No. 2014-26
27 August 2014

Technical Line

FASB — final guidance

The new revenue recognition standard — automotive

A key issue for automotive entities includes identifying performance obligations.

What you need to know

- The new revenue recognition standard is more principles-based than current revenue guidance and will require automotive entities to exercise more judgment.
- 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.
- The new standard is effective for public entities for fiscal years beginning after 15 December 2016, including interim periods within those years, and for nonpublic entities in years beginning after 15 December 2017.

Overview

Automotive entities may need to change certain revenue recognition practices as a result of the new revenue recognition standard jointly issued by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards). The new revenue recognition standard will supersede virtually all revenue recognition guidance in US GAAP and IFRS.

The new standard provides accounting guidance for all revenue arising from contracts with customers and affects all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other US GAAP requirements, such

as the leasing literature). The guidance also provides a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate.

Our Technical Line, *A closer look at the new revenue recognition standard* (SCORE No. BB2771), provides an in-depth discussion of the new revenue standard. This publication summarizes certain implications for automotive entities.

Automotive entities also may want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG). The Boards created the TRG to help them determine whether more implementation guidance or education is needed. The TRG won't make formal recommendations to the Boards or issue guidance. 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. Any views or guidance produced by the TRG or AICPA is non-authoritative.

The views we express in this publication 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. As our understanding of the standard evolves, we will update our guidance.

Key considerations

To apply the new standard, 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 identify separate performance obligations (i.e., unit of account) where today they do not. The accounting for contracts with repurchase options or residual value guarantees also may change.

Incentives

OEMs frequently offer sales incentives in contracts to sell vehicles to dealers. These sales incentives can be in the form of a cash rebate bonus or other incentive to dealers and retail customers (who purchase the vehicle from the dealer). These incentives can also include free or heavily discounted goods or services provided to retail customers, such as free satellite radio or free maintenance for a specified period.

Under the new standard, cash incentives (or 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 accounted for as a reduction in the transaction price, and therefore of revenue. However, if the payment to the customer is in exchange for a distinct good or service that the customer transfers to the OEM and the OEM is able to reasonably estimate the fair value of the good or service transferred, the OEM would account for the purchase of the good or service in the same way it accounts for other purchases from suppliers. This is similar, but not identical, to today's guidance, so OEMs will need to evaluate whether the new standard changes the accounting for its cash incentive programs.

Under the new standard, incentives to provide free or discounted goods will likely represent promised goods or services (i.e., they are likely revenue elements) rather than marketing incentives. The Boards' concluded that even if such incentives (e.g., free maintenance services performed by a dealer for which the OEM provides reimbursement) 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 promises in the contract, and the OEM will be required to account for the free services as a revenue element.

Under current guidance, some OEMs record the cost of sales incentives, including free goods or services, as a reduction in revenue. Treating a free good or service as a revenue element will be a significant change in practice for those 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 guidance on 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 of the equipment required to manufacture the part (referred to as tooling) to meet the OEM's specifications. In many cases, the APS will construct and transfer the legal title of the tooling to the OEM after construction, even though they will retain physical possession of it to produce the parts.

Currently, some APSs account for tooling as a revenue element because they have concluded it is a deliverable in the arrangement. Those APSs will likely be able to reach the same conclusion under the new revenue standard because the Boards concluded that incidental goods and services are goods or services for which the customer pays and to which the entity should allocate consideration (i.e., identify as performance obligations) for purposes of revenue recognition.

APSs may be required to change when they recognize revenue for supplying customized parts.

Other APSs have concluded that tooling is not a revenue element because it does not represent a deliverable in the arrangement. In order to reach the same conclusion in the new standard, APSs will need to conclude 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 conclusion.

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. In making this evaluation, an APS will have to consider whether the tooling is separately identifiable from the production of the specified parts (e.g., is the tooling highly dependent on, or highly interrelated with, the production of the specified parts). APSs will have to apply significant judgment in making these determinations.

An entity recognizes revenue when it transfers control of the promised good or service to the customer, which can occur over time or at a point in time. If the tooling is distinct, an APS would separate the tooling from the production of the other specialized parts and recognize revenue for the tooling over time or at a point in time depending on how control of the tooling transfers to the OEM. If the tooling is not distinct, the APS would combine the tooling with the production and recognize revenue as control of the specialized parts are delivered to the OEM. This evaluation will require judgment and careful consideration of the facts and circumstances.

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 fit specifically within a particular make and model 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 some combination of them) are considered a single performance obligation. After the performance obligations are identified, APSs will also need to evaluate whether the performance obligations meet the criteria for recognizing revenue over time (rather than at a point in time, such as when delivery occurs).

The Boards concluded that 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 asset for any other purpose. The standard 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, such as selling it to a different customer, when determining whether an asset has alternative use. A contractual restriction needs to be substantive (i.e., the customer could enforce its rights to the promised asset if the entity directed the asset for another use), and a practical limitation only exists if an entity would incur significant economic losses to direct the asset for another use. An APS might consider these concepts in the context of selling customized parts to an after-market supplier. The evaluation of whether an asset has alternative use will require significant judgment.

APSs also will 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. The standard 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 at least compensates it for performance completed to date, even if the customer can terminate the contract for reasons other than the entity's failure to perform as promised.

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). If the APS produces work in process or finished goods inventory at the end of a reporting period that is material, then this change in the timing of revenue recognition for the customized parts may 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). Under today's guidance, OEMs account for these vehicle sales as leases in accordance with Accounting Standards Codification (ASC) 840, *Leases*.

Under the new standard, arrangements repurchase features must be evaluated to determine whether they represent a sale, lease or financing, based on 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.

OEMs frequently agree to make the customer whole for the difference between the resale price the customer obtains in an open market and the guaranteed minimum resale value. Under the new guidance, these arrangements should be accounted for in accordance with ASC 460, *Guarantees*, and the revenue standard.

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

Next steps

- Entities should perform a preliminary assessment on how they will be affected 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 won't change significantly or at all.
- Entities also may want to monitor the discussions of the Boards, the Securities and Exchange Commission (SEC) staff and the TRG.
- Public entities also should consider how they will communicate the changes with investors and other stakeholders, including their plan for disclosures about the effects of new accounting standards discussed in SEC Staff Accounting Bulletin (SAB) Topic 11.M. The SEC staff has indicated it expects an entity's disclosures to evolve in each reporting period as more information about the effects of the new standard becomes available, and the entity should disclose its transition method once it selects it.

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