VAT - a Simple Guide

Full Cost Apportionment - Simplified Variant Agreed

Since the release of the High Court decision maintaining there were two separate supplies involved in the dispensing of spectacles, opticians and local VAT officers have been grappling with the problem of how to apportion the income received between the taxable supply of goods and the exempt supply of dispensing.

Introduction

Initially, agreement was reached between HM Revenue & Customs (HMRC) formerly HM Customs & Excise and the optical professional bodies that there were three methods of calculating the apportionment:

- Cost Plus
- Fixed Mark Up
- Full Cost Apportionment.

The first two methods were only ever intended as interim methods to allow opticians to retrospectively recover VAT overpaid and Customs & Excise effectively withdrew their use with effect from 1 January 1998 by the issue of Information Sheet 3/97. This left the Full Cost Apportionment method which many opticians believed only ever applied to the larger optical practices, but was in fact negotiated on the basis that it could be used by all opticians regardless of their size and the legal status of their business (limited company, partnership or sole proprietor).

Separately Disclosed Charging (SDC)

As a result of the withdrawal of the Cost Plus and Fixed Mark Up methods, opticians have been using a method where they separately charge their customers for the supplies of goods and services. HMRC accept this as long as the customer is aware that he is paying for two separate supplies and is informed of the price he is paying for the goods and for the dispensing services.

HMRC do not specify the manner in which this information is provided to the patient but the optician must be able to demonstrate to HMRC that the information is being conveyed even if it is not requested by the patient. The preferred method of conveying the information is on any invoice/till receipt provided to the customer. A business should be able to justify the basis of the charging for the supply of any goods and services to the customer.

The use of SDC is becoming more common in all types of practices as the use of Electronic Point of Sale (EPOS) makes the VAT calculation much simpler. However, in setting up SDC professional advice should be taken in the first instance to ensure full compliance with the various VAT regulations in force.

Full Cost Apportionment (Simplified)

This document aims to explain Full Cost Apportionment and identify the steps needed to produce an apportionment with the use of a fully worked example. The method explained in this document is a variant of the Full Cost Apportionment method originally agreed in Information Sheet 10/98.
1. The Full Cost Apportionment Method

This method utilises the relationship between the cost of making the supply of goods and the cost of making the supply of dispensing services in order to determine the respective selling prices of the goods and dispensing service. It assumes that the relationship between the costs of making the two supplies is the same as the relationship between the two supplies when they are sold to the patient. Essentially this means that the profit margin on the sale of the spectacles is split proportionately between the goods and the dispensing service. If a business is able to provide support for an alternative attribution of the profit between the goods and services, which for example weights the attribution to the professional service, it will be necessary to produce satisfactory evidence to HMRC.

Consequently, in order to operate this method it is necessary to determine the cost of the goods being supplied to the patient and also the cost of providing the service of dispensing the spectacles.

2. Cost of Goods

In establishing the cost of goods, it is necessary to determine the average cost of frames and lenses plus the cost of any glazing which is performed in-house.

a) Frames and Lenses

It is suggested that the initial calculation is based upon the purchases which have been made in a financial year, rather than in a VAT year, as the information should be more readily available.

You should extract from your accounting records for the year in question the following information:

- the number of frames purchased in the year
- the cost of the frames purchased in the year excl. VAT
- the number of lenses purchased in the year
- the cost of the lenses purchased in the year excl. VAT

*Note: Opticians may include in certain instances, and at certain times as part of a promotion, spectacle cases or other items within the total cost of the sale of a pair of spectacles. These items should be excluded for the purpose of this calculation.*
Once the figures have been extracted from the financial accounts an average value of the cost of frames and lenses can be calculated as follows:

<table>
<thead>
<tr>
<th>Cost of Frames</th>
<th>= Average cost of frame</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Frames Purchased</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Cost of Lenses</th>
<th>= Average cost per lens</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Lenses Purchased</td>
<td></td>
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</tbody>
</table>

If it is not possible to identify the number of frames or lenses purchased in the year from the purchase invoice, the total cost of frames and lenses and the number of spectacles dispensed in the year may be used. Whilst this method will not take account of changes in stock it will produce a result which can be used in the Full Cost Apportionment calculation.

b) In-house Glazing Costs

To establish the cost of in-house glazing, it is necessary to determine the cost of labour and consumables used in the glazing process.

The labour cost will be the wages paid to the technician including PAYE and employers National Insurance. Where glazing is undertaken by either an optometrist or DO, an apportionment of their cost should be established by reference to the time spent on glazing.

*Note: Any indirect costs which are incurred by the business, such as general overheads and depreciation on fixed equipment, should not be included for the purposes of this calculation.*

The calculation to determine the average labour cost of glazing is as follows:

<table>
<thead>
<tr>
<th>Hours on glazing</th>
<th>x salary + consumables</th>
<th>+ no. of dispensings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total hours</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

C) VAT Inclusive Costs

It is necessary to add VAT at 20% to the cost of goods in order to correctly apply the formula to the VAT inclusive selling price of the spectacles.
3. Cost of Service

In any practice there may be both an optometrist and a dispensing optician (DO). An optometrist is permitted to carry out sight tests and also dispense spectacles and contact lenses, whereas a DO is only permitted to dispense spectacles. Some DOs hold an additional qualification that permits them to fit and supply contact lenses.

In order to determine the cost of service for the purpose of the Full Cost Apportionment calculation, it is necessary to calculate the costs of the optometrist, DO and also any non-registered person who works under the direct supervision of an optician enrolled with the General Optical Council who can be considered Directly Supervised Persons (DSPs). Once these costs have been established, it will be necessary to determine the involvement in the dispensing of spectacles.

Optometrists and DOs who own the business

In smaller practices, it is common for the business to be owned by the optometrists or DOs who are also the professional staff within the business. In such circumstances, it is necessary to be able to determine the cost to the business of receiving the professional services of the owner. The methodology will be dependent upon the status of the business.

Sole Practitioner and Partnerships

In these types of business, the professional cost can be achieved by using the drawings figures from the financial accounts. In determining the drawings, it is necessary to take account of all the benefits which are received from the business plus any payments which are made by the business on behalf of the individual such as income tax liability. However, this can be affected by various factors, including market conditions and an average should be established by using drawings from the business for the last 3 years.

Limited Company

To determine the direct cost of an optometrist who is a director of a limited company and is actively involved in the provision of professional services, you will need to consider the salary paid as per the financial accounts, plus the payment of any dividend to him, in order to obtain a fair and true position. It is also necessary to include any benefits in kind which are paid to the director such as the provision of a car. It may be necessary to consider the salary and dividends paid over a three year period to obtain an average value.

Employed optometrists, DOs and DSPs

For professional staff who do not own the business, it is necessary to calculate the direct costs of employing the individuals. When calculating the direct cost of optometrists, DOs and DSPs the following principal costs will need to be included:

- Salary
- Employers National Insurance Contributions
- Pension contributions by employer
- Cost of provision of vehicle to optometrists and DO's involved in dispensing of spectacles
- Optical training of opticians and supervised persons
- Professional body subscriptions incurred by the practice
- Professional indemnity costs incurred by the practice
- Recruitment costs

(This is not necessarily an exhaustive list.)
Having calculated the average cost of the professional staff, it is necessary to establish their cost in the dispensing of spectacles. This may be achieved as follows:

**Optometrists**

The optometrist is involved in the dispensing of spectacles and contact lenses and the provision of sight tests. Consequently, it is necessary to determine the proportion of their costs which are attributable to the dispensing of spectacles.

As the optometrist is always involved to some degree in the dispensing of spectacles, there will always be a requirement to apportion their costs between the sight testing and the dispensing.

In the unlikely event that the optometrist maintains a record of the amount of time which they spend on the various activities which they perform, it may be possible to use this record as the basis for determining the involvement of the optometrist in the dispensing process.

However, it must be recognised that time may not be the only factor which needs to be taken into consideration when establishing the value of the involvement of the optometrist in the dispensing process. If an optometrist does not maintain any records, it would be difficult to determine their involvement in the spectacles dispensing process on a time basis due to the complexity and diversity of the tasks which they undertake.

If no time records are maintained, and the maintenance of such records cannot be imposed upon an optometrist, one method of determining the costs attributable to the dispensing of spectacles would be to use the following calculation:

<table>
<thead>
<tr>
<th>Spectacles Income</th>
<th>x</th>
<th>Direct Costs of optometrist in relation to provision of professional services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spectacles, Contact Lens &amp; Sight Test Income</td>
<td></td>
<td></td>
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</tbody>
</table>

The result of this calculation can be substantiated by the optometrist demonstrating their degree of involvement in the dispensing process.

Whether a business wishes to adopt this or an alternative method, it will be necessary to agree this with HMRC.

When determining whether any method is capable of producing an acceptable result, it must be remembered that the method must be based on information which can be readily verified by HMRC. Consequently, it is not possible to use arbitrary percentages on the basis that it is not possible to determine whether they are correct.
Dispensing Opticians

As the DO is usually involved in the dispensing of spectacles and contact lenses, their costs attributable to the dispensing of spectacles can be determined by the following calculation:

<table>
<thead>
<tr>
<th>Spectacles Income</th>
<th>x</th>
<th>Direct Costs of DO in relation to provision of professional services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spectacles and Contact Lens Income</td>
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</table>

Directly Supervised Persons (DSP)

A proportion of the direct labour costs of DSPs who are involved in the dispensing of spectacles can be included in the Full Cost Apportionment calculation. In determining the level of the costs to be included it may be appropriate to use an income based calculation similar to that used for optometrists and DOs but with the denominator being the total of the income which is generated by the DSPs (this is likely to be the total of the spectacles plus accessory income.)

However, the actual percentage of these costs will need to be agreed by the VAT registered optician and HMRC and may vary from practice to practice.

The cost of service should also include any VAT which is incurred in the costs of making the exempt supply of dispensing spectacles.

4. Calculation of income from spectacle sales attributable to taxable supplies

As the costs of supplying both the goods and services have now been calculated, it is possible to determine the amount of VAT due the dispensing of spectacles. This amount of VAT due is achieved using the following formula:

<table>
<thead>
<tr>
<th>Cost of Goods plus VAT at 20%</th>
<th>x</th>
<th>Spectacles income x 1/6 income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs of Goods plus VAT at 20% &amp; Cost of service including VAT</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5. Recalculation

Customs & Excise would not expect a business to have to recalculate their percentages attributable to taxable and exempt supplies, unless there has been a material change to the business or three years have elapsed since the last calculation. A business should refer to any written agreement with HMRC to determine when a recalculation should be undertaken. A material change can include a change in the legal status of the business, expansion of the business and a change in the rate of VAT.
6. For the future
If you decide to implement the Cost Apportionment method, it will be as well to consider whether you need to alter current book-keeping practices so as they will allow you to extract any required information easily.

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