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ANALYTICAL APPROACH TO THE FORMATION OF CURRENCY RISK MANAGEMENT STRATEGY OF A GROUP OF RELATED COMPANIES

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ABSTRACT

An exchange rate risk related with the threat of economic losses being a result of changes in an exchange rate during the execution of a foreign economic contract is a significant risk for the group of international companies. The rejection of fixed exchange rate at the global level has led to the fact that subjects of foreign economic activity in different countries should pay more and more attention to minimizing the negative impacts of exchange rate differences. For corporate-type enterprises that have many business relationships and transactions with foreign economic counterparties, the area of exchange rate differences management is being updated in the context of minimizing risks of the group's economic activity. The article is devoted to the formation of an analytical approach to currency risk management of a group of international interconnected companies, which are formed during intra group foreign economic transactions. With the proposed approach, group managers can form a *currency risk management strategy, minimize losses and gain additional benefits from changes in exchange rates.*

Key words: foreign economic operations, related parties, corporate management, exchange differences.

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1. INTRODUCTION

When carrying out foreign economic activity under national currency depreciation conditions and a decrease in its purchasing power, an important task of internal audit of the enterprises is to identify the exchange rate risks, analyse exchange rate differences and develop strategies to manage exchange rate risks both at individual enterprises and within the activities of a group of enterprises. The issues of accounting and reflection of exchange rate differences in the reporting have been sufficiently formalized in the relevant accounting standards (IAS 21 NAS 21). At the same time, the processes of analysing and managing exchange rate risks remain relevant and require improvement.

The availability of investments in the activities of foreign enterprises leads to an increase in risks and a decrease in the financial result of the investing enterprise due to the presence of assets and liabilities denominated in foreign currency. Thus, it can be noted that the activity of an enterprise, in which foreign investments are being made, can be profitable but, at the same time, it can reduce the financial result of the investing enterprise due to the depreciation of foreign currency in relation to the functional currency of the investing enterprise. In this regard, the enterprise transactions management program, which carries out foreign investments, should contain appropriate analytical procedures to check the exchange rate differences, which could become the basis for the development of foreign exchange risks management strategies.

Many foreign publications deal with the issues of management in group of enterprises, which are included in foreign economic activity. Many authors study the processes of introducing European requirements into the system of control of foreign economic transactions - Devereux, M., & Maffini, G. (Eds) (2007) [1], Hira, A., Murata, B., & Monson, S. (2019) [2], Huda, M., Nugraheni, N., Kamarudin, K., (2017) [3], Sinenko, O., Mayburov, I. (2017) [4]. Many works are devoted to the implementation of the BEPS plan in the system of management and control of foreign economic activity of enterprises - West, C. (2017) [5], Larsen, M. M. (2015) [6], Eccleston, R., & Smith, H. (2016) [7]. There are studies that address the issues of deoffshorization and its impact on the economies of countries - Khalatur, S., Radzevicius, G., Velychko, L., Fesenko, V., & Kriuchko, L. (2019) [8, 9], Larsen, M. M. (2015) [6]. Many authors consider the problem of tax evasion in foreign economic transactions by groups of international companies, for example Avi-Yonah, R., Clausing, K., Durst, M., (2009) [10], Beebeejaun, A., (2019) [11], Clifford, S., (2019) [12], Marques, M., Pinho, C. , Montenegro, T., (2019) [13], Prettl, A. (2018) [14]. The sphere of currency risk management of groups of enterprises that arise during foreign economic transactions and affect the financial performance of enterprises and, as a consequence, the replenishment of the state budget remains insufficiently studied. Based on this, the purpose of the study is to form an analytical approach to currency risk management of a group of enterprises.

2. METHODS

The methodological basis of the study are the fundamental provisions of modern economic science, a set of general and special methods of cognition, in particular: the method of induction and deduction, the method of systematic approach, a method of comparing and structuring analysis. The method of matrix analysis is used to develop an analytical approach to the formation of currency risk management strategy. The main advantage of the matrix approach is the ability to consider the strategy of currency risk management in its dynamics, to form management actions to avoid losses from foreign economic transactions between enterprises of one group of companies.

3. RESULTS

Exchange rate differences based on the results of transactions held with independent enterprises should be recognized as part of operating expenses (income) in the reporting period in which they arose and should not be capitalized in the value of assets, but form (decrease or increase) the financial result of the reporting period, determining the risks of operating expenses overestimation in the financial statements of a group of companies.

Exchange rate differences based on the results of transactions with related enterprises are recognized as part of the financial investments cost, that is, they increase the value of the assets of the enterprise engaged in foreign economic transactions with an enterprise, in the capital of which it participates. In this case, the balance sheet asset item reflecting financial investments in related companies also becomes an accounting area that is subject to exchange rate risk.

Exchange rate differences on intra-group transactions between the parent company and its subsidiaries are consolidated and reflected in the consolidated financial statements of the entire group of companies, which means that exchange differences obtained from intra-group transactions have an impact on the financial performance of the group as a whole and, consequently, on profitability of the capital invested.

When managing intra-group transactions, their impact on the consolidated financial statements of the group of companies shall be considered. As is known, the results of intra-group transactions are mutually exclusive in the process of financial statements consolidation; but this rule does not apply to exchange rate differences being the result of intra-group transactions. Exchange rate differences being the result of intra-group transactions shall be recognized only when the recipient of the service (commodity, loan) is a component of the group with a different functional reporting currency.

The accounting of the subsidiary will show loss (gains) on the exchange differences, if a foreign economic unit uses a functional currency other than the parent company’s functional currency and imports products from the parent company under a contract in which the price is determined according to the parent company’s functional currency; this is due to the need to purchase the currency other than that of the subsidiary.

Recently, the foreign exchange risks management of the group of companies is being held not only in the direction of minimizing losses from exchange rate differences, but also in the direction of conscious obtaining of economic benefits from positive exchange rate differences. The managers of the group of companies are focused on managing exchange rate risks also in terms of their impact on the company's value, which may be decreased due to significant foreign exchange risks.

It is possible to use the cash flows balancing method in the group subdivisions when managing exchange rate risks within the framework of the activities of the group of companies. This method assumes a flexible response to actual cash flows in foreign currency within the group components: an increase in the expenditure side (in monetary terms) in subdivisions with positive dynamics of cash receipts; an increase in the revenue side (in monetary terms) in subdivisions with positive dynamics of cash payments.

An urgent scientific task is the development of an analytical approach to manage exchange risks arising as a result of the activities conducted by the related enterprises (associates, subsidiaries, joint ventures) and the levelling of their negative impact on the indicators of the consolidated financial statements.

The internal system of management of foreign exchange risks of a company shall reasonably include determination and analysis of the exchange rate differences, which arise from the activities of the related enterprises and which are transferred (in whole or in part) to the reporting indicators and the financial result of the parent-enterprise (in cases of the activities held by a group of companies –transfer shall be performed to the indicators of the consolidated statements).

The financial result from the enterprise exchange rate differences can be determined by the formula:

$$(FR^{ed} = ED^{a}+ED^{re}), \quad (1)$$

Where FR^{ed} – the financial result of the company from exchange rate differences; ED^{a} – exchange rate differences from the activities of the enterprise arising from the ordinary transactions of the operating, financial, investment activities of the company itself; ED^{re} – exchange differences, which are recognized in the reporting of the parent-enterprise based on the transfer of exchange differences of the related enterprises.

Thus, the exchange rate difference arising as the results of the activities conducted by the related enterprises can be formed based on: exchange rate differences from intra-group transactions; exchange rate differences from independent (external) transactions of the related enterprise (Fig. 1).

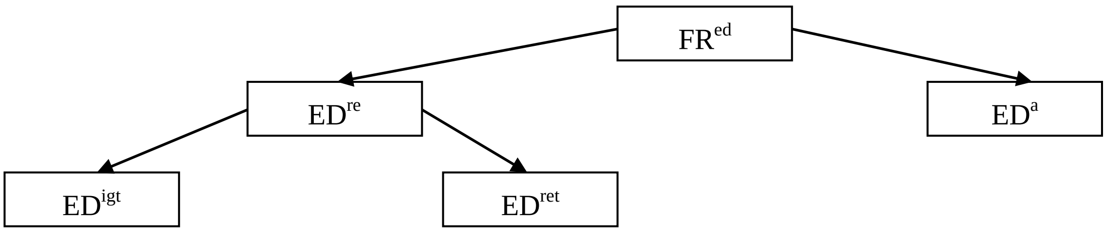

Figure 1 Formation of exchange rate differences in the reporting of the investing enterprise

Source : developed by the authors.

where FR^{ed} is a financial result of the enterprise from exchange rate differences; ED^{re} - exchange rate differences, which are recognized in the reporting of the parent enterprise based on the transfer of exchange rate differences of related enterprises; ED^{a} - exchange rate differences from the activities of the enterprise arising from the ordinary transactions of the operating, financial, investment activities of the enterprise itself; ED^{igt} - exchange rate differences from intra-group transactions; ED^{ret} - exchange rate differences from transactions of a related enterprise with counterparties that are not part of the group of companies.

Negative exchange differences from the activities of an enterprise can be offset by positive exchange differences of the related enterprises and vice versa. Therefore, an urgent task is to determine the factors influencing the occurrence of exchange rate differences and the development of tools for managing exchange rate differences in enterprises that make investments in foreign business units.

Exchange rate differences from intra-group transactions arise as a result of the sale (purchase) of goods (services) between the enterprises belonging to the same corporate group and the results of transactions of consolidated in the reporting/accounting statements of the parent company. In such cases, exchange rate differences might be recognized, if the recipient of the goods (services) was an enterprise that is part of a corporate group and had a different functional reporting currency. Exchange rate differences from transactions of a related enterprise arise based on the results of the enterprise, which in the course of its ordinary activities with other counterparties (not part of the corporate group) has reflected exchange differences in its accounting statements. Thus, it is possible to determine the exchange rate differences of the enterprise, which arise in the process of conducting activity by an entity related to it, using formula:

$$(ED^{re} = ED^{igt} + ED^{ret}), \qquad (2)$$

Where ED^{re} – exchange rate differences, which are recognized in the financial statements of the parent enterprise as a result of the transfer of exchange differences of related enterprises; ED^{igt} – exchange rate differences fromintra-group transactions between the parent and the related enterprise; ED^{ret} – exchange rate differences from the transactions of the related enterprise with other counterparties.

Exchange rate differences from intra-group transactions(ED^{IGT})	Exchange rate differences from the annual transactions of the related enterprise (**ED^{RET}**)		
	$ED^{RET} < 0$	**$ED^{RET} = 0$**	**$ED^{RET} > 0$**
$ED^{IGT} > 0$	1 $ED^{RE} = 0$ Compensated equilibrium	4 $ED^{RE} > 0$ Successful connection	6 $ED^{RE} >> 0$ Effective exchange rate (currency) strategy
$ED^{IGT} = 0$	7 $ED^{RE} < 0$ Unfavorable connection	2 $ED^{RE} = 0$ Stable equilibrium	5 $ED^{RE} > 0$ Effective corporate management
$ED^{IGT} < 0$	9 $ED^{RE} << 0$ Exchange crisis	8 $ED^{RE} < 0$ Inefficient corporate management	3 $ED^{RE} = 0$ Unstable equilibrium

Figure 2 Matrix of exchange risk management strategies for a group of related enterprises

Source: developed by the authors.

The division of the exchange rate differences in transactions with related parties into such two components is due to the difference in the their management tools and the prevention of negative exchange differences in the financial result of the parent company. Obtaining negative exchange rate differences from intra-group transactions and transactions of related enterprises involves the development of various recommendations by the internal auditor on the formation of currency risk management strategy for the group of companies.

The combinations of exchange rate differences of various types form an appropriate strategy for managing exchange rate risks of a group of enterprises, the effectiveness of which shall be assessed by the overall financial result obtained from exchange rate differences in foreign economic transactions with related enterprises. The corresponding matrix of the exchange risk management strategy for a group of related enterprises is provided in Fig. 2.

The value of exchange rate differences from related enterprise has been considered in the above-mentioned matrix in terms of a combination of their volume due to exchange rate differences arising from intra-group transactions and exchange rate differences arising from external transactions of related enterprises with foreign counterparties.

4. DISCUSSION

The exchange rate success zone is located above the diagonal 1-2-3 (quadrants 4,5,6 and partially 2,3); this zone corresponds to the value of $ED^{ret} \geq 0$, which is the result of an effective policy aimed at managing the company's exchange rate risks in the field of activities with related non-resident enterprises. The quadrants located under the diagonal (7,8,9 and partially 1,2) constitute a zone of ineffective foreign exchange policy of the enterprise in the field of activities with related non-resident enterprises, which leads to additional costs from exchange rate differences due to the formation of their negative balance.

Each quadrant of the matrix characterizes the corresponding result of the foreign exchange policy of the enterprise in the field of transactions with related non-resident enterprises, which can be changed by various methods: management of exchange rate differences within the intra-group transactions; management of exchange rate differences due to their impact on the related enterprise’s business.

There are three positions formed in the matrix, namely, the following: three positions of exchange rate equilibrium, three positions of exchange rate success (making profit from exchange rate differences) and three positions of exchange rate losses (receiving a loss from exchange rate differences). Equilibrium in the area of gains / losses from exchange rate differences of the related enterprise is achieved under the condition of mutual compensation of exchange rate differences from intra-group and external transactions of the related enterprise, which corresponds to quadrants 1, 2 and 3.

In quadrant 1, equilibrium is achieved by compensating for negative exchange rate differences from intra-group transactions with positive exchange rate differences from external transactions of the related enterprise*(Quadrant 1 "Compensated equilibrium":* $ED^{ret}<0$; $ED^{igt}> 0$*).* Exchange rate differences from the transactions of the related enterprise are negative, which may indicate an irrational structure of the related enterprise's cash flows. However, they are offset by the positive exchange rate differences arising from intra-group transactions owning to the fact that the functional currency of the investing enterprise is depreciated against the reporting currency of the related enterprise. Minimization of the negative exchange rate difference of related enterprises is possible through balancing of cash flows. It is possible to move to Quadrant 4, characterized by additional foreign exchange benefits, if the negative exchange rate differences of the related enterprise have been neutralized and the volume of intra-group transactions has increased. With a decrease in the volume of intra-group transactions, it is possible to move to quadrant 7, which is characterized by a loss from exchange rate differences (Fig. 3.18).

The state of foreign exchange risk management in quadrant 2 is characterized by stability *(Quadrant 2 “Stable equilibrium”:* $ED^{ret} = 0$ $ED^{igt} = 0$*),* which corresponds to a situation in which exchange rate differences from the transactions of a related enterprise and intra-group transactions are not recognized in accounting.

This may indicate the stability of the currencies in which enterprises conduct their transactions, as well as the effectiveness of the use of exchange rate risk management tools (hedging policy and client orientation). A transition to quadrant 4 is possible, if the volume of intra-group transactions increases. The impact on the transactions held by the affiliated enterprise and an increase in the volume of intra-group transactions will provide for a transition to the quadrant 6 status characterized by the greatest benefits from exchange rate management. The impact on the transactions of the related enterprise with a decrease in the volume of intra-group transactions will lead to a transition to quadrant 5 characterized by the positive effect of foreign exchange influence on the transactions of the related enterprise.

Negative exchange rate differences that have arisen in related enterprises due to unsatisfactory exchange rate policy will lead to a transition to quadrant 7. In the event of intra-group transactions with negative exchange differences, the enterprise may suffer significant losses due to ineffective exchange differences management at the level of transactions in the group and transactions of individual components of the group (transition to quadrants 8 and 9).

It is possible to develop the below-mentioned proposals in order to maintain a state of equilibrium and obtain additional income from exchange rate differences for an investing enterprise, the exchange risk management strategy of which corresponds to the status of quadrant 2: to increase the volume of intra-group transactions, which will allow to reach quadrant 4; to apply methods of forecasting the exchange rate in which the related enterprise conducts foreign economic transactions, thus preventing the transition to the zone located under the equilibrium diagonal.

The state of foreign exchange risk management in quadrant 3 is characterized by increased risks of losing equilibrium *(Quadrant 3 "Unstable equilibrium": $ED^{ret} > 0$; $ED^{igt} < 0$).* Exchange rate differences from the transactions maintained by the related enterprise are positive, which may indicate a rational structure of the related enterprise's cash flows. However, exchange differences between intra-group transactions are negative and shall be offset by exchange differences between transactions of the related enterprises. This status characterizes a risky foreign exchange policy of the parent company and an unstable foreign exchange equilibrium, which is mainly ensured by positive exchange rate differences of related enterprises, the influence on the management of which is limited by the equity interest. The policy on improvement of the result of foreign exchange risk management shall be aimed at transition to quadrant 5, which is characterized by making profit from exchange rate differences in the transactions of related enterprises.

Gaining losses from exchange rate differences of the related enterprise reflects the state of an ineffective exchange rate risk management strategy (quadrant 7,8,9). The result of foreign exchange risk management in quadrant 7 can be assessed as negative in case of a negative exchange rate difference, which is reflected in the statements of the related enterprise based on its external transactions results *(Quadrant 7: "Unprofitable connectedness": $ED^{ret} < 0$; $ED^{igt} = 0$)*; this indicates an irrational cash flow structure of the related enterprise and the ineffective foreign exchange risk management in the related enterprise. Minimization of the negative exchange rate difference of the related enterprise scan be achieved through balancing of cash flows, if the share of participation in the related enterprise's capital makes it possible to influence its economic activity. Since the accounting of the investing enterprise does not recognize exchange rate differences related to intra-group transactions, this indicates a decrease in the financial result of the group due to ineffective exchange rate policy of one enterprise of the group. A transition to quadrant 1 is possible in the event of advantageous difference in exchange rates with an increase in the volume of intra-group transactions. However, a policy of exchange rate influence on the transactions of the related enterprise with the purpose to rationalize the structure of cash flows will still be a viable strategy. The impact on the transactions of the related enterprise and the increase in the volume of intra-group transactions with positive exchange rate differences will allow to transit to a status of quadrant 4, which is characterized by gaining profit from the foreign exchange office. The impact on the transactions of the related enterprise with a simultaneous increase in the volume of intra-group transactions with negative exchange rate differences will lead to a transition to quadrant 9, which is characterized by a negative effect from exchange rate management.

The result of foreign exchange risk management in quadrant 8 is characterized by ineffective management of exchange rate differences precisely at the parent/head enterprise, which forms negative exchange rate differences from intra-group transactions *(Quadrant 8: "Ineffective corporate governance":* $ED^{act}= 0$ $ED^{igt}<0$*).* Such a result may arise due to the sales of goods (services) to a subsidiary (related enterprise) in a currency different from the functional currency of accounting at the related enterprise, which requires additional forecasting of the functional currency rate for the foreign company and the investing enterprise.

The internal auditor can identify an exchange rate crisis *(Quadrant 9: "Currency crisis":* $ED^{ret}<0$; $ED^{igt}<0$*),* provided that negative exchange rate differences from intra-group transactions are formed together with negative exchange rate differences from external transactions of the related enterprise. An enterprise under the condition of a foreign exchange crisis should carefully review its business transactions with related parties and the reasons for the occurrence of exchange rate differences in the reporting of the related enterprises.

Positions of foreign exchange success (making profit from exchange rate differences) correspond to the positive value of exchange rate differences, which are recognized in the reporting of the parent-enterprise based on the results of the transfer of exchange rate differences of the related enterprises (quadrants 4,5,6).

Subject to the formation of positive exchange rate differences from intra-group transactions, the result of foreign exchange risk management can be characterized as positive *(Quadrant 4: "Successful connectivity":* $ED^{ret}= 0$ $ED^{igt}> 0$*).* This status determines that the enterprise effectively manages foreign exchange risks and the conditions of foreign economic intra-group transactions. The enterprise receives additional income from the positive exchange rate differences precisely from transactions between the enterprises of the same group. The exchange rate differences of the related enterprises do not arise (Fig. 3.24).

The result of foreign exchange risk management in quadrant 5 shall be assessed as positive due to the positive exchange rate difference, which has been formed when conducting external transactions by a related enterprise *(Quadrant 5: "Effective corporate governance":* $ED^{ret}> 0$; $ED^{igt} = 0$*);* this indicates a rational structure of monetary flows of the related enterprise and effective management of foreign exchange risks by the managers of the individual enterprise of the group. The group as a whole receives additional income from positive exchange rate differences of the related enterprises with other counterparties. An increase in the income obtained from exchange rate differences is possible through managing the conditions for performing intra-group transactions, which will lead to a transition to quadrant 6 of the matrix.

The result of foreign exchange risk management in quadrant 6 shall be assessed as positive due to the simultaneous recognition of a positive exchange rate difference from intra-group transactions and a positive exchange rate difference from external transactions of the related enterprise*(Quadrant 6: "Effective foreign exchange strategy":* $ED^{ret}> 0$; $ED^{igt}> 0$*);* this indicates a rational structure of transactions in foreign currency both of an individual related enterprise and its participation in the intra-group transactions. The group's management generally conducts effective foreign exchange policy and earns additional income from exchange rate differences.

5. CONCLUSION

Upon receipt of positive exchange rate differences from related enterprises, the internal corporate auditor develops recommendations on the content of the state of exchange rate success in order to reduce the risk of losses from exchange rate differences and prevent the transition to the exchange rate loss quadrant (6 => 2 => 9, 6 => 5 => 8, 6 => 4 => 7, etc.). It is reasonable to determine and present the types of recommendations in the sphere of exchange rate risk management for a group of enterprises (Table 1), based on the results of applying the above-mentioned analytical procedure on the basis of the matrix approach.

Table 1 Recommendations in the field of exchange rate risk management of a group of enterprises

Assessment of the quality of the group's foreign exchange risk management	The result of exchange rate risk management according to the matrix	Recommendations to the Management Staff
Unsatisfactory	Quadrants 1,7	To intensify the impact on the process of exchange rate risk management in the related enterprise
	Quadrants 3,8	To optimize the intra-group transactions
Effective	Quadrants 2,4,5,6	To adhere to a defined management strategy
Exchange rate crisis	Quadrant 9	To review the group's exchange risk management policy

Source: developed by the authors.

Constituently, within the framework of the activities of the group of enterprises, it is possible to provide several recommendations of the internal auditor: to develop the management impact on the economic activities of the enterprise of the group, which is limited by the level of participation in a capital and the opportunity to influence it; to rationalize intra-group transactions in order to reduce transactions for which negative exchange differences arise; to adhere to the current currency risk management strategy; to completely review group's exchange risk management strategy.

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