ORANGE COUNTY

NEW ACCOUNTING RULES FOR **Development stage entities**

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n June 2014, the Financial Accounting Standards Board (FASB) issued new guidance for financial reporting for start-up companies, effective for annual reporting periods ending December 31, 2014.

As the originator of our generally accepted accounting principles (GAAP), the FASB plays a significant role in how we advise our clients. Its new rules set forth in Accounting Standards Update No. 2014-10 (ASU2014-10) specifically pertains to our clients who may historically have been referred to as "development stage entities" (DSEs)—those that are pre-revenue and have been investing in their research and development efforts.

The goal of ASU2014-10 is to reduce the cost and complexity associated with reporting requirements of DSEs previously defined as an entity that substantially devotes all of its efforts to establishing a new business for which: (a) planned principal operations have not commenced; or (b) planned principal operations have commenced, but have produced no significant revenues (e.g., start-ups). ASU2014-10 attempts to achieve this goal by eliminating disclosure requirements that have limited relevance and are generally not a useful decision for investors, donors, and/or creditors. More specifically, all incremental financial reporting requirements (e.g., inception-to-date information) from US GAAP for DSEs are removed. Key changes include the following:



- The definition of DSEs was removed from the Master Glossary, thereby removing the financial reporting distinction between DSEs and other reporting entities from US GAAP.
- The following DSE requirements are eliminated: presenting inception-to-date information, labeling financial statements as those of a DSE, disclosing a description of the development stage activities in which the entity is engaged, and disclosing in the first year in which the entity is no longer a DSE that in prior years had been in the development stage.

With the relaxed disclosure requirements of ASU2014-10, the reduction of the reporting burden once required of start-up companies may transfer to investors in those entities and decisions to invest in the start-up companies may be affected.

 The requirements of reporting "risks and uncertainties" are now applicable to entities that "have not commenced planned principal operations" (e.g., entities that previously would be defined as DSEs). This burden is easily met using rather general language (an example is given in the ASU2014-10).

ASU2014-10 also eliminates an exception provided to DSEs in Topic 810 (Variable Interest Entities (VIE) Guidance). The former exception stated that a DSE is not a VIE if the entity can demonstrate that the equity invested in the entity is sufficient to permit it to finance the activities that it is currently engaged in, and the entity's governing documents and contractual arrangements allow additional equity investments.

Under ASU2014-10, all entities within the scope of VIE Subsections of Subtopic 810-10 are required to evaluate whether the total equity investment at risk is sufficient using the guidance provided in paragraphs 810-10-25-45 through 25-47, which require both qualitative and quantitative evaluations. Therefore, the same guidance will be applied for determining whether an entity is a VIE, and whether the VIE should be consolidated, regardless of whether that entity has commenced planned principal operations or has significant revenue from its principal operations.

If the DSE is deemed to be a VIE, it would be required to perform a consolidation analysis under the more complex VIE model and accumulate information necessary to meet the VIE disclosure requirements.

DSEs were previously required to report a significant amount of financial information going back to the inception of the company. Some companies-including clients of ours-are perpetual or long-term DSEs (e.g., IP-intensive entities such as research

and development companies that never get beyond the development stage) and go through several rounds of complex funding, resulting in voluminous and complex reports that must be generated and submitted. In fact, we know of examples where companies were in the so-called development stage for more than thirty years and had changed auditors several times. Each one of the changes in auditors presented issues in "rolling forward" the information to be reported from the inception date. As noted in ASU2014-10, this resulted in additional reporting and auditing costs that are not required of seasoned operating entities.

ASU2014-10 greatly reduces the reporting costs and burden for start-up companies, which will allow costs and efforts to be allocated to other areas such as research and development. This makes sense given the fact that financial information is readily obtainable through the entity's Management's Discussion and Analysis for those registered with the U.S. Securities and Exchange Commission (SEC), or as part of disclosures regularly made to potential investors. Many of our clients are in industries such as pharmaceuticals, biotechnology, and software development, three of the

main industries in which perpetual DSEs are identified. The elimination of incremental reporting requirements for these clients will allow them to focus more on developing and procuring intellectual property.

Because there was some concern that valuable information may be lost by

elimination of the disclosure requirement, the FASB modified ASC 275 to ensure that an entity that has not commenced principal operations is required to include a description of risks and uncertainties related to activities in which the entity is currently engaged, and an understanding of what those activities are

being directed towards. ASC 275-10-55-3A provides an example of how a company can comply with the modified requirement. The language used in the example is concise and general, but is intended to allow users of financial statements to understand that the entity's activities are subject to different and varied risks, and that the entity is dependent on additional capital resources for the continuation and expansion of its activities.

This requirement aligns DSEs with other

entities, as ASC 275-10-50 already requires a description of the nature of operations and current vulnerability to concentrations from entities that commenced planned principal operation. In public company filings, these disclosures increase as companies cover the

discussion of their operational and financial uncertainties in the Risk Factors section of their periodic filings with the SEC.

With respect to the removal of the previous consolidation exception applied to DSEs, this could change the consolidation analysis and decision, as well as the disclosure requirements, for a company that

has an interest in a development-stage entity. Generally, for income-tax-reporting purposes, consolidation of investee entities is required when there is greater than 50% ownership for California, or 80% percent for federal, purposes; while GAAP requires consolidation when there is greater than 50% ownership, or other such elements of control. As a result, information about the DSE, once included in a consolidated income tax return or consolidated financial statement presentation, may result in less clarity of the specifics of the DSE given its overall relevance and materiality to the investor/parent entity.

Consolidation requirements can affect the tax consequences of investors from the initial formation of a start-up entity to those that may be bought or sold through merger and acquisition activities, as well as the overall financial reporting requirements of the investor. With the relaxed disclosure requirements of ASU2014-10, the reduction of the reporting burden once required of start-up companies may transfer to investors in those entities and decisions to invest in the start-up companies may be affected.



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