Plus+ accounting

chartered accountants

VAT accounting schemes

This guide looks at how the 3 main accounting schemes work and how they can help businesses.

Special VAT accounting schemes for small businesses have been available for a number of years, but they are still underused. The 3 main schemes are: cash accounting, annual accounting and the flat rate scheme.

The cash accounting scheme (CA)

Cashflow can often be a headache for businesses. Were it not for this scheme, VAT would be due based on invoice dates, which means paying HMRC on unpaid invoices at the end of each period. CA enables businesses to account for VAT on the basis of payments received and made instead.

Input tax not being deductible until purchase invoices are paid is a disadvantage, but as the norm is making a profit, the scheme is usually beneficial.

CA can be used by businesses with an expected taxable turnover not exceeding £1,350,000 in the next 12 months. The business must also be up to date with its VAT payments or have agreed a plan with HMRC for clearing any outstanding debts.

The key factor in deciding whether or not to use CA is the period of time between issuing sales invoices and receiving payment - the longer the gap, the stronger the case for CA. Clearly, it would also not be advantageous for repayment traders to use it where input tax regularly exceeds output tax.

Other advantages are:

- simplified accounting, in that well-analysed cash and bank records are usually enough
- no need for VAT relief on bad debts because it is not paid to HMRC up front.

There are other conditions for using the scheme, such as having to use it for the whole of a business and normally staying in it for at least 2 years, but these are not usually a burden.

Businesses can leave the scheme at any time if they are not benefiting from it or struggling with the accounting requirements. Records must be kept in such a way that invoices issued and received can be easily cross-referred to payment dates but that is usually straightforward.

It is not compulsory to leave the scheme and revert to accruals-based accounting until annual taxable turnover reaches £1,600,000. This built in 25% tolerance gives flexibility for growing businesses. On leaving the scheme, all outstanding tax must be paid within 6 months of the leaving date.

VAT accounting schemes

The annual accounting scheme (AA)

AA was introduced at the same time as CA and has the same turnover thresholds for joining and leaving it. It involves making pre-agreed payments on account and completing only 1 VAT return per year. So its purpose is to aid cashflow and budgeting.

For those wishing to join the scheme who have been VAT registered for less than a year, the taxable turnover for the purpose of the scheme is usually the amount shown on the application to register. In any case, the value of capital asset sales or anticipated sales is ignored.

An application form must be completed in order to join the scheme. Businesses that apply to register for VAT online can apply online to use AA if the application is submitted at the same time.

Withdrawal from the scheme is possible at any time by application in writing to the business's local VAT office.

Benefits of AA:

- only 1 VAT return is required each year, with an extra month for submission
- the return can be prepared at the same time as the annual accounts
- cashflow is known in advance
- monthly payments spread the load
- it simplifies the operation of retail or partial exemption schemes.

Sometimes the regular payments set for a subsequent year can be unreasonably high but, if the difference is significant, a reduction can be negotiated. Seasonal variations can also have an impact either way.

The regular budget payments are usually:

- 9 monthly interim payments of 10% of the previous year's VAT payments (or 10% of their estimated payments if registered for less than a year), commencing on the last day of the fourth month of the VAT year, or
- 3 quarterly interim payments of 25% of the previous year's VAT payments (or 25% of their estimated payments if registered for less than a year).

The monthly method is the default unless the business specifically requests quarterly payments.

Payments can be adjusted to allow for any expected changes in turnover and trading. The annual return then shows actual VAT due for the year then ending and the balance, if any, of that amount, less the budget payments already made, is due no later than 2 months after the return date. Payments must be made by direct debit, or by a choice of electronic payment methods.

Failure to comply with the scheme rules, or general non-compliance with other VAT rules can result in expulsion from the scheme.

The flat rate scheme (FRS)

FRS was introduced more recently than the other 2 schemes and has a much lower turnover threshold for eligibility, meaning fewer businesses can use it.

Its objective is to reduce the cost of VAT compliance. It does this by applying a fixed percentage to gross income, which builds in an allowance for deemed input tax, thus avoiding the need for detailed records of purchases and expenses. Invoices are still issued and received as normal. It is just the VAT accounting which is simplified.

FRS is available to businesses that expect their VAT exclusive taxable turnover (excluding expected sales of capital assets) in the next 12 months to be no more than £150,000. As with the other schemes, there is a tolerance threshold meaning businesses using the scheme can continue to do so until their taxable turnover increases to £230,000.

As the fixed percentage applies to all income, the largest advantage is to eligible businesses making only standard rated supplies. Although the fixed rate is designed to allow for typical zero-rated and exempt supplies by the type of business (as well as to give a set credit for input tax), users may be disadvantaged if they make a lot of that type of supply. It is always worth comparing the scheme against normal VAT accounting first, to ensure there is a benefit.

A table of FRS rates is available from HMRC, which is usually only changed if there is a VAT rate change. It is important for the user to ensure their business has the correct classification. If their activity includes supplies in 2 or more sectors, the percentage to be used is that appropriate to the main activity as measured by expected turnover in the year ahead.

Joining the scheme is by completing an application on form online (if the business used HMRC's online services to register for VAT) or by downloading the form and posting it to HMRC.

Contact us if you are considering registering for one of these schemes.