Grant Thornton

Technical Accounting Alert

Inventory discounts and rebates

Introduction

This alert discusses methods of accounting by the purchaser for discounts and rebates on inventory purchases.

Relevant standards

References are made to standards issued by the International Accounting Standards Board. The Australian equivalent to each standard included in this alert is shown below:

International Standard reference	Australian equivalent standard
IAS 1 Presentation of financial statements	AASB 101 Presentation of financial statements
IAS 2 Share-based payments	AASB 2 Share-based payments
IAS 18 Revenue	AASB 118 Revenues

Overview

Trade discounts should be deducted from the cost of inventories (IAS 2.11).

Settlement discounts (ie discounts for prompt payment) should be deducted from the cost of inventories, such that the inventory and related liability are initially recorded at the net (lower) amount. If the purchaser does not take advantage of the discount, the additional amount paid should be recorded as a finance charge since a settlement discount is effectively a financing arrangement and should be accounted for accordingly.

Contractual rebates that are related to inventory purchases (eg retrospective, volume-based rebates) should be recognised once receipt is **probable**.

Once recognised, the rebate should be recorded as a reduction to the cost of the related inventory. To the extent that the inventories have already been sold (or used in production that has been sold) that part of the rebate is recorded in the income statement (as a reduction of cost of sales in a presentation of expenses by function). The rebate is recognised to the extent that the related volume target has been met.

Other rebates that do not in substance relate to inventory purchases (eg contributions to promotional costs) should not be deducted from the cost of inventories. There are many types of rebate arrangement, and the appropriate accounting treatment will depend on the specific arrangement.

Rebates received in exchange for services rendered in the course of the entity's ordinary activities are within the scope of IAS 18 (IAS 18.1 and 7). Certain other rebates give rise to "other income" rather than revenue. In those cases, the principles of IAS 18 are useful guidance in developing an accounting policy.

It is not generally appropriate to offset income from rebates against promotional costs (see paragraph 32 of IAS 1 Presentation of Financial Statements).

This alert does not address accounting by the supplier for discounts and rebates allowed. IAS 18 specifies that the amount of revenue recognised should take account of those factors (IAS 18.10).

Examples

Example 1- Settlement discount

Purchaser P buys inventory from supplier S on 1.1.X1. The price is $1,000 with a 2.5% discount for settlement within 30 days. P decides not to take advantage of the discount, and settles at $1,000 on 28.2.X1.

Analysis

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:

1.1.X1 - Initial recognition	Debit	Credit
Inventory	$975	
Current liability		$975

Period 1.1X1 - 28.2.X1/accrue finance cost and record settlement	Debit	Credit
Finance Cost	$25	
Current liability		$25
Current liability	$1000	
Cash		$1000

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

Example 2- Volume Rebate

Purchaser P buys inventory from supplier S at a basic unit price of $10 per unit, fixed for the year 20X1.

S agrees that if P makes total purchases of at least 10,000 in 20X1, it will pay a rebate of $5,000 (maximum). At the beginning of the year P's forecast purchases are 8,000 units for the year.

However, at 30.6.X1 P revises its forecast to 11,000 units.

At 30.6.X1 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 $13,000.

Analysis

At 30.6.X1, the adjustment to inventory cost has become probable. The revised best estimate of cost per unit for the first 10,000 units is:

($10 x 10,000 units - $5,000)/10,000 units = $9.50

(**Note:** This calculation is made based only on the first 10,000 units because any purchases in excess of that figure do not attract any further rebate.)

The cost of the 5,200 units purchased at 30.6.X1 should be therefore be adjusted downwards by $0.5/unit. Because 75% of the units have been sold, a proportion of the rebate recognised should be recorded in the income statement (cost of sales). The respective entries are as follows:

30.6.X1 - Record Probable Rebate	Debit	Credit
Prepayment	$2,600	
Inventory		$650
Cost of Sales		$1,950

Note: Subsequent inventory purchases up to the first 10,000 units are recorded at $9.5/unit as long as the rebate continues to be probable. Once the 10,000 threshold is exceeded the cost per unit reverts to $10.

Further information

For further information on any of the information included in this TA alert, please contact your local Grant Thornton Australia contact or a member of the National Audit Support team at NAS@grantthornton.com.au