Forward contracts

Finance

Advantages and Disadvantages of Using Forward Contracts and Options to Hedge Foreign Exchange Risk Introduction

Hedging is a term used in the financial markets to refer to managing foreign exchange risks to an extent that makes it more bearable (Doupnik & Perera, 2007). Forward contracts are often used as a means for hedging risks associated with foreign exchange fluctuations. Forward contracts can thus be referred to as customized agreements between two entities to fix the exchange rates for the purposes of future transactions (Meera, 2009). On the other hand, option arrangements or standby contracts are other tools for liability and asset management, which when appropriately used, can minimize the risks associated with interest rates fluctuations. Although these simple arrangements can easily mitigate foreign exchange rate risks, there are several advantages and disadvantages of using them to hedge foreign exchange risks (Feng, 2007).

Advantages

The first advantage of using forward contracts to hedge foreign exchange risks is that future rates can be fixed in advance. This therefore eliminates the downside risk exposure. Secondly, forward contracts are more flexible with respect to the amount of money to be covered. Thirdly, forward contracts are relatively simple and straightforward to both comprehend and organize (Feng, 2007).

On the other hand options allow the contracting party to settle forward contracts at an agreed and fixed exchange rate, but at any time between two specific dates. This means that option-date forward exchange contracts can be settled at the agreed rate if currency cash-flows occur between the two set dates (Meera, 2009).

Disadvantages

Although forward exchange contracts are simple agreements that can mitigate exchange rate risks, they have some shortcomings. In particular, it may be difficult to get a counter party who will agree to fix future exchange rates for the time period as well as the amount in question. Secondly, forward contracts do not provide an opportunity for the parties to benefit from favorable fluctuations in the exchange rates. Thirdly, forward markets only exist for major world trading currencies such as the Dollar, Euro, Pound or Yen, but they do not exist for exotic currencies (Doupnik & Perera, 2007). The main disadvantage with options is that the issuer of the option receives the fees upon the specified date and is obligated to buy the securities at the other party's option. Additionally, options are subject to basis risks and only provide a partial hedge (Meera, 2009).

Question 2

December 1, 2009

Accounts receivable [1, 000, 000 x $0. 088]$88, 000

Accounts receivable$88, 000

[Accounts receivable [1, 000, 000 x ($0. 088- $0. 084)]$4, 000

Foreign Exchange Gain $4, 000

December31, 2009

Accounts receivable [1, 000, 000 x ($0. 080-$0. 074)]$6, 000

Foreign exchange gain $6, 000

Premium revenue

[1, 000, 000 x ($0. 080- $0. 074) = $6, 000 x 0. 9803 = $5881. 8] $5881. 8

Forward contract$5881. 8

Revenues as at December 31, 2009

Sales$88, 000

Foreign Exchange gain$4, 000

Foreign Exchange gain$6, 000

Premium revenue $5, 881. 1

Total $103, 881. 1

References

Doupnik, T. & Perera, H. (2007) International Accounting. Boston: The McGraw-Hill Companies, Inc.

Feng, X. (2007) Corporate Hedging of Currency Exchange Risk. University of Twente. Retrieved from: Meera, A. (2009) Hedging Foreign Exchange Risk with Forwards, Futures, Options and the Gold Dinar: A Comparison Note. Malaysia: International Islamic University.