

Accounting for Tax 5: Annual Financial Statement Interpretation 3

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- 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

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

Recap:

What we looked at in session 1 & 2

Recap: What we looked at in session 1 & 2

- Importance of understanding Annual Financial Statement
 - AFS is a “language” – Understanding the “language” will assist in identifying tax challenges or tax opportunities
 - Understand the accounting treatment to be able to determine the correct tax treatment
 - Examples: IFRS 9 (tax follows accounting), 15 & 16, tenant installation allowances (tax and accounting treatment significantly different)
 - **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

Recap: What we looked at in session 1 & 2

- Before commencing with tax review:
 - Understand clients' business and industry they operate in
 - How?
 - Website, speak to client, visit premises and manufacturing facilities, review and analyse AFS
 - No face-less consulting
 - Importance of the non-financial information in the AFS
 - General information
 - Directors' report
 - Audit report
 - Accounting policies

Recap: What we looked at in session 1 & 2

Understanding the Balance Sheet

Potential apportionment issues (Loans incurred to acquire share investments)

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

Potential Transfer pricing – Thin capitalization and interest free loans

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

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

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

Potential adjustments for leasehold improvements

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

Why is this
important to get the
tax calculation right

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

Interpreting Annual Financial Statements

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
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Statement of
Comprehensive Income
(SoCI)
(Income Statement)

Interpreting AFS: Statement of Comprehensive Income (I/S)

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

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

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

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

Interest paid to entities not subject to tax in RSA may give rise to Section 23M limitations (Debts owed to a person not subject to tax)

Statement of Profit or Loss and Other Comprehensive Income for the year ended 29 February 2024

Figures in R	Notes	29 February 2024	28 February 2023
Revenue	17	657,474,128	535,315,288
Cost of sales	19	(189,509,380)	(144,571,591)
Gross Profit		467,964,748	390,743,697
Other income	18	11,788,592	2,072,715
Administrative costs	19	(20,630,160)	(41,118,507)
Other gains and (losses)		3,000	-
Profit from operating activities		459,126,180	351,697,905
Finance income	20	17,168,234	9,566,263
Finance costs	21	(83,741,893)	(81,960,746)
Profit before tax		392,552,521	279,303,422
Income tax expense	22	(109,817,821)	(74,008,760)
Profit for the year		282,734,700	205,294,662

Other comprehensive income net of tax

Components of other comprehensive income

Cash flow hedges

Items that will not be reclassified to profit or loss

Fair value adjustment on cash flow hedge	50,974	15,135,662
Deferred tax on fair value adjustment	(13,763)	(4,661,389)
Cumulative reclassification of hedge reserve	(5,861,182)	(3,857,895)
Deferred tax on cumulative reclassification of hedge reserve	1,582,519	1,475,723
Ineffectiveness of hedge	1,427,203	1,531,727
Deferred tax on ineffectiveness of hedge	(385,345)	(342,964)
Total other comprehensive income	(3,199,594)	9,280,864
Total other comprehensive income net of tax	(3,199,594)	9,280,864
Total comprehensive income	279,535,106	214,575,526

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

Revenue & other income

Revenue

17. Revenue

17.1 Revenue comprises:

Sales of electricity

Commercial Energy

Deemed Energy

Total revenue from contracts with customers

Sale of electricity – possible section 12B allowance (allowance for certain assets used in the production of renewable energy)

655,949,456	535,178,052
1,524,672	137,236
657,474,128	535,315,288

17.2 Sources of revenue

Contracts with customers - South Africa

657,474,128	535,315,288
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Revenue

Revenue	106 852 583	98 300 000
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21. Revenue

Revenue from contracts with customers

Rendering of services	-	-
Dividends received	106 852 583	98 300 000
	<u>106 852 583</u>	<u>98 300 000</u>

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

Revenue

Tax treatment:

- Example 1:
 - Gross income
- Example 2:
 - Gross income
 - But exemption ito section 10(1)(k) applies
 - Ensure taxpayer has completed DTR01 and 02 declarations
- Companies not trading, or earning only exempt income
 - Example holding companies
 - Income consists of only dividends or interest (passive income)
 - Section 23(f):

23. Deductions not allowed in determination of taxable income.—No deductions shall in any case be made in respect of the following matters, namely:

(f) any expenses incurred in respect of any amounts received or accrued which do not constitute income as defined in section one;
 - Need to consider if apportionment of expenses is required

Revenue

Apportionment of expenses

Total income for the year = R500 000

Description	Taxable	Exempt	Total taxable
Dividends		R300 000	R0
Management fee	R100 000		R100 000
Royalty income	R100 000		R100 000
Total	R200 000	R300 000	R200 000

Total expenses = R105 000

Description	Deductible
Audit fees	R30 000
Bank charges	R5 000
Office rental	R40 000
General costs	R30 000
Total	R105 000

Deductible portion:
 $R200\ 000 / R500\ 000 = 40\%$

Therefore:
 $R105\ 000 \times 40\% = \mathbf{R42\ 000}$

Income = R200 000
 Less allowable expenses = (R42 000)
Taxable income = R158 000

Other income

Description	Tax treatment
Bad debts recovered	If previously claimed under section 11(i) and not recovered, needs to be included in gross income as a recoupment
Sale of business	Selling price should be allocated to the underlying assets: <ul style="list-style-type: none"> • Portion relating to capital assets is capital receipts in nature • Portion relating to trading stock is revenue in nature
Damages and compensation	Difficult and not straight forward: <ul style="list-style-type: none"> • If for loss of capital asset, then capital in nature • If for loss of profits, then revenue in nature
Government Grants	Specifically included in gross income by par (1C), whether the grant is capital or revenue in nature. But might be exempt again in terms of the 11 th Schedule (government grant is defined in section 12P of the Act)
Private Grants	Not fortuitous gift. General rule applies: <ul style="list-style-type: none"> • If to subsidise revenue expenditure, then revenue in nature • If to subsidise capital expenditure, then capital in nature

Other income

Description	Tax treatment
Local dividends	Specifically included in gross income ito par (k) of gross income definition, but then exempt ito section 10(1)(k)
Foreign dividends	Specifically included in gross income ito par (k) of gross income definition. Certain exemptions apply.
Profit on foreign exchange differences	Realised gains (and losses) are taxable (deductible) ito section 24I Loans between the following: <ul style="list-style-type: none">• Companies that form part of the same group of companies• Connected persons<ul style="list-style-type: none">• Is treated ito section 24I(10A)• Exchange item should not be classified as current asset or liability for IFRS• No FEC must have been entered into for that exchange item• No FX gain or loss should be calculated for this exchange item

Other income

Description	Tax treatment
Employment tax incentive	<ul style="list-style-type: none">• Exempt ito section 10(s) of the Income Tax Act:• 10. Exemptions.—(1) <i>There shall be exempt from normal tax— (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;</i>

Not trading – new section 11G

New section 11G

Section 11G replaces PN 31

As a general rule, the deduction of expenditure requires that the amount is incurred in the production of income and in the course of carrying on a trade (sections 11(a) and 23(g))

Old: PN 31	New: Section 11G
Interest paid on moneys borrowed	Deduction of expenses incurred in the production of interest
Allows for a deduction of expenditure incurred by a taxpayer who does not carry on a trade up, to amount of any interest income earned by the taxpayer.	Allow a deduction from income of any person, interest incurred by that person to the extent that the interest— <ul style="list-style-type: none">• is incurred in the production of interest income that is included in the income of that person; and• is not incurred in carrying on a trade.
To be withdrawn on effective date of section 11G	Effective from 1 January 2025 to YoA starting on or after this date

Expenses

Expenses

Administrative expenses

Administration fees		313,619	304,178
Advertising and promotions	←	196,468	188,590
Amortisation	←	7,054,789	7,054,789
Bad debts	←	2,240,014	227,899
Bank charges		69,049	49,498
Changes in accounting estimates	←	(22,737,209)	9,927,624
Cleaning		21,820	20,501
Computer expenses	←	1,552,440	837,975
Courier and postage		11,348	1,931
Depreciation	←	412,127	404,683
DOE initiative costs	←	13,726,530	10,999,609
Employee costs	←	5,380,907	5,401,548
Entertainment		7,846	18,153
Facility fees		1,300,815	1,229,577

Expenses

Forex gains and losses ←	52,805	(4,412)
Insurance	129,006	139,979
Legal fees ←	1,122,866	691,629
Claims paid ←	7,125,000	-
Printing and stationery	29,900	1,409
Professional fees ←	1,127,796	1,985,169
Recruitment costs	191,437	191,802
Rent paid	181,489	173,014
Repairs and maintenance ←	1,855	11,450
Security	10,471	9,013
Staff welfare	126,250	89,135
Subscriptions	240,919	245,755
Telephone costs	40,800	98,105
Training	63,957	289,565
Travel costs ←	635,046	530,339
	20,630,160	41,118,507

Expenses

Employee costs


Salaries, wages, bonuses and other benefits	102 143 274	99 778 113
Long term incentive scheme (accounted for under IFRS 2)	(2 195 682)	(10 744 937)
Retirement benefit plans: defined contribution expense	10 753 814	13 331 642
Long service award	339 590	381 000
Total employee costs	111 040 996	102 745 818

On 25 April 2023, the Company settled the long term incentive to identified senior managers in line with the rules of the 2018 e4 Long Term Incentive Scheme. The amounts due were paid on behalf of the Company by e4 Group Holdings Proprietary Limited.

Leases

Leases of low value assets	84 782	67 359
Total lease expenses	84 782	67 359

Depreciation and amortisation

Depreciation of right-of-use assets 	5 299 528	5 997 137
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Expenses

13. Operating profit (loss)

Operating profit (loss) for the year is stated after accounting for the following:

Profit on sale of vehicles and equipment ←	184	394
Auditors remuneration	2 717	308
Consulting and services fees ←	2 691	4 122
Depreciation on property, plant and equipment ←	70 364	74 580
Employee costs	21 528	24 477
Labour brokerage	18 533	14 424
Operating lease charges	59 036	56 770
Foreign exchange (gain)/loss ←	9 629	84

Advertising and promotions

Look for donations included in this account

Also for any kind of entertainment expenses on which VAT cannot be claimed

Amortisation

What is the nature of the asset?

Software – is this self-developed or purchased? Need to apply correct rate ito IN47

If trademarks, designs, copyrights, patents - section 11(gB) for expenditure incurred for renewal etc

Section 11(gC) deals with the cost price of intellectual property.

No deduction for trademarks acquired. If self developed then might qualify for section 11D allowance

Bad debts

Section 11(i)

Any debt due to a taxpayer

That has become bad during the year

For income that were included in income in this or any previous year

Changes in accounting estimates

Need to carefully look at nature of the changes

For example – was a new IFRS statement introduced such as IFRS 9, 16 or 16

Determine what the tax consequences if (if any) ito gross income, section 11(a) or any other specific section of the Act

Computer expenses

Always analyse the computer expenses account

Look out for items that are capital in nature such as assets (headphones, mouse, screen)

Sometimes assets are group together

Assets of less than R7 000 can be written of in full

Expenses

Depreciation

IN 47

Confirm if accounting write-off periods agree to section 11(e) / 12B /12C etc

DOE initiative costs ("strange" costs)

Enquire into the nature of an expense if the description is not clear or is it is not an expense in the ordinary course of business

Look out for new accounts or expenses

Employee costs

Expect to see employee related provisions such as bonus and leave pay.

If not in separate accounts, then perhaps included in sundry / other accruals or general provision account

Enquire if all employee related expenses are accounted for through the payroll

Foreign exchange gains and losses

Refer slide on foreign exchange income

Same principles applies to FX loss

Legal, consulting and professional fees

Deductible if expense is in the production of income

Example: tax return fees, AFS preparation fees, employee related matters

Section 11(c):
Deduction for legal fees that relates to a claim, dispute or action of law.

Claim by / against taxpayer needs to be taxable or tax-deductible for legal fees to qualify as a deduction

R&M

Section 11(d) – allows for a deduction which would normally not qualify it to section 11(a)

Repair is a replacement of the subsidiary part of the whole and does not need to be the exact same material

Look out for assets included in this account such as security camera, carpets etc

Assets less than R7 000 can be claimed in full

Consider repair versus improvement

Depreciation on ROU assets

Needs to be added back in the tax calculation

Only actual lease payments can be claimed for tax purposes

Loss / Profit on sale of PPE

Accounting profit or loss needs to be reversed for tax purposes

Calculation needs to be done for tax based on NTV and accumulated tax allowance claimed in the past

Could either be: section 11(o) depreciable asset allowance, section 8(4)(a) recoupment, of capital gain/loss

Section 11(o) not available if disposed to connected person

BEE expenditure

Usually not in the production of income

Could be seen as donation without 18A certificate

Examples are Social Economic Development and Social Responsibility Expenditure

Costs are usually incurred to earn BEE scorecard points. If so then it is part of your income earning operations. Without these points will not be able to trade.

BCR 02 / section 11(a) and 23(g)

Donations

Section 18A

Need to be in possession of valid section 18A certificate

Disclosure of the split between 18A and non-18A donations in the ITR14 very important

Limitation of expenses that can be claimed for the year – limited to 10% of taxable income (before taking into account the donation deduction)

Any excess not allowed in the current year is carried over to the next year. Treat this as a temporary difference in the tax calculation and recognise a deferred tax asset on the amount

General comments

General comments

- When analysing income statement accounts, look out for provisions that are included in those accounts
 - Legal, consulting and professional fees
 - Repairs and maintenance
 - Audit and accounting fees
 - Computer equipment
- Enquire where the credit went to – for example to other / sundry accruals account
- Make sure these are included in the provisions being added back if it is a true provision and not an accrual

- Look out for income or expenses that were not there in prior years and enquire and investigate the nature of these, example:

18. Other income

Other income comprises:

Delay damages	7,069,749	-
Sale of Renewable Energy Certificates	4,718,843	2,072,715
Total other income	11,788,592	2,072,715

Deductions available not in the Income Statement

Additional deductions in the ITR14

Section 12H – Learnership deduction



INTERPRETATION NOTE 20 (Issue 8)

DATE: 28 July 2021

ACT : INCOME TAX ACT 58 OF 1962

SECTION : SECTION 12H

SUBJECT : ADDITIONAL DEDUCTION FOR LEARNERSHIP AGREEMENTS

Additional deductions in the ITR14

Annual allowance	Completion allowance
For each year that learnership is active	Once-off when completed
Apportioned	Not apportioned
Based on months in the year	If equal or more than 24 months, then allowance is claimed for each year of the learnership
Distinguish between disabled and non-disabled	Distinguish between disabled and non-disabled
Distinguish between NQF levels 1-6 and 7-10	Distinguish between NQF levels 1-6 and 7-10

- Allowance must be claimed in the applicable year and no “catch-up” claims can be made. Allowance is forfeit if not claimed in the correct year.
- IT10B documents needs to be completed for each learner – this is a question in the ITR14 return that requires a response
- Allowance is based on NQF level of learner before this learnership was entered into

Interest income and expense

Interest income and deductions

20. Finance income		
Finance income comprises:		
Bank interest received	17,101,256	9,426,312
Interest received from SARS	66,978	139,951
Total finance income	17,168,234	9,566,263

21. Finance costs		
Finance costs included in profit or loss:		
Interest bearing borrowings	70,866,380	68,304,996
Commercial facility	1,479,172	3,826,567
Hermes facility	73,755,761	66,804,597
Interest rate hedge	(4,433,978)	(2,326,168)
Interest paid to SARS	65,425	-
Leases interest rate charge	1,572,225	1,528,575
Asset decommissioning expense	7,765,308	8,044,695
Derivative financial instrument (gain)/loss - discontinued hedge	3,537,979	4,082,478
Total finance costs	83,741,893	81,960,746

Interest income and deductions

- Financial institution – taxable and deductible
- SARS – taxable BUT not deductible
- IFRS 16 – not deductible

- Other interests – need to look at the transaction and agreements to understand nature of the interest expense
- Is it perhaps just an IFRS accounting adjustment and not true interest

Thank You!