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Automotive Spotlight
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In This Issue

SEC Gives Automotive Suppliers Driving Directions to Account for Preproduction Activities Under the New Revenue Standard

The Bottom Line

- The FASB's new revenue standard (ASC 606, as amended)[1] did not supersede or otherwise amend the guidance in ASC 340-10[2] on accounting for preproduction costs in a long-term supply arrangement. Automotive suppliers that historically concluded that their preproduction costs were within the scope of ASC 340-10 should continue to apply that guidance upon adoption of the new revenue standard. Automotive suppliers that historically applied the guidance in ASC 340-10 by analogy should evaluate their preproduction costs under the fulfillment-cost guidance in ASC 340-40 upon adoption of the new revenue standard.
- If a supplier has historically accounted for reimbursements of preproduction activities as an offset to the related costs (i.e., not revenue), this practice would continue to be acceptable upon adoption of the new revenue standard.
- Upon adoption of ASC 606, it would be acceptable for a supplier that currently accounts for reimbursements of preproduction activities as revenue transactions and as a separate deliverable under ASC 605 to either (1) account for preproduction activities as a distinct performance obligation and classify reimbursements, when recognized, as revenue under ASC 606 if the applicable requirements of ASC 606 are satisfied or (2) conclude that the preproduction activities do not constitute a distinct performance obligation under ASC 606 as long as the supplier's explanation for the change in accounting policy is consistent with the principles of ASC 606 and related discussion of the FASB's transition resource group (TRG) in November 2015 (see TRG Agenda Paper 46). Alternatively, a supplier should consider consulting with the SEC staff if the supplier believes that a change in its accounting policy for reimbursements for preproduction activities is warranted under ASC 606 (i.e., a change from revenue to cost reimbursement, or a change from cost reimbursement to revenue).

* Updated to reflect the SEC staff's views on an entity's transition from a revenue model to a cost reimbursement model for reimbursements received for preproduction activities.

[1] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

[2] Formerly EITF Issue No. 99-5, "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements."

Beyond the Bottom Line

This *Automotive Spotlight* discusses how automotive suppliers should account for preproduction costs and reimbursements received from original equipment manufacturers (OEMs) in a long-term supply arrangement after adoption of the new revenue standard. For additional information about the new revenue standard, see Deloitte's ***A Roadmap to Applying the New Revenue Recognition Standard***.

Background

Automotive suppliers enter into long-term supply arrangements with OEMs to design, manufacture, and supply parts for the OEMs to use in the production of a particular vehicle model for the entire production life cycle (typically 5 to 10 years). In these arrangements, the OEM represents the automotive supplier's customer, as defined under ASC 606.[3] The supplier often incurs costs related to the engineering, design, and development (ED&D) of the parts that will be supplied to the OEM. In addition, the supplier may also incur costs to design and develop molds, dies, and other tools (collectively, "tooling") that will be used in manufacturing the parts.

As part of their long-term supply arrangements with OEMs, automotive suppliers often incur costs related to preproduction activities and may be entitled to reimbursement for those costs.

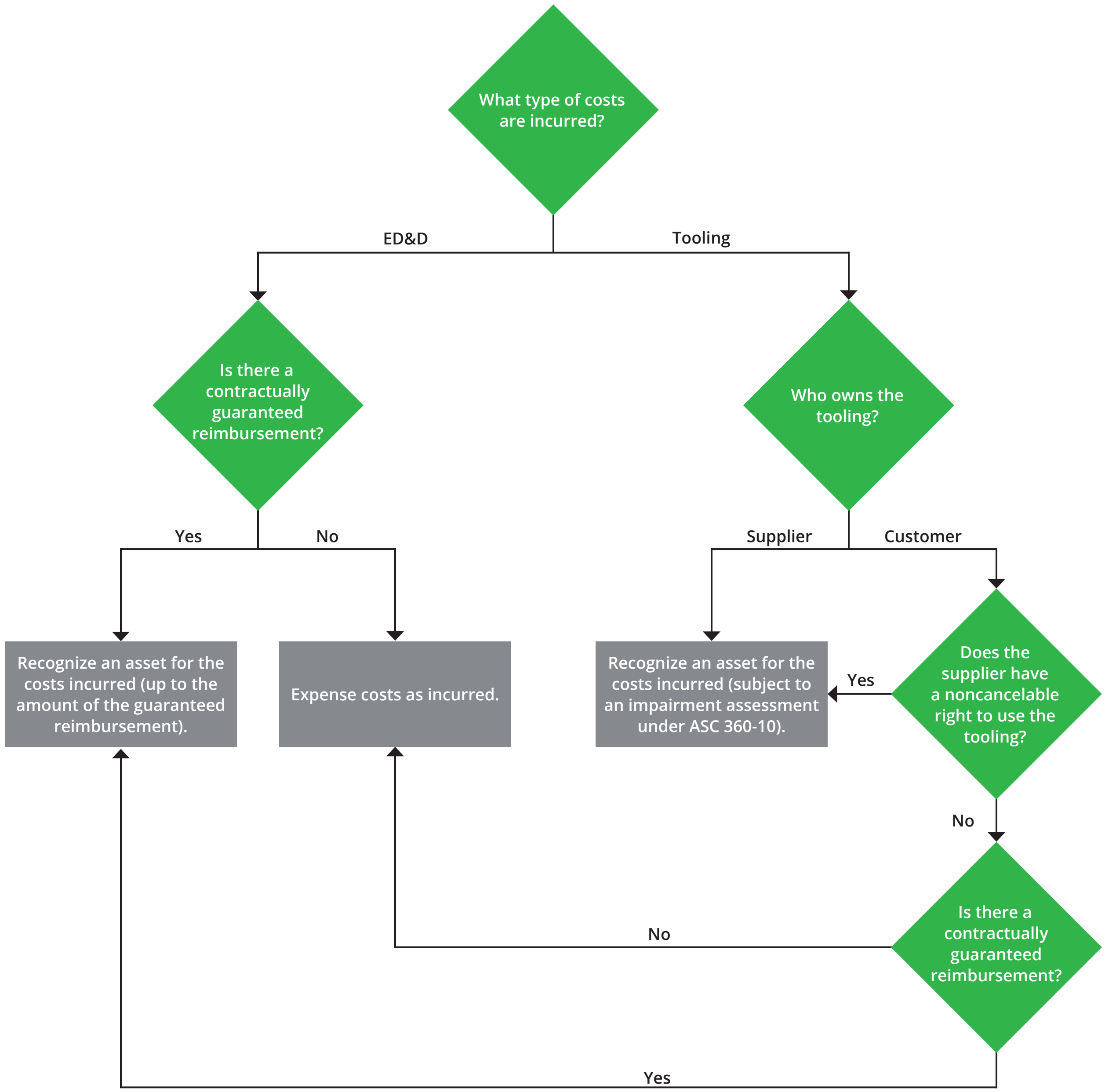
In certain arrangements, the OEM is contractually obligated to reimburse the supplier for the costs of these preproduction activities (ED&D and tooling) through a separate payment ("lump-sum reimbursement"). Such lump-sum reimbursements are typically evidenced by means of a separate purchase order issued by the OEM. In other arrangements, the OEM is not contractually obligated to reimburse the supplier, but the supplier may recover some or all of its costs associated with the preproduction activities via an increase in the piece price of the parts. Further, piece-price reimbursements may be either (1) guaranteed (i.e., the OEM is obligated to pay a minimum amount regardless of the actual quantity of parts purchased) or (2) unguaranteed (i.e., reimbursement is contingent upon the actual purchase of parts by the OEM).

Current Accounting — Preproduction ED&D and Tooling Costs

Many automotive suppliers account for costs incurred for preproduction activities (i.e., ED&D and tooling costs) in accordance with the guidance in ASC 340-10. Although many suppliers apply that guidance, they may have different reasons for doing so. That is, some suppliers believe that their preproduction costs are within the scope of ASC 340-10, whereas others apply the guidance by analogy (i.e., the supplier does not believe that the costs are within the scope of any other Codification topic).

Under ASC 340-10, the accounting for preproduction costs varies depending on several factors, including (1) whether reimbursement is contractually guaranteed, (2) which party owns the tooling, and (3) whether the supplier has a noncancelable right to use the tooling during the contract term. The diagram below illustrates the accounting for preproduction costs under ASC 340-10.

[3] ASC 606-10-20 defines a customer as "[a] party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration."



Current Accounting — Reimbursements for Preproduction ED&D and Tooling Costs

Although there is explicit authoritative guidance in U.S. GAAP on the accounting for preproduction ED&D and tooling costs, there is no such guidance in U.S. GAAP on the accounting for the related reimbursements received by the supplier. As a result, we are aware of diversity in practice under current U.S. GAAP in the accounting for these reimbursements and understand that automotive suppliers primarily apply one of the following approaches:

Approach 1: Cost Reimbursement	Approach 2: Revenue
• Account for reimbursements as a reduction of the related costs in the supplier's income statement or as a reduction of the asset created for the guaranteed reimbursement in accordance with the guidance in ASC 340-10	• Account for reimbursements as revenue (i.e., gross recognition) when the applicable revenue recognition criteria under ASC 605 are met

(Table continued)

Approach 1: Cost Reimbursement	Approach 2: Revenue
• Supporters believe that: ◦ The asset to be recorded for any contractually guaranteed reimbursements was characterized in the original Issue Summary for EITF Issue 99-5 (codified in ASC 340-10) as a receivable from the OEM ◦ The substance of the arrangement is a cost reimbursement because the pricing includes little to no profit ◦ Preproduction activities do not meet the definition of "revenue" in FASB Concepts Statement 6[4] because the activities do not constitute the supplier's ongoing major or central operations ◦ Preproduction activities do not constitute deliverables under the multiple-element-arrangement guidance in ASC 605-25	• Supporters believe that: ◦ ASC 340-10 provides explicit guidance only on the accounting for costs incurred for preproduction activities, not reimbursements ◦ Reimbursements are payments received from the supplier's customer and therefore should be classified as revenue ◦ Preproduction activities are revenue-generating activities or supply arrangements that represent multiple-element arrangements

To determine the appropriate accounting for preproduction costs upon adoption of the new revenue standard, it is important to understand *why* a supplier applies the guidance in ASC 340-10.

Accounting for Preproduction Costs Upon Adoption of ASC 340-40

As part of the revenue recognition project, the FASB created guidance in ASC 340-40 on accounting for fulfillment costs. This guidance is intended to apply to fulfillment costs that are outside the scope of other Codification topics. The new revenue standard, as initially issued under ASU 2014-09,[5] did not supersede or otherwise amend the guidance in ASC 340-10 on accounting for preproduction costs related to long-term supply arrangements.

Although the new guidance in ASC 340-40 is not intended to apply to fulfillment costs that are within the scope of other Codification topics (e.g., ASC 340-10), automotive suppliers have raised questions about how they should apply the new cost guidance when assessing preproduction activities, including questions related to the scope of the guidance (i.e., the costs to which such guidance would apply). In November 2015, TRG members in the United States discussed whether entities should continue to account for certain preproduction costs under ASC 340-10. TRG members generally agreed that the FASB should supersede the preproduction cost guidance under ASC 340-10.

After considering the TRG's recommendation and comment letters received from stakeholders, the FASB decided not to supersede the guidance in ASC 340-10. As a result, automotive suppliers continued to question the interaction between the existing guidance in ASC 340-10 and the new guidance in ASC 340-40.

In recent discussions with the SEC staff, emphasis was placed on understanding *why* an automotive supplier applies the preproduction cost guidance in ASC 340-10 to determine the appropriate accounting upon adoption of the new revenue standard. If a supplier historically concluded that the preproduction costs were within the scope of ASC 340-10, we believe that it would be acceptable for the supplier to continue applying the existing guidance in ASC 340-10. However, if a supplier historically analogized to the guidance in ASC 340-10, we believe that the supplier should evaluate whether the preproduction costs are within the scope of the new fulfillment-cost guidance in ASC 340-40.

[4] FASB Concepts Statement No. 6, *Elements of Financial Statements*.
[5] FASB Accounting Standards Update (ASU) No. 2014-09, *Revenue From Contracts With Customers*.

The following table summarizes the aforementioned views:

Current Accounting	Future Accounting	Anticipated Change?
Costs are within the scope of the guidance on preproduction costs related to long-term supply arrangements in ASC 340-10 (formerly EITF Issue 99-5)	Continue to apply ASC 340-10	No
Costs accounted for under ASC 340-10 by analogy (not within the scope of other guidance)	Evaluate under the new fulfillment-cost guidance in ASC 340-40	Yes

Connecting the Dots

As mentioned above, upon adoption of the new revenue standard, automotive suppliers that currently apply the guidance in ASC 340-10 by analogy should evaluate the preproduction costs under the new fulfillment-cost guidance in ASC 340-40. Although this may result in a change in the supplier's accounting policy, the supplier would not be required to establish preferability under ASC 250.[6] Rather, the supplier should apply the transition guidance in the new revenue standard.[7]

Diversity in practice will continue to be acceptable for accounting for reimbursements received for preproduction activities upon adoption of the new revenue standard.

Accounting for Reimbursements for Preproduction Activities Upon Adoption of ASC 606

Although the new revenue standard eliminates diversity in practice in certain areas and industries, we believe that diversity in practice will continue to be acceptable for accounting for reimbursements received for preproduction activities upon adoption of the new revenue standard.

We generally believe that it would be acceptable for an automotive supplier to elect to "stay in its lane" when accounting for reimbursements for preproduction activities. In other words, if a supplier previously concluded that the preproduction activities represented a deliverable under ASC 605 and classified reimbursements as revenue, we believe that it would be acceptable for the supplier to continue accounting for preproduction activities as a distinct performance obligation and classify reimbursements, when recognized, as revenue under ASC 606 if the applicable requirements in ASC 606 are satisfied. Similarly, if a supplier previously concluded that the preproduction activities were not a revenue-generating activity and thus accounted for reimbursements as a cost offset, we believe that it would be acceptable for the supplier to continue netting the reimbursements against the related cost in its income statement. Under either of these approaches, the supplier would not change the classification of the reimbursements in its income statement.

Suppliers that accounted for preproduction activities as separate deliverables and reimbursements as revenue under ASC 605 and that will continue to account for such reimbursements as revenue under ASC 606 may evaluate whether the preproduction activities represent a distinct performance obligation to determine the appropriate timing of revenue recognition under ASC 606. Our understanding is that the SEC staff would not object if a supplier that currently accounts for preproduction activities as a separate deliverable under ASC 605 changes its policy and concludes that the preproduction activities do not constitute a distinct performance obligation under ASC 606, as long as the supplier has a valid explanation for the change in accounting policy that is consistent with the principles of ASC 606 and the related TRG discussion from November 2015 (see TRG Agenda Paper 46).

[6] ASC 250-10-45-12 generally requires an entity to justify a change in accounting policy by demonstrating that the change is preferable to the accounting policy currently used.

[7] ASC 606-10-65-1.

Alternatively, a supplier may choose to "change lanes" (i.e., change its conclusions about the applicability of the revenue recognition guidance to preproduction activities and change the classification of the reimbursements in its income statement). If so, further analysis may be required, and consultation with the SEC staff is recommended. That is, consultation (either formal or informal) with the SEC staff is recommended if a supplier that currently accounts for reimbursements as a cost offset (i.e., not revenue) believes that a change to its policy under ASC 606 is warranted and proposes to account for the reimbursements as revenue upon adoption of ASC 606. Likewise, consultation with the staff is recommended if a supplier that accounts for reimbursements as revenue under ASC 605 believes that a change to its policy under ASC 606 is warranted and proposes to account for the reimbursements as a cost offset upon adoption of ASC 606.

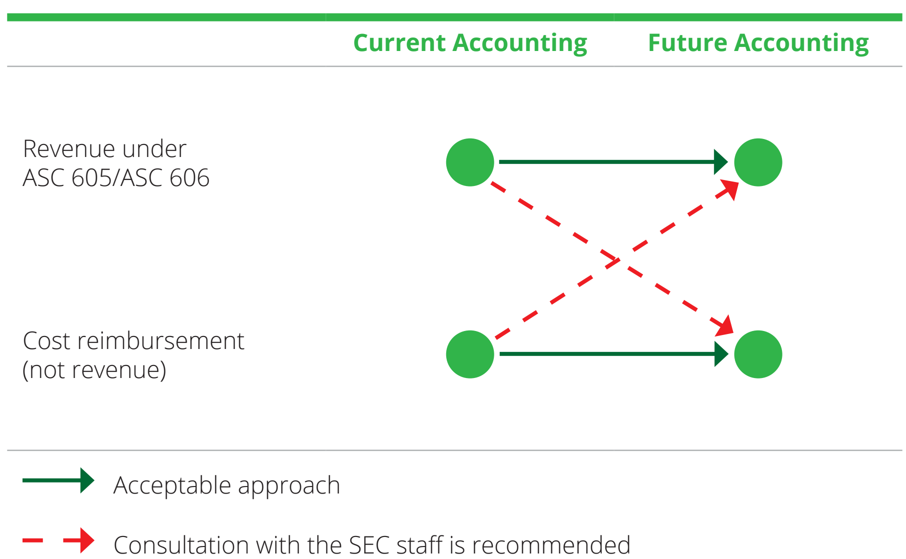
Connecting the Dots

If an automotive supplier decides to consult with the SEC staff, we recommend that the supplier provide the following information to the staff:

- Background on the supplier's business model and nature of its long-term supply arrangements with OEMs.
- The supplier's basis or support for its current accounting.
- The supplier's rationale for changing accounting policy under ASC 606.
- The supplier's understanding of what an investor deems to be important when reviewing the supplier's financial statements.
- The substance of the preproduction activities (e.g., fulfillment, setup, or revenue generating) and how the supplier views its relationship with the OEM (e.g., customer or other).
- The supplier's view of what it is being compensated for, related payment mechanisms, and materiality of preproduction activities.

If a supplier would like to change its policy from accounting for reimbursements as a cost offset to accounting for them as revenue upon adoption of ASC 606, further consultation with the SEC staff is recommended.

The graphic below illustrates the acceptable views for accounting for reimbursements received for preproduction activities.



Connecting the Dots

As noted above, if a supplier accounts for the reimbursements received for preproduction activities as revenue within the scope of ASC 606, the supplier will need to evaluate whether the preproduction activities represent a distinct performance obligation in the contract. As part of this assessment, we believe that a supplier should consider the principles outlined in TRG Agenda Paper 46 for assessing whether preproduction activities represent a promised good or service in the arrangement. In performing this assessment, the supplier should evaluate the nature of its promise with the customer to determine whether the preproduction activities represent a promised good or service (i.e., do the preproduction activities transfer a good or service to the customer) or a fulfillment activity (e.g., administrative tasks necessary to set up the contract). The topic of distinguishing between promised goods or services and fulfillment activities was discussed at the January 2015 TRG meeting (refer to TRG Agenda Paper 12). The determination of whether preproduction activities represent a promised good or service may require judgment. In TRG Agenda Paper 46, the FASB staff encouraged entities to consider whether the customer obtains control of the good or service and provided the following examples in paragraphs 9 and 10, which state, in part:

> 9. 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. 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.

We believe that the evaluation of whether a supplier's preproduction activities represent a promised good or service or a fulfillment activity will require judgment, and suppliers may reach different conclusions depending on the specific facts and circumstances.

If a supplier accounts for reimbursements as revenue under ASC 606, the supplier will need to evaluate whether the preproduction activities represent a distinct performance obligation in the contract.

Thinking Ahead

Given that the effective date[8] of the new revenue standard is quickly approaching for public business entities, automotive suppliers should begin finalizing their accounting policy decisions and roll out their updated accounting policies to affected individuals within their organization. Further, suppliers should consider the information that will need to be disclosed under the new revenue standard and in accordance with the requirements of the SEC's guidance in SAB Topic 11.M (SAB 74).[9] To the extent that a supplier implements new or changes existing systems and processes, the supplier should consider the controls that will need to be added or amended in accordance with the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) *Internal Control — Integrated Framework*, as updated in 2013.

[8] Public business entities must adopt the guidance in ASC 606 and ASC 340-40 for annual reporting periods beginning after December 15, 2017, and interim periods therein.

[9] SEC Staff Accounting Bulletin 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" (SAB 74).

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