Impact of VAT on the Profitability and the Cash Flow of Romanian Small and Medium Enterprises

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Abstract

The options available to taxpayers make tax systems attractive and give them an opportunity to choose one system or another after a careful analysis of the fiscal advantages and disadvantages of each choice. A small or medium company has to explore the options available, whether that is VAT registration or de-registration or choosing the best VAT special scheme. VAT optimisation is particularly interesting because of the high cash flow involved and because of the cash flow benefits that can be obtained. This paper presents an analysis of VAT costs and their impact on profitability and cash flow of small and medium enterprises. We also analysed specific mechanisms to improve profitability and cash flow through VAT optimisation.

Keywords: *VAT optimization, special VAT schemes, the compliance costs, profitability, cash-flow.*

1. Introduction

Modern taxation systems impose a heavy burden on taxpayers, particularly on small business taxpayers. That burden consists of three elements (Babone et al, 2012):

- In the first place there are taxes themselves;

- Secondly, there are the efficiency costs, involving tax-induced market distortions;

- Finally, there are the operating costs of the tax system: the costs to the government (ultimately borne by taxpayers) of administering and collecting the taxes and the costs expended by taxpayers in complying with their tax obligations.

Companies must optimize the relationship to taxation from a financial and economic point of view. This behaviour is possible when taxation offers business the opportunity to increase its profitability and liquidity when they exercise their tax options.

The enterprise' tax management objectives shall ensure tax security and effectiveness.

Tax security is obtained by complying tax obligations. In this way the companies avoid any penalty taxes and proceed to a better allocation of its financial resources.

Tax effectiveness involves minimizing taxes in observance of the tax law. This can be obtained either directly or indirectly. Direct effectiveness can be achieved through tax law which includes measures of incitement for tax purposes. An example of this is the company option to be liable for VAT even if its turnover allow it to qualify for a small businesses scheme (which means exemption from VAT).

The aim of this work is to analyse the impact of company management options of VAT on profitability and cash flow.

Obtaining tax advantages requires a good knowledge of tax legislation. This is why in the first chapter of this work we will identify the main characteristics of Romanian VAT system and we will go into detail on two special schemes of VAT: the small companies' scheme and the cash accounting scheme, which have a significant impact on the cost related to VAT.

The costs of complying with VAT regulations are separated into administrative costs, direct costs and costs related to the cash flow management. We will examine these costs in the second chapter.

At the end of our work we will try to identify for the managers of small companies some tools designed to improve cash flow, simplify accounting requirements and thus, reduce administrative burdens of VAT.

2. Key features of Romanian VAT system

2.1 Transactions within the scope of VAT

Supplies of goods or services, which have the place of supply in Romania, are subject to Romanian VAT, where made by a taxable person in the course of a business carried on by said person.

The transactions which fulfil the following conditions are subject to Romanian VAT:
- They represent a supply of goods/services in return for consideration or an operation treated as such.
- The deemed place of supply is in Romania.
- They are performed by taxable entities.
- They result from economic activities.

From the VAT point of view, persons may be classified as follows:

Table 1. Taxable and non-taxable persons in VAT system

<table>
<tr><td rowspan="3">Taxable persons</td><td colspan="3">Normal taxable persons – Romanian entities carrying out economic activities in excess of the small undertaking threshold of EUR 65,000 (RON 220,000).</td></tr>
<tr><td rowspan="2">Exempted persons</td><td>Taxable persons covered by the exemption for small companies</td><td rowspan="3">Group of the 3 entities which do not pay VAT</td></tr>
<tr><td>Romanian entities who carries out exclusively VAT exempt without deduction right</td></tr>
<tr><td rowspan="2">Non-taxable persons</td><td>Non-taxable legal persons</td><td>Public institutions,
Non-governmental organizations</td></tr>
<tr><td>Non-taxable natural persons</td><td colspan="2">Natural persons who do not carry out economic activities independently. These persons are not required to register for VAT purposes.</td></tr>
</table>

The persons of the Group of the 3 entities are not required to register for VAT purposes at the beginning of activity, but are required to register if their intra-Community acquisitions exceed EUR 10,000 /year.

Within the scope of the VAT enters various categories of transactions, such as (Grigore & Gurău, 2009):

1) Taxable transactions

- the supply of goods for consideration within the territory of a Member State by a taxable person acting as such;
- the supply of services for consideration within the territory of a Member State by a taxable person acting as such;
- the intra-Community acquisition of goods for consideration within the territory of a Member State by a taxable person acting as such;
- the acquisition of general business to business services taxable in Romania, from EU and non-EU suppliers;
- the importation of goods into Romania.

2) Transactions exempt from tax

a) Supplies of goods or of services exempt from tax, with the right to deduct the input VAT, sometimes called "zero-rating":

- Export of goods, transport and related services

- Intra-community supply of goods

- International transport of passengers

- Goods placed in free trade zones and free warehouses

b) Supplies of goods or of services exempt from tax, without the right to deduct the input VAT:

- activities including banking, finance and insurance

- medical, welfare and educational activities, if performed by licensed entities

- rental and lease operations involving immovable goods, as well as the supply of old buildings and non-constructible plots of land (however, the option to tax these operations is available)

c) Exemptions on intra-Community acquisition and importation (imported goods that would have been VAT exempt if supplied locally in Romania)

3) Special VAT schemes

The cash accounting scheme

Special scheme for small companies (taxable persons whose annual turnover is no higher than the equivalent in RON of 65.000 euro). These persons may opt either for the normal system of VAT.

Special scheme for travel agents

Special scheme for second-hand goods, works of art, collectors' items and antiques

Special scheme for investment gold

Special scheme for non-established taxable persons supplying electronic services to non-taxable persons

2.2. The cash accounting scheme

The introduction of cash accounting scheme is part of the wider EU measures aimed at combating intercompany indebtedness. VAT-registered suppliers of goods and services often provide credit to the state by paying the VAT due on their supplies before they have received the cash from their customers. In the meantime, their clients benefit from an ”advance” deduction of input VAT without effectively paying anything (including tax) to their suppliers. This effect is known as "pre-financing" and it is considered to be one of the flaws of the current VAT system.

Therefore, with the aim of reducing intercompany indebtedness, the EU has amended its legislation (Directive 2011/7/EU). One measure is to introduce an optional VAT cash accounting scheme, which Member States can opt to implement in their national legislation from January 1, 2013 (www.tmagazine.ey.com).

In Romania, this system was introduced on 1 January 2013 and taxable persons generating annual taxable turnover of up to EUR 500,000 (RON 2,250,000) were obliged to apply. These persons were supposed to record the output VAT only after the client had paid it but no later than 90 days from the date on which such VAT had been generated. Nevertheless, the taxable entity could not deduct the VAT related to acquisitions until the relevant invoices were paid.

The taxable entities registered for VAT purposes that did not apply the system but acquired goods or services from entities being obligated to apply it could not deduct the related VAT until the invoices for such acquisitions were paid. These entities had no obligation to collect VAT upon receiving the invoice value as they should comply with the general rules.

Because of the noticeable number of companies that were in this situation, more than 400,000, the Government expected a significant impact on unlocking money in the economy. Unfortunately, the effects were not as expected. The main problem, even observed by the European Commission, has been imposing deadline for payment of 90 days of VAT to the budget, even if the invoice was not received. At the same time, it was not specified a time limit for the deduction of value added tax, and the companies could credit the state budget, sometimes even for months.

The cash accounting system has been modified on 1 January 2014, due to European Commission pressure and the discontent of the business environment.

The system has undergone two essential changes:

- The system is not mandatory. Companies with annual taxable turnover of up to EUR 500,000 may choose to apply or not, depending on the cash flow and the activity type.

- More important, the second change has been eliminating the 90-day period in which output VAT had to be paid to the state budget, even if the amount was not received from their clients.

A positive side effect from the VAT cash accounting scheme is that it provides a means of combating VAT fraud. Most often, VAT is drained through fraudsters reclaiming input VAT on invoices documenting fictitious supplies. The application of the VAT cash accounting scheme should limit the number of such cases.

Currently, some large customers of small and medium enterprises have stronger negotiation powers and are dictating certain contractual conditions, such as long payment terms. These companies can benefit from VAT reclaim on their purchases before they actually pay the price (including the tax) to their suppliers. However, this will no longer be possible if the cash accounting scheme is applied. The need to recover input VAT may prove an incentive for larger companies to pay their SME suppliers more quickly.

Nevertheless, applying the cash accounting scheme may not be attractive to an SME compared with the threat of losing a big client who might dislike this inconvenience. It is currently difficult to predict whether this is a legitimate issue. To a large extent, the effectiveness and attractiveness of the scheme depends much more on the practical complexity of the registration procedure and the requirements for its application.

2.3 VAT Chargeability

In the standard system, VAT chargeability occurs on the date of the supply of goods/services. However, chargeability appears from the date of the invoice, when the invoice is issued before the delivery of the goods.

If the cash accounting scheme (CAS) is applied, the deduction and collecting of VAT shall take place as follows:

Table 2. The deduction of VAT, in the cash accounting scheme

<table>
<tr><th>Buyer</th><th>Supplier</th><th>VAT Chargeability</th></tr>
<tr><td rowspan="2">The buyer applies CAS</td><td>The supplier applies CAS</td><td rowspan="3">Input tax is deductible to the extent payments are made to suppliers</td></tr>
<tr><td>The supplier doesn’t apply CAS</td></tr>
<tr><td rowspan="2">The buyer doesn’t apply CAS</td><td>The supplier applies CAS</td></tr>
<tr><td>The supplier doesn’t apply CAS</td><td>Input tax is deductible from the date of the purchase of goods/services.</td></tr>
</table>

Table 3. The collecting of VAT, in the cash accounting scheme

<table>
<tr><th>Supplier</th><th>Buyer</th><th>VAT Chargeability</th></tr>
<tr><td rowspan="2">The supplier applies CAS</td><td>The buyer applies CAS</td><td rowspan="2">Output tax is chargeable upon receipt of payment.</td></tr>
<tr><td>The buyer doesn’t apply CAS</td></tr>
<tr><td rowspan="2">The supplier doesn’t apply CAS</td><td>The buyer applies CAS</td><td rowspan="2">Output tax is chargeable from the date of the supply of goods/services.</td></tr>
<tr><td>The buyer doesn’t apply CAS</td></tr>
</table>

2.4. Regime of deductions

A taxable person is allowed to deduct the VAT he paid on his purchases insofar as the goods or services are used for his business activities.

If a taxable person registered for VAT purposes performs both taxable and exempted transactions without deduction right, input VAT (for purchases) may be recovered according to the following criteria:

- VAT directly attributable to taxable transactions – direct deduction in full

- VAT directly attributable to exempt transactions – non-deductible in full

- VAT related to both taxable and exempted transactions – subject to pro-rata allocation.

The pro-rata allocation shall be made up of a fraction comprising the following amounts:

- as numerator, the total amount, exclusive of VAT, of turnover per year attributable to transactions in respect of which VAT is deductible;

- as denominator, the total amount, exclusive of VAT, of turnover per year attributable to transactions included in the numerator and to transactions in respect of which VAT is not deductible.

Net VAT to be paid or to be recovered shall be determined as follows:

• If the output VAT is higher than the deductible VAT, the difference between them is the VAT payment.

• If the deductible VAT is higher than the output VAT, the difference between them is the VAT to be recovered (a negative amount of tax).

2.5. VAT Compliance

As a general rule, the fiscal period is the calendar month. For taxable entities whose previous year-end turnover did not exceed EUR 100,000 and not performing intra-community delivery/acquisition of goods, the fiscal period is the calendar quarter.

VAT returns should be submitted to tax authorities by the 25th day of the month following the end of the fiscal period.

In addition to the VAT returns, tax payers must submit to tax authorities three other summative statements (390, 392A and 394).

The VAT payment shall be paid up to the date of submission of VAT returns.

The negative amount of tax shall be compensated with VAT payment in respect to the following period or shall be refunded. A request for VAT refund is made through a tick box that should be marked on the VAT return. The VAT refund is made after a tax audit is performed, either in advance of the refund or after the refund (subsequent procedure). The VAT refund with a subsequent procedure is only available for taxpayers having a low risk profile as determined by the fiscal authorities.

Refund claims must be processed by the tax office within 45 days from the submission date. In practice, this period may be longer.

3. The impact of VAT on the companies' profitability and the cash flow

VAT involves the following costs for the enterprise: the compliance costs, direct costs and costs related to the cash flow management.

3.1 The compliance costs (administrative costs)

The compliance costs are the costs expended by taxpayers in complying with their tax obligations. These costs are generated by:

- The complexity of legislation: frequency and nature of changes, costs involved in understanding legislation (exclusions, exemptions, deductions, good/services distinctions etc.)

- Procedural requirements. Companies registered for the purposes of VAT must draw up the supporting evidence and VAT registers. It also must be organized rigorous, detailed and complex enough accounting records to have the information necessary for drawing up the VAT return. This will involve additional work and therefore, the increase in expenditure on wages and salaries.

The Communication from the European Commission on the future of VAT (Communication from the European Commission to the European Parliament, the Council and the European Economic and Social Committee on the future of VAT, 2011) mentions that compliance costs for business represent 2% to 8% of VAT receipts. The compliance costs are disproportionately higher for small business. Furthermore the compliance costs are significantly higher when businesses are involved in cross border trade. SMEs have fewer resources for copying with the difficulties resulting from the differences in rules and obligations of each Member State. The cost is proportionally higher for them.

The administrative costs in the case in which the company applies the cash accounting scheme (CAS) are higher, for the following reasons:

- This system requires more accounting records, as well as completing several forms, statements and logs.

- If suppliers/service providers who are applying this system does not mention in the invoices ”CAS”, the beneficiaries shall be obliged, in order not to have problems with the right of deduction, to check the status in the register suppliers taxable persons who apply to the CAS available on the ANAF web site, resulting in additional bureaucratic work. (The National Agency for Fiscal Administration – ANAF, subordinated to the Ministry of Public Finances, has the mission to provide the resources for the public expenditures of the society by collecting and managing efficiently the taxes, charges, contributions and other amounts due to the general consolidated budget.)

3.2 Direct costs. VAT implications on the companies' profitability

Considering the impact of VAT on costs and default on the companies' profitability, there are two possible situations:

(A) value added tax is neutral for the enterprise only if two conditions are fulfilled simultaneously:

- The company falls within the scope of the payment of VAT or is a small company which has opted for VAT purposes

- The deductibility is 100%.

This neutrality is due to the fact that the company registers purchases and sales in the net value, exclusive of VAT. In this situation it is estimated that between accounting and taxation creates report neutral, accounting information being used as support for calculation of VAT.

(*B) value added tax adversely affects companies' profitability* as follows:

- If the company is not subject to VAT, the inputs VAT enter into the acquisition cost.

- If the company is subject to VAT, but supplies goods exempted from VAT without the right to deduction (pro rata allocation is less than 100 %), the non-deductible difference is included in the acquisition cost, thereby affecting the account of results by an increase in operating costs.

The increase in the operating costs involves reducing the management intermediate balances.

Thus, commercial margin will diminish with non-deductible VAT. This will result in reduction in the value added, the gross operating surplus, the operating result, the current result and the outcome of financial year.

Decrease of result will lead to the reduction of return rates, in view of the fact that these rates shall be determined as the ratio between the results and invested capital.

In order to optimize the cost tax, the company needs to analyse very well its object.

If the company is exempt from VAT and obtains its supplies of goods or services which have a relatively high value, it charges the cost of acquisition with the value added tax, risking to be excluded from the market. If the costs of acquisition, which determines the value added tax, are large, then the company's manager's decision must be to choose to be subject to VAT.

For a company whose object of activity is supply of services, through the analysis, consultations, assessment, design and exploitation of intelligence, in general, external consumption is small. In such situations, the company will not opt for VAT purposes, as this will be borne by the customer. Even if the quality level of the services provided is high, customers will choose non-taxable companies, because the cost will be lower.

3.3 Costs related to the cash flow management

Understanding and implementing cash flow management strategies is a vital piece in building a sustainable business. Managing capital in a responsible manner means making financial decisions related to short term financing as well as maintaining a balanced relationship between short term assets and short term liabilities. The ultimate goal of a company will be to be able to continue its day-to-day operations with enough cash flow to cover short term debts in a timely manner and to also handle operational expenses.

Costs related to the cash flow management are determined by the delay between receipt of claims and the payment of debts in the short term.

According to the financial equilibrium theory, net cash flow (NCF) is influenced by the difference between the delay revenue (inventories, claims, prepaid expenses, VAT refund etc.) and delayed payments (amounts owed to suppliers, to employees, to the state for tax obligations and social consisting of: VAT payment, profit tax, excise duties, contributions to social security etc.). These delays are compiled by an indicator called working capital needs (WCN), which has direct influence on net cash (NCF), as a result of the relationship:

NCF = WC – WCN

in which: WC = working capital = Current assets – Current liabilities

The relationship that highlights the impact of the value added tax on WCN look as follows:

WCN = (inventories + claims + VAT refund) - (accounts payable+ VAT payment + other short-term obligations)

VAT refund and VAT payment affect treasury monthly or quarterly. Thus, if the company records VAT payment, this amount shall be paid in the 25th day of the following month. Until that date the company will be able to use availabilities created and give up on loans. This will result in increasing financial autonomy and the decrease in the debts rate. The company benefits from this surplus cash-flow for 25 days, provided that the amount of sales to be paid by customers before the date of the first of the following month. Otherwise the surplus cash-flow shall be reduced in proportion to the number of days of delay in payment.

If the company has to recover VAT, then it will be faced with the need of cash. Even if refund claims must be processed by the tax office within 45 days from the submission date, in practice it may take months.

Financial implications of VAT may be highlighted also by the determination of three indicators: average collection period (ACP), average payment period (APP) and days of working capital needs (DWCN).

The average collection period (ACP) shows the average number of days it takes a business to collect payment for sales to customers on credit.

The formula used to calculate the average collection period is:

$$\text{ACP} = \frac{\text{Average of accounts receivable}}{\text{Average of sales}} \text{ x } 365$$

When the average collection period increases, the company is faced with a deficit of liquidity.

The average payment period (APP) is defined as the number of days a company takes to pay off credit purchases. It is calculated as follows:

$$\text{APP} = \frac{\text{Average of accounts payable}}{\text{Average of supplies}} \text{ x } 365$$

As the average payment period increases, cash should increase as well, but working capital remains the same.

If we take into account only those elements strictly generated by financial flows on VAT, the difference between ACP and APP will represent days of working capital needs (DWCN):

DWCN = ACP – APP

If the company’s goal is to minimize the use of working capital, then it has to do everything it can to keep accounts receivable low (for example, by offering discounts for quick payment) and accounts payable high.

The companies' cash flow can be also seriously affected by applying the cash accounting scheme. In 2013 this scheme had a positive impact on the cash-flow for some of the Romanian companies and a negative one for most businesses.

A negative impact on the cash-flow was felt by some small and medium companies obliged to implement the system in the year 2013, as well as at large companies that have been working with SMEs which applied the cash accounting scheme, in the sense that they have been able to deduct the input VAT only after payment of the invoice.

Although the cash accounting scheme should have led to an increase in the companies’ cash flow and should have help them in a time when banks were not yet open for financing, the reality was different. This scheme was not even a payment of VAT at collection time, but rather a deferment of payment until the 90th day at the date of the invoice, which did not bring taxpayers significant benefits.

What's more, the new scheme of VAT has led, in some cases, to elimination of small companies from the market, since some large companies, which were not eligible for the cash accounting scheme, had selected the providers of goods and services who don’t apply the new VAT scheme. Suppliers which applied the cash accounting scheme were excluded because large companies wanted to avoid administrative costs and improve their cash flow.

Since 2014, the cash accounting scheme became advantageous as a result of the elimination of two obligatory conditions in 2013: the obligation of firms with an annual turnover less than EUR 500,000 to apply the system and the obligation of them to pay the VAT in up to 90 days, even if the amount has not been received from the customer.

The main advantage of using this scheme is the positive impact on the supplier’s cash flow, if a customer is a late payer. Under this regime, the supplier should not bear the burden of paying VAT on the supply before receiving the payment from customers.

For purchasers, VAT recovery is delayed until payment for invoices subject to cash accounting. Therefore, the regime will indirectly help to improve the liquidity of the entities that opt to apply the cash accounting scheme by eliminating the situations when a customer benefits from input VAT reclaim before paying the supplier. In such cases, the customer would likely prefer to pay all invoices for which the cash accounting scheme is applied instead of keeping the invoices unpaid.

4. Conclusions

Small companies’ managers must plan carefully, choose wisely and in accordance with the type of their business and reduce the risk of failing to achieve tax compliance. In the area of VAT stand out two options for small businesses with major impact on the profitability and cash-flow:

- *The option of applying the system of VAT exemption for small business*

This scheme provides a competitive advantage by prices free of the VAT.

The option of applying the system of VAT exemption for small business is justified under the following conditions:

- The company doesn't carry out or estimates a turnover of less than EUR 65,000;

- The company doesn't carry out a significant investment process;

- The company is not carrying out operations exempted from VAT with the right to deduction (e.g. exports, intra-Community supplies of goods etc.);

- The company has mainly B2C (business-to-Consumer) transactions.

If the company has mainly B2B (business-to-Business) transactions then is better to register for VAT, as this will allow it to reclaim the VAT paid on goods and services purchased.

• *The option of applying the cash accounting scheme*

This option is justified under the following conditions:

- The firm carries out or estimates a turnover of less than RON 2,250,000;

- The firm collects invoices issued to customers after substantial periods of time;

- The firm has no significant acquisitions that should generate VAT to be refunded.

Such a situation can be found, for example, in the services sector, where input VAT is insignificant, in comparison with output VAT.

If the company collects invoices in a short period of time or is planning an investment process which will generate VAT refunds, it is better not to opt for the application of the cash accounting scheme. The main advantage will be that input VAT will be deducted immediately, no matter the time of the payment of the bills to suppliers, therefore, by default, the possibility to apply for a VAT refund more quickly.

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