03

GOVERNING and regulating

Tax compliance in the age of a surfeit of data

Complying with new tax rules is requiring banks to disclose larger volumes of financial and non-financial data. David Fernley delineates key developments driving this change in recent years.

The tax environment that banks operate in continues to evolve as the OECD's Base Erosion and Profit Shifting (BEPS) initiative, global corporate tax reform driven by the G20 countries, is implemented.

In the UAE and the GCC, new tax rules are frequently being introduced due to BEPS requirements and pressures on countries' budgets. There is also greater public scrutiny of the tax affairs of multinationals, with the function increasingly being considered as a key component of ESG.

The combination of these factors means there has been a step change in the approach taken by banks across the globe to tax, shifting from a focus on optimization, to an emphasis on compliance and risk management.

A key component of tax compliance and risk management is getting the right data to the bank's tax function. Compliance with new tax regimes requires data from a broad range of sources, not merely the traditional management accounting or transaction data that is relied upon for corporate tax and VAT. Most of these new regimes are referred to collectively as "tax transparency" as they involve sharing of data with foreign governments. Below, we discuss examples of these regimes and the risks they result in.

FATCA/CRS – Automatic Exchange of Information (AEOI) regimes

UAE banks have been required to comply with the US Foreign Account Tax Compliance Act (FATCA) and the OECD's Common Reporting Standard for a number of years. These regimes broadly require banks to report on their foreign tax resident customers to their regulator. This information is then shared with foreign tax authorities globally.

The customer data that is reported is extremely sensitive in nature; it covers major personal details of the customers as well as their account balance with the bank. Aside from the obvious data protection concerns, any data inaccuracy could result in a bank's customer being audited by foreign tax authorities. The OECD expects governments to audit banks' compliance with AEOI. Misreporting could be seen as an audit-related compliance failing by the regulator, and there may be fines associated with this.

Economic Substance Regulations (ESR)

ESR was introduced in 2019 and affects all UAE entities. Entities that perform "relevant activities", one of which is banking, are required to file an economic substance notification and file a report on the Ministry of Finance portal on an annual basis. The report is subject to review and audit by the Central Bank and/or the FTA. To produce the report, data is required on the entity's employees, premises, management, and costs, besides the need to conduct operations and maintain documentation to prove compliance with the substance tests (e.g. the requirement to have in the UAE core-income generating activities, direction and management, as well as adequate employee count, operating expenses and physical assets).

As of 2020, companies based in the UAE mainland and commercial free zones are required to file registers of their ultimate beneficial owners (UBO) and shareholders with the relevant registrar and licensing authorities. This information may be shared with foreign governments on request as part of international cooperation measures. Similar information is required to be filed under ESR.

Country by Country Reporting (CbCR)

Many UAE-headquartered banks are now subject to CbCR rules as they have an international footprint and consolidated revenues equal to or exceeding AED 3.15 billion.

CbCR requires UAE banks to report a significant amount of information to the UAE MOF including: revenues, profits/losses before income tax, income tax paid, income tax accrued, stated capital, accumulated earnings, number of employees, and tangible assets other than non-cash or cash-equivalent assets). Similar to the other regimes, this information is then shared with foreign governments.

Unlike CRS and ESR data requirements, CbCR data is holistic and typically consolidated, making interpretation difficult. Where context is limited, it can potentially result in further questions being raised. Given the OECD's 2020 CbCR peer review, further changes to CbCR are expected for FY21. Whilst the details are yet to be announced, the direction of travel on CbCR transparency is clear with further information (e.g. group royalty payments, withholding taxes etc.) most likely to be added to CbCR requirements in the future.

The preparation of CbCR data should take into consideration how it aligns to other information prepared and submitted to fiscal authorities. A holistic risk assessment should be performed to ensure any areas of uncertainty can be quickly and efficiently explained should an audit be initiated. This may be easier where tax authorities have other transfer pricing documentation to hand, for instance a group's master file or local file. However, where the CbCR data is publicly leaked, this becomes more challenging.

VAT

Due to a streamlining of the UAE VAT rules in 2020, banks now need to have a higher degree of visibility on knowledge of their non-resident clients to apply zero rating of fees and charges. These rules are now much more restrictive and require the bank to understand the purpose, nature and duration of any presence a client might have in the UAE. As digital banking strategies are rolled out, compliance with VAT is likely to require greater attention to detail.

Oversight and control of a global workforce

From a tax, legal and regulatory perspective, banks need to have readily available data on where their employees and officers are undertaking their day-to-day activities. In the absence of robust oversight and controls around remote working, the bank as well as its employees and officers could be exposed to foreign taxes. The risks have become magnified due to Covid-19 related travel disruption and remote working.

Considerations for UAE banks

To practically manage tax risks, banks in the UAE should integrate tax reporting into their finance and tax governance frameworks, and assign roles and responsibilities internally to ensure that the data being released is consistent and has been considered from all stakeholders' perspectives—including that of the board, employees, NGOs and the general public. Such processes should be flexible enough to adapt reporting strategies to the evolving UAE tax landscape given the likelihood of a global minimum tax rate being introduced by the OECD in 2022, likely to have a significant impact on UAE banks.

It is important to note that such responsibilities in foreign banks are often assumed by the (typically sizeable) tax team. Given such tax teams are less prevalent in the UAE, consideration as to who in the organization leads such efforts (and/or whether additional tax resource is required) is vital to avoid the additional burden that may potentially be placed on existing finance teams. Such a proactive and "helicopter" approach is often fundamental in meeting the board's agenda in efficiently preparing for change, addressing future challenges and ultimately managing reputational risk.

The tax department's role in an organization cannot be relegated to the sidelines: it has become more complex and intricate than ever. Sharing of information between various authorities is now commonplace, making accurate reporting essential. The function's footprint will need to be across the bank's business lines, and will need data from multiple sources besides finance to ensure compliance with a rapidly evolving regulatory landscape.

"Getting the right financial data has always been crucial for tax compliance. With new tax regulations being implemented, our tax function now has to work with stakeholders across the entire business to get the right data, remain compliant and manage tax risk.

Nick Giannopoulous, Head of Tax, ADCB

David Fernley
Director
Tax
KPMG Lower Gulf

The role of stringent regulatory compliance

A failure to develop and factor in regulatory expectations is a significant threat to an organization's ability to meet strategic objectives. Maryam Zaman explains why unforeseen changes to laws and regulations may derail otherwise well thought out plans.

Regulatory risk has been a major concern for financial institutions over the past few years. The global and local regulatory environment continues to become more complex, and a closer look at the results of the KPMG 2020 Global CEO Outlook[16] survey in the banking sector indicate why regulatory risk will remain a top concern for some time to come.

The banking sector's appetite for growth remains strong, with 99 percent of survey respondents stating they intend to grow their banks geographically over the next three years. Respondents also recognized that the complexity of regulatory risk increases as banks grow and become exposed to multiple regulatory environments. As a result, they also identified regulatory risk as a threat to their organizational growth plans. A further complication is the increasing pace of change within each regulatory environment. An understanding of the current regulatory landscape is no longer enough. Instead, banks must form expectations on the regulatory trajectory and factor these expectations into expansion plans.

In the UAE, the regulatory landscape is rapidly evolving. Over the last two years alone, local authorities have issued or revised many regulations to strengthen the banking sector, ensure financial stability, and reinforce a new round of economic growth. New banking regulations include those issued by the UAE Central Bank, such as the Governance, Consumer Protection and Risk Management regulations. The Federal Government has also been active, recently publishing an updated Banking Law, Anti-Money Laundering (AML) Law, and Companies Law. These are in addition to the many other regulations issued by the Securities and Commodities Authority (SCA), Abu Dhabi Accountability Authority (ADAA), and the Tax Authority over the same period.

Building robust compliance frameworks

To succeed in an environment characterized by continual change, banks must adopt compliance frameworks that are mature and flexible. Existing frameworks can be a good starting point. A well-established example is Compliance Management Systems (ISO 19600:2014). Banks may even opt to develop their own frameworks; however, they should ensure that key elements, such as compliance risk assessments, policies and procedures, training and communications, whistleblowing and investigation, monitoring, testing, and reporting are included in their framework. In all cases, the selected compliance framework should be tailored to the bank's circumstances, strategic objectives, and growth plans. If this framework alignment is sufficiently detailed, compliance costs need not rise as the bank grows and regulations change.

Emerging market regulators, such as those in the UAE, are playing catch-up to their developed market counterparts or industry-leading practices as they seek to facilitate greater integration with the global financial system and attract foreign investment. For example, the UAE Central Bank recently issued a Consumer Protection regulation[17] covering market and business conduct, disclosure and transparency, advertising, and sales, as well as data privacy and complaint management. Similar regulations have been in force in developed markets for over a decade. This catch-up pattern allows banks to proactively anticipate regulatory changes by benchmarking current local regulations against those in developed markets. Important insights into upcoming regulatory developments may be gained in this manner, particularly in areas relating to environmental protection, cybersecurity, data-privacy, and risk-based compensation. Of course, local economic and market conditions must be considered while performing such benchmarking analysis.

The compliance function itself has not escaped the attention of regulators. Several new banking regulations have introduced minimum standards aimed at ensuring the effectiveness of compliance functions. The UAE Central Bank's Corporate Governance Regulation, issued in July 2019, requires banks to establish an independent Compliance function that, while primarily reports the CEO, must have direct access to the board or a relevant board committee (e.g., board audit or risk committee). The 2018 Regulation on Internal Control, Compliance, and Internal Audit, also issued by the UAE Central Bank, requires the establishment of a board-approved compliance policy, quarterly compliance risk reporting to senior management and the board, an annual compliance function performance review by a board committee, as well as an independent external quality assurance review of the compliance function at least once every five years.

Formulating an action plan

Because new regulations often necessitate changes to multiple business processes, when a new regulation is issued, banks should follow the following steps:

- Update the bank's regulatory repository
- Communicate changes to the relevant stakeholders (e.g. process owners, senior management, the board, board compliance committee)
- Conduct an impact assessment of the new regulations
- Review policies and procedures across the bank impacted by the new regulation and assess whether any updates are required therein
- Identify, document and implement controls to ensure compliance with the new regulations
- Design appropriate compliance testing techniques and adjust compliance monitoring plans
- Conduct employee trainings on the new regulations, the revised bank's processes and their roles and responsibilities to ensure compliance.

Technology to the forefront

IT tools should be carefully considered when designing a compliance framework. They can help compliance functions implement complicated tasks more efficiently by supporting the maintenance and functioning of regulatory repositories, compliance checklists, and compliance monitoring plans. They can be leveraged for the automation of compliance self-assessments, provision of real-time compliance calendars, and implementation of bank-wide dashboards diagnosing the overall compliance health of the organization.

Given the pace of change and global development, coupled with the UAE's drive to develop its legislative and legal framework to ensure compliance with international standards, we can expect further regulatory developments. It is vital for compliance professionals to keep themselves up to date with ever-changing legislation and regulatory guidance. The deluge of new and expanded regulations is also a signal to banks in the UAE to start the process of re-designing compliance frameworks and re-thinking the way the compliance function operates, and its place within the organization. Failure to do so may lead to an exponential increase in compliance costs that can potentially reduce opportunities for growth.

Maryam Zaman
Partner
Internal Audit, Risk and Compliance Services
KPMG Lower Gulf

A gamut of sweeping changes: the transformative impact of ICOFR

The Sarbanes–Oxley Act introduced extensive requirements for internal controls over financial reporting (ICOFR). Supriya Kubal outlines its relevance to the UAE.

The Sarbanes–Oxley Act of 2002 (SOX) was the United States' response to a string of accounting scandals that characterized the years before and after the turn of the millennium. Among other developments, SOX introduced a plethora of requirements for internal controls over financial reporting (ICOFR) and financial disclosures, and mandated both audits and reports on those controls.

Similar regulation in the UK, detailed within the Corporate Governance Code, places the responsibility for establishing and monitoring ICOFR systems with the board. The board is also responsible for conducting an annual review of ICOFR systems, the results of which must be included in the bank's annual report.

Some Middle-Eastern regulators have also issued ICOFR-related regulations. For example, all Islamic banks in Kuwait are obliged to submit to the Central Bank annual reports on the extent and adequacy of their internal control systems, including those related to financial reporting. Such reports must be prepared by international audit firms approved by the Kuwaiti Central Bank.

Local developments

Regulators in the UAE recently enacted several new laws and regulations of a similar nature. The Central Bank's Internal Controls, Compliance, and Internal Audit regulation of 2018 states that the board and senior management of banks are responsible for implementing an adequate internal control framework that identifies, measures, monitors, and controls all risks. Specifically required (Article 2 section 2) are ICOFR systems that deal with "accounting and financial reporting policies and procedures". Unlike their US and UK counterparts, however, local banking regulators do not mandate periodic reviews on the effectiveness of ICOFR systems.

Keen observers will note that there is a local trend toward stricter requirements around ICOFR systems. The Abu Dhabi Accountability Authority (ADAA) issued a law this year stating that it will examine the ICOFR systems of all entities under its oversight. The recent Insurance Authority (IA) Circular 21 of 2019 also requires external auditors to understand and issue an opinion on the operational effectiveness of "internal controls relevant to the audit." It is therefore reasonable to expect similar ICOFR regulations to be issued by the Central Bank of UAE in the not too distant future.

Zeroing in on high-risk areas

A robust ICOFR system is one that provides stakeholders with reasonable assurance that material misstatements in financial statements are either prevented outright or detected and promptly corrected. It also should ensure unauthorized acquisition, use, or disposition of assets that could have a material effect on financial statements is prevented or detected in a timely manner. The latter point means that ICOFR systems cannot be restricted to the finance and accounting departments. Financial reporting teams depend on the quality of data reported by employees across the organization. ICOFR systems must therefore address risks throughout the bank by encompassing controls at the entity, core revenue-generating processes, and support function levels. Integrated internal control frameworks, such as the COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework adopted by many organizations, can help address this issue.

As a first step, banking boards and senior managers should assess existing ICOFR systems to identify the most high-risk areas. A common and critical area of weakness is ICOFR systems governance, where it is often unclear who owns the overall program, who designs, performs, and tests the controls. It can also be useful to define an ICOFR systems strategy that will reduce financial reporting risks without increasing costs by identifying the most critical areas. A robust and effective risk-assessment process will help establish and support the ICOFR strategy, control selection, and testing design. Banks can then focus both their control performance and testing efforts on the most critical areas.

Adapting to the times

Banks should also consider their ICOFR strategies when drafting Business Continuity Plans (BCPs). Management override of controls tends to increase during periods of crisis and uncertainty. For example, the Covid-19 induced social distancing rules and work-from-home arrangements have weakened controls related to supervisory review and document security. Although it may be justified during the initial crisis response phase, continued suspension of ICFOR systems in the long or even medium-term increases the risk of unintentionally creating environments conducive to errors or fraud. Covid-19 has also presented banks with accounting challenges that require an increased level of judgement on the part of senior managers, such as the computation of expected credit losses and identifying significant increases in credit risk.

The local and regional financial services industry is maturing. Regulators will almost certainly place more emphasis on transparency and increase ICOFR requirements. When implemented incorrectly, ICOFR systems can increase costs dramatically without significantly reducing financial reporting risks. On the other hand, well-designed ICOFR systems based on a thorough assessment of all critical areas of a bank can lead to significant reductions in financial, regulatory, and reputational risk, all with minimal increases in costs and disruption to daily operations.

That said, in many cases, it comes down to corporate culture.

"Although the three-lines-of-defense concept had been around for a long time, the real understanding of 'businesses themselves, not the control functions or Internal Audit, are the party with the main responsibility for identifying risks and implementing controls' came with the Sarbanes-Oxley Act in 2002," says Volkan Pekince, Group Chief Internal Auditor, Dubai Islamic Bank.

"However, the maturity on this still differs amongst organizations. The most successful are the ones with fully embedded risk management culture in daily operations at every seniority level, not the ones expecting that Internal Audit will capture all our problems"

Supriya Kubal
Director
Financial Services
KPMG Lower Gulf

Unlocking the value of external audit

Some commentators have recently been asking what the value of an audit is. Luke Ellyard and Mohammad Zamani outline the areas where it can add considerable value to the interests of all stakeholders, and the action that can be taken to facilitate this.

Too often, the audit is seen as a "tick-box exercise" rather than as a critical pillar in a bank's governance structure. Nowhere is a strong and effective corporate governance framework more important than in the banking sector. In the UAE, significant steps have been taken already, with regulations recently introduced on enhancing the corporate governance framework within banks to move towards international leading practice. However, less widely covered is the auditors' role in the overall corporate governance framework, and particularly the role external auditors play in supporting the aims of the Audit Committee (AC).

Encouraging robust dialogue

After the global financial crisis, the Institute of Chartered Accountants in England and Wales (ICAEW) presented several recommendations on how the audit process might evolve to promote confidence in the banking system. A key finding was that the relationship between auditors and ACs plays a critical role in good governance.

In the follow-up report, Enhancing the Dialogue between Bank Auditors and Audit Committees a working group of audit firms and banks made a number of observations on how to make the relationships work well, some of which have been implemented in the UAE.

The report stressed the need to strike the appropriate balance between cooperation and challenge. Whilst there is not always the need for extensive debate on judgments, engagement on these critical areas are sometimes lacking in ACs.

One of the topics most discussed with the external auditor in the AC is what we consider to be the range of provisioning judgements. It is vital the AC understands where management have positioned themselves on the auditors' views of the range of acceptable and possible outcomes. There are, however, several areas of judgement that can also be debated throughout the audit cycle, rather than at the end of the year. The ICAEW suggests "if those discussions result in a changed approach, there is time to implement the change in an orderly manner".

Attendance at audit and risk committee meetings

The discussion of the audit should not be considered as merely an 'agenda item' for the AC at quarter and year ends, but as an opportunity for the external auditor to provide independent insight on matters discussed in the AC meeting. In addition, audit teams typically have significant experience across a large number of different banks; extracting and taking full advantage of that experience can provide independent insight, contributing to an enhanced audit experience.

Good practice, as recommended by the ICAEW report, is that the audit partner attends the full meetings of the Audit and Risk committees. Our experience indicates it is clearly advantageous to ensure timely involvement of the auditors in understanding the background of critical matters, rather than reviewing minutes months later.

The ICAEW report recommends that where there are separate audit and risk committees, the auditor also attend the risk committee where "sharing risk assessments could assist both the auditor and risk committee in performing their roles".

Increasing auditor engagement

In recent years there has been commendable progress in the areas of direct engagement throughout the audit cycle and reviews of the audit files by some of the UAE's regulators. The DFSA has been recognized by the Independent Audit Regulators (IFIAR) as a leader of the Emerging Regulators Group (ERG) for four years, and it has worked with the World Bank to disseminate knowledge to new and potential audit regulators.

We would encourage more frequent bilateral, i.e. between regulator and auditor, and trilateral meetings, including the bank, to collectively create a better understanding of the audit approach taken and the work done.

Unleashing the power of data

Increasing use of Data & Analytics (D&A) is often the key to unlocking the rich information stores that businesses hold. For audits, this means D&A is providing better insight into an organization's controls and risks and enables the auditor to further challenge assumptions and conclusions.

As banks in the UAE are investing significantly in technology, the quality and depth of 'data pools' are enhanced. The value of data analytics and forecasting can be vast, but only if this data is made available timely, without significant undue effort, to the auditors who have also heavily invested in resources with data analytical capabilities.

Examples of where technology has been used effectively include revaluing 100% of derivatives portfolios using special platforms, and using analytics and machine-learning technology to identify unusual trends and outliers in 100% of journal entries and loan portfolios. By obtaining this deeper understanding of data populations and focusing on higher risk transactions, audit quality can be enhanced.

The audit profession is continually improving, evolving and reacting to audit regulator challenges. However, in order to unlock the value of external audit for stakeholders, there should be collective responsibility to ensure auditors work jointly with the audit committee and regulators. The ultimate objective is the same: to contribute to the quality of financial statements that provide a 'true and fair view'.

It is an exciting phase in the development of audit — the potential for auditors to add greater and deeper value, to clients and wider stakeholders in the capital markets, is significant.

Luke Ellyard
Partner
Financial Services
KPMG Lower Gulf

Mohammad Zamani
Director
Financial Services
KPMG Lower Gulf

Contact us

Nader Haffar
Chairman and CEO
t: +971 4 403 0400
e: naderhaffar@kpmg.com

Abbas Basrai
Partner
Head of
Financial Services
t: +971 4 403 0484
e: abasrai1@kpmg.com

kpmg.com/ae

Follow us on:

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2021 KPMG Lower Gulf Limited, licensed in the United Arab Emirates, and a member firm of the KPMG global organization of independent member firms affiliated with KPMG International Limited, a private English company limited by guarantee. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Designed by KPMG Lower Gulf Creative team.

Publication number: 3385

Publication date: April 2021