Applying IFRS in the Automotive Industry

The new revenue recognition standard – automotive industry

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What you need to know

- Application of the requirements of the new revenue recognition standard will require automotive entities to use a greater degree of judgement than they do today.
- Original equipment manufacturers and automotive parts suppliers may identify more performance obligations than they do today.
- Automotive parts suppliers may be required to change the timing of revenue recognition for contracts to supply customised parts.
- The standard is effective for annual periods beginning on or after 1 January 2017, with early adoption permitted.

Overview

Automotive entities may need to change certain revenue recognition practices as a result of the new revenue recognition standard, IFRS 15 *Revenue from Contracts with Customers*, that was jointly issued by the International Accounting Standards Board (the IASB) and the Financial Accounting Standards Board (the FASB) (collectively, the Boards). The new standard will supersede virtually all revenue recognition requirements in IFRS and US GAAP.

IFRS 15 provides accounting requirements for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other IFRSs, such as IAS 17 Leases). The standard also provides a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant and equipment (PP&E) and intangible assets.

Our *Applying IFRS, A closer look at the new revenue recognition standard* (June 2014),[1] provides an in-depth discussion of IFRS 15. This publication summarises the key implications of the standard for automotive entities.

To support stakeholders with the implementation of the new standard, the Boards established a Joint Transition Resource Group for Revenue Recognition (TRG). The TRG was created to help the Boards determine whether more application guidance or education is needed on implementation issues and other matters submitted by stakeholders.

Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 industry task forces to help develop a new accounting guide on revenue recognition under US GAAP and to aid industry stakeholders in implementing the standard. A task force has not been established for the automotive industry. Views or guidance produced by the TRG or AICPA are non-authoritative.

The views we express in this publication are preliminary. We may identify additional issues as we analyse the standard and entities begin to interpret it, and our views may evolve during that process.

[1] Available on www.ey.com/ifrs

Contents

Overview 1
Key considerations 3
Incentives 3
Long-term supply contracts 4
Tooling equipment 4
Customised parts 5
Repurchase options and residual value guarantees 6
Next steps 6

Key considerations

To apply IFRS 15, original equipment manufacturers (OEMs) will need to change the way they evaluate incentives, and automotive parts suppliers (APSs) will need to change the way they evaluate long-term supply contracts. Both types of entities may need to use significant judgement when they identify separate performance obligations (i.e., units of account), which may be different from those identified under current IFRS. The accounting for contracts with repurchase options or residual value guarantees may also change.

Automotive entities may need to change the way they account for various incentives as a result of IFRS 15.

Incentives

OEMs frequently offer sales incentives in contracts to sell vehicles to dealers. These sales incentives may be cash rebate bonuses or another type of incentive available to dealers and retail customers (who purchase the vehicle from the dealer). They may also include free, or heavily discounted, goods or services provided to retail customers, such as a free satellite radio or free maintenance for a specified period.

Under IFRS 15, cash incentives (i.e., cash, credits or other items that can be applied against amounts owed to the OEM) paid by the OEM to customers (dealers and retail customers) will generally be treated as a reduction of the transaction price and, therefore, of revenue. However, in some cases, the payment to the customer is in exchange for a distinct good or service that the customer transfers to the OEM. If the OEM is able to reasonably estimate the fair value of the distinct good or service transferred by the customer, the OEM accounts for that purchase in the same way it accounts for other purchases from suppliers. This is similar, but not identical, to current IFRS. As such, OEMs will need to evaluate whether the new standard changes the accounting treatment for its cash incentive programmes.

Under IFRS 15, incentives, whether directly from the OEM to retail customers or indirectly through dealers, providing free or discounted goods will likely represent promised goods or services (i.e., revenue elements), rather than marketing incentives. An example of such indirect incentives is free maintenance services performed by a dealer for which the OEM provides reimbursement. The Boards' concluded that, even if such incentives are not explicit promises in a contract, they would, nonetheless, be an implied promise if the OEM has a customary business practice that results in the retail customer having a valid expectation that the OEM is obligated to provide the maintenance services. Therefore, such amounts are considered as promises in the contract and the OEM will be required to account for the free services as a revenue element.

Treating a free good or service as a separate revenue element may be a change in practice for some OEMs. In addition, OEMs will have to review their processes for estimating rebates and other forms of variable consideration to make sure they fully address the new requirements for estimating the transaction price (and applying the constraint) and appropriately document their conclusions.

Long-term supply contracts

Tooling equipment

APSs commonly enter into long-term arrangements with OEMs to provide specific parts, such as seat belts or steering wheels. An arrangement typically includes the construction for the tooling, which is required to be used when manufacturing the parts to meet the OEM's specifications. In many cases, the APS will construct and transfer the legal title for the tooling to the OEM after construction, even though they will retain physical possession of it in order to produce the parts.

Currently, some APSs account for tooling as a revenue element because they have concluded it is a deliverable in the arrangement. Those APSs will likely be able to reach the same conclusion under IFRS 15, because the Boards concluded that these goods and services are goods or services for which the customer pays and to which the entity allocates consideration (i.e., identifies as separate performance obligations) for revenue recognition purposes.

Other APSs may have concluded that tooling is not a revenue element under current IFRS because it does not represent a deliverable in the arrangement. In order to reach the same conclusion under IFRS 15, APSs will need to conclude that the tooling does not transfer a good or service to the customer, similar to administrative tasks performed by a service provider to set up a contract. It is not clear whether this interpretation will be permitted under the standard. As contract terms can vary, careful consideration of the APS's terms with its customers will be necessary in order to make this determination.

Under IFRS 15, if the tooling is determined to be a revenue element, the entity must first evaluate whether the tooling is distinct (i.e., both capable of being distinct and distinct within the context of the contract) and, therefore, a separate performance obligation. In making this evaluation, an APS will have to consider whether the tooling is separately identifiable from the production of the specified parts (e.g., is the tooling highly dependent on, or highly interrelated with, the production of the specified parts?). APSs will have to apply significant judgement in making these determinations.

An entity recognises revenue when it transfers control of the promised good or service to the customer, which can occur over time or at a point in time. If the tooling is distinct, an APS would account for the tooling separately from the production of the other specialised parts. Revenue would be recognised for the tooling either over time or at a point in time, depending on how control of the tooling transfers to the OEM. If the tooling is not distinct, the APS would combine the tooling with the production. Revenue would be recognised as control of the specialised parts is transferred to the OEM. This evaluation will require judgement and careful consideration of the facts and circumstances.

APSs may be required to change when they recognise revenue for supplying customised parts.

Customised parts

Under their supply agreements, an APS may provide OEMs with a customised part (e.g., a car seat) that is designed and constructed specifically to fit within a particular make and model of vehicle. In these types of arrangements, APSs will have to carefully consider whether each individual part is a separate performance obligation or whether all the parts supplied in the contract (or some combination of them) are considered a single performance obligation. After the performance obligations are identified, APSs will also need to evaluate whether the performance obligations meet the criteria for recognising revenue over time (rather than at a point in time, such as when delivery occurs).

The Boards concluded that, when an entity is creating something that is highly customised for a particular customer, which may be the case in an APS contract, it is less likely that the entity could use that asset for any other purpose. When determining whether an asset has alternative use, IFRS 15 states that an entity needs to consider the effects of contractual restrictions and practical limitations on the entity's ability to readily direct that asset for another use (i.e., sell it to a different customer). A contractual restriction needs to be substantive (i.e., the customer could enforce its rights to the promised asset if the entity directed the asset for another use). A practical limitation only exists if an entity would incur significant economic losses to direct the asset for another use. An APS may need to consider these concepts in the context of selling customised parts to an after-market supplier. The evaluation of whether an asset has alternative use will require significant judgement.

APSs will also have to evaluate whether they have an enforceable right to payment for performance completed to date, considering the terms of the contract and any applicable laws or regulations. IFRS 15 states that the right to payment for performance completed to date need not be for a fixed amount. However, at any time during the contract term, an entity must be entitled to an amount that at least compensates it for performance completed to date. This applies even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised.

The APS may need to change the timing of the recognition of the revenue from the customised parts under IFRS 15. If the APS's performance does not create an asset with alternative use to the APS and the APS has an enforceable right to payment for performance completed to date, the APS is required to recognise revenue associated with the supply of customised parts over time (i.e., as production occurs), rather than at a point in time (i.e., when production is complete or when delivery takes place). This change in the timing of revenue recognition for the customised parts could be significant.

Repurchase options and residual value guarantees

OEMs may sell vehicles with a repurchase option or a residual value guarantee (e.g., when they sell fleets to rental car companies). Under a residual value guarantee, OEMs agree to compensate the customer ('make whole') for the difference between the resale price the customer obtains in an open market and the guaranteed minimum resale value.

Under IFRS 15, arrangements with repurchase features must be evaluated to determine whether they represent a sale, lease or financing, based on specified criteria. This evaluation includes considering factors such as the likelihood of a customer exercising a put option or the relationship between the repurchase price and the market value of the asset at the date of repurchase. Contracts that include residual value guarantees and make whole provisions may qualify for sale accounting under the revenue standard and also may include a component of variable consideration. These assessments will require considerable judgement.

Next steps

Automotive entities should perform a preliminary assessment of how they will be affected by IFRS 15 as soon as possible so they can determine how to prepare to implement the new standard. While the effect on entities will vary, some may face significant changes in revenue recognition. All entities will need to evaluate the requirements of the new standard and make sure they have processes and systems in place to collect the necessary information to implement the standard, even if their accounting results will not change significantly.

Automotive entities may also wish to monitor continued discussions of the Boards and the TRG.

Entities should also consider how they will communicate any changes with investors and other stakeholders. This includes their plan for disclosure of the effects of new accounting standards which are issued, but not yet effective, as required by IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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