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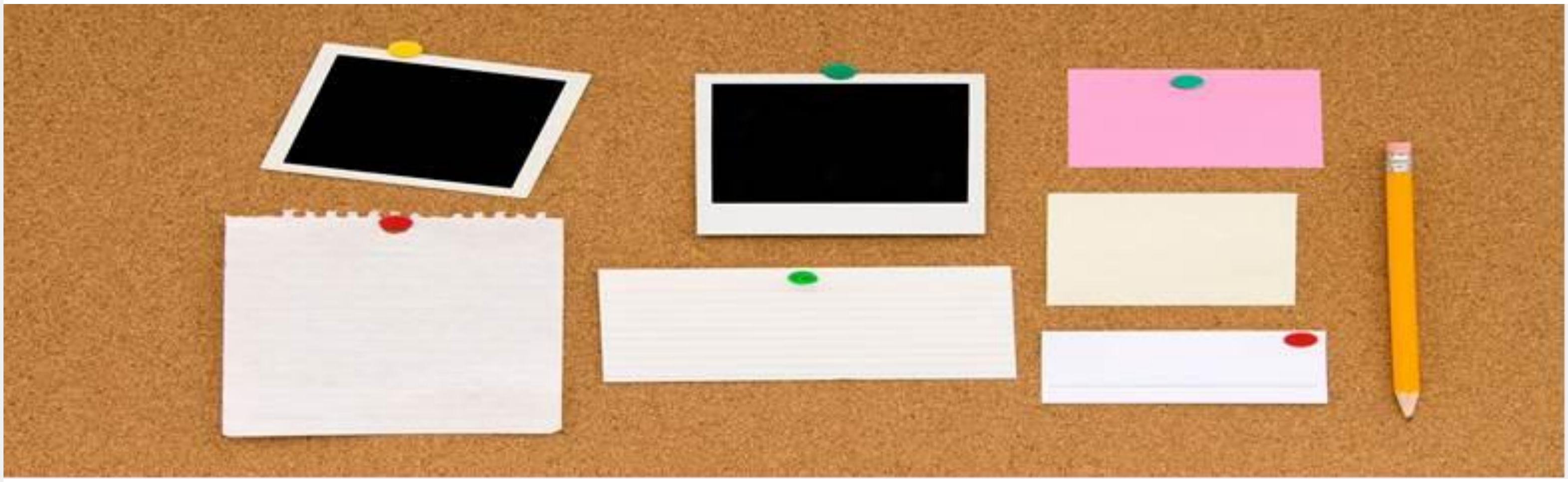

Accounting & Auditing News

IFRS 15 — *Revenue from Contracts with Customers*: Part 3O – Impact on Automotive Sector

When should variable or uncertain revenues be recognized?

Background

Contracts in the automotive sector can include significant variable elements, such as rebates, credits and incentives. There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognized would not be subject to significant future reversals as a result of subsequent re-estimation.

Effect

This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgment to estimate the amount of consideration that should be taken into account. Accordingly, the profile of revenue recognition may change for some entities as a result. Furthermore, within the automotive sector there can be more complicated arrangements which will be impacted by the new variable consideration requirements. A common example for an original equipment manufacturer (OEM) is a cash rebate incentive or other rebate to compensate the dealer network for offering discounted or free servicing components to the end customers. OEMs may be required to estimate the incentives that will be granted to the dealer networks even if the amount depends on a future event (e.g. sales to end customers).

Should Revenue be Recognized Over Time or at a Point in Time?

Background

IFRS 15 introduces a new approach to determine whether revenue should be recognized over time or at a point in time. Three scenarios are specified in IFRS 15 in which revenue will be recognized over time – broadly, they are when (i) the customer receives and consumes the benefits of the seller's performance as the seller performs; (ii) the seller is creating a work in progress asset which is controlled by the customer; and (iii) the seller is creating a work in progress asset which could not be directed to a different customer and in respect of which the customer has an obligation to pay for the entity's work to date.

Effect

If revenue is to be recognized over time, a method should be used which best reflects the pattern of transfer of goods or services to the customer. If a transaction does not fit into any of the three scenarios described above, revenue will instead be recognized at a point in time, when control passes to the customer. Automobile part manufacturers may be significantly impacted by these new requirements if the parts they manufacture cannot be directed to another customer and if they are entitled to payment for work to date. Careful analysis will be required as relatively small differences between otherwise similar contracts could have a fundamental impact on the timing of revenue recognition, and for example, require entities to recognized revenue over time when previously they have been recognizing it at a point in time.

How should warranties be accounted for?

Background

The new standard distinguishes between a warranty providing assurance that a product meets agreed-upon specifications (accounted for as a cost provision) and a warranty providing an additional service (for which revenue will be deferred). Consideration of factors such as whether the warranty is required by law, the length of the warranty coverage period, and the nature of the tasks the entity promises to perform will be necessary to determine which type of warranty exists.

Effect

If a customer can choose whether or not to purchase a warranty as an optional extra, that warranty will always be treated as a separate service. Where a warranty is determined to include both elements (assurance and service), that transaction price is allocated to the product and the service in a reasonable manner (if this is not possible, the whole warranty is treated as a service). In the automotive sector, it is common for warranties to include both elements. For example, a warranty may both assure the quality of the vehicle and provide a free maintenance plan for two years. Where a warranty contains both elements, judgment will be needed in order to determine how to allocate the transaction price in a reasonable manner, and this may result in warranties being accounted for differently than at present.

How to identify and allocate revenue to different goods and services?

Background

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgment when identifying the goods and services within a contract and then allocating the revenue to those goods and services identified. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15.

Effect

The new standard requires the revenue from a contract to be allocated to each distinct good or service provided on a relative standalone selling price basis, though a residual approach is permitted in limited circumstances.

This may significantly change the profile of revenue recognition for some entities where, for example, they offer a free maintenance period to customers as part of a transaction. Where entities have a large number of customers with different options, there may be some significant practical challenges to overcome in order to ensure systems are in place to deal with the new requirements.

Does the new Standard impact which types of transactions will be accounted for as revenue?

Background

It is common for companies in the automotive industry to offer vehicles to dealer or other customers under various agreements (or programs or different terms and conditions). For example, an OEM may agree to sell a vehicle to a dealer or rental car company and agree to repurchase the vehicle at a future date at a predetermined amount. Alternatively, programmers such as mobility as a service where customers can make use of a vehicle when or as needed are becoming more commonplace.

Effect

Entities should considered carefully their types of offers in light of the new Standard to determine whether they are in the scope of IFRS 15 or another Standard (e.g. leasing).

Should revenue be allocated to customer options to acquire additional goods or services at a discount?

Background

Some contracts in the automotive sector include a right for the customer to purchase additional goods or services at a discount, for example roadside assistance.

Effect

Where the contract conveys a material right, an entity must allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer, or when the option expires.

Should revenue be adjusted for the effect of the time value of money?

Background

IFRS 15 introduces new and more extensive guidance on financing arrangements and the impact of the time value of money. Sales by automotive companies may include financing arrangements in that the timing of cash inflows from the customer may not correspond with the timing of recognition of revenue.

Effect

Under the new Standard, the financing component, if it is significant, is accounted for separately from revenue. This applies to payments in advance as well as in arrears, but subject to an exemption where the period between payment and transfer of goods or services will be less than one year. This new guidance may change current accounting practices in some cases.

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