FASB Emerging Issues Task Force

Issue No. 09-2

Title: Research and Development Assets Acquired In an Asset Acquisition

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References:

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

FASB Statement No. 71, *Accounting for the Effects of Certain Types of Regulation* (Statement 71)

FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed* (Statement 86)

FASB Statement No. 141(R), *Business Combinations* (Statement 141(R))

FASB Statement No. 142, *Goodwill and Other Intangible Assets* (Statement 142)

FASB Statement No. 144, *Accounting for the Impairment and Disposal of Long-Lived Assets* (Statement 144)

FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method* (Interpretation 4)

FASB Interpretation No. 6, *Applicability of FASB Statement No. 2 to Computer Software* (Interpretation 6)

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

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* **The alternative views presented in this Issue Summary Supplement are for purposes of discussion by the EITF. No individual views are to be presented 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.**

FASB Highlights, *Computer Software: Guidance on Applying Statement 86,* February 1986 (Q&A on Statement 86)

AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts* (SOP 81-1)

AICPA Statement of Position 93-7, *Reporting on Advertising Costs* (SOP 93-7)

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

International Accounting Standard 36, *Impairment of Assets* (IAS 36)

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

International Financial Reporting Standard 3, *Business Combinations* (IFRS 3)

EITF Issue No. 96-6, "Accounting for the Film and Software Costs Associated with Developing Entertainment and Educational Software Products (Issue 96-6)

EITF Issue No. 96-7, "Accounting for Deferred Taxes on In-Process Research and Development Activities Acquired in a Purchase Business Combination" (Issue 96-7)

EITF Issue 98-11, "Accounting for Acquired Temporary Differences in Certain Purchase Transactions That Are Not Accounted for as Business Combinations" (Issue 98-11)

EITF Issue No. 99-5, "Accounting for Pre-Production Costs Related to Long-Term Supply Arrangements" (Issue 99-5)

EITF Issue No. 00-2, "Accounting for Web Site Development Costs" (Issue 00-2)

EITF Issue No. 07-1, "Accounting for Collaborative Arrangements" (Issue 07-1)

EITF Issue No. 07-3, "Accounting for Nonrefundable Advance Payments for Goods or Services Received for Use in Future Research and Development Activities" (Issue 07-3)

EITF Issue 08-6, "Equity Method Investment Accounting Considerations" (Issue 08-6)

Background

1. Prior to Statement 141(R), research and development assets were accounted for in the same manner irrespective of whether they were purchased as individual assets, as part of a group of assets, or in a business combination. Statement 141(R) changed the accounting requirements for research and development assets acquired in a business combination. That change has resulted in inconsistent recognition and measurement requirements for research and development assets acquired in a business combination or an asset acquisition.

2. Research and development assets acquired in a business combination are initially recognized and measured at fair value in accordance with Statement 141(R). In accordance with Statement 2, research and development assets acquired in an asset acquisition are only recognized if the assets have a future alternative use, otherwise the assets are expensed at the acquisition date. Tangible assets that meet the future alternative-use criterion are initially recognized at allocated cost. Intangible assets that meet the future alternative-use criterion are also initially recognized at allocated cost and subsequently accounted for in accordance with Statement 142.

3. In addition to Statement 2, other accounting literature addresses different aspects of accounting for research and development activities; for example, costs associated with computer software (for internal use or sale), which have very different recognition criteria as compared to Statement 141(R). That other accounting literature is based on the accounting requirements in Statement 2. Appendix 09-2A of Issue Summary No. 1 compares current initial recognition and measurement requirements for research and development assets acquired in a business combination with an asset acquisition under U.S. GAAP and IFRS. This comparison indicates that the current U.S. requirements for acquired research and development assets in an asset acquisition are inconsistent with Statement 141(R).

4. Respondents to the exposure draft for Statement 141(R) objected to the resulting inconsistent GAAP requirements for research and development assets acquired in a business combination and those purchased in another type of transaction. After considering responses to the exposure draft, the Board agreed with respondents that inconsistent accounting for research and development assets that is based on how the asset was acquired, is undesirable. Therefore,

the Board decided to add a separate project to its agenda to reconsider the accounting for research and development assets obtained in a transaction other than a business combination. At the January 15, 2009 EITF meeting, the FASB Chairman announced his decision to move the project from the Board's agenda to the EITF's agenda.

Scope

5. The scope of this Issue includes all tangible and intangible research and development assets acquired (either individually or with a group of other assets) in a transaction other than a business combination. The scope of this Issue includes:

a. Tangible and intangible assets resulting from research activities—for example, patents, blueprints, formulas, and designs for new products or processes
b. Tangible and intangible assets to be used in research activities—for example, materials and supplies, equipment and facilities, and even a specific in-process research and development project.

Payments for another entity's services to perform research and development activities are not considered acquired assets and are not within the scope of this Issue.

Prior EITF Discussion

6. At the March 19, 2009 EITF meeting, the Task Force discussed the following issues:

Issue 1— Whether the costs of acquired tangible and intangible research and development assets that are acquired in an asset acquisition and that do not have a future alternative use, shall be expensed immediately or capitalized

Issue 2— If the Task Force decides that all acquired research and development assets shall be initially capitalized, how acquired research and development assets shall be subsequently accounted for.

7. The Task Force reached a tentative conclusion on Issue 1 that all tangible and intangible research and development assets acquired in an asset acquisition shall be capitalized pursuant to Appendix D of Statement 141(R) regardless of whether those assets have a future alternative use.

8. In connection with Issue 1, the Task Force also discussed the recognition and measurement of contingent consideration in an acquisition of tangible and intangible research and development assets. The FASB staff noted that if the contingent consideration meets the definition of a derivative, Statement 133 would require that it be recognized at fair value. The Task Force observed that it may be difficult to differentiate between when the contingent consideration represents an additional payment for the acquired research and development tangible and intangible assets and when the contingent consideration represents a payment for services, when the seller maintains some form of continuing involvement. As a result, the Task Force requested that the FASB staff develop alternatives for discussion at a future meeting, including whether the Task Force could provide factors to consider when an entity is evaluating whether contingent consideration is payment for assets or services.

9. On Issue 2, the Task Force reached a tentative conclusion that tangible and intangible research and development assets acquired in an asset acquisition shall be considered indefinite-lived until the completion or abandonment of the associated research and development activities. During the period those assets are considered indefinite-lived, they shall not be amortized but shall be tested for impairment in accordance with paragraph 17 of Statement 142. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in Statement 142. The Task Force observed that the tentative conclusion conforms the subsequent measurement for tangible and intangible research and development assets acquired in an asset acquisition with the subsequent measurement for similar assets acquired in a business combination. Consistent with the guidance in paragraph 28 of Statement 144, intangible assets acquired that have been temporarily idled shall not be accounted for as if abandoned. Tangible research and development assets acquired in an asset acquisition shall be subsequently accounted for in accordance with their nature.

Current Discussion

Accounting Issues and Alternatives

Issue 3: How an entity should account for contingent consideration related to an acquisition of tangible and intangible research and development assets in an asset acquisition.

View A: All contingent consideration in an asset acquisition shall be measured at its acquisition-date fair value, regardless of whether the asset acquisition includes research and development assets. The fair value of the contingent consideration would be allocated to the individual assets acquired or liabilities assumed based on their relative fair values as described in Appendix D of Statement 141(R). Subsequent to initial measurement, changes in the fair value of contingent consideration would be accounted for in accordance with paragraph 65 of Statement 141(R).

10. View A proponents believe that the accounting for contingent consideration should be the same regardless of whether the form of the transaction is an asset acquisition or a business combination or whether there are research and development assets being acquired. They note that this view is consistent with Statement 141(R), which requires that the acquirer in a business combination recognize and measure contingent consideration at fair value on the acquisition date. View A proponents believe that measuring contingent consideration at fair value will address concerns about capitalizing contingent consideration in an asset acquisition as the fair value measurement will incorporate consideration of the probability, on the acquisition date, that the contingent consideration will be paid.

11. View A opponents note that this view is not entirely consistent with Statement 141(R) because the assets acquired and liabilities assumed (including the contingent consideration) will be initially recognized at relative fair value and the relative fair value computation will include the capitalization of transaction costs. Under Statement 141(R), all assets acquired and liabilities assumed (including contingent consideration) are initially recognized and measured at fair value and transaction costs are expensed.

12. View A opponents believe that capitalizing contingent consideration in an asset acquisition and subsequently evaluating the research and development assets for impairment may result in volatility in earnings and may reduce the comparability of actual research and development expenses when impairment expense is reported. In particular, some View A opponents indicated that due to the high probability that early- and medium-stage research and development efforts fail, an entity would be required to capitalize a research and development asset that will likely be impaired in the future. They note that contingent consideration is often part of the deal structure, rather than an upfront payment due to the high probability that the acquired research and development will not result in a commercialized product. Therefore, they question why it is appropriate to capitalize an asset that they expect will likely be impaired in the future.

13. View A opponents also note that this view broadens the scope of this Issue beyond acquired research and development assets. They believe that if the scope of this Issue is going to be expanded, the Task Force should also consider other differences in accounting between business combinations and asset acquisitions, such as the differences in accounting for acquisition-related costs.

14. Some View A proponents believe that the Task Force could consider limiting the scope of View A to contingent consideration related to research and development. However, they note that only measuring contingent consideration related to acquired research and development could be complex if the Task Force requires bifurcation of the contingent consideration between research and development assets and non research and development assets, especially considering the different recognition and measurement for contingent consideration dependent on whether it was for research and development assets.

View B: Contingent consideration should generally be included in the initial measurement of the cost of the acquired assets only if the contingent consideration is required to be recognized by specific authoritative guidance. However, if an asset acquisition involves a contingent consideration arrangement in which the fair value of the acquired assets exceeds the acquirer's initial cost, an amount equal to the lesser of the following shall be recognized as a liability:

a. The maximum amount of contingent consideration not otherwise recognized

b. *The excess of the acquired net assets over the initial cost measurement (including contingent consideration otherwise recognized).*

When a contingency is resolved relating to a liability recognized and the consideration is issued or becomes issuable, any excess of the fair value of the contingent consideration issued or issuable over the amount that was recognized as a liability shall be recognized as an additional cost of the acquisition. If the amount initially recognized as a liability exceeds the fair value of the consideration issued or issuable, that excess shall reduce the cost of the asset acquisition.

15. View B is based on the guidance in Issue 08-6 that addresses the accounting for contingent consideration by an equity method investor. View B proponents note that Issue 08-6 did not completely align the accounting by an equity method investor and acquirer in a business combination and believe that the same approach can be applied to address the accounting for contingent consideration in an asset acquisition. They believe that View B brings the accounting for research and development in an asset acquisition closer to that of a business combination.

16. View B opponents believe that whether to recognize contingent consideration at the acquisition date would be highly dependent on the valuation of the acquired research and development assets. They noted that often contingent consideration is included when the buyer and seller cannot agree on the fair value of the acquired research and development assets. As a result, they do not believe that a proper threshold for measuring the contingent consideration is the fair value of the acquired assets. Further, they do not agree that the amount of contingent consideration should be limited to the fair value of the acquired assets, noting that an acquirer may overpay for a research and development asset for various reasons.

17. View B opponents also note that adjusting the cost basis of the asset when the contingency is resolved is not consistent with the accounting under business combinations for either the acquired assets or the contingent consideration. These opponents note that part of the Task Force’s reasoning behind the tentative conclusion reached at the March 19, 2009 EITF meeting was to better align the accounting for research and development assets acquired in asset acquisitions with business combinations.

View C: Contingent consideration shall be accounted for in accordance with existing U.S. GAAP.

18. View C proponents believe that the issues relating to contingent consideration in an acquisition of research and development assets is best resolved as part of a comprehensive review of the accounting for asset acquisitions or Statement 2 and related pronouncements. View C proponents believe that the difficulties highlighted in Views A and B support their assertion that it will not result in an improvement in financial reporting to change the asset acquisition guidance in a piecemeal fashion.

19. View C proponents believe that there should not be a difference in the accounting for costs related to research and development assets depending on whether the research and development was acquired or internally generated. They note that Views A and B result in capitalization because the contingent consideration relates to research and development assets that were acquired. For example, under this view an acquirer could potentially capitalize the contingent payment when a milestone is met. However, if the entity had internally developed research and development assets and sets internal milestones (for example, payment of a bonus to employees when the milestone is met), it would not be permitted to capitalize any research and development costs.

20. View C proponents also believe that the Task Force should reconsider its tentative conclusion reached at the March 19, 2009 EITF meeting for the reasons discussed in View B of Issue Summary No. 1. In addition to the reasons discussed at the March meeting, they note that, in practice, there have not been enough transactions subsequent to the effective date of Statement 141(R) to determine the effect of the revised definition of a business and the level and extent of diversity in accounting for transactions that will exist as a result of that new definition. View C proponents note that while it is expected that more transactions will be considered business combinations, it is not clear exactly how the new definition of a business will change practice. In other words, View C proponents question whether the Task Force is trying to address an issue that does not necessarily exist yet. As a result, they believe that it would be preferable to observe

how practice applies the new guidance under Statement 141(R) before considering an amendment related to the accounting for asset acquisitions.

21. As part of the staff's research on the accounting for contingent consideration and the factors used to determine the parts of the asset acquisition, the staff received feedback on the Task Force's tentative conclusion reached on Issue 1. The feedback was received during discussions between the FASB staff and representatives from preparer entities that have significant research and development activities, such as pharmaceutical and biotechnology companies and technology companies. Certain View C proponents, especially in the pharmaceutical industry, continue to disagree with the guidance in Statement 141(R) to capitalize acquired research and development assets as indefinite-lived assets regardless of whether the research and development assets have an alternative future use. These proponents do not believe that acquired research and development assets meet the definition of an asset in accordance with Concepts Statement 6 in most circumstances due to the high failure rate of many research and development activities. Although they note that the Board has previously discussed this reasoning and dismissed it in its deliberations on Statement 141(R), they note that asset acquisitions of research and development assets have a historically high failure rate and thus do not believe that capitalizing an asset only to subsequently impair the asset, results in an improvement in financial reporting. View C proponents also believe that if the Task Force was to align the accounting for acquisitions of research and development intangibles, it would create more tension between the accounting for acquired intangibles and the accounting for internally developed intangibles, thus only shifting where the inconsistencies reside within the accounting framework.

22. View C opponents believe that it is possible to better align the model for in-process research and development assets and that it is not necessary to completely modify the accounting for intangible assets or asset acquisitions in order to do so. They note that many of the objections to Views A and B are not unique to acquired research and development intangible assets. For example, the initial measurement of most assets is different when acquired in business combinations than when acquired in asset acquisitions. Also, current GAAP treats all acquired intangible assets differently than internally generated intangible assets. View C opponents see a benefit in getting the model for research and development assets more closely aligned.

Issue 4: If the Task Force reaches a tentative conclusion on View A or View B for Issue 3, whether the Task Force wishes to provide factors to consider when determining whether contingent consideration is payment for the asset or payment for future services.

View A: Do not provide factors that are different from those provided in paragraph A86 and A87 of Statement 141(R).

23. View A proponents note that paragraph A86 of Statement 141(R) indicates that

> Whether arrangements for contingent payments to employees or selling shareholders are contingent consideration in the business combination or are separate transactions depends on the nature of the arrangements. Understanding the reasons why the acquisition agreement includes a provision for contingent payments, who initiated the arrangement, and when the parties entered into the arrangement may be helpful in assessing the nature of the arrangement.

Paragraph A87 of Statement 141(R) goes on to provide factors to consider when it is not clear whether the contingent payment is for the business combination or a separate transaction (See Appendix 09-02A for the factors provided in paragraph A87 of Statement 141(R)). View A proponents believe that the factors for determining whether contingent consideration is expensed or capitalized in an asset acquisition should be similar to the factors for determining whether contingent consideration in a business combination should be expensed or capitalized. Accordingly, they believe that if the Task Force does not provide factors, they would expect practice to analogize to the factors set forth in paragraph A87 of Statement 141(R). Alternatively, View A proponents believe that this issue could require consideration of the factors set forth in paragraph A87 of Statement 141(R) for consideration of additional services to be provided, not just employment. These proponents note that factors that discuss employment and employees would also require consideration of services to be provided by the seller.

View B: Provide additional factors (in addition to those in View A) to consider in differentiating between payments for assets and services.

24. The staff asked various preparers and auditors about factors that could potentially be used in determining whether contingent consideration is for the asset or for payment for services. In general, constituents believed that it would be difficult to provide factors due to the diverse nature of asset acquisitions and the level and extent of continuing involvement by the seller. Further, some constituents believe that there is a rebuttable presumption that contingent payments are for services when the seller has continuing involvement. The following factors were provided by constituents, in addition to the factors mentioned in View A:

a. *Where in the research and development life cycle the acquired asset is*—For example, if the acquirer purchases a drug candidate that is awaiting Federal Drug Administration (FDA) approval and the contingent consideration milestone is tied to that approval, it is more likely that the contingent consideration relates to the asset. Alternatively, if the drug candidate is in preclinical trials and will require additional work by the seller to achieve a milestone(s), it is more likely that the contingent consideration would relate to services.
b. *The nature and extent of continuing involvement by the seller in achieving the milestone(s)*—For example, how active is the seller in the ongoing activities related to the research and development activities?

Issue 5: If the Task Force reaches a tentative conclusion on View C for Issue 3, whether the Task Force wishes to reconsider its tentative conclusions on Issue 1 and Issue 2.

Disclosures

25. Statement 142 already specifies the disclosures to be provided for all intangible assets, including research and development intangible assets. However, the staff believes that financial statement users may benefit from additional disclosure about contingent consideration in an asset acquisition. Specifically, the staff recommends that the disclosures in paragraph 68(g)(2), and 68(g)(3) of Statement 141(R) be applicable to asset acquisitions as well.

26. The disclosures in 68(g)(2) and 68(g)(3) of Statement 141(R) related to contingent consideration are as follows:

A description of the [contingent consideration] arrangement and the basis for determining the amount of the payment

An estimate of the range of outcomes (undiscounted) or, if a range cannot be estimated, that fact and the reasons why a range cannot be estimated. If the maximum amount of the payment is unlimited, the acquirer shall disclose that fact.

27. Task Force members will be asked whether they agree with the above incremental disclosures.

Transition and Effective Date

28. The Task Force is being asked to consider whether a consensus reached in this Issue should be applied prospectively to new transactions, consistent with the decisions reached in Statement 141(R) and Statement 160. The staff considered whether the consensus reached in this Issue should be applied retrospectively. However, the staff notes that the application of this Issue could require the determination of the fair value of acquired research and development intangibles both for initial measurement and for purposes of considering impairment in prior periods. Entities may not have the information available to determine the fair value in prior periods of assets that were not recorded on the balance sheet but were expensed in their entirety. Therefore, the staff believes that determining fair value retrospectively would be difficult.

29. The Task Force is also being asked when a consensus reached in this Issue should be effective.

View A: A consensus reached in this Issue should be effective for transactions occurring in fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. Early adoption is permitted.

30. View A proponents believe that many entities will not be able to implement the change in the interim period after the issuance of this Issue. However, they believe that some entities will want to early adopt in order to increase the comparability between business combinations and

asset acquisitions. View A opponents believe that early adoption should not be permitted as it may reduce the comparability between different reporting entities.

View A': The consensus reached in this Issue should be effective for transactions occurring in fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2009. Early adoption is not permitted.

31. This view is the same as View A; however, it would not allow for early adoption. Proponents believe that View A' allows for the benefit of consistency and comparability for all future transactions and does not result in non-comparability in an annual reporting period. View A' opponents believe that there is generally a lack of comparability between entities' accounting for asset acquisitions and business combinations as each transaction is unique and therefore a lack of comparability should not be persuasive.

Appendix 09-02A

STATEMENT 141(R), PARAGRAPH A87, INDICATORS

The following are the factors provided in paragraph A87 of Statement 141(R) when it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination:

> A87. If it is not clear whether an arrangement for payments to employees or selling shareholders is part of the exchange for the acquiree or is a transaction separate from the business combination, the acquirer should consider the following indicators:
>
> a. *Continuing employment*—The terms of continuing employment by the selling shareholders who become key employees may be an indicator of the substance of a contingent consideration arrangement. The relevant terms of continuing employment may be included in an employment agreement, acquisition agreement, or some other document. A contingent consideration arrangement in which the payments are automatically forfeited if employment terminates is compensation for post combination services. Arrangements in which the contingent payments are not affected by employment termination may indicate that the contingent payments are additional consideration rather than compensation.
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> b. *Duration of continuing employment*—If the period of required employment coincides with or is longer than the contingent payment period, that fact may indicate that the contingent payments are, in substance, compensation.
>
> c. *Level of compensation*—Situations in which employee compensation other than the contingent payments is at a reasonable level in comparison to that of other key employees in the combined entity may indicate that the contingent payments are additional consideration rather than compensation.
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> d. *Incremental payments to employees*—If selling shareholders who do not become employees receive lower contingent payments on a per-share basis than the selling shareholders who become employees of the combined entity, that fact may indicate that the incremental amount of contingent payments to the selling shareholders who become employees is compensation.
>
> e. *Number of shares owned*—The relative number of shares owned by the selling shareholders who remain as key employees may be an indicator of the substance of the contingent consideration arrangement. For example, if the selling shareholders who owned substantially all of the shares in the acquiree continue as key employees, that fact may indicate that the arrangement is, in substance, a profit-sharing arrangement intended to provide compensation for post combination services. Alternatively, if selling shareholders who continue as key employees owned only a small number of shares of the

acquiree and all selling shareholders receive the same amount of contingent consideration on a per-share basis, that fact may indicate that the contingent payments are additional consideration. The preacquisition ownership interests held by parties related to selling shareholders who continue as key employees, such as family members, also should be considered.

f. *Linkage to the valuation*—If the initial consideration transferred at the acquisition date is based on the low end of a range established in the valuation of the acquiree and the contingent formula relates to that valuation approach, that fact may suggest that the contingent payments are additional consideration. Alternatively, if the contingent payment formula is consistent with prior profit-sharing arrangements, that fact may suggest that the substance of the arrangement is to provide compensation.

g. *Formula for determining consideration*—The formula used to determine the contingent payment may be helpful in assessing the substance of the arrangement. For example, if a contingent payment is determined on the basis of a multiple of earnings, that might suggest that the obligation is contingent consideration in the business combination and that the formula is intended to establish or verify the fair value of the acquiree. In contrast, a contingent payment that is a specified percentage of earnings might suggest that the obligation to employees is a profit-sharing arrangement to compensate employees for services rendered.

h. *Other agreements and issues*—The terms of other arrangements with selling shareholders (such as noncompete agreements, executory contracts, consulting contracts, and property lease agreements) and the income tax treatment of contingent payments may indicate that contingent payments are attributable to something other than consideration for the acquiree. For example, in connection with the acquisition, the acquirer might enter into a property lease arrangement with a significant selling shareholder. If the lease payments specified in the lease contract are significantly below market, some or all of the contingent payments to the lessor (the selling shareholder) required by a separate arrangement for contingent payments might be, in substance, payments for the use of the leased property that the acquirer should recognize separately in its postcombination financial statements. In contrast, if the lease contract specifies lease payments that are consistent with market terms for the leased property, the arrangement for contingent payments to the selling shareholder may be contingent consideration in the business combination.