Case 09-2

Pharmagen Pharmaceutical Development Funding

On January 1, 2006, Pharmagen, a pharmaceutical company ("Pharma" or the "Company") entered into a funding agreement ("Agreement") with Company XYZ, an unrelated third-party private equity investor ("PEI"). The PEI has no prior relationship or business operations related to Pharma.

As part of the Agreement, Pharma will receive up to a total of $500 million from the PEI for research and development ("R&D") costs incurred by Pharma for the development of a potential new drug ("X"). Pharma had already initiated the development of X as a self-funded research effort before entering into the Agreement. Therefore, the Agreement between Pharma and the PEI created an arrangement where the PEI would participate, financially, in the development of X. The Agreement was structured so that Pharma would receive up to the $500 million funding as R&D costs are incurred for the research efforts of X. The funding is to be used solely for the development of X and may not be used for any other purposes. Amounts received by Pharma are non-refundable and Pharma is not obligated under the Agreement to successfully complete the development of X. Rather, Pharma will receive incremental funding from the PEI as long as Pharma is demonstrating progress towards the development of X. In other words, Pharma is operating under a "best efforts" arrangement and has no additional performance obligations to the PEI after it receives the funding. Pharma has estimated that the total R&D costs to be incurred will be $1 billion and will take three years to complete from the execution of the Agreement. Finally, Pharma retains all the intellectual property rights to X. There are no other agreements that have been executed between Pharma and the PEI (i.e., joint marketing agreements, collaboration agreements, etc.).

The PEI will contribute funds to the development of X and is entitled to receive future royalties from Pharma in return. The PEI will receive (1) royalties associated with future revenues of X (if and when X has been successfully developed, approved by a regulatory agency, and commercialized for sale) and (2) future royalties associated with an existing commercialized drug for a defined period.

Required:

- Decide how to account for the funding of the R&D and royalty payments.
- Identify the authoritative literature applicable to this funding arrangement and discuss the appropriate accounting for the Agreement in accordance with that guidance.