Nexia SAB&T Training and Technical

Identifying if a Revenue or Purchase Transaction contains a financing element

There are different interpretations as to when one should "discount" revenue or purchases. There are two totally different views - the first one being that discounting begins on the day after the recognition of a sale or purchase and the second one allows for the concept of "extended payment terms" beyond "industry norms". **Note: This does not apply to debtors or creditors.**

This issue deals only with the initial identification of a financing component by sellers or buyers of goods in transactions that possibly contain financing elements. The assessment of whether the financing component should be separately identified and recognised – and the related determination of the sale and purchase price – should be performed on initial recognition at a contract or transaction level. This issue does not provide guidance for the application of transactions falling within the scope of IFRS 15.

Identification whether a transaction contains a financing element

The following should be considered in determining whether a transaction contains a financing element:

1. Differential pricing between the cash payment price and the price paid on deferred settlement terms;
2. Settlement terms deferred beyond industry norms and practice;
3. The date from which an entity is entitled to levy interest on overdue payments;
4. The existence of a transaction initiation process and credit assessment process;
5. Any collateral required for the transaction or payment;
6. A substantial amount of the transaction price is variable, the variability is outside the control of both parties, and the parties have decided to delay payment until a substantial amount of the variability is removed;
7. The business purpose for the different timing between delivery of the goods/ services and the payment; or
8. Volume of credit sales in relation to cash sales.

Example: View 1

Entity A sells goods to Entity B for R 1 000 on 30-day payment terms and expects payment in 30 days. Entity A does not charge its customers interest. Entity A has determined after considering qualitative factors that a financing element does not exist as the selling price will remain at R 1 000 at 30 days. Entity A should therefore recognise revenue for the sale of goods of R 1000. The following journal entry at transaction date is required.

At the transaction date: Entity A should record revenue at the fair value.

Account	Debit	Credit
Receivable	1 000	
Revenue		1 000

Example: View 2

Entity A sells goods to Entity B for R 1 000 on 30-day payment terms and expects payment in 30 days. Although Entity A does not charge its customers interest, as a result of recent regulatory findings they have deemed it prudent to follow regulatory advice which is that discounting begins on the day after the recognition of a sale or purchase. If one assumes that the interest rate is 12% then it would be 1% for 30 days. The present value or sale price at initial measurement would be R 990 and the financing component would R10. Entity.

The following journal entry at transaction date is required.
At the transaction date: Entity A should record revenue at the fair value.

Account	Debit	Credit
Receivable	990	
Revenue (R1,000/1+[12%/365 days])		990
Receivable	10	
Interest Received		10

Note: Neither view is right or wrong. It is important to verify each transaction by evaluating each of the 8 considerations as indicated as per "identification whether transaction contains a financing element" above.

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Example – Financing Component in Revenue transaction on "extended credit terms"

The Entity A provides services to Entity B. The services are invoiced for R1,500 and the payment is due in 90 days from invoice date. Invoice date is 15 June 2018. Normal credit terms for this type of service are **30 days**. Entity A does not charge Entity B any interest.

However, the transaction is in substance a financing transaction due to the payment being **deferred beyond normal credit terms**. Assume that the client would have paid 9% interest for 90 days' payment terms if the client obtained the service from another supplier. **Reporting date is 30 June 2018**. The following journal entries are required.

At transaction date: Entity A should record revenue at the fair value.

15 June 2018	Debit	Credit
Receivable	1,478	
Revenue (R1,500-(R1500 x (9%/365) x 60 days)		1,478

Thus the difference between the fair value (R1,478) and the nominal amount (R1,500) is interest (R22). This interest is recognised over the deferred payment term, which in this example is 60 days (90 days' payment less 30 days' normal terms).

At reporting date:

15 days has lapsed since transaction date which is still within the 30 days' normal credit term period thus no interest is recognised at reporting date.

Journal entries after reporting date: 30 days has lapsed after the 30 days' normal credit term period. Normal credit term period ended 15 July 2018. Interest should be recognised after30 days as follows:

14 August 2018	Debit	Credit
Receivable	11	
Interest (R1,478 x (9%/365) x 30 days)		11

60 days has lapsed after the 30-day normal credit term and 30 days has lapsed since interest was last recognised. Interest should now be recognised as follows:

13 September 2018	Debit	Credit
Receivable	11	
Revenue (R1,478 x (9%/365) x 30 days)		11

Total interest earned for the 60-day period exceeding normal credit terms is R22 (R11 + R11).

Example – Financing Component in Purchases transaction on "extended credit terms"

The Entity A purchases goods from Entity B. The goods cost R2,000 and the payment is due in 60 days from invoice date. Invoice date is 1 June 2018. Normal credit terms for this type of service are **30 days**. However, the transaction is in substance a financing transaction due to the payment being **deferred beyond normal credit terms**. Assume that the company would have paid 9% interest for 60 days' payment terms if it purchased the goods from another supplier. **Reporting date is 30 June 2018**. The following journal entries are required.

At transaction date: Entity A should record expenses at the fair value.

1 June 2018	Debit	Credit
Expenses (R2,000-(R2,000 x (9%/365) x 30 days)	1,985	
Payable		1,985

Thus the difference between the fair value (R1,985) and the nominal amount (R2,000) is finance cost (R15). This interest is recognised over the deferred payment term, which in this example is 30 days (60 days' payment less 30 days' normal terms).

At reporting date:

30 days has lapsed since transaction date and therefore finance cost is recognised at reporting date.

30 June 2018	Debit	Credit
Finance cost (R1,985 x (9%/365) x 30 days)	15	
Payable		15