

**FASB Emerging Issues Task Force  
Draft Abstract  
EITF Issue 07-1**

<b>Notice for Recipients of This Draft EITF Abstract</b>
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October 1, 2007

This draft abstract for EITF Issue No. 07-1, "Accounting for Collaborative Arrangements," addresses the following issues:

- Issue 1— How to determine whether an arrangement constitutes a collaborative arrangement within the scope of this Issue
- Issue 2— How costs incurred and revenue generated on sales to third parties should be reported by the participants in a collaborative arrangement in each of their respective income statements
- Issue 3— How an entity should characterize payments made between participants in a collaborative arrangement in the income statement
- Issue 4— What participants should disclose in the notes to the financial statements about a collaborative arrangement.

The attached draft abstract reflects the Task Force's consensuses-for-exposure reached at the September 11, 2007 EITF meeting. The Task Force invites individuals and organizations to send written comments on all matters within this draft abstract. Additionally, during its ratification meeting on September 26, 2007, the FASB requested that constituents provide comments on a number of matters raised during that Board meeting. Comments are requested from those who agree with the provisions in this draft abstract as well as from those who do not. Comments are most helpful if they identify the issue and the specific paragraph or group of paragraphs to which they relate and clearly explain the issue or question. Those who disagree with the consensuses-for-exposure presented in this draft abstract are asked to describe their suggested alternatives, supported by specific reasoning.

The Task Force and FASB specifically request that constituents provide comments on:

- a. Whether the proposed transition and effective date are appropriate? The draft abstract requires retrospective application of all consensuses-for-exposure unless impracticable<sup>1</sup>. Will it be impracticable to apply the consensuses-for-exposure retrospectively to any arrangements within the scope of the draft abstract? If yes, (i) approximately how many arrangements do you have that currently would meet the scope of the draft abstract, (ii) for how many of those would it be impracticable to retrospectively apply the guidance in the draft abstract, and (iii) what transition method should be required for those

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<sup>1</sup> Paragraph 11 of Statement No. 154, *Accounting Changes and Error Corrections*, provides guidance on determining when it is impracticable to make a change in accounting principle.

arrangements for which it is impracticable to retrospectively apply the draft abstract and why?

- b. Should the disclosure requirements in paragraph 19 of the draft abstract be annual or quarterly and why? If annual, should any specific disclosure requirement be included quarterly? Should any additional disclosures items be required and why?

### **New Format for FASB Documents**

This draft abstract has been written in a new format intended to improve its understandability. Notable changes from previous formats include the use of bold text at the beginning of each section to convey the accounting principle for that section and the inclusion of examples in the body of the standard to illustrate the proposed accounting guidance for certain paragraphs, when applicable.

Comments will be considered by the Task Force at the November 28-29, 2007 EITF meeting.

Responses from interested parties wishing to comment on the draft abstract must be received in writing by October 22, 2007. Interested parties should submit their comments by email to [director@fasb.org](mailto:director@fasb.org), File Reference No. EITF0701. Responses should not be sent by fax.

**EITF Issue No. 07-1, Accounting for Collaborative Arrangements**

**Dates Discussed:** March 15, 2007; June 14, 2007; September 11, 2007; [November 28–29, 2007]

**Objective**

**1. The objective of this Issue is to define collaborative arrangements and to establish reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties.**

<p>All paragraphs in this Issue have equal authority. Paragraphs in bold set out the main principles.</p>
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**Background**

2. Entities may enter into arrangements to participate in a joint operating activity to, for example, jointly develop and commercialize intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution.

3. The participants may conduct the activities associated with these arrangements without the creation of a separate legal entity (that is, the arrangement is operated as a "virtual joint venture"). In some arrangements, a legal entity may be utilized for specific activities or for a specific geographic location. The arrangements generally provide that the participants share, based on contractually defined calculations, the profits or losses from the associated activities.

4. Questions have arisen in practice as to the appropriate income statement presentation and classification for these activities and payments between the participants, as well as the sufficiency of the disclosures related to these arrangements.

**Scope**

**5. This Issue applies to participants in a *collaborative arrangement*. A collaborative arrangement is a contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties who are both (a) active participants in the**

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<sup>1</sup> This draft abstract is being exposed for a public comment period that will end on October 22, 2007.

**activity and (b) exposed to significant risks and rewards dependent on the commercial success of the activity.**

6. A collaborative arrangement within the scope of this Issue is not conducted through a separate legal entity created for that activity. However, in some situations part of a collaborative arrangement may be conducted in a legal entity for specific activities or for a specific geographic location. The scope of this Issue does not include arrangements for which the accounting is specifically addressed within the scope of other authoritative accounting literature. Furthermore, this Issue does not address recognition or measurement matters related to collaborative arrangements, for example, determining the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met.

7. Participants should evaluate whether an arrangement is a collaborative arrangement at its inception based on the facts and circumstances specific to the arrangement. However, a collaborative arrangement can begin at any point in the life cycle of an endeavor.<sup>2</sup> Participants should reevaluate whether an arrangement continues to be a collaborative arrangement whenever there is a change in either the roles of the participants in the arrangement or the participants' exposure to significant risks and rewards dependent on the ultimate commercial success of the endeavor. For example, the exercise of an option could change a participant's role in the arrangement or its exposure to risks and rewards.

### **Joint Operating Activity**

8. The joint operating activities of a collaborative arrangement might involve joint development and commercialization of intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution. However, there may also be collaborative arrangements that do not relate to intellectual property. For example, the activities of a collaborative arrangement may involve joint operation of a facility, such as a hospital. A collaborative arrangement may provide that one participant has sole or primary responsibility for certain activities or that two or more participants have shared responsibility for certain activities. For example, the arrangement may provide for one participant to have primary responsibility for research and development and another participant to have primary responsibility for commercialization of the final production.

### **Active Participation**

9. Whether the parties in a collaborative arrangement are active participants will depend on the facts and circumstances specific to the arrangement. Examples of situations that may evidence active participation of the parties in a collaborative arrangement include, but are not limited to, the following:

- Directing and carrying out the activities of the joint operating activity

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<sup>2</sup> For this Issue, the term *endeavor* refers to the activity that the participants collaborate on; for example, in a biotechnology or pharmaceutical environment the endeavor may be the development and commercialization of a drug candidate. In the entertainment industry, it may be production and distribution of a motion picture.

- Participating on a steering committee or other oversight or governance mechanism
- Holding a contractual or other legal right to the underlying intellectual property.

10. A financial investor is not an active participant in a collaborative arrangement within the scope of this Issue.

### **Significant Risks and Rewards**

11. Whether the participants in a collaborative arrangement are exposed to significant risks and rewards dependent on the commercial success of the joint operating activity depends on the facts and circumstances specific to the arrangement, including, but not limited to, the terms and conditions of the arrangement.

12. The terms and conditions of the arrangement might indicate that participants are not exposed to significant risks and rewards if, for example:

- Services are performed in exchange for fees paid at market rates.
- A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
- Initial profits are allocated to only one participant.
- There is a limit on the reward that accrues to a participant.

13. Other factors that should be considered in evaluating risks and rewards include:

- The stage of the endeavor's life cycle
- The expected duration or extent of the participants' financial participation in the arrangement in relation to the endeavor's total expected life or total expected value.

14. Many collaborative arrangements involve licenses of intellectual property, and the participants may exchange consideration related to the license at the inception of the arrangement. Such an exchange does not necessarily indicate that the participants are not exposed to significant risks and rewards dependent on the ultimate commercial success of the endeavor. An entity should use judgment in determining whether its participation in an arrangement subjects it to significant risks and rewards.

### **Other Presentation Matters (Income Statement Classification)**

**15. Participants in a collaborative arrangement shall report costs incurred and revenue generated from transactions with *third parties* (that is, parties that do not participate in the arrangement) in each entity's respective income statement pursuant to the guidance in Issue 99-19. An entity should not apply the equity method of accounting under Opinion 18 to activities of collaborative arrangements.**

16. For costs incurred and revenue generated from third parties, the participant in a collaborative arrangement that is deemed to be the principal participant for a given transaction under Issue 99-19 should record that transaction on a gross basis in its financial statements.

**17. Payments between participants pursuant to a collaborative arrangement that are within the scope of other authoritative accounting literature on income statement classification should be accounted for using the relevant provisions of that literature. If the payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election.**

18. An entity shall evaluate the income statement classification of payments between participants pursuant to a collaborative arrangement based on the nature of the arrangement, the nature of its business operations, the contractual terms of the arrangement, and whether those payments are within the scope of other authoritative accounting literature on income statement classification. If the payments are within the scope of other authoritative accounting literature, then the entity shall apply the relevant provisions of that literature. To the extent that these payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election. For example, if one party to an arrangement is required to make a payment to the other party to reimburse a portion of that party's research and development cost, that portion of the net payment may be classified as research and development expense in the payor's financial statements pursuant to Statement 2.

### **Disclosure**

19. In the initial period and all annual periods thereafter, a participant to a collaborative arrangement should disclose the following:

- a. Information about the nature and purpose of its collaborative arrangements
- b. Its rights and obligations under the collaborative arrangements
- c. The stage of the underlying endeavor's life cycle
- d. The accounting policy for collaborative arrangements in accordance with Opinion 22
- e. The income statement classification and amounts attributable to transactions between participants to the collaborative arrangement
- f. Amounts due from or owed to other participants under the collaborative arrangements.

Information related to individually significant collaborative arrangements should be disclosed separately.

### **Transition**

20. This Issue shall be effective for financial statements issued for fiscal years beginning after December 15, 2007, and interim periods within those fiscal years. This Issue shall be applied retrospectively to all prior periods presented. If it is impracticable to apply the effects of a

change in accounting principle retrospectively pursuant to the guidance in paragraph 11 of Statement 154, an entity should disclose both the reasons why reclassification was not made and the effect of the reclassification on the current period pursuant to the guidelines in paragraph 9 of Statement 154. The evaluation of whether transition through retrospective application is practicable should be made on an arrangement by arrangement basis.

21. Upon initial application of this Issue, an entity shall disclose the following:

- a. A description of the prior-period information that has been retrospectively adjusted, if any
- b. The effect of the change on revenue and operating expenses (or other appropriate captions of changes in the applicable net assets or performance indicator) and on any other affected financial statement line item.

<p style="text-align: center;"><b>The provisions of this Issue need not be applied to immaterial items.</b></p>
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### References

FASB Statement No. 2, *Accounting for Research and Development Costs*  
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*  
FASB Statement No. 154, *Accounting Changes and Error Corrections*  
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*  
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*  
APB Opinion No. 22, *Disclosure of Accounting Policies*  
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*  
EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"  
EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

## APPENDIX A - ILLUSTRATIVE EXAMPLES

The following examples illustrate potential application of this Issue for payments between participants in a collaborative arrangement based on the limited facts presented. The evaluations following each of the example fact patterns are not intended to represent the only manner in which the guidance in this Issue could be applied. These illustrative examples do not address recognition or measurement matters related to collaborative arrangements. For example, determining the income statement presentation, the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met is addressed in other authoritative accounting literature. Additional facts would most likely be required in order to fully evaluate the accounting and presentation issues related to these arrangements (in other words, to evaluate the possible impact of other literature).

For the purpose of these illustrations, assume that all of the arrangements are collaborative arrangements within the scope of this Issue.

### **Illustration 1**

**Facts:** Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent/50 percent arrangement). Biotech is responsible for conducting research and development activities relating to the drug candidate, and Pharma is responsible for the commercialization activities if and when the drug candidate is approved for sale. On a quarterly basis, Pharma and Biotech provide the other party financial information about the research and development activities performed by Biotech and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for the proportionate share of the excess of the companies' combined operating results pursuant to their joint development and marketing agreement. In the first annual period subsequent to the product launch, Biotech incurred research and development expenses of \$10 million and Pharma had sales of \$50 million and related manufacturing expenses of \$20 million and marketing expenses of \$10 million. Pharma owes Biotech \$15 million, such that each participant realizes a \$5 million net profit from the arrangement (total sales of \$50 million, less total expenses (including research and development) of \$40 million, divided by 2).

**Evaluation:** Pharma concludes that it is the principal on the sales transactions with third parties and will present 100 percent of the sales, cost of sales, and marketing expenses in its income statement. As the arrangement addresses several different activities, Pharma has evaluated the income statement classification for amounts due to Biotech associated with each separate activity. Pharma disaggregates its \$15 million net payable to Biotech in accordance with the nature of the individual components of the payable and characterizes the profit sharing portion of the payable for 50 percent of the profit related to the sales as cost of sales (\$10 million) and characterizes the portion of the payable to Biotech for research and development activities as research and development expense (\$5 million). Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Sales to third parties	\$50,000
COGS (including \$10,000 payable to Biotech for profit sharing)	30,000
SG&A	10,000
R&D (including \$5,000 payable as a reimbursement of Biotech's expenses incurred)	<u>5,000</u>
Net profit	<u><u>\$ 5,000</u></u>

Biotech records research and development expense (\$10 million) for its research and development activities. Biotech concludes that Pharma is its customer with respect to the research and development services. Additionally, licensing intellectual property and contract research and development services are part of Biotech's ongoing major or central operations. Accordingly, Biotech will characterize the portion of its net receivable from Pharma related to research and development services and the portion of the net receivable for profit sharing as revenue (\$5 million and \$10 million, respectively) when recognized. Biotech will not present sales, cost of sales, or marketing expenses related to the sales transactions with third parties because it is not the principal on those transactions.

Biotech presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Revenues from collaborative arrangement	\$ 15,000
COGS	-0-
SG&A	-0-
R&D	<u>10,000</u>
Net profit	<u><u>\$ 5,000</u></u>

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, the identification of the deliverables in the arrangement, and a determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

## **Illustration 2**

**Facts:** Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent/50 percent arrangement). Assume that Pharma and Biotech both agree to provide resources during the research and development phase, and Pharma is responsible for the commercialization activities if the drug candidate is approved for sale. As both participants are performing research and development activities, there may be periods in which Biotech must make a payment to Pharma for its proportionate share of the research and development activities

and periods in which Pharma must make payments to Biotech. On a quarterly basis, Pharma and Biotech provide financial information about the research and development activities performed by both parties and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to their joint development and marketing agreement. In the first annual period subsequent to the product launch, Biotech and Pharma incurred research and development expenses of \$10 million and \$15 million, respectively. Pharma had sales of \$75 million, related manufacturing expenses of \$22.5 million, and marketing expenses of \$20 million. As a result, Pharma owes Biotech \$13.75 million, such that each participant realizes \$3.75 million net profit from the arrangement (total sales of \$75 million, less total expenses of \$67.5 million, divided by 2).

**Evaluation:** Pharma concludes that it is the principal on the sales transactions with third parties and will present 100 percent of the sales, cost of sales, and marketing expenses in its income statement. As the arrangement addresses several different activities, Pharma has evaluated the income statement classification for payments associated with each separate activity. Pharma disaggregates the \$13.75 million net payable to Biotech in accordance with the nature of the individual components of the payable and characterizes the portion of the payable related to 50 percent of the commercialization activities (sales to third parties less associated manufacturing and marketing costs), as cost of sales (\$16.25 million) and characterizes the portion of the net payable related to research and development activities as a reduction of its research and development expenses (\$2.5 million), because performing contract research and development services is not part of its ongoing major or central operations. In addition, Pharma concludes that Biotech is not its customer with respect to the research and development activities in this arrangement. Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Sales to third parties	\$75,000
COGS (including \$16,250 payable to Biotech for profit sharing)	38,750
SG&A	20,000
R&D (net of \$2,500 due from Biotech as a reimbursement of expenses incurred)	<u>12,500</u>
Net profit	<u><u>\$ 3,750</u></u>

Biotech records research and development expense (\$10 million) for its research and development activities. Biotech will characterize the portion of the net receivable from Pharma related to commercialization activities (\$16.25 million) as revenue, based on the fact that licensing intellectual property is part of Biotech's ongoing major or central operations. Biotech characterizes the portion of the net receivable that relates to a reimbursement of Pharma's research and development costs (\$2.5 million) as additional research and development expense. Biotech bases that conclusion on the fact that the primary purpose of this collaborative arrangement is for the participants to work together to develop and commercialize a product for sale to third parties, and not to generate greater sales between the participants in the collaborative

arrangement. (If the facts and circumstances in this example were different and Biotech viewed the arrangement with Pharma as a vendor-customer relationship, the analysis would be that the reimbursement of Pharma's research and development costs would be subject to the guidance in Issue 01-9. As a result, Biotech would presume that the payment should be characterized as a reduction of revenue, unless Biotech receives a separable, identifiable benefit in exchange, and can reasonably estimate the fair value of the benefit, in which case, expense classification would be permitted. This Issue does not address whether the payable is within the scope of Issue 01-9.) Biotech will not present sales, cost of sales, or marketing expenses related to the sales transactions with third parties because it is not the principal on those transactions. Biotech presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Revenues from collaborative arrangement	\$16,250
COGS	-0-
SG&A	-0-
R&D (including \$2,500 payable as a reimbursement of Pharma's expenses incurred)	<u>12,500</u>
Net profit	<u><u>\$3,750</u></u>

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, identification of the deliverables in the arrangement, determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

### **Illustration 3**

**Facts:** Big Pharma and Little Pharma agree to jointly participate in the results of the research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement. Big Pharma and Little Pharma both agree to provide resources during the research and development and the commercialization activities. Little Pharma will be responsible for commercialization activities in the United States, and Big Pharma will be responsible for commercialization activities in Europe and Asia. Under the arrangement, they will share research and development costs incurred on a 50 percent/50 percent basis. Little Pharma will retain 65 percent of the net profits from commercialization activities in the United States, and Big Pharma will retain 70 percent of the net profits from commercialization activities in Europe and Asia. On a quarterly basis, Big Pharma and Little Pharma provide financial information about the research and development and the commercialization activities performed by both parties under the joint development and marketing agreement, and one participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to their joint development and marketing agreement. The results of the first annual period of the collaborative arrangement prior to any payments between the parties were as follows (in thousands):

	<u>Little Pharma</u>	<u>Big Pharma</u>	<u>Combined</u>
Sales to third parties	\$120,000	\$90,000	\$210,000
COGS	30,000	35,000	65,000
S,G &A	25,000	20,000	45,000
R&D	<u>35,000</u>	<u>20,000</u>	<u>55,000</u>
Net profit	<u>\$ 30,000</u>	<u>\$15,000</u>	<u>\$ 45,000</u>

**Evaluation:** Big Pharma concludes that it is the principal on the sales transactions with third parties in Europe and Asia and will present 100 percent of the sales, cost of sales, and marketing expenses related to those efforts in its income statement. As the arrangement addresses several different activities, Big Pharma has evaluated the income statement classification for the payments associated with each separate activity. Big Pharma disaggregates its \$4.75 million net receivable from Little Pharma in accordance with the nature of the individual components of the payable and characterizes the portion of the net receivable related to 30 percent of the profit related to the sales in Europe and Asia as cost of sales (\$10.5 million) and characterizes the portion of the net receivable related to a reimbursement of Little Pharma's research and development costs as research and development expenses (\$7.5 million). Big Pharma concludes that it will characterize the portion of the net receivable related to Little Pharma's sales in the United States as revenue (\$22.75 million) similar to a royalty and would characterize any payment from Little Pharma for research and development activities as a reduction of its research and development costs. Big Pharma's conclusion is based on the fact that performing contract research and development services is not part of its ongoing major or central operations. In addition, Big Pharma concludes that Little Pharma is not its customer with respect to the research and development activities in this arrangement. Big Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Sales to third parties	\$90,000
Revenue from collaborative arrangement	22,750
COGS (including \$10,500 payable to Little Pharma for profit sharing)	45,500
SG&A	20,000
R&D (including \$7,500 payable as a reimbursement of Little Pharma's expenses incurred)	<u>27,500</u>
Net profit	<u>\$19,750</u>

Little Pharma concludes that it is the principal on the sales transactions with third parties in the United States and will present 100 percent of the sales, cost of sales, and marketing expenses related to those efforts in its income statement. As the arrangement includes several different activities, Little Pharma has evaluated the income statement classification for payments associated with each separate activity. Little Pharma disaggregates its \$4.75 million net payable to Big Pharma in accordance with the nature of the individual item and characterizes portion of

the net payable related to 35 percent of the profit related to the sales in the United States as cost of sales (\$22.75 million) and characterizes the portion of the net payable to Big Pharma for research and development activities as research and development expenses. Little Pharma concludes that it will characterize the portion of the net payable related to profit sharing from Big Pharma's sales in Europe and Asia as revenue similar to a royalty (\$10.5 million) and will characterize any payment from Big Pharma for research and development activities as a reduction of its research and development costs (\$7.5 million). Little Pharma's conclusion is based on the fact that performing contract research and development services is not part of its ongoing major or central operations. In addition, Little Pharma concludes that Big Pharma is not its customer with respect to the research and development activities in this arrangement. Little Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

Sales to third parties	\$120,000
Revenue from collaborative arrangement	10,500
COGS (including \$22,750 payable to Big Pharma for profit sharing)	52,750
SG&A	25,000
R&D (including \$7,500 due from Big Pharma as a reimbursement)	<u>27,500</u>
Net profit	<u><u>\$25,250</u></u>

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, identification of the deliverables in the arrangement, determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

#### **Illustration 4**

**Facts:** Studio A and Studio B agree to jointly participate in the production and distribution of a major motion picture. Studio A will manage the day-to-day production activities and will be responsible for distribution in the U. S., while Studio B will be responsible for distribution in Europe and Asia. Even though Studio A will be managing the production, under the arrangement, both studios agree that they will share equally in all production costs incurred. For purposes of this example, no license to intellectual property has been conveyed to Studio B. Further, Studio A will pay Studio B 50 percent of the net profits (that is, revenues less distribution costs) from the United States distribution to Studio B, and Studio B will pay Studio A 50 percent of the net profits from European and Asian distribution to Studio A. The studios are responsible for initially funding all distribution costs in their respective locations. On a quarterly basis, Studio A and Studio B provide financial information about the production and distribution under the joint production and distribution agreement, and one participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to the joint production and distribution agreement.

At the completion of the production process, the total production costs of the film amounted to \$50 million for which Studio B paid Studio A \$25 million. In Year 1 of the film's release, the net profits were \$75 million in the United States and \$30 million in Europe and Asia. Accordingly, Studio A pays Studio B \$22.5 million (50 percent of the total net profits of \$105 million less Studio B's net profits of \$30 million). In Year 2 of the film's release, the net profits were \$25 million in the United States and \$60 million in Europe and Asia. Accordingly, Studio B pays Studio A \$17.5 million (50 percent of the total net profits of \$85 million less Studio A's net profits of \$25 million).

**Evaluation:** During (or at the completion of) production, Studio A records the cash received from Studio B as a reduction of its capitalized film costs. Thus, at the end of production, Studio A has only \$25 million in capitalized film costs reflected on its balance sheet for the project. Studio A has determined that, considering the guidance in Issue 99-19, it is the principal for the revenue generated in the United States. Accordingly, it characterizes all of the gross revenue related to the \$75 million in Year 1 as revenue in its income statement and likewise records all of the associated distribution costs for distribution in the United States. Studio A concludes that it is not within the scope of other authoritative accounting literature for payments to and from Studio B. Studio A's accounting policy with respect to profit sharing amounts due from and to its production partners is to record those amounts net, in cost of sales, as it views these amounts either as additional costs for production and distribution or a reimbursement of such costs. Accordingly, Studio A records its payment of \$22.5 million to Studio B as additional cost of sales. In Year 2, Studio A also characterizes the gross revenue related to the \$25 million of net profits as revenue in its income statement. Consistent with its accounting policy, Studio A records the receipt of \$17.5 million as a reduction of costs of sales in Year 2.

During production, Studio B records payments to Studio A as capitalized film costs. Thus, at the end of production, it has \$25 million in capitalized film costs reflected on its balance sheet for the project. Studio B has determined that, after considering the guidance in Issue 99-19, it is the principal for the revenue generated in Europe and Asia. Accordingly, it characterizes all of the gross revenue related to the \$30 million in Year 1 net profits as revenue in its income statement and likewise records all of the associated distribution costs for distribution in Europe and Asia. Studio B concludes that it is not within the scope of other authoritative accounting literature for payments to and from Studio A. Studio B's accounting policy with respect to profit sharing amounts due from and to its production partners is to record net amounts due from production partners as additional revenue and net amounts due to production partners as a cost of sales. Accordingly, Studio B records the receipt of \$22.5 million from Studio A as revenue. Studio B also characterizes the gross revenue related to the \$60 million in Year 2 net profits as revenue in its income statement. Consistent with its accounting policy, Studio B records the payment of \$17.5 million as additional cost of sales in Year 2.

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, the identification of the deliverables in the arrangement, and a determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.