Financial Guidance: Exchange Rates

Introduction

This document presents operational guidelines on the treatment of foreign currency denominated transactions and appropriate methodologies for the budgeting, recording, and management of exchange rate fluctuations. The guidance applies to the Department for International Development's UK Aid Direct fund.

Due to the nature of projects under UK Aid Direct, the majority of expenditure in any project is likely to be non-GBP denominated and will be transacted in the local currency in the country of implementation. Funding from DFID however will always be GBP denominated, as will be the budgeting and reporting against budgets. One of the most common difficulties experienced by grant holders in UK Aid Direct reporting is adopting suitable methodologies for setting exchange rates used in converting foreign currency denominated transactions into GBP and keeping the rate up to date.

Setting appropriate exchange rates

According to UK accounting practice, organisations have some flexibility in how they reported on foreign currency transactions. *IAS 21 states:*

"A foreign currency transaction shall be recorded, on initial recognition in the functional currency, by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction…
For practical reasons, a rate that approximates the actual rate at the date of the transaction is often used, for example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period"

As such rather than converting the currency on a transaction-by-transaction basis reporting organisations have the option to use an appropriate proxy rate.

The Fund Manager (FM) is aware that most grant holders will already have their own internal guidance on the calculation of exchange rates and, as far as is appropriate, are content for this to be used in the calculation of rates. For the convenience of grant holders however, this guidance sets out some good practice principles which must be adhered to and recommended methodologies which are cleared as appropriate.

Good practice principles:

- The methodology used in converting foreign currency denominated transaction into GBP should be set out in written guidance owned by the grant holder. For example, within a finance manual or similar document.
- The methodology used should remain consistent throughout the lifetime of the project. Any grant holders wising to change to a different reporting methodology should first clear the revision with the FM and provide justification for why the change is beneficial.
- Exchange rates used in the currency conversion must be verifiable through documentary evidence

- Exchange rates used in the currency conversion must be set by real world figures – either through the observable prevailing market rate, or through the actual rates received when making lump sum transfers from GBP into local currency.
- If there is a policy on rounding of exchange rate numbers, it should be consistently applied and set in writing.

There are two points during a project's life when the exchange rate policy must be considered. During the budgeting, both prior to the project commencement and re-budgeting/forecasting over the project's life, and reporting. The same methodology can apply to both budgeting and reporting; however, there will be some methodologies which cannot apply at the point of budgeting, for example where calculation of exchange rates is based on the actual rates received upon transfer between bank accounts.

Recommended and approved methodologies to apply to UK Aid Direct grants are as follows:

- **Lump Sum Transfer:** Most projects operate a system of periodic lump sum disbursements from the UK in GBP to a bank account in the implementing country at which point funds are converted to the local currency. Grant holders may choose to use the exchange rate applied at the point of transfer in reporting all transactions for the quarter[1].
- In some cases, grant holders may make two or more lump sum payments in a quarter. In these cases it is appropriate to use an average of the two rates weighted by the amount of funding transferred in each instance.
- **Daily Spot Rate:** The most accurate, but also time-intensive, means of converting foreign denominated transactions would be to take the prevailing spot rate on the day of the transaction and report using that as the rate of conversion. The source for this information should be available for verification with common sources including: www.oanda.com or www.xe.com or www.ft.com.
- **Average Market Rates:** Many grant holders choose to use the average market rates to estimate the applicable rate. The source for this information should be available for verification with common sources including: www.oanda.com, www.xe.com or www.ft.com. Grant holders could adopt either the monthly or quarterly average rates reported by these sources.
- **Daily Market Rate**: Grant holders may adopt a policy of setting exchange rate on a specific day for each quarter. For example, on the first day of the month. The source for this information should be available for verification with common sources including: www.oanda.com, www.xe.com, www.ft.com or the monthly Infoeuro rates: http://ec.europa.eu/budget/contracts_grants/info_contracts/inforeuro/inforeuro_en.cfm This methodology is most applicable to the budgeting and forecasting process.

Other methodologies for the calculation of exchange rates in reporting foreign denominated transactions may be acceptable, however any methodology not included on the above list must be agreed in advance by the FM.

[1] Often there will be a bank charge applied when transferring funds in this way. Grant holders should be aware of this and should record the bank charge as a separate cost – it should not be included in the exchange rate calculation.

Experience has shown there to be commonly used methodologies that have also been judged to be unacceptable. Some example methodologies which should not be used by grant holders include:

- Using the rate set at the point of agreeing the budget, as this quickly becomes out of date
- Estimating a rate based on the prevailing rate for the period, as this cannot be reproduced or validated and is subject to fraud
- Using cumulative average rates across the year. This applies to any methodology which would cause later periods to revise the claims from earlier periods, as this complicates the quarterly reporting process.

Exchange rate fluctuations

Exchange rate movements between GBP and the local currency can have significant impacts on the reported expenditure and the budgeting of a project. Grant holders should make sure they are aware of the risks of exchange rate variability so they can plan accordingly.

Budgeted rates vs reported rates

At the proposal stage all projects will have a budget set in GBP. As indicted in the above section, the budget must have taken a view on expenditure in the local currency and the appropriate exchange rate to use for the period. This budget remains fixed but the exchange rate used in reporting will vary according to actual rates observed, and may lead to under/overspends against budget:

- If the local currency depreciates against GBP then the movement is favourable to the project – a higher level of local expenditure is possible for the same budgeted GBP.
- If GBP depreciates against local currency then the movement is unfavourable to the project – a lower level of local expenditure is possible for the same budgeted GBP.

Example

> A project expects to buy one motorbike at a cost of USD 7,500. The grant holder uses www.oanda.com to find the prevailing exchange rates at the point of setting the budget which is GBP 1:1.5 USD, so a line item for capital expenditure of GBP 5,000 is entered onto the budget. By the time the project commences, exchange rates have changed to GBP 1:1.45 USD. As a result, when USD 7,500 is spent on the motorbikes the recorded expenditure against budget is GBP 5,172. As such the budget line is overspent by GBP 172.

Since budgets are fixed GBP figures, the impact of fluctuating exchange rates must be borne within the project budget by grant holders.

In order to allow for active management of budgets there are a number of mechanisms in place to support grant holders:

- Carry over requests: Carry overs are only approved in exceptional circumstances and as would not typically apply to exchange rate fluctuations unless there are additional extenuating circumstances.
- Budget change requests: Grant holders may request changes in their budgets throughout the financial year in order to move funding between different budget lines and headings. This allows the flexibility to respond to spending pressures created by currency fluctuation.
- Original budget: Where there is a significant time lag between the submission of the proposal and the project start date, the exchange rate used for the budget should be revised to reflect the trend in exchange rates prior to grant confirmation.

Actual rates vs reported rates

As set out above there are a number of different methodologies by which grant holders report foreign currency denominated transactions. In all of these methodologies there exists the potential for differences between the actual rate applied to expenditure on the project and the rate being reported to DFID.

This will manifest as unspent balances, or overspends in the project account, even when project recording shows the budget to be fully spent. The differences are created in one of two ways:

- **Where transactions are reported according to a market exchange rate.** For example, an organisation transfers GBP 10,000 into a local account at a rate of GBP 1:1.5 USD giving a balance of USD 15,000. They have an agreed policy to report to DFID using quarter average exchange rates from www.ft.com which shows the rate as GBP 1:1:52 USD. If the organisation spends all of the USD 15,000 then its reported expenditure to DFID will be GBP 9,868.
- **Where the lump sum methodology is used reflecting the actual rate received by the bank.** For arrears claimants, this will not cause an issue as bank statements will match the reporting. For advance claimants however, unspent balances create the same problem noted above. For example, in Q1 an organisation transfers GBP 10,000 into a local account at a rate of GBP 1:1.5 USD giving a balance of USD 15,000. In Q1, only USD 12,000 is spent and reported to DFID as GBP 8,000. In Q2 another GBP 10,000 is transferred, this time at a rate of GBP 1:1.6 USD which gives additional funds of USD 16,000 and a total funds balance of USD 19,000. If the organization spends the full USD 19,000 in Q2 then reported expenditure will be GBP 11,875. That means that across the two quarters spending against budget was GBP 19,875, an underspend of GBP 125.

Grant holders are not expected to track these amounts and where under/overspends exists they are expected to be small only, and should be borne by the grant holder or to the benefit of the grant holder. No further action need to be taken in reporting these amounts or correcting them.

Unspent balances

At the end of a project's life any unspent balances held by the grant holder must be returned to DFID. Due to fluctuations across the projects life between the timing of the multiple distributions and the end of project repayment exchange rates will have fluctuated so amounts to be repaid may not match the GBP total available to the grant holder.

Coming to an accurate calculation depicting the amount lost through these fluctuations is difficult as the unspent balance is effectively accrued across the project and is not the product of a single transfer. A simplified example is set out below:

A UK-based grant holder receives a disbursement of GBP 50,000 from DFID. The organisation then disburses GBP 10,000 to its local partner in Kenya. When the money reaches the partner's local account they receive KES 40,000 at a rate of GBP 1:4 KES. The partner spends the funds over a year and in each quarter, reported back to DFID based on the exchange rate of GBP 1:4 KES. At the end of the project, the partner had not spent all the money disbursed to it and still had unspent cash in hand of KES 8,000. As per DFID policy, the partner returns unspent funding to the grant holder to remit the balance to return to DFID. When the money is received in UK, it amounts to GBP 1,670 at an exchange rate of GBP

1:4.79 KES. However, the reporting will show an underspend of GBP 2,000. An exchange loss of GBP 330, has been incurred.

In the case above DFID would require the grant holder to return GBP 2,000, and as such the risk of the fluctuation (both benefit and cost is borne by the grant holder.

Underspends/overspends

For the reasons given above there will be situations where grant holders experience overspends or underspends caused by exchange rate variance. Regardless of the cause of the under/over spend the generic guidance of how to handle these is set out below:

- **Overspends:** As already indicated, DFID recognises the difficulty in predicting and managing exchange rate fluctuations, however the UKAID budget approval process is based around fixed GBP amounts without further flexibility. As such budget pressures created by exchange rate variance must be borne by the project budget and by the grant holder.
- Underspends: Where exchange rate variance creates additional spending power in the budget typically an underspend will occur. The following alternatives are available to grant holders to manage the underspend:
    - **Leave the funds unspent.** At the end of the year these amounts will not be carried over and so are not spent by the project. This is the default position.
    - **Complete additional work under the project.** The grant holder can submit for consideration by the FM proposal for expanding the scope of the project to fund new budget lines, or completing additional work under existing budget lines. For either of these options approval must be sought in advance. The proposal should show additional value for money to be achieved, as well as confirming the organisation's capacity to deliver the anticipated results. All activities of this nature should record and report the expenditure as being funded through additional match funding

Mitigating against exchange rate fluctuations

Grant budgets are fixed amounts in GBP recorded in grant arrangements. As such the impact of exchange rate fluctuations must be absorbed by the grant holder and by the project, and it is reasonable for grant holders to design their own internal procedures to minimize exposure to the risks of adverse currency movements.

DFID and the FM require only that grant holders consider this risk when designing their projects, there are no specific recommendations for action in this area. However, this guidance does highlight the practices used by some grant holders for information:

- Planning efficiently: In some cases, grant holders have been found to unnecessarily convert currencies twice instead of just once when moving funding around. In others, very poor exchanges rates were being received due to the use of local banks rather than international institutions. Grant holders should investigate the most efficient options.
- Transacting in hard currency: Regardless of the existence of local currency, many suppliers are happy to make arrangements for transactions to be made in GBP, USD or EUR. This may carry an implied exchange rate risk if the supplier is using market rates but may also be preferable to holding large sums in local currency.

- **Holding funding in a GBP account:** Grant holders often transfer GBP as a lump sum into a local currency account at the start of every quarter, where currencies are especially volatile consideration may be given to more frequent distributions of smaller sums to avoid holding large balances in local currencies.
- **Hedging/Forwards contracts**: Due to the technical nature of financial speculation it is not advised that grant holders engage in hedging against currency movements. UK Aid Direct funds are not permitted to be invested in this way, and the transactions costs of hedging cannot be claimed against project costs.

Further questions on this guidance

For further information or questions on this guidance, please contact your PRM.