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IFRS industry insights: Automotive sector

New revenue Standard could impact profile of revenue and profit recognition

Headlines

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, automotive companies will need to consider:
  - whether revenue should be recognised **over time** or at **a point in time**;
  - the impact of new guidance where pricing mechanisms include **variable amounts**;
  - the type of **warranty** coverage offered to customers;
  - the extent to which **distinct goods or services** are supplied, which should be accounted for separately; and
  - whether certain offers of vehicles fall within the **scope** of the new Standard.
- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the automotive sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the automotive sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the automotive sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition.

This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting systems and processes may require changes to cope with the new Standard
As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the automotive sector may require modifications to existing accounting systems and, in some cases, entities may conclude that they should develop new systems solutions. The availability of a 'portfolio approach' in some circumstances may reduce this additional complexity, but it will not be eliminated.

In determining the extent to which systems modifications will be required, entities will wish to consider the need for sufficient flexibility to cope with future changes in pricing and in the variety of product offerings made to customers. The 1 January 2017 effective date may set a challenging timeframe for developing new systems.

What are the most significant changes?

Should revenue be recognised over time or at a point in time?
IFRS 15 introduces a new approach to determine whether revenue should be recognised over time or at a point in time. Three scenarios are specified in which revenue will be recognised 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. If revenue is to be recognised 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 recognised 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 recognise revenue over time when previously they have been recognising it at a point in time.

When should variable or uncertain revenues be recognised?
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 recognised would not be subject to significant future reversals as a result of subsequent re-estimation. 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 judgement 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).

How should warranties be accounted for?
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. 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), the 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, judgement 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?
Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement 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. 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?
It is common for companies in the automotive industry to offer vehicles to dealers 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, programmes such as 'mobility as a service' where customers can make use of a vehicle when or as needed are becoming more commonplace. These types of offers will have to be considered carefully 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?
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. Where the contract conveys a material right, an entity must allocate a portion of the transaction price to the option and recognise 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 effects of the time value of money?
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. 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.

What else might change?
In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. Further industry publications are also available here.

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