
A look at current financial reporting issues

January 2018



Accounting considerations for foreign Currency transactions and balances in Nigeria under IFRSs.

Issue

The Naira deteriorated significantly against major currencies at the forex market as the nation's economy dipped into recession in 2016. The Naira was almost hitting N600 per Dollar at the parallel market at a time in 2017, until the Central Bank of Nigeria intervention.

In a bid to maintain forex liquidity while simultaneously allowing investors to trade their own dollars at a more market-determined rate, the Central Bank of Nigeria created different windows for various segments of the economy. Foreign currencies are traded in these markets/windows at different rates thus leading to a multiple exchange rate system.

The multiple exchange rate system 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 Nigeria under International Financial Reporting Standards (IFRSs).

Background

The Central Bank of Nigeria ("CBN") is the Federal Government of Nigeria's regulatory body responsible for maintaining Nigeria's external reserves to safeguard the international value of the Nigerian Naira.

The CBN achieves this by running a managed float exchange rate regime i.e. altering the equilibrium price of the Nigerian Naira (NGN) as determined by the forces of demand and supply. It achieves this with the use of the country's foreign exchange ("FX") reserves which is under its control.

The CBN intervenes in the market from time to time in order to resist fluctuations that they consider to be undesirable. It does this by participating in buying and selling of foreign exchange through different windows.



In April 2017, the CBN published a circular titled: 'Establishment of investors' and exporters' FX window' (FMD/DIR/CIR/GEN/08/007), with its provisions effective from 24 April 2017. This window is open to portfolio investors, exporters and end- users of FX, including the CBN. The CBN's main reason for its introduction is to, in its own words, 'boost liquidity in the FX market and ensure timely execution and settlement for eligible transactions'.

Thus, as at 24 April 2017, there are three official and two unofficial foreign currency markets available to businesses and individuals in Nigeria. These are:

1. CBN official window

The CBN may, at its discretion, intervene in the FX market through the Secondary Market Intervention Sales (SMIS) window. At SMIS window, CBN sells FX to Authorized Dealers (wholesale) or to end-users through Authorized Dealers (retail) via a multiple-price book building process using the FMDQ-Thomson Reuters FX Auction Systems, or any other system approved by the CBN. All SMIS bids shall be submitted to the CBN through the FX primary dealers

NiFEX is the reference rate for Spot FX operations in the CBN Official Window which comprises the CBN Secondary Market Intervention Sales (SMIS) or any other such designated CBN Official Intervention Window

NiFEX is a polled rate based on the submissions of ten (10) contributing banks and calculated using a trimmed arithmetic mean. Upon receipt of quotes, the individual contributing banks' submissions are calculated and ranked in descending order. The lowest and highest two (2) quotes are eliminated from the ranked rates leaving only the middle six (6) rates. The trimming of the top and bottom rates allows for the exclusion of outliers from the final calculation. The arithmetic mean of the remaining rates are then calculated to two (2) decimal places and disseminated as the NiFEX Spot Rate

As at 3rd January 2018, the SMIS window rate/NiFEX rate was N330 to 1USD. <http://www.fmdqotc.com/>

2. The Inter-bank Foreign Exchange Market (IFEM)/Autonomous market:

This is the market in which commercial banks sell foreign currency to other commercial banks (Inter-bank rates) and to big commercial customers.

At the inter-bank market, the CBN trades directly with the primary dealers either in FX spot or FX derivatives. The intervention-trading shall be for the standard amount (As defined in the guidelines for FX dealers). As at 3rd January 2018, the CBN official rate was N305.95 to 1 USD. <http://www.fmdqotc.com/>

3. The Nigerian Autonomous Foreign Exchange Rate Fixing (NAFEX)/Autonomous market

NAFEX is the reference rate for Spot FX operations in the Autonomous FX Market which comprises recognized FX trading segments, including but not limited to the Inter-bank market, the Investors' and Exporters' FX Window and any such approved and recognized trading segment as may be defined from time to time.

The Investors' and Exporters' FX Window is the market in which portfolio investors, importers and exporters, authorized dealers and other parties with foreign currency to exchange to Naira can sell/buy foreign currency to/from other commercial banks and to big commercial customers..

Like NiFEX, NAFEX rate also calculated using a trimmed arithmetic mean.

As at 3rd January 2018, the NAFEX FX rate was N361 to 1USD. <http://www.fmdqotc.com/>

4. The Bureau-De-Change (BDC) market

This is an unofficial market which is operated by registered BDCs. The forces of demand and supply determine the FX rate in this market. FX rates may be negotiated based on volume of transaction.

The FX rates also differ from one geographic location to the other. The last available rate was in November 2017, when the BDC FX rate as quoted on the CBN website was N 362.41 to 1USD.

<https://www.cbn.gov.ng/rates/exrate.asp>

5. The parallel market

This is the unofficial market where individuals and businesses who are unable to purchase foreign currency at the official rates source foreign currencies. The unofficial market is operated by private individuals. The forces of demand and supply determine the FX rate in this market.

The unofficial market has the highest FX rate of the four markets and FX rates can also differ from one geographic location to the other. FX rates may be negotiated based on volume of transaction. Unofficial markets FX rates are not quoted.

There is no official quoted market for parallel market transactions and the only way to observe these rates are based on individual transactions as negotiated per transaction

The existence of multiple FX markets with different exchange rates as well as the accessibility to such markets necessitates the review of the appropriate exchange rates that entities should use in accounting for and reporting its foreign currency transactions.

The following sections assesses various transactions and balances that may likely be affected as a result of these exchange rate fluctuations and of having multiple sources of foreign exchange.

Measuring transactions and balances denominated in foreign currency

Initial recognition

IAS 21, 'The effects of changes in foreign exchange rates', 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 (IAS 21, para 21).

Subsequent recognition

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

- a. Foreign currency monetary items shall be translated using the closing rate;
- b. 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; and
- c. Non-monetary items that are measured at fair value in a foreign currency shall be translated using the exchange rates at the date when the fair value was measured.

Spot rate

IAS 21 para 8 defines the spot exchange rate as the exchange rate for immediate delivery. Where a country has multiple exchange rates, an **official quoted** rate should be used as the spot rate.

Where several official quoted rates exists, the rate used to translate and record the foreign currency transactions and balances is the rate at which future cash flows or balances could have been settled if those cash flows had occurred at the measurement date (IAS 21 para 26).

Nigeria currently has multiple exchange rates and judgement will be required to determine which exchange rate qualifies as a spot rate that can be used for translation under IAS 21. 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.

Countries may experience economic conditions from time to time that affect the free-market convertibility of the local currency. As a result, the exchangeability between two currencies may be temporarily unavailable at the transaction date or a subsequent balance sheet date. IAS 21 requires entities to use the rate on the first subsequent date at which exchanges could be made (IAS 21 para 26).

The CBN official rate, Nigeria Inter-bank Foreign Exchange Fixing (NIFEX) rates and the Nigerian Autonomous Foreign Exchange Fixing (NAFEX) rates are quoted and can be used to convert or translate foreign currency transactions. The official platforms on which these rates are quoted are the CBN website (www.cbn.gov.ng) and the FMDQ OTC website (www.fmdqotc.com). It is expected that deposit money commercial banks in Nigeria would quote their FX rates on their websites and platforms as the banks are at liberty to determine their buy/sell spreads, thus, the Inter-bank/NAFEX rates may vary slightly from bank to bank. This is because NAFEX rate is a polled rate based on the submissions of ten (10) contributing banks and calculated using a trimmed arithmetic mean. This average would slightly differ from each bank's rate.

The judgment of which foreign exchange (FX) rate to use depends on the official FX rate at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date. This should take into account the specific facts and circumstances relating to each transaction or balance.



Types of transaction and balances

1. Translation of foreign operations

A foreign operation is an entity that is a subsidiary, associate, joint venture or branch of a reporting entity whose activities are based or conducted in a country or currency other than those of the reporting entity.

Foreign operations may have a functional currency different from the functional currency of the reporting entity. The reporting entity is to determine an appropriate exchange rate for translation of the results of foreign operations in preparing its own financial statement.

In preparing consolidated financial statements, the reporting entity will have to translate the results of its foreign operation. The applicable rate to use in this scenario will usually be the dividend remittance rate which is the rate in which returns on the investor's investment will be remitted in the form of dividends. If proceeds will be remitted in a different rate, that rate might be applicable instead.

In situations when specific rates are available, these specific rates should be used. In any other situation, the entity should settle these transactions by accessing the CBN official, NiFEX or the *NAFEX rate. Entities should use applicable exchange rates for the section of the foreign exchange market they have access to. The choice of official rate to be used is not optional. Rather, the entity is expected to use a rate at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date.

Example on translation of foreign operations

Translating the results of a foreign operation in Nigeria

Entity A has its operations in the United Kingdom, and has the Pounds as its functional currency. The entity sets up a subsidiary, Sub C, in Nigeria whose functional currency is the Nigerian Naira.

Entity A is preparing its consolidated financial statements at the end of 31 December 2017 annual reporting period and is considering what exchange rate it should apply in translating the results of Sub C. As at 31 December 2017, there are four possible exchange rates applicable in Nigeria i.e.

1. the NAFEX
2. the NiFEX,
3. the BDC rate; and
4. the parallel market

Question

What exchange rate should Entity A apply?

Solution

The translation of the financial statements of a foreign operation located in Nigeria should be translated at the NIFEX OR NAFEX rate because these are the two applicable rates at which they can remit proceeds from the investment whether from dividends or sale.

This also applies to any associate, joint venture or branch investments in a foreign operation that Entity A might have within Nigeria.

2. Measurement of foreign currency balances and transaction

A. Transactions during the period

Transactions such as sales and purchases should be recognized using spot rate at date of transaction or average rate if this is a reasonable approximation to the spot rate (average rates are permissible if there is no great fluctuation in the exchange rates).

CBN official, NIFEX or *NAFEX average rates could be applicable for translation purposes.

**The NAFEX rate will only be applicable from 24 April 2017.*

B. Transaction balances and cash balances

Entities that have receivable, payable or other monetary balances in a foreign currency should translate the receivables/payables using the CBN official, NIFEX or *NAFEX rate at the end of the reporting period.

Entities should translate or convert their foreign currency balances using rates quoted on an official market at reporting date. This means that either of the CBN official, NIFEX or NAFEX rates can be used to translate foreign denominated balances at the end of the relevant reporting period as they represent the ruling official exchange rates.

Importers of the items listed in Appendix C are banned from obtaining foreign currency from the CBN official, NIFEX or the NAFEX market. Therefore, for these importers and others without access to the IFEM market, the BDC and the unofficial markets are the only markets available for transactions. However, as these are unofficial markets, the rates for these markets cannot be used under IFRS.

For these entities, they can translate their foreign currency transactions and year end balances using either CBN official rate, NIFEX or the NAFEX rate as quoted on the CBN/FMDQ/Bank's websites, as the parallel market rates are not quoted on any officially recognized platforms.

**The NAFEX rate will only be applicable from 24 April 2017*

The choice between NAFEX, NIFEX and CBN Official rate

Where there are legal requirements or pre-contractual arrangements that determines the rate at which a liability will be settled or an asset realized, the legal or pre-contractual provisions applies.

For example, if a proceeds of a foreign currency asset balance is required to be delivered to a particularly market/window by law or contract. The rate at that market/window will apply for translation or conversion purposes.

In the absence of such provision, any of the CBN official, NiFEX or NAFEX rates could technically comply with the requirements of IAS 21.

The judgment of which foreign exchange (FX) rate to use depends on the official FX rate at which the future cash flows represented by the transaction or balance could have been settled if those cash flows had occurred at the measurement date.

In translating their financial statements, financial institutions like Banks would tend to use inter-bank rates that are peculiar to them rather than rates determined through some averaging methodologies for instance NiFEX fixing methodology

For foreign currency denominated asset balances, it is reasonable to expect that companies will convert at the highest possible rate provided that they have no obligation to settle at other markets and can access the market for immediate delivery at the reporting date.

However for foreign currency denominated liability balances, it is reasonable to expect that companies will convert at the lowest possible rate provided that they have no obligation to settle at other markets and can access forex in that market at the reporting date. For instance, an entity with foreign currency denominated liabilities will readily choose the CBN official rate (being the lowest of the available official rates) in translating its liabilities.

For compliance purposes, such entity must proof that it can access fund at the CBN official rate. Evidence that funds have been sourced at such rate in recent past would be a good reference point.

Other considerations

Exchange rate for translation of asset and liability: Bid or Ask Price

In foreign currency markets, the dealers usually quote exchange rates in bid – ask format. The bid price is the price that the dealer is willing to pay or “bid” for a currency, while the “ask” price is the price that the dealer wants for a currency.

For an investor with a financial asset denominated in foreign currency, the rate at which the investor will be able to convert the foreign currency to local currency in the foreign exchange market is the bid price, being the price any dealer will be willing to pay for such currency. While, in the event that an investor has a foreign currency denominated obligation that requires settlement in foreign currency, the investor would have to pay the dealer the ask price in order to access the foreign currency. Based on this, it is possible for corresponding foreign currency assets and liabilities in the different financial statements of 2 reporting entities to be translated at slightly different as the parties will report at the rate that they can convert the foreign currency asset to local currency or the rate to purchase foreign currency to settle the liability as the case may be.

Consider an investor with a foreign currency asset of \$1m and the price for USD at an exchange dealer kiosk is USD 1: NGN 360/365. The higher price, i.e. NGN 365 is the price that the dealer is asking to sell USD to the public (Ask price) while the lower price, i.e. NGN 360 is the price that the dealer is willing to pay to buy USD bid price (Bid price).

For a Nigerian company that has a liability account balance of \$1m, this will be translated in the financials

at the asking price of NGN 365 totaling NGN 365,000,000

On the other hand, for the company that has an asset balance of \$1m, this will be translated in the financial statement at a bid price of NGN 360 totaling NGN 360,000,000.

For ease of reporting, some entities simply assume the mid-rate, which is an average of the bid and the ask price and apply this rate uniformly to all foreign currency assets and liabilities in the financial statements, most times the impact on the foreign currency assets and liabilities will have a compensating effect and any resulting differences may likely not be material, hence this is considered an acceptable approach.

Disclosures

The rate (or rates) used and the implications should be disclosed clearly. The rate (or rates) used might also be a significant accounting judgment as such the basis for such judgment should be disclosed in the financial statements under the 'significant accounting estimates and judgements' note.

Where multiple quoted exchange rates are available, management should consider disclosing the sensitivity of using the different available quoted rates and the potential impact on profit or loss and other comprehensive income. This will be disclosed under the 'financial risk management' note.

It should be noted that more than one FX rate could be used to re-measure assets/liabilities within the same set of financial statements, but only one official FX rate can be used for purposes of translating the financial statements of a foreign operation.

Hyper-inflation

Hyperinflation can be described as an extremely rapid rise in inflation caused by large increase in money supply that is not supported by growth in gross domestic product.

According to the CBN, inflation in Nigeria stands at 15.9% as at November 2017 (<https://www.cbn.gov.ng/>) and is not expected to rise significantly in subsequent years as such the Nigerian economy is not experiencing hyperinflation therefore the requirement of IAS 29, 'Financial reporting in hyper-inflationary economies' does not apply.



APPENDIX

A: Summary of the CBN's circular on the 'Establishment of investors' and exporters' (I&E) FX window'

The responsibility for the operations of this new 'I&E' FX window lies with the FMDQ OTC securities exchange. The FX market rates will be published on the FMDQ's website on a daily basis. FMDQ will also be responsible for developing and publishing a new fixing called the Nigerian Autonomous Foreign Exchange Fixing (NAFEX). The CBN expects that this would make it easier to value its derivatives e.g. the OTC FX futures and the non-deliverable forward contracts (NDFs).

How the NAFEX rate is determined:

The NAFEX rates will be determined in a way similar to the London Inter-bank Offer Rate (LIBOR). It will be a poll of rates submitted by contributing banks and calculated using a trimmed arithmetic mean. For example if 10 banks submit Naira to USD quotes ranging from N350 to N420, the two lowest and highest quotes will be eliminated, leaving 6 rates. An average of the 6 rates will be calculated and this will be published as the NAFEX spot rate for the day.

The permitted transactions eligible to access this window include the following:

- 1) Invisible transactions (excluding international airlines ticket sales' remittances): loan principal and interest payments, dividend/income remittances, capital repatriation, management services fees, software subscription fees, technology transfer agreements, personal home remittances and other eligible transactions as contained in memorandum 1 5 of the CBN foreign exchange manual.
- 2) Bills for collection

NB: 1 & 2 above are only eligible to purchase US dollars sourced from the CBN FX window limited to the Secondary Market Intervention Sales (SMIS) wholesale (spot and forward) only.

However, international airlines ticket sales remittances shall eligible to access the CBN FX i.e. "SMIS" retail and wholesale (spot and forward).

- 3) Any other trade-related payment obligations (at the instance of the customer).

List of References:

CBN, (April 2017). Establishment of Investors & Exporters FX Window. *Central Bank of Nigeria (FMD/DIR/CIR/GEN/08/007)*. Pp.1-5
FMDQ OTC (April 2017). NAFEX (The Nigerian Autonomous Foreign Exchange Rate Fixing Methodology). Pp.1-6

B: Summary of the revised guidelines for the operation of the Nigerian Inter-bank Foreign Exchange Market (IFEM)

The guidelines which set out the new IFEM was introduced by the CBN on 15 June 2016, and took effect on 20 June 2016. It involves a single market structure for foreign exchange rates which shall be through the interbank/autonomous market. In addition to this, risk management products (i.e. forward futures), were also made a part of the arrangement.

The participants in the foreign exchange (FX) market will mainly be FX primary dealers (FXPDs), which comprises of all the deposit money banks (DMBs) in Nigeria. Other participants will include non-FXPDS, FX brokers and the CBN.

The official FX rate shall be as determined by the trading platforms in the FMDQ over-the-counter (OTC) Securities Exchange, operated by FMDQ - Thomson Reuters (FMDC TR) on each trading day. This FX rate will be known as the Nigerian Inter-Bank Foreign Exchange Fixing (NIFEX). These FX rates shall be quoted on both the FMDQ and CBN websites. It is also expected that the proceeds of foreign direct investment (FDI) shall be purchased at the interbank rate. Applicable exchange rate for the purpose of import duty payments shall be the daily inter-bank FX closing rate as published on the CBN website. However, the inter-bank funds shall not be sold to Bureau De Changes (BDCs).

Examples of eligible participants in the IFEM includes: authorised dealers, authorised buyers, oil companies, oil service companies, exporters, end-users and any other entity the CBN may designate from time to time.

The forty-one (41) items previously classified as “Not Valid for Foreign Exchange” as detailed in the CBN Circular Ref: TED/FEM/FPC/GEN/01/010, still remain inadmissible in the Nigerian FX market (See Appendix A).

i) CBN Interventions:

The CBN intends to participate in the FX market through two means namely: the IFEM and the Secondary Market Intervention Sales (SMIS).

The CBN can intervene in the inter-bank market through different means; buy or sell FX spot, place orders of non-standard amounts in FMDQ TRFXT, and to buy or sell FX forwards. In order to enhance liquidity, CBN shall offer non-deliverable OTC FX futures. FXPD's can also purchase OTC FX futures.

-Secondary Market Intervention Sales (SMIS): This is the second means through which the CBN can intervene in the FX market. The CBN will achieve this by selling FX to authorised dealers (wholesale) or to end-users through authorized dealers (retail). All SMIS retail sales shall only be for eligible transactions.

ii) Financial risk management

The risk management product introduced by the CBN are called forward futures. This market commenced operations from 27 June 2016. Authorized dealers and FXPDs are now permitted to offer Naira-settled non-deliverable over-the-counter (OTC) FX futures. FMDQ has the primary responsibility for running the OTC FX futures exchange.

Forward futures will help entities lock into a fixed exchange rate on the transaction date (or trade date), which will be settled in a future date (settlement date). The forward futures have all the characteristics of a derivative as there is no initial investment required, it will be settled at a future date, and the value changes

in response to a specified foreign exchange market rate.

They will also be tenured which means that entities can specify the maturity dates of the contract.

The forward futures are based on a notional amount, and there will be no cash exchange on both the trade and settlement dates (i.e. no obligation to deliver the underlying notional USD amount), but there will be a compensation margin to be earned by the authorized dealers.

Entities and their treasury teams can choose to designate this derivative as a hedging instrument to be used to hedge their foreign exchange risk. Hedging is a risk management strategy that helps entities minimize volatility in their income statements. However, strict hedge accounting rules under IAS 39 'Financial instruments: recognition & measurement', will have to be in place for a hedge to be recognised as one under IFRS. For annual periods beginning 1 January 2018, IFRS 9 'Financial instruments', will be effective and it will replace the requirements of IAS 39.

List of References:

CBN, (2016). Revised Guidelines For The Operation Of The Nigerian Inter-Bank Foreign Exchange Market. Central Bank of Nigeria. Pp.1-11
 FMDQOTC, (2016). OTC FX Futures Market Operational Standards

C: List of items ineligible for foreign currency in Nigeria (as at 31 March 2017)

Rice	Cement	Margarine
Palm kernel/Palm oil	Meat and processed meat products	Vegetables and processed vegetable products
Products		
Poultry chicken, eggs and turkey	Private airplanes/jets	Indian Incense
Tinned fish in sauce/ Sardine	Cold rolled steel sheets	Galvanized steel sheets
Roofing sheets	Wheelbarrows	Head pans
Metal boxes and Containers	Enamelware	Steel drums
Steel Pipes	Wire rods	Iron rods
Wire mesh	Steel nails	Security and razor wines
Wood particle boards and panels	Wood Fibre Boards and Panels	Wooden doors
Toothpicks	Glass and Glassware	Kitchen Utensils
Tableware	Tiles-vitrified and Ceramic	Textiles
Woven fabrics	Clothes	Plastic and rubber products
cellophane wrappers	Soap and cosmetics	Tomatoes/tomato pastes
Eurobond/foreign currency bond/share purchases	Plywood boards and Panels	

Source: <http://www.cenbank.org/Out/2015/TED/TED.FEM.FPC.GEN.01.010.pdf>

Questions?

PwC clients who have questions about this publication should contact their engagement partner. Engagement teams that have questions should contact members of the Capital Markets and Accounting Consulting Services (CMACS) team.

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