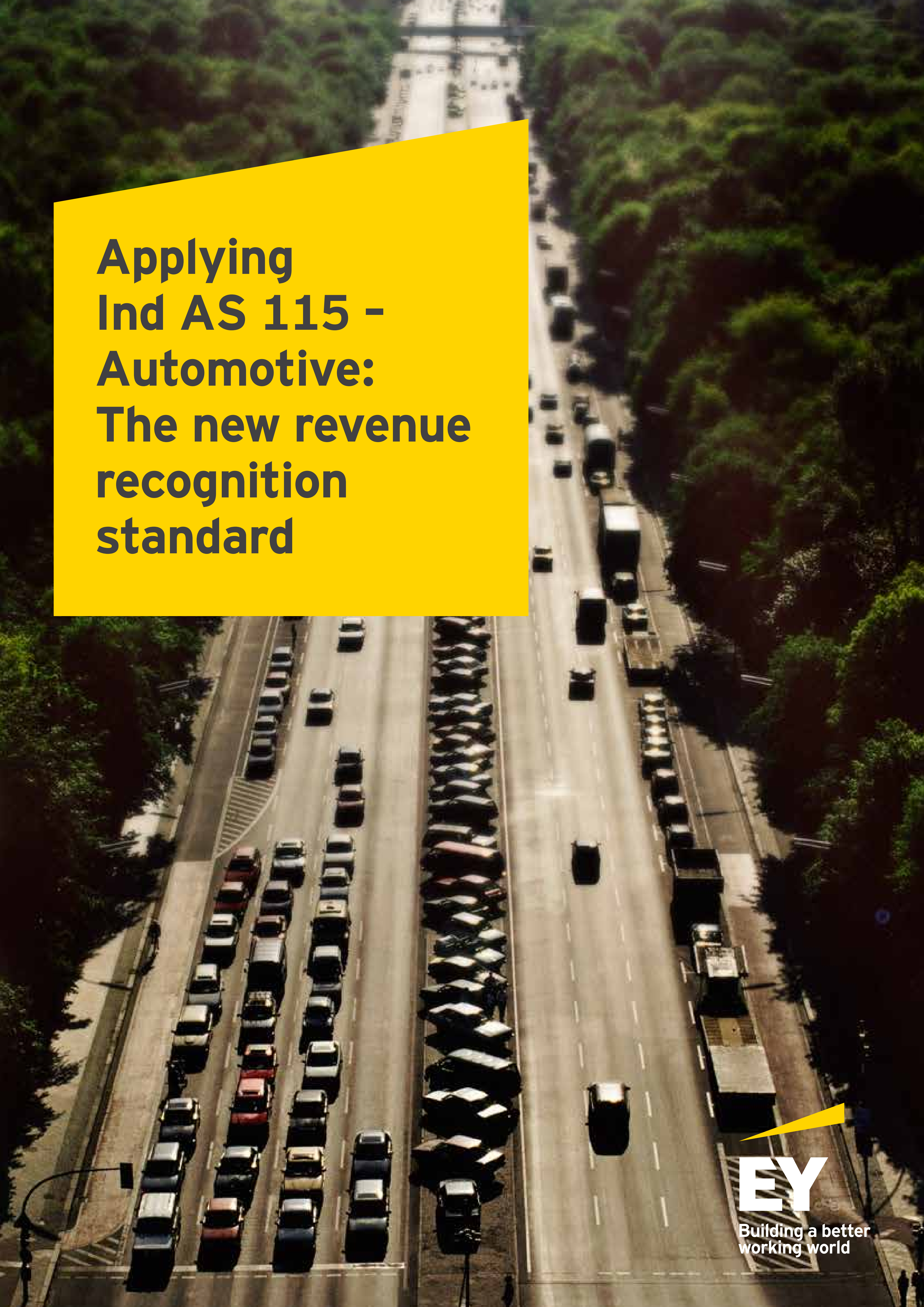
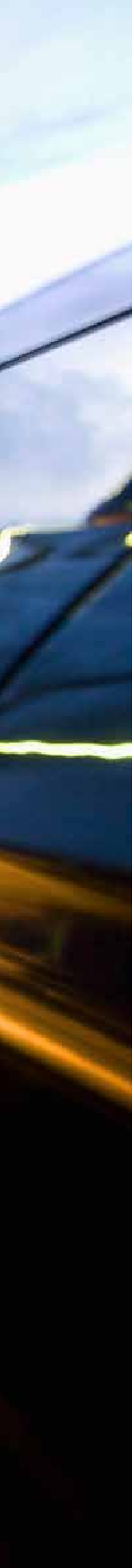
Applying Ind AS 115 - Automotive: The new revenue recognition standard





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What you need to know

- Application 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 customized parts.
- Ind AS 115 is applicable for annual period beginning on or after 01 April 2018. Globally corresponding IFRS 15 is applicable from annual period beginning 1 January 2018.

Overview

The Ministry of Corporate Affairs (MCA), the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have notified/issued new revenue standards, viz., Ind AS 115 *Revenue from Contracts with Customers,* IFRS 15 *Revenue from Contracts with Customers* and Accounting Standards Codification (ASC) 606 *Revenue from Contracts with Customers*, respectively. The requirements of these standards are substantially aligned; however, US GAAP contains a few differences vis-à-vis IFRS and Ind AS. These new revenue standards supersede virtually all legacy revenue recognition requirements in Ind AS, IFRS and US GAAP.

The standards provide accounting requirements for all revenue arising from contracts with customers. These standards affect all entities that enter into contracts to provide goods or services to their customers, unless the contracts are in the scope of other Ind AS or IFRSs or US GAAP requirements, such as the leasing standards. The standards also specify the accounting for costs that an entity incurs to obtain and fulfil a contract to provide goods and services to customers and provide a model for the measurement and recognition of gains and losses on the sale of certain non-financial assets, such as property, plant or equipment.

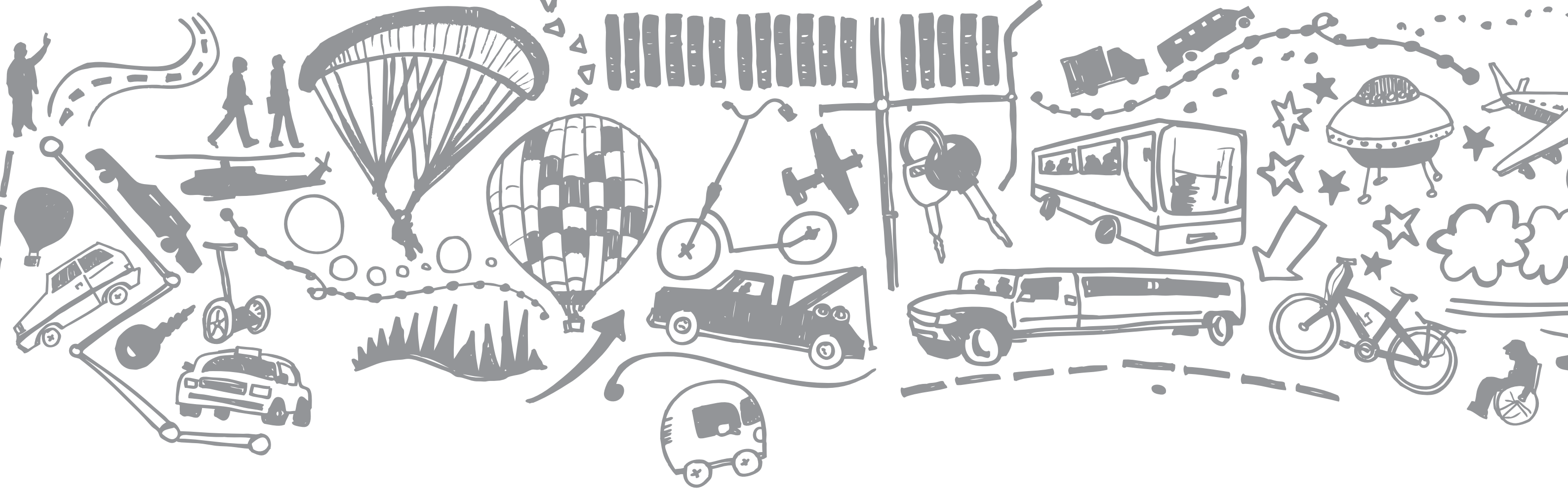
As a result, the standards will likely affect an entity's financial statements, business processes and internal controls over financial reporting. While some entities will be able to implement the standard with limited efforts, others may find it a significant undertaking. Successful implementation will require an assessment of and a plan for managing the change.

To support stakeholders with Ind AS implementation in India, the Institue of Chartered Accountants of India (ICAI) has constituted Ind AS Transition Facilitation Group (ITFG). Globally the IASB and FASB established a Joint Transition Resource Group (TRG) for revenue recognition. 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 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 ITFG, the TRG or the AICPA is non-authoritative.

Automotive entities may need to change certain revenue recognition practices as a result of the new revenue recognition standard, Ind AS 115 *Revenue from Contracts with Customers*.

This publication summarizes the key implications of the standard for automotive entities.

The views expressed here are preliminary. We may identify additional issues as we analyze the standard and entities begin to interpret it, and our views may evolve during that process.



Key considerations

To apply Ind AS 115, 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 the current Ind AS. 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 Ind AS 115.

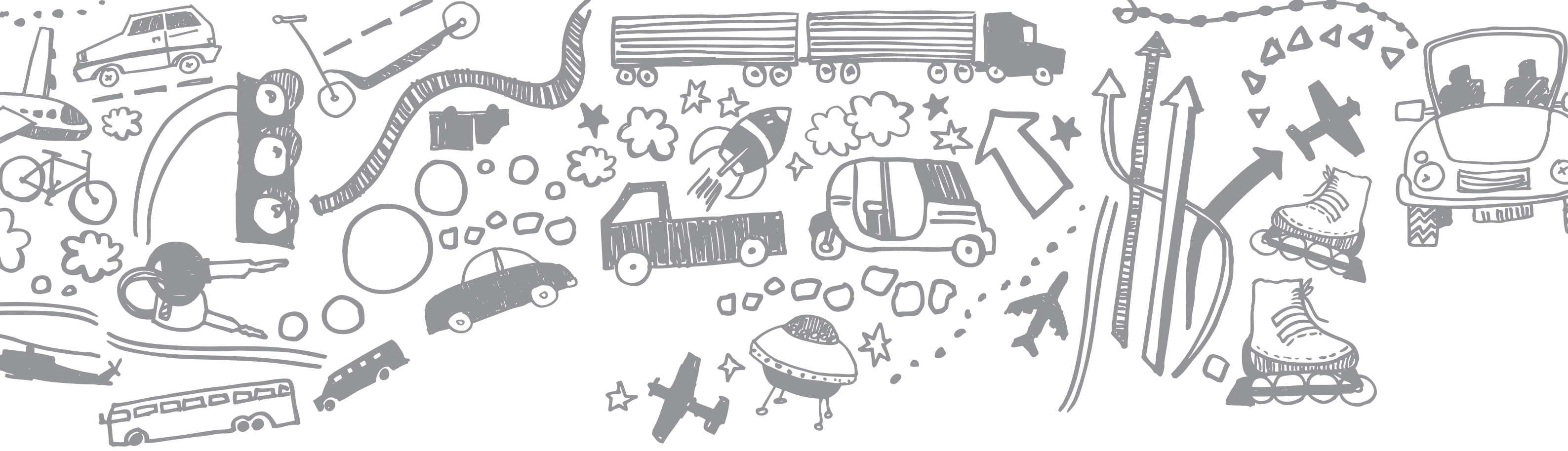
Incentives

OEMs frequently offer sales incentives in contracts to sell vehicles to dealers. These may be cash rebate, bonuses or other types of incentives available to dealers and retail customers (who purchase vehicles from the dealers). 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 Ind AS 115, 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 Ind AS. As such, OEMs will need to evaluate whether the new standard changes the accounting treatment for its cash incentive programs.

Under Ind AS 115, 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. 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 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

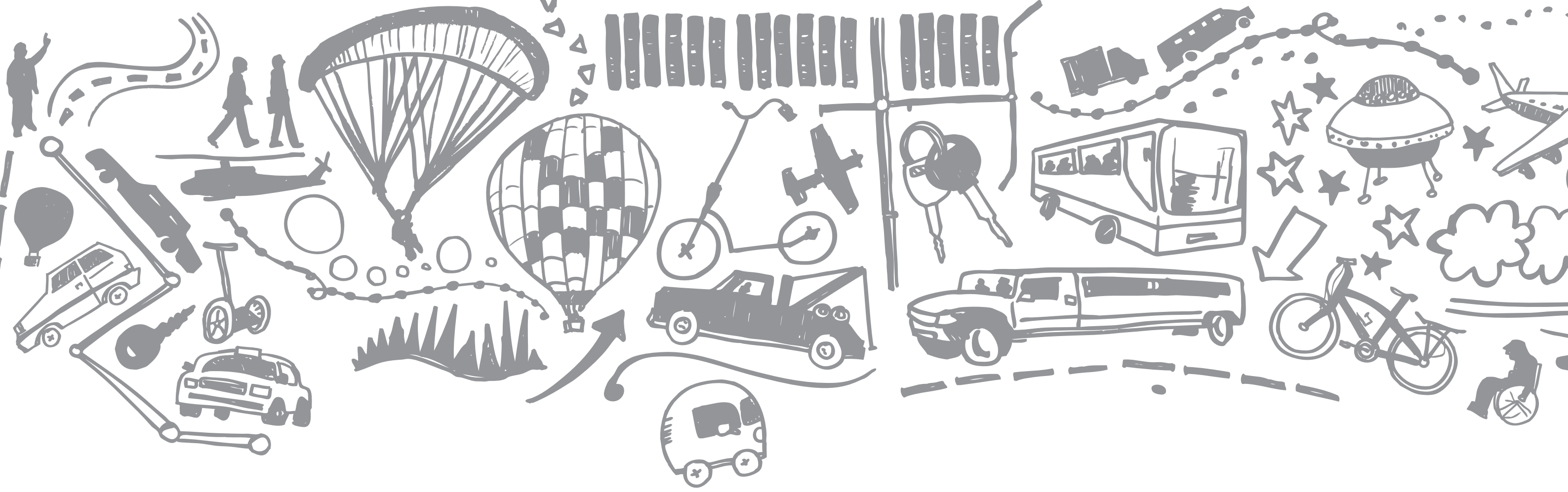
APSs commonly enter into long-term arrangements with OEMs to provide specific parts, such as seat belts or steering wheels. An arrangement typically includes the construction for the tooling, which is required to be used when manufacturing the parts to meet the OEM's specifications. In many cases, the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

Currently, some APSs account for tooling as a revenue element because they have concluded it as a deliverable in the arrangement. Those APSs will likely be able to reach the same conclusion under Ind AS 115, because these goods and services are paid by the customer and are the ones 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 Ind AS because it does not represent a deliverable in the arrangement. In order to reach the same conclusion under Ind AS 115, APSs will need to conclude (basis the terms of the contract along with the guidance under Ind AS 115) 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 Ind AS 115, 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. While evaluating, an APS will have to consider whether the tooling is separately identifiable from the production of the specified parts (e.g., whether it is 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 recognizes revenue when it transfers the control of the promised good or service to the customer, which can occur over a period of time or at a point in time. If the tooling is distinct, an APS would account for it separately from the production of the other specialized parts. Its revenue would be recognized either over a period of time or at a point in time, depending on how its control transfers to the OEM. If the tooling is not distinct, the APS would combine it with the production. Revenue would be recognized as control of the specialized 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

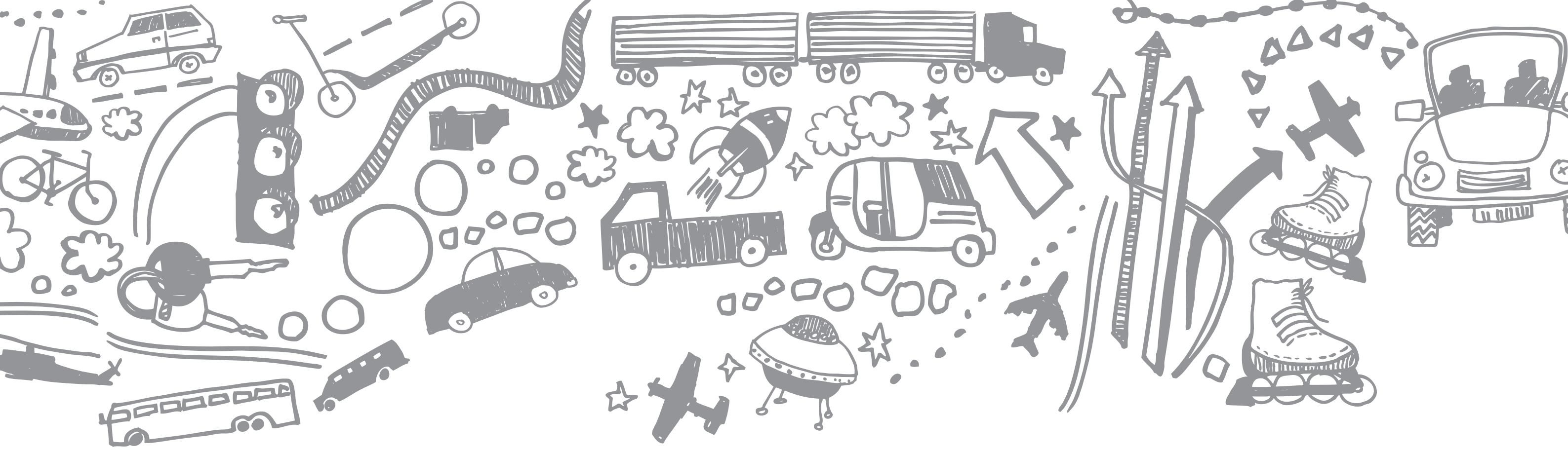
Customized parts

Under their supply agreements, an APS may provide OEMs with a customized part (e.g., a car seat) that is designed and constructed to specifically 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 their combinations) are considered a single performance obligation. After the performance obligations are identified, APSs will also need to evaluate whether they meet the criteria for recognizing revenue over a period of time (rather than at a point in time, such as at the time of the delivery).

When an entity is creating something that is highly customized for a particular customer, which may be the case in an APS contract, it is less likely that the entity could use that as an asset for any other purpose. When determining whether an asset has alternative use, Ind AS 115 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 directs 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 customized parts to an after-market supplier. The evaluation of whether an asset has an 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. Ind AS 115 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 compensates it for performance completed to date. This applies even if the customer terminates 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 customized parts under Ind AS 115. 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 recognize revenue associated with the supply of customized 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 customized 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). An entity must first assess whether a repurchase option or a guarantee is in the scope of either Ind AS 17 or Ind AS 109 Financial Instruments.

If those standards do not apply, under Ind AS 115, arrangements with repurchase features must be evaluated to determine whether they represent a sale, lease or financing, based on the 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 original selling price. Ind AS 115 also requires an entity to assess whether the guaranteed repurchase price is expected to significantly exceed the market value of the asset at the date of the repurchase (and, therefore, provide the customer with a significant economic incentive to exercise the option).

OEMs frequently agree to compensate the customer for the difference between the resale price the customer obtains in an open market and the guaranteed minimum resale value. The compensation is generally accounted for as a reduction of the transaction price if it is not accounted for under Ind AS 109.

While the economics of a repurchase agreement and a residual value guarantee may be similar, the accounting outcome could differ.

Next steps

Automotive entities should perform an assessment of how they will be affected by Ind AS 115 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 want to monitor clarification/issues addressed by the ICAI and the ITFG. Global discussions of the IASB, AICPA and the TRG should be monitored as well.

Entities should also consider ways to communicate any change with investors and other stakeholders. This includes their plan for disclosures about the effects of new accounting standards which are issued, but not yet effective, as required by Ind AS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

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