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Tolerance is the Foundation of Success, Profits are the Bond of Relationship: Case Study on Recognition of Interest Income in Income Discount Contract

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Abstract. IN accordance with IFRS15 New Income Principle, the income should be discounted in one contract with significant financing components. The margin between the fair value of income and the nominal amount of income should be recognized as interest income. The amount is typically large in corresponding contracts with significant financing components and its businesses and policies are relatively complex. This paper will take the recognition of interest income in discounted contract within country A as example, for the purpose of understanding the business motivation from the data through studying abnormal fluctuation of deferred interest income. It also identifies varieties of risk problems in compliance with the accounting standard requirements, and provides solutions from multiple perspectives based on temporary policies.

Project Background

A group company signed a contract with a country's customers for the sale of equipment worth 100,000,000 USD. Promissory note buyout financing payback was adopted in this contract. The current payment has been divided into seven periods. Each of them will be made in 730 days, 913 days, 1095 days, 1278 days, 1460 days, 1643 days and 1825 days respectively.

Interpretation of Key Provisions

In accordance with IFRS15 Principle, the contract with significant financing components meets the requirement for long-term redemption discounting, and the margin between the fair value of income and the nominal amount should be recognized as interest income. Theoretically, interest income should be accounted in the duration of return on the basis of the actual interest rate method. The interest income recognized per month equals to the amount of accounts receivable multiplied by the actual interest rate.

Mismatch between Data and Rules

This paper analyzed the interest income recognized in contract B, and discovered that the recognition of interest income fluctuated greatly per month, and there exist some mismatches between the data and accounting rules.

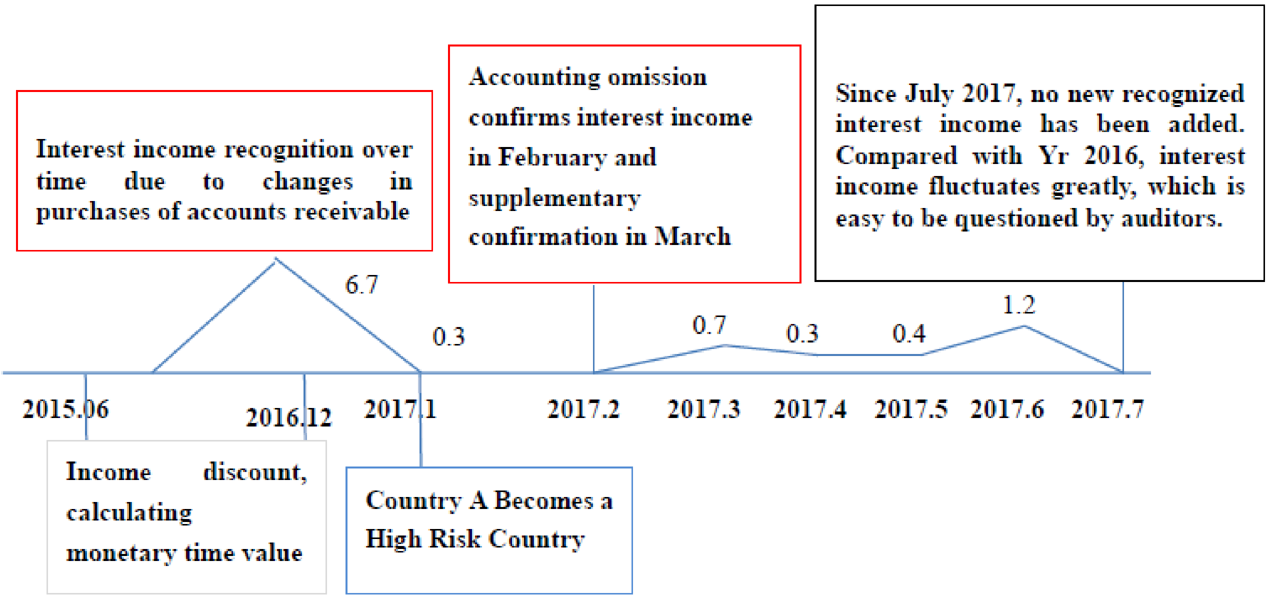

Figure 1. Recognition of Contract B Interest Income.

The Changes of A/R Buyouts Lead to Inter-period Confirmation of Interest Revenue

[Question] Contract B confirmed the first sales revenue on June 2015, but the first interest income is recognized in December 2016, with an interval of 1.5 years. According to the rules and regulations preset in the company, interest income should be recognized on a monthly basis. Does the inter-period confirmation of interest income truly exist?

[Analysis] The contract adopt newly payment method called 本票买断融资汇款. The company mails the waybill to the customers after delivering the goods, the customer then invoices the company with one promissory note attached corresponding amount within 10 days. The company eventually sells the promissory note to the commercial bank to realize the cash. Subsequently, the customer will pay the bank directly. In this case, the company provides financing solutions for their own customers by means of coordinating with commercial banks. Such method effectively solve temporary financial dilemma while the customers are in the shortage of fund. At the time of signing the contract, both the Zenith Bank and GTB Bank are the financing banks. The three parties completed the signing of the sell-off agreement. Historically, the same method of repayment has been frequently utilizing. The repayment period generally lasts 45 days. According to the <Guidelines for Operating Income Discount Accounting in Extra-Long Redemption Contracts>, the transfer of amount receivables will not impact the recognition of the present value of income discount, but it will surely affect the future interest income. If the accounts receivable has been disclosed in the financial statement while factoring or other financing is in progress, it accordingly will be regarded that principal and interest have been partially or totally transferred to banks or third parties. In the meantime, the corresponding interest receivable have been presented as well, the recognition of interest income therefore will not be necessary in terms of the accounts receivables that has been transferred. As for the contract that previously signed, it operates 100% non-recourse factoring, which, also means the company has transferred this financing service to the commercial bank, and the bank provides this financing service instead of company itself. As a result, there is no need for the company to re-recognize interest income. Instead, the company should offset the delivered yet un-invoiced receivables arising from discounting and the financing costs generated from selling out. But why is the interest income at the end of 2016 re-affirmed? In the year of 2015, the 30,000,000 USD receivables had successfully transferred as the GTB Bank implemented the selling-out operation. At the end of year 2015, the loan however was not finally approved by credit officer. And the bank had not timely presented the notice to cancel the transaction. In order to make the repayment be realized as soon as possible, the company made great efforts to seek for assistance from other commercial banks including Local Banks, Middle East investment institutions, Foreign

Investment Insurance Bank, European Investment Institutions and so forth, yet the result ended up being undesirable. Finally, the final transfer amount was 30,000,000 USD only. Due to the fact that the bank will not buy out the receivable from the company, the accounting methodology was altered at the end of 2016. The interest income of 6,700,000USD generated during this period was eventually re-recognized.

[Conclusion] Interest income did spread in different periods, and there truly existed some unreasonable data. But the related error could be attributed to the unexpected changes in the external environment rather than internal operations or in-compliance.

[Suggestion] It is not that easy to predict the change of external factors which sometimes intangibly impact upon the accounting judgments as well as treatments. Therefore, it is critically important to remain sensitive over daily businesses so that we are capable of discovering the real impact caused by changes. Most importantly, we are supposed to make timely adjustment on the accounting methods so as to ensure it conforms to the essence of businesses.

The Interest Income Was Omitted in February and Was Re-recognized in March

[Question] Since the receivable was not 100% sold out at the end of 2016, the interest income thus has been recognized in December 2016. However, the interest income was not recognized in February 2017. Was it reasonable that the interest income was not recognized owing to the fact that the newly commercial bank accepted the transfer of the accounts receivable?

[Analysis] We verified with the accountants and eventually found out the fact that the manual accounting as well as personnel rotation were the main cause of the omissions, resulting in subsequent recognition in March.

[Conclusion] Interest income should have been recognized in February, but it was not achieved due to the accounting error. It surely had a negative impact on the financial data quality as a whole. The accountant revised it in March.

[Recommendation] At the beginning, the un-billed AR was used while the discounting in contract B was in progress. But later the deferred interest income account was used after the accounting ledger put into operation. And the contract was due to expire as the progress of A/R was over 96%. Therefore, the manual accounting remained in use without accounting ledgers book. The accountant should remain prudent and careful while dealing with manual accounting ledger. It is suggested to prepare a complete checklists to ensure that no mistakes and omissions would occur.

The Interest Income Has Been No Longer Recognized Since July 2017. Compared with 2016, the Fluctuation Seemed Quite Large, Which is Easy to be Questioned by Independent Auditors

[Question] The interest income has been not recognized since July 2017. Previously July 2017, the discounted interest income confirmed per month in the contract was approximately 300,000 USD, which led to the dramatic fluctuation of customer financing interest income in 2017. Based on that, the inconsistency of policy implementation may raise the auditor's concern. Are there any special background? Or are there any change over related accounting policies?

[Analysis] Country A became a high-risk country in January 2017, the contract turned into a complex situation that high-risk and discounting coexist. Is it necessary to continue discounting at this moment? Is the discounted interest required to be recognized? Do we initially recognize sales income or interest income when there is a remittance transaction? Or should we recognize sales income and interest income proportionally under this circumstances? Bases on the research and discussion with the policy center, the corresponding solutions are presented as follows:

According to the current policies, income discount refers to one adjustment of the transaction price at the time when contract was signed, which does not equal to the variable consideration. We can regard it as that we sell equipment for our customers and offer them with loans simultaneously. Interest income is generated by loan principal itself instead of selling equipment. That is to say, the revenue discounting has been ascertained from the very beginning and it won't be altered. The upper limits of revenue among those high-risk clients is mainly determined by the exact time when the sales revenue can be recognized, which has nothing to do with interest income. Now that sales revenue depends on the repayment, then so does interest income. To put it in other way, the principal and interest are included in the confiscation of a sum of money, and the distribution of principal and interest, the sales revenue of equipment/service should be initially recognized, the interest income are subsequently to be recognized only when the cumulative amount of repayment exceeds the corresponding sales revenue of the equipment/service delivered. In the previous period, the sales revenue are the only element that took into account. According to the newly-published policy, the conclusion is that the discounted sales revenue and interest income should be confirmed based on upper limit of return and risk withdrawal. Also, the future applicable regulation should be adopted to not to retrospect another adjustment over confirmed interest income, and the interest income is no longer recognized since July 2017.

[Conclusion] The non-recognition of interest since July 2017 is the eventual result on the basis of high-risk policy. Since the country A became a high-risk country in January 2017, the return-ability of accounts receivable cannot be guaranteed, economic benefits become scarcely flow in, and thus interest income should not be recognized.

[Recommendation] High risk itself stands for that the economic interest is hardly flow in. Generally speaking, it is unlikely for the company to offer significant financing to customers with high credit risk. If the existed countries/customers need continuous long-term financing, their qualification is supposed to be re-verified. And the related accounting schemes is required to be attested, upgraded and discussed for the purpose of avoiding critical deviations or abnormal fluctuation in the process of implementation.

Summary

In the daily accounting, in addition to being familiar with the process and operation guidance, and accounting according to the operation guidance, it is also necessary to keep the sensitivity to the business at all times, communicate more business, understand the change of business situation, and timely rise to the level of leader or expert to exchange and discuss for complex and new business scenarios, so as to adapt the accounting policies and accounting rules based on the business scenarios. At the same time, strengthen the analysis and monitoring of accounting data, ensure the accuracy and fairness of financial statements through analysis, and conform to external compliance.

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