Transactions giving rise to Adjustments to Revenue/Purchases

Caution: This Circular applies only to those entities that are still applying IAS 18 – *Revenue.* Entities that have adopted IFRS 15 – *Revenue from Contracts with Customers* should not refer to this Circular for guidance. Matters on discounts, rebates and extended payment terms are addressed under 'variable considerations' in IFRS 15.

Introduction

.01 The process of using International Financial Reporting Standards (IFRS) implies not only the use of such standards, but also uniformity in the way in which the standards are applied. Increased global usage of International standards focuses attention on the way in which standards should be applied, which in some cases may differ from South African practice.

.02 This Circular has resulted from the International Financial Reporting Interpretations Committee (IFRIC) process and seeks to clarify, for South African preparers, auditors and other users, the treatment that the IFRIC has considered to be clearly required by the standards for certain transactions.

.03 Among the many issues that the IFRIC has considered is items relating to cash discounts, prompt settlement discounts, rebates and extended payment terms.

.04 On these items, the IFRIC has agreed that it does not need to issue an interpretation of the standards, as the appropriate accounting is considered to be clear. The required accounting that it indicated typically gives rise to an adjustment to the amount of revenue recognised on a sale, or the cost of purchase of an item of inventory.

05 In South Africa, it appears that entities may have recognised certain transactions with customers or with suppliers on a basis that is inconsistent with international practise. The South African Institute of Chartered Accountants' Accounting Practises Committee (APC) wishes to explain the requirements of IAS 18(AC 111) – *Revenue* and IAS 2(AC 108) – *Inventories* in the context of the IFRIC discussions.

Scope

.06 This circular only deals with the initial accounting by sellers (buyers) of goods in transactions that involve cash discounts, settlement discounts and other rebates (either given or received), and extended payment terms. The circular only considers the specific topics of cash discounts, settlements discounts, rebates, and extended payment terms to the extent that they were considered by the IFRIC. Other factors such as the subsequent measurement of these discounts and rebates, estimations of contingent rebates and the deferred tax implications are not addressed.

Accounting references

.07 Paragraph 10 of IAS 2(AC 108) states *"The cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition."*

.08 Paragraph 11 of IAS 2(AC 108) states *"The costs of purchase of inventories comprise the purchase price, import duties and other taxes, and transport, handling and other costs…. Trade discounts, rebates and other similar items are deducted in determining the costs of purchase."*

.09 Paragraph 18 of IAS 2(AC 108) states *"An entity may purchase inventories on deferred settlement terms. When the arrangement effectively contains a financing element, that element,* *for example a difference between the purchase price for normal credit terms and the amount paid, is recognised as interest expense over the period of the financing."*

.10 Paragraph 10 of IAS 18(AC 111) states *"The amount of revenue arising on a transaction is usually determined by agreement between the entity and the buyer or user of the asset. It is measured at the fair value of the consideration received or receivable taking into account the amount of any trade discounts and volume rebates allowed by the entity."*

Issues considered by the IFRIC: *Cash Discounts*

.11 The IFRIC considered whether it should provide guidance regarding how a purchaser of goods should account for cash discounts received.

Reason not taken to the IFRIC agenda

.12 Paragraph 11 of IAS 2(AC 108) – *Inventories* provides adequate guidance. Cash discounts received should be deducted from the cost of the goods purchased.

TRANSACTIONS GIVING RISE TO ADJUSTMENTS TO REVENUE/PURCHASES

Impact in South Africa

.13 Many entities in South Africa account for cash discounts received as 'other income'. This treatment would not be appropriate as the cost of goods purchased should be reduced by cash discounts receivable at date of purchase.

.14 Similarly, entities granting cash discounts to customers should reduce the amount of revenue recognised on the date of the sale.

Issue considered by the IFRIC: *Settlement Discounts*

.15 The IFRIC considered:

(a) the application of IAS 18(AC 111): whether discounts allowed for prompt settlement of invoices should be estimated at the time of sale and presented as a reduction in revenues, or should be recognised as financing expense or other operating expenditure;

(b) on the application of IAS 2(AC 108): whether discounts received for prompt settlement of invoices should be deducted from the cost of inventories or be recognised as financing income.

Reason not taken to the IFRIC agenda

.16 On (a), the IFRIC agreed that settlement discounts allowed should be estimated at the time of sale, and presented as a reduction in revenues.

.17 On (b), the IFRIC agreed that settlement discounts received should be deducted from the cost of inventories.

Impact in South Africa

.18 (a) Many entities in South Africa account for settlement discounts allowed to customers as 'operating expenses' when granted (i.e. when the debtor pays). The contention commonly presented is that the debtor is not entitled to this discount unless they pay promptly, and it is the prompt payment that generates the discount and not the sale of the goods. This treatment is not appropriate, as settlement discounts allowed have to be estimated at date of sale and the amount of revenue should be reduced accordingly. This is consistent with the requirement of IAS 18(AC 111) that revenue be measured at the fair value of the consideration received or receivable (IAS 18(AC 111) paragraph 9).

.19 (b) Many entities in South Africa account for settlement discounts received as 'other income' when the creditor is paid). The contention commonly presented is that it is the prompt payment that entitles the buyer to the discount and not the purchase of the goods. This treatment is not appropriate as settlement discounts receivable have to be estimated at date of purchase and the cost of the inventory purchased should be reduced accordingly.

Issue considered by the IFRIC: *Rebates*

.20 On the application of IAS 2(AC 108), the IFRIC considered whether all rebates (besides discounts received for prompt settlement of invoices) should be deducted from the cost of inventories. The alternative would be to treat some rebates as revenue or a reduction in promotional expenses.

Reason not taken to the IFRIC agenda

.21 The IFRIC agreed that IAS 2(AC 108) requires only those rebates and discounts that have been received as a reduction in the purchase price of inventories to be taken into consideration in the measurement of the cost of the inventories. Rebates that specifically and genuinely refund selling expenses would not be deducted from the costs of inventories.

Impact in South Africa

.22 Many entities in South Africa account for all rebates received as 'other income' when received. This treatment may not be appropriate, depending on the terms of the agreement. Grantors of rebates may account for the rebates as 'other operating expenses' when paid, but these may need to be estimated at the time of sale and be shown as a reduction in revenue.

Issue considered by the IFRIC: *Extended Payment Terms*

.23 The IFRIC considered the accounting for extended payment terms, such as the granting of six month's interest-free credit.

Reason not taken to the IFRIC agenda

.24 The IFRIC agreed that IAS 39(AC 133) – *Financial Instruments: Recognition and Measurement* applies to the receivable in such circumstances, and the effect of the time value of money should be reflected when this is material (IAS 39(AC 133) paragraphs AG69-AG82).

Impact in South Africa

.25 Paragraph 18 of IAS 2(AC 108) addresses deferred settlement terms and states that when the arrangement effectively contains a financing element, that element must be recognised as interest over the period of the financing. It also provides an example of a financing element – where there is a difference between the purchase price for normal credit terms and the amount paid.

.26 Many South African entities have contended that extended payment terms do not constitute a financing transaction, especially when such credit terms are considered 'normal' in that industry i.e. the amount paid is the purchase price for 'normal' credit terms.

.27 Furthermore, when cash sales are concluded at the same selling price as those with extended payment terms, the argument is often that the revenue to be recognised must be the same. The contention is that the amount of cash received remains constant irrespective of whether a cash sale or credit sale is made and it does not make sense to reflect a credit sale at the present value of the cash price alternative because this would result in the recognition of a lower amount of revenue than in a cash sale.

.28 Following the reasoning in the IFRIC discussions, these contentions are not acceptable and the effect of the time value of money must be accounted for. When the receivable is raised, IAS

39(AC 133) requires that the receivable be initially recognised at its fair value, and this would take into account the effect of the time value of money. The revenue on the transaction would be recorded at an equivalent amount.

.29 The 'cash price' is not necessarily the 'fair value of the consideration' as envisaged in the accounting standards. Financial reporting systems therefore have to distinguish between cash and credit sales even if conducted at the same price, so that they can account for the different fair values of the considerations.

.30 Similarly, for entities that the purchase goods on extended payment terms, IAS 39(AC 133) applies to the payable that arises. In such cases, the effect of the time value of money should be reflected in the purchases where this is material, i.e. one must record the purchase of inventory (and the recognition of the payable) at the present value of the future cash flows and accrue an interest expense until date of payment.

Conclusion

.31 The APC is aware that up to now in South Africa many entities that receive or allow cash discounts, settlement discounts, rebates and extended payment terms are accounting for these transactions in a manner different from what the IFRIC has communicated is clearly required under IFRSs.

.32 Cash discounts and rebates received (given) should: in the case of the purchaser be estimated upfront and be deducted from the cost of inventories purchased, and in the case of the seller be estimated upfront and deducted from the amount of revenue recognised.

.33 Where extended payment terms are granted, whether explicitly or implicitly, the effect of time value of money should be taken into account wherever this is material, irrespective of other factors such as the cash selling prices of the goods.

.34 Entities should account for any change in terms of IAS 8(AC 103) – *Accounting Policies, Changes in Accounting Estimates and Errors*.

Responsibility

.35 Members should determine the necessary action required in the context of their responsibility.

Johannesburg **I S Sehoole**
May 2006 **Executive President**