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Exchange Rate Fluctuation and Management of Foreign Donor-Funded Program Budget

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Abstract

The study was about the effect of exchange rate fluctuation on the management of foreign donor-funded program budgets. Humanitarian and development agencies receive funding from foreign donors, who require the program budgets and financial reports in their respective country currencies although the actual utilization of the budget in the host country's local currency during the program implementation. The study explored currency conversion methods and identified the best principles for effective management of the effect of exchange rate fluctuation. The research design used was both quantitative and qualitative where relevant literature related to exchange methods, donor requirements, and average monthly exchange rate data were reviewed. The sampling year used in this study is 3 years, 2021 to 2023 and the currency sample selected was Uganda Shillings (UGX) and United States Dollars (USD). First In and First Out (FIFO), Weighted average exchange rate methods, and daily spot rate methods were the most common currency conversion methods identified during the study. The study further noted the currency conversion method chosen should be documented in the written financial manual of the grant holder for reference. The study identified budget monitoring, requests for budget amendment, effective planning, provision for contingency reserves in the budget, and constant communication with the donors among the best ways to manage the effect of exchange rate fluctuation. The Study, therefore concluded that exchange rate fluctuation has either adverse or favorable effects on foreign donor-funded program budget and needed to be closely monitored and communicated to the donor for further guidance.

Keywords: *Exchange rate, Fluctuation, Foreign Donor- funded, Program and Budget.*

Introduction

Humanitarian and Development agencies around the globe receive funds from different foreign countries. These foreign donors work with the implementing partners to prepare a budget in foreign currency, but the actual implementation of the program activities takes place in the home currencies of the implementing partners. At the proposal stage, all foreign donor-funded programs will have a budget set in the currency of the funding country, yet the budget must be spent in the local currency utilizing the appropriate exchange rate to use for the reporting period. The foreign donor-funded budget remains fixed, but the exchange rate used in reporting may vary according to the prevailing actual currency rates observed and may lead to a surplus or deficit of the foreign donor-funded program budgets. A budget is a quantified plan of action expressed in monetary units within a given period. Every program has activities that are costly, which means those activities require money to have them executed. Humentum defined budget as money that an organization plans to raise and spend for a set purpose over a given period [1].

There are three stages of effective budget management. The planning stage is where the

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budget is built for the required actions, and the implementation stage is where the actual activities take place, funds are received and spent and at the review stage, the income and spending are monitored against the set budget. Given the fact that the program budgets are set in donor currencies, and the actual spending takes place in local currency, the exchange rate has a bearing at each stage of the budget management and ultimately on the donor financial report which compares the budget with the actuals expenditure because of the exchange rate fluctuation from one period to another.

Some of the programs are implemented on an annual basis while others may take more than one year but the program budget remains static despite the exchange rate fluctuation between the time of planning and implementation resulting in either increment on the budget or loss of the agreed budget yet having an adverse or favorable impact on the planned activities. Currency exchange is constantly affected by the volatility of currencies exchange rate because of the forces of demand and supply, interest rate, inflation, and timeline of fund remittance by the donors, delay from the side of the donor to disburse funding upon the execution of the grant award, has currency exchange effect on the budget [2].

International Monitoring Fund working paper 2003 associated causes of exchange rate fluctuation on the inflation and forces of demand and supplies. It further guided that monetary policy should focus on reducing the significance of the exchange rate that may result in bringing about speculation and undermine the stability of the monetary demand function [3]. This explains that the exchange rate is determined by the demand and supply of one country's currency relative to the demand and supply of another country's currency. For example, when a program proposal budget is submitted to United States Agency for International Development (USAID), the budget is always prepared in United States Dollars (USD) yet the actual cost during the program implementation is incurred in the local currency of the country of implementation.

The exchange rate is the amount of money needed in one currency to purchase another country's currency. The process is referred to commonly as currency conversion, it may be either fixed or floating, it is the price for which one currency may be exchanged for another at a given time. This rate is determined by the government through its Central Bank by controlling the circulation of money in the market, despite the exchange rate fluctuation, implementing partners are required by donors to develop a budget in foreign currency as well as report expenditure against the budget in foreign currency yet the actual implementation takes place in local currency as such there is significant variation between donor currency and implementing agencies' reporting currencies because the exchange rate of two currencies is determined by the countries purchasing power. The Purchasing Power parity (PPP) Theory was developed by Gustav Cassel a Swedish Economist, in 1918. The theory states that the exchange rate between two currencies is in equilibrium when their purchasing power is the same [4].

It is on this background that organizations need to be aware of how changes in exchange rates between countries' currencies affect the actual amount of the project budgets meant for program implementation because the impact of exchange rate fluctuation would result in either budget surplus or deficit. However, this would require the implementing partner to establish good multiple currencies financial management system that will automatically record transactions incurred in local currency and translate them into the donor currency for reporting and accountability. Although it would have been great to sign all the foreign project budgets in local currency, normally this is not possible as the donors would like the grant award budget to be signed in their home currencies. However, according to the United

Nations financial regulation, Persons responsible for the United Nations bank account and other negotiable cash instruments are not authorized to exchange one currency for another except for the minimum extent necessary for the transaction of official business and currency management [5].

The table1, below illustrates the average monthly exchange rate between the United States Dollar (USD) against Uganda Shillings in the past three years obtained from the Bank of Uganda website http://www.bou.or.ug/bou/rates_statistics/statistics.html. It is noted that in January 2020, a United State Dollar is exchanged for 3,680.79 Uganda Shillings while in January 2022, a United States Dollar buys 3,528.83 Uganda Shillings causing an exchange variation of 151.96 Uganda Shilling representing a 4% gain.

Table 1. Average Monthly Exchange Rate USD/UGX 2020-2022

Month	2020	2021	2022
Jan	3,680.79	3,691.56	3,528.83
Feb	3,676.85	3,667.32	3,514.51
Mar	3,772.91	3,662.87	3,589.84
Apr	3,785.75	3,623.30	3,541.46
May	3,791.46	3,552.79	3,633.07
Jun	3,737.94	3,540.35	3,747.38
Jul	3,703.54	3,552.31	3,791.59
Aug	3,677.53	3,537.04	3,832.45
Sep	3,695.09	3,530.63	3,825.33
Oct	3,719.92	3,579.94	3,822.27
Nov	3,710.68	3,551.52	3,760.23
Dec	3,666.54	3,554.99	3,690.86

Data extracted from: http://www.bou.or.ug/bou/rates_statistics/statistics.html\

This means that the Uganda Shillings has gained against United States Dollar in January 2022, you would need more United States Dollars to purchase a few Uganda Shillings. The effect of this exchange variation is that any expenditure incurred in Uganda Shilling in the period of January 2022, would mean an increased expenditure causing a budget deficit while expenditure incurred in Uganda Shillings in January 2020 when translated into United States Dollars it would mean reduced expenditure resulting into budget surplus when monthly exchange rate is used. Whereas in August 2022, a United States Dollar buys 3,832.45 Uganda Shillings resulting in a variation of 151.66 Uganda Shillings representing a 4% depreciation in the value of Uganda currency. Donors disburse the total grant amount in installments, the subsequent installment is disbursed when the prior installment is fully spent and accounted for. If an installment of $ 150,000 is disbursed into the local currency account of the implementing partner in January 2022, the amount received will be 529,325,025 Uganda Shillings and this same amount is translated into United States Dollars in August 2022 as $ 138,117 at the prevailing exchange rate of August 2022, instead of the $ 150,000 resulting into an exchange loss of $ 11,883 representing 8% reduction in the portion of the budget installments received in January 2020. Most donors don’t consider an exchange loss an eligible cost and expect the implementing agency to refund the $ 11,883. This means that activities worth $ 11,883 would not be implemented as there would be no funds to implement those activities.

The study aims at identifying how foreign exchange fluctuation affects foreign donor program budgets, manage the adverse effect of exchange rate fluctuation on the foreign-funded program budget and the best exchange risk mitigation options available to best minimize the risk of exchange rate fluctuation and explore the areas in which exchange rate fluctuation affects the performance of donor-funded program budget and the exchange rate modalities acceptable to the varies donors for effectively managing program budget. In the event of exceptional exchange rate fluctuation, the parties can consult each other to amend the budget to reduce the effect of such currency fluctuation, not ruling out the possible action of terminating the contract.

Foreign currency-dominated transaction focus on the realistic approach for the budgeting recording, accounting, and management of foreign exchange rate fluctuation and reporting, for example, Department for International Development (DFID) grant funding will always come in Great Britain Sterling Pounds (GBP) which means grant holders prepare their budget and report in this donor currency but the actual spending at the time of implementation takes place in the functional currency which may result into currency exchange rate risk on the program budget because of the exchange rate fluctuation. Although there is flexibility in the methodology used by the organization on how the organization can report foreign currency transactions incurred in functional currency, the spot exchange rate at the date of transaction, for practical reasons an appropriate proxy average weighted rate may be applied [6].

Normally, the time between budgeting and the award of the grant and receipt of the installment in foreign currency significantly differ and causing delay and exposing the program budget to the risk of the time value of money. When the amount is converted from foreign currency to functional currency at the prevailing marketing rate, it may have either a favorable or adverse impact on the program budget [7]. Therefore, the grant holder should be aware of the significant impact of the exchange rate fluctuation on the reported expenditure against the program budget and plan accordingly during the implementation to minimize the exchange loss.

At the point of budgeting, the budgeted exchange rate remains fixed, but the exchange rate used in the report could vary according to the actual rate observed on a particular day and time. Therefore, this could lead to budget overrun or underrun. If the functional currency depreciates against foreign currency the movement is favorable on the foreign currency program budget, then a higher level of local currency amount is possible for the same foreign currency program budget. Whereas if the foreign currency depreciates against the functional currency, then a higher level of expenditure is possible for the same program budget because more of the foreign currency could buy few functional currencies, hence you would need more foreign currency meaning advocating for the program budget increment. Although it is rear that the donors allow budget increments, it is a good practice to bring it to the attention of the donor for mutual discussion to seek the possibility of program budget amendment.

Problem Statement

International donors such as the United States Agency for International Development (USAID), Danish International Development Agency (DANIDA), Department For International Development (DFID), and European Civil Protection and Humanitarian Aid Operations (ECHO) fund programs in Sub-Saharan Africa, Middle East, North Africa, and Asia among other locations where the grant award budgets are in the currencies different from the currencies of the countries where the actual implementation take places forcing the implementing agency to convert the fund from the donor currency to home currency at the prevailing market exchange rate to facilitate the implementation. These market exchange rates could vary daily resulting in exchange rate fluctuation which affects the performance of the activities in the program budget through exchange rate variation between the time of budgeting and the actual program implementation [8].

During the program implementation, donors require the implementing agencies not to report more than the budget of the award agreement. However, this is not possible because of the inevitable exchange rate variation between the donor currency and the implementing partners' home currency leading to a budget deficit when the foreign currency depreciates and a budget surplus when the foreign currency appreciates. The unspent amount at the end of the program period is returned to the donor whereas the organization bears the burden of the budget deficit because the donors do not allow absorption of the extra cost other than the approved budget. The study noted that during the period of high volatility in exchange rates, organizations experienced relatively increased variance in the annual budget This means for each slight change in the exchange rate for an organization with high funding in foreign currency contracts there was a significant change in the budget variance experienced [9]. Implementing agencies, especially small national and community-based organizations may not have the capacity to implement the varying currency conversion methods.

Sida's agreement conditions state that currency exchange gains shall be repaid to Sida at the end of the program period, 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 those risks threatening the project or program results [10]. In the study conducted in Kenya on the effect of exchange rate volatility on the budget variance of international refugee non-governmental organizations, it was noted that most of the NGOs receive a significant portion of the budget funding in foreign currency while the market exchange rate continues to fluctuate while each donor and the organizations have different rules and methodologies in the effective management of the exchange gains and losses, the study alluded that their exchange rate has a positive correlation to the budget variance.

Therefore, implementing partners of these donor-funded programs could find it difficult to adopt consistently suitable methodologies for exchange rates used for converting foreign currency transactions to functional currency, during budgeting or converting transactions incurred in the home currency to donor program budget currency at the time of reporting and recordkeeping during implementation because of limited knowledge of sound practices to embraced for effective accountability of donor fund. In addition to the limited knowledge about the good practice for currency conversion among the implementing partner, associated is the risk brought about by the currency exchange rate fluctuation in the implementation of the donor-funded program budget**.**

Solutions to the Problem

To solve the above-mentioned problem, the humanitarian agencies have responsibilities to establish a secured and standardized method and consistent application of exchange rate and currency conversion in close collaboration with international donors and provide documentation for external auditors. Taking into consideration the context of the environment, the exchange rate conversion methodology decided by the agency should follow international accounting standards while being mindful of the exchange rate effects when it comes to financial reporting.

The exchange rate policy is required for accounting and reporting purposes, for example, an agency may choose to use the daily spot rate method for accounting for the payments made daily and the weighted average rate for donor reporting, all these have been clearly stated in the currency conversion policy of the implementing agencies. Periodic budget monitoring for the effect of exchange rate fluctuation should be affected to avoid surprises so that any deviation from the budget flexibility can be brought to the notice of the donor for consideration of either additional funds or budget realignment.

When implementing agencies understand the impact of the exchange rate fluctuation on the donor-funded project budget, they will take it upon themselves to engage the donor about the best practices to establish within the organization in mutual understanding with the donors, put in place systems and procedures that would enable them to hedge against the currency exchange loss to reduce the adverse effect on the project budget especially when the implementing partners do not have a well-documented exchange rate policy in place.

The overall objective is to ascertain the effect of exchange rate fluctuation on the management of foreign donor-funded program budgets with a specific focus on how to handle exchange rate fluctuation during program implementation. The overall objective is achievable through the following specific objectives:

1. Explore the various currency conversion methodologies acceptable by donors at budgeting and reporting during the implementation of the program budget.
2. Identify the best principles applicable for effective management of exchange rate fluctuation and management of foreign donor-funded program budgets.
3. Management of the effect of exchange rate fluctuation on the foreign donor-funded program budget.

Literature Review

If the local currency depreciates against foreign currency then the movement effect is favorable to the donor-funded program budget because a higher level of local expenditure is possible for the same foreign donor budget in foreign currency and it means less foreign currency is required to purchase more local currency whereas, if the foreign currency depreciates against local currency then the movement is unfavorable to the project because a lower level of local expenditure is possible for the same budgeted amount in foreign currency, it means more foreign currency is required to purchase less local currency since the budget is fixed, then an adverse effect arising from the exchange rate fluctuation is borne by the recipient and unspent balance resulting from favorable exchange rate would be returned to the donor [6].

The study conducted in Kenya about the impact of exchange rate movement on the financial performance of international non-government organizations noted an increase in funding of development programs and it noted that 49.7% and 30.7% of the respondents agreed and strongly agreed respectively, that exchange rate gains and losses which could lead to budget increment or reduction. Donors normally finance programs that an individual organization cannot finance with their financial resources and primary recipient of these donor fundings are International Non-Governmental Organizations, National Non-Government Organizations, Community Based Organizations and Government, Faith Based Organizations, Private Sectors, and Government Entities. The size and the capacity of the organizations normally determine the amount of funds such an organization could receive, Large Organizations attract large donor funds because of their high capacity to provide accountability and performance [11].

Donor like Sida supports activities that contribute to international developments and the Funds decided for this purpose are usually stated in Swedish Krona (SEK), yet the actual activities are implemented in other currencies. 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 countermeasures can be identified, for example, Sida may provide additional funds or that the project activities are changed and/or allow reallocations between budget lines [10].

Donors have their regulations related to currency exchange and implementing partners are expected to have guidelines about currency exchange embedded in their financial manual for planning, a contingency reserve of not exceeding 5% could be provided for possible exchange rate fluctuation in the program budget if allowed by the donor. However, the utilization of the contingency would be restricted in such a way that the fund can only be used upon prior approval by the contracting authority whereas currency exchange loss is a non-eligible cost and the responsibility of the recipient while for reporting, the exchange rate at the time of receipt of the installment applies, other usual accounting currency conversion practices can be used provided that they are; documented in the accounting policy, consistency with the grant award, equal treatment to transactions with other sources of fundings, systematic and accessible for verification [12].

Under normal circumstances, the market price of one currency to another would never be the same because of speculation and government interventions such as exchange rate and interest rate fixing which could lead to variation in the exchange and hence affect the general price in the market resulting into the weakening or strengthening the local currency. The United Nations operational rate of the exchange is effective on the date when the transaction takes place for recording in the books of account [13].

However, Organizations must have a written down policy to address exchange rates for consistency and provide backup documentation that could be required during an audit in case it becomes necessary. It is necessary to keep constant communication with the donor about the issue of the exchange rate’s impact on the program budget. Quarterly and annual financial reports to United States Government (USG) in local costs be captured in reports according to the exchange rate method of the organization [7].

The study conducted in Ghana about the effect of exchange rate volatility recommended that the volatile nature of the exchange rate market in the country could mean companies that import raw materials or market their product internationally needs to make use of forward contracts in other to hedge their payables and receipts. This will enable them to lock in to go around the problem of exchange rate volatility [14].

The document submitted in March 2005 to the UNHCR Standing Committee, to understand the impact of foreign currency exchange rate fluctuation on UNHCR’s operation, the document noted that while the impact of exchange rate fluctuations on income is relatively easy to assess because of the limited number of donor currencies other than US dollars the impact of exchange rate fluctuations on the expenditure side is very difficult. It is not possible to eliminate all gains and losses that arise from foreign exchange rate changes between the functional currency and the donor currency in a multi-currency environment and went further to suggest One typical way to mitigate the adverse impact of exchange rate fluctuations is hedging [15].

Several related kinds of literature explain the nature and causes of exchange rate fluctuation and major donor policies regarding currency conversion, this study, therefore, focuses on explicitly explaining the available currency conversion methods, the required best practices, and the management of the effect of the exchange rate fluctuation in the organization to attain effective management of foreign donor-funded program budget.

Research Design, Methodology, and Data Analysis

The study focused on the effect of exchange rate fluctuation on the management of foreign donor-funded humanitarian and development program budgets prepared in foreign currency but implemented in local currencies. The study adopted a pragmatism research philosophy because there are several methodologies to manage the exchange rate fluctuation effect and only one of that mechanisms can be adopted by one implementing agency which can be measured and interpreted, and this effect can either be negative or positive in the case of exchange gain or loss. There are different currency conversion methods adopted by different organizations and donors depending on the environment of operation and context.

The study adopted the mixed approach of both qualitative and quantitative approach where documentation related to exchange rate fluctuation and currency conversion methods by major foreign donors with a focus on the humanitarian and development sector, this information is extracted, summarized, analyzed, and presented in tabular and graphical format., the findings were discussed, summarized, and interpreted and conclusion reached.

The study employs the deductive research approach, by reviewing the existing currency exchange policies of the major humanitarian donors such as the United States Agency for International Development (USAID), Danish International Development Agency (DANIDA), Swedish International Development Cooperation Agency (SIDA), European Commission for Humanitarian Office (ECHO), Department for International Development (DFID) and United Nations (UN) and the practical experience and observations to arrive at the confirmation about the effect and the methods used among the organizations and donor when it comes to currency conversion and exchange rate fluctuation on the management of donor-funded project budget. This information gathered was used to conclude the subject matter.

The research embraced a document review strategy where relevant existing documents about foreign exchange rate fluctuation and currency conversions methods and the effects on the management of foreign donor-funded program budget. The study is cross-sectional as it focused on the effect of exchange rate fluctuation and various currency conversion methods, these various models of exchange rate and the associated risk brought about by the currency exchange fluctuation during the implementation of donor-funded program budget, where historical exchange rate against major currencies for a period of three years analyzed and the trend studied to arrive at the recommendations.

Research Results

This section explains the three specific objectives of the Currency Conversion Methods, effect, and management of exchange rate fluctuation in the management of foreign donor-funded program budget.

Currency Conversion Methods

This section addresses the first objective of the study, it explains the various options available at the disposal of grant holders for adaptation either during the budgeting process or reporting, regardless of the size and nature of the organization, the methods chosen should be applied consistently and well documented in the accounting and financial manuals for verification and reference. During the finding, the following exchange rate methods were identified. When program budgets are developed, the prevailing exchange rate at the time of proposal submission is used, but along the way exchange changes by the time the grant is awarded, and the receipt of the installment in the donor budget currency may change. When the fund received are converted to the home currency, the actual amount varies according to the different exchange rates used from the anticipated exchange rate used at the time of budget submission. This situation may either result in a surplus or deficit [7].

First In First Out (FIFO)

Most donors prefer to disburse funding to the implementing agencies in trenches or installments, after accounting for the previous installment that another installment would be discharged to the implementing partner, this approach could compel implementing Organizations to adopt the model of First in and First Out (FIFO). When a project grant is awarded in foreign currency, the grant holder is expected to submit a financial report in the foreign currency of the project budget. The donor disburses the total amount agreed in the award document in several trenches during the project implementation period as part of an effective fund management strategy, upon the receipt of each installment, the grant holder then converts the foreign currency into the functional currency for spending. The grant holder at the time of reporting then uses the rate at which the first installment is received until the amount is exhausted before moving to the next installment and using the rate for reporting the related expenses for that amount received. For example, if an implementing partner has an$ 150,000; tal budget of $ 300,000, and the grant agreement states the disbursement of the budget in three installments: January 2020 is $ 150,000, May 2020 is $ 100,000 and the final installment in September 2020 is $ 50,000. Each time these different trenches are received, they are exchanged at different exchange rates as shown below.

Table 2. Illustration of FIFO Methods of Currency Conversion

Month	**Amount (USD)**	**Exchange Rate**	**Amount (UGX)**
January-2020	150,000.00	3,680.79	552,118,909.09
May-2020	100,000.00	3,791.46	379,146,000.00
September-2020	50,000.00	3,695.09	184,754,363.64
Total	**300,000.00**	**-**	**1,116,019,272.73**

Source: Table constructed by the author

In Table 2 above, the first installment of $ 150,000 received in January 2020 is translated into Uganda Shillings of UGX 552,118,909.09 at an exchange rate of a United States Dollar for 3,680.79 Uganda Shillings. The first In First Out (FIFO) approach of exchange rate methodology requires that all the expenses incurred between the period of January 2020 through April 2020 should be translated into the donor reporting currency using the exchange rate of 3,680.79 Uganda Shilling until the total amount of UGX 552,118,909.09 is fully accounted before moving to the application of the next exchange rate.

If the implementing partner is required to submit a report to the donor biannually, On 15th July 2020, the partner's total project expenditure amounted to UGX 741,691,909.09. Using the FIFO methods of exchange rate at the time of reporting, first convert the total expenditure of UGX 552,118,909.09 using the January 2020 exchange rate to arrive at the $ 150,000 (UGX 552,118,909.09/3,680.79) and the remaining expenditure of UGX 189,573,000.00 for the exchange rate of May 2020 to arrive at an expenditure amount of $ 50,000 (UGX 189,573,000.00/3,791.46). Therefore, the total expenditure amounts to $ 200,000 ($150,000+$50,000) leaving an unspent fund balance of $ 100,000 representing a 33% budget variance.

Weighted Average Exchange Rate

This is where several installments received in the functional currency at different exchange rate within the specific period is summed up and divided by the total amount of the foreign currency disbursed. In a situation where the exchange rate fluctuates significantly, it is good practice to use the weighted average model to generate a realistic exchange rate. This model accurately captures the cost incurred and the fund balance, it minimizes exchange rate variance to be accounted for in the accounting system and helps to limit the exchange rate risks that could have resulted in budget deficit or surplus [7].

Table 3. Illustration of Weighted Average Method of Currency Conversion

Month	Amount (USD)	Exchange Rate	Amount (UGX)
Jan-20	150,000.00	3,680.79	552,118,909.09
May-20	100,000.00	3,791.46	379,146,000.00
Sep-20	50,000.00	3,695.09	184,754,363.64
Total	**300,000.00**	**3,720.06**	**1,116,019,272.73**

Source: Table Constructed by the author

In Table 3 above, the weighted average rate of 3,720.06 Uganda Shilling is used to translate all the project expenses incurred in local currency to donor reporting currency during the period. While using the approach of the weighted average method the total expenditure of UGX 741,691,909.09 translated to $ 199,376 (UGX 741,691,909.09/3720.06) leaving a project unspent balance of $ 100,624 representing 34% unspent fund. Therefore, when FIFO and Weighted Average currency conversion methods are compared, it should be noted that the FIFO method overstates expenditure hence bringing about a budget deficit whereas the Weighted Average methods understate expenditure resulting in a budget surplus. The weighted average method is very good, especially in situations where exchange rate fluctuation in the specified period is significant. This method accurately captures the cost incurred and the remaining fund balance, it minimizes exchange variance to be recorded in the according system, hence limiting exchange rate risk.

Lumpsum Transfer

This method suggested, the donor transfers periodic disbursement in trenches into the bank account of the implementing partner at which funds are converted into functional currency. The grant holder may choose to use this rate in reporting all the transactions related to this period. In some cases, the grant holder is required to have both a foreign currency account and a functional currency account and it is left at the discretion of the grant holders to determine the number of tranches to move the money from the foreign currency to functional currency based on the actual need and translate all the expenses incurred during that period using the actual market exchange rate to report in foreign currency. Under this approach, the donor may transfer the two-budget amount of $ 300,000 to the partners' local currency account which could amount to UGX 1,104,237,818 at the exchange rate of 3,680.79 Uganda Shilling for the whole project period. If this approach is adopted the total expenditure of UGX 741,691,909.09 will be $ 201,503 (UGX 741,691,909.09/3,680.79) leaving the project unspent balance of $ 98,497 representing 33% unspent fund. This approach results in a significant overstatement of the project expenditure leading to a potential budget deficit.

Daily Spot Rate

The grant holder may adapt the methods of the actual prevailing spot rate on the day the transaction has taken place and report using the rate of conversion. This means that an actual daily spending plan be prepared and only such specific amount enough to settle the expenditure in local currency is transferred from the foreign currency account to the local currency account. In a situation where there is rapid fluctuation, this method of currency conversion could lead to a significant budget surplus or deficit. Although the method is accurate but also intensive. The source of the information should be filed for verification and well documented (www.oanda.com, www.xe.com, www.ft.com). The payment made in foreign currency is converted to the home currency using the prevailing exchange rate on that specific date obtained from the bank.

Monthly Rate

The grant holder may consider setting an exchange rate on a specific day for each reporting, it could be the rate of the 1st day of the month and peg such rate for reporting all the transactions throughout the month. This approach ignores the rest of the daily market rate during the month, yet the expenditure is incurred daily but translated to the reporting currency at the single exchange rate obtained. This method may result in a varying level of expenditure overstatement or understatement during the program implementation period. This exchange rate is captured in the accounting system to convert every little transaction entered in the system to translate it from the original donor currency to the functional currency.

Application of Best Currency Conversion Principles

This section explains six good practices organizations could adopt to formulate a working exchange rate policy that may be used throughout the organization's lifetime.

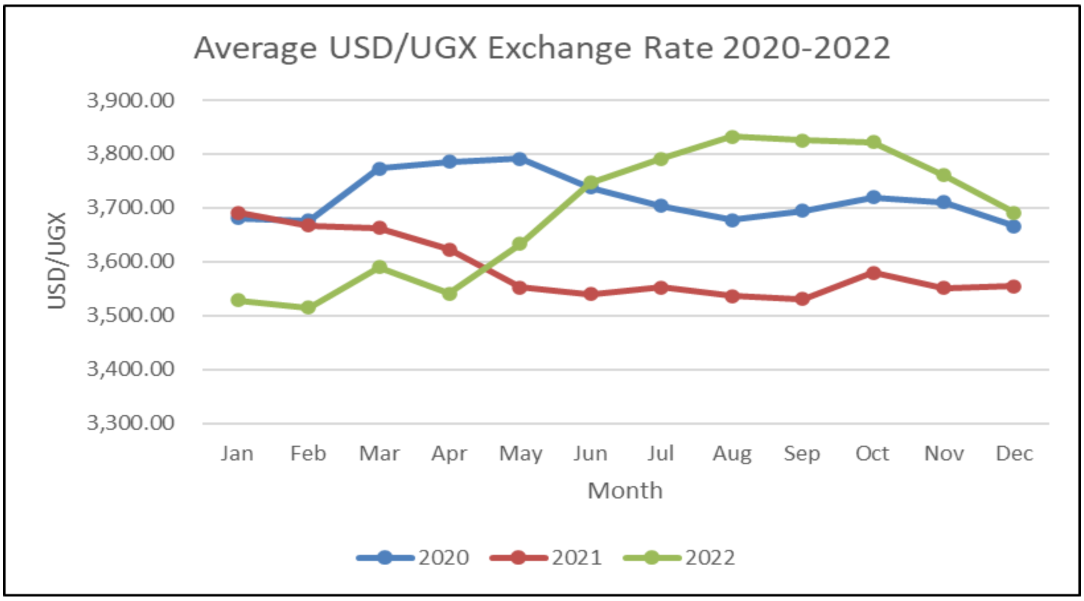
1. The organization has a choice of one method from the above-mentioned options, once such an option is identified, it should be consistently applied throughout the organization for all the program financial records, and justification should be provided in case the organization decided to change the chosen exchange rate conversion approach in future.
2. The currency conversion method chosen should be included in the written financial manual guide of the grant holder for clarity and reference for easy verification during the audit and donor expenditure verification whenever it becomes necessary.
3. The exchange rate used in the currency conversion must be through observation of the prevailing actual rate when the lumpsum foreign currency transfer amount is received in the functional currency account.
4. Due to the unavoidable time difference between budgeting, grant award, and receipt of the installments, the exchange rate policy should be taken into consideration that the rate at budgeting time would differ from the actual rate at the time of implementation and reporting during the program life cycle and this may result into either surplus or deficit of the budget.
5. In any case, the exchange rate used at the time of budgeting should not be applied during the time of reporting because it does not give a better picture of the financial situation especially when there has been significant exchange rate fluctuation due to the time value of money.
6. During implementation, the program budget must be closely monitored for the effect of exchange rate fluctuation and any deviation from the donor allowable flexibility threshold can be flashed to the donor for consideration of program budget

amendment or additional fund or budget line realignment for reprioritization.

Management of the Effects of Exchange Rate Fluctuation

This section explains that despite the associated exchange risk, it remains manageable with constant communication between the grant holder, donor, and management and periodic budget monitoring some of these approaches are included as follows: The immediate adverse effect brought about by exchange rate fluctuation is that it leads to loss of the fund, and this could cause budget deficit making it impossible to accomplish all the budgeted program activities, hence the program would not be able to achieve all the intended objectives. This could result in a loss of confidence and trust in the agency among the stakeholders. Good financial management practices are required for all forms of donation because they are important, especially for effective budget support where there is no donor fund allocated to specific expenditure and this can be aggravated by exchange rate fluctuation that poses risks and constraint the implementation of development program [16].

The graph below shows the exchange rate fluctuation trend over the period of three years. The exchange rates of Uganda Shillings (UGX) against the United States Dollar (USD) move up and down. In the graph below, it is noted that Uganda shillings is stronger against United States Dollar in January 2022 and depreciated against Dollar in August 2022, and further appreciated against Dollar in December 2022. In January 2021, the Uganda shilling depreciated against Dollar but appreciated in May 2021 and further in December 2021. Whereas the currency depreciated between March and May 2020 before appreciating in the month of July 2020 and further in December 2020. Therefore, the impact of this exchange rate fluctuation on the program budget is that let's assume we have three years program budget funded by USAID for the period 1 January 2020 – 31 December 2022, every expense incurred in August 2022 would result in fewer expenses when translated in Dollar compared to expenses in January 2022 because in August, the project would need more Uganda shilling to buy one Dollar but in January 2022, the project would need less Uganda Shillings to acquire one Dollar resulting to more Dollar amount reported in expenditure statement.



Source: Graph Constructed by the author

Figure 1. Three Years Exchange Rate Fluctuation: United States Dollar (USD) Against Uganda Shillings

The question is that in 2020, if the first trench of the fund is received in January 2020, is it better to receive the next trench in May or October 2020? The answer to this question lies in the organization's exchange rate policy. If the first installment comes in January 2020, the program will have more funds in the program's local currency account compared to when the fund is received in September 2020. However, under FIFO all the expenses incurred in the local currency will be translated to United States Dollars using the exchange rate of January 2020 That may result in less expenditure reported against the budget, in turn leading to the budget spent whereas if the monthly average rate is used in September 2020, the expenditure report will be more hence causing budget overrun.

Budget Amendment

To manage the donor-funded project budget very well, the aspect of periodic budget monitoring where the budget versus actual report is generated and discussed with the program team and any causes of budget deviations from the acceptable flexibility limits are identified and if possible, the donor can be informed for further budget realignment and activities reprioritization. The grant holder may request for budget amendment when it has been noticed that the budget has been significantly affected by exchange rate fluctuation throughout the financial year, the budget lines can be realigned to move funds from budget lines of lower priorities to those with higher priorities based on the donor budget allowable flexibility to easy budget spending and reduce pressure created by the currency fluctuation on the project budget.

Contingency Reserve

During budgeting, there should be a mutual agreement between the grant holder and the donor for the provision of a contingency reserve of at least 5% of the total grant budget included in the multiyear program budget to cater for exchange rate fluctuation for inflationary adjustment if allowed by donor policy. The general condition for humanitarian aid actions financed by European Union indicated that a reserve for contingencies and or possible fluctuations in exchange rates not exceeding 5% of the direct eligible costs may be included in the budget for the action, to allow for adjustments necessary in the light of unforeseeable changes of circumstances on the ground. It can be used only with the prior written authorization of the contracting authority, upon duly justified request by the coordinator (European Union General Conditions, July 2019). DANIDA funding, the budget may contain a contingency to cover unforeseen expenses such as currency fluctuations. The contingency should not exceed 5% of the budget for total direct cost, excluding contingency, for smaller projects (less than 10 million DKK). For engagements above 10 million DKK which are implemented over more than two years, the contingency may be up to 10% of the budget for total direct cost, excluding contingency. The contingency may only be used for activities already included in the approved budget and with the explicit approval of the MFA. Normally, changes exceeding 10 % will be presented to and approved by the steering committee or other relevant decision-making body. Spending more than the allocated budget (in DKK) cannot be covered by the Danish grant. Costs in currencies other than those of the accounts are translated using the exchange rate at the time of the transaction. A weighted average of currency rates can be applied for costs incurred by partners based on transfers [17].

Timely Fund Disbursement

Besides the option of agreeing with the commercial bank to negotiate a better exchange rate based on the need every month. There should be immediate consideration for quick disbursement of funds by donors to ensure that funds are received as soon as the grant award process is completed. Every donor wants their budget to be prepared in their home currency. For example, all DANIDA The budget should be comprehensive, and itemized by the specific period. A grant is always provided in DKK and cannot deviate from the amount expressed in DKK. The expenditures, however, are usually in a local currency, or one used by the partner organization to implement the activities. It is thus often necessary to calculate the budget in DKK and local currency, using a standard exchange rate.

Constant Communication With the Donor

In a situation where the budget is overrun by the grant holder due to the foreign currency exchange rate fluctuation such variance of loss must be borne by the grant holder while underspending can either be refunded to the donor or a prior approval for spending in other areas of priority can be sought from the donor. This requires the grant holder to be in constant communication with the donor. It is required that the implementing partner uses an appropriate exchange rate modality during the budget because it provides improvement for budget reliability and facilitates allocation of the available resources and flexibility for the management of the foreign exchange fluctuation during budget implementation. Implementers must follow the applicable accounting and reporting standards and best practices for effective foreign exchange management, accounting for foreign exchange gains and losses, and related risk management. The implementing partner must maintain a local currency bank account, which requires no physical conversion. However, for reporting purposes, implementing agencies must use the same spot rate as of the existing implementing period end-date for both the Financial Closure Report and opening cash balance of the new implementing and the remaining grant balance should be returned to the donor unless otherwise agreed in writing. Where the market rate and official rate are overvalued as compared to the unofficial rate, the implementing partner must use the rate that maximizes the fund in local currency while remaining compliant with the laws of the country and the mitigation measures. The implementing partner should factor in the inflation adjustment in the exchange rate used during budgeting as a contingency reserve may not be included in the budget because some foreign donors may not allow it. In an exceptional situation, the donor may consider fund disbursement directly in local currency and such an arrangement can be discussed beforehand and agreed upon in writing. The exchange rate gained can only be used by the implementing partner with prior approval of the donor to cover adjustments to the activities budget. As part of the exchange rate mitigation measure, it will be good to provide for the contingency reserve in a separate budget line if donor policy is required [18].

Effective Planning

The grant holder should design an internal system and reduce exposure of risk to exchange rate fluctuation through effective planning where currency can only be converted to the functional currency when it is necessary and must investigate an efficient option for the exchange rate, otherwise, optionally to hold funding in foreign currency account and avoid holding large amount in functional currency account. The study conducted in 2016, at Nairobi Securities Exchange defined foreign exchange rate as the price at which one currency is converted into another and noted, a strong relationship between the current foreign rate fluctuation and the financial performance of entities, the study concluded that the issues related to foreign exchange trading should always be considered in efforts to improve bank's foreign exchange transactions and financial performance [19] to which implementing partners of donor-funded programs budgets are no exception because foreign currency fluctuation continues to have a significant impact on the expenditure reported against the donor budget.

Documentation of Currency Conversion

To ensure proper recordkeeping for every signed foreign currency converted into functional currency, banks and foreign bureaus should be used. There should be no change of money in the black market. However, in some situations, implementation of humanitarian or development programs takes place in a geographical location where there are no formal banks and other financial institutions in such cases, money is exchanged with the local trader, and an agreement can be entered into with the local trader and each time fund is exchanged the exchange rate should be documented for verification and reference as signed by currency conversion committees.

Mutual Understanding between Donor and Implementing Agencies

In a situation where the implementing partners do not have a written policy about currency conversion for operational and reporting purposes, then the donor should be contacted as early as possible to reach an agreement on the exchange rate and the method to use for reporting. Although in most situations the donor guidance supersedes the partner's policy, and this should be done with mutual understanding between the donor and the implementing partners. The exchange rate fluctuation has an impact on the project budget especially when the budgeted costs are in foreign currency and, but the actual expenses are incurred in local currency, when the local currency appreciates against the foreign currency like United State Dollar, it would mean more dollars would be required creating budget deficit. This would require closer and regular monitoring of the project budget versus actual expenditure so that any significant impact resulting from exchange rate fluctuation can be brought to the notice of the donor for further consideration and guidance.

Budget Monitoring

It is the best practice to monitor the program budget periodically to ascertain within a reasonable time the impact of the exchange rate fluctuation on the program. If the Grant is converted into another currency than Swedish Kronor (SEK), the exchange shall be made through a national or commercial bank unless otherwise approved by Sida. If exchange rate fluctuations decrease the value of the Grant to such an extent that this will have consequences for the implementation of the Project/Core Activities, the Cooperation Partner shall inform Sida as soon as possible. A currency exchange gain can be netted against a currency exchange loss during the implementation of the project. A balance shall however be established for each year in the financial report, showing the annual net of such currency exchange gains and/or losses. Any surplus balance shall be treated as an income and be part of the outstanding balance, which shall be repaid to Sida according to Article 19.1. Any deficit balance shall not be covered by Sida [20]. However, most donor agreements do not cover any loss resulting from the exchange fluctuation, but this must be discussed with the donor so that a reliable solution is reached including the proposal to consider budget revision. In addition, exchange rate fluctuation may create another chronic wound when reporting project expenses incurred in local currency against the foreign currency budget, it is important to review the exchange rate more often to ensure that expenses incurred in local currency are accurately translated and posted in the ledger.

Discussion

Currency exchange can be a potential area of financial risk, especially in the cash economy and in the implementation of humanitarian operations in remote locations where it is not possible to find the existence of formal financial institutions but where currency exchange takes place in the open market which situation may not be inevitable, especially in developing countries. Where it is not possible to find a formal financial institution, the organization can form currency exchange committees that take responsibility to carry on the currency exchange depending on the need and assess the market situation and document the process of the currency rate that would be used for reporting.

Fund transfers by foreign donors to the implementing partner's account shall be made in the currency stated in the project budget. The partner shall spend an account in the same currency as stipulated in the project budget. The partners may apply the exchange rate in effect at the time of the transaction in case of expenses incurred in a currency other than the one stated in the project budget. However, most donors do not take the cost of gain/loss resulting from the foreign exchange rates.

High risks are often linked to currency exchange rate management and may even involve serious forms of fraudulent behavior such as unnecessary currency exchanges, counterfeit bank statements where staff of cooperation party work in collusion with bank staff, improper rate 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 leading to fund misappropriation. Sida does not advocate any method for how currency conversion should be made or how such transactions should best be dealt with in the accounts. This decision of currency conversion is left at the discretion of the implementing agencies. However, according to Sida's general principle, currency exchange gains and losses are reported on separate income and loss accounts. Currency exchange rate differences are recognized and reported on in the accounting records in the period in which they arise either using spot rates or monthly average rates as may be preferred by the implementing partners [10].

Due to the nature of projects under UK Aid Direct, most of the expenditure in any project is likely to be non-GBP denominated and will be transacted in the local currency in the country of implementation. However, funding from DFID will always be sterling GBP denominated, as will the budgeting and reporting against budgets. One of the most common difficulties experienced by grant holders in UK Aid in financial 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. According to UK accounting practice, organizations have some flexibility in how they reported on foreign currency transactions, it states that 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. Organizations have the option to use an appropriate proxy rate such as the monthly average rate. 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 [6]. It is mandatory that an implementing agency needs to choose a currency conversion method that suits its situation. However, the methodology chosen should be documented in the accounting manual.

Some donors like DANIDA may accept that the budget should contain a contingency amounting to a minimum of 6% and a maximum of 10% of the total intervention costs. The contingency may be used to cover unforeseen expenses on some of the other budget items. The contingency is typically spent in the case of currency fluctuations raising the costs of the intervention, The contingency may be used to cover unforeseen expenses on some of the other budget lines, such as increases in prices, salaries, exchange rates, and interest costs or when other conditions make purchases or other payments related to the activities more expensive than expected at the time of budgeting [21].

This gives the flexibility to manage the budget in case a significant impact of exchange rate fluctuation hurts the program budget. However, the contingency money provided in the budget can only be spent with the prior approval of the donor. When an agency spends contingency money allocated in the budget without donor prior approval the cost may be disallowed.

In dealing with the exchange rate fluctuation effect, it is important to take into consideration the budget flexibility rules of the donor. For example, according to Danida Market Development Partnership, the budget margin, which equals up to 5% of the overall project costs, can normally be reallocated to other major budget lines without prior approval from Danida in case of unforeseen expenses, such as price increases, exchange rate fluctuations, and salary increases.

The budget margin cannot be used to increase the activities of the projects. Funds moved from the budget margin, therefore, need to be charged to existing budget lines. Reallocations and the use of the budget margin should always be done within the overall purpose of the project and be related to concrete and specific objectives of the program. Overspending because of price or salary increases, or exchange rate fluctuations will not be covered by an increase in the grant amount. Instead, the budget margin mechanism should be used for such a purpose. Conversion of accounts kept in foreign currency should be based on the exchange rate used at the time of the transfers [22].

All donors the humanitarian and development donors require the program budget to be developed in their home currencies for example, it is DFID's policy to make its financial commitments in sterling. Budget totals must be provided in GBP with the stated exchange rate specified where foreign currency reports should be converted using the relevant exchange rate in OANDA www.oanda.com on a specific date of the transaction, to allow for transparency with audited accounts. The lead Partner Organisation is responsible for monitoring and managing any exchange rate fluctuations across the life of the program. Where significant exchange rate gains or losses are being accumulated the partner should notify DFID to jointly decide how these are managed. In the case of adverse movements in exchange for inflation rates, the Partner liaison with DFID will need to consider a range of options including re-assessing the outcomes/ deliverables of the funded activities and/or seeking additional budget through dialogue with DFID. Partners should not build in additional costs to protect against the risk of exchange rate/conflation losses [23]. This explains the importance of co-creation where the implementing agency and the donor work in collaboration with each other maintaining close communication with the donor and sharing any challenge that could impact negatively on the programme budget.

If funds provided under the Agreement are introduced into the Partner Country by USAID or any public or private agency for purposes of carrying out obligations of USAID hereunder, the Grantee will make such arrangements as may be necessary so that such funds may be converted into local currency at the highest rate of exchange which, at the time the conversion is made, is not unlawful in the country of the Grantee to any person for any purpose [24]. In any circumstance, the currency conversion should result in the benefit of the program, but this may not necessarily be the case because of the unavoidable prevailing market condition in each period.

Conclusion

Exchange rate fluctuation is one of the riskiest areas of financial management especially when it comes to the management of foreign donor-funded program budgets that are prepared in the foreign donor currencies. Humanitarian and Development foreign donors namely: United States Agency for International Development (USAID) require their budget to be prepared in United States Dollar (USD), Sida Swedish International Development Agency (SIDA) require the program budget to be prepared in Swedish Krona (SKK), Department for International Development (DFID) require the budget be made in sterling Pound and Danish International Development Agency (DANIDA) all the time require the budget funded by them be prepared in Danish Krona (DKK) and European Commission for Humanitarian Aid require the budget be prepared in Euros. One thing that is common among these donors is that they all require the financial report submitted against the budget to be prepared in their budget currency.

The study noted that different foreign donors have different regulations regarding currency conversion for reporting and accountability. However, the choice is left at the discretion of the implementing agencies to select the currency conversion methods favorable to their situation.

There are several currency conversion methods, but agencies are required to choose only one and apply it consistently throughout the accounting cycle. The exchange rate methods chosen should be well documented in the accounting manual for future reference and as a guiding policy should it be required by the auditor during an audit or donor expenditure verification. The study identified First In and First Out (FIFO), Weighted Average exchange rate methods, and daily spot rate methods as the most common currency conversion methods used for accounting and financial reporting among the humanitarian and development partners.

As best principles, the currency conversion method chosen should be included in the written financial manual guide of the grant holder. The exchange rate used in the currency conversion must be through observation of the prevailing actual rate for lumpsum transfer. The exchange rate at budgeting time would differ from the actual rate at the time of implementation and reporting during the program life cycle. The exchange rate used at the time of budgeting should not be applied during the time of reporting because it does not give a better picture of the financial situation.

To effectively manage the effect of exchange rate fluctuation, keep open and honest communication with the donor because in an exceptional situation, the donor may consider fund disbursement directly in local currency and such arrangement can be discussed beforehand and agreed upon in writing or additional fund in case of the adverse effect of exchange rate fluctuation on the program budget. The program budget must be closely monitored any deviation from the donor’s allowable flexibility threshold can be flashed to the donor for consideration. The grant holder may request budget amendment when it has been noticed that the budget has been significantly affected by exchange rate fluctuation. To ensure proper recordkeeping for every signed foreign currency converted into functional currency, banks, and foreign bureaus should be well documented. The grant holder can provide for contingency reserve in the budget upon consultation with the donor. It should be noted that not all donors allow for a contingency budget line to take care of unforeseen circumstances resulting from inflation or exchange rate fluctuation.

Program budgets require to be closely monitored for the effect of exchange rate fluctuation in this way surprise of budget overrun can be identified early and addressed either by contacting the donor for budget amendment or realignment. The study noted that exchange rate fluctuation can have either adverse or favorable effects on foreign donor-funded program budgets. Therefore, it needs to be monitored closely.

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Conflict of Interest

I declare to the best of my knowledge there is no potential conflict of interest that could influence this study.

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