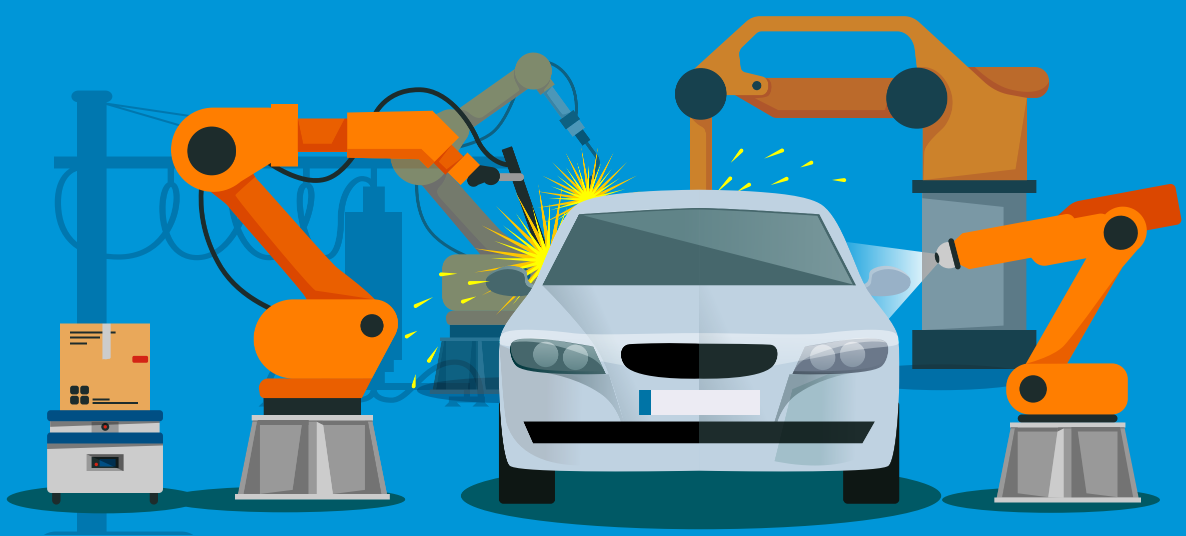
Revenue recognition - Ind AS 115 implications for automotive sector

This article aims to:

- Highlight the key impact of Ind AS 115 on the automotive sector.

Summary

- Determination of separate performance obligations is a key step e.g. for free goods and services and warranty.
- Variability in transaction price may be explicit or implicit, arising from customary business practices e.g. bonus, incentives, price concessions.
- When estimating stand-alone selling prices, it may be acceptable to select from a range of prices, particularly when stand-alone selling prices would be expected to vary from similar types for customers.
- For principal vs agent evaluation there is no specific hierarchy for the indicators, and all of the indicators are considered in making the assessment.



Introduction

The significance of the automotive sector as a critical growth engine for an economy cannot be over emphasised. The integral players of the value chain in automotive sector are the Original Equipment Manufacturers (OEMs) and component supplier units (who engage in production of components, parts and ancillary products used in vehicles and dealer network).

Revenue is considered as one of the key benchmarks for performance of these players in the industry. Ind AS 115, *Revenue from Contracts with Customers* is the standard on revenue recognition that is converged with IFRS 15, *Revenue from Contracts with Customers*. The new revenue standard is likely to throw up multifaceted challenges from an accounting perspective in the automotive sector, out of which we have attempted to provide our insights on specific issues confronting the companies in this sector.

The standard contains a single model that can be applied while accounting for contracts with customers across various industries including automotive sector.

Its core principle is that an entity is required to 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.

In this article, we highlight the steps in the five–step model that are likely to impact the automotive sector.

Framework agreements

A contract should create enforceable rights and obligations and specifies that enforceability is a matter of law. Contracts can be written, oral or implied by an entity's customary business practices. Under Ind AS 115, a contract should meet all the following criteria:

Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016

A contract does not exist when each party has the unilateral right to terminate a wholly unperformed contract without compensation.

Determining whether a contract exists is important because generally an automotive supplier cannot recognise revenue from an arrangement before all the criteria mentioned in Ind AS 115 are met.

Therefore, entities should involve their legal departments to evaluate whether a specific document or a set of documents has legal binding and creates a contract with a customer in the scope of Ind AS 115, for example, in the case of master service agreement and subsequent purchase orders.

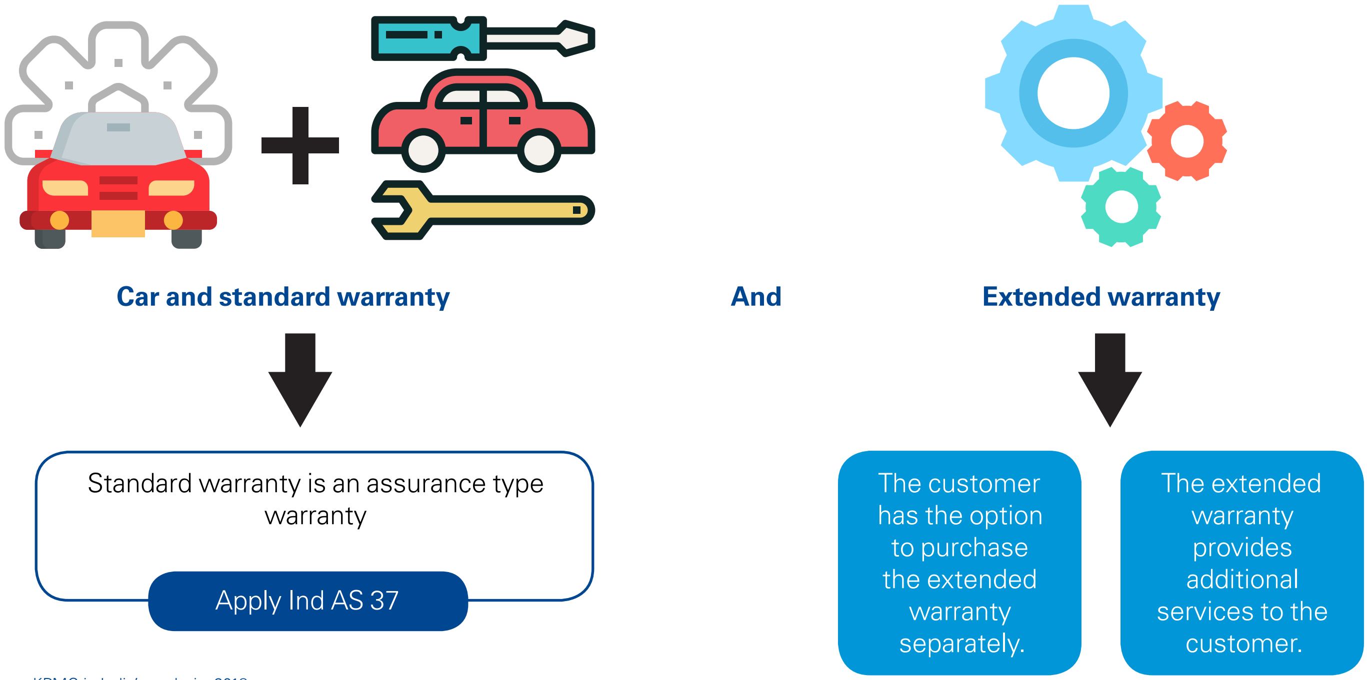
Performance obligations

An OEM needs to identify the performance obligations to determine whether it has promised transfer of goods or services that are distinct, or a series of distinct goods or services that meet certain conditions. These promises may not be limited to those explicitly included within contracts.

An OEM may have a history of offering free goods/ maintenance services to its dealer's customer. These services may not be explicitly stated in the contract between the manufacturer and dealers. If the automobile manufacturer has a customary business practice, this may then be treated as an implicit promise and maintenance, free spares and accessories would be treated as a separate performance obligation.

Another example of separate obligation is the warranty provided in connection with the sale of automobiles.

The nature and type of warranty could depend on the contract, law or the entity's customary business practices. Under Ind AS 115, a warranty is considered as a performance obligation if the customer has an option to purchase the good or service with or without the warranty. The standard identifies assurance-type warranties (an assurance that the related product will function as the parties intended because it complies with agreed upon specifications) and service warranties (which provides the customer with a service in addition to the assurance that the product complies with the agreed-upon specifications).



Source: KPMG in India's analysis, 2018

The standard has envisaged two situations in relation to accounting for warranty costs:

- **The customer has an option to purchase a warranty separately** (for example, because the warranty is priced or negotiated separately): The warranty is a distinct service because the OEM promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, the OEM would account for the promised warranty as a performance obligation and allocate a portion of the transaction price to that performance obligation
- **Customer gets additional services as part of the warranty:** When a warranty is not sold separately, (e.g. extended warranty) the warranty or part of the warranty may still be a performance obligation, but only if the warranty or part of it provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications. A warranty that only covers the compliance of a product with agreed- upon specifications (an 'assurance warranty') is accounted for under other relevant guidance e.g. Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets.*

The assessment of whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications is a matter of judgement which requires a consideration of factors such as:

- **Whether the warranty is required by law:** If an entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because such requirements typically exist to protect customers from the risk of purchasing defective products.
- **The length of the warranty coverage period:** The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to assurance that the product complies with agreed-upon specifications.
- **The nature of the tasks that the entity promises to perform:** If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks are unlikely to give rise to a performance obligation.

Sales incentive offered by a seller – variable consideration

Sale contracts between OEMs and dealers often include incentives such as cash rebates, bonuses, price concessions or credits which are contingent upon specific milestones such as the number of vehicles sold in a period. The incentives could also include reimbursement of free maintenance services (to dealers) given to customers. These incentive may result in variable consideration. Since automotive entities develop various sale promotion schemes in order to increase their sales, careful consideration and judgement is required to ensure appropriate accounting.

When estimating the transaction price for a contract with variable consideration, an entity's initial measurement objective is to determine which of the following methods best predicts the consideration to which the entity will be entitled. (see the table below)

Expected value	The entity considers the sum of probability-weighted amounts for a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.
Most likely amount	The entity considers that single most likely amount from a range of possible consideration amounts. This may be an appropriate estimate of the amount of variable consideration if the contract has only two (or perhaps a few) possible outcomes.

The method selected is applied consistently throughout the contract and to similar types of contracts when estimating the effect of uncertainty on the amount of variable consideration to which the entity will be entitled.

Financial assistance by OEMs – Significant financing component

In some arrangements, OEMs provide advances to automotive suppliers for parts before delivery. Payments made at an early stage of the project may provide the suppliers with financial assistance. Also other instances of significant financing components include cases where a taxi company may pay in advance for a fleet of cars, or a courier company may pay OEMs for a fleet of vehicles suitable for its purpose, etc.

Under Ind AS 18, *Revenue,* an entity discounts consideration to present value if payment is deferred and the arrangement effectively constitutes a finance transaction – e.g. a customer paying the agreed sales price two years after it takes ownership of the product. However, Ind AS 18 is silent on whether an entity adjusts consideration if payment is received in advance. OEMs may support their component and parts suppliers by providing them financial assistance through advance payments at an early stage of the project. Under the new revenue recognition standard Ind AS 115, suppliers need to consider whether these payment terms (i.e. deferred or advance) indicate that such contracts contain a significant financing component that adjusts the transaction price.

Suppliers may need to recognise interest expense on such prepayments made by OEMS. The interest expense recognised also causes an increase in transaction price.

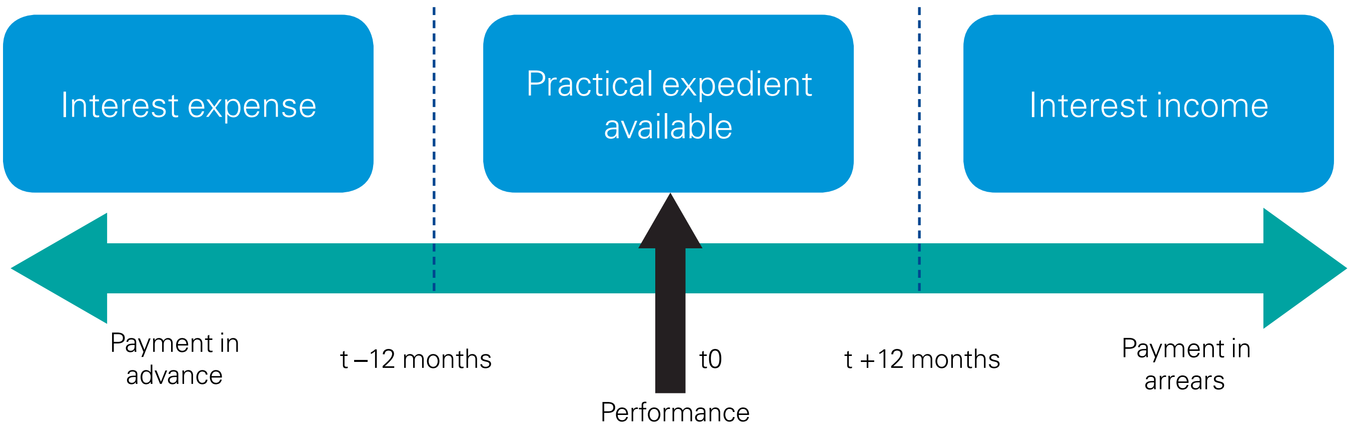
The objective when adjusting promised amount of consideration for a significant financing component is to recognise revenue at an amount that reflects what the cash selling price of the promised good or service would have been if the customer had paid cash at the same time as control of that good or service transferred to the customer.

The discount rate reflects the credit characteristics of the party receiving the credit.

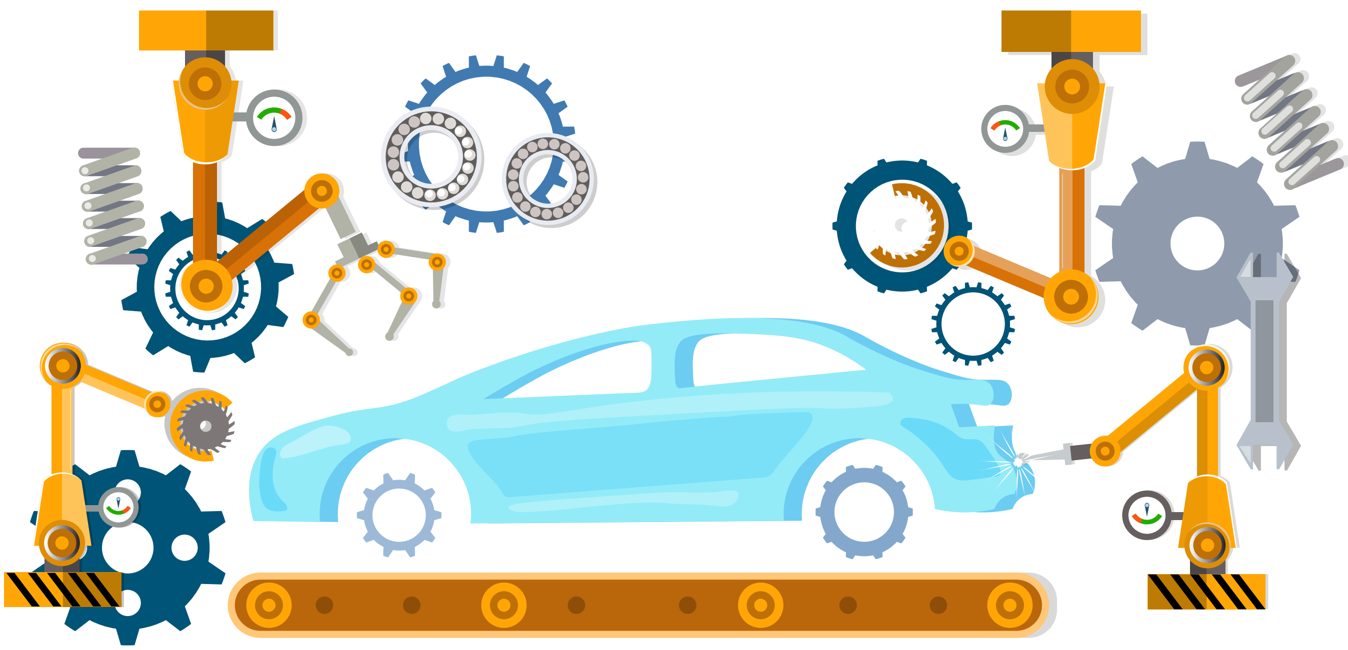
Ind AS 115 notes that a contract does not include a significant financing component in some specific circumstances-e.g. when a customer pays for goods in advance and the timing of the transfer of the goods is at the customer's discretion.

As a practical expedient, an entity is not required to adjust the transaction price for the effects of a significant financing component if, at contract inception, the entity expects the period between customer payment and the transfer of goods or services to be one year or less.

Significant financing component



Source: Revenue Issues In-Depth, KPMG IFRG Limited's publication, May 2016



Allocation of transaction price

Under Ind AS 18, consideration to be received could be allocated to components of a revenue transaction using the following methods:

- Components with reference to the relative fair values of the different components (relative fair value method) or
- The undelivered components measured at their fair value, with the remainder of the balance allocated to components that were delivered up-front (residual method).

Ind AS 115 provides detailed guidance on allocation of transaction price. In this step, an entity is required to allocate the transaction price at the contract inception to each performance obligation on the basis of relative stand-alone selling prices (unlike earlier Ind AS 18 where fair value of consideration was to be considered). The best evidence of such a price is the observable price from stand-alone sales of the goods or service to similarly - situated customers. If observable price is not available, then price need to be estimated by using:

- **Adjusted market assessment approach:** Evaluate the market in which goods or services are being sold and estimate the price that a customer would be willing to pay
- **Expected cost plus a margin approach:** Forecast expected costs of satisfying a performance obligation and add an appropriate margin for that good or service
- **Residual approach (only in limited circumstances):** Estimate the stand-alone selling price by reference to the total transaction price less the sum of observable stand-alone selling prices of other goods or services promised in the contract. The residual approach is appropriate only if the stand-alone selling price of one or more goods or services is highly variable or uncertain, and observable stand-alone selling prices can be established for other goods or services promised in the contract.

In the automotive sector, the key impact would be with respect to determination of stand-alone selling prices of extended warranties and free goods and services.

In case of sale of vehicle, a contractually stated price or list price could be the stand-alone selling price, but it could not be presumed to be the case. In practice, the OEM may provide certain price concessions, hence, the entity would need to consider the observable price.

Estimated stand-alone selling prices for a particular good or service may change over time due to changes in market conditions and entity specific factors. Although the estimated stand-alone selling prices for previously allocated arrangements are not revised, new arrangements should reflect current reasonably available information, including shifts in pricing, customer base, or product offerings.

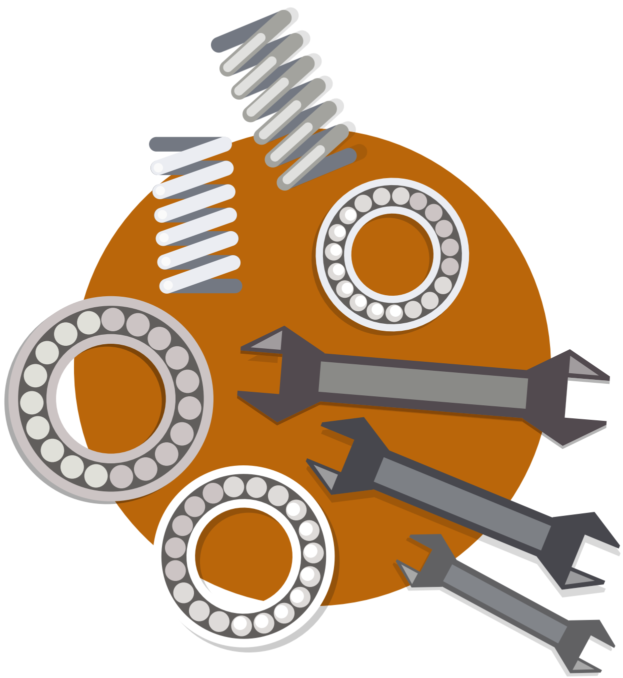
Principal vs agent

OEMs usually sell through a network of dealers. This entails movement of the vehicles from the manufacturer's premises to the dealer premises/showrooms. The nature of terms/arrangement between the OEM and the dealer to ship the vehicles from one location to the other could be different and need to be analysed carefully to determine whether a separate performance obligation exist.

If the scope of the contract is to supply the vehicles at the location of the dealer at a lump sum price, it may indicate that there is a single performance obligation and revenue should be recognised once the performance obligation is met i.e. the vehicles are delivered at the location of the dealer.

If the scope of the contract is to only supply the vehicles and arrange for shipping services (at the request of the dealer) to deliver the vehicles at the location of the dealer and the price is negotiated separately, it may indicate that there are two performance obligations – one for the supply of goods (vehicle) and other for rendering of services (shipping).

In such an arrangement which involves two parties (OEM and dealer), management will need to determine whether the entity has promised to provide the services of shipping itself (as a principal) or to arrange for the specified service to be provided by another party (as an agent).



If the OEM is acting as a **principal** for shipping services:

- Revenue will be recognised at gross amount paid by the customer for supply of vehicle and rendering of shipping service
- Amount paid to the party providing shipping service will be recorded as an expense
- Any other cost incurred in satisfying the performance obligation of shipping service will be recorded as an expense

Revenue for sale of vehicles will be recognised only once all performance obligations are met i.e. once the control in goods is passed on to the dealer.

If the OEM is acting as an **agent** for shipping services:

- Any commission or service charge paid to the entity will also be recognised as revenue.

Revenue for sale of vehicles will be recognised once the control in goods is passed on to the dealer.

Timing of revenue recognition

Ind AS 115 provides a control-based approach to be applied to all transactions i.e. at the contract inception, an entity need to evaluate whether it transfers control of the good or service over-time or at a point in time.

Under Ind AS 18, revenue from the sale of goods is recognised when, amongst the other criteria, the entity has transferred to the buyer significant risks and rewards of ownership. However, under Ind AS 115 revenue is recognised at a point in time at which control of the good or service is transferred to the customer. The new standard includes certain indicators of transfer of control such as the customer has:

- A present obligation to pay
- Physical possession
- Legal title
- Risks and rewards of ownership
- Accepted the asset.

It emphasises on transfer of 'control' as against transfer of 'risks and rewards'. Under Ind AS 115, revenue would be recognised as and when the **'control'** over vehicles is transferred to the customer. The standard requires entities to determine whether the control is passed on **over a period of time** or **at a point in time** for the purposes of recognising revenue.

Disclosures

The stated objective of the revenue disclosures is to enable users to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

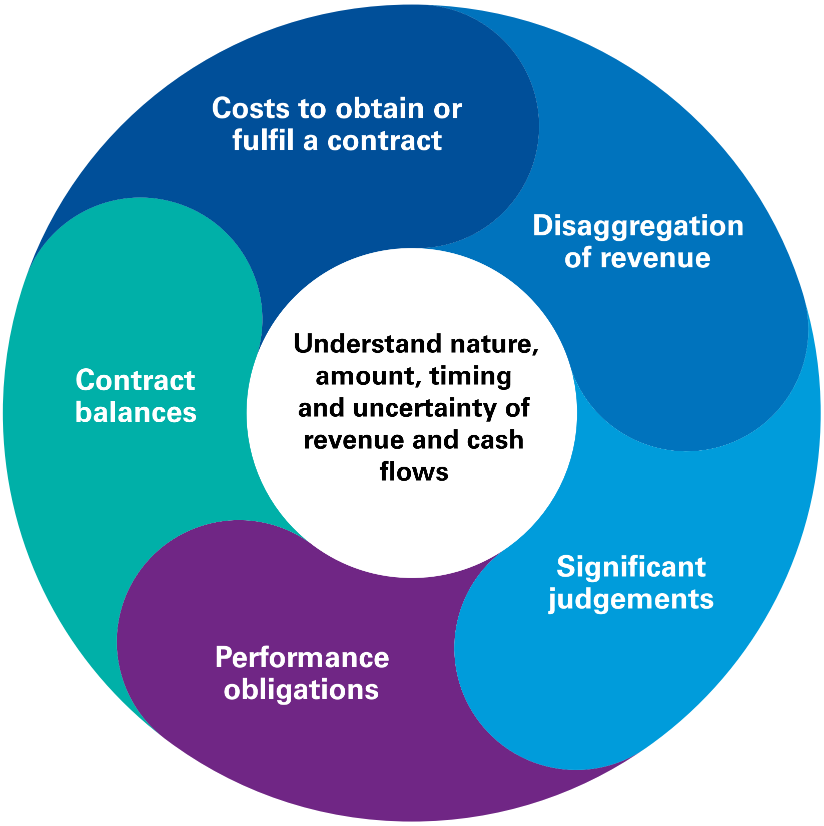
To meet this objective, the entity is required to provide the following disclosures about its contracts with customers:

- Disaggregation of revenue into categories that depict how the nature, amount, timing and uncertainty of revenue and cash flows are affected by economic factors. Examples of disaggregation include: type of good or service, geography, market, type of customer and type of contract. The entity is also required to disclose sufficient information to enable users to understand the relationship between the disclosure of disaggregated revenue and revenue information that is disclosed for each reportable segment.
- Narrative disclosure to describe changes in contract assets, contract liabilities and contract costs.
- Impairment losses recognised on any receivable or contract assets.
- Information about the entity's performance obligations in its contracts with customers.
- Amount of the transaction price allocated to remaining performance obligations and an explanation of when the entity expects to recognise the allocated amounts.

- The entity is also required to disclose significant judgements made in accounting for customer contracts, including judgements related to the following:
  - Methods used to recognise revenue over time (output method or input method).
  - Explanation of why the 'over time' method(s) faithfully depicts the transfer of goods or services.
  - Transfer of control of goods or services for performance obligations that are satisfied at a point in time.
  - Methods used to determine the transaction price and its allocation to performance obligations.
  - Estimates of stand-alone selling prices.
  - Measurement of obligations for returns.

The disaggregation of revenue disclosures are also required to be included in the entity's interim financial statements and the optional practical expedients that it has elected to use.

OEMs and automotive suppliers would need to assess whether their current systems and processes are capable of capturing, tracking, aggregating and reporting information to meet the new disclosure requirements. This may require significant changes to the existing data-gathering processes, IT systems and internal controls.



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