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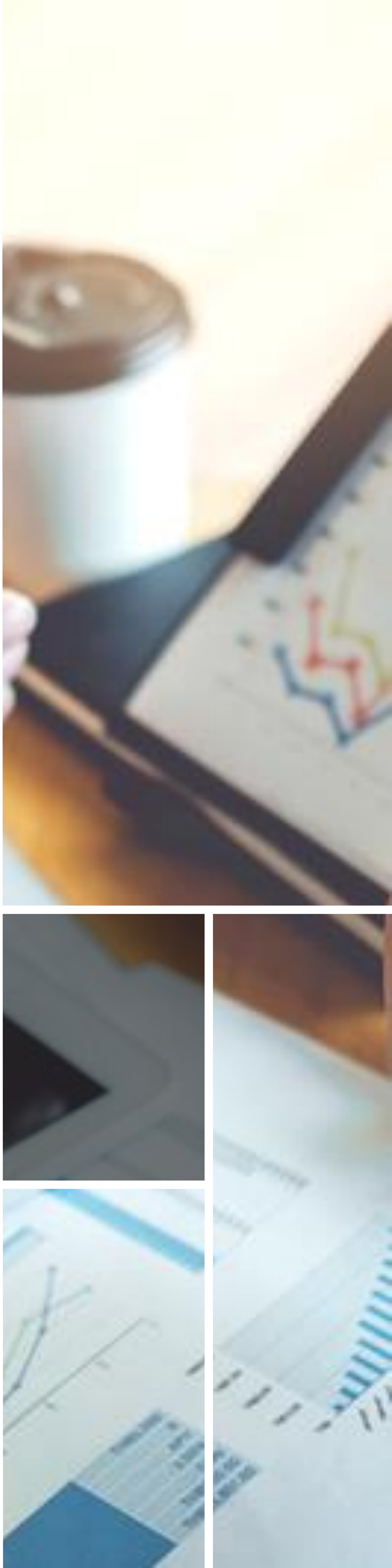
A look at current financial reporting issues

Implications of the reintroduction of the floating foreign exchange rate in Nigeria



August 2023

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Background

In 2016, the Nigerian economy dipped into a recession which saw the naira deteriorate significantly against major currencies at the foreign exchange (FX) market until the Central Bank of Nigeria ("CBN") intervened in 2017.

In a bid to maintain FX liquidity while simultaneously allowing investors to trade their own dollars at a more market-determined rate, the CBN created different windows for various segments of the economy with foreign currencies trading in these windows at different rates thus leading to a multiple exchange rate system.

This necessitated the need to consider the appropriate exchange rates for converting and translating foreign denominated transactions and balances for Nigerian businesses and foreign investments into naira in accordance with International Financial Reporting Standards (IFRS).

The multiple exchange rate system comprised of the following windows/rates:

CBN official window	The market in which CBN, at its discretion, intervenes in the FX market through the Secondary Market Intervention Sales (SMIS) window
Inter-bank Foreign Exchange Market (IFEM)/Autonomous market	The market in which commercial banks sell foreign currency to other commercial banks and to big commercial customers
The Nigerian Autonomous Foreign Exchange Rate Fixing (NAFEX)/Autonomous market	The autonomous FX market which comprises recognized FX trading segments, such as the inter-bank market, the Investors' and Exporters' (I&E) FX window and any such approved and recognized trading segment as may be defined from time to time
Bureau-De-Change (BDC) market	The unofficial market operated by registered BDCs. The forces of demand and supply determine the FX rate in this market
Parallel market	The unofficial market where individuals and businesses, unable to purchase foreign currency at the official rates, source foreign currencies. The unofficial market is operated by private individuals and the forces of demand and supply determines the FX rate in this market

On 14 June 2023, the CBN announced operational changes to the FX market which essentially abolished the multiple official FX windows and collapsed these into the I&E window with the reintroduction of the "Willing Buyer, Willing Seller" model.

April 2017

Introduction of the Nigerian Autonomous Foreign Exchange Rate Fixing (NAFEX) - a reference rate for foreign exchange activities in the Investors' & Exporters' (I&E) foreign exchange window

December 2018

Cessation of the Nigerian Foreign Exchange Fixing (NIFEX) rate - final calculation and publication of NIFEX

May 2021

Devaluation of the naira by 7.6% against the US dollar

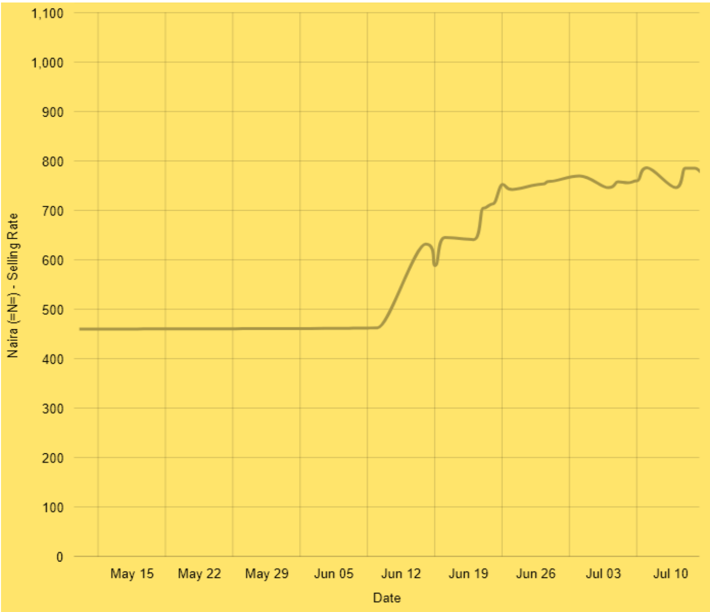
CBN removes the CBN 'official rate' of N379 per dollar from its website and adopts the NAFEX/I&E rate of N410.25 per dollar as the government's official exchange rate

July 2021

CBN discontinues the sale of foreign currencies to BDC operators in Nigeria and suspends the applications for and issuance of new licenses for BDC operations

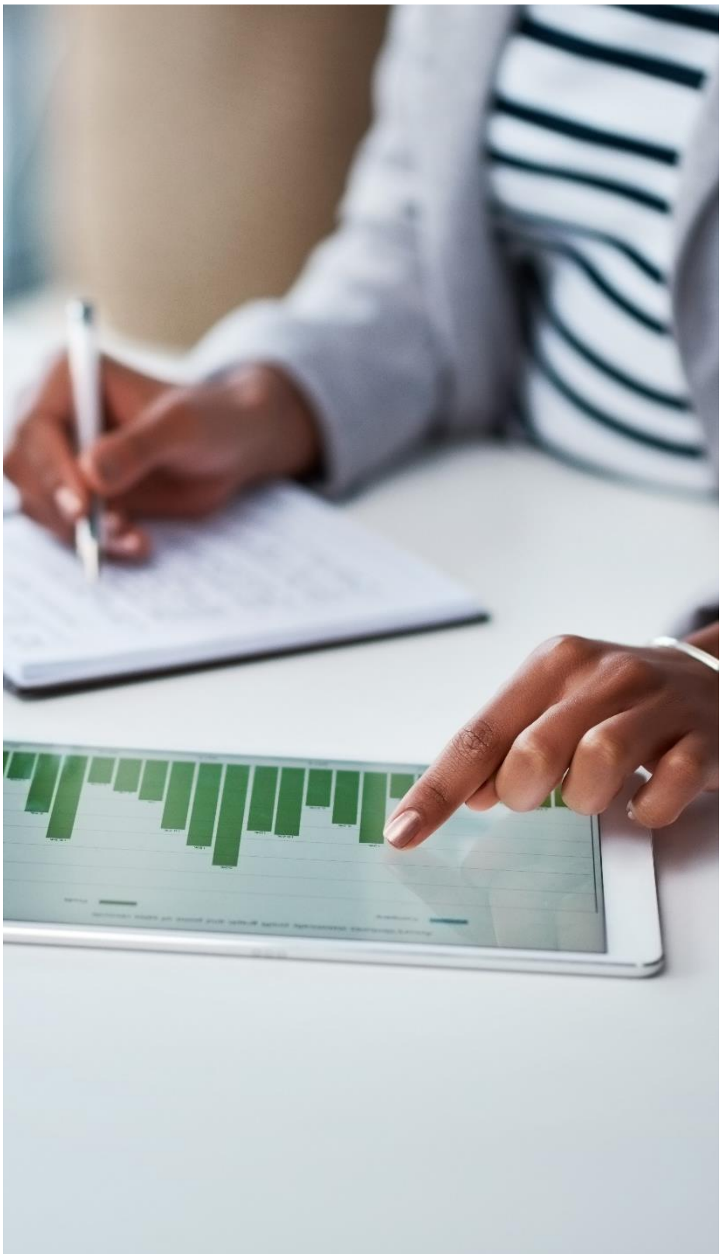
June 2023

CBN announces operational changes to the foreign exchange market with the reintroduction of the *"Willing Buyer, Willing Seller"* model at the I&E window which saw the I&E rate closing at N702.19 against the US dollar on 15 June



Source: https://www.cbn.gov.ng/rates/ExchRateByCurrency.asp

This publication focuses on the financial reporting implications of reintroduction of the floating FX rate in Nigeria on Nigerian businesses and foreign investments into Nigeria.



Measuring transactions and balances denominated in foreign currencies

IAS 21 *The Effects of Changes in Foreign Exchange Rates* ("IAS 21") prescribes how an entity should account for:

- foreign currency transactions (transactions that are denominated or require settlement in a currency other than the functional currency of an entity); and
- foreign operations (a subsidiary, associate, joint arrangement or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity).

The principal issues addressed by IAS 21 are which exchange rate(s) should be applied and how the effects of changes in exchange rates should be reported in an entity's financial statements.

Spot exchange rate

IAS 21 para 8 defines spot exchange rate as *"the exchange rate for immediate delivery"*.

In our view, in determining whether a rate is a spot rate, an entity should consider whether currency is available at an official quoted rate and whether the quoted rate is available for immediate delivery (with a normal administrative delay in obtaining the funds being acceptable).

Until the announcement of the operational changes to the FX market in June 2023, Nigeria had multiple exchange rates which required the application of judgement in determining which exchange rate qualified as a spot rate for translation under IAS 21.

This caused an issue for entities due to the illiquidity of the FX market with most entities being unable to obtain sufficient foreign currency at the official quoted rate.

Key consideration: Determining an appropriate source of an officially quoted rate

A key takeaway from the operational changes is that no single official rate has been determined.

Rather, it has been established that the I&E window is the market where official rates are quoted within Nigeria with the reintroduction of the *"Willing Buyer, Willing Seller"* model.

As such, all rates quoted through this market in which the exchange transaction would create **enforceable rights and obligations** are deemed acceptable.

In line with the CBN's announcement, brokers within the I&E window are at liberty to buy FX at whichever rate they decide, however, the reintroduction of order-based two-way quotes means that they cannot determine their bid-ask spread which is now limited to ₦1. Thus, the I&E rates may vary slightly from source to source as average rates are published on a daily basis

Rates within the I&E window are quotes and can, therefore, be used to convert or translate foreign currency transactions. Platforms where these rates are accessible are:

CBN website	The rate that must be used for all government related transactions which is the weighted average rate of the preceding day's executed transactions at the I&E window (https://www.cbn.gov.ng/)
FMDQ Securities Exchange (FMDQ) website	FMDQ plays a crucial role by providing market information and transparency with the website publishing the NAFEX rate which is the **reference rate for spot FX operations** in various trading segments (https://fmdqgroup.com/exchange/)
Deposit money commercial banks in Nigeria	These are financial organisations that are licenced by CBN to carry out the functions of funds safety, loan administration, financial advisory, among others (https://www.cbn.gov.ng/supervision/inst-dm.asp)

Initial recognition

IAS 21 para 21 requires that a foreign currency transaction should be recorded at initial recognition in the functional currency using the spot exchange rate at the date of transaction.

Key consideration: Use of a rate that approximates the actual rate at the date of the transaction

On initial recognition of a foreign currency transaction, a rate that approximates the actual rate at the date of the transaction is often used for practical reasons. (IAS 21 para 22)

In such cases, given the reintroduction of the floating exchange rate in Nigeria, fluctuations may be significant and, as such, using a straight yearly average rate might be inappropriate.

In our view, a monthly average or a grouped average should be used (i.e. an average of the exchange rate before the reintroduction of the floating exchange rate should be used to translate transactions before the announcement while an average of the exchange rates after the reintroduction of the floating exchange rate should be used to translate transactions after the announcement).

Subsequent recognition

IAS 21 para 23 requires that at the end of each reporting period:

- Foreign currency monetary items shall be translated using the closing rate (i.e. the spot exchange rate at the end of the reporting period);
- Non-monetary items that are measured at historical cost in a foreign currency shall be translated using the exchange rate at the date of the transaction (i.e. no remeasurement); and
- Non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rate at the date when the fair value was measured

Key consideration: Understanding the difference between the I&E window rates and the NAFEX rate

I&E window rates are the exchange rates at which foreign currency trades are executed within the I&E window and are determined based on prevailing market conditions **on a specific date** (i.e. the reporting date). These rates serve as a **benchmark for transactions within the I&E window**

NAFEX rate is a **reference rate used for spot foreign exchange transactions** within official/approved trading segments.

A summary of the methodology applied by FMDQ to determine the **daily** Volume-Weighted Average Price ('VWAP') opening and closing rates in the I&E window can be found here.

JULY 13, 2023: NAFEX $/N799.40

JULY 14, 2023: I&E FX Closing rate $/N803.90

Source: https://fmdqgroup.com/exchange/

Key consideration: Opening, closing, low, high and average spot rates

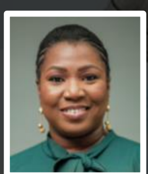
As stated previously, the spot exchange rate is defined as *"the exchange rate for immediate delivery"*.

In our view the use of the quoted VWAP rate would commonly be most appropriate as this represents the average executed prices and the value of the transactions in the I&E window on a specific date. As such, the use of the opening, low or high rates published:

- might not represent a rate that entities could obtain on that date for immediate delivery; and
- may understate or overstate the value of transactions and/or balances

Where an entity can provide evidence that FX was obtained at a lower or higher rate in the I&E window through an official channel that created enforceable rights and obligations, use of this rate in performing translation would be appropriate.

Contacts



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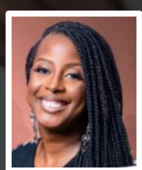

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