MASTER THESIS IN FINANCE AND ACCOUNTING

Managing Foreign Exchange Exposure
A case study on Lanka Ice

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EXECUTIVE SUMMARY

The purpose of this thesis is to examine current practices at Lanka Ice Group of companies' risk management activities, identifying strengths and weaknesses, and make recommendations. To carry out the objectives a single case study was selected and conducted using qualitative methods, with primary data sourced from company data and interviews.

Currency volatility has increased and firms face uncertainty with regards to prices of various goods and services. Large or small, trading or non trading, firms are exposed to economic, transaction, and translation risks, respectively. Risk management activities are aimed at minimizing expected earnings variability. Risk management offers an avenue for firms to shift risk they cannot bear to those better equipped to do so.

Arguments for and against have been put forward for the use of financial risk management products. Those arguing against suggest that markets are efficient and that investors are diversified and therefore managing risk by corporate managers is not a value adding activity. It is cited that managers destroy shareholder value in favour of their own empire building. Revelations on financial engineered products and some of their disastrous consequences have reignited arguments on risk management and the costs involved.

Firms face the choice between internal and external ways of managing currency exposures to exchange risk. Internal methods include invoicing, transfer pricing, netting, clauses in sales contracts, leading and lagging, and asset-liability management. Transfer pricing allows the firm to change prices for goods and services to control for fluctuations in currencies while billing in local currency transfers risk to counter parties. Netting lowers costs as the number of transactions reduces a product centralised cash management system. Firms can also take advantage of leads and lags in making payments thereby making savings and avoiding costs due to unfavourable movements in currency prices. Alternatively businesses can include sales clauses in contracts for attractive payment options too. Asset-liability management techniques are another option.

Lanka Finance estimates its foreign currency exposure to be between 0 and 25 percent respectively, generated from glass imports. The payments are settled through short term loans respectively, all denominated in USD. The exposure is expected to increase as Lanka sets up operations and expands into the food industry in the Netherlands. It was identified that Lanka operates on Letter of Credit which enhances credit reputation. Additionally, management is strongly supported by company directors. The weaknesses were a lack of financial infrastructure in the environment coupled with a weak operating currency.

Treasury experts at Rabobank and ABN-AMRO indicated forward contracts to be the most common type of hedging product for both small and large businesses. Expertise and skills are cited by both interviews in managing currency risk management. Additionally, it was revealed that risk shifting to counterparties and matching were other methods to consider when reducing exchange risk. Highlighted too was the need for a company to be aware of risk faced and take necessary steps early in the firm’s life cycle. Moreover, a firm needed to weigh the benefits and costs of risk management.

Finally, it is recommended that Lanka ice group of companies implement a twelve step process, as a corporate wide treasury management programme in managing its exposure. First and foremost the firm needs to address the issue from a policy point of view by clearly defining expectations, scope, and breadth of its risk management activities. Primarily the firm should consider matching purchases and payments for its glass. The firm should inquire about the possibilities of contract clauses with its suppliers to either pay early or delay the payments thus alleviating pressure on the cash conversion cycle. Additionally it is recommended that the firm consult with its banker on forward contracts as a supplement to
the Letter of Credit. The company also needs to properly measure its exposure. Having stated the above it is the view that the trading portfolio is still growing and therefore the firm doesn't need a radical shift from current practices, but the careful monitoring and evaluation of exposure will ensure the firm is prepared for a range of eventualities.
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CHAPTER 1

1.0 Introduction
The management of corporate risk for foreign exchange exposure has received considerable amount of attention following the collapse of the Bretton Woods system (Bartram, Dufey, & Frenkel, 2005). The volatility of exchange rates prompted a proliferation of financial instruments and an increasing number of firms using derivative instruments (Bartram, 2005; Bodnar, Hayt, & Marston, 1998). Foreign exchange exposure presents a challenge for firms and affects firms with no importing or exporting business functions (De Jong, Ligterink, & Macrae, 2006). Many financial catastrophies have been well documented due to losses arising foreign exchange exposure, resulting from unsound professional management.

Globalisation, technological advances, deregulation of markets, exchange volatility, market volatility, among others, have added to the complexity of managing business operations (Malindretos & Tsanacas, 1995). The floating system of exchange rates is a function of supply and demand of currencies and therefore firms exposed to fluctuations arising henceforth. The deregulation of markets and economies have exacerbated contagion due to interdependencies of economies which has led to mobility of capital flows; consequently this has resulted in lots of financial and currency crises, for example, the 1992-1993 European Monetary System, the Asian crisis in 1998 starting from the prior year, the crisis in Russia in 1998 and the Argentine crises in 2001 (Moosa, 2010).

Given the volatile nature of exchange rates it has become imperative for corporations to manage their exposure risks. As will be seen in the proceedings, there have been plethora of studies to investigate the effects of exchange rate exposure on firms, the hedging tools available, and arguments as to whether its is relevant for firms to engage in risk mitigating activities, particularly those that employ the use of financial and operational hedging methods. Hedging with derivatives when properly conducted can enhance risk management activities. On the other hand derivatives are very powerful instruments that can destroy shareholder value when improperly used.

The rest of chapter 1 discusses the company background, the objectives of the study, the research questions and the framework. Chapter two discusses the critical literature review examining arguments on risk management and common solutions in risk management. The third chapter discusses the choice of methodology validity and reliability considerations, and strategies. In chapter 4 field work data from interviews and company data are presented followed by discussion. Chapter 5 is the conclusions and recommendations; references and appendixes follow thereafter.
1.1 Company background
Lanka Ice Co (PVT) Ltd is a family operated business with 13 operating subsidiaries. The bulk of these subsidiaries are located in Sri Lanka. The firm was established in 1987 and started off as an industrial manufacturer of block ice. Since then the firm has extended its portfolio to include industrial refrigeration installation, processing facilities for marine foods, fruits, and vegetables. The group is also an importer and wholesaler of glass and mirror products. Additionally, the family business has ventured into the hotel and tourism business and conducts events management activities. Revenue for the whole group, for the year ending 2012, was 3.5 million Euros or 613 million Sri Lankan Rupees.

The company has a subsidiary operation, Lanka Leisure Holland, in Amsterdam catering for the tourism industry. Lanka Ice is currently negotiating with several supermarket stores in the Netherlands like Albert Heijn to be a supplier of spices. Lanka Ice also conducts import business from India where it sources some of its input materials.

1.2 Problem statement and research objectives
1.2.1 Problem statement
Firms, large or small face foreign currency risk exposure, more so, when competing in international markets. Foreign currency risk management minimises the unfavourable impact of adverse movements in currency prices. Many small firms do not fully understand the risks they face from currency exposure. Adverse changes can result in diminished firm value. Losses are determined by the nature and size of the net exposure a firm has. There are internal methods firms can make use of to manage currency risk exposure, and current market innovations in financial products enable small businesses to manage foreign currency exposure by using some of these tools. Risk management strategies can lead to increased value of expected cash flows, and risk management when properly implemented and carried out can be a source of competitive advantage.

Currently Lanka Ice does not have a financial risk management programme that can control for currency risk exposure faced. A lack thereof can lead to suboptimal cash flows due to losses resulting from not managing currency exposure.

The study has practical significance has it will highlight current practices and tools available for foreign currency risk management, thereby presenting ways and choices of risk management solutions for the firm. It is important for Lanka Ice implementing risk management in its treasury functions to reduce future losses as a result of currency volatilities.

1.2.2 Research objective
The purpose of this study is to investigate the current practice of foreign exchange risk management of the firm, identify strengths and weaknesses as well as limitations and thereby make recommendations to Lanka Ice on the best possible way to manage currency risk for its import and export business portfolio. Implementing a risk management program aided with proper administration can help the company reduce, not only its variability of its cash flows that are associated with volatile currency markets, but also mitigate numerous risks that are not so sensitive to cash flows but are potential risk drivers that can harm Lanka Group.
1.3 Research question
How can Lanka group better manage its foreign exchange risk exposure?

1.3.1 Sub questions

Theoretical
- What is foreign exchange risk exposure management?
- How is exposure measured and managed?
- Why do firms hedge?
- What tools are available for mitigating foreign exchange risk for small firms?

Empirical
- What is the size of Lanka’s currency exposure?
- What are current tools available and used by Lanka Group for foreign exchange management?
- How are these tools used or not used?
- What are the strengths and weaknesses or limitations of current practices?
- What obstacles does Lanka Group face for better risk management?
- How can their risk management practice be improved?
1.4 Conceptual framework schematic

Phase a

Theory on Risk management

Preliminary research

Phase b

External hedging

Assessment criteria

Phase c

Results of analysis

Phase d

Recommendations

Phase a

Result of analysis

Phase b

Internal hedging

1.4.1 Core concepts

Core concepts

Risk management

Foreign Exposure Risk Management

Costs

Derivatives

Transaction exposure

Economic Exposure

Hedging
1.4.2. Definition of concepts
For the purpose of this study the following definitions are as follows:

**Foreign exchange risk** is defined as the risk exposure resulting from sales and revenue generation in foreign currency denominations.

**Hedging** is defined as the managing risk due to changes in prices of currencies, commodities, and securities, by taking offsetting positions.

**Economic exposure**: defined as exposure to exchange rate risk arising from generating sales in one currency while incurring costs in another foreign currency.

**Transaction exposure** defined as exposure to exchange rate risk due to commitments to sell or purchase goods and services at an agreed price today which is affected by future exchange rates.
CHAPTER 2

2.0 Critical literature review
This chapter examines risk management by looking at literature that addresses many facets of risk management practice. It defines and briefly discusses the types of exposures that business firms face. The chapter then presents arguments for and against risk management by looking at factors like financial distress, taxes, investment policy, and looks at determining factors in the decision to hedge particularly, capital allocation, hedging costs firm size, growth forecasts, R & D, and then discusses exposure management, current concerns on derivatives, and concludes with answers to sub theoretical questions and summary.

2.1 Risk Management
Risk management is defined as the performance of risk activities amid at minimising the negative impact of uncertainty with regards to possible loses (Schmit & Roth, 1990). From the definition it is safe to infer that the prerequisite to managing risk is to understand the risk faced. The last few decades risk management, especially at the corporate level has become vital for business strategy (Guay & Kothari, 2003). Moreover, risk management establishes strategies to use that can help manage uncertainty that would otherwise cause financial distress (Stulz R. M., 1996). Not only should the management of risk be with quantifiable aspects but Risk management should protect other not so tangible elements like value and reputation the company has built over time (DeLoach & Gibbs, 2006).

2.2 Foreign exchange risk
"There is no sphere of human thought in which it is easier to show superficial cleverness and the appearance of superior wisdom than in discussing questions of currency and exchange."

Sir Winston Churchill
House of Commons: 28-09-1949

In broad terms exchange risk is defined as unexpected movements in the exchange rates that affect a firm’s value (Madura, 2009). Risk can be both favourable and unfavourable (Moosa, 2010). International business of challenges when operating within their domestic markets and the problem is even greater when operations are in foreign markets. These challenges and risks are a source of concern for managers as they have potential to drastically impact revenues, profits, and consequently firm value. Eiteman et al. (2013) provide the following definition on foreign exchange exposure:

"Foreign exchange exposure is a measure of the potential for a firm’s profitability, net cash flow, and market value to change because of a change in exchange rates.”

Foreign exposure is categorised as exposure due to accounting methods and exposure derived from operational competitiveness (ibid); transaction and translation exposure are a function of assets and cash flows being denominated in foreign currency while operational exposure represents the potential impact on an entity’s competitiveness due to movements in exchange rates. Transaction, translation, and economic/operational exposure are measures for foreign exchange risk.

2.3.1 Transaction exposure
This type of risk exposes the firm to potential changes in its receivables or payables if unanticipated changes in exchange rates take place. The value of either receivables or payables changes according to changes in exchange rates. Transaction exposure is a cash flow exposure associated, sometimes with trade flows from imports and exports and capital flows from interest obligations and dividends (Moosa, 2010). Measuring transaction
exposure requires that currencies are correctly identified as domestic for domestic currency risk and foreign currency risk (Adler & Dumas, 1984).

2.3.1 Economic exposure
Economic risk reflects possible changes in assets and liabilities or future income due to fluctuations in exchange rates. Economic exposure is also referred to as operating exposure (Eitman, Stonehill, & Moffett, 2013). Exposure and transaction exposure are different in that economic exposure is forward looking in anticipation of changes to exchange rates that affect its competitiveness (Moosa, 2010); additionally economic exposure does not have currency cash flow conversion. Therefore economic exposure is susceptible to risk drivers such as political and economic events, for example, a political unrest may affect sales in which case a firm has no control over political turmoil and cannot quantify the outcome.

2.3.3 Translation exposure
This is the risk a multinational faces when translating its earnings from its foreign subsidiaries and affects its net position of assets on the balance sheet.

2.4 Derivatives and hedging

Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses—often huge in amount—in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).


Financial derivatives are instruments used to hedge risk. They derive their value from another underlying asset. Firms will use derivative instruments to take advantage of gains possible only through such instruments or otherwise would be more costly without the use thereof, for example. Derivatives also benefit firms through predictability and hence help with their planning; this is because they can be sure of their returns without having to worry about volatility.

Hedging techniques can be categorised as external and internal hedging respectively. The common derivative tools ones for multinational businesses and indeed other businesses are namely, futures, forwards, swaps and options. These can further be regrouped into currency futures and currency forwards, and money market hedges.

2.4.1 Internal hedging techniques

2.4.1.1 Invoicing and transfer pricing
This strategy can be performed in several ways. One is for the subsidiary to increase its prices of goods and services when operating currency depreciates, therefore netting out the effects. This can be a useful technique when operating in economies plagued with currency devaluations. The company may also elect to change its billing currency and invoice in the foreign currency terms. Alternatively, intercompany transfer pricing can be practiced and take advantage of taxable income.

2.4.1.2 Intercompany netting
Netting is one method for internal hedging. When cash flows are denominated in same currency and have similar maturities and flows, netting is a possibility (Pringle, 1991). This
requires a centralised cash management system that is, the parent company of subsidiary returns all the foreign currency cash flows. Bilateral and multilateral are the methods of netting. In bilateral netting, for example, a Dutch multinational with a subsidiary in Germany and another in the US, with its subsidiaries with obligations to each other of €70000 and €40000, respectively. The amounts could be netted leaving the German firm paying only €30000 and consequently reduce on the number of transactions and ultimately exposure. Multilateral netting follows the same logic, albeit more sophisticated but produces the same effects. Netting can provide cost savings from transaction costs and from bid and offer costs for currencies that are not heavily traded (Shapiro, 1986); additionally, a netting system may be under regulatory control with other requirements needing to be met (ibid).

2.4.1.3 Clauses in sales contracts
An importing firm can include clauses to make payments ahead of time. This is helpful if the currency is forecasted to appreciate resulting with the firm taking advantage of low exchange rates.

2.4.1.4 Leading and lagging
This requires the timing of payments to be adjusted in anticipation of future currency movements. Leading allows a firm to make payments before they fall due while lagging is postponing payment. Lagging strategy delays the collection of foreign currency receivables if that currency is expected to strengthen while delaying payables if the currency is expected to depreciate (Hill, 2001). It should be noted too that this strategy is a non-zero sum game.

2.4.1.5 Asset-Liability Management (ALM)
ALM follows similar application to leading and lagging. A company expecting a fall in value in currency should reduce assets and increase its liabilities; the reverse holds true for appreciating currencies. As an example, for a depreciating currency a firm reduces its assets by reducing investments while increasing liabilities by increasing short-term debt. In the long run ALM is challenging to implement since factors of production like plant and equipment cannot be disposed of quickly, for example.

2.4.2 External hedging

2.4.2.1 Currency forwards
In a currency forward contract a firm takes an opposite position to its position in the spot market. For example, an exporting firm creates an exposure when it invoices which is recorded at the spot rate in accordance with international accounting rules (IFRS, 2012). To offset this risk the company can contract a forward hedge at an agreed future exchange rate. If payment is expected in 90 days a 3-month forward agreement can be entered into. However some instances arise when a firm has no access to funds and to deliver the currency at the future spot rate (Eitman, Stonehill, & Moffett, 2013). The uncovered position exposes the firm to unfavourable movements in exchange rates. On the other hand a fully covered forward removes exposure with only the forward premium as a cost.

2.4.2.2 Currency futures
A currency futures contract has similar characteristics to forward contract with future delivery of a certain amount of foreign exchange at an agreed price and set time. One difference with the forward contract is the fact that futures are marked to market on a daily basis (Whaley, 2006). Foreign currency futures have contract specifications and certain characteristics, in addition:

The transactions are conducted on a notional principal which is the amount or size of the contract which is done in currency multiple. The quotations are normally expressed in American terms, that is, the exchange rate is stated as the cost of the foreign currency in U.S dollar. The purchaser is also required to have a margin account. The margin account serves to capture gains or losses on a daily basis or marking-to-market as normally referred
to. The maintenance account can be established by letters of credit, cash, or treasury bills much like a performance bond would require (Eitman, Stonehill, & Moffett, 2013). Futures also have an important feature, that of having the exchange as the counter party risk. This means that a party to any particular contract do not have to worry about the credit worthiness of the other party as this positions is assumed by the exchange body. Consequently, this lowers credit default.

An example below shows the payoff for a short position on the Euro:

**Euro (CME)-€125,000; $ per €**

<table>
<thead>
<tr>
<th></th>
<th>Open</th>
<th>High</th>
<th>Low</th>
<th>Settle</th>
<th>Chg</th>
<th>High</th>
<th>Low</th>
<th>Open</th>
<th>Int</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sep 13</td>
<td>1.3276</td>
<td>1.3300</td>
<td>1.3255</td>
<td>1.3279</td>
<td>+.0033</td>
<td>1.3700</td>
<td>1.2755</td>
<td>216,683</td>
<td></td>
</tr>
<tr>
<td>Dec 13</td>
<td>1.3284</td>
<td>1.3302</td>
<td>1.3251</td>
<td>1.3284</td>
<td>+.0033</td>
<td>1.3717</td>
<td>1.2760</td>
<td>3,019</td>
<td></td>
</tr>
</tbody>
</table>

Est vol 296,183; vol n.a. n.a.; open int, 219,817, n.a..
Sources: SIX Financial Information; WSJ Market Data Group; historical data prior to 6/15/11: Thomson Reuters; WSJ Market Data Group

**Source:** (The Wall Street Journal, 2013)

From table 1 the gain (loss) on a December contract can be determined as follows:

\[
\text{Value at Maturity} = -\text{Notional principle} \times (\text{Spot} - \text{Futures})
\]

\[
= -€125000 \times (1.3279 - 1.3284)
\]

\[
= €62.5
\]

The trader would make a gain of €62.5 on the transaction.

2.5.2.3 Currency options

A foreign currency option contract is one that gives the purchaser the right to buy or sell currency at fixed rate of exchange and to be delivered at set time, but is not under any obligation to do so. The option to execute the transaction is the key valuable aspect of option contracts. This means that the loss is limited to the purchase cost. There are two types of options, a call option and a put option. A call option gives buyer the right and not the obligation to buy a certain amount of foreign currency. A put option is the right to sell foreign currency. See below for an illustration of a transaction of a call option:

Options as we have stated before have the advantage of enabling the holder to exercise it or not. Options will be exercised when the holder finds it profitable to do so or “in the money.” The upside for the holder can be unlimited profit if the sport exchange rate moves up in the anticipated direction; losses are limited to the premium, which is the price of the option. See below for a simple calculation for a holder of a call option:
Buyer of call option

Cost of option (EUR/USD): 0.010 cents
Exercise price: 0.590 cents
Spot price: 0.570, 0.580, 0.590, 0.605, 0.615.

A trader would only exercise the option the spot rate moved higher than 0.595 cents otherwise the trader is better off buying in the spot market. On the other hand if the spot rate moves to the right of 0.595 cents per euro per US dollar the option would be “in the money,” and trader would then exercise the option. For example if the spot rate is 0.605 the payoff is as follows:

\[
\text{Profit} = \text{Spot rate} - (\text{strike price} + \text{Premium})
\]
\[
= 0.605 - (0.590 + 0.10)
\]
\[
= €0.005/\$
\]

Note that the breakeven point is equal to the strike or exercise price plus price of option. Additionally the writer of the call option suffers the gains made by the buyer; it’s a zero-sum game.

2.5.2.4 Currency swaps

These agreements operate in similar fashion to interest rate swaps in that firms carry their own risk premium and only exchange the LIBOR component only. Currency swaps have become popular among some banks in funding long term loans like mortgages (Eklund, Milton, & Ryden, 2012). Currency swaps facilitate for firms to discard currencies they do not wish to hold and get currencies that are favourable to their operational needs.

2.5.2.5 Money market

In many respects the money market hedges operates like forward hedges. The contract is essentially a loan agreement. The firm borrows in one currency and exchanges the funds into a foreign currency. This way the company creates an accounts payable to be met form normal business operations. An iteration of a market hedge is alternatively referred to as matching; it functions by matching anticipated currency inflows with currency outflow by both maturity and currency. The difference between forward hedges and money market hedges rests in differences in interest rates facing a private firm and the inefficiencies that occasionally exist in the markets due to violations in parity conditions (Eitman, Stonehill, & Moffett, 2013).

In summary firms are faced with internal and external options of managing currency exposures to exchange risk. Internal methods include invoicing, transfer pricing, netting, clauses in sales contracts, leading and lagging, and asset-liability management. Transfer pricing allows the firm to change prices for goods and services to control for fluctuations in currencies while billing in local currency transfers risk to counter parties. Netting lowers costs through the reduction in transactions, a result of transfer centralised cash management system. Firms can also take advantage of leads and lags in making payments thereby making savings and avoiding costs due to unfavourable movements in currency prices. Alternatively businesses can include sales clauses in contracts for attractive payment options too. Asset-liability management techniques give the firm options to increase assets while at the same time reducing liabilities if currencies expected to appreciate.
A firm may engage in external hedging if internal methods are inadequate or complement to them. Financial instruments like forwards, futures, options, and swaps are most commonly used. Forward contracts are contracted for future delivery of currency at a predefined future spot rate. In like manner to forwards, futures contracts have delivery of currency at agreed price and time; futures contracts have the added feature of an exchange as counterparty hence low credit default probabilities. Options contracts give the holder the right to purchase or sale currency within contract terms but the holder not obligated to do so; the contract can be expired if conditions do not permit to exercise the contract. Currency swaps give firms an avenue of sourcing desirable currencies for operational purposes. Finally, money market hedges can be employed whereby firm creates assets and liabilities by borrowing foreign currency and changing the currency in currency’s domestic money market; the firm is then able to match inflows of foreign currency with outflows of the same foreign currency.

2.6 A brief note on options market and forwards markets

Financial markets have evolved and there are numerous products on the market to meet the needs of financial and non financial businesses, to manage or avoid risk altogether. Below is a description of the option and forward markets.

2.6.1 Currency options market

The use of currency options to hedge risk ad as well use for speculation has been increasing. Large financial institutes around the world issue options transactions of 1 million dollars or more. Over-The-Counter market offers custom tailored transactions in major currencies with time periods from 1 year to 3 years. The Philadelphia Stock Exchange was the first to introduce trading in standardised foreign currency option contracts in the U.S. exchanges, led by the Chicago Mercantile Exchange. Option contracts on the exchange provide an avenue for those with no access to OTC particularly individuals and speculators.

2.6.2 Over-The-Counter market (OTC)

The market is normally a trading of major currencies like the US dollar, Great British Pound, the Japanese Yen, Swiss francs, Canadian dollar, and the Euro. The main advantage of OTC markets is that they can be customised to the minute detail to meet the needs of clients; firms can choose strike price and maturity (Eitman, Stonehill, & Moffett, 2013). Over time the market has become liquid. Over-The-Counter services suffer from counterparty risk in the event that the issuing institution will not meet payment obligations (Stulz, 2010).

2.7 Should risk be hedged?

There are many arguments to not hedge. Those from the school of Efficient Market Hypothesis posit that markets are efficient enough to rid themselves of any opportunities to make a riskless profit. Moreover it has been argued market efficiency means that all the available information is reflected in stock prices and investor view on firm profitability is unaffected by hedging activities (Modigliani & Miller, 1958). Miller and Modigliani theorem (MM) contends that investors can hedge risk on their own and thus managers should not concern themselves with diversifying away risk. Furthermore, hedging adds no value since losses and gains from exchange rates average out over time (Dufey & Srinivasulu, 1983). The capital asset pricing model (CAPM) also gives weight to the argument in that the unsystematic risk can be diversified away in accordance with portfolio theory while the risk that is systemic is reflected in the price of assets (Adler & Dumas, 1984). Shapiro and Rutenberg (1986) posited that predicting future forward rates is as difficult as predicting spot rates and therefore of dubious value.

However companies conduct business transactions and operations in environments with frictional costs and not in an idealised environment with perfect information, no obstacles to price changes or parity conditions holding; therefore firms should manage risks as presented in the considered arguments below.
2.7.1 Arguments for hedging
Proponents have argued for the following reasons as to why firms should hedge their risks:

2.7.1.1 Tax consideration
Firms can take advantage of the tax structural code by taking positions in forward, futures and options instruments (Smith & Stulz, 1985). Hedging can reduce variability of pre-tax value of the firm thereby increasing firm value; however this is true if the cost of the hedge is not very significant. From an insurance standpoint Mayer and Smith (1982) argued that firm revenue can be driven to zero due to large uninsured losses and consequently losing tax saving benefits.

2.7.1.2 Financial distress
Stulz and Smith (1985) have argued that two incentives exist for shareholders to hedge; first point is that a constantly borrowing firm enhances its reputation as the price of its debt increases. The second advanced point is the reduction in financial distress that can result due to bond covenants, that places restrictions on activities a firm undertakes. Financial distress and bankruptcy threats have incentive effects on company stakeholders and affect the firm’s abilities to generate value (Shapiro and Titman, 1985). Figure 1 below shows the variability of cash flows and expected future value if firm is hedged or remains hedged.

![Variability of cash flows when hedged and not hedged](Eitman, Stonehill, & Moffett, 2013)

2.7.1.3 Investment policy consideration
Following the pecking order theory, and the greater cost for financing externally than internally, a result of information asymmetry hedging has shown to add value by reducing cash flow variability consequently generating internal funds for future investment opportunities (Froot et al. 1993). Additionally it has been shown that by hedging firms remove “excess cash” that may be overinvested by managers (Stulz, 1990).
Other arguments supporting hedging decisions state that transaction costs (Mayer and Smith 1982) and managerial skill (Breedan & Viswanthan, 1996). Frictional costs don’t allow for complete diversification by investors and therefore pay a stock premium for firms that hedge. Managers use hedging to signal and communicate their skills to external stakeholders like investors. It has also been argued that there is an incentive to hedging risk and reduce empire building by senior management at the expense of shareholders (Tufano, 1998); see also Stulz (1990).

2.8 Firms and hedging
A Wharton survey (Bodnar, Hayt, & Marston, 1998), (see also earlier 1995 Wharton Survey with similar findings) found that most firms covered not more than 25% of exposure. They also found that derivative usage was highest among firms with at least 83 % applying them, while for medium and small business units only 45 and 25 percent, respectively. Bodnar also indicates that FX risk as the most managed followed by interest rate risk and commodity risk, in that order. 60% of those not employing any derivatives stated that they did not face significant exposure to warrant derivative; others maintained that other means of exposure management sufficient such as operational diversification or risk shifting/sharing. Other cited concerns were difficulty in pricing and valuing the derivative instruments, unfavourable past experience, and limited knowledge. Moreover the costs of using derivatives were more than the benefits and thus not preferred. Similar results in a study of non financial firms in Norway, by the Norges Bank (2005), show that 64 % of firms did not hedge their net assets in foreign currencies preferring natural methods of hedging. An interesting tendency pointed out was medium and small sized firms invoicing in local Norwegian currency more than the larger firms; this way the firms were shifting risk to their trading counterparties thereby taking advantage of their lack in economies of scale.

2.9 Determinants of hedging
The paper has established the grounds for the management of foreign exchange risk. This section discusses the determinants of hedging and factors influencing hedging decisions.

2.9.1 Hedging costs and capital allocation
As already stated hedging can be through money market and forward operations. Hedging costs should reflect the difference between value received from an unhedged position to one and value resulting for a hedged position; this follows from the parity conditions which should ensure that both hedging strategies yield the same results if efficient markets prevail. Therefore the cost of hedging is only pure transaction costs (Frenkel & Levich, 1975). Normally these costs are attributable to dealers, brokers, and other related information search costs (Moosa, 2010). Costs of initiating and maintaining are not a simple matter. Brown (2001) in his case study estimated costs of 3million USD for managing a foreign currency hedging programme, with 1.5 million for operational cost and 2.3 million resulting from transaction costs

2.9.2 Capital allocation
Diversification has been highlighted as one way of hedging (see Bodnar, 1998). Multinational firms face the important question then, of where to allocate resources among several alternatives with regards to sale and production. Broll et al. (1993) argued that irrespective of the risk tolerance of a firm and its exchange rate expectation the capital allocation decision is an independent in the presence of a futures market. Froot et al. 1993 make similar observations

2.9.3 Factors affecting decision to hedge
Geczy et al. 1997, and Allayannis and Weston (2001) show that firm size, R&D, leverage, foreign trade, all to be influencing factors for hedging.
2.9.3.0 Firm size

Larger firms benefit from economies of scale. This means that they can spread their fixed costs over time. Hedging as entails set-up costs, for example, equipment has to be made available and the right personnel have to be hired and possibly trained. Equally important is the fact that large firms are more likely to be viewed as better counterparties to credit contracts.

2.9.3.1. Leveraging, profitability and growth prospective.

From the perspective of shareholders highly leveraged firms should hedge to reduce chances of financial distress and possible bankruptcy (Brealey, Myers, & Allen, 2011); profitable firms face lower chances of financial distress and find no benefit of hedging. Moreover, for less sound financial firms they trading is at a premium.

Firm value is dependent on future growth prospects argues Mayers (1977). From an anecdotal point of view, Froot et al. (1993) cite the work done by Lewent and Kearny (1990) on risk management practices at Merck with management there stating that in view of potential cash flow volatility and its impact on strategy Merck have to consider hedging thereby preventing underinvestment in R&D. Research has also shown that firms with large research and development costs, low gearing and with more investment opportunities are more likely to hedge (ibid) and (Gay & Nam, 1998), using market-to-book-value ratio and R&D identified similar characteristics; there work was based on a framework established by Froot et al. (1993).

Guay and Kothari (2003) have indicated that contemporary finance has seen an extensive usage of derivatives like futures, options, and swaps. Moreover, study also add that despite most firms having economic positions of derivates smaller in relation to firm-level exposures firms still thought the benefits of hedging were more important than costs. Their study was consistent with Brown (2001). Moreover, firms might engage in speculative trading if it was possible to increase net cash flow from derivative usage; this was one result that was found in the Wharton surveys of 1995 and 1998 respectively. Bodnar reported that firms were considerate of market expectations therefore market timing was a factor influencing hedging activities.

2.9.3.3 Measuring foreign exchange exposure

An analysis on Swiss firms on currency risk exposure, that is, in relation to operational and firm value indicated 40% of the firms were able to measure cash flow sensitivity to currency movements (Loderer & Pichler, 2000). In testing several hypotheses Loderer and Pichler firms thought that their exposures were negligible, that exchange rates would offset each other (an acceptable supposition in the long-run as substantiated by parity conditions) additionally it was reported that only direct and not indirect risk was hedged among most firms. Firms were also inclined to mangling quantifiable risks like taxes, a point indicted in the Wharton survey too; both studies also show the inability of most firms to measure the exposure risk properly.

2.9.3.4 Managing exposures

One consideration for multinational firms concerns organisation decentralisation or decentralised management of foreign management. Prindl (1976) suggests treasury management of foreign exchange exposure be centralised. It has been earlier stated of the cost savings that can take occur in centralised cash management.
2.9.3.5 Transaction risk

Marshall (2000) found that foreign exchange risk is one of the most important management activities in his survey of British, Asian, and US multinationals, respectively. The study further highlights on the main objectives of foreign risk management among the firms as (1) reduce the volatility of cash flows (2) reducing losses on foreign exchange (3) insure earnings from fluctuations and (4) risk should be hedged regardless of expectations. A survey of Swiss firms found that minimizing costs, easier planning, taxes, and ensuring cash flows were objective reasons for managing exposure (Loderer & Pichler, 2000).

Pichler and Loderer show that transaction risk was the most managed (ibid). See also (Batten, Mellor, & Wan, 1993). It has also been documented for transaction risk to be more managed in UK, US and Asian firms (Faff & Marshall, 2005).

2.9.3.6 Economic exposure

Economic exposure is not easily quantifiable (Froot, Stein, & Scharfstein, 1993); Marshall (2000). Marshall observes that depending the objectives of foreign exchange exposure management exposure levels were different for UK and Asian firms, with both lower in comparison to US companies. UK firms were disposed to guaranteeing cash flows while in Asian firms keen emphasis was on minimising business risk due to exposure. Differences in region and international trade characteristics were cited as partial explanations for the observed exposure patterns. A later study by Loderer and Pichler (2002) shows similar attitudes to managing economic exposure due to a lack of accurate measure of expected future cash flows; moreover firms believe that over the long run currency fluctuations will even out.

2.9.3.7 Translation exposure

Early empirical work on exposure management does confirm that US firms were managing translation risk (Rodriguez, 1977). Marshall (2000; 2005) obtains the same results. However it has been argued by Shapiro (1998) that translation risk is an accounting concept therefore no hedging is necessary.

2.9.4 Preferences of hedging tools

A study of hedging preferences by CFOs found the money market hedge was frequently used while not so frequently used were credit swaps (Malindretos & Tsanacas, 1995). Lagging and leading, forwards contracts, diversification of financial resources, and diversification of plant, marketing and operations were the most frequently used; the authors ranked the instruments from the most used to the least used as well as the most easy to apply as forwards, diversification of financial resources, matching of payables and receivables, acceleration (leading) and deceleration (lagging), and diversification of plant, marketing and operations.

2.9.5 Rethinking dangers of derivatives

Stulz considers the dangers of derivatives and argues, inter alia, that simple derivatives like vanilla options normally have a liquid market while more complex derivatives can be challenging in finding counterparties to contracts. Longer term maturity contracts are difficult to get out of once entered into. Additionally, the valuation models can be complex and only be appealing to a few over-the-counter traders who would look for peculiar factors to ensure that they understand what it is they are contracting for (Stulz R. M., 2004).

In his letter to shareholders Warren Buffet (2003) correctly noted that derivative contracts that were far into the future were subject to fanciful assumptions by counter parties and therefore firms were able to manipulate earnings through the usage of complex derivatives.
to increase reported earnings or hiding them (smoothing) as in the case of Enron and the tax payer funded Freddie Mac, for example. And in the past year, 2012, Freddie Mac was accused of betting against home owners by taking part in complex derivatives transactions, consequently, contradicting its position of providing affordable housing (Khimm, 2012) 

Equally notable is the fact that the disclosure aspect of derivatives partially shows the stand alone risks of these instruments but do not elaborate more on how they are used.

Stulz considers whether derivative trading is aided by compensation to top management. Stulz fashions that senior management may not side with risk managers who provide a low valuation of derivative position and favours aggressive behaviour of traders, this way the stock price is boosted and consequently stock options of top managers (Stulz, 2004). Adding to the problem is also the nature of derivatives like swaps that do not impose initial costs and allow firms to assume more risk; traditional accounting treatment does not fully portray the costs involved in maintaining such risk instruments which may not be profitable in turn.

Some past examples of derivative mishaps like Enron, Freddie Mac, long term capital (LTCM) have shown the derivatives can be dangerous if not well understood and monitored. There should be proper training for the use of these products and the inherent risks should be well measured and understood (ibid). Investigations into the accounting fraud and Freddie Mac show that personnel in accounting division did not have the skills and resources in applying accounting rules (Muolo & Collins, 2003). And Soros a well known currency speculator in the financial industry, in reference to a civil suit against Goldman Sachs, commented that transactions of derivatives and synthetic products were not socially beneficial stating that credit default saps (CDO) were not allocatively efficient (Soros, 2010); derivative and synthetic securities, he argued, were creating imaginary value out of nothing. Despite their usefulness Mr Soros alludes to the fact that they can increase imbalances in supply and demand in currency markets. Moreover, he comments that usage of such tools needs to be regulated even for sophisticated users and places emphasis on the part of regulators not to allow creation of instruments not fully understood and the implicative systematic risk.

On the part of regulators, an indirectly related example on the financial crisis complacency of regulators can be pointed out, in particular, the actions of then Fed Reserve Chairman Alan Greenspan. Mr Greenspan, after warnings of possible implosion of derivatives and housing markets had maintained his stance in favour of the powers of markets and their wealth creation (Henry, 2009). Greenspan had reduced interest rates to 1% for two years creating an influx of trillions of equity dollars in real estate; this resulted in speculative craze (Ward & Fitzgerald, 2005; Whitney, 2007). On the other hand mortgages were being repackaged and sold many times over with derivatives creating incentives of bonuses, fees and commissions (US Government Printing Office, 2011). Such exuberance was clearly not of rational behaviour as the crises has unfolded and shown. Even as regulators have clamped down on financial institutions financial derivatives have shown their ugly side with billions of dollars lost buy JP Morgan (Neil, 2012). At current the troubled US state of Detroit has filed for bankruptcy with credit derivatives being partly culpable (Stephen & Henny, 2013). Over the counter derivatives are in excess of 600 trillion dollars (Duffie, 2010) clearly dwarfing world GDP Of about 72 trillion (The World Bank, 2012). Clearly there is clear and present danger of a systemic collapse in the financial markets and the global economy as a whole.

Absenting capital scrutiny due to cash flow hedging may lead to managers allocating resources improperly and consequently destroying wealth of shareholders. Heading cash flows is a double edged sword; on the one hand it eliminates the need for expensive capital markets while on the other hand it removes market discipline on poor project selection (Tuffano, 1996). Some risk management programmes are tailored to suit projects of managers and not shareholders per se (ibid). Citing several anecdotes Tuffano finds managers hedging to meet input costs to meet budget targets which may be tied to compensation schemes or to ensure that they can get more resources in future. The study
also shows that risk management may facilitate managers prolonging poor projects as evidenced in his study of mining companies. Demarzo and Duffie in their study show abuse of hedging by managers showing that young managers are concerned about reputation and wages and may hedge to enhance managerial effectiveness by eliminating unsystematic risk (Demarzo & Duffie, 1995); also see (Nam, Wang, & Zhang, 2008).

Others have argued that even when parity conditions have been disturbed market correction takes place and conditions are quickly restored (Aretz, Bartram, & Dufey, 2007). Furthermore, in line with Miller and Modigliani’s efficient market hypothesis hedging will add no value to a firm and only shifts the security market line (Dufey & Srinivasulu, 1983) which implies that risk is already discounted in the expected returns. Aretz et al. (2007) elucidate on the fact that nonfinancial firms face business risk which is at the core of operations, difficult to hedge and suggests that no hedging is necessary since they have a competitive advantage in this regard. On the other hand the authors maintain that financial risks like interest rates, exchange rates, and commodity prices should be hedged into broader markets as nonfinancial firms have insufficient skills to do so. The authors conclude that evidence on hedging and its impact on firm value is inconclusive and that firms should use derivatives as part of firm strategy (ibid).

2.9.6 Theoretical sub questions answered

**Question:** What is foreign exchange risk exposure management?

**Answer:** managing and reducing unexpected effects on foreign cash flows of assets and liabilities due to currency market volatilities.

**Question:** How is exposure measured and managed?

**Answer:** measured by the amount of liabilities or assets in foreign currency

**Question:** Why do firms hedge?

**Answer:** Firms hedge to reduce the variability of cash flows thereby enhancing firm value

**Question:** What tools are available for mitigating foreign exchange risk for small firms?

**Answer:** Firms can internally hedge by matching, asset liability management, netting, leading and lagging, and contract clauses. Firms can also use financial products like forwards, options and money market hedges.

To summarise, foreign exchange risk exposure affects firm value through fluctuations in currency prices. Firms face exposures arising from economic, transaction, and translation, respectively. Internal and external hedging functions are risk management activities aimed at reducing currency exposure. Internal methods include invoicing, transfer pricing, netting, clauses in sales contracts, leading and lagging, and asset-liability management.

External hedging methods can supplement internal methods. Financial products like forwards, futures, options, and swaps are most commonly used. Forward contracts are contracted for future delivery of currency at a agreed future spot rates. In similar fashion to forwards, futures contracts there is delivery of currency at agreed price and time. Exchanges like the Chicago mercantile exchange serve as platforms for options and other over the counter services; theses exchange futures provide safety as counterparty. Options contracts give the holder the right to purchase or sale currency but the holder reserves the right to execute the contract. Currency swaps give firms an avenue of sourcing desirable currencies for operational purposes. Money market hedges can be used through creating assets and liabilities by borrowing foreign currency and changing the currency in currency’s domestic
money market, thereby matching inflows of foreign currency with outflows of the same foreign

The pros and cons of hedging through the use of financial instruments and the overall benefits of risk management have been debated. Market efficiency theorists have argued that risk management is unfounded given that markets are well informed and therefore investor perception is not skewed. Equally, portfolio theory contends that investors can, without the help of managers, reduce risk through diversification. It has also been argued that exchange rates losses and gains even out with time. Those arguing in favour of hedging have pointed out to tax benefits, reduced financial distress, less underinvestment and reduced agency costs.

Factors determining and influencing the decision to hedge are firm size, leverage, profitability, and future growth forecast, which all affect firm value. Hedging costs and capital allocation have been shown to affect hedging. The use of derivatives have been on the rise with some firms speculating on the chance that they can increase net cash flows and has resulted in market expectations having an effect on hedging activities. Transaction risk has been shown to be the most managed exposure although it has been shown that firms don’t fully understand the exposures they face. Studies also find different approaches to exposure management among firms geographically. With regards to hedging preference forwards were the most cited as the most utilised form of hedging with matching leading and lagging, diversification

Contemporary arguments consider the dangers of derivatives given several scandals and collapse of some notable household corporations. There have been calls to monitor the use of these instruments. Additionally others have called for more training even non the part of regulators to understand what they are combating. All in all the findings are mixed with arguments justified by both sides of the argument. However it is clear that derivatives are useful when aligned with strategy and in the hands of competent managers.
CHAPTER 3

3.0 Methodology
The proceeding chapter discusses methodology and tools for collecting data to answer the research questions aimed at meeting the set out objectives. The chapter presents a short overview on qualitative epistemologies, discusses sampling and sample size, data collection, study validity and reliability and finally interview protocol.

3.1 Qualitative epistemology overview
Methods are procedures for conducting research whereas epistemologies reflect ones world view or philosophical orientation in knowing and understanding social meaning (Ambert, Adler, Adler, & Detzner, 1985). Epistemologies when considered as methodological (see Gilgun et al., 1992) influence the questions and strategies used. Qualitative epistemologies are informed by interpretive, post modern and structural schools of thought. Positivist epistemology serves the purpose of quantifying to deduce rules or patterns of social interactions.

According to Ambert et al., (1985) qualitative philosophies are founded on ethno graphical anthropology where researchers enter the natural environments of research subjects and interact with them and in a non structured manner while asking questions, and synthesising emergent theories and hypotheses; the preceding epistemology is founded by the Chicago school of thought inclined by assumptions of groups, individuals, and the form of communication (verbal and nonverbal).

Cited works on existential sociology (Douglas & Johnson 1977) and (Kotarba & Fontana, 1984) go further and argue that people are irrational (moods) and emotional (feelings) and not only symbolic interactions therefore knowledge is difficult to ascertain since participants may present fronts to non members. In this regard existential scholars argue that quality of study is determined by how close researcher and research participants are.

Phenomenology discourse is based on common assumptions of everyday life. Heritage (1992) summed up this as “the common sense resources, procedures and practices through which the members of a culture produce and recognise mutually intelligible objects, events, and sources of action.”

The feminist paradigm has been essential in the revival of qualitative family research (Ferree, 1990). The feminist approach seeks to explain social positions and experiences of women; there are no specific feminist philosophies but use methods that align with feminist values. Feminists argue that research can only have a partial view of what is studied due to social position held by researcher (Gross & Pateman, 1986; Smith, 1990). This in turn affects ones approach to methods and interpretation.
A qualitative approach is the method for this study; the research is deductive reasoning or theory testing. The methodology used is important too due to the fact that the case study enables one to collect data in various ways and thereby tackling an issue from various facets (Verschuren & Doorewaard, 1999). Qualitative methods, according Bogdan and Taylor (1975), result in descriptive data that; that is, participants’ words, own writing or expressed behaviour.

The project will be done using a case study approach. This method is ideal when looking at a situation in a holistic manner. Moreover, the method allows me, the researcher, to observe the natural environment of the problem at hand. It will also enable me to make adjustments accordingly when needed, especially when considering interviews and other operational aspects like travel, for example. Authorities on research methods supporting this view have argued that case study methodologies address numerous issues like attitudes and behaviour, for example which help one to grasp complex phenomena (Hancock & Aglozzine, 2006). Furthermore, qualitative methods are grounded in hermeneutics and phenomenology philosophies, respectively, that explain human experience and the meanings and interpretations we infer (Kvale, 1996)

According to one of the foremost advocates of research methodology, case studies, in many respects, are suited to answering questions of “how” and “why” (Yin, 2009). He further adds that case study research can be categorised as explanatory, exploratory and descriptive case study respectively. Moreover as not all variables are known beforehand this research design enables for flexibility.

Eisner (1991) succinctly points out stating that quality of a qualitative study should help un in understanding the state of affairs that are confusing or enigmatic. Reliability in qualitative inquiry informs us of the quality of the research (Golafshani, 2003). The concept of quality is for the purpose of generating understanding (Steinbacka, 2001, cited by Golafshani)

3.2 Sample selection
A single case analysis is the sample for this study. Sampling is a function of questions posed, the availability of participants, the purpose of the study, and the complex nature of the model under study (Marshall M. N., 1996). The sampling approach for this study is an overlap between convenience sampling and judgemental sampling (ibid) this option meets important operational conveniences of access to subjects, time, and money. The convenience method may suffer from poor data quality. However it is complemented with purposeful sampling (expert subjects) of the judgmental approach and therefore is intellectually sufficient. Moreover, Marshall does allude to the fact that all qualitative studies have elements of convenience sampling.

Equally important, relationship between researcher and research participants, access to documents are factors that may impose limits on sample size and the parameter for study. Ambert et al., (1985) state that if the goal is to generalize to entire population then sample size should be large ad representative; on the other hand if intention is generalizing to theory then a small sample will suffice. When considering a single case study there are drawbacks unless it is representative of many perspective and realities and enshrined in ethnographic meanings or interviews with several participants. Advocates of the single case analysis put forward that single case studies are robust for probing feelings, context relationships and multifaceted points of view (ibid).
3.3 Data collection
Data will be collected from primary, secondary, and tertiary sources.

Primary sources:
- Interviews with the company director, company accountant, and data from company documents.
- Organisational publications like IMF, World Bank, and ECB.

Secondary sources:
- Research journals, Scholarly journal reviews, text books, news articles, course materials

Tertiary sources:
- Text book chapters and dictionaries

Data sources to be accessed through the library and through the Rotterdam business school’s databases. Relevant external data bases will also be consulted.

3.3.1 Tools
- Semi structured interviews will be used.
- Observation will be conducted by visiting the working premises of the project owner.

3.3.2 Interview
Spardley (1979) quoted in Kvale (1996) expressed his thoughts on interview inquiry as:

*I want to understand the world from your point of view. I want to know in the way you know it. I want it understand the meaning of your experience, to walk in your shoes, to feel things as you feel them, to explain things as you explain them. Will you become my teacher and help me understand?*

An interview is a platform on which knowledge is constructed as interviewee and interviewer characters’, respectively, interact (Kvale, 1996). Kvale notes that early stages of an interview are critical in that interviewee will feel more at ease in expressing thoughts and feelings once they have grasp of the interviewer.

Interviews can also take a different tone with regards to hypothesis testing vs. exploration; interviews may as well differ in the way they are interpreted and described with the interview taking a nuanced description of phenomena or a cooperative approach with the interviewee taking part in clarifying and interpreting observations together.

3.4. Validity and reliability
Patton (2000) argues that validity and reliability are of great concern for qualitative research during the design stage. One solution to this is that quality of each paradigm should be subjected to or judged based on its paradigm confines (Healy & Perry, 2001). Joseph Maxwell (1992) in arguing for validity typologies states that there are no procedures that produce conclusive or sound data on a regular basis. He further points out works of Brinberg and McGrath (1985) who support that validity cannot be commoditised and purchased with techniques further that it is more like integrity, character, all to be taken and assessed in relation to circumstances and purpose. Maxwell makes the important point of stating that *understanding* is a more fundamental concept in qualitative approach than validity per se.
Creswell (2009) provides eight validating strategies for documenting the ‘accuracy’ of the study and recommends that at least two of them are engaged by qualitative researchers.

- Prolonged engagement in the field to build rapport and making decisions on what is relevant and of interest to the study.
- Peer review or debriefing to act as external check to the study.
- Refining and revising initial hypothesis until it aligns with objectives.
- Clarifying researcher bias.
- Member checking; Creswell among other edicts argue for soliciting the views of participants on findings and interpretation as the most crucial element in establishing credibility; research findings should be taken back to participants to confirm or refute accuracy of results. Member reflections can shed light on whether participants to the research understand and appreciate the study. Answers to questions such as, do participants care? Do they find the study interesting? Have they taken time to read through the report? Can be telling as to the quality of the processes and contribution of the study (Tracy 2010).
- Rich and thick descriptions enable readers to make judgement on whether information can be applied to a range of other settings. The onus is on researchers to show and substantiate the complexity and circumstances of their data (Tracy, 2010); the data provided should be well detailed such that participants reach their own conclusions.
- Having external audits by persons not connected to the study to assess the methods and results to ascertain whether conclusions fit the data provided.
- Triangulation, which is, using different sources of information and data.

Tracy, adding on to the work of Golafshani (2003) and complementing Creswell among others, on best practices in qualitative research elaborates on multivocality, significance of the research, and ethical considerations with other themes already mentioned by Creswell above and therefore omitted:

- Multivocality encourages view points of many including those that diverge from the researcher’s views or are in a minority group and therefore, researchers should be aware of cultural differences and other demographics like race, gender, sexual orientation which can result in different connotations in the field.

Significance: research can be theoretically implicative for scholars, heuristically significant, practically and methodologically significant, respectively.

Practical significance asks if the knowledge generated is useful, whether it brings to light and frames a contemporary situation whether it is empowering for participants in perceiving the world differently, and whether it brings about justice for individuals. Furthermore, research should not displace social conditions but be complementary and supplementary.

Theoretical significance, on a lesser level, builds on current body of theoretical literature and studies how the concepts operate in different and changing environment. On a more advance level the study should challenge the status quo such that contributions from data result in insightful ways of conceptual perception that can aid future research.

Heuristic significance should elicit curiosity for further research exploration. Value can add to heuristics by making recommendations for future research where gaps are present or new contexts that might be interesting to consider. Some overlaps exist between practical and heuristic significances.

Methodological significance can be established through novel ways of study even with unsurprising theoretical findings. Tracy states that significance can come from re-
examining a study based on quantitative methods, for example. Additionally, new ways of expressing data and poetic evocation can contribute to the practice and craft skills in methodology for future researchers.

Ethical: relational and exiting ethics are categorised. Relational ethics considers how aware the researcher is of her/his character, the actions taken and how they impact on others. It emphasises care and mutual respect between research participants and researcher. Exiting ethics brings to point that researchers have no control of their study ex post data analysis and therefore researchers should be mindful in the presentation of their findings so that they converge with intended outcome and minimise misunderstandings in how it is read and used.

This thesis will implement the following two strategies:

- Member checking. Soliciting the views of participants on findings and interpretation is the most critical element in bringing about or establishing credibility. Creswell among other notable experts posit that findings should be taken back to participants to confirm or refute accuracy and credibility of findings.
- Rich and thick descriptions of observations of the working environment; the project owner has agreed, if time and other logistical issues allow, to take part in one or two business trips to observe business dealings with clients.
  - Triangulation.
  - Researcher reflexivity.

The strategies above will enable for triangulation of findings and interpretations of company data and information from interviews and field observations, respectively.

Reliability will be enhanced through detailed field notes obtained. Furthermore the recordings of interviews will be transcribed. Coding will be done using software if resources allow. Creswell (2009) suggests that coding follows resources and time availability.

3.5. Interview protocol

Interviewees will be notified ahead of interviews ahead of time. Additionally, they will receive the interview protocol in order to prepare and familiarise themselves with the concepts used in the study and the general research being conducted. More importantly participants will be asked for consent to record the interview sessions (Kvale, 1996).

In summation, case study methods answer “how” and “why” things are the way they are. Through hermeneutics and phenomenology philosophies qualitative methods help explain the lived experiences and shape the perspectives we draw. Qualitative approaches are flexible thereby allowing for several methods of collecting information. Qualitative methods allow the researcher to be intimate with research subjects and build rapport. Qualitative epistemologies as methods of research have a bearing on questions and strategy employed. Deficiencies in generalizing results of single case study are supplemented by the robustness that case study approaches require.

The sampling and sample size of a single case study was selected to meet the requirements of subject availability time and other resource consideration. Data collection makes use of primary, secondary, and tertiary sources, respectively; interviews and company data serve as the primary sources. To ensure validity and reliability the study makes use of member checking and making of rich and thick description, triangulation and researcher bias as strategy tools. Ethical considerations for participants and the study itself are observed at all times.
CHAPTER 4

4.0 Findings

This chapter presents and discusses the findings from data provided by the study case company, and data gathered from field interviews with company personnel from Lanka, the director for Lanka Leisure Hotels in Amsterdam, the chief accountant of the Lanka group and consultant financial logistics officer at Rabobank. The chapter also presents themes emergent from the interviews conducted. Interview transcripts are provided in appendices. Effort was made to transcribe as recorded; additionally audio recordings are attached.

4.1 Company data

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*Please see Appendix A for company accounting data

4.2 Case study interviews

The primary mode of data collection was through interviews. Three interviews were conducted (4th interview agreed in principle but date to be confirmed). The interviews were as follows:

1. Mr Malinga: Director Lanka Hotel and Travels (Amsterdam) 5th September 2013
2. Mr Weusten: Rabobank Maastricht 16th September 2013
3. Mr. Maplagama: Lanka Finance 17th September 2013
4. Mr. Kuipers: Senior Treasury Advisor ABN-AMRO Markets

Attempts to get an interview, with the Treasury school at VU Amsterdam did not materialise. The hope was to get information with regards to the skills and training need to run risk management programs and the maturity level a business has to reach to engage in risk management. However I decided to pose the same questions to the banking considering foreign currency risk management is normally their preserve.
Interview consent forms were sent to participants ahead of time and a copy produced at time of interview for signature and further clarification if need be. Additionally summary of themes or issues to be considered were stated when appropriate. Please refer to appendix F for consent forms.

4.2.1 Interview 1: Mr. Malinga

The introductory interview was very open. I did not have any prescribed questions to ask. I was interested in the owner talking about the business profile in general and the opportunities they saw in the Netherlands. Mr Malinga spoke at length on the hotel and leisure industry explain their set up there and how the elephant ridge hotel, a hot spot for tourists has been so successful and provided funds for other projects. He noted that they were competing on price in Sri Lanka and were on course to building up a new boutique hotel for the upper market which would be at affordable prices due to their input costs being lower, particularly building materials sourced from China.

And when prompted on the spic opportunities in the Netherlands and the resulting currency risk exposure created he pointed out that there was huge potential in the Netherlands for spices and mentioning that the Dutch Chamber of Commerce had given its blessings provided all the other requirements like quality control and other certifications were in place. Lanka plan to enter the food industry at the Horeca level and slowly build up from there and expand to bigger suppliers; Lanka are currently working on distribution channels in the Netherlands.

Mr Malinga expressed that he was aware of how currency fluctuations were a problem and how they can “really hurt the company” citing difficulties that can arise especially when trading and particularly when pricing, noting that they could just not mark up prices easily thereby putting them at “quiet some risk.” Furthermore he expressed his desire to He then talked about an oil hedging deal that resulted in the government of Sri Lanka losing money; malpractice and corruption were mentioned and of interest was the point he made about not fully understanding what contracts they were entering into.

Afterwards I thanked him for his time and he was courteous to say he was always available if needed; we then had some refreshments and he escorted to the train station.

4.2.2 Interview 2 Mr. Weusten (Consultant Financial Logistics at Rabobank)

Before the interview began I asked Mr. Weusten if he had gone through the consent form he acknowledged that he had but asked that he checks his computer to make sure. I then produced a hard copy for him which he read through and later declined to sign. I asked as to why, explaining to him that it was important for his own rights as a participant and as well as for the integrity of my thesis. However, he still refused to reconsider and stated that as long as he was being recorded he was fine and saw no reason to sign anything.

The interview started off with Mr. Weusten explaining the profile of Rabobank, the 136-140 smaller banks affiliated and the autonomy they have with the occasional consultation with headquarters in Utrecht when further expertise are necessary. He also alluded to the fact they performed better in the receding crisis due to the banks long term view as he described It and unaggressive behaviour.

When asked about product range for managing currency risk exposure and any offerings for small firms he responded that they had forward contracts, call options and put options. Other than that he stated that companies would transact on the spot. Forward transactions were more popular with larger companies participating more in options. Further he stated that when businesses had a healthy profit and loss account they were more content on taking the chance with the spot transactions and sometimes passing the costs onto their customers or counterparties. He explained that even with good profits it was important “to take care of currency risk.”
On questions of advice and better management, external versus internal methods of hedging and how a firm can save money on some of the product offerings, Mr. Weusten responded that firstly had to ensure that the client understood what product they were selling and secondly, implications to the profit and loss account were explained to the client if prices change and the client had the final say on the way forward. On how companies could make money Mr. Weusten in not so directed terms commented that the most important thing was whether the hedging process provided marginal benefits to the firm in question and its risk tolerance. Mr Weusten also highlighted that since the financial crisis firms are more responsive to currency risk and always looking at solutions. He also noted that the horizon for hedging was formally one year according to banking regulation but the commonly observed period was for six months.

When asked about expertise needed for currency risk functions Mr. Weusten stated “absolutely, you need a lot of expertise because you can’t sell these products without knowing what is happening.” He maintained that a lot of training was needed (bankers) and that they often took exams, further stating that it was impossible for one not know what was happening. To the question of maturity a business has to reach for engaging in currency risk management, bigger firms had more specialised personnel to handle currency risk while smaller firms at the start tended to consult the bank but still stated that even smaller ones had controllers as well to know what was happening (currency risk exposure).

4.2.3 Interview 3 Thushara (Lanka Ice Group Chief Accountant)

The interview could not be done through video or voice call as Mr. Thushara had some technical difficulties so we opted to use the chat method in Skype (see appendixes). The following is summary of the interview:

Mr Thushara estimated that the Lanka Ice Group of companies had exposure between 0 and 25 percent respectively. There suppliers normally quoted in USD and therefore there trading currency. Further he mentioned that they were currently negotiating with suppliers on forward contracts. They currently transact on the spot through letter of credit on sites basis. He also stated that normally they experienced currency fluctuations of about 10 to 15 percent of which was reflected in the prices to customers in the local market which was price competitive.

Mr Thushara also alluded to the fact that the financial markets don’t offer that many products and most firms were resigned to letter of credits, telegraphic transfers and demand drafts. He added that they also anticipated challenges with capital management, particularly the conversion cycle due to contracts with suppliers. He also stated that there was no currency risk management at the firm whatsoever but were working on it now. On policy matters, the Lanka directors had the final say on decisions and that directors were present at monthly meetings held by senior management. And on implementing risk management Mr. Thushara as chief accountant would be in charge of dispensing with risk management matters.
4.2.4 Interview 4: Mr. Wouter Kuipers (Senior Treasury Advisor, ABN-AMRO markets)

Due to illness Ms. Viergeijzer, my earlier contact was not able to take part in the interview as hoped. However, she asked another colleague, Mr. Kuipers, to take part who kindly agreed. Mr. Kuipers unfortunately at time of interview did not have facilities to conduct interview through Skype. I did also mention that we could have it through Google chat but after deliberation with Mr. Kuipers, and given time constraints, scheduling problems and other possible unforeseen happenings I made judgement call to have the telephone interview then.

Mr. Kuipers was reluctant to sign the consent document but I informed him that it was for his own rights and also the integrity of my paper. He read through it and stated in a short email that he was “ok with doc” and that would later sign the document and send scanned version.

To the first and second questions on product range and offerings for small businesses Mr. Kuipers indicated that forwards were the most common tools and that if companies wanted more, options were always available. Furthermore, interest rate risk solutions were available depending on business needs.

On internal versus external methods considerations, he indicated that it depended on the risk faced. He also confirmed that if companies can match their foreign currency inflows and outflows it was a good way to hedge. He still maintained though that much was down to risk faced and what the company needed. Mr. Kuipers also explained that it was also dependant in the type of market one operates in when dealing with currency risk. Another point was that sometimes it was better to shift the risk to your counterparty if possible.

And his response on business maturity level needed for currency exposure management Mr. Kuipers stated that risk management should be done in the early stages of the business cycle, further stating the need to be knowledgeable to do it. He also noted that it depended on risk, what the company sees as risk, stating that as CEO one has to be aware of risks a business faces and that one obviously needed to consult before starting a risk management programme.

Mr. Kuipers was asked whether he thought Letters of credit were an effective tool to which he replied that LOCs were guarantees to pay, eliminating counterparty risk, which was assumed by the bank. Mr. Kuipers also indicated that it was possible to purchase forwards for various amounts from as much as €25000 while highlighting that it was all in relation to the volume and risks faced.
4.3 Data analysis

Denzin and Lincoln (2000) suggest that new researchers can benefit from starting off analysis by hand; the authors further state that software is no substitute for sound analysis.

I tried to engage into a few software programmes to learn coding but they have proved difficult to use and time consuming altogether. Moreover listening to the interview several times helped in establishing a few themes already and thus opted to transcribe and code manually. Different lenses can and will result in different themes but if properly done should lead to similar inferences. An important consideration too is the intimate relationship with the data when done personally resulting from personal transcribing albeit a time consuming task. The process enables for a careful inspection and understanding of the data especially when searching for themes (Denzin & Lincoln, 2000)

Malterud (2001) gives four steps to data analysis starting with getting an overall perspective, identifying meaningful units or themes, content analysis, and lastly summarising. Malhotra and Birks (2006) have a similar approach which gives the following guide to data analysis:

The analysis process is motivated by the works of Denzin and Lincoln who cite several notable qualitative experts. The coding action in and of itself is data analysis (Miles & Huberman, 1994). Willms et al, (1990) posit that researchers begin by deriving themes from the literature review and develop other themes and sub themes as they progress (see also Miles & Huberman, 1994).

The data is collected through interviews and cash flow statement from the company for the year ending 2012. The company data was run through scenario analyses which are provided as summaries in later sections. As the interviews were few and allowed for simple coding and reduction of themes.

And an important consideration studying the lived human experience or try to understand certain phenomena is that there is inevitable bias which comes as part of the human condition for one reason or another. As Gilgun (2005) notes, we have preconceived biases and thus our interpretations are subjective; the subjectivity, Gilgun adds, has the potential to develop into rich and thick insights or result a researcher losing the analytic perspective. Later in the discussion section my reflections make mention of my biases as a researcher.
4.3.1 Company data analysis
A simple scenario analysis was run in excel to show the effects of the dollar depreciating against the Sri Lankan rupee by 35 percent and then appreciating 10 percent in 2014. Scenario manager summaries are presented below:

<table>
<thead>
<tr>
<th>Scenario Summary 1</th>
<th>Current Values:</th>
<th>Aggressive depreciation @ 35%</th>
</tr>
</thead>
<tbody>
<tr>
<td>YEAR</td>
<td>2013</td>
<td>2014</td>
</tr>
<tr>
<td>MONTH</td>
<td></td>
<td></td>
</tr>
<tr>
<td>APRIL</td>
<td>$198,755</td>
<td>$2,014</td>
</tr>
<tr>
<td>MAY</td>
<td>$176,038</td>
<td>$114,425</td>
</tr>
<tr>
<td>JUN</td>
<td>$177,878</td>
<td>$115,621</td>
</tr>
<tr>
<td>JULY</td>
<td>$94,981</td>
<td>$61,738</td>
</tr>
<tr>
<td>AUG</td>
<td>$102,108</td>
<td>$66,370</td>
</tr>
<tr>
<td>SEPT</td>
<td>$112,482</td>
<td>$73,114</td>
</tr>
<tr>
<td>OCT</td>
<td>$81,176</td>
<td>$52,764</td>
</tr>
<tr>
<td>NOV</td>
<td>$38,524</td>
<td>$25,040</td>
</tr>
<tr>
<td>DEC</td>
<td>$126,249</td>
<td>$82,062</td>
</tr>
<tr>
<td>JAN</td>
<td>$29,190</td>
<td>$18,974</td>
</tr>
<tr>
<td>FEB</td>
<td>$130,172</td>
<td>$84,612</td>
</tr>
<tr>
<td>MAR</td>
<td>$78,402</td>
<td>$50,961</td>
</tr>
<tr>
<td>Cash flow Total</td>
<td>$1,345,956</td>
<td>$874,871</td>
</tr>
</tbody>
</table>
### Scenario Summary 2

<table>
<thead>
<tr>
<th>YEAR</th>
<th>Current Values:</th>
<th>Conservative @25% appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2013</td>
<td>2014</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>MONTH</th>
<th>Current Values</th>
<th>Conservative @25% appreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td>April</td>
<td>$218,631</td>
<td>$248,444</td>
</tr>
<tr>
<td>May</td>
<td>$193,642</td>
<td>$220,048</td>
</tr>
<tr>
<td>June</td>
<td>$195,666</td>
<td>$222,348</td>
</tr>
<tr>
<td>July</td>
<td>$104,479</td>
<td>$118,726</td>
</tr>
<tr>
<td>August</td>
<td>$112,319</td>
<td>$127,636</td>
</tr>
<tr>
<td>September</td>
<td>$123,731</td>
<td>$140,603</td>
</tr>
<tr>
<td>October</td>
<td>$89,294</td>
<td>$101,470</td>
</tr>
<tr>
<td>November</td>
<td>$42,376</td>
<td>$48,155</td>
</tr>
<tr>
<td>December</td>
<td>$138,874</td>
<td>$157,811</td>
</tr>
<tr>
<td>January</td>
<td>$32,109</td>
<td>$36,488</td>
</tr>
<tr>
<td>February</td>
<td>$143,189</td>
<td>$162,715</td>
</tr>
<tr>
<td>March</td>
<td>$86,242</td>
<td>$98,002</td>
</tr>
</tbody>
</table>

**Cash Flow Total**

<table>
<thead>
<tr>
<th>Current Values:</th>
<th>$1,394,39</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conservative @25% appreciation</td>
<td>$1,682,445</td>
</tr>
</tbody>
</table>

**Notes:** Current Values column represents values of changing cells at time Scenario Summary Report was created. Changing cells for each scenario are highlighted in gray.

**Source:** Authors own production
4.3.2 Interviews
After listening to the recording and reading the transcription of the interview the following themes emerged: some themes were explicitly from interviewees. Others are inferences from the author based on several audio replays of the interviews and text analysis. The themes are displayed in the world cloud below:

![Emergent themes](image)

Figure 2: Emergent themes

Source: Authors own production

4.4 Discussion

4.4.1 Company data
Having looked at the company data it is surprising that they have not really thought about currency risk management explicitly. The amounts are quiet substantial and if the dollar, for example, moves adversely against the Sri Lankan rupee it would result in some significant outflows as indicated by the scenario analysis; equally the firm could save money from favourable movements. And considering the use of letter of credit it is safe to assume that they make payments at the going spot rate at time of payments and therefore Lanka is very exposed.

4.4.2 Interviews
The first interview was very informative despite it being an introductory. Mr Malinga was passionate about the business and talked at length with not much solicitation needed to engage him. From what I could infer they are trying to compete on price but at good quality. I am not sure exactly if that’s good strategic choice if one considers that quality and price move in the same direction, and being familiar with Porter and strategic management theory one can only employ one strategy and not both. However, Mr. Malinga did mention for example using contractors from China who were price competitive and able to produce prefabricated materials at low prices. This point had me reflecting on a past semester course in project management were it was taught that quality was what the end user wanted and therefore will differ and not necessarily universal. Additionally, considering that Sri Lanka is a
developing nation strategy issues of price and quality may not really be a great factor as would be the case in much more industrialised countries. The niche entry strategy and establishing name was very good I thought and seems to be a good work in progress.

Mr Malinger at the end of the interview talked about an oil deal gone wrong due to malpractice issues, but importantly also pointed to the issue of those contracting not fully understanding the mechanics of the financial products involved; this ties in with Stulz and many other experts on the need for skills and training needed to engage in some of the hedging products. Mr Malinga also noted the importance of being knowledgeable about currency fluctuations and how they could “hurt” firms especially when doing international trade.

Additionally the interview from Mr. Thushara echoed Mr. Malinga’s comments on price competition by alluding to the fact that the currency fluctuations that the firma faced were passed on to customers through price adjustment. My thoughts are that competing through price is something that other firms can easily replicate and not really a source of competitiveness unless you enjoy economies of scale. As they negotiate with new suppliers they should consider shifting the risk on to the suppliers as opposed to customers or finding a balance in between. It is not sustainable in the long run; however, it all depends on demand elasticity Lanka faces in its home market. It was not very clear as to why there was no currency risk management in place but I concluded that it had to do with the available products in the market as Mr. Thushara had explained. I think that as they consider and embark on risk management strategy they will find the right balance of managing currency fluctuations which would enhance their price competitiveness.

Mr Weusten’s interview very much highlighted the need for expertise in managing a currency risk management programme albeit from a banks perspective, it is clear that skills and training have to be there even for small firms. Theoretical literature and other empirical findings indicate it is that it is expensive to run risk management programmes. Obviously for larger firm’s risk management motives differ either for personal entrenchment or genuine concerns for shareholders and the firm as a whole, than for a small business whose strategy and motives are likely to be motivated and influenced by the company owner. I do agree with both bankers that risk management decision is the responsibility of the firm because the firm has understanding of its operations and is more likely to understand the risks it faces. An external perspective in the form of consultancy is always welcome, however.

4.4.3 Strengths and weaknesses

Following the interviews with one of the company directors and head accountant, the following were determined to be the strengths and weaknesses of Lanka Ice Group of companies:

<table>
<thead>
<tr>
<th>Strengths</th>
<th>Weaknesses</th>
</tr>
</thead>
<tbody>
<tr>
<td>LC on sites basis removing transaction costs and time saving</td>
<td>Underdeveloped financial infrastructure</td>
</tr>
<tr>
<td>Credit reputation</td>
<td>No systematic way of managing financial risks or other risks</td>
</tr>
<tr>
<td>Management support form directors</td>
<td>Weak Rupee</td>
</tr>
</tbody>
</table>

Table 3: Strengths and Weaknesses

Source: Authors own production.
4.4.4 Personal reflections
The whole process has been a good learning curve. It is the first time doing this type of research, very different from my bachelor study. It was filled with lots of exams and occasional essay assignments of which had lots of calculations to perform. My mind has been biased towards presenting everything in numerical form. And this has presented problems with the case study and have had to struggle with my thoughts as to whether the study would be valid especially in the early stages when reading on methodology and the criticism levelled at qualitative approaches, furthermore, it was not helped by the fact that I was biased towards number crunching; however the questions guided the methodology.

Initially I had preconceived ideas or biases that small businesses were not capable of running risk management program. I thought that they were expensive and that a company needed a very large amount of cash for some benefit to materialise. I also thought normally financial products are mostly for speculation and not particularly useful for non financial firms and particularly small firms. My bias was also influenced by my undergraduate studies in management especially the course on small businesses were it was clear that small businesses lacked long term strategic view and was expecting my sponsor firm to show such characteristics had it in mind that Lanka’s annual revenues were not sufficient for external hedging. Having spoken to the bankers however it was evident that small firms were hedging for smaller amounts.

The more I read and reflected I started to appreciate the qualitative approach, and also realised the amount of care I needed to have in collecting my data. Not everything can be explored or explained through numbers especially when we are trying to investigate phenomena like human behaviour; it’s something that needs in-depth probing at a personal level. I think it’s because positivist paradigms which emerged earlier and have, over time, conditioned a lot of us of seeking logical and scientific ways of expressing everything. However, no method can be said to be completely one or the other I think it’s a continuum, I did minor simulation to show my sponsor company what fluctuations can affect revenues to get my point across, for example, which may constitute aspects of quantitative analysis.

When it came to interviewing I was worried that my skills might not be up to date. We had practiced a single session during the Research Methods classes but it was with fellow student which lessened the nerves. Out there in the field work I would meet professionals including the company personnel and did not want to seem unprofessional compounded by the act that I was a master student and a certain level of conduct was expected. The interview with the company director was good the man was relaxed and which relaxed me as well although I noticed that I occasionally finished the sentences or ideas for him or talking at the same time which was a problem during transcription on a few segments. In the second interview I was mindful not to talk at the same time although it did occur a few times but I thought of it as learning and not to let it affect me.

One thing I also noticed which reminded me why the lecturer was adamant on having semi structured questions was the way participants talked and meandered to other topics especially the first introductory interview and to a lesser extent in the second interview. And I noticed it as well when I asked them if they was anything they would like to add on with which I was always scared would lead to something else.

I did not very much like the last two interviews with senior treasury advisor at ABN-AMRO and the head accountant at Lanka. I felt they were very impersonal. The modes of communication removed the expressiveness and implicit communication that face to face or video communication have, although lesser for the latter. In both cases we had to improvise which is one aspect I appreciated with qualitative approach, the ability to act on the spot and collect data.
In concluding, the study is accurate reliable but I think it may struggle on generalization based on the sample size. When one considers empirical evidence in literature review and the fact that small businesses in general lack the skills and expertise to run risk management programs which can be costly altogether. Sometimes the marginal benefits may not even be clear for having risk management. And it is clear from the banks that normally big clients are more likely to engage in swaps and interest risk management, which more or less can be inferred to mean that size, is a factor. However it is also possible for a small firm to engage in risk management, I feel, if its business is based on import and export, with a deterrent possibly being on the type of product available in the market. From the information gathered from the banks forwards are affordable and of course depends on ones bank and possibly volumes being traded.

Despite my never ending worries about validity of my study, and despite it being a single case study, however, I feel in and of itself regarding the circumstances is unique and can be replicated with similar results obtained. Moreover, it is honest and reliable. Of course more cases could have been selected and maybe pursue a more mixed methods approach with a larger sample size for generalization purposes, of which might not still explain to us certain behaviours, but it is one consideration that can be done for future study of which I strongly expect would lead to similar conclusions.

Moreover the findings are of practical significance in pointing the way forward for the firm. Whereas it may not radically change the present situation it will go a long way in empowering the firm’s management by having open perspectives on challenges faced in their journey in search of solutions. The important thing is that the study achieved its set out objectives and the findings corroborated with research participants. And as argued before the work of this thesis has to be scrutinised on its context.

4.4.5 Empirical sub questions answered

**Question:** What is the size of Lanka’s currency exposure?

**Answer:** Estimated between 0 and 25 percent, respectively

**Question:** What are current tools available and used by Lanka Group for foreign exchange management?

**Answer:** Lanka makes use of Letter of Credit on sites basis

**Question:** How are these tools used or not used?

**Answer:** Short term loans are contracted and settled on a monthly basis.

**Question:** What are the strengths and weaknesses or limitations of current practices?

**Answer:** Management has full support of company owners while operating using the Letter of Credit gives the firm a good reputation. Lanka’s external hedging choices are limited by underdeveloped financial market infrastructure

**Question:** What obstacles does Lanka Group face for better risk management?

**Answer:** Poor finance infrastructure in local market and unstable currency

**Question:** How can their risk management practice be improved?

**Answer:** The risk management can be improved by conducting a corporate-wide risk management programme as listed in the recommendations with primarily matching purchases and sales in foreign currency.
In summary, scenario analysis of provided result indicates the gains and losses of cash flow if the currency moves in favour or against the firm. Interviews with Lanka Ice Company personnel reveals two strategies of price competition and quality in the different lines of business it has. Management has the basic appreciation of the possible impacts associated with currency fluctuations and now considering risk management. The local environment lacks modern financial products which consequently affect the tools available to firms, and therefore a weakness; the firm’s management is firmly supported by the Board of Directors.

Treasury specialists at ABN-AMRO and Rabobank point to forward contracts to be the most hedging tools by both small and larger firms. Both experts additionally explained the need to have training and skilled personnel running risk management. The decision to hedge should the sole responsibility firms as they were in a better position to understand the risks they faced, it was pointed out. Important too was the need to start risk management activities in the early life cycle of a firm. On fieldwork matters the fieldwork work brought its own challenges especially with conducting the interviews which was a good learning curve. The flexible nature, strength of the qualitative approach was shown through improvised interviewing methods when circumstances determined so. It has been a going concern to ensure validity, and taken within the given context, the strategies employed, the study is valid and reliable.
CHAPTER 5

5.0 Conclusion

Since the era of the Bretton Woods currency volatility has increased and firms face uncertainty with regards to prices of various goods and services. Large or small, trading or non trading, firms are exposed to economic, transaction, and translation risks, respectively. Risk management activities are aimed at minimizing expected earnings variability. From a managerial point of view risk management helps in balancing the risk and returns; risk management provides a mechanism for strategy execution and remove much uncertainty that would cause financial distress. Risk management over time enhances firm value.

Many arguments have been put forward by academics and practitioners on the merits and demerits of financial risk management. Those arguing against suggest that markets are efficient enough to restore any deviations from parity conditions. It is also argued that investors are diversified and therefore managing risk by corporate managers is an unwarranted activity. These advocates further add that risk management benefits managers who either want to show their managerial skills or want to maintain the status quo. They cite that these agents (managers) destroy shareholder value in favour of their own empire building. And recent derivative disasters have sharply refocused debates on the nature of risk management and the costs inherent both in undertaking risk management and possible consequential fallout from it.

Proponents of risk management posit that pre-tax value variability is reduced resulting in increased firm value. Also it is argued that uninsured losses can drastically affect firm revenues. Furthermore, shareholders benefit from risk management as price of their firms debt increases. Additionally financial risk management can impose limits on lavish behaviour and embarking on self enrichment projects at shareholder sixpence through contract covenants. Advanced as well is the point that underinvestment, and financial distress are removed due to risk management.

Firms can manage risk through internal mechanisms or make use of tools in the financial markets. Internal methods include matching, lagging and leading, contract clauses, foreign denominated debt, or operational configurations in the long run. Financial markets provide various hedging instruments like swaps, options, futures, and forwards contracts as most common tools for external methods. The use of financial products comes at a cost. Costs can be prohibitive for small firms in particular. Capital allocation, agency costs, monitoring, are some among many elements to be factored in when deciding on a risk management programme. Important too is the training and skills needed to implement and run risk management programmes for which lack thereof can be an Achilles’ hell for small firms and even for the more established larger firms. Risk management is an avenue for firms to shift risk they cannot bear to those better suited to do so.

The data supplied by Lanka Finance does show considerable amount of cash flow from glass import in USD with payments settled through short term loans secured by Letter of Credit. The accountant revealed that the firm has an estimated exposure between 0 and 25 percent, respectively, all denominated in USD; the exposure is expected to grow as the business expands into spice exports to the Netherlands. The interviews with the director and accountant point to price competitive strategy in Sri Lanka with niche approach favoured for breaking into the Horeca industry in the Netherlands. The firm is also negotiating favourable terms with suppliers with which the accountant expressed concerns that it might affect their cash conversion cycle. In moving forward the chief accountant stated that he would be in charge of any risk a management program with the full confidence of the Board of Directors.
The interviews at Rabobank and ABN-AMRO Treasury converge on expertise and skills needed to run a currency risk management program either form a banking standpoint or any other non-financial firm; it was also highlighted that big firms had specialists for such while maintaining that controllers were nonetheless present in most small firms who understood currency risk. In both settings forward contracts were nominated as the first choice of hedging currency risk for all business types and sizes with options, currency swaps, and interest rate risk products for the preservation of larger firms. The interview findings on the hierarchy use of hedging instruments are consistent with literature review which also indicates forwards to be the most favoured method of external hedging.

Additionally, it was revealed that risk shifting to counterparties and matching were other methods to consider when reducing exchange risk. Importantly the banking officials identified the need for the company to be aware of risk faced and take appropriate action as early as possible in the business’ life cycle aided with professional consultation. Moreover, a firm needed to weigh the benefits and costs of managing the risk. The need to be mindful of currency risk, its potential dangers and being knowledgeable about it is a view shared by the company director at Lanka Hotel and Travel.

Finally, the use of derivative instruments and other financial products in competent hands, aided with strategic alignment and careful monitoring can offset costs of risk management and provide value to shareholders and company stakeholders, and result in economic welfare for the larger economy. The upside and downside of risk management have to be carefully evaluated for any firm engaging in risk management activities.
5.2 Recommendations

Having considered the literature review, data gathering and analysis of the data, it will save the interests of the company well to carry out a corporate wide risk management program. To carry out an effective program a foreign exchange risk policy will have to be made. The policy has to ensure that key aspects are included to ensure that risk is measured and properly managed. The following are the recommendations for Lanka Group of Companies:

Management

First and foremost there is need for training and education for treasury personnel, including those that are related to purchases and sales, in currency risk management. Only thereafter can the firm establish policy manifesto.

The policy document should clearly and precisely state management philosophy, objectives and goals of the treasury. There is need for the Board of Directors to explicitly express their support for the treasury through a policy document; leadership sponsorship is very central to realise any successes.

Key policy objectives should highlight the following:

- Hedging objectives
- Hedging strategy
- Risk monitoring
- Performance measurement
- The risk appetite for the firm needs to be defined in the policy setting.

It is importantly recommended that the treasury management to operate as a cost centre and not for profit making. Moreover, the firm needs a better estimate of its currency risk exposure and look at its other related businesses like tours and travels which also generate sales in foreign currencies and other related costs.

- The company should match its purchases and payments for its glass as a first method of hedging.
- Should consult with its bank or other banks for example HSBC operating in Sri Lanka, on forward contracts as an alternative to/or supplement to Letter of Credit.
- Risk sharing: If the parities to contracts are determined to be of long term then risk sharing should be considered this way the firms share the gains and losses from currency movements.
- Lanka should negotiate to either pay early or delay the payments for its glass payment. Not only will this help with payment terms but also ensure timely delivery of goods and impact favourably on the cash conversion cycle.
- The company should continue with risk shifting by passing on prices increases to customers whenever appropriate.
Systems

- Legal
- IT
- Accounting/Finance
  - A lawyer experienced with corporate finance should be consulted in drafting up agreements with banks, suppliers, and other contractors.
  - Foreign exchange markets are very volatile and therefore it is recommended that the firm makes bi-weekly reporting of its foreign currency exposure.
  - Lanka should implement basic software system is to keep abreast with currency exposure.
  - Internal controls to take into account segregation of duties, exposure monitoring and reporting, and to make clear who reports to whom and setting limits on transactions that can be made without board consent.
  - The appointed charges for risk management will need to be trained in current and relevant practices in currency risk management.

For illustrative purposes a simple example below shows the consequences of not having a covered position:

The short example below shows the importance of having a hedged position:

Consider that Lanka is extended credit by its bank for purchase of glass with the loan to be settled in 90 days time

Dollar debt in January 2014: US$120,000 * LKR 130.65/US$ = LKR 15,678,000

In three months time,

Dollar debt in March 2014: US$120,000 * LKR 160.75/US$ = LKR 19,290,000

The effects on equity are as follows:

<table>
<thead>
<tr>
<th>Lanka Ice Balance sheet</th>
<th>17/01/2014</th>
<th>20/03/2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
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<td></td>
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<tr>
<td>Cash</td>
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<td>$200,000.00</td>
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<tr>
<td>Office supplies</td>
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<tr>
<td>Total assets</td>
<td>$201,500.00</td>
<td>$201,500.00</td>
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<tr>
<td><strong>Liabilities</strong></td>
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<td></td>
</tr>
<tr>
<td>Accounts payable(loans)</td>
<td>$120,000.00</td>
<td>$142,470.00</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$120,000.00</td>
<td>$142,470.00</td>
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<tr>
<td><strong>Owners equity</strong></td>
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<td>$59,030.00</td>
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Therefore dollar debt increase in Sri Lankan Rupees LKR 3,612,000, representing a 23% ($22,470) increase in the dollar amount to be paid from $120000 to $142,427 of the initial loan excluding whatever the interest payments as determined by loan agreement. Clearly from the simple illustration above the impact on equity can be more severe if adequate measures are not put in place.
Hedging will give the firm more certainty and give quality to the planning and budgeting process. As the firms negotiates with suppliers it should work towards possible risk sharing with its counter parties.

Finally, in the near future Lanka should continue beyond financial risk management and take into account the entire business profile to understand its risk environment and devise risk management strategy that is convergent with Lanka’s long term objectives and vision. The firm’s life cycle in terms of trading is still growing and therefore there is no need for drastic measures at the moment.

These recommendations coupled with further analysis of the entire business profile risk assessment will help Lanka have considerable certainty of its cash flows, barring exceptional circumstances.
6.0 References


Associated Press. (2013). Japan’s CPI falls 0.9 percent in March as deflation drags on; central bank keeps policy intact. *Washington Post*.


7.0 BIBLIOGRAPHY

Primary Sources

Cash flow statement (Appendix A)

Interview 1 (Appendix B)

Interview 2 (Appendix C)

Interview 3 (Appendix D)

Interview 4 (Appendix E)


Secondary Sources


Associated Press. (2013). Japan’s CPI falls 0.9 percent in March as deflation drags on; central bank keeps policy intact. Washington Post.


http://www.casact.org/area/erm/frame.pdf


Appendices

Appendix A Lankan Glass cash flow statement for year ended 2012

<table>
<thead>
<tr>
<th>SUPPLIER</th>
<th>COUNTRY</th>
<th>LC OPEND DATE</th>
<th>L/C EXPIRY DATE</th>
<th>TERMS OF DELIVERY</th>
<th>VALUE (US$)</th>
<th>CLEARED DATE</th>
<th>DELIVERY</th>
<th>U.S. Loan Amount</th>
<th>Loan Granted Date</th>
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<td>CFI</td>
<td>46,223.45</td>
<td>13.02.2013</td>
<td>46,223</td>
<td></td>
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</tr>
</tbody>
</table>

US $ 287,121.35

Short Term Loans

Loan Maturity Schedule.
Appendix B Interview 1: Mr. Malinga

Interview guide:

- Questions or comments by interviewer are labeled as I:
- Comments or responses by interviewee are labeled as P:

The following is the introductory interview with Mr Malinga. An audio file is attached for further listening and clarification. The interview below and those to follow have been summarised in part with the “ums” and “uhhs” removed to aid with the flow of the dialogue. The ideas and core points remain the same however.

I: Good afternoon Mr. Malinga

P: Good afternoon

I: Thank you for taking time to take part in this interview, I know you are a very busy man. As I already mentioned in emails this is an introductory interview. The other interview depending on your schedule should take place next week or the week after

P: Yes not a problem

I: I hope you had the chance to read through the consent form

P: Yes I did and its fine with me

I: I guess if everything is fine we can start with the interview. As I mentioned too you guys are the teachers and I am learning from you

P: Ok

I: It is important that my recommendations are based on sound judgement. Only inside information can help me understand the operations of Lanka and its related affiliates

P: Correct

If you need any clarifications you can ask me any questions, be able to stop the interview at any point in time.

P: Sure

I: Why don’t you tell me a bit more about Lanka’s history, its establishment in Sri Lanka and how you guys have found yourselves in the Netherlands?

P: The Lanka hotels and travel known as LHT was founded in 2004. We are part of our main mother company which is Lanka group of companies. I am in charge of LHT so I will speak more about what LHT does and our operation.

Elephant ridge was one of the pioneer boutique hotels and our first project. It is located in the deep south of Sri Lanka close to the national park which is very famous for spotting leopards, elephants and other wildlife. We have been very successful in managing it and have since expanded to other industries such as travels, event management, marketing for properties in Sri Lanka, international trading, government procurement, and tendering. We recently launched two travel offices in London and Netherlands [Amsterdam]

I: Ok
P: And we have gone into food industry

I: Ok

P: We opened a restaurant in Heemstede [offering] Spanish Mediterranean cuisine

I: Here where we are in short

P: Yes, here where we are. We are looking to expand into hotel services, real estate and agricultural import and export. So that’s where we are today. We have a solid foundation [his phone rings]

I: Let me pause that.

END FIRST PART OF RECORDING

SECOND PART OF RECORDING CONTINUES:

I: You were sating about the solid foundation that you have

P: A solid foundation, we were very successful with the hotel which is one of our main funders for other projects; successful projects.

Which hotel?

P: In Sri Lanka

This has become a hot spot for locals and tourists. We have a blend of nature and echo tourism and have been awarded with many awards for echo friendly practices. It has been an encouragement and been the financial foundation for LHT to grow and other opportunities.

“So that’s were we are and are currently working on a new hotel project, a fifteen boutique hotel; beach resort catering to the upmarket clientele.” And we are also aggressively looking into budget accommodation concept which I believe and the company believes has a very good scope in Sri Lanka.

We should cater to budget clients or [provide] luxuries at a budget price. There is an economic recession but people want to go on holidays at a good price. They are very price conscious than 2 or 3 years ago

I: They really want good value for their money

P: Yes, value for money has gone up. They want to have same luxuries but now more than ever at a better price. So we believe in giving the star services but at competitive low price. We believe moving forward that’s the key to be successful in Sri Lanka

I: Ok

P: We are in negotiations with prefabricated manufactures in China who are very competitive and good with what they do. They also started [Citizen] M in Amsterdam for example, a small room but very classy. “All the necessary facilitates will be provided [boutique hotel] at very competitive rates.”

I: Ok… What of the opportunities in the Netherlands? You mentioned about spices. How is that going?

P: It is going very good. Our market research found huge demand and scope in spice market especially in the Netherlands, one of the highest importers of spices in Europe. We have a
very good understanding of the local market in Sri Lanka and our financials indicated it was
good industry. We have already finished the ground work in Sri Lanka and gotten the
necessary affiliations and contracts.

P: At the moment we are working on distribution channels in the Netherlands.

We will start with Horeca which is the hospitality industry in the Netherlands. It will be our
niche market to break in; there is good potential. We have to establish our name then move
to suppliers who do bulk purchasing.

I: Ok.

P: So far it has been very interesting and the financial benefits are very practical.

I: What of regulation and quality control?

P: We are checking with the Dutch Chamber of Commerce; it is very flexible with import of
spices especially those not produced under the European Union. Those produced in Europe
face high taxes and duty. Our spices are exempt with only BTV of 6% to be paid. Also
affiliates in Sri Lanka have the necessary ISO certifications enabling to export to European
countries. So we have only with import and distribution

I: In forward looking to our next interview, how do you manage exposure management due to
importing and exporting and the challenges faced?

P: One of the main challenges has been the high fluctuation rates. The rupee has hit an all
time low [against USD] and is not stable making trading difficult and sometimes risky. Prices
fluctuate every now and then. This influences our mark ups and selling rates so we have to
be alert and focused.

P: We have been trying to tackle this and it is one of the reasons we are discussing with you
so that we can get some good feedback from you.

I: Hopefully I can do that and not disappoint you

P: It will be nice to get your input because moving forward we are talking about thousands of
Euros of trading which can hurt the company if proper measures are not taken in advance.

I: I don't have anything to ask you at the moment but feel free to add on anything you would
like.
Appendix C Interview 2: Mr. Weusten

Interview guide:

- Questions or comments by interviewer are labeled as I:
- Comments or responses by interviewee are labeled as P:

I: Mr Vincent, thank you for having time for this interview.

P: It’s ok no problem.

I: And hopefully I don’t take up much of your time on what Rabobank offers

I am just here to ask you a few questions in terms of currency risk management, for either big businesses or small businesses

P: Yes.

P: First do you know the way Rabobank works? Because that’s also important for your thesis.

I: Actually you could actually share that with me

P: Yes that’s important for you to know. Rabobank is a corporation with 140 local banks and these banks own the banks in Utrecht. Utrecht is the Rabobank international and the experience [expertise] is in Utrecht. You see that these 140 little corporations own the big corporation, and the big corporation is exactly where the expertise are. Because you see that local banks are...the name says it already but that also means that the expertise we need...we have expertise in Maastricht of course but if it’s getting very difficult we or we need more expertise we to our corporate clients in Utrecht or Eindhoven which is another location. So that’s for currency risk its very important that you have local people who know about currency risk but if its getting very...

Big

P: Big and difficult...because now it’s hot currency risk, then we go to our friends at Rabo International and they have a local team that has more expertise

I: Ok, so in short you do also do manage currency risk within Maastricht on a smaller scale

P: Yes, yes, we do mange currency risk in Maastricht and we are allowed but sometimes you see if big companies come and these companies cannot do it their selves [themselves]but if they need information I am the first one to speak to the company and if its getting bigger or difficult then we call the corporate clients team, actually its named the corporate client team and they have the expertise and Eindhoven is one of the bases and Utrecht is the head quarters of the Rabobank. That’s 136/140 little Rabobanks [which] own the Rabo International. That’s in short the corporation. So that’s the difference between us and, for example, ABN or Deutsche or ING that these organisations are very centralised, they have headquarters in Amsterdam and tells you what to do. We are decentralised so we tell the local banks tell Utrecht what to do. But they [headquarters, Utrecht] but they give us the ICT, if we need money we go to Utrecht, if we need expertise we go to Utrecht. So to make the long story short for currency risk here I am the guy who is involved in currency risk, it its getting too much complicated I call my colleagues form Utrecht or Eindhoven, there is also a corporate client team and they help then with the deal that's in short what's happening.
I: Alright that’s good. So it is your competitive advantage and that’s how you have positioned yourselves?

P: Yes, the corporation, that’s what we see also, because of the crisis [financial] we as a corporate bank we have done better than the banks with stakeholders [shareholders] because they have more short term and we have long term

Long term view

P: That’s in short..that’s what you should know about Rabobank because that’s important also for currency risk, we not a bank who [which] takes enormous risk, we do slowly [not aggressive]

I: Ok that’s good, that’s good to know

I: So my first question for you is if you can just describe a few products that you have product range on risk management

P: Yes, ok, I can give it to you also because I just printed it. First of all if the client doesn’t want to do anything we talk about the spot transactions

I: Buy in the market [spot]

P: So its buy and sale but you have full risk if you want to buy in six months, then you say ok will see I will buy in six months and the full risk is to the client so thats the first thing you can do. On the other hand you can work with options, call options, put options, so that’s another thing, you can combine these options also so you have a lot of opportunities to combine the options so you have to pay less for the products, it’s a combination. And one of the most common products is the forward transaction

The forward transaction ya

P: But mostly people, what I see most people are into is spot transactions and then you see the forward transactions and the bigger companies chose to work with options.

Would you say maybe for them its more speculation or..

P: No its not speculation because(…..) it’s a different way to manage risk because the forward transaction says exactly in six months or one year what price you get the dollar for, nothing less, nothing more and that’s it.

Ok. So in terms for small businesses what offerings do you have for them?

P: What we do is… you have to know that sometimes the spot transaction is the best way to deal with things and sometimes of course the forward transaction is the good way to deal with things but you have to find out what the client wants. The thing I do if you have currency risk because you are in china and want to import [export] from china to Holland, so you have your currency risk [exposure] but how many [much] risk are you willing to take? That’s the first question, because you have your profits and you have your loss, and sometimes you see that the company makes a lot of money and say I can take the risks or I don’t want to have currency risk in forward transaction and will deal in the spot, also because they can do something with the prices. So some companies have the opportunity to say, ok the dollar runs the wrong for me, so the prices go up for me for the party I am selling to

I: Ok

P: Sometimes they don’t find it necessary to deal with the risk and pass it on to the other party and say “that’s your problem now.” Sometimes they say ok we don’t want to have any
risk and then it’s like what do you want to do then because you can go for the forward transaction or the option construction. And I explain to the parties, and mostly they know themselves because we do this mostly with the big companies and they know what’s happening, they have their own version of what is happening, and sometimes they have in their company profile that they need to have a forward transaction.

I: So just to clarify would you say then that small businesses like to buy on the spot and not necessarily engage in forward transactions?

P: Sometimes, because if they want to take the risk they say ok we deal with the spot transaction because I can have the risk because my profit is very good or because of the fact that I can go to my own party who buys from me and say ok the price went up and then they say ok we take the risk, and sometimes they say I don’t want any risk at all and they go for the forward transaction but you also have to be sure that the buyer of this product has to know what is happening so you have to be very careful and say ok you have a risk, do you want to do something with the risk or don’t you want to do something with the risk, and what happens if the prices goes up 5 or 10 percent because we can see in the system what happens the last year or half year then show the client what is happening and it’s up to him [client] if he wants to deal with this currency risk or not. Otherwise you see the bank has, lots of times [inaudible segment] so sometimes we say we say ok we think it’s very important that you do it because if something happens then your profit is gone and especially [inaudible segment] that have these other things going on like loans or whatever then it’s very important also for them to take care of their currency risk.

I: So in short they have to be knowledgeable about what they are getting themselves into?

P: Of course, if they don’t know what is happening then you should inform them very well, and currency its really easy, its spot transaction or the forward transaction and in between something but mostly spots and forwards and you will see what’s happening and you have to explain to them what it is, that’s very important but mostly they do understand and mostly they don’t want to have any risk so then they say ok I don’t want to have the forward risk so give me the forward transaction. And sometimes they say ok I take the risk and that’s up to me because I can do something about the prices, and that’s it.

I: Ok. Considering that you just mentioned that you guys are not aggressive would you or do you advise most companies to consider internal methods of hedging instead of going into the market or the banks or maybe do you give customised service…that look maybe we can manage your assets this and this other way?

P: We give customised service but the thing is that we are totally not aggressive; I assure you we want to know if the client understands what we are selling, first of all. And secondly we look at their profit, profit and loss and account how you call it and the only thing I do is like okay if the prices go up 10 or 15 percent what happens to your profit and loss because that’s very important and then the client understands what is happening. So it’s not aggressive it’s really an advice (…..)you really have to inform the client what is going on and then he can sees himself if necessary or not but it’s not like hey you have to buy because that doesn’t make sense, that’s what Rabobank absolutely never had and never wants to do because that’s not good.

I: Ok. So is there like an example maybe you can give me of how, for example, a company or a small business can make money through some of your products?

P: Yes, of course if for example, but then again what is a small company? But mostly companies who are dealing in foreign countries outside of Europe come and ask me about this currency risk and if it’s a couple of thousand Euros again you can do it but you have to see if its..
If it really gives you any marginal benefit

**P:** Yes that’s the most important thing because it needs to be good for the company that’s for sure. And lately we have done a little big companies and then you talk about a million dollars that you have to buy… this last company I had on a visit was exactly for a million Euros and they have to have the dollars in six months or whatever so I was looking at…of course they had to buy stuff in China so they had the currency risk in dollars and then we talked about how many[much] risk they want to take because for a million dollars or Euros (…) if the profit and loss for the company is very good of course you can say you ok I only want to do it for 500 thousand dollars but that’s up to the company.

**I:** Ok

**P:** So if they have a very good profit and loss then the necessity of forward transaction is less of course, that’s one thing but on the other hand these companies I know that they don’t want to have any risk. Especially this company says ok I now want to know what my price is in six months so I am not taking any risk although I can do something with the price but I don’t want any risk. That’s what you see in bigger companies they don’t want to have any risk, then I advise ok if you don’t want any risk you have the possibility for this forward transaction because you know today what the price is going to be in six months, do you want that and mostly they say ok that’s a fair deal so that’s what I want. On the other hand sometimes you can work with what I call option positions but then you have this band but still there is a bit of risk and mostly they say ok, and I think its fare, wed ont want to have any risk and we work with the forward transaction

**I:** Forward transaction, ok. So normally this hedging horizon, if you may, is it like over 6 months normally or 3 months?

**P:** The local banks are allowed to do the hedging for one year but mostly what I see is between… six months that’s the term that’s common now; of course with the crisis you see more companies and coming in and say ok…the crisis makes the companies very aware of the risk they have they want more to be safe and that’s hwy they come for more transactions and that what we see now

Ok. Considering that you are probably the expert around here, is there any level of particular education like expertise

**I:** Yes, for the banker?

**P:** For the bank as well

**P:** Of course, we need to have expertise, we get training, we have to do these courses, and we do get a lot of training. Of course we need to do exams; you have to be educated to sell these products. Again what I told you if the expertise at the local bank isn’t good enough or we think ok this is something that needs to be more clarified then we call corporate client team and there is more expertise and they come and advise the client. But absolutely you need a lot of expertise because you can’t sell these products without knowing what is happening, and that’s also important for the company because every local bank has its own person that sells these products, and gain they all need expertise and they always get training and its out of the question that you don’t know what is happening because its impossible

Ok but on the side of business itself, for example a business that comes to you, do you think they need a lot of expertise as well?

What we notice, we know which clients are doing business out of Europe, and also England (…..) at least once twice a year we go to these people and we ask them, ok you know you
have currency risk, do you want to talk about it and of course they want to talk about it then we explain what the currency risk is doing to your profit and loss account, is it acceptable or not acceptable. If acceptable we talk about it if not acceptable then we have a couple of products that can decrease your currency risk. We talk about it at least two times a year.

Two times a year, ok

P: And these companies have controllers so also these people know what is happening, they have the expertise also so it is easier for me to talk to them, and sometimes you have to explain and explain but mostly the people know what is happening and they make their own decisions of course but you have to be, you have to inform them once twice a year, again. The currency crisis makes it go like this (…) and it is important for your profit and loss

Ok. How mature are the type of businesses you look at or do you think any type of company can enter into these types of transactions or they really have to reach a certain level of maturity?

P: Yes and no, because if the company starts and says ok I want to do business with China, you have currency risk, so , you talk about the currency risk, we have to talk to them, business with China, you have the dollar risk mostly, so what do you want to do with the risk? You have to talk about them [risks] but if the company just started its very likely that the people who start the company don’t know anything about the currency risk. Its not only the currency risk or the trade, and the insurance its broader than the currency risk. But speaking about currency risk, small companies that just start you have to inform the people and the bigger the company gets the more people are specialised so you speak to the controller, so like I said they know what’s happening and the smaller companies also. In Maastricht not a lot of companies are doing business outside of Europe at our bank. We have a couple of them. sometimes it depends on the company one company always wants to work with forward transactions and other companies say ok you informed us but we want to take the risk it s no problem we want to work with spot transaction so it’s ok

I: Ok that’s great. That does it for me unless there is something that you would like to add on? That we haven’t covered?

P: Let me see…we began talking about Rabobank, that’s very important to know that Rabobank ahs these banks and headquarters in Utrecht (…..) we just want to inform our clients and the currency risk they have (…) and show them the products. And mostly up to them (…..)the most important thing it’s not about the profit it’s about the client, what the client wants, what the client needs and he needs the smallest risk so the forward transaction is good for the client if he thinks it’s good for him of course. Of course if he says no I don’t want the forward transaction, its ok he will take the risk, he will do it, its no problem but you are informed (…) 

I: Well Mr. Vincent, thank you so much for your time

P: No problem

I have been struggling to get appointments with banks here and there but

P: It’s difficult yes?

I: Yes it has been kind of difficult but thankfully

P: It’s no problem

Appendix D Interview 3: Mr. Thushara Mapalagama
Interview guide:

- Questions or comments by interviewer are labeled as I:
- Comments or responses by interviewee are labeled as P:

P: [10:12:32] Thushara Mapalagama: Dear Stephen something wrong with my eco sounds could you please discuss via massages

I: [10:33:43] Chileshe Nkhata: Is it possible for you to set up a google account? We can use the google talk platform which should perform better.

I: [10:37:12] Chileshe Nkhata: In any case its possible for us to dicuss through messages if its more convinient

I: [10:38:49] Chileshe Nkhata: Please let me know when to begin

[10:40:45] Chileshe Nkhata: Call to Thushara Mapalagama, no answer.

P: [11:05:08] Thushara Mapalagama: Sorry for delay in reply, I am ok now lets start massages


I: [11:06:49] Chileshe Nkhata: Thank you once more for taking the time to take part in this interview

I: [11:07:42] Chileshe Nkhata: Did you read through the consent form?


[11:08:30] Chileshe Nkhata: if you need any clarifications at any time please feel free to ask me


I: [11:09:39] Chileshe Nkhata: it will be very kind of you if you can download the copy and have it signed, scanned and emailed to me, if possible

P: [11:10:16] Thushara Mapalagama: ok I will send it after the skype

I: [11:12:00] Chileshe Nkhata: thank you. It is unfortunate I cant put voice and face to your name

I: [11:12:27] Chileshe Nkhata: how long have you benn working at lanka finance?

P: [11:13:44] Thushara Mapalagama: I joined Recently and almost completed one year and nine months at Lanka Ice as head of Finance Division


I: [11:17:32] Chileshe Nkhata: Mr. Malinga in our introductory interview explained about the busineses that Lanka is involve in. What percentage of your revenues are from foreign operations?

0- 25%
Don't know

**P:** [11:19:31] Thushara Mapalagama: May be 0-25% range

**I:** [11:21:43] Chileshe Nkhata: Alright. Having looked at the cash flow statements you emailed I gather the USD is the base currency of operations for foreign transactions?

**I:** [11:23:52] Thushara Mapalagama: Yes we do all our imports in US Dollars as all our foreign suppliers quotes on US dollars

**I:** [11:26:53] Chileshe Nkhata: Ok. How certain are your outflows and inflows of foreign currency? Is there a range or they fluctuate every now and then?

**P:** [11:30:35] Thushara Mapalagama: In Sri Lanka Us dollar is fluctuating and most of the time Sri Lankan rupee is depreciating against US Diller we have a foreign currency transaction and translating risk, hence range of fluctuations around 3% 10% as to my knowledge

**I:** [11:32:05] *** Chileshe Nkhata sent Scenario summary 4.docx ***

**I:** [11:34:00] Chileshe Nkhata: I run a scenario analysis and those are the results assuming the USD depreciates by 35% percent.

**I:** [11:35:32] Chileshe Nkhata: those are the potential kind of savings that can result. Having said that what current tools available and used by Lanka Group for foreign exchange management?

**I:** [11:38:02] Chileshe Nkhata: from $1,345,956 your outflows would be $874,871 with the 35% assumption

**P:** [11:40:12] Thushara Mapalagama: Thanks for the information before I joined we do not have any currency management tools and now we are negotiating with foreign suppliers to prices on forward contact prices.

**I:** [11:41:40] Chileshe Nkhata: You have been transacting on the going rates on the spot market?

**P:** [11:43:10] Thushara Mapalagama: yes we do on spot rate

**I:** [11:44:36] Chileshe Nkhata: in the time that you have been there how has your assessment been? that is, how have costs been?

[11:45:49] Chileshe Nkhata: transacting in the spot. have they been increasing or decreasing given that the ruppe has been underperforming against the USD

**P:** [11:49:41] Thushara Mapalagama: There wont be a much of a different as we do our LC on sight basis and as I told fluctuating rates would be within a range of 5% 10% and we
adjust our local pricing and margins accordingly with a competitive price to meet local competition

I: [11:51:06] Chileshe Nkhata: Are there any challenges or limitations with current use of Letter of Credit?


P: [11:57:04] Thushara Mapalagama: Yes but there is no other option as most 99% of suppliers prefer either TT of LC at sight but we are now negotiating with new suppliers for DA terms as well. really this will effect to our working capital management as our conversion cycle will effect with our credit period given to our local customers

I: [12:01:00] Chileshe Nkhata: You have stated that you are now considering risk management, are there any obstacles in implementing it, now or in the past?

P: [12:06:00] Thushara Mapalagama: Now we are trying to minimize our obstacles in implementing it that's why we are searching for new suppliers who can offer different payment terms, then we can negotiate with our local bankers and implement better foreign currency management tools. We do not have much on foreign currency management basically a zero management.

I: [12:08:07] Chileshe Nkhata: Ok. Are there any policy objectives from the Board of Directors or anyone responsible for making company policy?

P: [12:09:21] Thushara Mapalagama: Yes final decision & approval from the Board of Directors.

I: [12:10:38] Chileshe Nkhata: How often does the Board meet?

P: [12:12:59] Thushara Mapalagama: There is no such a time frame; it depends on major decisions but senior management meetings are on a monthly basis which most of the Directors also involved.

I: [12:14:56] Chileshe Nkhata: Alright. As you consider risk management going forward, has any consideration been given as to how it will be done or the personnel that will be charged with risk management functions?


I: [12:16:14] Chileshe Nkhata: Who will execute the functions?

P: [12:17:13] Thushara Mapalagama: Initially I have to do as a group Accountant and discuss with Directors.

I: [12:19:27] Chileshe Nkhata: Taking you back to issues of suppliers, how are payments made? And please also comment on how your cash management system operates whether it is centralised or decentralised?

P: [12:22:44] Thushara Mapalagama: Payments are made from head office and it is a centralised operation. We open LC via our local bank and we settle payments from our bank facility and convert the LC maturity value to a short-term loan and we will settle short-term loan from our cash generation from sales.

I: [12:25:16] Chileshe Nkhata: At this moment there are no further questions. Is there anything you would like to add on that we haven't discussed that would be important in your view?
P: [12:28:33] Thushara Mapalagama: With this details do you think that we have to do a dramatic change to mitigate the foreign currency risk and what do you fell if we are implementing tools like swaps & options.

I: [12:34:05] Chileshe Nkhata: The research and consultation is still ongoing and I should have full recommendations for the company sometime next week. But what I can say for now is that having risk management process in mind is a positive for the future.

P: [12:35:11] Thushara Mapalagama: I too agree

I: [12:37:31] Chileshe Nkhata: It has been a pleasure despite using the messaging system. Thank you very much for taking time to participate and I will be in touch through our usual emailing channel :)

P: [12:39:11] Thushara Mapalagama: No problem thanks It is pleasure to share the experience with you please feel free to contact me for any support. Thanks Bye.

[12:39:35] Chileshe Nkhata: Bye and good day
Appendix E Summary interview 4: Mr. Wouter Kuipers

Due to illness Ms. Vierveijzer, my earlier contact was not able to take part in the interview as hoped. However, she asked another colleague, Mr. Kuipers, to take part who kindly agreed. Mr. Kuipers unfortunately at time of interview did not have facilities to conduct interview through Skype. I did also mention that we could have it through Google chat but after deliberation with Mr. Kuipers, and given time constraints, scheduling problems and other possible unforeseen happenings I made judgement call to have the telephone interview then.

Mr. Kuipers was reluctant to sign the consent document but I informed him that it was for his own rights and also the integrity of my paper. He read through it and stated in a short email that he was “ok with doc” and that would later sign the document and send scanned version.

To the first and second questions on product range and offerings for small businesses Mr. Kuipers indicated that forwards were the most common tools and that if companies wanted more, options were always available. Furthermore, interest rate risk solutions were available depending on business needs.

On internal versus external methods considerations, he indicated that it depended on the risk faced. He also confirmed that if companies can match their foreign currency inflows and outflows it was a good way to hedge. He still maintained though that much was down to risk faced and what the company needed. Mr. Kuipers also explained that it was also dependant in the type of market one operates in when dealing with currency risk. Another point was that sometimes it was better to shift the risk to your counterparty if possible.

And his response on business maturity level needed for currency exposure management Mr. Kuipers stated that risk management should be done in the early stages of the business cycle, further stating the need to be knowledgeable to do it. He also noted that it depended on risk, what the company sees as risk, stating that as CEO one has to be aware of risks a business faces and that one obviously needed to consult before starting a risk management programme.

Mr. Kuipers was asked whether he thought Letters of credit were an effective tool to which he replied that LOCs were guarantees to pay, eliminating counterparty risk, which was assumed by the bank. Mr. Kuipers also indicated that it was possible to purchase forwards for various amounts from as much as €25000 while highlighting that it was all in relation to the volume and risks faced.
Notes taken during telephone interview with Mr Kuipers
Appendix F: Questionnaire

Interview questions Lanka Finance

I. General questions

Interviewee name:
Department/Position:

1. How long have you been working at the firm?

II. Company profile

5. What is the product portfolio of your company?
6. How geographically diversified is your business?
7. What percentage of your revenues are from foreign operations?
   - 0-25%
   - 25-50%
   - 50-75%
   - 75-100%
   - Don’t know

III. Exposure measurement

8. What is base currency of operations?
9. Which currency/currencies is the firm exposed to?
   How certain are your foreign currency inflow and outflows respectively?
10. In the budgeting process is there any consideration of exchange rates?
IV. Exposure management

18. What are current tools available and used by Lanka Group for foreign exchange management?
19. How are these tools used or not used?
20. What limitations do you face with current practices?
21. Are there obstacles to implementing risk management?

V. management and policies

22. Who is responsible for implementing company policies?
23. Is the cash function management centralised or decentralised?
24. How frequent does the Board of Directors meet?
25. How do you make payments to suppliers?
26. As you consider risk management have you thought of how it will be done or the personnel that will be involved?

Is there anything that you would like to add that we have not had the chance to discuss?

It has been a pleasure, thank you very much for your time and participation
Appendix C: Interview questions on product offerings by banking institutions

Company:
Interviewee name:
Department/Position:

I. Questions on products and management of foreign currency exposure

1. Can you please describe the product range for managing currency risk exposure for firms that you offer?
2. Are there any offerings catering to small businesses?
3. Which common products do small and medium sized businesses normally select?
4. Is it because they are affordable to implement or understandable or both?
5. What are some of the issues you give advice on better management of currency exposures?
6. In general would you recommend internal or external methods of managing their currency risk exposure?
9. Can you give me example of how a small firm is able to save or make money with some of your banks product offerings?
10. What is the normally observed hedging horizon that small businesses engage in?
11. What is the level of education or expertise needed in running a risk management program?
12. How mature should a business be to engage in risk management activities?

Is there anything that you would like to add that we have not had the chance to discuss?

Thank you very much for your participation
Appendix G: Restaurant observation pictures
Appendix F: Consent forms

INFORMED CONSENT FORM

Thank you for taking part in this study, which will take place on September 17, 2013. This form details the purpose of this study, a description of the involvement required and your rights as a participant.

The purpose of this study is:

- To get understanding of the inner workings of the treasury functions and other related areas with regards to currency risk management.

The benefits of the research will be:

- The information gathered will help in making recommendations for Lanka Ice and its currency risk exposure management

The methods that will be used to meet this purpose include:

- One-on-one interview (Skype)

At any time you may ask questions or raise concerns about the nature of the study or the methods I am using.

Our dialogue will be audio recorded. The recordings will only be heard by me for the purpose of this study. If you feel uncomfortable with the recording, you may ask that it be turned off at any time.

You also have the right to withdraw from the study at anytime. In the event you choose to withdraw from the study all information you provide will be excluded from the thesis.

Although direct quotes from you may be used in the paper, your name and other identifying information will be kept anonymous if you so wish.

The information collected from you will be used in writing a qualitative research report which will be read by my supervisors and possibly the Exam Board.

By signing this consent form I certify that I Thushara Mapalagama agree to the terms of this agreement.

(Print full name here)

18th September 2013

(Signature) (Date)
Appendix H Feedback: Mr. Malinga

Mr. Malinga,

Dear Sir/Madam,

All the sector's apologies for the delay in replying. I have gone through the attached documents and everything is in order.

Yours,

Malinga

Re: Ms. Malinga

Received 5th Nov 2013 at 11:35 AM. Mädchen Malinga <malinga@malingaoffice.com> wrote:

Dear Mr. Malinga,

Please find the attached document which is my assessment and conclusions from the combined interviews of Mr. Malinga and Mr. Thushara. It is important for the study and all confirmed that you have the chance to read through so that your views and comments are preserved fairly and accurately. Therefore I kindly ask that you go through these findings and state whether they reflect what was said or implied and not correct if not necessary. Your feedback is very important before I submit the document on Friday.

Best regards,

Stephan

Malinga Hernandez

Director

Sunrise Hotels & Travels (PVT) Limited

101 Bldg., 1st Floor, Hardman St., Colombo 3

T: (011) 221-3066/3067 F: (011) 221-34590

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Appendix J Feedback Mr. Weusten
Appendix I Feedback Mr. Thushara

Re: Feedback
From: C.S. NKHATA
To: Thushara

Dear Mr. Stephen,

Sorry for delay in reply you as I was extremely busy on month end.

Yes, I agree with you on Scenario analysis to some extent. Only thing is now we are trying to develop some risk mitigating strategies as I explain on the other day. Hopefully we believe this will give a better result in managing risk and pass the price difference to buyers rather than passing to our customers then we can gain the competitive advantage over other local suppliers. I totally agree with your comments on strength & weakness we have face and also we have a good opportunity to cater our customers with right price with proper mismanagement of risk. Rupee depreciation against other currencies is a Threat to us.

Regards
Thushara.

On 3 October 2013 15:28, C.S. NKHATA <ckhata@yahoo.com> wrote:

Good afternoon Mr. Thushara,

I have been waiting to get some feedback from you. Please when time allows you today or before the end of tomorrow just send me a short email to verify the information I collected and concluded upon. You just have to state whether it is accurate or not. It is part of the research process so that my bias does not distort the data or represent your comments in the wrong way; this way you have the chance to correct me where I might be inaccurate. I await to hear from you soon.

Thankyou and best regards