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Automotive Spotlight
New Revenue Recognition Model

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Executive summary

- On May 28, 2014, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) issued their final standard on revenue from contracts with customers. The standard, issued as Accounting Standards Update 2014-09 (and codified as Topic 606 in the FASB Accounting Standards Codification) by the FASB and as IFRS 15 by the IASB, outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition standard (including industry-specific guidance in U.S. GAAP).
- The Institute of Chartered Accountants of India (ICAI) has recently issued an Exposure Draft (ED) of the proposed Indian Accounting Standard (Ind AS) 115, Revenue from Contracts with Customers i.e. the proposed IFRS Converged accounting standard for Indian entities, which is identical to IFRS 15.
- The new revenue recognition standard [(Topic 606/ IFRS 15 / exposure draft Ind AS 115), *hereafter through this document the reference to "new revenue recognition standard" implies Topic 606/ IFRS 15 / exposure draft Ind AS 115*] requires management to use judgment to (1) determine whether contracts with one customer (or related parties) should be combined and treated as a single contract, (2) identify the number of performance obligations in a contract, and (3) determine the transaction price.
- Revenue from contracts for customised parts that an entity creates by providing a "service" to a customer (i.e., the parts have no alternative use to the entity and the entity has a right to payment for performance to date) will need to be recognised over time as the parts are constructed.
- Entities will need to determine whether contract costs should be capitalised and amortised as goods and services are transferred to the customer or whether such costs should be expensed as incurred.
- Entities will need to evaluate the appropriate accounting when a contract with a customer contains a repurchase right (e.g., an option that allows the customer to "put" the product back to the entity may represent a lease or a sale with a right of return).
- The new standard requires significantly more extensive disclosures than current standard; therefore, automotive entities may need to modify their systems and processes to gather information about contracts with customers that is not otherwise readily available.
- IASB and FASB have formed a joint Transition Resources Group (TRG) to inform both standard setting bodies about potential implementation issues arising when companies implement the new standard. TRG will not issue any guidance. The Board of TRG have met twice in 2014.
- This Automotive Spotlight discusses the new revenue model and highlights key accounting issues and potential challenges for automotive entities.

The new revenue recognition standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition standard.

Background

The goals of the new revenue recognition standard are (1) streamlining, and removing inconsistencies from, revenue recognition requirements; (2) providing “a more robust framework for addressing revenue issues”; (3) making revenue recognition practices more comparable; and (4) increasing the usefulness of disclosures. The new revenue recognition standards states that the core principle for revenue recognition is that an “entity shall recognise revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.”

Automotive entities must reassess their current revenue accounting and determine whether changes are necessary.

Under the new revenue recognition standard, entities must perform the following five steps in recognising revenue:-

- “Identify the contract(s) with a customer” (step 1);
- “Identify the performance obligations in the contract” (step 2);
- “Determine the transaction price” (step 3);
- “Allocate the transaction price to the performance obligations in the contract” (step 4); and
- “Recognise revenue when (or as) the entity satisfies a performance obligation” (step 5)

Entities must also reassess their current revenue accounting and determine whether changes are necessary. In addition, the new revenue recognition standard requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the revenue model; and (3) the assets recognised from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

Certain automotive entities (including suppliers, original equipment manufacturers, and dealers) may encounter accounting and operational challenges in applying the new revenue recognition standard. Some of these key accounting issues are discussed below.

Identifying the Contracts With Customers (Step 1)

In evaluating whether a contract with a customer exists, an entity would analyse the specific terms and conditions of an arrangement to determine whether the parties to the arrangement have a supplier-customer relationship or some other relationship (e.g., as collaborators or partners that are outside the scope of the new revenue recognition standard). The entity would consider all relevant facts and circumstances in assessing whether the counterparty to a contract meets the definition of a customer as given in the standard and whether the contract is within the scope of the standard. Contracts with customers may be written, oral, or implied and must create enforceable rights and obligations between two or more parties. Further, for a contract to exist, management must conclude that it is probable that the entity will collect the consideration to which it expects to be entitled.

If a contract with a customer does not meet the criteria to be accounted for under the new revenue recognition standard, the entity would recognise consideration received under the contract as revenue only when (1) the entity has no remaining obligations to transfer goods or services to the customer (because of complete fulfillment or cancellation of the contract), (2) the entity has collected all promised consideration, and (3) the consideration received is non-refundable.

Further, when assessing the contractual period to apply the new standard (e.g., to each outstanding purchase order or over a three-year master services agreement), entities will need to evaluate the contract to determine the period in which the parties to the contract have "present enforceable rights and obligations."

Contract Combination

Entities must also assess whether to account for multiple contracts as a single contract. The standard requires entities to combine contracts entered into at or around the same time with the same customer (or parties related to the customer) if one or more of the following criteria are met:

- "The contracts are negotiated as a package with a single commercial objective."
- "The amount of consideration to be paid in one contract depends on the price or performance of the other contract."
- "The goods or services promised in the contracts (or some goods or services promised in each of the contracts) are a single performance obligation.

Thinking It Through

Unlike current standard, under which entities may consider combining contracts in certain circumstances, the new standard **requires** contract combination when the above criteria are met. Automotive entities (especially suppliers) often enter into multiple contracts with the same customer around the same time but may not specifically evaluate whether those contracts are interdependent. After establishing controls to ensure that this evaluation is performed, automotive entities may need to use judgment to determine whether the above contract-combination criteria are met. A conclusion that the criteria are met could significantly affect (1) how performance obligations are identified, (2) how consideration is allocated to those obligations, or (3) when revenue is ultimately recognised. Note that contracts with different customers (that are not related parties) would not be combined.

Example

Entity A, an automotive supplier located in India, enters into two separate contracts with Entity B to supply parts: one with Entity B's U.S. subsidiary and one with its Chinese subsidiary. Because the contracts are with the same customer, Entity A would be required to assess whether the contract-combination criteria are met. Specifically, if the pricing in one contract depends on the price or performance of the other contract, Entity A may be required to account for the two contracts as a single contract.

Identification of Performance Obligations (Step 2)

The new revenue recognition standard requires entities to evaluate the goods and services promised in a contract to identify "performance obligations." Specifically, the standard requires an entity to account for a "distinct" good or service (or bundle of goods or services) or a series of distinct goods or services (if they are substantially the same and have the same pattern of transfer) as a performance obligation (i.e., a separate unit of account). The standard defines a distinct good or service as one that meets both of the following criteria:

- "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct)."
- "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the good or service is distinct within the context of the contract)."

A good or service that does not meet these criteria would be combined with other goods or services in the contract until the criteria are met.

The standard provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:

- "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract. In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
- "The good or service does not significantly modify or customise another good or service promised in the contract."
- "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, the fact that a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

The new revenue recognition standard requires entities to evaluate the goods and services promised in a contract to identify "performance obligations".

Thinking It Through

Automotive entities often provide multiple goods or services to their customers in a single contract. For example, in contracts to supply parts to an original equipment manufacturer (OEM), automotive suppliers may provide for engineering services or development of tooling. On the other hand, OEMs and dealers may offer free services and other incentives to their customers along with the purchase of a vehicle. Currently, entities may conclude that certain deliverables are inconsequential or perfunctory obligations or that they constitute "marketing" or "financing" deliverables. However, the new revenue standard does not have an exception for inconsequential or perfunctory obligations or for obligations that constitute marketing deliverables. An entity may need to use significant judgment in identifying all the goods or services in contracts with a customer and applying the above criteria to determine each performance obligation (especially when considering the new concept of "distinct within the context of the contract"). Further the TRG noted entities need to exercise significant judgement in assessing whether an option provided to the customers of receiving additional future goods or services at a discount constitutes a "material right".

Warranties

Accounting for warranties that ensure that a product complies with agreed-upon specifications will be done as a cost accrual similar to a provision. To the extent that a warranty constitutes any other service, it would be accounted for as a performance obligation (consideration would be allocated to this obligation and recognised as it is satisfied). The warranty would also be accounted for as a performance obligation if the customer has the option of purchasing it separately.

Automotive entities will need to carefully evaluate their warranties to identify any services or provisions that have an additional purpose besides ensuring the product's specifications. For example, the sale of a vehicle may include a warranty under which routine maintenance services are provided free of charge for a specified period and do more than ensure that the vehicle operates as specified. Entities may also need to consider the length of the warranty coverage and the nature of the product under warranty to ensure that the warranty period does not extend beyond the expected life of the product (which may indicate that the warranty constitutes a service). In assessing whether aspects of a warranty represent a performance obligation, an entity may need to use significant judgment.

Automotive entities will need to carefully evaluate their warranties to identify any services or provisions that have an additional purpose besides ensuring the product's specifications.

Thinking It Through

Automotive entities may have contracts that include variable elements (e.g., incentive bonuses, penalties, or varying contract prices). Consideration payable to the customer (e.g., cash rebates, credits, or discounts) may also be variable. Such variable consideration would be estimated by taking into account available information (e.g., past history or projected sales) and would be included in the transaction price to the extent that it is probable that its inclusion would not result in a significant future revenue reversal. While automotive entities' accounting for variable compensation may ultimately be consistent with their current accounting under respective GAAP, entities will need to evaluate their contracts under the new revenue recognition standard to assess whether their current accounting remains appropriate.

Determination of the Transaction Price (Step 3)

Under the new standard, entities must determine the transaction price[1] by estimating any variable consideration (including potentially contingent consideration). Estimates of variable consideration are only included in the transaction price to the extent that it is probable that the amount of cumulative revenue recognised would not be subject to a significant future revenue reversal when such estimates are revised.

[1] The transaction price is defined as the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer (excluding amounts collected on behalf of third parties) and consists of both fixed and variable consideration.

While automotive entities' accounting for variable compensation may ultimately be consistent with their current accounting under respective GAAP, entities will need to evaluate their contracts under the new revenue recognition standard to assess whether their current accounting remains appropriate.

Adjustments for the Time Value of Money

The standard requires entities to adjust the transaction price for the time value of money when a significant financing component exists (and provides guidance on determining when such a financing exists). The objective of this requirement is to adjust the promised amount of consideration to reflect what the selling price would have been if the customer had paid cash for the goods or services at the time (or over the period during which) such goods or services were transferred to the customer. As a practical expedient, an entity is not required to account for a significant financing component in a contract if, at contract inception, the expected time between payment and the transfer of the promised goods and services is one year or less. In addition, a significant financing component would not exist if the difference between the promised consideration and the cash selling price of the good or service arises “for reasons other than the provision of finance . . . and the difference between those amounts is proportional to the reason for the difference.”

Therefore, to the extent that an automotive entity receives an up-front payment for which the related revenue will be recognised over several years or the customer is not required to pay for a certain period after a good or service is provided, the transaction price may need to be adjusted for the time value of money (as if a hypothetical loan was provided to one of the parties in the contract). For example, if a separately priced extended warranty is sold to a customer (in which case the related revenue would be deferred) for an up-front payment, the entity will most likely need to adjust the transaction price for the time value of money as if the entity received a loan from the customer. In such circumstances, the amount of revenue recognised would increase and interest expense would increase by the same amount.

Recognising Revenue

Under the new standard, entities recognise revenue as “control” of the goods or services underlying a performance obligation is transferred to the customer[1]. This control-based model differs from the risks-and-rewards model generally applied currently. Entities must first determine whether control is transferred over time. If not, it is transferred at a point in time. Under the standard, control is transferred over time if any of the following criteria are met:

- “The customer simultaneously receives and consumes the benefits provided by the entity’s performance as the entity performs.”
- “The entity’s performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced.”
- “The entity’s performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.”

If none of these criteria are met, an entity would determine the point in time at which the customer obtains control of the good or service. Factors indicating that control has been transferred at a point in time include, but are not limited to, the following[2]:

- “The entity has a present right to payment for the asset.”
- “The customer has legal title to the asset.”
- “The entity has transferred physical possession of the asset.”
- “The customer has the significant risks and rewards of ownership of the asset.”
- “The customer has accepted the asset.”

After carefully evaluating whether revenue should be recognised over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or service), automotive entities will need to determine how to measure progress toward satisfying the performance obligation over time or the point at which control has been transferred to the customer.

After carefully evaluating whether revenue should be recognised over time (as production occurs) or at a point in time (most likely when the customer obtains the goods or service), automotive entities will need to determine how to measure progress towards satisfying the performance obligation over time or the point at which control has been transferred to the customer.

[1] Control of an asset refers to the ability to direct the use of and obtain substantially all of the remaining benefits from the asset as well as the ability to prevent other entities from directing the use of and obtaining the benefits from the asset.

[2] The individual indicators listed below are not definitive in and of themselves. An entity would consider all relevant facts and circumstances when determining the point in time at which control is transferred to the customer.

Contract Modification

The new revenue recognition standard requires entities to account for contract modifications as separate contracts if such modifications result in (1) the addition of “distinct” performance obligations and (2) an increase in the price of the contract by an amount of consideration that reflects the entity’s stand-alone selling price for the separate performance obligations. For a contract modification that does not meet the criteria to be accounted for as a separate contract, an entity must determine whether it should be accounted for (1) as a termination of the original contract and the creation of a new contract (i.e., the amount of consideration not yet recognised would be allocated to the remaining performance obligations) or (2) as if it were part of the original contract (i.e., the entity would update the transaction price and the measure of progress toward complete satisfaction of the performance obligation and would record a cumulative catch-up adjustment to revenue). The new standard provides specific guidance on making this determination. Depending on how revenue is recognised (i.e., over time or at a point in time) and the terms of a contract modification, the amount of current and ongoing revenue recognised can dramatically differ.

Example
Entity A, an automotive parts manufacturer, enters into a contract to sell customised chrome hubcaps to a customer. Because the hubcaps are customised, Entity A cannot rework them and sell them to another customer without incurring a substantial cost (i.e., there is no alternative use for the hubcaps). The contract requires Entity A to deliver 800,000 customised hubcaps to the OEM at a cost of Rs.2,000 per unit. The contract terms specify that if the OEM cancels the contract, Entity A is entitled to receive its cost to date plus a reasonable margin (enforceable right to payment). Entity A therefore concludes that its performance obligation (deliver 800,000 units) is satisfied over time. After Entity A has transferred control of 600,000 units, the OEM requests that the remaining units and an additional 400,000 units be rush-delivered because of higher-than-expected demand. The parties agree to modify the contract to require Entity A to deliver the 200,000 remaining units at the original price and 400,000 additional units at a cost of Rs.2,750 per unit on a rush basis. Because the remaining 600,000 units to be provided under the modified contract are distinct from the goods transferred on or before the date of the contract modification, the entity accounts for the modification as a termination of the original contract and the creation of a new contract. The entity would recognise the remaining consideration of Rs.1,500 million (200,000 units at Rs.2,000 per unit + 400,000 units at Rs.2,750 per unit) as the 600,000 remaining units are produced over time.

Contract Costs

The new standard requires capitalisation of the recoverable incremental costs of obtaining a contract (e.g., sales commissions).[1]This new requirement could represent a significant change for automotive entities that currently expense such costs.

In addition, if the following criteria are met, an entity must capitalise the costs of fulfilling a contact that are not within the scope of other GAAP literature:

- "The costs relate directly to a contract" (or a specific anticipated contract).
- "The costs generate or enhance resources of the entity that will be used in satisfying . . . performance obligations in the future."
- "The costs are expected to be recovered."

Nevertheless, costs related to satisfied (or partially satisfied) performance obligations must be expensed as incurred. In the automotive industry, many of the costs incurred in fulfilling a customer contract are likely to be accounted for in accordance with the inventory standard. Such standard would continue to apply to performance obligations satisfied at a point in time. However, if a performance obligation is satisfied over time, the costs would most likely be related to a partially satisfied performance obligation and would therefore need to be expensed as incurred (as noted above).

Costs capitalised under the new standard would be amortised in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (i.e., as the related revenue is recognised). In certain circumstances, the amortisation period may extend beyond the original contract term (e.g., when future anticipated contracts or expected renewal periods exist). All capitalised-cost assets would be subject to impairment testing if any impairment indicators exist.

The new revenue recognition standard requires capitalisation of the recoverable incremental costs of obtaining a contract. This new requirement could represent a significant change for automotive entities that currently expense such costs.

Repurchase Agreements

The new standard provides specifies on accounting for sales with repurchase agreements. Under the standard, if an entity is required (a forward), or a customer has the option of requiring an entity, to repurchase the asset (a put option) at a price lower than the original selling price, the entity will need to consider at contract inception whether the customer has a significant economic incentive to exercise its option. If the customer has such an incentive, the contract should be treated as a lease. Otherwise, the transaction should be accounted for as a sale with a right of return.

Thinking It Through

Automotive entities that have an obligation to (1) repurchase the asset (i.e., a forward) or (2) repurchase the asset at the customer's request (i.e., a put option) at a price that is lower than the original selling price of the asset will need to carefully evaluate the new provisions to ensure that they recognise revenue appropriately.

Required Disclosures

The standard requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The disclosure requirements are significantly more comprehensive than those in existing revenue standards.

[1] As a practical expedient, the new standard allows an entity to elect to expense costs of obtaining a contract when incurred if the amortization period of the asset that the entity otherwise would have recognized is one year or less.

Challenges for Automotive Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the requirements of the new standard, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for automotive entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Systems, Processes and Controls

To comply with the new accounting and disclosure requirements, automotive entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. Automotive entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the new revenue recognition standard.

To comply with the new accounting and disclosure requirements, automotive entities will have to gather and track information that they may not have previously monitored.

Note that the above are only a few examples of changes automotive entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the new requirements to determine whether any other modifications may be necessary.

Retrospective Application

Exposure Draft Ind AS 115 does not provide for any transitional provisions and retrospective applications.

Thinking Ahead

Although the exposure draft on revenue recognition is not effective until finalised by the ICAI and notified by the Ministry of Corporate Affairs, automotive entities should start carefully examining the exposure draft and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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