



### Solution 124.4

<b>Component</b>	Automotive industry
<b>Index</b>	Tooling – asset and/or revenue
<b>Short title</b>	Bifurcating components of a manufacturing contract

**Attention:** This guidance is based on the revised standards and interpretations that are mandatory for accounting periods commencing 1 January 2005. A company may early adopt an individual revised standard, but only in its entirety.

#### Issue

The recognition criteria should be applied to separately identifiable components of a single transaction in order to reflect the substance of the transaction [IAS18.13(R.05)].

How should management recognise revenue on a contract with separate elements?

#### Background

Entity X is a vehicle manufacturer. Entity X entered into a long term supply arrangement with Y, a supplier. The contract will last for a period of six years. The contract comprises two phases that are independent of each other. Supplier Y will construct the tools in phase I and will produce the seats in phase II. Entity X is not required legally or contractually to continue with phase II after the completion of phase I.

Supplier Y is required to manufacture seats for car type ABC over the contract period to X's specification. The seat is specific for car type ABC, so X requires Y to construct tools that will be used to manufacture the seats.

Entity X and Y have agreed a non-refundable fixed price for the tools. The tooling contract will take up to 18 months to complete. The ownership of the tools will be passed to X once the tools are completed.

They have not agreed on a specific quantity of seats to be delivered but agreed a fixed price for each seat over the contract period. The manufacturing provided by Y could be provided by other contract manufacturers. There is no proprietary information nor any legal or technical restrictions related to the tools that would preclude X from engaging other parties to manufacture the seats after the transfer of ownership of the tools.

Supplier Y has a history of producing and selling similar tools separately. It has, on this basis, determined that profit margin in the tools contract and the manufacturing contract is competitive compared to what other third party would charge for similar tools and manufacturing respectively. In addition, Y regularly



provides similar contracts for tools and manufacturing for other vehicle manufacturers for comparable profit margin.

### **Solution**

Supplier Y should treat the contract as two separate elements (that are the contract to produce tools and the contract to manufacture seats) as follows:

#### The contract to construct tools

The contract is a contract to build assets covering an extended period that meets the definition of construction contract in IAS 11. It is accounted for as such.

A loss may arise on the contract to construct tools. Any loss must be recognised immediately and cannot be deferred because the contract to manufacture the seats will be accounted for separately.

#### The contract to manufacture seats

The manufacture of the seats is not a service contract. It is a contract between a supplier and a purchaser for production of goods. The contract is for the construction of a series of assets that are not interrelated. The seats are not interrelated because one seat is not connected to or dependent on another seat in anyway. The contract is a contract to sell goods. Revenues from the sale of seats should be recognised as the seats are delivered and other criteria for revenue recognition in IAS 18 are met.