**FASB Emerging Issues Task Force**

**Issue No.** 07-1

**Title:** Accounting for Collaborative Arrangements

**Document:** Issue Summary No. 1, Supplement No. 3*

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**Dates previously discussed:** March 15, 2007; June 14, 2007; September 11, 2007

**Previously distributed EITF materials:** Issue Summary No. 1, dated February 26, 2007; Working Group Report No. 1 (distributed as Exhibit 07-1C to Issue Summary No. 1); Issue Summary No. 1, Supplement No. 1, dated May 30, 2007; Working Group Report No. 2 (distributed as Exhibit 07-1B to Issue Summary Supplement No. 1); Issue Summary No. 1, Supplement No. 2, dated August 28, 2007

**References:**

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

FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries* (FAS 94)

FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments* (FAS 107)

FASB Statement No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131)

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

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities* (FIN 46R)

APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock* (APB 18)

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

APB Opinion No. 22, *Disclosure of Accounting Policies* (APB 22)

APB Opinion No. 28, *Interim Financial Reporting* (APB 28)

AICPA Statement of Position 00-2, *Accounting by Producers or Distributors of Films* (SOP 00-2)

EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent" (Issue 99-19)

EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)" (Issue 01-9)

EITF Issue 02-16, "Accounting by a Customer (Including a Reseller) for Certain Consideration Received from a Vendor" (Issue 02-16)

**Background**

1. At the September 11, 2007 EITF meeting, the Task Force reached a consensus-for-exposure on this Issue and directed the staff to pursue the issuance of a draft abstract for public comment. During its ratification meeting on September 26, 2007, the Board questioned whether certain of the disclosure requirements of this Issue should be annual or quarterly and observed that the transition guidance in the consensus-for-exposure included an impracticability exception. The Board questioned whether the guidance provided by this Issue would ever be impracticable to apply. Accordingly, the notice for recipients specifically requested that constituents provide comments on:

a. Whether the proposed transition and effective date are appropriate? The draft abstract requires retrospective application of all consensuses-for-exposure unless impracticable.[1] Will it be impracticable to apply the consensuses-for-exposure retrospectively to any arrangements within the scope of the draft abstract? If yes, (i) approximately how many arrangements do you have that currently would meet the scope of the draft abstract, (ii) for how many of those would it be impracticable to retrospectively apply the guidance in the draft abstract. and (iii) what transition method should be required for the arrangements where it is impracticable to retrospectively apply the draft abstract and why?

b. Should the disclosure requirements in paragraph 19 of the draft abstract be annual or quarterly and why? If annual, should any specific disclosure requirement be included quarterly? Should any additional disclosures items be required and why?

2. The draft abstract was posted to the website on October 1, 2007, with a comment period that ended October 22, 2007. Comment letters received on the draft abstract have previously been distributed to Task Force members and have been analyzed below. At the November 29, 2007 EITF meeting, the Task Force will have the opportunity to consider those comment letters as it redeliberates the consensus-for-exposure. The Task Force will then be asked whether it agrees

[1] Paragraph 11 of Statement No. 154, Accounting Changes and Error Corrections, provides guidance on determining when it is impracticable to make a change in accounting principle.

with the staff recommendations for the proposed changes to the draft abstract and to affirm its consensus-for-exposure (as amended) on this Issue as a final consensus.

**Summary of Comment Letters and FASB Staff Analysis**

3. Six comment letters were received on the draft abstract, all from preparers. All respondents generally agreed with the principles underlying the Task Force's consensus-for-exposure. The staff also received informal comments on the draft abstract, which are identified and included in the analysis below. The formal and informal comments generally addressed the following matters:

a. Effect of legal entities on the scope
b. Clarifications of the description of "active participant"
c. Income statement classification
d. Disclosures
e. Illustrative examples
f. Effective date and transition.

*Effect of legal entities on the scope*

4. One respondent requested a clarification of the following discussion in paragraph 6 of the draft abstract:

> A collaborative arrangement within the scope of this Issue is not conducted through a separate legal entity created for that activity. However, in some situations part of a collaborative arrangement may be conducted in a legal entity for specific activities or for a specific geographic location.

The respondent observed that it is not clear whether the second sentence above is intended to indicate that an arrangement that contains "a legal entity for specific activities or for a specific geographic location" could still be a collaborative arrangement as defined in this Issue. The respondent requests that the Task Force clarify the impact of legal entities on the scope of this Issue.

5. The FASB staff acknowledges the respondent's concerns regarding the impact of legal entities on the definition of a collaborative arrangement in this Issue. However, the FASB staff believes that a legal entity may be utilized for part of a collaborative arrangement for specific activities or for a specific geographic location without necessarily disqualifying the arrangement from being a collaborative arrangement as defined in this Issue. The FASB staff has provided suggested changes to paragraph 6 of the draft abstract in Appendix 07-1A to address this comment.

*Clarifications of the description of "active participant"*

6. One respondent raised two questions with respect to the description of active participation in paragraphs 9 and 10 of the draft abstract. The respondent requested that the Task Force clarify whether a participant that owns the intellectual property underlying an endeavor and licenses that intellectual property to another party but does not otherwise participate in the joint operating activity, is considered an "active participant" pursuant to paragraph 9 of the draft abstract. The respondent also questioned the need for paragraph 10, which states that "a financial investor is not an active participant in a collaborative arrangement within the scope of this Issue." The respondent believes that the scope of the Issue is adequately addressed in paragraph 5 as supplemented by the additional descriptions in paragraph 9 for "active participation" and paragraphs 11–14 for "significant risks and rewards." Since the term "financial investor" is not defined in the draft abstract, the respondent believes that introducing the concept seems to add unnecessary complexity to the Issue. Accordingly, the respondent recommends deleting paragraph 10.

7. The FASB staff observes that descriptions of "active participation" included in paragraphs 9 and 10 of the draft abstract state that "holding a contractual or other legal right to the underlying intellectual property" is only one example of a situation that **may** evidence active participation in an arrangement. Further, the determination of whether an arrangement is a collaborative arrangement consists of an analysis of (a) a joint operating activity, (b) active participation in that joint operating activity, and (c) the exposure to significant risks and rewards dependent on the commercial success of the joint operating activity. This Issue requires an entity to evaluate

all aspects of an arrangement prior to determining whether an arrangement is a collaborative arrangement. Accordingly, the staff recommends no change to the draft abstract for this concern.

8. The FASB staff acknowledges the respondent's comment regarding the discussion of a financial investor in paragraph 10. While the FASB staff agrees that the discussions in paragraphs 5–9 and 11–14 of the draft abstract are adequate to describe a collaborative arrangement, the discussion of a financial investor was intended to clarify the scope of the Issue and was specifically discussed during the Task Force's deliberations. The FASB staff believes that the draft abstract should retain some discussion of a financial investor and has revised paragraph 10 to clarify that a financial investor (that is, an entity that solely provides financial resources to an endeavor) will generally not be considered an active participant in an arrangement. The FASB staff has noted this suggested change in paragraph 10 of the draft abstract.

*Income statement classification*

9. Informal comments provided to the FASB staff have identified concerns with the application of Issue 01-9 in the illustrative examples, specifically Illustration 2. Those constituents believe that the discussion in Illustration 2 erroneously indicates that the application of Issue 01-9 is optional to collaborative arrangements. They note that paragraph 17 of the draft abstract indicates that "payments between participants pursuant to a collaborative arrangement that are within the scope of other authoritative accounting literature on income statement classification should be accounted for using the relevant provisions of that literature." Accordingly, existing authoritative accounting literature, including Issue 01-9, should be applied **before** the development of an accounting policy and the evaluation in Illustration 2 should be revised accordingly.

10. Other constituents believe that a collaborative arrangement as defined by this Issue is separate and distinct from a vendor-customer relationship contemplated in Issue 01-9. Accordingly, payments between participants in a collaborative arrangement are not within the scope of Issue 01-9 or other authoritative accounting literature on income statement classification based on a vendor-customer relationship, and request that the draft abstract be revised to clarify

the scope. Still other constituents believe that the determination of whether a collaborative arrangement is a vendor-customer relationship depends on whether the "vendor" records revenue as a result of its transactions with the "customer" under the collaborative arrangement. If a participant records revenue, then a vendor-customer relationship exists, and the transactions are within the scope of Issue 01-9. Constituents of this view are comfortable with the guidance in the draft abstract but have concerns with the conclusion reached in the evaluation of Illustration 2 and recommend that the Task Force either clarify the guidance or change the evaluation.

11. The FASB staff acknowledges the potential lack of clarity regarding the application of Issue 01-9 in the context of a collaborative arrangement based on Example 2. The FASB staff believes that there are valid arguments supporting the various positions concerning the interaction of Issue 07-1 and Issue 01-9 discussed above, and therefore, the Task Force should specifically address the interaction of Issue 07-1 with other accounting literature that addresses income statement classification for payments in a vendor-customer relationship.

*Disclosures*

12. All respondents providing comments regarding the disclosure requirements expressed a preference for annual disclosures; some respondents supported requiring quarterly disclosures only for significant changes.

13. Two respondents expressed concern over some of the disclosures on the basis that they may reveal competitively harmful information that may be prohibited under the terms of the collaborative arrangement. In particular, concerns expressed related to the following disclosures, as well as to the requirement to disclose information related to individually significant collaborative arrangements:

- The stage of the underlying endeavor's life cycle
- Amounts attributable to transactions between participants to the collaborative arrangement
- Amounts due from or owed to other participants under the collaborative arrangement.

The constituents asserted that competitive harm could result from these disclosures by revealing sensitive information about the underlying endeavor; for example, the anticipated time to market for a given product, and sensitive information about the terms of the collaboration.

14. Other respondents expressed concerns regarding the disclosure of amounts due from or owed to other participants of a collaborative arrangement based on the relevance of this disclosure and a preparer's ability to implement such a requirement. Other relationships may exist between the participants of a collaborative arrangement outside the scope of a particular arrangement that are not necessarily segregated within an entity's financial reporting systems. Additionally, large, global arrangements may include many subsidiaries of the participants, which would increase the effort required to gather the necessary information for this disclosure. A respondent questioned the benefit that this information would provide to users of the financial statements, because there are usually frequent cash payments between the parties. One respondent indicated that the disclosure of amounts due from or owed to other participants of a collaborative arrangement was redundant when considered with other required financial statement disclosures, noting that if a reporting company has significant exposure to receivables from a single counterparty, there are existing standards that would require disclosure of these amounts.

15. Other respondents also requested various clarifications of the disclosure requirements; for example, whether the disclosure requirements relate to all transactions with the counterparty or just those transactions related to the collaborative arrangement.

16. The FASB staff observes that all respondents favored annual disclosures, which is consistent with the disclosure requirement in the consensus. Therefore, the FASB staff does not believe that the Task Force should reconsider the frequency of the required disclosures. With respect to quarterly disclosures, the FASB staff observes that APB 28 encourages entities to disclose the effects of significant events upon the interim financial results, which would include significant developments with respect to its collaborative arrangements.

17. The FASB staff discussed the respondents' concerns over the competitive harm and potential breeches of contractual terms that could result from making the proposed disclosures with some of the respondents and with users of financial statements. The respondents indicated that competitive harm could result by, for example, disclosing the stage of development of an endeavor, which could indicate the anticipated time-to-market to an entity developing a competing product. Furthermore, information about the balance sheet and income statement effects of these arrangements may put an entity at a disadvantage in a negotiation for a relationship with future collaboration partners if the potential collaboration partners are aware of existing terms of comparable arrangements. The risks of competitive harm resulting from these disclosures would fall disproportionately on small entities with fewer arrangements.

18. Users of financial statements were sympathetic to the concerns of the preparers, but they believe that much of the information required by the disclosures is already provided in financial statements and other communications with investors. The information that would be provided by the proposed disclosures is useful for users of financial statements in evaluating an entity. For example, its future prospects based on its research and development pipeline and its return on invested capital, whether in collaborative arrangements or in solo development efforts. The FASB staff has reviewed the financial statements of several pharmaceutical and biotechnology companies, and notes that many significant disclosures concerning collaborative arrangements are already being made under existing disclosure requirements. In fact, the FASB staff notes that disclosure of information regarding major customers (revenues amounting to 10 percent or more of total revenues) is currently required by FAS 131.

19. As a result of its discussions with preparers, users, and reviews of financial statements, the FASB staff does not believe that the Task Force should reconsider all of the required disclosures. However, the FASB staff recommends, for the reasons cited above, that the Task Force remove the proposed disclosure in paragraph 19(f) regarding amounts due from or owed to other participants in the collaborative arrangements. The FASB staff has made this and other suggested wording changes to the disclosure requirements based on the comments received.

*Illustrative examples*

20. Four respondents provided comments about the illustrative examples. One respondent requested that the illustrative examples be deleted from the final abstract. That respondent acknowledged that the evaluations following the fact patterns are not intended to represent the only manner in which the guidance could be applied, but the respondent believes that the evaluations will be viewed as the preferred accounting treatment by auditors and regulators. If the Task Force's intention is to provide the preferred accounting treatment, then the respondent recommended that the Task Force continue to deliberate the Issue until the evaluations in the illustrative examples are further developed. Two respondents supported including the examples in the draft abstract, noting that the examples will be helpful to preparers as they evaluate their collaborative arrangements.

21. Another respondent requested further substantive discussion regarding how Issue 07-1 has been applied in each of the illustrative examples. The respondent notes, for example, that in Illustration 2 "Pharma disaggregates the $13.75 net payable and classifies the payable in the income statement as $16.25 million of cost of sales and $2.5 million as a reduction of research and development expenses." The respondent does not believe that this example clearly illustrates how paragraph 17 of the draft abstract has been applied; that is, whether this treatment is based on authoritative accounting literature or on an accounting policy election. Another respondent noted that this Issue proposes that "profit sharing payments from the principal party be recorded as cost of goods sold in the principal party's Income Statement" and disagreed with that proposal. The respondent reached this understanding based solely on the illustrative examples.

22. At the September 11, 2007 meeting, the FASB staff asked the Task Force whether it wanted to include the illustrative examples in the abstract. The FASB staff was concerned that those examples may be oversimplified and may not capture the wide variety of facts and circumstances associated with collaborative arrangements. The Task Force considered the potential for over reliance on the examples and inappropriate analogies drawn to situations that were not contemplated by the Task Force or the FASB staff. Those concerns were echoed in one comment letter. At the September the Task Force decided to include the examples and believed

that the utility of the illustrative examples to constituents outweighed the concerns over undue reliance on the illustrative examples. Two respondents supported the Task Force's consensus-for-exposure in their comment letters. Based on the comment letter requesting removal of the examples and the comment letter that indicates an inappropriate conclusion drawn by a preparer based on the illustrative examples, the FASB staff believes that the Task Force should reconsider whether to include the illustrative examples in the final abstract.

23. Independent of the Task Force's decision on the other examples, the FASB staff recommends removing Illustration 4 from the abstract. Based on informal comments received, the FASB staff has learned that the facts presented and resulting accounting recognition illustrated may cause confusion among constituents regarding the application of the provisions of SOP 00-2. The FASB staff determined that a revised example that is more consistent with SOP 00-2 would be overly complex and that the benefits of illustrating the application of this Issue to an entity outside of the biotechnology and pharmaceutical industries would be outweighed by the necessary complexity of the illustration. In addition, the FASB staff believes that the accounting policies regarding the income statement classification of payments between participants to a collaborative arrangement are both generally accepted in the industry and that a specific illustration of those policies is not required. The FASB staff has made this suggested change to Appendix 07-1A.

*Effective date and transition*

24. Five respondents addressed the proposed transition and effective date and suggested various alternatives, including prospective transition, delaying the effective date, and providing an option for either prospective or retrospective transition. None of the respondents indicated that it would be impracticable to apply the consensus-for-exposure retrospectively, and one respondent specifically stated that it would not be impracticable. All respondents cited the brief implementation period during the already busy year-end reporting period for preparers as the main reason for disagreeing with the proposed transition and effective date. One respondent observed that significant collaboration arrangements are easily identified but smaller arrangements in local markets around the world will need to be evaluated. In addition, significant arrangements may result in transactions among the various subsidiaries of the

participants, thereby increasing the effort required to implement this Issue. Another respondent observed that contracts between participants to collaborative arrangements are complex in nature and are unique, requiring a considerable amount of time to review arrangements potentially subject to this Issue's consensus.

25. The respondent that proposed permitting the option of either prospective or retrospective application indicated that they believe that companies should be able to work with the users of their financial statements to determine the best way to communicate changes to financial statements as a result of adopting this Issue. In other words, let the market dictate the best transition method on a company-by-company basis.

26. The FASB staff acknowledges the concern preparers have regarding the amount of effort that will be required to apply the transition provisions of this Issue and that this effort would be required while entities are already managing normal year-end reporting requirements. Therefore, the FASB staff believes that the Task Force should reconsider the effective date for this Issue. The FASB staff recommends that the Task Force change the consensus-for-exposure making the Issue effective for financial statements issued for fiscal years beginning after June 15, 2008, and interim periods within those fiscal years.

27. Some respondents suggested retaining the proposed effective date while changing the transition method, for example, requiring only prospective transition for new collaborative arrangements or permitting an option to select either prospective or retrospective transition methods. The FASB staff believes that any change in an entity's income statement classification for collaborative arrangements as a result of this Issue is a change in accounting principle and that the transition method for such a change should be consistent with FAS 154. Respondents indicated that it is not impracticable to apply the consensus-for-exposure; therefore, the FASB staff does not support a prospective transition approach because such an approach would result in inconsistent presentation of similar arrangements for several years due to the long duration of many of these arrangements. Some respondents suggested providing optional transition approaches, that is, allowing preparers to select between prospective or retrospective application

of the consensus. The FASB staff does not believe that optional transition methods will be beneficial to users of financial statements.

*Summary*

28. Based on the FASB staff's analysis of the comment letters, the staff will ask the Task Force to consider the following items:

a. The interaction of the scope of this Issue with the scope of other accounting literature that addresses income statement classification for payments in a vendor-customer relationship
b. Whether to include illustrative examples in the final abstract
c. Revisions to disclosure requirements
d. Revisions to the effective date and transition provisions
e. Other editorial changes to the draft abstract.

**Accounting Issues and Alternatives**

**Issue 1: Is a collaborative arrangement within the scope of this Issue outside the scope of other accounting literature that addresses income statement classification for payments in a vendor-customer relationship?**

*View A: A collaborative arrangement as defined in this Issue is distinct from a vendor-customer relationship. Therefore, payments between participants in a collaborative arrangement are not subject to other accounting literature that addresses income statement classification for payments in a vendor-customer relationship, for example, Issue 01-9 and Issue 02-16.*

29. Proponents of View A believe that collaborative arrangements are unique commercial relationships that are distinct from more traditional vendor-customer relationships that were contemplated in Issue 01-9. Collaborative arrangements generally involve two or more parties jointly developing and marketing a product for future sale to third-parties. The payments

between the participants relate to that joint development and marketing effort, rather than a revenue generating activity through the sale of a product to end-consumers.

30. In addition, proponents of View A do not believe that participants in a collaborative arrangement are part of a distribution chain in the context of Issue 01-9. Collaborative arrangements typically do not involve the delivery of a completed product from one participant to another and then to an end-consumer. While collaborative arrangements may involve the license of intellectual property from one participant to another, collaborative arrangements frequently involve the further joint development of that intellectual property to enable it to be marketed to end-consumers at some point in the future. That is, the primary focus of the collaborative arrangement is not the generation of revenue by the participants from the participants, but rather the generation of revenue from parties outside of the collaborative arrangement.

31. As a result of those factors, proponents of View A believe that the participants to a collaborative arrangement should be permitted to develop accounting policies for the presentation of payments between participants in a collaborative arrangement that best reflect the nature of the relationship, rather than being bound by accounting literature that was developed for a different set of circumstances.

*View B: The consensus in this Issue should not alter the scope of existing authoritative literature. Therefore, payments between participants in a collaborative arrangement are subject to other accounting literature that addresses income statement classification for payments in a vendor-customer relationship.*

32. Proponents of View B believe that the Task Force intentionally required entities to first determine whether a transaction is within the scope of other existing literature before developing their own accounting policy for payments between participants. Many of these arrangements result in one party recording revenue as a result of the transactions with the other participant in the collaborative arrangement; for example, through a license of intellectual property or research and development services. As a result, proponents of View B believe that there must be a

vendor-customer relationship that is within the scope of other accounting literature that addresses income statement classification for payments in a vendor-customer relationship. Issue 01-9 did not specify that only certain types of transactions were within its scope. On the contrary, paragraph 1 of Issue 01-9 indicates that it "applies to vendors that derive their revenue from sales of services as well as those that derive their revenue from sales of products," indicating that the consensus is intended to be applied broadly to many different kinds of vendors.

33. Proponents of View B have also expressed concerns that excluding collaborative arrangements from the scope of accounting literature that addresses income statement classification for payments in a vendor-customer relationship could lead some constituents to question whether accounting literature that addresses revenue recognition is applicable to other transactions between the participants of a collaborative arrangement.

*View C: The determination of whether a collaborative arrangement is a vendor-customer relationship subject to other accounting literature that addresses income statement classification for payments in a vendor-customer relationship should be based on the facts and circumstances, including whether one of the participants records revenue for receipts from the other participant in the arrangement.*

34. Proponents of View C also believe that collaborative arrangements are unique commercial relationships that are distinct from traditional vendor-customer relationships. However, proponents of View C believe that binary approaches in Views A and B are not appropriate for these types of arrangements. They note that the current consensuses-for-exposure require entities to use reasonable professional judgment in determining the appropriate income statement classification of various transactions with the other participants in a collaborative arrangement. Proponents of View C believe that those judgments should also include the determination of the overall nature of the relationship, that is, whether the relationship is a collaborative relationship or a vendor-customer relationship. An entity's accounting policies regarding income statement classification should be based on that determination following the approaches in Views A and B above. For example, if an entity determines that a collaborative arrangement is a vendor-customer relationship, it will classify payments received from the other participant in the

collaborative arrangement as revenue, and should thus be subject to the provisions of accounting literature that address income statement classification for payments in a vendor-customer relationship. Conversely, if an entity determined that a transaction is part of a collaborative arrangement, it would not classify payments received from the other participant in the collaborative arrangement as revenue, and thus should not be subject to the provisions of accounting literature that addresses income statement classification for payments in a vendor-customer relationship.

35. If the Task Force is unable to reach a consensus on Issue 1, the practical effect is the same as a consensus on View C, because the FASB staff believes that View C is consistent with the Task Force's intent as articulated in paragraph 17 of the draft abstract. Absent explicit guidance with respect to the interaction of the scope of this Issue and other accounting literature that addresses income statement classification for payments in a vendor-customer relationship, constituents will have to evaluate the facts and circumstances of the arrangement to identify the appropriate accounting policies regarding the income statement classification of payments between participants in a collaborative arrangement.

**Issue 2: Whether the illustrative examples should be included in the final abstract.**

36. As discussed in the Summary of Comment Letters and FASB Staff Analysis above, the FASB staff recommends the Task Force reconsider its decision to include the illustrative examples due to the potential for over reliance on the examples and inappropriate analogies drawn to situations that were not contemplated by the Task Force or the FASB staff. If the Task Force decides not remove all of the examples, does it agree with the FASB staff's recommendation to remove Illustration 4.

**Issue 3: Whether the Task Force agrees with the FASB staff's recommended changes to the disclosure requirements in paragraph 19, including the recommendation to delete the disclosure in paragraph 19(f), "amounts due from or owed to other participants under the collaborative arrangements."**

**Issue 4: Whether the Task Force agrees with the FASB staff's recommendation to change the effective date of the consensus in this Issue to be effective for fiscal years beginning after June 15, 2008 and to retain retrospective transition.**

**Other Changes to the Draft Abstract**

37. The FASB staff has suggested changes to the wording in the draft abstract that it has determined are not significant enough to warrant specific consideration are indicated in the marked draft abstract included as Appendix 07-1A. The draft does not reflect, however, any changes to transition, disclosures, or the examples that, based on what has been brought to the Task Force for consideration by this Supplement, have yet to be considered and decided upon by the Task Force.

38. The FASB staff believes that there are no additional comments that warrant consideration by the Task Force and recommends that the Task Force affirm the consensus-for-exposure as a consensus including the results of the Task Force's considerations of Issues 1, 2, 3, and 4 above.

**Appendix 07-1A**

***EITF ABSTRACTS*** **(DRAFT[1])**

**Issue No. 07-1**

**EITF Issue No. 07-1, Accounting for Collaborative Arrangements**

**Dates Discussed:** March 15, 2007; June 14, 2007; September 11, 2007; [November ~~28–~~29, 2007]

## Objective

**1. The objective of this Issue is to define collaborative arrangements and to establish reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties.**

| All paragraphs in this Issue have equal authority.<br>Paragraphs in bold set out the main principles. |
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## Background

2. Entities may enter into arrangements to participate in a joint operating activity to, for example, jointly develop and commercialize intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution.

3. The participants may conduct the activities associated with these arrangements without the creation of a separate legal entity (that is, the arrangement is operated as a "virtual joint venture"). In some arrangements, a legal entity may be utilized for specific activities or for a specific geographic location. The arrangements generally provide that the participants share, based on contractually defined calculations, the profits or losses from the associated activities.

4. Questions have arisen in practice as to the appropriate income statement presentation and classification for these activities and payments between the participants, as well as the sufficiency of the disclosures related to these arrangements.

[1] ~~**This draft abstract is being exposed for a public comment period that will end on October 22, 2007.**~~

## Scope

**5. This Issue applies to participants in a *collaborative arrangement*. A collaborative arrangement is a contractual arrangement that involves a joint operating activity. These arrangements involve two (or more) parties who are both (a) active participants in the activity and (b) exposed to significant risks and rewards dependent on the commercial success of the activity.**

6. A collaborative arrangement within the scope of this Issue is not primarily conducted through a separate legal entity created for that activity. However, in some situations part of a collaborative arrangement may be conducted in a legal entity for specific activities or for a specific geographic location. The existence of a legal entity does not prevent an arrangement from being a collaborative arrangement as defined in this Issue. The scope of this Issue does not include arrangements for which the accounting is specifically addressed within the scope of other authoritative accounting literature. Furthermore, this Issue does not address recognition or measurement matters related to collaborative arrangements, for example, determining the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met.

7. Participants should evaluate whether an arrangement is a collaborative arrangement at its inception based on the facts and circumstances specific to the arrangement. However, a collaborative arrangement can begin at any point in the life cycle of an endeavor.[2] Participants should reevaluate whether an arrangement continues to be a collaborative arrangement whenever there is a change in either the roles of the participants in the arrangement or the participants' exposure to significant risks and rewards dependent on the ultimate commercial success of the endeavor. For example, the exercise of an option could change a participant's role in the arrangement or its exposure to risks and rewards.

## Joint Operating Activity

8. The joint operating activities of a collaborative arrangement might involve joint development and commercialization of intellectual property, a drug candidate, software, computer hardware, or a motion picture. For example, a joint operating activity involving a drug candidate may include research and development, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution. However, there may also be collaborative arrangements that do not relate to intellectual property. For example, the activities of a collaborative arrangement may involve joint operation of a facility, such as a hospital. A collaborative arrangement may provide that one participant has sole or primary responsibility for certain activities or that two or more participants have shared responsibility for certain activities. For example, the arrangement may provide for one participant to have primary responsibility for research and development and another participant to have primary responsibility for commercialization of the final production.

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[2] For this Issue, the term *endeavor* refers to the activity that the participants collaborate on; for example, in a biotechnology or pharmaceutical environment the endeavor may be the development and commercialization of a drug candidate. In the entertainment industry, it may be production and distribution of a motion picture.

**Active Participation**

9. 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:

- Directing and carrying out the activities of the joint operating activity
- Participating on a steering committee or other oversight or governance mechanism
- Holding a contractual or other legal right to the underlying intellectual property.

10. An entity that solely provides financial resources ~~investor~~ to an endeavor is generally ~~is~~ not an active participant in a collaborative arrangement within the scope of this Issue.

**Significant Risks and Rewards**

11. 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.

12. The terms and conditions of the arrangement might indicate that participants are not exposed to significant risks and rewards if, for example:

- Services are performed in exchange for fees paid at market rates.
- A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
- Initial profits are allocated to only one participant.
- There is a limit on the reward that accrues to a participant.

13. Other factors that should be considered in evaluating risks and rewards include:

- The stage of the endeavor's life cycle
- The expected duration or extent of the participants' financial participation in the arrangement in relation to the endeavor's total expected life or total expected value.

14. 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 should use judgment in determining whether its participation in an arrangement subjects it to significant risks and rewards.

**Other Presentation Matters (Income Statement Classification)**

**15. Participants in a collaborative arrangement shall report costs incurred and revenue generated from transactions with *third parties* (that is, parties that do not participate in the arrangement) in each entity's respective income statement pursuant to the guidance in Issue 99-19. An entity should not apply the equity method of accounting under Opinion 18 to activities of collaborative arrangements.**

16. For costs incurred and revenue generated from third parties, the participant in a collaborative arrangement that is deemed to be the principal participant for a given transaction under Issue 99-19 should record that transaction on a gross basis in its financial statements.

**17. Payments between participants pursuant to a collaborative arrangement that are within the scope of other authoritative accounting literature on income statement classification should be accounted for using the relevant provisions of that literature. If the payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election.**

18. An entity shall evaluate the income statement classification of payments between participants pursuant to a collaborative arrangement based on the nature of the arrangement, the nature of its business operations, the contractual terms of the arrangement, and whether those payments are within the scope of other authoritative accounting literature on income statement classification. If the payments are within the scope of other authoritative accounting literature, then the entity shall apply the relevant provisions of that literature. To the extent that these payments are not within the scope of other authoritative accounting literature, the income statement classification for the payments should be based on an analogy to authoritative accounting literature or a reasonable, rational, and consistently applied accounting policy election. For example, if one party to an arrangement is required to make a payment to the other party to reimburse a portion of that party's research and development cost, that portion of the net payment may be classified as research and development expense in the payor's financial statements pursuant to Statement 2.

**Disclosure**

19. In the initial period and all annual periods thereafter, a participant to a collaborative arrangement should disclose the following:

a. Information about the nature and purpose of its collaborative arrangements

b. Its rights and obligations under the collaborative arrangements

c. The stage of the underlying endeavor's life cycle <u>as of the latest balance sheet date presented</u>

d. The accounting policy for collaborative arrangements in accordance with Opinion 22

e. The income statement classification and amounts attributable to transactions arising from the collaborative arrangement between participants ~~to the collaborative arrangement~~ for each period for which an income statement is presented

~~f. Amounts due from or owed to other participants under the collaborative arrangements.~~

Information related to individually significant collaborative arrangements should be disclosed separately.

**Transition**

20. This Issue shall be effective for financial statements issued for fiscal years beginning after ~~December~~ June 15, 200~~7~~8, and interim periods within those fiscal years. This Issue shall be applied retrospectively to all prior periods presented. If it is impracticable to apply the effects of a change in accounting principle retrospectively pursuant to the guidance in paragraph 11 of Statement 154, an entity should disclose both the reasons why reclassification was not made and the effect of the reclassification on the current period pursuant to the guidelines in paragraph 9 of Statement 154. The evaluation of whether transition through retrospective application is practicable should be made on an arrangement by arrangement basis.

21. Upon initial application of this Issue, an entity shall disclose the following:

a. A description of the prior-period information that has been retrospectively adjusted, if any

b. The effect of the change on revenue and operating expenses (or other appropriate captions of changes in the applicable net assets or performance indicator) and on any other affected financial statement line item.

**The provisions of this Issue need not be applied to immaterial items.**

**References**

FASB Statement No. 2, *Accounting for Research and Development Costs*
FASB Statement No. 94, *Consolidation of All Majority-Owned Subsidiaries*
FASB Statement No. 154, *Accounting Changes and Error Corrections*
FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*
APB Opinion No. 18, *The Equity Method of Accounting for Investments in Common Stock*
APB Opinion No. 22, *Disclosure of Accounting Policies*
AICPA Accounting Research Bulletin No. 51, *Consolidated Financial Statements*
EITF Issue No. 99-19, "Reporting Revenue Gross as a Principal versus Net as an Agent"
EITF Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

## APPENDIX A - ILLUSTRATIVE EXAMPLES

The following examples illustrate potential application of this Issue for payments between participants in a collaborative arrangement based on the limited facts presented. The evaluations following each of the example fact patterns are not intended to represent the only manner in which the guidance in this Issue could be applied. These illustrative examples do not address recognition or measurement matters related to collaborative arrangements. For example, determining the income statement presentation, the appropriate units of accounting, the appropriate recognition requirements for a given unit of accounting, or when the recognition criteria are met is addressed in other authoritative accounting literature. Additional facts would most likely be required in order to fully evaluate the accounting and presentation issues related to these arrangements (in other words, to evaluate the possible impact of other literature).

For the purpose of these illustrations, assume that all of the arrangements are collaborative arrangements within the scope of this Issue.

### Illustration 1

***Facts:*** Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent/50 percent arrangement). Biotech is responsible for conducting research and development activities relating to the drug candidate, and Pharma is responsible for the commercialization activities if and when the drug candidate is approved for sale. On a quarterly basis, Pharma and Biotech provide the other party financial information about the research and development activities performed by Biotech and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for the proportionate share of the excess of the companies' combined operating results pursuant to their joint development and marketing agreement. In the first annual period subsequent to the product launch, Biotech incurred research and development expenses of $10 million and Pharma had sales of $50 million and related manufacturing expenses of $20 million and marketing expenses of $10 million. Pharma owes Biotech $15 million, such that each participant realizes a $5 million net profit from the arrangement (total sales of $50 million, less total expenses (including research and development) of $40 million, divided by 2).

***Evaluation:*** Pharma concludes that it is the principal on the sales transactions with third parties and will present 100 percent of the sales, cost of sales, and marketing expenses in its income statement. As the arrangement addresses several different activities, Pharma has evaluated the income statement classification for amounts due to Biotech associated with each separate activity. Pharma disaggregates its $15 million net payable to Biotech in accordance with the nature of the individual components of the payable and characterizes the profit sharing portion of the payable for 50 percent of the profit related to the sales as cost of sales ($10 million) and characterizes the portion of the payable to Biotech for research and development activities as research and development expense ($5 million). Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Sales to third parties | $50,000 |
| COGS (including $10,000 payable to Biotech for profit sharing) | 30,000 |
| SG&A | 10,000 |
| R&D (including $5,000 payable as a reimbursement of Biotech's expenses incurred) | 5,000 |
| Net profit | $ 5,000 |

Biotech records research and development expense ($10 million) for its research and development activities. Biotech concludes that Pharma is its customer with respect to the research and development services. Additionally, licensing intellectual property and contract research and development services are part of Biotech's ongoing major or central operations. Accordingly, Biotech will characterize the portion of its net receivable from Pharma related to research and development services and the portion of the net receivable for profit sharing as revenue ($5 million and $10 million, respectively) when recognized. Biotech will not present sales, cost of sales, or marketing expenses related to the sales transactions with third parties because it is not the principal on those transactions.

Biotech presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Revenues from collaborative arrangement | $ 15,000 |
| COGS | -0- |
| SG&A | -0- |
| R&D | 10,000 |
| Net profit | $ 5,000 |

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, the identification of the deliverables in the arrangement, and a determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

**Illustration 2**

***Facts:*** Pharma and Biotech agree to equally participate in the results of research and development activities for a drug candidate and in the commercialization activities if the drug candidate is approved for sale, pursuant to a joint development and marketing agreement (a 50 percent/50 percent arrangement). Assume that Pharma and Biotech both agree to provide resources during the research and development phase, and Pharma is responsible for the commercialization activities if the drug candidate is approved for sale. As both participants are performing research and development activities, there may be periods in which Biotech must make a payment to Pharma for its proportionate share of the research and development activities

and periods in which Pharma must make payments to Biotech. On a quarterly basis, Pharma and Biotech provide financial information about the research and development activities performed by both parties and the commercialization activities performed by Pharma under the joint development and marketing agreement. One participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to their joint development and marketing agreement. In the first annual period subsequent to the product launch, Biotech and Pharma incurred research and development expenses of $10 million and $15 million, respectively. Pharma had sales of $75 million, related manufacturing expenses of $22.5 million, and marketing expenses of $20 million. As a result, Pharma owes Biotech $13.75 million, such that each participant realizes $3.75 million net profit from the arrangement (total sales of $75 million, less total expenses of $67.5 million, divided by 2).

***Evaluation:*** Pharma concludes that it is the principal on the sales transactions with third parties and will present 100 percent of the sales, cost of sales, and marketing expenses in its income statement. As the arrangement addresses several different activities, Pharma has evaluated the income statement classification for payments associated with each separate activity. Pharma disaggregates the $13.75 million net payable to Biotech in accordance with the nature of the individual components of the payable and characterizes the portion of the payable related to 50 percent of the commercialization activities (sales to third parties less associated manufacturing and marketing costs), as cost of sales ($16.25 million) and characterizes the portion of the net payable related to research and development activities as a reduction of its research and development expenses ($2.5 million), because performing contract research and development services is not part of its ongoing major or central operations. In addition, Pharma concludes that Biotech is not its customer with respect to the research and development activities in this arrangement. Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Sales to third parties | $75,000 |
| COGS (including $16,250 payable to Biotech for profit sharing) | 38,750 |
| SG&A | 20,000 |
| R&D (net of $2,500 due from Biotech as a reimbursement of expenses incurred) | 12,500 |
| Net profit | $ 3,750 |

Biotech records research and development expense ($10 million) for its research and development activities. Biotech will characterize the portion of the net receivable from Pharma related to commercialization activities ($16.25 million) as revenue, based on the fact that licensing intellectual property is part of Biotech's ongoing major or central operations. Biotech characterizes the portion of the net receivable that relates to a reimbursement of Pharma's research and development costs ($2.5 million) as additional research and development expense. Biotech bases that conclusion on the fact that the primary purpose of this collaborative arrangement is for the participants to work together to develop and commercialize a product for sale to third parties, and not to generate greater sales between the participants in the collaborative

arrangement. (If the facts and circumstances in this example were different and Biotech viewed the arrangement with Pharma as a vendor-customer relationship, the analysis would be that the reimbursement of Pharma's research and development costs would be subject to the guidance in Issue 01-9. As a result, Biotech would presume that the payment should be characterized as a reduction of revenue, unless Biotech receives a separable, identifiable benefit in exchange, and can reasonably estimate the fair value of the benefit, in which case, expense classification would be permitted. This Issue does not address whether the payable is within the scope of Issue 01-9.) Biotech will not present sales, cost of sales, or marketing expenses related to the sales transactions with third parties because it is not the principal on those transactions. Biotech presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Revenues from collaborative arrangement | $16,250 |
| | |
| COGS | -0- |
| SG&A | -0- |
| R&D (including $2,500 payable as a reimbursement of Pharma's expenses incurred) | 12,500 |
| Net profit | $ 3,750 |

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, identification of the deliverables in the arrangement, determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

**Illustration 3**

***Facts:*** Big Pharma and Little Pharma agree to jointly participate in the results of the research and development activities for a drug candidate and in the commercialization activities if and when the drug candidate is approved for sale, pursuant to a joint development and marketing agreement. Big Pharma and Little Pharma both agree to provide resources during the research and development and the commercialization activities. Little Pharma will be responsible for commercialization activities in the United States, and Big Pharma will be responsible for commercialization activities in Europe and Asia. Under the arrangement, they will share research and development costs incurred on a 50 percent/50 percent basis. Little Pharma will retain 65 percent of the net profits from commercialization activities in the United States, and Big Pharma will retain 70 percent of the net profits from commercialization activities in Europe and Asia. On a quarterly basis, Big Pharma and Little Pharma provide financial information about the research and development and the commercialization activities performed by both parties under the joint development and marketing agreement, and one participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to their joint development and marketing agreement. The results of the first annual period of the collaborative arrangement prior to any payments between the parties were as follows (in thousands):

| | Little Pharma | Big Pharma | Combined |
|---|---|---|---|
| Sales to third parties | $120,000 | $90,000 | $210,000 |
| COGS | 30,000 | 35,000 | 65,000 |
| S,G &A | 25,000 | 20,000 | 45,000 |
| R&D | 35,000 | 20,000 | 55,000 |
| Net profit | $ 30,000 | $15,000 | $ 45,000 |

***Evaluation:*** Big Pharma concludes that it is the principal on the sales transactions with third parties in Europe and Asia and will present 100 percent of the sales, cost of sales, and marketing expenses related to those efforts in its income statement. As the arrangement addresses several different activities, Big Pharma has evaluated the income statement classification for the payments associated with each separate activity. Big Pharma disaggregates its $4.75 million net receivable from Little Pharma in accordance with the nature of the individual components of the payable and characterizes the portion of the net receivable related to 30 percent of the profit related to the sales in Europe and Asia as cost of sales ($10.5 million) and characterizes the portion of the net receivable related to a reimbursement of Little Pharma's research and development costs as research and development expenses ($7.5 million). Big Pharma concludes that it will characterize the portion of the net receivable related to Little Pharma's sales in the United States as revenue ($22.75 million) similar to a royalty and would characterize any payment from Little Pharma for research and development activities as a reduction of its research and development costs. Big Pharma's conclusion is based on the fact that performing contract research and development services is not part of its ongoing major or central operations. In addition, Big Pharma concludes that Little Pharma is not its customer with respect to the research and development activities in this arrangement. Big Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Sales to third parties | $90,000 |
| Revenue from collaborative arrangement | 22,750 |
| | |
| COGS (including $10,500 payable to Little Pharma for profit sharing) | 45,500 |
| SG&A | 20,000 |
| R&D (including $7,500 payable as a reimbursement of Little Pharma's expenses incurred) | 27,500 |
| Net profit | $19,750 |

Little Pharma concludes that it is the principal on the sales transactions with third parties in the United States and will present 100 percent of the sales, cost of sales, and marketing expenses related to those efforts in its income statement. As the arrangement includes several different activities, Little Pharma has evaluated the income statement classification for payments associated with each separate activity. Little Pharma disaggregates its $4.75 million net payable to Big Pharma in accordance with the nature of the individual item and characterizes portion of

the net payable related to 35 percent of the profit related to the sales in the United States as cost of sales ($22.75 million) and characterizes the portion of the net payable to Big Pharma for research and development activities as research and development expenses. Little Pharma concludes that it will characterize the portion of the net payable related to profit sharing from Big Pharma's sales in Europe and Asia as revenue similar to a royalty ($10.5 million) and will characterize any payment from Big Pharma for research and development activities as a reduction of its research and development costs ($7.5 million). Little Pharma's conclusion is based on the fact that performing contract research and development services is not part of its ongoing major or central operations. In addition, Little Pharma concludes that Big Pharma is not its customer with respect to the research and development activities in this arrangement. Little Pharma presents the following information in its financial statements with respect to this collaborative arrangement (in thousands):

| | |
|---|---|
| Sales to third parties | $120,000 |
| Revenue from collaborative arrangement | 10,500 |
| | |
| COGS (including $22,750 payable to Big Pharma for profit sharing) | 52,750 |
| SG&A | 25,000 |
| R&D (including $7,500 due from Big Pharma as a reimbursement) | 27,500 |
| Net profit | $ 25,250 |

This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, identification of the deliverables in the arrangement, determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.

~~**Illustration 4**~~

~~***Facts:*** Studio A and Studio B agree to jointly participate in the production and distribution of a major motion picture. Studio A will manage the day-to-day production activities and will be responsible for distribution in the U. S., while Studio B will be responsible for distribution in Europe and Asia. Even though Studio A will be managing the production, under the arrangement, both studios agree that they will share equally in all production costs incurred. For purposes of this example, no license to intellectual property has been conveyed to Studio B. Further, Studio A will pay Studio B 50 percent of the net profits (that is, revenues less distribution costs) from the United States distribution to Studio B, and Studio B will pay Studio A 50 percent of the net profits from European and Asian distribution to Studio A. The studios are responsible for initially funding all distribution costs in their respective locations. On a quarterly basis, Studio A and Studio B provide financial information about the production and distribution under the joint production and distribution agreement, and one participant is required to make a payment to the other participant for a proportionate share of the excess of the parties' combined operating results pursuant to the joint production and distribution agreement.~~

~~At the completion of the production process, the total production costs of the film amounted to $50 million for which Studio B paid Studio A $25 million. In Year 1 of the film's release, the net profits were $75 million in the United States and $30 million in Europe and Asia. Accordingly, Studio A pays Studio B $22.5 million (50 percent of the total net profits of $105 million less Studio B's net profits of $30 million). In Year 2 of the film's release, the net profits were $25 million in the United States and $60 million in Europe and Asia. Accordingly, Studio B pays Studio A $17.5 million (50 percent of the total net profits of $85 million less Studio A's net profits of $25 million).~~

~~***Evaluation:*** During (or at the completion of) production, Studio A records the cash received from Studio B as a reduction of its capitalized film costs. Thus, at the end of production, Studio A has only $25 million in capitalized film costs reflected on its balance sheet for the project. Studio A has determined that, considering the guidance in Issue 99-19, it is the principal for the revenue generated in the United States. Accordingly, it characterizes all of the gross revenue related to the $75 million in Year 1 as revenue in its income statement and likewise records all of the associated distribution costs for distribution in the United States. Studio A concludes that it is not within the scope of other authoritative accounting literature for payments to and from Studio B. Studio A's accounting policy with respect to profit sharing amounts due from and to its production partners is to record those amounts net, in cost of sales, as it views these amounts either as additional costs for production and distribution or a reimbursement of such costs. Accordingly, Studio A records its payment of $22.5 million to Studio B as additional cost of sales. In Year 2, Studio A also characterizes the gross revenue related to the $25 million of net profits as revenue in its income statement. Consistent with its accounting policy, Studio A records the receipt of $17.5 million as a reduction of costs of sales in Year 2.~~

~~During production, Studio B records payments to Studio A as capitalized film costs. Thus, at the end of production, it has $25 million in capitalized film costs reflected on its balance sheet for the project. Studio B has determined that, after considering the guidance in Issue 99-19, it is the principal for the revenue generated in Europe and Asia. Accordingly, it characterizes all of the gross revenue related to the $30 million in Year 1 net profits as revenue in its income statement and likewise records all of the associated distribution costs for distribution in Europe and Asia. Studio B concludes that it is not within the scope of other authoritative accounting literature for payments to and from Studio A. Studio B's accounting policy with respect to profit sharing amounts due from and to its production partners is to record net amounts due from production partners as additional revenue and net amounts due to production partners as a cost of sales. Accordingly, Studio B records the receipt of $22.5 million from Studio A as revenue. Studio B also characterizes the gross revenue related to the $60 million in Year 2 net profits as revenue in its income statement. Consistent with its accounting policy, Studio B records the payment of $17.5 million as additional cost of sales in Year 2.~~

~~This evaluation is not intended to illustrate the appropriate revenue recognition requirements for any of the transactions described above. Such an analysis would include, at a minimum, a determination of the applicable authoritative accounting literature, the identification of the deliverables in the arrangement, and a determination of the units of accounting in the arrangement and the appropriate revenue recognition requirements for those units of accounting.~~