

Life Sciences Spotlight

Effectively Treating the Impacts of the Converged Revenue Recognition Model

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The Bottom Line

The proposed revenue model requires management to use greater judgment in recognizing revenue and related costs and may change the timing of revenue recognition from current practice.

- On November 14, 2011, the FASB and IASB (the “boards”) jointly issued their revised exposure draft (ED) *Revenue From Contracts With Customers*. The ED proposes a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and would supersede most current revenue recognition guidance. In addition, on January 4, 2012, the FASB issued a companion proposed ASU for public comment that would codify the revised ED’s amendments.
- The proposed model would require life sciences entities to reassess their accounting for contracts with customers and determine whether accounting changes are necessary.
- Management would be required to use judgment to determine whether collaborative arrangements represent a contract with a customer (and thus are within the scope of the proposed standard).
- The proposed model would require companies to reevaluate their policies for recognizing variable consideration and may change the timing of revenue recognition for certain milestone payments.
- Under the proposed model, entities may need to closely evaluate up-front licenses in arrangements that also contain research and development (R&D) services.
- The proposed model would require management to increasingly rely on judgments and estimates for determining when to recognize revenue; management may need to design and implement strong controls over the development and use of such estimates.
- To meet the proposed accounting and disclosure requirements, an entity may have to gather information from contracts with customers that is not readily available.

Beyond the Bottom Line

This *Life Sciences Spotlight* highlights the framework of the proposed revenue recognition model and potential implications for life sciences entities that currently apply existing revenue recognition accounting standards under U.S. GAAP or IFRSs.

Background

The revised ED states that the goal of the boards' revenue recognition project, which began in 2002, is to "clarify the principles for recognizing revenue and to develop a common revenue standard for U.S. GAAP and IFRSs." After receiving nearly 1,000 comment letters and redeliberating almost every aspect of their June 2010 ED, the boards modified the proposed guidance and developed the revised ED (changes from the June 2010 ED are discussed in detail in Deloitte's November 15, 2011, *Heads Up*). The revised ED retained the overall model that was originally proposed, which outlined five sequential steps to recognizing revenue:

1. "Identify the contract with a customer."
2. "Identify the separate performance obligations in the contract."
3. "Determine the transaction price."
4. "Allocate the transaction price to the separate performance obligations in the contract."
5. "Recognize revenue when (or as) the entity satisfies a performance obligation."

As many comment letters on the boards' June 2010 ED have indicated, the proposed standard may significantly affect the revenue recognition policies of life sciences entities, requiring them to reevaluate their current business practices. While the boards addressed some of the key concerns in drafting the revised ED, the proposed standard remains a potential "game-changer" for the industry.

The revised ED requires life sciences entities to reassess the accounting for their contracts with customers and determine whether accounting changes are necessary.

Compared with current revenue recognition guidance, the revised ED requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the proposal's provisions; and (3) assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

The revised ED clarifies the revenue recognition principles and includes additional guidance on certain revenue transactions. Although the effect of the proposals on some entities is expected to be limited, life sciences entities may face significant accounting and operational challenges as a result of the revised ED, a number of which are discussed below.

Scope — Collaborative Arrangements

In comment letters on the June 2010 ED, industry leaders expressed concern that the ED did not provide sufficient guidance on determining whether the other party in a collaborative arrangement would meet the definition of a customer. Since then, the boards have determined that such arrangements would be within the scope of the proposed guidance only if the other party to the arrangement meets the definition of a customer.¹ However, the boards have chosen not to clarify the definition of a customer for specific industries; rather, an entity would need to consider all relevant facts and circumstances in assessing whether the counterparty meets this definition. The revised ED indicates that the collaborative R&D efforts of biotechnology and pharmaceutical entities would be one example of a contract for which an entity would need to perform such an assessment.

¹ A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities.

An entity will need to consider all relevant facts and circumstances in assessing whether the counterparty in a collaborative arrangement meets the definition of a customer.

Life sciences entities commonly enter into collaboration and licensing contracts to use their respective strengths and market positions to turn assets into revenue generators. These contracts commonly include (1) various goods or services, such as licenses of intellectual property, manufacturing, R&D activities, or participation in development oversight groups (commonly referred to as joint steering committees) and (2) various types of payment, such as milestones, royalties, and cost-sharing plans. Because such contracts are complex, it can be difficult to determine which guidance to apply to them (e.g., ASC 605-25² or ASC 808³).⁴ Life sciences entities will continue to be required to determine whether the contract or its elements are within the scope of the revised ED or other ASC topics. The revised ED states that “the counterparty to the contract might not be a customer but rather a collaborator or a partner that shares with the entity the risks and benefits of developing a product to be marketed” and indicates that such contracts are not within the proposal’s scope.

Identification of Separate Performance Obligations

The revised ED’s principle for identifying separate performance obligations requires that entities “evaluate the goods or services promised in a contract and . . . identify which goods or services (or which bundles of goods or services) are distinct.” Contracts for which “distinct” performance obligations have been identified must be treated as separate units of accounting. The revised ED contains criteria for determining whether goods or services represent distinct performance obligations that should be accounted for separately. Further, the boards decided that an entity would account for a bundle of goods or services as a single performance obligation if the goods or services are (1) highly interrelated and the entity provides a significant service of integrating them into a combined item or items and (2) significantly modified or customized to fulfill the contract.

Life sciences entities often license their intellectual property to other entities under license agreements. While the business rationale for entering into license agreements can vary, the licensee’s goal typically is to develop the intellectual property into a revenue-generating commercial product. License agreements commonly require the licensor to participate in R&D activities (provided that the licensor has the capacity or wherewithal to do so); the purpose of such activities is to develop the licensed intellectual property into a commercial product.

Under current U.S. GAAP, the license is deemed a separate unit of accounting when it has stand-alone value in accordance with ASC 605-25; the allocated transaction price is generally recognized as revenue upon delivery. If a license is not deemed to have stand-alone value from the R&D activities, it is bundled with other deliverables in the contract and recognized when earned. Under the proposed standard, the key consideration in the determination of separate performance obligations is whether each good or service is distinct. If the contract is a contract with a customer that is within the scope of the proposed standard, the conclusion would have a clear revenue recognition timing impact on the amount of consideration that may be separately allocated to the license.

² FASB Accounting Standards Codification Subtopic 605-25, *Revenue Recognition: Multiple-Element Arrangements*.

³ FASB Accounting Standards Codification Topic 808, *Collaborative Arrangements*.

⁴ The revised ED would supersede ASC 605-25 but would not appreciably affect ASC 808.

Entities will need to determine whether license and R&D activities constitute separate performance obligations.

Example

A biotechnology entity (“Biotech”) enters into a contract with a pharmaceutical entity (“Pharma”). The contract terms are as follows (assume that the pharmaceutical entity is deemed a customer):

- Pharma is granted a license with exclusive rights to use Biotech’s Technology A for the life of its patent and to market, distribute, and manufacture Drug B, which is developed by using Technology A.
- Biotech provides R&D services to Pharma; the objective of these services is to receive regulatory approval to use Technology A to market and distribute Drug B.
- Biotech must perform these R&D services because the knowledge of how to use Technology A is proprietary information and is not available to other entities (such as a clinical research organization).

In this example, the license is most likely not deemed distinct from the R&D services because (1) it is not sold separately and (2) Pharma is not able to benefit from the license on its own or together with other readily available resources. If comparable R&D services were sold separately by another entity or provided as an option (i.e., the license was sold separately by Pharma), the license might be deemed distinct.

Variable Consideration

Contracts that include variable consideration are common in the life sciences industry. Familiar types of variable consideration include royalties and milestone payments that are contemplated and earned under collaboration and licensing arrangements between life sciences entities. Royalties are typically based on a percentage of product sales, while milestone payments may be contingent on the achievement of cumulative sales thresholds or successful completion of key clinical development phases. Other common types of variable consideration in the life sciences industry include discounts and rebates offered on sales transactions.

Determining when and how to recognize revenue for contracts that include variable consideration can be challenging. Below is a discussion of some key considerations related to this topic.

Determining the Transaction Price

The revised ED requires entities to estimate the transaction price, including variable consideration, by using either an expected-value method (i.e., the sum of probability-weighted amounts in a range of possible amounts) or a most-likely-amount method (i.e., the single most likely outcome in a range of possible amounts), depending on which method is more predictive of the amount of consideration to which the entity will be entitled. An entity should apply the method it selects consistently throughout the contract. The revised ED suggests that the expected-value method may be appropriate when the entity has a “large number of contracts with similar characteristics,” while the most-likely-amount method may be appropriate when the contract “has only two possible outcomes.” Management would need to reassess the estimate as of each reporting date and update it if appropriate.

Entities will need to use judgment in determining whether the expected value or the most likely amount is more predictive of the consideration amount.

Under the boards' June 2010 ED, the only method used to estimate variable consideration was the probability-weighted method (referred to as the expected-value method in the revised ED); the most-likely-amount method was developed as part of the revised ED to address constituents' concerns. Many industry leaders believe that the current best-estimate approach, in addition to being less time-consuming and less costly, is as precise as the proposed probability-weighted approach and provides more useful information to financial statement users. Industry point of view aside, if the revised ED is implemented as currently written and the probability-weighted method is deemed more predictive, some entities may experience income statement volatility because this estimate could potentially change as of each reporting date. Furthermore, regardless of the method selected, management will be required to document its selection process, particularly why it considers the selected method to be more predictive.

Example

A biotechnology entity ("Biotech") enters into a license agreement with a pharmaceutical entity that includes a \$100 million milestone payment upon the occurrence of a future event (i.e., regulatory approval). At inception of the contract, Biotech estimates that it has a 35 percent chance of receiving the \$100 million milestone payment and a 65 percent chance of receiving no payment. In this example, the method that would most likely be more predictive of the amount to which Biotech is entitled is the most-likely-amount method given that Biotech is certain to receive only one of two possible consideration amounts, \$0 or \$100 million (i.e., \$0 is the single outcome with the highest probability).

Allocating the Transaction Price

As previously mentioned, collaborative and licensing contracts can be complex and may include multiple goods or services for which there are various forms of payment (see discussion below in the [Milestone Payments](#) section). Under current U.S. GAAP, ASC 605-25 stipulates how an entity should allocate the arrangement consideration to separate units of accounting. Entities are required, at the inception of an arrangement, to establish the "selling price" for all deliverables that qualify for separation. The manner in which selling price is established is based on a hierarchy of evidence that entities must consider; total arrangement consideration is then allocated on the basis of each deliverable's relative selling price. This hierarchy prohibits the use of a residual allocation method.

Under the proposed guidance, the transaction price must be determined and subsequently allocated to each separate performance obligation on a relative stand-alone selling price basis (in a manner consistent with current U.S. GAAP). However, the proposed guidance does not prescribe a hierarchy but requires that the method used to estimate the stand-alone selling price for a good or service maximize the use of observable inputs (when it is not directly observable through stand-alone sales). The proposed guidance notes that suitable methods for estimating the stand-alone selling price include, but are not limited to, (1) an expected-cost-plus-a-margin approach, (2) an adjusted market assessment approach, and (3) a residual approach (which is limited to situations in which the selling price is highly variable or uncertain). Entities would be required to update the transaction price over the life of the contract to reflect changes in circumstances or assumptions and allocate those changes to the previously identified performance obligations on the same basis as at contract inception (unless certain criteria are met, in which case a change would only be allocated to one or more separate performance obligations).

Entities would need to analyze milestone payments to determine whether changes in recognition are required under the revised ED.

An entity may find it difficult to determine the stand-alone selling price given the unique nature of the goods and services provided in contracts in the life sciences industry. Although the current guidance in ASC 605-25 precludes entities from using the residual method, the revised ED specifies that when the stand-alone selling price of a performance obligation is highly variable or uncertain, a residual technique may be used, regardless of the type of good or service being sold. However, the revised ED does not specify how entities should apply such a residual technique. Regardless of the estimation technique employed, management should maintain documentation to support its underlying assertions.

Milestone Payments

Under ASC 605-28,⁵ a milestone payment must meet certain criteria to be considered substantive and thus to result in revenue recognition in the period in which the milestone is achieved. Milestones might be deemed nonsubstantive when the payments are based, for example, on the licensor's future performance, the licensee's performance, or the passage of time rather than on the licensor's past performance. In accordance with ASC 605-25, nonsubstantive milestones are allocated to all units of accounting in the related contract and recognized in conjunction with such units of accounting.

Under the revised ED, entities must first determine the performance obligations associated with any arrangement under which milestone payments may be earned, estimate the transaction price, and then allocate the transaction price to the separate performance obligations on the basis of their relative stand-alone selling prices. The proposed guidance may allow entities to allocate consideration contingent on a future event (e.g., a milestone payment) entirely to a separate performance obligation (rather than to all obligations in the contract) when (1) the contingent terms are specifically related to the transfer of a distinct good or service or a specific outcome and (2) the allocation is consistent with the overall allocation principle in the revised ED.

Entities would need to analyze milestone payments to determine whether changes in recognition are required under the revised ED. When a milestone payment meets the criteria for allocation entirely to a separate performance obligation that has been satisfied, entities may have a similar pattern of recognition for milestone payments deemed substantive under current U.S. GAAP (provided that revenue is not constrained because it is not reasonably assured, as discussed in the [Timing of Revenue Recognition](#) section). However, the specific criteria in ASC 605-28 are not the same as the revised ED's proposals on allocating a contingent payment to a distinct good or service, so entities would need to closely evaluate the contract's specific facts and circumstances.

Timing of Revenue Recognition

Under current U.S. GAAP, variable consideration (e.g., royalty or milestone payments) is generally recognized only upon achievement of a contemplated event. Under the revised ED, entities would recognize revenue as control of a good or service is transferred to the customer. If the control of goods or services (and therefore satisfaction of the related performance obligation) is transferred over time, an entity would be required to measure the obligation's progress toward completion in a manner that best depicts the transfer of goods or services to the customer. The revenue from variable consideration for goods or services transferred to the customer (e.g., royalty or milestone payments) would be recognized when it is deemed "reasonably assured." The revised ED notes that an entity can determine whether the amount of consideration is reasonably assured only if both of the following criteria are met:

- a. The entity has experience with similar types of performance obligations (or has other evidence such as access to the experience of other entities).
- b. The entity's experience (or other evidence) is predictive of the amount of consideration to which the entity will be entitled in exchange for satisfying those performance obligations.

⁵ FASB Accounting Standards Codification Subtopic 605-28, *Revenue Recognition: Milestone Method*.

Variable consideration should be recognized when the related performance obligation has been satisfied and it is deemed reasonably assured.

This guidance may affect exclusive licenses, sales-based royalties, and milestone payments.

Exclusive Licenses

Unlike the June 2010 ED, the revised ED's implementation guidance does not include separate accounting requirements for exclusive versus nonexclusive licenses. Instead, entities would apply the revised ED's guidance on evaluating when control of the license is transferred to the customer. This may result in a change to the timing of revenue recognition for entities that currently recognize revenue over time versus at a point in time. The revised ED indicates that control of a license is often satisfied "at the point in time when the customer obtains control of the rights," which could result in revenue recognition upon transfer of the license to the extent that the amount of consideration is reasonably assured.

Sales-Based Royalties

Under current U.S. GAAP, sales-based royalty revenues are generally recognized in conjunction with the timing of a third party's product sales resulting from the license of intellectual property, provided that collectibility is reasonably assured. The revised ED states that an entity is not reasonably assured to be entitled to sales-based royalty payments from a license of intellectual property until the future uncertainty of the sale is resolved (i.e., when the subsequent sales occur). Therefore, like current U.S. GAAP, the revised ED would generally require entities to recognize revenue for royalties in the same period in which the related sales are made. However, many contracts include minimum royalties that would be deemed reasonably assured (and potentially recognized immediately upon transfer of the license) because they are not contingent on the future uncertainty of the sale.

Milestone Payments

The point in time at which a milestone payment meets the criteria for being reasonably assured may be different from the period in which the milestone is achieved, potentially resulting in different (possibly earlier) timing of revenue recognition for a milestone payment that can be completely allocated to a satisfied performance obligation (see [Allocating the Transaction Price](#) section above). However to recognize revenue before a milestone is achieved, entities would need to closely evaluate whether they have predictive experience with similar contracts.

Presentation and Disclosures

The revised ED would require significantly more extensive disclosures than current revenue standards, including quantitative and qualitative information about contracts and the significant judgments used in applying the guidance to those contracts. Entities should consider how detailed their disclosures need to be to meet the requirements and how much emphasis to place on each disclosure requirement. The required disclosures would include:

- A disaggregation of reported revenue in the "primary categories that depict how the nature, amount, timing, and uncertainty of revenue and cash flows are affected by economic factors."
- A reconciliation of the beginning and ending balance of contract assets and liabilities.
- Certain information about performance obligations (e.g., types of goods or services, significant payment terms, typical timing of satisfying obligations, and other provisions).
- Information about onerous obligations (extent and amount of such obligations, the reasons they became onerous, the expected timing to satisfy the liability, and reconciliation of onerous balances).
- A description of the significant judgments, and changes in those judgments, that affect the amount and timing of revenue recognition.

- Information about the methods, inputs, and assumptions used to determine the transaction price and allocate amounts to performance obligations.
- Information about assets recognized from costs to obtain or fulfill a contract, including a reconciliation of the beginning and ending assets (by main category of asset).

Several life sciences entities have commented on the practical challenges of collecting the required data to provide the above disclosures. Many have indicated that they do not track customer contracts in sufficient detail to meet the revised ED's requirements and that they may need to make significant process and systems changes to comply with these requirements. The revised ED also proposes amendments to interim reporting standards that will require entities to disclose several of the above items in interim and quarterly reports. A number of respondents have expressed concerns regarding these proposed amendments, believing that the revised ED should not alter the standards on quarterly reporting and that the boards should address this issue as part of a separate project. It remains to be seen whether the boards will take these comments into account when drafting the final standard.

Data, systems, processes, and controls that do not currently exist may be needed to support the implementation of the revised requirements.

Challenges for Life Sciences Entities

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the revised ED's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for entities to consider how the revised ED specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The revised ED proposes retrospective application, with certain optional practical expedients available to entities at their discretion. This aspect of the proposal may require life sciences entities to gather data and assess contracts that commenced several years before the revised ED's effective date. Life sciences entities also will most likely be required to perform dual tracking of revenue during this retrospective period, given the potential difficulty associated with retroactively recalculating revenue balances at the time the new standard becomes effective.

Systems, Processes, and Controls

The revised ED proposes several new practices and disclosure requirements under which life sciences entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems (e.g., data elements needed to determine and allocate the transaction price when new performance obligations are identified or elements related to the presentation and disclosure requirements outlined above).

In addition, to ensure the effectiveness of internal controls over financial reporting, management will need to assess whether additional controls need to be implemented. Given the complex nature of many customer contracts in the life sciences industry, entities may need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the proposed rules.

Taxes

Tax departments need to assess changes in book revenue recognition methods to prepare for the tax effects. Federal income tax law contains specific rules on certain types of revenue, such as income from long-term contracts and advance payments for goods and services. Those rules often overlap with a taxpayer's financial reporting policies, in which case the taxpayer often applies, as its tax method, the revenue recognition method it

uses in maintaining its books and records. Because the proposed guidance may change the amount and timing of revenue recognition for entities that maintain their books and records under U.S. GAAP or IFRSs, the accounting proposed in the revised ED may have cash tax implications or give rise to new book-tax differences that will need to be captured, calculated, and tracked through tax accounting processes and systems.

If a change in a tax accounting method is advantageous or expedient, including circumstances in which the book method has historically been used, the taxpayer will most likely be required to obtain approval from the relevant tax authorities. Similar implications may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs.

Thinking Ahead

Comments on the revised ED and the FASB companion proposed ASU were due by March 13, 2012. A final standard is not expected to be issued until the first quarter of 2013 and would be effective no earlier than for annual periods beginning on or after January 1, 2015 (with a minimum of a one-year deferral for nonpublic entities applying U.S. GAAP). Life sciences entities should take advantage of this time to carefully examine the revised ED, consider feedback on the proposed model, and begin assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

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