Perspectives on current issues and trends in CIPS/Issue 03/February 2016

Spot On

CIPS: Consumer and Industrial Products and Services

Spot On is a bi-annual magazine focusing on current issues and trends for businesses in the manufacturing, agriculture, oil & gas, retail, entertainment, tourism and hospitality sectors.

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Welcome to our third edition of Spot On publication, in which we share our perspectives on key topical trends impacting consumer, industrial products and services (CIPS) sectors in Kenya.

Introduction

In this edition, we focus on how some socio-economic trends are shaping and disrupting the business environment in Kenya and beyond.

Michael Mugasa is a Partner with PwC Kenya and the firm's Industry Leader for Entertainment and Media.

+254 20 285 5688
michael.mugasa@ke.pwc.com

There are five megatrends that we believe will continue to have a disruptive and transformative impact on business: rapid urbanisation, demographic shifts and social change, shifts in global economic power, climate change and resource scarcity, and technological breakthroughs.

In Kenya, we are feeling the impact of rapid urbanisation first-hand in many of our cities and towns across the country. Rapid urbanisation has put tremendous pressure on public resources, services and infrastructure in the cities and towns. Nowhere is this more noticeable than in public health services.

The recent outbreak of the Ebola virus in West Africa showed the vulnerability of local public health resources and expertise, and information management infrastructure in responding to such calamities. *Eratus Maina* discusses whether Universal Health Coverage for all Kenyans would improve public services and our health information management and infrastructure and also whether it is publicly affordable.

Rapid urbanisation driven by devolution is tremendously changing consumer behaviour and consumption. Thriving urban centres of commerce and government have emerged across the country, with increasing interconnectedness of county economies. *Richard Tonui* and *Kanau Imathiu* reflect on the impact of this phenomenon on the automotive industry in Kenya. They point out that although the growth in the automotive industry reflects many positive changes in the economy, regulatory considerations for the impact on public resources and the environment are lagging behind.

The price of new technologies continues to fall dramatically. New technologies are no longer solely the privilege of developed economies and the time it takes to go from breakthrough to the mass market is falling. The impact of digitalisation has been particularly profound and we're already seeing technology based around the internet create extraordinary value.

Kenya's recent digital migration of television broadcasting and the expansion of internet access, particularly through smart phones, allows businesses to reach a new, growing consumer base. Crucially, they can reach these consumers on a more personal level to help build brand loyalty and win a share of their wallets.

The most transformative impact of digital migration is the likelihood of digital convergence in the marketplace, among organisations in telecommunications, media, financial services and other sectors. I discuss this phenomenon in the article: *The great digital migration.*

As more 'Generation Y' or Millennial employees enter the workplace, it is a good time to raise some questions about the impact of demographic shifts on the workplaces of today and tomorrow. As generations work together, and as the diversity of our workplaces continues to increase, the outcome can be highly stimulating.

At PwC, we often say that our people are our greatest asset. Many other businesses feel similarly, and employee satisfaction surveys, assessment programmes, feedback forums and other avenues can generate volumes of data.

Handerson Mwandembo argues that data analytics applied to human resources management can help organisations to find patterns, derive clarity and act on insights. Workforce planning that is data-driven enables business leaders to make better decisions about managing people of different generations and backgrounds.

Many of the transformational, technological breakthroughs in business are having a disruptive impact on internal business processes like human resources, internal audit, fraud prevention and payroll compliance functions. Several of our writers comment on these functions separately but what strikes me is that for all the talk about interconnectedness in the outside world, we should not lose sight of the importance of partnership within our organisations.

When business functions are empowered to provide trusted insight to business leaders, these leaders can make better decisions. Best-in-class decision-making distinguishes market leading organisations.

This kind of partnership requires trust. For private companies or family-owned businesses, trusting the next generation of business leaders, advisors from outside the family and/or third-party expertise can be very difficult.

We have learned a great deal about challenges of trust from our services to privately owned and family businesses. *Moses Nyabanda* and *Jamila Aroi* explain that part of the private company owner's agenda should be to trust that someone else can make a decision and make it well on behalf of the business. This is a good lesson for businesses of all kinds.

We have pulled together a combination of articles that demonstrate the interconnectedness of global megatrends and their manifestations in Kenya. I trust that you will enjoy our publication and as always, we welcome your comments or the opportunity to discuss these trends in more detail.

Universal Health coverage for all Kenyans: Pipe dream or possibility?

This is the country I would love to live in: one that recognizes health as a right by guaranteeing all Kenyans the highest attainable standard of healthcare services and especially reproductive health services. In fact, this is the right guaranteed in our constitution and contained in the Jubiliee Coalition manifesto.

Erastus Maina is a Senior Manager in management consulting with PwC Kenya. He specialises in Finance and Accounting consultancy services.

+254 (20) 285 5376
erastus.maina@ke.pwc.com

Current as well as previous government coalitions have promised universal healthcare but failed to deliver on results. We are not alone when it comes to challenges of implementing universal healthcare: Rwanda, Uganda, Ghana, Nigeria and the United States of America among many others have committed to universal healthcare with varying degrees of success.

To make progress now, we should ask ourselves as Kenyans: is universal healthcare (UHC) a 'nice to have' pipe dream or real possibility?

So far, UHC has been impeded by several factors including: cultural issues affecting health especially in reproductive health; transport barriers and associated out-of-pocket costs and the lack of service-readiness among some public health facilities as demonstrated in the 2013 Kenya Service Availability and Readiness Assessment Mapping (SARAM) report.

The concentration of health facilities in urban areas illustrates Dr Julian Tudor Hart's inverse care law: The availability of good medical care tends to vary inversely with the need for the population served.

Current as well as previous government coalitions have promised universal healthcare but failed to deliver accountability and results. We are not alone when it comes to challenges of implementing universal healthcare

What is Universal Healthcare?

The World Health Organization (WHO) defines UNC as a situation where 'all people have access to the health services they need (prevention, promotion, treatment, rehabilitation and palliative care) without the risk of financial hardship when paying for them'. The progress towards UHC is measured on two dimensions: availability of services and financial risk. Under availability, the perspectives to consider include who has access to services and what services they have access to. Under the financial risk dimension, we need to consider what proportion of health costs are covered. Issues of coverage and equity in financing are therefore critical in assessing progress towards UHC. Besides this, a good UHC policy should address social determinants of health such as education, living conditions and household income which affect people's health and their access to services.

UHC models have over time evolved from the two basic models adopted by Britain and Germany; the Beveridge model in Britain which relied on general taxation, and the Bismarck (German) model which relied on social health insurance deductions from payroll. Aspiring countries like Kenya can select from a number of variants that have been successfully implemented by other countries over time. Countries with strong welfare states such as Sweden, Canada and Denmark provide good models. Closer home, Rwanda has also made it clear that the UHC dream can be a reality.

Kenya's government commits to Universal Healthcare…

Our current government led by the Jubilee Administration underlined its commitment to the health agenda by introducing free maternal health services and eliminating user charges in lower level facilities. This is noble progress but implementation has been challenging with complaints from public health facilities about delays in reimbursements for services provided, which then affects their ability to continue meeting increasing demand.

Recent reforms at the National Hospital Insurance Fund (NHIF), albeit the result of protracted court battles, increase premiums to pay for expansion of services for outpatient care. Reforms also provide subsidised coverage for extremely poor people to further expand the national risk pool and move us closer to universal coverage. These changes may finally bring to fruition the vision of creating a government-funded and sustainable risk pool across all socioeconomic groups.

The journey towards the UHC promise in Kenya however faces strong headwinds. Inefficiencies at NHIF, high administrative costs and allegations of mismanagement of funds are just some of the factors that have robbed the institution to deliver this dream of credibility. While donors would like to provide more structured support through NHIF, its past has created mistrust leading to more targeted approaches by development partners. Significant reform of the institution or its disbandment and formation of a new organ is imperative to regain the trust of Kenyans, development partners and other stakeholders.

Kenya has not met its commitment to the 2001 Abuja Declaration, where member states of the African Union committed to increase government funding for health to at least 15% of national income. Our devolved system of governance has introduced a new conundrum, where the overall budget allocations and spending to different sectors are not clear. Recent reports by the Auditor General and other reports on spending by the county governments show that limited resources may not achieve full accountability or may be diverted to frivolous expenditure. Whether devolution will aid or curtail the UHC promise remains to be seen, but the handling of the health function by the county governments thus far has left many calling for reversion of the function to the national government.

… But one of the main challenges is paying for it.

Kenya's ability to increase its health budget is also affected by challenges in tax collection, with a significant section of the population yet to be placed under the tax net. A large informal sector in Kenya also makes collection through payroll or income tax deductions challenging. To fund UHC, we should consider selecting a viable health financing mechanism. Furthermore, Kenya may not have the domestic revenue sufficient to fund UHC and the unmet requirements could be met through external assistance. Several development partners in Kenya have indicated willingness to support UHC.

The Japanese government for example recently loaned the Government of Kenya Kshs 3.3 billion specifically for UHC. The World Bank is currently preparing a programme titled 'Transforming Health Systems for Universal Care in Kenya'. Other donors like the German government (through KfW) have indicated they would like to transition from a targeted approach to a systemic approach (UHC) in the near future. At least 30% of the health financing in Kenya is derived from development partner programmes. Harmonising this support, which is currently fragmented with different donors adopting different approaches, and directing the aid to areas where it will have substantial impact and aligned to national priorities, is critical in realising Kenya's UHC dream.

A smoother road to Universal Healthcare should begin now.

Kenya's journey towards UHC has been tumultuous to say the least. From the Sessional Paper No. 10 on 'African socialism and its implications on planning' which aimed to provide equal access to health for all Kenyans and created NHIF in 1966, to the recent reforms affecting NHIF that have been subject to court battles, there have been many 'start-stop' interventions, grand schemes that fell by the wayside at the assentation stage by a stroke of a pen (or lack thereof), and the elimination and reintroduction of measures such as user charges. Countries like Rwanda and Thailand have proven that UHC can be a reality, even for developing countries; what may be lacking is universal commitment and the political willpower to achieve healthcare for all.

Will I see the UHC dream for Kenya come true during my lifetime? For me, the jury is still out on this question. But will my five year old son do so? I certainly hope so.

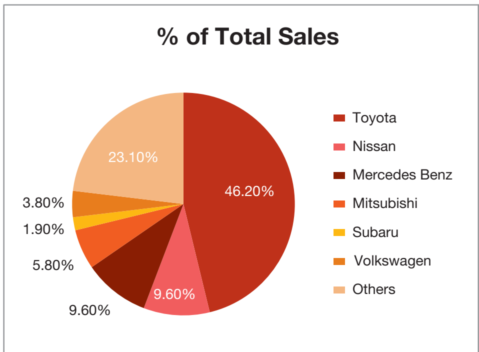
Kenya's motor vehicle sector of tomorrow

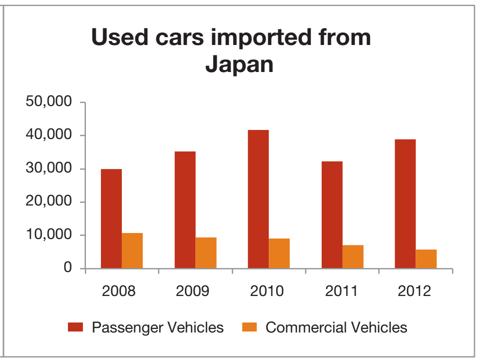
Anyone travelling on Kenya's roads knows that there are more and more vehicles vying for space. An increasing number of personal and commercial vehicles reflects Kenya's demographics, urbanisation and economic growth but also puts pressure on public resources like roads and air quality.

Getting the balance right between the availability of quality, affordable vehicles and investment in public infrastructure is a key priority for Kenya now and in the future.

Sales of new and used vehicles have increased steadily at about 7% annually since 2011 according to a survey of new vehicle owners, used vehicle dealers, online vehicle marketplace owners and industry stakeholders in Kenya.

The average consumer has a taste for unique but affordable brands; most popular brands for used vehicle purchasers:
Kenya is among the top 10 destination of the used cars from Japan and Toyota brand dominates the used passenger vehicle sales with 46% of the market share.





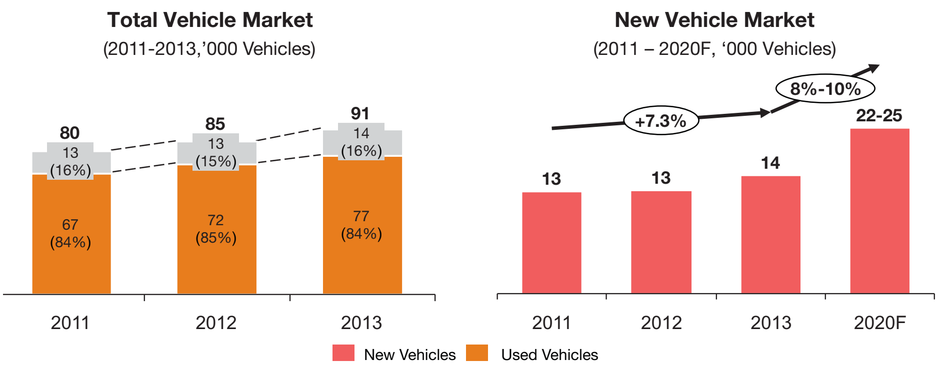
At the same time, customer views influencing purchase decisions have shifted markedly. Our research, Kenya Motor Vehicle Sector: Driving Growth in the Economy, was conducted jointly with our global Strategy& consulting business.

It shows that price, quality, features, residual value and parts availability all influence vehicle purchase decisions. More Kenyan customers want more personalised relationships with the businesses that sell these vehicles and they want personalised vehicle features that are tailored to their preferences.

At a high level, there are a number of significant megatrends that are influencing vehicle sales in Kenya. The construction industry and in particular, construction that improves roads infrastructure, contributes to sales of construction-related commercial vehicles as well as sales of personal vehicles.

Urbanisation is putting pressure on Kenya's informal public transport sector driven by demand for vehicles that transport people and consumer goods to,

Kenyan automotive industry is dominated by used cars imports; new vehicles market is expected to grow by 8%-10%



from and within Kenya's urban centres. Devolution has created new centres of commerce. County governments also have vehicle needs.

While over 80% of vehicles sold in Kenya are used vehicles, dealers of new vehicles continue to invest in marketing and innovations to attract customers.

These include vehicle customisations, online and interactive marketing, as well as financing options and relationship-focused sales and service. Kenya is a hub for the automotive industry in East Africa, but Kenya's new vehicle industry is primarily focused on assembly, retail and distribution—not manufacturing, which is dominated by South Africa.

Ever since the liberalisation of the motor vehicle market in the 1990s, the ease with which used vehicles are imported has been growing.

Used vehicle dealers argue that their sales have not impacted new vehicle sales because their target markets are different; buyers of used vehicles would not consider new vehicles and buyers of new vehicles will not easily return to purchasing pre-owned ones.

But increasingly our research shows that there is a grey area where potential vehicle buyers can be swayed either way. The key to unlocking these decisions are marketing, service and relationships.

Our research shows that customers are conscious of the brands they buy, and also consider the cost of owning a new vehicle. Used vehicles may be cheaper to purchase in the short run but there can be associated and hidden costs that come with maintaining a used vehicle in the longer term.

New vehicles may be more expensive up front but sales often include free servicing for a certain mileage and, being new, these vehicles may be more reliable. Even so, the predominant factors influencing vehicle purchase in Kenya is price and availability of spare parts.

Brand consciousness also play a role. Our research shows that many Kenyan consumers would prefer a used vehicle of a prestigious brand to a new, less prestigious vehicle at the same price.

Worryingly, the regulatory environment for Kenya's automotive industry lags well behind more developed markets. There are no emissions standards or mandatory inspections in Kenya.

Banks may stipulate vehicle age requirements when granting car loans, often limiting financing to vehicles that are no more than seven years old, but the average age of a vehicle in Kenya is still 15 years.

Although Kenya's automotive industry reflects many changes in Kenya's economy, we have some way to go before vehicle purchasing reflects concern for the environment and safety.

Richard Tonui is a Senior Manager and **Kananu Imathiu** is an Associate with PwC's Strategy consulting practice.

Richard Tonui

+254 (20) 285 5230
richard.tonui@ke.pwc.com

Kananu Imathiu

+254 (20) 285 5277
kananu.imathiu@ke.pwc.com

Highlights

- Used car sales account for over 80%+ of total sales
- Age limit of 8 years for used car imports, no vehicle emission regulations
- Huge appetite for used cars prompted Toyota Tsusho, the parent firm of Toyota Kenya, to establish a separate unit (Toyotsu Auto Mart) last year that deals in a wide range of second-hand brands including Toyota and Subaru

The great (digital) migration

The continued expansion of Kenya's middle class is creating greater competition among businesses seeking to build consumer awareness, win a share of their wallets and earn their brand loyalty.

Michael Mugasa is a Partner with PwC Kenya and the firm's Industry Leader for Entertainment and Media.

+254 20 285 5688
michael.mugasa@ke.pwc.com

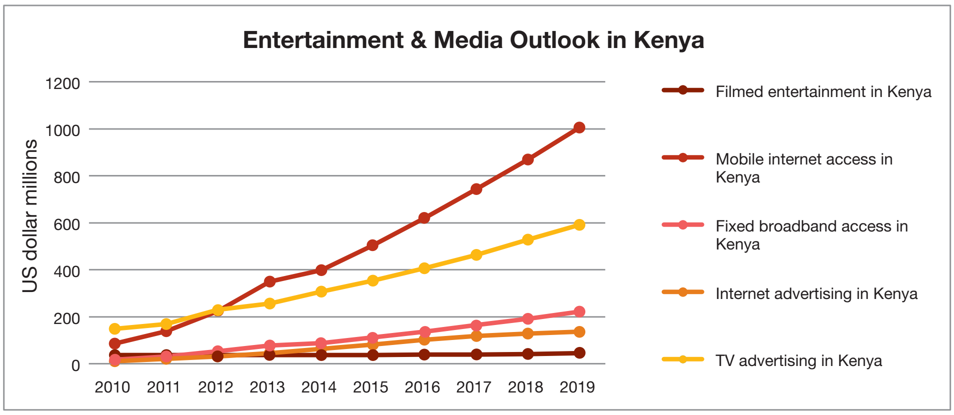
Businesses are now increasingly interacting with consumers through digital platforms which is having a transformational impact in the marketplace. The recent digital migration of television broadcasting is expected to accelerate this transformation.

Digital television broadcasting and the internet allow businesses to reach a wider audience and to grow their brands on a more personal level, such as through social media. Consumers also benefit from an expanded digital marketplace, online and real-time product reviews and more creative, interactive content.

Growth trends in television advertising and internet access help to illustrate how our marketplace is changing. According to our recent market research, PwC Entertainment & Media Outlook, 2015 – 2019, total TV advertising revenue in Kenya is projected to grow at a compound annual growth rate (CAGR) of 14.1% over the next five years to reach US $591 million, largely due to the continued emergence of a new urban middle class of consumers.

Internet advertising revenue is projected to grow at 16.8% CAGR to reach US $135 million by 2019, fuelled by the second-fastest growth in mobile internet subscribers worldwide.

The importance of mobile internet subscriptions to Kenya's internet advertising market is mainly driven by the relatively low expense of owning a smartphone compared to a laptop or computer with fixed broadband connection. An increasing number of middle class consumers can afford smartphones and internet access.



Transformative benefits

One of the transformative benefits of digital migration is the more efficient use of broadcast frequencies. Digital broadcasting also presents opportunities for businesses to invest in content that is high-quality, produced locally and targeted to specific consumer segments.

For consumers, digital broadcasting delivers better sound and picture quality, the capacity for more channels, wider geographic coverage and the ability to accommodate high definition and

standard definition viewing, mobile TV and digital audio.

Digital broadcasting will stimulate local production of programmes, sitcoms, films and advertising. Production companies that develop popular content will attract more investment and advertising spend will follow as consumer-focused companies seek to maximise their impressions among viewers.

It is also cheaper to produce programmes on digital platforms, which will not only lower the cost of acquiring content but potentially create variety and competition in the production sector.

The most transformative impact of digital migration is the likelihood of digital convergence in the market. Already, we are seeing players in telecommunication expanding into content development and internet access services.

Similarly, media houses are likely to explore the possibilities of building telecommunication and internet platforms. Even the financial services sector is already expanding and building alliances within the telecommunications space.

The most transformative impact of digital migration is the likelihood of digital convergence in the market.

The impact of this trend of convergence is likely to be greater cost efficiency and more competition between players across different sectors. The beneficiaries are Kenya's consumers. Overall, digital broadcasting is likely to create more jobs and foster economic activity.

The next migration

Certain tax implications may curtail the growth of the local production industry, however, as the Finance Bill, 2015 proposed to exempt from VAT goods and services acquired by the Kenya Film Commission, the Finance Act has amended this proposal by replacing the Kenya Film Commission with local film producers and local film agents.

This amendment will retain the initial intention of providing incentives to the film industry to spur its growth. This is a welcome amendment as it focuses the VAT exemption on the actual taxpayers in the film industry as opposed to their umbrella organisation, the Kenya Film Commission.

The 2015/2016 Budget policy speech also included a change to direct tax impacting foreign actors and crews who will now not be subject to Kenyan withholding tax. This is intended to promote Kenya as a premier filming destination by attracting renowned personalities and technical expertise to enhance the quality of local productions.

Subject to regulatory oversight, digital platforms open up the Kenyan market to a broad range of foreign productions and programming which changes the nature of competition and also inspires greater appreciation for diversity.

The transformational impact of Kenya's digital migration will continue to evolve. The progress we have made so far suggests that digital migration will have significant positive benefits for our economy.

Managing human resources through data analytics

What lends itself to analysis in the whole cycle of talent management?

Recently, a local manufacturing company had a problem with high levels of defects affecting one of its products, which was fragile. Even after the company improved the quality of the product so that defects were eliminated in the factory, many of the products still got broken before they reached the point of sale.

One day, a member of the early-morning cleaning staff realised that a train passing at 7am was shaking the factory and the products, making them more vulnerable to breakage. The problem was solved on the basis of input from human capital.

The value of data analytics is that it helps companies to filter through the noise created by volumes of data and find these gems of wisdom that help them to work smarter. The insights gained from data analytics matter to decision-makers at all levels in an organisation.

Surveys and assessments, feedback forums and other avenues can generate volumes of data. Analytics provides the filter for finding patterns and deriving clarity.

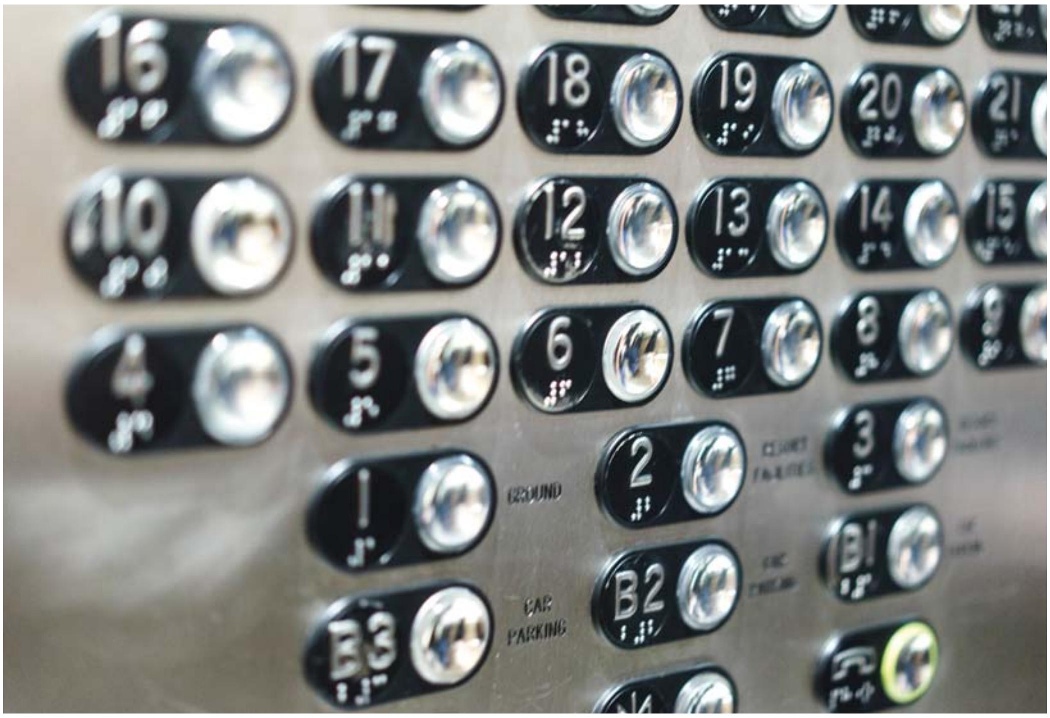
For example, I am working with a company that conducted an employee and client satisfaction survey. I encouraged the company's managers to look at both surveys together, because many of the issues may be related and it makes sense to look for commonalities. I helped them to look for the value-adding activities that contribute to satisfaction and retention on the part of employees and customers.

Employees may be unsatisfied because they don't have the training or skills to serve customers appropriately, and the customer may not be satisfied with the

Handerson Mwandembo is a Consultant with PwC Kenya's Technology Advisory practice.

mwandembo.handerson@uk.pwc.com

Data-driven organisations know that the processes driving data collection are just as important as the analytics-enabled filters that deliver insight. This is just as true for assessing human resources as it is for measuring client satisfaction, and the benefit is often improved retention.



level of service that they are getting from the company. At PwC, we would look at training opportunities that would make employees feel more confident and allow them to serve customers more effectively. This can have a far greater impact than an incremental salary increase or bonus programme.

Kenya's CIPS sector includes many companies with large sales forces. For the CEO at one of those companies, his biggest headache is financial management among his sales force. His managers get calls from the sales team when they run out of bus fare. We talked to him about raising the bar and improving financial acumen among the sales team, so that they can work more productively and in a more sophisticated way.

The company is now using a learning management system to provide relevant training and the outcome has been a sales force that is more capable of managing themselves. They can also talk more intelligently with their clients. This is working to improve retention among the sales force, as well as delivering greater sales and satisfaction to customers.

Workforce planning and retention are common challenges for companies in Kenya's CIPS sector. Retail companies, manufacturers and agribusinesses tend to employ large numbers of people at any given time.

These types of companies may have two workforces, at a basic level, where they employ a workforce on a permanent basis and another workforce on a more flexible basis, depending upon distribution channels, weather, seasonal production and many other factors.

For these companies, recruitment, retention and performance assessment benefit from an approach to workforce planning that is data-driven.

Many business growth strategies tend to focus on capital asset investments. Human capital investments are just as important as plans to hire a chemical engineer, a financial controller, a team of retail sales associates or lorry drivers.

Some investments in human capital will be more high-value than others, and the outputs expected will vary. For an employee who clocks in and clocks out, the number of hours that they work or the output that they produce is measurable. For knowledge workers, the output may be less tangible. An issue that can be missed in both cases is performance measurement.

How do companies assess the value and input of human capital?

CIPS companies can address this question by shifting their focus to planning and measurement. Many company managers assume that the deciding factor for retention is salary. Measuring performance is more challenging and assessing value and input is even harder, but we have found that employees whose performance is measurable and whose value is recognised tend to stick around longer. Some of the common obstacles to measurement and assessment are self-selection bias and systemic bias.

Companies distinguish themselves on the basis of processes, but these processes themselves can derail efforts to gain insight from data. 'Garbage in, garbage out' is common IT vernacular for data-driven processes that are fuelled by rubbish data and produce rubbish results.

Data-driven organisations know that the processes driving data collection are just as important as the analytics-enabled filters that deliver insight. This is just as true for assessing human resources as it is for measuring client satisfaction, and the benefit is often improved retention.

Facing the future full-on: Kenya's internal audit profession of tomorrow

In an environment of rapid change, many organisations rely on the concept of "True North" to help them stay on track with their strategic vision.

Sydney Ondari is a Manager with PwC Kenya's Risk Assurance Services practice and helps internal audit functions to face the future and become trusted business advisors.

+254 (20) 285 5194
sydney.ondari@ke.pwc.com

The concept originated decades ago from the Toyota Production System but today has evolved to mean using innovation, self-reflection and the ability to ask critically, 'What should we do?' in order to maintain focus.

This is relevant for internal audit functions in Kenya because we have seen the effects of empowered internal audit functions adding value to their organisations. And also the effects of those that do not.

Many internal audit functions are constantly raising the bar on what they deliver to the business. In return, they expect that the organisation's perception of the value of internal audit will also improve. Sometimes, however, this is not the case. Internal auditors may not feel recognised for their contributions. Generally this is because their role or function is not well integrated or valued within their organisation. The good news is that this can change.

In some cases the disconnect between expectations and perception is the result of audit functions' maturity. Other times, internal audit is viewed as a support function and internal audit does what it is required to do.

The risk of down-playing the significance of internal audit is that the function can seem like the organisation's policeman or investigator. This affects the value of internal audit as a function; much of their work is dictated by cost-saving initiatives (e.g., "find the fraud") rather than value-driven initiatives ("prevent it in the first place").

Internal audit can become a trusted advisor to the business. Before embarking upon a strategic direction, internal audit can provide oversight and business acumen.

At the tail end of a strategic shift, internal audit can give management and the Board a view of what went right and what did not. As the so-called third line of

Part of establishing the relevance of internal audit is articulating clearly what internal audit can do to support the business more effectively.

defense, internal audit can maintain an objective and independent perspective of great value to management.

The world today is heavily technology-oriented. Internal audit functions cannot deliver sufficient value if they are not tech-savvy. Some of the skills needed now are related to the tools used to conduct audits, including continuous auditing techniques, while others relate to data analytics and getting more assurance on the organisation's activities and those that bear risk to the organisation.

It is the obligation of internal auditors to appreciate the information available to them, decide how distinct data sets sitting in several systems and database tables affect each other, choose the relevant data environments to assess, establish critical modules to analyse and develop an internal audit plan and procedures that covers 100% of the relevant data.

"Big data" can assist senior management and boards of directors to develop a better understanding of the effectiveness of the organisation's risk management and compliance activities. Incorporating data analytics into internal audit can therefore benefit internal auditors by enhancing the value that they provide to their stakeholders, through better-quality testing techniques and a data-focused analysis of design and operational control activities around risks facing business processes.

A directed emphasis on data analytics can provide significant capabilities to enhance internal audits. These enhancements include an improved testing of business processes and controls using 100% of the data population, dashboards that deliver better insights to senior management, regarding operations and enabling the quantification of the impact of deficiencies in controls.

Partly internal audit functions are constrained by their budgets (or lack thereof). Internal audit is not a revenue-generating function. But an internal audit function's budget should be driven by what the function is expected to do and the needs and strategy of the business, including the risks that the business faces.

If the operational focus of internal audit—it's True North—is defined as transactional, then the type of skills and associated budget will also be constrained by this mandate. Part of establishing the relevance of internal audit is articulating clearly what internal audit can do to support the business more effectively. This will then inform a budget for internal audit that makes sense.

With the right training, skills and budget, internal audit functions can shift to be more future-facing and help management to achieve strategic objectives. They can embrace technology to deliver better services more effectively and efficiently. This is the True North for many of Kenya's internal audit functions.

One thing is certain: by defining their True North, Kenya's internal audit functions can face the future with confidence.

How to catch fraudsters with data analytics

Management of fraud and fraud-related activities such as corruption are a major concern for businesses in the region. The challenges facing the regulatory and operational environment in the Consumer and Industrial Products and Services (CIPS) sector, particularly in Kenya, have significantly evolved over the years with more and more players coming into the market.

Similarly, economic crimes have evolved in both sophistication and impact and these trends are threatening the survival of major businesses in the region. Data analytics is an important part of proactive fraud risk management.

Many organisations are at risk from fraud and vulnerable to its impact, which could include loss of goodwill, reputation and customer and regulator relations. All these may have an impact on a brand's value.

The need to manage and reduce the possibility of this negative impact cannot be overemphasised. Organisations should therefore always be conscious of the constant threats of fraud, whether perpetrated internally or by other business partners such as suppliers and customers.

Johnstone Masila is a Consultant with PwC Kenya's Business Recovery Services practice.

+254 (20) 285 5285
johnstone.mwendwa@ke.pwc.com

Data analytics may help organisations to tackle this ever-evolving threat. Leveraging data analytics may help organisations track compliance to regulatory frameworks on major economic issues such as corruption, money-laundering, and competition/anti-trust laws on both the global and local levels.

How can data analytics help?

Indicators of potential fraud or corruption lie within an organisation's financial, operational and transactional data. However, these data records are held in dissimilar applications and data sources and it would require tracking a specific transaction across different applications and systems to effectively test and monitor controls.

Current internal control systems therefore have inherent weaknesses in their inability to match these data records and have, in effect, enabled fraudsters to thrive without being detected. This has made the fraudsters bolder with higher losses being reported over time.

The rationale in data analytics is the examination of data patterns and flagging unexpected occurrences that could indicate potential fraud. Seemingly unrelated data records could therefore be flagged for investigation.

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Hypothetical example

Due to the reactive approach adopted by many businesses, it is common to find serious policy breaches that are not easily detectable but could adversely expose the organisation. For instance, the lack of segregation of duties between the user/initiator of a service and the approver of the payment for the same service presents a serious control weakness. In dire cases, these individuals would have personal interests in the entity or entities providing the service. The exposure to the business is crystal clear in this scenario.

In addition, there are common behavioural patterns by perpetrators of fraudulent acts which may not be uncovered by typical auditing procedures/controls. Some of these behavioural patterns include: processing of transactions at specific times and/or periods; processing of transactions below certain thresholds; repeat purchases from one entity for similar products; staff not taking leave for extended periods of time, and others.

Data analytics may assist in identifying some of these patterns in advance from the various data records (e.g. leave records, procurement, declaration of interest records, etc.) and serve to raise a red flag leading to deeper investigation.

The bigger picture

Assessing this hypothetical example reveals the value of forensic practitioners' Fraud Triangle and its three corners. The three corners represent the conditions that have to be met for an employee to commit fraud: first, the incentive/pressure to commit fraud; second, the opportunity and third, the rationalisation of the act. Our hypothetical example highlights the ability to both request and approve payments (potentially to an entity the person has interest in). The risk of fraud could be attributable to laxity in keeping records of conflicts of interest in relation to employees, a common oversight among many organisations. The incentive would be the cash gain; the rationale could be that he/she is underpaid. An effective fraud risk management plan may minimise the occurrence of these three factors. Data analytics may be able to analyse patterns across all three corners of the Fraud Triangle.

Corner one: Incentive/pressure to commit fraud

The incentive/pressure to commit fraud revolves around life challenges such as the need to achieve certain financial goals/obligations or being faced by certain personal pressures such as debts and/or lavish lifestyles. The employees would therefore be looking for a way to solve the grey challenges/ problems they could be facing.

Data analytics may assist in identifying potential indicators to underlying incentives/pressures that may lead employees to commit fraudulent acts. Some of these indicators may include: significant deductions towards personal debts on employee payslips; inability to meet performance targets or general underperformance.

Corner two: Opportunity

The 2014 PwC Global Economic Crimes Survey (GECS) reports economic crimes prevalence in Kenya at 52%; this is higher than the Africa average of 50% and substantially higher than the global average of 37%.

At 73%, the survey highlights 'opportunity' as the largest contributor among the three legs of the fraud triangle. It further indicates that, of the three factors, it is opportunity that is most within an organisation's control. This is because opportunity is presented by weaknesses in the implementation of an organisation's internal controls.

Data analytics may be able to map patterns that present breaches to standard procedures by mapping records from the financial, operational and transactional data records. For instance, records on conflicts of interest would be used to flag interactions on transactions in which certain employees have intrinsic interests.

Corner three: Rationale

For less-than-optimal decisions, employees would go through a justification process about why they need to take the action they are taking. Some of the justifications include being underpaid or that "everybody is doing it".

What more needs to be done

Most organisations are reactive in their approaches to fraud risk management. Data analytics can help to detect fraud earlier and to augment existing fraud prevention programmes. However, other proactive approaches such as having a fraud risk management strategy and conducting periodic fraud risk assessments to identify vulnerabilities in internal controls are equally critical.

We have found that fraud-related issues recur across organisations and have essentially included either one or a mix of the following:

- Misappropriation of assets (a major concern has been the pilferage of stock, including both raw materials and finished goods),
- Fraudulent disbursements/Abuse of purchase cards,
- Abuse of positions/Conflicts of interest,
- Fictitious credit notes,
- Financial misstatements,
- Defrauding an organisation's customers and
- Abuse of marketing material and related benefits (e.g., travel allowances), among others.

The major factor that we have observed is weak internal controls. We strongly recommend that organisations adopt Fraud Risk Management Strategies that would address recurring risks. The strategies should detail how reports on possible fraudulent activities are received and handled.

Data analytics would significantly boost the reporting cycle that has previously and primarily relied on anonymous tips and/or mere chance detections through generation of internal management alerts. To ensure efficacy of these strategies, management should take the overall responsibility and ensure employee awareness and commitment to fraud prevention, detection and deterrence. This can be achieved through Fraud Awareness Training.

In conclusion, early detection and prevention form the basis of an effective fraud risk management programme. Data analytics compounded with periodic fraud risk assessments may assist in identifying vulnerabilities before they become a catalyst for economic crime. It is the ultimate responsibility of the Board, however, to set the 'tone at the top' and ensure that an organisation develops and implements a comprehensive fraud risk management programme.

Why should organisations worry about payroll compliance?

Employees are an integral part of a company's operations and in most organisations payroll costs constitute the largest financial obligation. Many employers rely on the skills of payroll professionals to pay billions in form of wages, benefits, statutory remittances and retirement benefits on an annual basis.

Compliance with various payroll obligations is critical as non-compliance may result in employers incurring not only significant penalty costs but also reputational risks. Non-compliance can raise questions about a company's internal controls and corporate governance.

Bearing in mind that payroll is one of the biggest expenses in most organisations; compliance with payroll taxes, employment laws and regulations is inevitable. It is therefore critical that the payroll aspect of an organisation's business should be in the hands of competent employees or professionals who have the relevant qualifications, experience and expertise.

Changes in technology and legislation over the years have affected the way the payroll is handled today and more importantly, by whom and how it is done.

It is unfortunate that the "old school" work processes where payroll administration is seen as a back office job which requires little expertise - an 'add-on' to someone else's job is still in existence. For a number of organisations, the payroll administrator is often someone in the finance department who is given this extra responsibility. It still is a back office job which receives very little recognition and attention.

Changes in technology and legislation over the years have affected the way the payroll is handled today and more importantly, by whom and how it is done. Further, the global economies are evolving and the sophisticated tax regimes around the globe have resulted in much more complex payroll functions. In this new environment, payroll has now become a priority business process that should be managed well.

With the ever evolving remuneration structures, tax legislations with punitive penalties for non-compliance, it is surprising that until recently, there has been little focus on the importance of the payroll function. Not keeping abreast with changes in the legislation, accurate preparation of payrolls and timely remission of statutory deductions to the various authorities exposes organisations to many business risks. In light of the

Andrew Ondieki is a Tax Manager in PwC specialising in Personal Tax Services.

+254 (20) 285 5117
andrew.m.ondieki@ke.pwc.com

potential exposure associated with non-compliance, organisations should approach professionals to carry out regular checks in order to mitigate against any risk brought about by this. .

Challenges

One of the key issues that businesses need to determine is the relationship that exists between the business and the person performing the service in order to accord the resultant remuneration the correct tax treatment. Workers can be classified as an employee or an independent contractor. A correct classification is important as the tax treatment for each category is different. Employers are therefore encouraged to seek professional advice in order to avoid exposing their business to tax liabilities.

Another challenge is the payroll administration of expatriate staff who may be entitled to receive cross border compensation elements such as split remuneration, stay-at-home pay, assignment cash allowances, retirement benefits, performance bonuses and employee share option schemes.

A number of benefits are set out in the organisation's global compensation structure for expatriate employees and may not be visible to the local payroll administrator. The payroll function must ensure that they properly understand and determine payroll obligations for the various sources of compensation and ensure that employee compensation is properly considered for tax and all other statutory withholdings.

Payroll set up becomes a challenge where the payroll administrator has little knowledge of the payroll software in use, lack of proper and accurate payroll records for the employees and the "payroll is easy" attitude and therefore not seeking advice from professionals at the appropriate time.

How can an organisation be complaint?

For payroll compliance to be achieved, the payroll, human capital and finance functions must create seamless processes and systems capable of real time reporting and error free information. This system should be strictly adhered to.

Payroll compliance can only be achieved if the personnel involved clearly understand their roles and have the necessary qualification, experience and expertise. The personnel should have a deeper knowledge and understanding of the payroll software and compensation structure as well as the tax implications.

Tax legislations differ from one jurisdiction to another. It is therefore important that multinational organisations consider a single provider for all their payroll processes as this will provide comfort and peace of mind that compliance, higher payroll processing standards and leverage on knowledge of local legislation by the providers.

Conclusion

An effective payroll system is not just paying employees on time, it includes ensuring the appropriate processes are in place to facilitate the determination of taxable remuneration components, required tax withholdings and remittances not forgetting proper filings within the stipulated times.

Organisations should therefore invest in qualified and highly versatile people and technology in order to minimise wastage and errors, maintain compliance with the ever changing regulations and protect the reputation and integrity of the organisation by remaining compliant.

Trust matters to Kenya's private company owners

Trust is essential to the success of private companies in Kenya. Private company owners can build trust in next-generation leaders, third party specialists, non-family managers and independent Board members to navigate change and ensure sustainability.

But building trust with so-called 'outsiders' can push private company owners out of their comfort zones and into uncharted waters.

Many of Kenya's private company owners believe that they share certain common characteristics like curiosity and creativity. They can foresee taking new risks as part of growing their business. Even so, in the day-to-day operational management of their companies, they can also be very conservative.

Our recent Private Company Survey sought the views of over 60 family-owned and private company leaders in Kenya and the majority of them say that their companies are more entrepreneurial than other types of companies.

Over 60% say that decision making is more streamlined in companies like theirs. Sometimes 'streamlined decision making' means that senior family members make all of the decisions, however. Empowering someone else to make decisions requires a high level of trust.

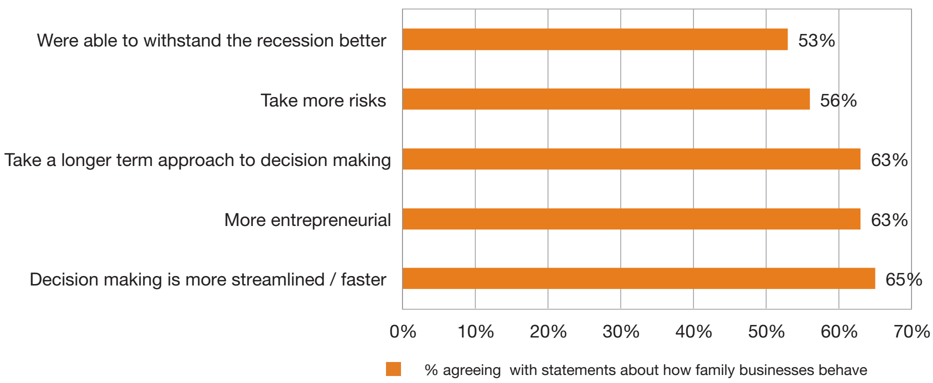
Opportunities

Most family-owned and private companies in Kenya are growing. In our survey, 69% reported growth over the last year and 88% expect to grow over the next five years.

Much of this growth is attributable to Kenya's low- and middle-income consumers, who exercise more and more purchasing power. Devolution is having a transformative effect on economic growth country-wide.

Many companies, including family-owned and private companies, are responding by developing packaging sizes, service lines and distribution channels in direct response to these consumers' needs and preferences.

2014 Kenya Private Company Survey:
Private company owners generally agree that their companies measure success differently



"Governance in our family business is a challenge. It can be incredibly difficult to exert any changes within the company or control expenditure as everyone makes their own decisions within senior management. Our profits would increase through better governance."

—2nd generation family business owner, Kenya

To meet demand and to grow economies of scale, businesses require financing. Options include leveraging assets, using cash reserves, or borrowing locally or from international financial institutions. Currency exposure poses a risk; raw materials and services can be sourced elsewhere but may require payment in hard currency.

These and many other considerations mean that business owners cannot afford not to place their trust in competent advisors.

Risks

Family businesses are also facing more risk and uncertainty. Risks like tax and regulatory change can be technically difficult and complex. There is also the risk of counterfeiting, which requires checks and balances to reduce exposure and innovations like product design to deter imitation. Third-party suppliers and their service-level agreements can also pose risks.

An emerging area of increased risk is IT security. Many companies lack capacity in terms of IT resourcing. (At least one business owner recently said, 'Once in a while, a certain guy comes in and works on some IT-related projects.')

They may not have any policies in place governing IT security or an information backup system in place. Managers use their home computers or Dropbox to save and share sensitive documents. Websites can be easy access points for hackers.

With regard to these and other risks, the issue of trust looms large. Part of the owner's agenda is trusting that someone else can make a decision and make it well on behalf of the business.

Agility

Trust is also key to the successful transition of ownership from one generation to the next, or from family business owners to new owners and managers. Trust manifests itself uniquely among Board members, and trust underpins many companies' reluctance to admit a non-family member to the Board.

> *"We want to attract equity investors who will come in to change the management process. We are looking to get more senior people into the company to help us expand into different markets."*
>
> **— 2nd generation family business owner, Kenya**

There is a lot of advice that independent, non-family Board members can provide to help build the business and challenge the company in new ways.

Competition is getting more intense for family businesses. Profit margins are under threat from multinational competitors—and other competitive family businesses.

Packaging, branding, inputs and documentation all require real focus as do expanding operations and new distribution channels throughout Kenya and the region. These and many other aspects of owning and running a business can benefit from trusted, third-party advice.

> *"Succession planning broadens the partnership base, but it is a challenge to get people to come into the business from outside."*
>
> **— Private company owner, Kenya**

Moses Nyabanda is an Associate Director of PwC Kenya's Assurance practice as well as a Private Company Services specialist.

+254 (20) 285 5394
moses.nyabanda@ke.pwc.com

Jamila Aroi is a Manager with PwC Kenya's IT Risk Assurance Services practice.

+254 (20) 285 5575
jamila.aroi@ke.pwc.com

Value Added Tax and Customs Duty: Challenges for sub-contractors in the Oil and Gas sector

The discovery of oil deposits in Ngamia 1 and Twiga 1 wells in Turkana County and a subsequent discovery of natural gas in Mbawa, Lamu County, in 2012, marked a critical turning point in the exploration history of Kenya.

Beatrice Wafula is a Senior Manager in Tax

+254 (20) 285 5217
beatrice.wafula@ke.pwc.com

The increasing prospect of commercialisation of oil and gas is a dream come true for our nation and a shot in the arm to government's ambitious development plans and national aspirations.

Energy has been singled out as one of the key enablers of Vision 2030. Energy security is a matter of national priority; expensive energy hinders the competitiveness of the economy by raising the cost of doing business. Full commercialisation of oil will not only bring down the cost but guarantee availability of energy to all sectors of the economy.

In this regard, the main players in the Oil and Gas sector are the contractors (the Licensee) and the sub-contractors. The contractors partner with the Government in the exploration and development of the potential petroleum resources and usually have the financial ability, technical competence and professional skills necessary to carry out the petroleum operations. The contractors enter into agreements, in the form of Production Sharing Contracts (PSC) in accordance with the provisions of Petroleum (Exploration and Production) Act, with the Government.

Thereafter the licensed oil exploration and production companies are allocated 'oil blocks' by the Ministry of Energy and Petroleum. The contractors then source for partners to complement the acquisition of technology, technical services such as seismic, gravity and geological surveys and assistance in financial resourcing.

Due to huge costs and the use of technology, equipment and the technical services at various levels of drilling of oil wells, the contractors enter into agreements with sub-contractors who own specialised and expensive equipment and employ specialised and experienced staff.

These sub-contractors' business is to serve the oil companies by providing the necessary equipment and services.

In light of the significant cost outlay in the sector and in order to encourage investment in prospecting and exploration, the government has provided tax incentives for the sector which are embedded in the Income Tax Act (IT), Value Added Tax Act, 2013 (VAT Act) and the East African Community Customs Management Act, 2004 (EACCMA).

2012

year natural gas was discovered in Mbawa, Lamu County

Legislation

The EACCMA provides for general customs duty exemption for machinery, spares and other inputs (excluding motor vehicles) imported by a licensed company for direct and exclusive use in oil and gas prospecting and exploration activities upon recommendation by a competent authority of a partner state. In turn, the VAT Act, 2013 exempts taxable supplies (i.e. goods), excluding motor vehicles, imported or purchased for direct and exclusive use in oil and gas prospecting or exploration activities.

Contractors

The contractors are permitted to import materials and equipment to be used solely in carrying out petroleum activities and the same shall be exempt from Customs Duties, VAT and Import Declaration Fees provided the Ministry of Energy has certified that the relevant goods are to be used solely in carrying out petroleum exploration activities. Local purchases of goods by contractors are also exempted from VAT.

Full commercialisation of oil will not only bring down the cost but guarantee availability of energy to all sectors of the economy.

Similar VAT exemption is however not available for the importation or local purchase of technical and specialised services. Instead, contractors who import and purchase locally the same from sub-contractors will be required to account for VAT at 16%.

It should be noted that under the repealed VAT Act, a remission was granted by the Minister of Finance for goods, motor vehicles, aircraft and taxable services imported or purchased by contractors. The effect of remission was to make the supplies of taxable goods and services zero rated.

Zero rating makes supplies free from VAT since the supplies are not charged output VAT while the VAT incurred in the inputs is refunded. The sub-contractors were therefore allowed to supply goods to contractors free from VAT while being allowed to deduct their full VAT inputs. The remission also applied to services. This differs from exemption that is granted in the VAT Act 2013.

In spite of the fact that the sub-contractors do not charge output VAT to contractors, the sub-contractor cannot currently deduct input tax and the same is factored into the cost of such supplies. In addition, the exemption does not cover

5.625%

payments to non-resident mining subcontractors will now be subject to withholding tax at the rate of 5.625%

taxable services supplied to contractors, which was covered by the remission in the repealed Act.

Services form a substantial amount of the inputs required for drilling of wells. Contractors are therefore worse off in the current VAT regime than they were before.

In the Finance Bill 2015, payments to non-resident mining subcontractors will now be subject to withholding tax at the rate of 5.625% (this is final tax) on the gross amount of the service fees. This aligns the taxation of mining subcontractors to that of the oil and gas subcontractors in the extractive sector.

Sub-contractors

The government's intention is to make the country's extractive industry attractive to investors/contractors.

Whereas the PSC provide for exemption from Customs Duty and VAT on taxable supplies (taxable goods and taxable services), imported or purchased locally by both the contractor and sub-contractor, the VAT Act and EACCMA limit such exemptions to contractors. This in effect implies that sub-contractors do not enjoy any special treatment under the EACCMA and VAT Act.

As outlined above, since the VAT Act does not provide for the exemption of imported or purchased taxable services, the sub-contractors who supply the said services to the contractors will have to account for VAT at 16%.

This becomes a challenge to the sub-contractors since their supplies will consist of both exempt goods and taxable services ('mixed' supplies) and as such will be required to apportion the input tax and deduct the portion that relates to taxable services.

The proportion of VAT that relates to exempt supplies is not deductible and this cost is transferred to the contractor. The entire VAT on services is also transferred to the contractors.

This position is contrary to the treatment of the supply of taxable goods and services by sub-contractors to the contractors under the repealed VAT Act. The then Act provided for VAT remission in relation to such supplies. This enabled the sub-contractors to claim their entire input tax as a result of which sub-contractors were at an advantaged position to supply taxable goods and services to contractors at a much lower cost during the prospecting and exploration phase.

In addition, during importation of exploration and production equipment, sub-contractors pay all customs duties (IDF, Import duties, VAT). This is in spite the fact that the equipment is exclusively used in exploration and production activities. This makes their supplies non- competitive. This additional cost of taxes inevitably ends up being absorbed by the oil companies.

Practices in other jurisdictions

Mozambique recently made discoveries and is comparable to Kenya. The VAT rate is 17%. It is levied on the local supply of all goods and services as well as on the imports with a few exceptions. The VAT regime was recently changed to exempt the acquisition of services related to drilling, exploration and construction of infrastructures within the oil industries during the exploration phase.

Ghana commenced commercial production in 2010, although exploration began much earlier. Value Added Tax and National Health Insurance Levy (VAT/ NHIL) in Ghana is at a rate of 15% and 2.5% respectively on taxable supply. Under most Production Agreements, contractors and sub-contractors are not subject to VAT. The Ghana Revenue Authority (GRA) has provided a mechanism through which contractors are relieved from paying VAT.

Under this mechanism, the GRA provides VAT Relief Purchase Order forms (VRPOs) to contractors, which the contractors in turn complete with any VAT amount charged on invoices issued to them by sub-contractors and furnish to those providers in lieu of cash settlement of VAT charged. By this process no cash outlay is made in respect of VAT charged.

A sub-contractor is required to charge and account for VAT on their services and deduct any input VAT incurred. Given that services are provided mainly to contractors (which do not settle VAT in cash), sub-contractors often have significant VAT refunds due to them. The sub-contractor can make a claim to the GRA for any refund due.

The GRA will however conduct an audit to confirm the refund amount before making the refund. In addition, contractors and sub-contractors are exempt from the payment of customs duties, except for minor administrative charges, on all items of plant, equipment and materials intended to be used solely for petroleum activities. If such items are subsequently sold within Ghana, import duties would apply.

Way Forward

Why would Kenya provide tax incentives to contractors while disregarding the sub-contractors whose supplies influence the ultimate cost of exploration operations? The benefits the sector expects to reap from exemption cannot be fully realized if the law only applies to contractors because most goods and services are supplied by sub-contractors. The tax costs borne by the sub-contractors shall be transferred to the oil companies, making exploration expensive and less attractive.

In order for the sector to reap the full benefits of exemption, both contractors and sub-contractors should be exempted from VAT and Customs duties at the investment stage, prior to production.

The only condition should be that the exempt supplies should be used exclusively in oil prospecting and exploration activities. All the goods (including motor vehicles, aircrafts) and services, which form a substantial proportion of the cost, should be exempted from VAT and import duties. The intentions captured in the PSC should have the full backing of tax legislation.

17%

VAT rate that is levied on the local supply of all goods and services as well as on imports with a few exceptions in Mozambique.

Globalisation and its tax discontents

With globalisation continuing apace and countries (both developed and developing) struggling with financing budget deficits, the taxation of multinational corporations (MNCs) is yet again in the global spotlight.

Herein lies the tension that has always existed in the international tax code, between the allocation of taxable profits generated from cross border trade between the residence states (often the developed countries) and the source states (often the developing countries)—without creating double taxation of the MNC.

Historically, double taxation has traditionally been managed by limiting the incidence of withholding taxes and creating a high threshold for the creation of permanent establishments. This sounds like a very technical and precise system so why then has the international tax system been so heavily criticised in recent years?

To answer these questions, we need to begin with a simpler one: How should MNCs be taxed?

One possible answer is that they should be primarily taxed in their home country because most of the "important" work is done in the head office of their home country. But perhaps they should be taxed in the country where they are expanding into because that activity is

the source of their sales and income. Or maybe they should they be taxed in both their country of residence and the source of their sales and income because both the residence and the source country are entitled to tax the profits of the MNC since the residence country is the principal place of domicile and the source country is the place where profits are generated.

Although it may sound like a reasonable compromise, this final scenario would lead to an extremely high tax rate for the MNC and tremendously increase the tax costs of doing business cross border.

Alice Muriithi is a Senior Manager with PwC Kenya's Tax practice, specialising in Transfer Pricing.

+254 (20) 285 5677
alice.k.muriithi@ke.pwc.com

Why are many countries, both developed and developing, so unhappy with the current international tax system?

We can further ask: Why are many countries, both developed and developing, so unhappy with the current international tax system?

As recipients of technical and management assistance, intellectual property and debt finance, developing countries have relied on withholding tax mechanisms and permanent establishment rules as contained in double tax treaties to try and ensure that payments out of their countries do not erode their tax base. There is an impression that the porous definitions in the double tax treaties and the vast array of double tax treaties at the disposal of MNCs have more or less rendered these taxing mechanisms ineffective (though very well intended).

Consequently, developing countries are now increasingly unhappy with the level of payments out of their countries in respect of management fees, royalties and interest and there is a nagging feeling that while these may have started off as legitimate tax deductions, they are now primarily intended to reduce tax costs.

Developed countries are also an unhappy lot. While their MNCs have been levying their foreign subsidiaries with interest and royalties, they have not seen much of this income accruing on their end. Where did all of this income disappear to?

Against this complicated background of competing interests and serious concerns, the OECD in July 2013 was mandated with the task of updating the global tax system to take into account the nature of international trade and prevent abuse of the tax system.

This led to various work streams to address the core areas identified: base erosion, double non-taxation, treaty abuse, permanent establishments and transfer pricing reform which are collectively and commonly referred to as BEPS (Base Erosion and Profit Shifting). On 8 October 2015, the G20 Ministers sitting in Lima, Peru endorsed the OECD's final package of a comprehensive, coherent and coordinated reform of international tax practices.

Some of the BEPS reforms mean that payments such as royalties and interest to offshore locations will only be justified where these are commensurate with the economic value created offshore. The days of payment of excessive interest to tax haven "cash box entities" or payments of brand royalties to an offshore company whose only employee is the Company Secretary have certainly come to an end.

The BEPS reforms also endorse tax transparency and availability of information in order to equip revenue authorities with information to make determinations on value creation. Country by Country Reporting is an initiative that is expected to promote the tax transparency agenda.

The OECD's BEPS agenda of legislative reforms is already having an impact in Kenya, with more changes coming soon. This is the subject of another discussion, but for now at least there seem to be more answers forthcoming on the key questions about international taxation.

About PwC

At PwC, our purpose is to build trust in society and solve important problems. We're a network of firms in 157 countries with more than 208,000 people who are committed to delivering quality in assurance, tax and advisory services. Find out more and tell us what matters to you by visiting us at www.pwc.com

In Africa, we're the largest provider of professional services with offices in 31 countries and over 8,000 people. This enables us to provide our clients with seamless and consistent service, wherever they're located on the continent.

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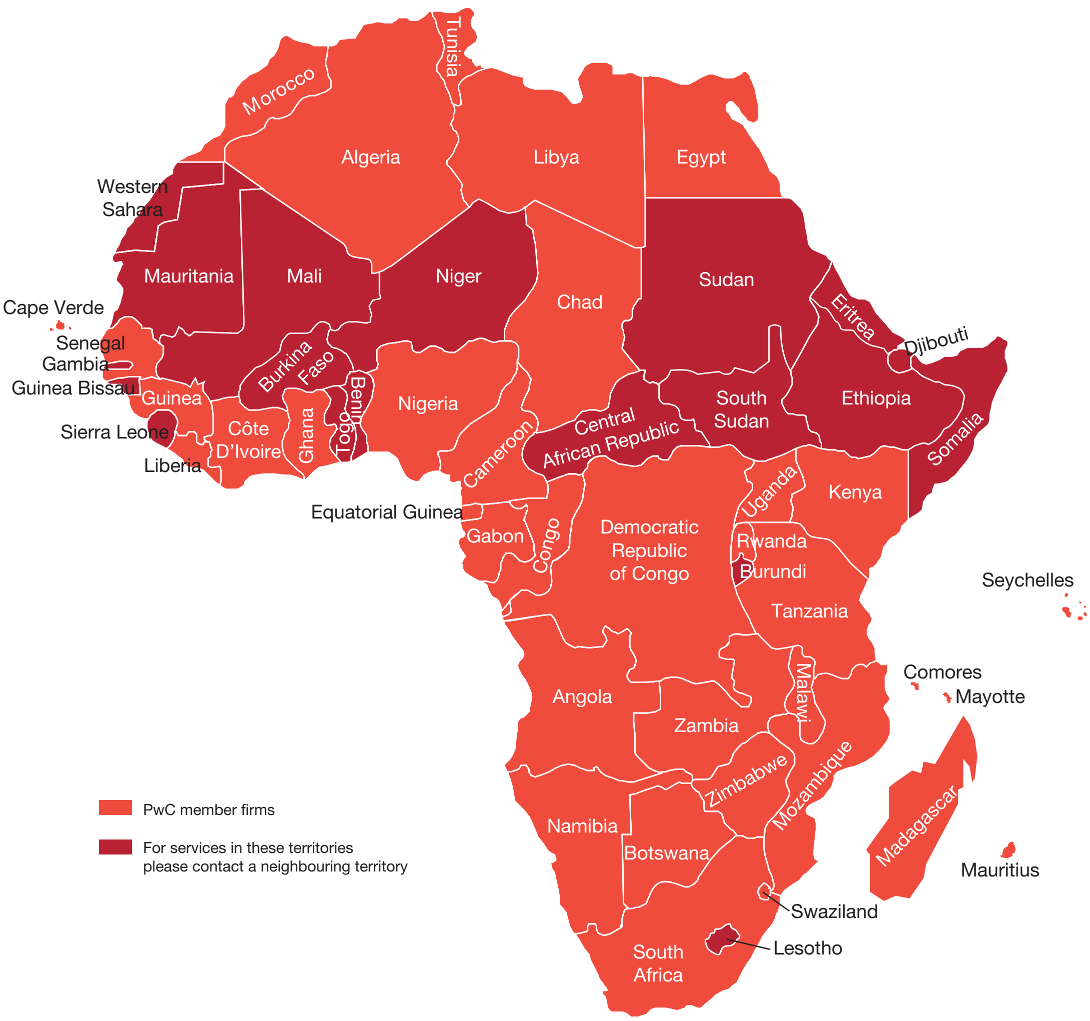

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