Pharmagen

Finance

Pharmagen case describes a $500 million Research and Development (“ R&D”) funding agreement between pharmaceutical company (“ Pharma”) and third-party private investor (“ PEI”). The issue is to decide on how to account for funding of the R&D and royalty payments, and identify authoritative literature applicable to the agreement. Case states the following facts about agreement:

•Pharma will receive up to $500 million from PEI for R&D cost for new drug X

•A non-refundable funding to be used solely for drug X development costs •PEI will provide incremental funding as long as Pharma is demonstrating progress, however Pharma is not obligated to successfully complete development, “ best effort” arrangement •Pharma estimated completion of project will take 3 years (from agreement date), and will cost estimated $1 billion

•Pharma retains all intellectual property rights to drug X

•PEI is entitled to receive future royalties on drug X revenues

•PEI is entitled to receive future royalties associated with an existing commercialized drug Facts presented in the case call for Accounting Standards Codification (ASC) section 730-20 to be applicable. This accounting standard provides clarification and guidance to entities that entered into R&D arrangements, and advises on proper recognition.

To define how transactions in Pharma and PEI agreement should be recorded, we should take a close look at ASC 730-20-25 -02, a recognition section that reads that “ an entity shall determine the nature of the

obligation it incurs when it enters into an arrangement with other parties who fund its research and development".

Based on the scenario, we need to determine if Pharma has an obligation to repay the other party (PEI) and should recognize funding and royalties as a liability on its' books, or liability does not exist. ASC 730-20-25-03 states " if the entity is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development, the entity shall estimate and recognize that liability. This requirement applies whether the entity may settle the liability by paying cash, by issuing securities, or by some other means".

Based on the agreement Pharma is to receive up to $500 millions in increments to fund its' $1 billion drug X R&D costs. Funding provided by PEI is non-refundable, and agreement does not specifically state re-payment commitments between Pharma and PEI. ASC section 730-20-25-04 states that " to conclude that a liability does not exist, the transfer of the financial risk involved with research and development from the entity to the other parties must be substantive and genuine". In order to determine if transfer of the financial risk occurred from Pharma to PEI, we need to take a look at four conditions that lead to " the presumption that the entity will repay", thus creating a liability.

Here are the conditions as specified in ASC 730-20-25-6:

•The entity has indicated an intent to repay all or a portion of the funds provided regardless of the outcome of the research and development

•The entity 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.

•A significant related party relationship between the entity and the parties funding the research and development exists at the time the entity enters into the arrangement

•The entity has essentially completed the project before entering into the arrangement Based the case facts let see if any of the conditions are met.

Firstly, even though there is no clear intent to pay back all or portion of funds, judging only by case facts PEI is entitled to receive future royalties on drug X revenues, and is also entitled to receive future royalties associated with an existing commercialized drug. These obligations can be considered as guaranteed re-payments to PEI " by some other means" (ASC 730-20-25-3), in form of royalties, thus show intent to repay.

Secondly, no penalties associated with repayment failure are mentioned in agreement, as there is no firm commitment to repay, so it does not apply. Thirdly, Pharma and PEI cannot be considered related parties, based on ASC 850-10-20 definition. It is clearly stated in the case that, PEI had no prior relationship or business operations related to Pharma. Finally, last condition does not apply as case provides information that Pharma started drug X research as self-funded effort.

Project was initiated right before entering in agreement with PEI, and is still in progress. Since first condition can be considered to be met, it will be correct to assume that Pharma is not transferring financial risk that is "

substantive and genuine” to PEI, and needs to recognize a liability on its’ financial statements. The other possible way to account for R&D funding and royalties is to prove that obligation is contractual, and Pharma is solely being contracted to do research and development for PEI. Taking in consideration four conditions described earlier, one can argue that re-payment intent is there and royalties might not be considered as repayments but rather an incentive for future benefits from drug X proceeds.

Case states that Pharma is operating under “ best efforts” arrangements, which according to online Business Dictionary is a “ very high standard of execution, failure to achieve which may be excusable under force-majeure clause or on demonstration that failure occurred despite one's dedicated and sustained efforts”.

In other words, payments of drug X royalties are contingent on successful development of the drug. ASC 730-20-25-8 advises that “ 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 entity shall account for its obligation as a contract to perform research and development for others”. Then, case also states that Pharma will retain all intellectual property rights to drug X.

This complies with ASC 730-20-25-9, that reads “ if the entity's obligation is to perform research and development for others and the entity 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 or business combination". None of the repayment intent conditions are met, so liability does not exist, and Pharma keeps ownership of intellectual property. Both assumptions lead to consider that Pharma's obligation to PEI is contractual.

If funding for R&D and royalties for drug X are recorded on contractual basis, terms of royalty arrangements and amount of costs incurred should be disclosed accordingly, based on ASC 730-20-50-1. One of the issues that would make recognition of R&D funding and royalties less desirable on contractual basis and would create liability, is uncertainty of PEI's entitlement to royalties. An agreement between Pharma and PEI states that PEI is entitled to future royalties associated with future revenues of drug X, and to future royalties associated with an existing commercialized drug for a defined period (3 years).

This seems to create an obligation to pay guaranteed payments (in form of royalties), regardless of drug X success. If agreement would have been revised and only royalties on drug X would be considered as guarantee payments (which depend only on success of the drug X), then I think agreement between Pharma and PEI should definitely be treated as a contract. In conclusion, I want to say that even though I think Pharma should recognize liability on its' books, it is definitely a dilemma to find a right approach to R&D funding and royalties recognition, as in this case facts do not provide solid information on repayments methods, and leave room for questions and debates. At the end of the day I think it is a matter of auditors personal educated judgment.