Contents

Foreword 4
IFRS 9: Not just a new standard, but a new way to manage credit risk 6
Recovery and Resolution Planning 18
Strategic Cost Management 23
Tax issues affecting insurance companies 29
Transfer Pricing issues within the Financial Services Industry 33
Real estate: Building the future in Africa 38
Money laundering and regulation 47
The new auditor reporting standard 52
Foreword
Nigeria was hit hard by the 2014 fall in oil prices. This coupled with early tensions over the outcome of the 2015 general elections which was regarded as being highly successful and the threats from Boko Haram insurgency had resulted in a slow pace of economic momentum in 2015. As we draw towards the end of 2015 and begin to look at the economic horizon in 2016, a combination of policy stagnation, lower oil prices and declining value of the Naira will affect the economic landscape of the country.

The second edition of our Nigeria Financial Services Journal focuses on what the future landscape of financial services in Nigeria might look like. In this publication, we touched on some immediate challenges facing Financial Institutions (FIs) around cost management and gave our insights on how CEOs can move beyond ‘cost cutting’ to ‘cost restructuring’ thereby achieving more sustainable results.

The requirements of IFRS 9 offer FIs an opportunity to improve on the level of sophistication of valuation models that are being used. In our view there are challenges we envisage that financial reporters would have to grapple with as Nigeria moves closer to the IFRS 9 adoption deadline.

The banking crisis of 2009 reminded us of the reality of having failed financial institutions and the attendant economic hardship it can cause. Nigerian banks that are deemed to be ‘too big to fail’ have until 1 January 2016 to submit their first set of Recovery Plans to the regulators. We examine the elements of a robust recovery plan and point out that those responsible for governance would do well to lead the charge towards creating such a plan.

Investment returns from real estate in Africa’s rapidly expanding economies significantly exceed those achievable in most other developed markets. The Nigerian real estate market mirrors what is happening elsewhere in Africa and is projected to grow at an average 10% in 2015 driven mainly by the ever growing middle class. Real estate investing in Africa is not without its risks, but we make a case that it is only investors that are able to navigate the risks that would reap the rewards.

Anti-Money Laundering (AML) regulations and the need for compliance are increasingly becoming the focal point of regulators as they impose tighter restrictions on banks aimed at curbing the menace caused by money laundering. As regulators adopt a global collaborative risk-based approach to their monitoring of compliance with money laundering rule, it is clear that regulatory action in one territory can quickly lead other territory regulators to take action against defaulting financial institutions. Hence there is a case for financial institutions to “act local but think global” as they take action to revamp their AML regimes.

We examine as well the tax regime currently in place for Nigerian Insurance companies which we believe are unduly at a tax disadvantage when compared with other companies in the financial services sector.

The current Transfer Pricing regulation clarifies rules in the various Tax Acts around transactions between related parties and emphasizes the need for taxable entities to observe the arm’s length principle.

Finally, we examine the new auditor reporting standard issued by the International Auditing and Assurance Standards Board (IAASB) and highlight what will be changing in the auditor’s report going forward.

I hope this publication gives you some insight into the future of financial services in Nigeria. As always, we welcome your comments and feedback regarding this publication as we look forward to discussing these and other rising trends affecting the financial services market with you.
IFRS 9: Not just a new standard, but a new way to manage credit risk
Costa Natsas
Partner
PwC South Africa
costa.natsas@za.pwc.com

Stephen Owuyo
Associate Director
PwC South Africa
stephen.x.owuyo@za.pwc.com

Omobolanle Adekoya
Partner
Capital Market & Accounting Consulting
omobolanle.adekoya@ng.pwc.com

Corné Conradie
Senior Manager
PwC South Africa
corne.conradie@za.pwc.com

Adeoye Ojuroye
Senior Manager
Financial Services
adeoye.ojuroye@ng.pwc.com
After lengthy deliberations, the IASB published the complete version of IFRS 9 Financial Instruments, which replaces most of the guidance in IAS 39. The IFRS 9 standard dealing with impairment requires the recognition of credit losses based on expected credit losses:

- Either 12-month or lifetime expected credit losses for:
  - amortised cost assets,
  - debt instruments at fair value through other comprehensive income (FVOCI) and
  - loan commitments and financial guarantees.

Credit losses will no longer be limited to the ‘incurred losses’ currently recognised under IAS 39.

The new standard outlines a three-stage impairment model based on changes in credit quality since initial recognition.
**Stage 1** includes financial assets (loans) that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date (i.e. investment grade assets). For these assets, 12-month expected credit losses (ECLs) are recognised and interest revenue is calculated on the gross carrying amount of the asset (i.e. without deduction for credit allowance). Twelve-month ECLs are the expected credit losses that result from default events that are possible within 12 months after the reporting date. These are not the expected cash shortfalls over the 12-month period, but the entire credit losses on assets weighted by the probability that the loss will occur in the next 12 months.

**Stage 2** includes financial assets that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date), but that do not have objective evidence of impairment. For these items, lifetime ECLs are recognised, but interest revenue continues to be calculated on the gross carrying amount of the asset. Lifetime ECL is an expected present value measure of losses that arise on default throughout the life of the asset.

**Stage 3** includes financial assets that have objective evidence of impairment at the reporting date. For these items, lifetime ECLs are recognised and interest revenue is calculated on the net carrying amount (i.e. net of credit allowance). The standard requires that when determining whether the credit risk on a financial asset has increased significantly, the bank considers reasonable and supportable information available to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial asset.
Challenges in the implementation of IFRS 9

What does it mean to implement IFRS 9? What are some of the questions that you should be asking to stir up debate or action in your organisation? We look at both the technical and operational challenges that we anticipate and that we are seeing the industry grapple with as it plans to implement this new standard.

Implementation of the standard, which is mandatory for annual periods beginning on or after 1 January 2018, presents a host of technical and operational challenges, which we analyse below.

Technical challenges of applying IFRS 9

Criteria for moving between the stages
When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition, management looks at the change in the risk of a default occurring over the expected remaining life of the financial instrument, rather than the change in the ECL. A bank should compare the risk of default as at the reporting date with the corresponding expected risk of default that was estimated as at the date of initial recognition.

In our opinion, a simple or absolute comparison of the probability of default (PD) at initial recognition (average PD used for pricing purposes) and at the reporting date is not appropriate. All other things staying constant, the PD of a financial instrument changes with the passage of time. Banks therefore need to consider the relative maturity of a financial instrument at inception and at the reporting date when comparing PDs.

Moving from delinquency only models to forward looking models
IFRS 9’s expected loss model requires banks to consider forward looking information and expected future level of risk to determine 12-month and lifetime ECLs.

The model can be applied at an individual or portfolio level. However, some factors or indicators may not be identifiable at an instrument level. This might be the case for financial instruments such as retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument basis until a customer breaches the contractual terms.
In such cases, the factors or indicators should be assessed at a portfolio level. Management cannot avoid calculating lifetime ECLs by considering the assessment at an individual asset level only if information available at portfolio level indicates that there has been an increase in credit risk for the instruments included in the portfolio.

There will be limited instances in which delinquency only models (i.e. models that ignore forward looking information) will be appropriate under IFRS 9. However, if information that is more forward-looking than past due status is not available, there is a rebuttable presumption that credit risk has increased significantly since initial recognition no later than when contractual payments are more than 30 days past due. This presumption may be rebutted and banks will need to consider for which products they wish to collect reasonable and supportable evidence to rebut the presumption that there has been a significant increase in the credit risk.

**Off-balance sheet items**

IFRS 9 has removed the distinction that existed under IAS 39 between off-balance sheet credit exposures (loan commitments and financial guarantees) and on-balance sheet exposures. Banks will in future have to apply the ECL model to both on-balance sheet exposures as well as off-balance sheet exposures, such as loan commitments and financial guarantees.

IFRS 9 requires the ECLs to be measured over the maximum contractual period over which the bank is exposed to credit risk. However, as an exception, for certain revolving credit facilities such as credit cards and overdrafts, ECLs will be measured over the period the bank is expected to be exposed to credit risk. This would be driven by customer behavior and demonstrated credit risk mitigation actions implemented by the bank. Therefore, IFRS 9 requires banks to model behavioural exposure at default (EADs) for revolving credit facilities. Banks will need to determine for which type of facilities a behavioural EAD is required and the period over which the EAD should be modelled. This assessment will require significant judgment and expertise.

**Adapt existing models or build new ones**

As discussed above, the standard allows banks to make the assessment of changes in credit risk by using a 12-month PD where it would not be expected to give a different result to using a lifetime PD. This does not mean that the 12-month PD used for regulatory purposes can be used without adjustment.

Twelve-month ECLs used for regulatory purposes are normally based on ‘through the cycle’ (TTC) probabilities of a default (that is, probability of default in cycle-neutral economic conditions) and can include an adjustment for prudence. The PDs used for IFRS 9 should be ‘point in time’ (PiT) probabilities (that is, probability of default in current economic conditions). Regulatory PDs might be a good starting point, provided they can be converted to an IFRS 9 PDs.

Under IFRS 9, estimates of PD will change as an entity moves through the economic cycle. Under many regulatory models, as PDs are calculated through the cycle, estimates are less sensitive to changes in economic conditions. Therefore, regulatory PDs reflect longer-term trends in PD behaviour as opposed to PiT PDs.

As a consequence, during a benign credit environment, IFRS 9 PD (PiT) will be lower than regulatory PD (TTC), while the adjustment will be the opposite during a financial crisis.

Banks will need to determine whether they will adapt existing models (regulatory, pricing or IAS 39 incurred loss models) or build new models to comply with IFRS 9. The decision to adapt existing models or build new ones may differ between banks.

The decision will include, for example, consideration of the following types of items: the level of sophistication of current models, how adaptable current models are, consideration of system requirements etc.

We envisage that the decision to build a new model or to retain an existing model will also vary from product to product due to the product’s characteristics and the availability of forward-looking information.

**Operational challenges**

**Skills and resources**

IFRS 9 will increase the level of judgment (e.g. estimation of forward-looking lifetime credit losses), which will further increase the need for an experienced team to manage credit risk and impairments. These skills, which include risk, actuarial, accounting and economic skills, are scarce, particularly in Africa.
We expect that behavioural and macro-economic models will play an even more important role under IFRS 9 in determining ECLs, increasing the need for skills in these areas. Specific areas of focus where specialised skills will be vital include:

• Assessing whether there has been a significant increase in credit risk when compared to expectations set at the point of origination.
• Determination of the triggers for moves between buckets (especially between stage 1 and 2).
• Incorporation of forward-looking information and macro-economic factors (forecasting) and the impact these have on ECLs.
• Definition of default.
• Behavioural life of revolving credit facilities.

Banks should start planning their skills requirements for completing and delivering a project of this nature.

**Systems and data**

Systems and data have always been key components of good credit risk management. The ability of banks to obtain and maintain data is and has always been critical in the estimation of PD and loss given default (LGD), not only for financial reporting, but also for regulatory reporting and pricing decisions.

Having the systems to collect, maintain, interrogate and manipulate data to meet the business requirements has not only been important but has been used to gain competitive advantage in recent years.

Systems and data (both historical and forward looking) are bound to gain even more prominence under IFRS 9, as they will be critical in some of the key assumptions made, including:

• Expected life of the customer to be able to determine lifetime losses, banks will need to estimate what the life of the exposure is likely to be for a specific product. This will be made even more difficult by the recent trend of customers transferring their facilities from one bank to another.
• Expected credit loss due to events over the next 12 months and beyond based on reasonable and supportable forward-looking estimates.
• Determination of relationship between credit risk and macro economic factors.

Currently, most entities do not collect the amount of credit information required by IFRS 9, in particular the term structure of credit risk at the point of origination.

Some of the systems currently being used by banks will also need to be significantly upgraded or replaced if they are to meet the demands of IFRS 9. The emphasis is likely to be on systems that can mine all the available data and be able to slice and dice the data efficiently to give businesses the ability not only to manage credit risk, but also provide valuable insights to inform decisions on strategy such as pricing.

**Impact on capital, pricing and strategy**

IFRS 9 introduces requirements that are far more onerous than those in IAS 39. These include:

• Pricing for more complex and onerous impairments.
• Complexity around the interaction of capital and impairments, including cases where the impairment basis would be more conservative than the capital basis.
• Strategies to deal with potential volatility in results when entire blocks of business move between Stage 1 and Stage 2 due to changing conditions.
• Ensuring consistency between lifetime estimates implicit in impairment, economic capital and pricing.
• Product design to remain competitive.

These factors, together with many others, will force most banks to review their current product offering and associated capital requirements and to conclude on whether it still makes business sense to continue selling these products.

We also expect to see the new requirements having an impact on how banks price their products going forward (by way of further risk-driven differentiation in pricing). The current pricing structures will need to change in line with the new landscape.

**Processes and impact on governance**

We expect to see significant changes in the current governance structures. As the level of judgment in these impairment models increases, so will the need for strong and robust governance processes to challenge the assumptions and decisions made to ensure that the final answer is not only correct, but also aligns with the business model.

It is expected that the IFRS 9 models will make increased use of judgment. The models used to support these judgements will therefore also be subject to a lot more scrutiny due to the large potential impact these models could have. This would include back testing and monitoring of projected results to ensure models are robust and defendable. The dynamic nature of these models will also mean more rigorous and frequent validation will be needed than has typically been necessary in the past.

All these factors could require an increase in the number of resources in these areas, but even more importantly, the need for increased skill level and experience.
Given the level of sophistication of credit risk management in Nigeria, what does the new standard mean? Where do you start and what are the immediate priorities?

In Nigeria, the use of internal data and modelling in assessing impairment and credit risk management has historically lagged behind the rest of the world, although there has been some improvement in these areas since the adoption of the International Financial Reporting Standards (IFRSs) in 2012.

Nigerian banks are in the continuous process of improving on the impairment models, some of which necessarily had to incorporate stop-gap measures to ensure compliance with IAS 39. The requirements of IFRS 9 presents an opportunity for the banks to improve on the level of sophistication of models and the granularity of data used for credit risk management and impairment accounting.

It is therefore in the best interests of banks to have a proactive plan in place now to invest in improving the level of sophistication of impairment models and the granularity of data. Such investment should be made with the strategic direction of the bank in mind and not just a last-minute rush for purposes of compliance.

This is, however, unlikely to be a smooth process with the following being the key challenges we foresee:

**Regulatory reporting versus IFRS reporting**

Under IAS 39 we saw the ‘accepted’ use of the non-distributable Regulatory Risk Reserve to bridge any differences between the impairment required by the Central Bank of Nigeria prudential regulations and that required by IFRS.

This discrepancy in treatment is likely to be made worse with the adoption of IFRS 9. Banks therefore need to start engaging with their regulators at this early stage to address how such differences will be resolved.

**Data**

Unlike their international peers, many banks in Nigeria have very limited empirical data,
if any, that can be used to inform the future expected performance of their current portfolios.

Collecting such data takes time (minimum five years). Given this challenge, one of the options would be for banks within the same country/similar market to share information. This presents a new dynamic, as banks have not done this in the past, but it might present the only viable and cost-effective (at least in the short term) solution to the challenge. The other alternative would be to obtain data from other comparable countries across the world. Most banks have until now used the same data for prudential reporting and just adjusted (with some difficulty) for IFRS reporting. This will become more difficult under IFRS 9.

**Systems and processes**

Collecting the data mentioned above also requires the right systems. Existing banking systems tend to be geared towards delivering to customers with little consideration being given to back office requirements, such as data warehousing, which is more common in banks operating in more developed economies.

Developing these capabilities will require significant investment by banks, which some have already started making. Such investment should, however, be made with strategic intent in mind, especially with the emergence of data mining and data analytics as a differentiator and tool to gain competitive advantage.

Being able to collect the right data is one thing, the real benefits, however, lie in having the right tools to mine for the nuggets that lie beneath. In addition to the IT systems, adoption of IFRS 9 will require re-engineering of the current processes in place (and the control environment) to ensure that these are able to meet the increased demands under the new standard.

What we currently see in practice is credit risk team supplying the exposure balances to the finance team, and finance team determining what the impairment should be. We foresee this role changing in line with other developed markets where credit teams take ownership of the impairment numbers and finance teams act as an independent check, challenging the reasonability of the impairment arrived at by credit teams.

**Modelling and actuarial skills**

Modelling and actuarial skills are quite scarce in Nigeria. In the past, the few local actuaries that have come up through the systems end up leaving for developed economies in search of deeper experience and gainful employment as a result of their skills not being fully utilised/appreciated locally.

Although there has been a reliance on ‘fly-in’ consultants to bridge skill gaps regarding similar accounting standard adoption projects in the past, banks will now need to be more involved in the integration of local resources in the IFRS9 project with a view to ensuring that they acquire the necessary skills that will enable them add value in subsequent ongoing governance of the impairment process.

Banks will therefore need to invest in these resources. This is especially so given that retail business dominates the market and impairment assessment for this book is likely to be portfolio based and quite judgmental.

**Basel II impairment model requirements**

The IFRS 9 impairment model based on the expected credit loss is a welcome convergence between Basel and IFRS regulatory standards. Under both accounting impairment and regulatory capital standards, the key input parameters for the computation of expected loss are Probability of Default (PD) and Loss Given Default (LGD).

Under the existing Basel regulatory capital framework, the treatment of impairment provisions is primarily dependent on the approach that a financial institution adopts for computing its regulatory capital for credit risk. The table below summarizes impairment provisions under different Basel credit risk measurement techniques, and analyzes whether or not the data used for modeling regulatory expected loss can be used to model expected loss under IFRS 9.
<table>
<thead>
<tr>
<th>IFRS 9</th>
<th>Basel framework</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected loss impairment model with PD is determined over a 12-months</td>
<td>The Standardized approach makes provision for incurred losses. The regulator</td>
<td>Data used in the determination of regulatory capital under the Standardized approach does not support the data requirement for accounting calculations under IFRS 9.</td>
</tr>
<tr>
<td>period or lifetime of the financial assets depending on the extent of</td>
<td>prescribes risk weights used in computation of regulatory capital.</td>
<td></td>
</tr>
<tr>
<td>credit risk deterioration thereon.</td>
<td>The Foundation Internal Ratings Based (IRB) approach utilizes an expected loss</td>
<td>Data used in the determination of loan loss under both the IRB and Advanced IRB approaches can be used for accounting calculations under IFRS 9 but with significant adjustments.</td>
</tr>
<tr>
<td></td>
<td>model that uses Loss Given Default, Exposure at Default (EAD) and Maturity (M)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>prescribed by the regulator, and a PD estimated by the bank.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>The PD time horizon for the Basel framework is 12-months while IFRS 9 is 12-months or lifetime.</td>
</tr>
<tr>
<td>No floors prescribed for the PD.</td>
<td>PD and LGD are subject to floors.</td>
<td>No floors are prescribed under IFRS 9 as opposed to Basel requirements where PD and LGD are subject to floors.</td>
</tr>
<tr>
<td>The expected loss is computed as PD *Present Value (PV) of cash</td>
<td>The expected loss is computed as PD<em>LGD</em>EAD.</td>
<td>Data used in the determination of loan loss under the Basel approach can be used for accounting calculations under IFRS 9 but with significant adjustments.</td>
</tr>
<tr>
<td>shortfalls.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>PD estimates are ‘point-in-time’.</td>
<td>PD estimates can be ‘point-in-time’ or ‘through-the-cycle’.</td>
<td>Basel estimates are based on long-run average default rates.</td>
</tr>
<tr>
<td>IFRS 9 does not define the term ‘default’.</td>
<td>Default has occurred either if it is unlikely that the obligor will be able to</td>
<td>Under IFRS 9, each entity has to define default with its credit risk management as opposed to Basel framework where it is clear as to when default has occurred.</td>
</tr>
<tr>
<td></td>
<td>repay its debt in full or the obligor is more than 90 days past due on a material debt.</td>
<td></td>
</tr>
</tbody>
</table>
Next steps and implementation planning

In planning for the adoption of IFRS 9, here are the key items we believe management and credit committees should be thinking about:

• Agreement of judgmental areas such as triggers for moving between stages and allowance for macro-economic conditions.
• Aligning current model development and processes such as management overlays to IFRS 9 requirements.
• Assessment of skills required to complete and deliver this project and the hiring of resources to maintain sustainable solutions.
• A clear and concise communication plan to reach all affected stakeholders.
• Governance processes to support the inherent significant judgment introduced by modelling expected credit losses.
• Assessing the capabilities of current systems and available data to support expected credit loss modelling.
• A model development plan, including sufficient time to refine models. Refining models would be more important due to the significant changes from the current delinquency-driven models.
• Aligning impairment, regulatory capital, economic capital and pricing model.

PwC - helping to shape IFRS 9 discussions and responses around the world

In addition to shaping IFRS 9 discussions through working with the Emerging Disclosure Task Force (EDTF) in the UK and the ITG (IASB’s Transition Group), PwC has developed an in-house methodology and software, a new generation technology that can handle the complete IFRS 9 Impairment modelling and calculation process. The in-house methodology and software helps you understand the impact of taking different methodology decisions, the sensitivity of your provisions to changing variables and give an independent perspective on your own IFRS 9 numbers.

It helps you build scenarios and allows you to quickly see the impact of changes in macroeconomic assumptions, transition criteria and other variables.

Conclusion

Depending on the type of financial instruments that a business has, the effort that would be required to adopt IFRS 9 may or may not be significant. One thing is certain; it would not be a mere desktop adoption exercise. It would require an integrated approach which would impact on an entity’s systems, processes, contracts, risk policy and would ultimately require management’s hands on involvement. Successful adoption of IFRS 9 requires early planning. Start adoption now rather than later.
Recovery and Resolution Planning
Not just another piece of Regulation.
Last days at Lehman

The run up to the collapse of Lehman Brothers (“the Bank”) was fraught with confusion, panic, and several last minute attempts at saving the bank. Not just weeks before its eventual collapse, but several months prior.

As far back as August 2007, it was apparent to many in the financial world that all was not well at the Bank. Following the collapse of two of Bear Stearns hedge funds, Lehman’s shares fell sharply and cracks had begun to appear in the US housing market. It was no secret that Lehman was the largest underwriter of mortgage backed securities (MBS) and at this point, ought to have trimmed its mortgage portfolio. Rather it continued to underwrite more MBS than any other bank globally. By the end of 2007, Lehman had amassed a portfolio purported to be worth USD85 billion, approximately four times its net worth. In March 2008, following the near collapse of Bear Stearns (they were eventually bought by JP Morgan), Lehman stock fell 48%. Fund managers, aware of the size of Lehman’s portfolio, and already questioning its valuation, began betting against the firm. This precipitated a steady and unstoppable decline in the Bank’s share value. Management in a bid to stem the decline, embarked on overtures which sometimes appeared incoherent and largely unsuccessful.

Firstly, steps were taken to sell toxic assets to a newly formed hedge fund, which was staffed by former Lehman MDs and employees, and had Lehman as its main investor. Then there was the announcement that the Bank would be spinning off its asset management and commercial real estate portfolio to a ‘bad bank’ which would then be sold. This was followed by the frantic search for a buyer, including the Korean Development Bank. Unfortunately, the market had begun to realise Lehman’s plight and its valuation of the bank was less than the shareholders of Lehman were willing to accept.

Eventually, the bank was allowed to fail setting off the global financial crisis, effects of which are still reverberating around the world today.

The Financial Stability Board, Dodd-Frank and the Basel Committee

The contagion from the collapse of Lehman Brothers was immediate. Banks, insurance companies and hedge funds struggled to remain solvent. A few collapsed, while several had to be bailed out. The US and UK governments committed a total of USD29 trillion and GBP850 billion respectively of tax payer’s money to assist the ailing institutions.

In response to this global crisis, the G20 leaders at a summit held in 2009 announced the creation of the Financial Stability Board (FSB). The FSB was made up of central bank governors and its primary purpose, was to address vulnerabilities in the financial services sector.

In 2012, the FSB and Basel Committee of Banking Supervision (BCBS) put forward proposals designed to reduce the likelihood of a systemically important financial institution (SIFI) failing, and in the event of failure, the impact on the financial system will be
reduced. Among other things, SIFI’s were required to prepare and submit credible Recovery and Resolution Plans.

SIFIs within the EU, USA and Canada have been preparing and submitting Recovery Plans since 2011.

**Nigerian Banks**

In 2009, Nigeria was facing a banking crisis of its own. The effects of the global economic crisis, declining oil prices, and excessive margin lending, were having a negative impact on many financial institutions. Prior to this the Nigeria stock market had been one of the world’s best performing stock markets which had led to a steady increase in margin loans to customers. Margin loans are loans made by brokerage houses (many of whom were subsidiaries or affiliates to the banks) to clients, which allows them to buy shares on credit. i.e. an investor could buy shares using a small portion of their own funds. The rest is provided by the brokerage with the shares held as collateral. The banks were financing about 65% of the Nigerian capital markets at this time through the margin facilities granted to investors and brokerage houses. Many banks shifted focus from providing credit to the real sector and instead favoured playing the capital markets for short-term speculative gain.

As the global financial crisis continued to bite, there was a large exit of foreign portfolio investors. Further to this, weak regulation allowed for unprofessional conduct by the banks and stockbrokers. Practices such as the setting up of special purpose vehicles to lend money back to themselves for stock price manipulation was rife. All these, contributed to the crash in the Nigerian stock market. Several banks had a large exposure to equity related loans, which resulted in a spike in non-performing loans. An examination of all banks in 2009 by the Central Bank of Nigeria (CBN) found that ten banks, accounting for a third of the banking assets, were either insolvent or under-capitalised. Just as in the US and UK, the Nigerian Government through the Central Bank, had to inject N620b (of tax payer’s funds) into the banking sector to provide liquidity and recapitalise the banks.

In September 2014, CBN and NDIC, in line with global trends, and as part of reform efforts to ensure financial stability in Nigeria, issued a framework for the supervision of domestic systemically important banks (D-SIBs).

Banks are classed as systemically important if their distress or disorderly failure causes significant disruption to the wider financial system and economic activity. Systemic importance of a Bank is determined by size, interconnectedness, substitutability, complexity of its business model, structure and extent of operations. In Nigeria, the largest and most complex banks, of which there are eight (8), account for more than 70% of the total industry assets.

This framework stipulates among other things, higher loss absorbency, more stringent liquidity standards, and quarterly capital and liquidity stress testing. In addition, all D-SIBs are required to submit their first set of Recovery Plans to the regulators on 1 January 2016, and every year thereafter.

**Recovery and Resolution Plans**

Although often used interchangeably, Recovery and Resolution Plans are two distinct plans, designed to be invoked at different stages of a SIFI’s distress.

**Recovery Plans**

These are detailed strategies for rapid, orderly and least cost recovery of a financial institution in the event of severe distress. An effective plan sets out the menu of actions a bank can use to recover from both idiosyncratic, and systemic financial stress or both.

**Resolution Plans**

These are designed to facilitate the effective wind-down of financial institutions without severe systemic disruption and without exposing tax payers to any loss.

As the illustration below depicts, an event may trigger a liquidity or capital crisis, which takes an institution below a ‘crisis threshold’. Below this threshold, and if reacted to on time, is the ‘recovery zone’, where pre-determined actions can be employed to recover from the negative shock. If allowed to continue, the institution crosses the ‘failure threshold’, at which point, efficient resolution activities will have to be used to facilitate its effective wind-down.
As a start, CBN and NDIC framework requires all D-SIBs to submit only Recovery Plans.

**Key components of a Recovery Plan**

A credible Recovery Plan should include:

**Strategic Analysis**
A background on the bank, its legal structure, and existing strategy. Its risk profile and framework already in place to address the various risks. The strategic analysis identifies the bank's core business, critical economic functions and material entities.

**Recovery Indicators and Triggers**
These are selected and developed along the bank's framework for qualitative and quantitative indicators. This section of the plan details how indicators will be monitored regularly.

**Robust Scenario and Stress testing**
Scenario definition including market wide, idiosyncratic, and combined scenarios; identifying the impact of events on capital,
liquidity, profitability and operations. Recovery Plans should include the definition, analysis and quantification of specific scenarios in order to determine and test the efficacy of the recovery options. The plans establish the metrics that will trigger the consideration of the implementation thereof. Unlike standard stress tests, scenario testing under Recovery Planning should be approached more robustly, and should cover the entire stress spectrum. It should analyse the firm’s ability to respond to a wide range of internal and external stresses.

**Recovery Options**
Selected options are broken down to granular details with a rationale provided for each. There should be a quantitative and qualitative evaluation of these options under business as usual and stress scenarios. D-SIBs have to ensure the credibility of their plan through analysis of the impact of each recovery option on counterparties, creditors, clients, depositors, and market confidence.

**Governance and Communication**
A plan for decision making during a crisis is important. Identification of responsible persons and description of the escalation and decision-making process, as well as of the indicators which would trigger this process is necessary.

**Document Release**
This is where sign-off and approval requirements by senior executives and the board is documented.

From our experience in other jurisdiction, regulators typically expect to see well thought out robust plans which demonstrates the below attributes:
- ownership of a plan,
- full integration into the risk management and crisis management framework,
- early warning indicators which are not set too late to risk execution,
- a broad mix of relevant quantitative and qualitative indicators,
- indicators on group financial position,
- ready to be used operationally,
- any barriers to implementation removed, and
- operational interconnectedness fully understood by banks.

In Nigeria, the global financial crisis that was taking shape internationally should have served as an indicator for the banks. Liquidity was drying up fast in the traditional markets. Several banks in Nigeria that had offshore credit lines and hedge funds that had exposure in the Nigerian Stock Exchange began withdrawing funds. All these were potential indicators and trigger points which with a robust plan, could have resulted in action to avert the crisis that unfolded.

The Nigerian economy is currently fragile, with the fall in oil prices, ever depreciating currency and recent political changes. Many businesses are struggling to remain profitable, service their debt, and even stay afloat. Financial institutions would do well to sit up and treat Recovery Planning as a critical and indispensable tool for survival irrespective of whether they are a D-SIB.

**Conclusion**
Recovery Planning could have prevented the desperate panic at Lehman’s that engulfed the board, management and staff, and would quite possibly have helped to avert the firm’s demise. The cracks that were appearing in the US housing market as far back as early 2007, should have been an indicator. The sharp fall in share price following the collapse of two Bear Stearns hedge funds that were heavily exposed to MBS (just as Lehman were), was another indicator. By the time Bear Stearns was sold, the market was aware of Lehman’s plight so all recovery actions subsequently, proved futile.
Strategic Cost Management
A challenge for Nigerian financial institutions
Current Realities

The fallout of the banking crisis in Nigeria as well as the impact of regulatory changes is prompting a crucial rethink of strategies, operating models and cost structures of Nigerian Financial Institutions (FIs). Recent reforms in the financial services landscape following the crisis have however contributed to declining income margins and increased operating costs. Some of these reforms include:

- Gradual phasing out of COT charges.
- Minimum requirement of a 3% interest rate on savings accounts.
- Harmonisation of reserve requirements on public and private sector deposits by increasing private sector deposits to 31% (up from 20%) and reducing public sector deposits to 31% (down from 75%)\(^1\).
- Limit to the purchase of dollars in the interbank market aimed at preventing speculative trading and saving the declining foreign reserves.
- Increase in the Asset Management Corporation of Nigeria (AMCON) Resolution Costs levy from 0.3% to 0.5% of total assets\(^2\).
- Exclusion of particular reserves from the computation of regulatory capital and the limitation of Tier 2 capital (including OCI Reserves) to 33.33% of total Tier 1 capital\(^3\).

Prior to the banking crisis, Nigerian Banks benefited from significant revenue growth accompanying the ‘post consolidation’ era. Cost reduction measures were merely focused on swift solutions that did not address ingrained operating model inefficiencies. Following the crisis, Banks struggled with high operating costs, declining revenue growth and a comparatively high Cost to Income Ratio. Few banks have been able to effectively manage this issue with average Cost to Income ratio for the Systemically Important Banks (SIBs) being as high as 65% in 2014. This is relatively higher than ratios recorded in other emerging markets such as the BRICS: Brazil – 43%, Russia – 69%, India – 45%, China – 31% and South Africa – 55%.

Other Financial Institutions face similar challenges. Revenue growth for insurance companies is threatened by low penetration (less than 2%) amongst Nigerians, limited product innovation and public awareness. Capital Market Operators also have to grapple with the new minimum capital requirements released in December 2013. These trends have ultimately resulted in more aggressive focus on revenue growth, which is typically accompanied by significant cost investment and deferred Return on Investment. The ability to grow revenues while maintaining a tight rein on attendant costs is vital to delivering top-tier returns in the current market environment.

In response to the highly regulated and competitive business environment, Financial Institutions have resorted to cost management as one of the few directly controllable and manageable profit drivers. While traditional

---

1. Central Bank of Nigeria (CBN) Communiqué No. 101 of the Monetary Policy Committee Meeting of Monday 18 and Tuesday 19 May, 2015
2. Central Bank of Nigeria (CBN) Communiqué No. 93 of the Monetary Policy Committee Meeting of Monday 20 and Tuesday 21 January, 2014
methods such as a reduction in headcount and outsourcing non-core capabilities brings short term reprieve, this may not necessarily be the answer. Financial Institutions need to take a long term and strategic approach to cost management and implement significant and sustainable cost restructuring initiatives.

**Tactical cost improvement is not enough**

The old way of viewing all spend as simply a cost is not effective today. Yesterday’s tactical solutions, despite consuming considerable resources, have failed in many organisations to deliver the planned reductions to the cost base and have not contributed to the creation of true competitive advantage in the long-term. In many cases, the cost savings achieved in the short term have leaked away and the cost base has returned to previous high levels, but with resultant considerable damage to corporate structure, image, culture and morale. It is time to adopt some new thinking - Cost is a strategic issue. It needs to be continuously optimised in the context of the entire business model of the organisation. Often, the business model may need to change to ensure the organisation remains competitive.

**Tactical cost reduction and continuous improvement initiative such as hiring freezes, staff rationalisation, deferring expenses, reducing travel/training and across-the-board budget costs may deliver short-term results.**

However, these results are mostly incremental and captured savings are generally not sustainable in the long term, as they fail to address the underlying demand and supply-side cost drivers. Tactical cost management initiatives tend to focus on reactive and arbitrary cost reduction measures without necessarily addressing the spend culture and productivity/efficiency indices. For example, rather than focus on headcount reduction as the sole means of reducing branch operating expenses, Financial Institutions can consider identifying key reasons why customers visit the branch and provide alternative channels to serving them.

In today’s competitive environment, smart companies view their spend (direct and indirect) as an investment. They make smart investment decisions based on strategic vision and their internal capability to deliver value from that investment. They see cost or expense through a new lens; one that takes a holistic view of the organisation and is more aligned to addressing the reality of external pressures and longer-term goals of the business.
CEOs are seeking new frontiers in cost management

CEOs today are seeking more sustainable cost reduction measures. PwC’s 17th Annual Global CEO Survey (2014) revealed that 57% of Banking and Capital Markets CEOs have identified cost management as a top priority in the coming months. This is more the case in Nigeria, with 80% of Financial Services (FS) CEOs surveyed implementing various cost reduction initiatives such as centralisation and outsourcing.

A different approach to Cost Management – PwC’s Point of View

Critical success factors for cost management/restructuring include:

| Executive Management influence | • Well communicated vision (target state).  
| • Clearly articulated facts/benefits cases delivered, sponsored and driven from the top.  
| • Executive management buy-in.  |
| Availability of relevant management information | • Robust management information and cost data.  
| • Tracking and analysing critical cost drivers.  |
| A well-organised transformational programme | • Clear mandate, defined targets and strong engagement across the business.  
| • Continuous tracking and benefits reporting.  |
| A balanced approach | • Timely combination of short, medium and long-term cost reduction initiatives that produce a range of savings over time.  |

PwC’s approach to cost management focuses on four key themes - ‘doing without’, ‘doing better’, ‘doing with less’ or ‘doing differently’. Focusing on these themes will help Financial Institutions move beyond “cost cutting” to “cost restructuring” and also facilitate achievement of more sustainable results.
Focus of Activities | Savings Levers | Opportunities
---|---|---
Restructure the cost base  
‘Do Different’  
(20%+ savings) | Closures and Exits | • Close or sell underperforming/non-critical parts of the business, customer types and/or product offerings.
| Strategic Sourcing | • Consolidate sourcing and vendor activity, create shared services, outsource non-core processes and platforms off-shore and replace core systems.
Reduce infrastructure  
‘Do with less’  
(15-20% savings) | IT Consolidation | • Consolidate IT platforms, hardware, infrastructure and data centres.
| Property Optimisation | • Review property demand and take advantage of what you have, look at ways to dispose of assets and reduce property related spend via sourcing/vendor reviews.
Create efficiencies  
‘Do better’  
(10-15% savings) | Process improvement | • Reduce complexity, errors, duplication and improve standards around key processes across the business using methods such as Lean and Straight Through Processing.
| Business Simplification | • Simplify and reduce duplication of roles and activities, consolidate and rationalise similar functions and activities.
Cut costs  
‘Do without’  
(5-10% savings) | Activity and Headcount Reduction | • Review and challenge team activities, workload capacity, line management structures and reporting lines leading to headcount reduction.
| Spend Reduction and Demand Management | • Challenge demand, discretionary spend, and policy compliance, reduce/eliminate discretionary spend, contractor spend and re-negotiate vendor contracts.
In conclusion...

As FIs seek to unravel the mystery that is cost management, CEOs need to take an objective look at their businesses and ask some critical questions:

• What are the potential cost implications of the current service delivery model?
• Has the product portfolio been reviewed to identify unprofitable or marginally profitable products?
• Are costs being “postponed” and not “managed”?

Government regulation protecting the consumer is increasing and price capping is becoming a common restraint on revenues for FS organisations. These, coupled with globalisation that forces territories to compete for resource and investment, means that organisations need to radically reduce their cost base to retain good return on investment. Taking advantage of process and back office improvements is necessary.

At PwC we help Financial Institutions design the right solutions that enable them to maintain the control they need, enhance service delivery and stay ahead.
Tax issues affecting insurance companies
Insurance In Nigeria

The Nigerian economy is currently facing challenges, arising from plummeting oil prices, which have a negative ripple effect on the country’s foreign reserves as well as the value of the Naira. These challenges present a unique opportunity to diversify the revenue base of the economy as well as an opportunity for the development of the Insurance sector in Nigeria.

The sector can play a vital role in economic development by pooling risks and reducing the impact of losses incurred by individuals and companies alike. As financial intermediaries with capacity for long term investment, insurance companies can contribute to the provision of long term finance for other sectors of the economy such as banks, infrastructure and real estate, and the bonds market.

The performance of insurance in any environment is driven by a number of factors such as per capita income, population size and density, demographic structures, income distribution, the availability of private credit, and religion. All of these make Nigeria an ideal environment for the sector to thrive. The country has witnessed a steady growth in GDP per capita in the last decade reaching an all-time high in 2014 following the GDP rebasing. This growth can be ascribed to the emergence of a young and upwardly mobile middle class who are seeking for financial ‘inclusion’ and demanding a range of appropriate products to fit their changing lifestyles.

Insurance in Nigeria is however faced with a lot of structural and regulatory challenges as well as negative public perception which has continued to affect its development in the country. The sector is unable to attract the best executives and staff when compared to banking with the latter perceived to be a lot more profitable and attractive.

In terms of public perception and insurance penetration, customers who have been disappointed in the past or have heard unpleasant stories from policy holders continually need to be convinced that they will access their claims when required. The situation is not helped by superstitious beliefs especially those associated with people avoiding life insurance because it feels like they are inviting death by doing so.

With regards to legislation, insurance companies are governed by the Insurance Act, 2003. The National Insurance Commission (NAICOM) was established by National Insurance Commission Act No. 1 1997 to ensure the effective administration, supervision, regulation and control of insurance business in Nigeria. With adoption of a code of corporate governance to improve stewardship, NAICOM and the players in the sector are taking steps to improve accountability. However, legislation in the tax area has lagged behind all other improvements and creates a huge disincentive to the insurance sector.

Challenges in the taxation of insurance companies

Income taxation of companies in Nigeria is imposed by the Companies Income Tax Act 2007 (as amended). Section 16 of this Act provides
guidelines for the taxation of life and non-life insurance companies in Nigeria.

Unfortunately, the current tax regime in Nigeria appears to be unduly unfair to insurance companies when compared with other companies in the financial service sector (such as banks). A review of the fiscal policies guiding the insurance sector is necessary to fast-track the development of the sector, as this will bring equity so that insurance companies can compete adequately within Nigeria and eventually with insurance companies in other emerging markets.

The issues with the current tax legislation is analysed below.

1. Restriction on carry forward of tax losses

Section 16(7) of CITA places a limit of four years on insurance companies to carry forward their tax losses. Through amendments made in 2007, other companies (including banks) can carry forward their tax losses indefinitely until they can be utilised against taxable profits. However insurance companies can carry forward their tax losses for four tax years (i.e. years of assessment).

There is no obvious reason for the restriction of carry forward of tax losses for insurance companies since historically, insurance companies have not been the most profitable in the financial services industry. Therefore, the country will not be losing any significant tax revenue from removing this restriction compared to the social and economic benefits to be derived if the insurance companies are encouraged to thrive.

The risk-taking nature of insurance business as well as the stage of development of the insurance sector warrants insurance companies to be able to take the tax benefit from their losses indefinitely similar to the allowance granted to other companies.

2. Cap on deductions for unexpired risks

The unexpired risk reserve is required to cover the claims and expenses that are expected to emerge from an unexpired period of cover. As long as the period of insurance cover has not expired, companies are required by the Insurance Act to anticipate and make a reserve for possible claims against premiums received.

Section 16(8) (a) of CITA stipulates a cap on deductions for reserves, claims and outgoings for general insurance business. It limits the amount of deduction for unexpired risks to 25% of total premium for marine cargo and 45% of other classes of general insurance business. This is inconsistent with Section 20(1) (a) of the Insurance Act which prescribes time apportionment as a basis for determination of the provision of unexpired risks.

Also, IFRS 4 paragraph 15 requires an insurer to assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. The Solvency II framework which represents best practice in the global insurance sector recommends that technical provisions be determined as a discounted best estimate augmented by a risk margin.

While insurance companies are restricted under Section 16(8) of the CITA to take a deduction, banks and other financial institutions are allowed in practice to deduct similar liabilities imposed under their regulations as specific provisions. The insurance sector should work with the Federal Inland Revenue Service (FIRS) to remove this restriction from the law so that insurance companies can compete more favourably in the global market.

3. Minimum taxable profit

Section 16(8) (b) limits the deduction allowed for an general insurance company such that after the deductions are made and capital allowances claimed, there will be an amount of “not less than 15% of taxable profit for tax purposes”. This phrase means nothing and has been redundant since its introduction in 2007. It has been rightly ignored by insurance companies in respect of their general business. It should therefore be deleted due to the confusion it could create.

Section 16(9)(b) suggests that after all limited deductions have been granted to life insurance companies, the company must have 20% of its gross income available as taxable profit.

This is a type of minimum tax provision different from the general minimum tax provision in Section 33(1) of the CITA which is computed roughly as 0.5% of the higher of a gross profits, net assets and paid-up capital plus 0.125% of turnover above N500,000.

This effectively means that life insurance companies are almost always subject to a higher basis of minimum
tax compared to other companies, including banks and financial institutions.

The restriction on minimum taxable profit for life insurance companies creates a competitive disadvantage and therefore should be removed through a legislative change.

4. **Earned investment income for life insurance business for tax purposes**

Under Section 16(5)(b) of the CITA, the income of a life insurance company which are subjected to tax include the whole income and other incomes. This raises an ambiguity on whether income earned from investment of life policy holders’ funds and annuities are taxable, even though these funds include undistributed amounts that would only be distributed upon maturity of the policy.

Due to the nature of life insurance business, it is logical for investment income from such policy holder funds and annuities to be taxed only to the extent that they are distributed during the year. The provisions of Section 16(5) will therefore need to be amended to reflect this deferral and to remove the ambiguity.

5. **Payment of value added tax (VAT) on commissions paid**

Another challenge faced by insurance companies in Nigeria is the practice of the FIRS requiring insurance companies to account for VAT on commissions paid to brokers and agents.

Based on the VAT Act, all companies are only required to charge and pay VAT on their output or supplies, except in a few instances such as oil and gas companies that account for VAT on their input or purchases. In this regard, an insurance company is required to charge and remit VAT on their commissions earned and have no legal requirement to account for VAT on commissions paid.

Any insurance company that goes the extra mile of deducting VAT on commissions paid is simply doing the FIRS a favour. However, there should be no exposure for the company if it accounts for VAT on only its commissions earned.

It would appear that a requirement for insurance companies to account for the VAT on behalf of its brokers and agents only exist because the insurance companies are easier targets for revenue collection than broker/agents who may not be properly registered for taxes. However, there must be a legislative mechanism for the FIRS to impose this additional obligation on the insurance companies.

A way forward will be for the key stakeholders in the insurance sector to have discussions with the tax authority, agree on a position based on the realities of the current business model and propose the required legislative change.

**Conclusion**

We are strong believers in the growth prospects of the insurance sector in Nigeria. Its enormous potential however requires growth focused economic and fiscal policies to be unleashed. The government and regulatory bodies should also be engaged by industry stakeholders to consider tax incentives which will deepen the market for performing insurance companies e.g. companies that pay a minimum percentage of claims submitted for processing while concerted effort is made to educate the public on the immense benefits of insurance in this age.
Transfer Pricing issues within the Financial Services Industry

The Regulations require related parties (referred to as connected taxable persons) to observe the arm’s length principle. Under the Regulations, persons are related if one of them participates (directly or indirectly) in the management, control or capital of the other or if a third person participates (directly or indirectly) in the management, control or capital of both persons. Related parties are required to transact at prices and terms that would normally be agreed between independent parties transacting under similar conditions. If this is not done, the tax authorities can adjust the transfer prices and tax any additional profits that arise as a result.

To comply with the Regulations, connected parties are required to prepare, and update annually, a TP documentation report. This report is to contain information and analysis which demonstrate that the transfer prices and other commercial terms of their related party transactions are in accord with the arm’s length principle.

Other compliance requirements include maintaining a TP Policy and filing TP declaration and disclosure forms. The Federal Inland Revenue Service will typically use this information to perform a risk assessment and subsequently select taxpayers for TP audits.

Banking and financial services groups often have transactions involving one or more group members. Some of the more common transactions include provision of loans (and other forms of financial support) and intragroup services. Intergroup services include management services, head office services and various other services (e.g. IT services, treasury services, risk management services etc.). The intergroup services within a financial services group will depend on the specific industry sub sector within which the group operates and could include generic management services and more specialised services. For example, an insurance group could have intragroup services such as risk management and reinsurance, contract and claims management, investment and asset management etc.

Some of the intercompany transactions that cut across the various industry subsectors as well as the key TP issues arising from those transactions are discussed below.
1. Head office/ Management/Shared services (Intra-group services)

It is common within groups to give an entity the responsibility for providing services to other group entities. Typically, the service provider would be the holding company. In other instances, it may be one of the operating companies within the group. The services include strategic functions and centralised management services such as executive administration (e.g. HR and legal), financial control, treasury management, internal audit, IT etc. Other functions which are usually performed by holding companies include financing, procurement and holding of intellectual property such as the brand and trademark.

Commercial reasons for these intra-group services include greater economies of scale, standardisation of processes and increased efficiency.

As with other connected party transactions, the pricing for these services must be at arm's length. For Nigerian headquartered groups, the FIRS will be looking to ensure that the Nigerian head office receives an appropriate remuneration for the head office and other services provided to group companies outside Nigeria. Where the Nigerian company is a subsidiary of a foreign company, the emphasis will be on ensuring that payments made for the head office and other services are not excessive.

Although different groups may have similar “service transactions”, the structure and manner of providing the services including the allocation of functions, risks and assets between the service provider and service recipient may be different. This will mean that the pricing approach and methods for the services could be different for different groups even though the services could appear to be similar on the surface. This creates a risk when dealing with tax authorities. Often, the expectations which the authorities form as a result of reviewing the transfer pricing affairs of one financial services group can influence their thinking on the pricing of these services in another group as they could expect the pricing arrangements to be the same or similar.

Industry players would therefore need to provide robust analysis supporting their transfer pricing practices. This analysis should include all factors relevant to the pricing of the transactions including industry factors, business specific factors etc.

A key consideration in determining whether it is appropriate to charge for a service is to determine whether an independent party would be willing to pay for the particular service.

Duplication of services
The FIRS (and other tax authorities) may not allow a management fee deduction if it believes the services are duplicated. This risk is high where a service recipient has staff that appear to be performing activities which are similar to those being provided by the service provider. The tax authority may argue that there is a duplication of services and there is no additional benefit which the service recipient obtains from the service provider. For example, if a management service fee is being charged for financial accounting services and the company receiving the service has a well-staffed financial accounting function, the tax authorities could argue that the management services are not necessary.

To prevent the risk of duplication, companies should clearly delineate the activities performed centrally from those performed...
locally. This information should be recorded in their TP documentation reports. Companies should also record evidence of the direct benefit derived from the provision of these services. Sometimes, demonstrating the benefit derived from the services can be challenging.

**Shareholder services**

These are activities which a holding company or head office undertakes for its own benefit and which do not provide any clear commercial benefit to the subsidiary. Tax authorities will not allow holding companies to recharge costs relating to shareholder activities to their subsidiaries. A common example of a shareholder cost will be costs incurred by the holding company while raising funds for the acquisition of its interests in subsidiaries. Another example is costs relating to the reporting requirements of the holding company such as consolidation of reports.

The line between what is for the benefit of the holding company and what is for the benefit of the subsidiary / operating company may not always be clear.

**Pricing and allocation**

Compensation to the service provider should be commensurate with the services and benefit. A common practice is for the provider to receive a fee which covers the costs incurred in providing the services together with an arm’s length mark-up. Where there are multiple recipients, the costs should be apportioned based on an allocation key that reflects the relative benefit received. Some common allocation keys include time spent by staff in providing services to each entity, headcount, number of IT users etc. The mark-up to be charged will depend on the nature, complexity and risks associated with providing the service.

### 2. Loans

Intercompany loans are a common source of funding within financial services groups. Related parties would be expected to satisfy the FIRS that the remuneration being received or charged for the intercompany loans are appropriate. Common risks with intercompany loans include the risk that the interest rate is not appropriate and the risk that the interest could be re-characterised as dividends.

**Risk of re-characterisation**

Groups in the financial services industry must investigate if the transaction meets the definition of a loan based on the law and accounting standards of the country of the borrowing company. Where the tax authority successfully argues that the loan does not meet the definition of debt, it can re-characterise the loan as equity and deem the interests paid as dividends. Ordinarily, interests paid on loans are tax deductible. However, if such loans are re-characterised as equity, the dividends will usually not be tax deductible.

Even where there are no express definitions of debt and equity in the tax law, tax authorities are still able to challenge the substance of the loans based on the nature of the transaction and the conduct of the parties. This is the case in Nigeria where the FIRS can rely on transfer pricing principles to challenge the substance of a related party loan and the resulting interest. In general, the risk of re-characterisation is relatively lower with banking groups compared to other businesses in the financial services industry.

Some of the factors which could lead the tax authorities to challenge the substance of a related party loan include where: the borrower is very thinly capitalised, there is no specified tenure or repayment date in the agreement, the tenure of the loan is unusually long, repayments are not made when due and are outstanding for a long period of time, the loans come with voting rights, the loans are tied to profitability, the loan in not secure in spite of significant transaction risks etc. These conditions suggest that the lender is taking on significant risks which it is not likely to take if it were dealing with an independent party. The risks associated with the lending are therefore considered to be similar to the risks taken by an equity investor, hence the re-characterisation of the loan to equity.

**Level of interest charged**

The interest charged on a loan must reflect the risk associated with the borrowing. Transaction terms such as loan currency, tenor, interest type (floating vs. fixed), presence of collateral and security, restrictive covenants, seniority of the loan etc. are relevant for assessing the risk and consequently determining the arm’s length interest rate. Other factors such as the country of borrower, business of borrower, economic circumstances at the time of the borrowing etc. also play a role in establishing the arm’s length interest rate.

Since the provision of loans is in the ordinary course of their business, banking groups have relatively more access to information that
can be used to determine the appropriate interest rate for intercompany loans. This information includes information on internal comparables i.e. independent companies who they have similar transactions with. The interest charged on comparable transactions with independent companies can be used as a benchmark for setting the interest rate on the related party loans. It will however be important to ensure that there are no material differences (between the third party and related party transactions) which could impact the interest rate. Where any material differences exist, appropriate adjustments should be made.

Where internal comparables do not exist it will be necessary to search for similar loan transactions involving two independent parties (i.e. external comparables). The first step will usually involve estimating the credit rating of the connected borrower and also identifying the material terms of the related party loan transaction (these steps are also applicable when internal comparables exist). The next step is to search for loan transactions between third parties where the borrower has a similar credit rating as that of the connected borrower. It is important to ensure that terms and conditions of the related party loan are similar to those of the third party loans. Where the transactions are considered similar enough, the interest rate applied on similar third party loans can be compared with or used as a basis to price the related party loan. Where there are material differences in transaction terms, adjustments will need to be made. Country risk, tenor risk and currency risk adjustments are some of the adjustments that are sometimes necessary to achieve comparability.

**Conclusion**

It is expected that groups in the financial services sector will be one of the targets of future TP audits. They must therefore be prepared and ensure that all intragroup transactions are priced appropriately and in line with the arm’s length principle. Group CFOs must be prepared for the future audits and should carry out reviews of their current TP practices and defence documentation to ensure that they are not exposed.
Real estate: Building the future in Africa
Real Estate 2020: Building the Future

During March 2014, PwC released its Real Estate 2020: Building the future report which highlights global trends and makes predictions about the real estate industry up to 2020. Some of these global trends are already evident in the African real estate industry and others will only start to appear in the future.

The six predictions made for 2020, and beyond, considered in the report are:

The global investible real estate universe will expand substantially, leading to a huge expansion in opportunity, especially in emerging economies;

• Fast-growing cities will present a wider range of risk and return opportunities.
• Technology innovation and sustainability will be key drivers of value.
• Collaborating with governments will become more important.
• Competition for prime assets will intensify further.
• A broad range of risks, including new risks, will emerge.

These predictions reflect the impact of global megatrends that will change the global real estate landscape considerably in the next five years, and beyond. Africa will not be an exception. The six global megatrends highlighted in the report are:

• Huge expansion in cities, with mixed results. By 2020, the 21st century’s great migration to the cities will be well underway. Cities will be swelling across the fast-growing countries in Asia, Africa, the Middle East and Latin America. Even developed Western nations will be urbanising, albeit at a slower pace. But not all cities will prosper. While some will become great centres of wealth creation in a multipolar world, others are likely to fail.

• Unprecedented shifts in population drive changes in demand for real estate. Demographic shifts will affect demand for real estate fundamentally. The burgeoning urban middle-class populations in Asia, Africa and South America will need far more housing. Meanwhile, the advanced economies’ ageing populations will demand specialist types of real estate, while their requirements for family homes will moderate.

• Emerging markets’ growth ratchets up competition for assets. Real estate is an integral part of the emerging markets’ growth phenomenon. Even as growth moderates in many emerging markets, the pace of construction activity remains rapid, increasing investment opportunities. The rise of emerging economies is also increasing competition among real estate managers and the investment community.
‘Sustainability’ transforms design of buildings and developments. Cities contribute an estimated 70% of the world’s energy-related greenhouse gases while occupying just 2% of its land. Their locations – often in low-elevation coastal zones – and large populations make them particularly vulnerable to the impacts of climate change, such as rising sea levels. As the world rapidly urbanises, so the pressures to make buildings more eco-efficient are mounting.

Technology finally comes to real estate and disrupts real estate economics. By 2020, it will have both altered the economics of entire subsectors of the industry and changed the way that real estate developers and the investment community operate.

Real estate capital takes financial centre stage. Private capital will play a critical role in funding the growing and changing need for real estate and its supporting infrastructure. Just as asset managers, real estate funds and sovereign wealth funds find the assets under their control swell, so governments will have increasing needs for capital to finance urbanisation. Private real estate capital will become an important partner of governments.

While the impact of most of these global megatrends are already being seen, there’s a natural tendency to underestimate them. The impact of many of these megatrends on the African landscape will differ from those expected in developed countries.

The drivers of growth in Africa

From our analysis of these megatrends, we have identified eight potential drivers of growth in the real estate industry in Africa.

1. Africa’s young population will drive demand for real estate and different types of real estate. There will be continued urbanisation, expansion in current cities and the rise of new cities across the continent.

According to the World Bank, Africa’s median age was 19.7 years in 2012 and it is expected to increase to 25.4 years by 2050, making Africa the continent with the youngest population. The global megatrend relating to ageing populations and the consequent increase in the demand for retirement homes is therefore not expected to have a significant impact in Africa by 2020.
Continued urbanisation will have a major impact by 2020, and beyond. It is estimated that the urban population in Africa will increase to 56% in 2050, making it the most rapidly urbanising region in the world.

Africa is the world’s second-largest and second-most populous continent at 30.2 million km$^2$, which is 20.4% of the total global land area. Mauritius is the most densely populated country on the continent with 639 people per km$^2$, while Namibia is the least densely populated with three people per km$^2$.

Figure 3: Population density in Africa

Continued urbanisation will have a major impact by 2020, and beyond. It is estimated that the urban population in Africa will increase to 56% in 2050, making it the most rapidly urbanising region in the world. The figure below shows the estimated urban population of a selection of African cities by 2025 compared to 2010:

---

The UN expects the fastest-growing urban agglomerations across Africa to be medium-sized cities and cities with fewer than one million inhabitants. The unprecedented demographic shifts will affect the demand for real estate fundamentally. In the residential sector, growing urban populations will increase demand for affordable housing, while a burgeoning middle-class will drive demand for more mid-range properties. While office, industrial, retail and residential will remain the dominant sectors, affordable housing, agriculture, healthcare, retirement and mixed-use properties will become significant sub-sectors in their own right.

Industrialisation will continue across Africa and will be accompanied by a rapid growth in the retail sector.

Indications suggest that much industrialisation will be funded by foreign investors, such as China. Intra-African trade and investment will continue to be an important driver of growth, as high-profile local companies expand into regional markets. The retail sector will also develop rapidly as growing populations and burgeoning middle classes demand greater volumes of more varied goods. The need for economic diversification, together with growth, will support the expansion of non-resource sectors and investment opportunities will arise through an increase in demand for real estate from these sectors.
Natural resources will remain a major source of economic growth in Africa. New discoveries continue to drive the growth of local activity, although a continued dependency on natural resources will present both opportunities and challenges for real estate developers and investors across the continent.

As global demand for food grows, revenue from Africa’s agricultural output will increase, while the significant areas of uncultivated arable land will provide opportunities for growth. The risk presented by the economic fragility of commodity-exporting countries will need to be offset by the potential rewards from investment – either directly in helping to exploit new commodity discoveries, or indirectly through developments aimed at catering to the increased consumer demand resulting from associated economic growth.

Growth sectors will continue to create demand for infrastructure investment. Connections to road, rail and public transport are vital for urban success. Doing business in Africa remains a challenge as infrastructure lags well behind the rest of the world, but there are distinct regional differences. Recent PwC research suggests that infrastructure spending in sub-Saharan Africa will exceed US$180 billion per annum\(^6\) by 2025, a growth rate of 10% per annum.\(^6\) Major infrastructure investment programmes in Nigeria and South Africa are now being accompanied by significant projects in other countries like Ghana, Kenya, Mozambique and Tanzania. However, a huge shortfall in government funding creates opportunities for private investors to support this development need through direct investment and public-private partnership (PPP) agreements.
Increased political stability on the continent and increased participation in local partnerships will continue to ease investors’ concerns relating to investing across Africa. Collaborating with governments or involving a local partner in future real estate developments in Africa will become more important to mitigate the risks. Governments and the investment community will have to work together to fund and build cities and their infrastructure.

Development finance institutions (DFIs), sovereign wealth funds (SWFs) – government-run investment vehicles that manage state-owned assets – and private equity providers continue to enter the market alongside private capital and institutional investors, while developers and investors will find raising capital in the markets easier as the local financial apparatus develops. With interest from a range of investor classes and continued high returns, competition for prime real estate and infrastructure assets will increase.

Online technology is already having a significant impact on the finance and banking industry across Africa with the rise of mobile banking. However, the full impact of technology on real estate in Africa will only be felt in the medium to long term, as access to technology increases across the continent and the traditional consumer culture in Africa begins to change. Innovative and low-cost building technologies will also help make housing affordable.
Sustainability will become entrenched in building design and occupier requirements, with Africa’s most ambitious countries changing city design and building practices

In some countries where new cities are being built, developers are using eco-friendly technologies to reduce their environmental impact. Some of these technologies include solar building integration, climate responsive building strategies, renewable building materials, recycling and reuse, ecological building materials, an integrated planning process, low-cost design and the use of innovative design tools. This kind of approach can be seen in One Airport Square project in Ghana, for example. This trend is expected to continue in Africa, albeit at a slower pace than in the developed world. Konza City in Kenya, Eko-Atlantic in Nigeria and Roma Park in Zambia are just a few of the entirely new urban villages focusing on the concept of ‘place making’ in a sustainable way. Use of these new technologies will be accelerated by new sustainability legislation in the most progressive African markets.

Risks of investing in Africa

One of the key predictions made for 2020 relates to the emergence of new risks, together with the rewards attributed to the new risks. Africa has 54 very different countries with low connectivity between them, and there is no single answer to ‘which countries to invest in’. Some of the additional risks of real estate investment in Africa include:

- The impact of political stability and changing government policy; a lack of economic diversity, with an overdependence on natural resources.
- Complex legal considerations, such as property ownership rights and investment restrictions.
- The volatility of local currencies against the US dollar.
- The time frame of investments and restrictions on possible exit strategy (e.g. limited institutional investors as compared to more developed markets).

It is important that investors give consideration to these risks when investing in Africa.

Why Africa?

Despite these risks, real estate investors and developers continue to see the African market as a huge opportunity.

Investment returns from real estate in Africa’s rapidly expanding economies significantly exceed those achievable in almost all developed markets. Forecasts of 20% net annual returns from investing in shopping malls, office blocks or industrial complexes in countries across Africa continue to draw in new investors.7

The opportunities across Africa are significant and span every sector. In almost all markets, demand for high-quality retail, office and industrial space continues to outstrip supply as international and local occupiers respond to new economic opportunities. Huge shortfalls in residential property across the continent give rise to opportunities for private development on a grand scale, while a lack of local funding for infrastructure projects provides a platform for new public private partnerships.

Demographic shifts and changes in consumer behaviour create demand for different types of real estate, allowing for the entry of more specialist investors into the market.

Economic growth, improving political stability and ongoing investments in infrastructure are opening previously inaccessible markets, while increased transparency and availability of local partners is helping to improve the ease of doing business. Barriers to local market entry may be high, but by entering the market early, investors may be able to reap rewards in the form of high returns and exploit new opportunities as they arise.

African opportunities can be exploited best by combining the competitive advantage of individual countries into a coordinated business model.

Risk appetite remains an important consideration for any investor in Africa, but for estate companies that can accept and manage these risks, there are significant rewards on offer from the right investment.
Money laundering and regulation
For the past few years, regulators in more developed markets have begun to turn their focus to anti-money laundering (AML) regulations, more specifically the enforcement of those regulations. This has particularly affected banks with operations in the USA and Europe. At the same time, fines have grown ever larger as regulators lose their patience and banks are often forced into settlement agreements for criminal and civil liability in addition to paying fines.

### Largest fines paid

<table>
<thead>
<tr>
<th>Year</th>
<th>Entity</th>
<th>Enforcement authority</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>Royal Bank of Scotland</td>
<td>OFAC</td>
<td>$500 million</td>
</tr>
<tr>
<td>2009</td>
<td>Lloyds TSB</td>
<td>OFAC</td>
<td>$217 million</td>
</tr>
<tr>
<td>2009</td>
<td>Credit Suisse</td>
<td>OFAC/DOJ</td>
<td>$536 million</td>
</tr>
<tr>
<td>2010</td>
<td>Barclays Bank</td>
<td>DOJ</td>
<td>$298 million</td>
</tr>
<tr>
<td>2011</td>
<td>JP Morgan Chase</td>
<td>OFAC</td>
<td>$88 million</td>
</tr>
<tr>
<td>2012</td>
<td>Standard Chartered</td>
<td>OFAC</td>
<td>$327 million</td>
</tr>
<tr>
<td>2012</td>
<td>Standard Chartered</td>
<td>DFS</td>
<td>$340 million</td>
</tr>
<tr>
<td>2012</td>
<td>ING Bank</td>
<td>OFAC</td>
<td>$619 million</td>
</tr>
<tr>
<td>2012</td>
<td>HSBC</td>
<td>OFAC</td>
<td>$1.9 billion</td>
</tr>
<tr>
<td>2013</td>
<td>GT Bank</td>
<td>FCA</td>
<td>£525 000</td>
</tr>
<tr>
<td>2014</td>
<td>BNP Paribas</td>
<td>OFAC</td>
<td>$963 million</td>
</tr>
<tr>
<td>2014</td>
<td>BNP Paribas</td>
<td>DOJ</td>
<td>$8.9 billion</td>
</tr>
<tr>
<td>2014</td>
<td>Standard Chartered</td>
<td>DFS</td>
<td>$300 million</td>
</tr>
<tr>
<td>2014</td>
<td>Deutsche Bank</td>
<td>FCA</td>
<td>£4.7 million</td>
</tr>
<tr>
<td>2014</td>
<td>Standard Bank plc</td>
<td>FCA</td>
<td>£7.6 million</td>
</tr>
<tr>
<td>2014</td>
<td>Standard Bank</td>
<td>SARB</td>
<td>R60 million</td>
</tr>
<tr>
<td>2014</td>
<td>FirstRand</td>
<td>SARB</td>
<td>R30 million</td>
</tr>
<tr>
<td>2014</td>
<td>Absa</td>
<td>SARB</td>
<td>R10 million</td>
</tr>
<tr>
<td>2014</td>
<td>Nedbank</td>
<td>SARB</td>
<td>R25 million</td>
</tr>
<tr>
<td>2015</td>
<td>Deutsche Bank</td>
<td>SARB</td>
<td>R10 million</td>
</tr>
<tr>
<td>2015</td>
<td>Capitec Bank</td>
<td>SARB</td>
<td>R5 million</td>
</tr>
</tbody>
</table>
What these statistics clearly show is that non-compliance is no longer commercially viable. The largest fines are so large that they affect profitability and the value of shares. Executives that willfully flouted requirements and circumvented controls earned their banks the largest fines, though even simple negligence has resulted in large fines being levied. One bank was fined for inadequate sanctions screening. Its defence? The system it had installed was too complicated and staff did not know how to operate it effectively.

The current state across Africa

Africa has thus far escaped relatively unscathed: the UK subsidiary of a South African bank received a £7.6 million fine for failings relating to its AML policies and procedures regarding corporate customers and their links to politically exposed persons.

The UK subsidiary of a Nigerian bank was fined £525 000 for failings in its AML controls for high-risk customers. Additionally, the South African Reserve Bank (SARB) has recently fined the four top South African banks for AML failings, and conducted inspections at a number of other banks including foreign banks that operate locally.

Indications are that AML is going to be a Central Bank of Nigeria (CBN) priority in the coming months.

While African banks, by and large, might not have much cause to fear that local regulators will be imposing fines worth billions of dollars’ on them any time soon, they are not in a position to be complacent.
Key drivers of change

Foreign operations

This is probably the most obvious concern for all banks, including those in Africa. A number of so-called African banks have operations in Europe or the USA making them subject to the requirements of foreign-based regulators. Foreign regulators have not shied away from imposing fines on local branches of foreign banks. Operating in their country makes the foreign bank just as accountable as any local bank, possibly even more so due to the potentially heightened risk associated with foreign customers from less stringent jurisdictions.

Failing to meet the necessary standards will put banks at risk of being fined by the relevant enforcement authorities. In addition to this the regulator may feel that it is necessary to take control of the operations of the bank. The worst case scenario for any bank would be that their transgressions are so severe that it is felt that the best course of action would be to suspend their banking license.

Correspondent banking

In order to enter into a correspondent banking relationship with a foreign bank, thereby accessing a foreign market, banks need to meet higher requirements to satisfy the foreign bank that they are sufficiently risk averse so as not to introduce unnecessary risk to their operations.

Part of this is the requirement that AML systems should be sufficiently robust to meet the requirements of the foreign regulator. By allowing a foreign bank’s customers access to your accounts, your organisation is duty bound to ensure that they are not being abused to launder money or move funds for sanctioned individuals or entities.

A foreign regulator will hold the bank responsible for any failings taking place on its accounts – regardless of the fact that they were the result of a lax correspondent bank. African banks will need to ensure that they take AML seriously in order to maintain their correspondent banking relationships.

Reputation

Adverse reputation should be a major concern for any bank. A negative reputation can frighten off customers and bring the regulator calling. A key example of just how damaging a negative reputation can be is seen in the case of FBME.

The Federal Bank of the Middle East (FBME) is headquartered in Tanzania and is the country’s largest bank with assets in the region of $2 billion. Over 90% of its assets and global banking business are, however, located in Cyprus.

FBME is facing serious challenges following the US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) naming it as a foreign financial institution of primary money laundering concern and proposing steps that will effectively shut FBME out of the US financial system.

Following this pronouncement, the Central Bank of Cyprus (CBC) took over the management of operations in Cyprus.

The CBC feared the FinCEN pronouncement would deal a serious blow to FBME’s operations, endangering the stability of the Cypriot financial system and risking depositors’ funds. The CBC intends to sell off operations to protect depositors.

Following the CBC’s pronouncement, the central bank of Tanzania, Bank of Tanzania (BoT), took control of FBME’s Tanzanian operations, protecting the stability of the Tanzanian banking system and the safety of customer deposits.

The actions of the CBC and BoT have resulted in their taking control of FBME. The bank is unlikely to survive in its present form. Central to this, however, is the fact that it was a bad reputation that set the chain of events into motion. Banks should pay heed to the fact that actions by unrelated foreign regulators can have disastrous consequences on their global operations.

What the future holds

In the past regulators focussed on a prescriptive approach. They dictated what banks needed to do in order to be compliant. Usually this took the form of providing lists of documentation that should be collected before a bank could take on a customer. The approach of regulators in this regard is changing.

When calculating fines, regulators take a bank’s level of cooperation into account, as well as the fact that steps have been taken to rectify identified shortcomings.
Regulators are shifting to a collaborative risk-based approach, as advocated by the global inter-governmental Financial Action Task Force. In this approach, banks must evaluate the risk posed by each customer and treat them accordingly. Banks will no longer be able to claim compliance because they collected the correct documentation, they will need to show that they had a comprehensive view of their client and took appropriate steps to mitigate the risk posed by that client.

This has the benefit of giving banks the freedom to design their own controls, but equally exposes them to far greater risk for non-compliance as regulators will take a dim view in cases where a bank does not apply sound rationale when assessing the risk posed by a client.

What clients should be thinking about

Compliance with AML regulations is no longer optional, and must be embedded into a bank’s operations to create a culture of compliance for bank employees at all levels.

The cost of implementing a sound AML regime pales in comparison to the fines being issued to banks. Even worse is the fact that having imposed a fine, the regulator will still expect the banks to take steps to rectify their shortcomings; so banks end up having to bear the implementation cost regardless.

The cost of waiting

\[ \text{Implementation Later} = \text{Implementation Now} + \text{Fines} + \text{Regulatory Scrutiny} + \text{Reputational Loss} \]

Banks should proactively take steps to bring their AML regimes into line with local regulation and leading international practice – particularly if they have operations in other jurisdictions – while they can still do so on their own terms.
The new auditor reporting standard
Towards a more transparent and relevant auditors’ reporting
The revised, new Auditor Reporting Standard was released in January 2015 in response to a need for enhanced transparency and readability of the auditors’ report. It is aimed at addressing some of the concerns raised by investors around auditors’ reporting as it relates to going concern and matters identified as involving significant auditor attention during the audit.

The International Auditing and Assurance Standards Board (IAASB) believe that the new auditors’ report will:

- increase confidence in the audit and the financial statements,
- enhance communication between the auditor and the board of directors/audit committee,
- increase attention by management to the disclosures in the financial statements to which reference is made in the auditor’s report, and
- renew focus of the auditor on matters to be communicated in the auditor’s report hence increasing the auditor’s professional skepticism.

The Standard will be effective for audits of financial statements for periods ending on or after 15 December 2016 with early application permitted.

**So what’s new?**

**Insight**
The new auditor’s report is aimed at providing insight on Key Audit Matters which are those matters that the auditor considers are of most significance in the audit of the financial statements.

**Transparency**
An introduction of an affirmative statement regarding the auditor’s independence is aimed at achieving improved transparency.

**Readability**
The restructuring of the auditor’s report, in particular, putting the audit opinion first, is aimed at improved readability. Standardised wording in the auditor’s report such as description of the auditor’s responsibilities and what is involved in an audit can be placed at the end of the report or in an appendix or can be referred to in a common website.

The key changes to the auditors’ report are as presented in the table below:
<table>
<thead>
<tr>
<th>Item</th>
<th>Content</th>
<th>Old Vs New Reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opinion</td>
<td>The audit opinion and identification of what has been audited will now be the first section of the report.</td>
<td>Audit opinion is usually the last section of the auditor's report. This will now be the first paragraph.</td>
</tr>
<tr>
<td>Basis for Opinion</td>
<td>The Basis for Opinion will directly follow the Opinion section and will now include the new assertion of the auditor's independence. If the audit opinion has been modified, the explanation would be included too.</td>
<td>Affirmative statement on auditor's independence is now required.</td>
</tr>
<tr>
<td>Material uncertainty regarding going concern (if any)</td>
<td>If there is a material uncertainty with respect to going concern, it will now be described in a separate section that identifies it as such.</td>
<td>This is a new requirement.</td>
</tr>
<tr>
<td>Key audit matters</td>
<td>A section providing insight into the key matters addressed in the audit will be required for audits of listed companies, but can also be included voluntarily by other companies.</td>
<td>This is a new requirement.</td>
</tr>
<tr>
<td>Other information</td>
<td>A section in the auditor's report will describe the auditor's responsibilities for other information (e.g., the rest of the annual report, including the management report) and the outcome of fulfilling those responsibilities.</td>
<td>This is a new requirement.</td>
</tr>
<tr>
<td>Emphasis paragraphs (if any)</td>
<td>An emphasis of matter paragraph may be next if it is relevant to understanding the financial reporting framework, or it might follow the key audit matters if it relates to a matter also addressed in that section.</td>
<td>This is a revision updating an existing requirement.</td>
</tr>
<tr>
<td>Other matter paragraphs (if any)</td>
<td>Placement of an Other Matter paragraph if it relates to the financial statement audit or later in the report if it relates to other legal or regulatory requirements.</td>
<td>This is a revision updating an existing requirement.</td>
</tr>
<tr>
<td>Responsibilities for the financial statements</td>
<td>The description of the Board’s responsibilities will be expanded to explain its responsibilities with respect to going concern.</td>
<td>This is a revision updating an existing requirement.</td>
</tr>
<tr>
<td>Auditor's responsibilities</td>
<td>This will now include a description of the auditor's responsibilities with respect to going concern.</td>
<td>This is a revision updating an existing requirement.</td>
</tr>
<tr>
<td>Date, address and signature</td>
<td>In addition to the signature, address and date, auditor's reports for listed companies will now also have to identify the engagement partner's name.</td>
<td>This is a new requirement of ISAs, but is already effective in Nigeria.</td>
</tr>
</tbody>
</table>

For non-listed companies, communication of KAMs and disclosure of the name of engagement partner is not required however; voluntary application is allowed for these companies.
Key Audit Matters (KAMs): what are they?

Investors, board of directors, audit committee and other users of the financial statement want to know the significant issues that arose in the audit process, how the auditor responded to them and what the auditor found. Key audit matters addressed in the audit are those areas that often involve difficult or complex auditor judgments which always involve significant auditor attention during the audit.

An iterative process is deployed in determining whether a matter is significant, and therefore may qualify as a key audit matter. In arriving at the KAMs, the auditor considers:

- Areas of higher assessed risk of material misstatement.
- Areas requiring significant auditor and management judgment, including accounting estimates identified as having high estimation uncertainty and more subjective areas of the financial statements.
- The effect on the audit of significant events or transactions that occurred during the period.
- Matters that pose challenges to the auditor in obtaining sufficient appropriate audit evidence or pose challenges to the auditor in forming an opinion on the financial statements.
- Significant technical matters in which an auditor may have consulted with others within or outside the firm.

How do auditors select Key Audit Matters?

Professional judgment will be needed to determine which, and how many, key audit matters to include in the audit report. This will be an important judgment. While key audit matters will be drawn from matters discussed with the audit committee, it is not expected that all such matters would be considered key audit matters to be included in the auditor's report. KAMs should also not be a long list, as that would be contrary to the notion of such matters being those of most significance in the audit.

The starting population of KAMs is all matters communicated with the board of directors and the audit committee. These are filtered from the pool of matters that required significant auditor attention in performing the audit and are determined as those that are of most significance. Sensitive matters can be excluded from the disclosure especially where the adverse consequences of public communication of such a matter would outweigh the public interest benefits.

Describing KAMs

The amount of detail is a matter of professional judgment, this might include:

- Why the matter is considered to be of the most significance.
- How the matter was addressed in the audit.
- Reference to related disclosure(s) if any.
- Description of the most relevant aspects of the response.
- A brief overview of procedures performed.
- An indication of the outcome of the procedures, or any key observations.

Getting it right

The standards mark a move to reports that are more informative, discursive and insightful. Implementation of the new Auditor's Report will bring both opportunities and challenges. The opportunities will arise from enhanced conversations among auditors, board of directors, audit committees, shareholders and regulators. The more informative reports will also demonstrate visibly, the value and relevance of audit.

There are challenges ahead which will require careful navigation. The new reporting will be as new to management and audit committees and users as it is to auditors. Auditors around the world will be on a learning curve – so we ask that stakeholders in the audit give us as much feedback as possible so that we can continue to improve the quality of our reports. It is hugely important that we get this right.

Where similar proposals have been rolled out in the UK, auditors have embraced the transformation – producing insightful reports with tailored information and less jargon. Shareholder reaction has been very positive, referring to a ‘sea of change’ in auditor reporting. This is a good start.

Here at PwC, we are committed to producing informative and insightful reports that reflect the spirit of the reforms. We have listened, we have understood and now we are changing.
Contacts

**PwC Nigeria Financial Services**

**West Market Financial Services Leader**
- Anthony Oputa
  - tony.oputa@ng.pwc.com

**Nigeria Financial Services Leader**
- Patrick Obianwa
  - p.obianwa@ng.pwc.com

**Financial Services Assurance**
- Gabriel Ukpeh
  - gabriel.ukpeh@ng.pwc.com
- Daniel Asapokhai
  - daniel.asapokhai@ng.pwc.com
- Sam Abu
  - samuel.abu@ng.pwc.com
- Obioma Ubah
  - obioma.n.ubah@ng.pwc.com

**Financial Services Advisory**
- Andrew Nevin
  - andrew.x.nevin@ng.pwc.com
- Andrei Ugarov
  - andrei.ugarov@ng.pwc.com
- Kwabena Asante-Poku
  - kwabena.asante-poku@ng.pwc.com

**Financial Services Tax and Regulatory Services**
- Taiwo Oyedele
  - taiwo.oyedele@ng.pwc.com
- Abolade Kehinde
  - abolade.kehinde@ng.pwc.com