Difference Between Transaction and Translation Risk

Key Difference - Transaction vs Translation Risk

Transaction and translation risks are two major types of exchange rate risks faced by companies that engage in foreign currency transactions. The key difference between transaction and translation risk is that **transaction risk is the exchange rate risk resulting from the time lag between entering into a contract and settling it** whereas **translation risk is the exchange rate risk resulting from converting financial results of one currency to another currency.**

What is Transaction Risk?

Transaction risk is the exchange rate risk resulting from the time lag between entering into a contract and settling it. Exchange rates are subjected to continuous changes, and an increased time lag between entering into a transaction and settlement leaves both parties unaware what the exchange rate would be at the time of settlement.

E.g. ABV Company in the UK is a commercial organization and intends to purchase 600 barrels oil from XNT Company in the USA, who is an oil exporter, in another four months. Since the oil prices are continuously fluctuating, ABV decides to enter into a contract to eliminate the uncertainty. As a result, the two parties enter into an agreement where XNT will sell the 600 oil barrels for a price of £170 per barrel.

Spot rate (rate as per today) of an oil barrel is £127. In another four months' time, the price of an oil barrel may be more or less than the contract value of £170 per barrel. Irrespective of the prevailing price as at the contract execution date (spot rate at the end of the four months). XNT has to sell a barrel of oil for £170 to ABV as per the contract.

After four months, assume that the spot rate is £176 per barrel. The difference between the prices ABV has to pay for the 600 barrels due to the contract can be compared with the scenario if the contract did not exist.

If the contract did not exist (£176 *600) = £105,600

Due to the contract (£170 *600)   = £102,000

= £3,600

Due to the contract, ABV managed to gain a profit of £3,600.

The exchange rate between UK £ and US $ is £/$1.25, which means 1£ is equivalent to $1.25. Thus, the payment ABV has to make for XNT is $81,600 (£102,000/1.25).

Above type of contract aimed to mitigate exchange rate risk is called a **forward contract**; this is an agreement between two parties to buy or sell an asset at a specified price on a future date. In addition to forward contracts, below instruments can also be considered in mitigating transaction risk.

Options

An option is a right, but not an obligation to buy or sell a financial asset on a specific date at a pre-agreed price.

Swaps

A swap is a derivative through which two parties arrive at an agreement to exchange financial instruments.

Futures

A futures is an agreement, to buy or sell a particular commodity or financial instrument at a predetermined price at a specific date in the future.

What is a Translation Risk?

Translation risk is the exchange rate risk resulting from converting financial results of one currency to another currency. Translation risk is incurred by companies who have business operations in multiple countries and conduct transactions in different currencies. If results are reported in different currencies it becomes difficult to compare results and calculate results for the entire company. For this reason, all the results in each country will be converted into a common currency and reported in financial statements. This common currency is usually the currency in the country where the corporate headquarters is based.

When a company is exposed to translation risk, reported results may be higher or lower compared to the actual result based on the changes in the exchange rate.

E.g. Company D’s parent company is Company A, which is located in the USA. Company D is located in France and conduct trading in Euro. At year end, results of Company D is consolidated with the results of Company A to prepare financial statements, thus the results of Company D are converted into US Dollar.

Below details of revenue, the cost of sales and gross profit are of Company D based on the transactions for the financial year of 2016.

	€000’
Sales	2,545
Cost of sales	(1,056)
Gross profit	1,489

Assuming an exchange rate of $/€0.92, (This means that one $ is equal to €0.92) the results of Company D will be converted to,

	$000’
Sales (2,545 *0.92)	2,341
Cost of sales (1,056 *0.92)	(972)
Gross profit (1,489 *0.92)	1,369

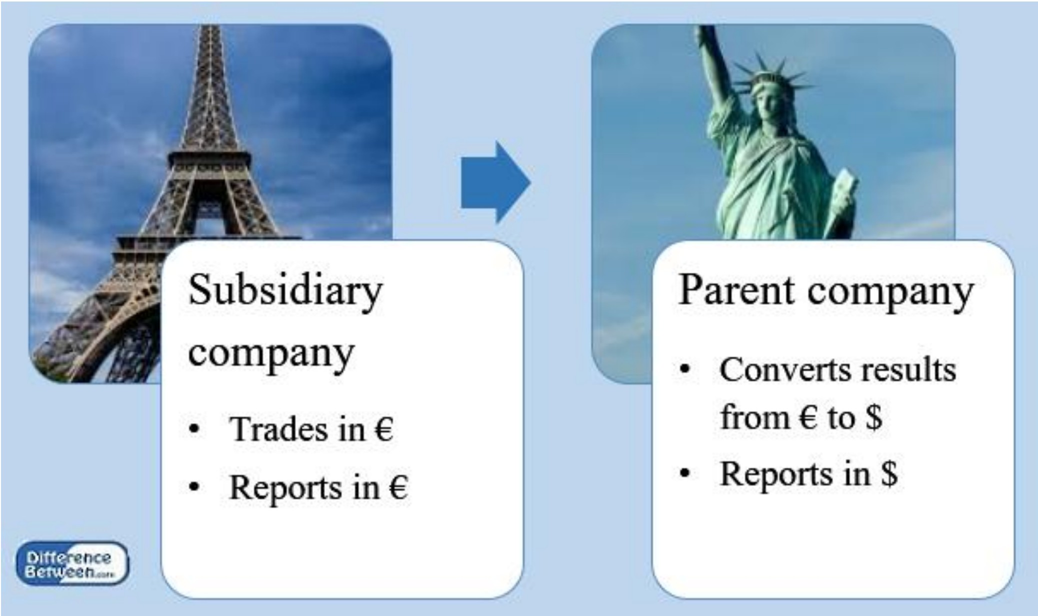

Figure 1: Currency Conversion leads to Translation Risk

Due to the currency conversion, the reported results are lower than the actual results. This is not an actual reduction and is purely due to the currency conversion.

What is the difference between Transaction and Translation Risk?

Transaction vs Translation Risk	
Transaction risk is the exchange rate risk resulting from the time lag between entering into a contract and settling it.	Translation risk is the exchange rate risk resulting from converting financial results of one currency to another currency.
Actual Change in the Outcome	
There is an actual change in the future outcome in transaction risk since the transaction is entered into at one point of the time and settled in the future.	There is no actual change in the outcome in translation risk since the visible change in results is merely due to the currency conversion.
Mitigation of Risk	
Transaction risk can be mitigated by entering into a hedging agreement.	Translation risk cannot be mitigated

Summary - Transaction vs Translation Risk

The difference between transaction and translation risk can be understood by realizing the reasons for them to arise. When a contract is entered to in the present, which will be settled at a future date, the resulting risk is a transaction risk. The exchange rate risk resulting from converting financial results of one currency to another currency is the translation risk. A company's foreign exchange transactions should be managed carefully so that they are not subject to significant changes since high transaction and translation risks are signs of volatility.

References:

1."Transaction Risk." Investopedia. N.p., 24 Nov. 2003. Web. Available here. 12 June 2017.
2."Basics of Derivatives." BSE Ltd. N.p., n.d. Web. Available here. 12 June 2017.

Image Courtesy:

1."1319600" (Public Domain) via Pixabay

How to Cite this Article?

APA: Difference Between Transaction and Translation Risk. (2017, June 16). Retrieved (date), from http://www.differencebetween.com/ difference-between-transaction-and-vs-translation-risk/

MLA: "Difference Between Transaction and Translation Risk." *Difference Between.Com*. 16 June 2017. Web.

Chicago: "Difference Between Transaction and Translation Risk." *Difference Between.Com*. http://www.differencebetween.com/ difference-between-transaction-and-vs-translation-risk/ (accessed [date]).