THE UNIVERSITY OF THE WEST INDIES
CAVE HILL

EXAMINATIONS OF APRIL/MAY 2011.

CODE AND NAME OF COURSE: MGMT3053 - INTERNATIONAL FINANCIAL ACCOUNTING

DATE AND TIME: **DURATION: 2 HOURS**

INSTRUCTIONS TO CANDIDATES: This paper has 8 pages and 23 questions.

Section one is compulsory and comprises of 20 multiple question worth 20 marks. Section two has three questions from which candidates may answer any two questions. Each question in this section is worth 25 marks.

SECTION 1

1. Which of the following is an example of direct foreign investment?

   a) exporting to a country.
   b) establishing licensing arrangements in a country.
   c) purchasing existing companies in a country.
   d) investing directly (without brokers) in foreign stocks.

2. Which of the following would likely have the *least* direct influence on a country's current account?

   a) inflation.
   b) national income.
   c) exchange rates.
   d) a tax on income earned from foreign stocks.

3. The international money market primarily concentrates on:

   a) short-term lending (one year or less).
   b) medium-term lending.
   c) long-term lending.
   d) placing bonds with investors.

TURN OVER

4. If a currency's spot rate market is _______, its exchange rate is likely to be _______ to a single large purchase or sale transaction.

   a) liquid; highly sensitive
   b) illiquid; insensitive
   c) illiquid; highly sensitive
   d) none of these

5. If you expect the British pound to appreciate, you could speculate by _______ pound call options or _______ pound put options.

   a) purchasing; selling
   b) purchasing; purchasing
   c) selling; selling
   d) selling; purchasing

6. It has been argued that the exchange rate can be used as a policy tool. Assume that the government would like to reduce unemployment. Which of the following is an appropriate action given this scenario?

   a) weaken the dollar.
   b) strengthen the dollar.
   c) buy dollars with foreign currency in the foreign exchange market.
   d) implement a tight monetary policy.

7. Due to _______, market forces should realign the relationship between the interest rate differential of two currencies and the forward premium (or discount) on the forward exchange rate between the two currencies.

   a) forward realignment arbitrage
   b) triangular arbitrage
   c) covered interest arbitrage
   d) locational arbitrage

8. Given a home country and a foreign country, purchasing power parity (PPP) suggests that:

   a) a home currency will depreciate if the current home inflation rate exceeds the current foreign interest rate.
   b) a home currency will appreciate if the current home interest rate exceeds the current foreign interest rate.
   c) a home currency will appreciate if the current home inflation rate exceeds the current foreign inflation rate.
   d) a home currency will depreciate if the current home inflation rate exceeds the current foreign inflation rate.

TURN OVER

9. Assume that interest rate parity holds. The U.S. five-year interest rate is 5% annualized, and the Mexican five-year interest rate is 8% annualized. Today's spot rate of the Mexican peso is \$.20. What is the approximate five-year forecast of the peso's spot rate if the five-year forward rate is used as a forecast?

   a) \$.131.
   b) \$.226.
   c) \$.174.
   d) \$.140.

10. Jacko Co. is a U.S.-based MNC with net cash inflows of Singapore dollars and net cash inflows of Sunland francs. These two currencies are highly negatively correlated in their movements against the dollar. Kriner Co. is a U.S.-based MNC that has the same exposure as Jacko Co. in these currencies, except that its Sunland francs represent cash outflows. Which firm has a high exposure to exchange rate risk?

    a) Jacko Co.
    b) Kriner Co.
    c) the firms have about the same level of exposure.
    d) neither firm has any exposure.

11. If interest rate parity exists and transactions costs are zero, the hedging of payables in euros with a forward hedge will:

    a) have the same result as a call option hedge on payables.
    b) have the same result as a put option hedge on payables.
    c) have the same result as a money market hedge on payables.
    d) require more dollars than a money market hedge.

12. Laketown Co. has some expenses and revenue in euros. If its expenses are more sensitive to exchange rate movements than revenue, it could reduce economic exposure by _______. If its revenues are more sensitive than expenses, it could reduce economic exposure by _______.

    a) decreasing foreign revenues; decreasing foreign expenses
    b) decreasing foreign revenues; increasing foreign expenses
    c) increasing foreign revenues; decreasing foreign revenues
    d) decreasing foreign expenses; increasing foreign revenues

TURN OVER

13. A firm will likely benefit *most* from diversifying if:

a) the correlations between country economies are high.
b) the correlations between country economies are low.
c) the variability of all country economy levels is high.
d) the correlations between country economies are low AND the variability of all country economy levels is high.

14. Assume an MNC establishes a subsidiary where it has no other existing business. The present value of parent cash flows from this subsidiary is more sensitive to exchange rate movements when:

a) the subsidiary finances the entire investment by local borrowing.
b) the subsidiary finances most of the investment by local borrowing.
c) the parent finances most of the investment.
d) the parent finances the entire investment.

15. Which of the following is *not* an advantage of international acquisitions over the establishment of a new subsidiary?

a) the firm can immediately expand its international business.
b) the firm benefits from existing customer relationships.
c) international acquisitions are generally cheaper than the establishment of a new subsidiary.
d) All of these are advantages of international acquisitions.

16. Assume the following information:

You have \$300,000 to invest
The spot bid rate for the euro (€) is \$1.08
The spot ask quote for the euro is \$1.10
The 180-day forward rate (bid) of the euro is \$1.08
The 180-day forward rate (ask) of the euro is \$1.10
The 180-day interest rate in the U.S. is 6%
The 180-day interest rate in Europe is 8%

If you conduct covered interest arbitrage, what amount will you have after 180 days?

a) \$318,109.10.
b) \$330,000.00.
c) \$312,218.20.
d) \$323,888.90.

TURN OVER

17. When determining whether a particular proposed project in a foreign country is feasible:

    a) a country risk rating can adequately substitute for a capital budgeting analysis.
    b) country risk analysis should be incorporated within the capital budgeting analysis.
    c) the effect of country risk on sales revenue is more important than the effect on cash flows.
    d) the project with the highest country risk rating (lowest country risk) should be accepted.

18. Ideally, a firm desires to denominate bonds in a currency that:

    a) exhibits a low interest rate and is expected to appreciate.
    b) exhibits a low interest rate and is expected to depreciate.
    c) exhibits a high interest rate and is expected to depreciate.
    d) exhibits a high interest rate and is expected to appreciate.

19. Consider a bank that acknowledges that it will make payments on behalf of a beer importer after the beer is delivered to the importer. This reflects:

    a) accounts receivable financing.
    b) forfeiting.
    c) factoring.
    d) a letter of credit.

20. MNCs may be able to lock in a lower cost from financing in a low interest rate foreign currency if they have:

    a) future cash inflows in that foreign currency.
    b) future cash outflows in that foreign currency.
    c) offsetting future cash inflows and outflows in that foreign currency.
    d) no other cash flows in that foreign currency.

TURN OVER

SECTION 2

Answer any two (2) questions in this section.

Question 1

Kabukali Inc. imports wood from Morocco. The Moroccan exporter invoices in Moroccan dirham. The current exchange rate of the dirham is $.10. Kabukali just purchased wood for 2 million dirham and should pay for the wood in three months. It is also possible that Kabukali will receive 4 million dirham in three months from the sale of refinished wood in Morocco. Kabukali is currently in negotiations with a Moroccan importer about the refinished wood. If the negotiations are successful, Kabukali will receive 4 million dirham in three months, for a net cash inflow of 2 million dirham. The following option information is available:

- Call option premium on Moroccan dirham = $.003
- Put option premium on Moroccan dirham = $.002
- Call and put option strike price = $.098
- One option contract represents 500,000 dirham.

Required

a) Describe how Kabukali could use a straddle to hedge its possible positions in dirham. **(4 marks)**

b) Consider three scenarios. In the first scenario, the dirham's spot rate at option expiration is equal to the exercise price of $.098. In the second scenario, the dirham depreciates to $.08. In the third scenario, the dirham appreciates to $0.11. For each scenario, consider both the case when the negotiations are successful and the case when the negotiations are not successful. Assess the effectiveness of the long straddle in each of these situations by comparing it to a strategy of using long call options to hedge. **(15 marks)**

c) Compare and contrast Compare and contrast the following hedging techniques used by MNC's:

- Leading and lagging
- Cross hedging
- Currency diversification

(6 marks)

TURN OVER

Question 2

a) Klondike, Inc., a U.S.-based MNC, has screened several targets. Based on economic and political considerations, only one eligible target remains in Malaysia. Klondike would like you to value this target and has provided you with the following information:

- Klondike expects to keep the target for three years, at which time it expects to sell the firm for 500 million Malaysian ringgit (MYR) after deducting the amount for any taxes paid.
- Klondike expects a strong Malaysian economy. Consequently, the estimates for revenues for the next year are MYR300 million. Revenues are expected to increase by 9% over the following two years.
- Cost of goods sold are expected to be 60% of revenues.
- Selling and administrative expenses are expected to be MYR40 million in each of the next three years.
- The Malaysian tax rate on the target's earnings is expected to be 30%.
- Depreciation expenses are expected to be MYR15 million per year for each of the next three years.
- The target will need MYR9 million in cash each year to support existing operations.
- The target's current stock price is MYR35 per share. The target has 11 million shares outstanding.
- Any cash flows remaining after taxes are remitted by the target to Klondike, Inc. The exchange rate is currently $.21. The 3 year annualized interest rate in the United States is 7.5% while the 3 year annualized interest rate in Malaysia is 6%. Assume Interest rate parity exists for the three year horizon and the forward rate is used to forecast exchange rates.
- Klondike's required rate of return on similar projects is 12%.

TURN OVER

Question 2 (cont'd)

Required

a) Calculate the net present value of this target. **(14 marks)**

b) The target's board has indicated that it finds a premium of 30 percent appropriate. You have been asked to negotiate for Klondike with the Malaysian target. Calculate the maximum percentage premium you should be willing to offer for the target. **(3 marks)**

c) Four main schools of thought exist as to the relevance of exchange rate risk. The Multinational Corporation's treatment of exchange rate risk is a result of their thoughts on exchange rate risk. Discuss **three** thoughts surrounding exchange rate risks, and the MNC's response to these arguments. (8 marks)

Question 3

Marshalls Company expects to receive 5 million euros in one year from exports. It can use any one of the following strategies to deal with the exchange rate risk. Estimate the dollar cash flows received as a result of using the following strategies:

- unhedged strategy
- money market hedge
- option hedge

The spot rate of the euro as of today is \$1.10. Interest rate parity exists. Marshalls uses the forward rate as a predictor of the future spot rate. The annual interest rate in the U.S. is 8% versus an annual interest rate of 5% in the eurozone. Put options on euros are available with an exercise price of \$1.11, an expiration date of one year from today, and a premium of \$.06 per unit.

Required:

a) Estimate the dollar cash flows it will receive as a result of using each strategy. State which hedge is optimal. **(11 marks)**

b) Compare and contrast the theories of Interest Rate parity, Purchasing Power parity, and the International Fisher effect. **(10 marks)**

c) Compare and contrast fundamental and technical forecasting methods, giving one example of each. **(4 marks)**

END OF QUESTION PAPER