

Basic Principles of VAT

Trainee certified book-keepers preparing for assessment in the ICB examinations need knowledge of the basic principles of VAT (value added tax)

This short paper focuses on the principles and the entries in both the books of prime entry and the general ledger.

Value added tax is a form of indirect taxation levied throughout the European Union.

It was introduced in the UK in the early 1970s when it replaced another indirect tax, 'purchase tax'.

In general, VAT taxes individuals, not businesses. So that while registered businesses must charge VAT to their customers, they may also reclaim (with a few exceptions) any VAT they pay to their suppliers. The net amount is paid over to HM Revenue and Customs.

VAT legislation requires registered businesses to maintain proper records, including copies of invoices on which VAT is charged or payable, and to make regular returns. These are usually quarterly although in the case of smaller businesses may be annual.

VAT accounting is usually on an accruals basis – that is to say outstanding invoices are taken into account – although again smaller businesses (those with a turnover below £660,000) may by concession account on a 'cash' basis (when only VAT amounts actually paid and received are accounted for). There has been some suggestion that HMRC may well raise the turnover requirement substantially in 2007.

There are also (a reducing number) of special schemes for particular types of business (sale of second hand cars, for example) requiring particular information to be kept.

Smaller unregistered businesses, and individuals cannot reclaim or set off any VAT paid – and it becomes a cost to them.

To register for VAT, UK businesses must currently have an annual turnover of at least £61,000 (or expect it to exceed this figure in the next 30 days). However this does not preclude the registration of businesses with turnovers less than £61,000 as they may apply for voluntary registration.

VAT chargeable sales by registered businesses are referred to as its 'outputs', and the VAT charged as 'output tax'. In a VAT context, purchases are 'inputs' and the VAT charged on them 'input tax'. The standard rate of VAT is currently 17.5 per cent. It does not apply to all goods since some are either zero-rated (food, for example) while others are outside its scope (exempt). And certain goods and services enjoy a reduced rate. For example, domestic fuel is now subject to a 5 per cent rate.

Since registered businesses in effect act as a collecting agent for HM Revenue and Customs, VAT charged by them does not form part of their turnover, nor VAT payable part of their costs. Any outstanding amount will, however, appear on the business balance sheet. In most circumstances Customs and Excise will be a creditor. However, some businesses often claim back more VAT than they are charged. In these circumstances the VAT repayment due will be a debtor.

All this can be accommodated within the double-entry book-keeping system. To do this, the layout of the day books need to include separate columns to derive totals for gross, VAT and VAT net amounts. Personal accounts in the sales and purchase ledger are debited or credited as appropriate with the individual gross amounts.

Likewise both the sales ledger and purchase ledger control accounts are posted with gross amounts.

Inputs and input tax column totals (net and VAT) will be posted separately – one to a cost account the other to the VAT account. Outputs and output tax will be treated in similar fashion – the net total to a sales account, the VAT total to the VAT account.

The cash book will also have a VAT column for amounts that do not pass through sales or purchase ledgers. So again, in the case of purchases, the total of VAT paid on such items will be debited to the VAT account and the net-of-VAT amount debited to the appropriate expense account.

Likewise, receipts that do not pass through the sales ledger will be split between VAT and net elements, the first being credited to the VAT account and the latter to an appropriate income account.

In this way the VAT account should always show the net amount payable to or reclaimable from HM Revenue and Customs.

Of course, VAT rules are complex with many rules on what is chargeable and what not and what constitutes an allowable item.

Case Study

Whitby Crescent Cleaning, which has a 31 December year end, had the following credit transactions during January 2006

- 1 Jan Purchases goods for resale from Stonehill Supplies £450 less 20% trade discount
- 2 Jan Sold goods to Crescent Parks £200
- 5 Jan Sold goods to Langley Flats £120
- 8 Jan Purchased goods from Cleaning Chemicals £1500 less 10% trade discount
- 12 Jan Received credit note from Cleaning Chemicals, goods returned, list price £500 (£450 net of trade discount)
- 14 Jan Sold goods to Victoria Hotel £1000
- 15 Jan Sold goods to Fox and Hounds Inn £400
- 18 Jan Sold goods to Dolphin Inn £300
- 24 Jan Issued credit note to Crescent Parks, goods returned £20
- 28 Jan Sold goods to Hawsker Hall £100
- 31 Jan Sold goods to Bagdale Inn £700

All transactions were subject to VAT.

It had the following balances in the sales and purchase ledger controls:

- Sales ledger control £2240
- Purchase ledger control £1050 and VAT account (CR Balance) £810

and its subsidiary sales and purchase ledgers contained the following accounts:

Debtors	£	Creditors	£
Crescent Parks	780	Stonehill Supplies	650
Langley Flats	760	Cleaning Chemicals	400
Bagdale Inn	700		
	<u>£2240</u>		<u>£1050</u>

The transactions for the month would be entered in the books of prime entry, the general ledger and the subsidiary ledgers as follows:

Sales Day Book

Date	Details	Net	VAT	Gross
2 Jan	Crescent Parks	200.00	35.00	235.00
5 Jan	Langley Flats	120.00	21.00	141.00
14 Jan	Victoria Hotel	1000.00	175.00	1175.00
15 Jan	Fox and Hounds	400.00	70.00	470.00
18 Jan	Dolphin Inn	300.00	52.50	352.50
28 Jan	Hawsker Hall	100.00	17.50	117.50
31 Jan	Bagdale Inn	700.00	122.50	822.50
		<u>£2820.00</u>	<u>£493.50</u>	<u>£3313.50</u>

The postings of the totals would be:	Credit sales account	Credit VAT account	Debit sales ledger control
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Sales Returns Day Book

Date	Details	Net	VAT	Gross
24 Jan	Crescent Parks	20.00	3.50	23.50
		<u>£20.00</u>	<u>£3.50</u>	<u>£23.50</u>

The postings of the totals would be:	Debit sales returns	Debit VAT	Credit sales ledger control
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Purchases Day Book

Date	Details	Net	VAT	Gross
1 Jan	Stonehill Supplies	360.00	63.00	423.00
8 Jan	Cleaning Chemicals	1500.00	262.50	1762.50
		<u>£1860.00</u>	<u>£325.50</u>	<u>£2185.50</u>

The postings of the totals would be:	Debit purchases account	Debit VAT	Credit purchase ledger control
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Purchases Returns Day Book

Date	Details	Net	VAT	Gross
12 Jan	Cleaning Chemicals	450.00	78.75	528.75
		£450.00	£78.75	£528.75
	The postings of the totals would be:	Credit purchases returns Account	Credit VAT	Debit purchase ledger control

The general ledger and subsidiary ledger accounts would show (prior to any receipts or payments for the month) the following:

General Ledger

Sales Ledger Control Account

1 Jan	Balance B/F	2240.00	31 Jan	Sales Returns Day Book	23.50
31 Jan	Sales Day Book	3313.50			

Purchase Ledger Control Account

31 Jan	Purchases Day Book	528.75	1 Jan	Balance B/F	1050.00
31 Jan	Purchases Day Book		31 Jan	Purchases Day Book	2185.50

Sales Account

			31 Jan	Sales Day Book	2820.00
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Sales Returns Account

24 Jan	Sales Returns Day Book	20.00			
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Purchases Account

31 Jan	Purchase Day Book	1860.00			
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Purchases Returns Account

		31 Jan	Purchases Returns Day Book	450.00
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VAT Account

31 Jan	Purchase Day Book	325.50	1 Jan	Balance B/F	810.00
31 Jan	Sales Returns	3.50	31 Jan	Sales Day Book	493.50
	Balance c/d	1053.25	31 Jan	Purchases Returns Day Book	78.75
		<u>£1382.25</u>			<u>£1382.25</u>
			1 Feb	Balance B/D	1053.25

The VAT account shows that there is a VAT creditor

Subsidiary Ledgers

Sales Ledger

Crescent Parks

1 Jan	Balance B/F	780.00	24 Jan	Sales Returns Day Book	23.50
2 Jan	Sales Day Book	235.00			

Langley Flats

1 Jan	Balance B/F	760.00			
5 Jan	Sales Day Book	141.00			

Bagdale Inn

1 Jan	Balance B/F	700.00			
31 Jan	Sales Day Book	822.50			

Victoria Hotel

14 Jan	Sales Day Book	1175.00			
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Fox and Hounds

15 Jan	Sales Day Book	470.00			
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Dolphin Inn

18 Jan	Sales Day Book	352.50			
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Hawsker Hall

28 Jan	Sales Day Book	117.50			
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Purchase Ledger

Stonehill Supplies

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	1 Jan	Balance B/F	650.00
	31 Jan	Purchases Day Book	423.00

Cleaning Chemicals

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12 Jan	Purchases Returns Day Book	528.75	
	1 Jan	Balance B/F	400.00
	8 Jan	Purchases Day Book	1762.50