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FASB Decides to Retain Guidance on Pre-production Costs

The FASB decided to retain the current guidance on capitalization of pre-production costs related to long-term supply arrangements while it conducts outreach to decide whether it should propose additional changes.[1]

The FASB also did not want to delay issuing its technical corrections for the revenue standard, most of which did not pertain to pre-production costs.[2]

Key Fact

- The FASB decided to retain the pre-production cost guidance, in part, because the revenue project did not include a broad reconsideration of cost guidance in U.S. GAAP. The FASB will conduct additional research about what effects the removal of this guidance may have on identifying performance obligations.

Key Impacts

- Suppliers will continue to expense pre-production costs, such as tooling, engineering, design, and development, unless the customer provides them with a contractual guarantee of reimbursement or a noncancellable right to use the tooling during the long-term supply arrangement.
- Suppliers should still evaluate whether consideration received from a customer for pre-production activities should be accounted for under the revenue standard.[3]
- U.S. GAAP would continue to differ from IFRS because there is no comparable IFRS guidance that restricts capitalization of pre-production costs.

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[1] See the FASB's Tentative Board Decisions from October 19, 2016, available at www.fasb.org.

[2] FASB Proposed Accounting Standards Update, Technical Corrections and Improvements to Update No. 2014-09, Revenue from Contracts with Customers (Topic 606), May 18, 2016, available at www.fasb.org.

[3] FASB ASC Topic 606, Revenue from Contracts with Customers, available at www.fasb.org.

Current Capitalization Guidance

U.S. GAAP requires the supplier to expense design and development costs in long-term supply arrangements relating to:

- Products that will be sold; or
- Tooling that it will not own, but that it will use to produce the related products.

However, U.S. GAAP requires capitalization if the supplier has a:

- Noncancellable right to use the tooling; or
- Legally enforceable contractual right for reimbursement of design and development costs that can be objectively measured and verified.

The FASB staff observed on October 19 that having a noncancellable right to use the tooling is similar to the concept of retaining control of the asset under the revenue standard.

In May 2016 the FASB proposed eliminating its pre-production cost guidance, which meant that the supplier would have applied the fulfillment cost guidance in Subtopic 340-40 (created by the revenue standard).[4] This could have required certain fulfillment costs that are currently expensed to be capitalized because the pre-production cost guidance in Subtopic 340-10 has a higher capitalization threshold.[5]

The FASB's October 19 decision means that the supplier will continue to apply current U.S. GAAP guidance on capitalization of pre-production costs associated with long-term supply arrangements.

Sale-leaseback Concerns

At its October 19 meeting the FASB said that some constituents were concerned that if the noncancellable right guidance was superseded, the supplier could conclude that it has sold the tooling and entered into a leaseback arrangement with the customer. The supplier may have reached this conclusion because it would have a right to use the customer's asset to produce the related products.

KPMG Observations

It is unclear whether these transactions would result in a lease. That would depend on whether the supplier, after transferring control of the tooling to the customer, controls the use of the tooling. If the customer, rather than the supplier, controls when, whether, and how much the tooling produces, the supplier would not direct the use of the tooling under the lease identification guidance and therefore a lease would not exist.[6] However, even if the sale-leaseback concerns are valid in some cases, the decision to retain the pre-

[4] FASB ASC Subtopic 340-40, Other Assets and Deferred Costs – Contracts with Customers, available at www.fasb.org.

[5] FASB ASC Subtopic 340-10, Other Assets and Deferred Costs – Overall, available at www.fasb.org.

[6] FASB ASC Topic 842, Leases, available at www.fasb.org.

production cost guidance would not alleviate those concerns. Under the revenue standard, situations may still arise when tooling arrangements result in the transfer of control of an asset to a customer.

Interaction with Revenue Standard

Even with the decision to retain the pre-production cost guidance, the supplier will still need to evaluate whether tooling and other pre-production activities would result in the transfer of control of a good or service to the customer for which it is entitled to consideration. For example, in a situation where the supplier does not have a noncancellable right to use the tooling (because both title and control transfer to the customer), and has a contractual guarantee of reimbursement from the customer, it may be reasonable to conclude that tooling is a separate performance obligation under the revenue standard. The supplier will consider the guidance in Subtopic 340-10 to account for the related costs.

If the FASB's outreach efforts result in a decision to eliminate the pre-production cost guidance, there are scenarios where the costs would be capitalized as fulfillment costs under Subtopic 340-40. For example, if the supplier does not have a noncancellable right to use the tooling nor a contractual guarantee of reimbursement from the customer, then those costs may qualify as fulfillment costs associated with a contract or anticipated contract for the sale of the related parts. With the retention of the pre-production cost guidance, the supplier would be required to expense those costs as incurred.

Looking Ahead

We encourage suppliers to consider the potential effects of the FASB's decision to retain the pre-production cost guidance on their financial statements, performance measures, and compensation arrangements. The FASB staff will contact preparers and auditors to understand some of their concerns and potential effects that may result if the Board decides to change the pre-production cost guidance.

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