Collaborative Arrangements

– A Fine Line in Revenue Recognition

By Josef Rashty

Curriculum: Accounting and auditing

Level: Basic

Designed For: CPAs in industry and public practice

Objectives: To provide background information for the interface between collaborative arrangements and revenue recognition guidance

Key Topics: Collaborative arrangements, revenue recognition and gross versus net revenue recognition

Prerequisites: None

Advanced Preparation: None

A contract with counterparties to participate in an activity where both parties share in the risks and benefits of that activity (such as development of a technology or a product) is a collaborative arrangement and not usually within the scope of revenue recognition guidance. In such arrangements, counterparties usually do not meet the definition of customers and, as a result, the contract does not fall within the scope of revenue recognition guidance.

However, there may be collaborative arrangements where, in substance, an entity sells goods or services to counterparties. In such instances, the arrangement could become within the scope of revenue recognition guidance even though it is referred to as a "collaborative" arrangement. Generally, revenue recognition guidance applies to all contracts, including transactions with collaborators and partners, as long as they are considered to be customers.

In November 2016, the Financial Accounting Standards Board (FASB) decided to add a project to its agenda to clarify when transactions between partners in a collaborative arrangement (that is within the scope of Topic 808, *Collaborative Arrangements*) should be accounted for as revenue transactions in Topic 606, *Revenue from Contracts with Customers*. As of the date of this article, FASB has not issued its exposure draft on this project.

This article will discuss the fine line that divides a customer from a collaborator based on the existing guidelines in collaborative arrangements and revenue recognition guidance.

Collaborative Arrangements

Entities often enter into arrangements with other entities to, for example, develop and commercialize a specific drug candidate, an intellectual property (such as a computer software) or jointly manage an operating facility (such as a factory or a distribution center). One of the counterparties may have the primary responsibilities for certain activities, for example, research and development, or two or more participants may jointly share such responsibility. These arrangements are very common in the technology industry, and particularly in pharmaceutical and bio technological companies.

Accounting Standards Codification (ASC) 808, *Collaborative Arrangements*, defines "collaborative arrangement" as a contractual arrangement that involves two or more parties who are actively participating in a joint operating activity and are exposed to significant risks and rewards depending on the commercial success of the arrangement (ASC 808-10-20).

ASC 808-15-8 identifies the following as evidence of active participation:

- Directing and carrying out the activities of collaborative arrangements.
- Participating in governance and oversight of collaborative arrangements.
- Holding an exclusive contractual right to the underlying technology or intellectual property.

However, the above list is not intended to be a comprehensive list and FASB has identified them only as examples.

ASC 808-15-11 also identifies some of the terms and conditions of the arrangement that may indicate that participants are not exposed to significant risks and rewards and, as a result, are not in a collaborative arrangement:

- 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.

Collaborative arrangements within the scope of ASC 808 are not typically conducted through a separate legal entity and if they are, should be accounted for under ASC 323, *Investments*, and ASC 810, *Consolidation* (ASC 808-15-4).

Management exercises significant judgment to consider all facts and circumstances to determine whether a contractual arrangement is a collaborative engagement at the outset, and reevaluates the arrangement as facts and circumstances change.

Accounting for Collaborative Arrangements

ASC 808 does not provide any specific guidance for presentation of collaborative arrangements on the income statement. However, any revenues on collaborative arrangements that are not within the scope of the revenue recognition guidance are generally presented separately from revenues for customers' contracts on the income statements and costs associated with collaborative arrangements are usually reflected as operating expenditures, whereas costs associated with generation of revenues from customers are reflected in cost of sales. Thus, the classification of revenues as collaborative arrangements versus revenues may impact the gross margin of companies significantly.

ASC 808-10-45-3 requires that transactions between collaborators pursuant to any collaborative arrangement that are deemed to be within the scope of other authoritative guidance shall be accounted for using the provisions of that guidance. Counterparties may be collaborators or customers, or be collaborators for certain parts of an arrangement and customers for other parts of it. Management assesses, on a case-by-case basis, whether certain counterparties are customers and that, as a result, their activities lead to revenue generating activities.

Revenue Recognition Guidance

A portion of a collaborative arrangement contract that is intended for the sale of goods and services between counterparties may be within the scope of the revenue recognition guidance if it meets the revenue recognition criteria.

Revenue Recognition Criteria

If a collaborative arrangement, or any part of it, is identified as a transaction with customers, the following revenue recognition criteria must be applied to that particular transaction.

SEC's Staff Accounting Bulletin (SAB) 104, *Revenue Recognition* (codified under Topic 605), outlines the general principles of revenue recognition under the current guidance, which requires the following four criteria for revenue recognition:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been performed.
- The seller's price to the buyer is fixed and determinable.
- Collectibility is reasonably assured.

In May 2014, FASB and the International Accounting Standards Board (IASB) jointly released their new standard for revenue recognition. The new revenue standard is effective for public business entities (PBEs) for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2018. The new revenue standard for nonpublic entities is effective for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2019.

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The core principle of the new guidance is to recognize revenues based on the transfer of promised goods or services to customers in an amount that reflects the consideration for transfer of such goods or services. The revenue recognition criteria under ASC 606 are as follows:

- Identification of contract(s) with customers.
- Identification of performance obligations.
- Determination of the transaction price.
- Allocation of the transaction price to performance obligations.
- Recognition of revenue as company satisfies performance obligations.

What has changed is that the new guidance (ASC 606) is a model based on control rather than the current guidance (ASC 605), which is based on risks and rewards.

Customer Criterion in ASC 606

The key in classification of a contract as a collaborative arrangement versus a revenue contract is to identify if a collaborator meets the definition of a customer under the new revenue guidance (ASC 606).

ASC 606-10-20 and International Financial Reporting Standards (IFRS 15), Appendix A, defines a customer as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Counterparties in collaborative arrangements could be considered customers under certain circumstances. ASC 606 applies to all contracts, including collaborative arrangements, as long as they are transactions with customers.

A customer is a party that obtains goods and services from an entity, which are the result of entity's ordinary activities and business. The scope of ASC 606 includes some transactions with collaborators that are engaged with the entity to obtain such goods and services. However, ASC 606 excludes collaborators that share the risks and rewards of certain activities or actively participate in such activities.

A contract with counterparties to participate in an activity where both parties share risks and rewards of the activity (for example, development of an intellectual property or technology) is considered a collaborative arrangement and is unlikely to meet the definition of customer under ASC 606. However, a collaborative arrangement where, in substance, one party sells goods and services to another party is likely to be within the scope of the revenue standard, even though the contract has been identified as a collaborative arrangement.

The general framework of customer definition in ASC 606 also applies to ASC 605; however, the real distinction between a collaborator and a seller in ASC 605 is based on a shift and different exposition to risks and rewards.

Risks and Rewards Criteria in ASC 605

As was discussed earlier, ASC 605 is a revenue model based on risks and rewards, and collaborative arrangements are based on risks and rewards, as well. The distinction is that when a collaborator becomes a customer, the facts and circumstances change, and the role of the counterparty and its participation in risk and reward changes. In collaborative arrangements, collaborators participate in the risk and rewards of conducting certain activities, whereas in revenue transactions, sellers are engaged in the risks and rewards of output (i.e., selling goods to customers).

Management should analyze all aspects of collaborative arrangements to determine if all or a portion of a collaborative arrangement is within the scope of ASC 606 or ASC 605. It is feasible that a portion of the collaborative arrangement shares risks and rewards on an activity outside the scope of the revenue standard, but another portion, for the sale of goods and services, falls within the scope of the revenue standard.

Agent vs. Principal Consideration

ASC 808 requires that collaborators in sales to third parties follow the revenue recognition guidance. More specifically, ASC 808-10-45-1 requires that participants in a collaborative arrangement report costs incurred and revenue generated from transactions with third parties (that is, the parties that are not collaborators) in their earnings pursuant to Subtopic 605-45 (*Revenue Recognition – Principal versus Agent Considerations*) and Paragraphs 606-10-55-36 through 606-10-55-40 (*Revenues from Contracts with Customers, Principal versus Agent Considerations*).

In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with a corresponding offset to cost of sales (e.g., a travel agency that sells an airline ticket to a customer). In this example, the travel agency recognizes the net revenue (the gross revenue less of cost of sales).

Nevertheless, regardless of the method of accounting, the net income remains the same under either method. However, many analysts may judge the performance of an entity based on top line (i.e., revenues) instead of bottom line (i.e., net income).

It is not within the scope of this article to discuss the detail criteria for principal vs. agent considerations. The criteria for principle versus agent distinction appear to have changed very little in ASC 606 compared to ASC 605, if any; nevertheless, the revenue model itself has changed from a risk-and-reward model to a control-based model.

Today's CPA in its January/February 2017 issue published an article on implications of reporting revenue transactions on gross versus net basis (Josef Rashty, "Amendment to Gross Versus Net Revenue Recognition"). This article discussed in detail the implications of dealing with these two different accounting methods. Nevertheless, regardless of the method of accounting that companies use, the net income remains the same under either method. However, many analysts may judge the performance of an entity based on its top line (i.e., revenues) instead of its bottom line (i.e., net income).

Illustration

The following two scenarios clarify the concepts discussed earlier in this article.

First Scenario

Biotech enters into a collaborative arrangement with Pharmco to jointly develop a drug for cancer treatment. They equally participate in costs for development of this drug. Subsequent to successful development of the drug, Biotech obtains a patent for the drug and later transfers the patent to Pharmco for a fee.

The amount that Biotech receives from Pharmco for the patent is unlikely to be within the scope of the revenue standard; therefore, Biotech records the patent fee received as collaboration revenue for the sale of the patent and reflects the associated costs for the development

Table 1

	Revenues from Customers	Cost of Sales	Gross Margin
Biotech – Principal	$170 (1)	$160 (4)	$10
Pharmco – Agent	$60 (2)	$20 (5)	$40
Pharmco – Principal	$170 (1)	$130 (6)	$40
Biotech – Agent	$110 (3)	$100 (7)	$10

(1) The gross amount of revenue for products sold to third parties.

(2) Pharmco's cost of sales and profit ($170 less $10 cost of sales less $50 profit margin of Pharmco).

(3) The selling price of products for Biotech sales to Pharmco.

(4) Biotech's costs of sales for $100 plus $60 for Pharmco's cost of sales and profit.

(5) Pharmco's cost of sales.

(6) $110 payout to Biotech plus Pharmco's cost of sales for $20.

(7) Biotech's cost of sales.

of the drug as operating expenses. Pharmco, on the other hand, may capitalize the cost of the patent acquired from Biotech and amortize it to the cost of sales as it manufactures and sells the drug to third parties.

Pharmco accounts for the sale of the drug to third parties in accordance with revenue recognition guidance, since these transactions occur within the normal course of Pharmco's business (i.e., selling drugs to customers).

The determination to classify the revenue as a collaborative revenue is based on the premise that if counterparties participate in an activity to develop an asset in a collaborative arrangement instead of obtaining the output of the entity during the course of their ordinary activities, the agreement would not be within the scope of the revenue recognition guidance (ASC 606-10-15-3).

Second Scenario

Biotech enters into a collaborative arrangement with Pharmco to jointly develop a drug for cancer treatment. They equally participate in costs for development of this drug. Subsequent to successful development of the drug, Biotech continues its research and development activities on the drug and also assumes responsibility for the manufacturing of the drug.

Assuming that the cost of the manufacturing of the drug per unit for Biotech is $100, Biotech sells the drug exclusively to Pharmco for $110. Pharmco, in turn, sells the drug to third parties for $170 per unit and its cost of sales is $20 per unit. Biotech maintains the right to use the research and development know-how on this project on its other projects.

In this scenario, it could possibly be argued that the contract is within the scope of the revenue recognition guidance and Pharmco is Biotech's customer (ASC 606), and risks and rewards are no longer associated with the development of the drug, but participation in the output (ASC 605). Therefore, both Biotech and Pharmco reflect these transactions as revenues from customers.

However, the question remains which entity is the principal and should reflect its revenues on a gross basis, and which entity is the agent and should reflect its revenue on a net basis.

Table 2

	Revenues from Collaboration (ASC 808)	Revenues from Customers (ASC 606 or 605)	Cost of Sales	Operating Expenditures	Gross Margin	Net Income
Biotech as Collaborator	$110	-	-	$100	-	$10
Pharmco as Principal	-	$170	$130	-	$40	$40

Table 1 and Table 2 reflect the financial presentation of Biotech and Pharmco under different scenarios.

The gross margin (and eventually net income) does not change regardless of gross versus net election; however, the top line (i.e., revenues) changes based on the selection of each particular method.

The determination of principal versus agent depends on which entity has the risk and reward (ASC 605) or which entity has control (ASC 606) and is based on the criteria stated in the revenue recognition guidance.

If Biotech sales to Pharmco were within the scope of ASC 808 and revenues were recognized as collaborative revenues, the financial presentation of Biotech and Pharmco is shown in Table 2.

If an entity reflects revenues from customers as part of a collaborative arrangement, it must meet all the revenue recognition criteria under ASC 605 or ASC 606 discussed earlier in this article.

Final Remarks

The revenue recognition guidance excludes from its scope contracts with a collaborator; however, a contract with a collaborator is within the scope of revenue recognition if the collaborator meets certain conditions. The counterparty can be a collaborator for certain parts of the contract and a customer or seller for other parts of the arrangement.

FASB and IASB decided not to provide any specific guidance for determining whether certain collaborative revenues would be within the scope of ASC 606. Thus, making the assessment of whether the counterparty is a collaborator or a customer or seller requires judgment and consideration of all applicable facts and circumstances. This judgment impacts the classification and presentation of the statement of income under both ASC 605 and ASC 606.

Companies currently apply different approaches to account for collaborative arrangements. This has led FASB to undertake a project to clarify when transactions between partners are within the scope of a collaborative arrangement (that is within the scope of Topic 808, *Collaborative Arrangements*) or whether they should be accounted for as revenue transactions under Topic 606, *Revenue from Contracts with Customers*. This article attempted to identify some of the issues involved. ■

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By Josef Rashty

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1 The article claims that FASB has added a project to its agenda to:

A. eliminate collaborative arrangements.
B. enhance revenue recognition guidance.
C. clarify when collaborative arrangements can be accounted for as revenue transactions.
D. none of the above.

2 The article claims that collaborative arrangements are very common in:

A. the transportation industry.
B. the technology industry.
C. the airline industry.
D. all of the above.

3 According to ASC 808, a collaborative arrangement is a contractual agreement that involves:

A. two or more parties.
B. parties that are actively participating in joint operations.
C. parties that are exposed to risks and rewards.
D. all of the above.

4 Active participation in a collaborative arrangement means, among other things, participating in governance and oversight of a collaborative arrangement.

A. True
B. False

5 Collaborative arrangements within the scope of ASC 808 are:

A. not typically conducted through a separate legal entity.
B. typically conducted through a separate legal entity.
C. all of the above.
D. none of the above.

6 Counterparties in a collaborative arrangement:

A. could be collaborators.
B. could be customers.
C. could be collaborators for certain parts of an arrangement and customers for other parts of it.
D. all of the above.

7 The article claims that a portion of a collaborative arrangement contract that is intended for the sale of goods and services between counterparties:

A. may be within the scope of the existing revenue recognition guidance (ASC 605).
B. may be within the scope of the new revenue recognition guidance (ASC 606).
C. either a or b.
D. neither a nor b.

8 ASC 606 ________ collaborators that share the risks and rewards of certain activities or actively participate in such activities.

A. excludes
B. includes
C. identifies
D. describes

9 According to ASC 605, revenue transactions sellers are engaged in risks and rewards of ________ (i.e., selling goods to customers).

A. arrangements
B. output
C. input
D. management

10 In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with a corresponding offset to cost of sales.

A. True
B. False

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