US GAAP—Issues and solutions for pharmaceutical and life sciences

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About the US GAAP—Issues and solutions for pharmaceutical and life sciences guide

This publication summarizes pertinent accounting solutions for the pharmaceutical, life sciences and medical device industry and highlights how industry-specific factors should be considered in relation to the authoritative literature. Because the accounting and financial reporting for specific transactions will reflect each company's specific facts and circumstances, we cannot address every nuance in this publication. For example, the structure in licensing, manufacturing, and research and development arrangements leads to variations in contracts, corporate structures, and accounting requirements. Therefore, the solutions we present are meant to provide a general framework for determining the appropriate accounting for situations that are commonly encountered in the industry; however, individual facts and circumstances may give rise to a different answer. The contents of this publication are based on guidance that is effective as of January 1, 2024. Therefore, whenever considering the solutions contained in the publication in future periods, it is important to keep in mind that the accounting guidance may have been superseded.

Revisions made in June 2024

For a list of key changes made since the 2019 version, refer to appendix A and appendix B.

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Chapter 1: Capitalization & impairment

FAQ

1-1 Accounting for internal development costs—Scenario 1

Background

Company A is developing a vaccine for HIV that was successful during Phases I and II testing. The drug is now in Phase III of testing. Management still has concerns about securing regulatory approval and has not started commercially manufacturing or marketing the vaccine.

Question:

How should management account for research and development costs incurred related to this project?

Solution

Costs to perform research and development, including internal development costs, should be expensed as incurred.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

1-2 Accounting for internal development costs—Scenario 2

Background

A pharmaceutical entity is developing a vaccine for HIV that was successful during Phases I and II of testing. The drug is now in the late stages of Phase III testing. It is structurally similar to drugs the entity has successfully developed in the past with very low levels of side effects, and management believes it will be favorably treated by the regulatory authority because it meets a currently unmet clinical need.

Question:

Should management start capitalizing the development costs?

Solution

No. Costs to perform research and development, including internal development costs, should be expensed as incurred, regardless of past history with similar drugs or regulatory approval expectations.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

1-3 Accounting for internal development costs when regulatory approval has been obtained in a similar market

Background

An entity has obtained regulatory approval for a new respiratory drug in Country A. It is now progressing through the additional development procedures necessary to gain approval in Country B.

Management believes that achieving regulatory approval in Country B is a formality. Mutual recognition treaties and past experience show that Country B's authorities rarely refuse approval for a new drug that has been approved in Country A.

Question:

Should the development costs associated with the additional development procedures necessary to gain approval in Country B be capitalized?

Solution

No. The development costs should be expensed as incurred, regardless of the probability of success and history.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred…

1-4 Accounting for development costs related to generics

Background

An entity is developing a generic version of a painkiller that has been sold in the market by another company for many years. The technological feasibility of the drug has already been established because it is a generic version of a product that has already been approved, and its chemical equivalence has been demonstrated. The scientific and regulatory experts advising the entity do not anticipate any significant difficulties in obtaining commercial regulatory approval.

Question:

Should management capitalize the costs incurred to develop a generic version of an approved product?

Solution

No. Research and development costs should be expensed when incurred, regardless of whether there is a similar product that is already approved.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

1-5 Accounting for sales and marketing costs related to an approved product

Background

Company A has obtained regulatory approval for a new respiratory drug and is now incurring costs to educate its sales force and perform market research.

Question:

Should Company A capitalize these costs?

Solution

No, Company A should recognize these costs as sales and marketing expenses as incurred, regardless of whether regulatory approval has been obtained for the product. These costs are not within the scope of research and development expenses per ASC 730-10-15-4.

Relevant guidance

ASC 730-10-15-4: The guidance in this Topic does not apply to the following transactions and activities…

e. Market research or market testing activities…

1-6 Accounting for internal development costs to add new functionality to an approved product

Background

Company A has developed a vaccine delivery device that has received regulatory approval. Company A is incurring costs to add new functionality to the existing device. The additional functionality will require Company A to receive regulatory approval prior to selling the enhanced device.

Question:

Should Company A capitalize these development costs?

Solution

No. Company A should expense the costs of adding new functionality as incurred as these costs are research and development expenditures.

Relevant guidance

ASC 730-10-15-3: The guidance in the Research and Development Topic applies to the following transactions and activities:

a. Those activities aimed at developing or significantly improving a product or service (referred to as product) or a process or technique (referred to as process) whether the product or process is intended for sale or use...

ASC 730-10-55-1: The following activities typically would be considered research and development within the scope of this Topic (unless conducted for others under a contractual arrangement—see paragraph 730-10-15-4[a])…

d. Testing in search for or evaluation of product or process alternatives

e. Modification of the formulation or design of a product or process…

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

1-7 Development of alternative indications

Background

Company A markets a drug approved for use as a painkiller. Recent information shows the drug may also be effective in the treatment of rheumatoid arthritis. Company A has commenced additional development procedures necessary to gain approval to market the drug for this indication.

Question:

Should Company A capitalize the development costs relating to alternative indications?

Solution

No. The internal development costs are research and development costs that should be expensed as incurred.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

1-8 In license of a compound

Background

Company A acquired a license to the intellectual property (IP) rights (an "in-license") to a compound for $5 million on January 1, 20X7. The compound is currently under development and there is no alternative future use for the IP. The acquired asset does not constitute a business. Company A expects to receive regulatory and marketing approval on March 1, 20X8 and plans to start using the compound in its production process on June 1, 20X8.

Question:

How should Company A account for the in-license of the compound?

Solution

Because the license to the compound was acquired prior to regulatory approval, the payment would be expensed as research and development costs (since there is no alternative future use and the acquired asset does not constitute a business).

If the license to the compound had been acquired after regulatory approval, Company A would have capitalized the intangible asset and amortized it over its estimated useful life (through cost of sales). Company A would have begun amortizing the intangible asset on the date it was available for its expected use, which would generally be the acquisition date for an approved compound.

Relevant guidance

ASC 730-10-25-2(c): Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350 [Intangibles—Goodwill and Other]. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

ASC 350-30-35-2: The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity...

ASC 350-30-35-6: ...The method of amortization shall reflect the pattern in which the economic benefits of the intangible asset are consumed or otherwise used up. If that pattern cannot be readily determined, a straight-line amortization method shall be used.

1-9 Accounting for a payment upon regulatory approval

Background

Company A acquired IP rights to a drug compound for an upfront cash payment of $25 million and agrees to make a one-time payment of $20 million if and when regulatory approval is obtained. The compound is currently under development and there is no alternative future use for the IP. The acquired asset does not constitute a business. Because the drug compound was acquired prior to regulatory approval, the upfront cash payment of $25 million was expensed as research and development costs. In assessing the $20 million milestone payment upon regulatory approval, at acquisition, Company A did not believe the amounts were probable, and therefore did not expense those contingent payments.

Question:

How should Company A account for the $20 million approval payment?

Solution

Assuming that the arrangement does not fall within the scope of the derivative guidance, Company A would recognize the $20 million approval payment when the achievement of the milestone is probable and reasonably estimable (which would likely be upon regulatory approval). The obligation to make the milestone payment, while contingent on regulatory approval, is established on the date the agreement to make the payment is entered into. Accordingly, at that date, it is a contractual contingent obligation, based on having received the intellectual property license rights.

Assuming the cost is recoverable based on expected future cash flows, Company A would capitalize the $20 million payment upon regulatory approval as an intangible asset because the payment relates to what is now an approved compound. Company A would amortize the intangible assets (through cost of sales) over the estimated useful life of the IP beginning on the date the asset is available for its intended use, which would generally be the regulatory approval date.

Relevant guidance

As described in section 2.3.3 of PwC's Property, plant, equipment and other assets guide, there is no specific guidance within ASC 805-50 for the recognition and measurement of contingent consideration obligations in an asset acquisition. We believe that contingent consideration in an asset acquisition that is not accounted for under other US GAAP (e.g., as a derivative under ASC 815) should be recognized when probable and reasonably estimable, by analogy to ASC 450-20.

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued... indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

b. The amount of loss can be reasonably estimated...

ASC 730-10-25-2(c): Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350 [Intangibles—Goodwill and Other]. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

ASC 350-30-20: Intangible Assets—Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill).

ASC 350-30-35-1: The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life shall be amortized; an intangible asset with an indefinite useful life shall not be amortized.

ASC 350-30-35-2: The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity...

1-10 Accounting for a sales-based milestone payment

Background

Company A acquires the intellectual property rights to one of Company B's approved compounds for an upfront cash payment of $15 million and agrees to make an additional one-time sales-based milestone payment of $10 million if and when sales for the related product in any one year reach a specified sales target. Company A has determined that the transaction does not constitute a business combination and, therefore, will account for it as an asset acquisition. The sales-based milestone payment, if made, does not entitle Company A to additional intellectual property rights beyond those already obtained in the initial asset acquisition.

Company A capitalizes the $15 million payment made to acquire the IP rights since the rights relate to an approved compound and the cost is considered recoverable based on expected future cash flows. In assessing the sales-based milestone, at acquisition, Company A did not believe the amounts were probable, and therefore did not capitalize those contingent payments. The useful life of the intellectual property rights is 15 years and Company A begins amortizing $1 million per year. At the end of the third year, following a significant uptick in sales of the product, it becomes probable that the specified sales level will be met the following year.

Question:

How should Company A account for the $10 million sales-based milestone payment?

Solution

Assuming that the arrangement does not fall within the scope of the derivatives guidance, Company A should accrue the milestone payment when the achievement of the milestone is probable and reasonably estimable. The obligation to make the milestone payment, while contingent on the company reaching a specified sales level, is considered to be established on the date the agreement to make the payment is entered into. Accordingly, at that date, it is a contractual contingent obligation, based on having received the intellectual property license rights. In this case, Company A would accrue the milestone obligation when it becomes probable that the payment will be made. The amount of the payment is reasonably estimable, as it is a fixed amount under the terms of the arrangement once the sales target has been achieved.

After it is accrued, Company A will need to consider the economics of the arrangement to determine the expense recognition pattern. Because $25 million is the total consideration paid for the intellectual property rights, it would be appropriate to adjust the carrying value of the intellectual property rights on a cumulative catch-up basis as if the additional amount had been accrued from the outset of the arrangement. Accordingly, Company A would immediately expense 20% (3 out of 15 years) or $2 million of the $10 million sales-based milestone and capitalize the remainder of the payment. At the end of the third year, Company A would have expensed an aggregate of $5 million, with $20 million remaining capitalized on the balance sheet.

Alternatively, if the economics of the arrangement were such that the payment appeared to be the equivalent of an additional royalty that is paid annually, it may be appropriate to expense the entire $10 million over a 1-year period. This might be the case, for example, if there were similar sales-based milestone targets in each year of the arrangement.

Amortizing the entire $10 million payment prospectively over the 12 remaining years in the life of the IP would only potentially be supportable if the payment was in exchange for additional intellectual property rights under the arrangement.

Relevant guidance

As described in section 2.3.3 of PwC's Property, plant, equipment and other assets guide, there is no specific guidance within ASC 805-50 for the recognition and measurement of contingent consideration obligations in an asset acquisition. We believe that contingent consideration in an asset acquisition that is not accounted for under other US GAAP (e.g., as a derivative under ASC 815) should be recognized when probable and reasonably estimable, by analogy to ASC 450-20.

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued… indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

b. The amount of loss can be reasonably estimated...

1-11 Indefinite-lived intangible assets

Background

Management of a pharmaceutical entity has acquired an intangible asset that it believes to have an indefinite useful life.

Question:

How should management account for the acquired intangible asset?

Solution

If none of the factors in ASC 350-30-35-4 limit its useful life, the asset should be considered to have an indefinite life. The asset would not be amortized, but would be tested for impairment annually and whenever there is an indication that the intangible asset may be impaired.

Pharmaceutical intangible assets that might be regarded as having an indefinite life could include acquired brands (e.g., over-the-counter products) or generic products. The limited life of patents means that prescription pharmaceutical products and medical devices generally would not have indefinite lives.

Relevant guidance

ASC 350-30-35-4: If no legal, regulatory, contractual, competitive, economic or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite. The term indefinite does not mean the same as infinite or indeterminate. The useful life of an intangible asset is indefinite if that life extends beyond the foreseeable horizon—that is, there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity...

ASC 350-30-35-15: If an intangible asset is determined to have an indefinite useful life, it shall not be amortized until its useful life is determined to be no longer indefinite.

ASC 350-30-35-16: An entity shall evaluate the remaining useful life of an intangible asset that is not being amortized each reporting period to determine whether events and circumstances continue to support an indefinite useful life.

ASC 350-30-35-18: An intangible asset that is not subject to amortization shall be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.

1-12 Indicators of impairment for intangibles

Background

Company A has capitalized the cost of acquiring the license rights to a product that has recently received regulatory approval on November 30, 20x9. Company A has plans to begin selling this product in six months.

Question:

What indicators of impairment should management consider at December 31, 20x9?

Solution

ASC 360-10-35-21 provides several examples of events or changes in circumstances that management should consider when assessing whether an intangible asset should be tested for impairment. Some of the events or changes in circumstances include: a significant decrease in the market price of the long-lived asset, a significant adverse change in the manner in which the asset is used or a significant adverse legal event.

Management of pharmaceutical and life sciences entities should also consider the following common industry-specific indicators, including:

- Development of a competing drug
- Changes in the legal framework covering patents, rights or licenses
- Ongoing evaluation of data that may call into question the drug's safety and/or efficacy
- Advances in medicine and/or technology that affect the medical treatments
- A pattern of lower than predicted sales
- A change in the economic lives of similar assets
- Relationship with other intangible or tangible assets
- Changes or anticipated changes in reimbursement policies of public and private insurance programs

Relevant guidance

ASC 350-30-35-14: An intangible asset that is subject to amortization shall be reviewed for impairment in accordance with the Impairment or Disposal of Long-Lived Assets Subsections of Subtopic ASC 360-10 by applying the recognition and measurement provisions in paragraphs 360-10-35-17 through 35-35...

ASC 360-10-35-17: An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use... or under development... An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

ASC 360-10-35-21: A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable...

1-13 Indicators of impairment for property, plant and equipment

Background

Company A announced a withdrawal of a marketed product due to unfavorable post-approval Phase IV study results. Company A informed healthcare authorities that patients should no longer be treated with this product. Company A has an asset group that is comprised primarily of the property, plant and equipment dedicated to the production of the terminated product which has no future alternative use.

Question:

What impairment indicators should Company A consider?

Solution

Company A should consider the general indicators given in ASC 360-10-35-21 when assessing whether there is an impairment of the asset group comprised of the property, plant and equipment. In addition, pharmaceutical and life sciences entities should consider the following common industry-specific factors:

- Patent expiry date
- Failure of the machinery to meet regulatory requirements
- Technical obsolescence of the property, plant and equipment (for example, because it cannot accommodate new market preferences)
- Changes in medical treatments
- Market entrance of competitive products
- Declining sales (e.g., due to market demand, a product recall)
- Changes or anticipated changes in third-party reimbursement policies that will impact the sale of product manufactured by the property, plant and equipment

Based on Company A's determination that the property, plant and equipment dedicated to the production of the terminated product cannot be repurposed for other use, the long-lived asset group is likely impaired.

Relevant guidance

ASC 360-10-35-21: A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable...

1-14 Single market impairment

Background

Company A acquired the rights to market a topical fungicide cream in Europe. The acquired rights apply broadly to the entire territory and, as such, Company A determined that it resided in a single asset group for purposes of impairment considerations. For unknown reasons, patients in Country X prove far more likely to develop blisters from use of the cream, causing Company A to withdraw the product from that country. As fungicide sales in Country X were not expected to be significant, the loss of the territory, taken in isolation, does not cause the recoverable value of the drug in other countries to be less than its carrying value.

Question:

What is the impact of the withdrawal from Country X on Company A's impairment analysis?

Solution

Company A acquired the rights to market the fungicide cream over a broad territory and not specifically in Country X. Company A determined the European territory as a whole represented one asset group for the entire territory since this would likely represent the lowest level of identifiable cash flows for testing impairment of the marketing rights. Because revenues from product sales in Country X were not significant, the withdrawal of the product from Country X would generally not be considered an event that would trigger the need for an interim impairment analysis. However, Company A should carefully consider whether the development of blisters in patients in Country X is indicative of potential problems in other territories.

If the issue cannot be isolated, the withdrawal in Country X could be a triggering event and a broader impairment analysis should be performed, including the consideration of the potential for more wide-ranging decreases in sales.

Relevant guidance

ASC 360-10-35-21: A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable...

ASC 360-10-35-17: An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use... or under development... An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

ASC 360-10-35-23: For purposes of recognition and measurement of an impairment loss, long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities...

1-15 Impairment testing and useful life

Background

Company A has a major production line that produces its blockbuster antidepressant. The production line has no alternative use. A competitor launches a new antidepressant with better efficacy. Company A expects sales of its drug to drop rapidly and significantly. Although positive margins are forecasted to continue, Company A identifies this as an indicator of impairment. As a result of the new competition, Company A may exit the market for this drug.

Question:

How should Company A assess the impairment and useful lives of long-lived assets when impairment indicators have been identified?

Solution

Assuming that the antidepressant asset group represents the lowest level of identifiable cash flows, Company A should evaluate the carrying amount of the antidepressant's asset group (including the production line) relative to its future undiscounted cash flows. An impairment loss should be recognized if the carrying amount of the antidepressant's asset group exceeds the future undiscounted cash flows. The resulting impairment would be based on the difference between the carrying amount of the asset group and its fair value.

Company A should revise the estimated useful life of the affected assets after the impairment analysis is performed based on the estimated period it expects to obtain economic benefit from the assets. After recognizing the impairment and revising the estimated useful life for the affected assets, Company A would continue to amortize the remainder of the asset over its expected useful life. However, regardless of whether there is an impairment recognized as a result of the impairment analysis, Company A should assess the useful life of the assets based on the estimated period it expects to obtain economic benefit from the assets and revise the useful life as necessary.

Relevant guidance

ASC 360-10-35-21: A long-lived asset (asset group) shall be tested for recoverability whenever events or changes in circumstances indicate that its carrying amount may not be recoverable...

ASC 360-10-35-17: An impairment loss shall be recognized only if the carrying amount of a long-lived asset (asset group) is not recoverable and exceeds its fair value. The carrying amount of a long-lived asset (asset group) is not recoverable if it exceeds the sum of the undiscounted cash flows expected to result from the use and eventual disposition of the asset (asset group). That assessment shall be based on the carrying amount of the asset (asset group) at the date it is tested for recoverability, whether in use... or under development... An impairment loss shall be measured as the amount by which the carrying amount of a long-lived asset (asset group) exceeds its fair value.

ASC 360-10-35-22: When a long-lived asset (asset group) is tested for recoverability, it also may be necessary to review depreciation estimates and method… or the amortization period… Any revision to the remaining useful life of a long-lived asset resulting from that review also shall be considered in developing estimates of future cash flows used to test the asset (asset group) for recoverability…

ASC 360-10-35-20: If an impairment loss is recognized, the adjusted carrying amount of a long-lived asset shall be its new cost basis. For a depreciable long-lived asset, the new cost basis shall be depreciated (amortized) over the remaining useful life of that asset. Restoration of a previously recognized impairment loss is prohibited.

1-16 Exchange of intangible assets when control of the nonfinancial asset is not transferred

Background

Company A is developing a hepatitis vaccine compound. Company B is developing a measles vaccine compound. Company A and Company B enter into a purchase and sale agreement to exchange the two products. The exchange of products will not involve the transfer of legal entity ownership interests. Company A retains an option to repurchase the hepatitis vaccine. As such, Company A will not lose and Company B will not gain control of the hepatitis vaccine compound. The fair value at contract inception of Company B's compound is $3 million. The carrying value of Company A's compound was zero, as it was internally developed.

Question:

How should Company A account for the swap of vaccine compounds, assuming that the transaction has commercial substance?

Solution

Given Company A can repurchase the hepatitis vaccine (i.e., via the call option), Company A would not recognize a gain or loss on the transaction as control has not transferred to Company B (as defined in ASC 606-10-25-30(c)).

Company A would evaluate the exercise price for the option to determine the accounting treatment. If the exercise price is greater than or equal to the original consideration received for the hepatitis vaccine (i.e., the $3 million fair value of the measles vaccine), Company A would recognize a financing arrangement. If the exercise price was less than the original consideration, Company A would recognize the arrangement as a lease under ASC 842. The accounting for repurchase arrangements associated with transfers of nonfinancial assets can be complex. Refer to PwC's Property, plant and equipment guide, Section 6.2.4.4 for further details.

Relevant guidance

ASC 610-20-25-6: Once a contract meets all of the criteria in paragraph 606-10-25-1, an entity shall identify each distinct nonfinancial asset and distinct in substance nonfinancial asset promised to a counterparty in accordance with the guidance in paragraphs 606-10-25-19 through 25-22. An entity shall derecognize each distinct asset when it transfers control of the asset in accordance with paragraph 606-10-25-30.

ASC 606-10-32-21: To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception.

ASC 606-10-25-30: If a performance obligation is not satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity satisfies the performance obligation at a point in time. To determine the point in time at which a customer obtains control of a promised asset and the entity satisfies a performance obligation, the entity shall consider the guidance on control in paragraphs 606-10-25-23 through 25-26. In addition, an entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

c. The entity has transferred physical possession of the asset—The customer's physical possession of an asset may indicate that the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset or to restrict the access of other entities to those benefits. However, physical possession may not coincide with control of an asset. For example, in some repurchase agreements and in some consignment arrangements, a customer or consignee may have physical possession of an asset that the entity controls. Conversely, in some bill-and-hold arrangements, the entity may have physical possession of an asset that the customer controls. Paragraphs 606-10-55-66 through 55-78, 606-10-55-79 through 55-80, and 606-10-55-81 through 55-84 provide guidance on accounting for repurchase agreements, consignment arrangements, and bill-and-hold arrangements, respectively.

ASC 606-10-55-66: A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

A 606-10-55-68: If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:

a. A lease in accordance with Topic 842 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset unless the contract is part of a sale-leaseback transaction. If the contract is part of a sale-leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale-leaseback in accordance with Subtopic 842-40.

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

1-17 Accounting for priority review vouchers

Background

Under the priority review voucher program, developers are "rewarded" for developing treatments for certain neglected or rare pediatric diseases. Following, and contingent upon, the treatment's approval by the Food and Drug Administration (FDA), the developer receives a voucher for priority review (priority review voucher or PRV) for a future drug candidate. A PRV provides the developer an expedited review by the FDA for a future drug candidate. A PRV can be transferred to an unrelated third party, to which it would afford the same benefits.

During 20X1, Company B received a PRV from the FDA concurrent with the successful internal development of a drug that treats a rare disease. On January 1, 20X3, Company A acquires the PRV from Company B for $110 million.

Question:

How should (1) Company B account for initial receipt of the PRV from the FDA, (2) Company B account for the subsequent sale of the PRV to Company A, and (3) Company A account for the subsequent purchase of the PRV from Company B?

Solution

(1) Company B's accounting for the initial receipt of the PRV from the FDA

When Company B receives the PRV from the FDA, it does not make any payments or incur any incremental costs related to the asset. Accordingly, Company B would measure and record the PRV asset at zero value on the date it is received.

(2) Company B's accounting for subsequent sale of the PRV to Company A

When the PRV is sold to Company A, Company B will recognize a gain on sale. The sale of the PRV asset generally should not be presented as revenue by Company B because the selling of PRVs would not represent a vendor / customer relationship and PRVs are not likely outputs of Company B's ordinary activities. Other than for the sale of long-lived assets, there is no explicit guidance under US GAAP on the income statement presentation of gains from the sale of nonfinancial assets.

As such, Company B should consider the nature of the gain in the context of its business model and financial reporting model in assessing the appropriate presentation of the gain.

(3) Company A's accounting for the subsequent purchase of the PRV from Company B

On January 1, 20X9, Company A should recognize the PRV asset at its cost of $110 million. Since the PRV has an alternative future use (specifically Company A can sell the PRV to another third party) and no specified term, it would be deemed to be an indefinite-lived intangible asset. Subsequent to the acquisition, Company A would test the PRV asset for impairment annually, or more frequently if events or changes in circumstances indicate that the indefinite-lived asset might be impaired.

When Company A commits to using the PRV to accelerate the FDA's review of its own drug candidate, the carrying amount of the PRV should be expensed as research and development. At that point, the PRV no longer has an alternative future use (i.e., the PRV is no longer available to be sold to another party and the drug for which it is used is not yet approved).

Alternatively, if Company A resells the PRV to another third party, the accounting would be the same as when

Company B sold the asset. The carrying amount of the PRV asset would be derecognized and any difference between the carrying amount and the proceeds received would be recognized as a gain or loss in the income statement.

Relevant guidance

ASC 730-20-25-13: Non-refundable advance payments for goods or services that have the characteristics that will be used or rendered for future research and development activities pursuant to an executory contractual arrangement shall be deferred and capitalized...

ASC 730-10-25-2(c): Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350, [Intangibles—Goodwill and Other]. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

ASC 350-30-20: Intangible Assets—Assets (not including financial assets) that lack physical substance. (The term intangible assets is used to refer to intangible assets other than goodwill.)

ASC 350-30-35-1: The accounting for a recognized intangible asset is based on its useful life to the reporting entity. An intangible asset with a finite useful life shall be amortized; an intangible asset with an indefinite useful life shall not be amortized.

ASC 350-30-35-18: An intangible asset that is not subject to amortization shall be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.

610-20-15-2: Except as described in paragraph 610-20-15-4, the guidance in this Subtopic applies to gains or losses recognized upon the derecognition of nonfinancial assets and in substance nonfinancial assets. Nonfinancial assets within the scope of this Subtopic include intangible assets, land, buildings, or materials and supplies and may have a zero carrying value. In substance nonfinancial assets are described in paragraphs 610-20-15-5 through 15-8.

610-20-32-2: When an entity meets the criteria to derecognize a distinct nonfinancial asset or a distinct in substance nonfinancial asset, it shall recognize a gain or loss for the difference between the amount of consideration measured and allocated to that distinct asset in accordance with paragraphs 610-20-32-3 through 32-6 and the carrying amount of the distinct asset. The amount of consideration promised in a contract that is included in the calculation of a gain or loss includes both the transaction price and the carrying amount of liabilities assumed or relieved by a counterparty.

ASC 606-10-20 definition of revenue: Inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.

ASC 606-10-20 definition of a customer: A party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

Chapter 2: Settlements for patent infringement litigation and other disputes

FAQ

2-1 Accounting for settlement payments for patent infringement

Background

Company A files a patent infringement lawsuit against Company B, alleging Company B has been selling Product Y that uses Company A's intellectual property (IP). Company B has commercially sold Product Y for the past 2 years.

Company A and Company B agree to settle the dispute. In accordance with the settlement, Company B agrees to make a nonrefundable upfront payment of $80 million and pay 5% royalties on future sales of Product Y in exchange for a non-exclusive license to use Company A's IP for 10 years and a release of any claims of infringement.

Question:

How should Company B account for the amounts paid to settle the patent infringement dispute?

Solution

Since Company B obtains a license to use Company A's IP prospectively and is released of any claims of infringement as part of the settlement, Company B concludes that the settlement agreement includes multiple components: (1) a non-exclusive license to use Company A's IP prospectively and (2) settlement for Company B's prior use of Company A's IP over a two-year period.

The nonrefundable upfront payment of $80 million is allocated to the components on a relative fair value basis. The components are then recognized based on the relevant guidance for each component.

Company B determines that the fair value of the non-exclusive license to use Company A's IP prospectively is $50 million plus 5% royalties. Additionally, Company B determines the fair value of Company B's prior use of Company A's IP is $30 million, calculated based on the fair value of royalties Company B otherwise would have owed to Company A if a license had been granted.

The $50 million allocated to the non-exclusive license to use Company A's IP is an acquired intangible asset capitalized on the balance sheet and amortized over its useful life. Additionally, because the $50 million plus 5% royalties approximate a market rate when acquiring a license to use similar IP, Company B allocates the 5% royalties entirely to the non-exclusive license to use Company A's IP as contingent consideration for an asset acquisition, which will be recognized when probable and reasonably estimable. The $30 million related to prior royalties that would have otherwise been payable to Company A to use its IP is expensed immediately.

In this fact pattern, the settlement does not include payments for damages or other components because Company B settles the infringement and obtains rights to use the intellectual property at market rates. However, in addition to rights to use the IP, a settlement may also include other components, such as damages (punitive or otherwise). If the settlement includes multiple components, the reporting entity should generally recognize the settlement payments based on the guidance applicable to each component. Determining the fair value of certain components of a settlement may be challenging, and thus, using a residual approach may be appropriate if a reporting entity concludes it cannot reliably estimate the fair value of such components.

Relevant guidance

ASC 350-30-25-1: An intangible asset that is acquired either individually or with a group of other assets shall be recognized.

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.

b. The amount of loss can be reasonably estimated.

ASC 805-10-55-21: If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

a. For a preexisting noncontractual relationship, such as a lawsuit, fair value

b. For a preexisting contractual relationship, the lesser of the following:

    1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.

    2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

2-2 Accounting for settlement payments to a customer

Background

Company A, a contract research organization, has a contract with Company B, its customer, to provide services to conduct Company B's clinical trial for its Phase II Drug Candidate. During the contract term, Company B alleges Company A did not follow certain contractually specified protocols for the clinical trial, resulting in $7.5 million of inappropriate billings to Company B.

In order to avoid the cost of litigation, Company A and Company B agree to settle the dispute and terminate their relationship. As part of the settlement, Company A will pay Company B a lump sum of $10 million in cash, and all existing contracts between the parties terminate (i.e., neither party has any ongoing responsibilities to perform or pay).

Question:

How should Company A account for the settlement?

Solution

The $10 million payment to Company B is consideration payable to Company A's customer, and thus, it is accounted for based on the guidance in ASC 606. Because Company A receives no distinct good or service from Company B in exchange for the $10 million payment, Company A accounts for the settlement payment as a reduction of revenue. Since the parties agree to terminate their existing contracts, the settlement relates entirely to past performance and therefore represents a price concession related to prior transactions. As such, Company A recognizes the $10 million payment to Company B immediately as a reduction of revenue.

In an alternative scenario where the settlement payment represents an incentive for Company B to enter into a new contract for future goods or services, Company A would consider whether it is appropriate to recognize all or a portion of the settlement amount as a reduction of revenue as the future goods or services are provided to Company B.

Additionally, for a settlement payment that relates to a contract in process, Company A should evaluate the change in price as a contract modification and determine whether a portion of the change in price should be accounted for separately from the contract modification. For example, a portion of the price change, such as $7.5 million of the total $10 million payment, may represent a refund that should be accounted for separately and recognized immediately as a reduction of revenue because it is an adjustment to the transaction price of the previously transferred goods.

Relevant guidance

ASC 606-10-32-25: Consideration payable to a customer includes:

a. Cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer)

b. Credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer)

c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13 .

ASC 606-10-32-27: Accordingly, if consideration payable to a customer is accounted for as a reduction of the transaction price, an entity shall recognize the reduction of revenue when (or as) the later of either of the following events occurs:

a. The entity recognizes revenue for the transfer of the related goods or services to the customer.

b. The entity pays or promises to pay the consideration (even if the payment is conditional on a future event). That promise might be implied by the entity's customary business practices.

2-3 Accounting for patent-related costs

Background

Company A has filed a number of patent applications and has incurred external legal and related costs in connection with the applications. Company A has also incurred legal costs in defense of its patents.

Question:

Should legal costs relating to the patent applications and defense of patents be capitalized?

Solution

Legal fees incurred relating to patent applications or litigation do not meet the definition of R&D costs.

However, determining whether to capitalize or expense patent application or patent defense costs involves judgment. Legal costs of applying for a patent as well as the costs of defending existing patents may, in theory, be capitalizable, as discussed below. However, in practice, given the uncertainty of successfully commercializing intellectual property that is still subject to ongoing research and development, patent application costs are expensed as incurred.

To capitalize patent application costs, the patented intellectual property must be probable of providing a future economic benefit to Company A; otherwise, the costs would be expensed as incurred. For example, if Company A's product is in the research and development phase and has not yet been approved for commercialization, the costs incurred in connection with the patent application should generally be expensed in the income statement because there is uncertainty as to the product's ability to produce a future economic benefit. If, on the other hand, a future economic benefit—e.g., commercial sales of products employing the intellectual property or another alternative future use, the patent application costs could be capitalized.

External legal costs to defend an existing patent can be capitalized when (1) a successful defense of the patent is probable and (2) the future economic benefit of the patent is expected to increase as a result of that successful defense. When the defense of the patent only maintains (rather than increases) its expected future economic benefit, the external legal costs would be expensed as incurred. Costs to defend allegations of infringement against other parties' patents are generally not in the defense of a company's own patents and would be expensed as incurred.

Relevant guidance

ASC 730-10-55-2: The following activities typically would not be considered research and development within the scope of this Topic:

(i). Legal work in connection with patent applications or litigation, and the sale or licensing of patents...

Chapter 3: Manufacturing & supply

FAQ

3-1 Accounting for costs to validate new machinery

Background

A laboratory has just completed the development of a new machine to mix components at a specified temperature to create a new formulation of aspirin. The laboratory produces several batches of the aspirin using the new machinery in order to obtain validation (approval for the use of the machine) from the relevant regulatory authorities. The validation of the machinery is a separate process from the regulatory approval of the new formulation of aspirin.

Question:

Should the expenditures to validate the machinery be capitalized?

Solution

Because validation is required to bring the machinery to its working condition, the laboratory should capitalize the costs incurred (including materials, labor, and applicable overhead) to obtain the necessary validation, together with the cost of the machinery. If, at some later date, the machinery requires revalidation, any costs incurred related to the revalidation process would be expensed as incurred akin to repairs and maintenance costs as the asset had already been prepared for its original intended use and revalidating the machinery does not increase the operating capacity of the machinery or extend its useful life.

Relevant guidance

ASC 360-10-30-1: Paragraph 835-20-05-1 states that the historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use. As indicated in that paragraph, if an asset requires a period of time in which to carry out the activities necessary to bring it to that condition and location, the interest cost incurred during that period as a result of expenditures for the asset is a part of the historical cost of acquiring the asset.

ASC 360-10-30-2: See the glossary for a definition of activities necessary to bring an asset to the condition and location necessary for its intended use.

FASB Master Glossary definition of “Activities”: The term activities is to be construed broadly. It encompasses physical construction of the asset. In addition, it includes all the steps required to prepare the asset for its intended use. For example, it includes administrative and technical activities during the preconstruction stage, such as the development of plans or the process of obtaining permits from governmental authorities. It also includes activities undertaken after construction has begun in order to overcome unforeseen obstacles, such as technical problems, labor disputes, or litigation.

3-2 Treatment of supplies used in development process

Background

A laboratory has purchased 10,000 batches of saline solution. These batches are used in trials on patients during various Phase III clinical tests. They can also be used as supplies for other testing purposes, but have no other uses (i.e., the laboratory has no intention to sell the batches in the future).

Question:

Should supplies used in clinical testing be accounted for as inventory, an other asset or research and development expense?

Solution

While in this fact pattern the saline batches do not meet any of the three characteristics of inventory in the definition in ASC 330-10-20—i.e., they are not held for sale, in process of production for sale, or consumed in the production of goods to be sold—they have the characteristics of supplies, which the definition of inventory in ASC 330-10-20 acknowledges may, in practice, be classified as inventory. The saline batches meet the conceptual definition of an asset since they have alternative future uses in other development projects and, notwithstanding the laboratory's intent not to sell them, the batches could be sold to another party for its use. Therefore, the cost of the saline batches should be recognized as an asset—supplies or another current asset. As batches are used, the cost of the batches consumed would be charged to research and development expense.

Relevant guidance

ASC 330-10-20, Inventory: The aggregate of those items of tangible personal property that have any of the following characteristics:

a. Held for sale in the ordinary course of business

b. In process of production for such sale

c. To be currently consumed in the production of goods or services to be available for sale.

The term inventory embraces goods awaiting sale (the merchandise of a trading concern and the finished goods of a manufacturer), goods in the course of production (work in process), and goods to be consumed directly or indirectly in production (raw materials and supplies). This definition of inventories excludes long-term assets subject to depreciation accounting, or goods which, when put into use, will be so classified. The fact that a depreciable asset is retired from regular use and held for sale does not indicate that the item should be classified as part of the inventory. Raw materials and supplies purchased for production may be used or consumed for the construction of long-term assets or other purposes not related to production, but the fact that inventory items representing a small portion of the total may not be absorbed ultimately in the production process does not require separate classification. By trade practice, operating materials and supplies of certain types of entities such as oil producers are usually treated as inventory.

ASC 730-10-25-2(a): Materials, equipment, and facilities. The costs of materials (whether from the entity's normal inventory or acquired specially for research and development activities) and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. The cost of such materials consumed in research and development activities and the depreciation of such equipment or facilities used in those activities are research and development costs. However, the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred...

3-3 Accounting for demonstration equipment

Background

Company A, a medical device manufacturer, provides its sales representatives with demonstration equipment that can be loaned to potential customers for a period of time before sale to the customer or return to Company A.

Question:

How should Company A account for demonstration equipment?

Solution

Demonstration equipment is classified as inventory or fixed assets depending on a number of factors, including the nature of the equipment, the length of time it remains in the field prior to being sold, and management's intent (i.e., to sell, place with another customer, continue to loan). The longer a unit remains in the field before being sold or if it is used by sales representatives to demonstrate the equipment to multiple potential customers, the more likely it is that the equipment is a productive asset of the company. It should then be classified as a fixed asset and depreciated over its estimated useful life down to its estimated recoverable value. Equipment that remains in the field for a relatively short period prior to sale is generally classified as inventory (on consignment) and reported at cost not to exceed net realizable value from its eventual sale.

Relevant guidance

Refer to the PwC Inventory Guide, section 1.5.3.

3-4 Pre-launch inventory—Treatment of "in-development" drugs

Background

Company A developed a new drug and needs to have sufficient quantities of inventory on hand in anticipation of commercial launch once regulatory approval to market the product has been obtained. Company A has filed for regulatory approval and is currently awaiting a decision. Company A believes that final regulatory approval is probable.

Company A produced 15,000 doses following submission of the filing for regulatory approval. If regulatory approval is not obtained, the inventory has no alternative use. Company A measures inventory using FIFO.

Question:

How should the costs associated with the production of pre-launch inventory for drugs in-development be accounted for?

Solution

Pre-launch inventory can be capitalized if there is a present right to an economic benefit, which is assessed based on the individual facts and circumstances. Factors to consider include whether key safety, efficacy, and feasibility issues have been resolved, the status of any advisory committee reviews, and an understanding of any potential hurdles to regulatory approval or product reimbursement.

Company A has filed for regulatory approval and believes there is a present right to an economic benefit. Accordingly, the pre-launch inventory can be capitalized at the lower of cost or net realizable value. Periodic reassessments should be made to determine whether the inventory continues to have a present right to an economic benefit (e.g., whether regulatory approval is still probable and whether the product will be sold prior to its expiration). If at any time regulatory approval is not deemed to be probable, the inventory should be written down to its net realizable value, which is presumably zero as it must be assumed that the product cannot be sold. If the value of inventory is written down, the reduced amount is the new cost basis (i.e., if regulatory approval is ultimately obtained, the inventory is not written back up).

Companies should consider whether additional financial statement disclosures are necessary related to the capitalization of pre-launch inventory, including the judgments around the present right to an economic benefit and total amount capitalized.

Further, if inventory that had previously been written down is ultimately sold, companies should consider disclosing the impact on margins.

Relevant guidance

ASC 330-10-20: Inventory: The aggregate of those items of tangible personal property that have any of the following characteristics: (a) held for sale in the ordinary course of business, (b) in process of production for such sale, or (c) to be currently consumed in the production of goods or services to be available for sale…

ASC 330-10-30-1: The primary basis of accounting for inventories is cost, which has been defined generally as the price paid or consideration given to acquire an asset. As applied to inventories, cost means in principle the sum of the applicable expenditures and charges directly or indirectly incurred in bringing an article to its existing condition and location. It is understood to mean acquisition and production cost, and its determination involves many considerations.

ASC 330-10-35-1B: Inventory measured using any method other than LIFO or the retail inventory method (for example, inventory measured using first-in, first-out (FIFO) or average cost) shall be measured at the lower of cost and net realizable value. When evidence exists that the net realizable value of inventory is lower than its cost, the difference shall be recognized as a loss in earnings in the period in which it occurs. That loss may be required, for example, due to damage, physical deterioration, obsolescence, changes in price levels, or other causes.

3-5 Treatment of raw materials when their ultimate use is not known

Background

Company A buys bulk materials used for manufacturing a variety of marketed drugs, samples, and drugs in development. The materials are warehoused in a common facility and released to production based upon orders from the manufacturing and research and development departments.

Question:

How should purchased materials be accounted for when their ultimate use is not known?

Solution

In this fact pattern, the raw materials are warehoused in a common facility and have not yet been designated to be used in marketed drugs, samples or drugs in development (i.e., their use is not known yet). Therefore, Company A should account for the raw materials that can be used in the production of marketed drugs as inventory.

Company A measures the inventory value at the lower of cost or net realizable value. When the material is consumed in the production of sample products, Company A should account for the sample product to be given away as an expense in accordance with its policy, which would generally be either when the product is packaged as sample product or the sample is distributed. When the materials are released to production for use in the manufacturing of drugs in development, the materials should be accounted for as research and development supplies. See FAQ 3-2 for the accounting for supplies to be used in R&D.

Alternatively, if the bulk materials were only able to be used for a particular research and development project, and did not have alternative future uses, the costs would be recognized as research and development expense when incurred, which would typically be when the bulk material is received by Company A.

Relevant guidance

ASC 330-10-20, Inventory: The aggregate of those items of tangible personal property that have any of the following characteristics: (a) held for sale in the ordinary course of business, (b) in process of production for such sale, or (c) to be currently consumed in the production of goods or services to be available for sale.

ASC 730-10-25-2(a): …The costs of materials (whether from the entity's normal inventory or acquired specially for research and development activities) and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. The cost of such materials consumed in research and development activities and the depreciation of such equipment of facilities used in those activities are research and development costs.

However, the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred…

3-6 Indicators of impairment for inventory

Background

Company A, a pharmaceutical manufacturer, has decided to temporarily suspend all operations at a certain production site due to identified quality issues. Company A initiated a recall of products manufactured at that site, which will need to be destroyed upon return. Company A maintains a significant amount of raw materials inventory used in the manufacture of the recalled product. There is no work-in-process on hand at the time operations are suspended, and Company A accounts for inventory using a FIFO cost flow assumption.

Question:

How should Company A assess if an impairment of the raw materials inventory may exist?

Solution

The raw materials inventory is subject to the guidance in ASC 330-10-35-1B requiring inventory to be reported at the lower of its acquisition cost and net realizable value. Net realizable value is determined considering all available evidence. Suspending production and recalling the product are indicators that the carrying value of the raw materials inventory used to manufacture the drug may not be recoverable. In addition, Company A would need to evaluate many factors, including whether the reason for the recall had to do with the quality of the raw materials or other issues with the production process, the shelf life of the raw materials, the likelihood that the quality issue can be fixed and production restarted, and whether the raw materials have an alternative use.

In addition to product recalls, the following events are typical indicators within the pharmaceutical and life sciences industry that may trigger the need for a specific assessment of the net realizable value of inventory:

- Patent expiration
- Failure to meet regulatory or internal quality requirements
- Product or material obsolescence
- Changes in medical treatment protocols
- Market entrance of competitor products
- Declining sales (e.g., due to market demand)
- Changes or anticipated changes in third-party reimbursement policies

Note that if Company A accounted for inventory using LIFO, a similar analysis would apply but “market” as defined in ASC 330-10-35-3 through 35-5 would replace “net realizable value.”

Relevant guidance

ASC 330-10-35-1B: Inventory measured using any method other than LIFO or the retail inventory method (for example, inventory measured using first-in, first-out (FIFO) or average cost) shall be measured at the lower of cost and net realizable value. When evidence exists that the net realizable value of inventory is lower than its cost, the difference shall be recognized as a loss in earnings in the period in which it occurs. That loss may be required, for example, due to damage, physical deterioration, obsolescence, changes in price levels, or other causes.

3-7 Selling raw materials to and purchasing finished goods from a subcontractor

Background

Company A outsources the manufacturing of certain products to Company B. Company A purchases raw materials from third-party suppliers and then sells the raw materials to Company B, which processes the raw materials into finished goods. Company A is then obligated to purchase the finished goods from Company B.

At the time of sale of the raw materials, Company A invoices Company B and executes a purchase order with Company B for the purchase of finished goods that contain that same quantity of raw materials. Company B invoices Company A for the finished goods when delivered to Company A. Company B has title to and physical risk of loss associated with the raw materials purchased from Company A once received. The price of the finished goods purchased by Company A far exceeds the price Company B pays to buy the raw materials from Company A.

Question:

How should Company A account for the sale of raw materials to Company B?

Solution

Consistent with ASC 470-40-05-2(a) and ASC 470-40-05-3, Company A should evaluate this arrangement under the repurchase agreement guidance in ASC 606-10-55-66 through 55-78. Company A should retain the raw materials on its books (effectively, as consigned inventory) when they are "sold" to Company B. Since Company A's repurchase of the finished good far exceeds the price Company B paid to purchase the raw materials, the initial sale of raw materials to Company B should be accounted for as a financing arrangement. Any consideration received from Company B in advance of Company A's repurchase of the finished goods should be accounted for as a financial liability. The liability would be relieved upon payment to Company B for the finished goods.

Relevant guidance

ASC 470-40-05-2: Product financing arrangements include agreements in which a sponsor (the entity seeking to finance product pending its future use or resale) does any of the following: (a) Sells the product to another entity (the entity through which the financing flows), and in a related transaction agrees to repurchase the product (or a substantially identical product)…

ASC 470-40-05-3:... For an arrangement described in (a), see Topic 606 on revenue from contracts with customers for guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78 and an illustration on repurchase agreements in Example 62, Case A, paragraphs 606-10-55-401 through 55-404.

ASC 606-10-55-66: A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

ASC 606-10-55-68: If an entity has an obligation or a right to repurchase the asset (a forward or a call option), a customer does not obtain control of the asset because the customer is limited in its ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset even though the customer may have physical possession of the asset. Consequently, the entity should account for the contract as either of the following:

a. A lease in accordance with Topic 842 on leases, if the entity can or must repurchase the asset for an amount that is less than the original selling price of the asset...

b. A financing arrangement in accordance with paragraph 606-10-55-70, if the entity can or must repurchase the asset for an amount that is equal to or more than the original selling price of the asset.

ASC 606-10-55-70: If the repurchase agreement is a financing arrangement, the entity should continue to recognize the asset and also recognize a financial liability for any consideration received from the customer...

Chapter 4: Business combinations & asset acquisitions

FAQ

4-1 Asset acquisition versus business combination—Scenario 1

Background

Company A owns the rights to several drug compound candidates that are currently in Phase I of development. Other than the stage of development, the compounds have no other similarities and are designed to treat disparate conditions. Company A's activities primarily consist of research and development (R&D) on these compounds. Company A employs management and administrative personnel as well as scientists, who are vital to the R&D.

Company B acquires the rights to all of the drug compound candidates along with Company A's workforce composed primarily of scientists. Two of the compounds are the predominant assets acquired.

Question:

Should Company B account for the transaction as a business combination or an asset acquisition?

Solution

Company B should first perform the screen test and consider whether substantially all of the purchase price is concentrated in a single identifiable asset or a group of similar identifiable assets. Because none of the acquired compounds are similar, and two of the compounds are the predominant assets acquired, the screen test is likely not met and a full assessment must be performed.

In the full assessment, Company B will need to consider whether it has acquired inputs, substantive processes, and outputs. Company B would likely conclude that there are no outputs acquired because the compounds are in an early stage of development. Company B would need to consider whether the scientists hired by Company B through the transaction would meet the definition of an organized workforce that can be combined with an input and process to convert or develop an output. Factors to consider when assessing whether the acquired set meets the definition of a business may include: the employees' roles, whether the workforce is subject to contracts with employers or service organizations and the nature and stage of the assets acquired. A conclusion that an organized workforce was acquired may result in Company B acquiring a business as opposed to assets.

Relevant guidance

ASC 805-10-55-3A defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Further, to be capable of this, a business must have, at a minimum, an input and a substantive process that together significantly contribute to the ability to create an output.

ASC 805-10-55-5A through 55-5C introduce a screen test to be performed prior to the full assessment. The screen test states that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business and no further analysis is required.

If the screen test is not met, then a company must perform further assessment. The framework for this assessment is discussed in ASC 805-10-55-5D through 55-9. To be a business, a set needs to have an input and a substantive process that together significantly contribute to the ability to create outputs (e.g., a continuation of revenues before and after the transaction). The framework to evaluate whether an input and a substantive process are present includes different criteria to consider depending on whether the set has outputs.

When outputs are not present, a set must include employees that form an organized workforce. An organized workforce must have the necessary skills, knowledge, or experience to perform an acquired process that when applied to another input, is critical to the ability to develop or convert the acquired input into outputs.

When outputs are present, the set will have both an input and a substantive process that together significantly contribute to the ability to create outputs if any of the following are acquired:

- Employees that form an organized workforce
- An acquired contract that provides access to an organized workforce
- An acquired process that cannot be replaced without significant cost, effort or delay in the entity's ability to continue producing outputs
- An acquired process that is unique or scarce

4-2 Asset acquisition versus business combination—Scenario 2

Background

Company A purchases a legal entity from Company B that contains the rights to a Phase III (in the clinical research phase) compound being developed to treat diabetes, or the in-process research and development (IPR&D) project. Included in the IPR&D project is the historical know-how, formula protocols, designs, and procedures expected to be needed to complete Phase III. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. No employees, other assets, or other activities are transferred.

Question:

Should Company A account for the transaction as a business combination or an asset acquisition?

Solution

Company A should perform the screen test and consider whether substantially all of the purchase price is concentrated in a single identifiable asset. The clinical research organization contract and the clinical manufacturing organization contract are at market rates and could be provided by multiple vendors in the marketplace. Therefore, there is no fair value associated with these arrangements. As a result, all of the consideration will be allocated to the IPR&D project, and the screen test is met. As such, Company A should account for the transaction as an asset acquisition.

Relevant guidance

ASC 805-10-55-3A defines a business as an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants. Further, to be capable of this, a business must have, at a minimum, an input and a substantive process that together significantly contribute to the ability to create an output.

ASC 805-10-55-5A through 55-5C introduce a screen test to be performed prior to the full assessment. The screen test states that if substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business and no further analysis is required. If the screen test is not met, then a company must perform further assessment. The framework for this assessment is discussed in ASC 805-10-55-5D through 55-9.

4-3 Accounting for acquired IPR&D

Background

Company A is in the pharmaceutical industry and owns the rights to several product (drug compound) candidates. Company A also has a product candidate that received FDA approval, but for which it has not yet started production. Company A's activities only consist of R&D on these product candidates.

Company B, also in the pharmaceutical industry, acquires Company A, including the rights to all of Company A's product candidates, testing and development equipment. Company B also hires all of the scientists formerly employed by Company A, who are integral to developing the acquired product candidates. Company B accounts for this transaction as an acquisition of a business.

Question:

How should Company B account for the acquired IPR&D?

Solution

Company B should measure the acquired IPR&D at its acquisition date fair value and record it as an indefinite-lived IPR&D intangible asset. Subsequent to the acquisition, the acquired IPR&D would be tested for impairment annually or more frequently if events or changes in circumstances indicate that the asset might be impaired. To do so, Company B may elect to perform a qualitative impairment assessment under ASC 350. If the qualitative assessment either failed or was not used, Company B would perform a quantitative assessment comparing the fair value of the IPR&D asset to its carrying value.

Incremental R&D costs subsequent to the acquisition would be expensed. Once the IPR&D asset becomes available for use, it should be amortized over its estimated useful life.

Company A's product candidate that has received FDA approval (it is no longer "in-process") would be recognized as a finite-lived intangible asset at the date of acquisition, separate from the acquired IPR&D, and amortized over its estimated useful life. The production, testing and development equipment would generally be separately recognized as tangible assets, measured at fair value, and depreciated over their estimated useful lives.

Relevant guidance

Under ASC 805, acquired IPR&D continues to be measured at its acquisition date fair value but is accounted for initially as an indefinite-lived intangible asset (i.e., not subject to amortization).

Post-acquisition, acquired IPR&D is subject to impairment testing, as required by ASC 350-30-35, until the completion or abandonment of the associated R&D efforts. If abandoned, the carrying value of the IPR&D asset is written off. Once the associated R&D efforts are completed, the carrying value of the acquired IPR&D is reclassified as a finite-lived asset and amortized over its useful life.

Incremental costs incurred on IPR&D after the acquisition date are expensed as incurred, unless there is an alternative future use, under ASC 730-10-25.

4-4 Unit of account—IPR&D

Background

Company A acquires Company B, a small pharma company, in a transaction accounted for as an acquisition of a business under ASC 805. Company B is developing a drug compound that is expected to become a leading product for its therapeutic indication. The project reached market approval in Canada, the US, and Europe just prior to acquisition, and regulatory approval is currently being pursued in Japan and Brazil. The project has been scaled to allow for additional trials to meet the regulatory requirements in each future jurisdiction.

Question:

What is the unit of account for the acquired IPR&D asset?

Solution

It depends. Industry practice would suggest that Company A may recognize at least two, and potentially up to five, separate assets: one intangible asset representing the rights to the compound in all market-approved jurisdictions (or a separate asset for each of the three market approved jurisdictions) and one IPR&D asset for the portion still being developed (or two, if separated by jurisdiction). The late stage of development combined with the plan to scale trials to meet regulatory requirements in each future jurisdiction may suggest that disaggregation by jurisdiction of the intellectual property being developed is warranted. However, the specific facts and circumstances would need to be assessed to determine if the risk of further development, along with the associated costs would be different in the two jurisdictions.

Relevant guidance

ASC 350-30-35 provides factors to consider in determining the appropriate unit of accounting both for recognition and subsequent impairment assessments of intangible assets. This determination for acquired IPR&D can be complex when an approved drug may ultimately benefit various jurisdictions. One approach is to record separate jurisdictional assets for each jurisdictions. Another approach is to record a single global asset. When making the unit of account determination, companies may consider, among other things, the following factors:

- Phase of development of the related IPR&D project
- Nature of the activities and costs necessary to further develop the related IPR&D project
- Risks associated with the further development of the related IPR&D project;
- Amount and timing of benefits expected to be derived from the developed asset
- Expected economic life of the developed asset
- Whether there is an intent to manage advertising and selling costs for the developed asset separately or on a combined basis
- Once completed, whether the product would be transferred as a single asset or multiple assets

4-5 Core or base technology

Background

Company A acquired Company B, which is accounted for as an acquisition of a business under ASC 805. Prior to the acquisition, Company B produced and sold a medical scanner that includes Version 1.0 of its proprietary software. Company B was also conducting R&D related to significant improvements to Version 1.0 (Version 1.0 was being modified and would be partly reused in Version 2.0) that Company B expects to sell in their new scanner. Company B believes there is potential for additional enhancements that may be included in the next generation scanner, including new software Version 3.0. Version 3.0 was not yet under development at the date of the acquisition.

Question:

How should Company A account for the various versions of the technology?

Solution

The fully developed and commercialized technology present in Version 1.0 would be recognized as a separate software technology asset and amortized over its useful life. The IPR&D activities related to the new technology to be included in Version 2.0 would be recognized as an indefinite-lived IPR&D asset. As Version 3.0 is not yet under development, and, therefore, lacks any substance as IPR&D, there would not be an asset recognized for Version 3.0.

Company A would also consider whether a separate enabling technology asset should be recognized for Version 1.0. The IPR&D guide indicates that the enabling technology, in order to be separately identifiable, should exhibit the same characteristics between the various products in which it is used. If the enabling technology shares the same useful life, growth risk, and profitability of the products in which it is used, a separate asset would likely not be recognized. Company A would likely not record a separate enabling technology as the design and technology of Version 1.0 is not used in the same form in the later versions (i.e., it is further enhanced and altered). As a result, the value of the Version 1.0 technology that is able to be reused in later versions would be included as part of the Version 1.0 intangible asset as it is not considered to be a separate enabling technology asset.

Relevant guidance

When IPRD involves enhancements to existing technologies, the allocation of value between a proven technology and an unproven (incomplete) research project can be difficult to measure. The AICPA's Accounting and Valuation Guide on acquired intangible assets used in research and development activities (the IPR&D Guide) notes that value should be allocated to all identifiable assets, which could include IPR&D.

As described in section 8.2.4.1 in PwC's Business Combinations guide, "[The IPR&D Guide] Enabling technology is…underlying technology that has value through its combined use or reuse across many product or product families. Examples of enabling technology provided in the IPR&D Guide include a portfolio of patents, a software object library, or an underlying form of drug delivery technology. If enabling technology meets the criteria for recognition as an intangible asset, it could be a separate unit of account if it does not share the useful life, growth, risk, and profitability of the products in which it is used. The IPR&D Guide indicates that enabling technology is not expected to significantly contribute to the amount of recognized goodwill; rather, if enabling technology does not meet the criteria for separate recognition, the value of enabling technology would be subsumed into other asset categories, such as IPR&D or specific developed technology intangible assets".

While the IPR&D Guide is non-authoritative, it reflects the input of financial statement preparers, auditors, and regulators and serves as a US GAAP accounting and reporting resource for entities that acquire IPR&D.

4-6 Assets acquired in a business combination to be used in commercial products and R&D

Background

Company A is the owner of patented intellectual property used in medical devices that it currently markets and sells to customers. Company A is also using the intellectual property in certain ongoing R&D activities.

Company B acquires Company A in a business combination. Company B expects to continue to use the intellectual property in the sale of currently marketed products as well as in identified future R&D activities.

Question:

How should Company B account for the acquisition of the patented intellectual property?

Solution

Company B would not assign the acquired patent an indefinite life upon acquisition because it is not solely being used for the purpose of ongoing R&D. The patent would be accounted for under ASC 350 and treated as a single intangible asset or grouped with other intangible assets associated with the currently marketed product and would be amortized over a finite life.

If the patent was solely used in ongoing R&D, the AICPA concluded that it may be appropriate to aggregate the patent with other intangible assets used in the R&D activities and capitalize it as an indefinite lived IPR&D asset.

Relevant guidance

ASC 350-30-25-1: An intangible asset that is acquired either individually or with a group of other assets shall be recognized.

ASC 350-30-35-17A: Intangible assets acquired in a business combination… that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered indefinite lived until the completion or abandonment of the associated research and development efforts...

The AICPA's Accounting and Valuation Guide on acquired intangible assets used in R&D activities makes a distinction between complete and incomplete intangible assets used in R&D. Completed intangible assets acquired in a business combination to be used in R&D activities lack the necessary characteristic of being incomplete to be recorded as IPR&D. As a result, the AICPA concluded that these assets should be accounted for in accordance with their nature (e.g., market-related, technology-based). Only intangible assets that are incomplete and used in R&D activities should be accounted for in accordance with ASC 350-30-35-17A (that is, assigned an indefinite useful life upon acquisition).

4-7 Amortization of acquired intellectual property

Background

Company A acquires Company B in a business combination accounted for under ASC 805. As part of the business combination, Company A acquires the intellectual property of Company B that meets the criteria for separate recognition of an intangible asset apart from goodwill. The intellectual property acquired by Company A does not represent IPR&D.

Question:

When should Company A begin amortizing the acquired intellectual property, what factors should be considered in determining the amortization period, and how should the costs be classified in the income statement?

Solution

Amortization of intangible assets should begin on the date the asset is available for its intended use, which is generally the acquisition date.

To determine the useful life, in addition to the factors in ASC 350-30-35-3, Company A should consider industry-specific factors, such as the following:

a. Duration of the patent right or license of the product

b. Redundancy of a similar medication/device due to changes in market preferences

c. Unfavorable court decisions on claims related to product liability or patent ownership

d. Regulatory decisions over patent rights or licenses

e. Development of new drugs treating the same disease

f. Changes in the environment that make the product ineffective (e.g., a mutation in the virus that is causing a disease, which renders it stronger)

g. Changes or anticipated changes in participation rates or reimbursement policies of insurance companies

h. Changes in government reimbursement or policies (e.g., Medicare, Medicaid) for drugs and other medical products

None of the above factors should be considered more presumptive than any other, and companies should consider all the facts and circumstances when estimating an asset's useful life. Companies should also evaluate the remaining useful lives of their intangible assets each reporting period to determine whether events and circumstances warrant revisions to the estimated useful lives. A change in the estimated useful lives of intangible assets is considered a change in an accounting estimate and should be accounted for prospectively in the period of change and future periods.

Income statement classification of an intangible asset's amortization expense should reflect the nature of the asset. If Company A expects to utilize the technology to support the commercialization process or to manufacture goods, the presumption is that amortization would be recorded as part of cost of goods sold.

Relevant guidance

Pursuant to ASC 805-20-55-2 through 55-4, an intangible asset that meets the contractual-legal criterion or separability criterion is considered identifiable and is recognized at fair value using the market participant framework contained in ASC 820, Fair Value Measurement. Intangible assets are amortized over their estimated useful lives. If the precise length is unknown, intangible assets should be amortized over a company's best estimate of the assets' useful life.

ASC 350-30-35-2: The useful life of an intangible asset to an entity is the period over which the asset is expected to contribute directly or indirectly to the future cash flows of that entity...

ASC 350-30-35-3: The estimate of the useful life of an intangible asset to an entity shall be based on an analysis of all pertinent factors, in particular, all of the following factors with no one factor being more presumptive than the other:

a. The expected use of the asset by the entity.

b. The expected useful life of another asset or a group of assets to which the useful life of the intangible asset may relate.

c. Any legal, regulatory, or contractual provisions that may limit the useful life. The cash flows and useful lives of intangible assets that are based on legal rights are constrained by the duration of those legal rights. Thus, the useful lives of such intangible assets cannot exceed the length of their legal rights and may be shorter.

d. The entity's own historical experience in renewing or extending similar arrangements, consistent with the intended use of the asset by the entity, regardless of whether those arrangements have explicit renewal or extension provisions. In the absence of that experience, the entity shall consider the assumptions that market participants would use about renewal or extension, consistent with the highest and best use of the asset by market participants, adjusted for entity-specific factors in this paragraph.

e. The effects of obsolescence, demand, competition, and other economic factors (such as the stability of the industry, known technical advances, legislative action that results in an uncertainty or changing regulatory environment, and expected changes in distribution channels).

f. The level of maintenance expenditures required to obtain the expected future economic benefits from the asset (for example, a material level of required maintenance in relation to the carrying amount of the asset may suggest a very limited useful life). As in determining the useful life of depreciable tangible assets, regular maintenance may be assumed but enhancements may not.

If an income approach is used to measure the fair value of an intangible asset, Company A should consider the period of expected cash flows used to measure fair value adjusted as appropriate for the entity-specific factors noted above.

The classification of amortization expense should generally be determined based on the asset's intended use and recorded in the income statement accordingly.

4-8 Cash flow presentation of up-front licensing fee

Background

Company A agrees to pay Company B a $3 million non-refundable upfront fee to license Company B's know-how and technology related to a compound in the research stage.

Company A determines that this meets the definition of an asset acquisition and the license has no alternative future use. Company A expenses, as incurred, the $3 million upfront fee prior to product approval as in-process R&D costs.

Question:

What is the appropriate presentation of the up-front licensing fee in the statement of cash flows?

Solution

Company A should consider the nature of the underlying cash flow in determining its classification. In general, Company A should classify the cash outflow based on what is likely to be the predominant use of cash. Given that the nature of this cash flow has aspects of more than one class of cash flows as well as the lack of authoritative guidance in this area, we believe that classification in either operating or investing is acceptable.

Company A should consistently apply their classification conclusion to similar transactions.

Relevant guidance

ASC 230-10-45-22: In the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows, including when judgment is necessary to estimate the amount of each separately identifiable source or use. A reporting entity shall then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities.

ASC 230-10-45-22A: In situations in which cash receipts and payments have aspects of more than one class of cash flows and cannot be separated by source or use... the appropriate classification shall depend on the activity that is likely to be the predominant source or use of cash flows for the item.

ASC 230-10-45-13C: All of the following are cash outflows from investing activities...Payments at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets...

ASC Master Glossary: Operating activities include all transactions and other events that are not defined as investing or financing activities (see paragraphs 230-10-45-12 through 45-15). Operating activities generally involve producing and delivering goods and providing services. Cash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income.

AICPA's Accounting and Valuation Guide on acquired intangible assets used in R&D activities—Q&A 5.12:

Question 1:

How should an acquiring entity classify in its statement of cash flows an R&D charge associated with the costs of IPR&D projects acquired as part of an asset acquisition that have no alternative future use?

Answer:

Best practices suggest that an acquiring entity should report its cash acquisition of assets to be used in R&D activities as an investing outflow in its statement of cash flows. In this regard, an acquiring entity should treat assets acquired to be used in R&D activities similar to how it reports other acquired assets in the statement of cash flows. Although acquired IPR&D may lack an alternative future use and, therefore, would be expensed immediately, it is still an asset for cash flow statement purposes.

When arriving at cash flows from operating activities under the indirect method of reporting cash flows, best practices suggest that an acquiring entity should add back to net income the costs of assets acquired to be used in R&D activities that are charged to expense. That adjustment is necessary to eliminate from operating cash flows those cash outflows of assets acquired to be used in R&D activities that are reflected in investing activities.

4-9 Exchange of intangible assets when control is transferred

Background

Company A is developing a hepatitis vaccine compound. Company B owns the rights to a measles vaccine that is already approved. Company A and Company B enter into an agreement to exchange the two products. The exchange of products will not involve the transfer of legal entity ownership interests. Company A will lose, and Company B will gain control of the hepatitis vaccine compound. The fair value at contract inception of Company B's product was $3 million. The carrying value of Company A's compound was zero, as it was internally developed.

Question:

How should Company A account for the swap of vaccine products?

Solution

To determine the accounting for the exchange transaction, Company A would first determine whether it qualifies for derecognition of a nonfinancial asset (i.e., the vaccine). The accounting guidance for the derecognition of nonfinancial assets refers to certain provisions in ASC 606, Revenue from Contracts with Customers, to assess the appropriate accounting for these types of transactions, including whether or not a contract exists, identifying each distinct nonfinancial asset and determining when control has transferred. After assessing the control criteria in ASC 606, Company A concluded that it has transferred control of the hepatitis compound to Company B. Company A would derecognize the carrying value of the hepatitis compound (for internally-developed IPR&D assets, the carrying value would typically be zero).

Company A would recognize $3 million for the measles product as this represents the fair value, at contract inception, of the noncash consideration received by Company A. The fair value at contract inception may be different than the fair value on the date when the noncash consideration is received. Company A would recognize a gain on the exchange of $3 million ($3 million value of the noncash consideration received less zero book value for the compound Company A gave up). If the acquired measles product was IPR&D (pre-approval) at the date of the exchange, Company A would be required to expense the $3 million.

Relevant guidance

ASC 610-20-25-6: Once a contract meets all of the criteria in paragraph 606-10-25-1, an entity shall identify each distinct nonfinancial asset and distinct in substance nonfinancial asset promised to a counterparty in accordance with the guidance in paragraphs 606-10-25-19 through 25-22.

An entity shall derecognize each distinct asset when it transfers control of the asset in accordance with paragraph 606-10-25-30.

ASC 606-10-32-21: To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception.

Chapter 5: Leases

FAQ

5-1 Accounting for leases—Lessees: Identifying a lease

5-2 Identifying and accounting for an embedded lease in a contract manufacturing arrangement

5-3 Identifying components in a lease arrangement

5-4 Build-to-suit

5-5 Accounting for modification—separate lease

5-6 Accounting for a sub-lease

5-7 Accounting for leases—Lessors: Identifying a lease

5-8 Lease classification

5-9 Allocation of consideration to components of lease contract

5-1 Accounting for leases—Lessees: Identifying a lease

Background

Company A, a biotech company, enters into an arrangement with Company B, a contract manufacturing organization, to produce medical equipment and disposables ("the Products") that Company A then sells to outside customers. Company B has multiple production lines that it uses to fulfill orders for multiple customers. The arrangement allows Company B to choose the production line used to fulfill Company A's orders. Even after the production of the Products commences on a product line, Company B can easily change to a different production line with minimal transfer costs. Company A submits legally-binding purchase orders quarterly to Company B and is contractually required to provide an annual non-binding production forecast. The Products are generic, can easily be stored and Company B has full discretion over the operating process, including the selection of materials to use in production.

Question:

Does this arrangement contain a lease?

Solution

The right to control the use of an asset may not necessarily be documented, in form, as a lease agreement. Often, the right to use an identified asset is embedded in an arrangement that may appear to be a supply arrangement or service contract. Therefore, Company A should consider the terms of this arrangement to determine whether it contains a lease. This arrangement likely does not contain a lease under ASC 842. While the use of an asset, the production line, is implicit in the contract, there is likely no identified asset because substantive substitution rights exist. Also, there is likely not a lease because Company B has the right to change the operating process and decide when the output is produced. Therefore, it likely does not control the use of the asset.

Relevant guidance

ASC 842-10-15-3: A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

ASC 842-10-15-4: To determine whether a contract conveys the right to control the use of an identified asset (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset (see paragraphs 842-10-15-17 through 15-19).

b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

ASC 842-10-15-10: Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

5-2 Identifying and accounting for an embedded lease in a contract manufacturing arrangement

Background

Company A, a biotech company, enters into an arrangement with Company B, a contract manufacturing organization, to produce medical equipment and disposables ("the Products") that Company A then sells to outside customers. The Products are highly specialized, there is a dedicated production line for the Products and Company B is contractually restricted from using any other production line to fulfill its obligations under the arrangement. Purchase orders are very frequent and key operating decisions are predetermined by Company A and any changes are subject to approval by Company A.

Question #1:

Does this arrangement contain a lease?

Question #2:

If so, how should Company A account for this embedded lease under ASC 842?

Solution

Question #1: Does this arrangement contain a lease?

There is an identified asset explicit in the contract (that is, the production line) and there are no substitution rights.

Company A has the right to obtain substantially all of the economic benefits from the use of the identified asset. Company A also directs the use of the identified asset because Company B does not have the right to change the operating instructions, including types of materials/components, overall production process, and other decisions related to the output, without prior authorization by Company A.

Further, Company A is also directing the use of the production line through frequent purchase orders, which, consequently, determine whether and when the equipment is used.

Company A controls the use of the identified asset because Company A (1) has the right to obtain substantially all of the economic benefits from the use of the identified asset and (2) has the right to direct the use of the identified asset and therefore, this arrangement is likely to contain a lease under ASC 842.

Relevant guidance

ASC 842-10-15-3: A contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration. A period of time may be described in terms of the amount of use of an identified asset (for example, the number of production units that an item of equipment will be used to produce).

ASC 842-10-15-4: To determine whether a contract conveys the right to control the use of an identified asset (see paragraphs 842-10-15-17 through 15-26) for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset (see paragraphs 842-10-15-17 through 15-19).

b. The right to direct the use of the identified asset (see paragraphs 842-10-15-20 through 15-26).

ASC 842-10-15-10: Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive only if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

Question #2: How should Company A account for this embedded lease under ASC 842?

Company A should allocate the expected consideration between the leased production line (lease component) and the services to produce the Products (non-lease component) based on their relative standalone selling prices at contract inception. If the arrangement contains fixed consideration, (or if Company A is required to purchase minimum volumes, which would establish fixed minimum consideration) then Company A would record a lease liability on its balance sheet at the present value of the amount of fixed consideration allocated to the lease component, and a corresponding right-of-use (ROU) asset. Alternatively, Company A can elect (by asset class) to not separate lease and nonlease components. In this case, all fixed consideration would be included as part of the measurement of the lease liability and ROU asset.

If the contract contains no minimum monthly volume, the arrangement would continue to contain an embedded lease; however, the consideration would be 100% variable. Because variable consideration is excluded from the measurement of the lease liability, there would be no initial accounting for this agreement. Instead, Company A would allocate and record a portion of each payment as variable lease expense for the embedded lease component and a portion as the cost of the contract manufacturing. Alternatively, under ASC 842, Company A can elect to not to separate lease components from non-lease components and instead disclose the consideration in the arrangement entirely as lease expense.

Relevant guidance

ASC 842-10-30-5: At the commencement date, the lease payments shall consist of the following payments relating to the use of the underlying asset during the lease term:

a. Fixed payments, including in substance fixed payments, less any lease incentives paid or payable to the lessee (see paragraphs 842-10-55-30 through 55-31).

b. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.

c. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option (assessed considering the factors in paragraph 842-10-55-26).

d. Payments for penalties for terminating the lease if the lease term (as determined in accordance with paragraph 842-10-30-1) reflects the lessee exercising an option to terminate the lease.

e. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction. However, such fees shall not be included in the fair value of the underlying asset for purposes of applying paragraph 842-10-25-2(d).

f. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees (see paragraphs 842-10-55-34 through 55-36).

ASC 842-10-30-6: Lease payments do not include any of the following:

a. Variable lease payments other than those in paragraph 842-10-30-5(b).

b. Any guarantee by the lessee of the lessor's debt.

c. Amounts allocated to nonlease components in accordance with paragraphs 842-10-15-33 through 15-42.

ASC 842-10-15-37: As a practical expedient, a lessee may, as an accounting policy election by class of underlying asset, choose not to separate nonlease components from lease components and instead to account for each separate lease component and the nonlease components associated with that lease component as a single lease component.

5-3 Identifying components in a lease arrangement

Background

Company A, a biotech company leases a biotech lab facility, including the land on which the building is situated, and laboratory equipment, from Company B, the lessor. Company B does not lease or sell the equipment separately, but other suppliers do. The laboratory equipment can be used in other facilities. The monthly payment to the lessor includes (a) fixed rent for the building, land, and laboratory equipment; (b) a fixed amount for property taxes and insurance; (c) a fixed amount for maintenance related to the laboratory equipment; and (d) a fixed amount related to the maintenance of building and land. The accounting effect of treating the right to use land as a separate lease component is insignificant because doing so would not have an impact on the classification of any lease component.

Question:

What are the lease components in this arrangement?

Solution

The lease components in the arrangement are the building (including land) and laboratory equipment. The lease of the laboratory equipment is considered a separate component from the lease of the building and land as it is neither dependent on, nor highly interrelated with the building or land since the equipment could be sourced from other providers and be used in other facilities.

The nonlease components are the maintenance services for the building (including land) and maintenance services for the laboratory equipment. Maintenance services for the building (including land) and equipment involve the provision of separate services to Company A and are considered separate nonlease components.

Real estate taxes and insurance do not represent separate goods or services and therefore are not contract components. Any payments related to those amounts would be included in the overall contract consideration to be allocated to the identified contract components.

Relevant guidance

ASC 842-10-15-28: After determining that a contract contains a lease in accordance with paragraphs 842-10-15-2 through 15-27, an entity shall identify the separate lease components within the contract. An entity shall consider the right to use an underlying asset to be a separate lease component (that is, separate from any other lease components of the contract) if both of the following criteria are met:

a. The lessee can benefit from the right of use either on its own or together with other resources that are readily available to the lessee. Readily available resources are goods or services that are sold or leased separately (by the lessor or other suppliers) or resources that the lessee already has obtained (from the lessor or from other transactions or events).

b. The right of use is neither highly dependent on nor highly interrelated with the other right(s) to use underlying assets in the contract. A lessee's right to use an underlying asset is highly dependent on or highly interrelated with another right to use an underlying asset if each right of use significantly affects the other.

ASC 842-10-15-29: The guidance in paragraph 842-10-15-28 notwithstanding, to classify and account for a lease of land and other assets, an entity shall account for the right to use land as a separate lease component unless the accounting effect of doing so would be insignificant (for example, separating the land element would have

no effect on lease classification of any lease component or the amount recognized for the land lease component would be insignificant).

ASC 842-10-15-30: The consideration in the contract shall be allocated to each separate lease component and nonlease component of the contract. Components of a contract include only those items or activities that transfer a good or service to the lessee. Consequently, the following are not components of a contract and do not receive an allocation of the consideration in the contract:

a. Administrative tasks to set up a contract or initiate the lease that do not transfer a good or service to the lessee.

b. Reimbursement or payment of the lessor's costs. For example, a lessor may incur various costs in its role as a lessor or as owner of the underlying asset. A requirement for the lessee to pay those costs, whether directly to a third party or as a reimbursement to the lessor, does not transfer a good or service to the lessee separate from the right to use the underlying asset.

5-4 Build-to-suit

Background

Company A, a pharmaceutical company, enters into an arrangement with a real estate company, Company B (landlord), for the lease of a building that will house biotech labs once constructed. Company B hires a construction company to build the building. Company A is required to provide the design for the building and to reimburse Company B for the construction to modify rooms to create labs and for Company B's purchase of the related equipment. The equipment will remain in the building at the end of the lease term, can be utilized by a subsequent tenant, and are considered Company B's assets. Company B holds legal title to the land on which the building will be built as well as the legal title to the building under construction. Company B does not have an enforceable right to payment for its performance to date. Company A does not have the right to buy the partially-constructed building at any point during the construction period.

Question:

How should Company A account for the above construction?

Solution

Company A does not control the building under construction because (a) the building is legally owned by Company B; (b) Company B does not have an enforceable right to payment for its performance to date; (c) Company B owns the land on which the building will be constructed and Company A does not control or lease the land; and (d) Company A does not have the right to buy the partially constructed building at any point during the construction period. Company A would record the costs incurred relating to the design of the building, the construction of the labs, and purchase of the related equipment as lease payments because they are costs incurred in connection with the completion of lessor assets and do not represent payment for goods or services provided to Company A. Company A would recognize such costs as prepaid rent (and reclassify the prepaid rent to the right-of-use asset upon commencement of the lease).

Relevant guidance

ASC 842-40-55-5: If the lessee controls the underlying asset being constructed before the commencement date, the transaction is accounted for in accordance with this Subtopic. Any one (or more) of the following would demonstrate that the lessee controls an underlying asset that is under construction before the commencement date:

a. The lessee has the right to obtain the partially constructed underlying asset at any point during the construction period (for example, by making a payment to the lessor).

b. The lessor has an enforceable right to payment for its performance to date, and the asset does not have an alternative use (see paragraph 842-10-55-7) to the owner-lessor. In evaluating whether the asset has an alternative use to the owner-lessor, an entity should consider the characteristics of the asset that will ultimately be leased.

c. The lessee legally owns either:

    1. Both the land and the property improvements (for example, a building) that are under construction.

    2. The non-real-estate asset (for example, a ship or an airplane) that is under construction.

d. The lessee controls the land that property improvements will be constructed upon (this includes where the lessee enters into a transaction to transfer the land to the lessor, but the transfer does not qualify as a sale in accordance with paragraphs 842-40-25-1 through 25-3) and does not enter into a lease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to lease the land for substantially all of the economic life of the property improvements.

e. The lessee is leasing the land that property improvements will be constructed upon, the term of which, together with lessee renewal options, is for substantially all of the economic life of the property improvements, and does not enter into a sublease of the land before the beginning of construction that, together with renewal options, permits the lessor or another unrelated third party to sublease the land for substantially all of the economic life of the property improvements.

The list of circumstances above in which a lessee controls an underlying asset that is under construction before the commencement date is not all inclusive. There may be other circumstances that individually or in combination demonstrate that a lessee controls an underlying asset that is under construction before the commencement date.

5-5 Accounting for modification—separate lease

Background

Company A, a life sciences company, enters into a 5-year lease for 2,000 square feet of warehouse space with Company B, a landlord, for $10,000 per month.

At the end of year one, Company A and Company B agree to amend their lease contract to include an additional 1,000 square feet of warehouse space in the same building for the remaining four years of the lease. Company A pays an additional $6,000 per month for the additional space. The additional $6,000 is in line with the current market rate to lease 1,000 square feet of warehouse space in that particular building at the date that the modification is agreed to. Company A will make monthly payments of $16,000 per month after the modification.

Question:

How should Company A account for this lease modification?

Solution

Company A should account for the lease modification as a separate lease because the modification granted Company A an additional right of use at a price that is commensurate with the standalone price for the additional space. Therefore, on the new lease commencement date, Company A would have two separate leases:

- The original lease for 2,000 square feet for five years
- A new lease for the additional 1,000 square feet for four years

The accounting for the original lease is not impacted by the modification.

Relevant guidance

ASC 842-10-25-8: An entity shall account for a modification to a contract as a separate contract (that is, separate from the original contract) when both of the following conditions are present:

a. The modification grants the lessee an additional right of use not included in the original lease (for example, the right to use an additional asset).

b. The lease payments increase commensurate with the standalone price for the additional right of use, adjusted for the circumstances of the particular contract. For example, the standalone price for the lease of one floor of an office building in which the lessee already leases other floors in that building may be different from the standalone price of a similar floor in a different office building, because it was not necessary for a lessor to incur costs that it would have incurred for a new lessee.

5-6 Accounting for a sub-lease

Background

Company A, a biotech company, enters into a building lease with a 25 year term. The building has a remaining economic life of 40 years. At the end of year 3, Company A enters into an agreement with Company B to sublease the building to Company B for the remaining 22 years. Company A is not relieved of its obligations under the original head lease.

Question:

How should Company A account for its sublease with Company B?

Solution

Company A would account for the sublease to Company B as an operating lease because the term of the sublease is not for a major part of the remaining life of the underlying asset of the sublease (i.e., the sublease term of 22 years represents only 59% of the remaining 37-year life of the building) and Company A has concluded that no other classification criteria in ASC 842-10-25-2 would result in a sales-type lease.

Relevant guidance

ASC 842-10-20, Sublease: A transaction in which an underlying asset is re-leased by the lessee (or intermediate lessor) to a third party (the sublessee) and the original (or head) lease between the lessor and the lessee remains in effect.

ASC 842-10-25-6: When classifying a sublease, an entity shall classify the sublease with reference to the underlying asset (for example, the item of property, plant, or equipment that is the subject of the lease) rather than with reference to the right-of-use asset.

ASC 842-10-25-2: A lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales-type lease when the lease meets any of the following criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.

e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

5-7 Accounting for leases—Lessors: Identifying a lease

Background

Company A, a medical device company, enters into an arrangement with Company B, a hospital, to provide a medical imaging scanner and supply medical imaging consumables (cartridges) for five years. Upon executing the arrangement, Company A installs a medical imaging scanner at Company B's premises that requires the use of Company A's consumables. The scanner has been customized to run Company B's proprietary software. Company A provides the scanner free of charge to Company B; however, Company A expects to recover the scanner cost through Company B's purchase of consumables. Legal title to the scanner remains with Company A. The contract permits Company A to substitute the scanner. However, due to the potential disruption substitution would have on Company B's activities, the contract includes a significant penalty in the event of downtime above a specified threshold. Therefore, it is expected that Company A will not substitute the equipment, except in the case of malfunction. Company A also provides maintenance services.

Question:

Does the arrangement contain a lease?

Solution

Yes, the arrangement contains a lease. Although the contract does not explicitly specify the scanner, it is on site and customized for Company B. As a result, it is implicitly identified. While Company A has the legal right of substitution, this right is not substantive due to the significant disruption and potential downtime penalty if the equipment was to be substituted (substitution for maintenance or malfunction is not considered a substantive right to substitute). Therefore, the arrangement contains an identified asset, i.e., the scanner.

Company B has the right to control the use of the equipment throughout the period of use because:

a. Company B has the right to obtain substantially all of the economic benefits from the use of the identified equipment based on its exclusive access and use of the equipment during the five-year term; and

b. Company B makes the relevant decisions about how and when the equipment is operated by the hospital staff in their practice of medicine throughout the period of use.

Relevant guidance

ASC 842-10-15-4: To determine whether a contract conveys the right to control the use of an identified asset... for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:

a. The right to obtain substantially all of the economic benefits from use of the identified asset...

b. The right to direct the use of the identified asset...

ASC 842-10-15-10: Even if an asset is specified, a customer does not have the right to use an identified asset if the supplier has the substantive right to substitute the asset throughout the period of use. A supplier's right to substitute an asset is substantive if both of the following conditions exist:

a. The supplier has the practical ability to substitute alternative assets throughout the period of use (for example, the customer cannot prevent the supplier from substituting an asset, and alternative assets are readily available to the supplier or could be sourced by the supplier within a reasonable period of time).

b. The supplier would benefit economically from the exercise of its right to substitute the asset (that is, the economic benefits associated with substituting the asset are expected to exceed the costs associated with substituting the asset).

5-8 Lease classification

Background

Company A, a medical device manufacturer, leases specialized medical imaging equipment to Company B, a hospital, designed and customized to work with Company B's proprietary software. Given the age and customization of the equipment for Company B, Company A would incur significant costs to modify the equipment for use with another lessee or to facilitate its sale. The costs exceed the expected benefit resulting from any such sale. The arrangement is a lease of the equipment with the following additional facts:

Lease term	4.5 years with no renewal option
Purchase option	None
Present value of lease payments	$200,000
Fair value of the equipment	$200,000
Remaining economic life of equipment	5 years
Title to the asset remains with Company A upon lease expiration	

Question:

How should Company A classify the lease?

Solution

Since the equipment is of such a specialized nature that it is expected to have no alternative use to Company A at the end of the lease term, Company A would classify the lease as a sales-type lease. In this example, Company B has effectively obtained control of the underlying asset, which is economically similar to Company A selling the asset to Company B. Therefore, upfront profit recognition would be appropriate assuming collectibility of the lease payments is probable.

Relevant guidance

ASC 842-10-25-2: A lessee shall classify a lease as a finance lease and a lessor shall classify a lease as a sales-type lease when the lease meets any of the following criteria at lease commencement:

a. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

b. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

c. The lease term is for the major part of the remaining economic life of the underlying asset. However, if the commencement date falls at or near the end of the economic life of the underlying asset, this criterion shall not be used for purposes of classifying the lease.

d. The present value of the sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments in accordance with paragraph 842-10-30-5(f) equals or exceeds substantially all of the fair value of the underlying asset.

e. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

ASC 842-10-55-7: In assessing whether an underlying asset has an alternative use to the lessor at the end of the lease term in accordance with paragraph 842-10-25-2(e), an entity should consider the effects of contractual restrictions and practical limitations on the lessor's ability to readily direct that asset for another use (for example, selling it or leasing it to an entity other than the lessee). A contractual restriction on a lessor's ability to direct an underlying asset for another use must be substantive for the asset not to have an alternative use to the lessor. A contractual restriction is substantive if it is enforceable. A practical limitation on a lessor's ability to direct an underlying asset for another use exists if the lessor would incur significant economic losses to direct the underlying asset for another use. A significant economic loss could arise because the lessor either would incur significant costs to rework the asset or would only be able to sell or re-lease the asset at a significant loss. For example, a lessor may be practically limited from redirecting assets that either have design specifications that are unique to the lessee or that are located in remote areas. The possibility of the contract with the customer being terminated is not a relevant consideration in assessing whether the lessor would be able to readily direct the underlying asset for another use.

5-9 Allocation of consideration to components of lease contract

Background

Company A enters into a five-year arrangement to lease medical equipment to Company B. Company A will also provide maintenance services and training related to the leased equipment. The arrangement requires Company B to purchase a minimum of 4,500 disposable units per year from Company A. Company A will receive $4.00 per disposable purchased. There are no additional payments required under the arrangement. Therefore, total fixed contract consideration in the arrangement is $90,000 (4,500 disposable units per year x 5 years x $4.00/unit).

The disposables can be used in operating both the leased equipment and other equipment. Furthermore, Company B can purchase disposables from other vendors besides Company A as well, if needed. Therefore, the number of disposables purchased by Company B is considered unrelated to the usage of the leased medical equipment.

Company A determines that the arrangement has one lease component—the lease of medical equipment, and three nonlease components—disposables, maintenance, and training. Any purchases above 4,500 units are considered optional purchases and therefore the right to purchase excess units is not considered a separate component.

Company A has not elected to utilize the practical expedient described in ASC 842-10-15-42A, which would allow lease and nonlease components to be accounted for as a single component if certain criteria are met.

The medical equipment has a useful life of five years and is not expected to have any residual value at the end of the lease term. Company A's cost of the medical equipment is $14,000. At the lease commencement date, the standalone selling price of each component is as follows:

- Leased equipment: $15,000
- Disposables: $3.00 per unit
- Maintenance: $12,500
- Training: $5,000

Question:

How should Company A allocate contract consideration among the various lease and nonlease components at lease commencement?

Solution

The lease and nonlease components represent separate performance obligations under the revenue guidance in ASC 606. The $90,000 contract consideration would be allocated to lease and nonlease components based on their relative standalone selling prices at lease commencement as follows:

	Standalone price (A)	Allocation % (A/$100,000) = (B)	Allocation of contract consideration (B*$90,000)
Leased equipment	$15,000	15%	$13,500
Disposables	67,500*	67.5%	60,750
Maintenance	12,500	12.5%	11,250
Training	5,000	5%	4,500
Total	**$100,000**	**100%**	**$90,000**

*4,500 disposable units per year x 5 years x $3.00 standalone price/unit

At the commencement date, Company A would classify the lease as a sales-type lease because the lease term (5 years) is for the major part of the remaining economic life of the medical equipment (5 years) and collectibility of lease payments is probable at commencement date. Based on the allocation of transaction consideration, Company A would record $13,500 in revenue and net investment in the lease. It would also remove the equipment (carrying value $14,000) from its balance sheet; and record $14,000 cost of goods sold, resulting in a day-1 loss of $500 at the commencement date.

Relevant guidance

ASC 842-10-15-38: A lessor shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) the consideration in the contract to the separate lease components and the nonlease components using the requirements in paragraphs 606-10-32-28 through 32-41. A lessor also shall allocate (unless the lessor makes the accounting policy election in accordance with paragraph 842-10-15-42A) any capitalized costs (for example, initial direct costs or contract costs capitalized in accordance with Subtopic 340-40 on other assets and deferred costs—contracts with customers) to the separate lease components or nonlease components to which those costs relate.

ASC 842-10-15-39: The consideration in the contract for a lessor includes all of the amounts described in paragraph 842-10-15-35 and any other variable payment amounts that would be included in the transaction price in accordance with the guidance on variable consideration in Topic 606 on revenue from contracts with customers that specifically relates to either of the following:

a. The lessor's efforts to transfer one or more goods or services that are not leases.

b. An outcome from transferring one or more goods or services that are not leases.

Any variable payment amounts accounted for as consideration in the contract shall be allocated entirely to the nonlease component(s) to which the variable payment specifically relates if doing so would be consistent with the transaction price allocation objective in paragraph 606-10-32-28.

ASC 842-30-25-1: At the commencement date, a lessor shall recognize each of the following and derecognize the underlying asset in accordance with paragraph 842-30-40-1:

a. A net investment in the lease, measured in accordance with paragraph 842-30-30-1.

b. Selling profit or selling loss arising from the lease.

c. Initial direct costs as an expense if, at the commencement date, the fair value of the underlying asset is different from its carrying amount. If the fair value of the underlying asset equals its carrying amount, initial direct costs (see paragraphs 842-10-30-9 through 30-10) are deferred at the commencement date and included in the measurement of the net investment in the lease. The rate implicit in the lease is defined in such a way that those initial direct costs eligible for deferral are included automatically in the net investment in the lease; there is no need to add them separately.

Chapter 6: Revenue recognition

FAQ

6-1 Scoping considerations for collaboration agreements—Scenario 1

Background

Company A enters into a license and collaboration agreement with Company B. Company A grants an exclusive license to a drug compound to Company B and will manufacture the compound for Company B. Company A receives an upfront payment of $40 million, per-unit payments for manufacturing services performed, and a milestone payment of $150 million upon regulatory approval. Consideration payable under this arrangement is at market rates, and all payments received by Company A are nonrefundable. Company B has sole decision-making authority over all key operating decisions related to the drug compound.

Question:

Is this arrangement within the scope of ASC 606?

Solution

ASC 606 is often referred to as a residual standard. If an arrangement is subject to other specific GAAP, then that GAAP would be applied first. ASC 606 also applies to revenue from contracts with customers, where revenue is defined as inflows to the entity from transferring goods or services that are the output of an entity's ongoing, major or central operations, and customers are entities to whom the reporting entity regularly delivers those goods and services.

When evaluating the accounting for the arrangement, Company A first considers whether the license and collaboration agreement meets the definition of a "collaborative arrangement" in ASC 808. In this case, Company A would likely conclude the arrangement is not a collaborative arrangement as it does not meet both of the following requirements: (a) active participation and (b) exposure to the significant risks and rewards dependent on the commercial success of the drug compound.

Company A is providing a license and manufacturing services to Company B and those goods and services are the outputs of Company A's ordinary activities. The fees paid are at market rates, and payments received are non-refundable. As such, it appears that Company A and Company B have a vendor-customer relationship. Thus, the arrangement should be accounted for based on the guidance in ASC 606.

Relevant guidance

ASC 606-10-15-3: An entity shall apply the guidance in this Topic to a contract…only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration.

ASC 808-10-20: Collaborative arrangement: A contractual arrangement that involves a joint operating activity (see paragraph 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:

a. They are active participants in the activity (see paragraphs 808-10-15-8 through 15-9).

b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 808-10-15-10 through 15-13).

6-2 Scoping considerations for collaboration agreements—Scenario 2

Background

Company A grants a co-exclusive license to a drug compound in Phase II clinical trials to Company B. Company A and Company B agree to jointly develop and commercialize the drug candidate worldwide. Company A and Company B establish joint steering committees with equal participation to govern and approve the key decisions related to the development and commercialization activities. The parties do not create a separate legal entity related to the joint activities.

During development, Company A will solely perform the research and development activities necessary to obtain regulatory approval. Upon achieving regulatory approval, both parties will manufacture and sell the drug to customers on a worldwide basis.

Company A receives a nonrefundable, upfront payment of $150 million and a milestone payment of $100 million upon regulatory approval from Company B. Company A and Company B share in the development costs and the commercial profits on a 50/50 basis.

Question:

Does the collaboration agreement meet the definition of a collaborative arrangement in ASC 808?

Solution

Yes. The collaboration agreement meets the definition of a collaborative arrangement in ASC 808 as both parties are (a) active participants in the joint operating activity and (b) exposed to the significant risks and rewards of the commercial success of the joint operating activity. The joint operating activity is the development and commercialization of the drug compound on a worldwide basis.

Active participation

Company A and Company B are both active participants in the joint operating activity because both parties are responsible for performing activities related to the joint operating activity. While the parties are responsible for performing different activities underlying the joint operating activity, both parties have equal participation on the governance committees and jointly approve decisions related to activities of the joint operating activity.

Although the parties have equal representation in this scenario, that is not the threshold for establishing "active participation." For example, even when one party may have a "tie-breaking" vote for certain decisions, assuming the participation of the other party is substantive, active participation could still be established.

Exposed to the significant risks and rewards

Company A and Company B are exposed to the significant risks and rewards of the commercial success of the joint operating activity because the parties agree to share in the development costs and commercial profits on a 50/50 basis. The upfront fee and milestone payment triggered upon regulatory approval would not necessarily indicate that the parties are not exposed to the significant risks and rewards. Rather, the upfront fee and milestone payment compensate Company A for the license to intellectual property at the inception of the agreement.

ASC 808 defines a "collaborative arrangement" and provides guidance for the income statement presentation, classification, and disclosures related to collaborative arrangements. While ASC 808 applies to the collaboration agreement, an entity will need to consider whether the collaborative arrangement is wholly or partially in the scope of other GAAP (e.g., ASC 606) for accounting purposes based on the nature of its units of account. For example, if an entire unit(s) of account of the collaborative arrangement is a transaction with a customer, that unit of account is in the scope of ASC 606.

Relevant guidance

ASC 808-10-20: Collaborative arrangement: A contractual arrangement that involves a joint operating activity (see paragraph 808-10-15-7). These arrangements involve two (or more) parties that meet both of the following requirements:

a. They are active participants in the activity (see paragraphs 808-10-15-8 through 15-9).

b. They are exposed to significant risks and rewards dependent on the commercial success of the activity (see paragraphs 808-10-15-10 through 15-13).

ASC 808-10-15-8: 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:

a. Directing and carrying out the activities of the joint operating activity

b. Participating on a steering committee or other oversight or governance mechanism

c. Holding a contractual or other legal right to the underlying intellectual property.

ASC 808-10-15-9: An entity that solely provides financial resources to an endeavor is generally not an active participant in a collaborative arrangement within the scope of this Topic.

ASC 808-10-15-10: 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.

ASC 808-10-15-13: 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 shall use judgment in determining whether its participation in an arrangement subjects it to significant risks and rewards.

6-3 Contract term

Background

Company A enters into a ten-year term license arrangement with Company B under which Company A transfers to Company B the exclusive rights to sell product using its intellectual property (IP) in a particular territory. The IP is considered "functional" (as defined in ASC 606) at the time the license is granted, and Company A has no other performance obligations in the arrangement. Company B makes an upfront nonrefundable payment of $25 million and is obligated to pay an additional $1 million at the end of each year throughout the stated term (i.e., ten additional payments of $1 million each).

Company B can cancel the contract for convenience at any time; however, it must surrender its rights to the licensed IP to Company A upon cancellation. Company B does not receive any refund of amounts previously paid upon cancellation.

Question:

What is the contract term for purposes of determining the transaction price?

Solution

Company A would likely conclude that the contract term is ten years because Company B cannot cancel the contract without incurring a substantive termination penalty. The substantive termination penalty in this arrangement is Company B's obligation to transfer an asset to Company A through the return of its exclusive rights to the licensed IP without a refund of amounts paid. As a result of concluding the contract term is ten years, Company A would also need to consider whether the 10-year payment term for the annual $1 million payments gives rise to a significant financing component. See FAQ 6-17 for more information on identifying and accounting for a significant financing component.

If a contract can be terminated early with no penalty, enforceable rights and obligations would likely not exist for the entire stated term. The contract may, in substance, be a shorter-term contract with a right to renew. In contrast, a contract that can be terminated early, but requires payment of a substantive termination penalty, is likely to have a contract term for accounting purposes equal to its stated term. This is because enforceable rights and obligations exist throughout the stated contract period.

The assessment of whether a substantive termination penalty is incurred upon cancellation could require significant judgment when the termination penalty is not explicit. In this example, surrendering the rights to the IP for no refund of consideration is considered to constitute a termination penalty. Assessing whether that termination penalty is "substantive" also requires judgment and consideration of the specific arrangement. Factors to consider include the nature of the license, the payment terms (for example, how much of the consideration is paid upfront), the business purpose of contract terms that include termination rights, and the impact of contract cancellation on other performance obligations, if any, in the contract.

If management concludes that a termination right creates a contract term shorter than the stated term, management should assess whether the arrangement contains a renewal option that provides the customer with a material right.

Relevant guidance

ASC 606-10-25-3: Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations…

ASU 2014-09, Revenue from Contracts with Customers (Topic 606) paragraph BC50: The Boards decided that Topic 606 should not apply to wholly unperformed contracts if each party to the contract has the unilateral enforceable right to terminate the contract without penalty. Those contracts would not affect an entity's financial position or performance until either party performs. In contrast, there could be an effect on an entity's financial position and performance if only one party could terminate a wholly unperformed contract without penalty. For instance, if only the customer could terminate the wholly unperformed contract without penalty, the entity is obliged to stand ready to perform at the discretion of the customer. Similarly, if only the entity could terminate the wholly unperformed contract without penalty, it has an enforceable right to payment from the customer if it chooses to perform.

6-4 Determining who the customer is when a manufacturer sells product to a wholesaler

Background

Company A, a pharmaceutical company, enters into an arrangement with Wholesaler X, whereby Wholesaler X can purchase drug tablets for list price (often referred to as Average Wholesale Price or AWP) less 3%. Wholesaler X can only return drug tablets to Company A if they have not been sold through and they only have six months remaining to their expiry. Wholesaler X enters into a contract with Hospital Y to sell the drug for list price plus 2%. Hospital Y does not need to buy from Wholesaler X; it can negotiate pricing for drug tablets with multiple wholesalers to obtain the cheapest price. Wholesaler X has the ability to sell the drug tablet to any customer at any price and can decide whether to sell the drug to Hospital Y or another entity (e.g., another hospital or pharmacy). Company A's sales team is actively marketing the drug to Wholesaler X's customers, including Hospital Y.

On January 1, 20X2, Wholesaler X orders 100,000 tablets (expiry is June 30, 20X6) from Company A. Company A delivers the units to Wholesaler X's warehouse. On February 20, 20X2, Hospital Y orders 25,000 tablets from Wholesaler X. Wholesaler X delivers the drugs to Hospital Y. Company A is responsible for the acceptability of the drug such that Hospital Y directs any quality issues to Company A.

Question:

Who is Company A's customer and how should Company A account for this transaction?

Solution

Company A would first identify the performance obligation(s) in the arrangement and would likely conclude that the underlying tablets are distinct performance obligations. Company A would then assess whether control of the tablets is transferred to Wholesaler X prior to Wholesaler X's onward sale to Hospital Y or any other customer to determine whether Wholesaler X is a principal or an agent.

If Company A transfers control of the drug tablets to Wholesaler X, Wholesaler X is a principal, in which case Wholesaler X would be considered Company A's customer and Company A would recognize revenue at its selling price to Wholesaler X upon transfer of control of the tablets to Wholesaler X.

Company A would consider the indicators of whether Wholesaler X controls the goods (drug tablets) before they are transferred to Hospital Y. Wholesaler X has the ability to sell the drug tablet to any customer and can decide whether to sell the drug to Hospital Y or another entity (e.g., another hospital or pharmacy). Wholesaler X has inventory risk because Wholesaler X purchased the drug tablets before obtaining a contract with Hospital Y and has the ability to direct the use of and obtain substantially all of the benefits of transferring the drug tablets to its customers. The fact that Company X has a right of return would need to be assessed by Company A and may result in some reduction of revenue for the potential returned goods.

The fact that Company A markets the drugs to Wholesaler X's customers is not determinative as many companies market their products to end users to generate demand. Similarly, Company A's responsibility for the quality of the acceptability of the drugs to Hospital Y is akin to a product assurance warranty that does not preclude a conclusion that control of the drugs has transferred.

In this example, the indicators appear to support a conclusion that Wholesaler X is the principal in the sale of the drugs to Hospital Y. Therefore, Wholesaler X is Company A's customer for the order of 100,000 tablets.

Because Wholesaler X is Company A's customer, Company A should record revenue, net of variable consideration for any estimated discounts, rebates, or contractual allowances that will become due and payable once the drug is sold on to Wholesaler X's customers, when control of the 100,000 tablets transfers to Wholesaler X.

The determination of which party is an entity's customer and who is the principal in a transaction involving three or more parties often requires judgment and can affect both the timing and amount of revenue ultimately recognized. Companies should assess the facts and circumstances when making the principal versus agent assessment.

Relavant guidance

ASC 606-10-55-36: When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

ASC 606-10-55-36A: To determine the nature of its promise (as described in paragraph 606-10-55-36), the entity should:

a. Identify the specified goods or services to be provided to the customer (which, for example, could be a right to a good or service to be provided by another party [see paragraph 606-10-25-18])

b. Assess whether it controls (as described in paragraph 606-10-25-25) each specified good or service before that good or service is transferred to the customer.

ASC 606-10-55-37: An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

ASC 606-10-55-38: An entity is an agent if the entity's performance obligation is to arrange for the provision of the specified good or service by another party. An entity that is an agent does not control the specified good or service provided by another party before that good or service is transferred to the customer. When (or as) an entity that is an agent satisfies a performance obligation, the entity recognizes revenue in the amount of any fee or commission to which it expects to be entitled in exchange for arranging for the specified goods or services to be provided by the other party. An entity's fee or commission might be the net amount of consideration that the entity retains after paying the other party the consideration received in exchange for the goods or services to be provided by that party.

ASC 606-10-55-39: Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

ASC 606-10-55-39A: The indicators in paragraph 606-10-55-39 may be more or less relevant to the assessment of control depending on the nature of the specified good or service and the terms and conditions of the contract. In addition, different indicators may provide more persuasive evidence in different contracts.

ASC 606-10-32-25: Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

6-5 Assessing distinct promises (license and R&D and manufacturing services)

Background

Company A enters into an arrangement to (1) provide Company B with a license to manufacture and commercialize a clinical-stage drug compound, and (2) perform ongoing R&D and manufacturing services to continue to develop the compound. The compound is currently in Phase II clinical trials. The license is delivered to Company B in the first quarter and the R&D and manufacturing services will be provided throughout the development period.

Question:

What factors should Company A consider when assessing whether the license is distinct in this arrangement?

Solution

Significant judgment is required when identifying the number of performance obligations in an arrangement that includes a license to intellectual property (IP) as well as R&D and/or manufacturing services performed by the licensor. In determining whether the license is distinct, Company A should consider whether the license is capable of being distinct and whether the promise to transfer the license is distinct in the context of the contract.

Capable of being distinct

This criterion is met if Company B can benefit from the license on its own or with other readily available resources. The license may not be capable of being distinct if the R&D or manufacturing services are highly specialized such that the services could only be performed by Company A, as opposed to Company B or another qualified third party.

Distinct in the context of the contract

This criterion is met if the promise to transfer the license is separately identifiable from the R&D or manufacturing services. The license may be separately identifiable from the R&D services if the R&D services are not expected to significantly modify or customize the licensed IP. This is often the case with a clinical-stage drug compound since the purpose of the clinical trials is to validate the usage and efficacy of the licensed IP (i.e., the drug compound). The license may be separately identifiable from the manufacturing services if Company B is not contracting for the combined output of the license and the manufactured product, and Company A could fulfill its promise to deliver the license independent of fulfilling the promise to provide manufacturing services.

The determination of whether a license and manufacturing services are distinct is judgmental, but in this case, because the IP is in clinical trials and the manufacturing services are not so highly specialized that no one other than Company A could perform them, Company A would likely conclude that the license and manufacturing services are distinct.

If the facts were changed such that the IP was in its very early-stages of development (i.e., still within the drug discovery cycle) whereby the R&D or manufacturing services are expected to involve significant modification of the drug formula or biological compound, Company A would most likely conclude that the license is not separately identifiable from the R&D or manufacturing services.

Relevant guidance

ASC 606-10-25-19: A good or service that is promised to a customer is distinct if both of the following criteria are met:

- The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

ASC 606-10-25-20: A customer can benefit from a good or service... if it can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

ASC 606-10-55-56: ...Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good
b. A license that the customer can benefit from only in conjunction with a related service...

6-6 Assessing distinct promises (license and manufacturing services)

Background

Company A enters into an agreement with Company B to provide Company B with a license to develop, manufacture, and commercialize a mature product for a period of 10 years. For the first 5 years of the license period, Company A will continue to manufacture the drug while Company B is building its manufacturing facilities and developing its manufacturing capabilities. As the license is related to a mature product, it is not expected that the underlying product will change over the license period. There are no other promised goods or services in the contract.

Question:

What factors should Company A consider when assessing whether the license is distinct in this arrangement?

Solution

Determining whether the license is distinct in this scenario will depend on the facts and circumstances surrounding the license and the related manufacturing services. Company A will need to determine whether the customer can benefit from the license on its own, as well as whether the license is separately identifiable from the manufacturing services.

For example, if the manufacturing process is highly specialized and only Company A has the knowledge and expertise to perform the manufacturing services, the license may not be distinct as Company B cannot benefit from the license on its own but rather requires the ongoing involvement of Company A to continue the manufacturing. Importantly, that evaluation is not made solely based on an evaluation of Company B's ability to perform the manufacturing based on its current circumstances but whether any entity other than Company A could perform the manufacturing services. If Company A is the only company with the requisite capabilities to perform the manufacturing services, the license may not be distinct as Company B has contracted with Company A for the license as well as the manufacturing of the product for the first 5 years. In other words, Company B can only benefit from the license in conjunction with the related manufacturing services and therefore the license and manufacturing services would be accounted for as a single performance obligation.

Conversely, if Company B could contract with another company (for example, a contract manufacturing organization) to perform the manufacturing services, the license would be capable of being distinct as the customer can benefit from the license on its own without Company A's ongoing involvement. This would be the case even if Company B is contractually required to use Company A to manufacture the product for the defined period. Additionally, the license may be separately identifiable as Company B is not contracting for the combined output of the license and manufacture of product, and Company A could fulfill its promise to deliver the license independent of fulfilling the promise to provide manufacturing services. In this instance, Company A would likely conclude that the license is distinct.

Relevant guidance

ASC 606-10-25-19: A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

ASC 606-10-25-20: A customer can benefit from a good or service... if it can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

ASC 606-10-55-56: ...Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

1. A license that forms a component of a tangible good and that is integral to the functionality of the good.

2. A license that the customer can benefit from only in conjunction with a related service...

6-7 Assessing whether a distribution license is distinct

Background

Company A enters into an agreement with Company B for a license to commercialize Company A's mature drug product in Country X for a period of 10 years. The license solely provides Company B with the right to sell Company A's mature drug product and cannot be transferred or sublicensed to other parties. Company A will also manufacture and supply the drug to Company B for Company B's commercial sales in Country X. There are no other promised goods or services in the contract.

Question:

Does Company A provide Company B with a distinct license?

Solution

Company A does not provide Company B with any rights beyond a right to distribute Company A's product. For example, Company B does not have the right to use the intellectual property to perform further development activities or to manufacture product. Further, Company B cannot obtain benefit from the license by transferring it to another party. Thus, the license does not have any standalone functionality and solely enables Company B to resell product purchased from Company A. The license is not distinct because Company B can only benefit from the license in conjunction with purchasing and reselling product from Company A.

Relevant guidance

ASC 606-10-25-19: A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

ASC 606-10-25-20: A customer can benefit from a good or service... if it can be used, consumed, sold for an amount that is greater than scrap value, or otherwise held in a way that generates economic benefits. For some goods or services, a customer may be able to benefit from a good or service on its own. For other goods or services, a customer may be able to benefit from the good or service only in conjunction with other readily available resources. A readily available resource is a good or service that is sold separately (by the entity or another entity) or a resource that the customer has already obtained from the entity (including goods or services that the entity will have already transferred to the customer under the contract) or from other transactions or events. Various factors may provide evidence that the customer can benefit from a good or service either on its own or in conjunction with other readily available resources. For example, the fact that the entity regularly sells a good or service separately would indicate that a customer can benefit from the good or service on its own or with other readily available resources.

ASC 606-10-55-56: ...Examples of licenses that are not distinct from other goods or services promised in the contract include the following:

a. A license that forms a component of a tangible good and that is integral to the functionality of the good.

b. A license that the customer can benefit from only in conjunction with a related service...

6-8 Accounting for options to additional license rights for the same underlying intellectual property

Background

Company A provides Company B with a license to use its intellectual property (IP) for a single indication. Company A also provides Company B with an option during the term of the arrangement to add rights to use the IP for additional indications if the IP is proven effective for those other indications.

Question:

How should Company A evaluate the option it provided to Company B?

Solution

Company A should consider whether the option provided to Company B is a material right. That is, does the option provide Company B a discount on a future purchase that is incremental to the range of discounts typically given to the same class of customer.

If the option provides a material right to Company B, then Company A would conclude there are two performance obligations in the arrangement: (1) the license to use Company A's IP for a single indication and (2) the right to purchase additional licensed rights for additional indications at a discount in the future. Company A would then allocate a portion of the transaction price to the initial license and a portion to the option for future licenses based on their relative standalone selling prices. If the standalone selling price for the option that Company A provided to Company B is not directly observable, Company A should estimate it. That estimate should reflect (1) the discount that Company B would obtain when exercising the option relative to any discount that would otherwise be available and (2) the likelihood that Company B will exercise the option. The amount allocated to the material right(s) would be recognized when the licenses (additional rights to use of the IP) transfer to Company B in the future, or when the option expires, if unexercised.

If the option to obtain the additional license rights is at a price that reflects the standalone selling price for the additional rights, the option does not provide Company B with a material right even if the option can only be exercised because of the previous contract. In that case, Company A should not allocate any portion of the transaction price to the option.

Relevant guidance

ASC 606-10-55-42: If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

ASC 606-10-55-45: If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may, as a practical alternative to estimating the standalone selling price of the option, allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration...

6-9 Price protection clauses

Background

Company A, a pharmaceutical drug manufacturer, enters into a sales arrangement with a group purchasing organization (GPO). Included in the agreement is a price protection clause that guarantees that the GPO will receive Company A's lowest selling price. If Company A sells its products to another customer at a lower price, the GPO will receive the lower price on all future purchases. Company A is not obligated to, and has no history of, providing retroactive price adjustments to its customers.

Question:

Does inclusion of this price protection clause impact the current sales to the GPO?

Solution

Company A will need to assess whether it has conveyed a material right to the GPO to buy products at a lower price in the future. In this determination, Company A would consider, among other things, whether the "discount" on future purchases (i.e., potentially lower price) is incremental to any discount that would be received by other similar classes of customers in the same market.

In this fact pattern, that would not appear to be the case as the GPO is not receiving the right to the future discount as a result of current purchases (e.g., a discount after achieving a specified volume of purchases). Rather, the GPO is entitled to lower future prices if lower prices are offered to another customer of Company A. At the time the GPO receives the lower pricing, it will be the same pricing charged to similar customers. As such, the price protection clause does not provide GPO a material right and would not impact the accounting for current sales. Future sales will be accounted for at the established prices.

When the price protection clause could require Company A to provide the GPO a retroactive price concession if it lowered its prices in the future, or if Company A has a history of providing such concessions to GPO or other large customers, the price protection clause would be evaluated as variable consideration for current sales, and, depending on the facts, a portion of contractual selling price might need to be allocated to a refund liability.

Relevant guidance

ASC 606-10-55-42: If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

6-10 Volume purchase arrangements

Background

On January 1, 20X1, Company A enters into a two-year arrangement with Company B for the sale of pharmaceutical drugs. The terms of the agreement do not specify any contractual minimum purchases by Company B. However, once the number of purchases exceeds 1,000 units of the drug, the price per unit decreases from $12 per unit (which represents the "list" price for this drug) to $8 per unit for each unit purchased thereafter (often referred to as a volume purchase arrangement). Company A routinely offers other similar customers (in terms of potential purchasing volume) a 5% discount. At contract inception Company A believes that Company B's total purchases will be 2,000 units based on its experience with similar contracts and forecasted sales to the customer.

As of December 31, 20X1, Company B has ordered 1,000 units of the drug and Company A still expects that another 1,000 units will be sold throughout 20X2.

Question:

How should Company A account for the sale of the first 1,000 units of the drug?

Solution

Company A needs to evaluate whether the volume purchase arrangement represents a material right.

Company A offers Company B a 33.3% discount on all purchases after the first 1,000 units ($8 per unit --> $4 less than $12 list price; $4 / $12 = 33.3%). Company A routinely offers other customers who purchase similar volumes of products a 5% discount on their purchases, indicating that the standalone selling price of the product is $11.40 per unit ($12 * 95%). Because the 33.3% discount is incremental to the range of discounts typically given by Customer A to that class of customer, the volume purchase arrangement contains a material right. Company A must calculate the value of the material right at contract inception and allocate the total transaction price based on relative standalone selling prices. Using the facts in this example, the allocation is as follows:

	Standalone selling price	Allocation	Transaction price
Standalone selling price of 1,000 units (a)	$11,400	77.0%	$9,240
Standalone selling price of material right			
Actual purchase price of 1,000 additional units at discounted contract price	$8,000		
Intrinsic value of option	$3,400		
Likelihood of exercise	100%		
Standalone selling price (b)	$3,400	23.0%	$2,760
Total standalone selling price ((a) + (b))	$14,800		$12,000

When Company A sells the first 1,000 units to Company B, it will receive $12,000. Company A would recognize $9,240 of revenue and $2,760 as a contract liability for the material right. The contract liability will be recognized as revenue upon exercise (that is, purchase of additional product) or expiry.

When Company A sells the second 1,000 units to Company B, it will receive $8,000 (1,000 units x $8). Company A would recognize the $8,000 received as well as the $2,760 allocated to the material right.

In this case, Company A would report $9,240 of revenue associated with the first 1,000 units of product and $10,760 ($8,000 plus $2,760) related to the second 1,000 units.

ASC 606-10-55-45 provides a practical alternative for allocating consideration to a material right if the discounted goods are similar to the initial goods. Applying that practical alternative, Company A would estimate the total consideration that Company B will pay under the volume purchase arrangement and allocate it to the expected total purchases of 2,000 units. The transaction price per unit on 2,000 units would be $10 ((1,000 units x $12 plus 1,000 units x $8 = $20,000)/2,000 total units). As each unit is delivered to Company B, Company A would recognize revenue of $10. At the end of each quarter, it would revise the estimate of sales under the volume purchase arrangement and record a true-up to reflect the cumulative adjustment on shipments through that date.

As illustrated in this example, the practical alternative will often result in a different allocation of revenue than the allocation based on relative standalone selling prices—i.e., $10,000 on the first 1000 units under the practical alternative compared to $9,240 using the relative standalone selling price allocation.

Relevant guidance

ASC 606-10-55-42: If, in a contract, an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract (for example, a discount that is incremental to the range of discounts typically given for those goods or services to that class of customer in that geographical area or market). If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

ASC 606-10-55-44: ...If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option

b. The likelihood that the option will be exercised.

ASC 606-10-55-45: If a customer has a material right to acquire future goods or services and those goods or services are similar to the original goods or services in the contract and are provided in accordance with the terms of the original contract, then an entity may... allocate the transaction price to the optional goods or services by reference to the goods or services expected to be provided and the corresponding expected consideration.

ASC 606-10-32-29: To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

6-11 Installation obligation—separate performance obligations

Background

Company A, a medical equipment company, receives a customer order for equipment and installation services. Company A will install the equipment at the customer site shortly after delivery and does not expect the customer to return or reject the equipment. The installation services typically take two months after delivery of the equipment to the customer's site. The contract price is $500, which includes the equipment and installation.

The installation services are routine in nature and Company A is not the only party capable of performing the services. As such, the customer can benefit from the equipment on its own or together with other resources that are readily available (i.e., the customer could engage another party to perform the installation services). Therefore, the equipment and installation services are capable of being distinct and are separately identifiable from one another. Based on this evaluation, Company A concludes the contract includes two performance obligations: the equipment and installation services.

Company A determines the standalone selling price of the equipment is $450 and of the installation services is $150.

Question:

How should Company A recognize revenue for the sale of the equipment and installation services?

Solution

Company A would first allocate the total transaction price of $500 to each performance obligation identified in the contract based on its relative standalone selling price. Based on the standalone selling prices ($450 and $150), this results in $375 ($450 / ($450 + $150) --> 75% x $500 = $375) being allocated to the equipment and $125 ($150 / ($450 +$150) --> 25% x $500 = $125) being allocated to the installation services.

The amount allocated to the equipment ($375) would be recognized as revenue at the point in time at which the customer obtains control of the equipment. The amount allocated to the installation services ($125) would be recognized as revenue as the installation services are performed by Company A using a measure of progress that depicts Company A's performance in satisfying the performance obligation.

Relevant guidance

ASC 606-10-25-14: At contract inception, an entity assess the goods or services promised in a contract with a customer and shall identify as a performance obligation each promise to transfer to the customer either: (a) a good or service (or a bundle of goods or services) that is distinct (b) a series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer...

ASC 606-10-32-29: To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

6-12 Standard product warranty vs. an extended product warranty

Background

Company A, a manufacturer of medical devices, provides a standard product warranty as part of its normal sales contract terms. The standard product warranty is an agreement to provide warranty protection by the manufacturer for a specific period of time; there is no separate charge for the warranty and it cannot be purchased separately from the product.

Company A also offers customers the option to purchase an extended warranty that provides coverage beyond the scope of coverage of the standard warranty. Customers also have the option of purchasing a product maintenance contract, under which Company A will perform certain agreed-upon services to maintain its product for a specific period of time.

Question:

Does the extended warranty or a product maintenance contract constitute a performance obligation in the arrangement?

Solution

Yes. Extended product warranties and contracts for product maintenance provide customers with a distinct service and would represent a performance obligation under ASC 606. Company A should allocate the transaction price to the product and the extended warranty and product maintenance services following the guidance in ASC 606-10-32-28 through 32-41. If Company A cannot reasonably account for the service element(s) of the warranty or product maintenance separate from the standard warranty, then the standard warranty and the service elements(s) of the warranty and/or product maintenance should be accounted for together as a single performance obligation under ASC 606.

Relevant guidance

ASC 606-10-55-31: If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10-55-34: If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

6-13 Accounting for upgrades and enhancements

Background

Pursuant to a sales agreement, Company A sells a medical device and is also obligated under the arrangement to deliver a specific upgrade that will be included in the next generation of the device. The contract terms also require that Company A provide unspecified "when-and-if-available" upgrades/enhancements to the device during the three-year term of the arrangement. Company A is entitled to, and receives, payment of the full contract price at the inception of the arrangement. Company A expects to deliver the specified upgrade shortly after the initial sale. The arrangement does not contain any general or specific rights of return.

Question:

Are obligations to deliver future upgrades or enhancements of a product considered separate performance obligations?

Solution

Both the specific and the unspecified upgrades/enhancements in the contract are promises under ASC 606-10-25-14 and should be evaluated to determine if they are separate performance obligations that necessitate separate accounting pursuant to ASC 606-10-25-19 through 25-22.

Company A would need to determine if the medical device, as delivered, is distinct from the specific and unspecified upgrades/enhancements to identify the performance obligations in the contract. The unspecified upgrades/enhancements in this example would most likely be a separate performance obligation because the device will be fully functional upon delivery and the customer can obtain the benefit of the equipment without the unspecified upgrades. Company A would also need to determine if the specified upgrade is a separate performance obligation.

If one or more of the goods or services significantly modifies or customizes, or is significantly modified or customized by, one or more of the other goods or services promised in the contract, this is an indicator that the good or service is not distinct. For Company A, a critical evaluation would need to be performed to determine if the specific upgrade may significantly modify the medical device and reflects (together with the original device) the combined product that the customer is actually purchasing. On the other hand, if the medical device is fully functional upon delivery and that functionality is not expected to be significantly modified by future upgrades, this would indicate that the medical device is distinct from the promised upgrades.

If Company A determines the contract has three performance obligations—the device, the specific upgrade, and the unspecified upgrades/enhancements—revenue for the device will be recognized for the allocated consideration upon delivery (transfer of control). For the specific upgrade, revenue will be recognized for the allocated consideration when the upgrade is delivered. The allocated consideration for the unspecified upgrades/enhancements would be recognized ratably over the three-year term of the contract.

If Company A concludes that the delivered medical device is not distinct, the delivered medical device would be bundled with one or more of the other distinct goods or services in the contract and recognized as revenue using an appropriate pattern based on the guidance in ASC 606-10-25-23. For example, if the initial medical device and the specific upgrade were not considered distinct, revenue would likely be recognized (1) upon the transfer of control of the specific upgrade for the amount allocated to this combined performance obligation, and (2) over the three-year term of the contract for the amount allocated to the unspecified upgrades/enhancements.

Relevant guidance

A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract. Paragraphs 606-10-25-14 through 25-22 further discuss identification of performance obligations.

ASC 606-10-25-18: Depending on the contract, promised goods or services may include, but are not limited to, the following:… e. Providing a service of standing ready to provide goods or services (for example, unspecified updates to software that are provided on a when-and-if-available basis) or of making goods or services available for a customer to use as and when the customer decides...

ASC 606-10-25-19: A good or service that is promised to a customer is distinct if both of the following criteria are met:

a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).

b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

6-14 Future discount on next-generation equipment

Background

Company A sells a medical device to Company B and there is no right of return. Company A is currently developing the next-generation product, which it expects to release in six months. As an incentive for Company B to purchase the current model, Company A offers a 40% discount on the next-generation model when it is released. Management has not determined what the selling price of the next-generation model will be.

Question:

How should Company A account for the sale of the medical device?

Solution

The 40% discount on the next-generation model provides a material right to the customer. Company A will need to allocate the consideration received for the sale of the device between the device and the material right based on the relative standalone selling prices of the medical device and the option.

Assume that Company A sells the current model of the device for $100 and uses the cost-plus-margin approach to determine that the estimated standalone selling price of the future model will be $110. Under this scenario, Company A would determine the amount of revenue to allocate to the material right (i.e., revenue that would be deferred from the total transaction price from the sale of the current model) by multiplying the estimated future standalone selling price of $110 by the 40% discount and assessing the probability that Company B will exercise the option, and then allocating the $100 transaction price between the device and the material right (the two performance obligations) based on their relative standalone selling prices, as described in ASC 606-10-32-29.

Relevant guidance

ASC 606-10-55-42: If … an entity grants a customer the option to acquire additional goods or services, that option gives rise to a performance obligation in the contract only if the option provides a material right to the customer that it would not receive without entering into that contract. ...If the option provides a material right to the customer, the customer in effect pays the entity in advance for future goods or services, and the entity recognizes revenue when those future goods or services are transferred or when the option expires.

ASC 606-10-55-44: ...If the standalone selling price for a customer's option to acquire additional goods or services is not directly observable, an entity should estimate it. That estimate should reflect the discount that the customer would obtain when exercising the option, adjusted for both of the following:

a. Any discount that the customer could receive without exercising the option.

b. The likelihood that the option will be exercised.

ASC 606-10-32-34: Suitable methods for estimating the standalone selling price of a good or service include, but are not limited to, the following:

a. Adjusted market assessment approach—An entity could evaluate the market in which it sells goods or services and estimate the price that a customer in that market would be willing to pay for those goods or services. That approach also might include referring to prices from the entity's competitors for similar goods or services and adjusting those prices as necessary to reflect the entity's costs and margins.

b. Expected cost plus a margin approach—An entity could forecast its expected costs of satisfying a performance obligation and then add an appropriate margin for that good or service.

c. Residual approach—An entity may estimate the standalone selling price by reference to the total transaction price less the sum of the observable standalone selling prices of other goods or services promised in the contract...

6-15 Trade-in credits offered to a customer for the purchase of next-generation equipment

Background

Company A enters into a contract with Company B for the sale of a medical device system for $25,000. Company A is currently developing the next-generation medical device system, which it expects to release within two years from the initial sale. As part of the initial contract to sell the medical device to Company B, Company A provides Company B with an offer to trade-in the purchased medical device system for a credit of $10,000 towards the purchase of the next-generation medical device system once it becomes commercially available. Company A anticipates it will sell the next-generation medical device system to customers for $32,500. The trade-in credit expires 18 months after next-generation medical device system is commercially available.

Question:

Is the trade-in credit a guarantee in the scope of ASC 460, a repurchase right in the scope of ASC 606, or simply a marketing offer?

Solution

Company A evaluates whether the trade-in credit is accounted for as a guarantee of the value of the medical device system or a repurchase right.

Prior to applying the guidance in ASC 606, Company A considers whether there are elements in the contract with Company B, such as the trade-in right, that may be subject to other specific GAAP. ASC 460 requires guarantees to be accounted for separately and provides a list of arrangements that meet the definition of a guarantee. Unless a guarantee qualifies for one of the exceptions for initial recognition of a guarantee liability, a liability for the fair value of the guarantee is recognized when it is issued.

Company A evaluates the relevant scope exceptions provided in ASC 460, specifically ASC 460-10-15-7(k), which states a sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods is evaluated based on the guidance in ASC 606 for repurchase agreements. The presence of a repurchase agreement will often result in the transaction being accounted for as a lease. While this scope exception applies to arrangements that require the seller to repurchase a product sold to a customer for a specified price at a specified time, it does not explicitly address whether the scope exception applies to a trade-in right that is contingent upon the customer entering into a subsequent contract to obtain additional goods or services from the seller. Thus, judgment is required to evaluate the substance of the trade-in right.

In this fact pattern, Company A might conclude that the trade-in right does not meet the scope exception in ASC 460-10-15-7(k) because Company B's right to require Company A to repurchase the initial medical device system is conditional on Company B's decision to buy the next-generation medical device system at a price of $32,500. Thus, Company A would account for the trade-in right as a guarantee.

Conversely, Company A might conclude that, except for the requirement for Company B to purchase the next-generation medical device system, the trade-in credit is consistent with an arrangement described in the scope exception ASC 460-10-15-7(k). Therefore, Company A would assess the trade-in credit as a customer put option based on the guidance in ASC 606. In general, if the put option requires the seller to repurchase the asset at a price that is less than the original sales price and the customer has significant economic incentive to exercise that right, the contract is accounted for as a lease and subject to ASC 842.

We believe applying either approach is acceptable when accounting for trade-in credits in contracts with customers where the credit is conditional on a future purchase.

Company A should also consider whether the trade-in credit is an in-substance discount on the purchase of another product that provides a material right to Company B. This may be the case if the medical device system is not expected to have value to the vendor at the time of the trade-in, such as when the trade-in credit is only exercisable at the end of the equipment's useful life or is otherwise obsolete.

When evaluating whether a trade-in credit is in the scope of ASC 460 or ASC 606, Company A should consistently apply the same approach to similar arrangements with similar terms and conditions.

Relevant guidance

ASC 606-10-15-2(d): An entity shall apply the guidance in this Topic to all contracts with customers, except the following… Guarantees (other than product or service warranties) within the scope of Topic 460, Guarantees.

ASC 460-10-15-4: Except as provided in paragraph 460-10-15-7, the provisions of this Topic apply to the following types of guarantee contracts:

a. Contracts that contingently require a guarantor to make payments…to a **guaranteed party based on changes in an underlying** that is related to an asset, a liability, or an equity security of the guaranteed party…

ASC 460-10-15-7: The guidance in this Topic does not apply to the following types of guarantee contracts:

k. A sales incentive program in which a manufacturer contractually guarantees to reacquire the equipment at a guaranteed price or guaranteed prices at a specified time, or at specified time periods (for example, the entity is obligated to reacquire the equipment or the entity is obligated at the customer's request to reacquire the equipment). That program shall be evaluated in accordance with Topic 606…specifically the implementation guidance on repurchase agreements in paragraphs 606-10-55-66 through 55-78.

ASC 606-10-55-66: A repurchase agreement is a contract in which an entity sells an asset and also promises or has the option (either in the same contract or in another contract) to repurchase the asset. The repurchased asset may be the asset that was originally sold to the customer, an asset that is substantially the same as that asset, or another asset of which the asset that was originally sold is a component.

ASC 606-10-55-72: If an entity has an obligation to repurchase the asset at the customer's request (a put option) at a price that is lower than the original selling price of the asset, the entity should consider at contract inception whether the customer has a significant economic incentive to exercise that right. The customer's exercising of that right results in the customer effectively paying the entity consideration for the right to use a specified asset for a period of time. Therefore, if the customer has a significant economic incentive to exercise that right, the entity should account for the agreement as a lease in accordance with Topic 842 on leases unless the contract is part of a sale and leaseback transaction. If the contract is part of a sale and leaseback transaction, the entity should account for the contract as a financing arrangement and not as a sale and leaseback transaction in accordance with Subtopic 842-40.

6-16 Determine the transaction price

Background

Company A and Company B enter into an arrangement to jointly develop a potential drug that is currently in Phase II clinical trials. As part of the arrangement, Company A agrees to provide Company B a license to Company A's proprietary intellectual property (IP) underlying the drug candidate. Company A also agrees to provide research and development (R&D) services—in the form of conducting clinical trials for the drug candidate—to Company B. Company A receives an upfront payment of $20 million at the inception of the arrangement and is eligible to receive a milestone payment of $25 million upon regulatory approval of the drug.

Question:

How should Company A determine the transaction price for this arrangement?

Solution

The upfront payment of $20 million is fixed consideration and included in the transaction price from inception.

The $25 million milestone payment if the drug receives regulatory approval is variable consideration and would be included in the transaction price by first estimating the amount of consideration and applying the constraint on variable consideration to that amount. Given the nature of the milestone in this fact pattern, Company A would use the "most likely amount" method to estimate variable consideration since the outcome of the contingency is binary; that is, either regulatory approval is granted and Company A will be entitled to $25 million or regulatory approval is not granted and Company A will receive $0.

At contract inception, due to the current stage of development and the fact that regulatory approval (which depends on the judgments and actions of third parties) is highly susceptible to factors outside of the company's control, Company A may not be able to assert that it is likely the regulatory approval will be granted. As such, Company A would likely conclude that the most likely amount of the variable consideration is $0, which also obviates the need to consider the constraint. Therefore, at contract inception, Company A's total transaction price would be $20 million, consisting of just the upfront payment.

Company A would need to update its estimate of variable consideration at each reporting date (i.e., update its assessment of the likelihood of regulatory approval).

Relevant guidance

ASC 606-10-32-2: An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer... The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

ASC 606-10-32-8: An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

6-17 Significant financing component

Background

On January 1, 20X5, Company A entered into a six-year arrangement to transfer a license to a mature drug product in exchange for a nonrefundable upfront fee of $500 million and an additional $200 million through five equal $40 million annual installments payable annually on January 1, 20X6 through January 1, 20Y0. There are no other performance obligations in the arrangement, and the arrangement does not include a right to terminate for convenience. Company A concludes it has transferred control of the license to Company B at the effective date of the arrangement.

Question:

Does a significant financing component exist?

Solution

A financing component exists in this arrangement because Company A provides Company B with all of the benefits of the licensed rights at the inception of the arrangement but allows Company B to pay a portion of the consideration over the contract term. Company A evaluates whether the financing component is significant to the contract. In making this evaluation, Company A notes that (1) there is a significant period of time between when control of the license is transferred (the effective date) and when all of the consideration is paid by Company B, and (2) the amount of consideration payable more than one year from the effective date is significant. As such, Company A would likely conclude that a significant financing component exists.

Company A would determine the present value the five future annual installments of $40 million using an interest rate appropriate for Company B's credit rating. For purposes of this example, assume an appropriate rate is 8%, and the present value would equal $160 million. Company A would recognize the $660 million as revenue on January 1, 20X5 when Company A transferred control of the license to functional IP to Company B. Company A would also recognize $40 million of interest income over the remainder of the contract term.

Relevant guidance

ASC 606-10-32-15: In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

ASC 606-10-32-19: To meet the objective in paragraph 606-10-32-16 when adjusting the promised amount of consideration for a significant financing component, an entity shall use the discount rate that would be reflected in a separate financing transaction between the entity and its customer at contract inception. That rate would reflect the credit characteristics of the party receiving financing in the contract, as well as any collateral or security provided by the customer or the entity, including assets transferred in the contract. An entity may be able to determine that rate by identifying the rate that discounts the nominal amount of the promised consideration to the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer. After contract inception, an entity shall not update the discount rate for changes in interest rates or other circumstances (such as a change in the assessment of the customer's credit risk).

6-18 Estimating variable consideration when an arrangement contains contingent bonus *payments*

Background

Company A, a contract research organization, enters into an arrangement with Company B, a pharmaceutical company, to perform a clinical trial on a Phase III drug candidate, which is expected to take two years to complete. Company A will receive fixed consideration of $20 million plus an additional milestone (bonus) payment of $2 million if it successfully screens and enrolls 100 patients in the clinical trial in the first two months of the contract term. Company A has extensive experience enrolling patients and completing similar types of trials in the same field that Company B's drug candidate is targeting. Company A believes (1) there is a large population of patients to potentially screen for the clinical trial and (2) its past experience of screening patients has significant predictive value.

Question:

At the inception of the arrangement, should Company A include the bonus payment in the transaction price?

Solution

The bonus payment represents variable consideration that must be estimated using either the most likely amount or the expected amount under the guidance in ASC 606. Since there is a binary outcome in this arrangement (i.e., Company A either will or will not enroll 100 patients in the first two months), Company A would use the most likely amount method to estimate variable consideration.

Because Company A has extensive experience in screening and enrolling patients and those activities are largely within its control as well as the fact that the contingency is expected to be resolved in a relatively short period of time, Company A would likely include the $2 million bonus in the transaction price at inception. It would then consider the variable consideration constraint and is likely to conclude that it is probable there will not be a significant reversal of cumulative revenue at the time the contingency is resolved due to the size of the bonus in relation to the upfront payment (10%) coupled with the expected stage of completion at the two-month mark when the contingency will be resolved in relation to the expected trial length of two years.

Relevant guidance

ASC 606-10-32-2: An entity shall consider the terms of the contract and its customary business practices to determine the transaction price. The transaction price is the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer... The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.

ASC 606-10-32-8: An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

ASC 606-10-32-12: ...Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

6-19 Applying the variable consideration constraint to milestone payments using a cost-to-cost measure of progress

Background

Company A enters into a license arrangement with Company B to develop a potential drug currently in a Phase I clinical trial. As part of the arrangement, Company A agrees to provide Company B a perpetual license to Company A's proprietary intellectual property. Company A also agrees to provide R&D services to Company B in the form of completing clinical trials to develop the potential drug. In this case, due to the early stage of development, Company A determined the license to the proprietary IP and R&D services are not distinct and thus are accounted for as a single performance obligation that is satisfied over time. Company A receives an upfront payment of $40 million at the inception of the arrangement and will receive a milestone payment of $10 million upon the successful completion of the Phase I clinical trial ("Phase I milestone").

Company A uses a cost-to-cost model (an input method) to measure progress as it has determined that method best depicts its progress toward satisfaction of the performance obligation under the agreement. At the inception of the arrangement, Company A estimates that the costs expected to be incurred through the completion of Phase I clinical trials is approximately 75% of the total expected costs. Due to the binary nature of the milestone payment—either Phase I clinical trials are successfully completed or not—Company A concludes that the most likely amount method is the appropriate approach to estimate the variable consideration associated with the milestone payment. Based on its experience with similar clinical trials and the nature of this research program, Company A believes the most likely outcome is that it will successfully complete Phase I, and therefore it includes the full $10 million payment in the transaction price.

Question:

How should Company A apply the variable consideration constraint at contract inception in this fact pattern?

Solution

Under ASC 606, variable consideration is included in the transaction price unless it is not probable that a significant reversal of cumulative revenue will occur if the uncertainty is resolved unfavorably. The assessment of the probability of whether a potential reversal of revenue is significant should be done at the contract level (i.e., in relation to the contract price), but also should consider the expected stage of progress (percentage of completion) at the time the uncertainty will be resolved.

In this arrangement, if the $10 million milestone payment for the successful completion of Phase I is included in the transaction price from contract inception, $37.5 million ($50 million x estimate of 75% progress toward completion of all of the services in the contract) of cumulative revenue will have been recognized at the expected completion of the Phase I clinical trial.

If the Phase I milestone is not successfully achieved, the entire arrangement would be terminated and no further services would be required of Company A, the potential adjustment to revenue would be additional revenue of $2.5 million ($40 million versus $37.5 million).

Company A should therefore include the Phase I milestone payment in the transaction price at contract inception because (1) Company A has estimated variable consideration of $10 million using the "most likely amount" approach and (2) if the milestone was not achieved, it would not result in a significant reversal of cumulative revenue.

Relevant guidance

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration, only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

ASC 606-10-32-12: ...Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

6-20 Accounting for reimbursement of costs when using a cost-to-cost measure of progress

Background

Company A, a biotechnology company, enters into an arrangement with Company B, a pharmaceutical company, to develop a potential drug currently in the pre-clinical stage. Company A agrees to provide Company B a perpetual license to Company A's proprietary IP and perform R&D services for Company B, including conducting clinical trials to develop the potential drug. In this case, due to the early stage of development, Company A determined the license to the proprietary IP and R&D services are not distinct and thus are accounted for as a single performance obligation that is satisfied over time. Company A determines that a cost-to-cost method best depicts its progress toward satisfying the performance obligation under the agreement. Company A receives an upfront payment of $100 million at the inception of the arrangement and will also be reimbursed for all R&D costs incurred at a rate of 100%.

Question:

At the inception of the arrangement, should Company A include an estimate of cost reimbursements for the R&D costs in the transaction price?

Solution

Cost reimbursements from a customer represent consideration under a revenue contract. Therefore, Company A should include an estimate of the total expected R&D reimbursements in the transaction price at the inception of the arrangement. For example, assume Company A expects to incur total R&D costs of $60 million to fulfill the performance obligation. It should include $60 million of estimated reimbursements in the transaction price based on the contractual reimbursement rate of 100%--i.e., total transaction price at inception of $160 million. Company A is also required to consider the constraint on variable consideration—i.e., whether it is probable that a significant reversal of cumulative revenue will not occur if the amount of the reimbursements end up being less than $60 million. Because, in this fact pattern, the reimbursements vary directly with the R&D services and those same R&D services are the sole inputs to the cost-to-cost measure of progress, the revenue related to the variable consideration would only be recognized as the costs are incurred such that, at no time, would Company A be exposed to a significant reversal of cumulative revenue related to variable consideration under the arrangement. Company A would update its estimate of the R&D reimbursements to include in the transaction price each reporting period to reflect the best and most current information available.

Relevant guidance

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration, only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

6-21 Price appreciation rights

Background

Company A, a pharmaceutical company, manufactures prescription drug B (the product) and sells the product to Company B, a wholesaler, at wholesale acquisition cost (WAC). Company B obtains control of the product before selling it to a retailer at a price determined by Company B.

Company A and Company B are parties to a distribution services agreement (DSA) under which Company A is entitled to price appreciation credits from Company B for any product that Company B has not yet sold through to a third party if Company A increases WAC for the product. That is, Company B will owe Company A for the difference between the old price and the new price for any product that Company B has on hand when the new WAC pricing takes effect. Company A increases WAC for the product on December 1, 20X0, which becomes effective on January 1, 20X1.

Company A generally has not made significant adjustments to an announced price increase between the price approval date and the effective date, and Company A has observed that Company B consistently maintains an approximate one month's supply of the product based on periodic inventory reports it provides Company A.

Question:

How should Company A account for December 20X0 sales?

Solution

The price appreciation right is a form of variable consideration in this arrangement. Under the variable consideration guidance, Company A would include an estimate of future price appreciation credits in the transaction price of the December 20X0 deliveries of the product and assess whether it is probable that a significant reversal of revenue will not occur (i.e., whether it is probable that Company A would make a significant downward adjustment to WAC from the previously announced level prior to when those units are sold through by Company B).

Assuming, based on Company A's history, that a significant reversal of revenue is not expected, and, ignoring for simplicity any other "gross to net adjustments" that Company A may need to consider, Company A would recognize revenue for the December 20X0 sales of the product at the expected higher ultimate price inclusive of the price appreciation credits because the product delivered during December 20X0 is expected to remain on hand in Company B's inventory through January 1, 20X1 (the effective date of the price increase).

Relevant guidance

ASC 606-10-32-8: An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled.

a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.

b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract). The most likely amount may be an appropriate estimate of the amount of variable consideration if the contract has only two possible outcomes (for example, an entity either achieves a performance bonus or does not).

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

6-22 Rebates paid to a customer's customer

Background

Company A enters into an arrangement with Distributor X for the sale of pharmaceutical drugs. Distributor X then sells the product to Customer B. Customer B is entitled to a rebate from Company A of 25% of its purchase price of 100 units if at least 1,000 units are purchased.

Company A has developed a relationship with Customer B from selling pharmaceutical drugs for a number of years. Further, Company A has offered a similar incentive to Customer B in prior years.

The unit price for the drug is $100. Company A believes that it has sufficient basis to estimate that Customer B will purchase at least 1,000 units during the year and earn the full rebate.

Question:

How should Company A account for rebates to be paid to Customer B?

Solution

Company A's performance obligations in the contract are the promises to deliver individual units of the pharmaceutical drug to Distributor X, when and as requested by Distributor X, over the term of the arrangement. To determine the transaction price, Company A will need to estimate the effect of the rebate offered to Customer B (Distributor X's customer). Even though the product is sold to Distributor X and the rebates are paid to Customer B, a payment to a customer's customer is considered a payment to a customer, and unless made in exchange for a distinct good or service, is treated as a reduction of revenue. Company A estimates that 1,000 units will be delivered to Customer B; therefore, the total rebate will be $2,500 (i.e., 100 units x $100 price per unit x 25% rebate). Therefore, the transaction price for each unit would be $97.50 ($100,000 less $2,500 rebate divided by 100 units).

As each unit is shipped, Company A would recognize a contract liability (rebate accrual) of $2.50 ($2,500 total rebate divided by 100 units) and a corresponding reduction of revenue. At the end of each reporting period, Company A would reassess its estimate of total expected sales and adjust the transaction price and rebate accrual accordingly, which would include a cumulative adjustment to revenue for product delivered through that date.

Relevant guidance

ASC 606-10-32-25: Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

6-23 Accounting for retroactive rebates

Background

Company A has a multi-year contract to sell pharmaceutical drugs to Company B and agrees to pay Company B an annual rebate if Company B completes a specified annual volume of purchases during any year of the contract period. The amount of rebate varies based on a tiered structure. Based on its historical experience selling pharmaceutical drugs to Company B, Company A has assigned probabilities to the various possible purchase volume outcomes.

Purchases	Rebate	Probability
1-1,000 units	0%	15%
1,001-2,000 units	2%	60%
Greater than 2,000 units	5%	25%

The unit price of the drug is $100.

Question:

How should Company A account for the rebate arrangement with Company B?

Solution

The rebate arrangement represents a form of variable consideration. For an arrangement with multiple potential outcomes, the “expected value” method better predicts the amount of consideration to which Company A will be entitled. Under the expected value approach, using the estimated probabilities outlined in the table, Company A would estimate the rebate to be 2.45% as follows:

Purchases	Rebate	Probability	Weighting
1-1,000 units	0%	15%	0.00%
1,001-2,000 units	2%	60%	1.20%
Greater than 2,000 units	5%	25%	1.25%
			2.45%

Therefore, as each unit is shipped during the year, Company A would recognize $97.55 of revenue and a rebate accrual of $2.45. At the end of each quarter, Company A would update its estimate of sales volumes to Company B and adjust the rebate accrual through a cumulative adjustment for revenue recognized to date.

The same guidance would apply to rebate programs mandated by or negotiated with a government health system.

Relevant guidance

ASC 606-10-32-25: Consideration payable to a customer includes cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). Consideration payable to a customer also includes credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer). An entity shall account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity. If the consideration payable to a customer includes a variable amount, an entity shall estimate the transaction price (including assessing whether the estimate of variable consideration is constrained) in accordance with paragraphs 606-10-32-5 through 32-13.

ASC 606-10-32-8: An entity shall estimate an amount of variable consideration by using either of the following methods, depending on which method the entity expects to better predict the amount of consideration to which it will be entitled:

a. The expected value—The expected value is the sum of probability-weighted amounts in a range of possible consideration amounts...

b. The most likely amount—The most likely amount is the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract)…

6-24 Pay-for-performance arrangements

Background

Company A manufactures, markets, and sells Drug B to a hospital. The hospital administers Drug B to its patients. Under the terms of their arrangement, the hospital is eligible for a full refund of the price paid for the administered product from Company A if the patient test results do not meet the predetermined objective criteria after three months of treatment. The hospital has two months after the treatment period to process the request for refund (i.e., a total of five months after the initial treatment).

Company A obtained FDA approval for Drug B two years ago and began selling Drug B immediately to the hospital. Over the past two years, Company A and the hospital have been tracking the number of patients whose post-treatment test results did not meet the predetermined criteria, and it has consistently ranged from 6-7%. Based on the nature of this drug and the relatively consistent patient results over the past two years, Company A expects future refunds to be consistent with historical results.

Question:

How should Company A account for this arrangement?

Solution

This arrangement includes a contingent refund, which represents a form of variable consideration. Company A will need to estimate the total transaction price at contract inception, which given its historical experience with a fairly large number of previous transactions, would likely be estimated using the expected value approach. Company A would then need to evaluate the variable consideration constraint and include an amount of variable consideration in the transaction price to the extent that it is probable that doing so would not subject the company to a significant revenue reversal of revenue under the contract when the uncertainty is subsequently resolved.

Although Company A's ability to predict the refund rate is enhanced by its historical experience, merely a lack of historical experience is not sufficient to fully constrain the variable consideration until the contingency is resolved. Even in a circumstance in which Company A has a limited history to draw upon, it would need to determine if there is a minimum level of estimated sales for which it is probable that a change in estimate would not cause a significant reversal of revenue, and record revenue for those sales.

Relevant guidance

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration... only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

ASC 606-10-32-12: ... Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.

b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.

c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.

d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.

e. The contract has a large number and broad range of possible consideration amounts.

6-25 Accounting for receipt of listed shares in exchange for a patent

Background

Company A agrees to acquire a patent from Company B to develop a drug. Company A will pay for the right it acquires by giving Company B 5% of its shares (which are listed and not subject to any restrictions). Company B is in the business of licensing and selling patents in its patent portfolio; therefore, Company A is considered a customer. The listed shares are considered to be equal in value to the patent. If Company A is successful in developing a drug and bringing it to the market, Company B will receive a 5% royalty on all sales.

Question:

How should Company B account for this transaction?

Solution

Company B should initially recognize the shares received as equity securities. Assuming that the equity security has a readily determinable fair value, subsequent changes in the fair value should be recognized in earnings. Company B should derecognize the patent transferred to Company A to the extent an asset has been previously recorded.

Company B concluded that Company A is a customer. In accordance with ASC 606, Company B should initially recognize as revenue the estimated fair value of the shares received at contract inception (i.e., the noncash consideration).

If Company B can estimate a minimum amount of royalties it expects to receive and it is probable that the amount will not result in a significant reversal of cumulative revenue in the future, such estimated amounts are included in the transaction price at the time of sale. Company B should update its assessment of these royalties at each reporting date. Since the transaction is a sale of IP and not a license, the sales-and usage-based royalty exception in ASC 606 does not apply.

Relevant guidance

ASC 321-10-20: Readily determinable fair value—An equity security has a readily determinable fair value if it meets any of the following conditions:

a. The fair value of an equity security is readily determinable if sales prices or bid-and-asked quotations are currently available on a securities exchange registered with the U.S. Securities and Exchange Commission (SEC) or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the National Association of Securities Dealers Automated Quotations systems or by OTC Markets Group Inc. Restricted stock meets that definition if the restriction terminates within one year.

b. The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above...

ASC 321-10-35-1: Except as provided in paragraph 321-10-35-2 [equity securities without readily determinable fair values], investments in equity securities shall be measured subsequently at fair value in the statement of financial position. Unrealized holding gains and losses for equity securities shall be included in earnings.

ASC 606-10-32-21: To determine the transaction price for contracts in which a customer promises consideration in a form other than cash, an entity shall measure the estimated fair value of the noncash consideration at contract inception...

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration estimated only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

6-26 Determining standalone selling price

Background

Company A enters into an arrangement that includes the transfer of a license to a developed drug compound as well as R&D services to identify other potential applications for the compound. The transaction price consists of a single upfront payment of $30 million. The license is delivered to the customer at contract signing, which occurs in the first quarter of Company A's fiscal year. The R&D services will be provided over a three-year period. Company A has assessed the promises in the arrangement—the license and the R&D services—and concluded that the license and R&D services are distinct. Therefore, Company A needs to allocate the total transaction price between them using the relative standalone selling price methodology. Company A has not previously sold either the license or R&D services individually.

Question:

How would Company A determine the standalone selling price of each performance obligation?

Solution

The standalone selling prices for the license and the R&D services are not directly observable as (1) the license to the intellectual property (IP) and (2) the R&D services are both unique to the underlying IP and Company A does not sell R&D services on a standalone basis. Therefore, Company A will need to estimate the standalone selling price of each performance obligation to allocate the transaction price.

ASC 606 does not prescribe a particular estimation method, nor does it prohibit any methods as long as the method used results in an estimate that fairly represents the price the entity would charge for the goods or services if they were sold separately. Additionally, while there is not a prescribed hierarchy for weighting the evidence or inputs used to develop the estimate, Company A should maximize the use of observable inputs in determining the estimated standalone selling price.

Company A may use any the following methods:

- Adjusted market assessment approach—A market assessment approach considers the market in which the good or service is sold and estimates the price that a customer in that market would be willing to pay. This approach would consider competitors' pricing for similar goods or services adjusted for specific factors such as position in the market, expected profit margin, and customer or geographic segments. Company A would need to also consider the exact rights associated with the license, the stage of development of the underlying product and the projected cash flows over the license period. Related to the R&D services, Company A may consider prices of similar services offered in the marketplace.
- Expected cost plus a margin—Under this method, an entity estimates the standalone selling price by considering the costs incurred to produce the product or service plus an adjustment for the expected margin expected on the sale. This method may be more appropriate if the license is in an early stage of development or forecasted revenues and cash flows do not exist. This method may also be appropriate to determine the selling price of R&D services by considering the level of effort necessary to perform the services.

- Residual approach—Under this approach, the estimated standalone selling price of other goods and services in the contract with known selling prices are deducted from the total transaction price to determine the standalone selling price for the remaining goods and services. In limited circumstances, the residual approach may be used to determine the estimated standalone selling price of a good or service. However, this approach may only be used if either (1) the entity sells the same good or service to different customers for a broad range of amounts or (2) the entity has not yet established a price for that good or service and the good or service has not previously been sold on a standalone basis. Given the unique nature of the license to the intellectual property, such an approach might be appropriate in this fact pattern.

Company A should use judgment to determine which method best reflects the price that Company A would charge if the license and R&D services were sold on a standalone basis.

Relevant guidance

ASC 606-10-32-29: To meet the allocation objective, an entity shall allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with paragraphs 606-10-32-31 through 32-35, except as specified in paragraphs 606-10-32-36 through 32-38 (for allocating discounts) and paragraphs 606-10-32-39 through 32-41 (for allocating consideration that includes variable amounts).

ASC 606-10-32-32: The standalone selling price is the price at which an entity would sell a promised good or service separately to a customer. The best evidence of a standalone selling price is the observable price of a good or service when the entity sells that good or service separately in similar circumstances and to similar customers...

6-27 Proceeds from licensing intellectual property

Background

Company A and Company B enter into an agreement in which Company A will license Company B's intellectual property (IP) related to a compound to treat HIV. Company B will not undertake any other activities under the contract. Company A will use Company B's IP for a period of three years. Company B receives a nonrefundable upfront payment of $30 million from Company A in exchange for the licensed rights to the IP. Company B will also receive a royalty of 20% of Company A's sales of the HIV compound if Company A successfully develops a marketable drug.

Question:

How should Company B account for the upfront payment and royalties received for the license of its IP?

Solution

Because the IP relates to a drug compound that Company A can use without any further development activities by Company B, Company B would conclude that it has granted a "right to use" license to functional IP. As a result, the nonrefundable upfront payment of $30 million would be recognized at the point in time that Company A obtains control of the rights contained in the license.

The royalties payable upon future sales by Company A are subject to the exception for variable consideration related to sales-or usage-based royalties received in exchange for licenses of IP. Therefore, Company B will recognize revenue for those royalties when (if) the subsequent sales occur in the future.

Relevant guidance

ASC 606-10-55-62: A license to functional intellectual property grants a right to use the entity's intellectual property as it exists at the point in time at which the license is granted unless both of the following criteria are met:

a. The functionality of the intellectual property to which the customer has rights is expected to substantively change during the license period as a result of activities of the entity that do not transfer a promised good or service to the customer... Additional promised goods or services (for example, intellectual property upgrade rights or rights to use or access additional intellectual property) are not considered in assessing this criterion.

b. The customer is contractually or practically required to use the updated intellectual property resulting from the activities in criterion (a)...

ASC 606-10-55-65: ...An entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

6-28 Accounting for a change in estimate of total expected costs using a cost-to-cost measure of progress

Background

In 20X1, Company A entered into a license arrangement with Company B to develop a potential drug currently in a Phase I clinical trial. As part of the arrangement, Company A agreed to provide Company B a perpetual license to Company A's proprietary intellectual property (IP) related to the drug candidate. Company A will provide research and development (R&D) services to Company B through the completion of the Phase 1 clinical trials. Company A receives an upfront payment of $50 million at the inception of the arrangement.

Company A determined that the licenses to the proprietary IP and R&D services are not distinct, and, thus, that the arrangement contains a single performance obligation that is satisfied over time. This example does not address how the company identified the performance obligations for this arrangement. For information on how to assess distinct promises, see FAQ 6-5.

Company A included the $50 million upfront payment in the transaction price at inception. In estimating variable consideration related to the regulatory milestone, at inception Company A concluded that the most likely amount was zero. Company A determined that it would be appropriate to use a cost-to-cost method to measure progress because this measure of progress best depicts its transfer of control of the R&D services to Company B under the contract.

At contract inception, Company A's best estimate of total costs to complete the Phase 1 clinical trials was $25 million. Through 20X2, Company A had incurred $15 million of actual costs and the estimated total costs remained at $25 million at that point. As a result, Company A had recognized $30 million of cumulative revenue (($15 million incurred costs to date divided by $25 million estimated total costs) times $50 million transaction price).

During 20X3, Company A needed to update the trial plans based on a notification from the FDA requiring an additional patient cohort. This resulted in an increase in Company A's best estimate of the costs to complete the Phase 1 clinical trials of $20 million to a total of $45 million. Cumulative actual costs of $30 million had been incurred through December 31, 20X3.

Question:

How should Company A account for the change in estimated costs in its December 31, 2023 annual financial statements?

Solution

Company A considers the increase in total estimated costs necessary to satisfy the R&D services performance obligation a change in estimate. Company A assessed the facts and circumstances surrounding the change in estimate, which resulted from new information communicated by the FDA in November 20X3. As a result, when completing its periodic update to estimated costs to complete and, in turn, cumulative progress toward completion of the performance obligation, Company A would use the updated estimate of total costs of $45 million as the denominator in the cost-to-cost model and recalculate the cumulative amount of revenue that should be recognized. That cumulative amount of revenue is compared to the cumulative amount of revenue recognized as of the prior period end (December 31, 20X2). This results in cumulative revenue of $33.3 million (($30 million incurred costs divided by $45 million estimated total costs) times $50 million transaction price). Company A would need to recognize $3.3 million of revenue for the year ended December 31, 20X3 as it has already recognized $30 million in cumulative revenue through December 31, 20X2.

It should be noted that depending on how the numerator and the denominator change as a result of new cost estimates, there may be circumstances when a company would recognize negative revenue for an individual accounting period. For example, if the facts were changed such that cumulative actual costs incurred through December 31, 20X3 were $26 million, Company A would have recognized negative revenue of $1.1 million because cumulative revenue should be $28.9 million (($26 million incurred costs divided by $45 million estimated total costs) * $50 million transaction price) compared to the $30 million in cumulative revenue recognized as of the prior period end.

Relevant guidance

ASC 606-10-25-31: For each performance obligation satisfied over time in accordance with paragraphs 606-10-25-27 through 25-29, an entity shall recognize revenue over time by measuring the progress toward complete satisfaction of that performance obligation. The objective when measuring progress is to depict an entity's performance in transferring control of goods or services promised to a customer (that is, the satisfaction of an entity's performance obligation).

ASC 606-10-25-32: An entity shall apply a single method of measuring progress for each performance obligation satisfied over time, and the entity shall apply that method consistently to similar performance obligations and in similar circumstances. At the end of each reporting period, an entity shall remeasure its progress toward complete satisfaction of a performance obligation satisfied over time.

ASC 606-10-25-33: Appropriate methods of measuring progress include output methods and input methods. Paragraphs 606-10-55-16 through 55-21 provide guidance for using output methods and input methods to measure an entity's progress toward complete satisfaction of a performance obligation. In determining the appropriate method for measuring progress, an entity shall consider the nature of the good or service that the entity promised to transfer to the customer.

ASC 606-10-25-35: As circumstances change over time, an entity shall update its measure of progress to reflect any changes in the outcome of the performance obligation. Such changes to an entity’s measure of progress shall be accounted for as a change in accounting estimate in accordance with Subtopic 250-10 on accounting changes and error corrections.

6-29 Determining whether a license of IP is "predominant"

Background

Pharma A licenses its patent rights to an approved, mature drug compound to Customer B for a license term of 10 years. Pharma A also promises to provide training and transition services relating to the manufacturing of the drug for a period not to exceed three months. The manufacturing process is not unique or specialized, and the services are intended to help Customer B maximize the efficiency of its manufacturing process. Pharma A concludes that the license and services are distinct. The only compensation for Pharma A in this arrangement is a royalty based on a percentage of Customer B's sales of the product.

Question:

Does the sales-and usage-based royalty exception apply to this arrangement?

Solution

Because this arrangement contains a license to intellectual property as well as other performance obligations, Pharma A needs to determine whether the license of IP is predominant. The sales-and usage-based royalty exception (the "royalty exception") only applies to (1) licenses of IP or (2) an arrangement in which the license to IP is predominant. Customer B would presumably ascribe significantly more value to the 10-year license of IP than to the three months of training and transition services. Thus, applying the exception, Pharma A would recognize revenue as the customer's subsequent sales occur.

In other scenarios when the vendor provides more substantive manufacturing services in addition to a license of IP in exchange for a sales-based royalty, it may be less apparent that the license of IP is predominant and judgment will need to be applied.

If an entity concludes that the license is not predominant, it would apply the general variable consideration guidance (including the variable consideration constraint) to estimate the transaction price and allocate the transaction price between the performance obligations in the arrangement—i.e., the license and the manufacturing services. The portion allocated to the license will be recognized when control of the IP has transferred to the customer—i.e., the customer is able to use and benefit from the license. The portion allocated to the manufacturing services will be recognized when (or as) control of the product is transferred to the customer.

Relevant guidance

ASC 606-10-32-5: If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

ASC 606-10-55-65: Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of IP only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

ASC 606-10-55-65A: The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of IP or when a license of IP is the predominant item to which the royalty relates (for example, the license of IP may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

6-30 Sales-based milestones

Background

Company A entered into an arrangement with Company B whereby Company A has agreed to provide to Company B a license to its IP. The license was transferred to Company B at contract inception. In return, Company B has paid Company A an upfront payment of $10 million and will pay Company A an additional $20 million in the event Company B's annual sales of products associated with this licensed IP exceed $250 million.

Question:

How should Company A account for the sales-based milestone?

Solution

We believe the $20 million sales-based milestone would be viewed as a sales-based royalty given it is based on Company B's subsequent sales of products associated with the licensed IP. Thus, the royalty exception applies.

Under the royalty exception, the milestone is recognized at the later of (1) when the subsequent sales or usage occurs or (2) full or partial satisfaction of the performance obligation to which some or all of the sales-based milestone has been allocated.

Company A would recognize the $20 million sales-based milestone as revenue when the subsequent sales entitling Company A to the milestone payment occur because the performance obligation was satisfied (control of the license transferred) at the beginning of the contract.

Relevant guidance

ASC 606-10-32-5: If the consideration promised in a contract includes a variable amount, an entity shall estimate the amount of consideration to which the entity will be entitled in exchange for transferring the promised goods or services to a customer.

ASC 606-10-32-6: An amount of consideration can vary because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items. The promised consideration also can vary if an entity's entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event. For example, an amount of consideration would be variable if either a product was sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone.

ASC 606-10-55-65: Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of IP only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

ASC 606-10-55-65A: The guidance for a sales-based or usage-based royalty in paragraph 606-10-55-65 applies when the royalty relates only to a license of intellectual property or when a license of intellectual property is the predominant item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates).

6-31 Milestone payment based on first commercial sale

Background

In June 20X1, Company A enters into an arrangement to license functional IP to Company B. The IP relates to an unapproved drug that will be further developed by Company B. The license is transferred at contract inception and there are no other performance obligations in the contract. In exchange for the license, Company A will receive:

- An upfront payment of $50 million, and
- A milestone payment of $30 million upon first commercial sale of a product by Company B.

In December 20X2, the drug is approved by the FDA, and the first commercial sale occurs in February 20X3. As of December 31, 20X2, it is probable that a commercial sale will occur.

Question:

How should Company A account for the milestone payment triggered upon first commercial sale?

Solution

The $30 million milestone payment is variable consideration. Because it is contingent upon Company B's subsequent sale of the drug using Company A's IP, we believe a reasonable interpretation of the guidance is that the sales-based or usage-based royalty exception would apply.

Applying the royalty exception, the milestone is recognized when the subsequent sales or usage occurs—i.e., February 20X3.

Company A should consider providing disclosure in the December 20X2 financial statements about the milestone and Company A's judgment that the sales-based royalty exception applies to the payment.

Relevant guidance

ASC 606-10-55-65: Notwithstanding the guidance in paragraphs 606-10-32-11 through 32-14, an entity should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

a. The subsequent sale or usage occurs.

b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

6-32 Right of return

Background

Company A sells cardiac drugs to a number of wholesale and retail customers. The drugs have a shelf life of 24 months from the date manufactured. Both wholesalers and retailers can return the drugs from six months before to six months after the expiration date, subject to compliance with other provisions in Company A's return policy.

Company A has sold these drugs for the past two years. Through December 31, 20X2, 3% of the drugs have been returned in accordance with policy.

On December 31, 20X2, Company A delivered 100 units to Distributor Z for $200 each, for a total sale of $20,000.

Question:

How much revenue should Company A recognize for the $20,000 sale on December 31, 20X2?

Solution

Company A would reduce the $20,000 sale for an estimate of returns.

Company A will need to use judgment to determine the exact amount of revenue to recognize on December 31, 20X2. Company A will need to analyze its return volume, return patterns, current demand levels, the level of inventory currently in the distribution channel, as well as any new or upcoming Company A or competitor products that may render the product obsolete or otherwise impact product demand.

Although Company A has sold the product for 2 years and has a history of returns experience, because of the extended nature of the return policy, it should assess whether the returns experience is sufficient to develop its returns estimate. However, even in a circumstance where a company has a limited history to draw upon to determine its estimate of returns, it would nonetheless need to develop an estimate of potential future returns—and reduce revenue—such that it is probable that future returns will not cause a significant reversal of revenue.

For example, if Company A estimates a 3% return rate (using the expected value approach for measuring variable consideration), it would recognize net revenue of $19,400 ($20,000 total order value—(3% x $20,000)) at December 31, 20X2, and a refund liability of $600 (3% x $20,000 product sales). Although in some cases it may be appropriate for an entity to recognize an asset and corresponding reduction to cost of sales for its right to the returned products in connection with settling the refund liability because the products in this case are perishable pharmaceuticals, Company A would typically not record an asset or an offsetting reduction to cost of sales.

Relevant guidance

ASC 606-10-55-22: In some contracts, an entity transfers control of a product to a customer and also grants the customer the right to return the product for various reasons (such as dissatisfaction with the product) and receive any combination of the following:

a. A full or partial refund of any consideration paid

b. A credit that can be applied against amounts owed, or that will be owed, to the entity

c. Another product in exchange.

ASC 606-10-55-23: To account for the transfer of products with the right of return...an entity should recognize all of the following:

a. Revenue for the transferred products in the amount of consideration to which the entity expects to be entitled (therefore, revenue would not be recognized for products expected to be returned)

b. A refund liability

c. An asset (and corresponding adjustment to cost of sales) for its right to recover products from customers on settling the refund liability.

ASC 606-10-55-25: An entity should apply the guidance in paragraphs 606-10-32-2 through 32-27 (including the guidance on constraining estimates of variable consideration in paragraphs 606-10-32-11 through 32-13) to determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned)…

6-33 Bill-and-hold arrangements

Background

A customer issues a purchase order on November 15, 20X1 to Company A, a medical equipment company, for Company A's standard machine. The machine is large and will require installation at the customer site, which will be performed by Company A. The purchase order requests a delivery and installation date of December 28, 20X1. On December 21, 20X1, the customer requests that Company A defer the planned delivery because the modification to the customer's facility that will enable the installation and operation of the equipment have been unexpectedly delayed. As of December 31, 20X1, Company A is able to identify and segregate the product for the customer in its warehouse, and the equipment is ready for transfer to the customer. Additionally, after inspecting the equipment and accepting the purchase, the customer has taken title to the equipment and has insured its purchase, thus restricting Company A's ability to redirect the machine to another customer. The customer has indicated that it will take delivery on January 25, 20X2 when the facility modifications are expected to be completed.

As of December 31, 20X1, Company A has invoiced the customer with payment terms that are consistent with its normal practices when shipping goods to customers.

Question:

When should Company A recognize revenue on this transaction?

Solution

This is a very facts-and-circumstances based analysis. Company A must first determine whether the medical equipment and the installation are distinct promises. Assuming that they are, Company A would then need to determine whether (1) control of the equipment has transferred to the customer even though the customer does not have physical possession, and (2) it has satisfied the additional criteria under the bill and hold guidance to recognize revenue. Typically, Company A recognizes revenue upon delivery, which is when control ordinarily transfers, using the guidance included in ASC 606-10-25-30. In this example, the indicators for transfer of control have been met, with the exception of the customer taking physical possession.

- Company A has a present right to payment for the asset (invoiced the customer with normal payment terms).
- The customer has legal title to the asset.
- The customer has the significant risks and rewards of ownership of the asset.
- The customer has accepted the asset.

Based on an analysis of these indicators, Company A would likely conclude that transfer of control has occurred for the product. Company A would then assess whether the additional bill and hold criteria under ASC 606-10-55-83 have been met.

- The customer has requested the bill and hold arrangement (and therefore, the arrangement must be substantive).
- The product is segregated and identified as belonging to the customer.
- The product is ready for physical transfer to the customer.
- Company A is not able to use the product or direct it to another customer.

In this fact pattern, all of the criteria have been met for the arrangement to qualify as a sale under the bill and hold guidance. Company A would therefore recognize revenue for the equipment as of December 31, 20X1.

Company A should also consider whether it has a remaining performance obligation for custodial services (in addition to the installation services). If so, unless the custodial services are considered an immaterial promise in the context of the contract, Company A will need to allocate a portion of the transaction price to this additional performance obligation and recognize the related revenue as the services are being performed.

Relevant guidance

ASC 606 includes specific guidance around bill-and-hold arrangements. As defined in ASC 606, a bill-and-hold arrangement is a contract under which an entity bills a customer for a product but the entity retains physical possession of the product until it is transferred to the customer at a point in time in the future.

ASC 606-10-25-30: ...An entity shall consider indicators of the transfer of control, which include, but are not limited to, the following:

a. The entity has a present right to payment for the asset...

b. The customer has legal title to the asset...

c. The entity has transferred physical possession of the asset...

d. The customer has the significant risks and rewards of ownership of the asset...

e. The customer has accepted the asset...

ASC 606-10-55-83: In addition to applying the guidance in paragraph 606-10-25-30, for a customer to have obtained control of a product in a bill-and-hold arrangement, all of the following criteria must be met:

a. The reason for the bill-and-hold arrangement must be substantive (for example, the customer has requested the arrangement).

b. The product must be identified separately as belonging to the customer.

c. The product currently must be ready for physical transfer to the customer.

d. The entity cannot have the ability to use the product or to direct it to another customer.

ASC 606-10-55-84: If an entity recognizes revenue for the sale of a product on a bill-and-hold basis, the entity should consider whether it has remaining performance obligations (for example, for custodial services) in accordance with paragraphs 606-10-25-14 through 25-22 to which the entity should allocate a portion of the transaction price in accordance with paragraphs 606-10-32-28 through 32-41.

6-34 Government vaccine stockpile arrangements

Background

Company A, a pharmaceutical company, and SEC registrant, sells 1 million influenza vaccines to the United States government for placement into a government vaccine stockpile. In December 20X1, Company A segregates the vaccines in its facility. The influenza vaccines are identified separately as belonging to the United States government. Company A does not have the ability to use the influenza vaccines or to direct them to another customer.

Question:

How should Company A account for this arrangement?

Solution

Company A should recognize revenue in December 20X1 when the 1 million influenza vaccines are placed into US government stockpile because the arrangement qualifies under the August 2017 SEC interpretive guidance related to US government stockpile programs, control of the vaccines has transferred to the customer, and the criteria in ASC 606 for recognizing revenue in a bill and hold arrangement are satisfied.

In addition, Company A will need to consider all of its performance obligations under the arrangement. For example, Company A will need to assess if the storage of stockpile product, the maintenance and rotation of stockpile product, and the shipping of product are separate performance obligations.

Relevant guidance

ASC 606-10-S25-1: …The Commission believes vaccine manufacturers should recognize revenue and provide the disclosures required under ASC Topic 606 when vaccines are placed into Federal Governmental stockpile programs because control of the enumerated vaccines will have been transferred to the customer and the criteria to recognize revenue in a bill-and-hold arrangement under ASC Topic 606 will have been met.

The following are the enumerated vaccines subject to this release:

- Childhood disease vaccines;
- Influenza vaccines; and
- Other vaccines and countermeasures sold to the Federal Government for placement in the Strategic National Stockpile.

Due to the uniqueness of the vaccine stockpile programs as discussed above, this interpretative guidance is not applicable to transactions other than the sales of enumerated vaccines by vaccine manufacturers.

6-35 Contract manufacturing

Background

Vendor A is hired by Customer B to manufacture a batch of 100,000 units of a drug with specific package labelling. The initial contract term is six months. Once bottled and labelled, there are significant practical limitations that preclude Vendor A from redirecting the product to another customer. Vendor A has an enforceable right to payment for performance completed to date if the contract is cancelled for any reason other than a breach or non-performance.

Question:

When and how should Vendor A recognize revenue?

Solution

Vendor A should recognized revenue over time pursuant to ASC 606-10-25-27(c). This is because (a) the drug to be manufactured has no alternative use to Vendor A (that is, Vendor A is practically precluded from redirecting the product to another customer once it has been bottled and labelled), and (b) Vendor A has an enforceable right to payment for any work in process if Customer B cancels the contract.

In a scenario in which Customer B maintains legal title to the raw materials throughout the contract manufacturing process, Vendor A would recognize revenue over time pursuant to ASC 606-10-25-27(b). In that scenario, the drug product is legally owned by Customer B throughout the manufacturing process and Vendor A's performance enhances Customer B's asset.

Relevant guidance

ASC 606-10-25-27: An entity transfers control of a good or service over time and, therefore, satisfies a performance obligation and recognizes revenue over time, if one of the following criteria is met:

a. The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs (see paragraphs (606-10-55-5 through 55-6).

b. The entity's performance creates or enhances an asset (for example, work in process) that the customer controls as the asset is created or enhanced (see paragraph 606-10-55-7).

c. The entity's performance does not create an asset with an alternative use to the entity … and the entity has an enforceable right to payment for performance completed to date (see paragraph 606-10-25-29).

6-36 Accounting for modifications

Background

Company A provided a license to its early-stage oncology drug target to Company B along with a promise to perform preclinical R&D services. Company A received an upfront, nonrefundable payment of $50 million and will receive reimbursement, at cost, for R&D services throughout the contract term up to a specified budget of $30 million. Company A is recognizing revenue over time for a single performance obligation (because it concluded the license and R&D services are not distinct) using a cost-to-cost model to measure progress.

Company A and Company B enter into an amendment to increase the budget for the R&D services to $40 million. As a result, Company A now expects to incur $10 million of additional R&D costs and to be reimbursed an additional $10 million by Company B. No other changes were made as part of this amendment.

Question:

How should Company A account for the modification?

Solution

The pricing for the additional R&D services (i.e., at cost) would not appear to represent standalone selling price. As a result, the contract modification would not meet the conditions to be accounted as a separate contract under ASC 606-10-25-12. The amendment merely extends the existing oncology R&D program, a single performance obligation that is only partially satisfied at the time of the amendment. Therefore, the modification does not add distinct goods and services at standalone selling price.

Applying the contract modification framework in ASC 606, Company A would (1) adjust the measure of progress by incorporating the additional costs it expects to incur in the denominator of its cost-to-cost model, (2) increase the transaction price by the additional consideration it now expects to receive, and (3) recalculate the cumulative revenue that should be recognized at the modification date and record a cumulative catch-up adjustment to revenue.

Relevant guidance

ASC 606-10-25-11: A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

ASC 606-10-25-12: An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).

b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract...

ASC 606-10-25-13: If a contract modification is not accounted for as a separate contract, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:

    1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and

    2. The consideration promised as part of the contract modification.

b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).

c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.

6-37 Gross vs. net arrangements

Background

Company A manufactures and sells a surgical instrument. The instrument requires a disposable that is manufactured and sold by Company B. To facilitate sales to its customers, Company A maintains an inventory of disposables and offers for sale both the surgical instrument and the disposables to its customers. If the disposables are not sold, Company A does not have a right of return to Company B.

Company A guarantees the performance of the disposables and offers a full refund to its customers on nonconforming parts. For nonconforming parts, Company A has a right to return the disposables for returns made by its customers for a replacement or a full refund from Company B.

While Company A has agreed with Company B not to sell the disposables for less than Company B's list price, Company A can charge any price at or above list price for its disposable sales. Company A receives a 10% discount off the list price when it purchases disposables from Company B.

Question:

Should Company A record revenue from the sale of disposables on a gross or net basis?

Solution

The transaction should be first evaluated against the principles of control in ASC 606-10-55-36 through 55-38, supplemented, as necessary, by the indicators detailed in ASC 606-10-55-39, to determine whether Company A has control over the disposables before they are transferred to the customer. In this example, Company A is primarily responsible for fulfilling disposables and the customer will look to Company A first to resolve any issues with the disposables. Company A also has inventory risk in the transaction and though Company A has agreed not to sell the disposables below Company B's list price, it still has some discretion in establishing the price. While significant judgment is required, the information above includes several indicators that Company A controls the disposables before they are transferred to the customer and would indicate that it is the principal in the transaction.

Relevant guidance

ASC 606-10-55-37: An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

ASC 606-10-55-39: Indicators that an entity controls the specified good or service before it is transferred to the customer (and is therefore a principal [see paragraph 606-10-55-37]) include, but are not limited to, the following:

a. The entity is primarily responsible for fulfilling the promise to provide the specified good or service. This typically includes responsibility for the acceptability of the specified good or service (for example, primary responsibility for the good or service meeting customer specifications). If the entity is primarily responsible for fulfilling the promise to provide the specified good or service, this may indicate that the other party involved in providing the specified good or service is acting on the entity's behalf.

b. The entity has inventory risk before the specified good or service has been transferred to a customer or after transfer of control to the customer (for example, if the customer has a right of return). For example, if the entity obtains, or commits to obtain, the specified good or service before obtaining a contract with a customer, that may indicate that the entity has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the good or service before it is transferred to the customer.

c. The entity has discretion in establishing the price for the specified good or service. Establishing the price that the customer pays for the specified good or service may indicate that the entity has the ability to direct the use of that good or service and obtain substantially all of the remaining benefits. However, an agent can have discretion in establishing prices in some cases. For example, an agent may have some flexibility in setting prices in order to generate additional revenue from its service of arranging for goods or services to be provided by other parties to customers.

6-38 Revenue recognition for customers with a history of long delays in payment

Background

Company A, a pharmaceutical company, sells prescription drugs to a governmental entity in Country X. Company A has historically experienced long delays in payment for sales to this entity due to slow economic growth and high debt levels in Country X. Company A currently has outstanding receivables from sales to this entity over the last three years and continues to sell product to Country X at its normal market price. The receivables are non-interest bearing.

Question:

How should Company A account for the outstanding receivables and future sales to Country X?

Solution

At the inception of each arrangement (each contract for revenue purposes), Company A will need to evaluate whether it is probable that it will collect all of the consideration to which it is entitled in exchange for the prescription drugs. ASC 606 indicates that for purposes of determining the transaction price, the entity should consider the variable consideration guidance, including the possibility of price concessions. If, based on its historical experience, Company A expects to ultimately provide a price concession to Country X, then the transaction price would be reduced by the amount of the expected price concession. Company A would then evaluate whether it is probable it will collect the adjusted transaction price. Assuming Company A concludes that it is probable that it will collect the transaction price, as adjusted for any expected price concessions, revenue will be recognized as Company A satisfies its performance obligation of delivering the drugs.

Additionally, if by agreement or based on past experience with the governmental entity, the amount of time expected between the sale of the prescription drug and expected payment from the governmental entity exceeds one year, before concluding on the final amount of the transaction price, Company A will need to consider if there is a significant financing element in the arrangement.

Company A will need to continually evaluate its outstanding receivables for impairment relating to the customer's credit risk using the cumulative expected credit loss (CECL) framework in ASC 326. Company A needs to consider whether any subsequent billing adjustments represent price concessions granted to the customer (i.e., a reduction to the transaction price) or a credit loss (i.e., a write-off of an uncollectible amount from the governmental entity). A modification of the transaction price reduces the amount of revenue recognized, while a credit adjustment is an impairment assessed under ASC 326, and recognized as a bad debt expense. The facts and circumstances specific to the adjustment should be considered, including the entity's past business practices and ongoing relationship with the customer, to make this determination.

Relevant guidance

ASC 606-10-25-1: An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met… (e) It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer... In evaluating whether collectability of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession...

ASC 606-10-32-11: An entity shall include in the transaction price some or all of an amount of variable consideration…only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

ASC 606-10-32-15: In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.

ASC 606-10-32-18: As a practical expedient, an entity need not adjust the promised amount of consideration for the effects of a significant financing component if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to the customer and when the customer pays for that good or service will be one year or less.

ASC 606 Example 1 (linked in ASC 606-10-55-93)—Collectability of the consideration…

ASC 326-20-30-1: The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset. At the reporting date, an entity shall record an allowance for credit losses on financial assets within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the allowance for credit losses for management's current estimate of expected credit losses on financial asset(s).

Chapter 7: Warranty

FAQ

7-1 Accounting for new product warranty

Background

Company A offers a standard warranty on a newly-launched medical device. Customers do not have the option to purchase the warranty separately. Company A has determined the standard warranty does not provide the customer a service in addition to the assurance that the product complies with agreed-upon specifications. Company A has no historical experience selling a similar medical device and has not offered a similar warranty on a different product in the past.

Question

How should Company A account for the standard warranty?

Solution

Company A would account for the warranty in accordance with ASC 460-10-25-5, which states that product warranties are contingencies. Therefore, Company A would consider the two conditions in ASC 450-20-25-2—i.e., whether a loss is (a) probable and (b) reasonable estimable. Company A would first assess whether it is probable that a loss was incurred in connection with the warranty. If it is probable that a loss was incurred, satisfaction of the second condition in ASC 450-20-25-2 (the amount can be reasonably estimated) will normally depend on the experience of the company or other available information.

If a customer has the option to purchase the warranty separately, or the warranty provides the customer with a service (e.g., repairing or replacing the device following damage caused by the customer) in addition to the assurance that the product complies with agreed-upon specifications, the warranty should be accounted for as a performance obligation and a portion of the transaction price would be allocated to the warranty performance obligation under ASC 606. If Company A cannot reasonably separate the service component from a standard warranty, then both should be accounted for together as one warranty-related performance obligation under ASC 606.

Refer to FAQ 6-12 for additional guidance on accounting for standard and extended product warranties.

Relevant guidance

ASC 606-10-55-31: If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10-55-32: If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 606-10-55-33: In assessing whether a warranty provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, an entity should consider factors such as:

a. Whether the warranty is required by law—If the entity is required by law to provide a warranty, the existence of that law indicates that the promised warranty is not a performance obligation because

such requirements typically exist to protect customers from the risk of purchasing defective products.

b. The length of the warranty coverage period—The longer the coverage period, the more likely it is that the promised warranty is a performance obligation because it is more likely to provide a service in addition to the assurance that the product complies with agreed-upon specifications.

c. The nature of the tasks that the entity promises to perform—If it is necessary for an entity to perform specified tasks to provide the assurance that a product complies with agreed-upon specifications (for example, a return shipping service for a defective product), then those tasks likely do not give rise to a performance obligation.

ASC 460-10-25-5: Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency. Losses from warranty obligations shall be accrued when the conditions in paragraph 450-20-25-2 are met.

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued... indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

b. The amount of loss can be reasonably estimated...

7-2 Accounting for warranty-related costs for equipment sold to customers

Background

Company A purchases components from various suppliers and integrates them into a single medical equipment solution that is sold to customers. Company A accounts for the sale of equipment in accordance with ASC 606. As part of its normal sales terms, Company A offers its customers a standard warranty that the medical equipment will (1) be free from defects and (2) operate in accordance with its published specifications. The warranty is not sold separately and is not considered a distinct service.

Additionally, the components of Company A's medical equipment include a standard warranty from the component manufacturers, such that in the event there is a defect related to a specific component, Company A will submit a warranty claim to its supplier, who will either replace or repair the defective component.

Question

How should Company A account for the standard warranty it provides to its customers?

Solution

Company A should account for the warranty in accordance with ASC 460-10-25-5 and, in turn, ASC 450-20-25-2 because Company A is liable to its customers for warranty claims related to the medical equipment it sold to its customers based on its contractual warranty terms. Company A would estimate its costs of honoring the warranty, net of any anticipated recoveries from component manufacturers, at the time of sale and accrue a warranty liability at that point. The warranty accrual would either be (1) charged with the cost of any repairs or replacement equipment or (2) reversed when the warranty expires.

To the extent that any warranty claims entitle Company A to recovery from its suppliers, Company A would only recognize an asset for recovery from the supplier if it has submitted a claim to the supplier. Any recovery asset would be limited to the amount of the loss recognized by Company A and would be presented separate from the warranty liability (i.e., the recovery from the supplier should not be offset against the accrued warranty liability).

Relevant guidance

ASC 606-10-55-32: If a customer does not have the option to purchase a warranty separately, an entity should account for the warranty in accordance with the guidance on product warranties in Subtopic 460-10 on guarantees, unless the promised warranty, or a part of the promised warranty, provides the customer with a service in addition to the assurance that the product complies with agreed-upon specifications.

ASC 460-10-25-5: Because of the uncertainty surrounding claims that may be made under warranties, warranty obligations fall within the definition of a contingency. Losses from warranty obligations shall be accrued when the conditions in paragraph 450-20-25-2 are met.

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued... indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

b. The amount of loss can be reasonably estimated…

7-3 Accounting for warranty-related costs as a distributor

Background

Company A, a distributor of medical equipment, purchases medical equipment from manufacturers and sells the equipment to end consumers. Company A accounts for the sale of equipment in accordance with ASC 606. Company A has concluded that it is the principal in the transactions with the end consumers since it obtains control of the medical equipment before it is transferred to the end consumer. Therefore, the end consumer is Company A's customer for the sale of the medical equipment.

The sale of the medical equipment includes a manufacturer's standard warranty, such that in the event there is a defect with the equipment, the customer will submit a warranty claim to the manufacturer, who will either replace or repair the defective product. Company A is not contractually responsible to its customer for the warranty offered on the medical equipment and has no obligation to facilitate warranty claims between its customer and the manufacturer.

Question

Should Company A account for the manufacturer's standard warranty related to the medical equipment?

Solution

No. Since the customer is required to file any warranty claims to repair or replace the product directly with the manufacturer and Company A has no contractual responsibility to its customer for the warranty, Company A does not account for the manufacturer's standard warranty related to the medical equipment. Therefore, no warranty expense would be recorded by Company A because it is not offering a warranty to the customer.

Relevant guidance

ASC 606-10-55-36: When another party is involved in providing goods or services to a customer, the entity should determine whether the nature of its promise is a performance obligation to provide the specified goods or services itself (that is, the entity is a principal) or to arrange for those goods or services to be provided by the other party (that is, the entity is an agent). An entity determines whether it is a principal or an agent for each specified good or service promised to the customer. A specified good or service is a distinct good or service (or a distinct bundle of goods or services) to be provided to the customer (see paragraphs 606-10-25-19 through 25-22). If a contract with a customer includes more than one specified good or service, an entity could be a principal for some specified goods or services and an agent for others.

ASC 606-10-55-37: An entity is a principal if it controls the specified good or service before that good or service is transferred to a customer. However, an entity does not necessarily control a specified good if the entity obtains legal title to that good only momentarily before legal title is transferred to a customer. An entity that is a principal may satisfy its performance obligation to provide the specified good or service itself or it may engage another party (for example, a subcontractor) to satisfy some or all of the performance obligation on its behalf.

7-4 Standard product warranty vs. an extended product warranty

Background

Company A, a manufacturer of medical devices, provides a standard product warranty as part of its normal sales contract terms. The standard product warranty is an agreement to provide warranty protection by the manufacturer for a specific period of time; there is no separate charge for the warranty and it cannot be purchased separately from the product.

Company A also offers customers the option to purchase an extended warranty that provides coverage beyond the scope of coverage of the standard warranty. Customers also have the option of purchasing a product maintenance contract, under which Company A will perform certain agreed-upon services to maintain its product for a specific period of time.

Question

Does the extended warranty or a product maintenance contract constitute a performance obligation in the arrangement?

Solution

Yes. Extended product warranties and contracts for product maintenance provide customers with a distinct service and would represent a performance obligation under ASC 606. Company A should allocate the transaction price to the product and the extended warranty and product maintenance services following the guidance in ASC 606-10-32-28 through 32-41. If Company A cannot reasonably account for the service element(s) of the warranty or product maintenance separate from the standard warranty, then the standard warranty and the service elements(s) of the warranty and/or product maintenance should be accounted for together as a single performance obligation under ASC 606.

Relevant guidance

ASC 606-10-55-31: If a customer has the option to purchase a warranty separately (for example, because the warranty is priced or negotiated separately), the warranty is a distinct service because the entity promises to provide the service to the customer in addition to the product that has the functionality described in the contract. In those circumstances, an entity should account for the promised warranty as a performance obligation in accordance with paragraphs 606-10-25-14 through 25-22 and allocate a portion of the transaction price to that performance obligation in accordance with paragraphs 606-10-32-28 through 32-41.

ASC 606-10-55-34: If a warranty, or a part of a warranty, provides a customer with a service in addition to the assurance that the product complies with agreed-upon specifications, the promised service is a performance obligation. Therefore, an entity should allocate the transaction price to the product and the service. If an entity promises both an assurance-type warranty and a service-type warranty but cannot reasonably account for them separately, the entity should account for both of the warranties together as a single performance obligation.

7-5 Allocating consideration for an extended warranty

Background

Company A, a manufacturer of medical devices, includes a standard product warranty as part of its normal sales contract terms. The standard product warranty is an agreement to provide warranty protection by the manufacturer for one year and is included in the price of the product.

Company A runs a promotion under which it offers a "free" extended three-year warranty when a customer purchases one of its medical devices for the regular price of $1,800. The extended warranty is regularly sold separately for $300. Under the promotion, customers must take the extended warranty. Company A has concluded the extended warranty provides a service to the customer beyond the assurance that the product complies with agreed-upon specifications and, therefore, the service represents a performance obligation.

Question

How should Company A allocate the $1,800 to the performance obligations in this arrangement?

Solution

Under ASC 606, Company A should allocate the transaction price to each performance obligation identified in the contract on a relative standalone selling price basis in accordance with ASC 606-10-32-28 through 32-41. This applies whether or not the extended warranty is priced separately as part of the transaction.

While the extended warranty is not being sold separately and is not optional to the customer under the promotion, Company A has concluded it provides the customer with a service beyond the assurance that the product complies with agreed-upon specifications. In accordance with ASC 606-10-32-36, Company A would likely allocate the implied $300 discount (the standalone selling price of the extended warranty) proportionately to all performance obligations in the contract. As such, the $1,800 total consideration would be allocated to each performance obligation based on its relative selling prices as follows:

Performance obligation	Standalone selling price	Percentage	Allocated transaction price
Product	$1,800	85.7%	$1,543
Extended warranty	$300	14.3%	$257
	$2,100	100%	$1,800

Relevant guidance

ASC 606-10-32-28 through 32-41 provides guidance on the allocation of the transaction price to each performance obligation.

Chapter 8: Research & development

FAQ

8-1 In-licensing agreements

Background

Company A and Company B enter into an agreement in which Company A will in-license Company B's technology to manufacture a compound to treat HIV. Company A cannot use the technology for any other project or otherwise assign or transfer the technology. Company A has not yet concluded if economic benefits are likely to flow from the compound or if relevant regulatory approval will be granted.

The agreement stipulates that Company A will be permitted to use Company B's technology in its own facilities for a period of three years. Company A will make a non-refundable payment of $3 million to Company B for access to the technology. Company B will also receive a 20% royalty from any future sales of the compound.

Question

How should Company A account for the in-licensing agreement?

Solution

Company A should expense the $3 million when incurred (normally when paid) as research and development costs since the technology has no alternative future uses.

If there are subsequent sales of the compound, the royalty payments of 20% would generally be presented in the income statement within cost of sales as incurred.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred...

ASC 730-10-25-2(c): ...the costs of intangible assets that are purchased from others for a particular research and development project and that have no alternative future uses and thus have no separate economic values are research and development costs at the time the costs are incurred.

8-2 Non-refundable upfront payments to conduct research

Background

Company A engages a contract research organization (CRO) to perform research activities for a period of two years in connection with a drug compound related to the treatment of HIV. The CRO is well known in the industry for having modern facilities and good practitioners dedicated to investigation. Company A pays the CRO a non-refundable, upfront payment of $3 million in order to carry out the research under the agreement. The CRO will have to present a quarterly report to Company A with the results of its research. Company A has full rights to the research performed, including the ability to control the research undertaken on the potential cure for HIV. The CRO has no rights to use the results of the research for its own purposes.

Question

How should Company A account for the upfront payment made to the CRO?

Solution

Although the payment is non-refundable, Company A will receive a future benefit (the rights to the research) as the CRO performs the research services over the two-year period. Therefore, the upfront payment should be capitalized as a prepayment and recognized in the income statement (as research and development expense) based upon the pattern of performance of the CRO in order to properly expense the costs under the arrangement based upon the level of effort necessary to perform the research services. Company A should continue to evaluate whether it expects the goods to be delivered or services to be rendered each reporting period to assess recoverability.

If the payment from Company A to the CRO (or a portion thereof) represents an advance payment for specific materials, equipment, or facilities with no alternative future use, it would be initially capitalized as a prepayment and subsequently recognized in the income statement as research and development expense when the related goods are delivered. If at any point Company A does not expect the goods to be delivered, the capitalized prepayment should be charged to expense.

Relevant guidance

ASC 730-10-25-1: Research and development costs… shall be charged to expense when incurred.

ASC 730-20-25-13: Non-refundable advance payments for goods or services that have the characteristics that will be used or rendered for future research and development activities pursuant to an executory contractual arrangement shall be deferred and capitalized...

8-3 Payments made to conduct research

Background

Company A needs to conduct clinical trials to obtain regulatory approvals for its products. Substantial portions of the company's clinical trials are contracted with third parties, such as CROs. The financial terms of these contracts are subject to negotiations, may vary from contract to contract and may result in uneven payment flows and timing of expense recognition. For example, CROs often require payments in advance of performing clinical trial services. These advance payments are commonly nonrefundable and made prior to the start of the research and development activities.

Question

How should Company A account for clinical trial payments?

Solution

Company A should record clinical trial expense for work performed by CROs in the period when services are performed, not necessarily when payments are made. An accrual should be recorded based on estimates of services received and efforts expended pursuant to agreements established with CROs and other outside service providers. These estimates are typically based on contracted amounts applied to the number of patients enrolled, the number of active clinical sites, the duration for which the patients will be enrolled in the study and the percentage of work completed to date.

Nonrefundable advance payments for future clinical trial management services should initially be capitalized and then expensed as the related services are performed. Company A should continue to evaluate whether it expects the services to be rendered. If services are not expected to be rendered, the capitalized advance payment should be charged to expense in the period in which this determination is made.

Relevant guidance

ASC 730-20-25-13: Nonrefundable advance payments for goods or services that have the characteristics that will be used or rendered for future research and development activities pursuant to an executory contractual arrangement shall be deferred and capitalized…

ASC 730-20-35-1: Nonrefundable advance payments... shall be recognized as an expense as the related goods are delivered or the related services are performed…

8-4 Fixed-fee contract research arrangements

Background

Company A enters into a contract research arrangement with Company B. Company B will perform research on a library of molecules and will catalogue the research results in a database.

Company A will pay Company B $3 million only upon completion of the contracted work. The payment is based on delivery of the research services.

Question

How should Company A account for the contract research arrangement?

Solution

Company A should accrue a liability for the costs of the contract research arrangement (with the charge reflected as research expense) as Company B performs the services. Company A requires some visibility into Company B's pattern of performance in order to properly expense the contract research costs under the arrangement based upon the level of effort necessary to perform the research services. The timing of the payment does not alter the timing of the expense recognition.

Relevant guidance

ASC 730-10-25-2(d): Contract services. The costs of services performed by others in connection with the research and development activities of an entity, including research and development conducted by others [on] behalf of the entity, shall be included in research and development costs.

8-5 Third-party development of intellectual property

Background

Company A has contracted with Company B, an independent third party, to develop an existing compound owned by Company A on its behalf. Company B will act purely as a service provider without taking any risks during the development phase and will have no further involvement after regulatory approval. Company A will retain full ownership of the compound. Company B will not participate in any marketing or production arrangements. Company A will make a $2 million non-refundable payment to Company B on signing the agreement, and an additional contingent payment of $3 million upon regulatory approval.

Question

How should Company A account for the upfront and subsequent milestone payments?

Solution

The initial upfront payment represents a prepayment for future development by a third party and should be capitalized and then recorded as research and development expense as Company B performs the research using a pattern that accurately depicts performance.

Under the contractual terms of the agreement, the milestone payment becomes payable upon the resolution of a contingency. Company A should accrue the milestone payment when the achievement of the milestone is probable (and the amount of the payment is reasonably estimable, which is the case in this example as it is a fixed amount under the terms of the arrangement).

If the milestone payment was instead intended to compensate Company B for future development services, Company A would capitalize the milestone payment and amortize it over the performance period in a pattern consistent with the pattern of underlying performance.

Due to the uncertainties associated with the FDA approval process, it may be difficult for Company A to conclude that achievement of the milestone is probable prior to notification of FDA approval. All facts and circumstances regarding the nature of the milestone should be considered when evaluating whether the achievement of a milestone is probable.

Relevant guidance

ASC 730-10-25-1: Research and development costs... shall be charged to expense when incurred.

ASC 730-20-25-13: Nonrefundable advance payments for goods or services that have the characteristics that will be used or rendered for future research and development activities pursuant to an executory contractual arrangement shall be deferred and capitalized…

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued... indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

b. The amount of the loss can be reasonably estimated.

8-6 Donation payment for research

Background

Company A has made a non-refundable gift of $3 million to a university. The donation must be used to fund research activities in the area of infectious diseases over a two-year period. Company A has no right to access the research findings.

Question

How should Company A recognize the donation?

Solution

Company A should expense the donation (generally as selling, general and administrative expense) when incurred (normally when paid) or at the time an unconditional promise to give cash is made, whichever is sooner.

Relevant guidance

ASC 720-25-25-1: Contributions made shall be recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of benefits given. For example, gifts of items from inventory held for sale are recognized as decreases of inventory and contribution expenses, and unconditional promises to give cash are recognized as payables and contribution expenses...

ASC 720-25-20, Contribution: An unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner…

ASC 720-25-20, Unconditional Promise to Give: A promise to give that depends only on passage of time or demand by the promisee for performance.

ASC 720-25-20, Promise to Give: A written or oral agreement to contribute cash or other assets to another entity. A promise carries rights and obligations—the recipient of a promise to give has a right to expect that the promised assets will be transferred in the future, and the maker has a social and moral obligation, and generally a legal obligation, to make the promised transfer. A promise to give may be either conditional or unconditional.

8-7 Capitalization of interest incurred on loans received to fund research and development

Background

Company A has obtained a loan from Company B, another pharmaceutical company, to finance the late-stage development of a drug to treat cancer.

Question

Can Company A capitalize the interest incurred for borrowings obtained to finance research and development activities?

Solution

Assuming Company A's costs incurred performing the research and development activities related to drug development are expensed as incurred, any borrowing costs associated with the research and development should also be expensed as incurred as they do not qualify for capitalization.

Relevant guidance

730-10-25-1: Research and development costs encompassed by this Subtopic shall be charged to expense when incurred.

ASC 835-20-15-5: Interest shall be capitalized for the following types of assets (qualifying assets):

a. Assets that are constructed or otherwise produced for an entity's own use, including assets constructed or produced for the entity by others for which deposits or progress payments have been made.

b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects (for example ships or real estate developments).

c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

8-8 Treatment of raw materials and trial batches for a new drug in development

Background

Company A, a commercial laboratory, is manufacturing a stock of 20,000 doses (trial batches) of a newly-developed drug using various raw materials. The doses can only be used in patient trials during Phase III clinical testing and cannot be used for any other purpose. The raw materials can be used in the production of other approved drugs.

Question

How should Company A account for the raw materials and trial batches?

Solution

Company A should initially recognize the raw materials acquired for the production of trial batches as inventory since the raw materials have alternative future use in the production of other approved drugs. As the trial batches do not have any alternative future use and the technical feasibility of the drug is not proven (the drug is in Phase III), the cost of the trial batches (including the cost of the raw materials used in their production) should be charged to research and development expense as they are produced.

Relevant guidance

ASC 730-10-25-2(a): Materials, equipment, and facilities. The costs of materials (whether from the entity's normal inventory or acquired specially for research and development activities) and equipment or facilities, that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed…

However, the cost of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred…

8-9 Fixed asset purchases used in research and development

Background

Company A incurs costs to construct assets that will be used to produce a medical device that has not yet received FDA approval. These costs represent expenditures necessary to construct the plant and facility that will be used to produce the device, at commercially viable levels, once regulatory approval has been obtained.

The project is in an advanced stage and Company A believes regulatory approval will be obtained and that recovery of the costs to construct the assets via future cash flows is probable.

Question

How should Company A account for the costs associated with the construction of the facility?

Solution

The important distinction is whether the activities to construct the plant and facility represent research and development costs subject to the guidance in ASC 730. Since the construction activities pertain to tangible assets that will be used to produce the end product at commercially viable levels, rather than costs associated with testing the product or the construction of a pilot facility or pre-production prototype, the construction project would not be considered research and development cost as contemplated in ASC 730-10-55-1. Instead, the costs are subject to the general concepts of fixed asset accounting and the related impairment considerations of ASC 360-10.

In this fact pattern, Company A is in an advanced stage and regulatory approval is probable. As Company A believes that use of the assets and recovery of the costs via future cash flows is probable, it would be appropriate for Company A to capitalize the construction costs incurred as plant and equipment. The assets would be subject to impairment testing under ASC 360 based on the expected future cash flows of the appropriate asset grouping, which would consider the various potential outcomes of the regulatory approval process and their associated likelihoods.

Relevant guidance

ASC 730-10-20, Research and development: Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

8-10 Accounting for funded research and development arrangements

Background

Company A partners with Investor B, an unrelated financial investor, for the development of a selected compound that is in Phase II development. Investor B commits a specified dollar amount to fund the research and development of the selected compound. In exchange for the funding, Investor B will receive royalties on future sales of products resulting from the compound being developed. Investor B will not be repaid if the compound is not successfully developed (i.e., the transfer of financial risk for the research and development is substantive). Investor B does not participate in any of the development or commercialization activities.

Question

What factors should Company A consider to determine the most appropriate accounting model for the research and development funding?

Solution

Company A should assess whether the contractual arrangement with Investor B meets all of the characteristics of a derivative or contains an embedded derivative, and if so, whether any of the scope exceptions to derivative accounting are applicable. Since Investor B would only receive royalties on future sales (assuming the development is successful), the settlement provisions under this contract are based on specified volumes of items sold. Therefore, the royalty exception would apply and Company A would not account for this arrangement as a derivative.

While ASC 730-20 only relates to research and development funding, ASC 470-10-25 does not specifically exclude research and development funding arrangements from its scope. If the research and development risk is substantive, such that it is not yet probable the development will be successful, the guidance in ASC 730-20 would generally be followed. However, if the successful completion of the research and development is already probable at the time the funding is received, the guidance in ASC 470-10-25 is applicable.

If Company A determines that there is significant risk associated with the research and development and that successful development is not probable, Company A would apply the guidance in ASC 730-20 to evaluate whether the research and development funding is a liability to repay the funding party or an obligation to perform contractual services.

To conclude that a liability does not exist, the transfer of financial risk involved with the research and development from Company A to Investor B must be substantive and genuine. When assessing the substance of the transfer of financial risk, Company A should consider any explicit or implicit obligations to repay any or all of the funding and consider the examples in ASC 730-20-25-6.

In this example, Company A has no explicit or implicit obligation to repay any of the funds and therefore determines that the arrangement is an obligation to perform contractual research and development services.

Refer to Example PPE 8-9 within the PwC Property, plant and equipment guide for additional guidance on accounting for obligations to perform contractual research and development services.

Relevant guidance

ASC 730-20-05-1, Research and development arrangements: This Subtopic provides guidance on research and development arrangements. Research and development arrangements have been used to finance the research and development of a variety of new products, such as…medical technology, experimental drugs…

ASC 730-20-25-1: This Subtopic deals with transactions in which the issue is whether, at the time an entity enters into a research and development arrangement:

a. The entity is committed to repay any of the funds provided by the other parties regardless of the outcome of the research and development.

b. Existing conditions indicate that it is likely that the entity will repay the other parties regardless of the outcome.

c. The entity is obligated only to perform research and development work for others.

ASC 470-10-25-1: An entity receives cash from an investor and agrees to pay to the investor for a defined period a specified percentage or amount of the revenue or of a measure of income (for example, gross margin, operating income, or pretax income) of a particular product line, business segment, trademark, patent, or contractual right. It is assumed that immediate income recognition is not appropriate due to the facts and circumstances…

ASC 815-10-15-59(d): Contracts that are not exchange-traded are not subject to the requirements of this Subtopic if the underlying on which the settlement is based is any one of the following… Specified volumes of sales or service revenues of one of the parties to the contract. (This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices).

Chapter 9: Income taxes

FAQ

9-1 Accounting for refundable income tax credits

Background

Company A receives a research and development (R&D) tax credit of $1 million that can be used to reduce its income tax liability. If Company A does not have an income tax liability of at least $1 million, which would be offset by the credit, the remainder of the credit, up to 100%, is fully refundable. Said differently, Company A can be in a taxable loss position and still receive a cash payment from the government for the full value of the tax credit.

Question

Is this type of refundable R&D tax credit accounted for as part of income taxes within the scope of ASC 740, *Income Taxes*?

Solution

This refundable R&D tax credit is not within the scope of the income tax accounting standard (ASC 740), because the ability to realize the credit does not depend on having an income tax liability. Company A should instead account for (and present) the R&D tax credit consistent with how it would account for a government grant.

However, in cases when there are significant disincentives for Company A to monetize the credit through refund versus reducing its income tax liability, it may be appropriate to account for the credit under ASC 740.

Refer to PwC Income taxes guide, section 1.2.4 for a more detailed discussion on refundable credits.

Relevant guidance

ASC 740-10-15-3: The guidance in the Income Taxes Topic applies to:

a. Domestic federal (national) income taxes (U.S. federal income taxes for U.S. entities) and foreign, state, and local (including franchise) taxes based on income.

b. An entity's domestic and foreign operations that are consolidated, combined, or accounted for by the equity method.

9-2 Valuation allowance: Whether a deferred tax liability for an IPR&D asset should be considered a source of income for realizing deferred tax assets

Background

Company A acquires Company B in a nontaxable business combination. Company A recognizes an in-process research and development (IPR&D) asset of $500 million with $0 tax basis and records an associated deferred tax liability of $125 million. Under ASC 805, Business Combinations, the IPR&D asset is classified as indefinite-lived until the project is either abandoned or completed, at which time a useful life will be determined. Subsequent to the acquisition, Company A plans to file a consolidated tax return that includes Company B. Company A had a pre-existing deferred tax asset of $100 million for net operating losses (NOLs) that will expire in 10 years (for simplicity, assume this is Company A's only deferred tax asset). Prior to the acquisition, Company A had a full valuation allowance against the deferred tax asset.

Question

Should the deferred tax liability related to the IPR&D asset be considered a source of income for realizing Company A's pre-existing deferred tax asset?

Solution

It depends. Company A must estimate both when the R&D project will be completed and the expected useful life of the resulting IPR&D asset in order to determine whether the deferred tax liability related to the IPR&D asset can be used as a source of taxable income. If Company A expects the R&D project to be completed within two years and expects the useful life of the IPR&D asset to be three years, then the deferred tax liability should be considered a source of future taxable income in assessing the realization of the deferred tax asset because the taxable temporary difference is expected to reverse (over years three to five) before the NOL carryforward expires. Any benefit recognized if Company A reverses all or a portion of its valuation allowance would be recorded outside of acquisition accounting in continuing operations pursuant to ASC 805-740-30-3.

Refer to PwC Income taxes guide, section 10.4.6 for additional discussion of deferred taxes for research and development activities, including consideration for when deferred tax liabilities for R&D activities should be considered a source of income for realizing deferred tax assets.

Relevant guidance

ASC 740-10-30-18: Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences

b. Future taxable income exclusive of reversing temporary differences and carryforwards

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law

d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:

    1. Accelerate taxable amounts to utilize expiring carryforwards

    2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss

    3. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

ASC 805-740-30-3: The tax law in some tax jurisdictions may permit the future use of either of the combining entities' deductible temporary differences or carryforwards to reduce taxable income or taxes payable attributable to the other entity after the business combination. If the combined entity expects to file a consolidated tax return, an acquirer may determine that as a result of the business combination its valuation for its deferred tax assets should be changed. For example, the acquirer may be able to utilize the benefit of its tax operating loss carryforwards against the future taxable profit of the acquiree. In such cases, the acquirer reduces its valuation allowance based on the weight of available evidence. However, that reduction does not enter into the accounting for the business combination but is recognized as an income tax benefit (or credited directly to contributed capital [see paragraph 740-10-45-20]).

9-3 Valuation allowance: Deferred tax liability related to an IPR&D asset in a jurisdiction with an unlimited loss carryforward period

Background

Company A operates in a jurisdiction with an unlimited NOL carryforward period and no annual NOL utilization limitations. Company A has $80 million of NOL deferred tax assets. Company A has a deferred tax liability of $100 million for an IPR&D asset. Company A has significant negative evidence as a result of historical losses and is unable to rely on projections of future taxable income or tax-planning strategies. Accordingly, the taxable temporary difference related to the IPR&D asset is the only potential source of future taxable income available to support realization of the deferred tax asset related to the NOL carryforward. However, Company A is currently unable to reliably estimate when the R&D project will be completed and therefore considers the related deferred tax liability to have an indefinite or indeterminable reversal period.

Question

Should Company A consider the taxable temporary difference associated with the IPR&D asset as a source of taxable income to support realization of the NOL deferred tax asset?

Solution

Yes. Company A would not record a valuation allowance against the deferred tax asset related to the NOL. While the taxable temporary difference related to the IPR&D asset currently has an indeterminable reversal period, since the NOLs never expire, they will always be available to shield any tax cost that would be incurred when the taxable temporary difference related to the IPR&D asset ultimately reverses.

In certain jurisdictions, the use of NOLs is limited to a percentage (e.g., 80%) of taxable income, in any given year. Companies should consider tax law limitations on the utilization of NOLs, which may result in the need to record a valuation allowance for the portion of the NOL deferred tax asset for which utilization is limited (e.g., 20% if NOL utilization is limited to 80% of taxable income).

Relevant guidance

ASC 740-10-30-18: Future realization of the tax benefit of an existing deductible temporary difference or carryforward ultimately depends on the existence of sufficient taxable income of the appropriate character (for example, ordinary income or capital gain) within the carryback, carryforward period available under the tax law. The following four possible sources of taxable income may be available under the tax law to realize a tax benefit for deductible temporary differences and carryforwards:

a. Future reversals of existing taxable temporary differences

b. Future taxable income exclusive of reversing temporary differences and carryforwards

c. Taxable income in prior carryback year(s) if carryback is permitted under the tax law

d. Tax-planning strategies (see paragraph 740-10-30-19) that would, if necessary, be implemented to, for example:

1. Accelerate taxable amounts to utilize expiring carryforwards
2. Change the character of taxable or deductible amounts from ordinary income or loss to capital gain or loss
3. Switch from tax-exempt to taxable investments.

Evidence available about each of those possible sources of taxable income will vary for different tax jurisdictions and, possibly, from year to year. To the extent evidence about one or more sources of taxable income is sufficient to support a conclusion that a valuation allowance is not necessary, other sources need not be considered. Consideration of each source is required, however, to determine the amount of the valuation allowance that is recognized for deferred tax assets.

9-4 Tax impact of acquired IPR&D in an asset acquisition

Background

On January 1, 20X1, Company A acquires the intellectual property (IP) of Drug A from Company B for $200 million. The payment was expensed as IPR&D because there is no alternative future use for the IP and the acquired asset does not constitute a business. Because of the manner in which the IP was acquired, the tax basis in the IP is zero.

Question

Should Company A recognize a deferred tax liability for the initial difference between the financial statement reporting amount ($200 million) and the underlying tax basis ($0)?

Solution

No. We believe the write-off of amounts assigned for financial statement reporting purposes to IPR&D expense occurs prior to the measurement of deferred taxes. Accordingly, deferred taxes are not provided on the initial differences between amounts assigned for financial reporting and tax purposes. As a result, the IPR&D expense is reflected without any offsetting tax benefit (i.e., as a permanent difference).

Refer to PwC Income taxes guide, section 10.12.1 for additional discussion regarding IPR&D acquired in an asset acquisition that is expensed immediately if it has no alternative use.

Relevant guidance

350-30-35-7: An intangible asset shall not be written down or off in the period of acquisition unless it becomes impaired during that period. However, paragraph 730-10-25-2(c) requires amounts assigned to intangible assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity that are to be used in a particular research and development project and that have no alternative future use to be charged to expense at the acquisition date.

730-10-25-2: Elements of costs shall be identified with research and development activities as follows (see Subtopic 350-50 for guidance related to website development):

c. Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.

ASC 740-10-20: Temporary Difference

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements

b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

9-5 Effects of IPR&D expense on estimated annual effective tax rate

Background

Company A records an impairment charge of $100M related to its IPR&D asset in the third quarter of 20X1.

Question

Should the impairment charge be included in measuring Company A's estimated annual effective tax rate or should the tax effect of the charge be treated discretely in the third quarter?

Solution

Judgment is necessary to determine whether an IPR&D impairment charge should be considered an unusual or infrequent item and therefore reflected entirely in the third quarter. When there has been no history of IPR&D impairments and there is no reasonable expectation of significant IPR&D impairments in the future, it may be appropriate to conclude that the IPR&D charge is unusual or infrequent and, therefore, the tax effect of the impairment would be reported discretely in the period in which the impairment is recorded. Alternatively, a history of IPR&D impairment charges or a reasonable expectation that future such impairments will occur would likely indicate that the impairment is neither unusual nor infrequent and, therefore, forms part of ordinary income such that it should be included in the estimated annual effective tax rate.

Refer to PwC Income taxes guide, section 16.3.1 for additional considerations when assessing whether a specific item is unusual or infrequent and consequently should be excluded from the annual effective tax rate calculation.

Relevant guidance

ASC 740-270-25-1: This guidance addresses the issue of how and when income tax expense (or benefit) is recognized in interim periods and distinguishes between elements that are recognized through the use of an estimated annual effective tax rate applied to measures of year-to-date operating results, referred to as ordinary income (or loss), and specific events that are discretely recognized as they occur.

ASC 740-270-25-2: The tax (or benefit) related to ordinary income (or loss) shall be computed at an estimated annual effective tax rate and the tax (or benefit) related to all other items shall be individually computed and recognized when the items occur.

ASC 740-270-30-8: The estimated effective tax rate also shall reflect anticipated investment tax credits, foreign tax rates, percentage depletion, capital gains rates, and other available tax planning alternatives. However, in arriving at this estimated effective tax rate, no effect shall be included for the tax related to an employee share-based payment award within the scope of Topic 718 when the deduction for the award for tax purposes does not equal the cumulative compensation costs of the award recognized for financial reporting purposes, significant unusual or infrequently occurring items that will be reported separately, or for items that will be reported net of their related tax effect in reports for the interim period or for the fiscal year. The rate so determined shall be used in providing for income taxes on a current year-to-date basis.

9-6 Intra-entity transfer of intellectual property (IP) with a contingent payment

Background

On January 1, 20X1, Company A transferred IP for Drug A, a commercial product, from the US parent company to a wholly-owned subsidiary in Jurisdiction X. No consideration was exchanged; however, for US tax purposes, Company A will report a deemed distribution from the subsidiary in Jurisdiction X equal to 10% of the revenues generated on sales of Drug A by the subsidiary in the future. Upon transfer, the initial tax basis in the IP in Jurisdiction X was $250 million based on the fair value of the IP at the time of transfer. The IP was internally developed by Company A and therefore has a book carrying amount of zero in the consolidated financial statements.

Question

How should Company A account for this intra-entity transfer of the IPR&D asset?

Solution

For US tax purposes, the transfer of the Drug A IP would be considered a "Section 367(d) transaction." A Section 367(d) transaction is a deemed sale of property in exchange for future payments (in this case, annual royalties of 10% of sales) that are contingent upon the future revenues generated from the underlying IP.

Based on the $250 million valuation, a deferred tax asset (subject to valuation allowance considerations) would be recognized by the subsidiary in Jurisdiction X for the difference between the buyer's tax basis of $250 million and the book basis in the consolidated financial statements of zero. Because the IP was transferred for no consideration from Company A, there is no current tax cost of the transaction in the US, and no deferred tax liability exists because the asset no longer resides in the US.

In future periods, the current US tax provision would reflect the effects of the deemed (or actual) royalties as they are includable in taxable income.

While an alternative view exists that the US entity will ultimately bear the tax consequences of the future royalty payments and therefore could conclude that a tax liability should be accrued at the time of transfer, we understand that the SEC staff believes that the non-recognition of a tax liability by the US entity at the time of transfer is an appropriate interpretation of US GAAP. An SEC registrant that is considering recognizing a tax liability at the time of transfer should consider consultation with the SEC staff prior to electing this approach.

Refer to TX 2.4.4.2 for additional discussion on other intra-entity IP transfers that are similar to Section 367(d) transactions.

Relevant guidance

ASC 740-10-20: Temporary Difference

A difference between the tax basis of an asset or liability computed pursuant to the requirements in Subtopic 740-10 for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Paragraph 740-10-25-20 cites examples of temporary differences. Some temporary differences cannot be identified with a particular asset or liability for financial reporting (see paragraphs 740-10-05-10 and 740-10-25-24 through 25-25), but those temporary differences do meet both of the following conditions:

a. Result from events that have been recognized in the financial statements.

b. Will result in taxable or deductible amounts in future years based on provisions of the tax law.

Some events recognized in financial statements do not have tax consequences. Certain revenues are exempt from taxation and certain expenses are not deductible. Events that do not have tax consequences do not give rise to temporary differences.

ASC 740-10-05-7: A temporary difference refers to a difference between the tax basis of an asset or liability, determined based on recognition and measurement requirements for tax positions, and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively. Deferred tax assets and liabilities represent the future effects on income taxes that result from temporary differences and carryforwards that exist at the end of a period. Deferred tax assets and liabilities are measured using enacted tax rates and provisions of the enacted tax law and are not discounted to reflect the time-value of money.

9-7 Timing of the recognition of a tax holiday

Background

Company A, a calendar-year company, operates in Jurisdiction X. On November 1, 20X1, Company A files its initial application for a specific tax holiday in Jurisdiction X. The holiday lasts for five years and applies to corporations that meet certain objectively determinable, statutory requirements with respect to the company's management, ownership, and foreign sales as a percentage of total sales. The statute that sets forth the requirements provides no discretion to the taxing authority or government officials to deny the application if the taxpayer meets the requirements set forth in the statute. On January 30, 20X2, Company A receives a letter from the taxing authority in Jurisdiction X acknowledging receipt of Company A's application.

Question

In which period should Company A account for the effects of the tax holiday: (1) the period in which Company A filed its application (i.e., Q4 20X1), or (2) the period in which the letter of acknowledgment was received (i.e., Q1 20X2)?

Solution

In general, we believe the tax effects resulting from the initial qualification for a tax holiday should be treated in a manner similar to a change in tax status. An election for a voluntary change in tax status should be recognized in the financial statements on the approval date, or on the filing date if approval is not necessary. Accordingly, in this fact pattern, Company A should recognize the effects of the tax holiday in the period in which the application was filed (i.e., Q4 20X1), rather than in the period in which the acknowledgement letter was received because approval is not necessary. Q4 20X1 is the point at which Company A had both met all the requirements set forth in the applicable statute and formally filed its application. As there was no basis under the statute for the taxing authority to deny the application, receipt of the acknowledgement letter was merely confirmation of Company A's entitlement to the holiday rather than formal approval of it.

It should be noted, however, that if granting of the holiday is subject to the discretion of the taxing authority or any government official, the effects of the holiday should not be reflected in the financial statements until the formal government approval date.

Refer to PwC Income taxes guide, section 4.3.3.3 for further discussion of tax holidays, including timing of the recognition of a tax holiday as well as scheduling the reversal of temporary differences in the context of a tax holiday.

Relevant guidance

ASC 740-10-25-33: The effect of an election for a voluntary change in tax status is recognized on the approval date or on the filing date if approval is not necessary and a change in tax status that results from a change in tax law is recognized on the enactment date.

ASC 740-10-25-35: There are tax jurisdictions that may grant an entity a holiday from income taxes for a specified period. These are commonly referred to as tax holidays. An entity may have an expected future reduction in taxes payable during a tax holiday.

ASC 740-10-25-36: Recognition of a deferred tax asset for any tax holiday is prohibited because of the practical problems in distinguishing unique tax holidays (if any exist) for which recognition of a deferred tax asset might be appropriate from generally available tax holidays and measuring the deferred tax asset.

Chapter 10: Other areas

FAQ

10-1 Advertising and promotional expenditure

Background

Company A has developed a new drug that improves the patient experience in the long-term treatment of kidney disease. Company A's commercial department has incurred significant costs on a promotional campaign, including television commercials, presentations in conferences and seminars for doctors.

Question:

How should these costs be accounted for and presented in the financial statements?

Solution

Company A should account for advertising and promotional costs in accordance with ASC 720-35 and expense as incurred. Company A should not recognize an intangible asset even though the expenditures may provide future economic benefits through sales of the product in future periods.

Advertising and promotional costs are not costs of goods sold and should be included in the income statement wherever other sales and marketing expenses are reported. Company A should charge all costs to create the content for the promotional campaign (i.e., costs to create a television commercial) to the income statement as the costs are incurred or the first time the advertising takes place, depending on Company A's accounting policy per ASC 720-35-25-1. Such costs should be expensed immediately if the advertising is no longer expected to occur. The costs of television airtime and print media space should not be expensed before it is aired or printed, respectively.

The notes to the financial statements should disclose (1) the accounting policy selected from the two alternatives allowed for reporting advertising costs and (2) the amount charged to advertising expense for each income statement presented.

Relevant guidance

ASC 720-35-25-1: The costs of advertising… shall be expensed either as incurred or the first time the advertising takes place. Deferring the costs of advertising until the advertising takes place assumes that the costs have been incurred for advertising that will occur. Such costs shall be expensed immediately if such advertising is not expected to occur. Examples of the first time advertising takes place include the first public showing of a television commercial for its intended purpose and the first appearance of a magazine advertisement for its intended purpose.

ASC 720-35-25-2: ...costs incurred to produce film or audio and video tape to be used to communicate advertising do not create tangible assets.

ASC 720-35-25-5: Costs of communicating advertising are not incurred until the item or service has been received and shall not be reported as expenses before the item or service has been received. For example: (a) The costs of television airtime shall not be reported as advertising expense before the airtime is used...

10-2 Product recall

Background

Company A manufactures and sells pharmaceutical products. Company A identifies a manufacturing defect in a particular product and subsequently issues a recall. The recalled product will be destroyed when it is returned, and customers will be offered the choice of receiving either replacement product or a credit that can be applied towards any future purchases by the customer.

Question:

How should Company A account for the costs associated with the product recall?

Solution

A probable loss is deemed to have occurred whenever the determination is made by Company A that a recall is necessary. If that determination was made after Company A's balance sheet date, but before the issuance of its financial statements, the liability related to the product recall should generally be recorded in Company A's financial statements to the extent it relates to sales made prior to the balance sheet date

The classification of the cost of the recall in the income statement depends on the nature of the recall. If Company A offers to replace the recalled product, it should account for the costs of the replacement similar to the accounting for warranties (ASC 606-10-55-29). Such amounts would generally be expected to be charged to cost of goods sold. If Company A offers the customer a cash refund or credit, it should recognize the amount expected to be refunded as a reduction of revenue similar to the accounting for a right of return (ASC 606-10-32-10).

In this example, because Company A gives customers the option to obtain a credit, which can be applied towards any future purchases, or receive replacement product, Company A will need to estimate which options, and in what proportion, the customers will elect, in estimating the loss, and classify the loss according to the estimated amount of each option as described above. Company A will also need to consider whether the carrying value of inventory on hand related to the recalled product needs to be adjusted, which would result in an incremental charge to cost of goods sold. In this example, as the recalled product will be destroyed upon receipt, no asset for the returned item should be recorded. The product recall may also require evaluation in other topical areas such as impairment assessments (e.g., goodwill, long-lived assets), realizability of deferred taxes, and the impact on going concern evaluations. Additionally, Company A may need to consider the possibility of any legal claims associated with the product recall.

Finally, depending on its significance, consideration should be given to providing clear disclosure of the nature of the recall and its impact on Company A's business and financial results.

Relevant guidance

ASC 450-20-25-2: An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

Information available before the financial statements are issued or are available to be issued... indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements...

The amount of the loss can be reasonably estimated…

ASC 606-10-32-10: An entity shall recognize a refund liability if the entity receives consideration from a customer and expects to refund some or all of that consideration to the customer...

ASC 606-10-55-25: …For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

ASC 606-10-55-26: An entity should update the measurement of the refund liability at the end of each reporting period for changes in expectations about the amount of refunds. An entity should recognize corresponding adjustments as revenue (or reductions of revenue).

ASC 606-10-55-29: Contracts in which a customer may return a defective product in exchange for a functioning product should be evaluated in accordance with the guidance on warranties in paragraphs 606-10-55-30 through 55-35.

Appendix A: Summary of key updates—June 2024

Note additional editorial changes have been made throughout the guide. The intent of this appendix is to capture those changes that are most significant.

Chapter	Question within updated guide	Mapping to previous guide	Description of change
Chapter 1	1-5 Accounting for sales and marketing costs related to an approved product	1-5 Development expenditure once capitalization criteria are met—Scenario 1	The title of this FAQ has been updated to better align with the nature of the question. Additionally, updates were made to further clarify the solution.
Chapter 1	1-6 Accounting for internal development costs to add new functionality to an approved product	1-6 Development expenditure once capitalization criteria are met—Scenario 2	The title of this FAQ has been updated to better align with the nature of the question. Additionally, updates were made to further clarify the relevant guidance.
Chapter 1	N/A	1-8 Cost that qualify as research and development costs	The question was deleted because it was duplicative to another FAQ.
Chapter 1	1-9 Accounting for payment upon regulatory approval	1-9A Accounting for a payment upon regulatory approval	Updates were made to further clarify the solution and relevant guidance.
Chapter 2	N/A	2-1 Accounting for a loss contingency when a settlement offer has been made in a lawsuit	Removed—covered in the PwC Financial statement presentation guide & FAQ did not provide any additional industry-context.

Chapter 2	N/A	2-2 Accounting for legal costs incurred in connection with a loss contingency	Removed—covered in the PwC Financial statement presentation guide & FAQ did not provide any additional industry-context.
Chapter 2	2-1 Accounting for settlement payments for patent infringement	N/A	New FAQ—outlines an example when evaluating the accounting for payments in a settlement as a result of infringing on a party's IP.
Chapter 2	2-2 Accounting for settlement payments to a customer	N/A	New FAQ—outlines an example when evaluating the accounting for a settlement payment to a customer.
Chapter 2	2-3 Accounting for patent-related costs	3-7 Accounting for patent-related costs	Updates were made to further clarify the solution and relevant guidance.
Chapter 3	3-1 Accounting for costs to validate new machinery	3-1 Treatment of validation batches	The title of this FAQ has been updated to better align with the nature of the question. Additionally, updates were made to further clarify the solution.
Chapter 3	3-2 Treatment of supplies used in development process	3-2 Treatment and presentation of development supplies	The title of this FAQ has been updated to better align with the nature of the question Additionally, updates were made to further clarify the solution.
Chapter 3	3-3 Accounting for demonstration equipment	3-3 Accounting for demonstration equipment	Updates were made to further clarify the solution and relevant guidance.

Chapter 3	3-6 Indicators of impairment for inventory	3-6 Indicators of impairment—Inventory	Updates were made to further clarify the solution and relevant guidance.
Chapter 3	N/A	3-8 Accounting for contingent insurance proceeds	Question deleted, refer to the PwC Property, plant, equipment and other assets guide for additional guidance.
Chapter 3	3-7 Selling raw materials to and purchasing finished goods from a subcontractor	3-9 Selling raw materials to and purchasing finished goods from a subcontractor	Updates were made to further clarify the solution and relevant guidance.
Chapter 5	5-1 Identifying a lease	5-1 Identifying a lease—Scenario 1	Updates were made to the solution and relevant guidance to further clarify concepts.
Chapter 5	5-2 Identifying and accounting for an embedded lease in a contract manufacturing arrangement	5-1 Identifying a lease—Scenario 2	The title of this FAQ has been updated to better align with the nature of the question. Updates were made to the solution and relevant guidance to further clarify concepts.
Chapter 5	5-3 Identifying components in a lease arrangement	5-3 Identifying components in an arrangement	Updates were made to the solution and relevant guidance to further clarify concepts.
Chapter 5	5-7 Accounting for leases-Lessors: Identifying a lease	5-7 Substitution rights	The title of this FAQ has been updated to better align with the nature of the question. Additionally, updates were made to the background and the solution to further clarify concepts.

Chapter 5	5-9 Allocation of consideration to components of lease contract	5-9 Allocation of onsideration to components of lease contract	Updates were made to the background and solution to further clarify concepts.
Chapter 6	6-2 Scoping considerations for collaboration agreements—Scenario 2	N/A	New FAQ—outlines the considerations when evaluating applicable scope of a collaboration agreement.
Chapter 6	6-7 Assessing whether a distribution license is distinct	N/A	New FAQ—outlines the considerations when determining whether a license to develop and commercialize, but not manufacture, is distinct.
Chapter 6	6-15 Trade-in credits offered to a customer for the purchase of next-generation equipment	N/A	New FAQ—outlines the considerations for accounting for a trade-in credit that is a guarantee in the scope of ASC 460.
Chapter 6	N/A	6-18 Distributor arrangement in new territory	Removed as duplicative of guidance within the PwC Revenue recognition guide.
Chapter 6	N/A	6-25 Medicare Part D coverage gap	Removed—FAQ was no longer relevant since the Affordable Care Act changed the requirements for Medicare Part D.
Chapter 6	N/A	6-27 Synthetic FOB destination	Removed—FAQ no longer relevant as a result of ASC 606. Refer to the PwC Revenue recognition guide for additional guidance.

Chapter 6	N/A	6-35 Accounting for payments to a customer	Removed as duplicative of guidance within the PwC Revenue recognition guide.
Chapter 6	6-12 Standard product warranty vs. an extended product warranty	6-32 Medical device with optional warranty	Duplicate FAQ—aligned FAQ to the extended warranty FAQ included in Chapter 7
Chapter 7	7-2 Accounting for warranty-related costs for equipment sold to customers	7-2 Recognition of warranty-related costs absorbed by manufacturer	New FAQ—outlines the accounting considerations for a standard warranty related to equipment sold to customers.
Chapter 7	7-3 Accounting for warranty-related costs as a distributor	7-2 Recognition of warranty-related costs absorbed by manufacturer	New FAQ—outlines the accounting considerations for a standard warranty when a distributor is not legally obligated to provide the warranty.
Chapter 8	8-5 Third-party development of intellectual property	No change	Updates were made to further clarify the solution and relevant guidance.
Chapter 8	N/A	8-6 Recording a milestone payment due to a counterparty	The question was deleted because it was duplicative to another FAQ.
Chapter 8	N/A	8-7 External development of intellectual property with buy back options	The question was deleted because it was duplicative to another FAQ.

Chapter 8	N/A	8-13 Research and development reimbursed by a third party	The question was deleted because it was duplicative to another FAQ.
Chapter 8	N/A	8-13 Research and development reimbursed by a third party	The question was deleted because it was duplicative to another FAQ.
Chapter 9	N/A	9-3 Accounting for the annual pharmaceutical manufacturers fee	Removed—FAQ is no longer applicable as a result of the final IRS regulations.

Appendix B: Renumbered FAQs

As part of the 2024 update certain FAQs have been renumbered or moved. See the chart below for a table of those impacted FAQs.

2019 FAQ	2024 FAQ
1-9	1-8
1-9A	1-9
1-16	4-9
1-17	1-16
1-18	6-25
1-19	1-17
3-7	2-3
3-9	3-7
6-2	6-27
6-4	6-16
6-7	6-17
6-8	6-26
6-9	6-8
6-10	6-36
6-11	6-18
6-12	6-19
6-12A	6-28
6-13	6-20
6-13A	6-4
6-14	6-29
6-15	6-30
6-16	6-31
6-17	6-38
6-19	6-32
6-20	6-21
6-21	6-22
6-22	6-9
6-24	6-10
6-26	6-24

6-28	6-33
6-29	6-34
6-30	6-35
6-31	6-11
6-33	6-13
6-34	6-14
6-36	6-37
8-8	8-6
8-9	8-7
8-10	8-8
8-11	8-9
8-12	8-10
9-1	10-1
9-2	10-2
10-1	9-1
10-2	9-2
10-3	9-3
10-4	9-4
10-5	9-5
10-6	9-6
10-7	9-7