchange rate, and the income statement items are translated at the average exchange rate for the year. The reconciling difference to the retained earnings account is recorded in the foreign currency translation reserve (Harris & Kaurs, 2013).

One reason that a company should hedge is to shield the domestic value of the investment. In this case, the value refers to the accounting value as the balance date, hence not the economic value of an asset. Basically it reflects the price which was paid for the asset that was adjusted for an annual change in the exchange rate. When hedging financial risks, it comes to mind that it means to protect the earnings and economic value of a company. However, in terms of an accounting valuation, it can't be hedged. Hedge which affects the cash flow of a company without protection being provided is not protecting the firm's economic value. The main purpose of hedging is to protect the net investment from negative revaluations. It is absolutely common that negative revaluations will be adjusted by positive revaluations in the long run. Another theory is that translation hedge also is capable of protecting the value of an asset for future realization (Harris & Kaurs, 2013).

However, there are two major complications associated with this debate. First, it is said

that very few companies have future realization date when it comes to their foreign assets. Second, the accounting value or historical cost does not affect the changes pertaining to economic company related conditions. Due to this reason, the accounting valuation has little similarity to the realizable value and the hedge is shielding a valuation which does not affect the evolving economic worth of an investment. Another foundation for hedging net foreign assets is that it disregards the effect of exchange rate movements on share prices.

There are two ways in which translation exposure can be reduced. First approach is to raise debt in the equivalent currency to provide natural balance sheet hedge on consolidation. Second approach is entering into an offsetting currency derivative contract. Thin capitalization can be considered as the rule in many countries that limit the amount of debt a subsidiary can raise. Therefore, equity exposure will always be there. To get around this conflict, the group borrowings are denominated in the US dollars and the natural hedge is established on consolidation.

There are two methods for dealing with translation exposure, if one desires to attempt to control accounting changes in the historical value of net investment. These methods are a balance sheet hedge and a derivatives hedge. (Eun-Resnick, 2007)

2.7.1 Balance Sheet Hedge

Note that translation exposure is not entity specific, rather it is currency specific. Its source is a mismatch of net assets and net liabilities denominated in the same currency. A balance sheet hedge eliminates the mismatch. Using euro as an example, if there are €1,826,000 more

exposed assets than liabilities. If the Spanish affiliate, or more practicably the parent firm or the Mexican affiliate, had €1,826,000 more liabilities, or less assets, denominated in Euros, there would not be any translation exposure with respect to the euro. A perfect balance sheet hedge would have been created. A change in the €/$ exchange rate would no longer have any effect on the consolidated balance sheet since the change in value of the assets denominated in Euros would completely offset the change in value of the liabilities denominated in Euros. Nevertheless, if the parent firm or the Mexican affiliate increased its liabilities through, say, euro-denominated borrowings to affect the balance sheet hedge, it would simultaneously be creating transaction exposure in the euro, if the new liability could not be covered from euro cash flows generated by the Spanish affiliate (Eun-Resnick, 2007).

2.7.2 Derivative Hedge

A derivatives hedge is not really a hedge, but rather a speculative position, since the size of the hedge is based on the future expected spot rate of exchange for the exposure currency with the reporting currency. If the actual spot rate differs from the expected rate, the hedge may result in the loss of real cash flows.

For example, if we determined that when the net exposure for the euro was €2,101,000, a depreciation from €1.1000/$1.00 to €1.1786/$1.00 would create a paper loss of stockholders' equity equal to $127,377. If one desires, a derivative product, such as a forward contract, can be used to attempt to hedge this potential loss. We use the word "attempt" because as the following example demonstrates, using a derivatives hedge to control translation exposure really involves speculation about foreign exchange rate changes.

2.8 Critique of Translation Exposure

Even with the stronger logic of FAS 52 and the discipline of FAS 133, users of accounting information must be aware that there are three systemic sources of error that can mislead those responsible for exchange risk management (Frederick, 2003).

1. Accounting data do not capture all commitments of the firm that give rise to exchange risk.
2. Because of the historical cost principle, accounting values of assets and liabilities do not reflect the respective contribution to total expected net cash flow of the firm.
3. Translation rules do not distinguish between expected and unexpected exchange rate changes.

Conceptually, though, it is important to determine the time frame within which the firm cannot react to unexpected rate changes by raising prices; changing markets for inputs and outputs; and/or adjusting production and sales volumes. Sometimes, at least one of these reactions is possible within a relatively short time; at other times, the firm is locked in through contractual or strategic commitments extending considerably into the future. Indeed, those firms that are free to react instantaneously and fully to adverse (unexpected) rate changes are not subject to exchange risk. A further implication of the timeframe element is that exchange risk stems from the firm's position when its cash flows are, for a significant period, exposed to unexpected exchange rate changes, rather than the risk resulting from any specific international involvement. Thus, companies engaged purely in domestic transactions but who have dominant foreign competitors may feel the effect of exchange rate changes in their cash flows as much

or even more than some firms that are actively engaged in exports, imports, or foreign direct investment.

The first point must be recognized that normally commitments entered into by the firm in terms of foreign exchange (e.g., a purchase or sales contract) will not be booked until the goods has been shipped. At best, such obligations are shown as contingent liabilities. More importantly, accounting data reveal very little about the ability of the firm to change costs, prices, and markets quickly. Alternatively, the firm may be committed by strategic decisions such as investment in plant and facilities. Such commitments are important criteria in determining the existence and magnitude of exchange risk.

The second point surfaced on the temporal method. Whenever asset values differ from market values, translation, however sophisticated, will not redress this original shortcoming. Thus, many of the perceived problems of FAS 8 had their roots not so much in translation, but in the fact that in an environment of inflation and exchange rate changes, the lack of current value accounting frustrates the best translation efforts.

In the third point, translation rules do not take account of the fact that exchange rate changes have two components:

(1) Expected changes that are already reflected in the prices of assets and the cost of liabilities (relative interest rates); and

(2) The unexpected deviations from the expected change that constitute the true sources of risk.

The significance of this distinction is clear. Managers have already taken account of expected changes in their decisions. The underlying principle for corporate foreign exchange exposure management is to shield net cash flows, and thus the value of the enterprise, from unanticipated exchange rate changes.

CHAPTER THREE

RESEARCH DESIGN AND METHODOLOGY

3.1 Introduction

This chapter sets out various stages and phases that were followed in completing the study. It provides a roadmap for the collection, measurement and analysis of data. In this section most decisions made about how research was executed and how respondents were approached. Therefore, in this section the research identified the procedures and techniques that were used in the collection, processing and analysis of data. The chapter describes the research design and methodology that was used to guide the study.

3.2 Research Design

Research design is the plan and structure of investigation conceived so as to obtain answers to research questions. The plan represents the overall strategy used in collecting and analyzing data in order to answer the research questions. The essentials of research design as an activity and time based plan; always based on the research question; guides the selection of sources and types of information; a framework for specifying the relationship among the study variables and outlines the procedures for every research activity.

A research approach could be quantitative, qualitative or mixed a combination of the two. Selection of one of these approaches depends on the nature of the research problem and its perspective.

Quantitative research approach is the process of collecting, analyzing, interpreting, and writing the results of a study. It also involves review of the existing literature to deductively develop theories and hypotheses to be tested. Well designed quantitative research has the advantage of being able to make generalizations for a broader population based on findings from the sample. To improve the generalization of findings, this approach follows standardized procedures in sample selection, instrument design, implementation and analysis. This standardization in turn increases the replication of procedures and the reliability of findings and also can mitigate the impact of interviewer and interviewee biases.

Qualitative research is a research approach that seeks to gain and in depth understanding of a subject or the driving factors behind a behavior using uncontrolled investigative techniques that infer conclusions based on subjective data. Qualitative approach is generally done in interviews, open-ended questions, or focus groups. In most cases, a small number of participants participate in this type of research, because to carry out such a research endeavor requires many resources and much time.

The mixed research approach that seeks a practical knowledge claim philosophy that consists of both quantitative and qualitative approaches.

Generally, the choice among the three research approaches is guided by the research problem apart from the underlying philosophy of each research method. That is, whether the research problem is based on a framework developed deductively through a review of the literature and prefigured information to be collected in advance of the study or to allow it to emerge from

participants in the project or both.

Finally, in order to achieve the objectives stated in the preceding section, considering the nature of research problem and perspective, this study mainly employed quantitative and qualitative research approach on the management of foreign exchange translation exposure in SOS Sahel Ethiopia over the last five years (2009 to 2013).

3.3 Data Sources

The data used for this study were from SOS Sahel Ethiopia's financial statements, policies and through questioners and interview questions distributed to selected staffs for this study. The income, expenditure and foreign currency translation gain (loss) data were collected from the audited financial statements (2007 to 2013) of the organization. Financial policy of the organization reviewed and used as an input for the exchange rate determination during conversion of the local currency (ETB) to other currencies. Clauses related to foreign exchange translation in different donor agreements assessed to get clear understanding on how to determine the exchange rate to translate local currency income and expenditures in to the donor currency. In addition to this related books, journal articles and various manuals were also used as sources of data.

3.4 Study Population and Sample Size

Currently thirty five staffs working in SOS Sahel Ethiopia in different levels of managerial positions. Due to their size the researcher believed that for meaningful analysis there is no need to sample as they are few in number to distribute questionnaires. Therefore, thirty five staffs

were incorporated in this study.

Target population is the specific population about which information is desired. Population is a well defined or set of people, services, elements, events, group of things or households that are being investigated. The target population should have some observable characteristics, to which the researcher intends to generalize the results of the study (Mugenda, 2003). The target population of this study included Directors, Program Managers and the Senior Finance Team at Head Office and Project Managers and Finance Officers at project sites of SOS Sahel Ethiopia, who are directly involved in the financial management of the organization.

3.5 Data Collection Instruments

Consistent and reliable research indicates that research conducted by using appropriate data collection instruments increase the credibility and value of the research findings (Koul, 2006). Accordingly, the study used both quantitative and qualitative instruments for data collection. This comprises of questionnaire as quantitative instrument and interview and open ended questions as qualitative instrument. Documents were reviewed to collect required information, which was relevant for addressing the objectives of the study, from manuals, policies and audited financial statements of the organization.

3.6 Data Analysis Methods

The collected data analyzed using both quantitative and qualitative data analysis methods. Quantitative method involved both descriptive and inferential analysis. This study used only descriptive analysis method, such as frequencies and percentages, to present quantitative data in

the form of tables and graphs. Descriptive statistics involves the use of absolute and relative frequencies, measures of central tendency and dispersion.

Data collected through the open ended questions and analysis of documents was analyzed qualitatively through content analysis using words and sentences. The collected data was first transcribed before coding the data into themes or categories. This involved breaking down of the data into manageable pieces, sorting and sifting while searching for types, classes, sequences, processes, patterns or themes. The aim of this process was to assemble or reconstruct the data in a meaningful or comprehensible fashion (Jorgensen, 1989). The categorizing was typically based on the major research questions guiding the study. Generalization from the themes about the phenomena in question and discussion in the light of the available literature was then made.

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter discusses the interpretation and presentation of the findings. The purpose of the study was to analyze the management of foreign exchange translation exposure in the case of SOS Sahel Ethiopia. The researcher made use of frequency tables, figures and graphs to present data.

4.2 Response Rate

Table 1: Response rate

	Frequency	Percentage
Responded	28	80%
Not responded	7	20%
TOTAL	**35**	**100%**

The study targeted a sample size of 35 staffs from the organization out of which 28 responses were received. This represented an 80% response rate. This is a reliable response rate for data analysis as it is greater than 50% of the sample size.

4.3 General Information

As part of the general information the researcher requested the respondents to indicate their level of education and work experience.

Table 2: Level of education

	Frequency	Percentage
Diploma	1	4%
Bachelors ‘degree	13	46%
Postgraduate degree	14	50%
TOTAL	**28**	**100%**

The study found that 50% of the respondents had a postgraduate degree. 42% has a bachelors' degree and the remaining 4% had diploma. This shows that the respondents are well educated and can provide relevant information on the subject matter of the information.

Table 3: Work experience

	Frequency	Percentage
1-5 years	16	57%
5-10 years	5	18%
10 years and above	7	25%
TOTAL	**28**	**100%**

The study tried to figure out how long the respondents serving the organization. Accordingly 57% of the respondents reported that they had been working with their organization for not more than 5 years, 25% serving more than 10 years and the rest 18% indicated that they are serving form 5 to 10 years. The findings clearly show that majority of the respondents serving the organization less than five years.

4.4 Foreign Exchange Exposure Management Policy

Table 4: Exchange rate policy

Which one of the following statement best described your organization exchange rate policy?	Frequency	Percentage
General guideline which are not documented	9	32%
General documented guideline	8	29%
Formalized foreign exchange policy	5	18%
No policy	6	21%
TOTAL	**28**	**100%**

The researcher requested the respondents to indicate which exchange rate policy best described their organization. According to the findings 32% of the respondents replied general guideline which are not documents best described the organization exchange rate policy. 29% replied general documented guideline while 18% replied formalized foreign policy. The remaining 21% replied as the organization doesn't have an exchange rate policy.

Table 5: Foreign exchange policy

Which one of the following best describes your foreign exchange policy?	Frequency	Percentage
Passive, foreign exchange risk is not hedged	7	25%
Active and risk averse	5	18%
Active and gain seeking	3	11%
Not certain	13	46%
TOTAL	**28**	**100%**

The study inquired how the foreign exchange policy described. From the findings majority of the respondents which are 46% stated that they are not certain whether the organization had a foreign exchange policy. 25% of the respondents replied that the organization foreign exchange policy best described as passive and foreign exchange risk is no hedged. 18% replied the policy is active and risk averse and the rest 11% stated that it is active and gain seeking.

Table 6: Foreign exchange translation exposure management

Which one of the following best described your organization foreign exchange translation exposure management?	Frequency	Percentage
Centralized	23	82%
Decentralized	2	7%
Hybrid	3	11%
TOTAL	**28**	**100%**

The researcher asked respondents how they are describing their organization foreign exchange translation exposure. 82% of the respondents replied that the organization best described by centralized management and 11% believed that it is hybrid. 7% of the respondents replied that the organization followed decentralized management.

Table 7: Foreign exchange transaction exposure position tracking

How frequently are you tracking your foreign exchange transaction exposure position?	Frequency	Percentage
Monthly	8	29%
Quarterly	7	25%
Yearly	6	21%
Other (need based)	7	25%
TOTAL	**28**	**100%**

The researcher requested respondents how frequently they are tracking their foreign exchange transaction exposure position and 29% of them replied that they are trucking monthly, whereas 25% replied quarterly and 21% monitored it yearly. The remaining 25% responded when the need arise.

Table 8: Foreign exchange translation exposure position tracking

How frequently are you tracking your foreign exchange translation exposure position?	Frequency	Percentage
Monthly	7	25%
Quarterly	7	25%
Yearly	6	21%
Other (Need based, no specified time frame)	8	29%
TOTAL	**28**	**100%**

The study tried to visualize how frequently the organization tracking its foreign exchange translation exposure position. 25% of the respondents replied that they are monitored monthly and quarterly and 21% replied on a yearly basis. For this question 29% of the respondents replied that they monitor the position when the need arise rather than sticking on monthly, quarterly or yearly interval.

Table 9: Management of translation exposure

How could your organization manage translation exposure?	Frequency	Percentage
By a comprehensive system of risk management approach	10	36%
By a speculative approach to exchange rate movements	9	32%
Doesn't know	9	32%
TOTAL	**28**	**100%**

The study requested the respondents how their organization manage translation exposure. For this question 36% of the respondents replied by a comprehensive system of risk management approach and 32% responded that the organization manage its translation exposure by a speculative approach to exchange rate movements. The rest 32% doesn't know how the organization manages its translation exposure.

Table 10: Foreign exchange translation exposure hedging method

Which one of the following best described your organization foreign exchange translation exposure hedging method?	Frequency	Percentage
Balance sheet hedge	12	43%
Derivative hedge	5	18%
Doesn’t know	11	39%
TOTAL	**28**	**100%**

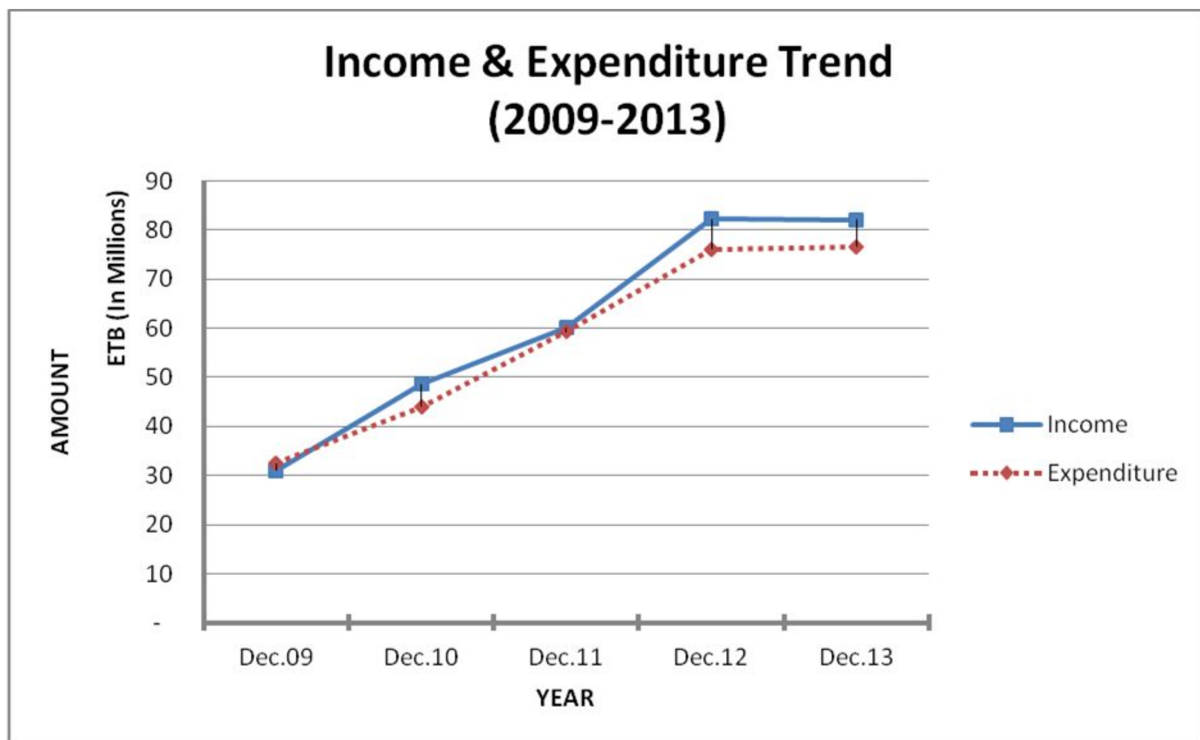
The researcher raised a question on how the respondents described their organizations foreign exchange translation exposure hedging method and 43% of them replied that the organization used balance sheet hedging. 18% responded that derivative hedging method is used by the organization. The remaining 39% doesn’t know what translation hedging method used by the organization.

Table 11: Internal hedging method

Which one of the following internal hedging methods is using by your organization?	Frequency	Percentage
Local currency contract	4	14%
Currency rate adjustment clause in the donor contract	15	52%
Leading and lagging of cash transfers	4	14%
Other (Doesn’t know)	6	21%
TOTAL	**29**	**100%**

The study requested the respondents what internal hedging methods used by the organization and 52% of them replied that the organization used currency rate adjustment clause in the donor contract. 14% of them replied that local currency contract and leading and lagging of cash transfers used as internal hedging. The rest 21% replied that they doesn't know what internal hedging method used by the organization.

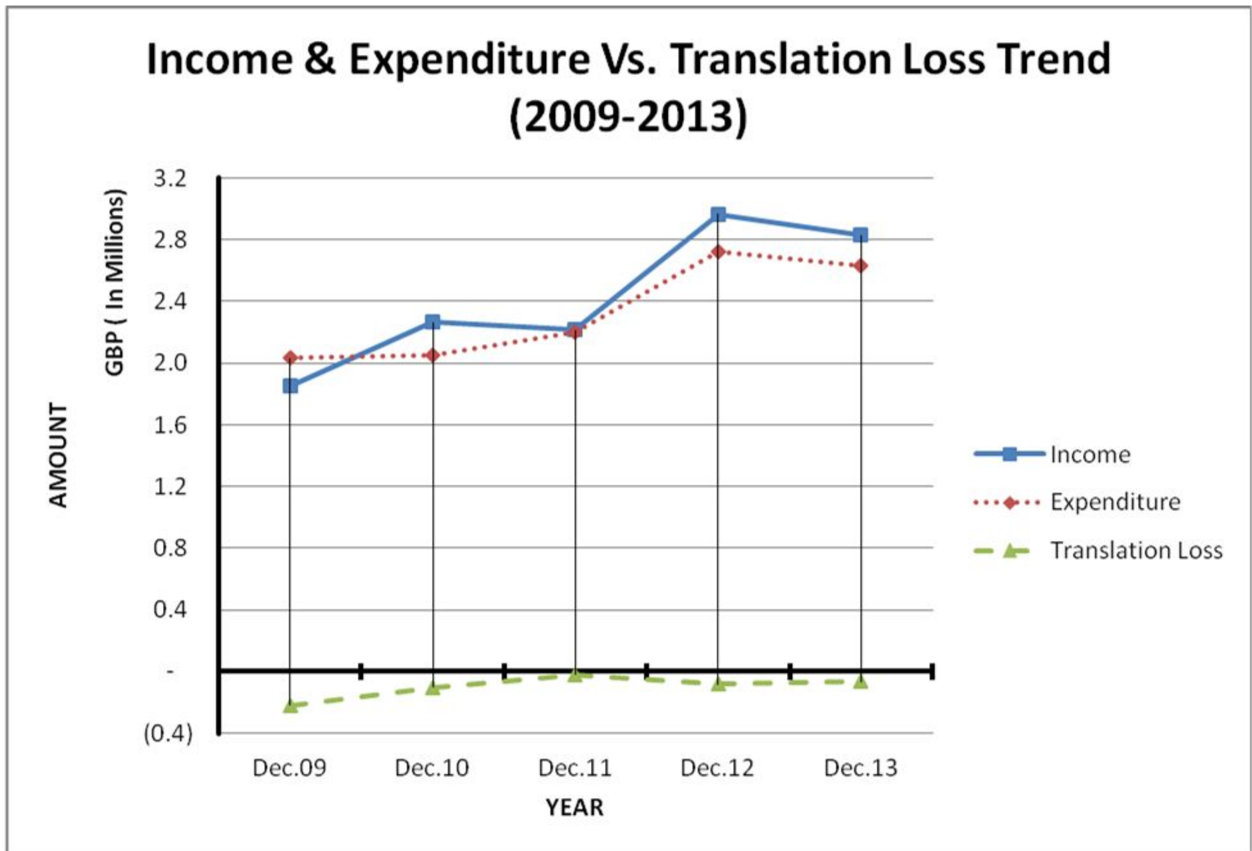
4.5 Review of Financial Statements



Source: SOS Sahel Ethiopia audit report (2009-2013)

Figure 1: SOS Sahel Ethiopia Income and Expenditure Trend

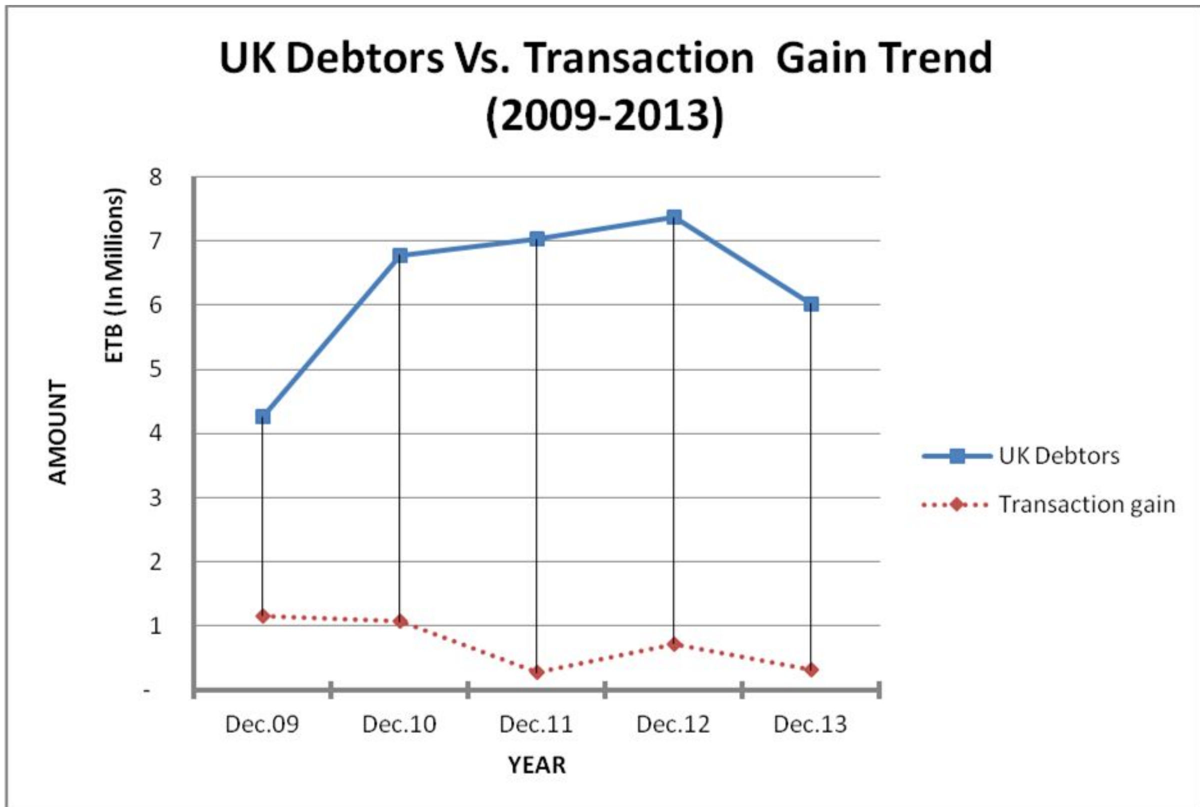
The income and expenditure trend of the organization as shown in figure 1 indicated that expenditure was over income in 2009 and for the last four years (2010-2013) income exceeds expenditure at an increasing rate and the graph skewed to the right.



Source: SOS Sahel Ethiopia audit report (2009-2013)

Figure 2: SOS Sahel Ethiopia Income and Expenditure vs. Translation Loss Trend

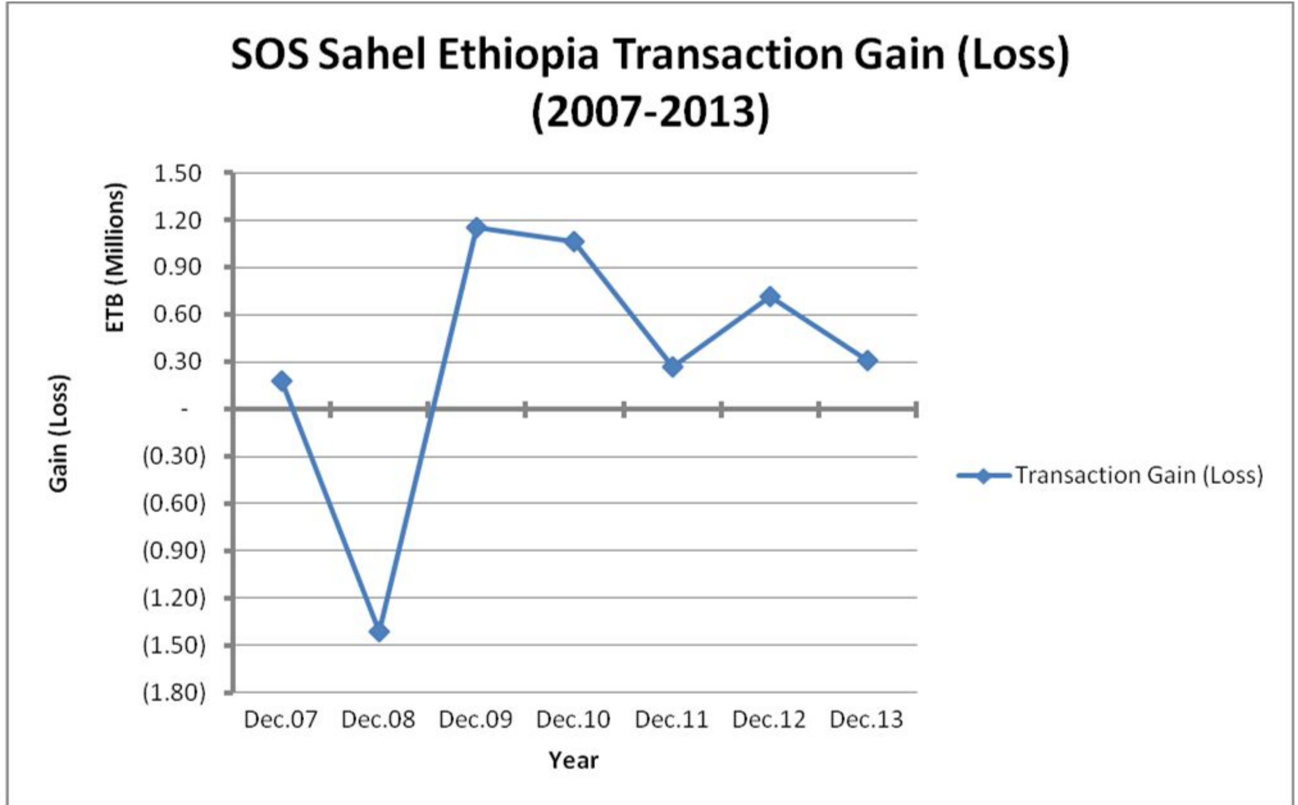
The study tried to compare income and expenditure against currency translation loss for the last five years (2009-2013) and plotted the trend in line graph as shown above in figure 2. The graph indicated that the translation loss decreased at an increasing rate from 2009 to 2011 and raised in 2012 and fallen in 2013.



Source: SOS Sahel Ethiopia audit report (2009-2013)

Figure 3: SOS Sahel Ethiopia UK Debtor vs. Transaction Gain Trend

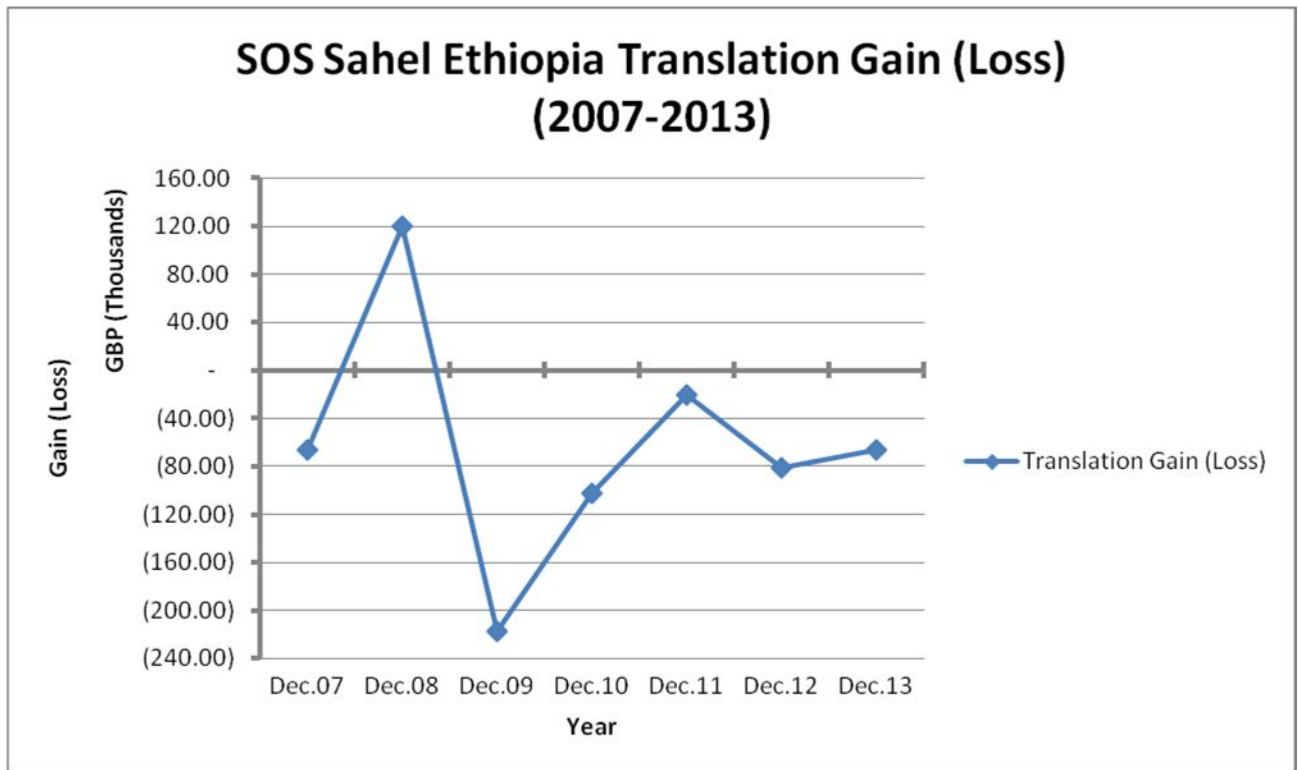
The study explored the organization financial statements and figured out the trend of UK debtors account verses translation gain. As indicated in figure 3 above the UK debtors account increased from 2009 to 2012 and decrease in 2013 on the other hand the translation gain fallen from 2009 to 2011 and risen in 2012 and fallen again in 2013.



Source: SOS Sahel Ethiopia audit report (2007-2013)

Figure 4: SOS Sahel Ethiopia Transaction Gain (Loss) Trend

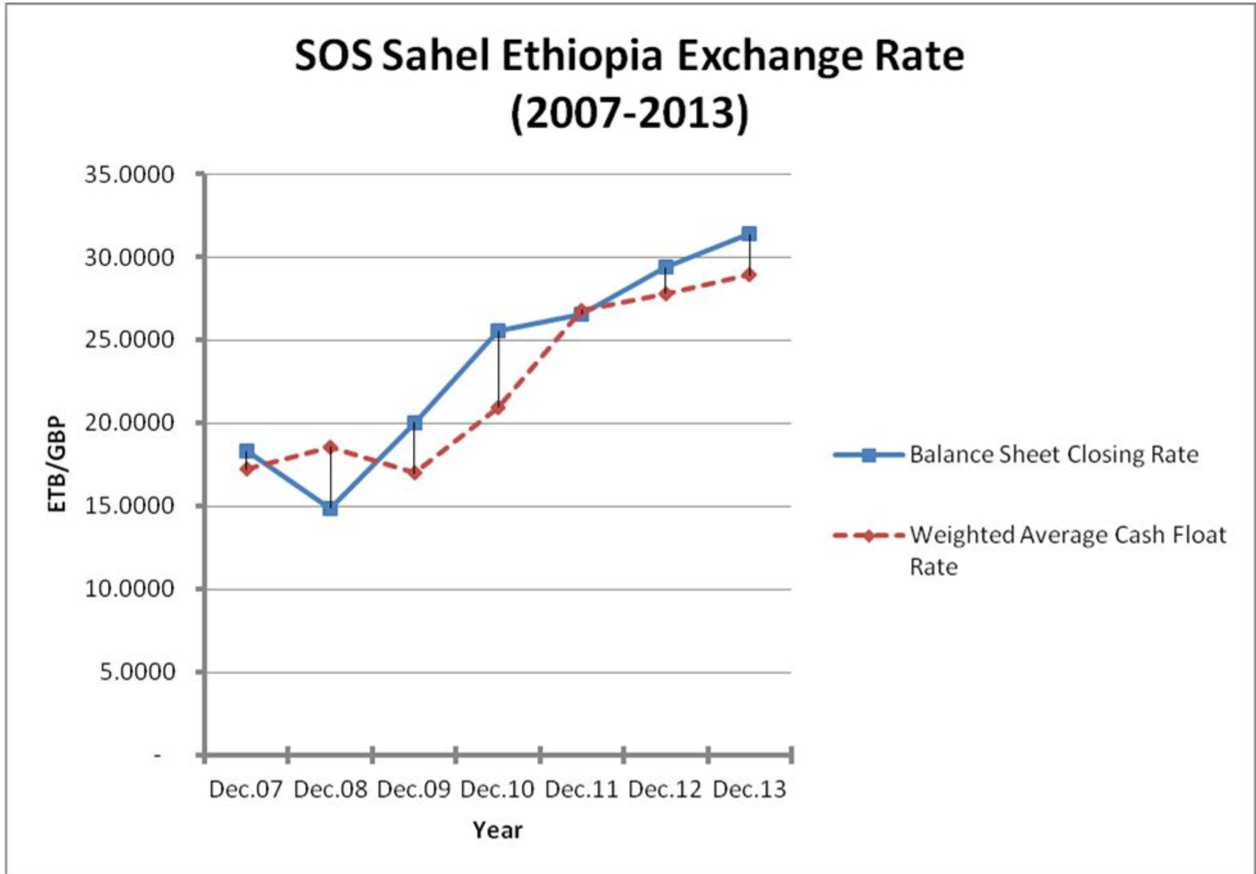
The study investigated the organization transaction gain (loss) trend from 2007 to 2013 as shown above in figure 4 and found that it moved inconsistently. From the last seven years one special incident happened in 2008 is that the organization incurred a significant transaction loss which occurred due to economic crises in that year. The remaining years shown transaction gains although it moved up and down inconsistently from year to year.



Source: SOS Sahel Ethiopia audit report (2007-2013)

Figure 5: SOS Sahel Ethiopia Translation Gain (Loss) Trend

The researcher also reviewed financial statements (2007- 2013) to figure out the trend of the organization's foreign exchange translation gain (loss) and presented in line graph as shown above in figure 5. Within seven years the organization realized translation gain only in 2008 which is also resulted due to an appreciation of the local currency following the economic crises in that year. The remaining years incurred losses in an inconsistent trend.



Source: SOS Sahel Ethiopia financial statement (2007-2013)

Figure 6: SOS Sahel Ethiopia Exchange Rate Trend

The researcher studied the organization exchange rate trend from 2007 to 2013 and presented graphically as shown above in figure 6. The study reveled that except in the years 2008 and 2011 the closing rate exceeded the weighted average cash float rate. The reason for 2008 closing rate reduction was the deterioration of the foreign exchange rate due to economic crisis, where as the 2011 reduction was incidental.

Table 12: Donor reporting currency

In your opinion which currency is suitable for donor reporting? Why?	Frequency	Percentage
Local Currency	16	57%
Donor Currency	12	43%
TOTAL	**28**	**100%**

The study requested the respondents which currency is suitable for donor reporting and why. 57% of the respondents agreed that local currency is suitable for donor reporting because it avoids currency exchange risk. The rest 43% replied that the donor currency is more suitable because it is less exposed to inflation.

Table 13: Translation method

Which translation method do you think suitable for your organization general account? Why?	Frequency	Percentage
Current / Noncurrent Method	1	4%
Monetary / Nonmonetary Method		0%
Temporal Method		0%
Current Rate Method	17	61%
Doesn’t know	10	36%
TOTAL	**28**	**100%**

As per 61% of the respondents the current rate method is suitable for the organization general account. The reason is that it is easy to manage, it provides the real financial position of the organization and the organization doesn't have significant long term assets and liabilities as it is a project based charitable organization. 4% believed that the current/noncurrent method is suitable to give consideration for the immaterial long term balance sheet items. The remaining 36% of the respondents doesn't know which translation method is suitable for the organization.

The researcher conducted interview only with the Finance Director and Finance Manager of the organization as they are the key staffs in financial management. Although the Program Managers have a role in project financial management due to time constraint they are not able to conduct the interview.

The researcher raised a question for the respondents do you have a role in financial management? If yes what is it?

The Finance Director and Finance Manager replied that have a role in financial management. The Finance Director role is more of strategic financial management and the role of the Finance Manager is in the technical part of the financial management.

The researcher raised a question to the respondents have you participate in financial report preparation? If yes, in what form and in which type of report?

Both the Finance Director and Finance Manager responded that they had participated in preparation of financial reports. Most of the financial reports prepared by the Finance Manager and verified by the Finance Director. The cash flow of the organization is controlled by the Finance Director and cash flow statement prepared and monitored monthly to look the liquidity of the organization. As it is a strategic component of financial management the Finance Director keep tracking the daily exchange rates of foreign currencies under the organization donor agreement and plan when to raise cash transfer request and make payments in foreign currency. The Finance Manager prepared monthly weighted average exchange rate which is used to convert the local currency in to GBP as the organization financial statement prepared both in ETB and GBP.

The study raised a question what do you understand by foreign exchange translation exposure or risk. Does it affect your organization? When and How? How it is severe?

The Finance Director replied that foreign exchange translation exposure is an exposure arising from change in exchange rate with reference to time. The Finance Manager responded that it is a risk born by a change in foreign exchange rate when converting one currency to another during preparation of financial reports in dual currency.

Both replied that foreign exchange translation exposure affected their organization. It affected them when the funding agreement signed in foreign currency and it required preparation of the financial report in foreign currency. It can bear currency translation gain or loss. As the organization prepared its financial reports in dual currency the local currency (ETB) converted in

to foreign currency (GBP) using the monthly weighted average rate and it affected the organization as it is subject to translation gain or loss.

Both reported the severity of the translation exposure depends on the fluctuation of the exchange rate. If the rate increase or decrease significantly the impact could be more severe else it is moderate.

The researcher raised a question to the respondents who is responsible to control foreign exchange translation exposure.

The respondents replied that as it is strategic issue in general the Finance Director is responsible. Although the level of responsibility varied all the project managers also responsible to track their projects foreign exchange translation exposure as it affected their implementation plan.

The study raised a question to the respondents who set the exchange rate to translate the local currency in to foreign currency for balance sheet and income and expenditure accounts.

The respondents replied that the organization financial policy stated that the local currency (ETB) converted in to foreign currency (GBP) using the monthly weighted average rate of the cash transfer rates during the month and all its accounts converted using that rate. At the end of the year all balance sheet items converted in to GBP using the official bank rate at the closing date of the year. It also affected the fund balance in the income and expenditure account.

The researcher raised a question to the respondents how could they tackle foreign exchange translation risk.

The respondent replied that they can tackle by signing the donor agreement in local currency, by tracking the exchange difference and for significant variations consulting donors for budget revision to keep the project quality, by requesting the cash transfers when the exchange rate favored the organization, by requesting cash transfers when the rate is higher and by requesting only the required amount of cash on a monthly basis.

4.6 Foreign Exchange Translation Impact

Table 14: Foreign exchange risk

How much your organization affected by foreign exchange risk?	Frequency	Percentage
High	9	32%
Moderate	17	61%
Low	2	7%
Not at all		0%
TOTAL	**28**	**100%**

The researcher asked the respondents how the organization affected by foreign exchange risk. 61% of them believed that the organization has moderate risk where as 32% replied that the risk is high. The rest 7% of the respondents stated that the level of risk is low.

Table 15: Foreign exchange translation clause in the donor's contract

Do you have a foreign exchange translation clause in your donor's contract?	Frequency	Percentage
Yes	21	75%
No	7	25%
TOTAL	**28**	**100%**

The study requested the respondents whether they have a foreign exchange translation clause in the donor contract. 75% of the respondents replied "yes" and the remaining 25% replied "No".

Table 16: Foreign exchange translation method

If your answer is **"yes"** for the above question, which one of the following method best describe it?	Frequency	Percentage
Weighted average of the rates on the date of cash transfers	8	35%
Predetermined rates by the donors	6	26%
The rate which is used to convert the local currency (ETB) budget in to the foreign currency	2	9%
The bank rate at the end of the report date, such as month end, quarter end, year end, etc.	6	26%
Other (Depends on the funding agency exchange policy)	1	4%
TOTAL	**23**	**100%**

From those who are replied “yes” in the above question 35% of the respondents replied weighted average of the rates on the date of cash transfers best described the foreign exchange translation clause in the donor contract. 26% of the respondents replied predetermined rates by the donors and the bank rate at the end of the report date best described the translation clause in the contract. 9% replied the rate which is used to convert the local currency budget in to the donor currency best described it. The rest 4% of the respondents replied that it depends on the funding agency exchange policy and they may choose a rate other than the above four.

Table 17: Foreign exchange transaction loss

When there is foreign exchange transaction loss, who is going to cover it?	Frequency	Percentage
The donor	10	36%
Your organization	18	64%
TOTAL	**28**	**100%**

The researcher requested the respondent who is going to cover the foreign exchange translation loss whenever it appeared. 64% of the respondents replied that the organization covered the loss. The rest 36% replied that the donor covered the loss.

Table 18: Foreign exchange translation loss

When there is foreign exchange translation loss, who is going to cover it?	Frequency	Percentage
The donor	17	61%
Your organization	11	39%
TOTAL	**28**	**100%**

The study raised a question when foreign exchange translation loss arises, who is going to cover it. 61% of the respondents replied that the donor covered the loss and the remaining 39% replied that the organization covered it.

Table 19: Donors willingness to receive fund balance in local currency

Are your donors willing to receive the unspent balance in local currency at the end of the project, although the contract is in foreign currency?	Frequency	Percentage
Yes	13	46%
No	15	54%
TOTAL	**28**	**100%**

The researcher raised a question to the respondents whether the donors are willing to receive the unspent balance of a project in local currency although the contract is in foreign currency and 54% of them replied that “no” and the remaining 46% responded “yes”.

Table 20: Currency used to refund the unspent balance of a project fund

If your answer is **"yes"** for question, which one of the following rate is best to use while returning the unspent balance of a project fund during phasing out?	Frequency	Percentage
The bank rate at the date of transfer	5	38%
Weight average of all transfer rates	7	54%
The rate used to convert the local currency to donor currency during budget preparation.	1	8%
Other		0%
TOTAL	**13**	**100%**

Those who are replied "yes" in the above question responded that weighted average of all transfer rates is best to return the unspent balance. 38% of the respondents stated that the bank rate at the date of transfer is best. The rest 8% replied that the rate used to convert the local currency to donor currency during budget preparation is best to refund the unspent balance of a project.

4.7 Gaps in Managing Translation Exposure

Table 21: Absence of foreign exchange translation clause in the donor's contract

When your donor contract doesn't have a clause regarding the foreign exchange translation, what exchange rate are you using?	Frequency	Percentage
Weighted average of the rates on the date of cash transfers	9	32%
The rate which is used to convert the local currency (ETB) budget in to the foreign currency	6	21%
The bank rate at the end of the report date, such as month end, quarter end, year end, etc.	7	25%
Other (No idea)	6	21%
TOTAL	**28**	**100%**

In the absence of foreign exchange translation clause in the donor's contract weighted average of the rates on the date of cash transfers is best to use selected by 32% the respondents. 25% of the respondents replied the bank rate at the end of the report date is best to use. 21% replied that the rate which is used to convert the local currency budget in to the donor currency is best. The remaining 6% doesn't have any idea which exchange rate is best to use.

The study raised an open ended question if donors are not willing to cover foreign exchange ***translation loss*** what mechanisms are to be used to overcome the problem and the respondents proposed answers are summarized below.

1. Keep tracking the cash transfer from funding agencies and project spending in local currency and hold payments when the two equal.
2. Choosing suitable time to receive cash transfer from donors, when the exchange rate is higher, and spend more in the period when the exchange rate is higher.
3. Revising the plan to the size of the available resource on a regular interval. It helped to reduce the loss without compromising the project quality.
4. Negotiate with donors to sign the agreement in local currency and to report them in local currency as well. This is 100% free from exchange loss.
5. Looking for other funding agencies that are willing to match the project in local currency and absorbed the loss.
6. Using the organization general reserve to cover the loss.

The researcher raised an open ended question if donors are not willing to cover foreign exchange ***transaction los***s what mechanisms to be used to overcome the problem and the respondents proposed the following mechanisms.

1. Negotiate with the funding agencies to sign the agreement in local currency, to receive the transfer in local currency and to transfer the unspent balance in local currency as well.
2. Convince donors to use weight average rate of all cash transfer rates to convert the local currency in to donor currency while reporting and transfer the unspent balance at the date when the exchange rate is lower than the weighted average rate.
3. Requesting the cash transfer when the exchange rate is higher and transfer the unspent balance when the exchange rate is lower.
4. Refund timely the unspent balance to funding agencies.
5. Use the organization general reserve to cover the transaction loss.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Introduction

This chapter presented the summary of major data findings, conclusion drawn from the findings and recommendation made to overcome the shortcomings. The conclusions and recommendations drawn were focused on addressing the objective of this study which was to study management of foreign exchange translation exposure in the case of SOS Sahel Ethiopia. From the analysis and data collected, the following discussions, conclusions and recommendations were made.

5.2 Summary

Foreign Exchange Exposure Management Policy

From the findings on the organization exchange rate policy, the study found that the organization used a general guideline which is not documented. The study also reveled that majority of the respondents were not certain whether the organization has a foreign exchange policy. Regarding the foreign exchange translation exposure, majority of the respondents confirmed that the organization followed centralized system. The study tried to investigate how frequently the organization tracking its foreign exchange transaction exposure position and confirmed that most of the respondents tracked their position on a monthly basis. The study raised same question for translation exposure and reveled that majority of the respondents tracked their translation exposure position when the need arise rather than sticking on a specific period. The implication of the above inconsistency may result in different foreign exchange translation gain (loss).

As indicated by the majority of the respondents the study found that a comprehensive system of risk management approach followed by the organization to manage foreign exchange translation exposure. The study also tried to find out the organization's foreign exchange translation exposure hedging method and most of the respondents indicated that the balance sheet hedging method is used by the organization. The study also tried to figure out which internal hedging method used by the organization and majority of the respondents replied that currency rate adjustment clause in the donor contract followed by the organization and some of the respondents replied that both local currency contract and leading and lagging of cash transfers method used by the organization. These imply that the organization lacks uniformity in applying its systems and procedures.

Review of Financial Statements

The researcher tried to figure out the trend of the organization foreign exchange translation exposure movements and made the following trend analysis; income and expenditure trend, income and expenditure vs. translation gain (loss) trend, UK debtor vs. translation gain (loss) trend, transaction gain (loss) trend, translation gain (loss) trend and exchange rate trend**.**

The income and expenditure trend of the organization indicated that they moved in the same direction with a small gap between the two and from this we can inferred that expenditure is highly dependent on income of the organization. The income and expenditure vs. currency translation loss trend visualized that translation loss doesn't have direct relationship with income

and expenditure as the trend moved inconsistent with income and expenditure. As plotted in the UK debtors account vs. translation gain trend we can deduced that UK debtors account doesn't have direct relationship with translation gain. From the organization transaction gain (loss) trend we can conclude that transaction exposure can be borne by economic situations such us currency appreciation or depreciation and in 2008 the organization incurred huge loss due to local currency appreciation. The organization's foreign exchange translation gain (loss) trend also shown significant change in 2008 which was a gain unlike other years and resulted from economic instability. Finally the organization exchange rate trend indicated that the closing rate was lower than the weighted average rate in 2008 and consequently it resulted in unusual translation gain and transaction loss.

The study tried to figure out which currency is suitable for donor reporting and majority of the respondents indicated that the local currency is best as it is free from currency exchange risk. Some of the respondents preferred donor currency due to its less exposure to inflation. From the findings the study reveled that current rate method of translation is suitable for the organization general account. Choosing a wrong currency and translation method may resulted in unexpected gain/loss to the organization. Therefore, the organization should have to take due care in selecting the reporting currency and translation method.

The study reveled that the strategic aspect of foreign exchange translation management handled by the finance director and the finance manager participated in the technical part as it is reported by the respondents.

Foreign Exchange Translation Impact

The study tried to indicate the level of foreign exchange risk and from the findings majority of the respondents confirmed that the organization affected by moderate risk. The study reveled that majority of the organization donor contracts had a foreign exchange translation clause as indicated by the respondents. The study tried to figure out the translation method used by the organization and most of the respondents indicated that the organization used weighted average of the rates on the date of cash transfer. Some of them indicated that the organization used predetermined donor rates and the bank rate at the end of the report date. Having different translation clause and application of different rate of translation result in inconsistency and it affected the value of the organization.

The study tried to investigate how transaction losses covered and as per majority of the respondents the organization covered the loss. On the other hand the study reveled that the organization translation loss covered by the donor as confirmed by the respondents. As per majority of the respondents the study reveled that donors are not willing to receive the unspent balance of a project in local currency. The consequence of this is as the size of the loss increased and repetitive the implication affected the organization sustainability.

Gaps in Managing Translation Exposure

The study indicated that when the donor contract doesn’t have a foreign exchange translation clause the organization used weighted average of the rates on the date of cash transfer.

The study reveled that the following protective mechanisms used by the organization to hinder

translation loss: currency tracking, choosing suitable time for receipts and payments in foreign currency, revising the plan to the size of the available cash, signing contract in local currency, looking for matching fund and using the organization general reserve.

The researcher tried to investigate the mechanisms used by the organization when donors obeyed to cover transaction loss and following are some of the methods: signing contract in local currency, convince donors to use weighted average rate, leading and lagging, timely refund the unspent balance and use organization's general reserve.

The implication of lack of well designed translation loss protective mechanism and proven translation method affected the organization financial sustainability and existence.

5.3 Conclusion

The study realized that foreign exchange exposure management policy affects the financial sustainability of the organization to a great extent. The aspect of foreign exchange exposure policy includes exchange rate, foreign exchange policy, foreign exchange exposure management, foreign exchange exposure position tracking, foreign exchange translation method and foreign exchange exposure hedging techniques. This is in agreement with the review of related literatures in previous chapter. Good foreign exchange exposure policy requires sound organizational cash flow planning and the setup and implementation of sound systems, policies and procedures which can respond to accommodate and overcome the foreign exchange exposure challenges of the organization.

Up on reviewing the financial statements of the organization, the study revealed that the drivers for foreign exchange translation exposure includes donor contracts in foreign currency, the translation rate used to convert local currency (ETB) spending in to donor currency while preparing donor financial reports, translation rate used to convert local currency (ETB) to foreign currency (GBP) during preparation of yearend financial statements, inflation rate and lack of financial market in the country.

The study found that foreign exchange risk, foreign exchange translation clause in donor's contract, foreign exchange translation loss and currency used to refund unspent balance of a project fund had contributed a lot for foreign exchange translation exposure of the organization.

Finally the study tried to figure out some of the gaps in managing the organization translation exposure and reveled absence of foreign exchange translation clause in donor's contract and incidents of donor's unwillingness to cover foreign exchange translation and transaction losses as indicative points.

5.4 Recommendations

From the study findings it was clear that foreign exchange translation exposure management policy affects the financial viability of the organization. Therefore, the study recommends that in order to assure the organization's sustainability, it should have been necessary to develop foreign exchange translation exposure policy. It also insures application of consistent translation procedures within the organization. Having a sound foreign exchange translation exposure policy gives clear direction to the management and funding agencies of the organization. The detailed

procedures strengthen the capability the finance department in applying the translation techniques and hedging mechanisms.

It is clear that the funding agency policy incorporated in the grant contract cannot be violated with the organization's own policy and non negotiable. Therefore the study recommended leading and lagging technique, which is one of internal hedging techniques, to tackle such incidents. The study further recommended using one of the proven translation methods, current rate method, to translate its financial statements as the organization doesn't have long term assets and liabilities.

The study also recommended a risk register (foreign exchange positioning) system to monitor the level of foreign exchange translation exposure and take preventive action before incurring a loss.

The study recommended using the gaps in grant contract such as lack of foreign exchange clause to make advantage of minimizing the translation loss by using weighted average rate of all transfers while preparing donor report.

Finally, the study recommended further research on the management of foreign exchange translation exposure of all local nongovernmental organizations in Ethiopia in order to arrive for generalization.

REFERENCES

Albanese, Chira, “Analysis – Charitable Sectors Get Savvy in FX Hedging”, fxweek.com. FX-Week, 25 Apr 2011. Web. 12 Aug 2014.

Andrew, Derry, “Charity Management”, charityfinancials.com. Charity Financials, 20 Dec 2009. Web. 26 Aug 2014.

Bogicevic, Jasmina (2013), “Accounting Implications of Foreign Currency Transactions Translation and Hedging”, Economic Horizons, pp. 137-151.

“Currency Risk a Growing Concern for Charities – Report”. Westernunion.com. Western Union Business Solutions – WU, 19 Mar 2011. Web 6 Jan 2015.

DeMaskey, A., “Measuring and Managing Foreign Exchange Exposure”, scribe.com. Scribe, 23 May 2011. Web. 12 Aug 2014.

Dohring, Bjorn (2008), “Hedging and Invoicing Strategies to Reduce Exchange Rate Exposure: a Euro-Area Perspective”, European Economy, pp. 299.

Dumitrescu, Dalina (2009), “Managing Transaction Exposure”, Annales Universtatis Apulensis.

Eiteman, David and Stonehill, Arthur and Moffet, Michael (2007), “Multinational Business Finance”, Pearson International Edition

Eun-Resnick (2007), “International Financial Management”, 4th Edition, McGraw-Hill, 99. 244-246.

“Foreign Currency Exchange Rate Guidelines”, usaid.gov. United States Agency for International Development – USAID. Web. 6 Jan 2015.

Frederick, D.S. Choi (2003), International Finance and Accounting Handbook”, 3rd Edition, John Wiley & Sons, Inc., pp. 6.8-6.28

Harris, P. and Kaur S. (2013), “An Overview of Foreign Currency Exposure”, Asian Journal of Empirical Research – AESS, pp. 957-961

"International Affairs – NGOs", mfa.gov.et. Federal Democratic Republic of Ethiopia Ministry of Foreign Affairs – MOFA, web. 25 Aug 2014.

John, J. Stephens (2001), "Managing Currency Risk – Using Financial Derivatives", John Wiley & Sons Ltd., pp. 8-10

Jorgensen, L. (1989), "Participant Observation: A Methodology for Human Studies", Newbury Park, CA: Sage Publications.

Koul, L (2006), "Method of educational research", Vikas Publishing House, New Delhi.

Levi, M.D. (1996), "International Finance", 3ed Edition, McGraw-Hill.

"Malaysian Institute of Accountants (2009), "International Management Accounting Practices – Currency Exposure and Risk Management", International Federation of Accountants.

"Managing Translation Exposure: Towards a Strategic Approach", financialcertified.com. American Academy of Financial Management – AAFM, web. 28 Jan 2015.

Maurice, D. Levi (2005), "International Finance", 4th Edition, Rout|edge Taylor & Francis Group, London and New York, pp. 191-251

Mehtab, Fozia (2013), "Foreign Exchange Risk Management at Inforsis Limited", VSRD International Journal of Business and Management Research, vol. 3, no. 44, pp. 123.

Moffet, Michael and Stonehill, Arthur and Eiteman, David (2009), "Multinational finance", Pearson International Edition

Mugenda, O.M. and Mugenda, A.G. (2003). "Research methods: Quantitative and qualitative approaches", ACTS Press, Nairobi, pp. 46-48

Nobes, C., and Parker, R. (2010), "Comparative International Accounting", Pearson Education Limited.

"Publications – Annual Report 2011-2012", nbe.gov.et. National Bank of Ethiopia – NBE, 18 Nov 2013. Web. 20 Aug 2014.

APPENDICES

Appendix 1: Research Questionnaire

This questionnaire is prepared to study **Management of Foreign Exchange Translation Exposure** in the case of SOS Sahel Ethiopia. Therefore, please put an "**X**" mark in the appropriate box to indicate your choices. You are kindly requested to return the questionnaire within a week. Thank you in advance for your kind cooperation.

A. General Information

1. Your level of education?

- ☐ Diploma
- ☐ Bachelors'degree
- ☐ Postgraduate degree
- ☐ Other specify ………………………………………………………..…………..

2. Your work experience in the organization

- ☐ 1-5 years
- ☐ 5-10 years
- ☐ 10 years and above

B. Foreign Exchange Exposure Management Policy

3. Which one of the following statement best described your organization exchange rate policy?

- ☐ General guideline which are not documented
- ☐ General documented guideline
- ☐ Formalized foreign exchange policy
- ☐ No policy

4. Which one of the following best describes your foreign exchange policy?

- ☐ Passive, foreign exchange risk is not hedged
- ☐ Active and risk averse
- ☐ Active and gain seeking
- ☐ Not certain

5. Which one of the following best described your organization foreign exchange translation exposure management?

- ☐ Centralized; foreign exchange translation exposure management is performed by a single unit, such as head office finance, within the organization.
- ☐ Decentralized; no central control over foreign exchange translation exposure management, each program manager manages its own exposure
- ☐ Hybrid; some aspects of foreign exchange translation exposure management are centralized some decentralized

6. How frequently are you tracking your foreign exchange transaction exposure position?

- ☐ Monthly
- ☐ Quarterly
- ☐ Yearly
- ☐ Other, specify ………………………………………………………………….

7. How frequently are you tracking your foreign exchange translation exposure position?

- ☐ Monthly
- ☐ Quarterly
- ☐ Yearly
- ☐ Other, specify ………………………………………………………………….

8. How could your organization manage translation exposure?

- ☐ By a comprehensive system of risk management approach
- ☐ By a speculative approach to exchange rate movements
- ☐ Other, Specify ………………………………………………………..……..
- ☐ Doesn't know

9. Which one of the following best described your organization foreign exchange translation exposure hedging method?

- ☐ Balance sheet hedge
- ☐ Derivative hedge
- ☐ Other, Specify …………………………………………………………………..
- ☐ Doesn't know

10. Which one of the following internal hedging methods is using by your organization?

- ☐ Local currency contract
- ☐ Currency rate adjustment clause in the donor contract
- ☐ Leading and lagging of cash transfers
- ☐ Other, specify ……………………………………………………………….

C. Review of Financial Statements

11. In your opinion which currency is suitable for donor reporting?

- ☐ Local Currency, Why …………………………………………………….
- ☐ Donor Currency, Why …………………………………………………….

12. Which translation method do you think suitable for your organization general account?

- ☐ The Current / Noncurrent Method
- ☐ The Monetary / Nonmonetary Method
- ☐ The Temporal Method
- ☐ The Current Rate Method
- ☐ Other, Specify ………………………………………………………………..
- ☐ Doesn't know

Why? ……………………………………………………………………………….……

D. Foreign Exchange Translation Impact

13. How much your organization affected by foreign exchange risk?

- ☐ High
- ☐ Moderate
- ☐ Low
- ☐ Not at all

14. Do you have a foreign exchange translation clause in your donor's contract?

- ☐ Yes
- ☐ No

15. If your answer is yes for question no. 7 above, which one of the following method best describe it?

- ☐ Weighted average of the rates on the date of cash transfers
- ☐ Predetermined rates by the donors
- ☐ The rate which is used to convert the local currency (ETB) budget in to the foreign currency
- ☐ The bank rate at the end of the report date, such as month end, quarter end, year end, etc.
- ☐ Other, Specify ……………………………………………………………

16. When there is foreign exchange transaction loss, who is going to cover it?

- ☐ The donor
- ☐ Your organization

17. When there is foreign exchange translation loss, who is going to cover it?

- ☐ The donor
- ☐ Your organization

18. Are your donors willing to receive the unspent balance in local currency at the end of the project, although the contract is in foreign currency?

- ☐ Yes
- ☐ No

19. If your answer is yes for question no. 17, which one of the following rate is best to use while returning the unspent balance of a project fund during phasing out?

- ☐ The bank rate at the date of transfer
- ☐ Weight average of all transfer rates
- ☐ The rate used to convert the local currency to donor currency during budget preparation.
- ☐ Other, specify ……………………………………………………………

E. Gaps in Managing Translation Exposure

20. When your donor contract doesn't have a clause regarding the foreign exchange translation, what exchange rate are you using?

- ☐ Weighted average of the rates on the date of cash transfers
- ☐ The rate which is used to convert the local currency (ETB) budget in to the foreign currency
- ☐ The bank rate at the end of the report date, such as month end, quarter end, year end, etc.
- ☐ Other, Specify ……………………………………………………………..

21. If donors are not willing to cover foreign exchange translation loss what mechanism are you using to overcome the problem?

…………………………………………………………………………………………………

22. If donors are not willing to cover foreign exchange transaction loss what mechanism are you using to overcome the problem?

…………………………………………………………………………………………………

Appendix 2: Research Interview Questions

This interview questions are prepared to study **Management of Foreign Exchange Translation Exposure** in the case of SOS Sahel Ethiopia.

1. Do you have a role in financial management? If yes what is it?

2. Have you participate in financial report preparation? If yes, in what form and in which type of report?

3. What do you understand by foreign exchange translation exposure or risk? Does it affect your organization? When and How? How it is severe?

4. Who is responsible to control foreign exchange translation exposure?

5. Who set the exchange rate to translate the local currency in to foreign currency for balance sheet and income and expenditure accounts?

6. How could you tackle foreign exchange translation risk?

INDIRA GANDHI NATIONAL OPEN UNIVERSITY

SCHOOL OF MANAGEMENT STUDIES

MASTERS THESIS PROPOSAL

MANAGEMENT OF FOREIGN EXCHANGE TRANSLATION EXPOSURE: THE CASE OF SOS SAHEL ETHIOPIA

A RESEARCH PROPOSAL SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUREMENT FOR THE MASTERS OF BUSINESS ADMINISTRATION IN FINANCE

PREPARED BY
Tesfu Nega
Enrolment No. ID1217853

September 2014
Addis Ababa
ETHIOPIA

TABLE OF CONTENT

Acronyms i
1. INTRODUCTION 1
  1.1 Background of the study 1
  1.2 Statement of the problem 3
  1.3 Objective of the study 5
  1.4 Significance of the study 5
  1.5 Methodology 6
  1.6 Scope and limitation of the study 7
  1.7 Organization of the study 7
References 8

Acronyms

CAD – Canadian Dollar

ETB – Ethiopian Birr

EU – European Union

GBP – Great Britain Pound

MOFA – Ministry of Foreign Affair

NBE – National Bank of Ethiopia

NGO – Non-Governmental Organization

NOK – Norwegian Kroner

UK – United Kingdom

USD – United States Dollar

1. INTRODUCTION

1.1 BACKGROUND OF THE STUDY

The Ethiopian government issued Charities and Societies Proclamation No. 621/2009 in 2009 in order to support and facilitate the role of Non-Governmental Organizations (NGOs) in the overall development of the Ethiopian people (MOFA). Accordingly the NGO sector played an important role in the poverty alleviation and socio economic development activities in collaboration with the Ethiopian government (MOFA website).

As per the National Bank of Ethiopia (NBE) annual report the total amount of foreign currency cash transfer to the country through NGOs in 2011/12 is amounting USD 1.3725 billion and it is 23.1% of the total unrequited transfers. When we compare the 2011/12 receipt with 2010/11 it increased by 32.8 % and the 2010/11 receipt increased by 3.8% as compared with 2009/10 (NBE Annual Report 2011-2012). This shows an increasing trend of foreign currency transfer to Ethiopia through NGOs. The sources of this huge amount of money are multilateral, bilateral and institutional funding agencies represented by NGOs.

Charities and not-for-profit organisations might not be the most typical participants in the foreign exchange market. But as their foreign exchange volume increased their hedging needs are becoming as important as any other business organizations and it leads them to exercise their hedging strategies.

A gradual increase in foreign exchange market volatility in recent years has boosted the need for strategic risk management, and managers say charities and NGOs increasingly now hedge their positions with forwards as well as spot contracts.

NGOs are becoming more sophisticated in their fund raising and more aware of the risks they face. The sophistication is mainly to do with the assessment of asset and liability foreign exchange exposures. An international NGOs will now think about where it raises funds, what currencies it holds, including foreign exchange of assets, in what currency its income naturally arises, how its liabilities will be paid out and how these liabilities might vary as currencies move (Albanese, 2011).

Exposure refers to the degree to which a company is affected by exchange rate changes. Exchange rate risk is defined as the variability of a firm’s value due to uncertain changes in the rate of exchange (DeMaskey, 2011).

At the firm level, currency risk is called exposure. The globalization of the business environment has turned exposure into a general management responsibility. In analyzing the foreign exchange exposure three types of foreign exchange exposure should be considered (Moffett, 2009). These are: transaction exposure, economic exposure, and translation exposure (balance sheet exposure).

Transaction exposure refers to the currency risk of transactions denominated in foreign currency (John, 2001). Economic exposure measures the degree to which a firm's expected cash flows are affected by unexpected changes in exchange rates (Maurice, 2005). Translation exposure measures potential accounting-based changes in a firm's consolidated statements that result from a change in exchange rates (Frederick, 2003).

In relation to the above background information foreign currency exchange exposure directly affected NGOs and the rationale of this study is to assess the hedging practices of SOS Sahel Ethiopia and identify the management gap if any.

SOS Sahel International (UK) started work in the Sahelian Dry lands Zone, both in Western and Eastern Africa in 1984. In Ethiopia, it began rural development projects focusing on food security and community based resource management five years after its establishment in 1989.

In 2005, SOS Sahel Ethiopia was registered (No. 1986) as an independent national NGO by the Ethiopian Ministry of Justice and reregistered (No. 0320) in 2012 as Ethiopian Residents Charities as per the charities and societies proclamation no. 621/2009. SOS Sahel Ethiopia is a national NGO and has more than 24 years of rural development experience in Ethiopia.

SOS Sahel Ethiopia envisions a world without poverty and it is dedicated to improve the living standards of smallholder farmers and marginalized pastoralists through better management of their environment. The work of SOS Sahel focuses on community-based natural resources management, food security, agriculture, policy analysis, value chain analysis and development, pro-poor value chain development.

SOS Sahel Ethiopia based in Addis Ababa, the capital city of Ethiopia, and operating in three regional states of Ethiopia: namely Amhara, Oromia and Southern Nations Nationalities and Peoples Region (SNNPR). Currently the organization has 19 projects and 182 staffs.

1.2 STATEMENT OF THE PROBLEM

The statement that 'most international charities are currency speculators' may at first glance appear somewhat controversial; surely such behavior is the sole purview of hedge funds and investment banks (Andrew, 2009). But, unfortunately, this statement is accurate. Many non-

governmental organisations find themselves with income and expenditures denominated in different currencies (Andrew, 2009).

NGOs typically derive income from countries in the developed world, but have program expenditures in the developing world. Any such NGO is therefore naturally exposed to movements on the foreign exchange markets. Changes in exchange rates between their revenue currencies and those in which their expenditures are denominated will either positively or negatively impact their ability to fund their programs. An NGO will benefit if the currencies of developed world countries appreciate versus the rest of the world, and of course vice versa (Andrew, 2009).

As per charities and societies proclamation no. 621/2009 article 2 sub article 3 Ethiopian residents charities should have receive more than ten percent of their fund from foreign sources. Accordingly SOS Sahel Ethiopia received funds from local as well as international funding agencies denominated in different foreign currencies, such as USD, GBP, CAD, EURO, NOK, etc. The local currency Ethiopian Birr (ETB) is used as a base currency in the budget preparation process and it converted to donor currency at the prevailing rate of that currency.

For example in the year 2013 SOS Sahel Ethiopia received Euro 2.1 million, USD 0.56 million, GBP 0.32 million, CAD 0.15 million and NOK 0.69 million as part of the annual income of ETB 81 million, which is equivalent to GBP 2.8 million. The organization has also incurred a currency translation loss of GBP 65,689, which was GBP 81,208 in 2012. This loss arises due to currency translation during cash transfer from the funding agency i.e. donor currency translated in to ETB at the date of transfer and the balance sheet closing rate used at the end of the year to translate ETB in to GBP as per the organization policy.

The fund transferred to the organization is converted to the local currency by the official rate of the bank at date of transfer. On the other hand the expenditures are converted in to foreign currency using the rate predetermined by the funder (e.g. EU) or weight average of the cash transfer rates. This change in exchange rate affects the operation of the project as well as organization as a whole.

Based on the above gap this study analyzes foreign exchange translation practices of SOS Sahel Ethiopia and identifies how it affects the operation of the organization. In contrast with the related literatures it recommends the best hedging technique to minimize foreign exchange translation exposure.

1.3 OBJECTIVE OF THE STUDY

The overall objective of this study is to assess foreign exchange translation exposure management practices and to provide general idea to the management of the organization. The specific objectives are as follows:

1. To assess policies of the organization if any with regard to foreign exchange translation exposure.
2. To review financial statements in line with foreign exchange translation exposure.
3. To investigate the foreign exchange translation impact
4. To identify the major gaps in managing translation exposure.

1.4 SIGNIFICANCE OF THE STUDY

The output of this study will give information about the implication of foreign exchange translation exposure, and the hedging mechanisms used by SOS Sahel Ethiopia in order to

protect the resulting risk. It gives an insight to the management of the organization and it is their decision how to use the output of this study. It also helps researchers for further investigation and gives highlight to the policy makers to review their working policies.

1.5 METHODOLOGY

Both qualitative and quantitative research design methods will be used in this study. The study will use cross-sectional survey method as starting point.

This study considers both primary and secondary data. Primary data will be collected through questionnaire and interview.

The questionnaire will include few open ended questions to capture the qualitative aspect or explanations for some responses. This questionnaire will be distributed to all project managers and finance and admin officers at project site.

The interview questions will be semi-structured to ensure the necessary data is collected. Interviews will be conducted with directors, program managers and the senior finance team at Addis Ababa.

Secondary data will be gathered from annual financial reports, donor reports, books, periodicals, internet, government publications, company flyers and previous studies.

The study focuses on those who have direct relationship with the financial management of projects and the organization as a whole. These are directors, program managers and the senior finance team at head office, project managers and finance officers at project sites. This comprises of 35 staffs and the study will incorporate all of them.

Tables and graphs will be used to present the collected data and analyzed using both qualitative and quantitative methods.

1.6 SCOPE AND LIMITATION OF THE STUDY

This study will be conducted specifically in SOS Sahel Ethiopia. It is difficult to conclude that this study represents the overall NGO sector in Ethiopia. Due to resource (money and time) limitation it is not possible to study the Ethiopian NGO sector as a whole. Therefore it is important to state that the study is limited to SOS Sahel Ethiopia only.

1.7 ORGANIZATION OF THE STUDY

The study will have five chapters. Chapter one will contain background of the study, statement of the problem, objective of the study and significance of the study. Chapter two will contains literature review. Chapter three will contains methodology. Chapter four will be data presentation and analysis. Chapter five, the last chapter of the study will be conclusion and recommendation.

REFERENCES

Albanese, Chira, (Analysis – Charitable Sectors Get Savvy in FX Hedging", fxweek.com. FX-Week, 25 Apr 2011. Web. 12 Aug 2014.

Andrew, Derry, "Charity Management", charityfinancials.com. Charity Financials, 20 Dec 2009. Web. 26 Aug 2014.

DeMaskey, A., "Measuring and Managing Foreign Exchange Exposure", scribe.com. Scribe, 23 May 2011. Web. 12 Aug 2014.

Eiteman, David and Stonehill, Arthur and Moffet, Michael (2007), "Multinational Business Finance", Pearson International Edition

Frederick, D.S. Choi (2003), International Finance and Accounting Handbook", 3rd Edition, John Wiley & Sons, Inc., pp. 6.8-6.28

"International Affairs – NGOs", mfa.gov.et. Federal Democratic Republic of Ethiopia Ministry of Foreign Affairs – MOFA, web. 25 Aug 2014.

John, J. Stephens (2001), "Managing Currency Risk – Using Financial Derivatives", John Wiley & Sons Ltd., pp. 8-10

Maurice, D. Levi (2005), "International Finance", 4th Edition, Rutledge Taylor & Francis Group, London and New York, pp. 191-251

Moffet, Michael and Stonehill, Arthur and Eiteman, David (2009), "Multinational finance", Pearson International Edition

"Publications – Annual Report 2011-2012", nbe.gov.et. National Bank of Ethiopia – NBE, 18 Nov 2013. Web. 20 Aug 2014.