



IFRS 15 for automotive suppliers

Are you good to go?



Application guidance

December 2017

Contents

Purpose of this document	1
What may change?	2
1 Tender offer phase – Nomination fees	4
2 Framework agreements	9
3 Pre-production engineering	14
4 Tooling	23
5 Financial assistance by OEMs – Significant financing component	29
6 Pricing arrangements – Customer options	33
7 Production phase	38
8 Modifications and price adjustments	46
9 Transfer of work in progress from OEM	50
10 Transition adjustments	53
11 Disclosures	56
Further resources	58

Purpose of this document

What is *Good to go*?

IFRS 15 *Revenue from Contracts with Customers* may change the way automotive suppliers (suppliers) account for various stages of their projects, such as framework agreements, tooling arrangements, serial production, modifications and price adjustments. In the past, when major IFRS change has led to large-scale implementation projects, management at companies – usually group financial controllers – have asked us ‘How will I know when we’re done?’

To help to answer that question, we’ve created a SlideShare accompanied by this guide that list the key considerations that all suppliers need to focus on to get to the finish line.

Each section within this guide deals with a different issue and considers the new requirements and how they differ from existing requirements.

More information

Please refer to the back of this publication for further resources to help you apply the new standard’s requirements.

What may change?

This document focuses on the following areas that may result in a change in practice for automotive suppliers on adoption of IFRS 15.

Nomination fees

The new guidance on accounting for payments to customers in the new standard may result in more payments to Original Equipment Manufacturers (OEMs) accounted for as a reduction of revenue compared with current practice. Judgement will be required to determine whether payments that are made before a contract exists under the new standard – e.g. when there is only a framework agreement – could be capitalised and amortised as a reduction of revenue over the expected purchases in the agreement.

Framework agreements

The new standard contains more detailed guidance on whether a contract exists, which may result in no revenue being recognised for pre-production activities under certain circumstances, or a change in the transaction price allocated to certain activities in a project. The guidance on contract combination under the new revenue standard differs in some respects from the existing guidance. This may require analysis of whether, and which, purchase orders made under the same project need to be combined.

Pre-production engineering and tooling

The new standard excludes from its scope collaborative arrangements and activities that are in the scope of other standards. This may result in some pre-production activities being accounted for outside of revenue. Further, some pre-production activities may not be considered as a separate deliverable and any consideration paid for them may be attributable to the provision of future goods or services.

Financial assistance

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

Pricing arrangements

If suppliers offer predetermined or implicit price reductions to OEMs, then any consideration received at the beginning of the contract may require allocation to future purchase orders. Other price reductions may represent variable consideration – i.e. they need to be estimated and updated throughout the contract term.

Production phase

The new standard may result in different timing of revenue compared with current practice. Subtle differences in the contract terms and the nature of parts or tools produced could result in different outcomes. Revenue for parts that is currently recognised at multiple points in time could be recognised as a single continuous series. This may bring forward the revenue recognised for learning curve costs.

Modification and price adjustments

The new standard's modification guidance differs from current requirements. Some modifications of purchase orders that are currently accounted for as separate contracts may need to be combined with previous, unfinished purchase orders and pre-production activities.

Transfer of work in progress

Similar to current requirements, work in progress transferred from an OEM is recognised as a supplier's asset only if the latter controls it. However, because of more specific guidance on the transfer of control in IFRS 15, the accounting outcome may differ in some circumstances.

1 Tender offer phase – Nomination fees

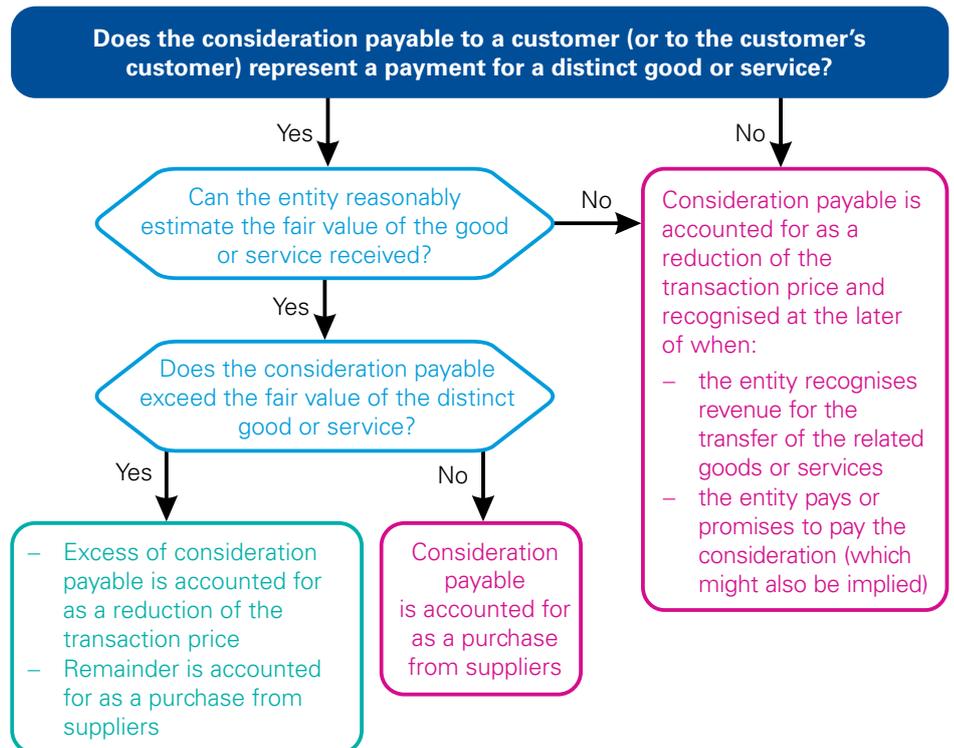
Overview

Automotive suppliers may be required to make a payment to OEMs to take part in the tendering process for specific projects (sometimes also referred to as 'programmes'). These payments are often called 'pay to play' or 'nomination fees'. Judgement is required when determining whether these payments are recognised up-front as an expense, as a reduction of revenue or may be capitalised as an asset. If capitalised, then they are amortised as a reduction of revenue.

Requirements of the new standard

Consideration payable to a customer includes cash amounts that an entity pays or expects to pay to the customer, or to other parties that purchase the entity's goods or services from the customer.

An entity evaluates the consideration payable to a customer to determine whether the amount represents a reduction of the transaction price, a payment for distinct goods or services, or a combination of the two.



These requirements are discussed further in Chapter 5.3 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Customer incentives

Currently, there is diversity in practice over whether payments to customers are accounted for as a reduction in revenue, an expense or an asset. The requirements of the new standard may change the accounting for some automotive suppliers.



Application of the new requirements

Judgement may be required when determining whether payments to potential customers could be capitalised

Non-refundable up-front payments, including payments such as 'pay to play' or 'nomination fees', may be made before there is a contract with a customer. For example, they may be paid to participate in the tendering process, or upon signing a framework agreement – e.g. a master service agreement – which may not on its own meet the definition of a contract under IFRS 15 (see Section 2).

If up-front payments are not in exchange for a distinct good or service, then they are accounted for as a reduction of the transaction price. However, if an automotive supplier makes these payments when there is no enforceable contract with a customer or the contract term is very short, then judgement may be required to determine whether these payments:

- may be capitalised and amortised as a reduction of revenue over expected purchases;
- are recognised as a reduction of revenue over the existing contract; or
- are recognised immediately in profit or loss.

When determining the appropriate accounting for an up-front payment, factors to consider may include:

- the underlying reason for the payment;
- whether the payment is recoverable – e.g. if an exclusive relationship is secured and it is probable that the customer will make sufficient purchases to recover the payment; and
- the history of renewals and the average project life, which usually indicate whether the expected initial contract will be obtained and whether the payment will be recovered through the initial contract or anticipated renewals.

Scope of consideration payable to a customer is wider than payments made under the contract

Payments made to a customer that are not specified in the contract may still represent consideration payable to that customer. A supplier needs to develop a process for evaluating whether any other payments made to a customer are consideration payable under the new standard.

Consideration payable may include payments made outside a direct distribution chain

Determining how broadly payments within a distribution chain need to be evaluated requires judgement.

Consideration payable to a customer includes amounts paid to a customer's customer – i.e. amounts paid to end customers in a direct distribution chain.

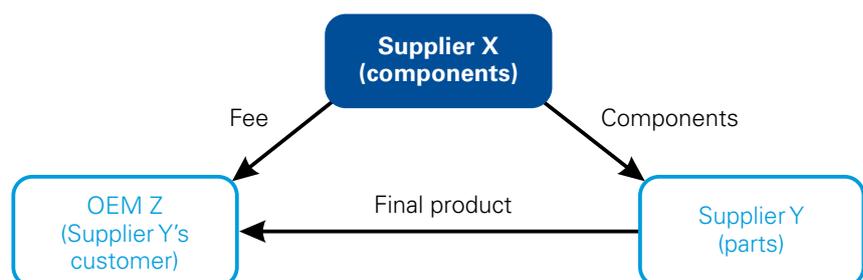
In addition, in some cases, a supplier may conclude that it is appropriate to apply the guidance more broadly – i.e. to amounts paid outside the direct distribution chain. However, a supplier need not always identify and assess all amounts ever paid to a customer to determine whether they represent consideration payable.



Example – Consideration paid to a customer's customer

Automotive Supplier X enters into a contract in the scope of IFRS 15 with Automotive Supplier Y to sell components worth 1,500 during the year as a subcontractor. Y will then integrate these components into parts it sells to OEM Z.

As part of the arrangement, X has agreed to pay a one-off administrative fee of 15 to Z so that it can be added to Z's list of suppliers.



X notes that Z is the end-customer in a distribution chain that includes Y. Therefore, payments to Z may be considered as consideration payable to a customer.

X concludes that the payment to Z is not in exchange for a distinct good or service. Consequently, X determines that the payment of 15 is a reduction of the transaction price, which it recognises as a reduction in the revenue earned as it transfers the promised components to Y.

**Example – Payments to a customer – Framework agreement**

Automotive Supplier S makes a non-refundable up-front payment of 1 million to OEM C as part of the negotiations for a three-year framework agreement to supply specialised parts to C exclusively. The parts will be assembled into an updated version of one of C's vehicles, which has been very successful in the market. C has been a customer of S for many years and S has been able to provide reliable forecasts of the results of its projects with this customer.

The framework agreement stipulates a price of 100 per part. C provides a non-binding projection of its supply requirements, which forecasts probable purchases of 100,000 parts over the three years (for a total of 10 million). S's profit margin on these parts is 20%. However, there is no enforceable contract until C submits a purchase order (see Section 2).

S considers the following factors to evaluate the accounting for the 1 million up-front payment to C.

- It has secured an exclusivity agreement with C.
- It has a long history of doing business with C that is used as a basis for forecasting C's future purchases.
- The payment is expected to be recoverable from probable future purchases that will earn it a margin of 2 million (10 million x 20% profit margin).
- The primary purpose of the fee is to secure an exclusive relationship with C and these transactions are common in the industry.

Based on its overall evaluation of these factors, S concludes that the payment should be capitalised and amortised as a reduction in revenue over the anticipated future purchases.

**Example – Payments to a customer – New product**

Automotive Supplier S enters into a framework agreement with OEM B to supply a specialised component as part of a new product that B is developing. Supplying the part will require extensive pre-production engineering activities, for which S will be paid only if the development process succeeds. B does not commit to a minimum quantity of parts before S produces the first prototype. Because this is a new product, S does not have historical experience with it.

As part of the arrangement, S pays a non-refundable up-front nomination fee to B of 100,000.

When determining how to account for the payment to B, S notes that it:

- cannot reasonably estimate whether the development process will be successful and hence whether it will receive payment for this activity;
- has no contract for a minimum quantity of parts; and
- lacks historical experience with the new product. The uncertainty over the pre-production engineering activity indicates that the payment may not be recoverable through future purchases.

On evaluating these factors, S concludes that this up-front payment does not represent an asset. Therefore, it accounts for the payment as an expense when it is obligated to make the payment.

2 Framework agreements

Overview

What constitutes a contract in the scope of IFRS 15?

Automotive suppliers' arrangements with OEMs are structured differently in different countries and may involve multiple phases. Suppliers and OEMs may enter into framework agreements (often referred to as Master Supply Agreements or MSAs) to determine standard terms of their cooperation – e.g. warranty claims and payment terms. Framework agreements serve as a basis for subsequent purchase orders for the delivery of specific parts.

In some jurisdictions, OEMs confirm suppliers' offers through a 'tender offer'. The offers may contain information about the project's term, its different phases, including development, engineering, tools and prototypes, estimated volumes of parts to be produced each period, prices per unit sold, as well as minimum and maximum production capacity requirements and their location. However, some may not specify minimum quantities of parts to be purchased or guarantee minimum contractual consideration, even if a supplier is required to take part in pre-production activities, such as engineering or construction of tools. Others may include consideration for the pre-production activities, either directly or through termination clauses that guarantee the supplier compensation if the project is terminated early.

When accounting for projects in the nomination letter or tender offer phase, suppliers need to consider whether a contract exists under IFRS 15. In addition, they need to assess whether subsequent purchase orders will be combined with each other and be analysed together with the terms and conditions in the nomination letter and framework agreement, as a single unit of account.

Requirements of the new standard

Contract existence

When applying the new standard, a contract exists only if it is legally enforceable and meets all of the following criteria:

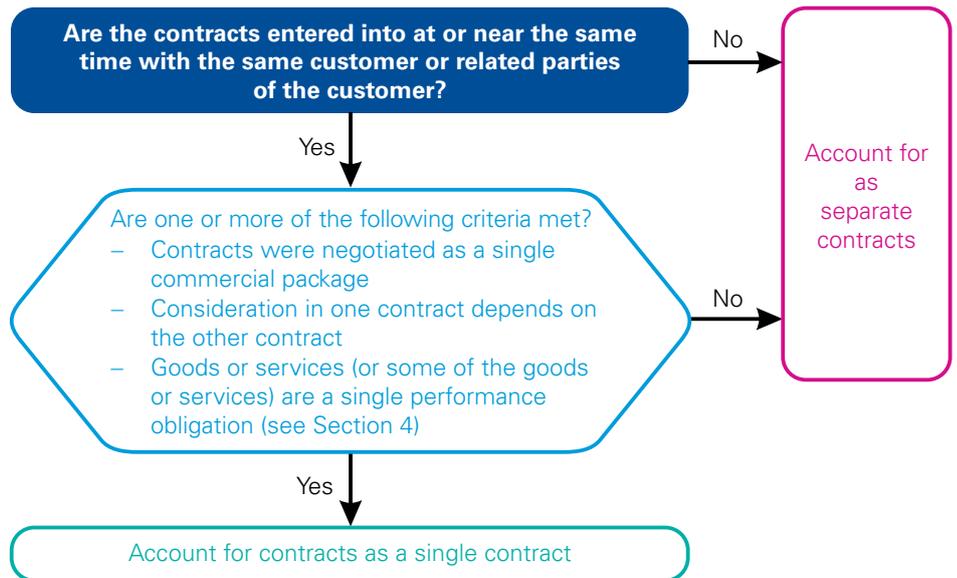
- the contract is approved and the parties are committed to their obligations;
- the rights to goods and services and payment terms can be identified;
- the contract has commercial substance; and
- collection of the consideration is probable.

If any of these criteria are not met, a contract does not exist under IFRS 15 and, generally, no revenue is recognised.

These requirements are discussed further in Chapter 5.1 of our [Revenue Issues In-Depth](#) publication.

Combining contracts

The following flowchart outlines the criteria in the new standard for determining when an entity combines two or more contracts and accounts for them as a single contract.



These requirements are discussed further in Chapter 5.1.4 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Two definitions of a contract exist in IFRS

IAS 11 *Construction Contracts* and IAS 18 *Revenue* do not include a detailed contract existence test. The definition of a contract in the new standard focuses on legal enforceability. Although the term 'contract' is also defined in IAS 32 *Financial Instruments: Presentation*, the IAS 32 definition is different and stops short of requiring the contract to be legally enforceable.

The IASB did not amend the definition of a contract in IAS 32 on the grounds that this may have unintended consequences on the accounting for financial instruments. As a result, there are two definitions of a contract in IFRS – one in IFRS 15 and another in IAS 32.

Combination of contracts

The new standard is broadly similar to the requirements of IAS 11 and IAS 18. However, IAS 11 requires an entity to consider combining a group of contracts as a single contract when the contracts are performed concurrently or in a continuous sequence. In contrast, IFRS 15 states that contracts are combined, inter alia, when the goods or services promised in the contracts are a single performance obligation. In addition, IFRS 15 provides more specific guidance on when to combine contracts than IAS 18, and requires combining of those contracts when the conditions are met.

Current requirements also allow contracts with different customers to be combined in certain circumstances. In contrast, IFRS 15 permits combining of contracts only if they are with the same customer or a related party of the customer.



Application of the new requirements

Careful analysis is required to determine whether agreements with OEMs create enforceable rights and obligations

Determining whether a contract exists is important because, generally, an automotive supplier cannot recognise revenue from an arrangement before all of the criteria listed above are met.

Generally, for a contract to exist with a customer, the terms and conditions in a document or a set of documents that identify specific (or minimum) quantities to be purchased and/or guarantee a minimum contractual consideration. Framework agreements on their own often set only general terms and conditions and, therefore, do not create enforceable rights and obligations. Similarly, the terms in nomination letters and tender offers may not in themselves create a contract in the scope of IFRS 15 for the supply of parts; however, they may do so for other goods or services – e.g. a development service for an agreed amount of consideration.

The requirement for an OEM to place subsequent purchase orders to obtain goods or services alone does not constitute a contract with a customer. When a specific document on its own – e.g. a framework agreement, nomination letter or tender offer – does not create enforceable rights and obligations, it is normally a combination of documents, including a purchase order, that creates enforceable rights and obligations between the supplier and the OEM.

Careful analysis of the relevant local laws and regulations is required to determine whether a specific document or a set of documents has legally binding consequences and creates a contract with a customer in the scope of IFRS 15.

Purchase orders under the same project may need to be combined

Even if the nomination letters themselves do not create legally enforceable obligations, the pricing of the subsequent purchase orders may be interrelated. Purchase orders that are issued separately need to be evaluated and combined if the criteria for combining contracts are met. This may result in a transaction price for an individual purchase order being different from the stated contract price.

When a purchase order is not entered into at or near the same time as previous ones, suppliers need to evaluate whether the new purchase order is essentially a modification of an existing contract. If this is the case, then, in some circumstances, new purchase orders may need to be treated together with previous contracts as a single unit of account (see Sections 3 and 8).

Suppliers need to assess the terms and conditions in the framework agreement and the tender offer to determine whether there are implicit or explicit promises that need to be considered when identifying performance obligations or determining the transaction price. This includes assessing whether the pricing of subsequent performance obligations includes a material right (see Section 6) or any variable consideration (e.g. a rebate or discount).



Example – Contract exists for engineering services, but not for supply of parts

On 1 January, OEM G approves Automotive Supplier S's offer to manufacture a specialised part for its cars. G and S agree that S will also perform engineering and design (E&D) activities on behalf of G, necessary for the production of the part. S concludes that these pre-production activities transfer a service to G (see Section 3). The framework agreement between G and S does not specify a separate price for E&D services, but the price of each part includes a mark-up to compensate S for those services. The framework agreement does not state a minimum quantity of parts to be ordered by G. The agreement also contains a termination clause under which S will be reimbursed for any costs incurred for the E&D services in case G terminates the agreement.

On 1 April, S completes the E&D activities.

On 1 December, G orders the first batch of parts.

S concludes that on 1 January no enforceable rights and obligations arise in relation to the parts, because the agreement does not establish minimum quantities of parts to be purchased. However, because the termination clause in the agreement guarantees compensation for the E&D activities, a contract exists for the E&D services under IFRS 15.

On 1 December, G's purchase order gives rise to enforceable rights and obligations for the first batch of parts. S assesses whether this contract should be combined with the contract to provide E&D services. It concludes that the contracts should *not* be combined because they are not entered into at or near the same time. However, S assesses whether the contract modification guidance applies (see Section 8).



Example – Combining a nomination letter with subsequent purchase orders

On 1 January, OEM F approves Automotive Supplier S's offer to manufacture a specialised part for its cars. F's nomination letter confirms that the price of the units ordered in February and March will be 80 and 100 respectively. F expects to order 50,000 units in each of February and March.

S notes that the nomination letter or the framework agreement do not contain minimum quantities for F to purchase. It concludes that the nomination letter and the framework agreement, on their own, do not create enforceable rights and obligations and, therefore, a contract does not exist under IFRS 15.

S identifies each purchase order as a contract under IFRS 15. This is because S can identify the payment terms and F's right to goods from the purchase orders together with the framework agreement and the nomination letter.

S also assesses whether the purchase orders should be combined under the new standard. S concludes that the two contracts should be combined because the purchase orders were made near the same time and the pricing for all the units ordered was negotiated as a package with a single commercial objective during the tender phase. This results in revenue of 90 per unit for the 100,000 units sold in February and March.

3

Pre-production engineering

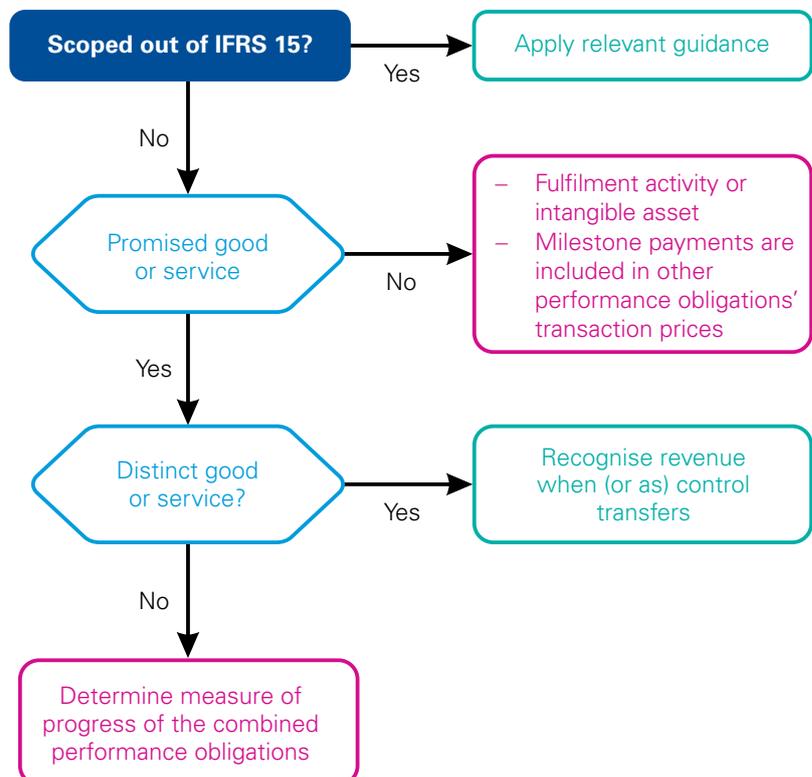
Overview

Automotive suppliers may undertake to perform certain pre-production engineering and development activities for OEMs before serial production commences – e.g. to create new technology, or adapt existing technology or product design to the needs of the OEM. These pre-production engineering and development activities are often a prerequisite to delivering the subsequent parts. Suppliers may be entitled to milestone payments for this activity.

The key considerations in accounting for pre-production activities are whether:

- they are collaborative arrangements that are not in the scope of IFRS 15;
- the activities transfer control of a good or service to the OEM for which the supplier is entitled to consideration;
- they represent a separate performance obligation(s); and
- any costs incurred in fulfilling these activities are eligible for capitalisation.

The following flowchart illustrates how to apply these key considerations in determining the accounting for pre-production engineering and development activities.



Requirements of the new standard

Determining whether an activity is in the scope of IFRS 15 – Collaborative arrangements

A contract with a customer may be partially in the scope of other accounting guidance (see also Section 4). The new standard excludes from its scope those contracts with a collaborator or a partner that is not a customer but shares the risks and rewards of participating in an activity or process with the entity. However, a contract with a collaborator or a partner is in the scope of the new standard if the counterparty meets the definition of a customer for part or all of the arrangement. Accordingly, a contract with a customer may be part of an overall collaborative arrangement and the new standard is applied to that part.

These requirements are discussed further in Chapter 4.3 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Current requirements do not provide any specific guidance on collaborative arrangements. Therefore, the guidance in the new standard may differ from an entity's previous interpretation of whether all or any part of a contract was accounted for in accordance with the revenue accounting guidance.



Application of the new requirements

Accounting for collaborative arrangements requires judgement

Some OEMs partner with automotive suppliers to design, develop and/or produce parts. In these cases, judgement may be required to determine whether all or part of the arrangement is a collaborative arrangement. For example, this may be the case when the rights to research results and designs are jointly owned by the OEM and the supplier and the risks of success or failure are shared equally by the two parties.



Example – Collaborative agreement

Automotive Supplier S has entered into an arrangement with OEM D to develop a new technology for D's cars. Both S and D agree to participate equally in the results of the engineering and development activities. Under the arrangement, S will also produce 100 units of the part developed for 10,000. Because the parties are active participants and share in the risks and rewards of the engineering and development activities – i.e. the technology – this part of the contract could be a collaborative arrangement. However, there is also a revenue contract to produce a series of parts within the overall agreement, which is accounted for under the new revenue standard.

Determining whether an activity transfers goods or services to the customer

In some cases, an activity that an entity is required to undertake to fulfil a contract does not result in the transfer of a promised good or service to the customer. Instead, it is a set-up activity. If the activity does not result in the transfer of a promised good or service to the customer, then any up-front payment received for it is an advance payment for performance obligations to be satisfied in the future and is recognised as revenue when those future goods or services are provided. Conversely, if the activity is a separate performance obligation, then a portion of the transaction price is allocated to it, even if the activity is not separately priced in the contract (see below).

If an up-front payment represents an advance for future performance obligations, then it may give rise to a material right for future goods or services. If the up-front payment gives rise to a material right, then the supplier attributes all of it to the goods and services to be transferred, including the material right associated with the up-front payment (see Section 6).



Application of the new requirements

Determining whether payments on pre-production activities relate to a transfer of a good or service

Pre-production engineering activities in the scope of IFRS 15 could be performance obligations, administrative tasks or fulfilment activities depending on the specific facts and circumstances. To determine the appropriate accounting, the key question is whether the activities transfer control of a good or a service to the OEM for which the automotive supplier is entitled to consideration.

If a supplier retains the rights to the engineering and development output, such as the intellectual property (IP) it produces – e.g. patents – then this may suggest that no goods or services are transferred.

If the pre-production engineering activities do not result in the transfer of control of a good or service to the customer, then they might be fulfilment activities or intangible assets (see below).

In addition, if the supplier is not entitled to consideration for the pre-production activities and this promise is not a part of a larger production contract or is not combined with a production contract, then for accounting purposes, these activities may not be in the scope of IFRS 15 (see Section 2). Suppliers assess whether costs incurred before a contract in the scope of IFRS 15 exists may be capitalised as fulfilment costs of an anticipated contract, or in accordance with other guidance (see below).



Example – Engineering and development activities

Automotive Supplier S develops a new part for OEM D. As part of the contract, S is required to provide D with the design information completed to date in the event of contract termination.

S is also performing engineering and development activities for OEM P and is required to provide periodic progress reports in a level of detail that would not require P to re-perform the work.

Both D and P can transfer the project to another supplier if S fails to complete it, or if the contract is terminated.

S effectively transfers the know-how or IP it is developing to D and P. These activities are considered promised goods and services that may be accounted for as separate performance obligations if they are determined to be distinct (see below).

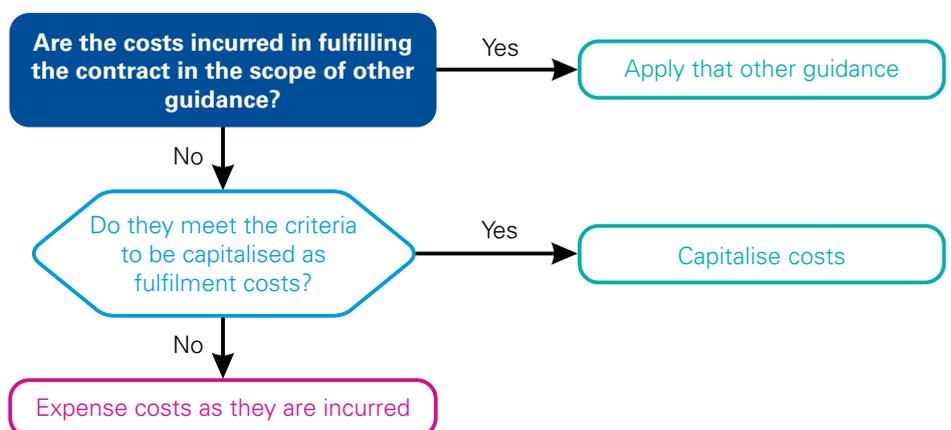
If these activities are separate performance obligations, then S allocates a part of the transaction price to them. However, these contracts may result in a loss to S if it is only partially reimbursed for the development costs through future orders that are not enforceable.

Fulfilment costs

If the costs incurred in fulfilling a contract with a customer are not in the scope of other guidance – e.g. inventory, intangibles, or property, plant and equipment (PP&E) – then an entity recognises an asset only if the fulfilment costs:

- relate directly to an existing contract or specific anticipated contract;
- generate or enhance resources that will be used to satisfy performance obligations in the future; and
- are expected to be recovered.

If the costs incurred to fulfil a contract are in the scope of other guidance, then the entity accounts for them using that other guidance.





How does this approach differ from existing requirements?

The new standard requires an entity to capitalise the costs of fulfilling an *anticipated* contract if other conditions are met. This is similar to the notion in IAS 11 that costs incurred before a contract is obtained are recognised as contract costs if it is 'probable' that the contract will be obtained. It is not clear whether the IASB and the FASB intend the term 'anticipated' to imply the same degree of confidence that a contract will be obtained as the term 'probable'.

IAS 2 *Inventories* remains relevant for many contracts for the sale of goods or services in which revenue is recognised at a point in time (see Section 7).



Application of the new requirements

Determining whether pre-production costs can be capitalised

When automotive suppliers control the rights to the IP arising from engineering and development activities, costs incurred in fulfilling these activities are often in the scope of IAS 38 *Intangible assets*. If this is the case, suppliers need to assess whether the internally-generated intangible assets meet the criteria for capitalisation. If IAS 38 precludes the recognition of an asset arising from a particular cost, the costs are not capitalised as fulfilment costs under IFRS 15.

Conversely, if specific costs incurred in fulfilling engineering activities are not in the scope of IAS 38 or another standard, then a supplier considers whether these costs meet the capitalisation criteria in paragraph 95 of IFRS 15.



Example – Set-up costs

Automotive Supplier S undertakes a large-scale project to produce a highly customised part for OEM L. The contract with L guarantees a minimum amount of parts to be ordered throughout the life of the project. Before producing the parts, S:

- develops a new enterprise resource planning (ERP) system that enables it to manage large-scale projects such as the one with L;
- trains its employees to use the new ERP system; and
- builds a technology platform that migrates and tests some of L's databases that contain information necessary for the production of the parts.

The ERP system is considered S's IP and can be used to manage future projects. The technology platform is not transferred to L and is not considered a separate performance obligation. Therefore, S concludes that these set-up costs relate primarily to activities to fulfil the contract, but do not transfer goods or services to the customer. S accounts for them as follows.

Type of cost	Accounting treatment
ERP system	Capitalised under IAS 38.
Training of employees	S determines that it has insufficient control over the economic benefits arising from its employees and therefore it cannot capitalise these costs under IAS 38.
Technology platform	Capitalised under IFRS 15 because the costs: <ul style="list-style-type: none"> – relate directly to the contract with L; – generate or enhance resources of S that will be used to satisfy performance obligations in the future – i.e. the production of parts; – are expected to be recovered over the life of the project.

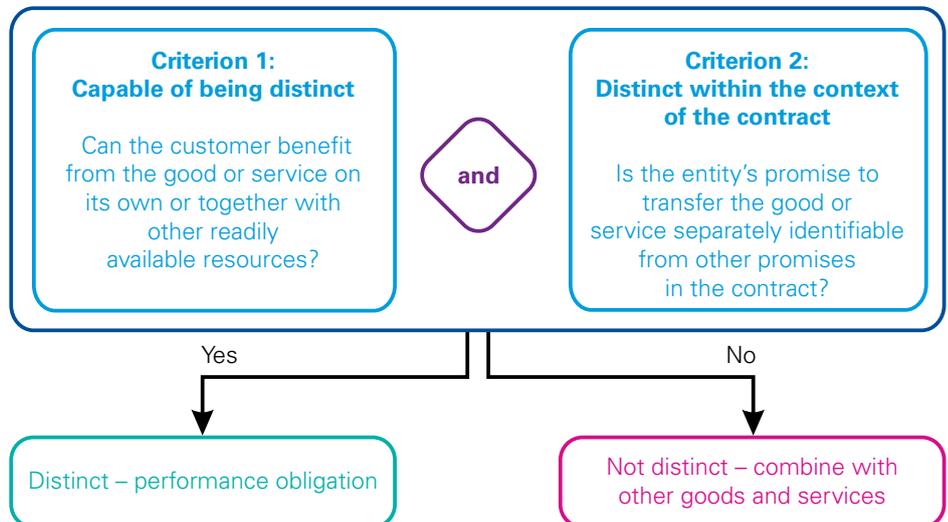
The capitalised software costs are subsequently accounted for under IAS 38. Costs capitalised under IFRS 15 are subject to its amortisation and impairment requirements. These requirements are discussed further in Chapters 6.3 and 6.4 of our [Revenue Issues In-Depth](#) publication.

Identifying performance obligations

A 'performance obligation' is the unit of account for revenue recognition. An entity assesses the goods or services promised in a contract with a customer and identifies as a performance obligation either:

- a good or service (or a bundle of goods or services) that is distinct; or
- a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer – i.e. each distinct good or service in the series is satisfied over time and the same method is used to measure progress) (see Section 7).

On contract inception, an entity evaluates the promised goods or services to determine which goods or services (or bundle of goods or services) are distinct and therefore, constitute a performance obligation.



Promises to transfer a good or a service can be stated explicitly in a contract or implicitly, based on established business practices that create a valid expectation that the entity will transfer the good or service. Conversely, tasks that do not transfer a good or service to the customer are not separate performance obligations and are not included in the analysis – see above.

These requirements are discussed further in Chapter 5.2 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Current IFRS includes limited guidance on identifying whether a transaction contains separately identifiable components. However, our view is that, based on an analogy to the test in IFRIC 18 *Transfers of Assets from Customers*, an entity should consider whether a component has a stand-alone value to the customer and whether that fair value can be measured reliably.

The new standard introduces comprehensive guidance on identifying separate components, including accounting for a series of goods or services as a single component under certain circumstances. This guidance applies to all revenue-generating transactions. This could result in goods or services being unbundled or bundled more frequently than under current practice.



Application of the new requirements

Determining whether pre-production activities are a separate performance obligation

Automotive suppliers often enter into contracts with OEMs that will result in the delivery of multiple units of highly complex, specialised parts. The terms of the contract may require the supplier to carry out pre-production activities that may involve significant time or effort.

Judgement is required to determine whether the pre-production activities are distinct within the context of the contract. The evaluation needs to take into account the relationship between the activities and the parts – i.e. the level of integration, modification or interdependence amongst the promises.

In addition, in applying that judgement, suppliers need to consider whether the nature of the promise to the OEM is to:

- establish and provide a customised production process of contracted parts based on the OEM’s specifications; or
- be involved in the development of a production process that can be used to produce goods for multiple contracts with the same or other OEM(s).

If an OEM is not committed to purchase a minimum quantity of parts, then enforceable rights and obligations related to the delivery of the parts may not exist. Therefore, these cannot be included in the analysis. Judgement is required to determine whether subsequent purchase orders are:

- combined with the contract to provide pre-production activities (see Section 2);
- treated as a modification of the original contract (see Section 8); or
- analysed as a separate contract.

In applying this judgement, suppliers need to consider whether the purchase order is for goods or services that are distinct from the pre-production activity and whether the ordered goods’ price is commensurate with their stand-alone selling price.



Example – Pre-production activities are not distinct

Automotive Supplier S enters into a contract with OEM B to supply a prototype of a specialised component as part of a new product OEM B is developing. The component is based on a newly-developed technology and supplying it will require extensive pre-production engineering activity. According to the contract, B has the right to the IP resulting from S’s activities and S is obliged to provide periodic updates on its development process, which B requires for the development of other parts of the product.

B guarantees that S will be compensated for the costs of the engineering activities, including a reasonable margin. However, B does not agree to commit to a minimum quantity of parts. Any subsequent purchase order will be priced in accordance with its stand-alone selling price. Therefore, S observes that the contract does not include a promise to produce additional components. Further, it concludes that the contract does not provide a material right to purchase components at a discount (see Section 6).

S concludes that it effectively transfers the know-how arising from its pre-production activities to B. Therefore, it identifies two promises in its contract with B:

- pre-production engineering activities; and
- production of a component prototype.

Capable of being distinct

S assesses the promises in the contract and determines that each of the promised goods and services are capable of being distinct. This is because B can benefit from the IP generated by the pre-production activities using readily available production services offered by other suppliers. S can also produce the prototype using IP it has already transferred to B.

Distinct within the context of the contract

When determining whether the pre-production activities and the production of the prototype are distinct within the context of the contract, B notes that there is a transformative relationship between the two, since the outcome of the engineering and the development process will determine to a great extent the structure of the prototype. It also notes that the nature of the promise to B is to provide it with a customised prototype, built to its specifications. Therefore, it concludes, that the pre-production activities and the production of the prototype is a single performance obligation.



Example – Subsequent purchase order

Continuing the example above, before the pre-production process is finished, OEM B orders five components from Automotive Supplier S. Judgement is required when assessing:

- whether the purchase order is accounted for as a modification of the original contract; and
- whether the production of the components is distinct from the performance obligation for the production of a prototype.

As part of this assessment, B considers the extent to which its various activities in the overall project are interdependent and interrelated in a way that a change in *each* of S's activities – e.g. the production of the components – affects all the other activities in the contract, such as the production of the prototype.

4

Tooling

Overview

Tooling arrangements are typically contracts or MSAs between an OEM and an automotive supplier in which the supplier builds or receives a tool that is used for the production of customised parts ordered by the OEM. Typically, these tools are unique to an OEM and cannot be used by any other customer. Such tooling arrangements vary widely.

- *Development*: In some cases, the tool is developed by the supplier (either on its own, or by a tooling subcontractor). In other cases, it is developed by the OEM.
- *Payment terms*: In some arrangements, the OEM provides specific consideration for the tool, separate from the consideration for parts. In other arrangements, the cost of the tool is recovered through the price charged for the parts that are subsequently ordered. In the latter case, the recovery may be implicit or stated explicitly as a per unit amount in the contract.
- *Title*: The title to the tool or ownership of the related IP may pass to the OEM or be retained by the supplier. Ownership rights may be merely a protective measure or may grant the OEM substantive rights over the tool.

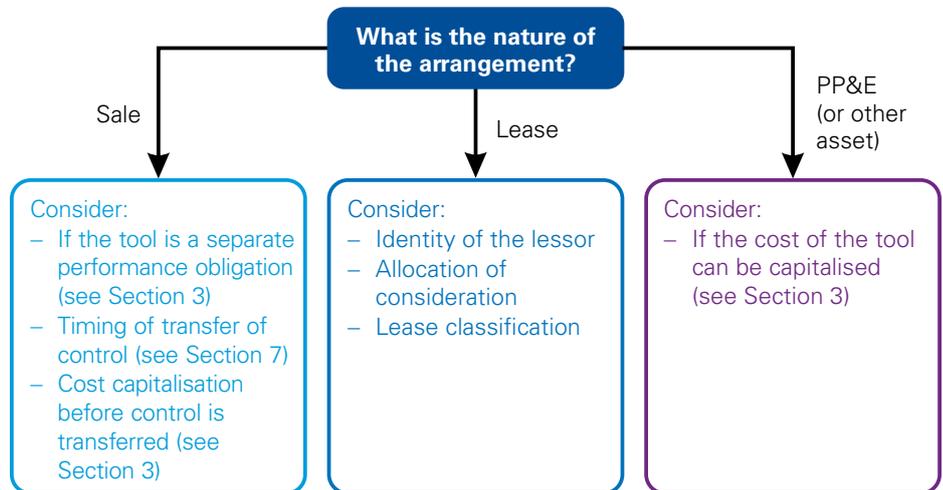
The supplier is usually responsible for maintaining the tool, which remains physically with the supplier for use in its production process. Generally, the tool is used for its entire useful life, or otherwise has no significant residual value. This is because another supplier is unlikely to use the same tool in its production process. In some arrangements, the economic life of an individual tool is shorter than the life of the project. In these cases, replacement tools are usually required. The arrangements for replacement tools vary in practice.

When accounting for tooling arrangements, suppliers assess:

- Whether the arrangement is a sale, a lease or development of its own PP&E (or other asset) to be used in the production process.
- Whether the arrangement contains a lease and, if so, the identity of the lessor and the classification of the lease.
- Whether the arrangement is in the scope of IFRS 15 and, if so, whether a tool manufactured by the supplier is transferred to the OEM:
 - If the tool is transferred to the OEM, then whether it is a separate performance obligation (see Section 3) and the timing of transfer of control (see Section 7).
 - If the tool manufactured by the supplier is not transferred to the OEM, then whether the cost of the tool may be capitalised in accordance with IAS 16 *Property, Plant and Equipment*, IFRS 15 or other guidance (see Section 3).
- Whether a tool manufactured by the OEM is sold or leased to the supplier.

The considerations above are also relevant for arrangements to provide replacement tools.

The following flowchart illustrates how to apply the key considerations in determining the appropriate accounting for tooling arrangements.



Requirements of the new standard

Contracts partially in the scope of IFRS 15

A contract with a customer may be partially in the scope of the new standard and partially in the scope of other accounting guidance. If the other accounting guidance specifies how to separate and/or initially measure one or more parts of a contract, then an entity first applies those requirements. For example, according to IFRS 16 *Leases*, if a contract contains a lease component and non-lease components, then a lessee allocates the consideration in the contract to the lease component on the basis of:

- the relative stand-alone price of the lease component; and
- the aggregate stand-alone price of the non-lease components.

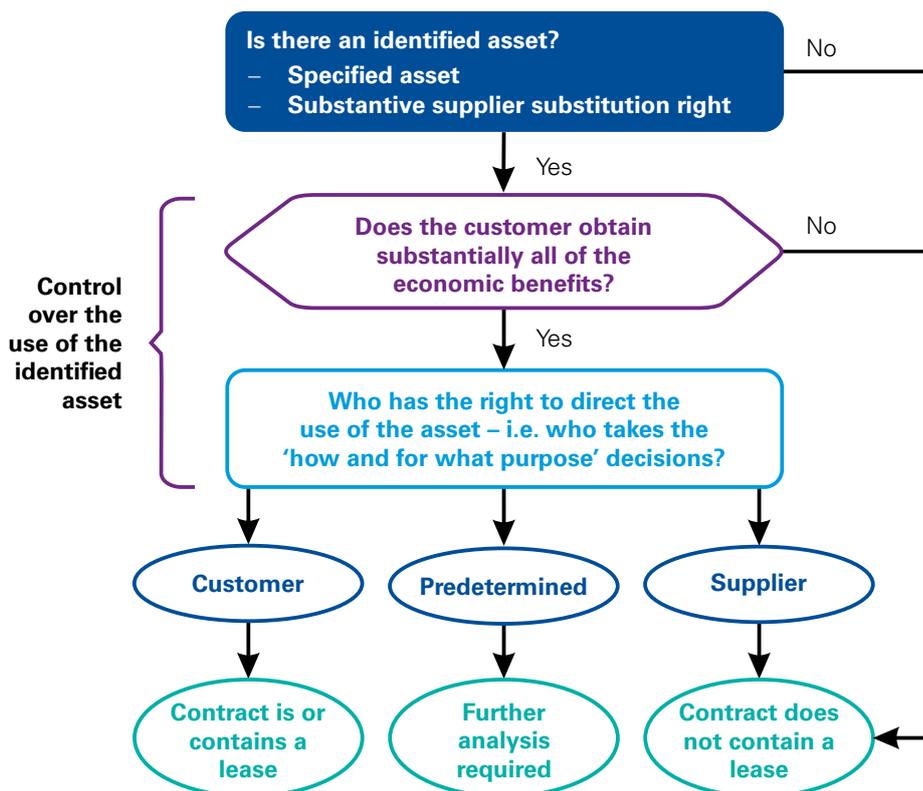
The lessor allocates the consideration in the contract in accordance with the requirements of IFRS 15 – i.e. according to the stand-alone selling prices of the goods and services included in each component.

If the other accounting guidance does not specify how to separate and/or initially measure parts in the contract not in the scope of IFRS 15, then the entity applies the revenue standard to separate and/or initially measure the separately identified parts of the contract. The following flowchart highlights the key considerations when determining the accounting for a contract that is partially in the scope of the new standard.

These requirements are discussed further in Chapter 4.3 of our [Revenue Issues In-Depth](#) publication.

Determining whether an arrangement contains a lease

A lease is a contract, or part of a contract, that conveys the right to use an asset (the underlying asset) for a period of time in exchange for consideration. The key factors to consider when applying the lease definition in accordance with IFRS 16 are as follows.



These requirements are discussed further our [Lease Definition](#) publication.



Application of the new requirements

Nature of a tooling arrangement

Judgement is required to determine the nature of a tooling arrangement – i.e. whether an automotive supplier sells a tool to an OEM, leases a tool to the OEM or develops a tool as its own asset – because the legal form of the arrangement may not indicate its substance. If control over a tool is transferred to an OEM, then the arrangement is in the scope of IFRS 15. Conversely, the arrangement could be a lease in the scope of IFRS 16 (see below) or development of own PP&E in the scope of IAS 16.

Although the detailed analysis – and the presentation and disclosure requirements – differ under the leases and the revenue standards, the broad accounting may be similar. This may be the case, for example, for a tooling arrangement in which there is a finance lease of the tool to the OEM, and a tooling arrangement in which there is a point-in-time sale of the tool to the OEM.

In these cases, the point in time at which control over a tool is transferred to the OEM (under IFRS 15) may be similar to the time when a finance lease of the tool to the OEM (under IFRS 16) commences (see below). Also, the supplier would apply a broadly similar accounting model to a tooling arrangement in which there is an operating lease of the tool to the OEM and a tooling arrangement in which the tool is PP&E of the supplier.

Tools produced by a supplier – Sale

In some tooling arrangements, legal ownership of the tool is transferred from the supplier to the OEM. Transfer of legal ownership, together with other facts and circumstances, may indicate that the supplier transfers control of the tool to the OEM and a sale has occurred.

For example, when a tool can be used only to produce parts for that OEM, either due to contractual restrictions (such as exclusivity arrangements) or technical constraints, and the contract establishes a right for the supplier to be reimbursed for developing the tool, either directly or indirectly – e.g. through sufficient minimum quantities of parts to be ordered or through termination penalties.

If a supplier determines that a tooling arrangement constitutes a sale of a good, then it applies IFRS 15. In these cases, the supplier applies similar judgements as those applied to other engineering and development activities (see Section 3). In particular, the supplier determines:

- whether the activity transfers a good or a service to the OEM;
- whether the production of a tool is a separate performance obligation;
- the timing of transfer of control over the tool (see Section 7); and
- whether any costs incurred in developing and producing the tool before control over it is transferred to the OEM (if applicable) can be capitalised in accordance with IAS 2, IAS 16, IFRS 15 or other guidance.

Tools produced by a supplier – Lease

To determine whether a tooling arrangement contains a lease, the following factors are considered.

Factor	Description
Right to obtain substantially all of the economic benefits from use for a period of time	When a tool can be used only to produce parts for a single OEM, either due to contractual restrictions (such as exclusivity arrangements) or technical constraints, this may indicate that the OEM has the right to obtain substantially all of the economic benefits from the use of the tool throughout the arrangement period.
Right to direct the use of the tool	Judgement is required to determine who controls how and for what purpose the customised tool will be used. Examples of relevant decisions – i.e. decisions that significantly affect the economic benefits derived from use of the tool – that may grant the right to control how and for what purpose a customised tool is used include the following. <ul style="list-style-type: none"> – A right to change <i>when</i> the output is produced. – A right to change <i>whether</i> the output is produced and the quantity (how much) of that output. – A right to change <i>where</i> the output is produced. This may only be relevant when the supplier has more than one production facility and substantive decisions can be taken about the location of the parts' production – e.g. the location of the production is not contractually predetermined.
Predetermined decisions	Tooling arrangements that run on 'auto pilot' are likely to be rare, because most contracts to supply parts involve some degree of decision-making – e.g. over the production process itself and over production levels.

Commencement

If a tooling arrangement contains a lease, then that lease is accounted for only on commencement of the lease – i.e. when the tool is made available for use. Under IFRS 16, if a supplier incurs costs relating to the construction or design of the tool before commencement of the lease, then it accounts for those costs under the applicable standard – e.g. as inventory or PP&E. Once the tool is available for use, any lease identified in the arrangement is accounted for according to its classification (see below).

Classification

If a supplier concludes that it leases the tool to an OEM, then it needs to consider the classification of that lease. When a substantial portion of the tool's fair value is expected to be recovered only through optional purchases by the OEM – i.e. recovery is not contractually guaranteed either directly or through sufficient contractual minimum quantities of parts to be ordered – this suggests that the lease is classified as an operating lease.

Under an operating lease, the supplier accounts for tools produced as its own PP&E (see below). The supplier recognises payments from the OEM allocated to the lease as operating lease income. Lease income is disclosed separately from revenue from contracts with customers.

Under a finance lease, the supplier derecognises the tools upon lease commencement. This accounting outcome is similar to point-in-time sale transactions in the scope of IFRS 15.

Tools produced by a supplier – Own asset

Unless control over a tool is transferred over time as it is constructed (see Section 7), a supplier considers whether any costs incurred during the construction of the tool can be capitalised under the applicable standard – e.g. IAS 2, IAS 16 or IFRS 15. If control over a tool is not transferred to an OEM and it is not leased to the OEM in a finance lease, then costs capitalised are depreciated (amortised) and tested for impairment in accordance with the relevant standard (see Section 3).

Tools produced by OEMs

In some arrangements, tools required by the supplier for the production of customised parts are developed and manufactured by the OEM, and subsequently transferred to the supplier. Similar to the discussion above, judgement is required to determine whether control over the tool is transferred to the supplier or whether the supplier has a right to use the tool, which is then accounted for as a lease. If a supplier obtains control over a customised tool or leases it, then the supplier also needs to consider whether the tool itself or the right to use it is non-cash consideration received from the OEM (see Section 9) for a contract in the scope of IFRS 15 (see Section 2).

5

Financial assistance by OEMs – Significant financing component

Overview

In some arrangements, OEMs prepay automotive suppliers for parts before delivery. Payments made at an early stage of the project may provide the suppliers with financial assistance. Suppliers need to consider whether these payment terms indicate that the contracts with the OEMs contain a significant financing component that adjusts the transaction price.

Requirements of the new standard

The objective when adjusting the 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.

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.

Interest income and expense recognised in respect of a significant financing component are recognised in finance income and expense. They are not presented as revenue from contracts with customers.

These requirements are discussed further in Chapter 5.3 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Significant financing components arise more frequently

Generally, entities applying IAS 11 do not adjust revenue to reflect a financing element.

Under IAS 18, 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. Current IFRS is silent on whether an entity adjusts consideration if payment is received in advance.

Significant financing components are expected to arise more frequently under the new standard because the standard applies to both deferred and advance payments, as well as both point-in-time and over-time contracts. The calculations can be complex, especially when the contract includes over-time performance obligations.

The new standard also includes a practical expedient that allows entities to choose not to account for a significant financing component if the period between payment and performance is 12 months or less. This practical expedient may apply for certain over-time contracts with scheduled payments throughout the production period.



Application of the new requirements

Determining whether a contract includes a significant financing component

When determining whether a contract includes a significant financing component, an automotive supplier considers the period between performance and payment for that performance, and the discount rate that applies. However, the new standard 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.

For contracts in which revenue is recognised at a point in time, the period considered is that between transfer of control of the good and the payment. Therefore, if payment for a good is made before or after the date on which control is transferred, an entity assesses whether the contract includes a significant financing component, especially if the period is greater than 12 months.

The analysis is essentially the same for over-time contracts. However, the amount being financed will change over time as the supplier performs its obligations under the contract. This is because only the portion of the good not yet transferred to the customer is still being financed.

It is important to note the effect of deferred and advance payments on the amount of revenue recognised compared to the contract price. Advance payments from the customer lead to a higher amount of revenue being recognised than the cash paid because the supplier accepts a lower amount in return for financing. As the supplier recognises interest expense related to the financing component, the corresponding amount is recorded as a contract liability/revenue. Conversely, deferred payments reflect the supplier providing finance to the customer and, therefore, the amount of revenue recognised is less than the cash paid and the supplier recognises the difference as interest income.

Limited examples provided when payments have a primary purpose other than financing

The new standard notes that an entity considers all relevant factors when determining whether a contract includes a significant financing component and highlights a number of factors that are relevant, including considering whether the difference in timing is for reasons other than finance.

Determining whether a difference between the amount of promised consideration and the cash selling price of the goods or services arises for reasons other than the provision of finance requires judgement. A supplier considers all relevant facts and circumstances, including whether the difference is proportionate to any other reason provided. It may be more common for the difference to be for a reason other than financing when payments are received in advance of the delivery of goods or services.

In some circumstances, a payment made in advance or in arrears on terms that are typical for the industry and jurisdiction may have a primary purpose other than financing. For example, a customer may withhold an amount of consideration that is payable only on successful completion of the contract or on the achievement of a specified milestone. The primary purpose of these payment terms may be to provide the customer with assurance that the entity will perform its obligations under the contract, rather than to provide financing to the customer.

Although the new standard addresses retention payments in the construction industry, it is unclear how this concept might apply to other situations. The Board considered advance payments received by an entity during its redeliberations explicitly – e.g. compensating the entity for incurring up-front costs – but decided not to exempt entities from accounting for the time value of money effect of advance payments.



Examples – Assessing whether a contract contains a significant financing component

Fixed prepayment

OEM M submits a purchase order to Automotive Supplier P for the delivery of 10,000 parts over five years for a fixed price of 1 million. Under the contract, M will pay the full amount in advance. The contract also contains a predetermined delivery schedule for the parts. P has determined that if it received a loan for a similar amount, to be repaid over five years, the loan would bear interest of 5%.

P determines that the contract includes a significant financing component, owing to the five-year period between the prepayment and the delivery date of the last part and the 5% interest rate. P does not identify any indicators that the deferred terms are for reasons other than financing.

Delivery is at the OEM's discretion

OEM M enters into an MSA with Automotive Supplier D. In the MSA, M commits to a minimum quantity of 10,000 parts to be delivered over five years. However, the timing of delivery is fully at M's discretion. M agrees to prepay 1,000,000 for the first 10,000 parts. Purchase orders of additional parts will be paid for at the time of delivery.

D concludes that the MSA does not contain a significant financing component, because even though M has paid for 10,000 parts in advance, the timing of the transfer of the parts is at M's discretion.

6 Pricing arrangements – Customer options

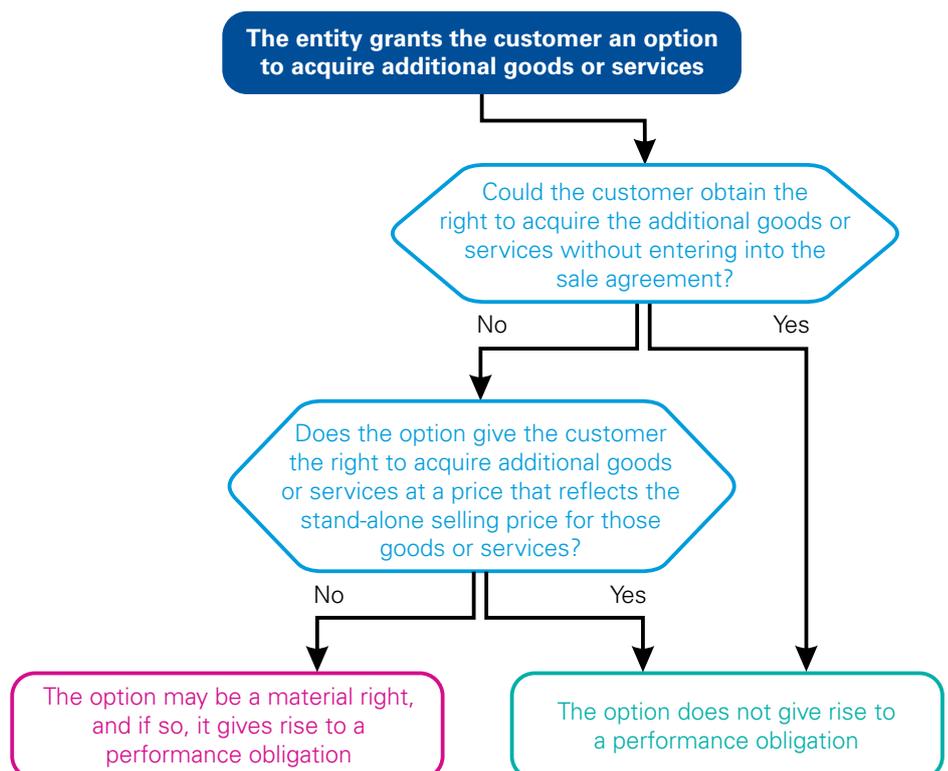
Overview

Some automotive suppliers offer OEMs a price reduction after a certain period or threshold of purchase orders ('efficiency savings'). In some instances, price reductions are a customary business practice. The price reductions allow OEMs to participate in suppliers' increased efficiency and fall in learning curve costs. These reductions may be contractually agreed and granted on a prospective or a retrospective basis, or may result from periodic negotiation between the parties. Judgement is required to determine whether 'efficiency savings' provide OEMs with material rights that suppliers account for as separate performance obligations.

Requirements of the new standard

When an entity grants the customer an option to acquire additional goods or services, that option is a performance obligation under the contract if it provides a material right that the customer would otherwise not receive without entering into that contract.

The following flowchart helps to determine whether a customer option is a performance obligation.



If the stand-alone selling price for a customer's option to acquire a material right to additional goods or services is not directly observable, then an entity needs to estimate it. This estimate reflects the discount that the customer would obtain when exercising the option, adjusted for:

- any discount that the customer would receive without exercising the option; and
- the likelihood that the option will be exercised.

As a practical expedient, if the goods or services that the customer has a material right to acquire are similar to the original goods in the contract – e.g. when the customer has an option to renew the contract – then an entity may allocate the transaction price to the optional goods or services with reference to the goods or services expected to be provided and the corresponding consideration expected to be received.

These requirements are discussed further in Chapter 10.4 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Other than the guidance on customer loyalty programmes, there is no specific guidance on accounting for customer options under the existing revenue standards. There is currently diversity in practice over whether options are accounted for as a reduction in revenue, an expense or a separate deliverable. Therefore, the additional guidance included in the new standard may result in changes in the accounting for some automotive suppliers.



Application of the new requirements

Price reductions may be variable consideration or may convey a material right

Different structures of price reductions may have a different effect on the transaction price. For example, some framework agreements provide price reductions that apply to all purchases made under the agreement – i.e. on a retrospective basis – once a volume threshold is met. In other cases, the price reduction may apply only to future purchases – i.e. on a prospective basis – once a volume threshold has been met.

If a price reduction applies retrospectively to all purchases under the contract once the threshold is met, then the price reduction represents variable consideration. In this case, an automotive supplier estimates the volumes to be purchased and the resulting discount when determining the transaction price and updates that estimate throughout the contract term.

Other pricing arrangements not dependent on previous sales may also be subject to the variable consideration guidance. Examples include, but are not limited, to the following.

- Implicit price concessions – if the supplier’s customary business practice and other relevant facts and circumstances indicate that it may accept a lower price than stated in the contract, then the variable consideration guidance may apply. Suppliers need to exercise judgement and consider all relevant facts and circumstances when distinguishing between implicit price concessions and accepting an OEM’s risk of default – i.e. reductions arising from credit risk. Further, price reductions that are not implicit price concessions but negotiated with the OEM may be contract modifications (see Section 8).
- Tiered pricing structure over time – e.g. a contract with price reductions predetermined for periodic time intervals could be variable consideration, if the price reductions are not dependent on sale volumes.

If a tiered pricing structure provides price reductions for future purchases after a volume threshold is met, then the supplier evaluates the arrangement to determine whether the arrangement conveys a material right to the customer. If a material right exists, then this is a separate performance obligation to which the supplier allocates a portion of the transaction price. If a material right does not exist, then there are no accounting implications for the transactions completed before the volume threshold is met and purchases after the threshold has been met are accounted for at the reduced price.

Judgement is required to determine whether price reductions for a fall in learning curve costs represent a ‘material right’

A supplier may offer an OEM a price reduction to share a fall in learning curve costs or other efficiencies after a specific volume is produced. To evaluate if this price reduction represents a material right, a supplier determines whether the reduced price represents the stand-alone selling price of a mature part, or whether the discount is incremental to a price decrease that follows a fall in the learning curve costs. If the reduced price represents the parts’ stand-alone selling price, then it does not provide the OEM with a material right, even if it is offered only because the OEM has placed previous purchase orders.

Judgement is required to determine whether prospective price reductions provided to OEMs convey a material right. The example below illustrates how slightly different fact patterns can lead to different conclusions.

Estimate of the likelihood of option exercise is not revised

When determining the stand-alone selling price of a customer option for additional goods or services, a supplier estimates the likelihood that the customer will exercise the option. This initial estimate is not subsequently revised because it is an input into the estimate of the stand-alone selling price of the option. Under the new standard, a supplier does not reallocate the transaction price to reflect changes in stand-alone selling prices after contract inception.

The customer’s decision to exercise the option or allow the option to expire affects the timing of recognition of the amount allocated to the option, but it does not result in a reallocation of the transaction price.



Example – Prospective discounts

Scenario 1 – Prospective discounts do not provide a material right

Automotive Supplier X produces standard, non-customised parts that are used by various OEMs. X enters into a two-year MSA with OEM M, a new customer, to manufacture parts for 200 per part. Each part is a distinct good that is transferred at a point in time.

M is committed to purchase a minimum quantity of 500 parts per year. If M purchases more than 1,000 parts, then the price of future purchase orders is decreased prospectively to 150 per part. This reflects the expected reduction in X's learning curve costs.

X prices parts of a similar size and complexity consistently, based on expected annual sales volumes to a specific OEM:

- OEMs expected to order less than 1,000 parts usually pay 200 per part; and
- OEMs expected to order in total more than 1,000 parts usually pay 150 per part for *all* purchases. That is, prices usually do not decrease prospectively as those OEMs purchase additional volumes.

X notes that other OEMs could order similar volumes of parts of similar size and complexity for a price of 150 without a similar prospective price reduction. Therefore, in the absence of any other quantitative or qualitative factors indicating otherwise, X concludes that the pricing on future purchases does not provide M with a material right.

Scenario 2 – Prospective discounts provide a material right

Modifying Scenario 1, Automotive Supplier X provides the same prospective price reductions to *all* OEMs similar to M – i.e. no OEM can buy parts for 150 per part before buying more than 1,000 parts.

In evaluating whether the price reduction provides M with a material right, X notes that:

- it is not appropriate to compare the pricing to price reductions provided to other OEMs, as they all receive future discounts as a result of prior purchases; and
- the right for reduced prices accumulates and incentivises M to make future purchases. This is a qualitative indicator that M pays for the option to purchase future parts at a discount in its previous purchases.

Therefore, in the absence of any other quantitative or qualitative factors indicating otherwise, X concludes that the prospective price reduction conveys M with a material right.

M places an order for 500 parts in the first year. X expects that M will purchase, on average, 1,200 parts in total – i.e. it will receive a discount on 200 parts. This is based on X's historical experience with MSAs with similar payment mechanisms.

X concludes that M has, in substance, paid for 50% of the right for future discounted parts as M purchased 500 of the 1,000 parts required for it to be entitled to a price reduction.

X allocates the transaction price between the parts ordered and the material right for a future discount on a relative selling price basis as follows.

Performance obligation	Stand-alone selling prices	Selling price ratio	Price allocation	Calculation
Parts ¹	100,000 ²	95.2%	95,238	(100,000 x 95.2%)
Material right	5,000 ³	4.8%	4,762	(100,000 x 4.8%)
Total	105,000	100%	100,000	
Notes				
<ol style="list-style-type: none"> Each part is a separate performance obligation but for simplicity they are presented as a single item in this table. 500 parts x 200. Stand-alone selling price for the material right is calculated as the expected volume of parts to be sold at a discount (200) x the discount of 50 (200 - 150) x 50% of the quantity required to receive future discounts (500/1000). 				



Example – Periodic price decreases in a framework agreement

Automotive Supplier Y enters into a three-year MSA with OEM T to supply highly complex parts. Each part is a distinct good that is transferred at a point in time.

Under the MSA, T is not obliged to purchase a minimum quantity of parts. However, it sets the price for parts that will be ordered during the MSA's term. The price per part declines each year as follows.

- Year 1: 700 per part.
- Year 2: 660 per part.
- Year 3: 600 per part.

This reflects the expected reduction in Y's learning curve costs.

Shortly after the MSA is signed, T orders 50 parts. Y notes that under this fact pattern:

- price reductions are dependent only on the passage of time and not previous purchase orders. Therefore, the purchase order does not provide T with a material right; and
- the purchase order fixes the price for the parts to be delivered. Therefore, the consideration in the contract is not variable.

When T submits subsequent purchase orders, Y assess whether they should be combined with the first one (see Section 2) and whether contract modification guidance should be applied (see Section 8).

7

Production phase

Overview

After the pre-production activities are finished, an OEM usually places binding purchase orders with automotive suppliers for serial production of parts. When accounting for the serial production phase, suppliers need to:

- consider whether revenue is recognised at a point in time or over time; and
- consider whether the series guidance applies if revenue is recognised over time; or
- consider when control over the parts is transferred to the OEM if revenue recognised at a point in time.

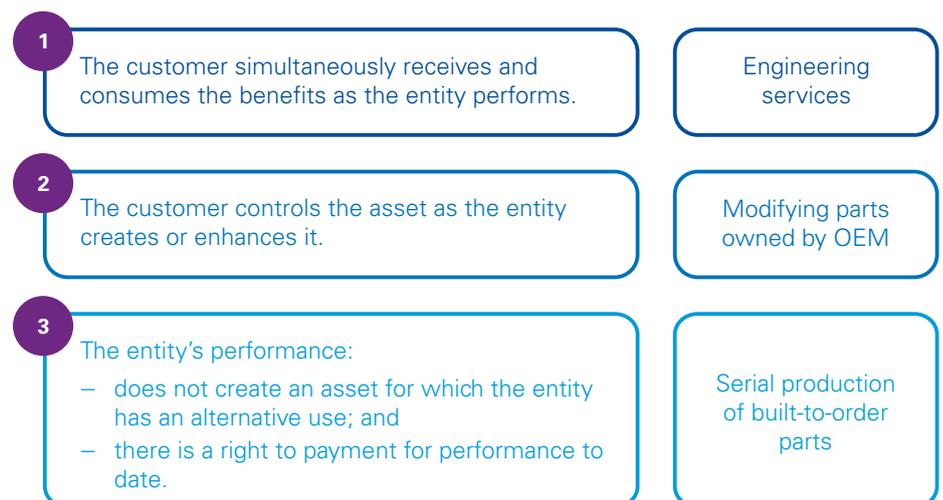
Other arrangements that may require similar analysis include engineering services and modification of parts owned by the OEM.

Requirements of the new standard

Over-time revenue recognition

IFRS 15 requires an entity to recognise revenue over time when any one (or more) of the following three criteria is met.

A performance obligation is satisfied over time if either:



These requirements are discussed further in Chapter 5.5 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Contracts are currently accounted for under the percentage-of-completion method in accordance with IAS 11 when they meet the definition of a construction contract. By contrast, the new standard uses new wording and new concepts that entities need to apply to the specific facts and circumstances of individual performance obligations. Subtle differences in contract terms could result in different assessment outcomes – and therefore significant differences in the timing of revenue recognition – compared with current practice.



Application of the new requirements

Applying criteria for over-time revenue recognition to automotive suppliers' arrangements

The following summarises how each of the over-time criteria may apply to automotive suppliers.

- Criterion 1 is not relevant to assessing tangible items such as parts or tools, because the customer does not consume the benefit of these items immediately as the supplier performs. However, it may apply to service offerings, such as engineering activities.
- Criterion 2 is generally met when a supplier is performing work on assets owned by the OEM (see Section 9). This is because, in this case, the work creates or enhances an asset controlled by the OEM.
- Criterion 3 is likely to be a frequent cause for suppliers to recognise revenue over time. It is generally most relevant when the terms of the contract give the supplier rights to compensation if the contract is terminated. This criterion also applies if the contract is non-cancellable – i.e. when the contract (or other laws) entitles the supplier to continue to transfer the parts promised in the contract and requires the OEM to pay consideration for them.

Evaluating Criterion 3

When applying Criterion 3, the first part of the test – 'no alternative use' – is generally met if the contract includes a clause that the manufactured part cannot be sold to another party. These types of clauses are generally sufficient for the part to be considered to have no alternative use to the supplier. For a specialised part, the 'no alternative use' test can also be met if, at inception of the contract, the supplier determines that it has no practical ability to use the part for another purpose – e.g. due to design specifications that are unique to the OEM.

Determining whether the supplier has a right to payment can be more challenging. The right to payment need not be an unconditional right but it should be enforceable if the contract is terminated for reasons other than non-performance by the supplier. Enforceability needs to be examined in light of the local laws that apply to the contract. The analysis should focus on the supplier's legal rights, rather than whether it intends to enforce them.

The payment should be available throughout the performance period. The compensation that a supplier is entitled to should at least cover performance to date and include a reasonable profit margin. The amount to which the supplier is entitled does not need to equal the contract margin, but needs to be based on a reasonable proportion of the supplier's expected profit margin, or a reasonable return on the supplier's cost of capital. For example, a contract under which a supplier has the right to recover only its costs incurred to date on termination by the OEM does not meet the right to payment requirement because the right does not include a reasonable margin. Also, milestone payments may not meet the right to payment requirement because they may not give the supplier a right to payment that reflects performance to date between the milestones.



Example – Application of Criterion 3

Automotive Supplier S enters into a contract with OEM W to build 100 steering wheels. A clause in the contract states that if W terminates the contract for reasons other than S's failure to perform, W is required to compensate S for its costs incurred to date plus a 10% margin; 10% is considered a reasonable margin.

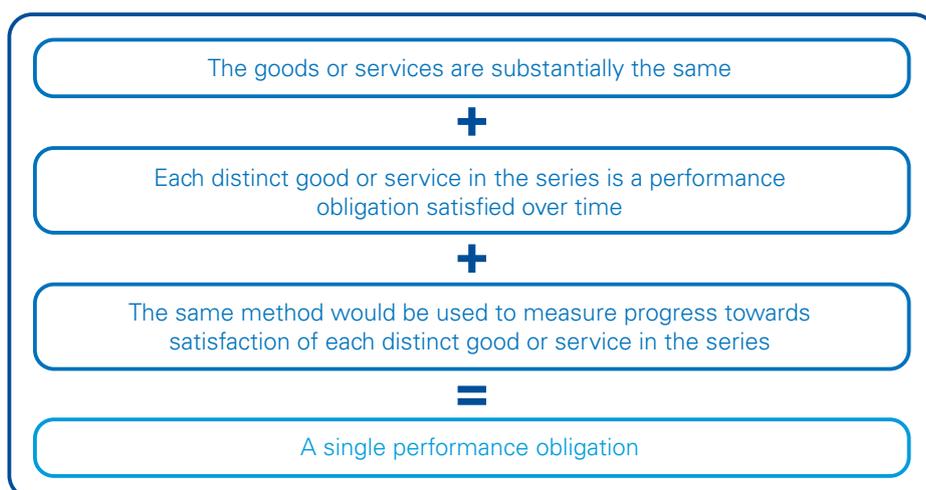
S builds steering wheels for various OEMs. However, the design of some components of W's steering wheel is considered to be W's IP. Therefore, S is not allowed to sell completed steering wheels to other OEMs. In addition, S would incur significant costs to rework the design of the steering wheel in its completed state if it replaced W's unique components with other OEMs' components. W enforces this contractual restriction by performing periodic inspections in S's warehouses.

On contract inception, S assesses whether each completed steering wheel will have an alternative use. S concludes that there are substantive contractual restrictions that limit its ability to direct the completed steering wheels to another OEM. Therefore, S concludes that the steering wheels have no alternative use.

Additionally, the contract terms give S an enforceable right to payment for its performance completed to date (costs incurred plus a reasonable margin). Therefore, S meets Criterion 3 and can recognise revenue over time because the asset has no alternative use and S has a right to payment throughout the construction period.

Series of goods or services

A contract may contain promises to deliver a series of distinct goods or services that are substantially the same. On contract inception, an entity determines whether the series of goods or services is a single performance obligation. This is the case when they meet the following criteria.



These requirements are discussed further in Chapter 5.2.3 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Under existing requirements, there is no equivalent of the series guidance and a contract is accounted for over time if it meets the definition of a construction contract or is a service contract (see above).

Conversely, IAS 11 provides specific guidance on when a construction contract is segmented. Contracts previously segmented under IAS 11 may need to be reassessed to determine whether the segments represent a series of distinct goods or services that is treated as a single performance obligation.



Application of the new requirements

Series guidance is a requirement, not an option

For automotive suppliers, the series guidance is most relevant for contracts to build multiple units of a single type of asset – e.g. an order of 100 highly-customised parts for which revenue is recognised over time.

Application of the series guidance is not optional. If the requirements are met, then that series of goods or services is treated as a single performance obligation. Also, it is not necessary for the goods be delivered or for services to be performed consecutively over the contract period to apply the series guidance. There may be a gap or an overlap in delivery or performance, but this would not affect the assessment of whether the series guidance applies.

Learning curve costs may impact the revenue profile

The series guidance may affect the revenue profile when a contract has significant learning curve costs such that unit costs decrease over time. In these cases, if the series guidance applies and a supplier elects a cost-to-cost measure of progress, then more revenue and expense is recognised earlier in the contract when the first units are produced, because a higher proportion of the total cost is incurred when producing the earlier units in the series.



Example – Series of distinct goods

Automotive Supplier S enters into an MSA with OEM C to produce specialised sensors for a fixed price of 200 per sensor. Subsequently, C places a non-cancellable purchase order for 1,000 sensors. The MSA and the purchase order constitute a contract in the scope of IFRS 15. S concludes that each sensor is capable of being distinct and is distinct in the context of the contract because the sensors are not highly integrated and S does not provide a significant integration service. S also determines that the contract meets the criteria for the revenue to be recognised over time.

S applies the series guidance to this contract because:

- all the 1,000 sensors are of the same design;
- they meet the over-time criteria; and
- the measure of progress is the same because each sensor is manufactured identically.

Therefore, the 1,000 sensors are accounted for as a single performance obligation for which revenue is recognised over time, with a transaction price of 200,000.

S expects to incur significant learning curve costs in the production of the first units. Consequently, if S chooses a cost-to-cost measure of progress for the performance obligation, then revenue recognised for the earlier units produced will be higher than 200 per sensor and revenue for the later units produced will be less than 200 per sensor.

Transfer of control at a point in time

If a performance obligation is not satisfied over time, then an entity recognises revenue at the point in time at which it transfers control of the good or service to the customer. The new standard includes indicators of when the transfer of control occurs.



The standard also contains specific application guidance for consignment arrangements and bill-and-hold arrangements. These requirements are discussed further in Chapter 5.5 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

Currently, revenue from the sale of goods that are in the scope of IAS 18 is recognised based on when, amongst other criteria, the entity has transferred to the buyer the significant risks and rewards of ownership. Under this approach, which is unlike the new standard, revenue is typically recognised at the point in time at which risks and rewards pass rather than when control transfers. Therefore, the point in time at which revenue is recognised may change under the new standard.



Application of the new requirements

Accounting for some delivery arrangements may change

Revenue is not recognised currently if an automotive supplier has not transferred to the OEM the significant risks and rewards of ownership. For product sales, the analysis of whether risks and rewards are transferred usually takes into account shipping terms (normally 'Incoterms'). For example, when a product is subject to delivery to the OEM's site, legal title passes to the OEM when the product is physically handed over to it. When a product is shipped to the OEM's 'free-on-board' (FOB) shipping point, legal title passes and the risks and rewards are generally considered to have transferred to the OEM when the product is handed over to the carrier.

An example of a delivery arrangement that may result in a change in accounting is when a supplier ships a product to a FOB shipping point, but has a historical business practice of providing free product replacements or waiving its invoice if the products are damaged in transit (commonly referred to as a 'synthetic FOB destination arrangement').

Under current guidance, revenue recognition is generally precluded until the product is delivered to the OEM's destination, because the risks and rewards of ownership have not transferred to the OEM, despite having satisfied the FOB shipping point delivery terms. However, under the new standard, whether the significant risks and rewards have been transferred is one indicator of transfer of control. A supplier evaluates all indicators and could reach a different conclusion about the timing of transfer. The transfer of legal title is also only one indicator of control and different suppliers may reach different conclusions about when control transfers depending on the facts and circumstances of their arrangements.

If a supplier concludes that transfer of control has occurred when the product is shipped, then under the new standard, a supplier also considers whether its business practices give rise to a separate performance obligation in addition to the performance obligation to transfer the product itself – i.e. a stand-ready obligation to cover the risk of loss if goods are damaged in transit. If a separate performance obligation is identified, then only the revenue allocated to the sale of the goods is recognised at the shipping date.

A supplier needs to evaluate the facts and circumstances and apply judgement to determine whether the lack of transfer of the significant risks and rewards of ownership of an asset results in a conclusion that either:

- control of the asset has not transferred to an OEM; or
- the supplier is providing a separate performance obligation.



Example – Consignment arrangement

OEM C requires Automotive Supplier S to deliver a predetermined number of brake lightbulbs to C's warehouse based on a forecast production plan. However, legal title over the lightbulbs and a right to payment arise only when the parts are retrieved from the warehouse and moved to C's assembly line.

Brake lightbulbs produced by S can also be sold to other OEMs and S has the contractual right to require C to return the parts or deliver them to another OEM. S is also required to accept any excess lightbulbs returned by C.

S determines that control over the lightbulbs has not transferred to C on delivery to C's warehouse because:

- C does not have an unconditional obligation to pay for the lightbulbs until they have been moved to its assembly line; and
- S is able to require that the lightbulbs be transferred to another OEM any time before C installs them in its cars.

S determines that control of the lightbulbs transfers when they are moved to C's assembly line – i.e. when C has an unconditional obligation to pay S and can no longer be asked to return or transfer the goods.

S notes that the contract does not identify (or implicitly identify) a specified location in C's warehouse where the lightbulbs are stored. Therefore, it concludes that the contract does not contain a lease (see also Section 4).



Example – Not a consignment arrangement

OEM D enters into contract with Automotive Supplier S to deliver windshields for D's cars. According to the contract, S is required to maintain a minimum number of windshields in D's warehouse during the contract term. Once delivered, S cannot access the windshields (other than for stocktaking). It also has no right to require the windshields to be returned or redirected to another OEM.

The price of the windshields is determined when they are delivered to D's warehouse. S has a right to payment for the windshields either when they are moved to D's assembly line or within six weeks from delivery, whichever is earlier.

While stored at D's warehouse, D bears any insurance fees and storage costs. In addition, it is liable for the risk of loss, theft or damage. However, S retains legal title to the windshields until payment is received.

According to the relevant legal framework in D's jurisdiction, goods are deemed to be accepted if D does not claim otherwise without an undue delay.

S concludes that the arrangement with D is not a consignment arrangement, because:

- it is unable to require D to return the windshields or to transfer them to a third party; and
- S has an unconditional right to payment for the windshields once delivered that is dependent only on the passage of time. D's actions can only influence the timing of the payment.

Judgement is required to determine the point in time at which control over the windshields is transferred to D. Under this fact pattern, S notes that:

- it is unable to direct the windshields to another use once delivered;
- it has an unconditional right to payment for windshields (see above);
- even though it retains legal title to the windshields, this is a protective measure against D's failure to pay;
- it has transferred physical possession of the windshields to D;
- it has transferred the significant risks and rewards of ownership of the windshields – i.e. the price risk, demand risk and inventory risk; and
- under the local law, D is deemed to accept the windshields delivered to its warehouse if it does not claim otherwise shortly after delivery.

Therefore, S concludes that control over the parts has been transferred to D on delivery to its warehouse.



Example – Bill-and-hold arrangement

Automotive Supplier S enters into a contract to sell standard parts to OEM B, control over which is transferred at a point in time. B is awaiting completion of a manufacturing facility and requests that S holds the parts until the manufacturing facility is completed.

S bills and collects the non-refundable transaction price from B and agrees to hold the parts until B requests delivery. The transaction price includes appropriate consideration for S to hold the parts indefinitely. The parts are complete and segregated from S's inventory and are ready for shipment. S cannot use the parts or sell them to another customer. B has requested that the delivery be delayed, with no specified delivery date.

S concludes that B's request for the bill-and-hold basis is substantive. It also concludes that control of the parts has transferred to B and that it will recognise revenue on a bill-and-hold basis even though B has not specified a delivery date.

The obligation to warehouse the goods on behalf of B represents a separate performance obligation. S needs to estimate the stand-alone selling price of the warehousing performance obligation based on its estimate of how long the warehousing service will be provided. The amount of the transaction price allocated to the warehousing obligation is deferred and then recognised over time as the warehousing services are provided.

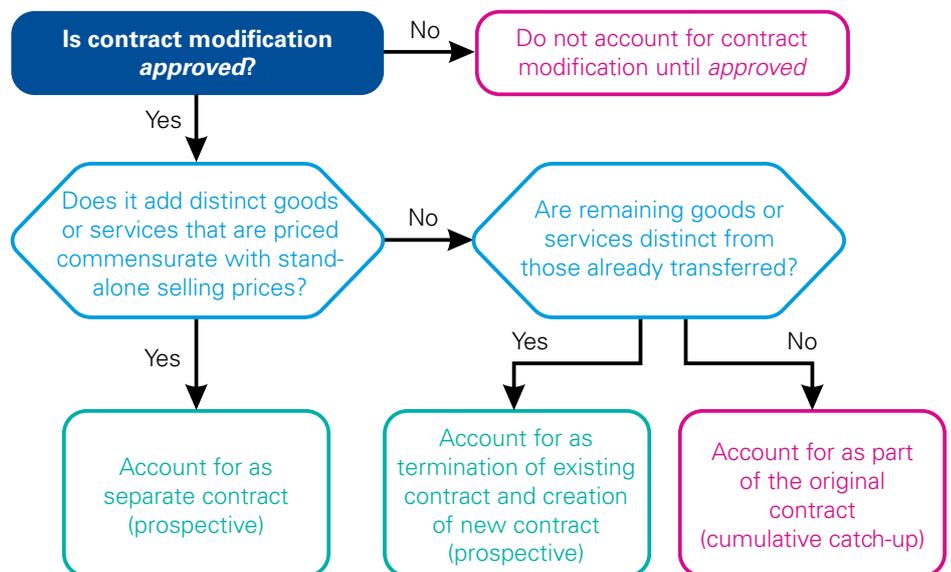
8 Modifications and price adjustments

Overview

Automotive suppliers and OEMs often renegotiate the price and volume of parts throughout the life of a project. Suppliers need to determine how to account for these contract modifications under the new standard.

Requirements of the new standard

A contract modification is a change in the scope or price of a contract, or both. It may be described as a change order, a variation or an amendment. The flowchart below provides an overview of the requirements.



A contract modification is approved when it creates or changes the enforceable rights and obligations of the parties to the contract. The approval may be written, oral or implied by customary business practices but it must be legally enforceable.

These requirements are discussed further in Chapter 7 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

New requirements are more prescriptive and apply to all types of contracts

There is no specific guidance for contract modifications in IAS 18, although IAS 11 includes specific guidance on the accounting for claims and variations in a construction contract, which is not carried forward into the new standard.

The new standard's criteria for recognising a contract modification, and for applying the general requirements about variable consideration to some contract modifications, may change the timing of revenue recognition for some arrangements. Whether the new guidance accelerates or defers revenue recognition depends on the specific facts and circumstances of the contract.

Changes may be required to align existing accounting practices with the more specific requirements in the new standard. See the flowchart above.



Application of the new requirements

Accounting for some contract modifications may change

Generally, for projects that initially include a single performance obligation for which revenue is recognised over time, a contract modification is not distinct from the existing goods and services in the contract – e.g. a modification to the design of a prototype being manufactured that is not distinct from related pre-production engineering services (see the example below and Section 3). For such projects, modifications to contracts are generally accounted for as part of the original contract, with a cumulative catch-up adjustment recorded at the date of the modification.

When a series of distinct goods is accounted for as a single performance obligation (see Section 7), a supplier evaluates whether the modification is distinct from other distinct goods in the series. This may simplify the contract modification assessment for some entities. For example, if a series of 10 distinct parts is treated as single performance obligation, when determining whether a modification is distinct from the units in the original contract, the assessment is made on the basis that the existing 10 parts are distinct from each other. This leads to prospective accounting.

Also, if a supplier enters into a new purchase order or other agreement with an existing OEM with which it has a pre-existing contract with an unfulfilled performance obligation, then the new agreement may need to be evaluated to determine whether it is a modification of the pre-existing contract (see Section 2).

**Example – Modification assessment – Potential catch-up adjustment**

Automotive Supplier S enters into a contract with OEM M to develop a new part and manufacture a prototype of the part for a fee of 1,000. S concludes that the engineering and development services, and the construction of the prototype, are a single performance obligation that is satisfied over time. According to the contract, M is not committed to purchase a minimum quantity of parts once the development process is completed. However, the contract sets the price for every part ordered at 30, which is its stand-alone selling price.

During the development process, M places a purchase order for 20 parts.

When evaluating how to account for the purchase order, S first needs to determine whether the modification adds distinct goods or services (see Section 3).

- If the parts are distinct, then because the price increase reflects the stand-alone selling price of the parts, they are accounted for separately from the original contract. This results in prospective accounting for the modification, as if it were a separate contract for the additional parts.
- If the additional parts are not distinct from the development services and the prototype, then S accounts for the purchase order as a contract modification. The parts and the other goods and services in the contract are combined into a single performance obligation. If S does not change its conclusion that revenue for the combined performance obligation is recognised over time, then it accounts for the performance obligation as partially satisfied at the date of the contract modification and updates the measure of progress under the cumulative catch-up method.

**Example – Modification assessment – Separate contract**

This example is based on the same fact pattern as the first example in Section 2.

On 1 January, OEM G enters into a framework agreement with Automotive Supplier S to perform engineering and design (E&D) activities and produce parts. The agreement between G and S does not specify a separate price for E&D services, but the price of each part includes a mark-up to compensate S for those services. The agreement does not state a minimum quantity of parts to be ordered by G, but it contains a termination clause under which S will be reimbursed for any costs incurred for the E&D services in case G terminates the agreement. Therefore, on 1 January S concludes that a contract exists for the E&D activities but not for the production of parts under IFRS 15.

On 1 April, S completes the E&D activities.

On 1 December, G orders the first batch of parts.

S assesses whether the purchase order of parts should be treated as a modification of the contract to provide E&D services.

S notes that the consideration for the parts does not reflect their stand-alone selling price, because the price of the parts is meant to compensate S for the lower margin on the E&D services. Therefore, S concludes that it may be appropriate to consider the modification guidance.

S concludes that the parts ordered are distinct from the E&D activities, because, inter alia, they are produced after the E&D activities are completed and their production cannot affect the way the E&D activities are performed (see also Section 3).

Under the modification guidance, S would account for OEM G's purchase order together with any remaining performance obligations. However, S notes that no remaining obligations are left under the E&D contract. Therefore, it does not allocate any consideration payable for the parts to the E&D services, and accounts for the purchase order as a separate contract.

9

Transfer of work in progress from OEM

Overview

In some arrangements, automotive suppliers purchase or receive work in progress from OEMs. The work in progress received is subsequently resold or returned to the OEM, but only after the supplier has incorporated its own parts in it or provided other related services. Suppliers need to assess:

- whether they obtain control over the work in progress; and
- how to account for any cash paid to the OEM.

Requirements of the new standard

Assets received from customers

Assets received from the customer to facilitate an entity's fulfilment of the contract – e.g. materials or work in progress – are assessed to determine whether the entity obtains control of them.

If control is obtained over the assets received, then they are accounted for as non-cash consideration and measured at fair value. If an entity cannot make a reasonable estimate of the fair value, then it refers to the estimated selling price of the promised goods or services. Non-cash consideration increases the transaction price to the extent that its fair value is higher than any payment made to the customer.

These requirements are discussed further in Chapter 5.3.3 of our [Revenue Issues In-Depth](#) publication.



How does this approach differ from existing requirements?

The requirement to measure non-cash consideration at fair value is broadly similar to the current IFRS requirements. However, under current IFRS, when the fair value of the goods or services received cannot be measured reliably, the revenue is measured at the fair value of the goods or services given up, adjusted by any cash transferred. By contrast, under the new standard, the entity measures the transaction price at the stand-alone selling price of the goods or services transferred.



Application of the new requirements

Judgement is required to determine whether control over work in progress is transferred

IFRS 15 does not provide detailed guidance on assets received from customers. To determine whether control over work in progress has transferred from an OEM, an automotive supplier can consider:

- IFRS 15's guidance on transfer of control at a point in time (see Section 7);
- the existence of an OEM's obligation (a forward) or a right (a call option) to repurchase the work in progress; and
- its right to require the OEM to repurchase the work in progress (a put option).

The impact of forwards, call options and put options on the transfer of control is discussed further in Chapter 5.5.5 of our [Revenue Issues In-Depth](#) publication.

If control over work in progress has not been transferred to the supplier, then the supplier is merely performing work on components owned by the OEM. Therefore, the supplier does not recognise the OEM's work in progress on its balance sheet, but only revenue from the goods or services it provides to the OEM (see Section 7).

Payment to the OEM could be wholly or partially accounted for as a reduction of revenue or a financial asset

If control over work in progress is not transferred to the supplier and the arrangement involves a payment from the supplier to the OEM, then the supplier needs to assess whether the payment is consideration payable to the customer that reduces revenue, or results in a contractual right to receive cash back from the OEM.

If the supplier obtains control over work in progress, then it needs to assess whether consideration payable to the OEM exceeds the fair value of the goods purchased. If so, then a portion of the payment is accounted for as a reduction of revenue (see Section 1).



Example – Contractual obligation to repurchase work in progress

Automotive Supplier S enters into a contract with OEM D to install locks in 100 car doors. As part of the contract, S agrees to purchase 100 partially-constructed doors from D for 10,000. D is obliged to repurchase the doors – with the locks installed – after four months for 10,700. If either S or D cancels the contract, then D is required to repurchase the doors in their original state for 10,100 at the end of the fourth month.

S concludes that it does not obtain control of the doors because D has a contractual obligation (a forward) to purchase the doors. S notes that the contract is partially in the scope of the financial instruments standard because the cash payment to D grants it an unconditional contractual right to receive cash of 10,100. S excludes from the transaction price an amount equal to the fair value of the loan granted to D. Based on the loan's term and D's credit risk, S concludes that the fair value of the financial asset is 10,000.

During the following four months S recognises, inter alia:

- interest income of 100; and
- revenue of 600 for the installation of the locks.

10

Transition adjustments

Requirements of the new standard

The new standard offers the following transition options.

Retrospective method (with optional practical expedients)	<p>Entities recognise the cumulative effect of applying the new standard at the start of the earliest comparative period presented.</p> <p>They can also elect to use any or all of four practical expedients. Two of these provide relief from applying the new standard to certain types of contracts that are completed under current GAAP. One provides relief with respect to contract modifications and another provides exemption from disclosing the amount of the transaction price allocated to the remaining performance obligations for the comparative periods presented.</p>
Cumulative effect method	<p>Entities recognise the cumulative effect of applying the new standard at the date of initial application, with no restatement of the comparative periods presented – i.e. the comparative periods are presented in accordance with current GAAP.</p> <p>An entity may choose to apply the new standard to all of its contracts or only to those contracts that are <i>open</i> under current GAAP at the date of initial application.</p> <p>Entities may also elect to use the practical expedient available for contract modifications.</p> <p>For the current period, entities are required to disclose the quantitative effect and an explanation of the significant changes between the reported results under the new standard and those that would have been reported under current GAAP.</p>

For detailed discussion on the transition requirements, refer to our publication [Revenue Transition Options](#).



Application of the new requirements

Retrospective or cumulative effect approach

An automotive supplier can choose to apply the new standard either from the start of the earliest comparative period presented (retrospective approach) or from the start of the current period (cumulative effect approach).

If a supplier applies the new standard from 1 January 2018 and presents one year of comparative information, under the retrospective approach it would present revenue for both 2017 and 2018 in accordance with the new standard and adjust retained earnings at 1 January 2017. Under the cumulative effect approach, the supplier would present only the current year, 2018, in accordance with the new standard and adjust retained earnings at 1 January 2018.

It is also important to note that the transition approach and practical expedients are applied at the entity level – i.e. they cannot be used on a contract by contract basis.

Completed contracts practical expedient

Under either approach, a supplier can choose to apply the standard only to those contracts that are not complete at the date of transition. The new standard defines a completed contract as a contract for which the entity has transferred to the customer all the goods or services identified under IAS 11, IAS 18 and related interpretations. This means that construction contracts are generally considered complete when the entity has finished construction of the asset and the customer has accepted it. Unlike IFRS 15, the current requirements do not contain specific guidance on determining the term of a contract or a contract's existence (see Section 2). Therefore, judgement is needed to determine whether a project is 'completed' for the purposes of the transition requirements. For example, a two-year framework agreement that does not require minimum quantities of parts to be purchased or guarantee minimal contractual consideration may be considered 'completed' if the customer has yet to place a binding purchase order.

If a supplier has a small population of multi-year projects, then the choice of transition approach and use of the completed contracts practical expedient may result in little difference on transition, because there may be limited differences in the contracts considered in the scope of the new standard.

Contract modification practical expedient

Under the contract modifications practical expedient, a supplier need not evaluate the effects of contract modifications separately before the beginning of the earliest reporting period presented.

Instead, a supplier may reflect the aggregate effect of all of the modifications that occur before the beginning of the earliest period presented in:

- identifying the satisfied and unsatisfied performance obligations;
- determining the transaction price; and
- allocating the transaction price to the satisfied and unsatisfied performance obligations.

Under the cumulative effect approach, a supplier can choose to apply this practical expedient to modifications that occur up to the start of the current period.

This practical expedient essentially allows a supplier to use hindsight when assessing the effect of a modification on a contract. However, it does not exempt a supplier from applying other aspects of the requirements to a contract – e.g. identifying the performance obligations in the contract and measuring the progress towards complete satisfaction of those performance obligations.

Variable consideration practical expedient

Under the retrospective method, a supplier may choose to use the transaction price at the date on which the contract was completed, rather than estimating the variable consideration amounts.

The main advantage in applying this practical expedient is that for completed contracts, a supplier need not apply the variable consideration guidance to variable amounts in the transaction price. This may result in revenue being recognised earlier than it would have been under a fully retrospective approach. For example, if a contract included a completion bonus, then the supplier could use the known outcome for that bonus when calculating the transaction price, rather than estimating the amount using the variable consideration guidance.

Disclosure practical expedient

Under this practical expedient, for reporting periods presented before the date of initial application, a supplier need not disclose:

- the amount of the transaction price allocated to the remaining performance obligations; or
- an explanation of when the supplier expects to recognise that amount as revenue.



Example – Contract modification practical expedient

Automotive Supplier S enters into a contract with OEM M to manufacture a new tool for a fixed amount of consideration of 1,000. The contract began on 1 April 2016 and is expected to be completed by 1 April 2018.

Before the date of initial application – i.e. 1 January 2018 – the contract was modified several times, changing both the scope of the work and the amount of consideration. All modifications were agreed on and approved before 31 December 2017.

On 1 January 2018, S determines that the modified contract includes two performance obligations under the new standard:

- manufacturing a tool, the specification of which has been modified since contract inception; and
- manufacturing an additional tool.

The modified consideration is 2,300.

S applies the cumulative effect method and elects to use the contract modifications practical expedient. If S applies the expedient to all modifications that occur before the date of initial application, then it does not evaluate separately the effects of the modifications that occur in comparative periods. Under this method, at the date of initial application S determines the transaction price, identifies the performance obligations in the contract (both satisfied and unsatisfied) and allocates the transaction price to the performance obligations.

S applies the contract modification guidance to account for each contract modification (if any) that occur after the date of initial application.

11

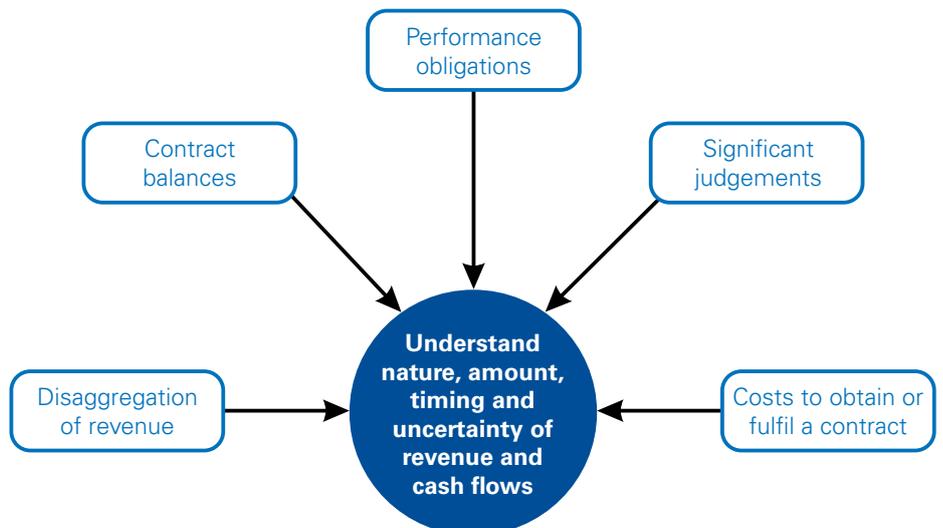
Disclosures

Requirements of the new standard

The objective of the disclosure requirements is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

Entities disclose, separately from other sources of revenue, revenue recognised from contracts with customers and any impairment losses recognised on receivables or contract assets arising from contracts with customers. If an entity elects either the practical expedient not to adjust the transaction price for a significant financing component, or the practical expedient not to capitalise costs incurred to obtain a contract, then it discloses this fact.

To meet the disclosure objective, the new standard has specific disclosure requirements in the following areas.



For further information on the disclosure requirements, refer to our [Guide to annual financial statements – IFRS 15 supplement](#).



How does this approach differ from existing requirements?

Disclosures are significantly expanded under the new standard

Existing IFRSs include minimal specific disclosure requirements with respect to revenue. In comparison, the new standard has extensive disclosure requirements that are intended to help users better understand the nature, amount, timing and uncertainty of revenue and cash flows arising from contracts with customers.

The new standard introduces disclosures that require information not previously needed for financial reporting. The disclosures may require information that is incremental to the data and information needed for recording revenue in the financial statements.



Application of the new requirements

All automotive suppliers are affected by the disclosure requirements

All automotive suppliers are affected by the new disclosure requirements to some extent. The additional information needed will vary depending on the relevance of the different requirements to the supplier. It is important to assess the additional disclosure requirements fully.

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

A helpful table of what's new with respect to disclosures is included in KPMG's [Guide to annual financial statements – IFRS 15 supplement](#).

Further resources

High level briefing	
IFRS Blog IFRS 15 Revenue – The reality may surprise you	First Impressions IFRS 15 Revenue
Web article New revenue standard – Introducing the new IFRS 15	Briefing Accounting for revenue is changing
In-depth analysis	
Issues In-Depth Revenue Issues In-Depth: IFRS & US GAAP	Guide to annual financial statements IFRS 15 supplement
Transition Options Revenue	

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