

# Accounting for Tax 3: Annual Financial Statement Interpretation

27 June 2024



## **Marina Pretorius**

### **Kreston South Africa**

- Marina joined the Kreston Pretoria team on 1 March 2021 after specialising in tax at KPMG for the last 13 years. She is an experienced tax advisor who holds an H. Dip(Tax) Degree. She completed her articles at Deloitte where she also passed the CA(SA) qualifying examination.
- She worked in the UK on large listed clients for 2 years and joined KPMG tax department in 2007.
- As Associate Director and head of KPMG's Global Compliance Managed Services business unit, she is very experienced in tax and accounting reporting requirements for large multi-nationals.
- This includes ITR 14 disclosures required for multi-nationals as well as submissions of CbC Reports, Master Files and Local Files.

### **Education and Qualifications**

- B. Com (Accounting)
- B. Com (Accounting) (Hons)
- Certificate in the Theory of Accounting
- Passed qualifying CA(SA) exam.
- H.Dip (Tax)
- Registered Tax Practitioner



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# ABOUT THE PRESENTER

## Johan Heydenrych

Kreston South Africa

**Johan is a Chartered Accountant who specialised in taxation since 1991. He holds the following qualifications:**

- B. Com (Accounting) (Cum Laude)
- B. Com (Accounting) (Hons) (Cum Laude) (Award: “Best student in Audit 700”)
- Certificate in the Theory of Accounting
- M. Com (Taxation) (Cum Laude) (Award: “Best M. Com (Tax) student”)
- Chartered Accountant (Specialising in Taxation)
- Member of SAICA
- Registered Tax Practitioner

**Johan was a tax partner at KPMG from 1997 to 2020 and is currently a partner in the Kreston SA network specialising in taxation.**

**He provides a wide range of tax services to various clients across industries. These include but are not limited to the following:**

- Advice on Tax Risk Management and Tax Governance.
- Tax compliance services including but not limited to ITR 14 and IT 14SD
- Dealing with tax disputes including representing clients at Alternative Dispute Resolution (ADR) hearings.
- Submission of documentation and revised returns under the Voluntary Disclosure Programme.
- Issuing of tax technical opinions on Income Tax, VAT and PAYE. This include preparing briefs to Senior Counsel and submissions of requests for Binding Opinions from SARS.
- Audit support services that includes Normal Tax and Deferred Tax disclosure and disclosure of uncertain tax positions.
- Assistance with implementation of tax reporting for new accounting standards such as IFRIC 23, IFRS 9, IFRS 15 and IFRS 16.
- Facilitation of tax diagnostic sessions with existing and prospective clients.
- Advice on mergers, acquisitions and reorganizations.
- Tax due diligences
- Advice on tax implications of recapitalization transactions, debt restructures, liquidations and deregistration’s



# Content

## **Topic:**

- Financial Statement Interpretation

## **Event overview:**

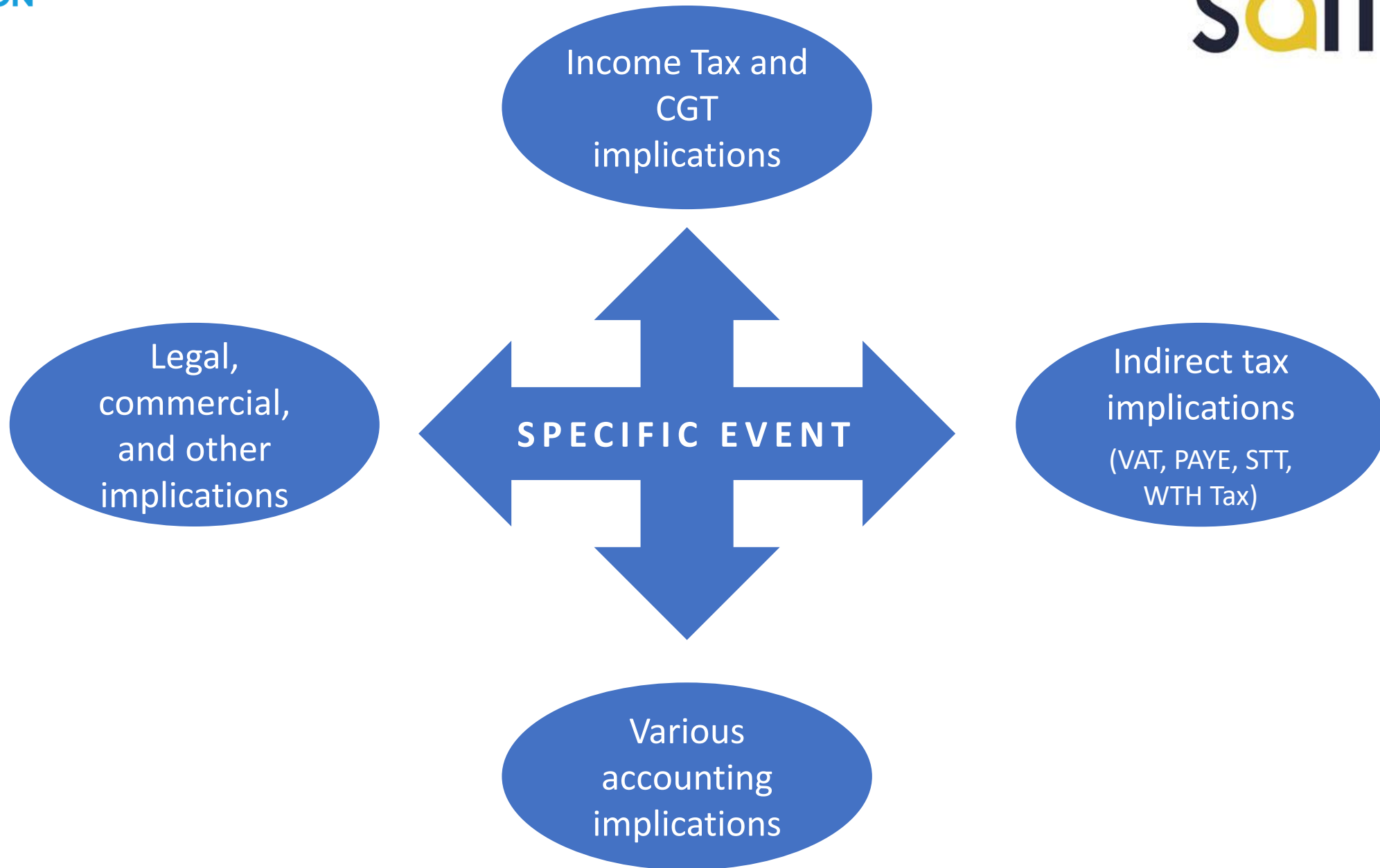
- The ability to interpret the Annual Financial Statements ("AFS") is an important skill of the Tax Practitioner irrespective of the type of tax services rendered. It enables the tax advisor to engage in value-added discussions with clients, identify opportunities for improved tax efficiencies and identify tax risks that can be pro-actively managed. This process is however complicated by IFRS rules where "substance over form" takes precedence.
- AFS interpretation skills are not only important for the person responsible for disclosure of normal and deferred tax in the AFS but is invaluable when performing other multi-disciplinary services including but not limited to tax compliance, tax due diligences, mergers and acquisitions, audit support services and dispute resolution.

In this course we will focus on:

- 1. AFS interpretation skills
- 2. Multi-disciplinary tax technical skills
- 3. Improving skills to perform tax compliance, tax due diligence, business rescue, external audit support

# Importance of understanding Annual Financial Statement

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# Importance of understanding Annual Financial Statement

- The modern tax practitioner is not only faced with complex tax rules that change at a on-going pace, but they are also faced with complex accounting rules where the “substance” of transactions takes precedence over its legal form.
- Despite the fact that the starting point of any income tax computation is Net Income Before Tax (NIBT”), tax practitioners often believe that they do not require solid accounting skills when providing tax advice to clients.
- At the same time, despite the fact that normal tax, VAT and PAYE invariably have a material impact on the AFS, accountants often believe that they are not required to have a solid understanding of tax rules when preparing or auditing AFS.
- The result of the “limitation of skills” of the tax advisor and the accountant is that significant tax risk arises where an overlapping of accounting and tax skills is required to ensure accurate tax returns and complete and reliable AFS.

# Importance of understanding Annual Financial Statement

- The following are examples where the tax treatment is dependent on the accounting treatment:
  - Section 11(j) and 11(jA) doubtful debt allowances.
  - Application of section 24I(10A) to foreign exchange losses.
  - Reportable arrangements where accounting is based on the substance of the transaction.
- The following are examples where the accounting treatment is significantly different from the tax rules, mainly due to the substance of the agreement not necessarily aligning with the form thereof.
  - IFRS 16 treatment of leases.
  - Date of disposal and acquisition of assets where the effective date for accounting may differ from the date applicable for Capital Gains Tax and the date of the legal agreements.
  - Accounting for derivatives.
  - Recognition rules of revenue in terms of IFRS 15.
  - Recognition of rehabilitation assets and liabilities.
  - Tenant installation allowances and underlying costs.

# Importance of understanding Annual Financial Statement

- The situation is worsened due to inconsistency in definitions of basic terms such as leases, finance leases, operating rentals and instalment credit agreements for purposes of IFRS, VAT and Income Tax.
- The published AFS contains a wealth of information that may assist the tax practitioner to provide multi-disciplinary value-added advice to their clients. Statements in these reports may lead to unplanned tax risks for the company due to financial accountants having inadequate basic tax skills. Unfortunately, many tax practitioners ignore valuable information contained in the director's report, chairman's report and auditors report.

# Interpreting Annual Financial Statement

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# Interpreting AFS

- Before commencing with any tax assignment, it is important to critically review the AFS with the view to identify potential risk areas and adjustments.
- AFS is a “language” – Understanding the “language” will assist in identifying tax challenges or tax opportunities
- In addition to reviewing the AFS::
  - Speak to the client
  - Review their website
  - Search for SENS announcements
  - Download Brochures
  - Visit client site such as factory, plant, warehouse facilities
  - Do not do “faceless consulting”

# Interpreting AFS

## Step 1:

### Understand the industry:

- Each industry has its own tax challenges
- Most industries have tax specific legislation
- Most industries have tax rulings, interpretation notes, tax opinions relevant to the industry

### Examples

- Retail (IFRS 16, inventory, inventory write-offs and obsolescence provisions)
- Banking (IFRS 9, section 11(i) and (j))
- Short term and long-term insurance (Section 28 and 29A)
- Mining (Rehabilitation, section 37)
- Manufacturing (Large capital investments in factory, plant and machinery, section 12C)
- Automotive industry (Manufacturing, section 12C, section 12P & 11<sup>th</sup> Schedule)
- Telecommunication (R&D, section 11D)

# Interpreting AFS

## Step 2:

Understand that AFS contains both financial and non-financial information:

- Report of the directors
- Report of the chairman
- External audit report
- Accounting Policies
- Integrated report contains extensive non-financial information

## Step 3:

Identify any major events that may give rise to tax challenges: (Examples)

- Proposed merger/acquisition/Unbundling/reorganisations (Corporate Rules S42-47)
- Introduction of new shareholders
- Fraud
- Competition Commission investigations
- Significant investment in capital
- Raising of finance
- New acquisitions or disposals
- Disputes with 3rd parties (Commercial, Competition Commission, Customers, Shareholders, SARS, Foreign Entities)
- Change in accounting policies
- Restatement of prior years – fundamental errors
- Change in financial year-end

# Interpreting AFS: Statement of Financial Position

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Potential apportionment issues (Loans incurred to acquire share investments)

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Potential unproductive interest (Interest bearing loans incurred to fund interest free loans)

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Potential Transfer pricing – Thin capitalization and interest free loans

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Potential IFRS adjustments – e.g., IFRS 16, derivatives, fair valuations, Rehabilitation Provisions debited to Balance Sheet

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Potential 24I(10A) adjustments on exchange items with connected parties reflected as non-current assets/liabilities

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Potential PAYE and dividend tax issues (e.g., interest free loans made to shareholders and companies owned by shareholders)

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Potential adjustments for leasehold improvements

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Terms and conditions of loans and shares may lead to adjustments in terms of S8EA, S8E, S8F, S8FA.

# Interpreting AFS: Statement of Comprehensive Income

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Non-deductible and non-taxable items e.g. dividends, penalties etc.

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Adjustments reflected via OCI and Equity that may have a tax impact.

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Potential apportionment issues – e.g. holding company that received interest, management fees and dividends from group companies.

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Can provide insight as to whether or not the company is trading and assessed losses from prior years can be carried forward.

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Interest paid to entities not subject to tax in RSA may give rise to Section 23M limitations

## Notes and narrative provides insight

### Normal tax and Deferred Tax notes

Analysing the normal tax, tax rate recon and Deferred tax notes can provide insights into potential adjustments that are required.

Prior year over/understatements should be compared to actual assessments.

### Non- Income Tax

The AFS may indicate non-income tax risks e.g. VAT, STT, Dividend Tax, PAYE, Royalty WTH Tax and non-RSA taxes. E.g. Supplies to connected parties may give rise to VAT risks Royalty payments to non-residents may give rise to WTH Tax and Transfer pricing risks

Why is this  
important to get the  
tax calculation right

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# The Tax Administration Act

Section 241(2) of the Tax Administration reads as follows:

- *“A senior SARS official may lodge a complaint with a ‘recognised controlling body’ if a registered tax practitioner has, in the opinion of the official without exercising due diligence prepared or assisted in the preparation, approval or submission of any return, affidavit or other document relating to matters affecting the application of a tax Act;*
- Preparing a tax calculation and subsequent ITR14 tax return is not merely an administration function of filling in forms

# Reading Annual Financial Statements

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# Structure of Annual Financial Statements

Directors' Responsibilities and Approval	2
Directors' Report	3 - 4
Independent Auditor's Report	5 - 7
Statement of Financial Position	8
Statement of Profit or Loss and Other Comprehensive Income	9
Statement of Changes in Equity	10
Statement of Cash Flows	11
Accounting Policies	12 - 24
Notes to the Financial Statements	25 - 60
The supplementary information presented does not form part of the Financial Statements and is unaudited: Income Tax Computation	61

# General information / Directors Report

## Extracts from General Section / Directors Report in AFS

### Nature of business and principal activities

Freight forwarding and clearing services

Expect to large capital investment in vehicles

### Nature of business and principal activities

Holding company with interests in the Services Industry

- Expect dividend income
- Company most likely not trading and assessed loss cannot be created

## 2. REVIEW OF ACTIVITIES AND OPERATIONS

Finbond Mutual Bank, registration number 01102, is a leading South African Financial Services Institution that specialises in the design and

- Large ECL provisions - might have ruling to allow for 85% s11(j) allowance
- Bad debts written off
- Interest income will be high
- Apportionment of VAT

# Extracts from General Section / Directors Report in AFS

## 2. Nature of business

The business of DEF continues to be the manufacturer of vehicles, distribution of vehicles and spare parts, rendering of services to customers in the form of maintenance and service contracts and digital services through ConnectedDrive.

- Large capital investment in machinery and buildings
- Manufacturing industry – section 12C (where does process of manufacture start and end)
- Employment costs will be high – fringe benefits ito 7<sup>th</sup> Schedule to the Act
- ETI
- Section 12H learnerships

# Extracts from General Section / Directors Report in AFS

## Main business and operations

ABC Wind Farm Proprietary Limited ("The company") engages in the design, development, engineering, procurement, construction, financing, commissioning, operating and maintenance of an on shore wind energy generation facility. There were no major changes herein during the year.

- Owns and operates a wind farm
- Renewable energy sector – section 12B
- Original capital investment will be significant
- Most likely not on land that is owed by die client – LHI and capital investment such as road needs to be looked at in carefully
- How was business funded – section 24J

## 2. Review of activities

Main business and operations:

The business purpose of the company comprises the sale of wind turbine generators (WTG's) and the closely associated service and maintenance business.

- Construction of wind farms and sale of renewable energy assets
- Maintenance contract – section 24C

# Extracts from General Section / Directors Report in AFS

## 3. Review of financial results and activities

The annual financial statements have been prepared in accordance with IFRS Accounting Standards and the requirements of the Companies Act No.71 of 2008 of South Africa. The accounting policies have been applied consistently compared to the prior year.

- Full IFRS applied – expect IFRS 9 and 16 adjustments

## 6. Dividends

Dividends of R25,000,000 were declared and paid in the current year (2022: R26,000,000).

- Advice client about reporting requirements (DTR01 and 02) and possible WHT requirements

## 3. Share capital

Refer to note 15 of the consolidated annual financial statements for detail of the movement in issued share capital.

- Implication on CTC
- Advice client on STT requirements and possible payment
- Look out for Corporate Rule transaction

# Extracts from General Section / Directors Report in AFS

## 11. Interest in subsidiaries

- Look out for controlled foreign companies and the need for imputation of income into section 9D

**Holding company**

**Ultimate controlling party**

- If foreign dividends were paid – WHT requirements and declaration required
- Management fees / royalties paid to foreign holding company
- Intercompany loans – S23M & N
- Transfer pricing

## Extracts from General Section / Directors Report in AFS

### 12. Going concern

The annual financial statements have been prepared on the basis of accounting policies applicable to a going concern. This basis presumes that funds will be available to finance future operations and that the realisation of assets and settlement of liabilities, contingent obligations and commitments will occur in the ordinary course of business.

### 9. Going concern

We draw attention to the fact that at 31 December 2023, the company had accumulated losses of R 26 248 463 (2022: R 24 230 536) and that the company's total liabilities exceed its total assets by R 26 247 463 (2022: R 24 229 536). The shareholder

- If not going concern – consider impact on recognition of deferred tax asset
- Does not necessarily mean that company is not trading

# External Audit Report

# External Audit Report

## Opinion

We have **audited** the consolidated and separate financial statements of XYZ Proprietary Limited and its subsidiaries (“the Group and Company”) set out on pages 9 to 50, which comprise **the consolidated** and separate statements of financial position as at 31 December 2023, and consolidated and separate statements of profit or loss and other comprehensive income, the consolidated and separate statements of changes in equity and the consolidated and separate statements of cash flows for the year then ended, and notes to the consolidated and separate financial statements, including a summary of material accounting policy information.

In our opinion, the consolidated and separate financial statements **present fairly**, in all **material respects**....

- Consolidated financial statements – ensure question in the ITR14 is answered correctly
- AFS was audited and not reviewed
- Unqualified audit opinion issued

- Note “material aspects”
- Remember that audits are performed on a materiality basis – materiality does not affect tax calculation and definitely does SARS not consider materiality!!

# Accounting Policies

# Accounting Policies

## 1.3 Property, plant and equipment

Property, plant and equipment is initially measured at cost.

Property, plant and equipment is carried at cost less accumulated depreciation and any impairment losses.

Property, plant and equipment are depreciated on the straight line basis over their expected useful lives to their estimated residual value. The useful lives of items of property, plant and equipment have been assessed as follows:

Item	Average useful life
Computer equipment	3 years
Computer software	2 years
Furniture and fixtures	10 years
Office equipment	10 years
Leasehold improvements	5 years
Plant and machinery	5 years
Cellphones	2 years
Small asset	1 year

- Accounting policies provides more information on account standards applied
- Asset write-off periods for accounting is provided – need to evaluate if this is in line with PN47
- Small assets less than R7000 can be claimed in full
- LHI is contentious

# Accounting Policies

## 1.14 Revenue

Revenue arises mainly from Software solutions

To determine whether to recognise revenue, the company follows a 5-step process:

- 1) Identifying the contract with a customer
- 2) Identifying the performance obligations
- 3) Determining the transaction price
- 4) Allocating the transaction price to the performance obligations
- 5) Recognising revenue when/as performance obligation(s) are satisfied.

- Evaluate if accounting treatment is in line with gross income definition for recognition of income (or non-taxable / deferral of income)

# AFS and the ITR14

# AFS and the ITR14

Is the company part of a group of companies that prepares consolidated financial statements?

Y  N

Is the company a member of a Multinational Entity (MNE) group as defined in the Country-by-Country (CbC) Regulations?

Y  N

Have the financial statements been audited?

Y  N

Have the financial statements been reviewed?

Y  N

If Yes, provide the name of the entity that conducted the audit / review

**PWC**

Have the financial statements been qualified?

Y  N

If Yes, does this have any tax effects?

Y  N

Did the company participate in any farming activities?

Y  N

Is the company carrying on banking, financial services or insurance business?

Y  N

Is the company part of a group of companies as defined in s1?

Y  N

Is the company part of a multinational enterprise?

Y  N

Did the financial year end of the company change during this year of assessment?

Y  N

- What if you submit an ITR14 return based on unsigned AFS?
- Answer both questions NO
- NOT recommended

# SARS and AFS Interpretation



## FAQ: Will SARS assist with the interpretation of financial statements?

No. The SARS agent will not assist with the interpretation of the financial statements and will only capture the information completed by the Company representative/Public Officer.

### Note:

- The SARS agent in the branch will not assist with the interpretation of the financial statements and will only capture the information completed by the Company Representative/Public Officer. SARS recommends that you consult a tax practitioner of your choice should you require assistance with interpretation of the financial statements or unable to complete the ITR14 using the guide and the example of the ITR14 on the SARS website.

# Practical Examples

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# Employment Tax Incentive

## **EMPLOYMENT TAX INCENTIVE ACT NO. 26 OF 2013**

**7. Determining amount of employment tax incentive.**—(1) During each month, commencing from 1 January 2014, that an employer employs a qualifying employee, the amount of the employment tax incentive available to that employer is the sum of the amounts determined in respect of each qualifying employee of that employer stipulated in subsections (2) and (3) and section 9.

(2) During each month of the first 12 months in respect of which an employer employs a qualifying employee, the amount of the employment tax incentive in respect of that qualifying employee, if the monthly remuneration of the employee is—

- (a) less than R2 000, is an amount equal to 75 per cent of the monthly remuneration of the employee;
- (b) R2 000 or more but less than R4 500, is an amount of R1 500;
- (c) R4 500 or more but less than R6 500, is an amount determined in accordance with the following formula:

$$X = A - (B \times (C - D))$$

in which formula—

- (i) “X” represents the amount of the monthly employment tax incentive that must be determined;
- (ii) “A” represents the amount of R1 500;
- (iii) “B” represents the number 0,75;

## Employment Tax Incentive

10(s) any amount by which the employees' tax as defined in section 1 of the Employment Tax Incentive Act, 2013, payable by an employer as contemplated in section 3 of that Act is reduced in terms of section 2 (2) of that Act or paid in terms of section 10 of that Act;

If client does claim ETI's, best to advise them to account for ETI in separate account to be able to identify correct amount and not overlook this

# Dividend Tax

SARS issues:

DT-GEN-01-G02 – Declaration of Dividends Tax via eFiling – External Guide

DT-GEN-01-G03 – A Quick Guide to Dividends Tax – External Guide

LAPD-IT-G19 – Comprehensive Guide to Dividends Tax

Dividends paid disclosed in the Statement of Changes in Equity

Ensure client:

- Paid WHT over to SARS
- Completed and submitted DTR01 and 02

Where dividend is exempt or reduced rate applies – client needs completed declaration from shareholder declaring it qualifies for the exemption / reduced rate of WHT and in terms of which section they so qualifies for.

# Dividend Tax

Where is amount of WHT tax disclosed in the AFS?

## 24. Taxation

### Major components of the tax expense

#### Current

Current tax in respect of the current year	147,021	133,081
Local income tax - recognised in current tax for prior periods	1,680	(3,952)
Withholding tax	(1,702)	573
	<b>146,999</b>	<b>129,702</b>

TO Continue... 8 August 2024

Thank you