

IFRS industry insights: Life sciences sector

New revenue Standard could have a major impact profile of revenue and profit recognition

Headlines

- The **profile of revenue and profit recognition** will change for some entities as the new Standard is more detailed and more prescriptive than the existing guidance and introduces new complexities. In particular, life sciences companies will need to consider:
 - the impact of new guidance where pricing mechanisms include **milestone payments and other variable amounts**;
 - the extent to which **distinct goods or services** are supplied, which should be accounted for separately;
 - the **types of licence** that are sold and whether the accounting treatment will need to change;
 - the appropriate accounting for customer options to acquire **additional goods or services at a discount**; and
 - the existence of **collaborative arrangements** and whether they fall within the scope of the new Standard.
- The new Standard requires significantly more **disclosures** relating to revenue and entities will need to ensure that **appropriate processes** are in place to gather the information.

What's happened?

The International Accounting Standards Board (IASB) has published a new Standard, IFRS 15 *Revenue from Contracts with Customers* ('the new Standard'). The new Standard outlines a single comprehensive model of accounting for revenue arising from contracts with customers and supersedes current revenue recognition guidance, which is found currently across several Standards and Interpretations within IFRSs. The core principle is that an entity recognises revenue to reflect the transfer of goods or services, measured as the amount to which the entity expects to be entitled in exchange for those goods or services.

The new Standard is effective for reporting periods beginning on or after 1 January 2017, with earlier application permitted. Entities can choose to apply the Standard retrospectively or use a modified approach in the year of application. It is the result of a convergence project with the US Financial Accounting Standards Board (FASB) that began in 2002. Almost fully converged, the most significant differences between IFRSs and US GAAP relate to interim disclosures and timing of adoption.

Implications for the life sciences sector

Below, we highlight certain key impacts resulting from the new Standard that will be of particular interest to those in the life sciences sector and then consider parts of the new Standard that may contribute to those impacts. Of course many more complexities exist and, as described below, Deloitte has produced further guidance which explores these in greater detail.

How might this affect you?

The timing of revenue and profit recognition may be significantly affected by the new Standard

Whereas previously IFRSs allowed significant room for judgement in devising and applying revenue recognition policies and practices, IFRS 15 is more prescriptive in many areas relevant to the life sciences sector. Applying these new rules may result in significant changes to the profile of revenue and, in some cases, cost recognition.

This is not merely a financial reporting issue. As well as **preparing the market and educating analysts** on the impact of the new Standard, entities will need to consider wider implications. Amongst others, these might include:

- changes to **key performance indicators** and other **key metrics**;
- changes to the **profile of tax cash payments**;
- availability of **profits for distribution**;
- for **compensation and bonus plans**, impact on the timing of targets being achieved and the likelihood of targets being met; and
- potential non-compliance with **loan covenants**.

Current accounting processes may require changes to cope with the new Standard

As explained below, IFRS 15 introduces new requirements to move to a more conceptual approach. The complexity of applying this approach and of producing the detailed disclosures required by the new Standard in the life sciences sector may require modifications to existing accounting processes. Entities should ensure they allow sufficient time to develop and implement any required modifications to processes.

What are the most significant changes?

When should milestone payments and other variable or uncertain revenues be recognised?

Contracts in the life sciences sector can be of a long-term nature and will often include significant variable elements, such as rebates, incentives, performance bonuses, contingencies or concessions. For example, the transaction price would be considered variable if it depended on the price at which a product is resold by a reseller or distributor or on achieving certain milestones. Additional complexity may arise because attrition rates in the industry are often high. For example, a drug candidate is typically required to go through several studies, testing and regulatory approval before it can be commercialised and it is not uncommon for products to fail at some point in the process.

There are new specific requirements in respect of variable consideration such that it is only included in the transaction price if it is highly probable that the amount of revenue recognised would not be subject to significant future reversals as a result of subsequent re-estimation. This approach to variable and contingent consideration is different from that previously reflected in IFRSs and, in certain scenarios, will require a significant degree of judgement to estimate the amount of consideration that should be taken into account. Where revenue is generated as the product progresses through the stages, typically via milestone payments that are awarded on the successful passing of a research phase, the high attrition rates may make it difficult to determine the probability of success at the inception of the contract in order to make an upfront estimate of revenue. Accordingly, the profile of revenue recognition may change for some entities as a result.

How to identify and allocate revenue to different goods and services?

Previously, given the lack of specific guidance in IFRSs, there was greater room for judgement when identifying the goods and services within a contract and then allocating the revenue to those goods and services. Entities may have to amend their current accounting policies as a result of the more detailed guidance in IFRS 15 and, in particular, the new rules on how revenue is allocated between different items. For example, in the life sciences industry, a single contract may include both the sale of intellectual property, and the provision of subsequent research and development services relating to that intellectual property. Careful analysis and judgement may be required to determine whether the sale of intellectual property and subsequent services should be regarded as distinct and, if so, to determine the appropriate allocation of revenue between them based on the requirements of the new Standard. It will also be necessary to consider the appropriate profile for recognition of revenue relating to the services, as they may not be provided on a straight line basis.

How will the type of licence sold impact when revenue is recognised?

IFRS 15 distinguishes between licences that represent the transfer of a right to use an entity's intellectual property and licences that represent the provision of access, over a period of time, to an entity's intellectual property, and specifies criteria to determine which type of licence is being sold. Revenue for the former will typically be recognised at a point in time; revenue for the latter will typically be recognised over the period of access. Some entities within the life sciences sector sell a right to distribute drugs whereas some entities sell the entire intellectual property relating to a drug. It will be important to examine the specific terms of licence arrangements in the light of this new guidance, and assess if changes are required to existing accounting policies. Where a change is required, this may have a significant impact on the timing of revenue recognition.

Should revenue be allocated to customer options to acquire additional goods or services at a discount?

Some life sciences contracts include a right for the customer to purchase additional goods or services at a discount. For example, a company may sell the intellectual property in respect of a specific drug to another entity and at the same time grant that entity an option to sub-contract the manufacture of the drug back to the seller at a fixed price, which might be below the price that another sub-contractor would charge. If such an option represents a material right for the customer, the seller will need to allocate a portion of the transaction price to the option and recognise revenue when control of the goods or services underlying the option is transferred to the customer, or when the option expires. In this particular scenario, the company selling the licence will need to consider whether some of the revenue receivable at the time of granting the licence should be deferred and instead recognised at a later date when the drugs are manufactured.

Are collaborative arrangements in the scope of the new Standard?

It is not uncommon in the life sciences sector for two separate entities to combine their resources and collaborate in the development and production of a drug. Where this is the case, an entity will have to assess whether the other entity is its customer in order to establish whether the transactions with the other entity are within the scope of the new Standard. The new Standard introduces new specific guidance on this topic, and this may result in some arrangements that have not previously been regarded as revenue transactions nevertheless falling within the scope of the new Standard. It may also result in some arrangements which have previously been treated as revenue transactions being outside of the scope of the new Standard and entities will need to consider in these cases whether it is still appropriate to apply the new Standard by analogy.

What else might change?

In addition to the key changes discussed above, the new Standard introduces detailed guidance in many areas regarding the reporting of revenue and entities will need to ensure that they have considered all of these when assessing the extent to which their accounting policy for revenue may need to be amended.

More detailed information on the impact of IFRS 15 can be found in Deloitte's IFRS in Focus publication available from www.iasplus.com. Further industry publications are also available here.

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