# EXCHANGE RATE RISK AND THE PERFORMANCE OF SMEs IN UGANDA
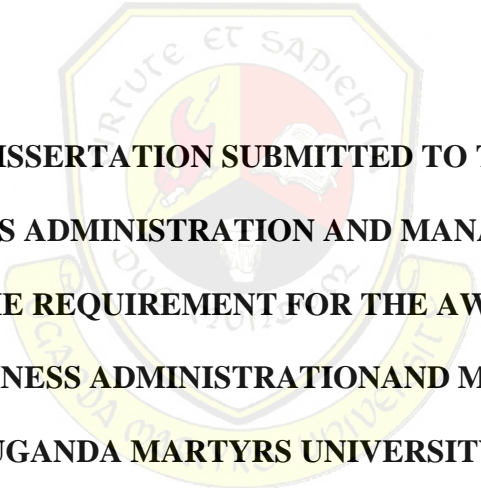
**Submitted by**

**NKERA ALVIN**

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# DEDICATION

I dedicate this work to my family in appreciation for their love and financial support. To my beloved parents mum Mrs. Mugabo Ford Jane and Mr. Mugabo John my father who has put in a lot of effort and sacrificed a lot for my education. I dedicate this as well to my brothers and sister for their prayers and encouragement that they have given me. May the almighty Lord reward and bless you all.

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First and foremost, I thank God for His guidance during the process of study and for having enabled me to attain this academic study.

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**May God bless you all!**

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## ABBREVIATIONS

SME              Small and Medium Enterprise

BOU             Bank of Uganda

UBOS           Uganda Bureau of Statistics.

UEPB           Uganda Export Promotion Board.

URA              Uganda Revenue Authority.

EU                European Union

FERE           Foreign Exchange Rate Exposure

WTO            World Trade Organization

SPSS           Statistical Package for Social Scientists

US$              US Dollar

# ABSTRACT

This study sought to examine the exchange rate risk and the performance of SMEs in Nakawa division Sub County. The main objective of the study was to assess the effect of exchange rate risk on the performance of small and medium enterprises. The study had three objectives; to evaluate the relationship between industry characteristics and firm performance, to examine the relationship between exchange rate fluctuations and firm performance and to identify the most commonly quoted currency and its performance against the shilling.

Exchange rate risk was varied in terms of economic exposure and industry characteristics whereas the performance of small and medium enterprises was varied in terms of sales growth and profitability. A survey research design was used to carry out the study. The samples were randomly selected from a population of 50 small and medium enterprises in which data collection methods such as interviews and questionnaires were used. Data was analyzed using SPSS to affirm a positive relationship between exchange rate risk and performance of small and medium enterprises.

The study found that there was a positive relationship between industry characteristics and firm performance. The findings of the study indicated that the SMEs were affected due to the fluctuations in the exchange rates and that the US Dollar is the most used foreign currency.

The study concludes that there is a positive relationship between exchange rate risk and performance of small and medium size firms in Uganda. Firms need techniques or approaches on Foreign exchange risk management as the results from the study show that foreign exchange risk shouldn't be taken lightly.

# CHAPTER ONE

## GENERAL INTRODUCTION

### 1.0 Introduction

This study aims to establish the relationship between exchange rate risk and the performance of SMEs in Kampala district. The exchange rate risk involves how change in currency rates against another could affect investments or firms. Few studies have been made on the exchange rate risk and its effects so there is need to look into it to assess the effects it has on business. It has been recognized globally that economic development depends heavily on small and medium sized enterprises (SMEs). SMEs are the prime source of new jobs and play a crucial role in income generation as well as in industrialization processes.

Uganda's private sector is made up of approximately 90 percent of small and medium sized enterprises (SMEs) with 80 percent of these SMEs in urban areas and are largely involved in trade, agro-processing, and small scale manufacturing (Badagawa, 2002; Kisaame, 2002). According to the bank of Uganda sector report (2009), SMEs have contributed to economic development through tax payments which is used by the government to improve on the country for example infrastructure. They provide employment to approximately 2.5 million people, contributing 75 percent of the Gross Domestic Product

**1.1 Background to the study**

Over one in every three adult Ugandans was engaged in some form of business according to the Global Entrepreneurship Monitor (2004), the report shows that these businesses do not live to see their first birthday and approximately every 35 percent of the SMEs businesses close and about 37 percent start new businesses again. The report ranked Uganda as the country with the highest business failure rate in the world and the second highest in terms of business start-ups. Only 5 to 10% survive and make it to maturity (Private Sector Foundation Uganda, 2006).

Much as SMEs have contributed well to Uganda's economic development, there is still a high rate of unemployment, poverty and illiteracy in the country. This could be greatly caused by the large population and according to the Facts and Figures report from Uganda Bureau of Statistics of 2013; the total population recorded mid-2012 and was recorded at 34 million and population of Kampala district which is the capital city (2013 mid-year) at 1.79 million. This large population exploits the scarce resources available. 35 percent of SMEs fail to live to their first birthday due to failure to keep up with general expenses. According to Kiingi (2007) the rate at which SMEs are failing due to poor performance, stands now at 50% annually. SMEs also don't have major assets which make it hard to get big loans from banks that need to value security before they can loan out. Borrowing is necessary for business performance and improving SMEs development if it is fully accessible and reasonably fair cost of money. SMEs find themselves starved for funds at all stages of their development ranging from start-up to expansion and growth (Beyene, 2002). SMEs are some of the businesses in the world that cannot function/survive without an appropriate finance because of the nature of their operations and management style (Kasekende & Opondo, 2003). They also fail due to lack of innovation, having limited access to

information on market opportunities and organizational learning. Also due to lack of entrepreneurial skills and lack of adequate technical and management support services (Global Entrepreneurship Monitor, 2008). According to Wanja (2009), access to credit facilities is the main constraint for SMEs in Uganda and limited access to capital to meet their operating working capital and long term investments. Lending rates for short and medium term loans range between 17-28% per annum (Kibirige, 2009).

The International "Doing Business Survey 2010" report ranked Uganda 112th out of 183 countries on a wide range of business indicators. Adequate infrastructure is one of the important determinants for economic growth and competitiveness in Uganda. Problems are identified in particular registering property, trading across borders, protecting investors, starting a business, enforcing contracts, and getting credit. These impediments or barriers, among others, are affecting the competitiveness of the economy, with the main issues being access to finance, infrastructure, tax administration, work ethics, and government bureaucracy (World Bank, 2011). To address the high cost of doing business in such a landlocked country, the government needs to invest heavily in transport, energy and skills development infrastructures (EAC, 2012).

The rest of the world that has tried business incubation have claimed success rate of over 85%. Business incubation programs have been considered as a remedy for the disadvantages that small and new firms encounter by providing useful business support services (Sherman and Chappell, 1998). They are useful in fostering technological innovation, entrepreneurship, commercialization and industrial renewal (Hackett and Dilts, 2004). For this reason many countries have increasingly been engaged in establishing business incubators (Lalkaka, 1997; Lalkaka and Abetti,

1999; Akcomak, 2009). It is also widely acknowledged that incubators are a technology transfer mechanism, means of promoting entrepreneurship and the commercialization of new knowledge and innovations (Phillips, 2002). Commercialization driven by market and profit motive is the utilization of research results or new findings (the transfer of knowledge to end users) where firms seek to gain an economic return of investment from research, product development and marketing.

## 1.2 Statement of the problem

SMEs operating are more likely to have the biggest cost of business failure (Kluer, 2013). The same study explains that the make or break period for a new small business is within the first two years of operation. According to the study "Redefining Small Business Success" by the US Small business Administration, statistics of 2012 show roughly 66 percent of new businesses survive two or more years while 50 percent survive at least four years and just 40 percent survive 6 years or more. The World Bank (2014) released the Doing Business report for over 185 countries globally based on their performance and Uganda was ranked 132nd out of the 185 countries for ease of doing business which shows a great failure rate in the country. A failure rate that is high is negative for an economy, especially in developing economies like Uganda.

There isn't available research that appears to show the factors of business failure although some writers point out Exchange rate risk as one of the critical factors but they seem not to have focused their studies in developing countries and this is the focus of this study.

**1.3 Broad objectives**

To evaluate the impact of exchange rate risk and the performance of SMEs

**1.4 Specific objectives**

1. To evaluate the relationship between industry characteristics and firm performance.

2. To examine the relationship between exchange rate fluctuations and firm performance.

3. To identify the most commonly quoted currency and its performance against the shilling

**1.5 Research questions**

1. What is the relationship between industry characteristics and firm performance?

2. What is the relationship between exchange rate fluctuations and firm performance?

3. How has fluctuation of the most commonly quoted currency affected firm performance?

**1.6 Research hypothesis**

There is a relationship between Exchange rates and performance of SMEs

**1.7 Significance of the study**

SMEs should also know how to cope with the exchange rate risk; they need to analyze this in order to survive. If money must be converted into a different currency to make a certain investment, changes in the value of the currency relative to the foreign currency will affect the total loss or gain on the investment when the money is

converted back. This risk usually affects businesses, but it can also affect individual investors who make investments called currency risk.

The study aims at benefiting the policy makers at both national and institutional levels through policy formulation and change of policies in regard to organizational learning innovation and SME performance.

The findings of the study will bring to light the relevance of the exchange rate risk on businesses and will act as feedback to all existing providers of SME strengthening initiatives such as Enterprise Uganda and Private sector foundation that have been involved in training SME managers in an attempt to improve their competences.

The research shall contribute to the knowledge of foreign exchange exposure and impact of exchange rate risk. It shall bring to light the practice of Ugandan firms as to whether they give due attention to foreign exchange risk, if not, they can adopt these techniques to help salvage themselves from the increasing foreign exchange exposure as the effects are becoming a global phenomenon.

## 1.8 Justification of the study

This study is important as it comes at a point in time when SME performance is of widespread concern as they have contributed to economic development through tax payments in both developed and developing countries and due to globalization, most are involved in either exports or imports.

## 1.9 Scope of the study

1.  **Subject scope**

The main subject under study will be focused on exchange rate exposure and performance of SMEs.

## 2. Geographical scope

The study will be carried out in the central region of Kampala, Nakawa division Sub County, Uganda looking at around 50 SMEs in the area. According to the Uganda Small Scale Industries Association Annual Report (2010), there over 1,200 SMEs carrying out business in Nakawa division.

## 3. Time scope

The data collection analysis reporting is done for a single period.

## 1.10 Conceptual framework

The model shows the relationship between exchange rate risk and firm performance of SMEs. The independent variables are exchange rate with firm performances as the dependent variable. The economic exposures are based on the extent to which the value of the firm, as measured by the present value of its expected cash flows will change when exchange rate changes. Economic exposure or operating risk basically refers to the risk of a firm's future operating cash flows fluctuating due to exchange rate volatility. The foreign currency cash flows can stem from both revenues from export and domestic sales of foreign subsidiaries, or from operating expenses recognized in foreign currencies (Mikkelsen and Dahlgaard 2013). The study is also going to look at mainly industry characteristics businesses that are import and export as they're most likely to be affected by the fluctuations in the exchange rates. Exchange rate movements affect some industries differently than others because some are more export or import dependent than others (Bodnar and Gentry, (1993).

According to Brown (1996), performance measures must focus attention on what makes, identifies and communicates the drives of success and provides a basis for assessment and rewards. West and Fair (1996), define performance as a function of an

organization's ability to meet its goals and objectives by exploiting the available resources in an efficient and effective way. Therefore perceived firm performance will be seen from the perspectives of sales growth, and profitability.

**Figure 1.1: Conceptual Framework**

| **Independent variables** | **Dependent variables** |
|---|---|
| Industry Characteristics | Sales growth |
| Economic exposure | Profitability |

**Factors**

State of the country

Relationship between states
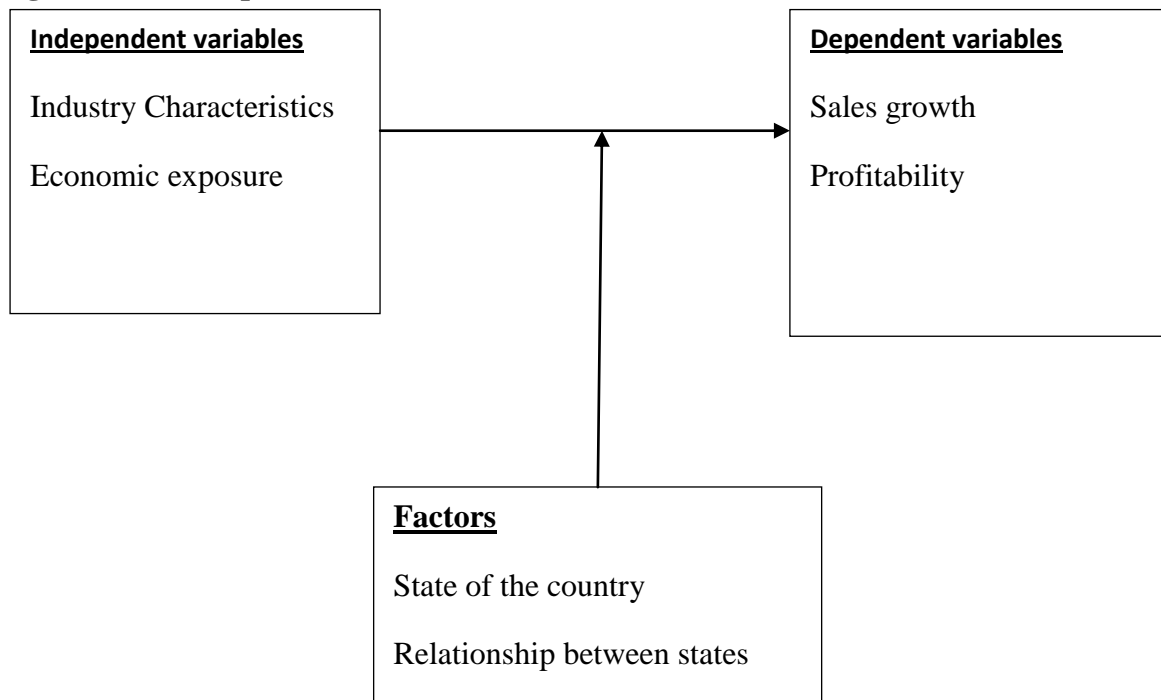
Source: Literature review (Brown, 1999; Mikkelsen and Dahlgaard 2013)

## CHAPTER TWO

## LITERATURE REVIEW

**2.0 Introduction**

This chapter presents a review on existing literature on Exchange rate risk as an independent variable and performance of SMEs as a dependent variable as well as the relationship between the two variables in order to understand the above developed conceptual framework.

**2.1 Small and Medium-sized Enterprises**

While the importance of the SME sector and the informal sector is acknowledged internationally, defining an SME is a challenging task, as every country has its own definition. There is no single, uniformly accepted definition of a small firm (Storey, 1994). Firms differ in their levels of capitalisation, sales and employment. Hence, definitions which employ measures of size (e.g. number of employees, turnover, profitability and net worth) when applied to one sector might lead to all firms being classified as small, while the same size definition when applied to a different sector might lead to a different result.

In practice, SMEs are defined in a number of different ways, generally with reference either to the number of employees or to turnover bands (or a combination of both, as in the National Small Business Act 1996, which also allows for variations according to industry sector). The definition of SMEs by size is necessary, but it is not sufficient for an understanding of a sector where the realities are not only complex, but also dynamic.The abbreviation SME occurs commonly in the European Union and in international organizations, such as the World Bank, the United Nations and the WTO. It means that small and medium enterprises which are further defined as

companies whose headcount or turnover falls below certain limits. EU Member States traditionally have their own definition of what constitutes an SME, for example the traditional definition in Germany had a limit of 250 employees, while, for example, in Belgium it could have been 100. But now the EU has started to standardize the concept. Its current definition categorizes companies with fewer than 10 employees as "micro", those with fewer than 50 employees as "small", and those with fewer than 250 as "medium" Small medium organizations need to have between 20-500 employees ( European Commission (2003).

SMEs have seemed to be an accepted as a good form of development for countries. The definitions of SMEs vary significantly according to different stages of economic development; economic structures and issues that authors of studies intend to address (Castel-Branco, 2003). Some analyses define them in terms of total revenue, while others use the number of employees as an indicator (World Business Council for Sustainable Development and World Business Council for Sustainable Development, 2007). Although there is no universally agreed definition of SMEs, some of the commonly used criteria are the number of employees, value of assets, value of sales and size of capital as well as turnover. The most common definitional criteria as used in SMEs is employees because of the comparatively ease of collecting information and here again there is variation in defining the upper and lower size limit of an SME. As cited by Albaladejo, 2002 defines small enterprises as firms that employ between five and nineteen workers while medium enterprises are firms that employ between twenty and ninety nine. Statistical definition of SMEs varies by country and is usually based on the number of employees, and value of sales and/or value of assets. Due to its ease of collection, the most commonly used variable is the number of employees.

SMEs can therefore be defined as a business amounting or arranging from about five employees to ninety nine employees.

SMEs are defined as businesses which employ less than 250 staff and have an annual turnover of less than 50 million Euros and / or their balance sheet total is less than 43 million Euros (Annual Report on European SMEs, 2014)

Small and medium sized enterprises (SMEs) are a very heterogeneous group. SMEs are found in a wide array of business activities, ranging from the coffee shop at the corner in a mall, the boutique in a small town, to a small sophisticated engineering or software firm selling in overseas markets and a medium sized automotive parts manufacturer selling to multinational automakers in the domestic and foreign markets. The owners may or may not be poor; the firms operate in very different markets from urban to rural, national to regional and international and embody different skills, capital, sophistication and growth orientation, and also may be in the formal or informal economy.

The definitions of SMEs are arbitrary and vary significantly according to different stages of economic development; economic structures and issues that authors of studies intend to address (Castel-Branco, 2003). Though SMEs definition is individual country specific and is based on size and level of economic development, there is not yet an agreed definition for SME in Uganda. Attempts have been made to define SME in a developing country.

Directorate-General Enterprise and Industry carries out a regular monitoring of the implementation of the SME definition. Building on the results of evaluations performed in 2006 and 2009, an independent study was carried in 2012, focusing on how the SME definition works in practice in the implementation phase.

## 2.2 Industry Characteristics

Exchange rate movements affect some industries differently than others because some are more export or import dependent than others (Bodnar and Gentry, (1993). Bradley and Moles (2002) find that there is a significant relationship between a firm's exchange rate sensitivity and the degree to which it sells and funds itself internationally. Firms in export industries and import competing sector would benefit from dollar depreciation since fewer foreign currency units are required to purchase the exported goods. Any depreciation will have the opposite effect on import-intensive industries since more units of the domestic currency are needed to purchase one unit of foreign currency. Firms with higher incentives for derivatives use are more likely to use currency derivatives and thus are less likely to be exposed to foreign exchange rate movements (Lee and Walker, 2001). Exchange rate movements affect both the prices of imported finished goods and the costs of imported inputs, thus influencing indirectly those companies that compete with such firms (Grambovas and McLeay, 2006).

An importing or exporting firm is directly influenced by currency appreciation and depreciation in terms of revenue generation (Crowley, 2013).Exporters expressed their concern over the exchange rate fluctuations in the year (2012) saying if the trend continues their industry will generally be affected in 2013 (National Bank of Uganda 2012). Internationalized and innovative businesses are faster growing, more profitable and better able to create wealth and jobs than their domestically focused peers (Love and Roper 2013). Fluctuations in exchange rates may decrease or eliminate profits, or may even result in losses, Uganda Export Promotion Board (2000).

Whereas there isn't any specific definition of firm characteristics in the existing scholarly literature, it has been described in terms of international competences and overall business competencies. For example firm size has been found to have a significant effect on the decision to enter new export markets (Reid, 1983, 2001).

## 2.3 Performance of SMEs

Despite the significant contribution of small and medium enterprises to the Ugandan economy, the potentials of the SMEs have not been exploited fully and this is a concern of all stakeholders in the economy (UNCTAD, 2002; Ekanem, 2010; Tushabomwe-Kazooba, 2006). Fluctuations in exchange rates may decrease or eliminate profits, or may even result in losses, Uganda Export Promotion Board (2000).From a financial perspective, Gopinathan and James (2009) agree that profitability and sales with respective ratios measure performance based on financial reporting. Maria (2008) pronounced that profit margins are percentage ratios of profits and sales. In enterprise management, an organization's performance depends on how well the organization is managed and the value the organization delivers for customers and other stakeholders (Felix, 2013).

Some writers believe that the performance of SMEs is measured by many factors such as internal and external to the SMEs themselves (Kotey and Meredith, 1997; Pearce and Robinson, 2002). They cited sales turnover, calibre of management and ability to meet daily obligations of the business.

Firm performance is arguably the most important construct in management research. A wide variety of definitions of firm performance have been proposed in the literature (Barney, 2007), with frequent reference to how efficiently and effectively a firm utilizes its resources in generating economic outcomes. Performance can be

determined in various ways. It might stand for financial performance, market performance, customer performance or overall performance, at least. In this research performance is measured by financially-based performance measures.

According to Brown (1996), performance measures must focus attention on what makes, identifies and communicates the drives of success, support organization learning and provides a basis for assessment and rewards. On the other hand, West and Fair (1996), define performance as a function of an organization's ability to meet its goals and objectives by exploiting the available resources in an efficient and effective way. Stoner (1989) adds that performance entrails effectiveness which refers to the firm's ability to serve and produce what the market requires at a particular time and efficiency, which means achieving the objectives at the lowest cost possible with highest possible benefits. Balunywa (1989) looked at performance in terms of competitive performance, financial performance, and quality of service, flexibility, resource utilization and innovation. Studies by Whyte (1991), show that performance can be measured at both organization and individual levels and this measurement is sometimes referred to as performance appraisal. He urges that organizations have desired potentials in terms of capacity attraction, market share and financial strength and that performance is the difference between those potentials and what has been achieved.

A new paradigm of performance measure has been adopted by many SME's. This is based on identifying what the business does in terms of levels of processes and attaching Key performance indicators to those processes. The recording and analysis of the key performance indicators should significantly contribute to the achievement of business goals. Key performance indicators tell businesses how well they provide

services, how long they take to process customer requests, their product delivery performance and how much time they spend fixing mistakes.

The KPIs are those critical measures which ultimately determine profitability and shareholder value. The traditional Statement of Financial Performance, Statement of Assets and Liabilities and Management Accounts are not enough to effectively manage businesses which are seeking to survive and add shareholder/owner value. Management needs additional timely information, much of which is not traditional Financial Data, if they are going to effectively manage their businesses. A Performance Indicator (PI) measure is a measure of the behaviour of a business process. In business, understanding the state of the financial health of a business is a very important issue relating to business survival. There is a strong similarity between physical fitness and the health of a business. The Cash Flow of a business can be likened to the blood circulating through a person. If there is blood loss in the flow, the consequences are swift and predictable.

According to Sudhir & Subrahmanya (2009) &Dalrymple (2004), growth over a period of time can be used for performance measurements of SMEs since this, rather than short term performance, will reflect the long-term strategy of the firm. The researchers (Sudhir & Subrahmanya) probed how far Indian SMEs carried out technological innovations as a result of technology and other related inputs acquired through subcontracting relationships and achieve growth using the case study approach covering two SMEs in Bangalore. It was established that customer requirements were the major causal factors while internal factors such as self-efforts and in-house technical capability along with external factors in the form of technical inputs, suggestions and initiative from Large Enterprises (LE) customers were the sources of innovations for these SMEs. Because of these innovations, SMEs achieved

growth in terms of investment in plant and machinery, output and customer base, which are ideal indicators of SME performance.

At the height of a number of initiatives undertaken by the government of Uganda aimed at improving and promoting the business environment, reduce the cost of compliance with business regulations, the reforms have not improved the situation as the performance of SMEs in Uganda is still below the expectation (UIA, 2008; Ernst and Young, 2011) and this possess a threat to the Ugandan economy since SMEs are great contributors to the GDP.

## 2.4 Sales Growth

A sale is the pinnacle activity involved in selling products or services in return for money or other compensation. It is an act of completion of a commercial activity. Sales growth is often used as a measure of performance. The assumption is often made that if sales increase, profits will eventually follow (Thomas & Mason, 2007). A key determinant of success is a firm's growth in sales, provided, of course, that the profits and cash flows generated from sales are adequate to cover the costs incurred in generation of the revenue.

## 2.5 Economic Exposure

Adler and Dumas (1984) defined exchange rate exposure as the sensitivity of the value of a firm to unanticipated changes in exchange rates. Madura (1989) specified the unhedged exposure of firms as the possible direct or indirect loss in a firm's cash flows, assets and liabilities or net profit, and in turn, its market capital as a result of exchange rate fluctuations. Gylfason (1998) used cross-sectional data covering 160 countries for the period 1985-1994 and found that high inflation tended to be

associated with low exports in proportion to GDP. According to J di Giovanni (2007), raising interest rates will slow spending and growth, while lowering interest rates generally leads to more spending and higher growth. Fluctuations in exchange rates may decrease or eliminate profits, or may even result in losses, Uganda Export Promotion Board (2000). The research by Abor (2005), on Ghanaian firms revealed that, they are more interested in the business as a going concern knowing that increased foreign risk could result in the collapse of the firm.

This is exposure pegged to the anticipated foreign currency flows that are currently not reflected in financial statements or other records. Economic exposure thus refers to the impact of exchange rate movement on the present value of its expected future cash flows. It basically reflects the risk to the firm's present value of future operating cash flows from exchange rate movements. Economic risk concerns the effect of exchange rate changes on revenues being domestic sales and exports. Kester and Luehrman (1993) defined economic exposure as the response of future operating cash flows to unexpected exchange rate changes. For multinational companies, economic exposure draws from the International Finance perspective. Therefore, a change in exchange rates affects the expected value of the firm's future cash flow streams. The Economist survey Article, published in February(1996), Smith et.al, (1993), Kester and Luehrman, (1993); MCNaughton, (1996) Shapiro (1989) hypothesizes that the focus on economic exposure is on the value of the firm as measured by the net present value of the firm's expected future after tax cash in-flows when exchange rate changes. The effect of exchange rate on the revenue streams is measured through discounting the cash in-flows by an appropriate discount rate. This measures the effect of exchange rates on accounts namely the income statement and the balance sheet. Williamson (2001) presents the justification for a competition variable

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declaring exchange rate exposure to be a function of demand elasticity and firms' abilities to adjust prices to fluctuations in exchange rates.

In literature pertaining to exchange rates, the fact that numerous studies lack findings of statistical significance is referred to as the exposure puzzle (Bartram et al., 2009; Bodnar and Bartram, 2007). Furthermore, whereas there have been many studies investigating the measure of firms' net exchange rate exposure, few studies have been able to conduct a firm level empirical analysis on exchange rate exposures referable to specific firm characteristics (Ito et al., 2015).

Exchange rate movements can thus affect the value of the firm, as it directly affects its cash flow, and indirectly affects its cost of capital. This is what is known as foreign exchange economic exposure, and results from changes of the home currency value of the firm to unexpected changes in exchange rates. The extent of this risk depends not only on the amount of international transactions the company executes, but also on the extent to which the economies in which it carries out its transactions are exposed to foreign influences.

## 2.6 Exchange rate risk and performance of SMEs

There are many factors affecting every business' performance, so it is vital to focus on a handful of these and monitor them carefully (Nangoli, et al., 2013). According to Featherson, Littlefield & Mwangi (2006), foreign exchange risk arises when fluctuation in the relative values of currencies affects the competitive position or viability of an organization. Firms are exposed to foreign exchange risk if the results of their projects depend on future exchange rates and if exchange rate changes cannot be fully anticipated. Generally, companies are exposed to, Transaction exposure, Economic exposure and Translation exposure (El - Masry, 2006; Salifu et al, 2007).

Economic currency risk according to Uganda Export Promotion Board (2000) and Abor (2005) this occurs as a result of changes in real exchange rates. Economic currency risks are not directly accounted for in the financial statements of an exporter.

 The definition of risk includes both the down-side effect of uncertain outcomes as well as their upside potential, but managers and investors are more often concerned with just the down-side effects of risk, and where possible seek to protect any upside benefit (Meulbroek, (2002). (Belk, 2002) states the aim of foreign exchange risk management as limiting volatile forex exposure on the firm's financial performance whereas (Shapiro, 2006) describes performance in terms of higher profit margin, sales growth and overall liquidity of firm. This relates how currency risk assessment stimulates financial objectives.  Empirical tests have found mixed evidence in favour of signalling and portfolio balance channels. For example, Dominguez and Frankel (1993) estimate the effect of intervention on contemporaneous exchange rate movements and on forecasts of future exchange rates.

Bradley and Mole (2002) notes that foreign exchange risk management is a financial function and thus affects the firm`s financial position. Volatile exchange rates do reduce cash flows and profitability of any firm. Belk (2002) states the aim of foreign exchange risk management as limiting volatile forex exposure on the firm's financial performance whereas Shapiro (2006) describes performance in terms of higher profit margin, sales growth and overall liquidity of firm.

Using survey data to measure exchange rate expectations, they find a significant effect of intervention on market expectations, especially if interventions are announced and coordinated. They also show that secret interventions are largely ineffective. One exception was a study that found a significant and potentially large

portfolio effect during the 1984– 88 periods, using survey datam to measure exchange rate expectations and risk premium (Dominguez and Frankel, 1993). The research by Abor (2005), on Ghanaian firms revealed that, they are more interested in the business as a going concern knowing that increased foreign risk could result in the collapse of the firm.

A firm's Foreign exchange rate exposure is significantly related to the level of its foreign involvement (Jorion, 1990). Professor Waswa (2015) says the shilling will continue to depreciate for as long as the economy doesn't produce much for export. The Ugandan shilling has depreciated against the US currency by more than 15 per cent over the last one year, one of the biggest drops in more than five years (Alon Mwesigwa 2015)

A common definition of exchange rate risk relates to the effect of unexpected exchange rate changes on the value of the firm (Madura, 1989). Measuring and managing exchange rate risk exposure is important for reducing a firm's vulnerabilities from major exchange rate movements, which could adversely affect profit margins and the value of assets (International Monitory Fund report, 2006). Firms engaged in international trade are often confronted with foreign exchange risk .Foreign exchange risk management is therefore crucial for companies frequently trading in the international market Abor (2005). The adoption of foreign exchange risk management techniques in firms has a positive relationship with the firm's degree of internationalization (El- Masry et al 2007). Salifu , Osei & Adjasi (2007), have suggested further studies to examine the importance of firm size and location in foreign exchange exposure management and firm performance

However, in theory, a firm's profits should be affected by exchange rate movements, but empirical studies have found no significant effects from exchange rate fluctuations. Volatility may have harmful effects on trade and capital flows, although evidence supporting this claim is weak (Kihangire, 2004; 2009; Rogoff, 1999). As Bartram and Bodnar (2005) mention: "Our review of this research suggests that a majority of these studies still find significant exposures in just 10–25% of the cases (with marginally higher percentages for firms in open, export-oriented economies and nonlinear exposures), a level that still appears to be below the prior expectations of the researchers based upon theoretical and anecdotal predictions.". Although Allayannis (1996) mentions that in contrast to the largely insignificant exchange rate exposure at short horizons, at long horizons the exchange rate exposure is statistically very significant. These results suggest that the relationship is stronger when measured over a longer time horizon. Exporters expressed their concern over the exchange rate fluctuations in the year 2012 saying if the trend continues their industry will generally be affected in 2013 (National Bank of Uganda 2012).

## 2.7 Management of exchange rate risk

According to John Alzak (2007) risk management is the identifying of risks, assessing the impact on the business of a security incident that occurs and making the right financial decision about how to deal with the result of the assessment. Bradley and Mole (2002) notes that foreign exchange risk management is a financial function and thus affects the firm`s financial position. Volatile exchange rates do reduce cash flows and profitability of any firm. The value of a firm is the present value of all future cash flows (Berk and DeMarzo, 2013) and in turn, the future cash flows are affected by exchange rate fluctuations (Doukas et al., 2003). According to Bank of Uganda

Publications (2000), Risk management is described as the performance of activities designed to minimize the negative impact of uncertainty regarding possible losses.

It is well known that firms are exposed to exchange rate risk which can severely affect cash flow and profitability. In this regard, financial managers are routinely involved in exchange rate risk management to secure the firm's profitability (Crowley, 2013). To guard against this inconsistence of risks, exporting firms develop strategies to either eliminate or reduce this currency risk, which is the major aim of foreign exchange risk management (Dawson &Rodney, 2002). There are several studies that have examined the relationship between monetary policy and exchange rate (Sarno and Taylor, 2001)

Foreign Exchange Risk Management (FERM) is the process of measuring or assessing currency risk and then developing strategies to manage the risk. It deals with the systematic management of the risk of loss from exchange rate movements on international transactions. FERM minimizes quarter-to-quarter or year-to-year earning fluctuations stemming from currency fluctuations (Shapiro, 2003).

One strand of the literature examined the relationship between general monetary policy and the exchange rate using VAR models (Clarida and Gali (1994), Eichenbaum and Evans (1995), Kim and Roubini (2000)) focused on the effects of monetary policy shocks on the exchange rate. Another strand of literature aimed at analysing the relationship between monetary policy and foreign exchange intervention, by examining how the central bank intervention in the foreign exchange market affected the exchange rate (Kaminsky and Lewis, 1996; Lewis, 1995; Dominguez and Frankel, 1993. Related studies in this strand of literature examined how the monetary authority reacts to exchange rate changes (Clarida et al., 1998, 2000; Kim, 2001). Kirt C. Butler (2008) refers foreign exchange risk as the risk

related with the unexpected changes in exchange rates and foreign exchange exposure as the extent to which unexpected changes in exchange rates affect the value of a firm's assets or liabilities. Taggert and McDermott (2000) assert that forex related firms are subject to foreign exchange risk on thepayables and receipts in foreign currencies.

Evan et al., (1985) defines foreign exchange risk management is a program of assessment (identification and quantification) and counter- strategies to mitigate exchange rate risk and saves firm`s economic value. Kirt further adds foreign exchange risk is a financial risk to manage value creation and loss prevention in a firm by internal and external financial tools. Piet and Raman (1995) say spot rate changes are offset by changes inflation though small firms may depend on unstable currency rates for profits.

According to Giddy and Dufey (2002), the first step in management of foreign exchange risk is to acknowledge that such currency risk does exist and managing it is in the interest of the firm. Firms should identify the nature and magnitude of foreign exchange exposure. Exchange rate movements affect both the prices of imported finished goods and the costs of imported inputs, thus influencing indirectly those companies that compete with such firms (Grambovas and McLeay, 2006).

Basic elements of a sound risk management system are synthesized from Bank of Uganda guidelines focus on five elements of a sound risk management system that is, an active board & management oversight, adequate policies, procedures & limits, adequate risk monitoring and management information systems (MIS), adequate internal controls and a risk management committee. A well-functioning risk management system would clearly and unambiguously define where and with whom

the responsibility for the risk lies (Abor 2005); foreign exchange risk management follows these principles too. According to Abor (2005) and Uganda Export Promotion Board (2000), Foreign exchange risks can be managed in various ways; however the risk managers' choice of the different types of hedging techniques may be influenced by costs, taxes, effects on accounting conventions and regulation. Planning for, covering foreign exchange risk is hedging the risk.

# CHAPTER THREE

# RESEARCH METHODOLOGY

## 3.1 Introduction

This section shows the instruments or tools the researcher used in collecting data and the ways or methods in which data was collected by the researcher during the research process and these ways or methods include; interviewing, administering questionnaires, reading educative literature or materials like text books, journals, magazines and reports, surfing and reading articles on the internet. The research findings of the study were done with the help of 16.0 version of the SPSS software program. The population of the study, sample size and selection as well as the research design is also discussed below. Limitations that were encountered and strategies employed for overcoming them are also shown.

## 3.2 Research design

This is a general plan of how the researcher was to go about and answer the research questions and objectives. Amin (2005) furthermore defines a research design as a conceptual structure with in which the qualitative research is conducted and it constitutes the blue print for the measurement of the variables, collection and analysis of data. It mainly involved what instruments were to be employed, how data was to be collected, how the instruments were used and the intended means for analyzing data collected.

The researcher used a survey research design was used to carry out the study. This research design enabled the researcher to follow and use appropriate procedures when carrying out the study. It was cross- sectional as the time covered was only that during the study because the researcher was collecting and analyzing data for a single period.The researcher used both quantitative and qualitative data collection methods.

This is because the quantitative design was used to interpret the codes that were attached to the questionnaires plus qualitative which was used to enable data collection from literature from secondary sources so as to establish the relationship between exchange rate risk and the performance of SMEs.

## 3.3 Study population

A population is defined as the total number of elements in a given study (Byaruhanga, 2014). The population in this study was composed of the management, managers and staff of the randomly 50 selected small and medium enterprises. This enabled collection of a wide range of information about exchange rate risk since the mentioned respondents above have got the right information in regard to the SME performance and how the main aspects of financial literacy are being applied or practiced. The study population consisted of SMEs in export and import business such as farms, car bonds and boutiques.

## 3.4 Study Area

Kampala is one of the found districts in Uganda and considered the capital city, it is found in the central region of the country, highly industrialized with a high potential for business establishment, growth and success. The study is to be carried out in Nakawa division. The researcher saw this as a convenient location as he stays around the area. SMEs performing or carrying out operations in this division were studied basing on how the exchange rate affects their daily activities.

## 3.5 Sample size

Simple random sampling technique was used to select respondents from the SMEs within Nakawa division Sub County. Random sampling gives an individual an equal chance of being selected into the sample of the study population, reduced bias towards

selection and provided a highly representative sample of the study population. As most of the SMEs are found to be managed solely by the owners, one respondent is selected from each SME. Ppurposive samplings since these were key informants and possess the required information for the study.

### 3.6 Data Sources

Primary data is to be obtained from the SMEs under the use of questionnaires involving questions designed by the researcher to respondents. According to Bryman, (2000), a questionnaire is a carefully designed instrument for collecting data in accordance with the specification of the research hypothesis. The questionnaire addressed issues concerning the data of the respondents, and questions related to exchange rate risk and the performance of SMEs.

Face to face interview were also carried out, for example in the case of foreign exchange rate risk management most owners didn't actually know that there were techniques or didn't know the name that is used to refer to the techniques they were using to handle this.

Secondary data was also collected gathering material such as UBOS and IMF Report. It was also collected through the review of relevant literature from publications such as journal articles, textbooks and other related publications.

### 3.7  Methods of data collection

### 3.7.1 Questionnaire

Primary data was collected using Questionnaires, which were self-administered as there was need to obtain a high response rate, reduce time on data collection and give explanations to the questions. The questionnaires had questions that offered the respondents a list of answers of which he/she chose from for example 1**.** Strongly

Agree, 2. Agree, 3. Neither Agree nor Disagree, 4. Disagree, 5. Strongly disagree, on the Likert-scale. Respondents, to be able to establish adequate knowledge of the topic at hand, awareness of the non-response rates and to easily clarify on the questions that were not clear to them were to fill the questionnaires themselves.

### 3.7.2 Interview

The researcher held discussions with the respondents and the data obtained during discussions was compared with data from the instruments to ascertain correctness.

### 3.8 Data analysis and presentation

Data from the field was compiled and sorted to have the required quality and accuracy that the researcher desired and felt suitable for the study. It involved putting data in a form that people can easily use. Relating to this research, it was done in an organized way so as to enable the researcher obtain meaningful information from it. Having collected the data it was edited for consistency, errors and omissions. Quantitative data which normally generalizes the information gathered in terms of figures , using mean mode standard deviation , responses were categorized and further analyzed with the help of an installed software known as SPSS (Statistical Package for Social Scientist) into meaning full information presented inform of tables were used to present the data.

### 3.9 Quality control

### 3.9.2 Validity

Validity is the degree by which the sample of test items represents the expert validity. The test designed to measure content validity which is employed by this study is a measure of the degree to which data collected using particular instruments represents a specific domain or content of a particular concept.

Validity was assured with the support and help from experts on the study by looking at the data collection methods such as the questionnaire and simply approving if they of standard and meet the objectives of the study possible by giving more time to the research so as to ensure that the research objectives are a success.

### 3.9.3 Reliability

Reliability refers to the degree to which a measure of concept is testable. The respondents were given questionnaires to answer in order to test reliability and validity. To ensure reliability of data, pretesting and testing of the data collected. A sample size was used to test the value of the data collecting tools used.

### 3.10 Measurement of variables

The measurement of the study variables was conducted through the secondary data, more specifically the independent variables (Foreign exchange rate exposure and Interest rate exposure), were subjected to annual trend analysis and the fluctuations were justified by the results obtained in the graphs. Foreign exchange risk was measured by the real exchange rate El-Masry (2006).

Firm performance among SMEs can be measured basing on (Erikson, 2002) using sales growth and profitability. A five point rating scale ranging from strongly agree (1), agree (2), neither agree nor disagree (3), disagree (4), strongly disagree (5) was adopted for the study.

### 3.11 Ethical considerations

The researcher had to get a letter from the Dean of my faculty that allowed me to gather information from selected companies in order to produce a quality and reliable study. This letter offered assurance towards the respondents that the researcher was just a student carrying out a research for academic purposes.

Participation was to be voluntary as the researcher felt that respondents had to be respected and they might not give true answers if bothered. The researcher also maintained confidentiality as was promised to the respondents.

Scholarly authors and writers were fully cited and recognized by name of the author, title of book journal and year in which the article, book or journal was written in prior to carrying out the research.

## 3.12 Study limitations

Some respondents spent a lot of time with the questionnaires while others lost them, this may have arisen due to the unwillingness as they might have felt that the exercise was unbeneficial to them.

Some respondents weren't well learned which made it hard to explain certain technical terms. Most of the SME operators have low education levels GEM (2003) The fact that uniform questionnaires were given to all the respondents irrespective of the level of education, there was a problem of misinterpretation of the questionnaires. To solve the problem, the researcher was there to explain to most of the respondents what exactly was required.

Some of the responsible personnel like the owners of the business were not available when interviews were going on and questionnaires being administered. The responsible personnel were represented by their employees such as the managers or shop attendants who most likely had a different perspective or view on the variable of financial literacy compared to the responsible personnel such as the legitimate owners of the business or enterprise.

Some of the questionnaires were filled out by representatives of the owners as of cases when the owners weren't available when the interview was going on. This may

have brought about a problem of a different perspective or different view on the topic

between the owner and the representative for example manger.

# CHAPTER FOUR

## PRESENTATION AND DISCUSSION OF FINDINGS

### 4.0 Introduction

The aim of this study was to evaluate the exchange rate risk and the performance of small and medium enterprises. This chapter analyses and presents the findings of the study. It contains presentation and interpretation of study findings. The tables and figures in this chapter were derived from the findings of the study.

This chapter provides the analysis and interpretation of data which was obtained from the questionnaires that were distributed to the owners or managers of small and medium enterprises in Nakawa division Sub County.

**Table 4.1 Response rate**

| RESPONSE | FREQUENCY | PERCENTAGE |
|---|---|---|
| USABLE | 39 | 78 |
| NON USABLE | 11 | 22 |
| TOTAL | 50 | 100 |

**Source; Primary data, 2015**

50 questionnaires were distributed to small and medium enterprises in the import and export sector as they have the highest risk to exchange rate fluctuations. However, 39 usable ones were analyzed as they were the only ones received from the field. Random sampling and the questionnaires were used to collect the information from the various SMEs. The research was generally carried to find out how exchange rate fluctuations affects SME performance .The respondents were both men and women, the male respondents were 28 and the female were 11 respectively.

According to Amin (2005), the results of a research study are considered reliable and valid when the rate of responses is 50% and above. This makes the research findings reliable and valid considering that the response rate was 78 %.

**4.2 Background information of respondents**

The first part of the questionnaire was intended to collect background and basic information about the respondents. This included gender, age, level of education, years of operation and form of the business. The background information of the respondents was based on the form of the business in order to know the share of business that the respondents may own.

Frequency and percentages were used to establish the background information on the respondents as presented below.

**4.2.1 Age group of the respondent**

**Table 4.2 Age group**

| AGE | FREQUENCY | PERCENTAGE |
|---|---|---|
| Below 25 Years | 8 | 20.5 |
| 26-35 Years | 15 | 38.5 |
| 36-45 Years | 11 | 28.2 |
| 46-55 Years | 5 | 12.8 |
| TOTAL | 39 | 100 |

**Source; Primary data, 2015**

The results of the study showed in the table above indicate that the majority of the respondents with a percentage of 38.5% fall within the age bracket of 26 – 35 years,

followed by 28.2% of respondents 36-45 years. 12.8 % were in the range of 46-55 years recording the least percentage and 20.5% below 25 years. This implies that the business owners who are actively carrying out business operations in Nakawa division sub county lie between the age brackets of 26-35 years.

**4.2.2 Gender characteristics of respondents**

The gender characteristics of the respondents were fully analysedusing the information provided by the respondents as shown below

**Table 4.3 Gender characteristics of respondents**

| Gender characteristics | Frequency | Percentage |
|---|---|---|
| Male | 28 | 71.8 |
| Female | 11 | 28.2 |
| Total | 39 | 100.0 |

**Source: Primary data, 2015**

According to the results of table 4.2 above, majority of the respondents were male with a percentage of 71.8% and the minority of the respondents were female with a percentage of 28.2%. This shows that most of the businesses are run by men in this area.

**4.2.3 Category that best describes the legal status of this organization**

In the study, the form of business was analyzed and all the details are presented in the table below.

**Table 4.4 Form of business of respondents**

| Form of business | Frequency | Percentage |
|---|---|---|
| Sole Proprietorship | 24 | 61.6 |
| Partnership | 10 | 25.6 |
| Limited Liability | 5 | 12.8 |
| Total | 39 | 100 |

**Source; Primary data, 2015**

Based on table 4.3 above, the category with the highest number of respondents is Sole Proprietorship with a percentage of 61.6%. This means that majority of the respondents were doing their businesses solo. 25.6% were partners and 12.8% were Limited companies.

**Table 4.5 Educational Characteristics of Respondents**

|  | FREQUENCIES | PERCENTAGE |
|---|---|---|
| O' LEVEL | 3 | 7.7 |
| A' LEVEL | 13 | 33.3 |
| BACHELOR'S DEGREE | 18 | 46.2 |
| MASTERS DEGREE | 2 | 5.1 |
| PhD | 1 | 2.6 |
| Professional courses | 2 | 5.1 |
| TOTAL | 39 | 100 |

**Source: Primary data, 2015**

As seen in the table 4.4 above majority were degree holders, the highest being 46.2% with Bachelor's degree. Basing on the above statistics it is clear that the industry is dominated by degree holders with PhD holders being the least participants.

**4.2.4 Years in business operation of the organization**

The organization's years in operation were analyzed and results are presented in the table below

**Table 4.6 Years in Business Operation of the organization**

| Number of years | Frequency | Percentage |
|---|---|---|
| less than 3 years | 7 | 17.9 |
| 3-6 | 13 | 33.3 |
| Above 6 | 19 | 48.8 |
| Total | 45 | 100.0 |

**Source: Primary data**

Table above indicates the results for the number of years of operation of the respondent's business. In the study, it was found that majority of the businesses have been in operation for over 6 years with 48.8%, followed by businesses that have been in operation for 3-6 with a percentage of 33.3% . The least is 17.9% for businesses that have been in existence for less than 3 years. This shows that most of the businesses are mature or have been in the industry for quite some time now.

**4.2.5 Currency**

Frequencies and percentages were done for the distribution to determine the currency which is mostly used. There was need to determine the currency which is dominantly used in transactions by the firms for purposes of critical analysis of that currency verses the Uganda shilling.

**Table 4.7 Currencies used in transactions**

| CURRENCY | FREQUENCY | PERCENTAGE |
|---|---|---|
| US DOLLAR | 21 | 53.8 |
| JAPANESE YEN | 6 | 15.4 |
| THE EURO | 6 | 15.4 |
| THE POUND STERLING | 2 | 5.1 |
| OTHERS | 4 | 10.3 |
| TOTAL | 39 | 100 |

**Source: Primary Data**

The results from the table above shows the US$ being the most frequently used currency or quoted currency in the operations of the respondent firms with a response of 53.8 % usage, the Euro (€) taking and the YEN (¥) taking 15.4% and the POUND (£) being the least used. The Other currencies category comprised of the Kenya Shilling, the Rwandese Francs and the Tanzania Shilling 10.3%.

**Table 4.8 Firm's Performance**

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Our business is involved in international trade | 39 | 1 | 2 | 1.26 | .442 |
| Our currency of exchange in International trade is stable in value | 39 | 2 | 5 | 3.87 | .801 |
| The rate of exchange of the domestic currency to the foreign is unstable | 39 | 1 | 3 | 1.92 | .580 |
| My business experiences losses as a result of exchange rate fluctuations | 39 | 1 | 3 | 1.49 | .683 |

**Source; primary data, 2015**

The above table on exchange rate covers different categories such as: the involvement in international trade, Value of the domestic currency, Stability of the domestic currency and Losses experienced.

**4.3.1 Our business is involved in international trade**

The outcomes of each category shown in the table indicate that the majority of the respondents agreed to the fact that their businesses are involved in international trade. The respondents are represented with a mean of 1.26 meaning they strongly agreed. Many of them agreed as they saw it as an opportunity to grow. Internationalized and innovative businesses are faster growing, more profitable and better able to create wealth and jobs than their domestically focused peers (Love and Roper 2013).

**4.3.2 Our currency of exchange in International trade is stable in value**

Majority of the respondents were represented with a mean of 3.87 and a standard deviation of .801. This means that they disagreed to our currency of exchange in International trade being stable in value. Professor Waswa (2015) says the shilling

will continue to depreciate for as long as the economy doesn't produce much for export

### 4.3.3 The rate of exchange of the domestic currency to the foreign is unstable

This category represents majority of the respondents with a mean of 1.92 means that they agreed the rate of exchange of the domestic currency to the foreign ones is unstable. The Ugandan shilling has depreciated against the US currency by more than 15 per cent over the last one year, one of the biggest drops in more than five years (AlonMwesigwa 2015)

### 4.3.4 My business experiences losses as a result of exchange rate fluctuations

This category has to do with whether the respondents businesses experiences losses as a result of exchange rate fluctuations. The respondents are represented with a mean of 1.49 and a standard deviation of .683. A mean of 1.49 clearly shows that most of the respondents agreed that their businesses have suffered losses from exchange rate fluctuations. Fluctuations in exchange rates may decrease or eliminate profits, or may even result in losses, Uganda Export Promotion Board (2000).Exporters expressed their concern over the exchange rate fluctuations in the year 2012 saying if the trend continues their industry will generally be affected in 2013 (National Bank of Uganda 2012).

**Table 4.9 Exchange Rate Exposure**

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Exchange rate fluctuations have been favorable to our firm's business lifecycle | 39 | 2 | 4 | 3.33 | .806 |
| Our company's input costs are affected due to fluctuations in exchange rate. | 39 | 1 | 5 | 2.85 | 1.159 |
| Exchange rate movements create uncertainty in the company's business operations. | 39 | 2 | 4 | 2.92 | .774 |
| Exchange rate movements affect our company's operations over time. | 39 | 1 | 3 | 1.69 | .766 |

**Source; Primary data 2015**

The above table shows the different categories on risk such as the exchange rate affecting the business lifecycle, input costs, causing uncertainty in operations and affecting the company's operations.

**4.4.1 Exchange rate fluctuations have been favorable to our firm's business lifecycle**

Majority of the respondents disagree that the exchange rate fluctuations have been favourable to their firm's business lifecycle. This is represented with a mean of 3.33 showing that they disagree with the statement. According to the Global Entrepreneurship Monitor (2004), the report shows that these businesses do not live to see their first birthday and approximately every 35 percent of the SMEs businesses close and about 37 percent start new businesses again.

**4.4.2 Our company's input costs are affected due to fluctuations in exchange rate.**

Majority of the respondents agreed with the statement that their company's input costs are affected due to fluctuations in exchange rate. This was represented by a mean of 2.85 however a standard deviation of 1.159 indicated that there was a wide variation in the opinions or views given by the respondents.

**4.4.3 Exchange rate movements create uncertainty in the company's business operations**

The respondents are represented with a mean of 2.92 and a standard deviation of .774. A mean of 2.92 shows that most of the respondents agreed that their businesses face uncertainty in the business' operations from exchange rate fluctuations.

**4.4.4 Exchange rate movements affect our company's operations over time**.
Based on the results in the table above, most of the respondents were represented with a mean of 1.69. This basically means that the respondents agreed to their company's operations being affected overtime. An exchange rate movement affects both the prices of imported finished inputs, thus influencing indirectly those companies that compete with such firms, (Grambovas and Mcleay, 2006 as cited by El-Masry*et al*, 2007).

**Table 4.10: Exchange Rate Risk**

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| Exchange rate fluctuation has affected our export prices | 39 | 1 | 4 | 2.59 | .993 |
| Exchange rate fluctuation has affected our export earnings | 39 | 1 | 4 | 2.38 | 1.091 |
| Exchange rate fluctuation has affected our export volumes | 39 | 1 | 4 | 2.44 | .852 |
| Exchange rate fluctuation has affected our import prices | 39 | 1 | 4 | 2.51 | .854 |
| Exchange rate fluctuation has affected our import earnings | 39 | 1 | 5 | 2.41 | 1.229 |
| Exchange rate fluctuation has affected our import volumes | 39 | 1 | 5 | 2.85 | 1.136 |
| High inflation rates have affected our International Trade | 39 | 1 | 4 | 2.72 | .944 |
| High interest rates have affected our international trade | 39 | 1 | 5 | 2.77 | 1.347 |

**Source; Primary data**

The above table shows the different categories on exchange rate risk such as exchange rate fluctuation affecting the export prices, earning and volumes, import prices, earning and volume, inflation and interest rates affecting international trade.

**4.5.1 Exchange rate fluctuation has affected our export prices**

The respondents are represented with a mean of 2.59 showing that they agreed with the statement that exchange rate fluctuation has affected their export prices. As most of them cared to explain saying in cases where the domestic currency appreciates, then exporters suffer as their prices seem higher because foreigners will need more of

their currency to buy the domestic ones in order to purchase the good. Appreciation of the currency makes exports more expensive and reduces the competitiveness of exporting firms. Williamson (2001) presents the justification for a competition variable declaring exchange rate exposure to be a function of demand elasticity and firms' abilities to adjust prices to fluctuations in exchange rates.

### 4.5.2 Exchange rate fluctuation has affected our export earnings

Majority of the respondents agree with the statement that exchange rate fluctuations affect their export earnings. This was represented by a mean of 2.38, however a standard deviation of 1.091 indicated that there was a wide variation in the opinions or views given by the respondents. An importing or exporting firm is directly influenced by currency appreciation and depreciation in terms of revenue generation (Crowley, 2013).

### 4.5.3 Exchange rate fluctuation has affected our export volumes

The respondents are represented with a mean of 2.44 showing that they agreed with the statement that exchange rate fluctuation has affected their export prices. This could be both negatively and positively in a way that if your small business requires payment in Uganda shillings for your exports, your customers may buy more of your products because their currency converts to more Uganda shillings.

### 4.5.4 Exchange rate fluctuation has affected our import prices

The respondents are represented with a mean of 2.51 and a standard deviation of .854. A mean of 2.51 clearly shows that most of the respondents agreed that their businesses have had their prices affected by exchange rate fluctuations. An exchange rate movement affects both the prices of imported finished inputs, thus influencing indirectly those companies that compete with such firms, (Grambovas and Mcleay, 2006 as cited by El-Masry*et al*, 2007).

**4.5.5 Exchange rate fluctuation has affected our import earnings**

Majority of the respondents agree with the statement that exchange rate fluctuations affect their import earnings. This was represented by a mean of 2.85, however a standard deviation of 1.229indicated that there was a wide variation in the opinions or views given by the respondents. An importing or exporting firm is directly influenced by currency appreciation and depreciation in terms of revenue generation (Crowley, 2013).

**4.5.6 Exchange rate fluctuation has affected our import volumes**

The respondents agree with the statement that exchange rate fluctuations affect their import volume. This was represented by a mean of 2.41, however a standard deviation of 1.136indicated that there was a wide variation in the opinions or views given by the respondents. This could be both negatively and positively in a way that if your small business requires payment in Uganda shillings for your imports, your customers may buy less of your products because their currency converts to less Uganda shillings.

**4.5.7 High inflation rates have affected our International Trade**

This category has to do with whether the respondents businesses experiences losses as a result of exchange rate fluctuations. The respondents are represented with a mean of 2.72 and a standard deviation of .944. A mean of 2.72 clearly shows that most of the respondents agreed that their businesses have been affected due to high inflation. However, during the interviews, most felt that the high inflation didn't affect them. Inflation affects us all and this is why the central government sets up a policy interest rate to forestall any danger of inflation rising above the medium term policy target of 5 percent (BOU statement on Exchange rate 2015).Gylfason(1998) used cross-

sectional data covering 160 countries for the period 1985-1994 and found that high inflation tended to be associated with low exports in proportion to GDP.

**4.5.8 High interest rates have affected our international trade**

This was represented by a mean of 2.77, however a standard deviation of 1. 347 indicated that there was a wide variation in the opinions or views given by the respondents. The mean meant that the respondents agreed to the statement that interest rates affected international trade. According to J di Giovanni (2007), raising interest rates will slow spending and growth, while lowering interest rates generally leads to more spending and higher growth.

**CHAPTER FIVE**

**SUMMARY OF FINDINGS, CONCLUSIONS AND RECOMMENDATIONS**

## 5.0 Introduction

This chapter presents the summary on the findings of the research from the information obtained, the conclusions about the views obtained and recommendations basing on the topic of "Exchange rate risk and the performance of SMEs."

The data collected from the study was analyzed inform of tables which were used to examine the relationship between Exchange rate risk and the performance of SMEs.

## 5.1 Summary of the Findings

Businesses have been affected by the fluctuations in the exchange rate both positively and negatively. The most frequently used currency or quoted currency in the exports of the respondent firms was the US$ dollar. The domestic currency which is the Ugandan shilling hasn't been stable for the past years.

### 5.1.1 Industry characteristics and firm performance.

Size estimation was important for gauging the financial strength and the magnitude of transactions regardless of whether they are generated locally or from trade. Existence of the Firm that is how long the firm has been in the trade business, this was to measure the experience of the firms in business and foreign exchange rate risk exposure. Firms with more than 6 years in operation were the majority. The results revealed a majority of the respondent firms being adult firms. Internationalization in regard to the intensity was generated to measure the extent the firms are engaged in export and import and what compositions of its total sales are attributed to imports and exports. It was discovered that the industry characteristic has an effect on performance in a way that import and export firm were affected differently by the

fluctuations in the exchange rate. Also, firms that were considered bigger than others had lasted longer in operation.

Exports continue to show an increasing trend amidst the volatility of the US$, the exporter remains uncertain especially as the Uganda shilling appreciates against the US$, but gains when the Uganda shilling depreciates against the US$.

### 5.1.2 Exchange rate fluctuations and firm performance

The study established that exchange rates have continued to fluctuate at an unstable trend. Majority of the sampled firms are involved in international trade, whose transactions are dominated in the US$ which is facing volatility. A fluctuating exchange rate directly impacts both positively and negatively as when some of the interviewees mentioned for example the importers suffer from an appreciation in the foreign currency as they'll now need more of the domestic currency to change to the foreign currency in order to import. The downside of depreciation is that Ugandan firms who import raw materials will see an increase in the cost of buying raw materials as well. If there is an appreciation in the value of the shilling, exports will be more expensive. This will lead to lower demand for Ugandan exports or firms will have to reduce their profit margin.

### 5.1.3 Most commonly quoted currency and its performance against the shilling

The study established that the US Dollar as the most commonly used currency in international currency. The results showed US$ being the most frequently used currency or quoted currency in the operations of the respondent firms with a response of 53.8 %.The Ugandan shilling this year has depreciated against the US currency which has been one of the biggest drops in the past five years.

## 5.2 Conclusions

The first objective of the study was to evaluate the relationship between industry characteristics and firm performance. The indicators under firm characteristics were Firm size, Firm Age and Internationalization. The study revealed that a volatile Exchange rate affects trade. The volatility of the US$ against the Uganda shilling indeed has had effects on trade. The Internationalization is significantly related to the foreign exchange risk and positively related to performance.

The second objective was examine the relationship between exchange rate fluctuations and firm performance, the US dollar turned out to be the most dominant source of exchange rate risk. In general, most firms are significantly exposed to foreign exchange risk arising from all the major hard currencies of international trade, namely, the US dollar, the Sterling pound, the Euro and the Japanese Yen. The survey contained questions on both appreciation and depreciation because exchange rate exposure may not be symmetrical. At the individual level, it seems that firms regard their exposure to be symmetrical: enterprises which expected a negative effect from appreciation also forecasted a positive effect from depreciation.

In identifying the most commonly quoted currency and its performance against the shilling. The study showed that the US Dollar is the most used currency in international transactions and that the shilling has continued to be unstable over the past few years.

## 5.3 Recommendations

Firms need techniques or approaches on Foreign exchange risk management as the results from the study show that foreign exchange risk shouldn't be taken lightly since it has the ability to affect performance of businesses. There is little knowledge or awareness regarding the measures on how to reduce the risks.

As the exchange rate has a significant impact on trade flows, monetary authorities should consider the effects of monetary policy on trade flows. As appreciation of the U.S. dollar reduces exports and thereby trade flows, monetary officials should avoid contractionary monetary policies, such as increased interest rates, to reduce inflation in an attempt to strengthen the Ugandan shilling against foreign currency.

Export and import firms can no longer afford to take foreign exchange risk management as a by the way, it must be parts and parts of their organizational strategic activity thus a component of their annual budgets. There must be deliberate attempts to analyze risk and the possible techniques to manage this exposure. The technique should be well spelt out and known to the management.

## 5.4 Suggestions for further research

The research has been limited to exchange rate risk and SME performance researcher, therefore , it is required that other researchers may try to broaden the study by further looking at other critical aspects of exchange rate such as the best ways to manage the exchange rate risk.

Research on what the government is doing in order to analyze the policies being used and how effective they are in helping stabilize the domestic currency.

This study focused on SMEs in Nakawa Division Sub-County and Uganda is such a big economy to generalise these findings to other business centres. Therefore, future research opportunities can be exploited by conducting the same study in other business districts.

Further research could be done in other determinants of SME performance or if there are other variables that need to be combined with these variables in order to enhance performance of SMEs in Uganda.

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## Appendix I:  Questionnaire

## UGANDA MARTYRS UNIVERSITY-NKOZI

## QUESTIONNAIRE FOR THE RESPONDENTS

**RESEARCH QUESTIONNAIRE**

Dear Sir/ Madam,

I am Nkera Alvin, a student of Uganda Martyrs University pursuing a Bachelor of Business Administration and Management. I'm doing a study on **EXCHANGE RATE RISK AND THE PERFORMANCE OF SMEs IN UGANDA**. This study is only for academic purposes and any information provided will be treated with confidentiality. I humbly request for your cooperation.

1. **AGE (Tick the option)**

| Below 25 YEARS | 26-35 YEARS | 36-45 YEARS | 46-55 YEARS | 56-65 YEARS |
|---|---|---|---|---|
|  |  |  |  |  |

2. **GENDER (Tick the option)**

| MALE |  |
|---|---|
| FEMALE |  |

3. **Category that best describes the legal status of this organization(Tick the option)**

| Sole proprietorship |  |
|---|---|
| Partnership |  |
| Limited company |  |
| Others (Specify) |  |

## 4. EDUCATIONAL LEVEL

| | |
|---|---|
| O' LEVEL | |
| A' LEVEL | |
| BACHELOR'S DEGREE | |
| MASTERS DEGREE | |
| PhD | |
| Professional courses (CPA, ACCA etc.) | |

**5.** How long has this organization been in export or import business? **(Tick the box of your option)**

| | |
|---|---|
| Less than 3 years | |
| 3 to 6 years | |
| Above 6 years | |

**6.** Which currency are your export or import transactions frequently quoted in? **(Tick the box of your option)**

| | |
|---|---|
| US DOLLAR | |
| JAPANESE YEN | |
| THE EURO | |
| THE POUND STERLING | |
| OTHERS (specify) | |

**Please Respond By TickingOne Of The Given Options** 1**.** Strongly Agree, 2. Agree, 3. Neither Agree nor Disagree, 4. Disagree, 5. Strongly Disagree.

| ECONOMIC PERFORMANCE | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Exchange rate fluctuation has affected our export prices | | | | | |
| Exchange rate fluctuation has affected our export earnings | | | | | |
| Exchange rate fluctuation has affected our export volumes | | | | | |
| Exchange rate fluctuation has affected our import prices | | | | | |
| Exchange rate fluctuation has affected our import earnings | | | | | |
| Exchange rate fluctuation has affected our import volumes | | | | | |
| High inflation rates have affected our International Trade | | | | | |
| High interest rates have affected our international trade | | | | | |

**Please Respond By TickingOne Of The Given Options** 1**.** Strongly Agree, 2. Agree, 3. Neither Agree nor Disagree, 4. Disagree, 5. Strongly Disagree.

| EXCHANGE RATE RISK | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Our business is involved in international trade | | | | | |
| Our currency of exchange in International trade is stable in value | | | | | |
| The rate of exchange of the domestic currency to the foreign is unstable | | | | | |
| My business experiences losses as a result of exchange rate fluctuations | | | | | |

**Please Respond By TickingOne Of The Given Options** 1**.** Strongly Agree, 2. Agree, 3. Neither Agree nor Disagree, 4. Disagree, 5. Strongly Disagree.

| EXCHANGE RATE RISK | 1 | 2 | 3 | 4 | 5 |
|---|---|---|---|---|---|
| Exchange rate fluctuations have been favourable to our firm's business lifecycle | | | | | |
| Our company's input costs are affected due to fluctuations in exchange rate. | | | | | |
| Exchange rate movements create uncertainty in the company's business operations. | | | | | |
| Exchange rate movements affect our company's operations over time. | | | | | |