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## EDITORIAL NOTE

This edition focuses on the need to ensure the financial health of Small and Medium Enterprises (SMEs) in the country. The SMEs are recognized as vital to job creation and economic development. The Bulletin addresses critical technical issues that SMEs face in the country including bookkeeping, auditing, taxation and the various tax incentives available to SMEs in the country.



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# ENTREPRENEURSHIP AND SMES – BOOKKEEPING, TAXATION, AND RELEVANT LAWS


## INTRODUCTION

Entrepreneurship refers to the concept of developing and managing a business venture to gain profit by taking several risks in the corporate world. It is an essential driver of economic growth and innovation, involving high risks, which could be highly rewarding. There are four fundamental types of entrepreneurial organizations; small businesses, scalable start-ups, large companies, and social entrepreneurs.

This article focuses on Small and Medium-sized Enterprises (SMEs).

## What are SMEs?

Countries define SMEs differently, usually based on the number of employees, annual sales, assets, or any combination of these. SME's definition could also vary from industry to industry.

In Nigeria, for instance, the Companies and Allied Matters Act (CAMA) 2020 defines a small company as a private company with a net asset value not more than N60million and whose turnover is not more than N120million. The CAMA further states that no small company member is an alien or foreign, government, or government corporation or agency. The Directors between them must hold at least 51% of its equity share capital.

The Central Bank of Nigeria (CBN), on the other hand, defines SMEs for Small and Medium Scale Enterprise Credit Guarantee Scheme (SMECGS) as an enterprise that has an asset base (excluding land) of between N5million – N500 million and a labour force of between 11 to 300 employees.
Despite the lack of uniformity in defining SMEs, the following are some standard features of SMEs in Nigeria:

**a.** Concentration of management to one individual;
**b.** Limited access to long term funds;
**c.** Relatively small share of the market;
**d.** Low capitalization; and
**e.** Incomplete accounting records.

SMEs are a vital element of Nigeria's economy because of their immense potentials for income redistribution, employment generation, and innovation. Studies by the International Finance Corporation (IFC) show that about 96% of Nigerian businesses are SMEs. This positions SMEs to represent a vast potential tax base for the government.

## SMEs and Bookkeeping

Bookkeeping is the systematic recording, storing, and retrieving of financial transactions for a business entity. A comprehensive bookkeeping system allows a business owner to analyze business transactions from one period to another and compare performance with other business entities. It helps companies in making informed decisions and monitoring their transactions. Bookkeeping is a useful tool for budget planning and monitoring. It aids in preparing financial statements, which communicate critical financial information to investors to permit informed decision-making.

SMEs must keep a proper record of their business activities and transactions to ensure control, efficiency, and credibility.

## International Financial Reporting Standards (IFRS) for SMEs

For IFRS purposes, SMEs are defined as entities that do not have public accountability and publish general purpose financial statements. IFRS for SMEs provides an accounting framework for entities that are not of the size nor have the resources to adopt full IFRS. It offers numerous benefits to investors, lenders, and those seeking to raise funds.

A comparison of the IFRS for SMEs with full IFRS indicates a reduction of more than 85 percent in the accounting guidance volume required by the full IFRS. The implementation guidance in full IFRS has been omitted, together with the detailed explanation and requirements relating to the more complex circumstances not usually applicable to SMEs.

The IFRS for SMEs does not just reduce disclosure requirements but also simplifies the recognition and measurement requirements.

The IFRS for SMEs mainly requires items to be measured at their historical cost. However, it requires the revaluation of investment property and biological assets to fair value, where such information is readily available. It also requires specific categories of financial instruments to be measured at fair value. All items are subject to impairment other than those carried at fair value.

## Auditing for SMEs

There are no separate auditing standards for SMEs. The International Auditing Standard (ISA) can be applied proportionally to the audit of SMEs. ISAs are principle-based, allowing practitioners to apply professional judgment and tailor audit procedures. Some ISAs only apply to larger entities, and thus its requirements can be scaled down to be more proportional to SMEs' audit.

Simpler businesses do not necessarily mean a more straightforward audit. The characteristics of small businesses require increased attention, for example, fewer financial controls, more related-party transactions, the lower capacity to close the books (i.e., the accuracy of accruals and provisions). Thus, the audit of SMEs requires a dynamic approach. It is essential to ensure an effective and efficient audit process because the audit procedures must be tailored to meet SMEs' needs and challenges.

Over the years, the business environment has continued to change from physical brick and mortar into digital type mechanisms via e-commerce. As a developing country, the investment of vast wealth and resources in SMEs and their business auditing is crucial to our economy's financial growth and prosperity.

## Taxation of SMEs in Nigeria

Companies, individuals, partnerships, firms, and joint ventures are all subject to tax in Nigeria. The applicable tax regime of the SMEs mirrors the entity type. For example, SMEs that are registered as business names are subject to tax under the Personal Income Tax Act (PITA), and taxes due from owners' incomes are payable to the State Internal Revenue Service (SIRS), while SMEs registered/incorporated as limited liability companies are subject to tax under the Companies Income Tax Act (CITA). Taxes due should be payable to the Federal Inland Revenue Service (FIRS).

Per the CITA as amended by Nigeria's Finance Act, 2019, the categorization of a company as either a small or medium enterprise is tied to the turnover of such entity. Specifically, pursuant to the CITA, a small company has a turnover of less than N25million. In contrast, a medium-sized company is one with a turnover of N25million – N100million.

## Taxation of SMEs registered as corporate entities

### a) Companies Income Tax (CIT)

Every SME incorporated as a company with the Corporate Affairs Commission (CAC) is required to register with the FIRS. Such a company must file its first CIT returns with the FIRS within six months after its financial year-end or 18 months from its incorporation, whichever is earlier. Assuming the company's financial year runs from January – December, it must file its returns for January 2019 - December 2019 by June 2020.

Small companies are exempted from CIT, while the CIT rate applicable to medium-sized companies is 20%.

### b) Tertiary Education Tax (TET)

Companies, including SMEs, expect to pay a 2% TET on assessable profits. TET payment and filing are made together with the CIT returns.

## Taxation of SMEs not registered as corporate entities

SMEs also exist as sole proprietorships, partnerships, and non-corporate bodies. As noted above, the business income of SMEs registered as sole proprietorships, partnerships, and non- corporate bodies are subject to tax under the PITA. The business owner is required to file tax returns to the relevant SIRS where the individual is resident. The applicable income tax rate graduates across income bands, ranging from 7% - 24%.

## Other taxes applicable to the SMEs

### a) Value Added Tax (VAT)

VAT is charged at 7.5% on the supply of goods and services other than goods specifically exempt in the VAT Act. This means businesses should ordinarily add 7.5% VAT to the price of their goods or services in the invoice issued to customers (output VAT).

VAT incurred by a company on purchases of goods and services is known as input VAT. Accordingly, in computing the VAT payable every month, a company is expected to deduct the input VAT incurred from its output VAT. Suppose the output VAT exceeds the input VAT. In that case, the difference should be remitted to the FIRS on or before the 21st day following the month of the transaction. Likewise, where the amount paid as input VAT outweighs the output VAT, the business is due for a refund from the FIRS, which could also be set-off against future VAT obligations.

Concerning input VAT, the input VAT to be set-off against the output VAT is limited to the input VAT incurred on goods purchased or imported directly for resale and goods that form the stock in trade used for direct production of new product on which the output VAT is charged. Input VAT incurred on overheads should be expensed in the income statement, while input VAT incurred on fixed assets should be capitalized with the assets' cost.

Notwithstanding and by the Finance Act 2019 amendment to the VAT Act, only businesses that make taxable supplies up to N25 million are required to charge, collect, remit VAT and file monthly VAT returns with the FIRS. Thus, it is expected that many SMEs may not meet the N25million taxable supplies threshold and, as such, should be exempted from VAT compliance obligations. However, upon meeting the threshold at any time in a year, such SME should be required to comply with the VAT requirements.

### b) Withholding Tax (WHT)

WHT is an advance payment of income tax. The legal basis for WHT is contained in the provisions of the CITA, PITA, and the Extraordinary Gazette No. 47 of 1998.

Based on the applicable laws, SMEs are required to withhold tax (at applicable rates of 5% or 10%) on transactions that are liable to WHT and remit same to the relevant tax authority as at when due. Tax withheld from payments made to limited liability companies is payable to the FIRS. In contrast, tax withheld from individuals, partnerships, and other non-corporate bodies is payable to the relevant SIRS.

Where taxes have been deducted at source, remittance must be made within 21days and 30days for payments due to the FIRS and SIRS, respectively. The penalty for non-compliance is 10% of the default amount plus interest at the prevailing commercial rate.

In turn, the tax authority would issue a withholding tax credit note for the benefit of the entity or person whose income was withheld. The credit note can be used by the beneficiary to offset its income tax obligations.

#### c) Stamp Duties

Stamp duties are payable on instruments executed in Nigeria or relating to any property situated in Nigeria or any matter or thing done in Nigeria. An "instrument' as defined in Section 2 of the Stamp Duties Act (SDA) includes 'every written document.' However, this was amended by Section 52 of the Finance Act, 2019, to include electronic instruments.

The applicable rates under the Stamp Duty Act are of two kinds; flat and ad valorem. The flat rate is usually a fixed nominal amount. In contrast, the ad valorem rate is a percentage of the value of the contract.

According to Section 23 of the SDA, chargeable instruments should be stamped within 30 or 40 days of execution, depending on whether the applicable duty is ad valorem or fixed. For instruments subject to ad valorem duty and executed outside Nigeria, such instruments should be stamped within 30 days after being first brought into Nigeria. Otherwise, they should be stamped within 40 days after execution.

SMEs that engage in transactions utilizing various instruments that are subject to stamp duties should ensure that the stamp duties due are remitted to the relevant tax authorities to avoid penalty and interest payments.

#### d) Employee Taxes

The salaries of SMEs employees are subject to tax through Pay As You Earn (PAYE). This is administered by the respective SIRS in which the employees are residents.

by the respective SIRS in which the employees are residents. SMEs have an obligation to deduct, on a monthly basis, the PAYE due to the salaries paid to their employees. The PAYE deducted is required to be remitted to the relevant SIRS on or before the 10th day of the following month.

## Tax incentives applicable to SMEs in Nigeria

#### a) General Tax Incentives

**i) Pioneer status:** This is an incentive granted to companies in specific industries, which are agriculture, mining and quarrying, manufacturing, electricity and gas supply, Waste management, construction, trade, information and communication, professional services, financials, and administrative services. The full list of the specific products that are eligible for the pioneer status incentive can be found in the Federal Republic of Nigeria gazette for pioneer industries. The pioneer status is given for 3 to 5 years. SMEs that engage in any of the pioneer products or activities will be exempt from its income tax during the pioneer period.

**ii) Export Expansion Grant (EEG) Scheme:** The scheme is designed to encourage manufactured products' exportation. EEG provides an incentive that can be used to settle all federal government taxes, such as VAT, WHT, CIT, among others. It can also be used to purchase government bonds and repay government credit facilities and debts due to the Assets Management Company of Nigeria (AMCON).

**iii) Profit from Export Sales:** The profits of any Nigerian company regarding goods exported from Nigeria are tax-exempt provided that the proceeds from such export are used for the purchase of raw materials, plants, equipment, and spare parts.

**iv) Export Processing Zones:** Export processing zones (EPZs) – also known as free trade zones (FTZs) – are areas in which businesses are exempt from the normal regime applicable in Nigeria, particularly regarding Customs duty and tax. SMEs established within the zone are exempt from all taxes.

**v) Gas utilization incentives:** 100% capital allowance on qualifying plant and machinery, a tax-free period for up to five years, and dividends are exempt from tax.

**b) Specific tax Incentives Based on the Finance Act, 2019**

i) Profits from a small company (turnover less than N25 million) are exempt from tax. Furthermore, dividends received from small companies in the manufacturing sector in the first five years of their operation are exempt from tax.

ii)Modification of the commencement and cessation rules in the computation of income tax payable to the preceding year basis to avoid overlaps.

iii) Minimum tax rate amended to 0.5% of a company's turnover. Companies with a turnover of less than N25 million in a year of assessment are exempted from the minimum tax.

iv) Reduction of CIT rate to 20% for medium-sized companies (turnover between N25million - N100million).

v) Bonus of 2% of tax paid for medium-sized entities for early payment of CIT due within 90 days before the due date (6 months after year-end). Bonus so granted shall be available as a tax credit against future taxes.

vi) Introduction of VAT compliance threshold to exempt companies with taxable supplies below N25 million from VAT registration and filing.

vii) Expansion of VAT exempt list to include more basic food items, locally manufactured sanitary towels, tuition, and services rendered by Microfinance Banks.

## Conclusion

Confidence in SME businesses will benefit all stakeholders, including the company, consumers, creditors, and government.

The following benefits will emerge from effective and efficiently managed SMEs.

- Enhanced companies' competitiveness and growth;
- Easy access to credit facilities with banks and other financial institutions;
- Increased company focus as management and directors are made accountable;
- Increased ability to compete globally;
- Access to foreign investors;
- Assurance of financial integrity; and
- Value-add insight on internal controls and processes.