Global Journal of Management and Business Research: C
Finance
Volume 20 Issue 4 Version 1.0 Year 2020
Type: Double Blind Peer Reviewed International Research Journal
Publisher: Global Journals
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

# Evaluation of the Effects of Forward Contracts on Financial Performance of Listed Multinational Companies in Kenya

By Mark Onchari, Asenath Moabe & Mactosh Onwonga
Kisii University

*Abstract-* The aim of the study was to evaluate the effect of forwards contracts on the financial performance of multinational companies in Kenya. The study used descriptive and cross-sectional research designs. The population consisted of nine companies listed at Nairobi securities exchange under the banking sector and one form the energy sector. The sample size of this study was three companies. Purposive sampling was applied to arrive at the sample size of three Multinational companies. Secondary data was collected from published annual financial reports for ten years from 2009-2018. Descriptive and inferential methods were applied to analyze the obtained data. The findings of the analysis were presented using tables and figures. The study found out that forward contracts had a positive correlation with the financial performance of multinational companies. The study concluded that forwards had direct and statistically insignificant effects on financial performance.

*Keywords: derivatives, forward contracts, financial performance, multinational companies, return on asset.*

*GJMBR-C Classification: JEL Code: G00*

EVALUATIONOFTHEEFFECTSOFFORWARDCONTRACTSONFINANCIALPERFORMANCEOFLISTEDMULTINATIONALCOMPANIESINKENYA

*Strictly as per the compliance and regulations of:*

# Evaluation of the Effects of Forward Contracts on Financial Performance of Listed Multinational Companies in Kenya

Mark Onchari [α], Asenath Moabe [σ] & Mactosh Onwonga [ρ]

*Abstract-* The aim of the study was to evaluate the effect of forwards contracts on the financial performance of multinational companies in Kenya. The study used descriptive and cross-sectional research designs. The population consisted of nine companies listed at Nairobi securities exchange under the banking sector and one form the energy sector. The sample size of this study was three companies. Purposive sampling was applied to arrive at the sample size of three Multinational companies. Secondary data was collected from published annual financial reports for ten years from 2009-2018. Descriptive and inferential methods were applied to analyze the obtained data. The findings of the analysis were presented using tables and figures. The study found out that forward contracts had a positive correlation with the financial performance of multinational companies. The study concluded that forwards had direct and statistically insignificant effects on financial performance.

*Keywords: derivatives, forward contracts, financial performance, multinational companies, return on asset.*

## I. Introduction

Forwards contracts refers to an agreement or contract between a buyer and a seller to exchange financial assets at a pre-determined price at pre-determined future date. Forward contracts are utilized by market participants to lock in prices, an exchange rate, and interest rates on a specific date against fluctuations. This gives buyers opportunity to continue their uninterrupted operations. Forward contracts hedge against financial risks hence give firms protection (Njoroge, Matumo & Maina, 2013).

Forwards provides a cover over foreign exchange perils in Serbia. However, their application and fluctuations of forex rates does not have a positive relationship. This is because, only big outfits participants in the use of forward contracts to protect themselves. These firms apply forward contracts on a continuous basis while considering their business cycles not changes in forex rates. Despite the use of forward contracts, many smaller firms does not apply them because of lack of clear regulation, handful developed firms, awareness of their benefits by many companies and neglecting the management of forex rates risk by other players in the financial sector. Hence, high forex rates movements does not underlie the use of forward contracts by many firms in Serbia (Djenic, Avric & Barjaktarovic, 2012).

*Author: Department of Accounting and Finance, Kisii University, Kisii, Kenya. e-mail: wycliffeotera@gmail.com*

Forwards contracts are preferred by many exporters in Uganda (62%) to any other tool of managing forex risk. In comparison, most exporters who use forward contracts to protect themselves came from agro-processing industry, which accounts for 78.5% of the forwards applied in forex risk control as opposed to 44 % of the users manufacturing industry. On the other hand currency futures, currency option and insurance risks are fairly used but at a low rate. Use of forwards contracts to control foreign currency perils had a direct relationship with profit margin before tax of firms involved in exporting products in Uganda (Mbabazize, Daniel & Ekise, 2014).

Participating forward contracts cushions firms and investors against unfriendly changes in forex rates either at the time of entering PFC agreement or at the date of finding out the PFC (cut off time) or pre-determined rate at maturity. PFC, also are capable of being doctored to specifically meet the needs of their customers. Foreign exchange forward contracts overs protection to its users against fluctuations in forex rates for the period of the agreement .Forward contracts are able to give assurance in terms of rates at which you will trade currencies. Accordingly, this helps firms and individuals using it to cushion themselves against volatility in foreign currencies. Hence, at maturity, you get the amount you agreed as per rate. Also, forward contracts cushions users against uncertainty in cash flows, provision of tailored products like maturity date and hence, gives an opportunity to plan for payment in foreign denominated currencies early enough (WBC, 2017).

### a) *Statement of the Problem*

The application of forward contracts contributes immensely towards increased financial performance of multinational companies. Multinational companies are hard hit by financial perils due to their nature of their operations hence they apply under obligation to keep tabs on these risks which affects their profitability. Overall profit after tax in 2012 was 16,007 million (annual reports, 2012). In 2016 the profits after tax was 8843million (annual reports, 2016). The profits after tax declined tremendously by 7164 from 2012 to 2016.

Global Journal of Management and Business Research ( C ) Volume XX Issue IV Version I Year 2020

Accordingly, such decline in profits was attributed to the usage of derivatives in multinational companies in Kenya.

*b) Objective of the study*

This study focused on the following specific objective:

i. To examine the effect of forward contacts on the financial performance of listed multinational companies in Kenya.

*c) Research hypothesis*

*$H0_1$:* Forward contract has no significant effects on financial performance of listed multinational companies in Kenya.

## II. Theoretical Review

*a) International Fisher Effect Model*

The International fisher theory was developed and named after its pioneer, the U.S economist Irving Fisher (1867-1947) in the year 1930.The International Fisher model applied market interest rate as opposed to inflation to give reasons behind the periodic changes in the exchange rates over time. According to the international Fisher model, fluctuations in exchange rates are offset by interest rate changes .i.e. the value of a country's currency with high interest rates will depreciate as compared to the one whose tariffs are relatively low. The Fisher theory is of the view that actual interest rates amongst countries are equal because of arbitrage opportunities available amongst financial markets that involve capital income and out flows. Higher IR insinuates higher inflation rates. The difference between nominal interest rates between countries depicts exchange rate volatility. In principle, international Fisher theory says that, interest are low in a country whose currency is appreciating, and high in depreciating currencies, to balance currency benefits and losses (Madura, 2010).

International Fisher model was limited by availability of interest differential amongst countries, existence of additional costs like transportation costs, taxes, asymmetry of information among others. Like in the PPP theory, international Fisher theory doesn't give a crystal clear indication that the interest rates differential is responsible for future currency changes (Kimani, 2014).

This model was relevant because, in pre-setting of prices and date at which derivatives must exchange hands, the level of IR and forex rates are taken account. High interest rates mean devaluation of currency and hence MNCs must enter into derivatives contracts when interest rates are favorable to hedge against unseen losses as a result of devaluation of currencies among countries. Accordingly, investor will shift their wealth from economy to another with favorable interest rates in a process called arbitrage.

*b) Empirical Review*

*i. Forward contacts and Financial Performance*

Roon, Nijman and Werkeras's study (as cited in Vargas and Kessakorn, 2013), evaluated the performance of applying forward contracts to hedge currency risk in international stock portfolio case of US investors. This study was hinged on well advanced markets within G5 countries, such as France, Germany, Japan, UK and USA. The study also applied regression analysis to examine hedging performance in three distinct cases. Findings of this study showed that to combat risks statically using currency forwards cannot enhance the performance of portfolio performance for those investors in the US who also has investments in other G5 countries. The further found out that hedging with strings attached that like current interest rate spread leads tremendous increase in the performance of portfolios.

Mittal, Khakhar and Mittal (2015), did a study on the hedging an effective tool for Risk Management. The study focused on efficiency of forward contracts on hedging against chosen Indian companies to manage currency exchange risk. To attain its aims, the study banked on the following objectives: to get understanding on how forwards are used to hedge, to examine how efficiently forward contracts can be utilized to curb risks of currency exchange, to get the insights on the current techniques used to hedge foreign exchange risk and to find out the effectiveness of applying derivative tools by chosen Indian companies to hedge. This study also applied descriptive Study. Secondary data was extracted from annual statements between 2013-2014. The sample size for this study was 100 companies that were earmarked using convenient sampling method. The study found out that forward contracts are widely used by companies under study thanks to the stability it brings on total risk arising out of the volatility of forex rates.

Yin and Han (2011), did a study on the pros and cons of forwards in international portfolios hedging. The aimed at found out why and when forwards can be used over options. They found out that maximum application of forward contracts can outshine the using protective put on hedging against foreign exchange. They further found out that forwards in the main ought to use to hedge as compared to other strategies thanks to its effectiveness.

Hasan (2015), assessed how importer companies hedge against forex risk exposure using forwards and floating techniques to reduce importing expenses. This study banked on the following objectives to achieve its targets constant profit margins, natural hedging and forwards contracts to achieve its objectives. In this study also, secondary data from the costs of international online retail store was used. Collected data was analyzed using Pearson chisquared. The study established that the application of forwards contracts to hedge foreign exchange risk led to overall decrease in the daily transaction costs.

## III. Methodology

A research design is the plan, structure, strategy and techniques to be used by the researchers to get answers to the research questions and to control variance. Dooley (2007) defines a research design as the scheme, outline or plan that was applied to come up with answers to research problems. This study adopted a descriptive and cross section research designs. Mugenda (2009), descriptive design is used to describe a phenomena aiming at obtaining data for to hypotheses testing or provide answers to questions showing progress of designs studied.

The target population for this study was 9 listed companies. 8 companies were listed under banking sector and 1 MNC listed under energy sector out of which a sample size was obtained. These MNCs have been active in Kenya from 2009 to 2018 and they use all the four financial derivatives.

The sample size for this study was 3 MNCs 2 in form the banking sector and 1 from the energy sector in Kenya. This study adopted purposive sampling technique. According to Suheyli (2015), if objects in the population are homogeneous, purposive sampling technique can be used. Hence, the study applied purposive sampling technique to obtain sample size of 3 MNC that are using forward contracts.

Purposive sampling was applied to select a sample size of firms that used all four financial derivatives. Thus two firms were selected form the banking sector. Other six firms listed under the banking sector who didn't apply all four financial derivatives were eliminated from the sample size. Under energy sector, only one firm applied all four financial derivatives. Purposive sampling was applied to select it for the study. Banking on these reason, this study applied purposive sampling technique to select a sample of 3 MNCs: 2 from banking sector and 1 from energy sector to refer to the entire population.

Data applied in the study was obtained from secondary data sourced from published annual financial reports for each outfit. Annual reports accessed for 10 years (2009 -2018).

The data analysis was though mean and standard deviation. Correlation analysis was done establish the linkage between independent variable and dependent variables.

Correlation, simple and multiple regression analyses were employed to establish the relationship between independent variables and dependent variable. Forward contacts was the independent variable and financial performance of MNCs is dependent variable. The regression was used to establish the relationship between independent variable and dependent variable.

## IV. Results and Discussions

| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
|---|---|---|---|---|---|---|
| | | B | Std. Error | Beta | B | Std. Error |
| 1 | (Constant) | 9.649 | 7.225 | | 1.335 | .218 |
| | FORWARD | .024 | .045 | .186 | .537 | .606 |

*a Dependent Variable: Financial performance*

*Source: (FR 2009-2018)*

From the table above, the study discovered that forward contracts had a statistical insignificant effect on financial performance. r= 0.024, t=0.537, p-value 0.606 > 0.05. Taking other factors be constant at zero financial performance would be 9.649.Aslo the study found out that use of forwards contributed to 24% change in financial performance of MNCs other determinants explained 76% of financial performance. This meant the increase in the application of forwards contracts would insignificantly upscale profitability. Hence, use of forwards contracts had insignificant and hence, up scaling use of forwards enhanced performance. This findings are similar to (Limo, 2014) who found out forward exchange contracts are more often applied by companies to combat financial risks. Simple regression model was Y = 9.649+ 0.024X. Further Correlation analysis identified that forward contracts had positive relation with financial of companies.

*Hypothesis Testing*

*$Ho_{1:}$* Forward contracts has no significant effects on performance of multinational in Kenya.

The established that forward contacts has a direct but insignificant effect on the financial performance r= 0.024, t=0.537, p-value 0.606> 0.05.This insinuated that use of forward contracts would affect profitability but not to the greater extent. Hence the hypothesis was accepted in its null form. According (Mbabazize, Daniel and Ekise, 2014), applying forwards contracts to curb foreign currency perils had a direct relationship with profit margin before tax of firms involved in exporting products in Uganda

## V. Conclusion and Recommendation

The aim of the study was examine effect of forward contacts on financial performance of multinational companies in Kenya. The findings of the study indicated that forward contracts had direct but insignificant effect on financial performance. This meant that increased application of forwards, would improve financial performance however not the greater extent. According to Yin and Han (2011), maximum application of forward contracts can outshine the use of protective put options on hedging against foreign exchange. They further found out that forwards in the main ought to use to hedge as compared to other strategies thanks to its effectiveness.

## VI. Conclusion

The study concluded that forward contracts had a direct but insignificant effects on financial performance. Hence, a variation in the usage of forwards by a single unit would lead to a small change in financial performance of listed Multination in Kenya.

## VII. Recommendation

The study recommended that companies should apply forwards contracts to manage financial risks since it will contribute to their growth even its small. Further, the study recommended that since Forwards are OTC derivatives, that exchange of forwards should be electronic. This will make it easily accessible to many Multinationals hence improving their performance.

## References Références Referencias


1. Dooley. K. E. (2007): Viewing agricultural Educational research through a Qualitative lens: *Journal of agricultural education* (48)4, pp32-42
2. Djenic. M, Avric,. P. S and Barjaktarovic. L (2012): Importance of forward contracts in the financial crisis. *Journal of Central Banking Theory and Practice* 1(2) 75-96.
3. Hasan. K., R. (2015) Hedging Foreign Exchange Risk Exposure by Importer Companies. *International Journal of Economics, Finance and Management Sciences*. (3)5, Pp.435-440. doi: 10.11648/j.ijefm.
4. Kimani. K. K (2014). The Effect of Currency Derivatives on the values of Listed Commercial Banks *in* Kenya. *Global Advanced Research Journal of Management and Business Studies,* 2(5), 258-267.
5. Mugenda, O. M., & Mugenda, A. G. (2009). Research methods. Quantitative and Qualitative Nairobi: *African Centre for Technology Studies.*
6. Madura, J. (8th ed). (2010). *International Financial Management*, South-Western College Publishing, Boston, MA, 78-89.
7. Mbabazize. P. M, Daniel. T and Ekise. E. I (2014) the Role of Foreign Exchange Risk Management on Performance Management of Exporting Firms in Developing Countries: A Case Study of Uganda's Exporting Firms. *Research journal's Journal of Economics* (2)3,
8. Mittal. S., Khakahr. D., and Mitaal. D (2015): Hedging-An effective tool for risk Management (2)1. *International multidisciplinary research journal* (RHIMMRJ).
9. Njoroge, N, Matumo M. & Maina, K. (2013). Factors influencing development of financial Derivatives markets. *Global Advanced Research Journal of Management and Business.* Vol. 2(5) pp. 258-267.http://garj.org/garjmbs/index.htm.
10. Westapac banking corporation (2017): participating forward contracts. www.disclose-register.Company iesoffice.govt.nz
11. Yin, L., & Han, L. (2011). Forward or Options? Currency Risk Hedging for International Portfolios via Stochastic Programming. *International Research Journal of Finance and Economics*, (7)2*,* pp84-99.
12. Suyheli R., (2015): Determinants of Insurance Companies in Ethiopia. MSC. Thesis. AA
13. Vargas. A. C., and Kessakorn. K., (2013): Effectiveness in Hedging Currency Risk in International Portfolios: Forwards versus Options .http://lup.lub.lu.se/student –papers/record/3878608