

**A Case Analysis of Licensing Revenue Recognition in the Pharmaceutical Industry under ASC 606**

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**Abstract**

In this case, students are required to review a license agreement made between two Pharmaceutical companies and to assess the revenue recognition implications that would be required under Generally Accepted Accounting Principles (GAAP) ASC 606. Students are required to prepare a memo based on the five-step revenue recognition model discussed in ASC 606. The case will require research into the revenue recognition requirements and critical thinking to determine how the facts of the license agreement in the case should be applied to the various steps of the revenue recognition model. The case also requires students to utilize their writing skills by preparing a memo with their analysis of the case. Students will need access to the FASB's GAAP codification to complete this case.

**Keywords:** ASC 606, revenue recognition, license agreements, in-licenses, and out-licenses

In this case, you will assume the role of the new assistant controller of Seloid Pharmaceutical. You are to write a memo that makes recommendations related to the appropriate timing and amount of revenue that should be recognized based on a recently signed contract to out-license a drug to another company. Your memo will focus on the revenue recognition requirements of ASC 606 – Revenues from Contracts with Customers.

It is late December 2019 and you are just settling into your position, having joined the company four months ago. You had spent the prior three years working for a large public accounting firm as an auditor and moving over to an industry job felt like the right move. While working in public accounting you had been part of audit teams for several other pharmaceutical companies. When you were contacted regarding the assistant controller position at Seloid Pharmaceutical, it was an opportunity you could not pass up. Seloid Pharmaceutical and its affiliated organizations were never clients of your prior public accounting firm employer, so you had no professional conflicts of interest and the position offer was very good.

Seloid Pharmaceutical was formed in July 2017 and is listed on the NASDAQ stock exchange. It was formed when two smaller pharmaceutical companies decided to merge through a statutory consolidation. Even with the consolidation, Seloid Pharmaceutical was still only considered a small to medium-sized company within the industry. Each of the originating companies brought a mix of mature drugs still under patent as well as development-stage compounds that were quickly approaching late-stage clinical trials.

Given the high cost of marketing existing, patented drugs and the expensive R&D process to complete clinical trials on potential new drugs, the originating companies decided a merger was in the best interests of the shareholders of both companies. Both originating companies believed that a merger would allow for the better utilization of existing resources--particularly marketing expertise--on a more focused set of mature drugs. In addition, a merged company would be better able to focus on clinical trials for compounds that had the best chance of success and would enhance Seloid's existing inventory of drugs.

One of your major duties at Seloid Pharmaceutical is to be part of the team that is negotiating to out-license drugs that the company currently has under patent. Seloid has the marketing

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expertise to maximize the revenue of its existing drug portfolio, but there are several drugs that do not meet this criterion.

One patented drug the company has been trying to out-license to another pharmaceutical company is a blood-pressure drug called Betafall. This drug came to the merged company from one of the originating companies, and it still has 10 years left on its patent. Seloid Pharmaceutical is currently the only company that is manufacturing and selling the drug. However, the drug has never really achieved its full sales potential. There are a number of competitors in the market with different blood-pressure reducing medications. Since Seloid Pharmaceutical has not been able to focus on marketing the blood-pressure medication, Betafall remains relatively unknown in the medical profession. In addition, the company believes that some incremental R&D on this drug could lead to a more effective version, but Seloid Pharmaceutical would only be willing to perform that research if it is done as part of an R&D arrangement with the company acquiring the in-license for the drug.

Several pharmaceutical companies with expertise in marketing blood-pressure medications were especially interested in acquiring an in-license to manufacture and market this medication when they learned that Seloid Pharmaceutical was in the market to out-license the drug. After serious negotiations with a number of these companies, Belco Pharmaceutical became the preferred company to acquire Betafall in a license agreement.

The license contract that Seloid Pharmaceutical and Belco Pharmaceutical signed is shown below.

**PHARMACEUTICAL LICENSE AGREEMENT**

This AGREEMENT (dated as of December 20, 2019) is made by and between Belco Pharmaceutical, Inc. (a publically owned corporation having its principal place of business in San Diego, CA) and Seloid Pharmaceutical, Inc. (a publically owned corporation, having its principal place of business in Santa Clara, CA).

**I. Introduction**

Seloid Pharmaceutical developed and obtained patent rights to Betafall (an approved blood pressure medication). Belco Pharmaceutical desires to license from Seloid Pharmaceutical the right to develop, market, make, use, and sell certain drug formulations that are applied to humans through the use of Betafall. In consideration of the mutual covenants and promises contained in this Agreement and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Belco Pharmaceutical and Seloid Pharmaceutical agree as follows:

**II. License and Other Fees**

- a) Upon signing of this agreement, Belco Pharmaceutical shall pay Seloid Pharmaceutical \$100 million in consideration of the license to further develop, market, manufacture, make, use and/or sell Betafall. The license will remain the property of Belco Pharmaceutical for a period of 25 years from the date of transfer of the license. Belco Pharmaceutical will have the rights to market and sell Betafall in all countries during that time 25 year time period. Seloid Pharmaceutical retains no rights to make or sell Betafall during the 25 year time period. Seloid Pharmaceutical will transfer license control to Belco Pharmaceutical on January 15, 2020. On January 14, 2020, Seloid Pharmaceutical will cease to manufacture Betafall and Belco Pharmaceutical will have the right to begin manufacturing Betafall on or after January 15, 2020.

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- b) Seloid Pharmaceutical will provide R&D work for a period of up to 5 years after this agreement is signed. The R&D work will focus on providing advance variations of Betafall, and Belco Pharmaceutical will be charged on a discounted per-hour basis. Seloid Pharmaceutical retains the right to terminate this R&D work at any point in time. Belco Pharmaceutical will be fully entitled to any variations or improvements to Betafall resulting from Seloid's R&D process under this license agreement. Additionally, Belco Pharmaceutical will be fully entitled to any variations or improvements to Betafall resulting from any R&D completed by another entity.
- c) Upon the gross sales of \$1 billion of Betafall worldwide as specified within the term of this contract, Belco Pharmaceutical will provide an additional payment to Seloid Pharmaceutical in the amount of \$200 million in consideration of this agreement.

**III. Representations, Warranties, and Covenants**

Seloid Pharmaceutical hereby represents and warrants that:

- (i) Seloid Pharmaceutical has the authority to grant to Belco Pharmaceutical all of the rights to Betafall granted hereunder;
- (ii) Seloid Pharmaceutical owns or controls all Betafall Patent Rights and Technology Rights; and
- (iii) Seloid Pharmaceutical is unaware of any rights superior to those held by Seloid Pharmaceutical over Betafall that would prevent Belco Pharmaceutical from fully exercising the rights licensed to it herein.

**IV. Intellectual Property Rights**

**IV.1. Ownership.** Belco Pharmaceutical shall under this license agreement own all rights and interest in Betafall, including all patent and technology rights for 25 years.

**IV.2. Other Legal Rights and Responsibilities.** Seloid Pharmaceutical agrees that during the term of this Agreement, Seloid Pharmaceutical shall provide Belco Pharmaceutical with copies of all substantive communications to and from patent office's regarding applications or patents relating to Betafall promptly after the receipt thereof. Copies of proposed substantive communications to such patent offices shall be provided to Belco Pharmaceutical in sufficient time before the due date in order to enable Belco Pharmaceutical an opportunity to comment on the content thereof. Seloid Pharmaceutical shall use reasonable efforts to incorporate Belco Pharmaceutical's comments into any substantive communications. Seloid Pharmaceutical shall notify Belco Pharmaceutical on a timely basis (but in no event less than 30 days prior to the expiration of any priority rights period) if Seloid Pharmaceutical intends not to seek patent protection for Betafall in any country other than the U.S. Belco Pharmaceutical shall have the right, at its expense and in Seloid Pharmaceutical's name, to file, prosecute, maintain, and enforce patents relating to Betafall in any country.

IN WITNESS WHEREOF, the Parties hereto have caused this Agreement to be executed in their names by their properly and duly authorized officers or representatives as of the date first above written.

Seloid Pharmaceutical

Belco Pharmaceutical

By: John Herd  
CEO  
December 20, 2019

By: Jami Milnar  
President  
December 20, 2019

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Prior to the approval and signing of the above license contract, you and your team developed and presented the following additional information and estimates to the Seloid Pharmaceutical Board of Directors:

Upon signing of the above agreement, Seloid Pharmaceutical estimates that it will be assigned approximately \$20 million worth of R&D work from Belco Pharmaceutical. Seloid's estimate is based on its prior experience in similar arrangements and on the discounted hourly rates Seloid will charge for the R&D work. Seloid Pharmaceutical further estimates that if the R&D work were provided to other, standalone customers, the undiscounted price would be \$25 million. Seloid Pharmaceutical also believes that it will difficult to achieve worldwide sales of \$1 billion needed to trigger the contingent milestone payment of \$200 million. Based on research performed prior to the signing of the contract, Seloid Pharmaceutical is aware that the standalone price of the license would have been the \$100 million, even if no R&D services or other milestone payments had been included in the contract.

On December 20, 2019 (the date the license contract was signed), John Herd (CEO of Seloid Pharmaceutical) stopped by your office to congratulate you and your team on completing the out-license contract. He noted that a wire transfer for the initial \$100 million specified in the contract had just been received. However, just as he was leaving your office, he commented that the signing of the contract could not have come at a better time. The December 31, 2019 fiscal year end is near, and he noted the extra profit generated by the license contract would be very helpful in meeting the profit guidance the company had provided to the financial community in their quarterly conference calls. John indicates that he wants you to evaluate the revenue implications of this contract and provide him with specifics as soon as possible.

You are aware that ACS 606 contains new revenue recognition requirements that may impact the timing and amount of revenues to be recorded for this license contract. Given the CEO's request, you decide to perform research on ASC 606 with specific attention on the five-step revenue recognition model and any sections that refer to license revenues.

### Required

Please write a memo to Seloid's CEO, John Herd, which indicates the timing and amounts of revenues that can be recorded for this license under GAAP's ASC 606. Any specific guidance in ASC 606 related to license contracts will receive special emphasis in your memo, since you know that our company will likely out-license several other drugs in the near future. You will need access to the FASB's GAAP codification to complete your work.

The memo you are writing will follow the five-step revenue recognition model discussed in ASC 606 so the CEO can understand the new revenue recognition process. Therefore, your memo should be structured to contain the following sections:

- a) Identify the contract with the customer,
- b) Identify the performance obligations in the contract,
- c) Determine the transaction price,
- d) Allocate the transaction price to the performance obligations,
- e) Recognize revenue when the entity satisfies a performance obligation.

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