Guidelines on the handling of Currency Exchange Gains and Losses

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Executive Summary

The purpose of these guidelines is to clarify Sida's requirements regarding the handling of currency exchange gains and losses and to provide guidance to Sida's Cooperation Partners in this regard.

The guidelines covers project and program support. As a consequence, core support or support to UN Organizations fall outside the scope and is handled in a different order.

In summary, the following can be determined:

- All currency exchange transfers must be deemed necessary for the implementation of the project/program.

- Currency exchange gains and losses should be clearly stated in the financial reporting to Sida so that an annual balance pertaining to the currency handling can be identified.

- Currency exchange gains must be repaid to Sida. The refund shall be made at the end of the project/program period. In cases where Sida agrees that the Cooperation Partner may use this amount for additional purposes, a decision must me made accordingly and include a budget. Currency exchange rate losses at the end of the project/program period are not covered by Sida.

- Currency exchange gains and losses within the same project or program, can be netted against each other within the same accounting period. Netting is also allowed within the agreement period (which can be more than one year). In such cases, Sida shall decide on the annual currency exchange rate balance.

- The financial reporting to Sida must display how Sida´s Cooperation Partner has handled (booked) and reported on currency exchange rate differences, accounting principles and any changes in principles that may have taken place between the accounting periods.

- Sida's Cooperation Partner is responsible for the handling of an eventual balance regardning currency exchange gains or losses that may occur as a result of forwarding of funds to third parties. The Cooperation Partner's agreement with third parties must therefore ensure that any such balance is handled so that they can fulfill all their commitments towards Sida. In the case of forwarding of funds, it is also permitted to net exchange rate gains and losses between different legal entities within the same project or programme unless other mandatory rules and regulations prevents it.

Introduction

Sida shall support activities that contribute to the objectives of international development cooperation. Sida's overall objective is to promote improved living conditions for people in poverty and oppression. Funds decided for this purpose are usually stated in Swedish kronor (SEK). Projects and programmes are however often executed in other currencies and then SEK must be converted into a currency that best suits the development activity at hand.

Sida does not advocate any particular method for how currency conversion should be made or how such transactions should best be dealt with in the accounts. The Cooperation Partner can freely choose the method they consider best suited and in accordance with mandatory rules and regulations. However, Sida has certain minimum requirements that the Cooperation Partner must adhere to in order to use funds from Sida. In essence, these requirements stipulate that currency exchange gains must be repaid to Sida at the end of the project/program period (unless the parties agree otherwise) and that currency exchange rate losses are not to be covered by Sida support.

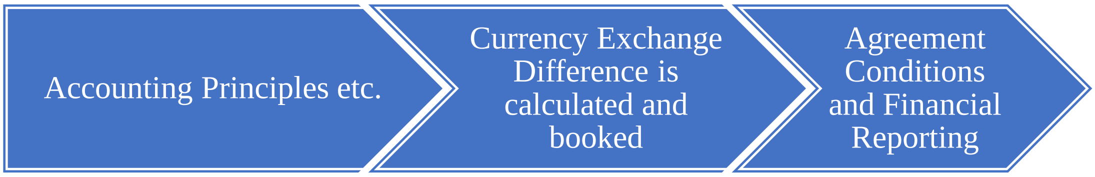
Currency Exchange rate gains and losses

The value relation between two currencies is called the *exchange rate*. If this value changes over time, different currency exchange rates arise. If a comparison is made between two such currencies, a currency exchange difference occurs.

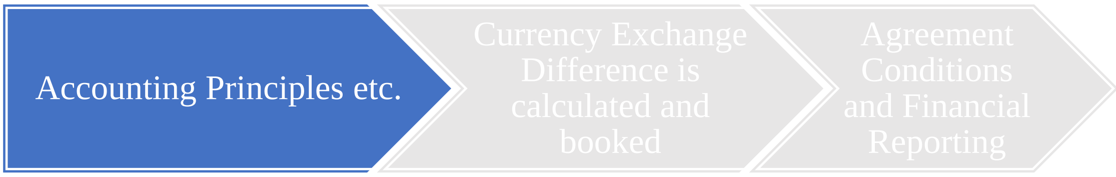
"The exchange rates are measures of the relative value of two currencies i.e. the current market price to buy (or sell) one currency in exchange for another currency. Values of different currencies depend on a wide range of underlying economic and political determinants, as these change, the relative value of currencies will fluctuate".[1]

[1] Cevik S., Harris R and Yilmaz F., 2015, Soft Power and Exchange Rate volatility, IMF working paper,. WP/15/63.

In order to facilitate an understanding and handling of currency exhange gains and losses in relation to Sida's agreement conditions, the following three parts can be considered.



Accounting Principles etc.



In this section basic accounting principles are outlined that are applicable when currency exchange rate differences are reported on in the accounts. An organization's "*accounting currency*" is the currency used in the accounts. This means that an entity's income and expenses in currencies other than the accounting currency must be converted to the accounting currency. The International Accounting Standard (IAS) 21 provides guidance on how this should be done.

The IAS 21 Standard states inter alia that:

(i) Transactions shall be disclosed and reported on in the accounts of the entity's "*accounting currency*" or "*functional currency".*

(ii) Exchange rate transactions must be recorded at the first reporting ocurrance in the accounting records i.e. at the transaction date. The exchange rate difference arises when the accounting currency rate is compared with and differs from the currency in which the transaction is made.

(iii) Exchange rate differences should be recognized directly as a gain or loss in the income statement.

Currency exchange rate gains and losses should be recorded as they occur during the agreement period.

According to General Accounting Principles[2], the following should be noted:

(i) currency exchange gains and losses are reported on separate income and loss accounts;

(ii) currency exchange rate differences are recognized and reported on in the accounting records in the period in which they arise

(iii) the value of assets and liabilities at the end of the financial year shall be re-evaluated using the closing rate of exchange.

Applicable local rules and recommendations may affect how currency exchange transations need to be managed.

Currency Exchange difference is calculated and booked

Transactions in a currency other than the accounting currency shall, in accordance with the above accounting principles, be re-calculated into the accounting currency.

The re-calculation should be made when the transaction is recorded and the currency exchange rate to be used is the rate of the transaction day. This rate is called the "*avista*"spot rate.

As a result of the above, the most accurate would be to determine and document the *actual* currency exchange rate if this can be identified. For example, in a bank transfer, the currency exchange rate used by the bank, appears in the bank statement, and usually also the amount paid and its equivalent amount in the counter currency. Should it be preferred however, it is also possible to use a monthly average of currency exchange rates or other average calculation bases that may be deemed appropriate to calculate the currency exchange rate difference. It is the Cooperation Partner that decides

[2] For example; BFNAR 2012:1, Förordning 1274/2008/EG i.e. regulation 1274/2008/EU

which method to use and Sida has no view on this as long as it is done in a reasonable and systematic manner based on the current business context.

Currency exchange rate gains and losses may arise in different ways and are also handled differently depending on which accounting method the Cooperation Partner uses.

The most common accounting methods are; (i) the accrual based accounting method; (ii) the cash based accounting method and; (iii) a hybrid between the two former called modified cash based accounting method. The Cooperation Partner decides which accounting method is best suited for their activities and Sida has no views on the choice of the selected method. It is important to recall however, that if a change of accounting method is made between different financial periods, such a change must be clearly stated in the financial reporting to Sida.

The following example shows how a currency exchange rate difference can occur if the organization applies the accrual based accounting method. The accounting currency is in local currency, but a purchase has been made in USD. As the local currency used in the example has weakened in relation to the USD, a currency exchange loss has occurred. The example shows how a currency exchange effect arises in the expenditure/cost chain.

Example No 1

Ex: Records are kept in local Currency (LC). An invoice (expenditure) of 10 000 USD is received and booked in the records. The currency exchange rate at the date of purchaise is 10 while the currency exchange rate at the time of payment is 12. Below shows the relevant recording in the books: (1)when the invoice is received and (2) at the time of payment:

1	Credit accounts payable	100 000 (10 000 x 10)
1	Debet cost account	100 000
2	Credit bank account	120 000 (10 000 x 12)
2	Debet currency exchange loss account	20 000
2	Debet accounts payable	100 000

In the example the currency exchange rate increased from 10 to 12 from that the invoice was received to the time it was paid. This increase resulted in a more expensive purchase in that a currency exchange loss occurred with 20 000.

According to IAS 21, currency transactions must be booked at the first reporting occurrence in the accounting currency used. In the above example, this takes place when the purchase invoice arrives and is booked. If the amount of the invoice changes due to a change in the currency exchange rate so that the amount to be payed (at a later stage) is higher in comparison with the amount that was booked inititally when the invoice arrived, then an exchange rate difference has arisen (in the example above a currency exchange loss). According to IAS 21, such currency exchange difference should be reported over the income statement, as shown in the above example.

The example below describe how a currency exchange rate effect can arise in the income/revenue segment.

Example No 2

Ex: The accounting currency is EURO.Sida decides on a contribution of 10 000 000 SEK with an exchange rate of 10=1 (SEK/EURO) at the time of the decision. This amounts to 1 000 000 EURO. The exchange rate 10 constitute also the reference rate i.e. the rate used to establish the budget. When the Cooperation Partner receives the payment from Sida, the currency exchange rate has changed to 9,50 SEK. Below shows the relevant recording in the books:

Debet Bankaccount	**1 052 632 (10 000 000/9.50)**
Credit Account Sida	**1 000 000 (10 000 000/10)**
Credit currency exchange gains	**52 632**

In this example the currency exchange rate changed from 10 to 9,50 from the time when Sida made the decision to the date when the Cooperation Parner received the money from Sida. As a consequence, the Cooperation Partner received more money then was forseen at the time of the decision and when the budget was made, i.e. a currency exchange gain has occurred with 52 632 EURO.

Regardless of which accounting method an organization uses to manage its currency, it is important to remember that when it comes to funds from Sida, transfers between different currencies can only be made if they are deemed necessary for the execution of the project or programme activites. It is not permitted to use funds from Sida in order to create currency exchange rate changes or speculate in different currencies. The auditor will examine how the Cooperation Partner has handled any currency exchange transactions as part of the annual audit.

The possibility to net currency exchange gains against losses

It is possible to net currency exchange gains against losses during:

(i) the same accouting period,
(ii) an agreement period (which may comprise more than one year) as long as it is within the same project or program,
(iii) between organizations (different legal entities) as long as it concerns the same project or programme.

However, netting between different projects or programmes is not allowed. For requirements regarding the reporting of an exchange rate balance to Sida at the end of the financial year, please see “financial reporting”, below. Please note that the possibility to net currency exchange gains against losses in the way displayed in this section only takes into account an interpretation of the Sida agreement terms and conditions. It is always the responsibility of the Cooperation Partner to ensure adherance to relevant rules and regulations that may impose restrictions on the right to net gains against losses as displayed in this section.

Agreement Conditions and Financial Reporting

Agreement Conditions

Sida's agreement conditions states that currency exchange gains shall be repaid to Sida at the end of the project/program period (unless the parties agree otherwise), while currency exchange rate losses are not to be covered by funds from Sida.

From the agreement it is also clear that the Cooperation Partner must inform Sida if any major changes have occurred that may affect the implementation of the project or program. This condition is very important as it ensures both Sida and the partner that measures can be put in place quickly and efficiently if something unforeseen occurs that risks threatening the project or programme results.

As regards currency issues, this means that if the currency exchange rate changes to such an extent that there is a risk that agreed activities may not be implemented as intended, the partner should inform Sida as soon as possible so that counter-measures can be identified, for example that Sida provides additional funds or that the project activities are changed and/or allow reallocations between budget lines.

Finansiell rapportering

In the financial reporting to Sida, the Cooperation Partner shall state which accounting principles that have been applied. Sida's contribution shall also be specified both in the currency of transfer and the amount in the local currency. Furthermore, the financial report shall contain explanatory notes including a description of the accounting policies used and any other explanatory material necessary for transparent financial reporting of the Project/Program.

Currency exchange rate gains and losses shall be reported on separately in the income statement so that it is possible to "determine" a currency exchange rate balance.

The financial report shall be audited annually by an external, independent and qualified auditor and the auditor shall review the currency exchange rate balance and shall also ensure that the Cooperation Partner has handled the currency exchange gains and losses in a systematic manner and in accordance with the accounting principles stated in the financial report.

Sida shall decide on the annual currency exchange rate balance in connection as the financial reporting is received from the Cooperation Partner. The currency exchange balance that has arisen during the reporting period shall be part of Sida's assessment of the Cooperation Partner’s financial need.

In cases where Sida approves that the partner may retain the exchange rate gain, Sida must make a formal decision and ensure that there is an approved budget to outline the use of such funds. Should a currency exchange loss occur at the end of the project or program period, such loss cannot be covered by funds from Sida.

Handling of currency exchange differences in situations with forwarding of fund

Cooperation Partners that apply forwarding of funds are expected to have routines and procedures in place to calculate and report also on exchange rate differences, at least annualy. Such routines and procedures must be in place through-out the agreement/contract chain so as to ensure proper reporting, approval or refusal of parties handling of the currency exchange amounts.

Similarly, a dialogue should be conducted with Sida regarding the effects of exchange rate differences so that this can be taken into account when the annual plan and the budget are drawn up.

The same principles apply for handling of the currency exchange rate balance as for any other requirements that applies for forwarding of funds. The partner's agreement with third parties must therefore ensure that Sida's Partner can fulfill all their obligations towards Sida. Sida´s Cooperation Partner shall for example take a position on the currency exchange rate balance as occurred in the operation of the third parties. The same opportunities and limitations in the right to net currency exchange gains and losses apply to Sida's partner in relation to third parties as to the Cooperation Partner's relation to Sida.

Since Sida's agreement, given that it concerns the same project or program, does not hinder netting situations that have been stated in this guidance, it is important to identify the exchange rate differences in the accounts. This applies not only to Sida's Cooperation Partner but also to any third party who have received forwarded funds and it concerns currency exchange effects in both income and expenditure items. The reporting of these currency exchange rate differences should thus be characterized by the required transparency, i.e. that the respective currency exchange rate should be evient for each currency conversion made. For methods where a weighted exchange rate is used, it is also necessary to specify how such a weighted currency rate index is composed and which exchange rates that were used.

How this should be handled is however ultimately the responsibility of the Cooperation Partner that must also comply with the laws and regulations that apply to the environment in which they operate.

Risks in Currency Management

High risks are often linked to currency exchange rate management and may even involve serious forms of fraudulent behavior. It is therefore very important that all transactions can be linked to the implementation of the project or program and thus be deemed necessary. It is also important that Sida and Sida's Cooperation Partners are able to make adequate risk and reasonable assessments both in connection with the budget and during the follow-up of operation, so as to curb the risk of irregularities. For example, it is important to assess the reasonableness of the used reference rate and that reported exchange rate fluctuations are considered reasonable.

Fraud risks that may arise in currency contexts may, for example, be linked to unnecessary currency exchanges, counterfeit bank statements where staff of cooperation party work in collusion with bank staff, improper use due to differences between official and unofficial exchange rates, where changes in official currency are stated in the accounts while the exchange takes place using the more favorable unofficial rates. If this continues during a longer period, considerable amounts may be misappropriated. It is therefore important to pay due attention to abnormal events and to be able to make reasonable assessments related to currency management on an ongoing basis.