Entities will likely continue to reach different conclusions about the accounting for pre-production and tooling activities when they adopt ASC 606.

**What you need to know**

- Diversity in practice in the accounting for pre-production and tooling activities and the related costs is likely to continue when entities adopt the new revenue standard.

- We believe that entities can continue to apply the conclusions they reached under legacy guidance about whether these activities generate revenue. We also believe that entities that currently account for these activities as revenue-generating activities could change that conclusion if they determine that the activities don't involve the transfer of a good or service to a customer.

- Entities will continue to account for pre-production and tooling costs that are in the scope of the legacy cost guidance in ASC 340-10 using that guidance. Entities that currently apply ASC 340-10 by analogy or apply other guidance need to determine whether these costs are in the scope of the new cost guidance in ASC 340-40 that the Financial Accounting Standards Board issued along with the new revenue standard.

**Overview**

Manufacturing and production companies in various industries have raised questions about how they should account for activities and costs incurred prior to the production of goods under a supply arrangement after they adopt the new revenue recognition standard.¹

The Joint Transition Resource Group for Revenue Recognition (TRG)² addressed a number of these questions, including whether pre-production activities are promised goods or services, how to account for pre-production costs that entities currently account for in accordance with the
cost guidance in Accounting Standards Codification (ASC) 340-10\(^3\) and whether pre-production costs for contracts that are currently in the scope of ASC 605-35\(^4\) are in the scope of the legacy cost guidance in ASC 340-10 or the new cost guidance in ASC 340-40.\(^5\) Companies continue to raise questions about this accounting and some public companies have since disclosed that they likely will have to change their accounting for these costs when they adopt the new revenue guidance in ASC 606.

As public companies finalize their ASC 606 accounting policies and prepare to adopt the new standard, however, a consensus has emerged that a number of views related to the accounting for pre-production and tooling activities could be appropriate. This publication describes the views that we believe would be appropriate.

The questions arose because some long-term supply arrangements require an entity to incur up-front engineering and design costs to create new technology or adapt existing technology to the needs of the customer. These pre-production activities are often a prerequisite to delivering any units under a production contract.

For example, a manufacturer may incur costs to perform certain services related to the design and development of products it will sell under long-term supply arrangements and may incur costs to design and develop molds, dies and other tools that will be used to produce those products. A contract may call for the customer to reimburse the manufacturer for these costs, or reimbursement may be implicitly guaranteed as part of the price of the product or by other means.

While ASC 340-10 provides guidance on capitalizing certain pre-production and tooling costs, diversity in practice exists because ASC 340-10 does not provide guidance on how to account for reimbursements received from customers for pre-production and tooling activities.

**Key considerations**

Entities that currently account for pre-production and tooling activities as deliverables under the legacy guidance in ASC 605 should evaluate whether the activities are promises in a contract with a customer (and potentially performance obligations) under ASC 606. When making this evaluation, entities should determine whether the activity transfers a good or service to a customer. If an entity determines that these activities are promised goods or services, it will apply the guidance in ASC 606 to those goods or services.

However, an entity that currently accounts for pre-production activities as revenue-generating activities under ASC 605 may conclude that, based on the facts and circumstances, the activities do not represent a promised good or service under ASC 606. In some cases, an entity will need to apply judgment to determine whether pre-production and tooling activities transfer a good or service to a customer.

Entities that don't currently account for pre-production and tooling activities as revenue-generating activities can continue to apply this conclusion after they adopt ASC 606 if there are no other changes to the facts and circumstances. Many entities have concluded under current US GAAP that pre-production and tooling activities are not revenue-generating either because the activities were not part of ongoing major or central operations based on the Statement of Financial Accounting Concepts No. 6 definition of revenue or because the activities were considered fulfillment or development activities.
The following table summarizes our views of how entities may appropriately account for pre-production and tooling activities.

<table>
<thead>
<tr>
<th>Current accounting</th>
<th>Our view of appropriate accounting under ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>An entity has concluded that these activities are deliverables that generate revenue under ASC 605.</td>
<td>We believe that the entity could account for these activities in either of the following ways as long as its conclusions are consistent with the principles in ASC 606 and the related TRG discussions:</td>
</tr>
<tr>
<td></td>
<td>• A performance obligation that generates revenue</td>
</tr>
<tr>
<td></td>
<td>• Not a performance obligation and therefore not a revenue-generating activity</td>
</tr>
<tr>
<td>An entity has concluded that these activities are not in the scope of ASC 605.</td>
<td>We believe it would be reasonable for the entity to conclude that these activities are not in the scope of ASC 606.</td>
</tr>
<tr>
<td></td>
<td>If a public company concludes that these activities are performance obligations that generate revenue under ASC 606, we believe the company should consider discussing this conclusion with the Securities and Exchange Commission (SEC) staff. The SEC staff has indicated that it is available for consultations on a formal or informal basis as needed.</td>
</tr>
</tbody>
</table>

How we see it

We generally expect entities that currently account for pre-production and tooling activities as non-revenue-generating activities under ASC 605 to conclude that the activities are not in the scope of the new revenue standard.

Accounting for pre-production costs

The following table summarizes our views of appropriate accounting for pre-production and tooling costs.

<table>
<thead>
<tr>
<th>Current accounting</th>
<th>Our view of appropriate accounting under ASC 606</th>
</tr>
</thead>
<tbody>
<tr>
<td>The costs are in the scope of ASC 340-10, and the entity applies that guidance.</td>
<td>We believe it is appropriate for the entity to continue to apply ASC 340-10. If the entity later determines that a change to this accounting is necessary, it would need to perform a preferability analysis and apply the other requirements of ASC 250.</td>
</tr>
<tr>
<td>The entity applies ASC 340-10 by analogy or applies ASC 605-35 or ASC 350-40.</td>
<td>We believe the entity needs to perform a thorough analysis of the facts and circumstances to determine whether ASC 340-40 applies. Entities that determine when adopting the new revenue standard that ASC 340-40 applies should use the ASC 606 transition guidance to account for the change (a preferability analysis is not required).</td>
</tr>
</tbody>
</table>
Entities that apply ASC 340-10 because they have concluded that pre-production costs are in the scope of that guidance should continue to apply ASC 340-10 when they adopt the new revenue recognition standard. However, entities that currently apply ASC 340-10 by analogy or apply other guidance should assess whether the costs are in the scope of the new guidance in ASC 340-40, which is effective at the same time as the new revenue standard. An entity in this situation that determines that the costs are in the scope of ASC 340-40 should follow the transition guidance in the new revenue standard (i.e., the entity would not be required to establish preferability under ASC 250).

**How we see it**

We believe that many entities won’t have to change how they account for pre-production and tooling reimbursements from customers after they adopt the new revenue guidance, but they may have to change the accounting for the pre-production and tooling costs that are not in the scope of ASC 340-10.

**Endnotes:**

1. ASC 606, *Revenue from Contracts with Customers.*
2. 9 November 2015 TRG meeting; agenda paper no. 46.
4. ASC 605-35, *Revenue Recognition – Construction-Type and Production-Type Contracts.*
5. ASC 340-40, *Other Assets and Deferred Costs – Contracts with Customers.*
6. ASC 250, *Accounting Changes and Error Corrections.*