Title: Accounting for Transactions with Elements of Research and Development Arrangements

Dates Discussed: November 17–18, 1999; January 19–20, 2000; May 17–18, 2000

References:
- FASB Statement No. 57, Related Party Disclosures
- FASB Statement No. 68, Research and Development Arrangements
- FASB Statement No. 94, Consolidation of All Majority-Owned Subsidiaries
- FASB Statement No. 160, Noncontrolling Interests in Consolidated Financial Statements
- FASB Statement No. 167, Amendments to FASB Interpretation No. 46(R)
- FASB Interpretation No. 46, Consolidation of Variable Interest Entities
- FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities
- FASB Staff Position FIN46-6, “Effective Date of FASB Interpretation No. 46”
- AICPA Accounting Research Bulletin No. 51, Consolidated Financial Statements
- APB Opinion No. 20, Accounting Changes
- APB Opinion No. 29, Accounting for Nonmonetary Transactions
- AICPA Audit and Accounting Guide, Audits of Investment Companies
- SEC Staff Accounting Bulletin No. 63, Views on Application of SFAS No. 68, Research and Development Arrangements

ISSUE

1. Statement 68 establishes standards of financial accounting and reporting for an enterprise that is a party to a research and development arrangement through which it can obtain the results of research and development funded partially or entirely by others. Statement 68 states that an enterprise shall determine the nature of the obligation it incurs when it enters into an arrangement with other parties that fund its research and development. If the enterprise is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development, the enterprise shall estimate and recognize that liability. To the extent that the financial risk associated with the research and development has been transferred, because repayment of any of the
funds provided by the other parties depends solely on the results of the research and
development having future economic benefit, the enterprise shall account for its
obligation as a contract to perform research and development for others.

2. Transactions have developed in which a sponsor (the “Sponsor”) capitalizes a new
company (“Newco”) with cash and rights to certain technology developed by the
Sponsor, in exchange for Newco Class A and Class B common stock. The Class B
common shares convey essentially no financial interest to the Sponsor and, other than
certain blocking rights, provide the Sponsor essentially no voting rights. The Sponsor
subsequently distributes the Newco Class A common stock to its shareholders subject to
a purchase option held by the Sponsor. The Sponsor then receives funds from Newco to
perform research and development activities. Other potential structures designed to
achieve similar objectives also exist.

3. The issue is how the Sponsor should account for the research and development
arrangement.

EITF DISCUSSION

4. The Task Force agreed that the scope of this Issue should be limited to those
research and development arrangements in which all of the funds for the research and
development activities are provided by the Sponsor of the research and development
arrangement. Transactions in which the funds are provided by third parties would
generally be within the scope of Statement 68. The following example is used for
illustrative purposes:

A sponsor (the “Sponsor”) capitalizes a newly created, wholly owned subsidiary,
Newco, with $110 million and rights to certain technology developed by the
Sponsor (assumed to have no book value) in exchange for Newco Class A
common stock and Newco Class B common stock with a nominal fair value. Concurrent with its formation, the Sponsor and Newco enter into various agreements including a Development Contract and a Purchase Option (each described below). Shortly thereafter, the Sponsor distributes all of the Newco Class A common stock to the Sponsor’s stockholders. The fair value of the Newco Class A common stock at distribution is $80 million.

After the distribution, the Sponsor owns all of the authorized shares of the Newco Class B common stock. The Newco Class B common stock conveys essentially no financial interest to the Sponsor and, other than certain blocking rights, provides the Sponsor essentially no voting rights. Under the Development Contract, Newco will be required to spend all of the cash contributed to it by the Sponsor (the Available Funds) in the research and development of technologies mutually agreed upon with the Sponsor. Newco will have no employees other than its CEO and no facilities other than a nominal amount of office space. (For purposes of this example, investment income on the Available Funds, the CEO’s salary, and office space rent are ignored.) In addition, Newco will contract with the Sponsor to perform all of Newco’s research and development activities under the Development Contract at the Sponsor’s cost plus 10 percent. Newco expects that, in paying for such activities, the Available Funds will be substantially exhausted within the first two years of its existence. For purposes of this example, it is assumed that the Sponsor incurs $50 million in research and development costs for each year under the Development Contract. As a result, Newco pays $55 million to the Sponsor for each year of the Development Contract.

Under the Purchase Option, the Sponsor will have the right to purchase all of the Newco Class A common stock at an exercise price that is intended to approximate
the fair market value of the shares. The purchase option is exercisable at any time until the second anniversary of the distribution of the Newco Class A common stock. For purposes of this example, two scenarios are assumed under the Purchase Option—one in which the option is not exercised and one in which the option is exercised for $200 million just prior to the second anniversary of the distribution of the Newco Class A common stock.

Under Newco’s certificate of incorporation, Newco is prohibited from taking or permitting any action inconsistent with, or that will in any way alter, the Sponsor’s rights under the Purchase Option without the preapproval of the Sponsor. In addition, until the expiration of the Purchase Option, Newco may not merge, liquidate, or sell any substantial portion of its assets or amend its certificate of incorporation to alter the Purchase Option, Newco’s authorized capitalization, or the provisions of the certificate of incorporation governing Newco’s board of directors without the preapproval of the Sponsor.

5. The Task Force reached a consensus that the Sponsor should account for the research and development arrangement as follows: (a) the Sponsor should reclassify the cash contributed to Newco as restricted cash at the time of distribution of the Newco Class A common stock and recognize research and development expense as the research and development activities are performed, and (b) the Sponsor should account for the distribution of the Newco Class A common stock as a dividend to common stockholders of the Sponsor. The Newco Class A common stock should be presented outside of permanent equity (equivalent to noncontrolling interest). [Note: See STATUS section.] The amount of the dividend recognized on the distribution of the Newco Class A common stock should be based on the fair value of the Newco Class A common stock and should be recorded at the time the Sponsor distributes the Newco Class A common stock to its stockholders. Further, the Task Force reached a consensus that research and
development expense recognized by the Sponsor should not be allocated to the Newco Class A common stock in determining net income or earnings available to common stockholders of the Sponsor in the calculation of earnings per share. [Note: See STATUS section.] Task Force members observed that, procedurally, if the Task Force had reached a consensus requiring a consolidation approach to the Sponsor’s accounting, and if the incurred research and development costs were allocated to the Newco Class B common stock held by the Sponsor (because the value of the Newco Class A common stock is derived from the Sponsor’s purchase option on those shares, not from the Sponsor’s initial funding of Newco), the accounting that would result from consolidation would be essentially the same as that required by this consensus.

6. With respect to the purchase option, the Task Force concluded that the Sponsor should account for the exercise of the option to acquire the Newco Class A common stock like the acquisition of noncontrolling interest. That is, the excess of the option exercise price over the carrying amount of the Newco Class A common stock should be allocated to the assets acquired (generally, in-process or completed research and development) and liabilities assumed (if any). However, if the Sponsor does not exercise the purchase option, the Newco Class A common stock should be reclassified to additional paid-in capital upon expiration of the option as an adjustment to the initial dividend. Exhibit 99-16A provides an example of the application of the consensuses in this Issue.

7. These consensuses apply to research and development arrangements consummated after May 18, 2000, and to existing research and development arrangements in which a commitment, in any form (including the Sponsor’s guarantee of Newco’s debt), to provide additional funding is made after May 18, 2000. A research and development arrangement is considered consummated if Newco’s shares have been distributed to the Sponsor’s shareholders and all related agreements have been executed including (a) the
creation and commitment to a specified amount of capitalization of Newco, (b) development and purchase option agreements, and (c) other related agreements, such as sponsor financing or guarantees. If a commitment for additional funding is made after May 18, 2000, with respect to an arrangement that existed at that date, the existing arrangement should be accounted for pursuant to these consensuses, with the revised accounting for the arrangement reported as the cumulative effect of a change in accounting principle under Opinion 20.

STATUS

8. Interpretation 46(R), as amended by Statement 167, addresses consolidation by business enterprises of variable interest entities, which include many special-purpose entities used in research and development arrangements. That Interpretation requires a variable interest entity to be consolidated by an enterprise if that enterprise has a variable interest (or a combination of variable interests) that provides the enterprise with a controlling financial interest in a variable interest entity. Paragraphs 14–14G of Interpretation 46(R), as amended by Statement 167, provide guidance on determining whether an enterprise has a controlling financial interest.

9. Interpretation 46 was issued in January 2003. The consolidation requirements of Interpretation 46 apply immediately to variable interest entities created after January 31, 2003. The consolidation requirements apply to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply in all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established.

10. FSP FIN46-6 deferred the effective date for applying the provisions of Interpretation 46 for:
a. Interests held by a public entity in variable interest entities created before February 1, 2003, if the public entity has not issued financial statements reporting that interest in accordance with Interpretation 46. The application of Interpretation 46 to those interests is deferred until the end of the first period ending after December 15, 2003.

b. Nonregistered investment companies accounting for their investments in accordance with the specialized accounting guidance in the investment company Guide.

11. Interpretation 46(R) was issued on December 24, 2003, and replaced Interpretation 46. An enterprise with an interest in an entity to which the provisions of Interpretation 46 were not applied as of December 24, 2003, must apply the effective date and transitions provisions in Interpretation 46(R) to that entity. Application by public companies of Interpretation 46 or Interpretation 46(R) to entities commonly referred to as special-purpose entities is required no later than as of the end of the first reporting period that ends after December 15, 2003. Public enterprises must apply Interpretation 46(R) to all entities no later than the end of the first reporting period that ends after March 15, 2004 (public enterprises other than small business issuers) or December 15, 2004 (small business issuers). Nonpublic enterprises must apply Interpretation 46(R) to entities created after December 31, 2003, immediately and to all other entities by the beginning of the first annual period beginning after December 15, 2004. An enterprise that has applied Interpretation 46 to an entity prior to the effective date of Interpretation 46(R) shall either continue to apply Interpretation 46 until the effective date of Interpretation 46(R) or apply Interpretation 46(R) at an earlier date.

12. Statement 167 was issued in June 2009 and amends Interpretation 46(R). Statement 167 shall be effective as of the beginning of each reporting entity’s first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Earlier application is prohibited.
13. Statement 160 was issued in December 2007. It amends ARB 51 to establish accounting and reporting standards for noncontrolling interests in subsidiaries. Under Statement 160, noncontrolling interests are now classified as equity, but separate from the parent’s equity.

14. No further EITF discussion is planned.
Exhibit 99-16A

EXAMPLE OF THE APPLICATION OF THE EITF CONSENSUSES ON ISSUE 99-16

Impact at Consolidated Sponsor Level

Distribution of Newco’s Class A Common Stock
Restricted Cash  $110,000,000
Cash  $110,000,000
Common Dividend  80,000,000
Newco Class A Common Stock  80,000,000

Year 1 Research and Development
Research and Development Costs Incurred by the Sponsor
R&D Expense  $ 50,000,000
Cash  $ 50,000,000
Reimbursement under Development Contract
Cash  $ 55,000,000
Restricted Cash  $ 55,000,000

Year 2 Research and Development
Research and Development Costs Incurred by the Sponsor
R&D Expense  $ 50,000,000
Cash  $ 50,000,000
Reimbursement under Development Contract
Cash  $ 55,000,000
Restricted Cash  $ 55,000,000

Purchase Option (Two Scenarios)
Scenario 1—Option Not Exercised
Newco Class A Common Stock  $ 80,000,000
APIC  $ 80,000,000
Scenario 2—Option Exercised
In-Process/Completed R&D  $120,000,000
Newco Class A Common Stock  80,000,000
Cash  $200,000,000

Impact of All the Entries
Scenario 1—Option Not Exercised
Common Dividends  $ 80,000,000
R&D Expense  100,000,000
APIC  $ 80,000,000
Cash  100,000,000

1Accounted for like noncontrolling interest.
**Scenario 2—Option Exercised**

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<th>Amount</th>
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<td>Common Dividends</td>
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<tr>
<td>R&amp;D Expense</td>
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<tr>
<td>In-Process/Completed R&amp;D</td>
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Suggested Index Entries for EITF Issue No. 99-16, “Accounting for Transactions with Elements of Research and Development Arrangements”

CONSOLIDATION
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RESEARCH AND DEVELOPMENT ARRANGEMENTS
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