1 Introduction

This book is designed to cover the modules of Level 5 validated by QQI:

- Accounting Manual and Computerised 5N1348
- Bookkeeping Manual and Computerised 5N1354 (the setting up of stock and product codes are part of the student resources).

It also covers the modules of Level 6:

- Bookkeeping Manual and Computerised 6N4865, except for:
  - Learning Outcomes 2 and 3 – Analysis of Reports
  - Learning Outcome 5 – Recurring Journals and foreign currency.
- Computerised Accounts 6N3911, except for:
  - Part of Learning Outcomes 2 and 3 – Set up foreign currencies and recurring transactions
  - Learning Outcomes 9 to 12 – Management Reporting.

The book clearly explains the process of accounting, using practical assignments from the source documents to the preparation of a Profit and Loss account and Balance Sheet with end-of-year adjustments to the accounts. This is demonstrated manually, in *TASBooks* and in *Sage 50* Accounts.

Part 1 explains the concept of double-entry, preparation of manual accounts, bank reconciliation and VAT. This part also explains the main accounting concepts and the importance of an audit. The tasks are demonstrated using a practical example with detailed explanations and a solution to each task.

Part 2 explains the Profit and Loss account and Balance Sheet, together with end-of-year adjustments to final accounts. The tasks are demonstrated using examples with detailed explanations and solutions. This part also demonstrates ratio analysis of a business.

Part 3 introduces forecasts and budgets, listing their types and purposes. It demonstrates the preparation of a cash budget and forecasted Profit and Loss account and Balance Sheet.

Part 4 introduces computerised accounts, with advantages and disadvantages. It also lists the various accounts packages currently available. It covers the importance of data accuracy and anti-virus software.

Part 5 starts with the installation of *TASBooks*. It explains the use of the main ledgers in *TASBooks*, using the same practical example as in Part 1, Manual Accounting. This section also demonstrates the creation of final accounts with end-of-year adjustments and explains VAT reporting, bank reconciliation and entering opening balances.

Part 6 starts with the installation of *Sage 50* Accounts. It explains the use of the main modules in *Sage 50* Accounts, using the same practical example as in Part 1, Manual Accounting. This section also demonstrates the creation of final accounts with end-of-year adjustments and explains VAT reporting, bank reconciliation and entering opening balances.

Student Resources are available on www.gillmacmillan.ie. They contain set-up files for both *TASBooks* and *Sage 50* Accounts. They also contain source documents for the three different businesses that are used as examples in this book. In the case of the business Daly's Pharmacy Ltd, this also includes the *TASBooks* configuration and the setting up of a Chart of Accounts (COA) using *Sage 50* Accounts.

There are practical assignments and questions at the end of the sections to give students a clear understanding of the tasks demonstrated throughout this book.

Part 1

Manual Accounting

1.1 Principles of Accounting

Learning outcomes (Accounting Manual and Computerised 5N1348): 1, 2, 3 and 4
Learning outcomes (Bookkeeping Manual and Computerised 5N1354): 1 (part)

Accounting is the mechanism that provides us with reliable financial information. This financial information is used by managers, employees, shareholders, potential purchasers, customers, suppliers and financial institutions. Accounting is an information system that identifies, collects, describes, records and processes data and then communicates it as financial information. The accounting system will vary from one business to another, depending on its nature and size, the volume of transactions and the demands made by its management, but the system's components and the method of processing the information are essentially the same in all accounting systems.

In order to be able to provide such financial information for users, each business must keep an accurate record of its activities on a day-to-day basis. Bookkeeping is defined as the recording of financial transactions of a business in daybooks and ledgers – collectively known as the books of prime entry.

Accounting can be defined as using these daybooks and ledgers and the preparation of a Profit and Loss account, Balance Sheet and cash flow statements.

Double-entry principle

The term 'double-entry' infers that every business transaction has a dual aspect – a debit and a credit. The dual-aspect rule arises from the recognition that every time a transaction takes place, there must always be a two-sided effect within the business. The method of recording these dual transactions is through the ledger accounts. Ledger accounts are normally known as T-accounts; the terms *debit* and *credit* apply to the left and right sides respectively and are used repeatedly in the recording of entries.

The bookkeeping process

Most businesses have such a large number of transactions each year that it would be very difficult to record them directly into the accounts. This problem is resolved by using the bookkeeping system that includes daybooks and ledgers, i.e. the books of prime entry. The recording process uses them in the following steps:

1. Analyse each transaction in terms of its effect on the accounts.
2. Enter the transaction information into a daybook.
3. Transfer the daybook information to the ledger, where a double-entry takes place.
4. Balance each ledger account.
5. Summarise the balances of the ledgers in a Trial Balance.

Before examining the books of prime entry in depth, keep in mind that the actual sequence of events begins with a source document, such as a sales invoice, a cheque received, a purchase invoice or a cheque written, which is analysed before being recorded in the books of prime entry.

Daybooks

The daybooks are used to compile lists of similar transactions. They are totalled periodically (usually at the end of the month) and these totals form the basis of entries into the ledgers (the T-accounts). In this way, a business such as a retailer with thousands of transactions can effectively handle its workload. A business can have daybooks for any type of transaction; the most common are:

- **Sales daybook (including returns):** a list of credit sales and returns, with date, invoice number, customer name and amount of sale
- **Purchases daybook (including returns):** a list of credit purchases and returns, with date, invoice number, supplier name and amount of purchase
- **Cash book:** a list of cash receipts (with date, lodgement slip number, 'received from' and amount received) and a list of cheque payments (with date, cheque number, payee and amount)
- **Petty cash book:** a list of small cash payments and receipt transfers from the bank current account.

Accounting terms and definitions

Before considering the double-entry system, some explanation is needed of the main accounting terms.

- **Debtor**: a company or individual who owes money or its equivalent. A trade debtor is a person or business that buys goods on credit and makes payment for such goods at a later date.
- **Creditor**: a company or individual to whom money or its equivalent is owed. The term specifies a party who has delivered goods or services on credit and is owed money by one or more debtors.

To put it simply, the debtor–creditor relationship is complementary to the customer–supplier relationship.

- **Asset**: something of value that a business owns, benefits from or has use of in generating income. Examples are: machinery, property, vehicles, stock of goods, cash and debtors.
- **Liability**: an obligation that a business has to others, arising from past transactions or events. Examples are: creditors, bank overdrafts and loans.
- **Expense**: an item of day-to-day expenditure that a business incurs in order to function. A business incurs expenses through its operations in order to earn income. Examples are: rent paid, wages, insurance and telephone charges.
- **Income**: an amount of money or its equivalent received during a period of time, in exchange for goods or services. Examples are: sales income, rental income and investment income.
- **Profit**: the excess of income over expenses during a period of time.
- **Loss**: the excess of expenses over income during a period of time.
- **Capital**: the money or equivalent invested in a business by its owner or owners. It is the practice to think of the owner as being separate from the business. The capital account records what the owner has contributed to the business out of his/her private resources in order to start the business and keep it going. In other words, it shows what the business 'owes' the owner. In accounting, it is always the records of the business that are presented and therefore capital is treated as a liability. It is part of the 'owner's equity' of the business.
- **Dividend**: a share of the profits from a company, either paid or payable to its shareholders as cash.
- **Shareholder:** a person, company, or other institution that owns at least one share in a company's capital. A company is a separate legal entity, distinct from its owners, who are known as members or shareholders. A shareholder may also be referred to as a stockholder. They have a direct or indirect interest in the activities of the business. The shareholders of a limited company have limited liability, meaning that they cannot be required to contribute more capital than the value of their shares. There are two main types of shareholders: preference and ordinary shareholders.
  - **Preference** shareholders always receive their dividends first, assuming that a dividend is declared by the company. This dividend is fixed as a percentage of the nominal value of the preference share capital. Preference shareholders are ranked higher than ordinary shareholders in the event of company liquidation.

    As with ordinary shares, preference shares represent ownership in a company, although they do not enjoy any of the voting rights of ordinary shareholders. The main benefit to owning preference shares is that the investor has a greater claim on the company's assets than ordinary shareholders.
  - **Ordinary** shareholders are the owners of any shares that are not preference shares and do not have any predetermined dividend amounts. An ordinary shareholder has capital ownership in a company

and is entitled to a vote in matters put before shareholders in proportion to their percentage ownership in the company.

Ordinary shareholders are entitled to receive dividends, if any are available after dividends on preference shareholders are paid. They are also entitled to their share of the residual economic value of the company should the business unwind; however, they are last in line after secured creditors and preference shareholders for receiving business proceeds. As such, ordinary shareholders are considered unsecured creditors.

Accounting standards and principles

Generally Accepted Accounting Principles – GAAP

Generally Accepted Accounting Principles (GAAP) are a common set of accounting principles, standards and procedures that companies use to compile their financial statements. GAAP are a combination of authoritative standards (set by policy boards) and simply the commonly accepted ways of recording and reporting accounting information.

GAAP are imposed on companies so that investors have a minimum level of consistency in the financial statements they use when analysing companies for investment purposes. Companies are expected to follow GAAP rules when reporting their financial data through financial statements. If a financial statement is not prepared using GAAP principles, it may not give a true and fair view of the state of affairs of the business.

That said, keep in mind that GAAP is only a set of standards. There is plenty of room within GAAP for accountants to distort figures. So, even when a company uses GAAP, a reader needs to scrutinise its financial statements.

(Adapted from: www.investopedia.com/terms/g/gaap.asp)

International Financial Reporting Standards (IFRS)

International Financial Reporting Standards (IFRS) are designed as a common global language for business affairs so that company accounts are understandable and comparable across international boundaries. They are a consequence of growing international shareholding and trade and are particularly important for companies that have dealings in several countries. They are progressively replacing the many different national accounting standards. The rules are to be followed by accountants to maintain books of accounts which are comparable, understandable, reliable and relevant as per the users, internal or external.

IFRS began as an attempt to harmonise accounting across the European Union but the value of harmonisation quickly made the concept attractive around the world. They are sometimes still called by the original name of International Accounting Standards (IAS). IAS were issued between 1973 and

2001 by the Board of the International Accounting Standards Committee (IASC). On 1 April 2001, the new International Accounting Standards Board (IASB) took over from the IASC the responsibility for setting International Accounting Standards. During its first meeting the new board adopted existing IAS and Standing Interpretations Committee standards (SICs). The IASB has continued to develop standards, calling the new standards International Financial Reporting Standards (IFRS).

(Adapted from: http://uk.ask.com/wiki/International_Financial_Reporting_Standards?qsrc=3044)

The importance of accounting standards

If accounting is the language of business, accounting standards are its grammar. Properly developed and implemented, they can encourage business expansion and help regulate the economic system. High-quality accounting standards can facilitate the flow of information from businesses to a range of different users. These include investors, banks, creditors, revenue commissioners, regulators, employees and the general public. The availability of accounts prepared in accordance with recognised accounting standards encourages trade by promoting confidence in business.

However, financial statements are inherently limited in nature. They provide a snapshot of financial position, performance and cash flows of a company as at the reporting date. They are a function of the estimates and judgements of directors and of the choices made under accounting standards.

Accounting standards are themselves not without controversy. Both the financial crises and recent developments in international accounting standards have drawn attention to the content of accounting standards, the process by which they are developed and the role accounting standards have played in the economic system. For example, both the G20 leaders and the Report of the Financial Crisis Advisory Group have called for the development of a single set of high-quality global accounting standards to facilitate transparency and stability in the global economic system (IASB, 2009a; 2010a).

Section 149(1, 2) of the *Companies Act 1963* requires that company directors present to their shareholders financial statements which give a 'true and fair view' of the company's financial position and profit or loss. What constitutes a 'true and fair view' is not defined by legislation in Ireland or internationally. Rather 'a true and fair view' is a concept which originates in the nineteenth century and has subsequently been refined by case law. This case law has established that if company directors comply with accounting standards in preparing the financial statements, this is very strong evidence that the financial statements give 'a true and fair view'. In other words, accounting standards define best practice in accounting.

Financial statements presenting a true and fair view are prepared applying GAAP (in Ireland – either UK and Irish GAAP or IFRS) whilst audits are carried out having regard to independently established auditing standards – in Ireland, International Auditing Standards as published by the Auditing Practices Board (APB).

(Adapted from: www.oireachtas.ie/parliament/media/housesoftheoireachtas/libraryresearch/spotlights/accounting_standards.pdf)

Accounting concepts

We can make three observations concerning accounting entries:

1. Accounting measures transactions in money.
2. Agreement is reached among people as to the monetary value of a transaction.
3. There is consistency in the preparation of financial statements, e.g. in layout, the yearly time interval and the methods of dealing with transactions.

These are obvious characteristics, but accounting does not tell us everything about the business. If a business makes a healthy profit, do we assume it is healthy and will be in existence in the future?

Basic accounting concepts – SSAP 2

Historically, the starting point for accountants has been the four 'fundamental accounting concepts' listed in the Statement of Standard Accounting Practice (SSAP) 2 'Disclosure of Accounting Policies'. This was superseded from December 2000 by the International Financial Reporting Standards (IFRS) 18. This applies to all accounts within its scope for accounting periods ending on or after 22 June 2001.

SSAP 2 was issued in November 1971 and its objective was to ensure the disclosure in accounts of clear explanations of accounting policies adopted for the purpose of giving a true and fair view. There was no statement of how accounting policies were to be defined but the four accounting concepts were introduced. These concepts were regarded as expedient and working assumptions, having general acceptance at the time the standard was issued.

Under SSAP 2 there were 'broad basic assumptions' underlying the periodic financial accounts of businesses. The four main assumptions are explained in the following sections.

1. Prudence concept

This requires that revenue and profits were not anticipated, but recognised by inclusion in the Profit and Loss account only when realised in the form either of cash or of other assets, the ultimate realisation of which could be assessed with reasonable certainty. Provision is made for all known liabilities (expenses and losses), whether the amount of these is known with certainty or is a 'best estimate' in light of the information.

The prudence concept injects a note of caution where estimates are required in uncertain situations. Managers generally tend to be over-optimistic when making predictions about future sales or cost overruns. For example, slow-moving stock may suggest obsolescence, a fact that a manager may be reluctant to accept, and similarly, a customer with an overdue debt may have to be considered a write-off. Where loss is probable, prudence requires that these losses be accounted for immediately. If in doubt, overstate losses and understate profits.

2. Consistency concept

This requires that accounting treatments be applied consistently within accounts, and from one period to the next. Users of financial statements need to be able to compare businesses based on performance and financial position. They must also be able to compare a business's performance over a number of periods. For example, if a business depreciated its equipment using the 'straight-line' method in the first year, then it should continue with the same method in subsequent years. Where there is a change in the accounting method, the effect of this change has to be calculated and recorded, for example, if it gives a more accurate picture of the state of the business. This concept provides confidence to users of accounting statements when comparing present and previous sets of accounts.

3. Going-concern concept

This requires that the business will continue in 'operational existence' for the foreseeable future and that the value of its assets is appropriately accounted for in the accounts. If the business is being wound up, then the assets need to be valued at their market value.

4. Accruals (matching) concept

This requires that revenue and costs be accrued, i.e. recognised as they were earned or incurred, not as money is received or paid, and matched with one another in so far as their relationship can be established or justifiably assumed. They are to be dealt with in the Profit and Loss account of the period to which they relate.

The intent here is to have revenues and profits of a period matched with the associated expenses incurred in earning them. As we will see later, cash received in a period could be for payment of goods sold in the previous period or even for services to be performed in a future period. Later, we will distinguish between the accruals basis and the cash basis of accounting, a distinction greatly assisted by the matching concept. For now, we can say that when a business has provided a service or sold goods in a period and is not paid until the next period, then the business must accrue the amount for that sale. Similarly, if a business has paid for goods or a service in advance, the business must recognise that one asset, cash, has been translated into another asset, prepayment.

Further accounting concepts

In addition to the four concepts listed above, there are a number of other concepts that are accepted as general accounting practice.

- **Materiality:** An error in the accounts may or may not have a significant impact on the financial statements. What constitutes 'significant' is determined by how 'material' that error is. As long as the financial statements give a true and fair view, an immaterial error need not be accounted for. Where errors are deemed to be material, they must be corrected.

  Judgement on an accountant's part is often required to decide on what is material. For example, a €1,000 error in the cash account of a multinational company may be immaterial, unlike a small business where such an error would materially affect the reported position.
- **Entity concept:** A business is a separate entity and exists distinct from its owners. Whether it is a profit or a non-profit making business, only the financial matters relating to that entity can be included in the accounts and not those of the owners and others. Establishing the dividing line between private dealings and the transactions of the business is imperative for the accountant.
- **Dual aspect:** This is the basis for the bookkeeping equation, where there are two aspects to accounting for financial information. This means that wherever there is a debit in the accounts, there is a corresponding credit.
- **Monetary measurement:** Only those transactions and events that can be measured in monetary terms can be recorded in the accounts. Without this monetary measurement unit, we could not make any meaningful comparisons of value.
- **Historical cost:** The historical cost concept values transactions at their original cost and is recorded in the books as such. Although events such as inflation may affect costs, subsequent changes in prices or value are usually ignored.
- **Realisation:** This concept allows a business to realise a transaction when a value can be placed on it and when we are certain that the resources will be transferred. This means that if there is a sale in August, but the business does not get paid until October, we can recognise the sale in August, as long as we are reasonably certain of payment.

  The rules or concepts listed are the foundation of accounting. The most important are stipulated in SSAP 2, as issued by the IASB. Although many have been superseded by International Financial Reporting Standards (IFRS), some are still in force.

Accounting policies of FRS 18

FRS 18 deals primarily with the selection, application and disclosure of accounting policies. Its objective is to ensure that for all material items:

- an entity adopts the accounting policies most appropriate to its particular circumstances for the purpose of giving a true and fair view
- an entity should prepare its financial statement on a going-concern basis, unless the entity is being liquidated or has ceased trading, or the directors either intend to liquidate the entity or to cease trading, or have no realistic alternative but to do so
- the accounting policies adopted are reviewed regularly to ensure that they remain appropriate, and are changed when a new policy becomes more appropriate to the entity's particular circumstances
- sufficient information is disclosed in the financial statements to enable users to understand the accounting policies adopted and how they have been implemented.

The FRS supersedes the SSAP 2 'Disclosure of accounting policies', which was published in 1971. Although in many respects SSAP 2 was still broadly satisfactory, the framework within which it discussed accounting policies was out of step with modern accounting. The FRS updates that framework to make it consistent with the IASB's Statement of Principles for Financial Reporting.

(Adapted from: www.frc.org.uk/Our-Work/Codes-Standards/Accounting-and-Reporting-Policy/Standards-in-Issue/FRS-18-Accounting-Policies.aspx)

The FRS came into force for accounting periods ending on or after 22 June 2001. It summarises the qualitative characteristics of financial statements and requires that the characteristics of relevance, reliability, comparability and understandability pertain to all statements in order to have confidence in them.

Control of accounting systems

It is the responsibility of the owner of the business to safeguard its assets and to maintain the integrity of the financial data. This is a great challenge facing the accounting profession, focusing as it does on the issue of adequate controls in accounting systems. In a business, there are internal and external control systems in place and internally created control systems are tested by an independent external source – the auditor.

Internal control environment

The threats to a business are significant and broad. The main threats are from dishonest and/or incompetent employees, human error and poor management practices. Internal control management consists of the methods and measures maintained in a business to safeguard all assets from theft/ unauthorised use and enhance the accuracy and reliability of its accounting records by reducing the risk of errors and irregularities.

To achieve these control mechanisms, the business must follow a number of internal control principles. Specific control mechanisms may vary from one business to another, but the following principles apply to most business environments.

- **Establishment of responsibility:** This calls for assignment of responsibility to specific employees. Control is most effective when only one person is responsible for a given task.
- **Segregation of duties:** Related activities such as ordering, receiving and paying for goods, run the risk of abuse if completed by the same person. For example, goods might be ordered from friends who give kickbacks, or payments might be approved for fictitious invoices. Also, sales-related activities should be assigned to different persons. Another example of segregation of duties is to ensure that the bookkeeper of an asset does not have access to that asset; equally, the person in charge of an asset should not maintain or have access to the accounting records for that asset. Similarly, an employee in charge of cash is not likely to make personal use of it if another employee is responsible for the accounting of that cash.
- **Document procedures:** Procedures should be established for all documentation. First, documents should be pre-numbered and all documents accounted for. Source documents such as invoices should be promptly forwarded to the person responsible for the accounting to help timely and accurate recording of transactions.
- **Physical controls:** Physical controls, such as safes and secure warehouses, should be in place to safeguard the assets of the business. Computer security is particularly challenging. All computer facilities should have password controls and backup systems, and there are natural dangers to secure against, such as blackouts and obsolete technology. Due to human-made threats, such as hacking, viruses and data manipulation, access should be restricted by an ever-challenging password system.
- **Independent internal verification:** This involves the review, comparison and reconciliation of information by internal employees acting independently. This can be in the form of verification by an employee, on a periodic basis, of information supplied by another department. A large business will almost certainly have its own internal auditing system, where regular verification constitutes a significant part of the work. Any discrepancies or exceptions should be reported to the senior management, who are capable of corrective action.

External control environment

An external audit is carried out by outsiders, who investigate the accounting system and transactions of a business and then ensure that the financial statements have been prepared in accordance with accounting principles. These auditors should be expert and independent so that investors, lenders and the Revenue Commissioners can rely on their report. External control relies on effective internal control procedures being in place and on the ability of management to enforce those controls.

The external auditor, who is appointed by the owner of the business or, in the case of a company, at the AGM on behalf of its shareholders, reports on the accounts of the business. The auditor states, in his/her opinion, whether the accounts and records fairly and accurately reflect the activities of the business in the period under review. This also includes the state of its assets and liabilities at the end of that period. The auditor effectively acts as a check on management.

Role of the auditor

The **internal auditor** is often employed in medium-to-large companies to install and maintain internal controls. It is impossible for senior management in large companies to exercise direct control and supervision of operations. An internal auditor is able to bridge the gap in controls and, in a sense, provide an independent check on the accounting records and other operations of the company.

While the scope of the internal auditor is defined by management, maximum benefit is obtained if the auditor's duties extend beyond mere checking for accuracy of records. They should cover all aspects of financial and non-financial matters. In order to do this, the auditor must be completely independent from executive responsibility and allowed to investigate any area of the company's activities. This independence is underlined if the internal auditor reports directly to the board or a committee made up of board members and senior-management personnel.

The **external auditor** is an outside person, not employed within the business, who investigates the accounting systems and transactions of the business. The external audit is conducted by independent reviewers whose objective is to express an opinion on whether the financial statements give a true and fair view of the business's affairs at the end of the period under review and of its profit and loss for that same period. It also includes an opinion on whether the accounts have been properly prepared in accordance with relevant legislation and applicable accounting standards. The focus of the external auditor's attention includes not only financial statements, but also notes, reconciliations and estimates associated with the statements.

The external auditor will report to the shareholders of a company and must state whether:

- the auditor has had access to all records and information considered necessary
- the Balance Sheet and Profit and Loss account are in agreement with the accounts in the ledgers
- the accounts give a true and fair view of the state of the company's affairs

- the Balance Sheet and Profit and Loss account comply with the legal requirements contained in the various companies acts
- proper books of account have been kept.

The primary function of an auditor, whether internal or external, is not to detect fraud and error, but rather to obtain sufficient, appropriate audit evidence to form an opinion on the financial statements. However, the auditor is bound to exercise due care in the conduct of the audit. Auditors should be conscious that the possibility of fraud and errors may occur, which may result in a significant misstatement of the accounts. They should therefore plan and perform their work accordingly. As long as the audit provides a reasonable expectation of detecting material fraud or error, then the auditor is not liable for failing to detect it.

Advantages and disadvantages of an audit

There are inherent *advantages* in having accounts audited. These include:

- An auditor may well discover material fraud or errors during the audit, even though such a discovery is not the primary objective of the audit.
- The in-depth examination of the business may enable the auditor to give constructive advice to management on improving the efficiency of the business.
- Applications to banks and other parties for finance and for dealing with potential purchasers may be enhanced by providing audited accounts.

Disadvantages include:

- Audits can be costly as they involve the services of a professional.
- Disruption of the work of employees is unavoidable as the audit requires management and employees to spend time providing information to the auditor.

Review questions

1. Identify the appropriate accounting concept suggested by each of the following statements (SSAP 2 Disclosure of Accounting Policies):
   a. '…the profit and loss account and balance sheet assume no intention or necessity to liquidate…'
   b. '…accounting treatment of like items within each accounting period and from one period to another…'
   c. '…revenue and profits in the Profit and Loss account are matched with associated costs and expenses…'
2. State which accounting rule is referred to in each of the following:
   a. telephone expenses incurred in one period and paid for in another period

   - **b.** a demand by the owner of the business to include every detailed transaction in the preparation of the financial statements
   - **c.** a valuation of three litres of petrol in a motor vehicle at the end of the accounting period
   - **d.** a proposed change in the method of depreciation
   - **e.** a fixed asset that could be sold for more than its cost price.
3. State whether each of the following statements are true or false:
   - **a.** Accounting is based on a theoretical framework.
   - **b.** Accountants can adopt different rules to suit different businesses.
   - **c.** The owner's personal property should be part of the accounts of his/her business.
4. The checking of, and reporting on, accounts is termed:
   - **a.** Financial accounting
   - **b.** Management accounting
   - **c.** Auditing
   - **d.** Financial management.
5. Name three main financial statements.
6. Name three internal threats to a business's resources.
7. List three functions of the internal auditor.
8. List three functions of the external auditor.
9. What is meant by Generally Accepted Accounting Principles (GAAP)?
10. Name and briefly explain the four fundamental accounting concepts as defined by SSAP 2.

1.2 Value-Added Tax (VAT)

Learning outcomes (Accounting Manual and Computerised 5N1348): 9 (part)
Learning outcomes (Bookkeeping Manual and Computerised 5N1354): 1 (part)

Value-added tax (VAT) is a tax on consumer spending. It is collected by VAT-registered traders on their sales of goods and services within the State to their customers. Each such trader in the chain of supply from manufacturer through to retailer charges VAT on his/her sales and is entitled to deduct from this amount the VAT paid on purchases. The effect of offsetting VAT on purchases against VAT on sales is to impose the tax on the added value at each stage of production – hence 'value-added' tax. The final consumer, who is not registered for VAT, absorbs VAT as part of the purchase price.

VAT rates

The standard rate of VAT is 23%. There are reduced rates of 13.5% and 9% and a zero rate.

In Ireland, the 23% rate mainly applies to goods, such as:

- certain beverages – alcohol, soft drinks, bottled waters, cigarettes
- transport fuels – petrol, auto diesel, motor oil, liquid petroleum gas
- vehicles – cars, lorries, car accessories, tyres, motorcycles, pleasure boats, mobile homes
- consumer goods – adult clothing, adult footwear, jewellery, cosmetics, pottery and glassware, sports goods, stationery, toys, bicycles, CDs/DVDs, computers, electrical equipment, carpets and floor coverings, furniture, soft furnishings, household goods
- hiring/leasing/rental of equipment, vehicles, household goods, DVDs/videos
- certain services – accountancy, advertising, haulage, telecommunications, professional services (e.g. legal), toll roads
- confectionery – sweets, chocolates, ice cream, crisps, peanuts.

Examples of zero-rated goods include:

- most food
- children's clothes and shoes

- books
- oral medicines.

Examples of items at the 9% reduced rate include:

- tourist accommodation
- commercially provided meals, e.g. in hotels, restaurants
- cinema admissions
- hairdressing
- newspapers.

Examples of items at the 13.5% reduced rate include:

- electricity, gas, home-heating oil, fuel for domestic use, e.g. coal, turf, peat briquettes
- new houses and the construction sector
- locally-supplied, labour-intensive services, e.g. car repair and maintenance, small repair services
- certain agricultural and horticultural services.

VAT registration

To register for VAT, a Form TR1 must be completed if the trader is an individual or partnership, or a Form TR2 if the trader owns a company. The form, when completed, should be forwarded to the local Revenue District. Special care should be taken when completing the form to include the name, address, PPSN, business type and the relevant tax types. The form must also be signed and dated.

A trader who supplies goods and/or services is generally required to register for VAT, subject to turnover exceeding certain thresholds. The most common thresholds are €37,500 for the supply of services, and €75,000 for the supply of goods. Some traders are generally not required to register for VAT, although they may choose to do so. These include traders whose turnover does not exceed the thresholds above, and also farmers.

Invoice basis accounting for VAT

VAT-registered persons normally account for VAT on an invoice ('sales') basis. This means that VAT is due when the invoice is issued to the customer, rather than when the customer pays. Also, VAT is claimed by the trader when he/she purchases goods and services, that is, when the purchase invoice is received. However, certain persons may opt to account for VAT on the moneys received ('cash') basis, i.e. by reference to payments actually received by them (see 'Cash basis accounting for VAT' this section).

Right to claim VAT

In computing the amount of VAT payable in respect of a taxable period, a registered trader may deduct the VAT charged on most goods and services that are used for the purposes of the taxable business. No deduction may be made, however, for the VAT on goods and services used for any other purpose. To be entitled to the deduction, the trader must have a proper VAT invoice. These invoices and other records must normally be kept by the trader for six years.

A trader may not deduct VAT on any of the following, even when the goods and services in question are acquired or used for the purposes of a taxable business:

- expenditure incurred on food, drink or accommodation or other personal services for the trader or the trader's agents and/or employees
- entertainment expenses incurred by the trader or the trader's agents and/or employees
- the purchase or hiring of passenger motor vehicles generally (other than motor vehicles held as stock-in-trade, or hired for the purpose of a business, or for use in a driving school business)
- the purchase of petrol other than as stock-in-trade.

Importance of invoices and credit notes

In order for VAT-registered traders to claim VAT on purchases, they must receive a proper VAT invoice from their supplier. It is vital, therefore, that these invoices are properly drawn up and carefully retained. The checking of invoices and credit notes forms a very important part of the periodic examination, which revenue officers may make of a trader's VAT position.

VAT law contains specific requirements for the issue and retention of invoices, credit notes and related documents. Failure to comply with these requirements leaves a trader liable to penalties. Traders who issue invoices and credit notes, and persons to whom these documents are issued, should ensure that the documents accurately represent the transactions to which they refer.

Information required on a VAT invoice

The VAT invoice issued must show:

- date of issue
- invoice number
- full name, address and VAT registration number of the person who supplied the goods or services
- full name and address of the person to whom the goods or services were supplied

- quantity and nature of the goods supplied or the extent and nature of the services supplied
- date on which the goods or services were supplied
- unit price, exclusive of VAT, of the goods or services supplied
- amount of the consideration, exclusive of VAT taxable at each rate (including zero rate), and the rate of VAT chargeable
- VAT payable in respect of supply.

Electronic invoicing

It is open to traders to operate an electronic invoicing system, provided the particulars to be contained in such invoices or other documents are recorded, retained and transmitted electronically by a system that ensures the integrity of those particulars and the authenticity of their origin. The electronic system in use must be capable of producing, retaining and storing invoices and credit notes.

Cash basis accounting for VAT

Under the normal invoice basis for accounting, a trader is liable to account for VAT when an invoice is issued to a customer. Under the cash basis (also called the 'receipts' or 'moneys received' basis) of accounting, a trader is liable to account for VAT when payment is actually received.

A trader must fulfil one of two criteria to be on the cash basis. Either:

- annual turnover does not exceed €1.25 million (with effect from 1 May 2013); or
- supplies are almost exclusively (at least 90%) made to customers who are not registered for VAT, or are not entitled to claim a full deduction of VAT.

In practice, the cash basis of accounting is mainly used by shops, restaurants, public houses and similar businesses, and by any other person supplying goods or services directly to the public. A person or business applying for VAT registration, who wishes to use the cash rather than invoice basis, must apply for permission in writing at the time of registration.

VAT returns

A VAT-registered trader normally accounts for VAT on a two-monthly basis (e.g. January/February, March/April). The return is made on the Form VAT3, together with a payment for any VAT due, and remitted to the Collector-General on or before the 19th of the month following the end of the taxable period. In 2009, the Revenue introduced important changes regarding mandatory electronic filing and payment of taxes. From 1 June 2012, on Phase 4 of Revenue mandatory e-filing requirements, all traders must submit their VAT Return form and payment using the Revenue Online Service (ROS).

They must submit their VAT Return form and payment on or before the 23rd of the month following the end of the taxable period.

From 1 July 2007, the frequency of filing VAT returns was reduced for certain persons on the following criteria:

- For businesses with a yearly VAT liability of €3,000 or less, the option of filing returns on a six-monthly basis is available.
- For businesses with a yearly liability of between €3,001 and €14,400 the option of filing returns on a four-monthly basis is available.

How to complete a VAT3 Return form

The VAT3 Return form records the total value of transactions carried on by the trader over the course of a tax period. The figures representing the transactions carried out should be recorded in the boxes on the ROS system, as follows:

- **T1 Box – VAT on Sales**: This figure is the total **VAT** charged by the trader on sales to customers in the taxable period.
- **T2 – VAT on Purchases**: This figure is the total **VAT** incurred by the trader on purchases of goods for resale (if any) and on expenses incurred for business purposes in the taxable period.
- **T3 – VAT payable**: Where the figure in T1 is greater than that in T2, then the trader has a net liability to Revenue, which is calculated by subtracting T2 from T1.
- **T4 – VAT repayable**: Where the figure in T2 is greater than that in T1, then the trader is entitled to a net refund of VAT, which is calculated by subtracting T1 from T2.

Intra-EU transactions

Where the trader has made supplies of goods to customers in other EU countries, or purchased goods from suppliers in other EU countries, this must be reflected in the VAT3 as follows:

- **E1 – Intra-EU supply of goods:** This is the total value of goods sold to customers in other EU countries.
- **E2 – Intra-EU acquisition of goods:** This is the total value of goods purchased from suppliers in other EU countries.

Where the trader has supplied services to customers in other EU countries, or received services from suppliers in other EU countries, this must be reflected in the VAT3 as follows:

- **ES1 – Intra-EU supply of services:** This is the total value of services supplied to customers in other EU countries.

- **ES2 – Intra-EU acquisition of services:** This is the total value of services received from suppliers in other EU countries.

A Sample VAT3 Return is contained on your Student Resources, which represents the ROS e-filing system.

Review questions

1. Goods were sold at a price of €1,210 inclusive of VAT at 23%. The VAT amount is:
   a. €278.30
   b. €226.26
   c. €757.48.
2. List four situations in which VAT incurred by a taxable person is not recoverable.
3. A person must register for VAT if their annual turnover from the supply of goods exceeds or is likely to exceed:
   a. €37,500
   b. €75,000
   c. €41,000.
4. What information should normally be included in the E1 and E2 boxes of a VAT3 return?
5. VAT is an expense to be suffered by:
   a. companies dealing with goods
   b. all traders dealing with goods
   c. all traders, registered for VAT, dealing with goods
   d. the final consumer of the goods.
6. Aine paid €4,000 to buy equipment from Lorraine and sold it for €5,000 plus VAT at 23% to Sandra who, in turn, sold it for a VAT-inclusive price of €7,050 to James, a customer. Aine and Sandra are VAT-registered, while Lorraine is not. How much VAT would Aine and Sandra have to pay?
   a. Aine €1,150; Sandra €1,318
   b. Aine €1,150; Sandra €1,234
   c. Aine €168; Sandra €1,318
   d. Aine €1,150; Sandra €168