

# The Impact of Risk of Exchange Rate Fluctuations on Corporate Profits-A Review

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## ABSTRACT

*The study aims to clarify the effect of the dangers of fluctuations in local currency exchange rates and company profits, which is considered one of the risks associated with the international activities of companies. The study problem was identified with questions revolving in its tracks about the extent to which bank profits are affected by fluctuations in exchange rates, by reviewing the literature The previous discussion on this topic, and the researchers found an update of that literature that any change in the exchange rates did not reflect a positive change in profits, and the study recommended the necessity of reviewing the previous exchange rates due to the great role that forecasts play to form part of the prediction of exchange rates for the coming years, which in turn It reduces the losses that incoming companies may be exposed to on new investments. Hence, the importance of managers adopting traditional and modern technical methods to forecast exchange rates and ways to avoid them.*

**Keywords:** *exchange rate risk, corporate profits*

## INTRODUCTION

Banks are constantly seeking to improve their profits and maximize shareholders' wealth, but several factors will affect bank profits, including (inflation, interest rate, indebtedness, taxes, financing structure, dividend policy, political conditions, and the exchange rate). Focusing on the relationship of exchange rate fluctuations with bank profits, as the risk of the exchange rate is one of the most important factors that affect bank profits, (Donald, 2015: 3) and stability of exchange rates is one of the priorities of monetary policy in various countries because it is essential to provide the appropriate environment for investment And then to maintain this stability, the risk of the exchange rate arises from the continuous fluctuations in the exchange rate of the local currency, and it is one of the most important risks affecting the prices and values of the financial assets traded within the markets. The decline in trade, economic growth, and capital flows, which avoids investors increasing the level of their economic activity, which means its impact on the activity of

companies operating in those markets (Al-Hasani, 2002, 178). Therefore, most governments seek to adopt policies It aims to ensure the stability of the exchange rates of its currencies to avoid the sharp fluctuations that the currencies go through from one period to another. The internationalization of the financial markets and the reduction of trade restrictions during recent decades have provided many investment opportunities outside international borders, which encouraged investors and companies to conduct international business. Increasing uncertainty in that environment about price trends, their movements, the size of its volatility, and its timing, and gives the banking sector a key indication of the vitality of the economic situation in the country and through the various banking services it provides and works to stimulate economic and commercial operations, so it was necessary to evaluate the performance of banks. And the extent to which it is affected by economic changes such as exchange rates and its fluctuations.

## LITERATURE REVIEW

### First - the concept of the exchange rate

It is also known that each country has its own currency that is used in internal payment processes, and it is necessary to use foreign currencies when commercial or financial relations are established between companies operating inside the country with companies operating outside it, as the imported companies need the currency of the importing country to pay the value of the imported goods. By doing this (translating foreign currencies), and you are forced to go to the exchange market to buy the currency of the source country for the transaction to take place. In fact, it is not only the companies that do trade abroad that need international currencies. Every person who moves outside the country in which he resides needs the currency of the country he wants to go to, then he finds himself obliged to do exchange operations (Morey, 2010, 1).

Hence, there are many concepts of the exchange rate and this is noted through the literature presented by researchers and those interested in the subject, and all agree in highlighting the elements and aspects that distinguish it and mentioning aspects without others from one concept to another, so the exchange rate was defined as the number of units of the national currency that must be paid to buy one unit of foreign currency, or it is the number of units of foreign currency needed to purchase one unit of another foreign currency (Bin Yani, 2012, 43), and some of them define it as the price of a country's currency denominated in the form of another country's currency, or it is the ratio of the exchange of two currencies (Parlapiano, 2012: 125). Also, it is considered the ratio or price of exchanging one currency for another. Thus, one of the two currencies is a commodity, while the other is the monetary price for it. The exchange rate is also defined as the ratio based on which national monetary units are exchanged for foreign units at a known time (Al-Hasani, 2002, 148). (Samuel and Nurina) also defined the exchange rate as the value of the currency against which another currency is matched. The exchange rate can be divided into two groups, namely the fixed exchange rate and the flexible exchange rate. The fixed exchange rate is determined by the state. The flexible exchange rate is determined by the state. In a market with or without

government influence in stabilizing the currency (Donald, 2015: 3)

The researchers believe that all the previous concepts focus a basic point represented in the value of the local currency exchange by banks. These transfers result in the risk of the local currency exchange rate, which (risk) arises mainly from continuous fluctuations in that value, and the researcher believes that the clearest definition of the exchange rate of the currency is the number of units of the national currency that need to be paid to purchase one unit of foreign currency.

The exchange rate for any currency in the foreign exchange market is determined according to the forces of supply and demand for currencies, so the demand for Iraqi exports is matched by a demand for the Iraqi dinar, and it also means an offer of foreign currencies, as there are sometimes interventions by the monetary authorities in determining the appropriate exchange rate for all foreign currencies to achieve their goals. Among the forms of the exchange rate, we mention:

1 - Nominal exchange rate: the nominal exchange rate is determined according to the forces of supply and demand in the exchange market at a specific moment in time and terms of the exchange system adopted in the country, and the nominal exchange rate is divided into the official exchange rate, which is the price in force about official current exchanges, and The exchange rate in force in parallel markets, meaning that there can be more than one nominal exchange rate at the same time for the same currency and in one country (Bin Hassine et al., 2013, 103).

2 - The real exchange rate: the real exchange rate represents that weighted average that works on combining both the nominal exchange rate fluctuations and the variation in inflation rates, given that it takes into account the fluctuations that occur in foreign prices, and linking them to the domestic price level (Al-Amiri, 2013: 4).

3 - Actual exchange rate: The actual exchange rate expresses the indicator that measures the average change in the exchange rate of a currency about several other currencies in a period of time, meaning that the actual exchange rate is equal to the average of several bilateral exchange rates. The effective exchange rate indicates the extent to which a country's currency has improved or

developed about a basket of currencies over a period of time (El-Hiti, 2010: 11)..

4- The real effective exchange rate: The real exchange rate measures how the exchange rate of a particular country has changed vis-à-vis its trading partners compared to a certain base period, but the nominal price movements do not involve anything related to the purchasing power of the currency (Hamed, 2011: 6)..

5- Equilibrium exchange rate: The equilibrium exchange rate is the price determined by the forces of supply and demand when the required value is equal to the offered value of one of the currencies regardless of the impact of speculation and unusual capital movements, so the equilibrium exchange rate is like the equilibrium for any commodity traded in the market Free competition in the presence of perfect competition (Al-Abbas, 2003, 12)..

The banks that practice their activities at the international level in the sense that they deal in several foreign currencies, so their decisions are affected by the expectations of the local currency exchange rate, and therefore it is incumbent on the financial managers in such away.

Banks understand and understand the mechanisms of forecasting the exchange rate, which may prevail in the future, and in a way that enables them to make successful decisions that contribute to maximizing the value of the bank (Al-Nuaimi, 2012, 227).

Some decisions can be reviewed in international banks for which forecasting the exchange rate is one of the necessary matters that the financial management must do, and some considerations must be taken into consideration when undertaking the process of forecasting the foreign exchange rate. Deciding whether or not to hedge cash flows in foreign currency and the decision to invest in foreign branches that, if taken, contribute to increasing cash flows, and obtaining the required financing in foreign currencies that contributes to reducing the cost of financing and that leads to achieving the main goal of maximizing profit and then maximizing the bank's value (Madura, 2006,266)

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(Al-Hassani, 2002) believes that exchange rate risk is the risk that arises as a result of fluctuations or possible adverse changes in the exchange rates of currencies or in the positions held in those currencies. For example, the company maintains assets in a particular currency that is greater than the liabilities of the same currency, then the risk lies in the lowering of the exchange rate, and if the opposite is that the company maintains liabilities in a particular currency that are greater than the assets, then the risk lies in the rise in the exchange rates of this currency (Al-Hasani, 2002, 178) .

Exchange rates cannot be predicted with complete accuracy, but the facility can at least measure its exposure to the risks of fluctuations in the exchange rate. If the company has a high degree of risk of exchange rate fluctuations, it can take into account the methods that contribute to reducing the degree of its exposure to those risks. And such methods will be briefly recognized as follows: (Al-Nuaimi, 2012, 272)

1-The risk arising from transactions and deals arises from transactions that involve future cash flows and are denominated in a different currency than the home currency, as the value of the cash inflows and received by the company in different currencies will be affected by the exchange rates of each of these currencies expected to be received, especially when you convert them into the currency. Desired (Dhanani, 2002, 40). In the same manner, the value of cash outflows that the company will pay in different currencies will depend on the expected exchange rates for those currencies, and the degree to

which the value of future cash transactions may be affected by exchange rate fluctuations is called the term transaction exposure to exchange rate risk (Transaction Exposure). And the presentation of the transaction or transaction could have a fundamental impact on the company's profits, so if a company is working on evaluating its exports in foreign currency, then a decrease of (10%) in the value of that currency means a decrease in the value of its receivables in local currency by the number of exports.

2- Risks of translation or translation: The transfer of foreign currencies is one of the most difficult and controversial issues faced by companies operating in the international field, as a result of globalization of business and fluctuations in the foreign exchange markets and global stock markets. Companies with important operations outside the borders cannot prepare unified lists unless their accounts and accounts are expressed. Its branches are in one currency, and usually, the single currency is the currency of the parent company when the functional currency is (the basic currency of the economic environment in which the company conducts its activity), (Al-Amiri, 2013, 94) as the currency of the foreign branch is different from the currency of preparing the special financial statements In the multinational company (whether that currency is the currency of the country of the foreign branch or the currency of a third country), the matter requires converting the financial statements of the branch from the functional currency to the currency of preparing the financial statements of the multinational company, (Vanhoese and Daniels, 2010, 142) as it creates a risk Transfer from the need to convert the financial statements of foreign branches from foreign currency into the local currency of the company to prepare and integrate the final reports. The risk of transfer is defined as "counting M. The balance resulting from the merger, merger, or consolidation of the financial statements of the branches of the multinational company.

3 - Economic risks: They are related to cash flows and are concerned with the extent to which the present value of future cash flows will be affected by all changes associated with the rise and fall of the currency value. Exposure to economic risks, which is also called exposure to competitive risks or exposure to strategic risks, represent real risks. (Vanhouse and Daniels, 2010, 142) as these risks affect the company's ability to compete in a

particular market over a future period of time. Some economists believe that part of the foreign direct investment results from companies 'attempt to avoid economic risks. By owning a factory or office in the foreign country in which it operates, the company can avoid some exchange rate risks in comparison to the risks it faces when all of its factories and offices are Found on local websites only. (Balazouz, 2010, 336).

### Second - managing exchange rate risk

It is imperative that countries be aware of exchange rate risks in all sectors of the economy and still building the capacity of market participants to manage these risks, as well as the ability of supervisory authorities to put in place a system that ensures proper control and regulation takes a long time, and without a doubt, achieving this is recommended before exit. From the fixed exchange rate. (Aabo, et.al, 2003, 1) Also, exchange rate risk exists in systems of linking exchange rates to another currency, but the regulation and management of risks is more urgent inflexible systems where exchange rates fluctuate daily, and the management of financial institutions involves price risk Spending on establishing information systems to control risk sources and designing rates based on accounting principles, analytical technical methods for measuring future risks, and developing internal policies and procedures to face risks. These technologies can be divided into two types:

1-Traditional techniques, including:

-Billing in the local currency, invoicing in the national currency, allows the company to avoid the risk of exchange because the amount expected to be collected or paid on the due date is specific and known to the company since the date of the conclusion of the contract, and this gives it advantages in the ease and homogeneity of the coverage process. This technique avoids the exchange losses, but it It also does not allow it to achieve profits from the positive changes in the exchange, and the problem that arises is the conflict of interests of both the importer and the exporter, as each seeks to liberalize the process in the national currency that suits its interests, but this technique is not always applicable in relations between traders (Shawqi, 2009, 33-34.)

- Multilateral clearing, the application of this technique in particular to companies with multiple branches located in

foreign countries that have mutual financial or commercial dealings between them, and according to which a clearing of debts and the dues of these branches is organized, and it is allowed to reduce the number and amounts of transfers between them.

The matter is limited to paying the differences in debts, and here it is necessary to agree on a reference date for the payments between the various branches, as well as the currency used and the exchange rate agreed to be applied.

-Insurance companies intervene in foreign trade. They are national companies whose role is to ensure the peaceful end of export and import operations. They intervene to secure foreign trade risks as well as to secure exchange risks when the latter is not covered by one of the market techniques. Therefore, exporters can conclude insurance contracts with this company to avoid The risks arising from commercial loans to foreign clients by insuring it (Belazouz, 2010, 336).

-The hard currency billing center is a unit or branch of a multinational company, aiming to face the risk of exchange, and it is located in countries where covering the risk of exchange is easier to bear, meaning not in countries that do not have a special exchange regulation, each branch of The multinational company writes its invoices in its national currency by order of the invoicing center, the latter guarantees the payment of the invoice and then it is paid by the branch's customer, and he also receives the consideration in the national currency of the branch. It obtains coins from branches in order to cover its costs (Tariq, 2009, 35)

2- Modern technologies: The investor faces great risks in the foreign exchange markets as a result of changing the exchange rates of different currencies, as the traditional techniques are not sufficient to cover the risk of exchange, so the need has become urgent to find modern tools to cover the risks of exchange rate fluctuations by resorting to derivative contracts on the Currencies, represented by currency futures, currency options and currency swaps.

- Coverage by means of currency futures contracts

Such contracts are used to cover the risks that arise from the change in the exchange rate of the local currency against foreign currencies. Studies have shown that there is a dire effect of the exchange rate on the profits of

companies, especially those that are international companies or companies operating in the field of export and import. On the other hand, we find that the exchange rate is a constantly changing variable that may lead to huge losses for companies in short periods, and from here it can be said that the company faces exchange rate risks, and fortunately, this type of risk can be eliminated through hedging operations or hedging operations. (Al-Shahawi and Al-Hinnawi, 2012, 296).

- Swap operations

The currency swap process combines the immediate purchase of a currency and selling it at the same time and vice versa, and it also involves writing two simultaneous contracts, one of which is a purchase contract and the other is a sale contract, and the value of each of the two contracts is one, but their maturity dates are different and separated by a period of time, and the price of the swap is known as) the difference between The spot rate and the forward rate of the currency i.e. the exchange rate difference) (Morey, 2010, 52)..

- Exchange options

Foreign trade dealers can cover exchange fluctuations through exchange options. For exporters who did not receive their revenues immediately, they can buy the selling option to exercise it in the event of a decrease in the value of the hard currency in which the transaction is carried out at the time of collection, but in the case of the opposite, they sell their revenues collected in The exchange market in cash to benefit from an increase in the value of the hard currency, (Tariq, 2009, 35) the basis of the transaction, as for importers who have not paid the amounts of their transactions, to buy the purchase option, which is useful to exercise in the event of an increase in the value of the currency at the moment of payment, but if the opposite occurs, i.e. the value of the foreign payment currency decreases The moment of payment, it is in their interest to buy the transaction amount in the exchange market in cash, meaning that the currency price is less than the option price.

Exchange options provide an avoidance of potential losses arising mainly from fluctuations in the exchange rate (Morey, 2010, 52)..

From the foregoing, it became clear that there are many concepts about the exchange rate, all of which revolve around a fundamental point, which is the value of the currency conversion made by international companies, as these transfers result in the exchange rate risk that arises mainly from the continuous fluctuations in that value.

The risk of exchange arises before the conclusion or completion of the transaction or the commercial transaction, as well as through financial operations such as lending and borrowing in different terms, for several reasons, including that the currency exchange rate is determined by supply and demand factors, which in the end is responsible for fluctuations in the exchange rates, and there are other factors. (Tariq, 2009, 35) They are the cause of fluctuations in exchange rates such as the general situation of the balance of payments, the rise in the interest rate in the country and other reasons that were discussed during the research, but on the other hand there are methods that companies take to avoid facing the risk of the exchange rate by dealing in the local currency and other methods as there are Several methods are used by companies to confront the risk of the exchange rate.

### Third : corporate profits

Profits are the main driver of many capital activities in the economy, and corporate profits are one of the economic indicators. Profitability provides a summary of a measure of the success or failure of companies, and then it is a basic indicator of economic performance and at the same time it is used for evaluation and related measures to evaluate The implications for companies of changes in economic or political conditions (Morey, 2010, 52). Finally, it can be said that corporate profits are an important component of income and play a role in measuring total income resulting from the production and distribution of income across different economic sectors. (Belazouz, 2010, 336).

#### 1-The concept of profit

Profit: an accounting concept and another economic one, from the accounting point of view, it is the increase in total revenues over total costs during a certain period, (Morey, 2010, 53) meaning that it is the difference between the value of the revenues achieved and their cost, and this can be explained according to the following equation:

$$(1).....P = TR - TC$$

Where: P represents accounting profit

TR: represents total revenue

TC: Represents the total costs

In economic terms, profit: it is an increase in wealth, which includes an increase in the revenues generated over its costs, added to it the costs of alternative opportunities, and it is also known as an increase in total revenues over total costs (apparent costs and implicit costs) and this means that economic profit is less From the accounting profit due to the existence of implicit costs (not apparent). Economic profit can be expressed according to the following equation: (Ramadan and Jawdat, 2006, 91-92).

$$(2).....P = TR - (TC + Cn)$$

Where P: economic profit.

TR: Total revenue.

TC: total costs.

CN: Opportunity costs.

The companies seek to achieve the goal of increasing the wealth of the owner by means of achieving appropriate profits, that is, not less than that achieved by other companies, which are exposed to the same degree of risk and distribute it to them after keeping part of it in the form of compulsory and optional reserves, various allocations and non-profits Intended for distribution.

#### 2-The concept of revenue and its types

The revenue represents the positive side of the profit determination equation by contrasting the revenues with the expenditures that define the net profit equation. Revenues are measured by the amount of the increase in the company's assets or the decrease in its liabilities, or both, resulting from the company doing some or all of the following activities: (Jerboa, 2004, 102).

- Sell goods

- Performing services to clients or leasing company assets to others

- Selling an asset item such as land, buildings or securities

Revenue is income that presents itself in the normal course of the company's activities, and is referred to by a variety of different names including sales, fees, interest and dividends (Mark, 2014,145) .Revenue is also the total flow of cash and receivables or other considerations that arise in the course of the establishment's normal activities from selling goods, providing services, others' use of the company's resources, and in terms of sources of obtaining it, revenue is considered an increase in assets resulting from the company's operating activities (Dabbagh , 2016, 60). From the previous definitions of revenue, we find that the concept of revenue can be viewed as an influx of values into the accounting unit as a result of its performance of its activities during the period. In determining the nature of the revenue according to this trend, it is stipulated that goods and services must be transferred to an external party (completion of the exchange process) and that this results in an increase in the net assets of the accountant unit.

### 3-The concept of costs

Costs represent all expenditures that have a direct relationship with outputs in the form of final goods or services. (Mark, 2014,145). Thus, costs always express all expenditures that are directly related to the revenue realized as a result of the causal relationship and the direct link between them and the resulting revenue. In terms of their relationship with the assets, (Belazouz, 2010, 336). costs are the value of the assets that have been exhausted or obtaining their services in the operational stage or the use of production factors and have a direct relationship with the realized revenue, whether this revenue is realized or not, and if the said exhaustion process results in achieving revenue, then the cost becomes an expense, and

if not Offset to a revenue or benefit, the cost becomes a loss. (Dabbagh , 2016, 60). There are those who define the term (cost) as the amount of expenditures (actual or nominal) resulting from something or attributable to a specific thing or activity, in addition to that it can be defined in monetary terms as a measure of the amount of resources used for the purpose of producing goods or services provided, (Al-Jalili et al. , 2006, 126).

### CONCLUSIONS

There are many concepts about the exchange rate, all of which revolve around a fundamental point, which is that the number of units of the national currency must be paid to purchase one unit of foreign currency. The researchers agree with the literature There is a clear impact of exchange rate risk on corporate profits and the purchasing power parity theory provides a future vision that can be relied upon in assessing fluctuations in currency exchange rates when environmental conditions are stable, and it does not provide such a vision in unstable environmental conditions such as those of Iraq. Banks are the most popular type of company that follows the methods of hedging against currency exchange fluctuations, and then exchange companies, respectively. The two researchers believe that this result is a logical result due to the availability of highly qualified specialized staff in banks on the one hand, and on the other hand, most exchange companies are companies that deal on a daily basis in currencies, and this explains their coming in second place. As costs represent all expenditures that have a direct relationship with outputs in the form of final goods or services, and thus the costs always express all the expenses directly related to the revenue realized as a result of the causal relationship and the direct link between them and the resulting revenue.

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