KPMG
cutting through complexity

Defining Issues®

January 2014, No. 14-4

AICPA Issues Practice Aid on Acquired In-Process Research and Development Assets

The AICPA recently revised its accounting and valuation guide (Practice Aid) on acquired assets to be used in research and development activities for preparers, auditors, and valuation professionals.[1] The Practice Aid was initially developed by the AICPA staff and IPR&D Task Force in 2001.[2]

Key Facts

The Practice Aid discusses:

- The rationale for publishing an update to the 2001 practice aid, including the history of changes in applicable U.S. GAAP;
- In-process research and development (IPR&D) assets acquired in business combinations and asset acquisitions;
- Intangible assets acquired to be used in research and development (R&D) activities, particularly in the software, electronic devices, and pharmaceutical industries;
- Subsequent accounting for IPR&D assets; and
- Valuation methodologies including a comprehensive valuation example.

Key Impacts

Although nonauthoritative, the Practice Aid:

- Identifies best practices relating to key accounting and valuation issues; and
- Promotes consistency when accounting for and valuing IPR&D assets.

Contents

[1] AICPA Accounting & Valuation Guide: Assets Acquired to be Used in Research and Development Activities was developed by the AICPA staff and IPR&D Task Force and is available for purchase at www.cpa2biz.com.

[2] AICPA Practice Aid: Assets Acquired in a Business Combination to be used in Research and Development Activities: A Focus on Software, Electronic Devices, and Pharmaceutical Industries.

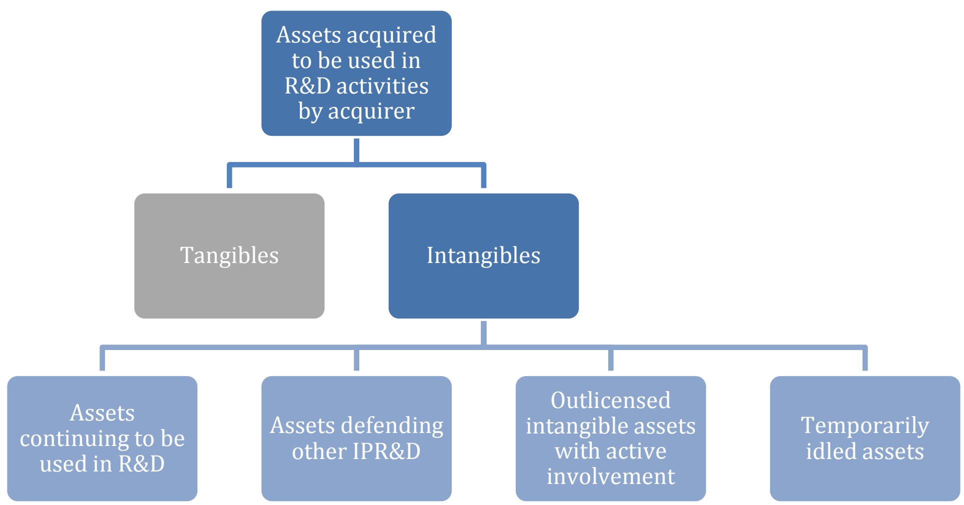
IPR&D Assets Acquired in Business Combinations

Under current accounting guidance, an entity does not expense assets acquired in business combinations to be used in research and development (R&D) activities that do not have an alternative future use. Rather, an entity recognizes all tangible and intangible assets that will be used in R&D activities regardless of whether they have an alternative future use. These assets are measured at acquisition-date fair value. After initial recognition, tangible assets are accounted for according to their nature while IPR&D assets are treated as indefinite-lived until the completion or abandonment of the associated R&D project, at which time the appropriate useful lives should be determined.

Some of the Task Force's interpretation of current accounting guidance and recommended best practices are summarized below.

Initial Recognition

Used in R&D Activities. The Task Force believes that an asset acquired in a business combination that is to be "used in R&D activities" by the acquirer is distinguishable from other acquired assets because the *acquirer* has specifically identified an IPR&D project that is expected to incur R&D costs. As presented in the table below, the Task Force identified four categories of intangible assets that satisfy this criterion.



Acquired intangibles not within these categories should be accounted for under other U.S. GAAP accounting principles. In addition, the intangible assets to be used in R&D activities must have *substance* and *incompleteness* to be within the scope of the guidance that requires these assets to be capitalized and classified as indefinite-lived until completion or abandonment of the associated R&D project. The Practice Aid provides factors to consider when making these determinations.

Exception to incompleteness criterion: individually completed intangible assets that are exclusively and directly related to IPR&D projects may be aggregated with other IPR&D Assets.

Assets Continuing to Be Used in R&D Activities

These represent R&D assets acquired in a business combination that will continue to be actively used in an R&D project that will be pursued by the acquirer.

Defensive IPR&D Assets

These are intangible assets that an acquirer intends to use to defend the value of other intangible assets used in R&D activities. The Task Force believes these assets would be considered "to be used in R&D activities" and be assigned an indefinite life until the defended asset is completed or abandoned.

Temporarily Idled or Abandoned Assets

Temporarily idled assets may be categorized as IPR&D assets. The Task Force cautions that assets associated with abandoned projects should be carefully considered to determine whether they have a defensive purpose that may enhance or maintain the value of other assets. If not, abandoned assets should be valued using market participant's assumptions and impaired when the acquirer decides not to use them. The Task Force expects expensing such intangible assets immediately upon acquisition to rarely occur.

Outlicensed Assets

A transferor, such as a pharmaceutical company, may subsequently enter into an arrangement where it transfers (outlicenses) its rights to a previously identified and measured indefinite-lived IPR&D asset to a third party (transferee). The intangible asset transferred is commonly known as the outlicensed asset. The outlicensed asset may be an IPR&D asset if the acquirer intends to play an active role in the development of that asset.

The Task Force does not recommend reallocating the value previously recognized as core technology to other intangible assets. Further, it does not recommend assigning any value to core technology when performing Step 2 of the goodwill impairment test.

Unit of Account. The Task Force believes that assets used in separately identified IPR&D projects can be aggregated into one unit of account if they are substantially the same. The Task Force does not believe, however, that it would be appropriate to combine tangible assets used in R&D activities with intangible assets used in R&D activities. The Practice Aid provides several examples to illustrate considerations when determining the unit of account. Factors to consider include:

- Phase of development of the related IPR&D project;
- Nature of activities and costs and risks related to further development;
- Amount and timing of benefits expected from completed assets;
- Economic life of the developed assets; and
- How the assets or project will be managed and transferred.

Core Technology. In light of current guidance that IPR&D assets are no longer expensed at the acquisition date, the Task Force believes that it is no longer appropriate to recognize core technology apart from IPR&D.[3] The Task Force

[3] Core technology is defined in the 2001 practice aid as "[t]hose technical processes, intellectual property, and the institutional understanding that exist within an organization with respect to products or processes that have been completed and that will aid in the development of future products, services, or processes that will be designed in a manner to incorporate similar technologies."

believes that values that historically were allocated to core technology represent technical processes, intellectual property, and institutional understanding. Therefore, they will meet the U.S. GAAP fair value recognition criteria and the core technology will be captured in other intangible assets, including IPR&D assets.[4]

Subsequent Accounting

In periods subsequent to the business combination, management may (1) continue internal R&D efforts associated with the acquired assets or collaborate with another party in R&D efforts; (2) dispose of the assets through sale; (3) outlicense the assets; (4) decide to temporarily postpone further development; or (5) abandon R&D efforts. IPR&D assets may be subject to different subsequent accounting treatment depending on the course of action chosen by management with respect to those assets. The Practice Aid provides factors to consider under these circumstances.

Intangible IPR&D assets are assigned an indefinite life at the acquisition date and are tested for impairment at least annually until completion or abandonment of the associated R&D project. R&D expenditures related to the acquired indefinite-lived IPR&D assets and incurred subsequent to the business combination or outside a business combination are generally expensed as incurred.

Impairment Testing of Indefinite-lived IPR&D Assets. A reporting entity has the option to perform a qualitative assessment for indefinite-lived intangibles to assess whether it is necessary to perform a quantitative test. Indefinite-lived IPR&D assets should be tested for impairment as indefinite-lived intangible assets annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the assets are impaired.[5] The quantitative test is a one-step quantitative analysis where the impairment loss is measured as the amount the asset's carrying amount exceeds its fair value. The Task Force notes that it would not expect impairment of an acquired IPR&D asset immediately after an acquisition.

Accounting for Assets Resulting from R&D Activities. At completion, IPR&D assets are to be accounted for as assets resulting from R&D activities and the useful life of the IPR&D asset needs to be determined. However, before starting amortization, the IPR&D asset should be tested for impairment one last time as if it were indefinite-lived. Thereafter, assets with a finite life resulting from R&D activities are tested for impairment under U.S. GAAP only when events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable.[6] The Practice Aid provides a detailed discussion on accounting for finite-lived assets, including methods of amortization, remaining useful life, and subsequent impairment testing.

---

[4] FASB ASC Topic 820, Fair Value Measurement, available at www.fasb.org.

[5] FASB ASC Section 350-30-35, paragraphs 18–19, available at www.fasb.org.

[6] FASB ASC Topic 360, Property, Plant, and Equipment, available at www.fasb.org.

IPR&D Assets Acquired in Asset Acquisitions

Accounting guidance for IPR&D assets acquired in asset acquisitions did not change as a result of FASB Statement No. 141R and has remained the same since the issuance of the 2001 practice aid.[7] Some of the key concepts, however, are summarized below.

The Task Force believes that an asset has an alternative future use if the acquirer intends to use the asset in an alternative way, economically benefit from that use, and the alternate use does not require further development after the acquisition date.

Initial Recognition

Assets acquired to be used in R&D activities must have an alternative future use to be capitalized. These assets are to be measured at cost allocated based on their relative fair values. IPR&D assets acquired in asset acquisitions may have indefinite or finite lives to be determined using accounting guidance for intangible assets. Transaction costs in an asset acquisition are capitalized and would form part of the basis of the assets.

Subsequent Accounting

An IPR&D asset with an alternative future use is capitalized and amortized over its useful life. Although IPR&D assets are likely to be finite-lived, amortization does not begin until the R&D projects are completed.

Valuation of IPR&D Assets

The Practice Aid discusses the applicability of valuation methodologies to IPR&D assets and includes a detailed discussion of the methodologies. It also applies fair value concepts to the valuation of IPR&D assets. The Task Force expects the income approach to be most prevalent when valuing IPR&D assets, while the market and cost approaches are expected to be applicable in limited situations.

Fair Value Concepts

The Practice Aid includes consideration of fair value concepts in the context of IPR&D assets, including principal (or most advantageous) market, highest and best use for nonfinancial assets, market participants, valuation techniques, and fair value hierarchy. The Practice Aid includes numerous questions and answers on how these concepts can apply to the valuation of IPR&D assets.

Prospective Financial Information

Prospective financial information (PFI) is a critical component of the income approach and must be consistent with the perspective of a market participant. The Practice Aid provides the following process for developing PFI:

[7] FASB Statement No. 141R, Business Combinations, available at www.fasb.org.

1. Select the PFI that most reflects assumptions made in determining the final purchase price
2. Evaluate and document the key assumptions
3. Ensure assumptions are consistent with market participants
4. Isolate PFI related to IPR&D Assets
5. Compare IPR&D Assets' PFI to the overall entity's PFI

The Practice Aid provides a detailed discussion of each step. Key topics addressed include technology migration, enabling technology, synergies, types of technology, and disaggregation of PFI into subcomponents.

Valuation Methods

The Practice Aid provides a detailed discussion of the application of the multiperiod excess earnings method (MPEEM), relief from royalty method, and decision-tree analysis method. This section notes divergent practices in applying these methods and recommends best practices. A brief overview of the primary methods used to value IPR&D assets is provided below.

Multiperiod Excess Earnings Method. In cases in which there is an identifiable stream of cash flows associated with more than one asset, the MPEEM may provide a reasonable indication of the value of a specific asset. Under this method, the value of an intangible asset is equal to the present value of the after-tax cash flows attributable solely to the subject intangible asset, after making adjustments for the required return on and of (when appropriate) the other associated assets.

Relief from Royalty Method. The premise of the relief from royalty method is that ownership of the subject asset relieves the owner of the need to license the asset from a third party. Thus, by owning the intangible asset, the owner avoids the royalty payments required to license the asset. A critical element of this method is the development of a royalty rate that is comparable to ownership of the specific asset.

Decision-tree Analysis. Decision-tree analysis is an income-based method that explicitly captures the expected benefits, costs, and probabilities of contingent outcomes at future decision points, or nodes. Decision-tree analysis is particularly applicable to the valuation of assets subject to risks that are not correlated with the market, such as the risk that a particular technology will succeed or fail.

Valuation Report Considerations

A valuation specialist typically prepares a written report to document the characteristics of the assets, methodologies, and assumptions used and the conclusions of value. The Practice Aid provides guidance on the key items that should be included in a valuation report.

Disclosures

The Task Force observes that the disclosures required by U.S. GAAP and regulators in relation to IPR&D assets are somewhat limited. The Task Force offers the following considerations when determining whether to provide additional disclosures about IPR&D assets:

- The asset must be quantitatively or qualitatively material;
- The asset should be considered in the context of financial statements as a whole and should not give undue emphasis to IPR&D;
- Public companies may consider including forward-looking information outside the financial statement disclosures, such as in management's discussion and analysis; and
- Nonpublic companies should consider the disclosures that public companies would make.

Accounting guidance also requires disclosing the amount of IPR&D assets acquired in asset acquisitions, the amount written off in the period, and the line item in the income statement where the written off amount is aggregated.

Contact us: This is a publication of KPMG's Department of Professional Practice 212-909-5600

Contributing authors: Randolph P. Green, Peter F. Lyster, and Michael Riyanto

Earlier editions are available at: http://www.kpmginstitutes.com/financial-reporting-network