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How to do VAT Impact Assessment-UAE VAT Part -2
Key impact areas for Top Management

In the first part, we had discussed the broad aspects to be covered and the manner in which it may be covered for VAT impact assessment. One can refer the "part 1" at below link:
https://hiregange.com/knowledge-pool/articles/gcc-vat/all

There could be a different perspective of impact assessment of VAT by any business as there could be different users of the outcome of the report.

Following aspects could be relevant for consideration of top management to assist them in taking crucial decisions.

1) Comparative tax outflows: This indicates the gap between taxes and other statutory levies payable before the introduction of the VAT and thereafter. The analysis may be made at a gross level (without adjusting recoverable input tax) as well as at net level. Considering the fact that there were not many taxes before the advent of VAT in UAE, VAT would be a mostly incremental tax. The impact of the tax on taxes i.e. VAT on Customs duty, excise duty, municipality fees should also be properly considered.

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2) Impact on margin: This is the area with which top management would be highly concerned with. With the introduction of any new tax, small erosion in margin is inevitable (i.e. there could be few irrecoverable input taxes adding to the cost) but there need to be conscious efforts to intact margins by focusing on all key areas. In fact, it could boost margin of those businesses who have robust infrastructural and compliance system in place in line with the tax law compared to competitors lacking in these aspects. The impact calculation on margin would require an in-depth assessment of financial as well as nonfinancial statements. The following could be the approach for computations:

- Take the base financial year which could be representative of the period immediately post taxation. Profit of this period may be taken as a base to make suitable adjustments as per below.

- The scenario may be built taking revenue at the same level as of past + likely revenues at different levels in coming period based on management projected growth plan appropriately adjusted with the impact of the new taxation system.

- Impact of tax on "top line" need assessment considering the type of business and nature of contracts with customers. If the contract does not have any tax clause and customer is not ready to amend the agreement, it could directly eat into the margins. Not only this, a business may have to compensate others also (i.e. pre-printed MRP where retailers may not sale on more than MRP and thus have to bear additional tax burden). All such factors need to be considered.

- Next would be recoverability of input tax on various expenses as this directly affects margins. Taxes payable on procurement (inputs, capital goods, services) need to be assessed as to whether these can be recovered. Wherever cannot be, would directly result in a drop in margin else it would be neutral to margins.

- One important element is going to interest cost depending upon the impact on working capital. Incremental fund deployment entails interest cost which needs to be factored into margin computation.

Following broad format may be used:

Net Profit as per Financial Year…..		XXX
Less: Factors resulting in margin reduction		
(i) Nonrecoverable input tax	(XXX)	
(i) Impact of revenue drop on margin	(XXX)	
(i) Interest cost of additional funds deployed	(XXX)	
(i) Tax cost in all-inclusive contracts	(XXX)	
(i) Compensation of loss to successive supply chain	(XXX)	
(i) Any other factors resulting in decrease in margins	(XXX)	(XXX)
Add: Factors contributing increase in margins		XXX
Expected Net Profit		XXX
Increase/(Decrease) in profit		

3) Impact on working capital: Imposition of tax has a direct impact on working capital as a business would have to put in more money in the business to meet the increased need of finance. The impact on working capital depends upon the following aspects:

- Credit period extended by suppliers
- Credit period extended to customers
- Inventory holding period (raw material, WIP, finished goods)
- Cycle of tax payment

One may evaluate the impact on working capital by analyzing the tax involved in these items of current assets/liabilities and differential working capital needs.

4) Impact on product pricing: With the introduction of the VAT, the product pricing is likely to go up but it requires consideration of multiple factors to determine the likely impact. It would not be correct to say that imposition of the tax by 5% would directly require an equivalent increase in the prices. Impact of recoverable and non recoverable input tax also needs to be evaluated. It also depends on the nature of products, type of users, consumption pattern etc. In case of B2B supplies, the impact may not be much so long as other party is eligible to recover input tax. But in case of end user based/MRP products, the pricing determination is going to be very critical. One could have the following approach for determination of MRP based products considering variation in costs and tax involved:

- Keeping absolute margin constant at all channel of distributions and determine revised MRP
- Keeping variable margin constant at all channel of distributions and determine revised MRP
- Keeping MRP constant and determination of impact on margin at all level of distribution

One may have to evaluate the impact under each of the options and to take a final call as to what should be revised price and need for compensation to trade channel. In long-term, the price is determined by competitive market forces but failure to adjust the price correctly could have an impact on margin or sales volume especially in highly competitive industries.

5) Strategic Decisions: Introduction of VAT could have implications on many strategic decisions for the entity. The following could be few instances:

- Having business operations in the designated zone (all FTZ may not be designated zones) or mainland
- Model of doing business in terms of exports and imports
- Entering into or exit from new product line/segment of business
- Changes in the supply chain model (to reduce the intermediary chain so that final price does not increase much) and so on.

There cannot be straight jacket formula to evaluate the impact considering the diverse business scenarios. However, the discussion areas and approach discussed above could be used as a first-hand tool for professionals to make impact study on the business. Certainly, these may have to be tailored on the case to case basis to serve the ultimate purpose of the management.

We welcome suggestions us for improvements. Feel free to write at madhukar@hiregange.com or ashish@hiregange.com

Thank You

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