**FASB Emerging Issues Task Force**

**Issue No.** 07-3

**Title:** Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities

**Document:** Issue Summary No. 1, Supplement No. 1*

**Date prepared:** May 24, 2007

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**Date previously discussed:** March 15, 2007

**Previously distributed EITF materials:** Issue Summary No. 1, dated February 26, 2007

**References:**

FASB Statement No. 2, *Accounting for Research and Development Costs* (FAS 2)

FASB Statement No. 154, *Accounting Changes and Error Corrections* (FAS 154)

FASB Concepts Statement No. 6, *Elements of Financial Statements* (CON 6)

AICPA Statement of Position 98-1, *Accounting for the Costs of Computer Software Developed or Obtained for Internal Use* (SOP 98-1)

AICPA Statement of Position 98-5, *Reporting the Costs of Start-up Activities* (SOP 98-5)

International Accounting Standard 38, *Intangible Assets* (IAS 38)

EITF Issue No. 99-16, "Accounting for Transactions with Elements of Research and Development Arrangements" (Issue 99-16)

* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presumed to be acceptable or unacceptable applications of Generally Accepted Accounting Principles until the Task Force makes such a determination, exposes it for public comment, and it is ratified by the Board.**

**Background**

1. At the March 15, 2007 EITF meeting, the Task Force reached a tentative conclusion on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. The draft abstract was posted to the website on April 4, 2007, with a comment period that ended May 3, 2007. The Task Force specifically requested that constituents provide comments on:

a. Whether constituents will have the ability to access information from their existing arrangements pertaining to the amount of research and development activity that has occurred in order to calculate the cumulative-effect adjustment to be made to retained earnings or other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption.

b. Whether constituents will have the ability to access information from existing arrangements in periods subsequent to the adoption of this Issue pertaining to the amount of research and development activity that has occurred in order to determine the amount of research and development expense to be recognized in future financial statements.

2. Comment letters received on the draft abstract have been distributed to Task Force members and have been analyzed by the FASB staff. At the June 14, 2007 EITF meeting, the Task Force will have the opportunity to consider these comment letters as it redeliberates the tentative conclusion in the draft abstract. The Task Force will then be asked to affirm its tentative conclusion on this Issue as a consensus.

**Summary of Comment Letters**

3. Two comment letters were received on the draft abstract, both from preparers. Both respondents indicated that while the tentative conclusion reached by the Task Force was conceptually sound, they were concerned about the amount of effort necessary to operationalize the tentative conclusion.

4. In addressing the questions raised by the Task Force pertaining to the transition provisions of the tentative conclusion (included in the Notice to Recipients attached to the draft abstract), one respondent indicated that applying the tentative conclusion through a cumulative-effect adjustment would require a significant amount of effort in order to validate an adjustment that would not likely be significant. The respondent observed that for a typical multinational

organization there are thousands of contracts located in many different countries that would require an assessment pursuant to the guidance in this tentative conclusion. The respondent also observed that these contracts are complex in nature and lack standardization, which adds to the difficulty in applying the tentative conclusion. The respondent suggested that the practical solution would be to permit application of the transition provisions prospectively for new contracts from the effective date. The other respondent raised similar concerns and indicated that this approach and transition methodology would not likely provide any additional benefit to the users of the financial statements.

5. Regarding the availability of information on research and development activities in subsequent periods, one respondent indicated that it depends on how the application of this Issue would be operationalized from an audit perspective. The respondent observed that if their external auditors required them to obtain more detailed information on actual activity, applying the tentative conclusion on this Issue would be challenging both from the perspective of having the ability to readily obtain the information and from the perspective of the related ongoing cost and effort. The other respondent raised similar concerns about the additional effort that would be necessary for preparers; specifically, when executing new contracts and at interim and annual reporting periods in order to validate an adjustment that may not be significant.

6. Lastly, one respondent raised an additional concern about the interaction of this Issue's tentative conclusion and SOP 98-5, since that respondent believes that many contracts are written after considering the SOP's guidance, which may conflict with the tentative conclusion on this Issue.

*FASB Staff Analysis*

7. The FASB staff acknowledges the concern preparers have about the amount of effort that will be required to apply the transition provisions of this Issue, which the preparers believe will result in little improvement in financial reporting for the amount of additional cost. That concern has been brought up in the comment letters discussed above as well as in informal discussions that the staff has had with other preparers. The main concern heard from the large multinational organization perspective (whose general practice has been to expense these nonrefundable advance payments when incurred) is that the transition methodology proposed in the tentative conclusion will not likely result in material adjustments even though the preparers will still be

required to put forth a significant amount of effort to validate that conclusion. It is the staff's understanding that this belief stems from the notion that the timing of the advance payment is on average about six to eight months in advance of the research and development activity. Therefore, the FASB staff believes that the Task Force should reconsider the transition method for this Issue.

8. The FASB staff also believes that one respondent raised a valid concern regarding whether the preparer's external auditors will require entities to obtain actual documentation to support the amount of activity that has occurred or whether the external auditors can rely on estimates based on a combination of actual data and historical experience. The FASB staff does not recommend that the Task Force address this question as part of this Issue Summary Supplement since it is a question about evaluating audit evidence specific to the individual facts and circumstances of a particular arrangement. It is, however, a question that the Task Force should consider in affirming the tentative conclusion as it pertains to the availability of information.

9. The FASB staff considered the interaction of SOP 98-5 in developing the original views included in Issue Summary No. 1 for this Issue. While both FAS 2 and SOP 98-5 are broadly consistent in the recognition aspect of these costs, that is, these costs should be charged to expense when incurred, the nature of a start-up cost as described in paragraph 5 of SOP 98-5 is not the same as the guidelines provided in paragraphs 8–10 of FAS 2 for research and development activities. Additionally, paragraph 8 of SOP 98-5 specifically scopes out research and development costs included within the scope of FAS 2. The term as used in Issue 07-3 is intended to be consistent with the terminology of research and development costs as that term is defined in FAS 2. While the Task Force tentatively concluded that nonrefundable advance payments for future research and development activities should be deferred and capitalized and recognized as an expense as the related goods are delivered or the related services are performed, the basis for that decision was not clarified; whether it was due to the guidance in CON 6 (paragraph 249), the existing guidance in Issue 99-16, or some other reason. Therefore, the FASB staff believes that research and development costs as defined in FAS 2 (that is, as nonrefundable and paid in advance) should be addressed by this Issue and that start-up costs should continue to be accounted for pursuant to the guidance in SOP 98-5.

## Accounting Issues and Alternatives

**Issue 1: How entities should apply the consensus on Issue 07-3.**

*View A: Entities should recognize the effect of applying the consensus in this Issue prospectively for new contracts entered into after the effective date of this Issue.*

*View B: Entities should recognize the effect of applying the consensus reached in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption.*

10. At the March 15, 2007 EITF meeting, the FASB staff recommended that the tentative conclusion be applied as a change in accounting principle through retrospective application. The Task Force disagreed with the FASB staff's recommendation on retroactive application due to the concern about the preparer's ability to access the information needed to determine the amount of research and development activity that had occurred in order to apply the tentative conclusion without excessive cost and effort. As a result, the Task Force tentatively concluded that entities apply the tentative conclusion through a cumulative-effect adjustment and asked preparers to provide comments on both the availability of the information needed to apply the transition provisions using a cumulative-effect adjustment and the availability of the information needed to apply the tentative conclusion in subsequent periods. As discussed in the Summary of Comment Letters Section above, both respondents highlighted their concern about the administrative burden and excessive cost that entities would incur in attempting to apply the transition methodology described in the tentative conclusion. The FASB staff spoke to a user who indicated that there was little concern about the tentative conclusion reached on the Issue itself or the tentative conclusion reached on transition, but rather the concern was whether the information would be comparable among entities. If the Task Force were to conclude that entities should apply the tentative conclusion on this Issue prospectively for new arrangements, the ability to compare one entity to another entity and one entity's current results to the results of its previous fiscal years, may be lacking. As described previously, however, since the length of time between the advance nonrefundable payment and the actual activity is generally six to eight months, that lack of comparability would be reversed within a relatively short period of time;

however, it would remain when comparing the fiscal periods of an entity. A consensus that the transition provisions should be applied prospectively for new contractual arrangements would alleviate the burdensome task for preparers of reviewing all open contracts as well as address the concern raised about the availability of the information about the activity that has occurred pertaining to the advance nonrefundable payment.

11. The FASB staff believes that there are no additional comments that warrant consideration by the Task Force and recommends that the Task Force affirm the tentative conclusion as a consensus including any change to the transition provisions as outlined in Issue 1.

**Other Changes to the Draft Abstract**

12. Suggested changes to the wording in the draft abstract that the staff has determined are not significant enough to warrant specific consideration are indicated in the marked draft abstract included as Exhibit 07-3A. The draft does not reflect, however, any changes to transition that, based on what has been brought to the Task Force for consideration by this Supplement, have yet to be considered and decided upon by the Task Force.

**Appendix 07-3A**

***EITF ABSTRACTS* (DRAFT)**

**Issue No. 07-3**

**Title:** Accounting for Nonrefundable Advance Payments for Goods or Services to Be Used in Future Research and Development Activities

**Dates Discussed:** March 15, 2007; [June ~~13~~ 14, 2007]

**References:** FASB Statement No. 2, *Accounting for Research and Development Costs*

FASB Concepts Statement No. 6, *Elements of Financial Statements*

## ISSUE

1. Entities involved in research and development activities (R&D entities) may make advance payments for goods or services that will be used in future research and development activities. These arrangements often involve one specific research and development project (for example, the development of a drug compound), and the activities to be performed under these arrangements generally do not have an alternative future use at the time the arrangements are executed. Often times, a portion of the advance payment may be refundable; however, it is common for at least some portion of the advance payment to be nonrefundable (that is, if the R&D entity is not able to advance the project to the stage at which the goods or services paid for in advance are necessary, the R&D entity will not be reimbursed for the advance payments). Questions have arisen about how an R&D entity should account for the non-refundable portion of an advance payment made for future research and development activities.

2. The issue is whether nonrefundable advance payments for goods or services that will be used or rendered for research and development activities should be expensed when the advance payment is made or when the research and development activity has been performed.

### Scope

3. The scope of this Issue is limited to nonrefundable advance payments for goods and services to be used or rendered in future research and development activities. Refundable advance payments for goods and services to be used in future research and development activities are excluded from the scope of this Issue. Entities should not apply the [consensus] in this Issue by analogy to other types of advance payments.

## EITF DISCUSSION

4. The Task Force reached a [consensus] that nonrefundable advance payments for future research and development activities should be deferred and capitalized. Such amounts should be recognized as an expense as the related goods are delivered or the related services are performed. Entities should continue to evaluate whether they expect the goods to be delivered or services to be rendered. If an entity does not expect the goods to be delivered or services to be rendered, the capitalized advance payment should be charged to expense.

**Transition**

5. The [consensus] in this Issue should be effective for financial statements issued for fiscal years beginning after December 15, 2007, and ~~including~~ interim periods within those fiscal years. Earlier application is not permitted. Entities should report the effects of applying the [consensus] in this Issue as a change in accounting principle through a cumulative-effect adjustment to retained earnings or to other components of equity or net assets in the statement of financial position as of the beginning of the year of adoption. An entity should disclose the cumulative effect of the change on retained earnings or on other components of equity or net assets in the statement of financial position. ~~Earlier application is not permitted.~~

**Board Ratification**

6. At its [June 27, 2007] meeting, the Board ratified the [consensus] reached by the Task Force in this Issue.

**STATUS**

7. No further EITF discussion is planned.