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Accounting practice regarding discounts. Limitations and actions for a modern legislation

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Abstract

Revenue is an important indicator for the users of financial statements in their assessment of an entity's financial position and performance. Therefore, the applicable regulations regarding the recognition and measurement of revenues play an important role in shaping the corporate image.

This article focuses on some specific accounting transactions under Romanian GAAP (The Order of the minister of public finance no. 1802/2014) by comparing the accounting treatment with that in compliance with IFRS 15 Revenue from contracts with customers. Whenever it was considered necessary, there were presented the new tax requirements - according to the new Tax Code in force from January 1st, 2016. This new standard intends to cover the gaps from other previous standards (IAS and IFRS) or their respective interpretations (SIC and IFRIC) such as IAS 18 Revenue and IAS 11 Construction contracts.

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Introduction

Given the importance assigned by the users of financial statements to financial performance indicators, in general, and particularly revenues, the legislation affecting the value and structure of revenues impact an entity's performance evaluation. At this time, Romanian companies organize their accounting system either on the basis of the local accounting regulations, in accordance with the European Directives, or by conforming to the International Financial Reporting Standards. Any and all differences between the two accounting and reporting systems are able to affect the users' assessments of company performance, especially if they are associated with an important component of revenues, such as revenues from contracts with customers.

The IFRS 15 Revenue from contracts with customers encloses a better revenue recognition model and it offers more information and guidelines than the previous standards. It also covers areas that were not treated with sufficient clarity or not completely covered by the provisions from the previous standards. This new standard supersedes some of the previous ones, such as IAS 11 Construction Contracts, IAS 18 Revenue, IFRIC 13 Customer Loyalty Programs, IFRIC 15 Agreements for the Construction of Real Estate, IFRIC 18 Transfers of Assets from Customers and SIC-31 Revenue - Barter Transactions Involving Advertising Services. The Romanian accounting regulations, applicable to entities that did not implement the International Financial Reporting Standards, also include new provisions that affect the recognition of revenues from contracts with customers, and particularly the discounts granted to customers.

Consequently, in the content of the paper there are presented some particular cases about the recognition of revenues from contracts with customers, aiming to provide a practical and recent perspective on this topic. The analysed examples focus on the matter of discounts, since it was significantly affected by the recent legislative change. The article is ended with the authors' interpretations, conclusions and recommendations, based on their research and professional experience.

1. Transactions involving financial discounts

In the following paragraphs, there are presented some of the transactions that are common and frequent in marketing practice. Taking into consideration the vastness of the topic, the choice was made to present only some of the transactions, aiming to provide a thorough analysis, to answer certain questions and, at the same time, to initiate debates. The selected transactions are presented from both the perspective of Romanian accounting regulations (the updated Order of the Minister of Public Finance No. 1802/2014 – OMPF 1802/2014) and in terms of International Financial reporting standards, namely the IFRS 15. Whenever it was considered relevant, there were presented the main aspects of a fiscal nature, in accordance with the new Fiscal Code in force starting with January 1st, 2016.

1.1. Sales of goods or services involving the granting of discounts for immediate payment or payment before maturity

Within the commercial relationships between suppliers and customers, parties may enter clauses into the commercial agreements which grant customers a discount for payment within a well-defined timeframe. The manner in which such discounts can be treated by the entities observing the local regulations in accordance with the European Directives and by the entities which implemented the IFRS is presented in full detail in the following paragraphs.

Accounting treatment from the IFRS 15 perspective

If the seller gives a discount for immediate payment or payment within a certain period of time, then a part of the amount that would be collected is variable, due to the fact that there is no certainty about the payment in the conditions that generate receiving the discount. The company's management will estimate the discount to be applied, based on previous experience and on the number of customers. Typically, these values are not significant from the perspective of financial statements. This discount affects the seller's turnover or the buyer's purchase cost.

Accounting treatment from the national regulations perspective

According to art. 77, para. (1) of the appendix to the order 1802/2014, the financial discounts are granted for settlement and payment of debts before the normal date of maturity. Whatever the period covered by the discounts, in the accounting records of the supplier they are accounted for as expenses of the period (account 667 Expenses on discounts granted), while in the accounting of the customer they represent income of the period (account 767 Income from discounts obtained). In other words, the reductions granted/received for the receipt/payment of debt before maturity - no matter the period covered by the discounts – are not diminishing the turnover, in the case of the seller, or the purchase cost, in the case of the buyer. They are only impacting the accounting results of the financial activity.

1.2. Sales of goods or services involving a significant financial component

Accounting treatment from the IFRS 15 perspective

There may be situations where there is a significant gap between the moment of transferring goods/services to the buyer and the moment of the payment. The standard requires the management of the company to adjust the transaction price, when the transaction incorporates a significant financial component, in order to reflect the time value of money, so that the amount recognized as income from sales/services to be comparable with the price that would be used if the buyer would pay at the moment of transfer of risks and benefits of the goods or when considering that the service was actually rendered as agreed (IASB, para. 60).

The transaction under review should include *a significant financial component*, a fact that the entity must determine by considering various factors, among which we can mention the following (the list does not have a limitative character):

(i) The amount to be paid by the customer is substantially different from the amount which would be paid when the transfer of goods takes place or immediately, under the existing contractual agreement;

(ii) The elapsed time between the delivery of goods and the payment;

(iii) The interest rate, implicit or explicit, specified in the agreement between the parties by comparison with the market interest rate (IASB, para. 61). If there is a financial component, then this will have to be reflected separately or as financial income or expense. The amount of the financial component will be determined in accordance with IFRS 9.

Accounting treatment from the national regulations perspective

The order no. 1802/2014 does not explicitly require that the time value of money be part of the adjustment of the income from sales of goods/ providing of services and the financial component to be shown separately.

2. Transactions involving trade discounts

There may be contractual agreements whereby the seller:

a. Pays the buyer various amounts of money for services provided by the buyer (e.g. shelf fees, fees for favourable display positions, fees for providing sales reports regarding the points of sale etc.);
b. Grants trade discounts which are reflected in shelf prices, so that the final consumer can purchase products at lower prices, or grants trade discounts on the basis of vouchers;
c. Participates in marketing and advertising campaigns alongside the customers;
d. Provides free products to stimulate sales (2 pieces for the price of one) or for product testing at the point of sale (e.g., provision of samples, testers etc.).

Marketing practices may be different and sometimes complicated, which generates difficulties in terms of the accounting recognition of the associated transactions. There are also tax implications, as it will be subsequently discussed.

2.1. Transactions requiring the seller to make payments to the customer

Accounting treatment from the IFRS 15 perspective

The standard requires the entity to determine whether those amounts paid or payable represent either a price discount, or payment for a service or good received by the seller from the customer. The standard provides guidance on which entity determines the category of the transaction (IASB, para. 26-30).

It can be stated that the good or the service is deemed to be distinct if the customer sells it separately and on a regular basis or the entity may receive the good or the service, either on their own or together with other resources available to him. In these cases, the accounting of the service or asset received will be as such as it would have been acquired from a third party in the normal course of business. Services will be recorded as expenses or, where appropriate, capitalized in accordance with IFRS.

In all the other cases, the payments made or to be made by the vendor are considered trade discounts.

Accounting treatment from the national regulations perspective

The accounting and the disclosure of the items from the Balance Sheet and from the Income Statement are performed taking into account the economic substance of the transaction or of the commitment. Compliance with this principle aims at the faithful/fair representation in accounting and in the financial statements of transactions, in line with the economic reality, highlighting the rights, the obligations and the risks associated with them according to art. 57, para. (1) of the appendix to the Order no. 1802/2014.

The legal form of a document must be consistent with the economic reality. According to art. 57, para. (3) of the appendix to the Order no. 1802/2014, whenever there are differences between the substance or the economic nature of a transaction and its legal form, the entity will account for the transaction in compliance with their economic substance.

At art. 76, para. (7) of the appendix to the Order no. 1802/2014 there are exemplified the following categories of trade discounts:

(i) rebates - received for quality defects and are determined by reference to the selling price;

(ii) remises – received for higher volumes in sales than the volumes agreed with the seller, or if the buyer has a preferential status; and

(iii) allowances - discounts which are determined based on the entire volume of transactions with the same third party, during a given period of time.

It can be noticed that there are no mentions and examples leading to the recording of payments, made or to be made by the seller, for services or goods received from customers as trade discounts. Therefore, it must be considered the economic reality and the economic substance of the transaction.

The Romanian tax legislation perspective

According to art. 319, para. (20), letter i) of the new Fiscal Code, it is mandatory that the invoice includes the following information: [...] the tax base of goods and services or, where appropriate, the advances invoiced for each share, exemption or non-taxable transaction, the unit price, excluding tax, and rebates, remises, allowances and other discounts, if they are not included in the unit price.

Also, the art. 286, para. 4a) of the Fiscal Code states that the tax base of VAT does not include rebates, remises, allowances, financial discounts and other types of discounts granted directly by suppliers to their customers on the date the tax becomes chargeable. For the price discounts granted after invoicing, art. 287c) of the Fiscal Code provides that the taxable amount is adjusted/reduced if the rebates, remises, allowances and other types of discounts are granted after the delivery of goods or services. Moreover, the methodological norms in force for the application of the art. 286 of the Fiscal Code are conditioning the non-inclusion in the taxable base only *if there are granted directly to the benefit of the customer and they are not, in fact, the remuneration for a service or a delivery.* In other words, the seller *will not record as discounts* the payments made or to be made for services or deliveries made by the client; the seller is required to record the services received or the deliveries of goods as expenses in accordance with the *contractual terms, support documents and the invoice issued by the customer.* According to the example from the legislation, the seller may grant - during promotional campaigns –trade discounts to the final consumer, via traders, only based on vouchers.

2.2. The seller pays the customer a certain amount to get a favourable position in the sale outlets

Such a transaction arises, for example, when it is intended to acquire a 3 shelves display in each sale outlet for a certain make-up brand (X).

Accounting treatment from the IFRS 15 perspective

Analysing the Standard's provisions in relation to the conditions under which it can be considered that a distinct service/good was received, it can be concluded that, in this case, the seller does not receive a distinct service and therefore he can treat these payments as a price discount.

Accounting treatment from the national regulations perspective

The order no. 1802/2014 does not include separate provisions to determine the conditions under which it may be considered that a distinct service/good was received. Therefore, it would be appropriate for such payments to be recorded as expenses when they are incurred, taking into account the accrual accounting convention.

The fiscal perspective in accordance with Romanian regulations

If we consider the foregoing stipulations of the Fiscal Code, we cannot reduce or adjust the VAT base if the discounts constitute, in fact, *the remuneration for a service or a delivery.* In order for these expenses to be deductible for tax purposes, the principle introduced by art. 25 para. 1) of the new Fiscal Code must be applied; establishes the deductibility rules for the expenses incurred during the normal course of business, as well as the contractual terms agreed upon by the parties and the support documents that justify the actual rendering of services.

2.3. The seller and the customer jointly participate in campaigns to promote products by publishing advertisements in magazines

The case under review is that when the customer initially bears the entire cost of the advertising campaign, and subsequently is expected to send an invoice to the seller to cover part of the costs.

Accounting treatment from the IFRS 15 perspective

Analysing the provisions from the Standard regarding the conditions under which it can be considered that a distinct service/good was received, it can be concluded that, in this case, the seller receives a distinct service because the customer used a third party service. The seller could have obtained directly the service from the entity that publishes the magazine. In conclusion, the services will be recorded as expenses as they are incurred.

Accounting treatment from the national regulations perspective

The previous observations (2.2) are also valid in this case, meaning that these services will be registered as expenses when they are incurred. In our opinion, for these cases, it is relevant to analyse some tax issues that depend on the price used by the customer for the re-invoicing of the services, meaning that there may be two options:

a. The customer uses the same price for which he acquired the advertisement from the third party when he sends the invoice (a situation known as "*commissioner structure*" from the VAT perspective) and
b. The customer invoices directly, at a higher price.

In our opinion the first situation is the one that may cause some problems in practice, which makes us to provide details for the following aspects. In the case of a *commission contract*, the commissioner is, in fact, an intermediary between a seller (supplier) and a buyer. The commissioner may:

a. Only issue commission for any intermediation service to any of the two parties or to both;
b. Receive *invoices on his own behalf* from the supplier and subsequently *issue invoices addressed to the buyer*. In this case the commissioner becomes a buyer-reseller ("commissioner structure ").

The *cumulative conditions* under which the commissioner structure can be applied are important, as it follows (p. 31 (5) - (6) of the application norms of art.286, para. 3 of Fiscal Code):

(i) re-invoiced deliveries of goods or rendering of services *are not part of the commissioner's economic activity ;*
(ii) the commissioner *does not recover more than the expenditure incurred*, but he may recover less;
(iii) to the extent that the commissioner can prove that the only goal is the re-invoicing of expenses, then he is not bound to have previously declared as an

operating activity the rendering of services which he re-invoices.

In the case of the commissioner structure, the buyer-reseller has the right to deduct the VAT related to the rendering of services/purchases of goods that will be re-invoiced, in accordance with the legislative provisions, and is required to collect the VAT for the taxable transactions. Please note that there may be situations - such as those involving tax expenses or incidental expenses, which fall under the commissioner's responsibility for the operations carried out - when the commissioner structure does not apply.

The commissioner will also consider the p. 432 of the appendix to the Order no. 1802/2014, according to which "amounts collected by an entity on behalf of third parties, including the case of agent contracts, commission or commercial mandate contracts signed in accordance with the law, do not constitute income from the operating activity, even if in terms of VAT the persons acting on their behalf are considered buyers - resellers. In this situation, the revenues from the operating activity are the fees payable".

2.4. The seller (distributor) agrees to bear part of the costs of a price discount campaign practiced by the customer (reseller) in their own stores

As a result of such an agreement, the final consumer (the direct customer of the reseller) receives a discount to the price commonly applied to the shelf.

Accounting treatment from the IFRS 15 perspective

Analysing the provisions of the Standard, it can be concluded that such a payment may be recorded by the seller (distributor) as if it were a trade discount granted directly to his customer (reseller). In other words, payments related to such discounts - granted indirectly, through the reseller, to the final consumer (the reseller's customer) - are not treated differently from those that are granted by the seller (distributor) directly to its customer (reseller).

Accounting treatment from the national regulations perspective

The Order no. 1802/2014 makes no distinct reference to the situation when a seller (distributor) grants indirect trade discounts – through his client (reseller) – to the final consumer, which is, in fact, the reseller's customer.

However, some stipulations of the Fiscal Code should be taken into account to avoid potential tax risks. Thus, returning to the previous aspects on the reduction or adjustment of the VAT tax base, we emphasize the following issues that must be considered cumulatively:

- Price discounts are not included in the taxable amount *if they are granted directly for the customer's benefit* – in our case it might be interpreted that these discounts are not given directly to the customer (reseller), but in fact are granted indirectly – through the reseller – to the final consumer, who benefits from an "in store" discount;
- Price discounts are not included in the taxable amount if they are granted directly for the customer's benefit and *are not*, in fact, *remuneration* for a service *or a delivery* – in our case it might be interpreted that these discounts represent *the payment for a delivery namely the delivery which the customer (reseller) makes to the final consumer,* in the sense of offering to the latter a product at a lower price;
- There is an example in the content of the rules for the application of art. 286 from the Fiscal Code where manufacturers/distributors may grant, based on vouchers and in certain conditions, trade discounts to final consumers via traders (buyers - resellers).

In our opinion, this type of operation, common in marketing practice, should be regulated more clearly to avoid any risk of wrong calculation of debits and accessory amounts for VAT and income tax purposes.

2.5. The seller delivers goods to customer and the customer has the right of return

Within the marketing practice there can be found contractual agreements between the buyer and the seller in which, together with the transfer of rights and obligations on property, the customer is granted the right to return the product for various reasons, such as: deterioration of the product over time, changing the product range with a new one, ending of the contract etc. The return operation can generate several situations:

a. The client is entitled to return, entirely or part of the amount originally paid for the goods;
b. The customer can receive a discount invoice (*a credit note*) which will diminish future payments made within his relationship with the seller;
c. The client is entitled to receive another asset in exchange for the returned one; or
d. A combination of the above.

In these cases, it is important to determine the amount of revenues recognized by the seller, taking into account his client's rights of return and the probability of return.

Accounting treatment from the IFRS 15 perspective

The Standard encloses, within the appendix (The Implementation Guide) stipulations related to sales accompanied by the right of return (para. B20 - B27). In the case of transfers of goods, when the right of return exists, or the rendering of certain services, subject to a possible refund, an enterprise should recognize the following:

(i) Revenues for the assets transferred in the amount of the value that the entity considers it is entitled to; therefore, the entity would not recognize revenue for the goods expected to be returned;
(ii) A debt to be repaid; and
(iii) An asset, simultaneously with the cost of goods sold, to reflect the seller's right to collect the goods from the customer in order to establish the debt to be repaid.

The entity must also consider the possibility that the condition of returned goods may be significantly different from their condition at the time of delivery, even with the risk that the goods cannot be used further. Under these circumstances, the value of the recognized assets will have to be the carrying amount of the assets at the time of sale, minus any impairment or necessary costs of recovery. The debt to be repaid and the asset recognized at the date of return must be presented as separate items in the financial statements. The entity *will measure and adjust accordingly*, at the date of the financial statements, the expected level of returns and related debt, by appropriately changing the level of income.

Moreover, the value of the recognized asset will change whenever the debt changes, or whenever there are indications that an impairment of value exists. If the entity cannot estimate the level of returns, revenues will not be recognized until the date on which the estimation can be reasonably made, date that may correspond with the end of the period within which a customer has can return the goods.

Accounting treatment from the national regulations perspective

In terms of returns, we considered the provisions of point 330, para. (1) and (2) of the appendix to the Order no. 1802/2014, relating to the accounting treatment for goods for resale/finished goods returned by the customers. Thus, if the return of goods takes place in the same financial year in which the selling transaction took place, than there must be adjusted the amounts recorded at the time of sale and removal from stock in the receivables, revenues, expenses and inventories accounts.

If the amounts involved are known at the balance sheet date, then the adjustment must be recorded at the balance sheet date, even in the absence of an invoice. VAT treatment in these cases is specified by the legislation.

In respect of the presentation value of an asset in the financial statements, it is indicated that the carrying amount of an asset is the amount after deducting the accumulated depreciation/amortization and the accumulated impairments (see section 82 from the appendix to the Order no. 1802/2014).

It is noted that the international standard is more restrictive than the national legislation, in the sense that management is required to make an estimate of returns. National legislation calls for the recording of returns only if the amounts involved are known at the balance sheet date.

2.6. The seller delivers goods to the customer and the customer seeks to replace the goods with similar ones, in terms of quality and price

Accounting treatment from the IFRS 15 perspective

The standard clearly states that the change made by the client of a good with another one of the same kind, quality, condition and price is not considered a return and therefore it does not involve any adjustment to the transaction price (IASBa, para. B26). The right to change one good with another, in the aforementioned conditions, must be perceived as the right to return, under warranty, a product that does not function properly.

Accounting treatment from the national regulations perspective

The accounting regulation (order no. 1802/2014) does not distinctly present the case, but it mentions that any transaction is recorded at the time it is carried out in a support document (p. 314, para. 2-3). It is also mentioned that revenues and expenses that resulted directly and simultaneously from the same transaction are recognized in the accounts simultaneously, through direct association between the costs incurred and the revenues gained, with distinct disclosures of such revenues and expenses (p. 53, para. 3).

In practice, this operation is reflected by a return, followed by a delivery. There are no changes in revenues, due to the fact that the selling price is the same, but there may occur changes in the cost of goods sold if the acquisition cost of the goods is different (for example, the goods were purchased from external partners, at different times, and the exchange rate used and the date of receipt is different).

Conclusions

Each entity must establish its own business strategy, by ensuring that in drafting the commercial contracts there are primarily identified the limits and conditions outlined by the commercial legislation. Typically, an entity's trade policies cannot be limited to any accounting or tax legislation, since it is the result of implementing the best trade rules and practices, in compliance with the relevant legislation. Therefore, a major role in shaping trade policies is awarded to the legal department. Even if both the tax and the accounting legislation have defined substance over form as a fundamental principle, we believe that any valid contractual stipulation must be applied strictly throughout the duration of the commercial contract. In addition, the accounting and tax treatments must be configured from the design phase of the commercial contract, precisely to ensure the conformity of the transactions carried out by the entity with the provisions of the Tax Code and the Order no. 1802/2014.

The next step entails the introduction of the aforementioned treatments into the accounting and tax policies textbooks, starting from the taxonomy of discounts used in transactions, and continuing with the procedures for the preparation, circuit and use of the corresponding accounting and financial documents, the measurement and the entering of discounts into the accounting records etc.

From a fiscal perspective, there should be considered at least the aspects related to the impact of price discounts on the taxable amount in terms of VAT and income tax, because the discounts adjust by diminishing the value of goods and services, either at the time of the original transaction, or subsequently.

A comparative analysis of the stipulations of IFRS 15 and the national accounting regulations leads us to discover significant differences in the regulation of practical issues, by reference to the actual conditions in the economy. Therefore, we provided various solutions for the recognition and measurement of price discounts.

Even if the Romanian legal and economic practices are saturated with the use of numerous types of discounts, we consider that legislation appears to be dense, rigid, inadequate and generally interpretable. For example, most marketing practices and general rules of marketing are regulated by the Government Ordinance 99/2000 on the marketing of products and services. The terminology and marketing practices are not assimilated into the accounting legislation, which is far from being connected with the current economic realities, and it is also providing limited and general exemplifications. Additionally, the new provisions in the accounting regulations in terms of trade and financial discounts that cover the entire value of goods and services may lead to erroneous interpretations regarding the sale at a loss, and also to the mistaken separation of current and accrued revenues. Taxation enforces different and uncorrelated regulations that may lead to the impossibility of using modern and flexible marketing practices, and also to major risks of tax and contributions adjustments.

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