Gavi CSO funding mechanism

Financial Guidance:

3. Exchange rates

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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 Gavi CSO Fund (the Fund).

All grants awarded under the Fund will be denominated in US Dollars (US$), this will be reflected in the Grant Agreement signed between the fund manager (MannionDaniels) and the grantee. Consequently, all budgets and financial reporting must also be in US$. Grantees should ensure that they have a bank account capable of receiving US$ disbursements from the fund manager, and should budget for the required bank charges.

Due to the nature of projects under the Fund, most expenditure in any project is likely to be non-US$ denominated and will be transacted in the local currency of the country of implementation. It is important that grantees understand the nature of the currency risks their project is exposed to, as well as the expectations for reporting and management of these risks. This guidance covers suitable methodologies for setting exchange rates used in converting foreign currency denominated transactions into US$, clarifications of the nature of currency risks, and methodologies for the monitoring and management of these risks.

Setting appropriate exchange rates

According to normal accounting practice, organisations have some flexibility in how they report 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.

Gavi accepts that most grantees 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 under the Fund. For the convenience of grantees, this guidance sets out some good practice principles which must be adhered to, and recommended methodologies which are cleared as appropriate to the Fund.

Good practice principles:

- The methodology used in converting foreign currency denominated transaction into US$ should be set out in written guidance owned by the grantee (for example, within a finance manual or similar document.)
- The methodology used should remain consistent throughout the lifetime of the project. Any grantee wishing to change to a different reporting methodology should first clear the revision with the fund manager and provide justification for why the change is beneficial. Changes requested for prior periods will not be accepted.
- 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 US$ 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 financial reporting under the Fund are as follows:

- **Lump sum transfer**: Grantees may choose to use the exchange rate applied at the point of transfer from the fund manager in reporting all transactions for the quarter (all disbursements are made in US$). The method of reporting keeps the exchange rate used for reporting in line with the actual exchange rates experienced, as such it is often preferred among grantees to minimise exchange rate risks.
- **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: Oanda (opens in new window), XE (opens in new window).
- **Average market rates**: Some grantees 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: Oanda (opens in new window), XE (opens in new window). Grantees could adopt either the monthly or quarterly average rates reported by these sources.

- **Daily market rate**: Grantees may adopt a policy of setting exchange rate on a specific day for each quarter (for example, the first of the month). The source for this information should be available for verification with common sources including: Oanda (opens in new window), XE (opens in new window).

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 fund manager.

There are also commonly used methodologies which have been determined to not be appropriate for the Fund. Examples of methodologies which should not be used by grantees include:

- Using the rate set at the point of agreeing the budget. This rate quickly becomes out of date so is inappropriate for the whole length of the project.
- Estimating a rate based on the prevailing rate for the period. An approximate rate 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 reporting from earlier periods. It is important that once a rate has been set for financial reporting of a quarter, then it should not be later revised.

Exchange rate fluctuations

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

Since budgets and grant agreements are fixed in US$, grantees take on the exchange rate risks of currency fluctuations themselves. Adverse movements in exchange rates can have significant impacts on the amount of funding to be received by the grantee – Gavi will not provide additional funding in compensation for adverse movements. Grantees are expected to gain an understanding of these exchange rate risks and carry out mitigating measures where possible.

The remainder of this section sets out some of the consequences of exchange rate variations.

Budgeted rates vs reported rates

At the proposal stage all projects will have a budget set in US$. However, when setting the budget grantees must have taken a view on expenditure in the local currency and the appropriate exchange rate to use for all forward periods. 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 US$, then the movement is favourable to the project – a higher level of local expenditure is possible for the same budgeted US$
- If US$ depreciates against local currency, then the movement is unfavourable to the project – a lower level of local expenditure is possible for the same budgeted US$.

Example
A project expects to buy one motorbike at a cost of Kenya Shillings (KSH) 600,000. The grantee uses www.oanda.com to find the prevailing exchange rates at the point of setting the budget which is US$ 1 : 200 KSH. A line item for capital expenditure of US$ 3,000 is entered into the budget.

By the time the project commences, exchange rates have changed to US$ 1 : 180 KSH, as such when KSH 600,000 is spent on the motorbike the recorded expenditure against budget is USD 3,333. As such, the budget line is overspent by US$ 333.

Since grant budgets are fixed US$ amounts the impact of fluctuating exchange rates must be borne within the project budget by grantees. To allow for active management of budgets there are a number of mechanisms in place to support grantees:

- **Budget flexibility**: Grantees are permitted a certain degree of flexibility in their budgets without need to request any budget changes from the fund manager. This flexibility does not increase the total budget but allows for reprioritization of budget between budget lines[1].
- **Budget change requests**: Grantees may request additional flexibility in their budgets throughout the financial year to move funding between different budget lines. Once again this does not increase the total budget, but allows further flexibility for prioritisation.
- **Budget finalisation**: 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 prior to the project commencement.

[1] Further detail on the limits of this flexibility are included in the associated guidance *2.) Budget classification and management*

Actual rates vs reported rates

As set out above, there are a number of different methodologies by which grantees report non-US$ denominated transactions. In all of these methodologies there exists the potential for differences between the actual rate experienced by the grantee compared to the rate being reported to Gavi.

This will manifest as unspent cash 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, a grantee organisation transfers US$ 10,000 into a local account at a rate of US$ 1 : 190 KSH giving a balance of KSH 1,900,000. The grantee has an agreed policy to report to Gavi using quarterly average exchange rates from www.xe.com which shows the rate as USD 1:200 KSH. If the organisation spends all the KSH 1,900,000 then its reported expenditure to Gavi will be US$ 9,500. This shows an underspend of US$ 500.
- Where the lump sum methodology is used, reflecting the actual rate received by the bank, unspent balances can create the same problem noted above. For example, in Q1 an organisation transfers US$ 10,000 into a local account at a rate of US$ 1 : 190 KSH giving a balance of KSH 1,900,000. In Q1 only KSH 1,500,000 is spent and reported to Gavi as US$ 7,500. In Q2 another US$ 10,000 is transferred, this time at a rate of US$ 1 : 200 KSH which gives additional funds of KSH 2,000,000 and a total funds balance of KSH 2,400,000. If the organization spends the full KSH 2,400,000 in its bank account during Q2 then reported expenditure will be US$ 12,000. Across the two quarters spending against budget was US$ 19,500, an underspend of US$ 500.

In both cases above, scenarios are shown where exchange rate variations lead to the reporting of an underspend. While this may seem harmless it is important to note – **any underspend must be repaid to the Fund, if the cash balance is fully expended but underspends are reported then the Grantee will be at risk at meeting the deficit from their own resources.**

It is strongly advised that to manage this risk grantees monitor both cash-in-hand under the Fund, as well as their position against budget.

Mitigating against exchange rate fluctuations

The impact of exchange rate fluctuations must be absorbed by the grantees and by the project, and it is reasonable for grantees to design their own internal procedures to minimize exposure to the risks of adverse currency movements.

Gavi requires only that grantees 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 grantees for information:

- **Regular financial reporting**. Most of the issues identified in this paper can be monitored closely and identified before they become an issue. While adverse currency fluctuations may still put pressure on grant budgets, strong financial monitoring will help grantees identify and address budget pressures early.
- **Planning efficiently**. In some cases, grantees have been found to unnecessarily convert currencies twice instead of just once when moving funding around, and in others very poor exchanges rates were being received due to the use of local banks rather than international institutions. Grantees should investigate the most efficient options.
- **Transacting in hard currency**. Regardless of the existence of local currency, many suppliers are happy to plan for transactions to be made in US$, GBP, or EUR. This may carry an implied exchange rate risk if the supplier is using market rates but may also be preferable to holding large sums in local currency.
- **Holding funding in a US$ account**. Grantees often transfer US$ 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, grantees should exercise great caution when considering using financial instruments to reduce exposure to currency risk and should seek expert advice. Gavi funds are not permitted to be invested in this way, and the transaction costs of hedging cannot be claimed against project costs.