

Statement of Financial Accounting Standards No. 68

[FAS68 Status Page](#)
[FAS68 Summary](#)

Research and Development Arrangements

October 1982



Financial Accounting Standards Board
of the Financial Accounting Foundation
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CONTENTS

	Paragraph Numbers
Introduction	1–2
Scope	3
Standards of Financial Accounting and Reporting	4–15
Obligation Is a Liability to Repay the Other Parties	5–9
Obligation Is to Perform Contractual Services	10–11
Loan or Advance to the Other Parties	12
Issuance of Warrants or Similar Instruments	13
Disclosures	14
Effective Date and Transition.....	15
Appendix A: Background Information	16–23
Appendix B: Basis for Conclusions	24–39

FAS 68: Research and Development Arrangements

FAS 68 Summary

This Statement specifies how an enterprise should account for its obligation under an arrangement for the funding of its research and development by others. The enterprise must determine whether it is obligated only to perform contractual research and development for others, or is otherwise obligated. To the extent that the enterprise is obligated to repay the other parties, it records a liability and charges research and development costs to expense as incurred.

INTRODUCTION

1. The FASB has been asked how an enterprise should account for an arrangement through which research and development is funded by other parties. Some consider a research and development arrangement to be simply a contract to do research for others. Others believe that such arrangements are, in essence, borrowings by the enterprise. They believe the research and development expenditures should be reflected in the enterprise's financial statements as current expenses in accordance with FASB Statement No. 2, *Accounting for Research and Development Costs*. As a result of those different views, the reporting of similar arrangements has been inconsistent.

2. The legal structure of a research and development arrangement may take a variety of forms and often is influenced by federal and state income tax and securities regulations. An enterprise might have an equity interest in the arrangement, or its legal involvement might be only contractual (for example, a contract to provide services and an option to acquire the results of the research and development).

SCOPE

3. This Statement establishes standards of financial accounting and reporting for an enterprise that is a party to a research and development arrangement through which it can obtain the results

of research and development funded partially or entirely by others. It applies whether the research and development is performed by the enterprise, the funding parties, or a third party. Although the limited-partnership form of arrangement is used for illustrative purposes in this Statement, the standards also apply for other forms. This Statement does not address reporting of government-sponsored research and development.

STANDARDS OF FINANCIAL ACCOUNTING AND REPORTING

4. An enterprise shall determine the nature of the obligation it incurs when it enters into an arrangement with other parties who fund its research and development. The factors discussed in paragraphs 5-11 and other factors that may be present and relevant to a particular arrangement shall be considered when determining the nature of the enterprise's obligation.

Obligation Is a Liability to Repay the Other Parties

5. If the enterprise is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development, the enterprise shall estimate and recognize that liability. This requirement applies whether the enterprise may settle the liability by paying cash, by issuing securities, or by some other means.

6. To conclude that a liability does not exist, the transfer of the financial risk involved with research and development from the enterprise to the other parties must be substantive and genuine. To the extent that the enterprise is committed to repay any of the funds provided by the other parties regardless of the outcome of the research and development, all or part of the risk has not been transferred. The following are some examples in which the enterprise is committed to repay:

- a. The enterprise guarantees, or has a contractual commitment that assures, repayment of the funds provided by the other parties regardless of the outcome of the research and development.
- b. The other parties can require the enterprise to purchase their interest in the research and development regardless of the outcome.
- c. The other parties automatically will receive debt or equity securities of the enterprise upon termination or completion of the research and development regardless of the outcome.

7. Even though the written agreements or contracts under the arrangement do not require the enterprise to repay any of the funds provided by the other parties, surrounding conditions might indicate that the enterprise is likely to bear the risk of failure of the research and development. If those conditions suggest that it is probable ¹ that the enterprise will repay any of the funds regardless of the outcome of the research and development, there is a presumption that the enterprise has an obligation to repay the other parties. That presumption can be overcome only

by substantial evidence to the contrary.

8. Examples of conditions leading to the presumption that the enterprise will repay the other parties include the following:

- a. The enterprise has indicated an intent to repay all or a portion of the funds provided regardless of the outcome of the research and development.
- b. The enterprise would suffer a severe economic penalty if it failed to repay any of the funds provided to it regardless of the outcome of the research and development. An economic penalty is considered "severe" if in the normal course of business an enterprise would probably choose to pay the other parties rather than incur the penalty. For example, an enterprise might purchase the partnership's interest in the research and development if the enterprise had provided the partnership with proprietary basic technology necessary for the enterprise's ongoing operations without retaining a way to recover that technology, or prevent it from being transferred to another party, except by purchasing the partnership's interest.
- c. A significant related party ² relationship between the enterprise and the parties funding the research and development exists at the time the enterprise enters into the arrangement.
- d. The enterprise has essentially completed the project before entering into the arrangement.

9. An enterprise that incurs a liability to repay the other parties shall charge the research and development costs to expense as incurred. The amount of funds provided by the other parties might exceed the enterprise's liability. That might be the case, for example, if license agreements or partial buy-out provisions permit the enterprise to use the results of the research and development or to reacquire certain basic technology or other assets for an amount that is less than the funds provided. Those agreements or provisions might limit the extent to which the enterprise is economically compelled to buy out the other parties regardless of the outcome. In those situations, the liability to repay the other parties might be limited to a specified price for licensing the results or for purchasing a partial interest in the results. If the enterprise's liability is less than the funds provided, the enterprise shall charge its portion of the research and development costs to expense in the same manner as the liability is incurred. For example, the liability might arise as the initial funds are expended, or the liability might arise on a pro rata basis.

Obligation Is to Perform Contractual Services

10. To the extent that the financial risk associated with the research and development has been transferred because repayment of any of the funds provided by the other parties depends *solely* on the results of the research and development having future economic benefit, the enterprise shall account for its obligation as a contract to perform research and development for others.

11. If the enterprise's obligation is to perform research and development for others and the enterprise subsequently decides to exercise an option to purchase the other parties' interests in

the research and development arrangement or to obtain the exclusive rights to the results of the research and development, the nature of those results and their future use shall determine the accounting for the purchase transaction.³

Loan or Advance to the Other Parties

12. If repayment to the enterprise of any loan or advance by the enterprise to the other parties depends solely on the results of the research and development having future economic benefit, the loan or advance shall be accounted for as costs incurred by the enterprise. The costs shall be charged to research and development expense unless the loan or advance to the other parties can be identified as relating to some other activity, for example, marketing or advertising, in which case the costs shall be accounted for according to their nature.

Issuance of Warrants or Similar Instruments

13. If warrants or similar instruments are issued in connection with the arrangement, the enterprise shall report a portion of the proceeds to be provided by the other parties as paid-in capital. The amount so reported shall be the fair value of the instruments at the date of the arrangement.

Disclosures

14. An enterprise that under the provisions of this Statement accounts for its obligation under a research and development arrangement as a contract to perform research and development for others shall disclose ⁴ the following:⁵

- a. The terms of significant agreements under the research and development arrangement (including royalty arrangements, purchase provisions, license agreements, and commitments to provide additional funding) as of the date of each balance sheet presented
- b. The amount of compensation earned and costs incurred under such contracts for each period for which an income statement is presented

Effective Date and Transition

15. The provisions of this Statement shall be effective for research and development arrangements covered by this Statement that are entered into after December 31, 1982 with earlier application encouraged in financial statements that have not been previously issued. This Statement may be, but is not required to be, applied retroactively to previously issued financial statements. If previously issued financial statements are restated, the financial statements shall, in the year that this Statement is first applied, disclose the nature of any restatement and its effects on income before extraordinary items, net income, and related per share amounts for each restated year presented.

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

This Statement was adopted by the unanimous vote of the seven members of the Financial Accounting Standards Board:

Donald J. Kirk, *Chairman*
Frank E. Block
John W. March
Robert A. Morgan
David Mosso
Robert T. Sprouse
Ralph E. Walters

Appendix A: BACKGROUND INFORMATION

16. Research and development arrangements have been used to finance the research and development of a variety of new products, such as information processing systems, medical technology, experimental drugs, electronic devices, and aerospace equipment. Enterprises may enter into arrangements for different reasons. The objectives of entering into an arrangement may be to:

- a. Transfer all or part of the uncertainty and risk involved with the research and development to others
- b. Obtain the benefit of funds that are made available because of tax incentives for investors
- c. Attract qualified research and development personnel who otherwise might be concerned that funding might not be assured
- d. Avoid expanding the ownership of the enterprise and the impact on earnings per share that would result from issuing equity securities
- e. Avoid debt service expenditures and the impact on the enterprise's debt-to-equity ratio that would result from issuing debt securities
- f. Avoid the impact on the enterprise's near-term earnings that would result if it incurred the related research and development expenses

17. Many arrangements have been formed as limited partnerships. In some, the enterprise or a related party is the general partner who manages the research and development activities. Sometimes, the limited partners are related to the enterprise. In some arrangements, the enterprise has the basic technology needed for the research and development and has performed preliminary research and development work to determine the attractiveness of further work. The enterprise might contribute the preliminary research and development work and basic technology

to the partnership for a minor equity interest or might license or give the rights to the preliminary work and basic technology to the partnership.

18. The terms of the arrangement usually contemplate, but do not guarantee, that the funds provided by the limited partners will be sufficient to complete the intended research and development. However, some agreements permit or require the general partner to sell additional limited-partnership interests or to use its own funds if the funds provided are insufficient to complete the research and development effort. The enterprise sometimes provides additional funds through loans or advances to the partnership. Repayment of the loans or advances sometimes is guaranteed by the partnership although repayment sometimes is contingent on realization of future economic benefits of the research and development; for example, repayment might be made through offsets against the purchase price for the results of the project or against royalty payments.

19. The enterprise or a related party of the enterprise usually performs the research and development work under a contract with the partnership. The compensation under the research and development contract usually is either a fixed fee or reimbursement of direct costs plus a fixed fee or fixed percentage of those costs. The work is performed on a best-efforts basis with no guarantee of either technological or commercial success. The partnership retains legal ownership of the results of the research and development and sometimes retains legal rights to the basic technology provided by the enterprise.

20. Either as part of the partnership agreement or through contracts with the partnership, the enterprise usually has an option either to purchase the partnership's interest in or to obtain the exclusive rights to the entire results of the research and development in return for a lump sum payment or royalty payments to the partnership. Some arrangements contain a provision that permits the enterprise to acquire complete ownership of the results for a specified amount of the enterprise's stock or cash at some future time. In some of those purchase agreements, the partnership has the option to receive either the enterprise's stock or cash; in others, the enterprise makes the decision. Sometimes, warrants or similar instruments to purchase the enterprise's stock are issued in connection with the arrangement.

21. An enterprise that is a party to an arrangement through which research and development is funded by other parties usually incurs an obligation when it enters into the arrangement. The nature and extent of the enterprise's obligation are sometimes difficult to determine and can range from an obligation to perform contract research and development work to an obligation to repay the other parties, with a return, for the funds provided.

22. If the results of the research and development are determined to have sufficient future economic benefit, the enterprise probably will exercise its option either to purchase the partnership's interests in or to obtain the exclusive rights to the entire results. If the results do not have future economic benefit, the enterprise usually is not legally required to exercise its option; however, there may be valid business reasons for the enterprise to acquire the results

even though the original objectives of the research and development are not met. For example, the enterprise may want to obtain ownership of results that have value to the enterprise even though they do not meet the original objectives. Other reasons may be to maintain the ability to enter into another arrangement with the same parties or similar arrangements with other parties; to recover the ownership of or rights to the enterprise's basic technology or to prevent the partnership from providing that technology to others; to avoid any potential future claim against the use of the results; or to fulfill a moral obligation (for example, the enterprise is the general partner and due to a conflict of interest feels compelled to exercise its option).

23. Although the enterprise's legal liabilities will be specified in the various contracts and agreements under the arrangement, accounting representations should not necessarily be limited to legal requirements. Depending on the facts and circumstances involved in a particular research and development arrangement, future payments by the enterprise to the other parties ostensibly for royalties or to purchase the partnership's interests in or to obtain the exclusive rights to the research and development results might actually be any of the following: (a) the settlement of a borrowing, (b) the purchase price of an asset, or (c) royalties for the use of an asset. The financial reporting of an enterprise that is a party to a research and development arrangement should represent faithfully what it purports to represent and should not subordinate substance to form.

Appendix B: BASIS FOR CONCLUSIONS

24. An Exposure Draft of a proposed Statement, *Research and Development Arrangements*, was issued on April 27, 1982. The Board received 37 letters of comment in response to that Exposure Draft. This appendix discusses the factors that the Board considered significant in reaching the conclusions in this Statement. Individual Board members gave greater weight to some factors than to others.

25. Several respondents to the Exposure Draft questioned the need for a project to specify how an enterprise that is a party to a research and development arrangement should account for its obligation under the arrangement. Although they generally agreed with the principles proposed in the Exposure Draft, they expressed the view that a careful reading of other Statements, such as FASB Statements No. 2, *Accounting for Research and Development Costs*, No. 5, *Accounting for Contingencies*, and No. 57, *Related Party Disclosures*, would lead to the correct answers. However, because information received by the Board showed significant diversity in the accounting practices of enterprises involved in similar research and development arrangements, the Board concluded that those Statements do not provide adequate guidance. Some enterprises accounted for the proceeds received from the other parties as contract revenues from performing research and development for others while other enterprises accounted for the proceeds from similar arrangements as borrowings. Various regulatory agencies raised questions about the diversity in accounting for similar arrangements, and industry and the accounting

profession asked the FASB to provide guidance.

26. Some people believe that most, if not all, research and development arrangements are borrowing transactions. Those with that view believe that in most, if not all, cases the enterprise controls the right to the future economic benefits of the research and development and has in one form or another an obligation to repay principal and pay interest on the borrowed funds, even though those amounts may be paid in the form of royalties.

27. Others argue for contract accounting because they believe that in most, if not all, research and development arrangements the financial risk is transferred to others, the results of the research and development belong to the partnership, and the enterprise is not obligated to acquire the results or to acquire the partnership's interest therein. They believe that the enterprise has a liability only if it decides to exercise its option.

28. The Board believes that each of the above positions is appropriate in certain situations and that neither position is universally applicable to all research and development arrangements. The Board's conclusions in this Statement are derived from FASB Concepts Statement No. 3, *Elements of Financial Statements of Business Enterprises*, which defines liabilities as:

. . . Probable . . . future sacrifices of economic benefits arising from present obligations . . . of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events. [paragraph 28]

Concepts Statement 3 uses the term *obligation* to include duties imposed legally or socially; that is, what an enterprise is bound to do by contract, promise, or moral responsibility. Therefore, an enterprise may have a liability that is recognized for financial reporting even though it is not a legal liability.

29. Some respondents believed that the Board should have based its conclusions on the definition of a loss contingency in Statement 5 rather than on the definition of a liability in Concepts Statement 3. The Board concluded that Statement 5 does not address the primary issue involved in determining whether an enterprise involved in a research and development arrangement has a liability. Statement 5 deals with contingencies; that is, an existing condition, situation, or set of circumstances involving *uncertainty as to possible gain or loss* that will ultimately be resolved when one or more future events occur or fail to occur. This Statement deals with a transaction in which the issue is whether at the time an enterprise enters into a research and development arrangement (a) it 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 enterprise will repay the other parties regardless of the outcome, or (c) the enterprise is obligated only to perform research and development work for others.

30. Some people consider the likelihood of success of the research and development as the

key issue in who bears the risk of failure of those activities. However, even though future benefits from a particular project may be foreseen, the amount generally cannot be measured with a reasonable degree of certainty. The key question in determining who bears the risk of failure is whether the enterprise is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development. Concepts Statement 3 states that "an enterprise is not obligated to sacrifice assets in the future if it can avoid the future sacrifice at its discretion without significant penalty." ⁶ A determination must be made of the penalty, if any, that the enterprise will incur if it does not repay any of the funds provided.

31. If an enterprise is contractually committed to repay any of the funds provided or has guaranteed or assured the other parties of repayment of the funds provided, regardless of the outcome of the research and development, the enterprise clearly has a liability to repay the other parties. However, because of tax considerations, the agreements and contracts under the arrangement normally state that the enterprise is obligated only to perform services and generally do not require the enterprise to repay any of the funds provided if the research and development does not have future economic benefit. Nonetheless, the Board believes that substantive and genuine transfer of risk is essential for the enterprise's obligation to be limited to performing contractual services and that certain conditions create a presumption that the transfer of risk to the other parties may not be substantive or genuine. An enterprise involved in a research and development arrangement might incur equitable or constructive obligations through actions that bind the enterprise or by circumstances that change the nature of the enterprise's obligation from one to perform services for a fee to one to repay amounts provided by the other parties. For example, an enterprise might provide the partnership with basic technology necessary for the enterprise's ongoing operations without retaining a way to recover that technology, or to prevent it from being transferred to another party, except by purchasing the partnership's interest in the research and development. Another example might be that there is a conflict of interest and the limited partners could reasonably be expected to litigate successfully if the enterprise does not buy out the partnership.

32. Some respondents questioned whether the mere presence in a research and development arrangement of parties related to the enterprise should lead to a presumption that a liability has been incurred. In particular, they questioned the relevance of the enterprise's role as general partner. Although transactions between related parties commonly occur in the normal course of business, the conditions of competitive free-market dealings between independent parties may not exist. Accordingly, the enterprise might be influenced by considerations other than those that would exist in arm's-length transactions with unrelated parties. This is particularly true if the related parties can directly or indirectly influence the enterprise's decision whether or not to acquire the results of the research and development. The Board concluded that the combined attractiveness of "off-balance-sheet" financing for the enterprise and tax incentives for related party investors may cause the substance of such an arrangement to differ from its form. However, the Board does not believe that the enterprise's obligation should be accounted for as a liability just because the enterprise is the general partner. The example in paragraph 8(c) has been revised accordingly.

33. The Board believes that the enterprise should account for the amount of any loan or advance to the partnership, the collection of which is contingent on the results of the research and development having future economic benefit, as costs incurred by the enterprise because of the uncertainty of recovery of those loans and advances. As discussed in the "Basis for Conclusions" of Statement 2, "estimates of the rate of success of research and development projects vary markedly—depending in part on how narrowly one defines a 'project' and how one defines 'success'—but all such estimates indicate a high failure rate." ⁷ Statement 2 further states that "even after a project has passed beyond the research and development stage, and a new or improved product or process is being marketed or used, the failure rate is high." ⁸ Statement 2 requires any research and development costs to be charged to expense as those costs are incurred. If the costs relate to some other activity, for example, marketing or advertising, the costs should be accounted for according to their nature.

34. If the enterprise exercises an option to purchase the partnership's interest in or to obtain the exclusive rights to the results of the research and development, a question arises as to whether the amount paid should be an expense or the purchase price of an intangible asset. If an intangible asset is developed, the Board believes that there is a distinction between an amount paid for the results of a known successful project and the costs incurred in ongoing research and development whose ultimate success or failure is unknown. An enterprise exercising a purchase option on a successful project has made a decision about the results of past research and development costs. The uncertainty usually has diminished to the point that an evaluation, comparable to an evaluation made when an intangible asset is acquired from an independent party, can be made about the future economic benefits of the results. If a purchase price is reported as the cost of an intangible asset, the provisions of FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, or of APB Opinion No. 17, *Intangible Assets*, apply.

35. If the enterprise's liability is less than the amount of funds provided by the other parties, the Exposure Draft would have required an enterprise to charge its portion of the research and development costs relating to the research and development to expense on a pro rata basis. Several respondents argued that a pro rata approach is appropriate only if the enterprise must repay on a pro rata basis. In some instances, the enterprise's liability might arise as the initial funds are spent. The Board agreed that a pro rata approach might not be appropriate in all circumstances. Paragraph 9 has been revised to require that the enterprise charge its portion of the research and development costs to expense in the same manner as the enterprise's liability is incurred.

36. Several respondents suggested that the final Statement provide detailed guidance for the various aspects of research and development arrangements. Most of the guidance sought deals with accounting in general or is addressed by other existing generally accepted accounting principles; for example, guidance for discounting a liability is contained in APB Opinion No. 21, *Interest on Receivables and Payables*, and guidance for recognition of losses on cost overruns is

contained in Statement 5. Accordingly, the Board concluded that it is unnecessary to specify such detailed guidance in this Statement. Some respondents also requested that the final Statement specify the accounting and reporting for contract revenues and costs under a research and development arrangement. Those issues relate to accounting and reporting for contracts in general, which is beyond the scope of this Statement.

37. The Exposure Draft included a notice to recipients specifically requesting comments on the proposed disclosures. Several respondents said that the proposed disclosure requirements were excessive for an enterprise's obligation accounted for as a liability because adequate disclosures are required by other existing generally accepted accounting principles. The Board agreed with those respondents and, accordingly, the disclosure requirements for an obligation accounted for as a liability have not been carried forward from the Exposure Draft. Some respondents also disagreed with requiring the disclosures as of each balance sheet presented and about requiring that the disclosures be presented in the footnotes. The Board concluded that the disclosures required by this Statement should be provided for each balance sheet presented because the research and development activities often are long-term in nature and the disclosures are useful for comparison. The Board agreed that it is acceptable to present the disclosures either in the primary financial statements or in the footnotes and revised the disclosure requirements accordingly.

38. Some respondents requested that the transition provisions of the Exposure Draft be modified to permit retroactive restatement of previously issued financial statements. They believe that permitting retroactive restatement would enable enterprises that have used various accounting alternatives to report old and new arrangements consistently and thereby improve overall comparability. The Board agreed and revised the transition to permit retroactive restatement for previously issued financial statements.

39. The Board concluded that it can reach an informed decision on the basis of existing information without a public hearing and that the effective date and transition specified in paragraph 15 are advisable in the circumstances.

Footnotes

FAS68, Footnote 1--*Probable* is used here consistent with its use in FASB Statement No. 5, *Accounting for Contingencies*, to mean that repayment is likely.

FAS68, Footnote 2--*Related parties* are defined in FASB Statement No. 57, *Related Party Disclosures*.

FAS68, Footnote 3--Paragraph 5 of FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method*, states: ". . . the accounting for the cost of an item to be used in research and development activities is the same under paragraphs 11 and 12 of Statement 2 whether the item is purchased singly, or as part of a group of assets, or as part of an entire enterprise in a business combination accounted for by the purchase method." The accounting for other identifiable intangible assets acquired by the enterprise is specified in APB Opinion No. 17, *Intangible Assets*.

FAS68, Footnote 4--Statement 57 specifies additional disclosure requirements for related party transactions and certain control relationships.

FAS68, Footnote 5--An enterprise that is a party to more than one research and development arrangement need not separately disclose each arrangement unless separate disclosure is necessary to understand the effects on the financial statements. Aggregation of similar arrangements by type may be appropriate.

FAS68, Appendix B, Footnote 6--Concepts Statement 3, paragraph 135.

FAS68, Appendix B, Footnote 7--Statement 2, paragraph 39.

FAS68, Appendix B, Footnote 8--*Ibid.*, paragraph 40.