

ELECTIVE PAPER 6A: RISK MANAGEMENT

SUGGESTED SOLUTION

Case study 3

Note: Please note these solutions are for guidance purpose only.

A. (1) SWOT Analysis of Sunshine Ltd. is as follows:

Strength

- Specialization in the software development for their clients.
- Providing unique solutions to the clients.
- IT professional employed with the company.
- Sound Internal Control system
- A major portion of revenue comes from fixed price projects which allow it the flexibility to determine the resources it deploys and use software tools to deliver services.

Weakness

- Derives a major portion of its revenues from customers discretionary spending which is linked to their business outlook.
- Three-fourth of the revenue of is from traditional services.
- Dependence on the people.

Opportunity

- More focus on software led services which coincide with newer areas such as digital and cloud.

Threat

- Restrictive visa policy by USA may affect the work of sunshine Ltd. and threaten the prospect of global mobility of people as distributed software development requires free movement of people.
- Appreciation of the rupee against any major currency results in the revenue denominated in that currency to appear lesser in reported terms.
- Clients cutting their budgets on such services and shifting their focus on newer areas such as digital and cloud.

(2) The first political risk is toughening of visa policies by present US Government. The new directive rescinds the previous guidance, which gave "deference" to previously approved visas as long as the key elements were unchanged and there was no evidence of a material error or fraud related to the prior determination. This may affect the free movement of IT people from India across USA thereby also affecting the work of Sunshine Ltd.

Secondly, the exit of Britain from European Union i.e. Brexit only added to the woes of the IT sector. Of the \$108-billion of the IT industry's estimated exports in 2015-16, 17 per cent was to the UK and about 11.4 per cent to other nations within the EU. For large Indian IT companies, over a fourth of their revenues come from Europe, in particular from the UK. This may affect the profitability position of Sunshine because of the currency fluctuations.

- (3) The types of exposures risks to be encountered by Sunshine Ltd. are discussed as below:

Transaction Exposure - It measures the effect of an exchange rate change on outstanding obligations that existed before exchange rates changed but were settled after the exchange rate changes. Thus, it deals with cash flows that result from existing contractual obligations. For example, in the case of Sunshine Ltd. if services are exported to USA for \$10,00,000 due in one month and if the dollar depreciates relative to the rupee, a cash loss occurs. Conversely, if the dollar appreciates relative to the rupee, a cash gain occurs.

Further, domestic ratings agency ICRA has highlighted that the appreciation in the rupee is aggravating the troubles of the Indian IT sector, which is already hit by a change in the market landscape and compressing revenue growth.

Economic Exposure – It refers to the extent to which the economic value of a company can decline due to changes in exchange rate. ICRA has said that despite an 8.1 per cent growth in USD revenue, IT players have registered a growth of only three per cent in the second quarter of the current fiscal, due to the rupee appreciation of four per cent during the quarter.

It also pointed out that IT Services players profitability also remains sensitive to rupee depreciation vis-a-vis major currencies such as USD, GBP and Euro and the same too will have an impact.

- (4) The company tackle the exposure of difference in exchange rates when sale took place and when invoice is collected through hedging currency risks which are explained as below:

(i) **Internal Techniques:** These techniques explicitly do not involve transaction costs and can be used to completely or partially offset the exposure. The techniques relevant to Sunshine Ltd. can be further classified as follows:

- **Invoicing in Domestic Currency:** Should the seller (exporter) i.e. Sunshine Ltd. elect to invoice in foreign currency, perhaps because the prospective customer prefers it that way or because sellers tend to follow market leader, then the seller should choose only a major currency in which there is an active forward market for maturities at least as long as the payment period. Currencies, which are of limited convertibility, chronically weak, or with only a limited forward market, should not be considered.
- The seller's ideal currency is either his own, or one which is stable relative to it. But often the seller is forced to choose the market leader's currency. Whatever the chosen currency, it should certainly be one with a deep forward market.
- **Price Variation:** Price variation involves increasing selling prices to counter the adverse effects of exchange rate change. This tactic raises the question as to why the company has not already raised prices if it is able to do so. In some countries, price increases are the only legally available tactic of exposure management.
- **Asset and Liability Management:** This technique can be used to manage cash flow exposures. In essence, asset and liability management can involve aggressive or defensive postures. In the aggressive attitude, the firm simply increases exposed cash inflows denominated in currencies expected to be strong or increases exposed cash outflows denominated in weak currencies. By contrast, the defensive approach involves matching cash inflows and outflows according to their currency of denomination, irrespective of whether they are in strong or weak currencies.

(ii) **External Techniques:** Under this category range of various financial products are used which can be categorized as follows:

- **Money Market Hedging:** At its simplest, a money market hedge is an agreement to exchange a certain amount of one currency for a fixed amount of another currency, at a particular date.

For example, suppose a business owner in India expects to receive 1 Million USD in six months. This Owner could create an agreement now (today) to exchange 1 Million USD for INR at roughly the current exchange rate. Thus, if the USD dropped in value by the time the business owner got the payment, he would still be able to exchange the payment for the original quantity of U.S. dollars specified.

- **Derivative Instruments:** A variety of derivative instruments such as Forward, Futures, Options and Swap are available to hedge the exposure of foreign exchange.

(5) The Internal Financial Control System of the Sunshine Ltd. is more or less efficient. The reasons are given as below:

- Recording and providing reliable financial and operation information.
- Safeguarding assets.
- Ensuring compliance with corporate policies.
- Well defined delegation of power.
- Efficient ERP system.
- Internal audit by one of the big audit firm.
- Periodic audit by specialized third party consultants.

And, finally Audit Committee found internal financial control adequate which shows that Sunshine Ltd. has a good Internal Financial Control System.

B. Answers to Multiple Choice Questions

1. (a)
2. (a)
3. (c)
4. (a)
5. (d)
6. (c)
7. (d)
8. (c)
9. (c)
10. (c)