Grant Thornton

# IFRS Viewpoint

## Inventory discounts and rebates

Our 'IFRS Viewpoint' series provides insights on applying IFRS Accounting Standards in challenging situations. Each issue will focus on an area where the IFRS Accounting Standards have proved difficult to apply or lack guidance. This issue considers how a purchaser accounts for discounts and rebates when buying inventory.

### What's the issue?

Discounts and rebates can be offered to purchasers in a number of ways, for example trade discounts, settlement discounts, volume-based rebates and other rebates.

Accounting for these reductions will vary depending on the type of arrangement. This IFRS Viewpoint provides our views on the purchaser's accounting treatment for the different types of rebate and discount, along with some application examples.

**Relevant IFRS Accounting Standards**
IAS 2 'Inventories'
IFRS 15 'Revenue from Contracts with Customers'
IFRS 18 'Presentation and Disclosure in Financial Statements'

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## Our view

Below is an overview of the accounting treatment of a variety of discounts:

| Type of discount | Description | Treatment |
|---|---|---|
| Trade discount | A discount granted to customers that operate in the target industry of the vendor | Deduct from the cost of inventories. |
| Settlement discount | A discount granted for payments made within a defined time period | Deduct settlement discounts received from the cost of inventories, such that the inventory and related liability are initially recorded at the net (lower) amount. If a settlement discount is available but not taken, the accounting depends on whether the payment was made within normal credit terms. |
| Inventory-related rebate | A discount granted retrospectively for volume-based rebates | Recognise when it is probable that the rebate will be received and can be measured reliably. Once recognised, the rebate should be accounted for as a reduction in the cost of the related inventories. |
| Other rebates | A rebate that does not, in substance, relate to the purchase of inventory, for example contributions to promotional, marketing or selling costs | The appropriate accounting treatment depends on the substance of the specific arrangement. |

## More analysis

### Trade discounts

IAS 2 'Inventories' requires that 'trade discounts, rebates and other similar items are deducted in determining the cost of purchase'. The treatment of trade discounts is therefore clear.

### Settlement discounts

The treatment of settlement discounts is not specified by IAS 2. However, in November 2004 the IFRS Interpretations Committee (IFRIC) considered this and issued an agenda decision concluding that settlement discounts received should be deducted from the cost of the inventories.

The IFRIC did not provide guidance on accounting for settlement discounts that are not taken. Our view is that inventory purchases for which the supplier offers a settlement discount should be recorded at the transaction price (ie gross of the settlement discount that was available but not taken), provided that the purchase is on normal credit terms. However, if the purchase is on deferred settlement terms and effectively contains a financing element, that element is recognised as a finance cost over the period of the financing. The term 'normal credit terms' is used in IAS 2 but is not defined. Judgement is required to determine whether the purchase is on normal credit terms, as this assessment ultimately drives the accounting outcome.

### Inventory-related rebates

In our view, volume-based discounts should be recognised when it is probable that they will be received and can be measured reliably. Measuring volume-based discounts should be based on the best estimate of the purchase volume expected to be achieved.

When the cost of inventory is subject to uncertainties, the entity should estimate the expected cost in accordance with IAS 2. Therefore, rebates that are probable should be deducted from the cost of inventories and recognised as a receivable or similar asset. The probability of obtaining the rebate should be reassessed at each reporting date if the arrangement remains open. If receipt is no longer probable, then the receivable should be reversed with a corresponding adjustment to inventory for items still on hand and/or cost of sales for items already sold (or other expenses if the reversal relates to previous periods).

If receipt of the rebate is not probable, or the amount cannot be measured reliably, then the inventory should be recorded at its gross purchase price. This assessment should be updated at each reporting date. If the assessment changes, then the rebate should be recognised at this stage (refer to the example below). If at this point some of the related inventory has been sold, then the proportion of the discount relating to those items should be recognised in cost of sales.

The rebate recorded should be based on the number of units purchased and should result in a systematic reduction to the cost of those units.

## Other rebates

It is common in some industries for purchasers to enter into arrangements that involve receiving payments from their suppliers ('supplier payment arrangements'). These arrangements vary widely and can be complex. Some arrangements relate to inventory purchases, while others relate to separate transactions. This IFRS Viewpoint is not intended to provide comprehensive guidance on all such arrangements; however, key considerations are discussed below.

Supplier payment arrangements require careful analysis to determine whether they relate to inventory purchases or to something else. The legal form of the arrangement may not reflect its economic substance. If these arrangements do not relate to inventory purchases, further analysis is required to determine the appropriate recognition, measurement and presentation of any resulting income.

In a November 2004 agenda decision, the IFRIC concluded that rebates that "specifically and genuinely refund selling expenses" should not be deducted from the cost of inventories. For example, if the amounts received from the supplier are to reimburse specific costs incurred by the purchaser, it may be appropriate to offset the income against those costs in the statement of profit or loss to the extent that the reimbursement is consistent with the expenses incurred.

The requirements of IFRS 15 should also be considered in the analysis where relevant. If a supplier payment arrangement involves the purchaser providing goods or services to its supplier that are 'distinct' from the inventory purchases, the arrangement may result in revenue recognition. Such revenue should be recognised in accordance with IFRS 15 when the receiving party obtains control of the goods or services, provided that:

- the goods or services are distinct
- the consideration receivable for such goods and services reflects their fair value, and
- they represent outputs of the entity's ordinary activities.

In some situations, the purchaser may conclude that the first two conditions are met but the goods or services provided to the supplier are incidental to its main revenue generating activities. In such cases it might be appropriate to present the related income in a line item other than revenue.

Any excess of the consideration over the fair value of distinct goods or services should not be recognised as revenue or other income by the purchaser of inventory and should be further analysed. Such excess may represent either a refund of the purchaser's expenses (see the guidance on the IFRIC agenda decision above) or a rebate on the purchased inventory.

If the amount receivable from the supplier depends on the volume of inventory purchased, this is likely to be a strong indicator that such amounts receivable do not represent the fair value of any distinct goods or services provided by the purchaser to the supplier.

If the purchaser is not providing distinct goods or services, the arrangement is likely to relate to inventory purchases, in which case the rebate should be accounted for as a reduction of inventory cost.

Careful consideration of all the facts and circumstances is necessary. Judgement is then required to determine the most appropriate accounting treatment.

**Example 1 – Settlement discount**

A purchaser (Entity P) buys inventory from a supplier (Entity S) on 1 January 20X6. The price is CU 1,000 with a 2.5% discount for settlement within 30 days. Entity P decides not to take advantage of the discount and settles at CU 1,000 on 28 February 20X6.

The purchase was on deferred payment terms and Entity P has determined that it contains a financing element. This judgement is based on the analysis of the circumstances specific to this transaction and the existing market practices in Entity P's jurisdiction.

**Analysis**

Entity P records the inventory net of the discount entitlement. The ultimate payment of the discount is recorded as a finance cost. The respective entries are as follows:

| 1 January 20X6 – initial recognition | Debit (CU) | Credit (CU) |
|---|---|---|
| Inventory | 975 | |
| Current liability | | 975 |

| Period 1 January 20X6 – 28 February 20X6 – accrue finance cost and record settlement | Debit (CU) | Credit (CU) |
|---|---|---|
| Finance cost | 25 | |
| Current liability | | 25 |
| | | |
| Current liability | 1,000 | |
| Cash | | 1,000 |

Note: in principle, the finance charge should be accrued evenly over the period of the liability, based on estimated cash flows.

The accounting outcome would be different if Entity P concluded that the purchase was on normal credit terms. In that case, Entity P would record the cost of inventory at the transaction price of CU 1,000 with a corresponding liability of the same amount. No finance cost would be recorded.

If the impact of settlement discounts is material and the judgement made in relation to the payment terms is determined to be significant, it should be disclosed in the financial statements.

**Example 2 – Volume rebate**

A purchaser (Entity P) buys inventory from a supplier (Entity S) at a basic unit price of CU 10 per unit, fixed for the year 20X6. Entity S agrees that if Entity P makes total purchases of at least 10,000 units in 20X6, it will pay a rebate of CU 5,000 (maximum). At the beginning of the year Entity P's forecast purchases are 8,000 units for the year. However, at 30 June 20X6 Entity P revises its forecast to 11,000 units.

At 30 June 20X6 Entity P has purchased 5,200 units, of which 3,900 have been used/sold. The remaining 1,300 are held in inventory at a cost of CU 13,000.

**Analysis**

At 30 June 20X6, the adjustment to inventory cost has become probable. The revised best estimate of cost per unit for the first 10,000 units is:

(CU 10 × 10,000 units – CU 5,000)/10,000 units = CU 9.50

Note: this calculation is made only for the first 10,000 units because any purchases in excess of that figure do not generate further rebate.

The cost of the 5,200 units purchased at 30 June 20X6 should therefore be adjusted downwards by CU 0.5 per unit. Because 75% of the units have been sold (3,900 / 5,200 = 75%), a proportion of the rebate recognised should be recorded in the income statement (cost of sales). The respective entries are as follows:

| 30 June 20X6 – record probable rebate | Debit (CU) | Credit (CU) |
|---|---|---|
| Rebate receivable | 2,600 | |
| Inventory | | 650 |
| Cost of sales | | 1,950 |

Note: in this example, the rebate is allocated to the first 10,000 units, reflecting the fact pattern that purchases beyond this level do not give rise to additional rebates. Consequently, units purchased in excess of the threshold are recorded at the gross price of CU 10.

However, other systematic allocation approaches may be acceptable depending on the facts and circumstances, provided they are applied consistently and reflect the expected economics of the arrangement.

## How we can help

We hope you find the information in this article helpful in giving you some insight into aspects of accounting for inventory discounts and rebates. If you would like to discuss any of the points raised, please speak to your Grant Thornton contact or visit **www.grantthornton.global/locations** to find your local member firm.

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