Appendix 08-9A

EXAMPLES

The following examples are provided to illustrate the application of the various views under Issue 2 of Issue Summary No. 1, Supplement No. 1.

Fact Pattern - Biotech License and R&D Contract

Biotech Company (Biotech) enters into an agreement with Pharmaceutical Company (Pharma) on January 1, 20X1. The agreement includes Biotech (a) licensing certain intellectual property rights to Pharma and (b) providing research and development (R&D) services to Pharma with the objective of developing a viable drug candidate and receiving U.S. Food and Drug Administration (FDA) approval of the drug candidate.

Arrangement consideration is as follows:

- Biotech receives $5 million in licensing fees upon signing the agreement
- Biotech receives $250,000 per year for each full-time equivalent (FTE) that performs R&D activities
- Milestone Events:
  1. Biotech receives $2 million upon identification of a viable drug candidate
  2. Biotech receives $3 million upon successful Phase II clinical trial completion
  3. Biotech receives $5 million upon FDA approval.

The license and FTE fees are comparable to rates charged by Biotech in other arrangements and are also considered comparable to rates charged by Biotech's competitors and contract research organizations. None of these payments, once received, are refundable, even if FDA approval is never received. In addition, while Biotech must perform on a best-efforts basis, it is not obligated to achieve the milestones.

Biotech’s analysis of its other R&D arrangements indicates that R&D projects usually terminate (a) at five years if no viable drug candidate is identified, (b) at nine years if the drug candidate is successful in reaching FDA approval, or (c) at seven years in most other instances (that is, when
a viable drug candidate is identified but the drug candidate does not successfully complete Phase II clinical trials). Based on its experience with other R&D projects and its knowledge of the R&D to be performed, Biotech estimates at the inception of the arrangement that it will average nine FTEs over seven years. In addition, Biotech estimates that it will average nine FTEs over the estimated life of the arrangement.

For the purpose of this fact pattern, there are no adjustments to Biotech’s estimates over the term of the arrangement that could affect the revenue recognition patterns. Furthermore, the following additional facts are utilized:

- License and R&D services are accounted for as 1 unit of accounting
- Milestone Event 1 is not considered a substantive milestone
- Milestone Events 2 and 3 are considered substantive milestones
- Biotech has a policy of recognizing revenue proportionately over R&D hours
- Milestone Event 1 is achieved after incurring 18,720 R&D hours
- Milestone Event 2 is achieved after incurring 60,000 R&D hours
- Milestone Event 3 is never achieved
- The arrangement terminates at the end of Year 7
- 18,720 R&D hours are incurred each year (9 FTEs per year)
- Total R&D hours estimated to be incurred over 7 years is 131,040
- Total contingent consideration possible under the arrangement is $10,000,000.

Because of the simplistic assumptions included in the following illustrations, the consideration from the license and R&D services is recognized as revenue ratably over the arrangement term for each of the views at a rate of $714,286 ($5,000,000 ÷ 7) and $2,250,000 (9 × $250,000) per year, respectively. Because the recognition of the license and R&D services consideration is the same for each of the views, the table at the end of this document compares the timing of revenue recognition for only the contingent consideration under each of the views.

**Evaluation – View A**

Note that under View A, the revenue recognized related to contingent consideration is limited to the nonrefundable contingent consideration. While View A can be viewed as being internally inconsistent (that is, it takes consideration that will most likely only be achieved if the R&D services are performed over nine years and amortizes that amount over the vendor’s best estimate of service (seven years)), View A is intended to remove the need to assess the probability of achievement for each contingency. To require an assessment of the probability of achieving
each contingency could result in certain contingencies not being considered in the initial consideration to be recognized. As a result, the question of how to treat such amounts would remain unanswered.

Because Biotech recognizes its fixed or determinable fees over R&D hours, under View A all arrangement consideration is recognized based on R&D hours. As a result, Biotech would recognize approximately $76 ($10,000,000 ÷ 131,040) of contingent consideration as revenue per R&D hour incurred. However, the amount of contingent consideration to be recognized as revenue for any period is limited to the nonrefundable contingent fees. For example, when the first milestone is met at the end of Year 1, Biotech recognizes $1,428,571 ([$10,000,000 ÷ 131,040] × 18,720). In Year 2, Biotech would have recognized an additional $1,428,571; however, the total nonrefundable contingent fees are $2,000,000, therefore, Biotech can only recognize $571,429 ($2,000,000 − $1,428,571).

**Evaluation – View B**

Under View B, contingent consideration is allocated between past and future performance based on the selling price of the delivered and undelivered elements of the arrangement. For the purpose of this example, the allocation was performed using the relative selling price method. Furthermore, for the purpose of this example, the license is considered delivered at inception of the arrangement.

At the time the first milestone event is achieved, the selling price of the delivered and undelivered elements is $9,250,000 and $13,500,000, respectively. As a result, Biotech will allocate $813,187 and $1,186,813 of the first milestone consideration to past and future performance, respectively. At the time the second milestone event is achieved, the selling price of the delivered and undelivered elements is $17,000,000 and $8,500,000, respectively. As a result, Biotech will allocate $2,000,000 and $1,000,000 of the second milestone consideration to past and future performance, respectively. Because Biotech recognizes its fixed or determinable fees over R&D hours, contingent consideration allocable to future performance is recognized based on R&D hours. As a result, Biotech would recognize approximately $11 ($1,186,813 ÷ 112,320) of contingent consideration as revenue per R&D hour incurred after achievement of the
first milestone and an additional $14 ($1,000,000 ÷ 71,040) of contingent consideration as revenue per R&D hour incurred after achievement of the second milestone.

**Evaluation – View C**

Because Biotech recognizes its fixed or determinable fees over R&D hours, under View C the contingent arrangement consideration is recognized based on R&D hours. As a result, Biotech would recognize approximately $15 ($2,000,000 ÷ 131,040) of contingent consideration as revenue per R&D hour incurred related to the first milestone event. Biotech would also recognize approximately $23 ($3,000,000 ÷ 131,040) of contingent consideration as revenue per R&D hour incurred related to the second milestone event. However, because the amount of contingent consideration to be recognized as revenue for any period would be limited to the nonrefundable contingent fees, Biotech is precluded from recognizing any consideration on the first and second milestone until they are achieved. For example, at the time the second milestone is achieved, Biotech would recognize a catch-up for consideration not recognized in Years 1–3 because of the limitation.

**Evaluation – View D**

Because Biotech recognizes its fixed or determinable fees over R&D hours, the non-substantive contingent consideration under View D would also be recognized based on estimated total R&D hours to be incurred over the life of the arrangement. As a result, Biotech would recognize $15 ($2,000,000 ÷ 131,040) of contingent consideration as revenue per R&D hour incurred. However, the amount of contingent consideration to be recognized as revenue for any period would be limited to the nonrefundable contingent fees. In addition, when and if Biotech achieves a substantive milestone event, it would recognize the full amount of the associated fee in the period the event was achieved.

**Summary**

The following is a summary of how the contingent consideration is recognized as revenue under Views A – D:
<table>
<thead>
<tr>
<th>Contingent:</th>
<th>View A</th>
<th>View B</th>
<th>View C</th>
<th>View D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year 1</td>
<td>$ 1,428,571</td>
<td>$ 813,187</td>
<td>$ 285,714</td>
<td>$ 285,714</td>
</tr>
<tr>
<td>Year 2</td>
<td>571,429</td>
<td>197,802</td>
<td>285,714</td>
<td>285,714</td>
</tr>
<tr>
<td>Year 3</td>
<td></td>
<td>197,802</td>
<td>285,714</td>
<td>285,714</td>
</tr>
<tr>
<td>Year 4</td>
<td>3,000,000</td>
<td>2,407,261</td>
<td>2,000,000</td>
<td>3,285,714</td>
</tr>
<tr>
<td>Year 5</td>
<td></td>
<td>461,316</td>
<td>714,286</td>
<td>285,714</td>
</tr>
<tr>
<td>Year 6</td>
<td></td>
<td>461,316</td>
<td>714,286</td>
<td>285,714</td>
</tr>
<tr>
<td>Year 7</td>
<td></td>
<td>461,316</td>
<td>714,286</td>
<td>285,716</td>
</tr>
<tr>
<td>Total</td>
<td>$ 5,000,000</td>
<td>$ 5,000,000</td>
<td>$ 5,000,000</td>
<td>$ 5,000,000</td>
</tr>
</tbody>
</table>