

Effect of Exchange Rate on Financial Performance of Small and Medium Sized Enterprises in Mogadishu

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ABSTRACT

The general aim of this study is to investigate the effect of exchange rate on financial performance of small and middle-sized companies in Mogadishu. Specifically, this study investigated the effects of Balance of payments, the effect of foreign direct investment, the degree of Inflation and the effect of Taxation. The related theories of exchange rate are Purchasing power Theory, Interest Rate Theory and Product Cycle Theory. This study was conducted through a descriptive study. In addition the study employed a survey research design in data collection. The sampling procedure of this study used non-probability sampling procedure particularly purposive sampling or judgmental sampling, this research employed quantitative data collection method whereby data was gathered by the use of closed ended questionnaires which are self-administered. The data collected was analyzed using the software called Statistical Package for the Social Sciences (SPSS) version 22 and results shown in terms of frequency distribution and percentages, the target population of the study is 160 employees of some merchandising companies in Mogadishu. A sample of 48 respondents was selected using Mugenda and Mugenda's formula. The study used primary data. Data collection methods used included use of questionnaires. The selection sample technique was purposive or judgmental approach. A regression model was applied to determine the relationship between Balance of payments, foreign direct investment, inflation and Taxation as the independent variables and financial performance for small and medium sized enterprises as the dependent variable. The key findings of this study were: Most of the respondents agreed that International trade has a direct effect on the financial performance of the company. Most of the respondents also agreed to the fact that Company owners think they can create high profit for the company if they gain investment income. Company managers are always responsible when companies fail to implement financial transactions. The researchers recommended that: Somali merchants should try to increase domestic productions so as to add value to their money. The researcher's second recommendation is that Somali government should control all import-export activities and try to increase exportations rather than importation Also top management of small and medium sized enterprises should motivate their employees to increase the performance.

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1. Introduction

Exchange rates can depart from their equilibrium level for two reasons. First, as a result of government intervention directly aimed at altering the real exchange rate (currency manipulation). In this respect, governments and/or central banks possess a number of policy instruments that can affect the real value of the exchange rate, including the introduction of capital controls or targeted intervention in foreign exchange markets. Second, misalignments can be the unintended side effect of macroeconomic policies aimed at achieving domestic objectives, or the result of distortions in the international financial architecture or in domestic structural conditions. There is an academic debate on the extent to which the real exchange rate is a variable that policy makers can influence, see for instance, Eichengreen (2007) and Rodrik (2008).

In addition, to ascertain the root cause of a currency misalignment is often a difficult matter in practice. The

ensuing discussion will abstract from the cause of the misalignment and will, instead, focus on its trade effects in the long- versus the short-run. Standard economic theory defines the long-run as the period in which all prices are fully flexible. Put differently, in the long-run prices have the time to adjust to any policy change (or other shock). In this context, money is like a veil to the real economy, an intuition that dates back at least to David Hume's essays on money and the balance of trade. In particular, when markets have no distortions, an exchange rate misalignment - such as a devaluation of the currency - has no long-run effect on trade flows or on real economic activity, as it does not change relative prices. The short-run, on the other hand, can be different. The reason is that, if some prices in the economy take time to adjust (i.e. are "sticky"), movements in nominal exchange rates can alter relative prices and affect both the allocation of resources between non-tradable and tradable sectors and international

trade flows. The short-run trade effects of exchange rate misalignments, however, are not straightforward; see Staiger and Sykes (2010). Recent macroeconomic literature shows that these effects depend, among other things, on the currency in which domestic producers invoice their products.

Exchange rate movements have been a big concern for investors, analyst, managers and shareholders since the abolishment of the fixed exchange rate system. This system was replaced by a floating rates system in which the price of currencies is determined by supply and demand of money. Given the frequent changes of supply and demand influenced by numerous external factors, this new system is responsible for currency fluctuations. These fluctuations expose companies to foreign exchange risk. Moreover, economies are getting more and more open with international trading constantly increasing and as a result companies become more exposed to foreign exchange rate fluctuations. Foreign exchange exposures are the sensitivity of changes in the real domestic currency value of assets liabilities or operating incomes to unanticipated changes in exchange rate (Abor, 2005).

In practice, economic exposure is computed as the net sensitivity of some aggregate measure of firm value to currency fluctuations. By focusing on the net sensitivity, economic exposure includes the direct and indirect effects of currency fluctuations. In practice, there is little consensus on the use of appropriate choice of aggregate measure. The focus of this paper is on the economic exposure of UK non-financial firms. Overall, theory supports the existence of a relationship between the values of the firm and exchange rate movements. Economic theory suggests that changes in the exchange rate can produce a shift in stock prices, directly in the case of multinational firms, exporting and importing companies, firms which import part of their inputs and indirectly for other companies. 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 (Amos, 2009). Exchange rates may affect a firm through a variety of business operation models: a firm may produce at home for export sales as well as domestic sales, a firm may produce with imported as well as domestic components, a firm may produce the same product or a different product at plants abroad. The model of the firm must be broad enough to capture all of these channels. The firm described below is a multinational firm (producing and selling at home and abroad) that uses both foreign and domestic components. The liberalization of the exchange rate regime in 1986 has led to introduction of various techniques with the view of finding the most appropriate method for achieving acceptable exchange rate for Given the frequent changes of supply and demand influenced by numerous external factors, this new system is responsible for currency fluctuations (Abor, 2005). These fluctuations expose companies to foreign exchange risk. Moreover, economies are getting more and more open with international trading constantly increasing and as a result companies become more exposed to foreign exchange rate fluctuations.

Foreign exchange rate risk refers to the sensitivity of a firms cash flows, real domestic currency value of assets, liabilities, or operating incomes to unanticipated changes in exchange rates, Generally, companies are exposed to three types of foreign exchange risk: accounting (translation) exposure, transaction (commitment) exposure and economic(operational, competitive or cash flow) exposure

(Eiteman et al., 2006).The high volatility of exchange rates is a fact of life faced by every company engaged in international business, bringing in uncertainties in their bottom line. In recent years, a variation in value of Kenya shilling has been very impulsive and unpredictable, defines foreign exchange risk as the risk of change (gain or loss) in the company's future economic value due change of foreign exchange rates. It is manifested by exposure, the degree to which a company performance is affected by exchange rate changes. Thus, Shapiro (2006) suggests adherence to foreign exchange risk management, which involves currency assessment (identification and quantification) and designed counter-strategies against foreign exchange risk.

Trade and investment in a country are likely to be impacted by the happenings in the foreign exchange market. This means therefore that a stable exchange rate, is likely to have positive effects on household incomes and consumption; firms investment, import and employment decisions; government's fiscal, debt and monetary policies; and trade balance (Adebisi, 2006). Moreover, exchange rate stability is likely to discourage capital flight and speculation in the foreign exchange market. It has been established that foreign exchange developments affect all aspects of an open economy including its financial markets. Charles (2006) for instance established that floating exchange rate appreciation reduces the competitiveness of export markets; and has a negative effect on the domestic stock market of export dominated economies. However, it has positive effect on the stock market by lowering input costs, for an import dominated country. In effect countries such as Kenya which is import oriented can experience price instability in the face of exchange rate volatility because its economy is heavily dependent on imports of raw materials, capital goods and consumer goods, hence, the need to manage the foreign exchange market.

Exchange rate therefore plays an increasingly significant role in any economy as it directly affects domestic price level, profitability of traded goods and services, allocation of resources and investment decision. The impact of exchange rate volatility on trade has been studied more in industrialized countries than in less developed economies. Agu (2002) state that this lack of attention in developing countries is caused by insufficient time series data, according to Gachua (2011) there is a need for this kind of empirical studies to be undertaken in developing countries such as Kenya with time-variant exchange rates in order to counter this prevalent ambiguity in the literature and fill the research vacuum in less developed countries. This study therefore seeks to fill this gap by examining the effects of foreign exchange rate volatility on the financial performance of oil marketing companies in Kenya.

In the context of Somalia, There is no specific period that can be traced the starting era of the use of money metallic coins in Somalia, but from the history the researcher acknowledged that the trade relations between the neighboring countries in the exchange of goods were based with the currencies used by those inhabitants of the region namely in the Arabian Peninsula and in India. The history of the Somali currency or the monetary system it is important even briefly to mention the developed stage of civilization achieved by the different societies of the different regions of Somalia. Among the oldest cities flourished with trade can be quoted: Zeila, BuloHar, Berbera, Warsheikh, Mogadishu, Brava and Kismayo. Bronze. This new coins had exchange rate with one the Maria Theresa Thaler to 150 cents.

In the same year the Italian Administration injected into circulation coins made by nickel with an exchange rate of 25 cents each, the Administration's currency policy had not procured satisfactory results and in 1909 it was introduced new currency in different denomination of coins "Italian Pesa" divided in one, two and four Pesas, with an exchange rate of 150 Pesas per one Maria Theresa Thaler. The Moroccan explorer, Ibn Batuta, who visited Somalia's coasts, and in his memorable book which he wrote during his long journey along the Somali coasts, revealed that he has landed Mogadishu describing widely that the city was big, booming and with several small industries and handcrafts artisans. The principal form of currency in Somalia has been based metallic coins, usually silver, and by the first half of the 19th century the main unit of currency was the Maria Theresa Thaler which was known in Somalia "Sharuq". It was a coin containing four parts silver and one part copper, and has been issued by the Austrian Empire, in honor of the Empress Maria Theresa, who ruled Austria, Hungary and Bohemia from 1740 to 1780. It had gained acceptance in the Arabia Peninsula and in the Horn of Africa, Somalia, Ethiopia and Eritrea, as its high silver content satisfied the people's desire for base.

According to our knowledge every organization is apparently aware that they face hasty change in the future. This signal of future oriented ambiguity, attached with individual demands for increased complaints at all levels of the organization, has dramatically changed insights of exchange rate. Economic activity is globally unified today to an unprecedented degree. Changes in one nation's economy are rapidly transmitted to that nation's trading partners. These fluctuations in economic activity are reflected, almost immediately, in fluctuations in currency values. Consequently, multinational corporations, with their integrated cross-border production and marketing operations, continually face devaluation or revaluation worries somewhere in the world. Sekine, Toshitaka (2006).

According to the researcher's knowledge and awareness it seems that there are no strong functioning central banks that carry out monetary policy for controlling and regulating the current exchange rate and supply of money in order to achieve predetermined macroeconomic goals and all SMEs tend to look for their profitability basing on the inflation and deflation of foreign exchange rates. However in My best awareness, the effect of exchange rate on financial performance in Mogadishu seems to be unclear and no other researcher tried to observe the situation and conduct a research so, I saw a big gap that needs to be covered. Therefore this study investigated the effect of exchange rate on financial performance of SMEs in Mogadishu.

1.3. Research objectives

1. To analyze how balance of payments affects financial performance of SMEs in Mogadishu.
2. To evaluate the effect of foreign direct investment on the financial performance of SMEs in Mogadishu.
3. To assess how inflation affects on the financial performance of SMEs in Mogadishu.
4. To find out the effect of taxation on the financial performance of SMEs in Mogadishu.

2. Literature Review

Theoretical Framework

Purchasing power Theory

Purchasing power parity (PPP) is a disarmingly simple theory that holds that the nominal exchange rate between two currencies should be equal to the ratio of aggregate price

levels between the two countries, so that a unit of currency of one country will have the same purchasing power in a foreign country. All of our surveys are nationally representative and cover both rural and urban households. In contrast, the ICP collected only urban prices in a number of countries, including most of Latin America, but also in China, while, in India, urban outlets were overrepresented in the price surveys. For the urban only countries, we need a measure of the price of consumption in rural relative to urban, and for this we follow Chen and Ravallion (2010) and use the ratio of rural to urban poverty lines in those countries. While it is a big assumption that the ratio of the poverty lines correctly measures the relative price levels, there is no other obvious source of such information, and some correction is necessary. For countries where the adjustment is made, we adjust our surveys prior to the calculations by converting all household expenditures to urban prices by scaling upper capita household expenditure for each rural household by the ratio of the urban to rural poverty line. Once this adjustment is made, the sectors are ignored, and the survey treated as a single national sample to which the global poverty line, converted at the urban PPP, can be applied to calculate expenditure weights and counts of the numbers in poverty. India is treated somewhat differently. First, to take account of the fact that, although the ICP collected both urban and rural prices, the former were overrepresented; and second, to recognize that the ratio of official urban to rural poverty lines is implausibly high, and has long been suspected to be the result of a computational error (Deaton 2003). Deaton and Dupriez (2009).

Interest Rate Theory

Interest Rate Parity is a no-arbitrage condition representing an equilibrium state under which investors will be indifferent to interest rates available on bank deposits in two countries. The fact that this condition does not always hold allows for potential opportunities to earn riskless profits from covered interest arbitrage. Two assumptions central to interest rate parity are capital mobility and perfect substitutability of domestic and foreign assets. Given foreign exchange market equilibrium, the interest rate parity condition implies that the expected return on domestic assets will equal the exchange rate-adjusted expected return on foreign currency assets. Investors then cannot earn arbitrage profits by borrowing in a country with a lower interest rate, exchanging for foreign currency, and investing in a foreign country with a higher interest rate, due to gains or losses from exchanging back to their domestic currency at maturity. Interest rate parity takes on two distinctive forms: uncovered interest rate parity refers to the parity condition in which exposure to foreign exchange risk (unanticipated changes in exchange rates) is uninhibited, whereas covered interest rate parity refers to the condition in which a forward contract has been used to cover (eliminate exposure to) exchange rate risk. Each form of the parity condition demonstrates a unique relationship with implications for the forecasting of future exchange rates: the forward exchange rate and the future spot exchange rate (Feenstra, 2008). Economists have found empirical evidence that covered interest rate parity generally holds, though not with precision due to the effects of various risks, costs, taxation, and ultimate differences in liquidity. When both covered and uncovered interest rate parity hold, they expose a relationship suggesting that the forward rate is an unbiased predictor of the future spot rate. This relationship can be employed to test whether uncovered interest rate parity holds, for which economists have found, mixed results. When

uncovered interest rate parity and purchasing power parity hold together, they illuminate a relationship named real interest rate parity, which suggests that expected real interest rates represent expected adjustments in the real exchange rate. This relationship generally holds strongly over longer terms and among emerging market countries. (Mishkin, 2006).

Product Cycle Theory

The Product Life Cycle (PLC) concept is a well-known marketing strategy and planning tool.

The concept is based on a simple biological analogy of stages over a product's "life," which is intuitively appealing, but unfortunately has limited utility in practice. For such a prominent marketing tool, the lack of both a focus on consumers and a theoretical basis is surprising. Diffusion of innovation models and theory offer considerable promise to provide a theoretical basis for the PLC. To date, diffusion models have been limited to explaining and forecasting PLC sales patterns. This paper consolidates this literature to develop an over-arching conceptual PLC model and managerial tool for consumer durables. The approach defines the new PLC phases based on some key consumer trends during product market evolution, resulting in a four-phased PLC model: Innovation → Imitation → Repeat → Substitute. New marketing strategy implications emerge for each phase due to this additional focus on consumers. The model is operationalized using diffusion models, thereby providing a basis for both identifying and predicting PLC transitions. The types of data that need to be collected to fully operationalize and test this PLC model are discussed. The new PLC model does not ignore variations in PLC sales patterns. Rather, it provides an opportunity to explain such sales pattern variations and determine the underlying conditions that lead to different PLC shapes. An empirical illustration of the new PLC model is presented. The PLC literature centers around what can be termed the "traditional PLC concept," a version of which can be found in almost any general marketing text (e.g. Kotler, 2000). Though it is assumed that the reader is familiar with this concept, it is useful to re-examine its underlying assumptions.

Conceptual framework

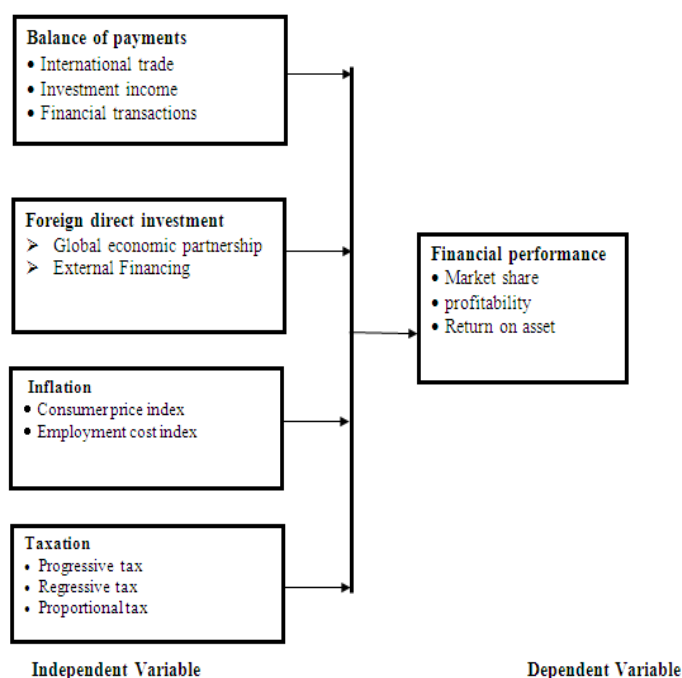


Figure 2.1. Conceptual Framework.

Balance of payment

A country's balance of payments is commonly defined as the record of transactions between its residents and foreign residents over a specified period. Each transaction is recorded in accordance with the principles of double-entry book-keeping, meaning that the amount involved is entered on each of the two sides of the balance-of-payments accounts. The balance of payments (BOP) is a summary of economic activities between the residents of a country and the rest of the world during a given period, usually one year. The main purpose of keeping these records is to inform government authorities of the overall international economic position of the country in order to assist them in arriving at decisions on monetary and fiscal policy, on the one hand, and trade and payments policy on the other. Balance of payments statistics are therefore helpful to government authorities charged with maintaining macroeconomic stability. Balance of payments accounting is governed by a set of principles and conventions that ensures the systematic and coherent recording of transactions, which are consistent across countries and over time. These principles and concepts will be discussed and where necessary practical examples will be used to elucidate the concepts (Lattie, 2005).

The balance of payments is constructed according to the principles of double-entry bookkeeping. Under this system a transaction is represented in the balance of payment by two entries with equal values. One of these entries is designated a credit and the other a debit. There are some basic rules governing how entries are recorded in the balance of payments. A credit entry is recorded when the transaction gives rise to a receipt by a domestic resident from a foreign resident. The receipt itself may take the form of an increase in the residents' foreign assets or balances of foreign currencies. Whatever its form, the receipt is recorded as a debit entry. Conversely, any transaction that gives rise to a payment by a resident to a foreign resident is recorded as a debit entry. The payment that results from this transaction is recorded as a credit entry. (Robinson, 2004).

Foreign Direct Investment

According to the IMF and OECD definitions, direct investment reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The "lasting interest" implies the existence of a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprise and all subsequent capital transactions between them and among affiliated enterprises⁴, both incorporated and unincorporated. It should be noted that capital transactions which do not give rise to any settlement, e.g. an interchange of shares among affiliated companies, must also be recorded in the Balance of Payments and in the IIP. Concerning the terms direct investor and direct investment enterprise, the IMF and the OECD define them as follows. A direct investor may be an individual, an incorporated or unincorporated private or public enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which have a direct investment enterprise, operating in a country other than the country of residence of the direct investor (McIntosh, 2005).

A direct investment enterprise is an incorporated or unincorporated enterprise in which a foreign investor owns

10% or more of the ordinary shares or voting power of an incorporated enterprise or the equivalent of an unincorporated enterprise. Direct investment enterprises may be subsidiaries, associates or branches. A subsidiary is an incorporated enterprise in which the foreign investor controls directly or indirectly (through another subsidiary) more than 50% of the shareholders' voting power. An associate is an enterprise where the direct investor and its subsidiaries control between 10% and 50% of the voting shares. A branch is a wholly or jointly owned unincorporated enterprise. It should be noted that the choice between setting up either a subsidiary/associate or a branch in a foreign country is dependent, among other factors, upon the existing regulations in the host country (and sometimes in its own country, too). National regulations are often more restrictive for subsidiaries than for branches but this is not always the case (Maitena, 2003).

Inflation

Inflation is the continuing increase in the general price level that is upward movement in the prices of the majority of goods and services. Inflation may arise from a variety of factors but the basic reason for inflation is having too much money competing to buy the available goods at their existing prices, allowing those prices to rise. Bank of Jamaica (BOJ), the country's central bank, has the primary objective of ensuring price stability in the economy. In other words, the Bank is mandated to keep inflation in check. But why has BOJ been given this mandate? The ultimate goal of economic policy is to ensure a sustainable increase in the standard of living of Jamaican citizens. Keeping inflation under control to avoid a loss of purchasing power of earnings and savings is an important means to this end. Price stability also makes it easier to plan over relatively long time horizons and therefore encourages saving and investment.

Inflation is measured through the use of the Consumer Price Index (CPI), which captures the rate of price change for goods and services consumed in Jamaica. It is the most widely used indicator of inflation in Jamaica. The Statistical Institute of Jamaica (STATIN) measures the CPI on a monthly basis. The CPI measures the average price change in a selected set of goods and services that is purchased by *the representative Jamaican* in a certain income range. To the extent that the goods and services consumed by each particular individual differ from the set of goods monitored by STATIN, the price changes published by STATIN will not precisely measure the price changes faced by every Jamaican. (Harriott, 2000).

Taxation

Tax is a central but neglected element of development policy. The structure and administration of taxation are frequently omitted from discussion and research agenda. Questions of a primarily redistributive nature may be deemed political, and so unsuitable for neutral economic analysis, and moreover as questions to be resolved by the democratic process in individual countries. On the other hand, many questions are posed in terms of system reform and these may instead be considered as purely 'technical' – matters of economic and bureaucratic efficiency to be settled by experts. As a result, tax generates neither the sort of attention given by independent empirical academic research to e.g. questions of optimal exchange rate arrangements, nor the level of NGO advocacy focus devoted to e.g. multinational investment behavior. This twin neglect may explain how an element of such importance for human development has such a low profile – and possibly why its contribution may have been damaging. This neglect, it is argued, has led to two main

developments. First, the treatment of tax as a specialist area, with a resultant focus on 'efficiency' rather than theoretical analysis or practical research, has contributed to a lack of knowledge of potentially important peculiarities of individual countries. This in turn has contributed to treatment of poor countries' systems as simply underdeveloped versions of rich country equivalents. Technical assistance has then focused on helping the former to reach 'our level', rather than a more careful and constructive engagement. (Cobham, 2000).

Kenya has grown direct and sales taxes together, seeking to address persistent revenue shortfalls as Cheese man and Griffiths (2005) detail, and to this end have also managed during the 1990s to reverse the slide in trade tax revenues (albeit not to the levels of the 1980s and 1970s). It is of concern that poorer countries are not only less able to raise revenue in absolute terms, but moreover that they appear less able *proportionally* also. Teera (2002) has calculated, following Goode (1984), measures of 'tax effort' – a static measure of a country's utilization of its tax capacity, and of 'tax buoyancy' – a dynamic measure capturing the elasticity of tax revenue with response to policy changes and growth.

Financial performance

Finance always being disregarded in financial decision making since it involves investment and financing in short-term period. Further, also act as a restrain in financial performance, since it does not contribute to return on equity. A well designed and implemented financial management is expected to contribute positively to the creation of a firm's value (Padachi, 2006). Dilemma in financial management is to achieve desired tradeoff between liquidity, solvency and profitability

(Lazaridis *et al.*, 2007). Management of working capital in terms of liquidity and profitability management is essential for sound financial recital as it has a direct impact on profitability of the company (Rajesh and Ramana Reddy, 2011). The crucial part in managing working capital is required maintaining its liquidity in day-to-day operation to ensure its smooth running and meets its obligation (Eljelly, 2004). Ultimate goal of profitability can be achieved by efficient use of resources. It is concerned with maximization of shareholders or owners wealth (Panwala, 2009). It can be attained through financial performance analysis. Financial performance means firm's overall financial health over a given period of time. A bank is a financial intermediary that accepts deposits and channels those deposits into lending activities. Banks are a fundamental component of the financial system, and are also active players in financial markets. The essential role of a bank is to connect those who have capital (such as investors or depositors), with those who seek capital (such as individuals wanting a loan, or businesses wanting to grow) (DUFERA, 2010).

Various groups of individuals are particularly interested in evaluating bank performance. First and foremost, *bank shareholders* are directly affected by bank performance. Investors take advantage of bank information to develop expectations concerning future performance that can be used to help price common shares (in addition to capital notes and debentures that may be issued by the bank). Second, *bank management* traditionally is evaluated on the basis of how well the bank performs relative to previous years and compared with similar (or peer group) banks. Hence, employees' salaries and promotions are frequently tied to the performance of the bank. Bankers also need to be informed about the condition of other banks with which they have

business dealings. Third, *regulators*, concerned about the safety and soundness of the banking system and the preservation of public confidence, monitor banks using on site examinations and computer based “early warning systems” to keep track of bank performance. Fourth, *depositors* may also be interested in evaluating the performance of the bank, as the nominal values of their deposits are not guaranteed. Fifth, and last the *business community* and general public should be concerned about their banks’ performance to the extent that their access to credit and other financial services is linked to the success or failure of their bank (Benton and James2005).

If the financial market were efficient, market price for banks' stock price would be one of the most appropriate tools for measuring banks' performances. The alternative to the market approach is the accounting-based financial ratio approach, which has commonly been used for measuring the financial performance of firms (Abdu, 2004).

Empirical review

The first issue is the nature of the market model used to estimate corporate foreign exchange exposure. The focus of this paper is not the validity or efficiency of the various asset pricing models, but instead, based on prior studies, the research focus on how foreign exchange exposure is estimated. Earlier studies used a monthly, contemporaneous horizon to measure exposure. Initial research in this area focused on whether corporations are exposed to foreign exchange risk. Another issue in developing foreign exchange exposure estimates has to do with portfolio size. Generally, there are two major choices in this regard. The first method is to estimate exposure on the firm level and the other method is to estimate the exposure for portfolio groupings, formed either by size, industry, level of international activity, or another criteria. Many studies assess both the firm level and portfolio level exposures. As indicated earlier, prior studies have focused on exposures of internationally involved or multinational firms. Using a large sample of firms from many different countries, Doidge, Griffin and Williamson (2002) find that foreign exchange exposure is related to the level of foreign activity. They also find that large firms exhibit more foreign exchange exposure than smaller firms after controlling for the level of foreign activity. Find an increase in equity volatility following the breakdown of the Bretton Woods agreement and increased exchange rate volatility but equity risks increased much more for firms with a multinational presence than it did for a control sample of domestic firms. As has been noted in theoretical studies, industry effects also seem important in estimating foreign exchange rate exposure. Using a sample of firms in the automotive industry in the US and Japan, Williamson (2001) found that foreign sales are a major determinant of exposure but there is considerable time variation in exchange rate exposure. However, Griffin and Stulz (2001) find the effect of exchange rate shocks is minimal in explaining relative US industry performance and is even smaller in other countries that are more open to trade finding that industry effects are more significant than exchange rate effects. While there may be some differences in empirical findings, foreign exchange exposure most likely depends on the competitive structure in an industry. Additional firm characteristics have also been assessed as to their impact on foreign exchange exposure. Koutmos and Martin (2003) used industry sector portfolios from four countries and find that exchange rate exposure is asymmetric over different appreciation depreciation periods. Furthermore, these asymmetries are more pronounced in the financial and non-

cyclical sectors. Overall, studies of foreign exchange exposure find that multinational corporations and corporations with extensive foreign business have significant foreign exchange exposure. However, most studies find that this estimated exposure is less than expected by economic theory perhaps due to operational and financial hedges used by companies facing foreign exchange exposure. While a few studies have included domestic firms without foreign activity and generally found them not to be exposed to foreign exchange risk, no prior study has addressed the determinants of foreign exchange exposure of domestic firms. It is common practice among firms to use a combination of production and marketing strategies across the firm's different operating units, operational hedges to manage long term exposure, whereas foreign exchange derivatives, financial hedges are more often used for managing short term exposure. Long-term operating policy adjustments are costly and difficult to reverse hence they are most effective when the firm possesses a network of multiple operating units that span many business and geographic areas.

3. Methodology

This is an empirical study that analyzed the impact of foreign exchange rates on a firm's financial performance. The study answered the puzzle on the effect of foreign exchange on the firm's financial performance of listed companies in Mogadishu that has been of a concern. The research is a descriptive research design which generally describes the characteristics of a particular situation, event or case.

A regression model was applied to determine the effects of each of the variables with respect to financial performance. Regression is concerned with describing and evaluating the relationship between a given variable and one or more other variables. More specifically, regression is an attempt to explain movements in a variable by reference to movements in one or more other variables.

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$$

Where Y: is the financial performance.

X_1 : is Balance of payments.

X_2 : is foreign direct investment.

X_3 : is Inflation.

X_4 : is a government regulation.

ε : Error term

4. Research Findings

Balance of payment on financial performance

The study required to investigate the effects of Balance of payment on financial performance. Table 4.6 summarizes respondents' level of agreement on how Balance of payment affects financial performance of SMEs. Most of the respondents agreed that International trade has a direct effect on the financial performance of the company as shown by a mean of 1.83. Most of the respondents also agreed to the fact that Company owners think they can create high profit for the company if they gain investment income, reporting a mean of 2.17. Company managers are always responsible when companies fail to implement financial transactions reported a mean of 2.31, the receipt is recorded as a debit entry. Conversely any transaction that gives rise to a payment by a resident to a foreign resident is recorded as a debit entry. The payment that results from this transaction is recorded as a credit entry.(Robinson, 2004).

Table 4.1. Balance of payment on financial performance.

Statement	N	Mean	S.D
International trade has a direct effect on the financial performance of the company	42	1.83	.881
Company owners think they can create high profit for the company if they gain investment income	42	2.17	.824
Most businesses do well when they adopt financial transactions.	42	2.33	.816
Company managers are always responsible when companies fail to implement financial transactions.	42	2.31	1.199

Foreign direct investment on financial performance

The study sought to establish the effects of foreign direct investment on financial performance

From the findings indicated in Table 4.1 most of the respondents agreed that Global economic partnership has a higher risk to your company with a mean of 1.93 being obtained. The results also conquer with the findings on the question that was asked whether Business entities generate profits by taking advantage of the external financing.. The findings on this question obtained a mean of 2.00. Some of the respondents agreed that economic partnership is a very good way to get profit, with a mean of 2.10. The findings on external financing makes analyzing risks difficult obtained a mean of 2.36. A direct investor may be an individual, an incorporated or unincorporated private or public enterprise, a government, a group of related individuals, or a group of related incorporated and/or unincorporated enterprises which have a direct investment enterprise, operating in a country other than the country of residence of the direct investor.(McIntosh, 2005)

Table 4.2. Foreign direct investment on financial performance.

Statement	N	Mean	S.D
Global economic partnership doesn't have a higher risk to your company.	42	1.93	.838
Global economic partnership is a very good way to get profit	42	2.10	1.078
External financing makes analyzing risks easy.	42	2.36	1.100
Business entities generate profits by taking advantage of the external financing.	42	2.00	1.126

Inflation on financial performance

The study sought to establish the effects of Inflation on financial performance. Respondents agreed that Consumer price index affects the profitability and long-term strategy of the organization as represented by a mean of 1.86, most of the respondents agreed that the ability of profit levels have decreased over the last years as shown by a mean of 2.02 and a mean of 2.14 was obtained on the question whether Finance officers and owners take decisions related Consumer price index control.

Table 4.3. Inflation on financial performance.

Statement	N	Mean	S.D
Consumer price index affects the profitability and long-term strategy of the organization.	42	1.86	.814
The ability of profit levels have decreased over the last years.	42	2.02	.975
Our company has a policy towards Employment cost index	42	2.50	1.018
Finance officers and owners take decisions related Consumer price index control	42	2.14	1.117

The CPI measures the average price change in a selected set of goods and services that is purchased by the representative Jamaican in a certain income range. To the

extent that the goods and services consumed by each particular individual differ from the set of goods monitored by STATIN, the price changes published by STATIN will not precisely measure the price changes.(Harriott, 2000)

Taxation on financial performance

The study sought to establish the effects of Taxation on financial performance. Respondents agreed that Company managers always try to ignore paying the tax as represented by a mean of 1.81, some of the respondents agreed that Management of the company adopts to pay low tax so as to keep owners' wealth maximization as shown by a mean of 2.02 and a mean of 2.07 was obtained on the question whether Paying the tax will enable decision makers to feel free from any government intervention and some other respondents admitted that The tax guides the company to perform well and gain high profit as indicated by a mean of 2.24. The treatment of tax as a specialist area, with a resultant focus on 'efficiency' rather than theoretical analysis or practical research, has contributed to a lack of knowledge of potentially important peculiarities of individual countries. This in turn has contributed to treatment of poor countries' systems as simply underdeveloped versions of rich country equivalents. Technical assistance has then focused on helping the former to reach 'our level', rather than a more careful and constructive engagement. (Cobham, 2000).

Table 4.4. Taxation on financial performance.

Statement	N	Mean	S.D
Company managers always try to ignore paying the tax	42	1.81	.969
The tax guides the company to perform well and gain high profit.	42	2.24	1.265
Paying the tax will enable decision makers to feel free from any government intervention	42	2.07	1.091
Management of the company adopts to pay low tax so as to keep owners' wealth maximization.	42	2.02	.780

Financial performance

A number of questions were asked to determine how financial performance was conducted in SMEs in Mogadishu, Somalia. Respondents agreed that the shareholders are interested in the financial growth of the company, obtaining a mean of 1.93. The respondent agreed that some companies are risk averse because they are afraid of loss obtaining a mean of 2.02 and a mean of 2.24 was obtained on the question whether Market share allows financial managers upper hand in taking firm's overall decisions. Also some respondents agreed that Profitability is measured by measuring the rate of foreign exchange obtaining a mean of 2.31. Management of working capital in terms of liquidity and profitability management is essential for sound financial recital as it has a direct impact on profitability of the company Rajesh and Ramana Reddy, (2011).

Table 4.5. Financial performance.

Statement	N	Mean	S.D
Market share allows financial managers upper hand in taking firm's overall decisions	42	2.24	.906
Profitability is measured by measuring the rate of foreign exchange.	42	2.31	.897
Some companies are risk averse because they are afraid of loss	42	2.02	1.070
The shareholders are interested in the financial growth of the company.	42	1.93	1.091

Multiple Regression Analysis

Multiple regression analysis was performed to evaluate the relationship between the dependent variable (financial performance) and the independent variables (balance of

payment, foreign direct investment, inflation and taxation) and to test the research on the factors affecting financial performance for merchandise companies in Mogadishu, Somalia. Standard multiple regression analysis was conducted for hypotheses testing (Cooper & Schindler, 2013; Sekaran, 2008), while stepwise multiple regression analysis was conducted in order to establish the best combination of independent (predictor) variables would be to predict the dependent (predicted) variable and to establish the best model of the study (Cooper & Schindler, 2013).

Model Summary

Model summary is a summary that describes how far the independent variables explain the dependent variables that mean the greater R value has the greater number the greater independent variables explain with dependent variable. In order to test the research, a standard multiple regression analysis was conducted using financial performance as the dependent variable, and the four determinants of financial performance: balance of payment, foreign direct investment, inflation and taxation as the predicting variables. Tables 4.10, 4.11 and 4.12 present the regression results. From the model summary in Table 4.4, it is clear that the adjusted R^2 was 0.642 indicating that a combination of balance of payment, foreign direct investment, inflation and taxation explained 64.2% of the variation in the financial performance of SMEs in Mogadishu.

Table 4.6. Model Summary.

Model	R	R^2	Adjusted R^2
1	.891	.793	.771

Analysis of Variance

Analysis of Variance (ANOVA), as the name implies, is a statistical technique that is intended to analyze variability in data in order to infer the inequality among population means. This may sound illogical, but there is more to this idea than just what the name implies. The ANOVA technique extends what an independent-samples t test can do to multiple means. The null hypothesis examined by the independent samples t test is that two population means are equal. If more than two means are compared, repeated use of the independent-samples t test will lead to a higher Type I error rate (the experiment-wise α level) than the α level set for each t test.

Table 4.7. Analysis of Variance.

ANOVA					
Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	12.701	4	3.175	35.533	.000
Residual	3.306	37	.089		
Total	16.007	41			

From the ANOVA Table 4.6, it is clear that the overall standard multiple regression model (the model involving constant, balance of payment, foreign direct investment, inflation and taxation) is significant in predicting how balance of payment, foreign direct investment, inflation and taxation determine financial performance of SMEs in Mogadishu, Somalia. The regression model achieves a high degree of fit as reflected by an R^2 of 0.793 ($F = 35.533$; $P = 0.00 < 0.05$).

Regression Coefficients

Table 4.6 presents the regression results on how balance of payment, foreign direct investment, inflation and taxation determine financial performance of SMEs in Mogadishu, Somalia. The multiple regression equation was that: $Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \varepsilon$ and the multiple regression equation became: $Y = .235 + .272 X_1 + .263 X_2 + .355 X_3 + .314 X_4$. As depicted in Table 4.7, there was positive and significant effects of BOP on financial performance ($\beta = .253$; $t = 3.092$;

$p < 0.05$). There was positive and significant effects of FDI on financial performance ($\beta = .275$; $t = 2.509$; $p < 0.05$). There was a strong positive and significant effects of taxation on financial performance ($\beta = .278$; $t = 2.798$; $p < 0.05$) However, there was also positive insignificant effects of inflation on financial performance ($\beta = .351$; $t = 3.467$; $p > 0.05$).

Table 4.8. Regression Coefficients.

Model	Unstandardized Coefficients		Standardized Coefficients	T	Sig.
	B	Std. Error	Beta		
(Constant)	.235	.233		1.009	.019
BOP	.272	.088	.253	3.092	.004
FDI	.263	.105	.275	2.509	.017
Inflation	.355	.102	.351	3.467	.001
taxation	.314	.112	.278	2.798	.008

a. Dependent variable: Financial performance

5. Conclusions

Financial performance has a strong positive and highly significant correlation on balance of payment, foreign direct investment; it also has a moderate positive significance on inflation and taxation. Financial performance has been seen as an important factor influencing other factors. Since the four independent variables (balance of payment, foreign direct investment, inflation and taxation) that the researcher applied indicated that there is positive relationship among these variables and the dependent variable: (financial performance). Also the results showed that balance of payment and foreign direct investment had strong positive significant with financial performance in SMEs in Mogadishu, while inflation and taxation also had moderate positive significant with financial performance, which can lead positive and negative impacts on financial performance of SMEs in Mogadishu.

The positive side is that it provides positive effects on financial performance of employees and results into enhancing their employee morals, and on the other hand it has moderate impacts which may lead to an overall lack of control and guidelines over employees, it also avoids decision making and problem solving.

A prior study indicates that balance of payment and foreign direct investment have great influence in financial performance and are the most effective factors of financial performance, while taxation has a moderate influence on financial performance and inflation has a weaker influence, it is not very effective factor in financial performance, but this study found out that foreign direct investment is the most effective factor and has the greatest influence on financial performance in SMEs in Mogadishu.

6. Recommendations

According to the findings after doing the study which was the effect of exchange rate on financial performance of SMEs in Mogadishu Somalia, the researcher found out that exchange rate has a significant relation with the financial performance of SMEs in Mogadishu Somalia.

Therefore the researchers recommended that:

1. The researchers recommended that: Somali merchants should try to increase domestic productions so as to add value to their money.
2. The researcher's second recommendation is that Somali government should control all import-export activities and try to increase exportations rather than importation.
3. Also top management of small and medium sized enterprises should motivate their employees to increase the performance so as to improve the financial performance.

7. Further Research

First this study used quantitative approach as a research method of collecting primary data and objectivity of the questions that had effect overall results of the study. So the combination of both quantitative and qualitative data collection approaches might produce significant results. Second based on small and medium sized enterprises could affect the findings, therefore adding other institutions and taken a large sample size might generate a significant results and also the study employed as research instrument questionnaire instead of interview, so using other tool such interview would be good. Finally, this research focused on the effect of exchange rate on financial performance of SMEs in Mogadishu.

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