IFRS | FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF PAPER

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Project	**FASB/IASB Joint Transition Resource Group for Revenue Recognition**
Paper topic	Pre-Production Activities

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Purpose

1. Some stakeholders informed the staff that there are questions about the guidance in Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* and IFRS 15 *Revenue from Contracts with Customers* (collectively referred to as the "new revenue standard"), regarding pre-production activities. This paper addresses the following questions:

   (a) Question 1: How should an entity assess whether pre-production activities are a promised good or service (or included in the measure of progress towards complete satisfaction of a performance obligation that is satisfied over time)?

   (b) Question 2: How should an entity account for pre-production costs that currently are accounted for in accordance with guidance in Subtopic 340-10? (U.S. GAAP Question Only)

   (c) Question 3: Are pre-production costs for contracts that were previously in the scope of Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, in the scope of cost guidance in Subtopic 340-10 or Subtopic 340-40? (U.S. GAAP Question Only)

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Background

2. The joint FASB-IASB revenue project resulted in each Board issuing some cost guidance. The scope of the new cost guidance includes costs incurred in fulfilling a contract with a customer that are not in the scope of another Topic or Standard. The new cost guidance in U.S. GAAP is included in Subtopic 340-40, Other Assets and Deferred Costs—Contracts with Customers. The new cost guidance in IFRS is included in IFRS 15, paragraphs 91 through 104. The basis for conclusions of the new revenue standard describes the reasons for the Boards providing the guidance, as follows:

> **BC305.** The cost guidance in Subtopic 340-40 [requirements in IFRS 15][1] is intended to achieve the following:
>
> a. Fill the gap arising from the withdrawal of previous revenue guidance—Subtopic 340-40 and Topic 606 [IFRS 15] will result in the withdrawal of some guidance on contract costs, in particular, the previous guidance on accounting for construction contracts.
>
> b. Improve current practice—The cost guidance provides clearer guidance on accounting for some costs to fulfill a contract (for example, setup costs for services) and results in an entity no longer having to rely on, or analogize to, guidance that was not developed specifically for contracts with customers. For instance, in accounting for setup costs, an entity applying U.S. GAAP may previously have needed to analogize to the guidance on the deferral of direct loan origination costs in paragraph 310-20-25-2. An entity applying IFRS may have evaluated those costs in accordance with IAS 38, Intangible Assets.

[1] IFRS 15 references are included in "[XX]" throughout this paper.

Specifying clear guidance also will result in greater consistency in practice.

c. Promote convergence in accounting for contract costs—More costs will be accounted for similarly under U.S. GAAP and IFRS (although total consistency in accounting for costs to fulfill a contract will not be achieved unless the Boards align their respective standards on inventories; property, plant, and equipment; intangible assets; and impairment of assets).

3. The new cost guidance applies to costs that are not within the scope of another Topic or Standard. In circumstances in which there was fulfillment cost guidance in IFRS or U.S. GAAP that was not superseded by the new revenue standard, then an entity would continue to apply that prior guidance. The new guidance applies when no previous guidance existed or the previous guidance was superseded by the new revenue standard (for example, costs for construction contracts). The introduction of new cost guidance was not a fundamental reconsideration of cost accounting. Rather, the Boards wanted to ensure that gaps were not created in cost guidance when certain revenue guidance was superseded. The scope of the cost guidance for U.S. GAAP and IFRS follows:

U.S. GAAP: **340-40-15-3** The guidance in this Subtopic applies to the costs incurred in fulfilling a contract with a customer within the scope of Topic 606 on revenue from contracts with customers, unless the costs are within the scope of another Topic or Subtopic, including, but not limited to, any of the following:

a. Topic 330 on inventory

b. Paragraphs 340-10-25-1 through 25-4 on preproduction costs related to long-term supply arrangements

c. Subtopic 350-40 on internal-use software

d. Topic 360 on property, plant, and equipment

e. Subtopic 985-20 on costs of software to be sold, leased, or otherwise marketed.

IFRS: **IFRS 15, paragraph 8** This Standard specifies the accounting for the incremental costs of obtaining a contract with a customer and for the costs incurred to fulfil a contract with a customer if those costs are not within the scope of another Standard (see paragraphs 91–104). An entity shall apply those paragraphs only to the costs incurred that relate to a contract with a customer (or part of that contract) that is within the scope of this Standard.

Question 1: How should an entity assess whether pre-production activities are a promised good or service (or included in the measure of progress towards complete satisfaction of a performance obligation that is satisfied over time)?

4. Some stakeholders have raised questions on how to account for pre-production activities. Some long-term supply arrangements require an entity to undertake efforts in up-front engineering and design to create new technology or adapt existing technology to the needs of the customer. The pre-production activity is often a prerequisite to delivering any units under a production contract.

5. If a pre-production activity is a promised good or service (a performance obligation or a part of a performance obligation) in a contract with a customer, then the activity will have implications for the timing of revenue recognition. An entity would allocate a portion of the transaction price to that good or service if it is a single performance obligation, or allocate a portion of the transaction price to a combined performance obligation that includes the pre-production activities along with other goods and services. If the pre-production activities transfer to a customer and are included in a single performance obligation satisfied over time, then those activities are considered when measuring progress towards complete satisfaction of the performance obligation.

6. The entity first would evaluate the nature of its promise with the customer. The new revenue standard specifies that not every activity that is performed to fulfill a contract is necessarily a promise to the customer for purposes of identifying performance obligations. Therefore, an entity should consider whether pre-production activities are a promised good or service or activities that do not transfer a good or service to the customer. The following is the applicable guidance from the new revenue standard:

> **606-10-25-17 [25]** Performance obligations do not include activities that an entity must undertake to fulfill a contract unless those activities transfer a good or service to a customer. For example, a services provider may need to perform various administrative tasks to set up a contract. The performance of those tasks does not transfer a service to the customer as the tasks are performed. Therefore, those setup activities are not a performance obligation.

7. The topic of whether activities are a promised good or service or, instead, fulfillment activities was discussed at the January 2015 TRG meeting. Refer to TRG paper No. 12. At that meeting, TRG members discussed that the new revenue standard acknowledges (paragraph 606-10-25-17 [25]) that an entity is often required to undertake numerous activities to ultimately fulfill its promise to a customer, and that not every activity will result in the transfer of a promised good or service. For example, the profit-directed activities of an entity that includes the process by which revenue is generated, encompassing activities such as purchasing raw materials, manufacturing goods, transporting goods to market, and selling generally would not be additional promises to the customer to undertake those activities. Fulfillment costs that an entity incurs when performing some activities, although required to ultimately transfer the good or service to the customer, are not necessarily a promise to transfer an additional good or service to the customer. In BC93, the Boards reiterated their intent that an entity should not account for activities that do not transfer a good or a service to a customer, including fulfillment activities "even though those activities are required to

successfully transfer the goods or services for which the customer has contracted."

8. The determination of whether pre-production activities are a promised good or service in a contract sometimes will require judgment. Entities may find it helpful to consider that the core principle of the new revenue standard "is that an entity shall recognize revenue to *depict the transfer of promised goods and services* to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[2] Furthermore, the new revenue standard specifies that the good or service is transferred when (or as) the customer obtains control.[3]

9. Accordingly, if an entity is having difficulty determining whether pre-production activities are a promised good or service, the staff think it would be helpful for the entity to consider as part of this assessment whether control of that good or service is ever transferred to the customer. For example, if the entity is performing engineering and development as part of developing a new product for a customer and the customer will own the intellectual property (for example, patents) that results from those activities, then the entity likely would conclude that it is transferring control of that intellectual property to the customer. Consequently, the entity likely would conclude that the activities are a promised good or service in the contract.

10. The staff have used the straightforward example above to illustrate a case in which it would be clear that control has transferred. However, sometimes an entity will need to apply judgement to determine whether control of a good or service is ever transferred to the customer. The new revenue standard includes criteria in paragraph 606-10-25-27 [35] for determining whether an entity transfers control of a good or service over time and, therefore, satisfies a performance obligation over time. The staff think one of those criteria that may be applicable to pre-production activities is whether the customer simultaneously receives and consumes the benefits provided by the entity's performance as the

[2] Paragraph 606-10-10-2 [2]

[3] Paragraph 606-10-25-23 [31]

entity performs. Paragraph 606-10-55-6 [B4] notes that sometimes an entity may not be able to readily identify whether this criterion is met. In those circumstances, an entity would consider whether another entity would need to reperform the work that the entity has completed to date if that other entity were to fulfill the remaining performance obligation. For example, consider a scenario in which an entity is performing engineering and development as part of developing a new product for a customer. If the entity provides the customer with periodic progress reports (in a level of detail that would not require the customer to contract with another entity to reperform the work) or if the entity is required to provide the customer with the design information completed to date in the case of a termination, then the entity likely would conclude that control of that service has transferred to the customer.

11. The notion of control and considering when goods or services do not transfer to a customer also can be found in the guidance on measuring complete satisfaction of a performance obligation, as follows:

> **606-10-25-34 [42]** When applying a method for measuring progress, an entity shall exclude from the measure of progress any goods or services for which the entity does not transfer control to a customer. Conversely, an entity shall include in the measure of progress any goods or services for which the entity does transfer control to a customer when satisfying that performance obligation.

12. As an example, when a piece of equipment is transferred over time, an entity has determined that the customer has control over the asset because, for example, the entity has a right to payment for an asset with no alternative use. The entity might include labor costs in a cost-to-cost input method measure of progress for constructing the piece of equipment. The labor itself is not a separate promised good or service to the customer in the contract. However, each time the worker turns a wrench, the asset (the equipment) is changed and the customer obtains control of that changed asset. Similarly, an entity might determine the pre-production cost should be included in the measure of progress, depending on the

circumstances of the arrangement. However, if the arrangement involves a significant amount of costs for the entity near the start of the arrangement and the activities giving rise to those costs do not transfer a good or a service to the customer, then the entity should consider the guidance on adjustments to measure of progress when using a cost based input method in paragraph 606-10-55-21 [B19]. Application of that guidance would require an entity to consider whether the costs for certain activities should be excluded from the measure of progress or whether the input method should be adjusted to recognize revenue only to the extent of that cost incurred.

Question 2: How should an entity account for pre-production costs that currently are accounted for in accordance with guidance in Subtopic 340-10? (U.S. GAAP Question Only)

13. Some manufacturers incur pre-production costs related to products they will supply to customers under long-term supply arrangements. For example, a manufacturer might incur costs to perform certain services related to the design and development of the products and might incur costs to develop molds, dies, and other tools used in the production process.

14. Subtopic 340-10, Other Assets and Deferred Costs—Overall, provides guidance on accounting for pre-production costs related to long-term supply arrangements. An excerpt of this guidance is included in Appendix A. That Subtopic includes guidance on capitalizing versus expensing pre-production costs. Update 2014-09 (the new revenue standard) did not amend the guidance on pre-production costs in Subtopic 340-10. Some stakeholders have raised questions as to whether pre-production costs that historically have been accounted for in accordance with Subtopic 340-10 should be evaluated under the scope of the new revenue guidance.

15. This question on capitalization of costs is applicable regardless of whether an entity determines that the pre-production activities are a promised good or service. The determination of whether costs should be expensed or capitalized is a separate analysis from whether those activities transfer a good or service to the customer. For example, consider a scenario in which an entity incurs costs to

activate services at a new customer's location. The entity might consider the activation to be an administrative task that does not transfer a service to the customer even if the entity is entitled to an activation fee. Regardless of the entity's conclusion about whether activation services do or do not transfer a service to the customer, the cost of the services should be capitalized, if the costs meet the criterion in Subtopic 340-40 for capitalization, and amortized in accordance with that guidance.

16. Consider another scenario in which an entity is manufacturing inventory for sale to customers. As the asset is manufactured, the entity capitalizes the costs to manufacture the inventory in accordance with Topic 330, Inventory. When the entity enters into an arrangement with a customer to sell the inventory, it would recognize revenue in accordance with the new revenue standard. Although this is a straightforward example, it demonstrates that the determination of when to recognize revenue is a separate assessment from whether costs are expensed or capitalized. That is, revenue relates to the transfer of goods or services (an asset) to a customer. An entity incurs costs to create those assets to be transferred. Entities should account for those assets by referring to existing standards and the new cost guidance.

17. Subtopic 340-10 includes guidance on determining whether pre-production costs should be expensed or capitalized. As noted earlier, this guidance on pre-production costs (which is included in Appendix A) was not amended when Update 2014-09 was issued. The basis for conclusions to the new revenue standard notes:

> **BC307.** Because the Boards decided not to reconsider all cost guidance comprehensively, paragraphs 340-40-25-1 through 25-8 specify the accounting for contract costs that are not within the scope of other Topics. Consequently, if the other Topics preclude the recognition of any asset arising from a particular cost, an asset cannot then be recognized under Subtopic 340-40 (**for example, in U.S. GAAP, pre-production costs under long-term**

> **supply arrangements will continue to be accounted for in accordance with paragraphs 340-10-25-5 through 25-8,** and in IFRS, initial operating losses, such as those incurred while demand for an item builds, will continue to be accounted for in accordance with paragraph 20(b) of IAS 16). **[Emphasis added.]**

18. Because the guidance in Subtopic 340-10 did not change as a result of the new revenue standard, the staff thinks that an entity that is following the guidance in Subtopic 340-10 appropriately today would continue to do so after the implementation of the new revenue standard.

Question 3: Are pre-production costs for contracts that were previously in the scope of Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, in the scope of cost guidance in Subtopic 340-10 or Subtopic 340-40? (U.S. GAAP Question Only)

19. Some stakeholders have raised a question about accounting for pre-production costs for contracts that previously were accounted for under Subtopic 605-35, Revenue Recognition—Construction-Type and Production-Type Contracts, which was superseded by the new revenue standard. Although there was no guidance specific to 'pre-production' in Subtopic 605-35, the staff thinks that most construction entities considered those types of costs as 'contract costs' in the scope of that guidance. This question arises because the scope of Subtopic 340-10 (which was not amended by Update 2014-09) states that the guidance applies to *all entities*.[4] However, prior to the issuance of Update 2014-09, the guidance on costs for construction-type and production-type contracts was included in Subtopic 605-35, rather than Subtopic 340-10.

20. As noted in the background section of this paper, the basis for conclusions of the new revenue standard (BC305) explains that the new cost guidance in Subtopic 340-40 is intended fill the gap arising from the withdrawal of previous revenue

[4] Paragraph 340-10-15-2

guidance including previous guidance on accounting for construction contracts. Therefore, the staff thinks that those costs related to contracts appropriately accounted for in the scope of Subtopic 605-35 currently should be accounted for in accordance with the new guidance in Subtopic 340-40 when applying Update 2014-09.

Question for the TRG Members
1. Do the TRG members agree with the staff's interpretations in this paper?

Appendix A

Topic 340-10 (formerly, EITF 99-5, *Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements)*

> Preproduction Costs Related to Long-Term Supply Arrangements

25-1 Design and development costs for products to be sold under long-term supply arrangements shall be expensed as incurred. Design and development costs for molds, dies, and other tools that a supplier will own and that will be used in producing the products under a long-term supply arrangement shall be capitalized as part of the molds, dies, and other tools (subject to an impairment assessment under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10) unless the design and development is for molds, dies, and other tools involving new technology, in which case, the costs shall be expensed as incurred in accordance with Subtopic 730-10.

25-2 Design and development costs for molds, dies, and other tools that a supplier will not own and that will be used in producing the products under the long-term supply arrangement shall be capitalized (subject to an impairment assessment under the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic 360-10) if the supply arrangement provides the supplier the noncancelable right (as long as the supplier is performing under the terms of the supply arrangement) to use the molds, dies, and other tools during the supply arrangement. Otherwise, those design and development costs shall be expensed as incurred, including costs incurred prior to the supplier's receiving the noncancelable right to use the molds, dies, and other tools during the supply arrangement.

25-3 If a contractual guarantee for reimbursement exists for design and development costs that otherwise would be expensed based on the guidance in this Section, those costs shall be recognized as an asset as incurred. For purposes of this Subtopic, contractual guarantee means a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified.

25-4 See Examples 1 through 4 (paragraphs 340-10-55-2 through 55-5) for preproduction costs related to long-term supply arrangements.

>> Example 1: Entity Agrees to Reimburse Supplier up to a Maximum Amount

55-2 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to reimburse the supplier for preproduction design and development costs incurred under the arrangement, up to a maximum reimbursement of $1,000,000. Under this arrangement, the amount of reimbursement for

design and development costs can be objectively measured and verified. The supplier shall recognize the design and development costs as an asset as costs are incurred, up to a maximum of $1,000,000.

>> Example 2: Entity Agrees to Pay Supplier Specified Amount per Part

55-3 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $55 per part for the first 200,000 parts produced and $50 for every part thereafter. No agreement exists concerning reimbursement of the supplier's design and development costs if fewer than 200,000 parts are produced under the arrangement. Under this arrangement, the amount of reimbursement for design and development costs cannot be objectively measured and verified. The supplier shall expense the preproduction design and development costs as incurred.

>> Example 3: Entity Agrees to Pay Supplier Specified Amount per Part Plus Reimbursement if Minimum Amount Not Produced

55-4 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $55 per part for the first 200,000 parts produced and $50 for every part thereafter. The arrangement provides that if fewer than 200,000 parts are produced, the supplier will be reimbursed for design and development costs incurred under the arrangement, up to a maximum reimbursement of $1,000,000 reduced by $5 per part for each part produced under the supply arrangement. For example, if 190,000 parts are produced under the supply arrangement, in addition to the $55 per part received for the parts produced, the supplier would be reimbursed for design and development costs incurred under the arrangement, up to a maximum of $50,000 [$1,000,000 - ($5 X 190,000)]. Under this agreement, the amount of reimbursement for design and development costs can be objectively measured and verified. The supplier shall recognize the design and development costs as an asset as costs are incurred, up to a maximum of $1,000,000.

>> Example 4: Entity Agrees to Pay Supplier Specified Amount per Part Plus Specified Amount per Part Not Produced if Minimum Not Produced

55-5 This Example illustrates the recognition guidance in paragraphs 340-10-25-1 through 25-3. It is assumed that the design and development costs would be expensed under that guidance absent a reimbursement arrangement. It is also assumed that the

supply arrangement is legally enforceable. An entity enters into a long-term arrangement with a supplier in which the entity agrees to pay the supplier $52.50 per part. The arrangement requires that a minimum of 400,000 parts be produced. If fewer than 400,000 parts are produced under the arrangement, the supplier will receive a payment of $52.50 per part not produced under the arrangement, up to a maximum of 400,000 parts. Under this arrangement, the amount of reimbursement for design and development costs cannot be objectively measured and verified. The supplier shall expense the design and development costs as incurred.