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International
Accounting Standards
Board

INFORMATION FOR OBSERVERS

Board Meeting: **17 October 2006, London**

Project: **Business Combinations II**

Subject: **In-process Research and Development (Agenda Paper 2B)**

INTRODUCTION

1. The purpose of this memo is to ask the Boards to consider the accounting for research and development (R&D) assets that was proposed in the Business Combinations Exposure Draft (BC ED).

2. The proposed accounting for R&D assets would require a significant change to current U.S. GAAP. FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method,* requires an acquirer to immediately expense tangible and intangible assets *to be used in* research and development that have no alternative future use. R&D assets that have alternative future uses are capitalized. The BC ED proposes that an acquirer would recognize identifiable tangible and intangible assets acquired in a business

combination that are used in research and development activities regardless of whether those assets have an alternative future use.

3. IFRS 3 *Business Combinations* already requires that an acquirer recognize an intangible asset (including an in-process R&D asset) separately from goodwill if it meets the criteria for recognition in accordance with IAS 38 *Intangible Assets.* Therefore, the proposals in the BC ED would not change the accounting for acquired R&D assets under IFRS. Respondents that apply IFRS did not raise any specific issues in applying the IFRS 3 guidance related to acquired R&D assets.

4. Respondents to the FASB BC ED expressed significant concerns about the accounting for in-process R&D projects in accordance with the proposals since in-process R&D projects that were previously expensed would be capitalized at the acquisition date. Therefore, the remainder of this memo addresses issues related to in-process R&D raised by FASB constituents in their comment letters to the BC ED.

5. This memo:

   a. Summarizes the proposed and current guidance for R&D assets (including in-process R&D) acquired in a business combination

   b. Summarizes the FASB's initial deliberations and basis for conclusions

   c. Discusses respondents' concerns about the proposed accounting for in-process R&D

   d. Asks the Boards to affirm the proposed accounting for the initial recognition and measurement of R&D assets acquired in a business combination

   e. Asks the FASB to:

      (1) Affirm the proposed accounting for subsequent expenditures related to in-process R&D acquired in a business combination

      (2) Consider what guidance should be provided in the final Statement for the impairment testing of in-process R&D acquired in a business combination

(3) Consider expanding the scope of the proposed accounting for in-process R&D acquired in a business combination to all acquired in-process R&D (that is, in-process R&D purchased singly, as part of a group of assets, or in a business combination).

BACKGROUND

6. This section provides background about the FASB's previous deliberations about R&D. This section discusses:

   a. The reasons why acquired R&D assets were not addressed by the FASB in phase 1 of its business combinations project that led to the issuance of FASB Statements No. 141, *Business Combinations*, and No. 142, *Goodwill and Other Intangible Assets*

   b. A summary of the proposed accounting and the current guidance for R&D assets (including in-process R&D) acquired in a business combination

   c. The FASB's initial deliberations related to in-process R&D that led to the issuance of the BC ED.

Reasons R&D Was Not Addressed in Statements 141 and 142

7. During phase 1 of the FASB's business combinations project, the FASB decided that the guidance in Interpretation 4 should be reconsidered. At the FASB's February 24, 1999 Board meeting, the FASB tentatively decided that all acquired in-process R&D, whether acquired in a business combination or purchased singly or as part of a group of assets, should be recognized as an asset and amortized over its useful economic life. At the FASB's May 5, 1999 Board meeting, the FASB tentatively concluded that, conceptually, subsequent costs to complete all acquired in-process R&D assets should be capitalized and those assets should be subject to impairment testing. However, the FASB reversed its tentative decisions at its July 28, 1999 Board meeting and decided not to reconsider the

accounting for acquired in-process R&D until research and development costs could be considered comprehensively for the following reasons:[1]

a. Based on the research and feedback received, the staff learned that the distinction between acquired in-process R&D costs and internally generated in-process R&D costs is not always clear.

b. Developing operational guidelines on what constitutes in-process R&D assets might not be feasible given the constraints imposed by Statement 2 and its “expense all” model.

8. Therefore, neither Statements 141 nor 142 proposed to change the requirement in paragraph 5 of Interpretation 4 that the amounts assigned to tangible and intangible assets to be used in a particular research and development project be charged to expense at the acquisition date unless they have an alternative future use. A few respondents to the 2001 BC ED suggested that the amount of R&D assets acquired in a business combination should be subsumed in goodwill. However, the FASB affirmed its conclusion not to reconsider the guidance in Interpretation 4 until research and development costs could be considered comprehensively. Therefore, the FASB concluded that R&D acquired in a business combination should continue to be measured at fair value and expensed at the acquisition date in accordance with Interpretation 4 regardless of whether it meets the criteria in paragraph 39 of Statement 141 for recognition separate from goodwill (Statement 141, paragraph B170, paraphrased).

Summary of Proposed Accounting and Current Guidance for R&D Acquired in a Business Combination

9. The following table outlines the accounting for R&D proposed in the BC ED and required by IFRS 3 and U.S. GAAP.

[1] Reasons recorded in the minutes of the July 28, 1999 FASB Board meeting.

	FASB BC ED	IASB BC ED	IFRS 3	U.S. GAAP
Initial recognition and measurement	Paragraph A27 states that an acquirer shall recognize and measure, separate from goodwill, the acquisition date fair value of all *identifiable* intangible and tangible assets that are used in research and development activities and acquired in a business combination regardless of whether those assets have an alternative use. If the FASB affirms the proposal in the BC ED, it would nullify FASB Interpretation No. 4, *Applicability of FASB Statement No. 2 to Business Combinations Accounted for by the Purchase Method.* Interpretation 4 requires research and development assets acquired in a business combination that have no alternative future use to be measured at their fair value and expensed at the acquisition date.	Consistent with the FASB BC ED and the current requirements in IFRS 3.	Paragraph 45 of IFRS 3 requires that an acquirer separately recognize an intangible asset (including an in-process R&D project) of the acquiree at the acquisition date only if it (a) meets the definition of an intangible asset in IAS 38 and (b) its fair value can be measured reliably.[2] IAS 38 defines an intangible asset as an "identifiable (arising from contractual-legal rights or separable) non-monetary asset without physical substance."	Paragraphs 35 and 37(e) of Statement 141 and paragraph 4 of Interpretation 4 require that an acquirer allocate a portion of the purchase price to an intangible asset (including an asset to be used in research and development activities) if it meets the criteria in paragraph 39 to be recognized as an asset separate from goodwill based on its estimated fair values at the acquisition date. However, amounts assigned to an asset to be used in research and development activities that is acquired in a business combination are charged to expense at the acquisition date in accordance with paragraph 5 of Interpretation 4.
Subsequent expenditures related to acquired R&D	After the initial recognition of research and development assets acquired in a business combination, subsequent expenditures related to those	Consistent with the FASB BC ED and the current requirements in IFRS 3	Paragraph 43 of IAS 38 requires subsequent research or development expenditures that relate to acquired in-process R&D be accounted for as follows:	Interpretation 4 requires that an asset to be used in research and development activities acquired in a business combination be immediately expensed at the

[2] The BC ED proposes to eliminate the additional criterion in IFRS 3 and IAS 38 that an intangible asset must be able to be measured reliably to be recognized separately from goodwill. This is because the IASB tentatively decided that all *identifiable* intangible assets can be measured with sufficient reliability to be recognized separately from goodwill. See Memo #25/Agenda Paper 2B for a discussion of that proposed change.

	FASB BC ED	IASB BC ED	IFRS 3	U.S. GAAP
	assets would continue to be expensed in accordance with FASB Statement No. 2, *Accounting for Research and Development Costs,* as amended.		a. Research expenditures are expensed as incurred b. Development expenditures are added to the carrying amount of the acquired in-process R&D project if they meet the recognition criteria (otherwise they are expensed as incurred). The recognition criteria are met if an entity can demonstrate *all* of the following: (1) Technical feasibility (2) Its intention to complete the asset (3) Its ability to use or sell the asset (4) How the asset will generate probable future economic benefits. (5) The availability of adequate technical, financial and other resources to complete the development and to use or sell the asset (6) Its ability to measure reliably the expenditure attributable to the asset during its development (Par. 57 of IAS 38)	acquisition date. Subsequent research or development expenditures are also expensed.
Subsequent accounting	After the business combination, the provisions of FASB Statement No. 142, *Goodwill and Other*	Consistent with the current requirements in IFRS 3.	After initial recognition, an intangible asset (including acquired in-process R&D), whether it has a	Not applicable

	FASB BC ED	IASB BC ED	IFRS 3	U.S. GAAP
	Intangible Assets, as amended, would be applied to research and development assets acquired in the business combination. Specifically, an intangible R&D asset acquired in a business combination that has no alternative future use would be considered *indefinite-lived* until the completion or abandonment of the associated research and development efforts. Once the project is completed, the entity would decide whether it is finite-lived or indefinite-lived and would account for the asset accordingly.		*finite* or *indefinite* useful life, is measured at: a. Cost less any accumulated amortization and impairment losses (IAS 38, paragraph 74); or b. A revalued amount, if there is an active market, being its fair value (determined by reference to an active market) at the date of revaluation less any subsequent accumulated amortization and any subsequent accumulated impairment losses (IAS 38, paragraph 75). Similar to the requirements in Statement 142, IAS 38 requires that an intangible asset with a finite life be amortized and be tested for impairment in accordance with IAS 36, *Impairment of Assets.* An indefinite-lived intangible asset is not amortized but is tested for impairment in accordance with IAS 36 annually and whenever there is an indication that the intangible asset might be impaired.	

The FASB's Initial Deliberations Leading to the Issuance of the BC ED

10. The FASB discussed in-process R&D at several FASB Board meetings leading up to the issuance of the BC ED. The decisions reached in those meetings are summarized in Appendix A, and the materials and minutes for those meetings can be accessed on the FASB's Intranet or will be made available in hard copy form upon request. The IASB decided not to change its initial or subsequent accounting guidance for in-process R&D.

11. At the its February 5, 2003 Board meeting, the FASB decided that acquirers should capitalize in-process R&D acquired in a business combination because (a) it was an asset, (b) the requirements in Interpretation 4 were counterintuitive (that is, measure at fair value but immediately expense), and (c) the decision converged with the IASB. While the Board believed that conceptually all acquired in-process R&D should be capitalized, the Board decided not to extend its decision to in-process R&D acquired in an asset acquisition because it was outside the scope of the business combinations project.

12. At its December 3, 2003 Board meeting, the FASB decided to amend Statement 142 to clarify the subsequent accounting for in-process R&D assets acquired in a business combination. The FASB decided that in-process R&D assets acquired in a business combination would be classified as *indefinite-lived* until the project is completed or abandoned. While the project is classified as indefinite-lived, it would be tested for impairment in accordance with Statement 142. Once the project is completed, the acquirer would make a separate determination of the useful life of that asset in accordance with Statement 142. If the R&D asset is finite-lived, it would be amortized and tested for impairment in accordance with Statement 144. If the R&D asset is indefinite-lived, it would <u>not</u> be amortized but would be tested for impairment in accordance with Statement 142.

COMMENT LETTER RESPONSES

13. Few respondents commented on the proposed accounting for R&D assets, but those that did generally (a) apply U.S. GAAP and (b) disagree with the proposal. Generally, those respondents were accounting firms or preparers in the pharmaceutical or high-technology industries. They disagreed for two reasons:

    a. In-process R&D does not meet the definition of an asset since its low-likelihood of success does not represent *probable future economic benefits*.

    b. The fair value of in-process R&D is not reliably measurable.

14. Some respondents (both those that agreed with the proposals and those that did not) expressed concerns about the inconsistencies and mixed model this proposal would create. That is, the BC ED proposes that in-process R&D *acquired in a business combination* would be capitalized, while in-process R&D *acquired in an asset acquisition* or *internally generated in-process R&D* would continue to be expensed under Statement 2. Also, subsequent expenditures on the projects acquired in the business combination would be expensed even though those subsequent costs are likely to be more valuable since they get the project closer to completion. Because of the concerns about inconsistent accounting treatment, some respondents suggested that the FASB address in-process R&D accounting comprehensively rather than on a piecemeal basis.

15. A few respondents raised issues about the impairment testing of in-process R&D that would be required as a result of the Boards' decision to capitalize those assets. Those concerns related the difficulty and significant judgment required to perform an impairment test, including unit of account issues.

STAFF ANALYSIS

Initial Recognition and Measurement of R&D

16. Respondents expressed concern about two things related to the initial recognition and measurement of R&D acquired in a business combination: (a) whether the in-process R&D project *meets the definition of an asset* and (b) whether the in-process R&D is *reliably measurable*. The staff considers those two issues in its analysis.

When is an R&D Project an Asset?

17. The 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" (issued in 2001) states that acquired[3] in-process R&D as "a subset of an intangible asset to be used in R&D activities" (page 169). At their September 2006 meetings, the Boards affirmed that an intangible asset that is *identifiable* (that is, contractual or separable) can be measured with sufficient reliability and should be recognized separately from goodwill. The staff believes that in-process R&D acquired in a business combination meets the separability criterion because it "is capable of being separated or divided from the acquiree and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, asset, or liability" (BC ED, paragraph A28).

18. The AICPA Practice Aid also provides some best practices for determining whether a particular R&D project is an asset. In addition to exhibiting the characteristics of control and economic benefits, the AICPA Practice Aid states that the fair value of each R&D project should be estimable with reasonable reliability to be recognized as part of the business combination.

[3] The best practices described in the AICPA Practice Aid were written in the context of a business combination transaction; however, they also apply to an asset to be used in research and development activities that is acquired singly or as part of a group of assets.

Further, if the asset to be used in R&D activities is a specific in-process R&D project, that project should have:

a. Substance—that is, the acquired company performed the research and development activities that (a) meet the definition of research and development under Statement 2 and (b) result in the creation of value.

b. Incompleteness—that is, there are remaining risks (such as technological or engineering) or certain remaining regulatory approvals at the date of acquisition. Overcoming those risks or obtaining the approvals requires that the combined entity will incur additional research and development costs. (AICPA Practice Aid, paragraphs 3.2.02—3.3.05)

19. The staff acknowledges that it is not always clear when a specific R&D project has substance or whether it has been completed because projects change and evolve over time. To determine when a R&D project has substance, the AICPA Practice Aid describes four basic phases (some of which might occur simultaneously) of an R&D project's life cycle as follows:

a. *Conceptualization*—This phase entails coming up with an idea, thought, new knowledge, or plan for a new product, service, or process, or for a significant improvement to an existing product, service, or process, or it may represent a decision by a company to focus its research activities within certain core competencies. Management might make an initial assessment of the potential market cost, and technical issues for ideas, thoughts, or plans to determine whether the ideas can be developed to produce an economic benefit.

b. *Applied research*—This phase represents a planned search or critical investigation aimed at the discovery of additional knowledge in hopes that it will be useful in defining a new product, service, or process that will yield economic benefits, or significantly improve an existing product, service, or process that will yield economic benefits. In addition, work during this phase assesses the feasibility of successfully completing the project and the commercial viability of the resulting expected product, service, or process.

c. *Development*—This phase represents the translation of research findings or other knowledge into a detailed plan or design for a new product, service, or process, or for a significant improvement to an existing product, service, or process, and carrying out development efforts pursuant to the plan.

d. *Preproduction*—This phase represents the business activities necessary to commercialize the asset resulting from R&D activities for the entity's economic benefit. (The AICPA Practice Aid, paragraph 3.3.40)

20. The AICPA Practice Aid provides some guidance for when an in-process R&D project should be capitalized as an asset. That is, when and R&D project is determined to (a) be complete or (b) have an alternative use, that R&D project is an asset. The AICPA Practice Aid states that an in-process R&D project should be considered complete when the project has reached technological feasibility or received FDA approval (AICPA Practice Aid, paragraph 3.3.57). Similarly, paragraph 57 of IAS 38 includes six criteria that must be met to capitalize a project, one of which is technological feasibility.

21. The judgmental nature of determining when a specific R&D project has substance and whether it is complete for accounting purposes is illustrated in the AICPA Practice Aid, which states:

> A future product, service, or process is defined and its potential economic benefits are identified at some point within this life cycle after the project's conceptualization. After the time that a future product, service, or process has been defined and its potential economic benefits have been identified, a specific IPR&D project begins to demonstrate substance. This generally occurs when more than insignificant R&D efforts have been expended after the characteristics of the future product, service, or process have been defined and management has approved continued project funding. In addition, management has been able to make reasonably reliable estimates of the project's completion date, consider the impact of potential competition, and make reasonably reliable estimates of costs to complete, sales volumes, average selling prices, and related costs over the anticipated economic life of the expected product, service, or process. The task force believes that at that time or at a later point, the project is far enough along to enable an entity to make a reasonably reliable estimate of its fair value. (Paragraph 3.3.42)
>
> At some point before commercialization (that is, before earning revenue), and possibly before the end of the development or pre-production stages, the task force

> believes that the R&D project is no longer considered incomplete for accounting purposes (that is, ultimate completion of the project has occurred) and an asset *resulting from* R&D emerges from what was previously an asset used in R&D. (Paragraph 3.3.43)

22. Some respondents disagreed with the proposal because they believe that at the acquisition date in-process R&D does not meet the definition of an asset in FASB Concepts Statement No. 6, *Elements of Financial Statements.* As evidenced by the comments below, respondents believe that in-process R&D acquired in a business combination does not meet the definition of an asset because they believe its low-likelihood of success does not represent *probable future economic benefits*. For example, Cisco Systems, Inc. (CL #51) stated:

> We also do not agree with the Board's proposal to capitalize in-process research and development costs as an intangible asset. We believe this would result in capitalized IPR&D which could have a low probability of success. The nature of research and development is that the ultimate outcome is uncertain and the process is continuous. As a result, we believe that IPR&D does not meet the definition of an asset as set forth in the Conceptual Framework.

23. Pfizer (CL #70) stated:

> We understand that the Board views IPR&D as an asset that should be capitalized and therefore rejects the current expensing approach as inconsistent with that view. Board members know that companies frame business strategies around IPR&D, negotiate for it, pay for it, fair value it and nurture it and they view those seemingly rational actions as inconsistent with the notion that IPR&D has no probable future economic benefit. However, we view the current stop-gap measure of this Exposure Draft as inconsistent with the definition of an asset as outlined in CON 6 and with the longstanding, well understood principles of SFAS 2. . . .
>
> We all agree that all R&D has potential future benefit. Our concern is that IPR&D does not have a *probable* future benefit as an asset is described in CON 6. Based on our historical experience, we do not believe that the probability

> of success is high until after the completion of Phase III, at which point we would estimate it to be 70% to 80%. However, given the significant uncertainty of regulatory approval remaining at this stage, we do not believe that the probable future economic benefit exists until approval is received. Our view is consistent with the realities of the industry—that is, only one in five compounds from Phase II becomes an FDA approved product.
>
> Paragraph 25 of Concepts Statement 6 defines an asset as a *probable future economic benefit* obtained or controlled by a particular entity as a result of past transactions or events.

24. The staff believes that respondents are confusing the use of the word *probable* in Concepts Statement 6 with the use of the word *probable* in other U.S. GAAP such as FASB Statement No. 5, *Accounting for Contingences,* or FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes.* For example, the staff believes the following comment from Eli Lilly and Company (CL #107) illustrates that point:

> It is difficult to understand the FASB's position on the capitalization of IPR&D when the likelihood of success for many compounds is very low. This point of view is more difficult to understand when considering the opposite viewpoint that the FASB expressed in the *Accounting for Uncertain Tax Positions* Exposure Draft, when the FASB proposed that tax exposure items cannot be recorded as assets unless they are "probable" of being realized. Probable in the tax world usually equates to a "should" level opinion, which generally means a 70% - 80% likelihood of success. Many of the IPR&D assets, based upon the above percentages, are far less likely than "probable" of achieving success. It is unclear to us how the Board could arrive at such different conclusions in these two proposals that are presumably both based on the same conceptual definition of "probable".

25. Footnote 18 of Concepts Statement 6 clarifies the use of the word *probable* in the definition of an asset:

> *Probable* is used with its usual general meaning, rather than in a specific accounting or technical sense. . .and

> refers to that which can be reasonably be expected or believed on the basis of available evidence or logic but neither is certain or proved. . . . Its inclusion in the definition is intended to acknowledge that business and other economic activities occur in an environment characterized by uncertainty in which few outcomes are certain. . . .

26. The staff notes that IAS 38 also uses the word *probable* in determining whether an intangible asset should be recognized, but IAS 38 uses the term *probable* differently from Concepts Statement 6. Paragraph 21 of IAS 38 states that an intangible asset should be recognized if it is probable that the expected future economic benefits attributable to the asset will flow to the entity and the cost of the asset can be measured reliably.

27. Paragraph 33 of IAS 38 explains that the "fair value of an intangible asset reflects market expectations about the probability that the future economic benefits embodied in the asset will flow to the entity. In other words, the effect of probability is reflected in the fair value measurement of the intangible asset. Therefore, the *probability recognition criterion in paragraph 21(a) is always considered to be satisfied for intangible assets acquired in business combinations*" (emphasis added). In the definition in Concepts Statement 6, the *probable* is linked to the likelihood of obtaining the future benefits rather than the likelihood that the benefits will flow to the entity. That might be why some constituents believe that in-process R&D does not meet the definition of an asset in the FASB's Conceptual Framework.

28. The staff acknowledges that there is uncertainty surrounding the amounts and timing of the future economic benefits that in-process R&D will generate. However, the staff notes that the word *probable* was not intended to imply that a particular degree of certainty in obtaining the economic benefits is required before an item meets the definition of an asset. Uncertainty in the amounts or timing of future economic benefits does not

determine whether or not an asset exists, but rather enters into the measurement of the asset.

29. The word *probable* in the definition of an asset (or liability) has been misinterpreted by some constituents. In July 2006, the Boards discussed the following proposed working definition of an asset, which no longer uses the word probable:

> An asset is a present economic resource to which an entity has a present right or other privileged access. An asset of an entity has three essential characteristics:
>
> a. There is an economic resource.
>
> b. The entity has rights or other privileged access to the economic resource.
>
> c. The economic resource and the rights or other privileged access both exist at the financial statement date.

The staff notes that in-process R&D projects would also meet the Conceptual Framework project's working definition of an asset.

30. The staff believes that it is difficult to argue that in-process R&D is not an asset. As stated by Pfizer in its comment letter, ". . .companies frame business strategies around IPR&D, negotiate for it, pay for it, fair value it and nurture it. . . ." (CL #70). The next logical question is whether in-process R&D can be measured reliably.

Is the Fair Value of In-Process R&D Reliably Measurable?

31. Some respondents opposed the FASB's proposal to capitalize in-process R&D because they believe that the fair value of in-process R&D cannot be reliably measured. For example, Cisco Systems, Inc. (CL #51) stated:

> This accounting proposal also involves the use of a valuation model to estimate fair value and introduces judgments about impairment and useful life which involves assumptions that are subject to significant uncertainty. As

> stated previously, we believe that this uncertainty and the judgmental nature of the assumptions make it difficult to reliably estimate fair value of IPR&D.

32. The staff acknowledges that because of the uncertainty inherent in economic activities, judgments and estimates must often be used in financial reporting. Paragraph 23 of Concepts Statement 6 states:

> To be included in a particular set of financial statements, an item must not only qualify under the definition of an element but also must meet criteria for recognition and have a **relevant attribute** (or surrogate for it) that is **capable of reasonably reliable measurement or estimate**. [Emphasis added; footnote reference omitted.]

33. The use of estimates and judgment does not mean information is unreliable and it does it imply that measurements must be precise or certain. Paragraph 86 of the IASB's Framework states that "in many cases, cost or value must be estimated; the use of reasonable estimates is an essential part of the preparation of financial statements and does not undermine their reliability."

34. In Statement 141, the FASB concluded that *identifiability (*that is, an intangible asset arises from contractual-legal rights or is separable) is the condition that establishes a reliability of measurement threshold for the separate recognition of intangible assets. Therefore, the FASB concluded that if an intangible asset is *identifiable*, its fair value can be measured reliably. The staff believes that if in-process R&D is identifiable (because it meets the separability criterion), then it can be measured reliably. As discussed in Memo #25/Agenda Paper 2B, the staff consulted with some valuation experts who stated that all identifiable intangible assets can be measured reliably at fair value. As a result, the staff believes that Level 1, 2, or 3 inputs will always be available to measure *identifiable* intangible assets, including in-process R&D.

35. The Boards affirmed in their September 2006 meetings that intangible assets should be measured at a *current exchange value*. (The Boards will discuss whether a current exchange value is fair value at the October joint meeting). The staff notes that the fair value of in-process R&D acquired in a business combination is currently estimated in practice but immediately expensed.

36. The staff acknowledges that uncertainty and judgmental assumptions make it difficult to measure in-process R&D. However, the difficulty in measuring in-process R&D does not mean the measurement is unreliable. The staff also believes that relevance outweighs the concerns expressed about reliability for the reasons discussed in paragraph B60 of FASB Statement No. 123 (revised 2004), *Share-Based Payment,* which states:

> Without estimates, accrual accounting would not be possible. For example, financial statement amounts for loan loss reserves, valuation allowances for deferred tax assets, and pensions and other postretirement benefit obligations are based on estimates. For those and many other items in accounting that necessitate the use of estimates, companies are required to use appropriate measurement techniques, relevant data, and management judgment in the preparation of financial statements. **Few accrual-based accounting measurements can claim absolute reliability, but most parties agree that financial statement recognition of estimated amounts is preferable to the alternative—cash basis accounting**. [Emphasis added.]

Does Capitalizing In-process R&D Acquired in a Business Combination Provide Decision-Useful Information?

37. Some staff members believe that in-process R&D acquired in a business combination should continue to be expensed in accordance with Interpretation 4 until the Board comprehensively reconsiders the accounting for R&D. That is, those staff members find it difficult to accept a model in which an entity would capitalize in-process R&D that was acquired in a business combination but then subsequently expense any internal costs to complete the asset. The amount capitalized would represent the value of

the asset only on the acquisition date. Immediately after the acquisition date, the entity would incur costs that would presumably increase the value of the capitalized in-process R&D asset, but those costs would be expensed. Therefore, those staff members believe that after the acquisition, the amount recorded for the in-process R&D asset provides users with no more decision-useful information than if all research and development costs were expensed.

38. The staff members who believe that the FASB should continue to require expensing in-process R&D acquired in a business combination until it considers R&D accounting comprehensively also believe that the IASB's model for capitalizing development costs is flawed. That is, in-process R&D acquired in a business combination would be recognized as a separate intangible asset if it is *separable*, which is presumably at an earlier stage than technological feasibility. Then, in accordance with IAS 38 (a) subsequent research costs would be expensed, but (b) subsequent development costs that meet all of the criteria for recognition in IAS 38 (such as when the asset reaches technological feasibility) would be capitalized. Thus, any internal research costs would be expensed and the amount recorded for the in-process R&D asset does not provide decision-useful information either.

Proposed Clarification of Which In-process R&D Assets Would be Capitalized

39. The staff believes that if the FASB wants to capitalize in-process R&D acquired in a business combination, then it should be clear about its intent. The staff believes that the intent of the proposal in the BC ED was that if in-process R&D is *separable*, then it should be capitalized as an intangible asset separate from goodwill. Therefore, separability would be the criterion for separate recognition. That may differ from the point at which R&D acquired in a business combination is considered in-process R&D under Interpretation 4.

40. Interpretation 4 describes two types of in-process R&D:

a. **Tangible and intangible assets *resulting from* research and development activities**—for example, patents, blueprints, formulas, designs for new products or processes. Those examples are assets that would generally be considered intangible assets because they are no longer in-process.

b. **Tangible and intangible assets *to be used in* research and development activities**—for example, materials and supplies, equipment and facilities and even a specific in-process research project.

41. The assets that this paper is addressing are R&D assets *to be used in* research and development activities. The staff believes that the FASB did not intend to propose capitalizing <u>all</u> R&D assets *to be used in* research and development activities, but only those assets that meet the separability criterion. Therefore, the result of the proposals in BC ED would not mean reclassifying the in-process R&D assets that entities are currently expensing in a business combination as assets. Only a sub-set of those assets that are expensed in current practice would be capitalized. That is, the R&D assets *to be used in* research and development activities that are separable would be capitalized in a business combination.

Question 1: Do the Boards believe that R&D assets (including in-process R&D projects) acquired in a business combination should be capitalized at the acquisition date and measured using a current exchange value?

[The rest of this paper has been omitted from the Observer Notes because it addresses matters relevant only to the FASB.]