CIMA

Subject F1

Financial Reporting

Study Text

CIMA PUBLISHING

KAPLAN PUBLISHING

Published by: Kaplan Publishing UK

Unit 2 The Business Centre, Molly Millars Lane, Wokingham, Berkshire. RG41 2QZ

Notice

The text in this material and any others made available by any Kaplan Group company does not amount to advice on a particular matter and should not be taken as such. No reliance should be placed on the content as the basis for any investment or other decision or in connection with any advice given to third parties. Please consult your appropriate professional adviser as necessary. Kaplan Publishing Limited, all other Kaplan group companies, the International Accounting Standards Board, and the IFRS Foundation expressly disclaim all liability to any person in respect of any losses or other claims, whether direct, indirect, incidental, consequential or otherwise arising in relation to the use of such materials. Printed and bound in Great Britain.

Kaplan is not responsible for the content of external websites. The inclusion of a link to a third party website in the text should be not taken as an endorsement.

Acknowledgements

Questions from past live assessments have been included by kind permission of CIMA.

We are grateful to the CIMA for permission to reproduce past examination questions. The answers to CIMA Exams have been prepared by Kaplan Publishing, except in the case of the CIMA November 2010 and subsequent CIMA Exam answers where the official CIMA answers have been reproduced. Questions from past live assessments have been included by kind permission of CIMA

British Library Cataloguing-in-Publication Data

A catalogue record for this book is available from the British Library. ISBN: 978-1-78740-199-0

Printed and bound in Great Britain

Contents

Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2016 IFRS Standards Red Book.

How to use the Materials

These official CIMA learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your objective tests.

The product range contains a number of features to help you in the study process. They include:

- a detailed explanation of all syllabus areas
- extensive 'practical' materials
- generous question practice, together with full solutions.

This Study Text has been designed with the needs of home study and distance learning candidates in mind. Such students require very full coverage of the syllabus topics, and also the facility to undertake extensive question practice. However, the Study Text is also ideal for fully taught courses.

The main body of the text is divided into a number of chapters, each of which is organised on the following pattern:

- **Detailed learning outcomes.** These describe the knowledge expected after your studies of the chapter are complete. You should assimilate these before beginning detailed work on the chapter, so that you can appreciate where your studies are leading.
- **Step-by-step topic coverage.** This is the heart of each chapter, containing detailed explanatory text supported where appropriate by worked examples and exercises. You should work carefully through this section, ensuring that you understand the material being explained and can tackle the examples and exercises successfully. Remember that in many cases knowledge is cumulative: if you fail to digest earlier material thoroughly, you may struggle to understand later chapters.
- **Activities.** Some chapters are illustrated by more practical elements, such as comments and questions designed to stimulate discussion.
- **Question practice.** The text contains three styles of question:
  - Exam-style objective test questions (OTQs).
  - 'Integration' questions – these test your ability to understand topics within a wider context. This is particularly important with calculations where OTQs may focus on just one element but an integration question tackles the full calculation, just as you would be expected to do in the workplace.

– ‘Case’ style questions – these test your ability to analyse and discuss issues in greater depth, particularly focusing on scenarios that are less clear cut than in the objective tests, and thus provide excellent practice for developing the skills needed for success in the Management Level Case Study Examination.

- **Solutions.** Avoid the temptation merely to ‘audit’ the solutions provided. It is an illusion to think that this provides the same benefits as you would gain from a serious attempt of your own. However, if you are struggling to get started on a question you should read the introductory guidance provided at the beginning of the solution, where provided, and then make your own attempt before referring back to the full solution.

If you work conscientiously through this Official CIMA Study Text according to the guidelines above you will be giving yourself an excellent chance of success in your objective tests. Good luck with your studies!

Quality and accuracy are of the utmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details, or follow the link to the feedback form in MyKaplan.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon explanations

Definition – These sections explain important areas of knowledge which must be understood and reproduced in an assessment environment.

Key point – Identifies topics which are key to success and are often examined.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an assessment question. **Reference to this text is vital when self-studying.**

Test your understanding – Following key points and definitions are exercises which give the opportunity to assess the understanding of these core areas.

Illustration – To help develop an understanding of particular topics. The illustrative examples are useful in preparing for the Test your understanding exercises.

New – Identifies topics that are brand new in subjects that build on, and therefore also contain, learning covered in earlier subjects.

Tutorial note – Included to explain some of the technical points in more detail.

Study technique

Passing exams is partly a matter of intellectual ability, but however accomplished you are in that respect you can improve your chances significantly by the use of appropriate study and revision techniques. In this section we briefly outline some tips for effective study during the earlier stages of your approach to the objective tests. We also mention some techniques that you will find useful at the revision stage.

Planning

To begin with, formal planning is essential to get the best return from the time you spend studying. Estimate how much time in total you are going to need for each subject you are studying. Remember that you need to allow time for revision as well as for initial study of the material.

With your study material before you, decide which chapters you are going to study in each week, and which weeks you will devote to revision and final question practice.

Prepare a written schedule summarising the above and stick to it!

It is essential to know your syllabus. As your studies progress you will become more familiar with how long it takes to cover topics in sufficient depth. Your timetable may need to be adapted to allocate enough time for the whole syllabus.

Students are advised to refer to the examination blueprints (see page P.13 for further information) and the CIMA website, www.cimaglobal.com, to ensure they are up-to-date.

The amount of space allocated to a topic in the Study Text is not a very good guide as to how long it will take you. The syllabus weighting is the better guide as to how long you should spend on a syllabus topic.

Tips for effective studying

(1) Aim to find a quiet and undisturbed location for your study, and plan as far as possible to use the same period of time each day. Getting into a routine helps to avoid wasting time. Make sure that you have all the materials you need before you begin so as to minimise interruptions.

(2) Store all your materials in one place, so that you do not waste time searching for items every time you want to begin studying. If you have to pack everything away after each study period, keep your study materials in a box, or even a suitcase, which will not be disturbed until the next time.

(3) Limit distractions. To make the most effective use of your study periods you should be able to apply total concentration, so turn off all entertainment equipment, set your phones to message mode, and put up your 'do not disturb' sign.

(4) Your timetable will tell you which topic to study. However, before diving in and becoming engrossed in the finer points, make sure you have an overall picture of all the areas that need to be covered by the end of that session. After an hour, allow yourself a short break and move away from your Study Text. With experience, you will learn to assess the pace you need to work at. Each study session should focus on component learning outcomes – the basis for all questions.

(5) Work carefully through a chapter, making notes as you go. When you have covered a suitable amount of material, vary the pattern by attempting a practice question. When you have finished your attempt, make notes of any mistakes you made, or any areas that you failed to cover or covered more briefly. Be aware that all component learning outcomes will be tested in each examination.

(6) Make notes as you study, and discover the techniques that work best for you. Your notes may be in the form of lists, bullet points, diagrams, summaries, 'mind maps', or the written word, but remember that you will need to refer back to them at a later date, so they must be intelligible. If you are on a taught course, make sure you highlight any issues you would like to follow up with your lecturer.

(7) Organise your notes. Make sure that all your notes, calculations etc. can be effectively filed and easily retrieved later.

Progression

There are two elements of progression that we can measure: how quickly students move through individual topics within a subject; and how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

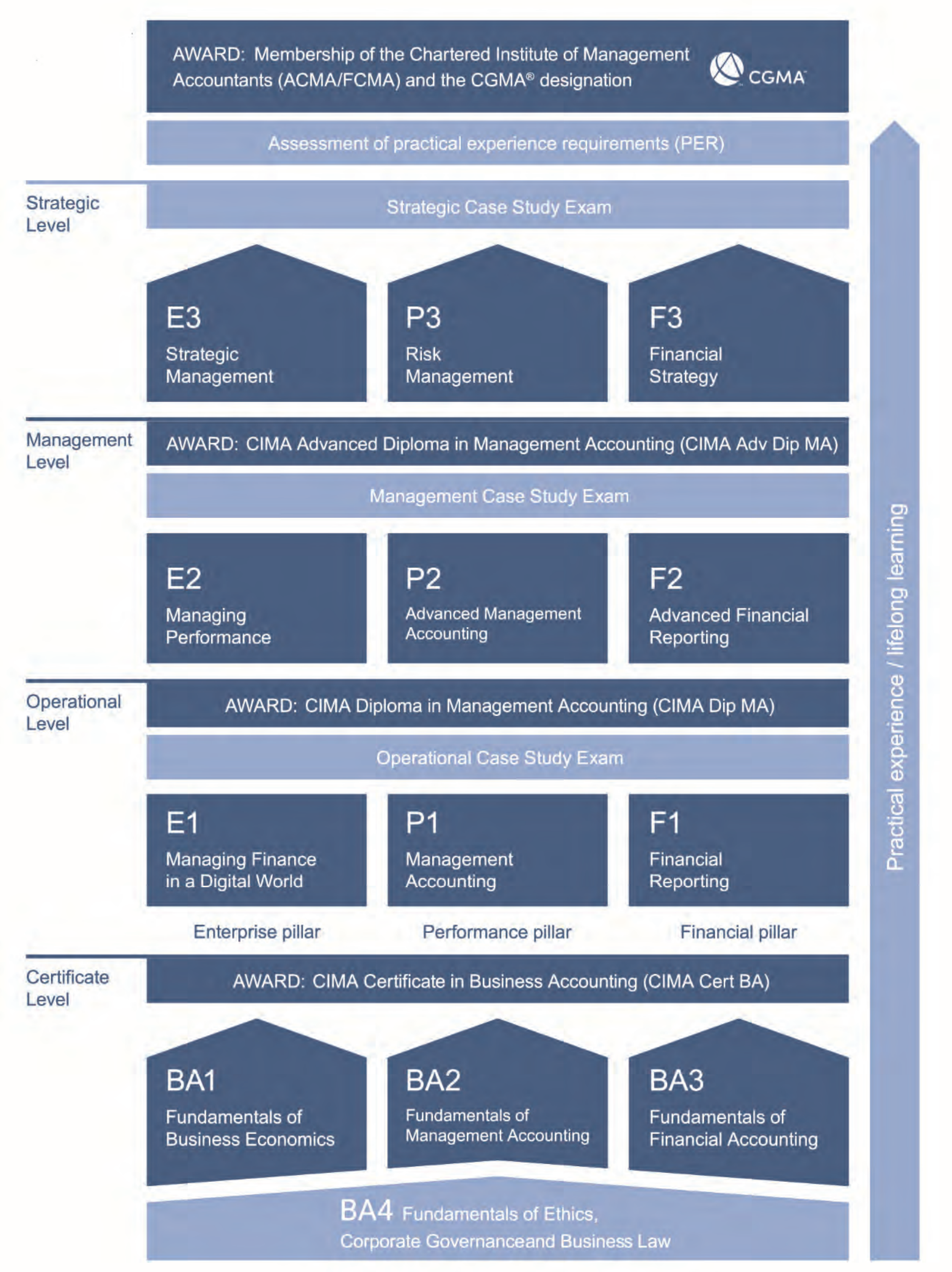
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example ‘I will finish this topic by 30 June’, or for overall achievement, such as ‘I want to be qualified by the end of next year’.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. For example, F1 *Financial reporting* builds on your knowledge of financial accounting from BA3 *Fundamentals of financial accounting* and lays the foundations for F2 *Advanced financial reporting*.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress. Make sure you carefully review the 2019 CIMA syllabus transition rules and seek appropriate advice if you are unsure about your progression through the qualification.



Reproduced with permission from CIMA

Objective test

Objective test questions require you to choose or provide a response to a question whose correct answer is predetermined.

The most common types of objective test question you will see are:

- Multiple choice, where you have to choose the correct answer(s) from a list of possible answers. This could either be numbers or text.
- Multiple choice with more choices and answers, for example, choosing two correct answers from a list of eight possible answers. This could either be numbers or text.
- Single numeric entry, where you give your numeric answer, for example, profit is $10,000.
- Multiple entry, where you give several numeric answers.
- True/false questions, where you state whether a statement is true or false.
- Matching pairs of text, for example, matching a technical term with the correct definition.
- Other types could be matching text with graphs and labelling graphs/diagrams.

In every chapter of this Study Text we have introduced these types of questions, but obviously we have had to label answers A, B, C etc. rather than using click boxes. For convenience, we have retained quite a few questions where an initial scenario leads to a number of sub-questions. There will be no questions of this type in the objective tests.

Guidance re CIMA on-screen calculator

As part of the CIMA objective test software, candidates are now provided with a calculator. This calculator is on-screen and is available for the duration of the assessment. The calculator is available in each of the objective tests and is accessed by clicking the calculator button in the top left hand corner of the screen at any time during the assessment. Candidates are permitted to utilise personal calculators as long as they are an approved CIMA model. Authorised CIMA models are listed here: https://www.cimaglobal.com/Studying/study-and-resources/.

All candidates must complete a 15-minute exam tutorial before the assessment begins and will have the opportunity to familiarise themselves with the calculator and practise using it. The exam tutorial is also available online via the CIMA website.

Candidates may practise using the calculator by accessing the online exam tutorial.

Fundamentals of objective tests

The objective tests are 90-minute assessments comprising 60 compulsory questions, with one or more parts. There will be no choice and all questions should be attempted. All elements of a question must be answered correctly for the question to be marked correctly. All questions are equally weighted.

CIMA syllabus 2019 – Structure of subjects and learning outcomes

Details regarding the content of the new CIMA syllabus can be located within the CIMA 2019 professional syllabus document.

Each subject within the syllabus is divided into a number of broad syllabus topics. The topics contain one or more lead learning outcomes, related component learning outcomes and indicative knowledge content.

A learning outcome has two main purposes:

(a) To define the skill or ability that a well prepared candidate should be able to exhibit in the examination.

(b) To demonstrate the approach likely to be taken in examination questions.

The learning outcomes are part of a hierarchy of learning objectives. The verbs used at the beginning of each learning outcome relate to a specific learning objective, e.g.

Calculate the break-even point, profit target, margin of safety and profit/volume ratio for a single product or service.

The verb '**calculate**' indicates a level three learning objective. The following tables list the verbs that appear in the syllabus learning outcomes and examination questions.

The examination blueprints and representative task statements

CIMA have also published examination blueprints giving learners clear expectations regarding what is expected of them.

The blueprint is structured as follows:

- Exam content sections (reflecting the syllabus document)
- Lead and component outcomes (reflecting the syllabus document)
- Representative task statements.

A representative task statement is a plain English description of what a CIMA finance professional should know and be able to do.

The content and skill level determine the language and verbs used in the representative task.

CIMA will test up to the level of the task statement in the objective tests (an objective test question on a particular topic could be set at a lower level than the task statement in the blueprint).

The format of the objective test blueprints follows that of the published syllabus for the 2019 CIMA Professional Qualification.

Weightings for content sections are also included in the individual subject blueprints.

CIMA VERB HIERARCHY

CIMA place great importance on the definition of verbs in structuring objective tests. It is therefore crucial that you understand the verbs in order to appreciate the depth and breadth of a topic and the level of skill required. The objective tests will focus on levels one, two and three of the CIMA hierarchy of verbs. However, they will also test levels four and five, especially at the management and strategic levels.

Skill level	Verbs used	Definition
Level 5 Evaluation How you are expected to use your learning to evaluate, make decisions or recommendations	Advise	Counsel, inform or notify
	Assess	Evaluate or estimate the nature, ability or quality of
	Evaluate	Appraise or assess the value of
	Recommend	Propose a course of action
	Review	Assess and evaluate in order, to change if necessary
Level 4 Analysis How you are expected to analyse the detail of what you have learned	Align	Arrange in an orderly way
	Analyse	Examine in detail the structure of
	Communicate	Share or exchange information
	Compare and contrast	Show the similarities and/or differences between
	Develop	Grow and expand a concept
	Discuss	Examine in detail by argument
	Examine	Inspect thoroughly
	Interpret	Translate into intelligible or familiar terms
	Monitor	Observe and check the progress of
	Prioritise	Place in order of priority or sequence for action
	Produce	Create or bring into existence
Level 3 Application How you are expected to apply your knowledge	Apply	Put to practical use
	Calculate	Ascertain or reckon mathematically
	Conduct	Organise and carry out
	Demonstrate	Prove with certainty or exhibit by practical means
	Prepare	Make or get ready for use
	Reconcile	Make or prove consistent/compatible

Skill level	Verbs used	Definition
Level 2 Comprehension What you are expected to understand	Describe	Communicate the key features of
	Distinguish	Highlight the differences between
	Explain	Make clear or intelligible/state the meaning or purpose of
	Identify	Recognise, establish or select after consideration
	Illustrate	Use an example to describe or explain something
Level 1 Knowledge What you are expected to know	List	Make a list of
	State	Express, fully or clearly, the details/facts of
	Define	Give the exact meaning of
	Outline	Give a summary of

Information concerning formulae and tables will be provided via the CIMA website, www.cimaglobal.com.

SYLLABUS GRIDS

F1: Financial Reporting

What the finance function does and its implications

Content weighting

Content area		Weighting
A	Regulatory environment of financial reporting	10%
B	Financial statements	45%
C	Principles of taxation	20%
D	Managing cash and working capital	25%
		100%

F1A: Regulatory environment of financial reporting

The preparation of financial statements is regulated by laws, standards, generally accepted accounting principles and by codes. The regulations ensure that financial statements of different entities are comparable and that they present a reasonably accurate picture of the performance, position and prospects of the organisation to their users. This section covers who the regulators are, what they do and why and how the regulations are applied. The objective is to provide candidates with a strong foundation for preparing and interpreting financial statements.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1 Identify regulators and describe their role.	a. Identify the major regulators. b. Describe what they do. c. Explain why they regulate financial reporting.	• National regulators • IFRS foundation • IASB • International Organisation for Securities Commissions (IOSCO) • Standard setting process • Differences between rules-based and principles-based regulations • Others such as International Integrated Reporting Council (IIRC)	Who are the regulators who determine how financial statements are prepared? What do they do? What value do they contribute to the production of financial statements? Coverage will include national and international regulators, stock exchange regulators and various accounting and financial reporting standards boards and major influential bodies like the IIRC.
2. Apply corporate governance principles to financial reporting.	a. Describe the role of the board in corporate governance. b. Apply corporate governance and financial stewardship principles to financial reporting.	• Need and scope for corporate governance regulations • Different approaches to corporate governance regulations	Boards have overall responsibility for ensuring that executives of organisations create value for their stakeholders and safeguard their assets. The role of boards is incorporated in various corporate governance codes. What are the main principles as they apply to financial reporting and the oversight of boards?

F1B: Financial statements

One of the roles of finance is to narrate how organisations create and preserve value. The financial statements are the means by which narration is done to particular audiences. This section enables candidates to prepare basic financial statements using financial reporting standards. It covers the main elements of the financial statements, what they intend to convey, the key financial reporting standards and how they are applied to prepare financial statements.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Identify the main elements of financial statements.	a. Identify the main elements of financial statements contained in the IFRS conceptual framework.	• Objectives and overall purpose of financial reporting • Qualitative characteristics of financial information • Reporting entity and its boundaries • Recognition (and derecognition) • Measurement bases • Presentation and disclosure • Concept of capital maintenance	This sets the main principles that underpin the preparation of financial statements. The focus is on the main principles. No detailed treatments are expected.
2. Explain specific financial reporting standards.	Explain the specific financial reporting standards related to: a. Non-current assets b. Leases c. Impairment d. Inventory e. Events after the period	• IAS 16 – Property, Plant & Equipment • IFRS 5 – Non-current Assets Held for Sale or Discontinued Operations • IFRS 16 – Leases • IAS 36 – Impairment of Assets • IAS 2 – Inventories • IAS 10 – Events After the Reporting Period	Examine the requirements for how major items of the financial statements are to be recognised, measured and disclosed. This covers the main areas and not specialist topics.
3. Apply financial reporting standards to prepare basic financial statements.	Apply financial reporting standards to prepare: a. Statement of financial position b. Statement of comprehensive income c. Statement of changes in equity d. Statement of cash flows	IAS 1 – Presentation of Financial Statements IAS 7 – Statement of Cash Flows	Give hands-on experience of preparing basic financial statements by bringing in all the elements.

F1C: Principles of taxation

One of the implications of value creation is how that value is distributed to different stakeholders. Taxation is part of this distribution. This section helps candidates distinguish between types of taxes and to calculate corporate taxes. In a digital world where revenue is earned through online trading that spans national boundaries, candidates are introduced to the issues relating to taxation across international borders and the ethics of taxation.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Distinguish between different types of taxes.	Distinguish between a. Direct versus indirect b. Corporate versus personal	• Features of direct and indirect taxes • Features of corporate and personal taxes	Gives a broad overview of the different types of taxes, who they affect and why they are used.
2. Calculate tax for corporates.	a. Explain the basis of taxation b. Explain the difference between accounting profit and taxable profit c. Calculate corporate tax	• Exempt income • Income taxed under different rules • Allowable expenditure • Capital allowances • Reliefs • Tax on sale of asset	The focus shifts here to corporate taxation. The main area covered is the difference between accounting profit and profit for taxation purposes. No national law is applied here. The main thing here is coverage and application of principles.
3. Explain some relevant issues that affect taxation.	Explain: a. Taxation across international borders b. Ethics of taxation	• Corporate residence • Types of overseas operations (e.g., subsidiary or branch) • Double taxation • Transfer pricing • Tax avoidance • Tax evasion	Given the increase of cross-border trading and revenue generation in the digital world what are the key issues affecting international taxation? What are the ethical issues that arise in the computation and payment of taxes?

F1D: Managing cash and working capital

Cash is the life blood of any organisation. The ability to provide cash, at the appropriate cost when it is needed is one of the key contributions that finance makes to organisations. It fulfils finance's role of enabling organisations to create and preserve value. This section provides candidates with the tools to ensure that the organisation has enough cash to ensure its continuing operations.

Lead outcome	Component outcome	Topics to be covered	Explanatory notes
1. Distinguish between the types and sources of short-term finance.	Distinguish between a. Types of short-term finance b. Financial institutions	• Trade payables • Overdrafts • Short-term loans • Debt factoring • Trade terms • Trade partners • Banks	What are the main types of funds needed for the short term? Where can those funds be accessed? How does one determine which type or source of finance is appropriate?
2. Explain and calculate operating and cash cycles.	Explain and calculate a. Operating cycle b. Cash flow cycle	• Inventory days • Trade receivable days • Trade payable days	The operating and cash cycle is one of the main means of putting together various elements of cash and near-cash items in a coherent manner to explain the cash needs of the organisation. What are these elements? How do they affect the availability and adequacy of cash for short-term operations?
3. Apply different techniques used to manage working capital.	a. Apply policies relating to elements of operating and cash cycle b. Prepare forecasts c. Explain risks relating to working capital	• Receivables management • Payables management • Inventory management • Risk of overtrading • Short-term cash flow forecasting • Investing short-term cash	What are the policies that organisations should put in place to manage working capital? How is the appropriate level determined, forecasted and accessed? What are the risks associated with accessing such funds?

Chapter

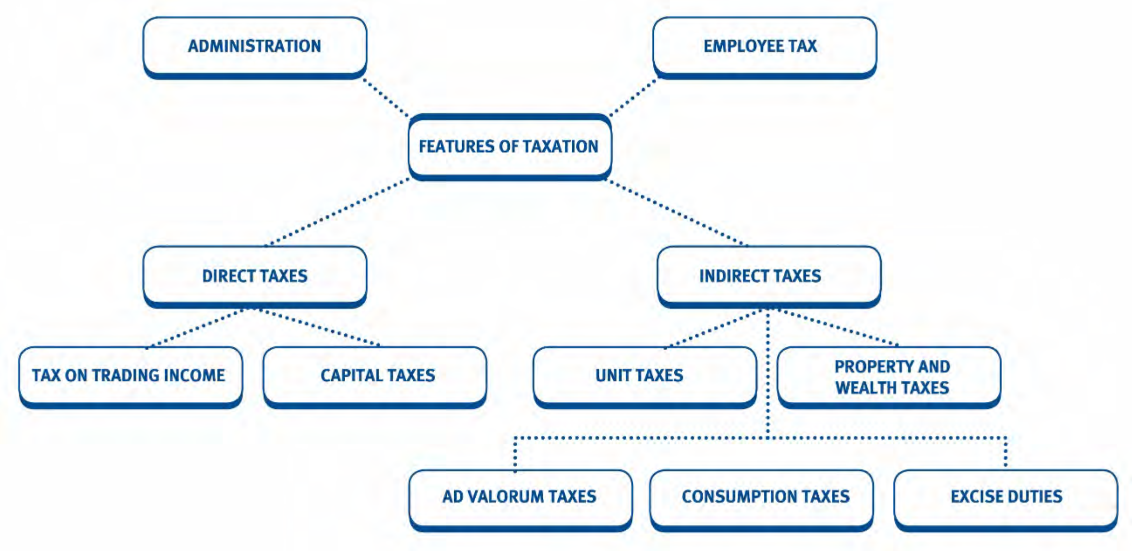
1

Features of Taxation and the Regulatory Environment

Chapter learning objectives

Lead	**Component outcome**
C1 Distinguish between different types of taxes	Distinguish between
	a. Direct versus indirect
	b. Corporate vs personal
C2 Calculate tax for corporates	a. Explain the basis of taxation
C3 Explain some relevant issues that affect taxation.	Explain
	b. Ethics of taxation

1 Session content



2 Introduction

Governments need tax revenues to finance expenditure on public services such as hospitals, schools, policing, retirement pensions, social benefits and to finance government borrowing. Governments can use tax to stimulate one sector of the economy and control another. For example, allowances on capital expenditure may develop the manufacturing sector, while high taxes on tobacco and alcohol may discourage sales.

In **Wealth of Nations**, Adam Smith proposed that a good tax should have the following characteristics:

- fair (reflect person's ability to pay)
- absolute (certain not arbitrary)
- convenient (easy to pay)
- efficient (low collection costs)

The 3 major principles of good tax policy are as follows:

- equity – A good tax should be fairly levied between one taxpayer and another.
- efficiency – A good tax should be cheap and easy to collect, i.e. UK tax system uses the PAYE (pay-as-you-earn) to collect tax at source on salaries and wages.
- economic effects – A good tax should consider the way in which a tax should be collected.

What is a good tax?

The American Institution of Certified Public Accountants lists the following principles that a good tax policy should have:

- equity and fairness
- transparency and visibility
- certainty
- economy in collection
- convenience of payment
- simplicity
- appropriate government revenues (determining the amount of tax revenues and date of collection)
- minimum tax gap (the difference between actual collection and amount due)
- neutrality
- economic growth and efficiency

It is not always possible to incorporate all ten into a tax system

Definition of terms

A tax is either a direct or an indirect tax.

Direct taxes

These are imposed directly on the person or enterprise required to pay the tax, i.e. tax on personal income such as salaries, tax on business profits or tax on disposals of chargeable assets. The person or enterprise must pay the tax directly to the tax authorities on their income. Examples in the UK of direct taxes would be income tax, capital gains tax or corporation tax.

Indirect taxes

This tax is imposed on one part of the economy with the intention that the tax burden is passed on to another. The tax is imposed on the final consumer of the goods or services. The more the consumer consumes the greater the tax paid. An example would be sales tax such as Value Added Tax (VAT) in the UK.

Tax bases

A tax base is something that is liable for tax. Taxes can be classified by tax base, that is, by what is being taxed. Taxes may be based on the following:

- Income: For example, income taxes and taxes on an entity's profits.
- Capital or wealth: For example, taxes on capital gains and taxes on inherited wealth.
- Consumption: For example, excise duties and sales taxes/value-added tax (VAT).

For example, in the US, the Federal government taxes income as its main source of revenue. State governments use taxes on income and consumption, while local governments rely almost entirely on taxing property and wealth.

Incidence

The incidence of a tax is the distribution of the tax burden, i.e. who is paying the tax.

What is incidence?

Incidence

This can be split into two elements:

1. **Formal incidence:** this is the person who has direct contact with the tax authorities, i.e. who is legally obliged to pay the tax.
2. **Actual incidence:** this is the person who actually ends up bearing the cost of the tax, i.e. who actually bears the burden of tax.

If we consider VAT – the formal incidence would be the entity making the sale because they will be responsible for making the payment to the relevant tax authorities. The actual incidence would be the consumer who bears the cost of the tax when they make a purchase from the entity.

Taxable person

The person accountable for the tax payment, e.g. individual or entity.

Competent jurisdiction

A taxable person normally pays tax in the country of origin. Competent jurisdiction is the tax authority that has the legal power to assess and collect the taxes. This is usually the combined responsibility of the central government and local authorities within a country. The tax law is enforceable by sanction (fines or imprisonment).

Hypothecation

This means that certain taxes are devoted entirely to certain types of expenditure, e.g. road tax is used entirely on maintaining roads e.g. the London congestion charge is used to pay for transport for the area.

Tax gap

This is the gap between the tax theoretically collectable and the amount actually collected. The tax authorities will aim to minimise this gap.

Tax rate structure

There are three types of taxes:

(1) **Progressive taxes**: These take an increasing proportion of income as income rises. (E.g. UK Income tax – 20%, 40%, 50%).

(2) **Proportional taxes**: These take the same proportion of income as income rises.

(3) **Regressive taxes**: These take a decreasing proportion of income as income rises. (E.g. UK National Insurance contributions – 11% then 1%).

Tax rate structure

Progressive tax means the proportion of tax increases as income increases, i.e. salary $10,000 pays tax of $1,000 = 10% but a salary of $20,000 pays tax of $3,000 = 15%.

Proportionate tax means the proportion of tax remains the same, regardless of the level of income, i.e. salary $10,000 pays tax of $1,000 = 10% and a salary of $20,000 pays tax of $2,000 = 10%.

Regressive tax means the proportion of tax reduces as income increases, i.e. salary $10,000 pays tax of $1,000 = 10% but a salary of $20,000 pays tax of $1,800 = 9%.

Source of tax rules

The sources of tax rules are as follows:

- Legislation produced by a national government of the country, e.g. Finance Acts in the UK.
- Precedents based on previous legislation. Tax authorities also issue interpretations, e.g. Tax bulletins in the UK.
- Directives from international bodies such as European Union guidelines on VAT.
- Agreements between different countries such as double tax treaties, e.g. UK/US Double tax treaties.

Income can be taxed twice

Foreign income is often taxed twice, once in the country of origin and once in the country of residency (see chapter 3 for corporate residency). In order to avoid this "double taxation", countries enter into tax treaties, (see chapter 2 for types of double taxation relief).

3 Direct taxes

There are two types of direct tax you need to consider:

- Tax on trading income
- Capital taxes

Tax on trading income

Trading income relates to income from the main business activity.

The tax base should be profits.

The accounting profit needs to be adjusted for tax purposes as in many countries there are differences between what the accounting standards allow you to show as an income/expense and what the tax system deems to be the income/expense. These adjusted profits will enable you to calculate the taxable profit.

The standard pro-forma is as follows:

	$
Accounting profit	X
Less income exempt from tax or taxed under other rules	(X)
Add: disallowable expenses	X
Add: accounting depreciation	X
Less: tax depreciation	(X)
Taxable profit	X

The taxable profit will then be charged at the appropriate tax rate for that accounting period.

The rules for allowed and disallowed items will vary according to the tax regime of the country in question. This will always be given in the assessment question.

The calculation of tax on trading income will be looked at in further detail in the next chapter of this publication.

Capital taxes

Capital tax gains are gains made on the disposal of investments and other non-current assets. The most common assets taxed are listed stocks and shares.

At a simple level, the gain is calculated as proceeds from sale less cost of the asset.

In most countries, the computation is based on cost but in a few countries an allowance is made for inflation. In the UK, the cost can be indexed, in certain cases, using the Retail Price Index. Indexation will be calculated on all allowable costs from the date of purchase to the disposal date of the asset. This indexation allowance will **reduce** the gain.

The standard pro-forma is as follows:

	$
Proceeds	X
Less: costs to sell	(X)
	——
Net proceeds	X
Less: cost of original asset	(X)
Less: costs to buy	(X)
Less: enhancement costs	(X)
Less: indexation allowance	(X)
	——
Chargeable gain	X

The chargeable gain will then be charged at the appropriate tax rate for that accounting period.

The calculation of capital taxes will be looked at in further detail in the next chapter of this publication.

4 Indirect taxes

Types of indirect taxes

Indirect taxes will either be:

(1) **Unit taxes**

This is a tax based on the number or weight of items, e.g. excise duties.

(2) **Ad valorem taxes**

This is a tax based on the value of items, e.g. sales tax.

Examples of indirect taxes

(1) **Excise duties**

This is a type of unit tax and it is on certain products such as alcoholic drinks, tobacco, mineral oils and motor vehicles. It is based on the weight or size of the tax base. These duties are imposed to:

- discourage over consumption of harmful products;
- to pay for extra costs, such as increased healthcare or road infrastructure;
- to tax luxuries (in the USA, this would include fishing equipment, firearms and air tickets).

The characteristics of commodities that make them most suitable for excise duties are:

- few large producers
- inelastic demand with no close substitutes
- large sales volumes
- easy to define products covered by the duty

(2) **Property taxes**

Many countries impose tax on property based on either the capital value or the annual rental value. Most countries tax land and buildings although in the USA, certain states also impose a tax on cars, livestock and boats.

(3) **Wealth taxes**

Some countries also impose a wealth tax on an individual's or enterprise's total wealth. The wealth can include pension funds, insurance policies and works of art.

(4) **Consumption taxes**

These are taxes imposed on the consumption of goods and added to the purchase price. There are two types of consumption tax.

- **Single stage taxes**

  Single stage taxes apply to one level of production only, for example at either the manufacturing, wholesale or retail level. The USA is a country which uses a retail sales tax although the tax rate is determined at the local state government level instead of at the central government or federal level.

- **Multi-stage sales tax**

  This is a tax charged each time a component or product is sold. There are two types of multi-stage sales tax:

  Cascade tax, and

  Valued added tax (VAT).

(5) **Cascade tax**

This is where tax is taken at each stage of production and is a business cost because no refunds are provided by local government.

Students will not be required to answer calculation style questions on cascade tax in their examination.

(6) Value added tax (VAT)

VAT is charged each time a component or product is sold but the government allows businesses to claim back all the tax they have paid (input tax). The entire tax burden is passed to the final consumer. The VAT system is used by almost all countries in the world.

VAT payable = output tax – input tax

Output tax – VAT charged on sales to customers

Input tax – VAT paid on purchases

VAT aims to tax most business transactions which are referred to as taxable supplies.

Therefore, supplies could be:

Standard Rated	– Taxed at the standard rate of VAT
Higher Rated	– Taxed at a higher rate
Zero Rated	– Taxed at a rate of 0% (Basic food, e.g. bread)
Exempt	– Not subject to VAT

In the UK, supplies such as food, children's clothing and exports are zero rated for the purpose of VAT. Businesses who sell zero rated sales are allowed to claim back input VAT on purchases.

Alternatively, in the UK, supplies such as finance and insurance are exempt for the purpose of VAT. Businesses who make exempt sales cannot claim back input VAT on purchases.

You will not be required to know the types of goods and services that are zero rated or exempt for the exam; the examiner will make this clear in the question.

It is important to identify the type of supply in order to claim back input tax. Input tax can only be claimed back on taxable supplies, i.e. zero and standard rated goods and services. Exempt supplies are outside the VAT system and VAT cannot be charged to customers but neither can the input tax on purchases be claimed back.

Taxable supplies, therefore, have a selling price exclusive of VAT (net price) and a selling price inclusive of VAT (gross price).

If the exclusive price is given, VAT is calculated by:

exclusive price × tax rate

If the inclusive price is given VAT is calculated by:

$$\frac{\textbf{inclusive price}}{\textbf{100 + tax rate}} \times \textbf{tax rate}$$

VAT registration

VAT registration is required by a taxable person making a taxable supply.

A taxable person can be an individual or a company.

A taxable supply can zero, standard or higher rated sales.

They will be required to register for VAT when their taxable turnover (zero, standard or higher rated sales) reach a certain limit (this will vary from tax year to tax year).

When registered they must:

- Issue VAT invoices
- Keep appropriate VAT records
- Charge VAT on taxable supplies to customers
- Be able to claim back VAT from purchases that are used for taxable supplies
- Complete a quarterly VAT return and make payments

For example, in the UK VAT **cannot** be recovered on:

- Cars (unless for resale, i.e. by a car dealer)
- Entertaining (unless for staff entertaining)

5 Impact of employee taxation

Employees are taxed on their earnings under income tax. Earnings can include salaries, bonuses, commissions and benefits in kind.

Benefits in kind are non-cash benefits in lieu of further cash payments such as:

- company cars
- living accommodation
- loans
- private medical insurance

The basis of assessment is based on the individual country:

- France – amount earned in previous year
- Switzerland – average of previous two years' earnings
- UK – amount actually received in the current tax year

Employees can deduct certain expenses which are wholly, exclusively and necessary for employment, such as business travel, contributions to pension plans, donations to charity through a payroll deduction scheme and professional subscriptions.

Both employees and companies have to pay social security taxes based on salaries paid to employees. In the UK, this tax is used to fund benefits such as the public health service and retirement benefits and is called national insurance.

Most governments expect enterprises to withhold tax on employees' salaries and report earnings to the tax authorities. In the UK, this tax system is referred to as Pay-As-You-Earn (PAYE).

The benefits of having a PAYE system are:

- Tax is collected at source, hence taxpayers are less likely to default payment.
- Tax authorities receive regular payments from employers – helps to budget cash flows for the government.
- The tax authority only has to deal with the employer, rather than a number of individuals.
- Most of the administration costs are borne by the employer, instead of the government.

Certain countries, such as the USA, require banks to collect property taxes with the mortgage payments. In addition to this, in the USA there is a separate Unemployment Compensation Tax.

You will not be assessed on the calculation of employment taxation but you should have a general appreciation of how an entity deals with taxation with regard to employees.

The standard pro-forma for calculating employee tax would be as follows:

	$
Salary	X
Plus: bonus, commission, benefits	X
Less: subscriptions	(X)
Less: pension contributions	(X)
Less: charity donations	(X)
Less: personal allowances	(X)
Taxable income	X

The taxable income will then be charged at the appropriate tax rate for the tax year.

This will normally be done by the entity using the PAYE system.

6 Administration

Record-keeping

Enterprises need to keep records to satisfy tax requirements for the following taxes.

Corporate income tax

All records required to support their financial statements and also the additional documents required to support the adjustments made to those statements when completing their tax returns.

Sales tax

Adequate records should be maintained of all the sales and purchases records such as:

- Orders and delivery notes
- Purchase and sales invoices
- Credit and debit notes
- Purchase and sales books
- Import and export documents
- Bank Statements
- Cashbooks and receipts
- VAT account

Overseas subsidiaries

Tax authorities would require documentation about the transfer pricing policy between the subsidiary and the parent. These are the prices charged for goods or services provided by one to the other. Most tax authorities require the price to be the same as it would be if charged to a third party.

Overseas subsidiaries will be looked at in more detail in the following chapters.

Employee tax

Employers have to keep detailed records of employee tax and social security contributions. They will also be required to prepare a number of year end returns to show the total deductions they have made from employees' wages, the employer's contributions and an analysis of any other amounts deducted. The employer is also required to provide details to the employee.

Tax authorities set deadlines for the payment of tax and the submission of the tax return. The enterprise will either be required to pay tax following an assessment from the tax authorities or will pay tax via self-assessment. In the UK and the USA, tax is paid via self-assessment. The tax authorities will then check the tax return to confirm whether the correct tax has been paid.

Minimum retention of records

There will be a minimum length of time for the retention of records; in the UK this is six years for all records relating to earnings and capital gains. The purpose of this is to enable the tax authorities to question or challenge records up to several years later.

Payment of tax

This will depend on the rules of the tax authority and will depend on the type of tax that is due. The tax is not always paid when the return is filed, it may happen earlier or later. Interest will be charged on late payments of tax.

Power of tax authorities

The revenue authorities have various powers to impose penalties and interest on late payment of tax. In addition, they have the power to:

- Review and query filed returns.
- Request special reports if they believe inaccurate information has been submitted.
- Examine records of previous years (in the US, tax authorities can go back 20 years).
- Enter and search the entity's premises and seize documents.
- Pass on information to foreign tax authorities.

Tax avoidance and tax evasion

Tax avoidance is tax planning to arrange affairs, within the scope of the Law, to minimise the tax liability. This could be setting up a subsidiary overseas in a low tax economy.

There have been a number of large entities that have been accused of tax avoidance in recent times. The public perception would be that the entities are not paying their fair share of tax and these entities have been criticised in the press for setting up their tax affairs so that they pay very little tax.

This has led to these entities receiving very negative publicity and often had an adverse effect on the overall business.

Tax evasion is the illegal manipulation of the tax system to avoid paying tax. Evasion is the intentional disregard of the law to escape tax and can include claiming a tax deduction for expenses that are not tax deductible, under declaring income and claiming fictitious expenses.

The tax authorities use various methods to prevent both tax avoidance and tax evasion:

1. Reducing opportunity, e.g. by deduction of tax at source and the use of third party reporting.
2. Simplifying tax structure by minimising the relief, allowances and exemptions.

3 Increasing detection through auditing tax returns and payments.

4 Developing good communication between tax authorities and enterprises.

5 Changing social attitudes towards evasion and avoidance by maintaining an honest and customer friendly tax system. The government should create a fair tax system and should encourage an increasing commitment.

6 Reducing lost revenue by reviewing the penalty structure.

Test your understanding 1 – Practice questions

1 **Which of the following is not usually a source of tax rules in a country:**

A Local legislation

B Double tax treaties

C Statements of practice of tax authorities

D International law

2 **What does 'competent jurisdiction' mean in the context of an enterprise being subject to a tax liability?**

A Country where enterprise has an office

B Country which has enforcement laws that apply to an enterprise

C Country where enterprise has business operations

D Country where enterprise has employees

3 BM has a taxable profit of $30,000 and receives a tax assessment of $3,000.

BV has a taxable profit of $60,000 and receives a tax assessment of $7,500.

BM and BV are resident in the same tax jurisdiction.

This tax could be said to be:

A a progressive tax

B a regressive tax

C a direct tax

D a proportional tax

4 **Country IDT has a duty that is levied on all drinks of an alcoholic nature where the alcohol is above 20% by volume. This levy is $2 per 1 litre bottle. This duty could be said to be:**

A Ad valorem tax

B Unit tax

C Direct tax

D VAT

5 **Which ONE of the following powers is a tax authority least likely to have granted to them?**

A Power of arrest

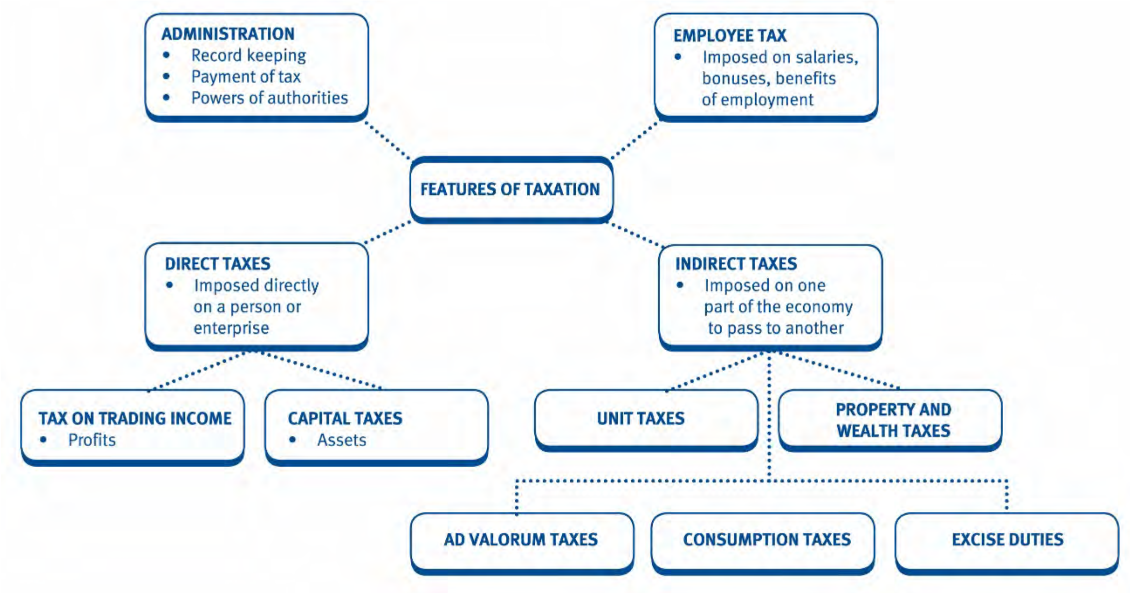
B Power to examine records

C Power of entry and search

D Power to give information to other countries' tax authorities

6 **List THREE possible reasons why governments set deadlines for filing returns and/or paying taxes.**

7 Summary diagram



Test your understanding answers

Test your understanding 1 – Practice questions
1 D – International Law.
2 B – Country that has enforceable laws that apply to an enterprise.
3 A – \$3,000 tax on \$30,000 = 10% and \$7,500 tax on \$60,000 = 12.5%. The tax rates increase as the income rises, hence a progressive tax.
4 B – Unit tax. This is a tax based on the number or weight of items, e.g. excise duties.
5 A – Power of arrest.
6 Answers could be:
Entities will know when payment is required;
It enables the tax authorities to forecast their cash flows more accurately;
Provides a reference for late payment – useful for applying penalties for not paying;
To prevent entities spending tax money deducted from employees. If tax is deducted from employees at source and not paid to the tax authorities fairly quickly, there is more chance of an entity spending the amount deducted, instead of paying it to the tax authorities.