

LESSON 4

Revision of Assumed Knowledge – VAT

On completing this lesson, you will have covered the following Knowledge & Understanding Criteria:

- 2 The relevant legislation and regulations
- 3 The main requirements of relevant Statements of Standard Accounting Practice and Financial Reporting Standards
- 24 The principles of double entry accounting

VAT

What is VAT?

VAT stands for Value Added Tax. It is a tax charged on the supply of most goods and services in the United Kingdom. VAT is added at every stage of production and it is the responsibility of the firm making the sale to charge and collect VAT from the customer. The collection of this tax, charged between traders in business, eventually falls to the consumer who is purchasing the product.

The Inland Revenue and Customs and Excise are now one department forming HM Revenue and Customs (HMRC). The Customs section is responsible for ensuring that VAT is paid by the business if relevant and both departments require the business to keep strict records.

Those businesses which are VAT registered, that is, they have received the Certificate of Registration from Customs, are given a VAT registration number and the date of their tax period, which in most cases is quarterly. The VAT Account is therefore normally settled on a three-monthly basis although other arrangements can be made.

Input and output tax

A taxable firm will have to add VAT to the value of its sales invoices. This is known as '**output tax**' (i.e. a tax on goods and services which go out of the business) and is based on the amount of the invoice after any trade discount is given.

However, a taxable firm will be able to get a refund of the VAT which it pays on its purchases - this is known as '**input tax**' (i.e. a tax on goods brought into the business) and is based on the amount of the invoice after any trade discount has been deducted. This covers purchases (stock bought for resale) and any expenses incurred such as gas, electricity, telephone, petrol etc.

Suppliers, who are tax registered, charge VAT for the goods and services they supply and the business (if tax registered) charges its customers VAT on the goods and services it provides to them. For a VAT registered business, all VAT transactions must be clearly identified so that the correct amount of VAT can be calculated.

The rates of VAT

There are three rates of VAT in the UK:

17.5 %	Standard Rate
5 %	Reduced Rate
0%	Zero rate

Standard rate

The 17.5% is the standard/basic rate, which is charged on the majority of goods and services. In this country, prices in shops are usually shown with the VAT included, but some businesses show the selling price of the goods and the VAT separately. A VAT receipt is needed showing the tax separately if it is to be reclaimed. The receipt must also show the VAT registration number of the business from whom the purchase has been made.

Reduced rate

The 5% rate is mainly due on household utilities such as gas and electricity. However, many businesses will not qualify for the reductions and will be charged 17.5% on these items.

Zero rate

A zero rate means that the item attracts VAT, but the Chancellor of the Exchequer has decided that no VAT is payable on the item, and a 0% rate is attached.

Zero rate supplies include:

- most food (but not catering which includes meals in restaurants)
- books and newspapers
- young children's clothing and footwear
- the export of goods
- prescription charges
- construction of new houses

Zero rated suppliers of goods cannot charge VAT on their sales but recover the VAT suffered on purchases and business expenses.

Exempt supplies

Some goods and services are exempt from VAT. Output VAT is not charged on such supplies and, in principle, input VAT attributable to such supplies cannot be reclaimed. If a trader trades in goods that are exempt from VAT then he must not charge VAT on the supplies of goods or services to his customer. Additionally, the trader is unable to reclaim any VAT that he may have paid on purchases or other business expenses.

Exempt supplies include

- insurance
- betting, gaming and lotteries (but not gaming machines)
- certain education and training
- the services of doctors, dentists, opticians
- membership benefits provided by trade unions and professional bodies

Non-registered businesses

If a business is not registered for VAT, it must not add VAT to its prices, although it may have to pay tax on its supplies. Although a non-registered business cannot charge VAT, it can still pass on the charge it has suffered

onto the customer, as the VAT paid is a cost to the business.

For example: A non-VAT registered business buys in supplies that cost £100 plus VAT which at standard rate will be £17.50. This means that the business has paid £117.50 for the goods. He is unable to reclaim the VAT back from Customs, as he is not registered. The cost to him is £117.50.

However, in the final price charged to his customers he can take the £117.50 as his cost price (rather than the £100 that he would if he was registered for VAT), add on an amount as profit and charge the customer the higher price. The business has thereby passed on the cost of the VAT to the final customer. Whatever the situation, always the end user or consumer ends up eventually paying for all of the VAT, as he is unable to pass the VAT on to another.

VAT registration

Until a business reaches a certain turnover, it **does not have to register for VAT**, although it may increase its business creditability if it does. It also means that the business can claim back the VAT it pays.

However once the turnover (sales) reaches the limit it must register for VAT unless it supplies exempt products or services. If turnover falls below a certain figure, the business may apply to be de-registered. The turnover figures change throughout most years. The current figures can be obtained from HMRC website for VAT www.hmrc.gov.uk by clicking on the VAT link under Businesses and Corporations. Note that there is a delay before AAT applies new tax legislation to an exam. Check the AAT website to find out your exam's tax knowledge requirements.

VAT periods

Most VAT tax periods are quarterly, although some traders prefer to have monthly tax periods, particularly if they are likely to get refunds because they deal with zero rated supplies. Other traders can have annual tax periods.

Annual periods

The annual accounting scheme allows businesses to make a VAT return just once per year but again, there is a turnover threshold. Traders must make payments on account of an estimated final liability to HMRC through the year, then one return is prepared at the year end adding up the VAT due less the payments made on account. This scheme is only open to smaller businesses.

Cash accounting

When a business is registered for VAT, the VAT normally becomes due when the invoice is raised. However, this often causes cash flow problem with small businesses, as they would have to pay the VAT to Customs on their sales invoices, when they may not had the money from their customers. Some businesses can therefore register for a system called **cash accounting**.

The cash accounting scheme allows traders the advantage of accounting for

their VAT on the basis of receiving and paying cash rather than on the normal invoice dates. In other words, the VAT return is prepared from the cash receipts (VAT outputs) less the cash payments (VAT inputs) in the given tax period.

Calculating VAT

The normal business will charge VAT at the standard rate of 17.5%.

For example, a business sells 4 desks at £180 each and adds VAT at 17.5%.

The calculation of VAT is £720 x 17.5% = £126
Therefore the gross invoice total will be £720 + £126 = £846

Often the value of goods and services quoted has the VAT **included** in the amount. To extract the VAT from the gross amount at the rate of 17.5% the formula is:

$$\frac{17.5}{117.5} \times \text{Gross Amount} = \text{VAT Charge}$$

The fraction of 17.5/117.5 can be simplified to 7/47, which is called the VAT fraction. The VAT fraction is used by HMRC. Using this fraction the formula is:

$$\frac{7}{47} \times \text{Gross Amount} = \text{VAT Charge}$$

An example of this is: What is the VAT on the sale price of £423?

$$\frac{7}{47} \times \text{£423} = \text{£63}$$

Therefore the goods value excluding VAT = £423 - £63 = £360

NOTE: The answer must be rounded to two decimal places – and it is usual to round down the VAT amount.

Invoices including VAT

All documents relating to VAT, including credit and debit notes, must be filed and retained in order to claim back the VAT. HMRC is entitled to visit the business and check that VAT is claimed correctly and they will require sight of these documents when they visit. When a registered trader issues an invoice, he must show clearly the following information:

- Identifying number
- Supplier's name and address
- Customer's name (or trading name) and address
- A description of the goods or services supplied
- The total cost of goods or services (excluding VAT)
- The total VAT payable
- The rate of any trade or cash discounts offered
- The total amount of the invoice
- Date of supply (the tax point)

Documents

A business must keep copies of all invoices and credit notes issued (for sales) and received (for purchases and expenses) for a period of 6 years. If a business is involved in trading abroad, copies of customers' entries for imported goods and evidence of the export of goods must be kept.

Recording VAT in the accounts

The rule is that there must be an easily recognised way of recording the VAT charged and collected separately. This is so that VAT can be isolated. Businesses that are registered for VAT must make regular returns to Customs, which show the sales, purchases, expenses (i.e. the VAT inputs and outputs) made in the period, and the amount of VAT collected or paid out.

It should be remembered that accounting for VAT means keeping track of amounts due to and from the HMRC. The VAT is isolated into an account called VAT Account (in HMRC language) or the VAT Control Account. A credit balance on the VAT Account shows the amount due to be paid to HMRC, and a debit balance is the amount due to be claimed back from HMRC.

Double entry for sales with VAT

Assume a VAT registered business makes a sale for £400 plus VAT; it will issue an invoice that totals £470. The VAT is £70. It needs to collect £470 from its customer, pay HMRC £70, and record a sale for the difference - £400. The entries in the Main Ledger would be:

Debit Debtors Control Account	£470	
Credit Sales Account		£400
Credit VAT Account		£ 70

With cash sales, the till roll will give the total sales for the day and the VAT will need to be extracted. If the till roll shows takings of £705, the VAT will be £105 (check this with the formula above), and the sales value will be £600. The entries in the main ledger would be:

Debit Cash Account	£705	
Credit Sales Account		£600
Credit VAT Account		£105

Double entry for purchases and expenses with VAT

Similarly, with a purchase on credit that includes VAT, a VAT registered trader requires the VAT to be isolated so that it can be reclaimed from HMRC. Assume the trader buys stock for £881.25 including VAT. The VAT will be £131.25 and the stock purchase will be £750. The entries in the Main Ledger would be:

Debit Purchases Account	£750.00	
Debit VAT Account	£131.25	
Credit Creditors Control		£881.25

If the above three transactions took place on 1 July the VAT Account would be:

DR		VAT Account		CR	
Date	Details	Amount £	Date	Details	Amount £
01-Jul	Purchases	131.25	01-Jul	Credit Sale	70.00
			01-Jul	Cash Sales	105.00

At this point the balance on the VAT Account is £43.75 credit - an amount payable to HMRC.

Primary records

To cope with VAT the day books need to be modified to separate the VAT from the net amount. A Sales Day Book would look like this:

SALES DAY BOOK

Date	Customer	Invoice Number	Details	Creditors Amount £	VAT £	Net £
08-Jul	Fortes Ice Cream	10023	Ice Cream Mixture	881.25	131.25	750.00
08-Jul	Uncles Ice Cream	10024	Ice Cream Mixture	264.37	39.37	225.00

The other day books would have similar layouts.

Irrecoverable VAT

The normal situation is that a VAT registered business can recover any input VAT. However, the government has passed legislation that stops these businesses recovering VAT on certain expenditure. This is known as irrecoverable VAT. The most common of these are:

- VAT on motor cars not for resale
- VAT on entertainment

In these instances, the VAT is part of the cost of the purchase. For example, a business entertains a customer to lunch at a restaurant. The bill comes to £60 plus VAT of £10.50, a total of £70.50. The VAT is not recoverable so the cost of the entertainment is £70.50.

SSAP 5 Accounting for Value Added Tax

A Statement of Standard Accounting Practice you need to know about is SSAP 5, which relates to VAT. It was produced when VAT was first introduced as there was some confusion on how to account for VAT.

The two main requirements are:

- Sales, as reported in the Profit and Loss Account, should not include VAT
- Irrecoverable VAT is to be included in the cost of the item.

The reason for the first of these is that, although businesses charge VAT on their sales it does not belong to them, but is the government's money. The business is the agent of the government in relation to VAT.

PRACTICE QUESTIONS

In a VAT quarter, Mason Ltd sells £100,000 of goods excluding VAT. It purchases Vatable goods and services for £70,500 including VAT. The company also bought a machine for £10,000 excluding VAT. All VAT is at 17.5% and is recoverable.

Use this information to tick the correct answers.

1. The output VAT, to the nearest £1, posted to the VAT Account will be:

	✓
£17,500 debit	
£17,500 credit	
£14,894 debit	
£14,894 credit	

2. The input VAT, to the nearest £1, posted to the VAT Account will be:

	✓
£10,500 debit	
£12,250 debit	
£10,500 credit	
£12,250 credit	

3. The Balance on the VAT Account will be:

	✓
£28,000 debit	
£5,250 credit	
£7,000 debit	
£4,394 credit	

4. To comply with SSAP 5, Mason Ltd should include in its financial statements for this quarter sales of:

	✓
£100,000	
£117,500	
£114,894	

ANSWERS TO PRACTICE QUESTIONS

In a VAT quarter, Mason Ltd sells £100,000 of goods excluding VAT. It purchases Vatable goods and services for £70,500 including VAT. The company also bought a machine for £10,000 excluding VAT. All VAT is at 17.5% and is recoverable.

Use this information to tick the correct answers.

1. The output VAT, to the nearest £1, posted to the VAT Account will be:

	✓
a. £17,500 debit	
b. £17,500 credit	✓
c. £14,894 debit	
d. £14,894 credit	

2. The input VAT, to the nearest £1, posted to the VAT Account will be:

	✓
a. £10,500 debit	
b. £12,250 debit	✓
c. £10,500 credit	
d. £12,250 credit	

3. The Balance on the VAT Account will be:

	✓
a. £28,000 debit	
b. £5,250 credit	✓
c. £7,000 debit	
d. £4,394 credit	

4. To comply with SSAP 5, Mason Ltd should include in its financial statements for this quarter sales of:

	✓
a. £100,000	✓
b. £117,500	
c. £114,894	

You are now ready to do Assignment 1. When you have done so, please send it to your tutor for marking and feedback. You will find it at the end of this book on page 110.

LESSON 5

Capital Expenditure – Acquisition

On completing this lesson, you will have covered the following Knowledge and Understanding criteria:

Knowledge & Understanding

- 1 – The types and characteristics of different assets and key issues relating to the acquisition and disposal of capital assets
- 2 – The relevant legislation and regulations
- 3 – The main requirements of relevant Statements of Standard Accounting Practice and Financial Reporting Standards
- 12 – How to use plant registers and similar subsidiary records
- 13 – How to use the transfer journal
- 14 – The methods of funding: part exchange deals

Performance Criteria

- Elements 5.1:
- A – record relevant details relating to capital expenditure in the appropriate records
 - B – ensure that the organisation's records agree with the physical presence of capital items
 - C – correctly identify and record all acquisition and disposal costs and revenues in the appropriate records
 - E – ensure that the records clearly show the prior authority for capital expenditure and disposal and the approved method of funding and disposal
 - G – ensure that the organisation's policies and procedures relating to the maintenance of capital records are adhered to