

The milestone method: FASB issues revenue-recognition guidance for research or development vendors



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The Financial Accounting Standards Board (FASB) recently released Accounting Standards Update (ASU) 2010-17, Revenue Recognition — Milestone Method (Topic 605): Milestone Method of Revenue Recognition (a consensus of the FASB Emerging Issues Task Force). The ASU amends the FASB Accounting Standards Codification (ASC) to provide guidance on when vendors may apply the milestone method of revenue recognition in arrangements involving research or development deliverables, as well as the associated disclosure requirements.

The issue

Revenue recognition is an issue for vendors that provide research or development deliverables to their customers, because these arrangements often involve multiple payment streams that are contingent on achieving uncertain future events or circumstances — that is, milestones. Milestone consideration might be contingent, for example, on the achievement of clinical trial results or regulatory approval for the product under development.

Under the commonly applied milestone method, a vendor recognizes revenue in the period during which the milestone is achieved. Each milestone is essentially treated as a separate contract for accounting purposes.

As FASB acknowledged, no authoritative guidance on the use of the milestone method was previously available. The amendments included in ASU 2010-17 are intended to remedy that situation. They apply to vendors that provide research or development deliverables in an arrangement in which payment provisions provide that a portion or all of the consideration is contingent on achieving uncertain future events, such as the successful completion of phases in a drug study.

What is a “milestone”?

The amendments covered by ASU 2010-17 add a specific definition of “milestone” to the ASC master glossary. According to that definition, a milestone event must carry a substantive uncertainty when the arrangement is entered as to whether the event will be achieved. A substantive uncertainty can exist even if a vendor expects to achieve the milestone.

Further, a milestone event must be contingent solely on the vendor’s performance. It can only be achieved based in whole or in part on either 1) the vendor’s performance or 2) a specific outcome resulting from the vendor’s performance. If an event is contingent solely on the passing of time or the result of a counterparty’s performance, it is not a milestone. Finally, a milestone event must result in additional consideration due to the vendor if achieved.

Is the milestone “substantive”?

The amendments reported in ASU 2010-17 allow a vendor to recognize revenue under the milestone method in its entirety in the period that a milestone is achieved *only* if the milestone is considered “substantive.” The amendments explain that the determination of whether a milestone is indeed substantive is a “matter of judgment” that must be made at the inception of the arrangement.

A vendor that elects early adoption must disclose, at a minimum, the following information for all previously reported interim periods in the year of adoption: revenue, income before income taxes, net income, earnings per share and the effect of the change for the captions presented.

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The following criteria must be satisfied for a milestone to be deemed substantive:

- > The milestone consideration must be proportionate with 1) the vendor's performance to achieve the milestone or 2) the delivered item's enhanced value resulting from the specific outcome of the vendor's performance to achieve the milestone.
- > The milestone consideration must be related solely to the vendor's past performance.
- > The milestone consideration must be reasonable relative to all deliverables and payment terms in the arrangement.

A milestone is not substantive if any portion of the associated consideration relates to the remaining deliverables. It also must be substantive in its entirety — milestone consideration cannot be bifurcated into substantive and nonsubstantive components. And, if part of the milestone consideration is refundable or subject to adjustment based on future performance (such as through a penalty or clawback provision), the consideration does not relate solely to past performance, and the milestone is not substantive.

If a milestone is substantive, other revenue recognition methods that result in the recognition of milestone consideration in its entirety in the period the milestone is achieved are not allowed. But a vendor may elect to apply a different accounting policy that results in the deferral of revenue relating to some portion of the milestone consideration.

The milestone method in action

For example, a vendor agrees to perform research on a new medication for a customer — a pharmaceutical company. According to the arrangement, the vendor will earn \$500 per hour, plus \$10 million in milestone consideration on the successful completion of clinical trials. The parties expect the clinical trials to be completed about halfway through the vendor's projected total of 55,000 hours of work.

During the accounting period that the arrangement began, the vendor performs 30,000 hours of work, and the trials are successfully completed. The vendor continues to expect that 55,000 hours total will be required to finish the project.

The vendor has earned \$25 million during the accounting period: \$15 million for 30,000 hours of work plus \$10 million for achieving the clinical trials milestone. The vendor expects to earn an additional \$12.5 million in hourly fees in future accounting periods. As long as the clinical trials milestone was substantive, the vendor can recognize the \$10 million of milestone consideration in the period the trials were completed.

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Required disclosure

The amendments included in ASU 2010-17 also add the requirement that a vendor must disclose its accounting policy for the recognition of milestone consideration. For each arrangement that includes milestone consideration accounted for in accordance with the amendments, a vendor must disclose in its financial statement notes:

- > A description of the overall arrangement,
- > An account of each milestone and related contingent consideration,
- > A determination of whether each milestone is considered substantive,
- > The factors that the vendor considered in determining whether each milestone is substantive, and
- > The amount of consideration recognized during the period for the milestone or milestones.

Vendors that adopt the milestone method must include certain related disclosures in the year of adoption. Those disclosures should allow users of the financial statements to understand the effect of the change in accounting principles.

Effective date and additional disclosures

The amendments covered by ASU 2010-17 are effective on a prospective basis for milestones achieved in fiscal years — and interim periods within those years — beginning on or after June 15, 2010. Early adoption is allowed, and vendors can elect to adopt the amendments retrospectively for all prior periods.

A vendor that elects early adoption must disclose, at a minimum, the following information for all previously reported interim periods in the year of adoption: revenue, income before income taxes, net income, earnings per share and the effect of the change for the captions presented.

Other options

The amendments reported in ASU 2010-17 make clear that the milestone method isn't the only acceptable revenue recognition model available for research or development deliverables or consideration contingent on the achievement of a substantive milestone. But research or development vendors must apply their policy for recognizing such consideration consistently to other similar deliverables or milestone-contingent consideration. If you have questions or need additional assistance please call your Baker Tilly advisor.