

MANAGEMENT OF FOREIGN CURRENCY EXCHANGE RISK



POLICY, PROCESSES AND PROCEDURES

RECOMMENDED

THAT the **Cash Handling Policy** and the contents thereof be tabled for approval at the Mayoral Committee.

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Reviewed By

_____ **Date:** _____

Supported By

INTERNAL AUDITOR

_____ **Date:** _____

Signature

CHIEF FINANCIAL OFFICER

_____ **Date:** _____

MUNICIPAL MANAGER

**Adopted by
the Mayoral
Committee**

_____ **Date:** _____

CHAIRPERSON

**Approved by
the Council**

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Contents

| | |
|--|----|
| 1. Policy..... | 4 |
| 1.1 Overview..... | 4 |
| 1.2 Purpose..... | 4 |
| 1.3 Objectives..... | 5 |
| 1.4 Business Process Framework..... | 5 |
| 1.4.1 Legal Framework..... | 5 |
| 1.4.2 Accounting Framework..... | 5 |
| 1.5 Recommendations..... | 6 |
| 2. Processes..... | 6 |
| 2.1. Definitions..... | 6 |
| 2.2. Explanatory Discussion..... | 8 |
| 2.2.1 Firm Rand Prices..... | 8 |
| 2.2.2 Tendered Prices..... | 9 |
| 2.2.3 Identification of Risk..... | 10 |
| 2.2.4 The Hedging decision..... | 10 |
| 2.2.5 Local supplier's obligation i.r.o. foreign currency hedging..... | 12 |
| 2.2.6 Permitted price adjustments..... | 12 |
| 3. Procedures..... | 14 |
| 3.1. Accounting Treatment of Foreign Exchange Transactions..... | 14 |
| 3.1.1 Recognition of transactions..... | 14 |
| 3.1.2 Disclosure of Foreign Exchange Transactions..... | 14 |
| 3.2. Evaluation of tenders/quotations..... | 15 |
| 3.3. Monitoring of hedge decisions..... | 16 |
| 3.4. Statement of Policies..... | 16 |
| 3.5. Subsistence Allowance for Travel Purposes..... | 18 |
| 3.6. Amendment and Review of the policy..... | 18 |

1. Policy

1.1 Overview

The Municipality, envisages that it will from time to time, procure goods and services from countries outside of South Africa, either by way of direct import, or, more commonly, through a local agent in South Africa. These goods and services are normally priced and payable in a foreign currency.

Upon payment by the Municipality, or by the local importer, of the foreign currency amount and conversion of that amount into South African Rand (Rand), an exchange profit or loss is realised. This exchange difference is normally for the account of the Municipality.

Over the past ten years, the value of the Rand has fluctuated significantly against the value of most of the currencies of South Africa's major trading partners. This means that the exchange differences realised upon settlement of foreign liabilities can become an expense, or loss, to the Municipality. Therefore it becomes important for the Municipality to protect itself against potential foreign exchange losses arising from the import of goods and services by identifying and quantifying the risk in such transactions and by taking steps to manage this risk in accordance with an approved policy.

1.2 Purpose

The purpose of this policy is to provide an agreed framework within which:

- 1.2.1 Foreign currency exchange risks are identified and managed in an efficient and cost effective manner;

- 1.2.2 Foreign exchange conversion differences are properly quantified, accounted for and fairly apportioned between the foreign supplier, any local agent and the Municipality;

1.3 Objectives

Responsibility for identifying and managing potential foreign exchange risk is clearly allocated to Municipal officials and business areas dealing with the following:

- 1.3.1 The direct import of goods and services from an overseas supplier;
- 1.3.2 The indirect import of goods and services through a local supplier;
- 1.3.3 The disbursement of subsistence allowance for travel in the pursuit of official Municipal business;
- 1.3.4 To advise to the accounting of revenue derived from foreign based transactions.

1.4 Business Process Framework

1.4.1 Legal Framework

The Municipal Finance Management Act (MFMA) 56 of 2003, the Municipal Systems Act (MSA) 32 of 2000, and all other applicable legislation, policies and circulars make reference.

1.4.2 Accounting Framework

The responsibility of the management of foreign exchange currency risk rests with the Municipal Manager and the Chief Financial Officer. The performance of this function may be delegated to subordinates; however this however does not

alleviate the responsibility of the Municipal Manager and Chief Financial Officer.

1.5 Recommendations

- i. This policy, processes and procedures document be adopted as the Management of Foreign Exchange Currency Risk Policy;
- ii. This policy, processes and procedures document be recognised as identifying, characterizing and addressing the various stages of Management of Foreign Exchange Currency Risk Policy;
- iii. This policy, processes and procedures document be recognised as denoting all internal control mechanisms relevant to the efficient and effective discharge of the policy;
- iv. This policy document is adopted by the Executive Management and the broader Council of Sedibeng District Municipality as the framework for the Management of Foreign Exchange Currency Risk Policy.

2. Processes

2.1. Definitions

| | |
|------------------------------|--|
| Exchange Transactions | Transactions in which the contracting party receives approximately equal value in exchange for goods or services |
| Exchange Rate | the ratio at which the currencies of two countries are exchanged |
| Exchange Differences | exchange gains or losses which result when the rate used to initially |

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| | record an item is different from the rate ruling at the final settlement date |
| Foreign Currency | a currency other than the South African Rand |
| Forward Exchange Contract [FEC] | an agreement with a commercial bank to exchange different currencies at a specified future date and at a specified exchange rate (the forward rate). |
| Hedge | a transaction by which future exchange gains or losses are controlled within agreed margins or entirely eliminated |
| Local Supplier | a supplier based in South Africa |
| Overseas Supplier | a supplier based in a foreign country |
| Premium or discount on a forward exchange contract | the difference between the spot rate at the time of inception of the FEC and the forward rate specified in the contract |
| Settlement Date | the date at which the supplier/creditor is actually paid |
| Spot Date | the exchange rate for immediate delivery of currencies to be |

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| | exchanged at a particular time |
| Tender Price | the price quoted by a supplier in response to either a formal tender or a request for quotations. |

2.2. Explanatory Discussion

2.2.1 Firm Rand Prices

It should not be an automatic assumption that goods and services sourced by the Municipality from outside South Africa, whether directly from an overseas supplier or indirectly through a local supplier, should be priced in foreign currency with any exchange differences being for the Municipality's account.

Wherever possible, the Municipality should contract with suppliers on a firm Rand price basis with any exchange risk being managed and borne by the supplier. This should be possible, bearing in mind the Municipality's considerable purchasing power, in a competitive market situation with many suppliers bidding for a contract.

However, for proprietary items and in situations where there is a limited number of potential suppliers, it is unlikely that the Municipality will be able to insist on firm Rand prices. If a firm Rand price is not obtainable, then the Municipality must manage the currency risk in association with the other parties to the procurement contract, viz. the overseas supplier, the local agent (*if applicable*) and the commercial banks.

2.2.2 Tendered Prices

Prices tendered in Rand by local suppliers for goods or services sourced from overseas must be indicated as either firm or subject to adjustment for movement in exchange rates. All Municipal tenders or requests for quotation for the procurement of such goods or services must clearly state whether Rand prices which are subject to exchange rate variation are acceptable, or whether firm Rand prices are required.

Where prices are quoted subject to exchange rate variation, the underlying foreign currency elements and prices must be clearly identified and disclosed.

The basis for their conversion to Rand and their incorporation into the final Rand price together with the local Rand denominated costs and prices, should also be clearly disclosed. In order to compare tendered prices on a common basis, the Municipality must specify in the tender document/request for quotations the exchange rates to be used by the local supplier for converting foreign currency prices to Rand.

These should normally be the spot selling rates quoted by the Municipality's main banker at a ruling rate referenced to the closing date for receipt of tenders/quotations.

However, where the anticipated supply lead time is more than three months, it will be more appropriate to specify a forward exchange rate at the ruling date based on the estimated delivery period and eventual payment date.

Prices tendered by overseas suppliers for goods or services sourced directly from overseas will normally be in foreign currency. For evaluation purposes, these prices must be converted to Rand at the rate specified to local suppliers as per the above.

Where there is a minimal difference between a firm Rand price and a Rand price subject to exchange rate variation, then preference should obviously be given to the firm Rand price.

2.2.3 Identification of Risk

It is the responsibility of the relevant procurement section to identify any element of foreign currency exchange risk to the Municipality in a procurement contract and to bring this to the attention of the Finance Department immediately after award of contract/placement of an order

A copy of (*or relevant extracts from*) the procurement contract/purchase order, together with the contact details of the supplier's local representative, should be submitted to the Finance Department of the Municipality within 5 working days of the signing of the contract/purchase order.

2.2.4 The Hedging decision

It is the responsibility of the Finance Department of the Municipality to decide on the hedging action required in respect of any foreign currency exchange risk identified by the procurement authorities. The decision may be to fully hedge, partly hedge or not to hedge at all.

If the decision to hedge is taken, the type, extent and period of the hedge will be decided by the finance department in conjunction, where appropriate, with the supplier, the supplier's banker and the Municipality's own banking advisers.

The hedge should be tailored to the particular currency risk in each procurement contract. The hedging decision should be made by the finance department within 5 working days of receipt of the necessary information/documentation from the procurement section as per the identification of risk above.

In the case of a currency hedge required for an indirect import of goods or services (*through a local supplier*), the finance department is responsible for instructing the local supplier to put the hedge in place, obtaining a copy of the foreign exchange contract with the supplier's bankers, documenting the hedging action, and supplying the procurement section/payments section with the necessary information for adjusting the eventual payment to the supplier to reflect permitted price adjustments in respect of conversion of foreign currency to Rand.

The supplier should be obliged, in terms of his contract with the Municipality, to make the necessary hedging arrangements with his banker within five days of receiving the relevant instructions from the Municipality's finance department.

In the case of a currency hedge required for a direct import of goods or services, the finance department will deal with the Municipality's own

bankers in putting the hedge in place within the five days referred to above.

2.2.5 Local supplier's obligation i.r.o. foreign currency hedging

Where the Municipality has agreed to accept tenders/quotations from a local supplier based on foreign currency prices, the tender document should clearly state that the Municipality has the right to instruct the supplier to take out a forward exchange contract or any other type of currency hedge in respect of the foreign currency element of the contract.

If so instructed, the supplier must act according to the Municipality's instructions and produce documentary proof of same to the Municipality within specified time frames.

2.2.6 Permitted price adjustments

Where the Municipality has accepted a tender or quotation which is subject to exchange rate variation, the supplier is entitled to claim from the Municipality the Rand equivalent of the foreign currency prices incorporated in the contract price, converted in accordance with the following:

Where the Municipality does not request the supplier to take out any form of currency hedge on its behalf, the rate of exchange in respect of the foreign currency component of the cost of the contracted goods or services shall be the closing spot selling rate as published by the Municipality's main bankers ruling at either;

- a) the date of shipment of the goods
- b) the date of clearance by the Customs and Excise authorities of the goods at their port of entry into South Africa
- c) the date of receipt of the services in South Africa, or
- d) such other date and on such other conditions as may be specifically provided for by the Municipality in any particular tender or request for quotation

Where the Municipality does request the supplier to take out a currency hedge on its behalf, the rate of exchange payable in respect of the foreign currency component of the cost of the contracted goods or services shall be the forward exchange or other hedging rate contracted with the relevant commercial bank on the Municipality's behalf.

The Municipality may, at its sole discretion, require the supplier to furnish such documentation relating to any aspect of the foreign exchange component of the cost of such goods or services as it may deem necessary, including shipping and Customs documents

3. Procedures

3.1. Accounting Treatment of Foreign Exchange Transactions

The basic principle is that revenue is measured at the fair value of the consideration received or receivable, including any trade discounts or rebates.

3.1.1 Recognition of transactions

- i. Services – recognized at the stage of completion i.e. when the outcome of the transaction can be accurately determined, as per GRAP 11. Where the outcome of the transaction cannot be accurately forecasted, revenue is only recognized to the extent that expenditures are recoverable;
- ii. Sale of Goods – when the purchaser has received the goods and it is effectively under his control and usage hence the associated revenue and costs can be accurately determined;
- iii. Interest – recognized via the effective interest method;
- iv. Royalties – recognized on an accrual basis as guided by the underlying agreement;
- v. Dividends – recognized when the right to payment occurs.

3.1.2 Disclosure of Foreign Exchange Transactions

SDM needs to disclose the following in its Annual financial reports;

- i. The accounting policy applied to the recognition and measurement of foreign exchange transactions;

- ii. The amount of revenue linked to foreign exchange transactions for the period under review and the nature of each underlying transaction;

3.2. Evaluation of tenders/quotations

Tenders/quotations for imported goods and services may be either in foreign currencies, Rand prices subject to exchange rate variation, firm Rand prices, or a combination of these. In order to place these prices on a comparable basis, it is necessary to convert the foreign currency prices to Rand.

In comparing firm Rand prices (*no exchange risk*) with prices which are subject to variations in rates of exchange, it is in Council's best interests to use a forward rate of exchange for converting foreign currency prices to Rand. The forward rate used should be based on best estimates of the expected delivery/payment date of the goods or services, taking into account the time required for evaluation of tender, committee reports, supplier lead time etc.

Note that for budgeting purposes, the relevant business user of the imported goods or services is also advised to use a forward exchange rate, rather than the spot rate, for estimating the future Rand costs of inputs denominated in foreign currencies.

3.3. Monitoring of hedge decisions

The Finance Department of the Municipality shall be responsible for monitoring its hedging decisions regarding the management of foreign currency risk. It should record full details of all decisions made and track the actual movement of exchange rates against the contracted hedge rates from date of initial identification of currency risk through to final settlement of the foreign exchange liability.

Realised exchange gains or losses, combined with the premiums and discounts payable on FEC, should be ascertained, together with their impact on Municipal costs, for each procurement transaction which has a foreign currency price component. In this way, the efficiency of the hedging function in protecting the Municipality against foreign currency losses can be monitored over time and corrective action taken as and when required.

3.4. Statement of Policies

1 Firm Rand prices, free of currency fluctuations/adjustments, shall be sought by the Municipality from suppliers, wherever possible, for the import of goods and services

2 Where prices are quoted subject to exchange rate variation, the underlying foreign currency elements and prices, and the basis of their conversion to Rand and incorporation in the final Rand

price, must be clearly disclosed by the supplier

- 3 Any exposure by the Municipality's foreign currency exchange risk must be clearly identified in every procurement contract at its inception. Responsibility for identifying this risk, and for bringing it to the attention of the Finance Department within the specified time frames, rests with the relevant procurement section
- 4 The Municipality must always take a view on the extent of currency risk in any procurement contract and make a decision on whether to hedge and to what extent Responsibility for any hedging action, within the specified time frames, rests with the Finance Department, advised, where appropriate, by the Municipality's or the supplier's Bankers.
- 5 Every procurement contract with a local supplier, where potential currency risk has been identified, must provide for the Municipality's right to instruct the supplier to take out a forward exchange contract or other hedging instrument on the Municipality's behalf
- 6 Claims from suppliers for permitted price adjustments in respect of exchange differences must be fully substantiated by

reference to forward exchange contracts, foreign currency purchases and other relevant documentation

- 7 Evaluation of tenders/quotations for imported goods or services shall be performed

using forward rates based on estimated supply lead times for conversion of foreign currency prices to Rand

- 8 All hedging decisions made by the Municipality in respect of managing foreign currency risk

shall be properly recorded by the Finance Department and subsequently monitored

up to the settlement date in order to ascertain the actual monetary gain or loss

realized as a result of the hedging action

3.5. Subsistence Allowance for Travel Purposes

All authorized travel for municipal officials on official business will include a subsistence allowance. Such allowance will be relative to the hedging decision undertaken by the municipality and based on the forward rate.

3.6. Amendment and Review of the policy

The Management of Foreign Exchange Policy shall be reviewed at the discretion of the CFO due to changing circumstances as a result of the legislation or otherwise.