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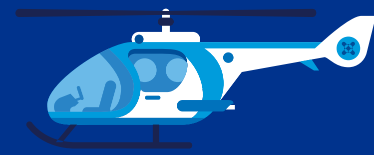

Defining Issues®

SEC comments on pre-production costs and customer reimbursements under ASC 606

August 8, 2017

KPMG reports that diversity in practice may continue when accounting for pre-production costs and customer reimbursements under the new revenue standard.

Applicability

Suppliers who are SEC registrants that engage in pre-production activities associated with long-term supply arrangements.

Key facts and impacts

KPMG is aware of diversity in practice in registrants' accounting for pre-production costs and customer reimbursements that result from different judgments being made under current US GAAP.

We understand from discussions with the SEC staff that it will continue to respect well-reasoned, practical judgments when those judgments are grounded in the principles of the accounting literature – including the different reporting outcomes that may result from applying those judgments after adopting ASC 606 and ASC 340-40.[1]

On adoption, costs that fall under ASC 340-40 will generally be capitalized if the supplier expects to recover them. A registrant may, in some cases, continue to apply historical accounting policies to pre-production costs and related customer reimbursements on the adoption of ASC 606 and ASC 340-40.

Many registrants have disclosed[2] that they may change how they account for pre-production costs and customer reimbursements when they adopt ASC 606 and ASC 340-40. Following the SEC staff comments, registrants should reevaluate their SAB 74 disclosures related to pre-production activities.

What are pre-production activities?

Pre-production activities are common in the automotive supplier industry as well as certain other industries. A supplier may enter into long-term arrangements with its customers to manufacture parts, and often incurs significant pre-production costs. Specifically, the supplier may incur costs to perform certain services related to the engineering, design and development (ED&D) of the products, and may incur costs to design and develop molds, dies and other tools (tooling) that it will use to produce those products.

In some cases, the customer agrees to reimburse the supplier for ED&D and tooling costs with a lump-sum payment. Or the supplier may expect to recover some or all of its costs by increasing the per-unit price for the related parts.

1 ASC 606, Revenue from Contracts with Customers, and ASC 340-40, Other Assets and Deferred Costs—Contracts with Customers

2 SEC Staff Accounting Bulletin (SAB) 74, Topic 11.M, Disclosure Of The Impact That Recently Issued Accounting Standards Will Have On The Financial Statements Of The Registrant When Adopted In A Future Period

Current guidance

Under current US GAAP (ASC 605 and ASC 340-10)[3] there has been diversity in accounting for pre-production activities even within the same industry.

Some registrants have determined that customer reimbursements for pre-production activities were part of a revenue transaction and represented a separate deliverable under ASC 605. Others have concluded that the reimbursements were not part of a revenue transaction because the activities were not part of 'ongoing major or central operations' under the definition of revenue[4], or because the activities were considered fulfillment or development activities.

There has also been diversity in practice related to how registrants account for the costs associated with pre-production activities. Some registrants determined that their pre-production costs were in the scope of ASC 340-10. Others decided that their pre-production costs were not in the scope of ASC 340-10, but still applied ASC 340-10 by analogy because no other guidance applied. ASC 340-10 requires pre-production costs to be expensed as incurred, unless the supplier has a non-cancellable right to use tooling or a contractual guarantee for reimbursement from the customer, in which case the costs would be capitalized.

Views on revenue – ASC 606

If a registrant concluded that tooling or other pre-production activities were a deliverable under ASC 605 (e.g. part of a multiple-element arrangement), it should evaluate whether the activities constitute a performance obligation under ASC 606 by considering the Transition Resource Group for Revenue Recognition (TRG) discussion and meeting minutes.[5] The SEC staff acknowledged that there may be instances in which a registrant concluded that pre-production activities were a deliverable under ASC 605, but now determines that the pre-production activities do not represent a separate performance obligation under ASC 606. In these instances, we believe that any customer reimbursement would still be recorded as revenue but would attach itself to other performance obligations in the contract (e.g. the parts).

If a registrant previously concluded that tooling or other pre-production activities were not a revenue-generating activity, the SEC staff would not object if the registrant continued to apply this conclusion after adoption of ASC 606, assuming that the facts and circumstances did not change.

If a registrant previously concluded that tooling or other pre-production activities were not a revenue-generating activity, but believes that the activities represent a performance obligation under ASC 606, the staff is available for consultation – on a formal or informal basis, as needed.

Views on costs – ASC 340-40

If a registrant historically concluded that tooling or other pre-production costs were in the scope of the existing cost guidance in ASC 340-10, the SEC staff expects the registrant to continue applying the cost guidance in ASC 340-10. However, if the registrant only applied ASC 340-10 by analogy because there was no other applicable guidance, it should assess whether the costs are in the scope of ASC 340-40; if they are, the registrant should follow the transition guidance in the new revenue standard and will not be required to determine preferability of adopting the new accounting standard.[6]

KPMG observation

The new guidance in ASC 340-40 is intended to fill the gap arising from the withdrawal of previous guidance.[7] For example, if a registrant has costs related to a construction- or production-type contract that are currently in the scope of ASC 605-35, it should apply ASC 340-40 when the guidance in 605-35 is superseded on the adoption of ASC 606.[8]

[3] ASC 605, Revenue Recognition, and ASC 340-10, Other Assets and Deferred Costs

[4] FASB Statement of Financial Accounting Concepts No. 6, Elements of Financial Statements

[5] FASB/IASB Joint Transition Resource Group for Revenue Recognition, Agenda Paper No. 46, Pre-Production Activities

[6] ASC 250, Accounting for Changes and Error Corrections

[7] ASU 2014-09, Revenue from Contracts with Customers (BC305)

[8] ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers (BC45)

KPMG observation

If a registrant has historically concluded that the costs were clearly in the scope of ASC 340-10, we believe it will be prohibited from accounting for these costs under ASC 340-40. This is because the new guidance in ASC 340-40 applies only to costs that are not in the scope of another Topic or Subtopic, *including ASC 340-10*. Therefore, we believe that a registrant should continue to account for its costs under ASC 340-10.

However, if a registrant has historically applied ASC 340-10 *by analogy* because there was no other applicable guidance, the SEC staff will not object to applying ASC 340-40 when the registrant adopts the new revenue standard. We believe that most registrants in this scenario will capitalize more costs when they adopt ASC 340-40.

Current accounting (ASC 605)	After adoption of ASC 606	KPMG's understanding
Customer reimbursements		
Revenue (deliverable)	Revenue (performance obligation)	Conclusion acceptable if it is consistent with the principles in ASC 606 and the related TRG discussion.
	Revenue (not a performance obligation accounted for separately)	
Not revenue	Not revenue	Conclusion acceptable.
	Revenue	SEC staff available for consultation – formally or informally, as needed.
Pre-production costs		
In the scope of ASC 340-10	Continue to apply ASC 340-10	Conclusion acceptable.
In the scope of ASC 340-10 by analogy	Apply ASC 340-40 if the costs are in its scope	Conclusion acceptable; use ASC 606 transition.

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