

EITF ABSTRACTS

Issue No. 99-5

Title: Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements

Dates Discussed: May 19–20, 1999; July 22, 1999; September 23, 1999

References: FASB Statement No. 2, *Accounting for Research and Development Costs*
FASB Statement No. 121, *Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of*
FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*
APB Opinion No. 20, *Accounting Changes*
AICPA Statement of Position 98-5, *Reporting on the Costs of Start-Up Activities*

ISSUE

1. Manufacturers often incur pre-production costs related to products they will supply to their customers under long-term supply arrangements. For example, the manufacturer may incur costs to perform certain services related to the design and development of the 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 in producing those products. While practice varies from industry to industry, the supplier may be contractually guaranteed reimbursement of design and development costs, implicitly guaranteed reimbursement of design and development costs through the pricing of the product or other means, or not guaranteed reimbursement of the design and development costs incurred under the long-term supply arrangement.

2. The issues are:

Issue 1—How an entity should account for costs incurred to design and develop products that will be sold under a long-term supply arrangement

Issue 2—How an entity should account for costs incurred to design and develop molds, dies, and other tools that it will own and that will be used to produce products that will be sold under a long-term supply arrangement

Issue 3—How an entity should account for costs incurred to design and develop molds, dies, and other tools that it will not own and that will be used to produce products that will be sold under a long-term supply arrangement

Issue 4—Whether the accounting for Issues 1 through 3 would be affected if a supplier will be reimbursed for design and development costs.

EITF DISCUSSION

3. The Task Force reached a consensus for Issue 1 that design and development costs for products to be sold under long-term supply arrangements should be expensed as incurred. The Task Force reached a consensus for Issue 2 that 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 the long-term supply arrangement should be capitalized as part of the molds, dies, and other tools (subject to a Statement 121 impairment assessment) [Note: See STATUS section.] unless the design and development is for molds, dies, and other tools involving new technology, in which case, the costs should be expensed as incurred in accordance with Statement 2.

4. The Task Force reached a consensus for Issue 3 that 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 should be capitalized (subject to a Statement 121 impairment assessment) [Note: See STATUS section.] 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 should 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.

5. The Task Force reached a consensus for Issue 4 that if a contractual guarantee for reimbursement exists for design and development costs that otherwise would be expensed under the consensus on this Issue, those costs should be recognized as an asset as incurred. For purposes of this Issue, *contractual guarantee* means a legally enforceable agreement in which the amount of reimbursement can be objectively measured and verified. Exhibit 99-5A provides examples of the application of that consensus.

6. The SEC Observer stated that registrants would be expected to disclose their accounting policy for pre-production design and development costs as well as the aggregate amount of:

- Assets recognized pursuant to agreements that provide for contractual reimbursement of pre-production design and development costs
- Assets recognized for molds, dies, and other tools that the supplier owns
- Assets recognized for molds, dies, and other tools that the supplier does not own.

7. The guidance in this Issue is effective for design and development costs incurred after December 31, 1999. Earlier application is encouraged. The Task Force observed that an entity may elect to adopt the consensus as a cumulative effect of a change in accounting principle.

STATUS

8. Statement 144 was issued in August 2001. Statement 144 establishes financial accounting and reporting standards for the impairment of long-lived assets to be held and used and supersedes Statement 121. However, as under the provisions of Statement 121, design and development costs for molds, dies, and other tools that are capitalized pursuant to Issues 2 and 3 of Issue 99-5 are subject to a Statement 144 impairment assessment.

9. No further EITF discussion is planned.

Exhibit 99-5A

EXAMPLES OF THE APPLICATION OF THE EITF CONSENSUSES ON ISSUE 99-5

The following examples are provided for illustrative purposes. It is assumed that the design and development costs would be expensed under the consensuses on this Issue absent a reimbursement arrangement. It is also assumed that the supply arrangements in the examples are legally enforceable.

Example 1

An entity enters into a long-term arrangement with a supplier in which the entity agrees to reimburse the supplier for pre-production 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 should recognize the design and development costs as an asset as costs are incurred, up to a maximum of \$1,000,000.

Example 2

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 should expense the pre-production design and development costs as incurred.

Example 3

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 [$\$1,000,000 - (\$5 \times 190,000)$].

Under this agreement, the amount of reimbursement for design and development costs can be objectively measured and verified. The supplier should recognize the design and development costs as an asset as costs are incurred, up to a maximum of \$1,000,000.

Example 4

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 should expense the design and development costs as incurred.