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Foreign exchange risk management: a case in the mining industry

Alpa Dhanani*

Cardiff Business School, Colum Drive, Cardiff, Wales CF1 3EU, UK

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Abstract

Using a case study approach, this paper reviews the corporate exchange risk management practices of a single large UK multinational company. The research results shed new light on the management of economic exchange rate risk and also have implications for the effects of movements in exchange rates in the context of the translation process. More generally, these results indicate that, instances in which corporate practices deviate from normative prescriptions do not necessarily imply sub-optimal behaviour, although some companies may benefit from the re-consideration of their exchange risk management policies. Finally, they highlight new areas of research and also emphasise the role of qualitative research in accounting and finance.
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1. Introduction

Exchange rate risk constitutes one of the most common forms of risk that firms in the international arena encounter and, in recent years, the management of this risk has become one of the key factors in overall financial management (Werner et al., 1996; Lee et al., 2001).[1] To the credit of the academic community, researchers have kept pace with the increasing importance of exchange rate risk management, as reflected in the intense theoretical and empirical research. For example, several theoretical studies have examined

* Tel.: +44-29-20876952.
E-mail address: dhananiav@cardiff.ac.uk (A. Dhanani).

[1] While introduction of the Euro has mitigated some level of exchange rate risk for firms operating within the Euro-zone, other firms not in this context (such as British firms) are further disadvantaged. Exchange rate risk to other currencies such as the US dollar and the Japanese Yen remains the same for all firms.

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the different types of corporate exchange risk and the relevance of these risks to corporate market value (Dufey, 1972; Adler and Dumas, 1984). Moreover, various capital market studies have sought to determine the extent to which multinational companies (MNCs) experience exchange rate risk (Jorion, 1990; Amihud, 1994). Finally, a number of survey—and interview—based studies have sought to inquire into the corporate management of this risk (Davis et al., 1991; Belk and Edelshain, 1997; Lee et al., 2001).

However, two issues appear to have received limited consideration in the literature: firstly, to explain the how, in terms of the processes involved in the management of exchange rate risk[2], and secondly, why, firms manage their risk in the ways they do (Brown, 2001, is a notable exception). This shortfall represents a significant gap in the literature, since results from prior studies indicate that corporate practices may be less than optimal because: (i) there are large discrepancies between the theory and practice of various aspects of the risk management process; and (ii) practices between firms are, on occasions, critically diverse (Davis et al., 1991; Belk and Edelshain, 1997). Like Brown (2001), the purpose of this paper is to address the gap in the current literature by conducting a detailed investigation of the exchange risk management process at a single multinational company. ABC plc[3], the case company is a large British multinational, operating in the mining industry.

To address the issues of the 'how's and 'why's, this paper focuses on the management of the three common forms of exchange rate risk: translation, transaction and economic exchange risk. The types of exchange rate risk that ABC plc has chosen to manage as part of its risk management programme conform closely to prescriptions from the theoretical literature. Aspects of the risk management process, particularly with regard to the economic exchange risk, are, however, different from prescriptions in theory. The nature of the industry that the firm operates in is seen to shape the management process. Practices at ABC plc have implications for other firms who operate in primary industries and also for firms who are concerned with aspects of the translation process amid movements in exchange rates. Moreover, this study draws on the research results to highlight new areas for future research and also to emphasise the role of the qualitative research methodology in research in accounting and finance.

The rest of the paper is organised as follows. Section two reviews the prior literature and summarises results of prior studies. Section three makes a case for and describes the research methodology. Section four focuses on the case itself, ABC plc. Finally Section five, a discussion section, examines the implications of the results for future corporate practice and new research areas.

2. Prior literature

This section covers the theoretical aspects of, and prior research on, the three forms of exchange rate risk: translation, transaction and economic risk. Consistent with Lessard

[2] This is so particularly with regard to the economic form of exchange risk, for which the process of risk management is critical, given the complex nature of the risk.

[3] This is a fictitious name to protect the identity of the company.

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