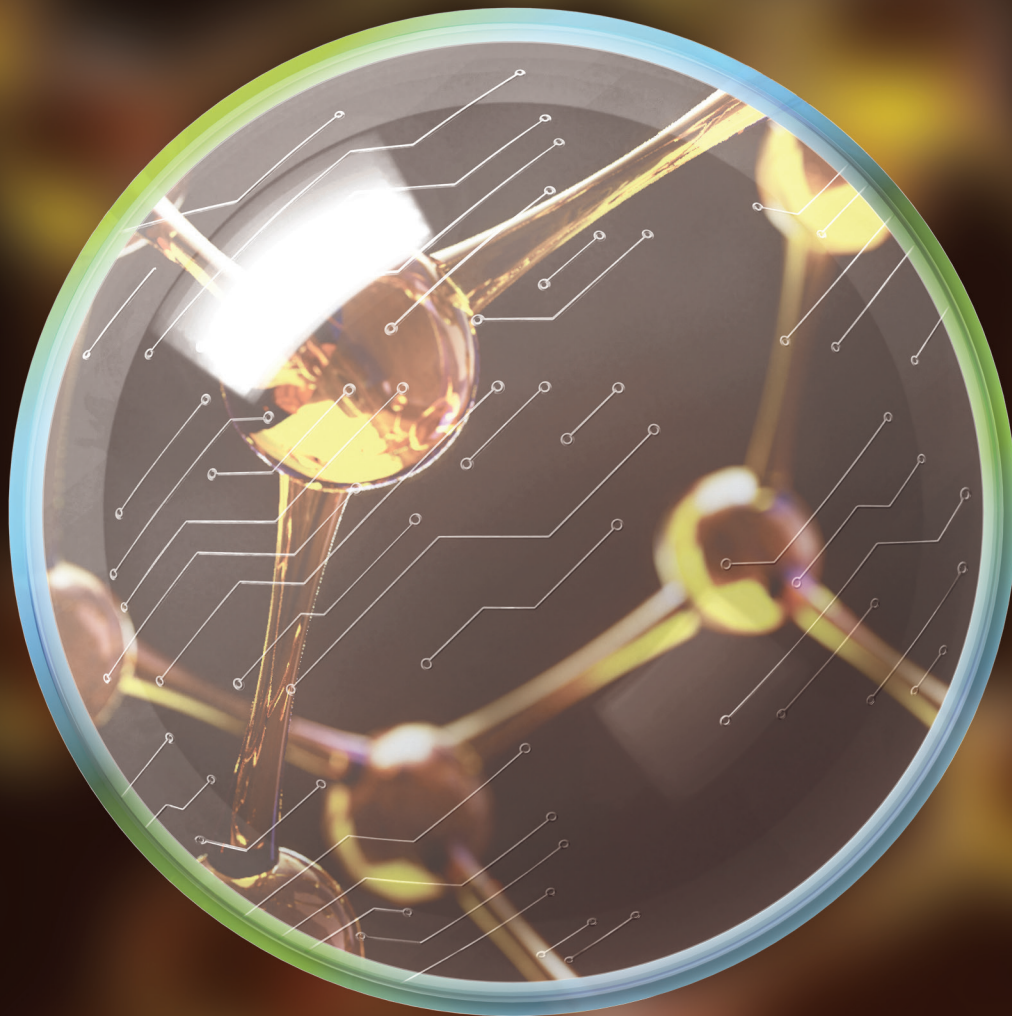


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# Life Sciences Industry Accounting Guide

March 2024

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# Preface

The life sciences ecosystem encompasses a wide array of entities that discover, develop, and manufacture health care products. Such entities include pharmaceutical manufacturers; biotechnology companies; medical device, diagnostic, and equipment manufacturers; and service companies such as drug distributors, contract research organizations (CROs), contract manufacturing organizations (CMOs), and health technology companies.

Finance and accounting professionals in the life sciences industry face complex issues and must exercise significant judgment in applying existing rules to matters such as research and development (R&D) costs, acquisitions and divestitures, consolidation, contingencies, revenue recognition, income taxes, financial instruments, and financial statement presentation and disclosure. The 2024 edition of Deloitte's *Life Sciences Industry Accounting Guide* (the "Guide") addresses these and other relevant topics affecting the industry this year. It includes interpretive guidance, illustrative examples, recent standard-setting and rulemaking developments (through March 8, 2024), and key differences between U.S. GAAP and IFRS<sup>®</sup> Accounting Standards. In addition, this Guide discusses (1) accounting and financial reporting considerations associated with the macroeconomic and geopolitical environment that apply specifically to the life sciences industry, (2) environmental, social, and governance (ESG) matters that have become topics of increased focus, and (3) the impact of the Inflation Reduction Act of 2022 (IRA).

[Appendix B](#) lists the titles of standards and other literature we cited, and [Appendix C](#) defines the abbreviations we used. Key changes made to this Guide since publication of the 2023 edition are summarized in [Appendix D](#).

We hope the Guide is helpful in navigating the various accounting and reporting challenges that life sciences entities face. We encourage clients to contact their Deloitte team for additional information and assistance.

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# Chapter 1 — Accounting and Financial Reporting in Uncertain Times: Considerations for Navigating Macroeconomic and Geopolitical Challenges

## 1.1 Executive Summary

Today's consumers and companies face numerous challenges associated with the current macroeconomic and geopolitical environment (the "current environment"). Reports of continuing global supply-chain disruptions, labor shortages, inflation, and geopolitical events dominate the news and are top of mind for many financial executives.

On the basis of Deloitte's [Q3 2023 CFO Signals survey](#), some of the most common issues affecting CFOs include (1) internal matters such as employee retention, employee working arrangements and morale, generative artificial intelligence (GenAI), and cost management and (2) external concerns such as inflation, interest rates, policies and regulations, and geopolitical tensions.

Certain of these challenges started during the COVID-19 pandemic, which gave rise to new operational and financial difficulties, often with unique accounting and financial reporting implications (see Deloitte's March 25, 2020 [updated January 11, 2021], [Financial Reporting Alert](#)). For example, as a result of significant global supply-chain disruptions and labor shortages brought on by the pandemic, many product and employment costs increased. In addition, global central banks raised interest rates in an attempt to temper the impact of historically high inflation rates.

More recently, the convergence of various macroeconomic and geopolitical factors has created a volatile and uncertain environment in which a business's decision-making and accounting and financial reporting have become increasingly challenging. As business leaders struggle to deal with macroeconomic and geopolitical changes, both preparers and users of financial statements need to understand the impacts and potential impacts of those changes, which involve a myriad of factors. Some of the more prominent factors affecting life sciences companies include:

- Risk of recession.
- Interest rate increases.
- Tightening of credit and concerns about the banking sector.
- Concerns about the real estate sector, both residential and commercial.
- Continuing inflation, including geographic and sector-specific impacts.

- Tightened labor market.
- Changes in foreign currency exposures as a result of both the geopolitical environment and supply-chain challenges.
- Climate risk.

While each factor on its own poses challenges in the application of accounting standards, the convergence of these factors significantly increases the level of complexity involved and, therefore, the amount of effort needed to develop significant accounting estimates, such as the valuation of receivables, inventory, investments, property and equipment, leased assets, goodwill, and intangibles. In addition to the many potential impacts on accounting estimates, the factors can also have more direct accounting implications. For example, as interest rates rise, debt covenant violations may increase, which could call for an evaluation of debt classification and going-concern considerations, among others. Further, given the current environment, life sciences companies may also need to reevaluate their foreign currency exposures, the effectiveness of hedging relationships, and — while generally considered rare — the potential need to change a foreign entity's functional currency as a result of significant changes in economic facts and circumstances.

In light of the changing macroeconomic and geopolitical environments, life sciences companies should also be mindful of the considerations below related to risk assessment, internal controls, and SEC disclosures.

### 1.1.1 Risk Assessment

To address the complexity in the current environment, life sciences companies may need to revisit their historical risk assessments and revise their processes and controls to ensure that their accounting and reporting reflects the changing macroeconomic and geopolitical factors. In August 2023, SEC Chief Accountant Paul Munter released a [statement](#) reinforcing the importance of assessing risk comprehensively to ensure effective financial reporting and internal controls. He discussed risk assessment considerations for both management and auditors related to the changing economic conditions.

At the highest level, addressing this changing environment means revisiting risk assessments to ensure that management has identified new risks or changes in existing risks, including fraud risks, that are affecting the company. For example, management might consider the following:

- If management mitigated its exposure to foreign currency fluctuations by denominating more of its transactions in a particular currency, has it unwittingly changed the functional currency of the related business? Alternatively, if management mitigated its foreign currency exposure by expanding its hedging program, has it adequately considered counterparty risk, especially given the concerns about the banking sector?
- If management changed or diversified its suppliers in response to supply-chain constraints or geopolitical concerns, has this supplier change increased the company's exposure to foreign currency fluctuations and, if so, is that appropriately disclosed in the company's financial statements and SEC filings?
- Which of the current macroeconomic and geopolitical factors, or combination of factors, affect the overall risk of fraud either at an entity level or with respect to specific risks within the entity's existing accounting and reporting structure?

In addition, organizations that use or are considering using GenAI in accounting and financial reporting should carefully consider the potential risks associated with this technology. GenAI models can be biased and inaccurate, and they may not be able to capture all the nuances of the current business environment. Therefore, organizations may need to revise their processes and controls to mitigate these risks.

While many of the changes outlined above are one-off occurrences, others have a clear recurring impact. For instance, when the inflation rate was lower, life sciences companies may have been successful in passing on minor cost increases to their customers so that cost changes may not have had a substantial impact on margins. However, because customers may now be more resistant to price increases, companies may face difficulties in passing on significant cost increases to their customers. Pressure to increase margins may instead lead companies to explore cost-saving initiatives such as layoffs and restructuring activities, which can create new accounting, reporting, and fraud risks.

### 1.1.2 Design and Operation of Internal Controls

Each new material risk identified by management is typically accompanied by a corresponding change in the design or operation of a company's internal control over financial reporting. From a design point of view, management may consider the need to challenge (1) how well the control addresses the risk, (2) the frequency with which the control is performed, (3) the competency and authority of those performing the control, and (4) the level of aggregation or disaggregation, predictability, and the criteria for investigation in a management review control. For example, management may consider the following:

- In a highly inflationary environment, does the existing fluctuation analysis, in which management reviews changes over an amount or percentage, continue to be effective as an internal control or should the criteria for investigation be changed? For example, in an inflationary environment, a decrease in costs as a percentage of sales may warrant investigation even if the decrease did not exceed a defined threshold for investigation. Conversely, in situations in which every cost has increased above management's threshold for investigation, should management consider whether that investigation has been diligent or whether it reflects a confirmation bias since management expected costs to increase?
- Do personnel reviewing the fluctuation analysis understand the business well enough to tell the difference between an unusual fluctuation and an expected fluctuation?
- As a result of the tight labor market, has the company experienced turnover and had challenges hiring qualified personnel? Management should also consider whether, as a result of these challenges in hiring qualified personnel, it takes more time to fill vacancies, which possibly puts stress on existing controls and processes and thereby increases the opportunity for fraud.

A common example of changing the frequency of when a control is performed is an interim goodwill impairment analysis in response to a triggering event. However, there are other circumstances in which the frequency of a control may need to be changed, even if it is not called for by accounting standards. For example, if an entity is experiencing significant cost increases, management should consider whether to only update the standard cost of inventory annually or to do it on a more frequent basis. If management instead relies on its process for capitalizing variances, it should assess whether (1) that process adequately considers the fact that some costs are relatively stable while others continue to undergo significant change and (2) the analysis should be disaggregated by product line, cost type, or other unit to ensure a reasonable allocation.



Beyond the design of a control, it is also important to think about how controls operate in a changing environment. Processes such as developing a forecast for use in an impairment analysis and reviewing that forecast may need to be modified when many of the factors discussed above come together. For example, a global entity may encounter very different economic circumstances in different geographic locations, with some countries experiencing deflation and others experiencing significant inflation. The company's consideration of inflation will necessarily be affected by the degree of inflation in the geographic locations in which the company operates, and a one-size-fits-all approach will not fit every company. In addition, since interest rate changes will affect the weighted-average cost of capital used in a discounted cash flow analysis, management should consider whether tightening credit has had an impact on debt-to-equity ratios. Even if a company is projecting solid profitable growth, its ability to grow could be challenged by labor availability in a tight labor market.

Management should consider the above factors, among others, in the preparation and review of forecasts and should challenge whether historical results and relationships continue to be indicative of future projected results. It should also consider potential fraud risks and schemes related to pressures resulting from interest rate changes, since such pressures could affect the company's forecasts and ability to meet targets for key performance indicators.

### **1.1.3 Inflation**

Although the effects of inflation vary by company, there are some common topics that life sciences companies should evaluate when considering how recent inflationary trends may affect their accounting and financial reporting.

Because inflation is most likely driving up costs of acquiring goods/inventory and related packaging materials, as well as employee wages, life sciences companies should consider whether they can pass along those increased costs to their customers.

Life sciences companies may also have increased costs associated with long-term revenue contracts that they may or may not be able to pass along to their customers. If a company is unable to raise its prices under a revenue contract, the company's estimated profitability on the contract may decline or result in a loss on the contract. Companies should consider the potential accounting implications of reduced or negative profitability on a revenue contract, including the period in which to record a loss if applicable.

Inflation may result in renegotiating long-term contracts, such as leases or long-term supply agreements, which in turn may have potential accounting implications. For example, depending on the terms, a modification to a lease contract may require a company to reassess the classification and measurement of the lease.

In addition, global central banks have raised interest rates in an attempt to temper the impact of high inflation. Companies should consider whether the increase in interest rates has resulted in an impairment of financial assets. Companies should also consider potential impacts on estimated credit and loan loss reserves.

As life sciences companies review their investment strategies in light of recent inflation, they may consider making different types of investments or moving away from holding excess cash on hand. For example, a company may consider investing in digital assets (such as cryptocurrencies) or Treasury Inflation-Protected Securities as a hedge against inflation. Companies contemplating such investments should consider the complex accounting and financial reporting that may result from holding them. For example, inflation-indexed debt securities are subject to specific interest recognition guidance under U.S. GAAP and should be evaluated to determine whether they contain any derivative that is required to be accounted for separately for accounting purposes.

Further, life sciences companies should monitor the appropriateness of the discount rate used to measure any pension-related liabilities, particularly since even a seemingly small change in the discount rate can affect a company's pension liability significantly. For example, higher interest rates may lead to decreases in pension liabilities and required employer contributions. However, such decreases may be offset by higher employee wages, which are further discussed in [Section 1.1.4](#).

### **1.1.4 Labor Shortages**

Labor shortages may manifest themselves in the form of employee turnover, departures, and demands for higher wages at all levels of the organization. As costs of retaining labor increase in a production environment, companies should consider how these increased labor costs affect the cost of inventory and whether these higher costs can be offset by price increases as companies sell these goods to their customers. Companies should also consider the potential accounting implications of including increased costs in inventory.

To address employee demands for increased compensation, many companies are revisiting their compensation structures. Adjustments may take the form of increased hourly wages, retention bonuses, improved incentive compensation or stock compensation, or other benefits. Companies should consider the accounting implications of these changes in compensation structure. For example, if a company provides retention bonuses to employees, the company should consider the contractual terms of those arrangements and assess during what period those bonuses should be recognized. In addition, certain companies may need to consider changes in their workforce and the related compensation structure when evaluating assumptions used to measure their pension liability.

In response to a shortage in labor, some companies may be forced to operate at a reduced capacity. In such a case, companies should consider whether there are costs that have been capitalized into inventory historically but should be expensed currently because of abnormal production levels (e.g., indirect costs such as rent and depreciation).

Increased turnover and the shortage of employees may also put stress on a company's internal control environment. As employee responsibilities shift, companies should assess whether appropriately skilled and trained individuals are in place to effectively design, implement, operate, and monitor controls, including controls related to information technology (IT).

### **1.1.5 Communication With Stakeholders**

In addition to considering potential accounting-related impacts of inflation and labor shortages, life sciences companies will need to evaluate their communication strategies related to such risks and uncertainties. While private and public companies alike will need to comply with the disclosure requirements under U.S. GAAP, public companies will also need to consider the SEC's reporting requirements, including required disclosures about trends and uncertainties in the business, risk factors, and MD&A sections of filings. For many companies, these issues may require disclosure in MD&A of known trends or uncertainties that could affect sales, net income, or liquidity. Further, companies should tailor these disclosures to their specific circumstances and avoid generic boilerplate descriptions of inflation and labor shortages. When public companies identify new or emerging risks in the current environment, they should consider the impacts of those risks and corresponding disclosure in MD&A.

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff discussed the importance of disclosures about risks and uncertainties, specifically the need for registrants to provide high-quality and transparent disclosures, especially during times of economic uncertainty. The SEC staff noted that when registrants discuss information about estimates and uncertainties, they should clearly explain their significant management judgments, key assumptions, and known risks so that investors can better understand the significant risks of adjustments to the financial statements in future periods and make informed investment decisions.

For more information, see Deloitte's September 15, 2023, [Financial Reporting Alert](#) and December 10, 2023, [Heads Up](#).

### **1.1.6 Ongoing Accounting and Financial Reporting Considerations Stemming From the Current Environment**

We believe that in addition to the economic factors discussed above, the following accounting and reporting issues will continue to be the most pervasive and challenging for life sciences entities as a result of the current environment:

- *Preparation of forward-looking cash flow estimates and forecasts* — The use of forward-looking information is pervasive in an entity's assessment of, among other things, the impairment of nonfinancial assets (including goodwill), the realizability of deferred tax assets, and the entity's ability to continue as a going concern. Unique complexities associated with preparing forward-looking information in the current environment include the following:
  - There is a wide range of possible outcomes.
  - The associated economic impact of the current environment is highly dependent on variables that are difficult to predict and may not affect all subsectors the same.
  - Each entity must then translate the effect of those macro conditions into estimates of its own future cash flows.

Nevertheless, entities will need to make good-faith estimates, prepare comprehensive documentation supporting the basis for such estimates, and provide robust disclosure of the key assumptions used and, potentially, their sensitivity to change.

- *Recoverability and impairment of assets* — Perhaps the most acute examples of the increased challenge associated with forward-looking information are the impairment tests for long-lived assets, intangibles, and goodwill. These nonfinancial assets use recoverability and impairment models that rely on the development of cash flow projections that are subject to the significant uncertainties noted above. However, impairments establish a new cost basis for the assets and do not permit the subsequent reversal of the recorded impairment. Good-faith estimates in the current reporting period could result in material recorded impairments; if unforeseen favorable developments occur in subsequent quarters, the recognized impairment would no longer be indicated, but it cannot be reversed.
- *Accounting for financial assets* — At the onset of the pandemic, many entities experienced severe declines in the fair value of financial assets, particularly equity securities. Likewise, the ability of debtors to comply with the terms of loans and similar instruments was adversely affected. Entities should continue to carefully consider and apply the appropriate impairment and loss recognition guidance.

- *Contract modifications and penalties* — Changes in economic activity caused by the current environment may cause many entities to renegotiate the terms of existing contracts and arrangements. Examples include contracts with customers, compensation arrangements with employees, leases, and the terms of many financial assets and liabilities. As a result of these changes, entities will need to ensure that the appropriate guidance in U.S. GAAP is considered.
- *Subsequent events* — It may be challenging for an entity to separate recognized and unrecognized subsequent events in a global marketplace that is extremely volatile and in which major developments occur daily (e.g., the stock market's daily reaction to new information). Although entities may not have all facts “on hand” on the balance sheet date, once such facts are gathered, an assessment must be based on conditions as they existed on the balance sheet date. As the global landscape evolves, entities are encouraged to remain vigilant, document the nature and timing of events, and consult with their accounting advisers.
- *Going concern* — In the current environment, entities need to consider whether, in their specific circumstances, they have the ability to continue as a going concern within one year after the date on which the interim or annual financial statements are issued (or available to be issued, when applicable). The initial assessment (before consideration of management’s plans) will require an entity to consider, among other things, (1) the extent of operational disruption, (2) potential diminished demand for products or services, (3) contractual obligations due or anticipated within one year, (4) potential liquidity and working capital shortfalls, and (5) access to existing sources of capital (e.g., available line of credit). An entity can only base this initial assessment on information that is available (i.e., known and reasonably knowable) as of the issuance date of the financial statements. An entity may be able to alleviate substantial doubt, if such doubt exists, if it is probable that the entity’s plans will be effectively implemented and, when implemented, will mitigate the conditions that are raising substantial doubt in the first instance and will do so within one year after the issuance date of the financial statements. Further, an entity must provide comprehensive disclosures in its annual and interim financial statements when events and conditions are identified that raise substantial doubt about the entity’s ability to continue as a going concern even when management’s plans alleviate such doubt.
- *Loss contingencies* — Many entities are facing disruption and delays or are incurring other contingencies in the current environment. Entities are required to disclose both recognized and unrecognized contingencies and the nature of the contingencies, particularly when loss is reasonably possible but not yet recorded in the financial statements.
- *Share-based compensation* — Many life sciences entities provide share-based compensation to incentivize employees and retain talent. Share-based compensation awards may be subject to various vesting conditions and requirements that have been affected in the current environment or, as a result of declines in financial performance of the underlying stock, may be considered deeply out-of-the-money. Entities should carefully evaluate changes in these awards to ensure that the appropriate accounting treatments are being applied.

Entities must carefully consider their unique circumstances and risk exposures when analyzing how recent events may affect their financial reporting. Specifically, financial reporting and related financial statement disclosures need to convey all material current or potential effects of the current environment. It is also critical that management understand the risks entities face and how those risks affect them. Further, SEC registrants must consider whether (1) certain disclosures are required by Form 8-K (e.g., material impairment charges, liquidity events that result in a violation of debt covenants) and (2) to disclose information in areas such as MD&A or the risk factors section in addition to their disclosures in the footnotes to the financial statements.

Registrants must consider the impacts of the current environment on their required disclosures and public filings. Applicable SEC staff guidance includes [CF Disclosure Guidance Topics 9](#) and [9A](#) (which were issued in response to the pandemic) and a [sample letter](#) discussing disclosure considerations (which was issued in response to the Russia-Ukraine War). While the guidance in those documents was prompted by specific events, it continues to apply in the current environment.

The remainder of this chapter further discusses key accounting and financial reporting considerations for life sciences entities related to conditions that may result from the current environment. In addition, disclosure matters related to the current environment are discussed in [Section 1.13](#). For more information about the topics highlighted in the sections below, see the following Deloitte *Financial Reporting Alert* newsletters:

- [“Accounting and Financial Reporting in Uncertain Times: Considerations for Navigating Macroeconomic and Geopolitical Challenges.”](#)
- [“Accounting and Financial Reporting Considerations Related to the Current Macroeconomic and Geopolitical Environment.”](#)
- [“Financial Reporting Considerations Related to COVID-19 and an Economic Downturn.”](#)
- [“COVID-19 and Financial Reporting Trends — Accounting for the Pandemic in the Current Quarter.”](#)
- [“COVID-19 and Non-GAAP Measures.”](#)
- [“COVID-19 Financial Reporting Trends — Different News or More of the Same?”](#)

## 1.2 Potential Impact on Contract R&D Arrangements

Life sciences entities that have contractual arrangements to perform contract R&D for others (e.g., biotechs and CROs) may experience changes in the cost of performing contract R&D (e.g., as a result of a shift in the mix of in-person monitoring visits and remote monitoring, or because of changes in patterns of enrolling patients in clinical trials), which could have revenue recognition implications. For example, an entity that uses a cost-based input method to measure its progress toward complete satisfaction of a performance obligation would need to reevaluate whether its measure of progress is affected by changes in the overall cost of the R&D program or whether any increased costs should be excluded from the measure of progress because they do not depict the entity's performance in transferring control of the contract R&D (e.g., if the costs are due to unexpected amounts of wasted materials, labor, or other resources). Further, the potential disruption in an entity's performance of contract R&D could affect its estimate of variable consideration in circumstances in which the entity is entitled to receive R&D milestone payments if (1) clinical trial regulatory approvals are received by a certain date, (2) regulatory approval for commercialization is ultimately achieved, or (3) both. See [Chapter 2](#) for more information about collaborative arrangements accounted for as revenue contracts.

### 1.3 Impairment of Nonfinancial Assets (Including Goodwill)

As a result of the changes in the current environment, life sciences entities should consider whether they are experiencing any conditions (e.g., decreased revenues, order cancellations, supply-chain disruptions, or declines in share price) that indicate that their assets should be tested for impairment (i.e., a “triggering event” has occurred). Even assets that have an annual impairment testing requirement, such as goodwill or indefinite-lived intangible assets, should be tested for impairment when a triggering event occurs. For example, the decline in global equity markets in the current environment may have led an entity to conclude that it was required to test goodwill for impairment (because a decline in market capitalization could signal a change in facts and circumstances “that would more likely than not reduce the fair value of a reporting unit below its carrying amount,” in accordance with ASC 350-20-35-30). The guidance on testing assets for impairment varies depending on the asset being tested. Some nonfinancial assets are tested for impairment individually, while others are tested as part of a larger unit of account. Further, some nonfinancial assets are tested by using a recoverability test, while others are tested by using a fair value or net realizable value test.

In addition, it is important to consider the order in which assets are tested so that the entity can ensure that any required adjustments are made before including those assets in the testing of larger units of account. Assets that are not held for sale should be tested for impairment in the following order: (1) assets outside the scope of ASC 360-10 (other than goodwill), such as inventory, capitalized costs of obtaining or fulfilling a revenue contract, and indefinite-lived intangible assets; (2) long-lived assets in accordance with ASC 360-10; and (3) goodwill in accordance with ASC 350-20.

#### 1.3.1 Indefinite-Lived Intangible Assets Other Than Goodwill

As stated in ASC 350-30-35-4, an indefinite-lived intangible asset is one for which “there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity.” Certain brands, trademarks, or licenses are common examples.

Indefinite-lived intangible assets are tested annually for impairment and more frequently if events or changes in circumstances indicate that it is more likely than not that the intangible asset is impaired in accordance with ASC 350-30. ASC 350-30-35-18B provides examples of these events or changes in circumstances, which include, but are not limited to, financial performance, legal or political factors, entity-specific events, and industry or market considerations. On the basis of the impairment assessment, if an entity determines that it is more likely than not that the carrying value of the intangible asset exceeds its fair value, the entity performs a valuation to determine the fair value of the asset and recognizes an impairment loss equal to the excess of the carrying amount of the intangible asset over its fair value.

A valuation technique that is often applied to the measurement of a brand or trademark is the relief from royalty method. This method, which focuses primarily on expected revenues and royalty rates, requires the entity to make fewer assumptions than other income methods. Entities are expected to use their best estimate of all required business and valuation assumptions for this or other income methods used to measure the fair value of an indefinite-lived intangible asset.

In addition to evaluating the need for an interim impairment test, an entity should also consider whether there are any indicators that an intangible asset classified as indefinite-lived has become finite-lived, which might occur if an entity changes its expected use of the asset in response to the effects of the current environment.





### Disclosure Considerations

ASC 350-30-50-3 provides specific disclosure requirements for each recognized impairment loss related to an intangible asset.

## 1.3.2 Long-Lived Assets

A life sciences entity should consider whether it is experiencing (1) a decline in revenues, (2) an increase in costs (i.e., a decline in net cash flows), or (3) both as a result of the current environment. Such changes may indicate that the entity should test its long-lived assets for recoverability. Although we expect each entity to be affected differently in terms of both the effects of the current environment on its cash flows and the susceptibility of its long-lived assets to impairment, an entity should document its considerations regarding the recoverability of its long-lived assets.

Entities are required by ASC 360-10-35-21 to test a long-lived asset (asset group) that is classified as held and used for recoverability “whenever events or changes in circumstances indicate that its carrying amount may not be recoverable” (e.g., a significant adverse change in the business climate that could affect the value of a long-lived asset [asset group]). Events or changes in circumstances that prompt a recoverability test are commonly referred to as “triggering events.” In light of events such as the idling of manufacturing facilities, or trends related to decreases in consumer spending, many entities are likely to experience one or more of the triggering events listed in ASC 360-10-35-21. For example, triggering events that may be present as a result of the current environment include, but are not limited to, a “significant decrease in the market price of a long-lived asset (asset group),” a “significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition,” or a “current-period operating or cash flow loss combined with . . . a projection or forecast that demonstrates continuing losses associated with the use of a long-lived asset (asset group).”

ASC 360-10-35-23 states that “a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.” Such a combination is called an asset group.

An asset group may include not only long-lived assets that are within the scope of ASC 360-10 but also other assets such as receivables, inventory, indefinite-lived intangible assets, or goodwill. ASC 360-10-15-5 provides a list of assets that are not within the scope of ASC 360-10. Note that ASC 360-10 applies to long-lived assets that are not within the scope of other GAAP, such as property, plant, and equipment (PP&E); finite-lived intangible assets (customer relationships, technology, brands, and tradenames); and right-of-use assets.

To test a long-lived asset (asset group) for recoverability, an entity compares the carrying value of the asset (asset group) to the undiscounted net cash flows generated from the asset’s (asset group’s) use and eventual disposal. While the use of undiscounted cash flows generally indicates that a long-lived asset (asset group) is less prone to impairment, reductions in the estimates of undiscounted cash flows based on the expected duration and magnitude of conditions in the current environment may indicate that the carrying amount of the long-lived asset (asset group) is not recoverable.

If an entity estimates future cash flows to test the recoverability of a long-lived asset (asset group), such an estimate should include only the future cash flows (cash inflows minus associated cash outflows) that are (1) directly associated with the asset (asset group) and (2) expected to arise as a direct result of the use and eventual disposition of the asset (asset group). To estimate future cash flows, the entity must consider both cash inflows and cash outflows. ASC 360 indicates that it may be useful for the entity to apply a probability-weighted approach when it is considering alternative courses of action to recover the carrying amount of a long-lived asset (asset group). Such an approach may also be beneficial when the

entity is considering alternative courses of action to manage cash outflows in response to anticipated revenue declines as well as when evaluating the extent of government intervention and the potential effects of any such intervention on both cash inflows and cash outflows.

ASC 360-10-35-30 states, in part, that the “assumptions used in developing [cash flow estimates should] be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others.”

If the entity determines that the carrying amount of the long-lived asset (asset group) is not recoverable, the entity then performs the next step in the impairment test by recognizing an impairment loss for the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. It then allocates that amount, in accordance with ASC 360-10-35-28, to the long-lived assets that are within the scope of ASC 360-10 “on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort.”

If an entity determines that a long-lived asset (asset group) is recoverable, it does not recognize an impairment loss, even if the carrying value of that asset (asset group) exceeds its fair value. Regardless of whether an entity recognizes an impairment loss, it should still consider whether the existence of a trigger indicates that there has been a change in the useful life or salvage value of its long-lived assets. If so, it should revise its depreciation or amortization estimates accordingly.

Sometimes, an entity may conclude that the affected long-lived assets will be sold, abandoned, or otherwise disposed of. Under ASC 360, if the held-for-sale criteria in ASC 360-10-45-9 are met, the entity is required to measure the asset (asset group) “at the lower of its carrying amount or [its] fair value less cost to sell” in accordance with ASC 360-10-35-43. A long-lived asset that will be abandoned will continue to be classified as held and used until it is disposed of. Such an asset is disposed of when it ceases to be used. However, a “long-lived asset that [is] temporarily idled shall not be accounted for as if abandoned,” in accordance with ASC 360-10-35-49. Further, in accordance with ASC 360-10-35-48, “[w]hen a long-lived asset ceases to be used, the carrying amount of the asset should equal its salvage value, if any.”



### Disclosure Considerations

ASC 360-10-50 provides disclosure requirements for impairments of long-lived assets classified as held and used and for long-lived assets classified as held for sale or disposed of.

## 1.4 Forecasting

Life sciences entities continue to face challenges related to forecasting as a result of the ongoing uncertainties associated with the current environment.

In thinking about both a new normal and future trends, some life sciences companies are evaluating whether customer preferences have shifted in such a way that they most likely will not reach the same performance levels they achieved before the pandemic. Other companies that may be benefiting currently are assessing whether they will continue to outperform in future periods or revert back to historical performance, or whether other trends or drivers (e.g., inflation, future regulations) are affecting results.

With all the unknowns and uncertainties, including the timing and pattern of economic recovery, we have noted that more companies are preparing multiple forecasts with different recovery scenarios and are probability-weighting the likelihood of each outcome. In addition, with the increase of liquidity challenges and shortfalls of capital resources, many companies have enhanced their focus on forecasting cash position and cash flows rather than allowing cash flow estimates to be simply derived on the basis of forecasted operations.

While the approach to forecasting operations that some companies have taken leverages historical data from the 2008 financial crisis (the “financial crisis”) as an appropriate benchmark, we believe that such companies should exercise caution in determining the extent to which the financial crisis is comparable to the current environment given the fundamental differences between the two economic periods. For example, the current environment may present a myriad of factors such as change in customer behavior, workforce adjustments, and industry-specific impacts, which were not necessarily present during the financial crisis and may not affect all entities in the same fashion.

While we do not believe that there is a one-size-fits-all approach to addressing the forecasting challenges that exist currently, we have seen the following strategies prove to be effective for a number of companies:

- Evaluating recovery and financial forecasts from an outside-in perspective first. Specifically, focusing on the factors, issues, and conditions outside of a company's control that are known and knowable.
- Automating components of forecasting to help remove bias and facilitate more real-time and frequent reforecasting as key drivers and trends change, while also analyzing data at a more detailed level.
- Considering facts that both support and contradict assumptions regarding the company's timing and pattern of recovery, sustainability, and growth.

## 1.5 Revenue Contracts

Some life sciences companies may seek to mitigate the effects of the current environment by offering features such as price concessions, discounts on the purchase of future goods or services, free goods or services, extended payment terms, opportunities to terminate agreements without penalty, or revisions to purchase commitments.

If revisions are made to a revenue contract, significantly different reporting outcomes may result depending on the nature of the changes. Companies must consider the specific facts and circumstances of changes in contractual terms (including their business practices and communications with customers) to determine whether to account for the impact of such changes at a single point in time or over a longer period. See [Chapter 2](#) for more considerations related to revenue recognition.

### 1.5.1 Failure-to-Supply Penalties

Some contracts with customers include a clause requiring the entity to pay a penalty to the customer if it is unable to fulfill an order on a timely basis or to meet certain performance conditions specified in the contract. As illustrated in Example 20 in ASC 606 (ASC 606-10-55-194 through 55-196), an entity should consider such a penalty to be variable consideration in estimating the transaction price with the customer. Further, the obligation to pay a penalty under such a scenario, once triggered, does not represent a contingent loss under ASC 450-20; rather, the obligation should be accounted for as a contractual liability. The probability of payment is irrelevant if settlement of the liability is required by law or by contract. That is, other than deferred revenues, liabilities established by law or contract should

be recorded at their stated amounts unless the guidance in U.S. GAAP requires otherwise. An entity's uncertainty about whether an obligee will require performance does not (1) allow the entity to choose to avoid the future sacrifice or (2) relieve the entity of the obligation. Once recognized, a contractual or legal liability that is not deferred revenue (i.e., a contract liability under ASC 606) should be derecognized only when the conditions for liability derecognition in ASC 405-20-40-1 have been met (i.e., relief through repayment, or through a legal release either judicially or by the creditor).

## 1.5.2 Retroactive Payback Provisions

In certain countries, companies are required to pay rebates to the country's government health care system if domestic industry sales exceed specified thresholds in a given year. In such a case, the portion of the payback allocated to an individual company is based on that company's current market share (or sales) in relation to the industry as a whole. For revenue recognition purposes, a retroactive payback provision represents variable consideration that would need to be estimated, subject to the variable consideration constraint. In light of the significant health care costs being incurred in many jurisdictions with such provisions, there may be an increased likelihood that domestic industry sales will exceed specified thresholds. Conversely, a life sciences entity's market share could be negatively affected by supply-chain disruption as a result of the current environment. Therefore, an entity may need to consider revising its estimates of such provisions.

## 1.6 Going-Concern Analysis and Disclosures

The current environment is significantly disrupting the operations of many businesses. Entities will need to consider whether such disruption will be prolonged and result in diminished demand for products or services or significant liquidity shortfalls (or both) that, among other things, raise substantial doubt about whether the entity may be able to continue as a going concern.

As part of performing this assessment, management may need to consider whether the entity's financial statements should continue to be prepared on a going-concern basis (i.e., whether ASC 205-30 is applicable). Even more importantly, management must consider whether (on the basis of ASC 205-40), (1) there are conditions and events that, when considered in the aggregate, raise substantial doubt about the entity's ability to continue as a going concern within one year after the date on which the interim or annual financial statements are issued and (2) these conditions are able to be mitigated by management's plans.

ASC 205-40 requires an entity to provide disclosures in the **annual** and **interim** financial statements when events and conditions are identified that raise substantial doubt about the entity's ability to continue as a going concern within one year after the financial statements are issued. Such disclosures are required even when management's plans alleviate such doubt about the entity's ability to continue as a going concern. If management's plans do not alleviate substantial doubt about the entity's ability to continue as a going concern, in addition to the required disclosures, management must state in the notes to the financial statements that there is substantial doubt about the entity's ability to continue as a going concern within one year after the date on which the annual or interim financial statements are issued.

As indicated in ASC 205-40-55-2, assessing whether there is substantial doubt about an entity's ability to continue as a going concern may involve the consideration of factors such as the following:

- a. Negative financial trends, for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and other adverse key financial ratios

- b. Other indications of possible financial difficulties, for example, default on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, a need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to seek new sources or methods of financing or to dispose of substantial assets
- c. Internal matters, for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, and a need to significantly revise operations
- d. External matters, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; and an uninsured or underinsured catastrophe such as a hurricane, tornado, earthquake, or flood.

Entities should consider the impacts to their forecasts described earlier in this chapter when updating their going-concern analysis. Management should be mindful of the timing of certain forecasted transactions and the entity's ability to accurately predict and consummate those transactions in the current environment. See [Section 13.6](#) for more information about a going concern.

## 1.7 Subsequent Events

Given the current environment and the likelihood that events may occur rapidly or unexpectedly, entities should carefully evaluate information that becomes available after the balance sheet date but before the issuance of the financial statements. ASC 855-10-25-1 and ASC 855-10-25-3 provide the following guidance on evaluating subsequent events:

### ASC 855-10

**25-1** An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

**25-3** An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.

Often the "events" are (1) company-specific and (2) associated with a specific account that permits a more precise analysis. However, sometimes the "events" are macroeconomic (such as those resulting from the current environment) and have a pervasive impact on many estimates in a set of financial statements, which may make it difficult to ascertain whether such conditions "existed" on the balance sheet date. The medium-term and long-term effects of the current environment on economic activity are still unknown. However, the current environment will be a factor in an entity's analysis of estimates residing in the financial statements, including, but not limited to, estimates related to receivable reserves, obsolescence reserves, impairment analyses, variable and contingent compensation, and current expected credit loss reserves. While the events stemming from the current environment are extremely volatile, entities will nevertheless be required to consider conditions as they existed on the balance sheet date when evaluating subsequent events. There are currently many approaches to the consideration of subsequent events in complex estimate analyses such as impairment models (e.g., whether changes in circumstances that alter projection models before the issuance date can be considered given the fluidity of the situation).

Given the current environment, significant judgment will most likely be required in assessments related to subsequent event matters. Entities are encouraged to consult with their advisers as needed.



### Disclosure Considerations

ASC 855-10-50-2 notes, in part, that “[s]ome nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading.” In such circumstances, the disclosures must include (1) the “nature of the event” and (2) an “estimate of its financial effect, or a statement that such an estimate cannot be made.”

## 1.8 Loss Contingencies

ASC 450 defines a loss contingency as an “existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur.” Instability in the economy resulting from the current environment may cause entities to incur losses that should be recognized, disclosed, or both.

All loss contingencies (including incurred but not reported [IBNR] claims such as those related to medical care) should be evaluated under ASC 450-20 unless the contingency is within the scope of other authoritative literature that specifically prescribes an alternate accounting model. ASC 450-20 requires accrual of a loss contingency when (1) it is probable that a loss has been incurred and (2) the amount can be reasonably estimated. To accrue a loss contingency, an entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss associated with the uncertain event. Loss contingencies that do not meet both recognition criteria may need to be disclosed in the financial statements. Given the general uncertainty associated with the current environment, entities may find it challenging to develop estimates for loss contingencies. For example, an entity that is self-insured for medical claims may have difficulty estimating its IBNR liability if it concludes that historical claim patterns may not be representative of future expected claims because of the current environment.



### Disclosure Considerations

Under ASC 450-20-50, entities must disclose both recognized and unrecognized contingencies if certain criteria are met. In some situations, disclosure of the nature of the accrual and amount accrued may be necessary to prevent the financial statements from being misleading. For unrecognized contingencies, disclosure of the nature of the contingency and an estimate of the possible loss or range of loss (or a statement that an estimate cannot be made) is required in certain situations. Specifically, disclosure is called for if there is a reasonable possibility that a loss may be incurred but has not been accrued in the financial statements because the amount is not probable or reasonably estimable. Disclosure is also required if there is a reasonable possibility of unrecorded losses in excess of the amount accrued in the financial statements.

For more information about loss contingencies, see Deloitte’s Roadmap [Contingencies, Loss Recoveries, and Guarantees](#) and [Chapter 6](#) of this Guide.

## 1.9 Recognition of Losses on Firmly Committed Executory Contracts

At the inception of a firmly committed executory contract, both parties to the contract expect to receive benefits that are equal to or greater than the costs to be incurred under the contract. Because of the impacts of the current environment, the fair value of the remaining contractual rights of a firmly committed executory contract may unexpectedly decline below the remaining costs, resulting in a firmly committed executory loss contract. For example, an entity engaged to provide services to its customer in accordance with a firmly committed executory contract may experience a significant increase in the cost of providing the services (e.g., lack of availability of personnel to provide services resulting in the use of higher outsourced labor cost), which could result in an overall loss on the contract. We generally believe

that in the absence of specific guidance to the contrary (e.g., a firm purchase commitment for goods or inventory under ASC 330 or certain executory contracts related to exit or disposal activities within the scope of ASC 420), it is inappropriate to accrue for a loss related to a firmly committed executory contract.

## 1.10 Future Operating Losses

An entity may forecast operating losses for a certain period as a result of the current environment. Such losses may result from declines in customer demand or disruptions in the supply chain. Future operating losses do not meet the definition of a liability, nor do they qualify for accrual under ASC 450-20. Instead, they should be reflected in the period in which the related costs are incurred.

## 1.11 Insurance Recoveries

Entities that incur losses stemming from the current environment may be entitled to insurance recoveries. For example, losses associated with increased medical claims, asset impairments, or shareholder litigation may be considered insured losses by many entities. Further, entities may have business interruption insurance that provides coverage for lost profits due to a suspension of the entities' operations.

### 1.11.1 Insured Losses

If an entity incurs a loss attributable to the impairment of an asset or to the incurrence of a liability and expects to recover all or a portion of that loss through an insurance claim, the entity should record an asset for the amount for which recovery from the insurance claim is considered probable (not to exceed the amount of the total losses recognized). The entity should subsequently recognize amounts greater than those for which recovery from an insurance claim was initially deemed probable only to the extent that those amounts do not exceed actual additional covered losses or direct, incremental costs incurred to obtain the insurance recovery. A conclusion that a potential insurance recovery is probable may involve significant judgment and should be based on all relevant facts and circumstances. In determining whether it is probable that an insurance recovery will be received, an entity will most likely need, among other factors, to understand the solvency of the insurance carrier and have had enough dialogue and historical experience with the insurer related to the type of claim in question to assess the likelihood of payment. Other potential challenges an entity may encounter when evaluating whether a loss is considered recoverable through insurance include, but are not limited to, (1) the need to consider whether losses stemming from a pandemic are specifically excluded as a covered event, (2) the extent of coverage and limits, including multiple layers of insurance from different carriers, and (3) the extent, if any, to which the insurance carrier disputes coverage. Consultation with legal counsel may also be necessary.



### Connecting the Dots

We believe that while applicable to SEC registrants, the following guidance from footnote 49 of [SAB Topic 5.Y](#) applies to all entities evaluating an insured loss that is contested by the insurance carrier:

The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.



Any expected recovery that is greater than covered losses or direct, incremental costs incurred represents a gain contingency and therefore has a higher recognition threshold. An entity should generally recognize insurance proceeds that will result in a gain when the proceeds are realized or realizable, whichever is earlier. Such insurance proceeds are realized when the insurance carrier settles the claim and no longer contests payment. Payment alone does not mean that realization has occurred if such payment is made under protest or is subject to refund.

### **1.11.2 Business Interruption**

Events associated with the current environment have led many entities to temporarily suspend operations for reasons ranging from supply-chain disruption to, during the pandemic, state and local government orders requiring individuals to shelter in place and temporarily cease operations. Business interruption insurance differs from other types of insurance coverage in that it is designed to protect the prospective earnings or profits of the insured entity. That is, business interruption insurance provides coverage if business operations are suspended because of the loss of use of property and equipment resulting from a covered loss. Business interruption insurance also generally provides for reimbursement of certain costs and losses incurred during the interruption period. Such costs may be analogous to losses from property damage and, accordingly, it may be appropriate to record a receivable for amounts whose recovery is considered probable. We encourage entities to consult with their independent auditors in connection with their evaluation of whether a receivable may be recorded for expected insurance recoveries associated with fixed costs incurred during an interruption period.

The loss of profit margin is considered a gain contingency and should be recognized when the gain contingency is resolved (i.e., the proceeds are realized or realizable). Because of the complex and uncertain nature of the settlement negotiation process, such recognition generally occurs at the time of final settlement or when nonrefundable cash advances are made.

### **1.11.3 Classification of Insurance Recoveries**

ASC 220-30-45-1 addresses other income statement presentation matters related to business interruption insurance from the perspective of classification and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing [U.S. GAAP].”

For presentation within the statement of cash flows, ASC 230-10-45-21B indicates that “[c]ash receipts resulting from the settlement of insurance claims, excluding proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, shall be classified on the basis of the related insurance coverage (that is, the nature of the loss).” For example, insurance settlement proceeds received as a result of claims related to a business interruption should be classified as operating activities.

## **1.12 Share-Based Compensation Plans and Awards**

We have seen an increased level of activity related to share-based compensation plans and awards. The ongoing impact of the current environment has led to the obsolescence of many previously established company-specific performance targets and the possibility that employees' outstanding stock options could become “underwater” or out-of-the-money. While some companies have modified awards to revise performance targets, others have delayed the timing of granting awards, issued “off-cycle” grants, modified the strike price of existing underwater options, and extended the exercise period for awards, all presumably in an effort to ensure that share-based compensation arrangements continue to provide the intended motivation for company employees and executives to work toward accomplishing company goals and objectives.



Regardless of the specific action taken, modifications of stock awards can lead to a host of accounting challenges and consequences. For example, when revising performance targets, companies need to be mindful that the performance conditions are sufficiently objective and determinable; otherwise, an award may not be considered “granted,” leading to variable and potentially increased expense if compensation cost must be recorded before the grant date is established. In addition, when modifying stock awards, companies need to consider whether such awards were expected to vest before the modification and, if so, whether the modified awards provide incremental value to the recipients. Further, companies that grant stock options or similar awards will need to consider recent market volatility when valuing their stock awards and the related compensation expense to be reported. See [Chapter 9](#) for additional considerations related to share-based compensation.

### 1.13 Considerations Related to Reflecting Impacts of the Current Environment in Non-GAAP Measures

While some of the key SEC requirements and interpretations related to non-GAAP measures address the prominence, reconciliation, usefulness, and purpose of such measures, an overarching theme of the guidance is that they should not be misleading, regardless of whether the measures are used in a filing (e.g., Form 10-K) or elsewhere (e.g., press release). As described in [Section 100](#) of the SEC Division of Corporation Finance (the “Division”) Compliance and Disclosure Interpretations (C&DIs) on non-GAAP financial measures, non-GAAP measures that could mislead investors may include those that:

- Exclude normal, recurring cash operating expenses necessary for business operations.
- Are presented inconsistently between periods (e.g., adjusting for an item in the current reporting period but not doing so for a similar item in the prior period without appropriately disclosing the change and explaining the reasons for it).
- Exclude certain nonrecurring charges but do not exclude nonrecurring gains (e.g., “cherry picking” non-GAAP adjustments to achieve the most positive measure).
- Are based on individually tailored accounting principles, including certain adjusted revenue measures.
- Are mislabeled or not clearly labeled as non-GAAP measures or otherwise include adjustments that are not clearly or accurately labeled or described.

In interactions with the SEC staff regarding non-GAAP measures viewed as misleading, some registrants have proposed supporting continued presentation of such measures by adding transparent disclosures related to the calculation of the measures or about the measures’ purpose and use. However, Question 100.06 of the C&DIs indicates that even detailed disclosures about a misleading measure would not prevent it from being misleading.

At the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff indicated that once a non-GAAP measure or adjustment is concluded to be misleading or otherwise inconsistent with non-GAAP rules, the staff expects the registrant to correct the presentation in the next filing or publicly available SEC document by removing the measure or adjustment. If comparable periods are presented, the non-GAAP measure or adjustment should be removed from all periods presented. At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC further emphasized that non-GAAP measures continue to be one of the topics the SEC staff comments on most frequently.



## Changing Lanes

On December 13, 2022, the SEC staff released **new and updated C&DIs** on non-GAAP financial measures. The staff has observed that the volume of non-GAAP disclosure comments has remained high over the past several years and that it continues to receive questions on this topic. The new and updated C&DIs help increase the transparency of the SEC staff's process for evaluating certain non-GAAP measures as well as its criteria for considering such measures misleading.

At the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Division Chief Accountant Lindsay McCord emphasized that the intent of the new and updated C&DIs is to communicate interpretive feedback that the SEC staff has provided to registrants in various speeches and the comment letter process. In addition, she noted that the updates to the C&DIs are not intended to change the SEC staff's position on non-GAAP adjustments that it has not objected to in the past (e.g., adjustments for restructuring costs and stock-based compensation). However, Ms. McCord further acknowledged that conclusions about the application of the C&DIs to non-GAAP measures and adjustments will depend on a registrant's individual facts and circumstances.

The following changes related to misleading non-GAAP measures were made to the C&DIs:

- C&DI Question 100.01 was updated to add interpretive guidance on what may be considered normal or recurring. The C&DI cautions issuers that a non-GAAP measure may be considered misleading if it excludes cash operating expenses that are normal and recurring in the operation of a registrant's business.

At the 2022 AICPA & CIMA Conference on Current SEC and PCAOB Developments, Ms. McCord explained that the SEC staff evaluates whether an expense is "normal" by considering the nature and effect of the non-GAAP adjustment and how the expense is related to the registrant's operations, revenue-generating activities, business strategy, industry, and regulatory environment. She also noted that the SEC staff evaluates whether an operating expense is considered "recurring" when it occurs repeatedly or occasionally, including at irregular intervals of reoccurrence.

- C&DI Question 100.04 was updated to clarify that adjustments that represent the application of individually tailored accounting principles extend beyond the original example of adjustments that accelerate revenue recognition. The C&DI specifies that non-GAAP adjustments that change the GAAP recognition and measurement principles would be considered individually tailored and may cause the non-GAAP measure presentation to be misleading. The C&DI includes new examples that illustrate the application of individually tailored accounting principles and thus may be misleading.
- C&DI Question 100.05 was added to highlight the SEC's guidance that non-GAAP measures should be labeled as such and that adjustments should be clearly labeled and described in the disclosures. The C&DI also gives examples of misleading labels and descriptions for non-GAAP measures.
- C&DI Question 100.06 was added to emphasize that no amount of disclosure can make a measure compliant with the non-GAAP rules if it has been determined to be misleading.

Further, when evaluating whether an adjustment stemming from the current environment is appropriate in a non-GAAP measure, a registrant should consider various factors, including, but not limited to, whether the adjustment is:

- Directly related to the current environment.
- Incremental to normal operations and nonrecurring (i.e., it is not expected to become the new normal).
- Objectively quantifiable, as opposed to an estimate or projection.

A registrant must use judgment when evaluating whether an adjustment is consistent with these factors. However, we believe that a non-GAAP measure of performance that eliminates normal recurring cash operating expenses would generally not be appropriate.

In addition, any new adjustments or changes to non-GAAP measures related to the current environment should be clearly labeled, and changes to such measures should be transparently disclosed. If new adjustments to non-GAAP measures are added because of the current environment, an entity should ensure that its disclosure controls and procedures address the assessment and approval of the revised non-GAAP measures, including the consistency of presentation between periods and transparent disclosures about any changes.

See Deloitte's Roadmap [Non-GAAP Financial Measures and Metrics](#) for more information about SEC requirements and interpretations related to such measures and metrics. In addition, see Deloitte's Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#) for current trends in SEC comments.

### **1.13.1 Alternatives to Non-GAAP Measures**

Given the potential challenges associated with many of the adjustments discussed above, an SEC registrant may determine that transparent disclosure in MD&A may more effectively inform investors about certain impacts of the current environment than non-GAAP measures. For example, if a registrant elects to provide disclosures that simply quantify the estimated impact of the current environment on financial statement line items without adjusting the registrant's GAAP results (i.e., without establishing new totals or subtotals), those disclosures are not considered non-GAAP measures. If a registrant provides disclosure that does not adjust a GAAP measure but instead describes unusual or significant activities that occurred during the period, the disclosure would not be subject to the SEC's requirements and interpretations related to non-GAAP measures. When presenting disclosure alternatives, a registrant should disclose individually material financial statement impacts stemming from the current environment separately.

# Chapter 2 — Revenue Recognition

## 2.1 Introduction

In May 2014, the FASB and the International Accounting Standards Board (IASB®) issued their final standard on revenue from contracts with customers (the “revenue standard” or the “standard”). Issued by the FASB as [ASU 2014-09](#) (codified primarily in ASC 606) and by the IASB as IFRS 15 and subsequently amended, the standard outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. Further, the standard supersedes most legacy revenue recognition guidance, including industry-specific guidance.

Upon issuing the revenue standard, the FASB and IASB formed a joint revenue transition resource group (TRG). The purpose of the TRG was not to issue guidance but instead to seek and provide feedback on potential issues related to implementation of the revenue standard. By analyzing and discussing potential implementation issues, the TRG helped the boards determine whether to take additional action, such as providing clarification or issuing other guidance (in the form of additional ASUs, in the case of the FASB).

ASU 2014-09 states that the core principle of the standard’s revenue recognition guidance is that an “entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services.” The ASU indicates that an entity should perform the following five steps in recognizing revenue:

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

The following graphic summarizes the five-step model for recognizing revenue under ASC 606:

<p><b>1. Identify the contract with a customer</b></p>	<ul style="list-style-type: none"> <li>• A contract is an agreement between two or more parties that creates enforceable rights and obligations.</li> <li>• A contract can be written, oral, or implied by an entity's customary business practices.</li> <li>• For a contract to exist under ASC 606, the following five criteria must be met: <ul style="list-style-type: none"> <li>◦ The parties to the contract have approved the contract.</li> <li>◦ The entity can identify each party's rights.</li> <li>◦ The entity can identify the payment terms.</li> <li>◦ The contract has commercial substance.</li> <li>◦ It is probable that the entity will collect the amount to which it expects to be entitled.</li> </ul> </li> </ul>
<p><b>2. Identify the performance obligations</b></p>	<ul style="list-style-type: none"> <li>• A performance obligation is the promise to transfer to the customer a good or service (or bundle of goods or services) that is distinct.</li> <li>• Distinct goods and services should be accounted for as separate units of account.</li> <li>• Entities need to determine whether a good or service (or bundle of goods or services) is "capable of being distinct" and "distinct in the context of the contract."</li> <li>• A series of substantially the same goods or services for which control transfers over time and that have the same pattern of transfer is accounted for as a single performance obligation.</li> </ul>
<p><b>3. Determine the transaction price</b></p>	<ul style="list-style-type: none"> <li>• The transaction price is the amount the entity expects to be entitled to in exchange for transferring promised goods or services to the customer.</li> <li>• The transaction price may include fixed amounts, variable amounts, or both.</li> <li>• To determine the transaction price, entities should consider the effects of: <ul style="list-style-type: none"> <li>◦ Variable consideration.</li> <li>◦ The constraint on estimates of variable consideration.</li> <li>◦ Significant financing components.</li> <li>◦ Noncash consideration.</li> <li>◦ Consideration payable to the customer.</li> </ul> </li> </ul>
<p><b>4. Allocate the transaction price</b></p>	<ul style="list-style-type: none"> <li>• The transaction price (from step 3) is allocated to each performance obligation identified (from step 2).</li> <li>• On the basis of its specific circumstances, an entity would use one of the following approaches to allocate the transaction price to the performance obligations: <ul style="list-style-type: none"> <li>◦ Allocate according to each performance obligation's stand-alone selling price.</li> <li>◦ Allocate a discount or variable amount to a specific performance obligation (or bundle of specific performance obligations) if certain criteria are met.</li> </ul> </li> </ul>
<p><b>5. Recognize revenue when (or as) performance obligations are satisfied</b></p>	<p>Requires consideration of:</p> <ul style="list-style-type: none"> <li>• Revenue recognition when (or as) control of the good or service is passed to the customer.</li> <li>• The criteria for satisfying performance obligations and recognizing revenue over time.</li> <li>• Measurement of progress toward satisfying performance obligations to determine a pattern of revenue recognition over time.</li> <li>• Indicators of when performance obligations are satisfied and when to recognize revenue at a point in time.</li> </ul>

In addition, ASU 2014-09 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 the application of the revenue standard; and (3) the assets recognized from costs incurred to obtain or fulfill a contract with a customer.

The sections below discuss some of the key accounting considerations under the revenue standard for life sciences entities. For more detailed information about the revenue standard, see Deloitte’s Roadmap *Revenue Recognition* and its *TRG Snapshot* series.

## 2.2 Scope

The standard’s revenue guidance applies to all contracts with customers as defined by the standard except those that are within the scope of other topics in the *FASB Accounting Standards Codification* (the “Codification”). For example, the guidance does not apply to contracts within the scope of ASC 842 (leases). In addition, certain provisions of the standard’s revenue guidance also apply to transfers of nonfinancial assets, including in-substance nonfinancial assets that are not an output of an entity’s ordinary activities (e.g., intangible assets such as intellectual property [IP] rights). Such provisions include guidance on recognition (including determining the existence of a contract and control principles) and measurement.

Some of the more common issues that life sciences entities have faced when considering the scope of the revenue standard are discussed below.

### 2.2.1 Collaborative Arrangements

As life sciences entities continue to adapt to an ever-changing marketplace, some may increasingly look to enter into or expand collaborations with third parties for the development or commercialization of certain drug candidates or medical products in an effort to share in both the costs and risks associated with such activities.

Collaborative arrangements frequently involve activities such as R&D, regulatory activities, manufacturing, distribution, sales and marketing activities, and general and administrative tasks. Often, a governance structure (e.g., a joint steering committee) is established to facilitate decision-making during the terms of the endeavor. In collaborations, the parties may allocate responsibility for individual activities to each other or share the responsibility for one or more activities under a joint operating arrangement. Joint operating activities may involve the joint development and ultimate commercialization of IP related to a potential new drug candidate, R&D, marketing (including promotional activities and physician detailing), general and administrative activities, manufacturing, and distribution activities. On the basis of contractually defined terms, the participants share in the profits or losses associated with these joint activities.

Such arrangements are often complex and can vary significantly in scope, terms, and conditions as well as risk mitigation objectives. The following are common forms of these arrangements:

- *Codevelopment and comarketing arrangements* — Joint operating agreements in which both parties to the agreement assume roles and responsibilities.
- *Copromotion arrangements* — Agreements in which companies partner together and use each company’s commercial capabilities and experience to promote a product (owned by one of the parties) in various markets.

Upon entering into a collaborative arrangement, the participants frequently exchange up-front license fees and agree to subsequent payments based on the achievement of milestones during drug development, as well as future royalties and profit- or loss-sharing provisions.

As noted in [Section 2.2](#), the revenue standard applies to all contracts with customers. ASC 606-10-15-3 defines a customer as “a party that has contracted with an entity to obtain goods or services that are an output of the entity’s ordinary activities in exchange for consideration.”

The Background Information and Basis for Conclusions of [ASU 2014-09](#) explains that the relationship between a customer and a vendor varies from industry to industry and that companies will therefore have to consider their own facts and circumstances to determine who is a customer in an arrangement. For many contracts, this will not be very difficult to determine; however, paragraph BC54 of ASU 2014-09 provides examples of arrangements in which the facts and circumstances would have to be assessed, including “[c]ollaborative research and development efforts between biotechnology and pharmaceutical entities or similar arrangements in the aerospace and defense, technology, and healthcare industries, or in higher education.”

The example below illustrates how an entity would determine whether an arrangement is a collaborative arrangement and, if so, whether it should be accounted for under ASC 606.

### Example 2-1

Biotech B (the reporting entity) and Pharma P enter into an agreement to research, develop, and commercialize drug X. Biotech B will perform the R&D, and Pharma P will commercialize the drug. Both parties agree to participate equally in all activities that result from the research, development, and commercialization. Biotech B concludes that a collaborative arrangement exists because both parties are active participants and have agreed to share in the risks and rewards.

Despite this conclusion, however, there still could be a vendor-customer relationship as a result of some of the activities between the participants in accordance with the collaborative arrangement. If such a relationship exists, those parts of the contract that are related to the vendor-customer relationship may need to be accounted for under ASC 606.



### Connecting the Dots

ASC 606 does not change the guidance in ASC 808 on the income statement presentation, classification, and disclosures applicable to collaborative arrangements within the scope of the revenue standard. It is important to understand that a contract could be within the scope of both the revenue standard and the guidance on collaborative agreements, as indicated in paragraph BC55 of ASU 2014-09:

The Boards noted that a contract with a collaborator or a partner (for example, a joint arrangement as defined in IFRS 11, *Joint Arrangements*, or a collaborative arrangement within the scope of Topic 808, Collaborative Arrangements) also could be within the scope of Topic 606 if that collaborator or partner meets the definition of a customer for some or all of the terms of the arrangement.

This is important because companies may have to assess the scope of both ASC 606 and ASC 808 for these types of arrangements. In addition, the Background Information and Basis for Conclusions of ASU 2014-09 does not preclude companies from analogizing to the guidance in ASC 606 when accounting for collaborative arrangement transactions within the scope of ASC 808. See [Section 2.2.1.2](#) for considerations relevant to applying ASC 606 by analogy to collaborative arrangements.

When an entity enters into a collaboration, management must consider whether the arrangement meets the U.S. GAAP definition of a collaborative arrangement to determine whether the arrangement is subject to the requirements of ASC 808. The legal characterization of an arrangement (e.g., as a collaboration or a collaborative arrangement) does not necessarily make the arrangement qualify as a collaborative arrangement under U.S. GAAP.

ASC 808-10-20 defines a collaborative arrangement as a “contractual arrangement that involves a joint operating activity” and involves two (or more) parties that are both of the following:

- “[A]ctive participants in the activity.”
- “[E]xposed to significant risks and rewards dependent on the commercial success of the activity.”

On the basis of these criteria, some types of collaborations in the industry may not meet the definition of a collaborative arrangement and therefore would not be within the scope of ASC 808. For example, certain arrangements in which one party solely provides financial resources for an endeavor and is generally not an active participant would not meet the definition of a collaborative arrangement. Alternatively, arrangements between two parties that involve codevelopment, comarketing, or copromotion activities, as well as the sharing of risks and rewards based on the success of such activities, would generally meet the definition of a collaborative arrangement.

A collaboration can begin at any point in the life cycle of an endeavor (e.g., during the R&D phase or after a product has been commercially launched). The facts and circumstances associated with the arrangement will dictate whether the parties (1) represent active participants and (2) are exposed to significant risks and rewards.

ASC 808-10-15-8 cites the following examples of situations in which active participation may exist:

- a. Directing and carrying out the activities of the joint operating activity
- b. Participating on a steering committee or other oversight or governance mechanism
- c. Holding a contractual or other legal right to the underlying intellectual property.

In addition, ASC 808-10-15-11 lists circumstances that might indicate that participants are not exposed to significant risks and rewards:

- a. Services are performed in exchange for fees paid at market rates.
- b. A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
- c. Initial profits are allocated to only one participant.
- d. There is a limit on the reward that accrues to a participant.

Further, in accordance with ASC 808-10-15-12, an entity should also consider other factors when evaluating participants’ exposure to significant risks and rewards, including (1) the “stage of the endeavor’s life cycle” and (2) the “expected duration or extent of the participants’ financial participation . . . in relation to the endeavor’s total expected life or total expected value.”

For collaborations that meet the U.S. GAAP definition of a collaborative arrangement, ASC 808 provides guidance on income statement presentation, classification, and disclosures. However, before the issuance of [ASU 2018-18](#) (which is discussed below), ASC 808 did not address recognition or measurement matters, such as (1) determining the appropriate unit of account or (2) when the recognition criteria are met. Thus, even for a collaboration within the scope of ASC 808, entities were required to look to other GAAP (possibly by analogy) to determine the appropriate recognition and measurement for the activities subject to the arrangement, as discussed below.



When determining the appropriate income statement presentation of amounts recorded as a result of a collaborative arrangement, entities also will need to separately evaluate (1) transactions with third parties outside of the arrangement and (2) transactions between collaboration participants. ASC 808 requires that each collaboration participant report costs incurred and revenue generated from transactions with third parties in its income statement in accordance with the principal-versus-agent guidance in ASC 606-10-55-36 through 55-40. The participant in the collaborative arrangement that is deemed the principal participant for a given transaction should record the transaction on a gross basis in its financial statements, notwithstanding the presence of cost sharing or cost allocation of such amounts on the basis of the terms of the agreement.

In addition, participants will need to evaluate the appropriate income statement presentation for payments between the collaboration partners (e.g., as a result of expense reimbursements or profit sharing). When such payments are within the scope of other authoritative accounting literature, entities should apply the income statement classification requirements on the basis of the relevant provisions of that literature. If the payments are not within the scope of other authoritative accounting literature (e.g., ASC 606), the income statement classification for the payments is based on an analogy to authoritative accounting literature or — if there is no appropriate analogy — a reasonable, rational, and consistently applied accounting policy election.

### **2.2.1.1 Clarifying the Interaction Between ASC 808 and ASC 606**

In November 2018, the FASB issued [ASU 2018-18](#), which made targeted improvements to the guidance on collaborative arrangements in ASC 808, including the following clarifications:

- In the evaluation of whether a transaction in a collaborative arrangement is within the scope of ASC 606, the unit of account is a distinct good or service.
- When the collaborative participant is a customer for a good or service (or bundle) that is distinct, the recognition, measurement, presentation, and disclosure requirements of ASC 606 should be applied to the transaction (i.e., the distinct good or service [or bundle]).
- An entity in a collaborative arrangement is precluded from presenting a transaction as revenue from a contract with a customer if the collaborative participant counterparty is not a customer.

While the amendments in ASU 2018-18 primarily affected the guidance in ASC 808, the ASU also amended ASC 606-10-15-3 to remove the following guidance:

A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

### **2.2.1.2 Collaborative Arrangements Outside the Scope of ASC 606**

In determining the accounting for collaborative arrangements outside the scope of ASC 606, many entities have historically applied revenue recognition guidance by analogy. These entities often conclude that the collaborative activities do not represent separate deliverables (i.e., they conclude that there is one “unit of account” which represents the right to actively participate in the collaborative arrangement over its term and to share in the profits or losses from the underlying endeavor).

Before the FASB issued ASU 2018-18, we believed that when analogizing to authoritative accounting literature, an entity should apply all (as opposed to limited) aspects of that literature to the extent applicable. For example, suppose that a biotechnology company entered into a collaborative arrangement with a pharmaceutical company and, as part of the collaboration, (1) provided the pharmaceutical company a license to use IP related to a drug candidate and (2) performed R&D services jointly with the pharmaceutical company. The biotechnology company may have concluded that while the arrangement meets the definition of a collaborative arrangement in accordance with ASC 808, none of its elements are within the scope of ASC 606. Nevertheless, the biotechnology company may have further concluded that revenue literature (e.g., ASC 606) represents appropriate authoritative guidance that the company should apply by analogy to determine the unit(s) of account, recognition, and measurement. Accordingly, if the company concluded that the license is not a distinct performance obligation, the revenue literature would require the license and R&D services to be combined for accounting purposes. Further, with respect to the appropriate income statement presentation for consideration allocated to the combined unit of account (in this case, the license and R&D services), such consideration would generally be presented consistently in the same category for income statement presentation purposes given the conclusion that the license and R&D services should be combined for accounting purposes.

However, as noted above, the FASB issued ASU 2018-18 in November 2018. Although the Board decided to provide unit-of-account guidance in ASC 808 and align that guidance with the guidance in ASC 606 for distinct goods or services, the Board decided not to include recognition and measurement guidance for nonrevenue transactions in a collaborative arrangement. The Board's reason for not including such guidance was to avoid developing a "one size fits all" accounting model for the various types of collaborative arrangements. The decision to align the unit-of-account guidance with the guidance in ASC 606 for distinct goods or services is limited to the context of assessing the scope of the revenue guidance. As noted in paragraph BC31 of ASU 2018-18, "the Board decided to continue to permit an entity to apply the revenue guidance in Topic 606 by analogy or, if there is no appropriate analogy, as a policy election, **without requiring the entity to apply all the guidance in Topic 606**, as long as it presents the transaction separate from revenue recognized from contracts with customers" (emphasis added). Accordingly, it is possible for an entity to conclude on the basis of its facts and circumstances that ASC 606 represents an "appropriate analogy" for determining the nonrevenue unit(s) of account but may not represent an appropriate analogy for recognizing or measuring such unit(s) of account. In such a case, the above guidance would support a conclusion that analogizing to ASC 606 could be limited to an entity's determination of the unit(s) of account. The entity would then be required to establish a policy that is "reasonable, rational, and consistently applied" as long as the nonrevenue transaction is presented separately from any revenue recognized from contracts with customers under ASC 606.

### 2.2.1.3 SEC Comment Letter Themes Related to Collaborative Arrangements

#### Examples of SEC Comments

- You state . . . that . . . you entered into a collaboration agreement with [Entity A] pursuant to which you granted [A] an exclusive right to develop and commercialize [Compound B], excluding the [Territory C], and a co-exclusive license in the U.S. to develop and commercialize [Compound B]. You state . . . that the agreement contains four material components. Please address the following:
  - Tell us how you applied ASU 2018-18 to determine that part of the agreement should not be accounted for under ASC 606. In this respect, tell us why the collaborative partner is not considered a customer within the unit of account under ASU 2018-18 that would be required to be accounted for under ASC 606.
  - For the portion of the agreement you believe is outside ASC 606, clarify what authoritative literature you are using or what methodology you are using to account for the non-ASC 606 portion. Refer to ASC 808-10-45-3.
  - Explain why the entire \$[X] million was allocated to the components accounted for under ASC 606 and why some of the amount was not required to be allocated to the other material components of the agreement.
  - Please clarify the nature of the transition date discussed . . . , why that date determines if you are the principal for the product sales, and if at that point, reimbursements will also be recorded as revenue. Clarify how the fact pattern compares to Example 3 in ASC 808-10-55-11 through 55-14 and provide any authoritative support.
- [Y]ou entered into the [collaboration agreement with Entity X] to jointly develop and commercialize [Product A]. You state that you identified two performance obligations, consisting of the delivery of the licenses and your participation on joint steering and other collaboration committees. Your accounting policy . . . states that for collaboration arrangements with multiple performance obligations, such as granting a license and performing research and development activities, you allocate the upfront and milestone payments under a relative standalone selling price method. It is not clear why amounts for research and development in the [collaboration agreement with X] are not considered a performance obligation nor why . . . you record cost reimbursement payments to you from [X] as a reduction of research and development expense rather than as revenue. It appears to us that your separation, measurement, allocation and classification of amounts related to the [collaboration agreement with X] is inconsistent with your accounting policy . . . and with your accounting for your agreement with [Entity Y]. Please provide us an analysis with reference to authoritative literature supporting your accounting for the [collaboration agreement with X]. Also, provide us proposed revised accounting policy disclosure to be included in future filings addressing this inconsistency or tell us why revised disclosure is not necessary.
- Please provide us the following terms governing the [X] collaboration, as well as your consideration of providing additional disclosure pursuant to ASC 606-10-50:
  - Quantify the amount allocated to each performance obligation.
  - Describe and quantify the methods and assumptions used to determine standalone selling price for each collaboration.
  - Provide a range of milestone and other payment obligations to be received by stage (e.g. development, regulatory and commercialization).

### Examples of SEC Comments (continued)

- With regard to the \$[X] million non-refundable, upfront license fee received in the [collaboration agreement with Entity A] and the estimates made in accounting for the agreement, please tell us:
  - [M]ore specifically what you mean by “Therefore, there was significant judgment applied in determining a reasonable, rational method of recognizing revenue under the [collaboration agreement with A], with the Company considering the guidance in ASC 606 Revenue from Contracts with Customers,” and whether and, if so, to what extent you analogized to ASC 606 or other literature and, if not, the basis in the accounting literature for the accounting you applied to separate, allocate, measure and recognize amounts within the collaborative arrangement,
  - [T]he amount allocated to each of [Compound B] and [Compound C] and your consideration of disclosing the amount allocated to each of [Compound B] and [Compound C] separately,
  - [H]ow you determined the five years over which you will complete development activities for [Compound B] when we note the FDA accepted a New Drug Application . . . ,
  - [Y]our basis in the accounting literature for recognizing milestone payments when achieved addressing regulatory milestones separately from sales milestones,
  - [W]hy you record reimbursement for [X]% of your development activity expenses incurred as a reduction to research and development costs rather than as part of the transaction price for purposes of recording revenue given your accounting for research and development activities as a performance obligation that you recognize using the proportional performance method,
  - [T]he basis in the accounting literature for presenting . . . the co-promote loss as negative revenue rather than as an expense, and
  - [T]he breakout showing the amount and type of regulatory versus sales milestone related to the \$[X] million in milestone payments upon [Compound B] regulatory approvals and first commercial sale events in certain major markets and an additional \$[X] million in milestone payments upon [Compound C] regulatory approvals and first commercial sale events in certain major markets.
- We note you considered the nature of the remittance of the net pre-tax profits to [Entity A] and ultimately concluded that an accounting policy of recording these net costs as a component of Other operating expense, net is a “reasonable, rational, and consistently applied accounting policy election” which accurately reflects the nature of these costs. Please address with more specificity why your characterization of the amounts [A] shares with you as Net Revenue and the amounts you share with them as Other operating expense, net is a consistently applied policy election.
- Based on your response, it appears that you are applying ASC 808-10 to the 50-year collaboration Agreement entered into in [year X]. In this regard, please describe to us the extent you have considered ASC 808-10-15-6, which sets forth, in part, that “participants shall reevaluate whether an arrangement continues to be a collaborative arrangement whenever there is a change in either the roles of the participants in the arrangement or the participants’ exposure to significant risks and rewards dependent on the ultimate commercial success of the endeavor.”
- Please address the following comments with regard to your accounting and disclosures for the License and Research Collaboration Agreement with [Company A].
  - Please expand your future filings to describe all material terms of the agreement, including the specific amount for the upfront payments, and the development and [commercialization] milestone payments. For the tiered royalty arrangement, please disclose the royalty term and quantification of the royalty rate, or a range no greater than 10 percentage points per tier.
  - Please provide us an analysis, and revise your future filings if necessary, of the components you have identified under this agreement that would fall under ASC 808 *Collaborative Arrangements* and the components under ASC 606 *Revenue from Contracts with Customers*. In your analysis, tell us how you have considered the unit of account guidance under ASC 808-10-15-5B.

Collaborative arrangements are common among biotech and pharmaceutical companies. As part of registrants' application of the revenue standard and the guidance in ASU 2018-18 on clarifying the interaction between ASC 808 and ASC 606, registrants need to evaluate whether transactions between partners in a collaborative arrangement are within the scope of the revenue standard. Inquiries to registrants have also focused on matters such as:

- The registrant's accounting policies regarding separation (i.e., unit of account) and allocation (i.e., when multiple units exist) for collaborative arrangements.
- Supplemental explanation of:
  - The registrant's determination and disclosure of (1) the separation, allocation, recognition, and classification principles that were used to account for payments between collaboration partners and (2) the factors that led the registrant to conclude that it is the principal (or agent) in transactions with third parties.
  - The authoritative literature that was used to make the determinations in items (1) and (2) above.
- Enhanced disclosure, when material, about the registrant's collaborative arrangements, including the overall effect of the collaborative arrangements on the financial statements, the nature and timing of payments between the parties, and the range of royalties to be paid under the arrangements.

## 2.2.2 Arrangements Involving Medical Device Consumables

The revenue standard does not apply to contracts with customers (or portions thereof) that fall within the scope of other applicable guidance, such as ASC 842 (leases). Some entities may need to obtain an understanding of the new leasing standard as well as their lease contracts to determine the full scope of customer arrangements that fall within the scope of ASC 606. For example, to facilitate the sale and use of medical device consumables, medical device companies may place equipment for free at the customer's location for a multiyear term. In exchange for the placed equipment, the customer is typically required to commit to a minimum purchase of consumable products during that term.

To determine how this type of arrangement should be accounted for under the revenue standard, the reporting entity should first consider whether the placement of equipment meets the definition of a lease under ASC 842. If the arrangement includes elements that meet the definition of a lease, the lease-related elements of the arrangement would need to be accounted for under the lease accounting literature unless the entity qualifies for and elects the lessor practical expedient under ASC 842-10-15-42A. If the arrangement does not meet the definition of a lease and no other literature is directly applicable, the revenue standard would be applied to the entire arrangement. For additional considerations related to the new leasing standard, see [Chapter 11](#).

## 2.2.3 Sale or Outlicensing of IP Rights

Life sciences entities frequently sell or outlicense IP rights (e.g., in-process research and development [IPR&D] or developed product rights) in exchange for future milestone payments, royalties, or both (i.e., variable consideration).

Determining the accounting model to apply to arrangements involving the transfer of IP rights requires significant judgment. Accounting for these transactions depends on whether the transfer involves (1) the sale of IP rights, (2) the license of IP rights, or (3) the sale of IP rights together with other inputs and processes that meet the definition of a business:

- *Sale of IP rights* — The revenue standard's provisions apply to transfers of nonfinancial assets, including in-substance nonfinancial assets that are not an output of an entity's ordinary activities (e.g., intangible assets such as IP rights). The following example in ASC 610-20-55-17 through 55-19 illustrates how an entity would account for the sale of a nonfinancial asset in exchange for variable consideration:

#### ASC 610-20

##### **Example 3 — Sale of a Nonfinancial Asset for Variable Consideration**

**55-17** An entity sells (that is, does not out license) the rights to in-process research and development that it recently acquired in a business combination and measured at fair value of \$50 million in accordance with Topic 805 on business combinations. The entity concludes that the transferred in-process research and development is not a business. The buyer of the in-process research and development agrees to pay a nonrefundable amount of \$5 million at inception plus 2 percent of sales of any products derived from the in-process research and development over the next 20 years. The entity concludes that the sale of in-process research and development is not a good or service that is an output of the entity's ordinary activities.

**55-18** Topic 350 on goodwill and other intangibles requires the entity to apply the guidance in this Subtopic to determine the amount and timing of income to be recognized. Therefore, the entity applies the derecognition guidance in this Subtopic as follows:

- The entity concludes that it does not have a controlling financial interest in the buyer.
- The entity concludes that the contract meets the criteria in paragraph 606-10-25-1.
- The entity also concludes that on the basis of the guidance in paragraph 606-10-25-30, it has transferred control of the in-process research and development asset to the buyer. This is because the buyer can use the in-process research and development's records, patents, and supporting documentation to develop potential products and the entity has relinquished all substantive rights to the in-process research and development asset.
- In estimating the consideration received, the entity applies the guidance in Topic 606 on determining the transaction price, including estimating and constraining variable consideration. The entity estimates that the amount of consideration that it will receive from the sales-based royalty is \$100 million over the 20-year royalty period. However, the entity cannot assert that it is probable that recognizing all of the estimated variable consideration in other income would not result in a significant reversal of that consideration. The entity reaches this conclusion on the basis of its assessment of factors in paragraph 606-10-32-12. In particular, the entity is aware that the variable consideration is highly susceptible to the actions and judgments of third parties, because it is based on the buyer completing the in-process research and development asset, obtaining regulatory approval for the output of the in-process research and development asset, and marketing and selling the output. For the same reasons, the entity also concludes that it could not include any amount, even a minimum amount, in the estimate of the consideration. Consequently, the entity concludes that the estimate of the consideration to be used in the calculation of the gain or loss upon the derecognition of the in-process research and development asset is limited to the \$5 million fixed upfront payment.

**55-19** At inception of the contract, the entity recognizes a net loss of \$45 million (\$5 million of consideration, less the in-process research and development asset of \$50 million). The entity reassesses the transaction price at each reporting period to determine whether it is probable that a significant reversal would not occur from recognizing the estimate as other income and, if so, recognizes that amount as other income in accordance with paragraphs 606-10-32-14 and 606-10-32-42 through 32-45.

- *License of IP rights* — In contrast to the accounting for a sale of IP, for a licensing transaction in which consideration is tied to the subsequent sale or usage of IP, the revenue standard provides an exception to the recognition principle that is part of step 5 (i.e., recognize revenue when or as control of the goods or services is transferred to the customer). Under this sales- or usage-based royalty exception, an entity would not estimate the variable consideration from sales- or usage-based royalties. Instead, the entity would recognize revenue at the later of when (1) the subsequent sale or usage occurs or (2) the performance obligation to which some or all of the sales- or usage-based royalty has been allocated is satisfied (or partially satisfied).
- *Sale of IP rights together with other inputs and processes that meet the definition of a business* — ASC 610-20 does not amend or supersede guidance that addresses how to determine the gain or loss on the derecognition of a subsidiary or a group of assets that meets the definition of a business. Gains or losses associated with such a transaction will continue to be determined in accordance with ASC 810-10-40. As discussed in [Section 4.2.5](#), entities should establish an accounting policy for the initial and subsequent measurement of this type of arrangement.

## 2.2.4 Contracts That Include Both Revenue and Nonrevenue Elements

When a contract includes both revenue and nonrevenue elements, some of which are within the scope of other standards, any separation and initial measurement requirements of the other standards are applied first and the deliverables within the scope of the revenue model are ascribed any residual amount, as provided in ASC 606-10-15-4.

### ASC 606-10

**15-4** A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

- If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).
- If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.

For example, if a contract with a customer includes performance obligations subject to ASC 606 and an equity component that is within the scope of other authoritative literature regarding separation, measurement, or both, the equity component would be recognized and measured in accordance with the applicable authoritative literature, with the residual transaction price recognized under ASC 606.

If there are no separation or initial measurement requirements in those other standards, the requirements in ASC 606 are applied. That is, the guidance in ASC 606 is the default guidance to be used if there is no other relevant guidance.



The examples below illustrate the application of ASC 606-10-15-4.

### Example 2-2

Biotech X enters into two arrangements with Pharmaceutical Company Y. The first arrangement is a license and collaboration arrangement that X has determined is within the scope of ASC 606 and consists of one combined performance obligation. The second arrangement is a share purchase arrangement whereby X sells shares of its common stock to Y.

Biotech X determines that the two arrangements should be accounted for as a single arrangement under ASC 606. It accounts for the common stock purchased by Y under applicable authoritative literature. The fair value of the common shares is excluded from the consideration that is allocated to the revenue unit of account. To the extent that the consideration for the common shares exceeds the fair value, the excess is allocated to the revenue unit of account.

### Example 2-3

Biotech X and Pharmaceutical Company Y enter into an arrangement in which X agrees to sell shares of its common stock to Y in exchange for consideration. In accordance with the arrangement, Y is entitled to receive information on the development of IP being developed by X and has a right of first refusal in connection with a future sale or license of this IP. The consideration paid by Y for the shares of common stock is at a premium (i.e., the consideration exceeds the fair value of the shares).

Biotech X accounts for the common stock purchased by Y under applicable authoritative literature. However, X determines that the excess of consideration over the fair value of the shares of common stock is associated with another element in the arrangement that is, in substance, a contract to perform R&D services.

Consequently, X must further assess the appropriate accounting literature to apply to this R&D element (e.g., ASC 606 if Y represents a customer) to determine the appropriate accounting for the transaction price that is allocated to the R&D element.

## 2.3 Identify the Contract (Step 1)

For contracts within the scope of ASC 606, the first step of the revenue standard is to determine whether a contract exists, for accounting purposes, between an entity and its customer.

### ASC 606-10

**25-1** An entity shall account for a contract with a customer that is within the scope of this Topic only when all of the following criteria are met:

- a. The parties to the contract have approved the contract (in writing, orally, or in accordance with other customary business practices) and are committed to perform their respective obligations.
- b. The entity can identify each party's rights regarding the goods or services to be transferred.
- c. The entity can identify the payment terms for the goods or services to be transferred.
- d. The contract has commercial substance (that is, the risk, timing, or amount of the entity's future cash flows is expected to change as a result of the contract).
- e. It is probable that the entity will collect substantially all of the consideration to which it will be entitled in exchange for the goods or services that will be transferred to the customer (see paragraphs 606-10-55-3A through 55-3C). In evaluating whether collectibility of an amount of consideration is probable, an entity shall consider only the customer's ability and intention to pay that amount of consideration when it is due. The amount of consideration to which the entity will be entitled may be less than the price stated in the contract if the consideration is variable because the entity may offer the customer a price concession (see paragraph 606-10-32-7).



A contract does not have to be written to meet the criteria for revenue recognition; however, it does need to create enforceable rights and obligations.

Some of the more common issues that life sciences entities have faced when considering step 1 of the revenue standard are discussed below.

### 2.3.1 Parties That Are Relevant to the Determination of Whether a Contract Exists

Given the number of entities involved in the distribution channel or pricing chain within the life sciences industry, questions have arisen about which parties are relevant to the determination of whether a contract exists. For example, for a pharmaceutical company, does a contract for purposes of step 1 include only the contract between the pharmaceutical company and the wholesaler, or does it also include “downstream” contracts with others in the pricing chain to whom discounts or rebates may be provided?

The criteria in ASC 606-10-25-1 that need to be in place to establish that a contract exists are intended to demonstrate that there is a valid and genuine transaction between an entity and *its customer* and that the parties to the contract have enforceable rights and obligations that will have true economic consequences. For a traditional pharmaceutical company, the wholesaler to which the company’s products are shipped would generally represent the customer. In these circumstances, other parties that may be involved in the distribution channel or pricing chain do not represent the company’s customers and therefore are irrelevant to the determination of whether a contract exists for accounting purposes. However, life sciences entities should keep in mind that any pricing adjustments (e.g., rebates, chargebacks) that are payable as result of this type of arrangement may represent variable consideration that is required to be estimated and potentially constrained under step 3 of the model.

### 2.3.2 Identifying the Payment Terms

A contract must include payment terms for each of the promised goods and services in an arrangement for an entity to determine the transaction price. The payment terms do not need to be fixed, but the contract must contain enough information to allow an entity to reasonably estimate the consideration to which it will be entitled for transferring the goods and services to the customer.

#### Example 2-4

Pharmaceutical Company X has received approval from a foreign government to sell Drug A to government hospitals in advance of obtaining full market authorization in the jurisdiction. During this “early access period” in which X’s application for full marketing authorization is being evaluated by the foreign government, X will be paid a preliminary price by the government hospitals. During this same period, X will be negotiating with the foreign government the final price to be paid to X. Upon obtaining full marketing authorization and completing pricing negotiations, X will be required to rebate to the foreign government the difference between the preliminary price and the final price.

In this fact pattern, payment terms may have been established between X and the government hospitals because X can (1) determine, for example, when payment is due and that the consideration is variable and (2) reasonably estimate the amount of consideration to which it will ultimately be entitled on the basis of the ongoing negotiations with the foreign government.

In a manner similar to how Pharmaceutical Company X in the example above obtains approval to sell a product in a foreign jurisdiction before receiving full market authorization to do so, a drug company may obtain advance approval to sell a product in the United States under the FDA's Accelerated Approval Program. The FDA describes the nature of the program on its [Web site](#) as follows:

The FDA instituted its Accelerated Approval Program to allow for earlier approval of drugs that treat serious conditions, and fill an unmet medical need based on a surrogate endpoint. A surrogate endpoint is a marker, such as a laboratory measurement, radiographic image, physical sign or other measure that is thought to predict clinical benefit but is not itself a measure of clinical benefit. The use of a surrogate endpoint can considerably shorten the time required prior to receiving FDA approval.

Drug companies are still required to conduct studies to confirm the anticipated clinical benefit. If the confirmatory trial shows that the drug actually provides a clinical benefit, then the FDA grants traditional approval for the drug. If the confirmatory trial does not show that the drug provides clinical benefit, FDA has regulatory procedures in place that could lead to removing the drug from the market.

The example below illustrates the determination of whether a drug company that obtains advance approval under the FDA's Accelerated Approval Program may recognize revenue from the sale of its product.

#### Example 2-5

Pharmaceutical Company X has received FDA approval under the FDA's Accelerated Approval Program to sell Drug A to customers in advance of obtaining traditional FDA approval for Drug A. As part of its contracts with its customers, X agrees to provide rebates if traditional approval of Drug A is not received. Pharmaceutical Company X concludes that it is probable that a significant reversal of revenue will not occur.

On the basis of the identified payment terms, X determines that the contingent rebates represent variable consideration that should be recognized to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

### 2.3.3 Price Concessions

As part of determining whether a valid and genuine contract exists, an entity is required to evaluate whether it is probable that the entity will collect substantially all of the consideration to which it is entitled under the contract. However, the consideration to which an entity is ultimately entitled may be less than the price stated in the contract because the customer is offered a price concession. Price concessions are a form of variable consideration and need to be analyzed when the transaction price is being determined (as part of step 3 of the model). However, as part of step 1, an entity would evaluate whether it is probable that the entity will collect the consideration to which it will be entitled for providing goods or services to a customer after considering any price concessions. This evaluation requires aspects of step 3 to be performed in conjunction with step 1.

Differentiating between credit risk (i.e., the risk of collecting less consideration than the amount the entity legitimately expected to collect from the customer) and price concessions (i.e., entering into a contract with a customer with the expectation of accepting less than the contractual amount of consideration in exchange for goods or services) may be difficult. Entities will need to use significant judgment in determining whether they have provided an implicit price concession or have accepted a customer's credit risk. This is particularly true of entities in highly regulated industries, such as health care and consumer energy, which may be required by law to provide certain goods and services to their customers regardless of the customers' ability to pay. Because of the nature of these arrangements, entities will need to evaluate all of the relevant facts and circumstances of their arrangements to determine whether they have provided implicit price concessions or whether the anticipated receipt of less than the total contractual consideration represents credit risk.

Example 2 in ASC 606-10-55-99 through 55-101, which is reproduced below, illustrates how a life sciences entity would evaluate implicit price concessions when assessing whether the collectibility criterion is met.

#### ASC 606-10

##### Example 2 — Consideration Is Not the Stated Price — Implicit Price Concession

**55-99** An entity sells 1,000 units of a prescription drug to a customer for promised consideration of \$1 million. This is the entity's first sale to a customer in a new region, which is experiencing significant economic difficulty. Thus, the entity expects that it will not be able to collect from the customer the full amount of the promised consideration. Despite the possibility of not collecting the full amount, the entity expects the region's economy to recover over the next two to three years and determines that a relationship with the customer could help it to forge relationships with other potential customers in the region.

**55-100** When assessing whether the criterion in paragraph 606-10-25-1(e) is met, the entity also considers paragraphs 606-10-32-2 and 606-10-32-7(b). Based on the assessment of the facts and circumstances, the entity determines that it expects to provide a price concession and accept a lower amount of consideration from the customer. Accordingly, the entity concludes that the transaction price is not \$1 million and, therefore, the promised consideration is variable. The entity estimates the variable consideration and determines that it expects to be entitled to \$400,000.

**55-101** The entity considers the customer's ability and intention to pay the consideration and concludes that even though the region is experiencing economic difficulty it is probable that it will collect \$400,000 from the customer. Consequently, the entity concludes that the criterion in paragraph 606-10-25-1(e) is met based on an estimate of variable consideration of \$400,000. In addition, based on an evaluation of the contract terms and other facts and circumstances, the entity concludes that the other criteria in paragraph 606-10-25-1 are also met. Consequently, the entity accounts for the contract with the customer in accordance with the guidance in this Topic.

### 2.3.4 Contract Term

Determining the term of the contract is an important step in the revenue recognition process since the contract term could affect the identification of promises under the contract, the transaction price, and disclosures. ASC 606 provides guidance on determining the contract duration, including the effect of termination clauses and contract renewals. The contract term is determined on the basis of the period over which the parties to the contract have present enforceable rights and obligations.

#### ASC 606-10

**25-3** Some contracts with customers may have no fixed duration and can be terminated or modified by either party at any time. Other contracts may automatically renew on a periodic basis that is specified in the contract. An entity shall apply the guidance in this Topic to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In evaluating the criterion in paragraph 606-10-25-1(e), an entity shall assess the collectibility of the consideration promised in a contract for the goods or services that will be transferred to the customer rather than assessing the collectibility of the consideration promised in the contract for all of the promised goods or services (see paragraphs 606-10-55-3A through 55-3C). However, if an entity determines that all of the criteria in paragraph 606-10-25-1 are met, the remainder of the guidance in this Topic shall be applied to all of the promised goods or services in the contract.

In the life sciences industry, CROs typically enter into long-term contracts with their customers to perform clinical trial management services. Because of the high failure rates in the clinical development process, it is customary for CROs in the industry to provide the customer the right to terminate the contract with the CRO without cause. The customer is often required to give a specified notice of termination (e.g., 30 days) and to compensate the CRO for all work performed through the date

of termination, as well as for any noncancelable arrangements the CRO has entered into and any wind-down activities required to close the study. In addition, some contracts may include a termination fee for early cancellation of a study.

### **2.3.4.1 Termination Clauses and Penalties**

When contracts have termination clauses and penalties, the duration of the contract is predicated on the contract's enforceable rights and obligations. Accordingly, regardless of whether one or both parties have the right to terminate the contract, an entity would need to evaluate the nature of the termination provisions, including whether any termination penalty is substantive. For example, an entity would assess factors such as (1) whether the terminating party is required to pay compensation, (2) the amount of such compensation, and (3) the reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered). Substantive termination penalties suggest that the parties' rights and obligations extend for the duration of the contract term.

A contract's accounting term could be less than the contract's stated term if a termination penalty is not substantive. For example, a 12-month stated contract term could, in effect, be a month-to-month contract if the contract could be terminated each month and the termination penalty is not substantive. An entity will need to carefully consider the effect of nonsubstantive termination penalties on the timing and amount of revenue to be recognized.

Because the assessment of termination clauses and penalties focuses on legally enforceable rights and obligations, certain economic factors such as economic compulsion should not be considered. Rather, the assessment depends on whether the terminating party is required to compensate the other party. For example, an entity may have a long-term agreement with a customer for a unique good or service that is critical to the customer's operations. If the agreement allows the customer to terminate it at any point and there are no contractual penalties if the customer does not purchase any goods or services, a contract for the purchase of additional goods or services does not exist even if it is highly likely that the customer will not terminate the agreement.

The economic considerations related to forgoing a discount on optional purchases would not be viewed as a substantive penalty suggesting that the parties' rights and obligations extend for a longer contract term. The discount on optional purchases should be assessed for the existence of a material right instead. Therefore, while an "economic" penalty may be incurred by a customer that elects not to purchase future but optional goods at a discount, that economic penalty would not rise to the level of a substantive penalty that lengthens the contract term.

The determination of whether a termination penalty is substantive requires judgment and would be evaluated both quantitatively and qualitatively. For example, data about the frequency of contract terminations may be useful in such a determination (i.e., a high frequency of payments made to terminate contracts may suggest that the termination provision is not substantive). Determining the enforceable term of a contract that includes termination provisions (e.g., cancellation fees) may be challenging, particularly when only the customer has a right to terminate the contract. When a customer has a right to terminate the contract without penalty, such termination provision is substantively the same as a renewal provision, as supported by both paragraph BC391 of ASU 2014-09 and Q&A 8 of the FASB staff's [Revenue Recognition Implementation Q&As](#) (the "Implementation Q&As").

In practice, CROs often experience a low frequency of payments made to terminate contracts, which may suggest that the termination provisions are substantive. A substantive termination penalty is evidence of enforceable rights and obligations on the part of both parties throughout the period in which the substantive termination penalty applies.

### 2.3.4.1.1 Termination Clauses in License Arrangements

As noted in Section 2.3.4.1 above, an entity needs to evaluate the nature of termination provisions, including whether any penalties are substantive (i.e., whether the transfer of any consideration from the customer to the entity is substantive). Careful consideration is required in the evaluation of whether giving up license rights is a form of penalty.

[Implementation Q&As 7 and 8](#) include the following factors that an entity should consider when determining whether a termination penalty is substantive:

- Whether the terminating party is required to pay compensation.
- The amount of such compensation.
- The reason for the compensation (i.e., whether the compensation is in addition to amounts due for goods and services already delivered).

The example below illustrates how an entity would determine whether a license arrangement includes a substantive termination penalty.

#### Example 2-6

Company A, a pharmaceutical company in the United States, owns and maintains a portfolio of patents related to an antibiotic that treats life-threatening diseases. On February 23, 20X8, A grants Customer B (a pharmaceutical company in Ireland) the exclusive right to use its patented drug formula to commercialize and supply the antibiotic in Europe. The IP is fully developed, and regulatory approval has been obtained; therefore, B is able to commercialize the IP. Company A has determined that the patented drug formula is functional IP and that therefore, the license grants B the right to use the IP.

In exchange for the exclusive right to use the patented drug formula, B agrees to pay A the following amounts:

- An up-front fee of \$300 million.
- Annual fixed fees of \$50 million payable at the end of each year in which the contract is effective.
- Sales-based royalties of 5 percent of B's sales of the antibiotic in Europe (recognized in accordance with the sales-based royalty exception in ASC 606-10-55-65).

The contract states that B has the exclusive right to use the patented drug formula through the patent term, which expires in 10 years (i.e., the contract ends when the patent expires). Notwithstanding the stated contract term, the contract states that B may terminate the contract before the expiration of the patent by providing three months' notice to A. All amounts already paid by B are nonrefundable in the event of early termination. The contract does not include an explicit termination penalty (i.e., B is not required to pay additional cash consideration to A upon early termination); however, upon early termination, the right to the patented drug formula in Europe would revert back to A, and A would be able to relicense the patented drug formula to a different pharmaceutical company in Europe. Unless B terminates the contract before the end of the stated term, A would not be able to benefit from licensing the patented drug formula to a different pharmaceutical company in Europe (i.e., A would receive this benefit only upon B's early termination of the contract).

Under these facts, A's contract to license the exclusive right to use its patented drug formula to B contains a substantive termination penalty. As previously discussed in [Section 2.3.4.1](#), it is important for an entity to evaluate the nature of the termination provisions in its contracts to determine the appropriate contract term for applying ASC 606.

**Example 2-6 (continued)**

In this example, A's contract to license the patented drug formula to B does not include an explicit termination penalty. That is, B can terminate the contract before the end of the stated term by providing three months' notice without paying additional cash consideration to A. Although the contract does not require B to pay additional cash consideration to A upon early termination, in the event that B terminates the contract early, the exclusive license rights related to the patented drug formula would revert back to A. Company A would then be able to license the patented drug formula to another customer in Europe for the remainder of the patent term, which it would not have been able to do if B had not terminated the contract. Therefore, although B is not paying additional cash to A upon termination, B is providing consideration (i.e., something of value) to A, and A is receiving something of value from B (i.e., the right to relicense the patented drug formula), upon termination. Although Implementation Q&As 7 and 8 focus on compensation as additional cash that an entity's customer would pay to the entity upon termination, compensation may also include noncash consideration that is of value to the entity. The fact that B is forfeiting its rights to the patented drug formula and providing A with something of value (i.e., the ability to relicense the patented drug formula to another customer in Europe) from the forfeiture upon early termination represents a substantive termination penalty in the contract.

In accordance with Implementation Q&As 7 and 8, the substantive termination penalty suggests that the parties' rights and obligations extend for the duration of the stated contract term. That is, the contract term is 10 years.

**2.3.5 Contract Modifications****ASC 606-10**

**25-10** A contract modification is a change in the scope or price (or both) of a contract that is approved by the parties to the contract. In some industries and jurisdictions, a contract modification may be described as a change order, a variation, or an amendment. A contract modification exists when the parties to a contract approve a modification that either creates new or changes existing enforceable rights and obligations of the parties to the contract. A contract modification could be approved in writing, by oral agreement, or implied by customary business practices. If the parties to the contract have not approved a contract modification, an entity shall continue to apply the guidance in this Topic to the existing contract until the contract modification is approved.

**25-11** A contract modification may exist even though the parties to the contract have a dispute about the scope or price (or both) of the modification or the parties have approved a change in the scope of the contract but have not yet determined the corresponding change in price. In determining whether the rights and obligations that are created or changed by a modification are enforceable, an entity shall consider all relevant facts and circumstances including the terms of the contract and other evidence. If the parties to a contract have approved a change in the scope of the contract but have not yet determined the corresponding change in price, an entity shall estimate the change to the transaction price arising from the modification in accordance with paragraphs 606-10-32-5 through 32-9 on estimating variable consideration and paragraphs 606-10-32-11 through 32-13 on constraining estimates of variable consideration.

Contract modifications can frequently happen in the normal course of business. Any time an entity and its customer agree to change what the entity promises to deliver or the amount of consideration the customer will pay (i.e., creates or changes the enforceable rights or obligations in a preexisting contract), there is a contract modification.

The first step in the identification of a contract modification is to assess whether, for a contract accounted for under ASC 606, there has been a change in the contract's scope or price, or both. The second step is to determine whether the parties to the contract have agreed upon the change. As defined above, contract modifications must be agreed to by both parties (written, orally, or through customary business practices). That is, both parties must agree to change the enforceable rights and obligations of the contract.

As noted above, CROs in the life sciences industry often enter into long-term contracts with their customers to perform clinical trial management services. Changes in the scope of these contracts is common in the industry.

If a CRO and its customer agree upon a change to a contract and the change qualifies as a contract modification under ASC 606-10-25-10 and 25-11, the CRO will be required to evaluate the appropriate accounting for that contract modification.

If a change in a contract qualifies as a contract modification under ASC 606-10-25-10 and 25-11, the entity must assess the goods and services and their selling prices. Depending on whether those goods and services are distinct or sold at their stand-alone selling prices, a modification can be accounted for as:

- A separate contract (see ASC 606-10-25-12).
- One of the following (if the modification is **not** accounted for as a separate contract):
  - A termination of the old contract and the creation of a new contract (see ASC 606-10-25-13(a)).
  - A cumulative catch-up adjustment to the original contract (see ASC 606-10-25-13(b)).
  - A combination of the items described in ASC 606-10-25-13(a) and (b), in a way that faithfully reflects the economics of the transaction (see ASC 606-10-25-13(c)).

### 2.3.5.1 Contract Modification Accounted for as a Separate Contract

#### ASC 606-10

**25-12** An entity shall account for a contract modification as a separate contract if both of the following conditions are present:

- a. The scope of the contract increases because of the addition of promised goods or services that are distinct (in accordance with paragraphs 606-10-25-18 through 25-22).
- b. The price of the contract increases by an amount of consideration that reflects the entity's standalone selling prices of the additional promised goods or services and any appropriate adjustments to that price to reflect the circumstances of the particular contract. For example, an entity may adjust the standalone selling price of an additional good or service for a discount that the customer receives, because it is not necessary for the entity to incur the selling-related costs that it would incur when selling a similar good or service to a new customer.

When an entity accounts for a contract modification as a separate contract in accordance with ASC 606-10-25-12, the entity's accounting for the original contract is not affected by the modification. Any revenue recognized through the date of the modification is not adjusted, and remaining performance obligations will continue to be accounted for under the original contract. The new contract is accounted for separately from the original contract and on a prospective basis.

There is no economic difference between (1) a modification of an existing contract with a customer that includes additional *distinct* goods or services at their *representative stand-alone selling prices* and (2) a completely new contract entered into by the two parties for goods or services at their representative stand-alone selling prices. Therefore, a modification of an existing contract should be accounted for as a new contract that is separate and apart from the existing contract when (1) there are additional *distinct* goods or services promised to a customer *and* (2) those goods or services are in exchange for consideration that *represents the stand-alone selling prices* of the additional distinct promised goods or services.



Because a modification to a CRO contract often may not add “distinct” goods or services at a price that reflects the stand-alone selling price of those goods or services, such a modification is generally not accounted for as a new contract separate from the original contract. Instead, as further discussed below, this type of modification is typically (1) viewed as part of a single performance obligation that is partially satisfied on the date of the modification and (2) accounted for as if it were part of the original contract.

A modification that results in a decrease in scope cannot be accounted for as a separate contract because the criterion in ASC 606-10-25-12(a) specifying an *increase* in the scope of the contract is not met.

Some contract modifications may meet the criterion in ASC 606-10-25-12(a) because they include additional promised goods or services that are distinct. To conclude that these contract modifications should be accounted for as a separate contract, an entity should be able to demonstrate that the price of the contract increases by an amount of consideration that reflects (1) the entity's stand-alone selling prices of the additional promised goods or services and (2) any appropriate adjustments to that price that take into account the circumstances of the particular contract. This may be challenging in certain arrangements in which stand-alone selling prices are not readily determinable. For example, life sciences entities frequently enter into collaborative arrangements that are accounted for under ASC 606, as discussed in [Section 2.2.1.2](#). Occasionally, these arrangements are modified to include additional compounds that the collaboration partners agree to develop. Questions may arise about how an entity should apply ASC 606-10-25-12(b) since similar compounds may not have been previously sold or licensed to other parties. See [Section 2.6](#) for a discussion of factors that an entity should consider when assessing the stand-alone selling price. Given the judgment required in making this determination, consultation with an entity's accounting advisers is recommended.

### 2.3.5.2 Contract Modification Not Accounted for as a Separate Contract

#### ASC 606-10

**25-13** If a contract modification is not accounted for as a separate contract in accordance with paragraph 606-10-25-12, an entity shall account for the promised goods or services not yet transferred at the date of the contract modification (that is, the remaining promised goods or services) in whichever of the following ways is applicable:

- a. An entity shall account for the contract modification as if it were a termination of the existing contract, and the creation of a new contract, if the remaining goods or services are distinct from the goods or services transferred on or before the date of the contract modification. The amount of consideration to be allocated to the remaining performance obligations (or to the remaining distinct goods or services in a single performance obligation identified in accordance with paragraph 606-10-25-14(b)) is the sum of:
  1. The consideration promised by the customer (including amounts already received from the customer) that was included in the estimate of the transaction price and that had not been recognized as revenue and
  2. The consideration promised as part of the contract modification.
- b. An entity shall account for the contract modification as if it were a part of the existing contract if the remaining goods or services are not distinct and, therefore, form part of a single performance obligation that is partially satisfied at the date of the contract modification. The effect that the contract modification has on the transaction price, and on the entity's measure of progress toward complete satisfaction of the performance obligation, is recognized as an adjustment to revenue (either as an increase in or a reduction of revenue) at the date of the contract modification (that is, the adjustment to revenue is made on a cumulative catch-up basis).
- c. If the remaining goods or services are a combination of items (a) and (b), then the entity shall account for the effects of the modification on the unsatisfied (including partially unsatisfied) performance obligations in the modified contract in a manner that is consistent with the objectives of this paragraph.



A contract modification that does not meet the requirements outlined in [Section 2.3.5.1](#) is not accounted for as a separate contract. Therefore, an entity would have to determine how to account for a blended contract that now includes one or both of the following:

- An original agreement plus or minus some other goods or services.
- A change in the amount of consideration due under the modified arrangement.

The determination of which model to use depends on whether the remaining goods or services (the originally promised items and the newly promised items) are *distinct* from the goods and services already provided under the contract.

In accordance with ASC 606-10-25-13(a), if the remaining goods or services are distinct from the goods or services already provided under the original arrangement, the entity would in effect establish a “new” contract that includes only those remaining goods and services. In this situation, the entity would allocate to the remaining performance obligations (or distinct goods or services) in the contract (1) consideration from the original contract that has not yet been recognized as revenue and (2) any additional consideration from the modification. Such a situation would arise when there is a modification to a contract that contains (1) remaining distinct performance obligations or (2) a single performance obligation accounted for as a series of distinct goods or services under ASC 606-10-25-14(b).

In contrast, in accordance with ASC 606-10-25-13(b), if the contract modification results in remaining goods and services that are not distinct, the entity should account for the modification as though the additional goods and services were an addition to an incomplete performance obligation. This may be the case when a CRO’s contract with a customer contains one performance obligation and the parties modify the terms to change the scope of the services provided. In this instance, a measure of progress, such as costs incurred, would typically be used to recognize revenue over time. For example, suppose that just before the modification, the entity’s performance was 30 percent complete. After the modification, the entity may determine that its performance is only 25 percent complete because the scope of the single performance obligation increased (or is 35 percent complete because the scope of the single performance obligation decreased). As a result, an updated revenue figure is calculated on the basis of the revised percentage, and the entity would record a cumulative catch-up adjustment.

The FASB and IASB recognized that there may be contracts in which some performance obligations include remaining goods or services that are distinct from the goods or services already provided under the original arrangement, while other performance obligations include remaining goods and services that are not (i.e., a change in scope of a partially satisfied performance obligation). The boards decided that in those circumstances, it may be appropriate for an entity to apply both models to a single contract, in the manner described in ASC 606-10-25-13(c), on the basis of an assessment at the performance obligation level. An entity would do so by considering whether, for the performance obligations that are not yet fully satisfied (including those that are partially satisfied), the remaining goods or services to be transferred in accordance with the promise are distinct from the goods or services previously transferred. No change would be made to revenue recognized for fully satisfied performance obligations.

## 2.4 Identify the Performance Obligations (Step 2)

Step 2 is one of the most critical steps in the revenue framework since it establishes the unit of account for revenue recognition. This step requires an entity to identify what it has promised to the customer. The entity then determines whether a promise or multiple promises represent one or more performance obligations to the customer. To accomplish this, the entity should determine whether the promises in the contract are distinct. ASC 606-10-25-19 notes that a “good or service that is promised to a customer is distinct if both of the following criteria are met”:

- a. The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct).
- b. The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (that is, the promise to transfer the good or service is distinct within the context of the contract).

Further, ASC 606-10-25-22 states that “[i]f a promised good or service is not distinct, an entity shall combine that good or service with other promised goods or services until it identifies a bundle of goods or services that is distinct. In some cases, that would result in the entity accounting for all the goods or services promised in a contract as a single performance obligation.”

The standard’s guidance on determining whether a customer can benefit from a good or service on its own or together with other readily available resources is generally consistent with the legacy guidance in ASC 605-25 on determining whether a good or service has “stand-alone value.”

To help an entity assess whether its promises to transfer goods or services to the customer are separately identifiable, ASC 606-10-25-21 identifies the following factors “that indicate that two or more promises to transfer goods or services to a customer are **not** separately identifiable” (emphasis added):

- a. The entity provides a significant service of integrating [the] goods or services with other goods or services promised in the contract . . . In other words, the entity is using the goods or services as inputs to produce or deliver the combined output or outputs specified by the customer. . . .
- b. One or more of the goods or services significantly modifies or customizes, or are significantly modified or customized by, one or more of the other goods or services promised in the contract.
- c. The goods or services are highly interdependent or highly interrelated. In other words, each of the goods or services is significantly affected by one or more of the other goods or services in the contract. For example, in some cases, two or more goods or services are significantly affected by each other because the entity would not be able to fulfill its promise by transferring each of the goods or services independently.

In the life sciences industry, CROs often provide multiple services for their pharmaceutical and biotechnology customers. For example, CROs may help design studies, recruit investigators (physicians), recruit patients, help manage clinical trials, monitor safety, and write reports on study results. These services are generally considered to represent a single performance obligation because they are not “separately identifiable.”

Some of the other more common issues that life sciences entities have faced when considering step 2 of the revenue standard are discussed below.

### 2.4.1 License of IP Bundled With Other Services

Arrangements involving the license of IP and other services (e.g., contract R&D services or contract manufacturing services) are common in the life sciences industry. For example, biotechnology companies frequently enter into license and development arrangements with pharmaceutical companies, and contract manufacturers frequently enter into license and supply arrangements with pharmaceutical companies.

Life sciences entities that grant a license bundled with other services (e.g., contract R&D services or contract manufacturing services) may need to use significant judgment when determining whether the goods or services in a contract (1) are capable of being distinct (have stand-alone value) and (2) are not highly interdependent or highly interrelated and do not significantly modify or customize one another (are separately identifiable). While the analysis of whether the goods or services are capable of being distinct is generally consistent with the analysis of stand-alone value under legacy guidance, the “separately identifiable” concept may require entities to account for a bundle of goods or services, which may have represented separate units of account under legacy guidance, as a single performance obligation (unit of account) under the revenue standard.

### 2.4.2 Feasibility of Performance of the Same Services by Another Vendor

In the evaluation of whether a license of IP and contract R&D services (or contract manufacturing services) are separate performance obligations, an entity may need to consider whether it is feasible for another vendor to provide the same services.

ASC 606-10-55-367 through 55-372A, relevant parts of which are reproduced below, include two fact patterns that illustrate how the determination of whether it is feasible for another life sciences entity to provide the same services affects the analysis of whether the “capable of being distinct” criterion is met.

#### ASC 606-10

##### Example 56 — Identifying a Distinct License

**55-367** An entity, a pharmaceutical company, licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability. The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug (for example, to alter its chemical composition). There are no other promised goods or services in the contract.

##### *Case A — License Is Not Distinct*

**55-368** In this case, no other entity can manufacture this drug while the customer learns the manufacturing process and builds its own manufacturing capability because of the highly specialized nature of the manufacturing process. As a result, the license cannot be purchased separately from the manufacturing service.

**55-369** The entity assesses the goods and services promised to the customer to determine which goods and services are distinct in accordance with paragraph 606-10-25-19. The entity determines that the customer cannot benefit from the license without the manufacturing service; therefore, the criterion in paragraph 606-10-25-19(a) is not met. Consequently, the license and the manufacturing service are not distinct, and the entity accounts for the license and the manufacturing service as a single performance obligation.

##### *Case B — License Is Distinct*

**55-371** In this case, the manufacturing process used to produce the drug is not unique or specialized, and several other entities also can manufacture the drug for the customer.

**ASC 606-10 (continued)**

**55-372** The entity assesses the goods and services promised to the customer to determine which goods and services are distinct, and it concludes that the criteria in paragraph 606-10-25-19 are met for each of the license and the manufacturing service. The entity concludes that the criterion in paragraph 606-10-25-19(a) is met because the customer can benefit from the license together with readily available resources other than the entity's manufacturing service (that is, because there are other entities that can provide the manufacturing service) and can benefit from the manufacturing service together with the license transferred to the customer at the start of the contract.

**55-372A** The entity also concludes that its promises to grant the license and to provide the manufacturing service are separately identifiable (that is, the criterion in paragraph 606-10-25-19(b) is met). The entity concludes that the license and the manufacturing service are not inputs to a combined item in this contract on the basis of the principle and the factors in paragraph 606-10-25-21. In reaching this conclusion, the entity considers that the customer could separately purchase the license without significantly affecting its ability to benefit from the license. Neither the license nor the manufacturing service is significantly modified or customized by the other, and the entity is not providing a significant service of integrating those items into a combined output. The entity further considers that the license and the manufacturing service are not highly interdependent or highly interrelated because the entity would be able to fulfill its promise to transfer the license independent of fulfilling its promise to subsequently manufacture the drug for the customer. Similarly, the entity would be able to manufacture the drug for the customer even if the customer had previously obtained the license and initially utilized a different manufacturer. Thus, although the manufacturing service necessarily depends on the license in this contract (that is, the entity would not contract for the manufacturing service without the customer having obtained the license), the license and the manufacturing service do not significantly affect each other. Consequently, the entity concludes that its promises to grant the license and to provide the manufacturing service are distinct and that there are two performance obligations:

- a. License of patent rights
- b. Manufacturing service.



### Connecting the Dots

Determining whether R&D services or manufacturing services are separately identifiable from licenses can require significant judgment. While “bright lines” do not exist, the stage of development may be relevant to the determination of whether R&D services are expected to significantly modify or customize the IP (e.g., R&D services for early-stage IP frequently involve activities that lead to changes in a drug compound’s formulation, dosing levels, and manufacturing process, whereas R&D services for later-stage IP may only involve validating the drug’s efficacy).

Similarly, if the manufacturing of an API is performed to support R&D services, the manufacturing and R&D may not be distinct because the company cannot fulfill its promise to perform R&D independently from its promise to manufacture the API. Conversely, manufacturing of an approved product may be more likely to be “distinct” if another party could perform the services.

## 2.4.3 Contractual Requirement to Use the Entity’s Services

A revenue arrangement for the license of IP and contract R&D services (or contract manufacturing services) may contain a contractual requirement that the entity’s customer must use the entity’s services. A contractual requirement that the entity’s customer must use the entity’s R&D services (or manufacturing services) does not change the evaluation of whether the promised goods and services are distinct. In accordance with ASC 606-10-55-150F, “[t]his is because the contractual requirement to use the entity’s . . . services does not change the characteristics of the goods or services themselves, nor

does it change the entity's promises to the customer." Specifically, paragraph BC100 of ASU 2014-09 notes the following:

The Boards observed that the assessment of whether the "customer can benefit from the goods or services on its own" should be based on the characteristics of the goods or services themselves instead of the way in which the customer may use the goods or services. Consequently, an entity would disregard any contractual limitations that might preclude the customer from obtaining readily available resources from a source other than the entity.

Accordingly, if the license and the services are otherwise capable of being distinct and separately identifiable, the license and the services would be accounted for as two performance obligations.

#### **2.4.4 Assessing the Availability of Alternative Service Providers and Its Impact on the Identification of Performance Obligations**

The illustrative examples in ASC 606 provide certain facts used to support a determination of whether a promised good or service is distinct and therefore a separate performance obligation. However, some facts may vary between examples while the conclusions are consistent. For instance, in Example 11, Case C (ASC 606-10-55-150A through 55-150D), one of the facts provided to support the conclusion that the equipment and installation services represent two performance obligations is that others can provide the installation services. However, in Example 11, Case E (ASC 606-10-55-150G through 55-150K), the conclusion that the equipment and specialized consumables are two performance obligations is reached even though the specialized consumables are not available from other entities. This is because the entity in the example would be able to fulfill each of its promises in the contract (i.e., each promise to provide an item of equipment and consumables) independently of the other promises.

If a good or service (e.g., installation service) is unavailable from alternative providers, or available from only a limited number of alternative providers, an entity is not precluded from considering the good or service to be a separate performance obligation. The unavailability of a good or service from alternative providers is a factor for an entity to consider in evaluating whether the good or service is distinct (and therefore a separate performance obligation), but that factor is not individually determinative (as noted in the examples cited above). Entities need to use judgment in evaluating whether a promise to provide a good or service, in addition to other goods or services, is capable of being distinct and is distinct within the context of the contract (i.e., separately identifiable) in accordance with ASC 606-10-25-19. In making that determination, an entity may focus on why a good or service is or is not available from other providers, especially when evaluating the following factors in ASC 606-10-25-21 to conclude on whether the good or service is separately identifiable:

- Whether there is a significant service of integrating goods or services.
- Whether the good or service significantly modifies or customizes another good or service.
- Whether the good or service and one or more other goods or services are highly interdependent or highly interrelated.

For example, if an entity sells medical device equipment and provides installation of that equipment, the determination of whether the installation services are available from another entity would be a factor to be considered in the evaluation of whether the installation is distinct within the context of the contract, but that factor alone would not be determinative. It is important for the reporting entity to consider why the installation is unavailable from (or available from only a limited number of) alternative providers to determine whether the installation is separately identifiable in accordance with ASC 606-10-25-21. For example, if the entity has a standard installation process that does not significantly customize or modify the equipment for the entity's customer, the entity may conclude that the installation is separately identifiable regardless of whether there are no other installation providers or only a limited number of

such providers. However, installation services that are unique and significantly modify or customize the equipment for the customer may suggest that the services are not separately identifiable and therefore are not distinct within the context of the contract.



### Connecting the Dots

In the life sciences industry, manufacturing facilities and processes are frequently required to be approved by regulators (e.g., the FDA). The absence of alternative facilities with regulatory approval to manufacture a particular product can affect the “distinct” analysis for arrangements involving a license of IP and manufacturing services.

Similarly, biotechnology companies that enter into revenue arrangements with pharmaceutical companies are frequently required by contract to participate in a joint steering committee in addition to licensing a drug candidate and performing R&D services. Although the obligation to participate in a joint steering committee could be determined to be a promised service, it may not represent a “distinct” service unless, for example, other parties could perform the service and the service does not involve a significant integration of other goods and services in the arrangement.

## 2.4.5 Warranties

Companies that offer a warranty on their products sold (e.g., medical devices) must assess whether the warranty represents a distinct service that should be accounted for as a separate performance obligation.

It is important to determine what type of warranty an entity offers to a customer because the way in which revenue is recognized will vary depending on that determination. An entity should determine whether it offers the customer an assurance-type warranty or a service-type warranty. An assurance-type warranty provides the customer with the peace of mind that the entity will fix or possibly replace a good or service if the original good or service was faulty. It is the type of warranty with which most customers are familiar. In contrast, a service-type warranty provides the customer with a service that is incremental to the assurance that the good or service will meet the expectations agreed to in the contract.

An entity may need to use judgment to determine whether a warranty is a service-type warranty (i.e., performance obligation). This is important because, depending on the outcome of the entity’s assessment, consideration could be allocated to the performance obligation and consequently change the pattern of revenue recognition.

To assess the nature of a warranty, an entity should consider whether the warranty provides an additional service. It is easy to make this determination if the warranty is sold separately. A contract is considered separately priced if the customer has the option of purchasing the contract for an expressly stated amount separate from the price of the product. As discussed in paragraph BC371 of ASU 2014-09, an entity could also separately negotiate a warranty with a customer and determine that a performance obligation exists.

However, a warranty does not necessarily have to be separately sold or separately negotiated to be considered a performance obligation. To determine whether a warranty is a performance obligation, an entity should consider various indicators in accordance with ASC 606-10-55-33.

A warranty that provides a service **in addition to** the entity's assurance that the goods or services transferred to a customer will function as intended or meet agreed-upon specifications would represent a separate performance obligation. Accordingly, the entity would need to allocate a portion of the transaction price to the separate service and recognize the related revenue when (or as) performance is completed even when this warranty is neither separately priced nor separately negotiated.

If the warranty merely provides what ASC 606-10-55-30 describes as "assurance that the related product will function as the parties intended because it complies with agreed-upon specifications," the assurance is not a service and therefore not a separate performance obligation. For an assurance-type warranty obligation incurred in connection with the sale of a product (i.e., an obligation that is not separately priced or sold or otherwise a separate performance obligation), the costs associated with providing the warranty would be accrued in accordance with ASC 460-10 (see ASC 606-10-55-32).

Assessing the substance of the promise in a warranty arrangement that is neither separately priced nor separately negotiated often will require judgment. To aid in such an assessment, ASC 606-10-55-33 lists three factors that an entity should consider in determining whether a warranty provides the customer with a service in addition to the entity's assurance that the good or service complies with agreed-upon specifications: (1) whether the warranty is required by law, (2) the length of the coverage period, and (3) the nature of the tasks that are promised.

See [Section 5.5](#) of Deloitte's Roadmap *Revenue Recognition* for information related to the evaluation of warranty arrangements.

#### Example 2-7

Company A offers its customers a program under which it would provide them with a free drug vial replacement whenever a drug vial is damaged or broken by a physician before the drug is administered to a patient (subject to a maximum number of drug vials annually per customer). The drug vial replacement program is not separately priced.

Because A has promised to provide a service of replacing a drug vial in situations beyond those addressing manufacturing defects, A determines that the program represents a separate performance obligation that is not separately priced. Therefore, A should (1) determine the stand-alone selling price of the drug vial replacement service and allocate an appropriate portion of the transaction price to it and (2) recognize that portion as revenue over the period in which the drug vial replacement service is provided.

### 2.4.6 Application of the Series Provision in Life Sciences Arrangements

Entities in the life sciences industry may enter into service arrangements with other entities in the industry as part of their product development process or commercialization strategies. For example, the developer of a drug compound or other IP may enter into an arrangement with a CRO for clinical research services ("R&D services"). These R&D services may involve various tasks such as patient enrollment, clinical trial site management, and activities related to regulatory filings. While the two entities agree to a set of objectives, the CRO providing the R&D services may not promise or guarantee an end result. Instead, the CRO satisfies its performance obligation to the IP developer by giving the developer access to clinical professionals to advance the R&D efforts toward agreed-upon objectives. Given the nature of such R&D services, the services may not be performed consistently or consecutively over the service period, and their nature and scope may change as the work progresses.



Conversely, a life sciences entity may commercialize its approved pharmaceutical products by retaining an outsourced sales team to promote and sell its products. The nature of the selling services may differ from R&D services in that each day's service is not modified or customized by another day's service, one day's service is not an input with another day's service that results in a combined output, and the services performed on different days are not highly interdependent or highly interrelated.

An entity's application of ASC 606 to a contract with a customer may be affected by whether the entity determines that its promises to the customer represent (1) a single combined performance obligation comprising multiple activities that are not distinct or (2) a single performance obligation consisting of a series of distinct increments. Specifically, the application of the guidance on allocating variable consideration, accounting for contract modifications, and providing disclosures related to remaining performance obligations differs for a series of distinct increments of goods or services. We believe that the determination of whether R&D or selling services provided by entities in the life sciences industry represent a series may require significant judgment.

The first step in the evaluation of whether an entity's promise to provide R&D or selling services to a customer represents a series is to assess whether the nature of the promise is one of the following:

- The delivery of a specified quantity of goods or services.
- A stand-ready obligation to provide an indefinite amount of goods or services during a specified period.

If the nature of the promise is to deliver a specified quantity of goods or services, the entity must determine whether *each good or service* is distinct, is substantially the same as the other goods or services, and has the same pattern of transfer to the customer as that of the other goods or services. If, on the other hand, the nature of the promise is to stand ready for a specified period, the entity must determine whether, for *each increment of time*, its promise of standing ready to provide the R&D or selling services is distinct, is substantially the same as its promise for each of the other increments of time, and has the same pattern of transfer to the customer as its promise for each of the other increments of time.

Contracts in the life sciences industry to perform R&D services appear in various forms. For example, some contracts may include a license to IP in addition to the R&D services. If it is determined that the license and the R&D services are both within the scope of ASC 606 but are not distinct promises (or if the customer already has control of a license and the entity's only promise in the contract is to provide R&D services), the series guidance may not apply to the combined performance obligation if the R&D services provided throughout the development period are cumulative in that each increment of service builds on and is dependent on the increments that precede it (i.e., such services would not be considered distinct within the context of the contract). This could be the case when the R&D activities performed on a particular day significantly modify the results of R&D performed on previous days in such a way that the R&D services performed on different days are highly interdependent, highly interrelated, or both. In such a case, the R&D services would generally be accounted for as a single combined performance obligation consisting of multiple activities that are *not* distinct, as opposed to a series of distinct increments of time or service. In certain other cases, R&D services may meet the criteria to be accounted for as a series, as illustrated in the example below.



**Example 2-8**

Entity X, a CRO, enters into an arrangement with Pharma, the developer of a new drug compound, to perform daily R&D services for Pharma as needed during phase III clinical trials by giving Pharma access to clinical professionals. In exchange for the R&D services provided to Pharma, X will receive a daily fee per person and success-based milestone payments.

The activities to be performed may vary each day as X and Pharma work toward agreed-upon objectives in connection with the phase III clinical trials. While the activities may vary by day, they represent fulfillment activities associated with providing the daily R&D services and do not represent separate promises in the arrangement. Further, X has determined that such services are readily available in the marketplace and are not cumulative because each day's research and corresponding results are not dependent on the prior day's research; thus, each day of services does not build on activities that precede it, and each day of services and the activities that precede it are not integrated, interdependent, or interrelated. That is, no day of services significantly affects either X's ability to fulfill another day of services or the benefit to Pharma of another day of services.

Entity X determines that Pharma is a customer within the context of providing the services and therefore likewise concludes that the services are within the scope of ASC 606. In addition, X determines that the services to be provided to Pharma meet the criteria in ASC 606-10-25-27(a) for recognition of revenue over time since the services performed during each increment of time contribute to Pharma's development of the drug compound and thereby allow Pharma to simultaneously receive and consume the benefits provided by X's performance as each task is performed.

**Nature of the Promise**

Entity X determines that the nature of its promise is to stand ready to provide daily R&D services as needed during phase III clinical trials. Accordingly, X must assess whether, for each increment of time, its promise of standing ready to provide the R&D services (1) is distinct, (2) is substantially the same as its promise for each of the other increments of time, and (3) has the same pattern of transfer to the customer as its promise for each of the other increments of time.

**Distinct**

Pharma benefits from each day of services on its own since the services contribute to Pharma's development of the drug compound and are readily available in the marketplace. Consequently, X concludes that each increment of services is capable of being distinct.

In addition, X determines that each increment of services is distinct within the context of the contract. This is because each day of services (1) does not significantly modify or customize another day of services and (2) does not significantly affect X's ability to fulfill another day of services or the benefit to Pharma of another day of services since the R&D services are not cumulative, as noted above.

**Substantially the Same**

Entity X determines that for all of the increments of time during which R&D services are performed, its promise of standing ready to perform those services is substantially the same. While the specific tasks or services performed during each increment of time will vary, the nature of the overall promise to provide Pharma with daily R&D services remains the same throughout the contract term.

**Same Pattern of Transfer**

Entity X determines that the services have the same pattern of transfer to Pharma because both criteria in ASC 606-10-25-15 are met. The criterion in ASC 606-10-25-15(a) is met because each distinct service meets the criteria in ASC 606-10-25-27 to be a performance obligation satisfied over time since Pharma simultaneously receives and consumes the benefits provided by X as X performs. The criterion in ASC 606-10-25-15(b) is met because the same measure of progress (in this case, a time-based output method) would most likely be used to measure the progress of X toward satisfying its promise to provide the daily R&D services.

**Conclusion**

On the basis of the above, X concludes that the R&D services are a series and accounts for them accordingly.

A similar conclusion might be reached for outsourced selling services. For example, each day of selling services may meet the criteria to be accounted for as a series for the following reasons:

- The selling services are distinct because:
  - The customer can benefit from the sales force activities each day as the sales force promotes and sells the pharmaceutical products.
  - Each day (or increment) of selling services does not affect any other day (or increment) of selling services. That is, each day's services may not be modified or customized by another day's services, one day of services is not an input with another day of services that results in a combined output, and the services performed on different days are not highly interdependent or highly interrelated. That is, the entity providing the selling services can satisfy its promise to transfer selling services each day separately from a subsequent day of services.
- All increments (i.e., days) of the selling services are substantially the same (i.e., providing a comprehensive selling service). The volume of services may vary as a result of factors such as attrition of the sales representatives, the doctors' offices visited, and the different selling activities conducted each day, but the nature of the promise is the same each day and the customer benefits from the services in the same manner each day.
- The customer simultaneously receives and consumes the benefits of having an outsourced sales force selling its pharmaceutical products. That is, the customer benefits from each increment of service (i.e., day, week, or month). In addition, if the contract were to be terminated, a third party would not need to reperform the selling services already provided since the customer would have already benefited from the sales that were made. As a result, each increment of service is distinct and is satisfied over time, and the same method (time elapsed) would most likely be used to measure the service provider's progress toward complete satisfaction of the performance obligation to transfer each distinct service in the series to the customer.

## 2.4.7 Framework for Identifying Immaterial Promised Goods or Services

ASC 606-10-25-16A states, in part, that an entity "is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer." This guidance should not be applied to a customer option to acquire additional goods and services that provides a customer with a material right in accordance with ASC 606-10-55-41 through 55-45.

ASC 606-10-25-16A and 25-16B provide the following guidance on immaterial promised goods or services:

### ASC 606-10

**25-16A** An entity is not required to assess whether promised goods or services are performance obligations if they are immaterial in the context of the contract with the customer. If the revenue related to a performance obligation that includes goods or services that are immaterial in the context of the contract is recognized before those immaterial goods or services are transferred to the customer, then the related costs to transfer those goods or services shall be accrued.

**25-16B** An entity shall not apply the guidance in paragraph 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right, in accordance with paragraphs 606-10-55-41 through 55-45.

In light of the wording in ASC 606-10-25-16A and 25-16B, stakeholders have asked about the framework an entity should use to identify a potential good or service that is immaterial in the context of the contract. We believe that the following considerations are relevant to the assessment of whether a good or service is immaterial in the context of the contract:

- An entity may conclude that a potential good or service is immaterial in the context of the contract if the estimated stand-alone selling price of the potential good or service is immaterial (quantitatively) compared with the total consideration in the contract (i.e., the amount that would be allocated to such good or service is immaterial in the context of the contract).
- An entity may conclude that a potential good or service is immaterial in the context of the contract if it determines that the customer does not consider the potential good or service to be material to the contract (i.e., the entity would evaluate qualitative factors, including the customer's perspective, in determining whether a potential good or service is immaterial in the context of the contract).
- An entity may conclude that a potential good or service is immaterial in the context of the contract if it determines that the customer would have entered into the contract and paid the same (or similar) consideration if the potential good or service was excluded from the contract.

For example, a medical device company might offer basic training or education services for equipment that it sells to a hospital. The value of this type of service may be immaterial (quantitatively) compared with the total consideration in the contract. Further, the basic training or education may not be a service that the customer considers to be material to the contract.

In addition, we think that when an entity performs an assessment to identify immaterial promised goods or services, it should also consider the guidance in ASC 606-10-25-16B on customer options (i.e., potential material rights) as well as the SEC staff's view of "material" as discussed in [SAB Topic 1.M](#).



### Connecting the Dots

As noted above, an entity should not apply the guidance in ASC 606-10-25-16A to a customer option to acquire additional goods or services that provides the customer with a material right. For example, a life sciences company may have a practice of providing customers with the ability to purchase 12 weeks of treatment at list price with an option to purchase an additional 12 weeks of treatment at a significantly discounted price if it is determined that the patient is benefiting from the treatment and additional treatment will be helpful. This type of discount on future treatments based on the efficacy of a drug during the initial treatment period may represent a material right. Similarly, arrangements that include the delivery of free drugs after a contractually defined purchase volume has been achieved may include a material right. Options that are deemed to represent material rights — and, therefore, a performance obligation — would result in a deferral of revenue associated with that performance obligation, as discussed below.

## 2.4.8 Customer Options for Additional Goods or Services (Material Rights)

An entity's contract with a customer may give the customer a choice of whether to purchase additional goods or services; such a choice is typically referred to as an option for additional goods or services. Entities are required to identify options for additional goods or services because in certain circumstances, such options can lead to performance obligations. As explained in paragraph BC386 of ASU 2014-09, the FASB and IASB realized that it could be difficult to differentiate between (1) an option for additional goods or services that was paid for by the customer and (2) a marketing or promotional offer for which the customer did not pay. The first type of option for additional goods or services would be identified as a performance obligation to which consideration must be allocated in accordance with step 4 of the revenue standard.

To help entities determine whether an option for additional goods or services is a performance obligation, the boards included the concept of a material right in the revenue standard. If an entity determines that an option for additional goods and services is a material right, the option should be considered a performance obligation. However, an entity will need to use judgment to determine whether a material right exists.

A material right in a contract is provided to a customer only if the customer would not have received it without entering into that contract. The guidance in the revenue standard describes an example of a material right as an option that provides the customer an incremental discount beyond the discounts that are typically given (considering the class of customer).

When an option is identified as providing a customer with a material right, the option is identified as a performance obligation. A portion of the transaction price is then allocated to the option and recognized when (or as) (1) the future goods or services related to the option are provided or (2) the option expires.

#### **2.4.8.1 Determining Whether an Option for Additional Goods or Services Represents a Material Right**

In determining whether an option for future goods or services is a material right, an entity should (1) consider factors outside the current transaction (e.g., the current class of customer) and (2) assess both quantitative and qualitative factors. Further, an entity should also evaluate incentives and programs to understand whether they are customer options designed to influence customer behavior (i.e., an entity should consider incentives and programs from the customer's perspective) because this could be an indicator that an option is a material right.

When determining whether a contract option provides a material right, entities should consider not only the quantitative significance of the option (i.e., the quantitative value of the benefit) but also previous and future transactions with the customer as well as qualitative factors. Specifically, qualitative features such as whether the rights accumulate are likely to provide a qualitative benefit that may give rise to a material right. In accordance with ASC 606-10-25-16B, entities should not apply the guidance in ASC 606-10-25-16A on assessing whether promises for immaterial goods or services are performance obligations to the assessment of whether a contract option provides a material right (i.e., an optional good offered for free or at a discount may not be material for an individual contract but could be material in the aggregate and accounted for as a material right).

An entity should consider its customer's reasonable expectations when identifying promised goods or services. A customer's perspective on what constitutes a material right might consider qualitative factors (e.g., whether the right accumulates). Therefore, a numeric threshold alone might not determine whether a material right is provided by a customer option in a contract.

See Examples 49 through 52 in ASC 606-10-55-336 through 55-356 for examples of how an entity would determine whether an option provides a customer with a material right.

The above issue is addressed in [Implementation Q&As 12 through 14](#) (compiled from previously issued [TRG Agenda Papers 6, 11, 54, and 55](#)). For additional information and Deloitte's summary of issues discussed in the Implementation Q&As, see [Appendix C](#) of Deloitte's Roadmap [Revenue Recognition](#).

### 2.4.8.2 **Likelihood That an Option for Additional Goods or Services Will Be Exercised**

Stakeholders have raised various issues related to whether an entity should assess optional purchases provided to customers to determine whether the customer is economically compelled — or highly likely — to exercise its option(s).

Some business models include arrangements under which a vendor will sell an up-front good or service and also provide the customer with an option to purchase other distinct goods or services in the future that are related to the up-front good or service (e.g., a specialized piece of equipment, such as an infusion pump, and an option to buy specialized consumables that will be needed for its operation, such as infusion tubes used to deliver intravenous medications). Such arrangements may include features that result in a degree of economic compulsion such that there is a very high level of confidence that the customer will exercise its option (e.g., purchase infusion consumables in addition to purchasing the infusion pump).

In such circumstances, when it is highly probable, or even virtually certain, that the customer will exercise its option, the additional goods or services should **not** be treated as performance obligations under the contract. The treatment of customer options is explained in paragraph BC186 of ASU 2014-09, in which the FASB and IASB clarified that “the transaction price does not include estimates of consideration from the future exercise of options for additional goods or services,” making no reference to the probability that those options will be exercised.

Accordingly, irrespective of how likely it is that a customer will choose to purchase additional goods or services, the entity should not treat those goods or services as performance obligations under the initial contract. Instead, the entity should evaluate the customer option (in accordance with ASC 606-10-55-41 through 55-45) to determine whether it gives rise to a material right.

The above issue is addressed in [Implementation Q&A 21](#) (compiled from previously issued [TRG Agenda Papers 48](#) and [49](#)). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see [Appendix C](#) of Deloitte’s Roadmap [Revenue Recognition](#).

### 2.4.9 Medicare Coverage Gap Discounts

As a result of the Patient Protection and Affordable Care Act, entities participating in Medicare Part D must provide Medicare beneficiaries in the Medicare coverage gap (or “donut hole”) with a 50 percent discount and annual increases to a maximum of 75 percent in their Medicare prescription drug coverage. See [Section 2.4.9.1](#) for a discussion of updates to the donut hole resulting from the IRA.

No accounting literature directly addresses the accounting for discounts offered to individuals in the Medicare coverage gap. We believe that under ASC 606, either of the following two methods would be an acceptable policy election:

- *Specific identification approach* — Under this approach, each individual patient purchase is a separate contract and cannot be combined with future “expected” but optional purchases. Accordingly, the consideration due and payable for each individual purchase is attributable to that individual sale. Coverage gap subsidies are viewed as a form of variable consideration attributable to individual sales of products to specific customers in accordance with ASC 606-10-32-6. As a result, the estimate of variable consideration specific to each individual transaction is recorded at the point of sale. In a manner similar to the accounting for any form of variable consideration, an entity would estimate the variability (i.e., the occurrence or nonoccurrence of a future coverage gap discount in accordance with ASC 606-10-32-8) and apply the constraint guidance (ASC 606-10-32-11 and 32-12) before recognizing revenue when control of a purchased pharmaceutical drug is transferred into the distribution channel.

- *Material right approach* — Coverage gap subsidies constitute a material right in accordance with ASC 606-10-55-42. In effect, entities have entered into contractual arrangements with the U.S. government on behalf of Medicare-eligible patients in which the entities offer significant discounts on future purchases through the Medicare channel (i.e., all sales with Medicare-eligible patients throughout the year are “linked”). Under this approach, entities allocate a portion of the transaction price between current sales and the material right, which represents the discount to be provided on future sales to any Medicare-eligible patient within the coverage gap, and recognize the value of the material right in revenue when the coverage gap subsidies are used. This approach is inappropriate if rebates are expected to be made early in the year (as is the case for certain high-priced drugs) because it would be inappropriate to record a contract asset for what otherwise represents optional purchases.

#### **2.4.9.1 Drug Pricing Impacts of the Inflation Reduction Act**

The IRA, which President Biden signed into law on August 16, 2022, includes the following provisions related to pharmaceutical drug pricing:

- *Drug price negotiation* — Selected drugs covered by Medicare Parts B and D will be subject to mandatory price negotiations with Medicare beginning in 2026, with negotiated prices subject to a cap. The number of drugs selected for negotiation will increase from 10 in 2026 to 20 in 2029 and subsequent years. The expenditure data used to determine the drugs selected for negotiation will be related to the period from June 1, 2022, to May 31, 2023. The pricing negotiation period began October 1, 2023.
- *Inflation rebate* — Certain drugs covered by Medicare Parts B and D for which prices are rising at a higher rate than that of inflation will become subject to rebates. Under Medicare Part B, the rebate will first be due with respect to the first quarter of 2023. Under Medicare Part D, the rebate will first be due with respect to the period from October 1, 2022, to September 30, 2023. The initial Medicare Parts B and D benchmark period, with the Consumer Price Index for Urban Consumers (commonly known as CPI-U) used to calculate future inflation rebates, is as of January 1, 2021. On February 9, 2023, the Centers for Medicare & Medicaid Services issued initial guidance on rebatable drugs to the following:
  - [Pharmaceutical manufacturers of Part B rebatable drugs and other interested parties.](#)
  - [Pharmaceutical manufacturers of Part D rebatable drugs and other interested parties.](#)
- *Medicare Part D benefit redesign* — The Medicare Part D coverage gap (i.e., donut hole) created under the Medicare Modernization Act in 2003 will be eliminated, and as of January 1, 2025, manufacturers will be subject to mandatory discounts on brand drugs in the initial coverage and catastrophic coverage phases. In effect, the change will cap the out-of-pocket spending for Medicare Part D costs at \$2,000 per year starting in 2025. The change will be phased in starting in 2024 by capping the out-of-pocket costs at approximately \$3,250 in that year.

Implementation of this legislation is expected to be carried out through additional actions by regulatory authorities.





## Connecting the Dots

With the exception of the Medicare Part D inflation rebate, many of the IRA's drug pricing provisions will have staggered effective dates beyond 2022 (the year of the IRA's enactment). Accordingly, life sciences entities should assess the potential financial statement impact of such provisions and, to the extent material, consider disclosure of the anticipated current and future impact on the results of operations, financial position, liquidity, and capital resources in MD&A. For example, potential financial statement impacts may include those related to the following:

- *Inflation rebates* — Inflation rebates represent a form of variable consideration that will become payable if prices of certain drugs covered by Medicare Parts B and D are rising at a higher rate than that of inflation (beginning in 2022 for Part D and 2023 for Part B). Under the revenue standard, an entity must include some or all of an estimate of variable consideration in the transaction price when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of cumulative revenue in subsequent periods.
- *Medicare Part D benefit redesign* — The IRA includes a Medicare Part D benefit redesign that, as of January 1, 2025, eliminates the requirement for entities participating in Medicare Part D to provide Medicare beneficiaries in the Medicare coverage gap with a discount in their Medicare prescription drug coverage. However, manufacturers will be subject to mandatory discounts on brand drugs in the initial coverage and catastrophic phases. Under this mandatory discount program, manufacturers generally must offer (1) a 10 percent discount when a beneficiary has satisfied the deductible and incurred costs less than the out-of-pocket threshold and (2) a 20 percent discount when a beneficiary has incurred costs greater than or equal to the out-of-pocket threshold. Because these discounts will vary depending on the costs incurred by the beneficiary, we believe that the specific identification approach and the material right approach methods described above will continue to represent an accounting policy election that entities should consistently apply.
- *Indirect impacts of the IRA on other estimates of variable consideration* — Discounts provided by manufacturers as a result of Medicare drug price negotiations may affect the determination of other estimates of variable consideration. For example, because Medicare prices affect the determination of “best price” used in Medicaid and 340B Drug Pricing Program drug price calculations, estimates of variable consideration associated with those programs may be affected. In addition, manufacturers of non-negotiated drugs in classes with a negotiated Medicare price may need to increase rebates to remain on formularies, which could affect an entity's estimates of variable consideration.

### 2.4.10 Shipping and Handling Activities

Shipping and handling activities are often provided by life sciences entities as part of a revenue arrangement. When goods are shipped free on board (FOB) shipping point, title passes to the buyer when the goods are shipped, and the buyer is responsible for any loss in transit. On the other hand, when goods are shipped FOB destination, title does not pass to the buyer until delivery, and the seller is responsible for any loss in transit.

It is important to understand the shipping terms of an arrangement to determine when control of the good is transferred to the customer. This is because the shipping terms often trigger some of the key control indicators (e.g., transfer of title and present right to payment). Therefore, a careful evaluation of shipping terms is critical to the assessment of transfer of control.

When control is determined to be transferred upon shipment, the seller should consider whether the risk of loss or damage that it assumed during shipping gives rise to another performance obligation (a distinct service-type obligation) that needs to be accounted for separately in accordance with the revenue standard. For example, such risk may represent another performance obligation if goods are frequently lost or damaged during shipping.

Further, entities should consider the practical expedient under U.S. GAAP (ASC 606-10-25-18B, added by [ASU 2016-10](#)) that allows entities the option to treat shipping and handling activities that occur after control of the good is transferred to the customer as fulfillment activities. Entities that elect to use this practical expedient would not need to account for the shipping and handling as a separate performance obligation. Instead, when the practical expedient is elected and revenue for the related good is recognized before the shipping and handling activities occur, the entity should accrue the costs of the shipping and handling activities at the time control of the related good is transferred to the customer (i.e., at the time of sale).

Entities should also consider the guidance in ASC 606-10-25-18A, which explains that shipping and handling activities performed before control of a product is transferred do not constitute a promised service to the customer in the contract (i.e., they represent fulfillment costs).

## 2.5 Determine the Transaction Price (Step 3)

In step 3 of the revenue standard, an entity determines the “transaction price,” which, as stated in ASC 606-10-32-2, represents “the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer, excluding amounts collected on behalf of third parties (for example, some sales taxes). The consideration promised in a contract with a customer may include fixed amounts, variable amounts, or both.” Because the transaction price is an expected amount, estimates are inherently required. When determining the transaction price, an entity is required under ASC 606-10-32-3 to “consider the effects of all of the following”:

- “Variable consideration.”
- “Constraining estimates of variable consideration.”
- “The existence of a significant financing component in the contract.”
- “Noncash consideration.”
- “Consideration payable to a customer.”

The effects of these elements are particularly relevant to life sciences entities, as explained in the sections below.

### 2.5.1 Variable Consideration

ASC 606-10-32-6 explains that variable consideration may arise “because of discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items” and that the promised consideration can vary “if an entity’s entitlement to the consideration is contingent on the occurrence or nonoccurrence of a future event” (e.g., when “a product [is] sold with a right of return or a fixed amount is promised as a performance bonus on achievement of a specified milestone”). In the life sciences industry, common forms of variable consideration include returns, chargebacks, rebates, cash and volume-based discounts, promotions, shelf stock adjustments, and other adjustments to revenue, as well as royalties, development-based milestones, and sales-based milestones.



### **2.5.1.1 Methods of Estimating Variable Consideration**

Regardless of the form of variability or its complexity, once variable consideration is identified, an entity is required under ASC 606-10-32-8 to estimate the amount of variable consideration to determine the transaction price in a contract with a customer by using either the “expected value” method or the “most likely amount” method, “depending on which method the entity expects to better predict the amount of consideration to which it will be entitled.” As ASC 606-10-32-8 explains, the expected value is “the sum of probability-weighted amounts in a range of possible consideration amounts. An expected value may be an appropriate estimate of the amount of variable consideration if an entity has a large number of contracts with similar characteristics.” ASC 606-10-32-8 further states that the most likely amount is “the single most likely amount in a range of possible consideration amounts (that is, the single most likely outcome of the contract).”

In the life sciences industry, it may be appropriate for an entity to estimate development-based milestones by using the most likely amount method since the achievement of a milestone has only two possible outcomes (an entity either achieves the milestone or does not achieve it). Other forms of variable consideration may be estimated under the expected value method. For example, estimates of returns under the expected value method may take into account factors such as the following:

- The period in which returns can occur.
- Experiences with products (or the inability to apply such experiences to current products).
- Availability of information about product levels and the age of the product in the distribution channel.
- Predictability of market conditions and competition (e.g., competitive entry of a similar or generic product).
- The current stage in the product life cycle (i.e., initial product launch vs. end/maturity of product life).
- Historical, current, and projected demand.

In addition to the factors listed above, the following factors may be relevant to the development of estimates of variable consideration in the form of chargebacks and rebates under the expected value method:

- The existence of product-specific historical information about chargebacks and rebates.
- The availability and specificity of customer-specific pricing information (including contractual arrangements with retailers, insurance providers, or governmental agencies).
- Information about the specific retailer and consumer product sales mix (to understand which customer pricing arrangement is applicable).
- The availability and specificity of customer inventory levels.

In applying the expected value method to these types of estimates, life sciences entities are not necessarily expected to develop complex modeling techniques to identify all possible outcomes of variable consideration. Although we think that it is appropriate for an entity to be pragmatic in deriving an estimate by using one of the required methods, we do not think that it is appropriate to use a method described as management’s best estimate as either the most likely amount or the expected value of variable consideration. Consequently, we would encourage an entity to document the basis for any conclusion that its approach aligns with the estimation methods of ASC 606.

### 2.5.1.2 Price Protection Arrangements

Life sciences entities sometimes enter into price protection arrangements, under which wholesalers are reimbursed for any difference between the current sales price and the lowest price offered during a specified subsequent period (e.g., one year).

Under the revenue standard, an entity must include some or all of an estimate of variable (or contingent) consideration in the transaction price (which is the amount to be allocated to each performance obligation and recognized as revenue) when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of cumulative revenue in subsequent periods. In price protection arrangements, the transaction price would therefore include an estimate of expected price protection determined under either the expected value method or the most likely amount method (i.e., whichever method the entity expects to better predict the amount of consideration to which it will be entitled), with revenue recognized when control is transferred to the distributor.



#### Connecting the Dots

Instead of providing a retroactive discount, price protection arrangements may be structured to provide a discount on future purchases if a life sciences company sells its products to another customer at a lower price during a specified subsequent period. In these circumstances, the entity should consider whether the price protection arrangement conveys a material right to buy products at a lower price in the future. If a material right is determined to exist, this would represent a separate performance obligation to which a portion of the transaction price would need to be allocated. If a material right does not exist (e.g., because the discount applies only to future purchases and is not based on the volume of past purchases), there would be no impact on current sales, and future sales would be recognized at the discounted prices.

### 2.5.1.3 Price Appreciation Rights

In contrast to price protection arrangements created to benefit the customer for subsequently reduced prices, life sciences entities may have price appreciation clauses in contracts with customers that are created to benefit the entity. Price appreciation clauses may allow the entity to charge the customer for any increases that the entity may make during the year (e.g., as the difference between the old and new wholesale acquisition costs for the product multiplied by the number of units of the product still held by the customer in inventory). An entity should assess whether the potential price appreciation in contracts with such clauses should be accounted for as variable consideration to be included as an estimate in the transaction price or whether the price appreciation should be treated as a contract modification when the price change occurs under ASC 606-10-25-10 through 25-13.

In arrangements with price appreciation rights, the transaction price would include an estimate of expected price appreciation to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty about whether a price increase will occur is subsequently resolved. In these circumstances, a life sciences entity will need to consider its past business practices of raising prices and its intentions with respect to such increases. For any such estimates that are included in the transaction price, a life sciences entity will need to estimate the amount of inventory that the customer will have on hand at the time of the price increase, as well as any resulting “gross-to-net” deductions (e.g., chargebacks, rebates, returns, and other similar adjustments) that will increase as a result of the increase in the wholesale acquisition cost.

### **2.5.1.4 New Product Launches With a Right of Return**

Under the revenue standard, the uncertainty associated with whether a product may be returned is treated, for measurement purposes, consistently with the uncertainty associated with other variable consideration. That is, under ASC 606-10-55-25:

An entity should . . . determine the amount of consideration to which the entity expects to be entitled (that is, excluding the products expected to be returned). For any amounts received (or receivable) for which an entity does not expect to be entitled, the entity should not recognize revenue when it transfers products to customers but should recognize those amounts received (or receivable) as a refund liability. Subsequently, at the end of each reporting period, the entity should update its assessment of amounts for which it expects to be entitled in exchange for the transferred products and make a corresponding change to the transaction price and, therefore, in the amount of revenue recognized.

The amount of historical information and evidence needed to support the estimates and assumptions regarding returns can vary depending on whether the product was (1) a modification of an existing product, (2) similar to other products in the market (i.e., an “analog”), or (3) a completely new product. Obtaining sufficient evidence for new products may be difficult when the company does not have a relevant history for an analog or a clear competitive advantage that allows for more predictable sales. When using an analog to aid in the estimation of returns, life sciences entities are encouraged to document the basis for their conclusions that the analog is similar to the product being sold. Typically, this documentation should reflect that the analog is part of a similar therapeutic class, provides a similar mechanism of treatment, and targets similar customers and markets.

### **2.5.1.5 Pay-for-Performance Arrangements**

Pay-for-performance arrangements are becoming increasingly more common in the life sciences industry. Pay for performance in health care gives financial incentives to clinicians for better health outcomes. Clinical outcomes, such as longer survival, can be difficult to measure, so pay-for-performance systems usually measure process outcomes. Also known as “value-based purchasing,” this payment model rewards physicians, hospitals, medical groups, and other health care providers for meeting certain performance measures for quality and efficiency. It provides a disincentive to caregivers for poor outcomes, medical errors, or increased costs.

Under the revenue standard, pay-for-performance arrangements represent another form of variable consideration. In a manner similar to the accounting in the examples above, a life sciences entity with these types of arrangements must include some or all of an estimate of variable consideration in the transaction price when the entity concludes that it is probable that changes in its estimate of such consideration will not result in significant reversals of cumulative revenue in subsequent periods.

### **2.5.1.6 Retroactive Payback Provisions**

In certain countries, companies are required to pay rebates to the country’s government health care system if domestic industry sales exceed specified thresholds in a given year. If the threshold is exceeded, the portion of the payback allocated to an individual company is based on that company’s current market share (or sales) in relation to the industry as a whole.

Under the revenue standard, an entity would account for the retroactive payback provision as a retroactive rebate (i.e., variable consideration) and possibly use the expected value method to estimate it, subject to the constraint.

### 2.5.1.7 *Volume-Based Rebates*

A life sciences entity may offer its customers rebates or discounts on the pricing of products or services once specific volume thresholds have been met. That is, an entity may either retrospectively or prospectively adjust the price of its goods or services once a certain volume threshold has been met.

A volume rebate or discount that is **retrospectively** applied should be accounted for under the revenue standard as variable consideration (rather than as a customer option to be evaluated as a potential material right). In accordance with ASC 606-10-32-6, which specifically includes discounts and rebates as a form of variable consideration, the “promised consideration also can vary if an entity’s entitlement to the consideration is **contingent on the occurrence or nonoccurrence of a future event**” (emphasis added).

However, an offer to **prospectively** lower the price per unit (once certain volume thresholds are met) should not be accounted for as variable consideration. Rather, when a volume rebate or discount is applied **prospectively**, an entity will need to evaluate the facts and circumstances of each contract to determine whether the rebate or discount represents a material right and therefore should be accounted for as a performance obligation. As part of this evaluation, entities would consider whether the offer to the customer is at a price that would reflect the stand-alone selling price for that good or service, in accordance with ASC 606-10-55-43.

### 2.5.1.8 *Discounts Provided to Group Purchasing Organizations*

Life sciences companies frequently enter into agreements with group purchasing organizations (GPOs) to provide discounts to hospitals that are affiliated with the GPOs. Distributors of the life sciences companies’ products then request reimbursement of the discounts provided to the life sciences companies’ hospital customers.

In accordance with the revenue standard, a life sciences company should treat these discounts as variable consideration and possibly use the expected value method to estimate the discounts, subject to the constraint.

In addition to providing these discounts, life sciences companies frequently pay administrative fees to GPOs to fund the expenses of GPO members. To determine the appropriate classification of these administrative fees as a reduction of revenue or as an increase to operating expense, a life sciences company should consider the relationships between the vendor, the GPO, and the GPO member to determine whether the GPO is a customer. For example, the company might consider the GPO to be a customer if the GPO is a related party of the GPO member or if there is a mechanism to pass through the administrative fee from the GPO to the GPO member. In those situations, the company may be required to reflect the fee as a reduction of revenue.



#### **Connecting the Dots**

Similar questions related to income statement classification may arise regarding payments made by life sciences companies to not-for-profit entities (NFPs) or other organizations that fund copay assistance programs to defray the cost of high-priced drugs. Specifically, there may be questions about whether these payments represent consideration paid to an indirect customer (e.g., because the contribution funds are ultimately used by patients to purchase the company’s products). While these payments may have been classified in expense under legacy guidance, life sciences companies are encouraged to evaluate their facts and circumstances to determine whether these payments represent a form of variable consideration under the revenue standard.

In June 2018, the FASB issued [ASU 2018-08](#), which clarifies the scope and accounting guidance for contributions received and contributions made. Specifically, the ASU indicates that its amendments are intended, in part, to help entities evaluate “whether transactions should be accounted for as contributions (nonreciprocal transactions) within the scope of [ASC 958] or as exchange (reciprocal) transactions subject to other guidance,” such as ASC 606. The ASU explains that while the issues it aims to address have been long-standing, “the amendments in [ASU 2014-09] place an increased focus on the issues because those amendments add new disclosure requirements and eliminate certain limited exchange transaction guidance that was previously contained in [ASC] 958-605.”

### **2.5.1.9 Contingent Development-Based Milestone Payments**

Life sciences entities often perform R&D activities in exchange for fixed consideration and milestone or bonus payments if predetermined objectives are achieved. For example, a CRO may enter into an agreement with a pharmaceutical company to perform a clinical trial in exchange for fixed consideration plus a milestone payment if it screens a specified number of patients for enrollment in the clinical trial within a specified period.

In accordance with the revenue standard, a life sciences company should consider contingent development-based milestone payments as variable consideration. It may be appropriate to estimate the milestone payments by using the most likely amount method since a milestone has only two possible outcomes (the entity either achieves the milestone or does not achieve it).

In the fact pattern described above, the CRO may consider its experience in screening patients for enrollment for similar types of trials for other pharmaceutical companies when determining whether to include the milestone payment in its estimate of the transaction price.

See [Section 2.10.5](#) for discussion of the accounting for sales-based milestone payments.

## **2.5.2 Constraining Estimates of Variable Consideration**

Since revenue is one of the most important metrics to users of financial statements, the FASB and IASB and their constituents agreed that estimates of variable consideration are useful only to the extent that an entity is confident that the revenue recognized as a result of those estimates will not be subsequently reversed. Accordingly, as noted in paragraph BC203 of ASU 2014-09, the boards acknowledged that some estimates of variable consideration should not be included in the transaction price if the inherent uncertainty could prevent a faithful depiction of the consideration to which the entity expects to be entitled in exchange for delivering goods or services. Thus, the focus of the boards’ deliberations on a mechanism to improve the usefulness of estimates in revenue as a predictor of future performance was to limit subsequent downward adjustments in revenue (i.e., reversals of revenue recognized). The result of those deliberations is what is commonly referred to as the “constraint.”

ASC 606-10-32-11 and 32-12 describe the constraint and provide guidance on how it should be applied.

#### **ASC 606-10**

**32-11** An entity shall include in the transaction price some or all of an amount of variable consideration estimated in accordance with paragraph 606-10-32-8 only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

**ASC 606-10 (continued)**

**32-12** In assessing whether it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur once the uncertainty related to the variable consideration is subsequently resolved, an entity shall consider both the likelihood and the magnitude of the revenue reversal. Factors that could increase the likelihood or the magnitude of a revenue reversal include, but are not limited to, any of the following:

- a. The amount of consideration is highly susceptible to factors outside the entity's influence. Those factors may include volatility in a market, the judgment or actions of third parties, weather conditions, and a high risk of obsolescence of the promised good or service.
- b. The uncertainty about the amount of consideration is not expected to be resolved for a long period of time.
- c. The entity's experience (or other evidence) with similar types of contracts is limited, or that experience (or other evidence) has limited predictive value.
- d. The entity has a practice of either offering a broad range of price concessions or changing the payment terms and conditions of similar contracts in similar circumstances.
- e. The contract has a large number and broad range of possible consideration amounts.

Importantly, the constraint does not apply to sales- or usage-based royalties derived from the licensing of IP; rather, consideration from such royalties is only recognized as revenue at the later of when the performance obligation is satisfied or when the uncertainty is resolved (e.g., when subsequent sales or usage occurs). See [Section 2.10](#) for additional discussion.

Inherent in ASC 606-10-32-12 are three key aspects of the assessment necessary for an entity to determine whether an estimate of variable consideration in a contract with a customer should be constrained in an entity's transaction price:

- The likelihood of a reversal in the cumulative amount of revenue recognized (i.e., a qualitative aspect).
- The magnitude (or significance) of the potential reversal in the cumulative amount of revenue recognized (i.e., a quantitative aspect).
- The threshold that triggers a constrained estimate (i.e., the use of "probable").

The determination of whether to constrain estimates of variable consideration may require significant judgment depending on the nature of the revenue stream being estimated. For example, it may be unnecessary for an entity to constrain revenue on the sale of established pharmaceutical products to wholesalers for the following reasons:

- Variable consideration (e.g., rebates, discounts) may not be highly susceptible to factors outside the entity's influence (e.g., volatility in a market, the judgment or actions of third parties, a high risk of obsolescence).
- The uncertainty about the amount of consideration may be resolved in a shorter period.
- The entity may have significant experience with similar types of contracts or with contracts that have predictive value.
- The range of price concessions is narrow.

In contrast, it may be necessary to constrain a significant portion of revenue on the sale of IPR&D, a nonfinancial asset, in exchange for future development milestones and royalties and sales-based milestones since the likelihood of reversal in the cumulative amount of revenue recognized could be high and the magnitude of the potential reversal could be significant. The uncertainty associated with revenue related to such a transaction arises from a number of factors:

- Before regulatory approval, uncertainty may arise from potential delays with clinical trials, success of competitor trials, or an inability to obtain regulatory approvals.
- After regulatory approval, uncertainty may arise from product safety concerns, manufacturing issues, potential product recalls, the introduction of competitor products, or possible sales and distribution channel issues.
- Both before and after regulatory approval, the amount of consideration to be received may be highly susceptible to factors outside the entity's influence because success is predicated on the efforts of the party to which the IPR&D was sold.

Although the guidance on constraining estimates of variable consideration is intended to avoid significant downward adjustments in revenue after it has been recognized, we generally do not think that it would be appropriate to constrain 100 percent of an estimate of variable consideration. That is, we do not think that the factors in ASC 606-10-32-12 could be so significant that an estimate of variable consideration should be entirely constrained from the transaction price. This concept is different from a \$0 *estimate* of variable consideration. A 100 percent constraint on an estimate of variable consideration that is not \$0, however, would generally go against the measurement principle of ASC 606, which is to include in the transaction price the amount to which an entity expects to be entitled for its performance so that the entity can provide financial statement users a better prediction of future revenues.

While the above is a general interpretation, there are exceptions in the revenue standard that may allow for a 100 percent constraint on an estimate of variable consideration. Example 25 in ASC 606-10-55 discusses an exception in which market-based factors are a significant driver of variability in the transaction price. Also, in paragraph BC415 of ASU 2014-09, the boards discuss their rationale for providing an exception for sales- or usage-based royalties in a license of IP.



### Connecting the Dots

Milestone payments that are due upon regulatory approval are inherently based on factors outside the entity's control. As a result, life sciences companies that use a most likely method to estimate variable consideration may conclude that the variable consideration associated with a regulatory approval milestone is \$0 before regulatory approval. However, there may be certain cases in which a milestone earned upon regulatory approval becomes probable before the approval date. For example, when an authorized generic of an existing branded drug is under FDA review, an entity may determine before the actual approval date that approval is likely to occur. Contrast that with a new drug compound for which there is no competitor on the market. In this case, it may be more difficult to assert probability in advance of the actual approval date.

## 2.5.3 Subsequent Changes in the Transaction Price

It is common for a life sciences entity to enter into a contract with a customer that entitles the life sciences entity to variable consideration in the event that the customer receives regulatory approval as a result of the R&D activities performed by the life sciences entity. Because the variable consideration is contingent on the customer's receipt of regulatory approval, the life sciences entity is required to estimate the amount of variable consideration to include in the transaction price. The life sciences entity may conclude that such variable consideration should be constrained until regulatory approval is obtained.



In certain circumstances, the uncertainty related to variable consideration may be resolved shortly after the end of the reporting period. When additional information (e.g., regulatory approval notification or denial) is received after the end of the reporting period and before the date on which the financial statements are issued or are available to be issued, an entity should refer to the guidance in ASC 855 on accounting for subsequent events. Paragraph BC228 of ASU 2014-09 states the following:

The Boards noted that in some cases, an entity might make an estimate of the amount of variable consideration to include in the transaction price at the end of a reporting period. However, information relating to the variable consideration might arise between the end of the reporting period and the date when the financial statements are authorized for issue. The Boards decided not to provide guidance on the accounting in these situations because they noted that the accounting for subsequent events is already addressed in Topic 855, Subsequent Events, and IAS 10, *Events after the Reporting Period*.

ASC 855 distinguishes between recognized subsequent events (ASC 855-10-25-1) and nonrecognized subsequent events (ASC 855-10-25-3) as follows:

#### ASC 855-10

**25-1** An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

**25-3** An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.

However, ASC 855 does not provide direct guidance on how to account for additional information about regulatory approval or denial that is received after the end of the reporting period and before the date on which the financial statements are issued or are available to be issued. We believe that the conclusion to account for information received regarding the regulatory approval process as either a recognized or a nonrecognized subsequent event will be based on the facts and circumstances and may require significant judgment. Accordingly, entities are encouraged to consult with their accounting advisers.

## 2.5.4 Significant Financing Components

In certain contracts with customers, one party may provide a service of financing (either explicitly or implicitly) to the other. Such contracts effectively contain two transactions: one for the delivery of the good or service and another for the benefit of financing (i.e., what is in substance a loan payable or loan receivable). The FASB and IASB decided that an entity should account for both transactions included in a contract with a customer when the benefit of the financing provided is significant.

#### ASC 606-10

**32-15** In determining the transaction price, an entity shall adjust the promised amount of consideration for the effects of the time value of money if the timing of payments agreed to by the parties to the contract (either explicitly or implicitly) provides the customer or the entity with a significant benefit of financing the transfer of goods or services to the customer. In those circumstances, the contract contains a significant financing component. A significant financing component may exist regardless of whether the promise of financing is explicitly stated in the contract or implied by the payment terms agreed to by the parties to the contract.



In determining the transaction price, an entity adjusts the promised amount of consideration to determine the cash selling price of the good or service to be delivered and reflect the time value of money if the contract has a significant financing component. The direction of the financing component (i.e., whether financing is provided to the entity through an advance payment or to the customer through payments in arrears) is irrelevant to the assessment, and as a result of the adjustment to the transaction price, the entity could recognize interest expense or interest income.

However, ASC 606-10-32-18 provides a practical expedient under which an entity does not need to adjust the promised amount of consideration for the effects of a significant financing component “if the entity expects, at contract inception, that the period between when the entity transfers a promised good or service to a customer and when the customer pays for that good or service will be one year or less.”

Life sciences entities often receive advance payments for services. For example, payments are often required by CROs in advance of performing clinical trials, or by third-party manufacturers to secure manufacturing capacity.

Entities must use judgment in determining whether a significant financing component exists. However, ASC 606-10-32-17 notes that a contract with a customer would not have a significant financing component if certain factors exist. The table below describes the factors of greatest relevance to life sciences entities and examples of arrangements in which these factors may apply.

<b>Factor (ASC 606-10-32-17)</b>	<b>Example</b>
“A substantial amount of the consideration promised by the customer is variable, and the amount or timing of that consideration varies on the basis of the occurrence or nonoccurrence of a future event that is not substantially within the control of the customer or the entity.”	Royalty arrangements, in which variability is provided to confirm the value of goods delivered.
“The difference between the promised consideration and the cash selling price of the good or service (as described in paragraph 606-10-32-16) arises for reasons other than the provision of finance to either the customer or the entity, and the difference between those amounts is proportional to the reason for the difference. For example, the payment terms might provide the entity or the customer with protection from the other party failing to adequately complete some or all of its obligations under the contract.”	Customer withholds consideration until the achievement of a certain milestone and to protect against nonperformance.  Customer is required to pay up front to secure supply of a good.

## 2.5.5 Noncash Consideration

When providing goods or services, an entity may receive noncash consideration from its customers (e.g., goods, services, shares of stock). It is not uncommon for companies in the life sciences industry to enter into revenue transactions with customers that involve receiving products from the customer as consideration (e.g., supplies). Step 3 requires entities to include the fair value of the noncash consideration in the transaction price. Paragraph BC248 of ASU 2014-09 states the FASB’s and IASB’s rationale for this requirement: “When an entity receives cash from a customer in exchange for a good or service, the transaction price and, therefore, the amount of revenue should be the amount of cash received (that is, the value of the inbound asset). To be consistent with that approach, the Boards decided that an entity should measure noncash consideration at fair value.” Further, in issuing ASU 2014-09 and IFRS 15, the boards included guidance stating that changes in the fair value of noncash consideration for reasons other than its form would be subject to the variable consideration constraint in ASC 606-10-32-11 through 32-13 (paragraphs 56 through 58 of IFRS 15).

ASC 606-10-32-21 and 32-22 require an entity to first look to measure the estimated fair value of the noncash consideration at contract inception and then consider the stand-alone selling price of the goods or services promised to the customer only when the entity is unable to reasonably estimate the fair value of the noncash consideration.

## 2.5.6 Consideration Payable to a Customer

ASC 606-10-32-25 through 32-27 establish requirements related to consideration payable to a customer. Consideration payable to a customer includes cash amounts<sup>1</sup> that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer). An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (typically resulting in the recognition of an asset or expense).

ASC 606-10-32-25 establishes that consideration payable to a customer includes equity instruments granted in conjunction with the sale of goods or services. In addition, ASC 718-10-15-5A provides that “[i]f share-based payment awards are granted to a customer as payment for a distinct good or service from the customer, then an entity shall apply the guidance in paragraph 606-10-32-26.” Under ASC 606-10-32-26, if the payment to the customer is in exchange for a distinct good or service that the customer transfers to the entity, the entity should “account for the purchase of the good or service in the same way that it accounts for other purchases from suppliers.”

For share-based payments issued as consideration payable to a customer in accordance with ASC 606 (i.e., share-based consideration payable to a customer that is not in exchange for distinct goods or services), entities must measure and classify share-based sales incentives by applying the guidance in ASC 718. Accordingly, entities should measure share-based sales incentives by using a fair-value-based measure on the grant date, which would be the date on which the grantor (the entity) and the grantee (the customer) reach a mutual understanding of the key terms and conditions of the share-based sales incentive. The resulting measurement of the share-based sales incentive should be reflected as a reduction of revenue in accordance with the guidance in ASC 606 on consideration payable to a customer. After initial recognition, the measurement and classification of the share-based sales incentive continues to be subject to ASC 718 unless (1) the award is subsequently modified when vested and (2) the grantee is no longer a customer.

### 2.5.6.1 Identifying Payments Within the Scope of the Requirements Related to Consideration Payable to a Customer

In accordance with ASC 606-10-32-25, consideration payable to a customer includes the following:

- a. Cash amounts that an entity pays, or expects to pay, to the customer (or to other parties that purchase the entity's goods or services from the customer)
- b. Credit or other items (for example, a coupon or voucher) that can be applied against amounts owed to the entity (or to other parties that purchase the entity's goods or services from the customer)
- c. Equity instruments (liability or equity classified) granted in conjunction with selling goods or services (for example, shares, share options, or other equity instruments).

An entity should account for consideration payable to a customer as a reduction of the transaction price and, therefore, of revenue unless the payment to the customer is in exchange for a distinct good or service (typically resulting in the recognition of an asset or expense).

<sup>1</sup> For a list of additional items included in consideration payable to a customer under ASC 606-10-32-25, see [Section 2.5.6.1](#).

An entity should assess the following payments to customers under ASC 606-10-32-25 to determine whether they are in exchange for a distinct good or service:

- Payments to customers that result from a contractual obligation (either implicitly or explicitly).
- Payments made on behalf of customers that are considered in-substance price concessions because the customer has a reasonable expectation of such payments (either implicitly or explicitly).
- Purchases made on behalf of customers in lieu of making cash payments to those customers.
- Payments to customers that can be economically linked to revenue contracts with those customers.

While an entity is not required to separately assess and document each payment made to a customer, an entity should not disregard payments that extend beyond the context of a specific revenue contract with a customer. Rather, an entity should use reasonable judgment when determining how broadly to apply the guidance on consideration payable to a customer to determine whether the consideration provided to the customer is in exchange for a distinct good or service (and is therefore an asset or expense) or is not in exchange for a distinct good or service (and is therefore a reduction of revenue).

Payments made to third parties on behalf of customers can come in many forms and may not necessarily be incentives paid to a customer's customer to be deemed consideration payable to a customer. In determining whether a payment made to a third party is on behalf of a customer, the entity making the payment should consider whether it receives a distinct good or service from the third party. Further, in determining whether a payment made to a third party is on behalf of a customer, the entity making the payment might consider whether it is acting as a principal or as an agent when the customer receives the good or service provided by the third party. For example, if an entity (1) sells a service to a customer, (2) pays a third party for a distinct good that is provided to the customer for free, and (3) is the principal in providing that good to the customer because it obtains control over that good before the good is transferred to the customer, the entity may determine that the payment made to the third party should be reflected as cost of sales. In this circumstance, the good provided to the customer may be considered a separate performance obligation in the entity's revenue contract with the customer. By contrast, if the entity is an agent in facilitating the provision of the good to the customer, the payment made to the third party could be deemed consideration payable to a customer because the payment is being made on behalf of the customer.

### **2.5.6.2 Presentation of Consideration Payable to a Customer**

When an entity enters into an agreement to sell products to a customer, the transaction with the customer may also involve the customer's supplying goods or services to the entity. The contract may be structured in such a way that the consideration payable by the entity to the customer for those goods or services is separately identified. Alternatively, the contract may be structured in such a way that it includes a single amount payable by the customer to the entity that reflects the net of the value of the goods or services provided by the entity to the customer and by the customer to the entity. When the fair value of the goods or services can be reasonably estimated, the accounting outcome should be the same in either circumstance.

The goods or services supplied by the customer should be accounted for separately if both of the following conditions are met:

- Those goods or services are “distinct.”
- The entity can reasonably estimate the fair value of the goods or services that it will receive (which may not correspond to any amount specified in the contract for those goods or services).

If both of these conditions are met, the fair value of the goods or services received from the customer should be accounted for in the same way the entity accounts for other purchases from suppliers (e.g., as an expense or asset). If any consideration payable to the customer with respect to those goods or services exceeds their fair value, the excess should be accounted for as a reduction of the transaction price.

If either or both of these conditions are not met, any consideration payable to the customer with respect to those goods or services should be accounted for as a reduction of the transaction price.

The examples below illustrate the application of this guidance.

#### Example 2-9

An entity sells goods to a customer for \$10,000 and, as part of the same arrangement, pays that customer \$1,000 to provide a service. If the service is determined to be distinct and its fair value can be reasonably estimated (as being, for example, \$600), a portion of the contractually stated amount will be recognized as a reduction of the transaction price for the sale of goods to \$9,600 (\$10,000 minus the \$400 payment made to the customer in excess of the fair value of the service received).

#### Example 2-10

An entity sells goods to a customer for \$10,000 and, as part of the same arrangement, pays that customer \$1,000 to provide a service. If the service is not determined to be distinct or its fair value cannot be reasonably estimated, the transaction price for the sale of goods will be reduced to \$9,000 (\$10,000 minus the full amount payable to the customer).

The requirements above apply irrespective of whether the consideration related to the goods or services supplied by the customer is separately identified in the contract. If the contract is net settled (i.e., the customer is required to pay cash and provide distinct goods or services as payment for the goods or services provided by the entity to the customer, and the entity does not make a cash payment to the customer for the distinct goods or services provided by the customer), the noncash consideration guidance would apply.



#### Connecting the Dots

Questions related to income statement classification may arise about payments made by a pharmaceutical manufacturer and a wholesaler in accordance with a distribution service agreement. Under such an agreement, the wholesaler performs certain distribution and logistics services for the manufacturer, such as providing the manufacturer with periodic reports of inventory on hand and inventory sold through to the wholesaler’s customers during the period, in exchange for inventory management fees. Although described as fees for specific services outlined in the agreement, such costs are typically classified as a reduction of revenue by the manufacturer because the fee paid to the wholesaler is not in exchange for distinct goods or services transferred to the manufacturer.

## 2.5.7 Applying the Guidance on Consideration Received From a Vendor

ASC 705-20 is a Codification subtopic that ASU 2014-09 added to provide specific guidance on consideration received from a vendor.

### ASC 705-20

**25-1** Consideration from a vendor includes cash amounts that an entity receives or expects to receive from a vendor (or from other parties that sell the goods or services to the vendor). Consideration from a vendor also includes credit or other items (for example, a coupon or voucher) that the entity can apply against amounts owed to the vendor (or to other parties that sell the goods or services to the vendor). The entity shall account for consideration from a vendor as a reduction of the purchase price of the goods or services acquired from the vendor unless the consideration from the vendor is one of the following:

- a. In exchange for a distinct good or service (as described in paragraphs 606-10-25-19 through 25-22) that the entity transfers to the vendor
- b. A reimbursement of costs incurred by the entity to sell the vendor's products
- c. Consideration for sales incentives offered to customers by manufacturers.

**25-2** If the consideration from a vendor is in exchange for a distinct good or service (see paragraphs 606-10-25-19 through 25-22) that an entity transfers to the vendor, then the entity shall account for the sale of the good or service in the same way that it accounts for other sales to customers in accordance with Topic 606 on revenue from contracts with customers. If the amount of consideration from the vendor exceeds the standalone selling price of the distinct good or service that the entity transfers to the vendor, then the entity shall account for such excess as a reduction of the purchase price of any goods or services acquired from the vendor. If the standalone selling price is not directly observable, the entity shall estimate it in accordance with paragraphs 606-10-32-33 through 32-35.

**25-3** Cash consideration represents a reimbursement of costs incurred by the entity to sell the vendor's products and shall be characterized as a reduction of that cost when recognized in the entity's income statement if the cash consideration represents a reimbursement of a specific, incremental, identifiable cost incurred by the entity in selling the vendor's products or services. If the amount of cash consideration paid by the vendor exceeds the cost being reimbursed, that excess amount shall be characterized in the entity's income statement as a reduction of cost of sales when recognized in the entity's income statement.

**25-4** Manufacturers often sell their products to resellers who then sell those products to consumers or other end users. In some cases, manufacturers will offer sales discounts and incentives directly to consumers — for example, rebates or coupons — in order to stimulate consumer demand for their products. Because the reseller has direct contact with the consumer, the reseller may agree to accept, at the point of sale to the consumer, the manufacturer's incentives that are tendered by the consumer (for example, honoring manufacturer's coupons as a reduction to the price paid by consumers and then seeking reimbursement from the manufacturer). In other instances, the consumer purchases the product from the reseller but deals directly with the manufacturer related to the manufacturer's incentive or discount (for example, a mail-in rebate).

The recognition guidance in ASC 705-20-25 on consideration received from a vendor has certain conceptual similarities to the measurement guidance in ASC 606-10-32 on consideration payable to a customer.

ASC 606-10-32-25 states that an "entity shall account for consideration payable to a customer as a **reduction of the transaction price** and, therefore, of revenue unless the payment to the customer is **in exchange for a distinct good or service** (as described in paragraphs 606-10-25-18 through 25-22) that the customer transfers to the entity" (emphasis added). Under ASC 606-10-32-26, "[i]f consideration payable to a customer is a payment for a distinct good or service from the customer, then an entity

shall account for the purchase of the good or service **in the same way that it accounts for other purchases** from suppliers. If the amount of consideration payable to the customer exceeds the fair value of the distinct good or service that the entity receives from the customer, then the entity shall account for such an excess as a reduction of the transaction price” (emphasis added).

Similarly, under ASC 705-20-25-1 and 25-2, an entity will need to determine whether consideration from a vendor is **in exchange for a distinct good or service** (as described in ASC 606-10-25-19 through 25-22) that the entity transfers to the vendor. If an entity concludes that consideration received from a vendor is related to distinct goods or services provided to the vendor, the entity should account for the consideration received from the vendor **in the same way that it accounts for other sales** (e.g., in accordance with ASC 606 if distinct goods or services are sold to a customer). If the consideration is not in exchange for a distinct good or service and is also unrelated to the items described in ASC 705-20-25-1(b) and (c), the entity should account for consideration received from a vendor as a **reduction of the purchase price** of the goods or services acquired from the vendor. Also similar to the guidance in ASC 606-10-32-25 and 32-26 is the requirement in ASC 705-20-25-2 that any excess of the consideration received from the vendor over the stand-alone selling price of the good or service provided to the vendor should be accounted for as a reduction of the purchase price of any goods or services purchased from the vendor.<sup>2</sup>

Notwithstanding the similarities between ASC 705-20 and ASC 606, determining whether an entity is a customer or a vendor in certain arrangements may be challenging. There are certain arrangements in which an entity may enter into one or more contracts with another entity that is both a customer and a vendor. That is, the reporting entity may enter into one or more contracts with another entity to (1) sell goods or services that are an output of the reporting entity’s ordinary activities in exchange for consideration from the other entity and (2) purchase goods or services from the other entity. In these types of arrangements, the reporting entity will need to use judgment to determine whether the other entity is predominantly a customer or predominantly a vendor. This determination might not be able to be made solely on the basis of the contractual terms. In such cases, the reporting entity will need to consider the facts and circumstances of the overall arrangement with the other entity.

To determine whether the other entity is predominantly a customer or predominantly a vendor in the arrangement, the reporting entity should consider both qualitative and quantitative factors, including the following:

- The extent to which the goods or services purchased from the other entity are important to the reporting entity’s ability to successfully sell its products and services to customers, or the extent to which the goods or services purchased from the reporting entity are important to the other entity.
- The quantitative significance of the reporting entity’s past, current, and expected future (1) purchases from the other entity and (2) sales to the other entity.
- The extent to which the reporting entity sells other products and services to the other entity.
- The historical relationship between the reporting entity and the other entity.
- The pricing of the reporting entity’s products and services sold to the other entity as compared with the pricing of products and services that the reporting entity sells to other customers of similar size and nature.

<sup>2</sup> If an entity concludes that the consideration received from a vendor was not in exchange for a distinct good or service that the entity transferred to the vendor, the entity will be required under ASC 705-20-25-1 to (1) determine whether the consideration received was either a reimbursement of costs incurred by the entity to sell the vendor’s products or consideration for sales incentives offered to customers by manufacturers and (2) account for the consideration received accordingly.

- The pricing of the other entity's goods and services purchased by the reporting entity as compared with the pricing of similar goods and services that the reporting entity purchases from other vendors.
- The substance of the contract negotiation process or contractual terms between the reporting entity and the other entity, which may indicate that (1) the reporting entity is the customer and the other entity is the vendor or (2) the other entity is the customer and the reporting entity is the vendor.
- The payment terms and cash flows between the reporting entity and the other entity.
- The significance of other parties involved in the arrangement.

## 2.6 Allocate the Transaction Price to the Performance Obligations (Step 4)

In step 4 of the revenue standard, an entity allocates the transaction price to each of the identified performance obligations. For a contract containing more than one performance obligation, the allocation is generally performed on the basis of the relative stand-alone selling price of each distinct performance obligation. However, as discussed in [Chapter 7](#) of Deloitte's Roadmap *Revenue Recognition*, there are exceptions that allow an entity to allocate a disproportionate amount of the transaction price to a specific performance obligation. For example, an entity may allocate a discount to a single performance obligation rather than proportionately to all performance obligations if certain factors indicate that the discount is related to a specific performance obligation.

In addition, in arrangements that include a license of IP along with ongoing services (e.g., R&D or manufacturing) that represent distinct performance obligations, an entity is required to allocate the total transaction price between the license and the services. If a history of selling the services or IP separately does not exist, the entity will need to estimate the stand-alone selling price of each performance obligation by using one of the following methods:

- *Adjusted market assessment approach* — Under this method, an entity considers the market in which the good or service is sold and estimates the price that a customer in that market would be willing to pay. In addition, the entity considers a competitor's pricing for similar goods or services as adjusted for specific factors such as position. For example, a life sciences company may need to consider the specific rights associated with the license, the stage of development of the underlying IP, and the projected cash flows over the license period. In some cases, it may be appropriate to use a Monte Carlo analysis, a scenario-based discounted cash flow method, an option pricing model, or a similar valuation technique to estimate the stand-alone selling price of the license. Regarding the R&D services, prices of similar services offered in the marketplace may be considered.
- *Expected cost plus a margin* — Under this method, an entity estimates the stand-alone selling price by considering the costs incurred to produce the product or service plus an adjustment for the expected margin on the sale. This method may be appropriate for an entity to use when it determines the selling price of R&D or manufacturing services by considering the level of effort necessary to perform the services.
- *Residual approach* — This approach may only be used if the entity sells the same good or service to different customers for a broad range of amounts, making the consideration highly variable, or the entity has not yet established a price for that good or service and the good or service has not previously been sold. Under this method, the entity deducts the observable stand-alone selling price of other goods and services in the contract from the total transaction price to determine the stand-alone selling price of the remaining goods and services.



In many other respects, the allocation model under the revenue standard may be similar to the model under legacy guidance, except for the revenue standard's elimination of the selling price hierarchy required under legacy guidance.

## 2.7 Determine When to Recognize Revenue (Step 5)

In a manner consistent with the core principle of the revenue standard — “an entity shall recognize **revenue to depict the transfer of promised goods or services to customers** in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services” (emphasis added) — step 5 focuses on recognition (i.e., **when** it is appropriate to recognize revenue).

The revenue standard requires an entity first to determine, at contract inception, whether *control of a good or service is transferred over time*; if so, the entity would recognize the related revenue over time in a manner consistent with the transfer of the good or service over time to the customer. If the entity cannot conclude that control is transferred over time, control is considered to be transferred at a point in time. As a result, the entity must determine at what specific point in time to recognize the related revenue. While generally speaking, goods are transferred at a point in time and services are transferred over time, this is not the case in all circumstances. Some of the more common issues that life sciences entities have faced when considering step 5 are described below.

### 2.7.1 When Revenue Recognition Over Time Is Appropriate for Goods (e.g., Contract Manufacturing)

Contract manufacturing is common in the life sciences industry. Entities that are delivering goods (e.g., contract manufacturers and other entities in customer manufacturing arrangements) should carefully analyze the contractual arrangement in accordance with the three criteria in ASC 606-10-25-27 to determine whether the promise in the contract to construct and transfer goods to the customer is a performance obligation that will be satisfied over time or at a point in time.

If an entity's obligation to produce a customized product meets one of the criteria in ASC 606-10-25-27 for revenue recognition over time (e.g., the entity's performance does not create an asset with an alternative use, and the entity has an enforceable right to payment for performance completed to date), revenue related to that product would be recognized as the product is produced, not when the product is delivered to the customer.

For example, an entity that has a contract with an original equipment manufacturer (OEM) to produce a customized part for the OEM's product would meet the criteria for revenue recognition over time if the customized part has no alternative use other than as a part for the OEM's product and, as stated in ASC 606-10-25-29, the entity has an enforceable right to payment for performance completed to date “at all times throughout the duration of the contract.” ASC 606-10-25-28 and 25-29 as well as ASC 606-10-55-8 through 55-15 provide detailed guidance on whether an asset has an alternative use to the entity and whether an entity has an enforceable right to payment for performance completed to date. An entity would need to carefully analyze the contractual arrangements and the specific facts and circumstances to determine whether those criteria are met.

If it concludes that revenue should be recognized over time, the entity would then be required to select a method of recognizing revenue over time that most faithfully depicts the entity's performance to date for producing the product. Therefore, contract revenue should be recognized as the entity performs (i.e., as the product is produced) rather than when the product is delivered to the customer.

In certain contract manufacturing arrangements of life sciences entities, inventory that is being manufactured has no alternative use (e.g., because the product cannot be redirected to another customer), and the contract terms provide the right to payment for performance completed to date in an amount that approximates the selling price of the work in process (e.g., recovery of the costs incurred plus a reasonable profit margin) if the contract is canceled. In these arrangements, revenue should be recognized over time as inventory is manufactured.

Entities may need to use judgment when evaluating some of these arrangements (e.g., when contracts are silent or unclear about whether a right to payment exists). We believe that when a contract's written terms do not specify the entity's right to payment upon contract termination, an enforceable right to payment is presumed not to exist. However, if the contract with the customer does not specify by its written terms the entity's right to payment upon contract termination and the entity asserts that it has an enforceable right to payment for performance completed to date, we would expect the entity to:

- Support its assertion on the basis of legislation, administrative practice, or legal precedent that confers upon the entity a right to payment for performance to date, as stated in ASC 606-10-55-14(a). This analysis would need to demonstrate that an enforceable right to payment (as defined by ASC 606) exists in the relevant jurisdiction. The fact that the entity would have a basis for making a claim against the counterparty in a court of law would not be sufficient to support the existence of an enforceable right to payment.
- Assess whether relevant legal precedent indicates that similar rights to payment for performance completed to date in similar contracts have no binding legal effect, as stated in ASC 606-10-55-14(b).

## 2.7.2 Impact of Shipping Terms on Revenue Recognition Over Time

Shipping terms in a contract that require a customer to pay only at a specific point in time (e.g., FOB destination) do not preclude the contract from meeting the criterion in ASC 606-10-25-27(c) for revenue recognition over time (specifically, the enforceable right to payment condition).

The guidance in ASC 606-10-55-12 makes clear that an enforceable right to payment “need not be a present unconditional right to payment” and that an entity may have “an unconditional right to payment only . . . upon complete satisfaction of the performance obligation.” In these circumstances, the guidance states, “an entity should consider whether it would have an enforceable right to demand or retain payment for performance completed to date if the contract were to be terminated before completion **for reasons other than the entity's failure to perform as promised**” (emphasis added).

When a contract's shipping terms require an entity's customer to pay only at a specific point in time (e.g., FOB destination), the possibility that the entity will not be paid if the goods are lost in shipment would represent “the entity's failure to perform as promised” and should be disregarded in the entity's assessment of whether the performance obligation meets the criterion in ASC 606-10-25-27(c) for revenue recognition over time (i.e., when an entity is assessing whether it has an enforceable right to payment, it should presume that it will perform as promised and that the goods will be delivered). Accordingly, the conclusion that the entity has an enforceable right to payment is not precluded when the contract's payment terms require payment only at specific points in the production or delivery process. Those payment terms may be overruled by contractual rights that give the entity an enforceable right to demand or retain payment (if the entity performs as promised). Therefore, the fact that the customer would not be required to pay for the goods if they were lost in transit would not, by itself, preclude the contract from meeting the criterion in ASC 606-10-25-27(c) for revenue recognition over time.

### 2.7.3 Methods for Measuring Progress

When a performance obligation is satisfied over time, an entity must select a measure of progress (e.g., time elapsed, labor hours, costs incurred) to depict its progress toward complete satisfaction of that obligation.

In accordance with ASC 606-10-25-33, appropriate methods of measuring progress include:

- *Output methods* — ASC 606-10-55-17 states that output methods “recognize revenue on the basis of direct measurements of the value to the customer of the goods or services transferred to date relative to the remaining goods or services promised under the contract.” These methods include “surveys of performance completed to date, appraisals of results achieved, milestones reached, time elapsed, and units produced or units delivered.”
- *Input methods* — ASC 606-10-55-20 states that input methods “recognize revenue on the basis of the entity’s efforts or inputs to the satisfaction of a performance obligation (for example, resources consumed, labor hours expended, costs incurred, time elapsed, or machine hours used) relative to the total expected inputs to the satisfaction of that performance obligation.”

In discussing the selection of a measure of progress, paragraph BC164 of ASU 2014-09 states:

The [FASB and IASB] decided that, conceptually, an output measure is the most faithful depiction of an entity’s performance because it directly measures the value of the goods or services transferred to the customer. However, the Boards observed that it would be appropriate for an entity to use an input method if that method would be less costly and would provide a reasonable proxy for measuring progress.

The above statement from paragraph BC164 of ASU 2014-09 does **not** mean that it is preferable for an entity to use an output method when measuring progress toward complete satisfaction of a performance obligation. As stated in paragraph BC159 of ASU 2014-09, an entity does not have a free choice in selecting an appropriate method of measuring progress toward complete satisfaction of a performance obligation but should exercise judgment in identifying a method that fulfills the stated objective in ASC 606-10-25-31 of depicting an entity’s performance in transferring control of goods or services promised to a customer (i.e., the satisfaction of the performance obligation).

Neither an input method nor an output method is preferred since each has benefits and disadvantages that will make it more or less appropriate to the facts and circumstances of each contract. While an output method is, as stated in paragraph BC164 of ASU 2014-09, conceptually preferable in a general sense, an appropriate measure of output will not always be directly observable; and sometimes, an apparent measure of output will not in fact provide an appropriate measure of an entity’s performance. Information needed to apply an input method is more likely to be available to an entity without undue cost, but care should be taken to ensure that any measure of an entity’s inputs used is reflective of the transfer of control of goods or services to the customer.

Considerations that may be relevant to the selection of a measure of progress include the following:

- An output method would not provide a faithful depiction of the entity’s performance if the output selected fails to measure some of the goods or services transferred to the customer. For example, a units-of-delivery or a units-of-production method may sometimes understate an entity’s performance by excluding work in progress that is controlled by the customer. (See paragraph BC165 of ASU 2014-09.)
- An input method may better reflect progress toward complete satisfaction of a performance obligation over time when (1) the performance obligation consists of a series of distinct goods or services that meets the criteria in ASC 606-10-25-14(b) to be treated as a single performance

obligation and (2) the effort required to create and deliver the first units is greater than the effort to create the subsequent units because of the effect of a “learning curve” of efficiencies realized over time. (See paragraph BC314 of ASU 2014-09.)

- An entity applying an input method must exclude from its measure of progress the costs incurred that (1) do not contribute to the entity’s progress in satisfying a performance obligation (e.g., the costs of unexpected amounts of wasted materials) and (2) are not proportionate to the entity’s progress in satisfying the performance obligation (e.g., the cost of obtaining goods from a vendor that accounts for most of the product’s cost). (See ASC 606-10-55-21.)



### Connecting the Dots

In the life sciences industry, CROs often incur out-of-pocket expenses and “pass-through costs” related to payments made to investigators (physicians) who participate in the clinical studies being conducted. Under the revenue standard, if the CRO activity is part of a combined performance obligation, these costs should generally be included in a CRO’s measure of progress when a cost-based input measure is used to recognize revenue over time.

#### 2.7.3.1 Consideration of Straight-Line Measure of Progress

Although ASC 606-10-55-16 through 55-21 provide guidance on when an entity would use an input or output method in measuring progress toward the complete satisfaction of a performance obligation, the guidance does not prescribe the use of either method. However, an entity does not have a “free choice” when selecting a measure of progress. While an entity may use either type of method, the actual method selected should be consistent with the clearly stated objective of depicting the entity’s performance (i.e., the entity’s satisfaction of its performance obligation in transferring control of goods or services to the customer).

Although ASC 606 does not permit an entity to default to a straight-line measure of progress on the basis of the passage of time (i.e., because a straight-line measure of progress may not faithfully depict the pattern of transfer), ASC 606 does not prohibit the use of a straight-line measure of progress, and such a time-based method may be reasonable in some cases depending on the facts and circumstances. Sometimes, for example, the nature of the entity’s promise in a contract is to “stand ready” for a period rather than to provide the goods or services underlying the obligation (e.g., to perform on a joint steering committee, provide regulatory approval assistance when necessary, or both). In the case of a stand-ready promise, the customer obtains (i.e., receives and consumes) a benefit from the assurance that a service or resource is available (“standing ready”) when and if needed or desired. For a stand-ready obligation that is satisfied over time, an entity may measure progress toward complete satisfaction of the performance obligation by using one of various methods, including time-based, input, and output methods. An entity would need to use judgment to select an appropriate measure of progress on the basis of the arrangement’s particular facts and circumstances.

#### 2.7.3.2 Use of a Multiple Attribution Approach (as Compared With a Single Method for Measuring Progress)

Life sciences entities such as CROs often provide multiple services for their customers (pharmaceutical and biotechnology entities). For example, CROs may help design studies, recruit investigators (physicians), recruit patients, help manage clinical trials, monitor safety, and write reports on study results. If an entity concludes that its contract with a customer contains a single performance obligation (i.e., in the context of the contract, the various services to be performed are not distinct) and that the performance obligation is satisfied over time, the entity is required to identify an appropriate measure to depict progress toward complete satisfaction of its performance obligation (see ASC 606-10-25-31 through 25-37).

For performance obligations meeting the requirements for revenue recognition over time, the entity must select a method for measuring progress toward satisfaction of the performance obligation.

Although the revenue standard indicates that an entity should apply a single method to measure progress for each performance obligation satisfied over time, stakeholders have questioned whether an entity may apply more than one method to measure progress toward satisfaction of a performance obligation that contains multiple goods and services bundled and recognized over time. In addition, stakeholders have questioned whether it would be acceptable to apply two different methods for measuring progress even though the contract has only one performance obligation.

The FASB staff notes that the revenue standard clearly indicates that “using multiple methods of measuring progress for the same performance obligation would not be appropriate.”<sup>3</sup> Accordingly, the staff concludes that an entity should use a single measure of progress for each performance obligation identified in the contract.

In addition, the FASB staff observes that selecting a common measure of progress may be challenging when a single performance obligation contains more than one good or service or has multiple payment streams, although it emphasizes that the selection is not a free choice. Further, the staff notes that while a common measure of progress that does not depict the economics of the contract may indicate that the arrangement contains more than one performance obligation, it is not determinative. However, a reexamination may suggest that the contract includes more performance obligations than were initially identified.

The above issues are addressed in [Implementation Q&As 47 and 48](#) (compiled from previously issued [TRG Agenda Papers 41](#) and [44](#)). For additional information and Deloitte’s summary of issues discussed in the Implementation Q&As, see [Appendix C](#) of Deloitte’s Roadmap [Revenue Recognition](#).



### Connecting the Dots

The revenue standard requires an entity to identify a single measure of progress that appropriately depicts its progress toward complete satisfaction of the performance obligation. As a result, CROs have generally concluded that input measures should be used under ASC 606.

## 2.8 Consignment Arrangements

Although physical possession is an indicator that control has been transferred to the customer, ASC 606-10-25-30(c) cautions that there are some arrangements in which physical possession may not be indicative of control. One example is a consignment arrangement.

Consignment arrangements occasionally exist in the life sciences industry (e.g., a medical device may be delivered to a hospital under a consignment arrangement until the device is needed for a surgery). Under ASC 606, the accounting for consignment arrangements may be consistent with legacy U.S. GAAP if control of the products delivered to a consignee is not transferred until the consignee sells the products to a third party.

<sup>3</sup> Quoted from [Implementation Q&A 47](#).

## 2.9 Government Vaccine Stockpile Programs

In August 2017, the SEC issued an [interpretive release](#) (the “2017 release”) updating the Commission’s previously issued guidance on accounting for sales of vaccines and bioterror countermeasures to the federal government for placement into stockpiles related to the Vaccines for Children Program or the Strategic National Stockpile. The update was aimed at conforming the SEC’s guidance with ASC 606.

Under the guidance in the 2017 release, vaccine manufacturers should recognize revenue when vaccines are placed into U.S. government stockpile programs because control of the vaccines has been transferred to the customer. However, these entities also need to evaluate whether storage, maintenance, or other promised goods or services associated with vaccine stockpiles are separate performance obligations. The guidance in the 2017 release applies only to the stockpile programs discussed in that release and is not applicable to any other transactions.

## 2.10 Licensing

Under the revenue standard, the framework used to account for licensing of IP is essentially the same as the framework used to account for a sale of goods or services. That is, the five-step model is generally applied to licensing transactions as well. However, licensing of IP can take many forms, and the economics and substance of such transactions can often be difficult to identify. Determining how to account for licensing transactions will often depend on the specific facts and circumstances and will require professional judgment. To help preparers exercise such judgment, the revenue standard provides supplemental guidance on recognizing revenue from contracts related to the licensing of IP to customers. The scope of the guidance includes all licenses that provide a customer with rights to IP, except for certain software hosting arrangements.

In the evaluation of how to account for a licensing transaction under the revenue standard, it is important for an entity to consider each of the five steps in the model (although, as discussed below, certain exceptions are provided for licensing transactions). Specifically, an entity will need to do each of the following:

- *Step 1: Identify the contract with the customer* — This step includes identifying the counterparty that is the customer, evaluating the enforceable rights and obligations (including implicit rights) of each party to the contract, and determining whether amounts under the contract are collectible.
- *Step 2: Identify the performance obligations under the contract* — This includes determining whether the entity’s obligation to transfer a license to a customer results in (1) a single promise that will be satisfied (i.e., a single performance obligation) or (2) multiple performance obligations. This step could also involve determining whether the license of IP is the predominant element in the arrangement.
- *Step 3: Determine the transaction price* — This includes identifying and, potentially, measuring and constraining variable consideration.
- *Step 4: Allocate the transaction price* — This includes considering whether the residual method could be used for determining the stand-alone selling price of one (or a bundle) of the performance obligations.
- *Step 5: Determine when control of the license is transferred to the customer* — This includes determining whether the license is transferred at a point in time (for a right to use IP) or over time (for a right to access IP).



Some of the key judgments an entity will need to make are likely to be in connection with step 2 (identify the performance obligations), step 4 (allocate the transaction price), and step 5 (recognize revenue) of the model. As part of step 2, an entity will need to evaluate license restrictions (and changes in any such restrictions) when determining whether the restrictions merely define the licenses (which may be the case when the restrictions are related to time or geography) or, in effect, give rise to multiple performance obligations (which may be the case when the restrictions change over the license period and require the entity to transfer additional rights to the customer).

As part of step 5, when an entity is determining whether it has granted a customer a right to use or a right to access its IP, it will need to assess the nature of the promised license to determine whether the license has significant stand-alone functionality. For licenses with significant stand-alone functionality, ongoing activities<sup>4</sup> of the licensor do not significantly affect the license's functionality (i.e., its utility). However, certain licenses do not have significant stand-alone functionality and require ongoing activities from the entity to support or maintain the license's utility to the customer. The nature of an entity's license of IP will determine the pattern of transfer of control to the customer, which is either at a point in time (if the customer is granted a right to use the IP) or over time (if the customer is granted a right to access the IP).



### Connecting the Dots

It is common in the life sciences industry for an entity to transfer a license of IP along with R&D services to the customer as a single performance obligation. The license may not be capable of being distinct without the R&D services. That is, the R&D services performed by the entity may be novel, requiring the entity to provide the R&D services for the customer to benefit from the license. In determining when revenue should be recognized for the single performance obligation with two promised goods (the delivery of the license and R&D services), the entity must determine whether the single performance obligation is satisfied over time or at a point in time. In this type of transaction, the criteria in ASC 606-10-25-27(a) and (b) for recognizing revenue over time may be met. The entity may conclude that the criterion in ASC 606-10-25-27(a) is met if it determines that the work that it has completed to date (related to the R&D services) would not need to be substantially reperformed by another entity if the other entity were to step in to fulfill the remaining performance obligation to the customer (since this would mean that the customer simultaneously receives and consumes the benefits provided by the entity's performance of the R&D services as the entity performs those services). In addition, the entity may conclude that the criterion in ASC 606-10-25-27(b) is met if it determines that (1) the customer obtains control of the license (i.e., the customer has the ability to direct the use of, and obtain substantially all of the remaining benefits from, the license) and (2) the R&D services provided will simultaneously enhance the license.

Alternatively, life sciences entities may enter into a contract with a customer to perform R&D services and provide the customer with an option to exclusively license the IP resulting from the R&D services at a stated price during the period in which the R&D services are performed or for a certain specified period after performance of the R&D services is completed. The option is priced at its stand-alone selling price and therefore does not represent a material right. The promise to provide R&D services may represent a single performance obligation; if so, the entity must determine whether the performance obligation is satisfied over time or at a point in time. In this type of transaction, the criterion in ASC 606-10-25-27(a) for recognizing revenue over time may be met. The entity may conclude that the criterion in ASC 606-10-25-27(a) is met if it determines that the work that it has completed to date (related to the R&D services) would not need to be substantially reperformed by another entity if the other entity were to

<sup>4</sup> These do not include activities that transfer one or more goods or services to the customer (e.g., maintenance activities), which an entity must assess to determine whether they constitute separate performance obligations.



step in to fulfill the remaining performance obligation to the customer (since this would mean that the customer simultaneously receives and consumes the benefits provided by the entity's performance of the R&D services as the entity performs those services).

For licensing transactions in which consideration is tied to the subsequent sale or usage of IP, the revenue standard provides an exception to the recognition principle that is part of step 5 (i.e., recognize revenue when or as control of the goods or services is transferred to the customer). Under this sales- or usage-based royalty exception, an entity would generally not be required to estimate the variable consideration from sales- or usage-based royalties. Instead, ASC 606-10-55-65 requires an entity to "recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following events occurs:

- a. The subsequent sale or usage occurs.
- b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)."



### Connecting the Dots

In the application of the sale- or usage-based royalty exception in ASC 606-10-55-65, it would not be appropriate for an entity to omit sales- or usage-based royalties from its financial statements merely because the associated sales data were received after the end of the reporting period or were not received when the financial statements were issued or available to be issued.

Some of the more common issues that life sciences entities have faced when considering the licensing guidance of the revenue standard are discussed below.

## 2.10.1 License Versus In-Substance Sale of IP

An entity may license IP to a customer under an arrangement that gives the customer exclusive use of the IP for either a perpetual term or a period that is substantially the same as the IP's useful life.

Stakeholders have questioned whether these arrangements would be within the scope of (1) the licensing implementation guidance in ASC 606-10-55-54 through 55-65B or (2) the general recognition and measurement model in the revenue standard, which could result in a different pattern of revenue recognition. Specifically, concerns have been raised about the application of the sales- or usage-based royalty exception. The FASB considered, but rejected, expanding the scope of the royalty recognition constraint because of complexities in legal differences between a sale of IP and a license of IP. More specifically, the FASB noted in the Background Information and Basis for Conclusions of ASU 2016-10 that an entity should not distinguish between licenses and in-substance sales in deciding whether the royalty exception applies. We generally believe that the legal form of the transaction will determine which revenue accounting guidance (i.e., the guidance on estimating royalties or the guidance on applying the royalty recognition constraint) is applicable.

## 2.10.2 Determining Whether Contractual Provisions Represent Attributes of a License or Additional Rights

A contract with a customer may contain provisions that limit the customer's use of a license of IP to a specific period, a specific geographic region, a specific use, or a specified number of targets. For example, an entity may license drug distribution rights to a customer that can be (1) used for three years, (2) made available only to consumers in North America, (3) used only for a specific drug indication, and (4) used on a specified number of targets. Often, such restrictions will be attributes of the license. That is, the restrictions will define the rights the customer has under the license. However, some

restrictions, or changes in restrictions over time, will require an entity to transfer additional rights to a customer. Specifically, ASC 606-10-55-64 and 55-64A clarify that (1) certain contractual provisions indicate that an entity has promised to transfer additional rights (i.e., an additional license) to a customer and (2) promises to transfer additional rights should be accounted for as separate performance obligations. When a license of IP is limited to a specified number of targets, the arrangement may allow for the customer to substitute targets (often referred to as “substitution rights”). An entity will need to carefully evaluate whether these substitution rights represent attributes of the license or may require the entity to transfer additional rights to the customer.

The following factors (not all-inclusive) may be helpful in an entity’s determination of whether a substitution right represents an attribute of the license or may require the entity to transfer additional rights to the customer:

- *Whether the contract provides for a fixed number of targets* — The entity should consider whether the customer can substitute one or more of the targets listed in the contract at inception (“existing targets”) for one or more other existing targets that the customer previously designated. If so, this implies that (1) the entity transferred the substitution right to the customer at contract inception and (2) the substitution right is an attribute of the original license.
- *Whether the exercise of the substitution right changes the number of targets allotted to the customer* — The entity should evaluate whether a substitution right that allows the customer to substitute one or more existing targets for one or more other existing targets that the customer previously designated changes the total number of targets allotted to the customer. For example, a customer may purchase the right to research three targets (Target A, Target B, and Target C). If the customer initially designates Target A, has the right to substitute another existing target for Target A, and loses the right to continue research on Target A, the total number of targets allotted to the customer will still be three (i.e., the same number of targets available to the customer at the inception of the contract), indicating that the substitution right is an attribute of the license.
- *Whether the entity is required to transfer an exclusive license to the customer in the event that the substitution right is exercised* — For example, when the customer exercises its substitution right, it may obtain an exclusive right to the substitute target. This may imply that the entity has provided an additional right to the customer since the entity is no longer able to license that substitute target to a third party. However, if it is unlikely that the entity would exclusively license that substitute target to a third party during the term of the contract because of the nature of the underlying field of study, the entity may not be transferring any additional rights to the customer upon the customer’s exercise of its substitution right.
- *Whether, in the event that the substitution right is exercised, the entity is required to transfer to the customer additional rights that did not exist at contract inception* — In the analysis of whether the substitution right is an attribute of the license, it is important to understand whether the substitution right transfers to the customer additional rights that did not exist at contract inception. For example, if the customer can obtain control of newly developed IP that it did not control when the license was transferred up front, the entity is transferring additional rights to the customer upon the customer’s exercise of the substitution right.

The determination of whether contractual provisions related to a license of IP represent an additional promise may require significant judgment. Contractual provisions (restrictions) that define the scope of a license of IP that has already been transferred to a customer would generally not be accounted for as a separate performance obligation. For example, a restriction that limits the use of a license to a five-year period would be an attribute of the single license. However, contractual provisions that define additional rights that will be transferred at a future date would generally be accounted for as a separate performance obligation, as illustrated in the example below.

#### Example 2-11

An entity transfers to a customer a two-year license of IP that can be used only in Jurisdiction A during year 1 but can be used in both Jurisdiction A and Jurisdiction B during year 2. In this example, the customer does not obtain control of the license in Jurisdiction B until year 2. That is, in year 2, the entity must transfer additional rights that entitle the customer to use the license in Jurisdiction B. Although the entity transfers the license to use the IP in Jurisdiction A at the beginning of year 1, the entity must still fulfill a second promise to deliver the license to use the IP in Jurisdiction B in year 2. Further, although the license of IP obtained by the customer in year 1 may be the same license of IP that will be used in year 2 (i.e., the customer currently controls the right to use or access the IP), the customer is precluded from using and benefiting from that license in Jurisdiction B until year 2. The obligation to transfer additional rights to the customer at the beginning of year 2 should be identified as an additional performance obligation under the contract with the customer.

### 2.10.3 Identifying the Nature of the License

In determining whether to recognize revenue from a license of IP over time or at a point in time, an entity needs to determine the nature of the licensing arrangement. The nature of the arrangement is determined on the basis of the entity's promise to the customer and whether that promise (1) provides access to the IP throughout the license term (i.e., "right to access") or (2) provides a right to use the IP as it exists at the point in time when control of the license is transferred to the customer (i.e., "right to use"). Revenue from a license that grants a right to access an entity's IP is recognized over time since the customer simultaneously receives and consumes the benefits of the entity's IP throughout the license periods (i.e., meets the requirement in ASC 606-10-25-27(a)). Revenue from a license that grants a right to use an entity's IP is recognized at the point in time when control of the license is transferred to the customer.

To assist in the evaluation of whether the license provides the customer with a right to access or right to use the entity's IP, the revenue standard distinguishes between two types of IP: (1) functional and (2) symbolic.

Examples of licenses of functional IP could include software, drug compounds and formulas, and completed media content. In accordance with ASC 606-10-55-62, the nature of a license to functional IP that is distinct will provide a customer with the right to use an entity's IP (i.e., point-in-time revenue recognition) unless (1) the entity's ongoing activities that will not transfer promised goods to the customer (i.e., those not deemed to be additional promised goods to the customer) will significantly change the utility of the license and (2) the customer is contractually or practically required to use the updated IP once available. If these criteria are met, the nature of the license is a right to access the entity's IP (i.e., a license for which revenue is recognized over time). As discussed in paragraph BC58 of [ASU 2016-10](#), the FASB expected that at the time of issuance of ASU 2016-10, the criteria in ASC 606-10-55-62 "will be met only infrequently, if at all." Consequently, revenue from a license of drug compounds and formulas that represents a distinct performance obligation would generally represent a right to use

an entity's IP and would be recognized at the point in time when control of the license is transferred to the customer. However, ASC 606-10-55-58C states the following:

#### ASC 606-10

**55-58C** Notwithstanding paragraphs 606-10-55-58A through 55-58B, revenue cannot be recognized from a license of intellectual property before both:

- a. An entity provides (or otherwise makes available) a copy of the intellectual property to the customer.
- b. The beginning of the period during which the customer is able to use and benefit from its right to access or its right to use the intellectual property. That is, an entity would not recognize revenue before the beginning of the license period even if the entity provides (or otherwise makes available) a copy of the intellectual property before the start of the license period or the customer has a copy of the intellectual property from another transaction. For example, an entity would recognize revenue from a license renewal no earlier than the beginning of the renewal period.



#### Connecting the Dots

Because revenue from customer renewals of licenses of IP cannot be recognized before both of the conditions in ASC 606-10-55-58C are met, revenue from a renewal of a right-to-use license is not recognized until the beginning of the renewal period, rather than when the parties agree to the renewal.

### 2.10.4 Considerations for Determining Whether a License Is Predominant

Under the sales- or usage-based royalty exception to the revenue standard's general rule requiring an entity to include variable consideration in the transaction price, if an entity is entitled to consideration in the form of a sales- or usage-based royalty, revenue is not recognized until (1) the underlying sales or usage has occurred and (2) the related performance obligation has been satisfied (or partially satisfied). That is, an entity does not estimate the amount of a sales- or usage-based royalty at contract inception; rather, revenue would be recognized when (or as) the subsequent sales or usage occurs (under the assumption that the associated performance obligation has been satisfied or partially satisfied).

As explained in ASC 606-10-55-65A, the sales- or usage-based royalty exception applies "when the royalty relates only to a license of intellectual property or when a license of intellectual property is the **predominant** item to which the royalty relates (for example, the license of intellectual property may be the predominant item to which the royalty relates when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates)" (emphasis added).

In the life sciences industry, licenses are often included with R&D services, manufacturing services, or both, with consideration in the form of a sales-based royalty. When the license and the services do not qualify as separate performance obligations, an entity will need to use significant judgment to assess whether the IP license is "the predominant item to which the royalty relates."

The revenue standard does not define “predominant.” However, ASC 606-10-55-65A notes that the license may be predominant “when the entity has a reasonable expectation that the customer would ascribe significantly more value to the license than to the other goods or services to which the royalty relates.” Consequently, life sciences entities should consider the customer’s perspective of value and the relative importance and value of the promised goods or services. For example, in a combined license and R&D arrangement, an entity might consider the remaining clinical trial studies that need to be completed and the expected size of the market upon approval. Since different interpretations may arise in practice and the consequences of these differences could be significant to the timing of revenue recognition, entities are encouraged to contemporaneously document the basis for their conclusion on whether the license, rather than the other services, is predominant.

### 2.10.5 Applicability of the Sales- or Usage-Based Royalty Exception to Sales-Based Milestones, Development-Based Milestones, or Guaranteed Minimum Royalties

The sales- or usage-based royalty exception would apply to sales-based milestones because the payment becomes due on the basis of the subsequent sales to the customer. However, the exception cannot be applied to development-based milestone payments because these payments are not contingent on the sales to or usage by the customer. In addition, the exception cannot be applied to guaranteed minimum royalties because those payments are essentially fixed consideration. However, the exception would apply to any variable royalty consideration that exceeds the fixed (guaranteed minimum) portion.



#### Connecting the Dots

In certain license arrangements, a milestone payment is due upon the first commercial sale of a product by the licensee. That is, such a payment does not represent a guaranteed minimum since it becomes due and payable only upon the achievement of a sale. Accordingly, we believe that an entity may (1) consider this type of milestone payment to be similar to a sales-based milestone payment because it is payable only upon a sale of the drug and (2) recognize it in a manner consistent with the guidance on sales- or usage-based royalties.

### 2.10.6 Interaction of Sales- or Usage-Based Royalty Exception With Measuring Progress Towards Satisfaction of a Performance Obligation

When applying the sales- or usage-based royalty exception, an entity typically would recognize revenue when (or as) the customer’s subsequent sales or usage occurs. However, if the sales- or usage-based royalties accelerate revenue recognition as compared with the entity’s satisfaction (or partial satisfaction) of the associated performance obligation, the entity may be precluded from recognizing some or all of the revenue as the subsequent sales or usage occurs.

ASC 606-10-55-65 specifies that revenue from a sales- or usage-based royalty promised in exchange for a license of IP is recognized only when (or as) the later of the following events occurs:

- a. The subsequent sale or usage occurs.
- b. The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied).

Accordingly, revenue should be deferred if, and to the extent that, recognition based on subsequent sales or usage (i.e., criterion (a)) is judged to be in advance of satisfaction of a performance obligation (i.e., criterion (b)). Royalty arrangements can differ greatly between entities and between contracts. Further, the timing of the recognition of royalties can depend on the nature of the underlying IP (i.e., right to access or right to use) as well as the structure of the royalty payments. Therefore, the determination of whether revenue from royalties should be deferred will depend on an analysis of the specific facts and circumstances.

Consider the example below, in which the parties agree to a variable royalty arrangement with declining royalties in return for the license of functional IP.

### Example 2-12

An entity enters into a contract to provide a customer with a noncancelable license to the entity's IP. The entity determines that the license is a right-to-use license (i.e., a license for which revenue is recognized at a point in time) for a three-year period. The customer's estimated sales are expected to be approximately equal for each of the three years under license. For the use of the IP, the agreement requires the customer to pay the entity a royalty of 10 percent of the customer's sales in year 1, 8 percent of the customer's sales in year 2, and 6 percent of the customer's sales in year 3.

The entity should account for the royalty payments in a manner consistent with the legal form of the arrangement and in accordance with the exception to the variable consideration guidance for licenses of IP that include a sales- or usage-based royalty. Consequently, the entity would include the royalties in the transaction price on the basis of the applicable contractual rate and the customer's sales in each year and then, in accordance with ASC 606-10-55-65, recognize revenue at the later of when (1) the "subsequent sale or usage occurs" or (2) the "performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)." Because the license is a right-to-use license for which control is transferred at the inception of the contract, the "later" of the two conditions is met when the subsequent sales occur.

## 2.11 Presentation

### 2.11.1 Contract Assets and Contract Liabilities

#### ASC 606-10

**45-1** When either party to a contract has performed, an entity shall present the contract in the statement of financial position as a contract asset or a contract liability, depending on the relationship between the entity's performance and the customer's payment. An entity shall present any unconditional rights to consideration separately as a receivable.

**45-2** If a customer pays consideration, or an entity has a right to an amount of consideration that is unconditional (that is, a receivable), before the entity transfers a good or service to the customer, the entity shall present the contract as a contract liability when the payment is made or the payment is due (whichever is earlier). A contract liability is an entity's obligation to transfer goods or services to a customer for which the entity has received consideration (or an amount of consideration is due) from the customer.

**ASC 606-10 (continued)**

**45-3** If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for impairment in accordance with Topic 310 on receivables. An impairment of a contract asset shall be measured, presented, and disclosed in accordance with Topic 310 (see also paragraph 606-10-50-4(b)).

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

**45-3** If an entity performs by transferring goods or services to a customer before the customer pays consideration or before payment is due, the entity shall present the contract as a contract asset, excluding any amounts presented as a receivable. A contract asset is an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer. An entity shall assess a contract asset for credit losses in accordance with Subtopic 326-20 on financial instruments measured at amortized cost. A credit loss of a contract asset shall be measured, presented, and disclosed in accordance with Subtopic 326-20 (see also paragraph 606-10-50-4(b)).

A contract with a customer creates legal rights and obligations. The rights under the contract will generally give rise to contract assets as the entity performs (or accounts receivable, if an unconditional right to consideration exists); and contract liabilities are created when consideration is received (or receivable) in advance of performance. Each reporting period, an entity is required to assess its financial position related to its contracts with customers. Depending on the extent to which an entity has performed and the amount of consideration received (or receivable) by the entity under a contract, the entity could record a contract asset or a contract liability.

Receivables should be recorded separately from contract assets since only the passage of time is required before consideration is due. That is, receivables are only subject to credit risk. In contrast, contract assets are subject to more than just credit risk (i.e., they are also subject to performance risk). For example, a contract asset would exist when an entity has a contract with a customer for which revenue has been recognized (i.e., goods or services have been transferred to the customer), but customer payment is contingent on a future event (i.e., satisfaction of additional performance obligations or other events). As discussed in paragraph BC323 of ASU 2014-09, the FASB and IASB believed that making a distinction between contract assets and receivables was important to financial statement users.

ASC 606-10-45-5 addresses the use of alternative descriptions for contract assets and contract liabilities as follows:

**ASC 606-10**

**45-5** This guidance uses the terms *contract asset* and *contract liability* but does not prohibit an entity from using alternative descriptions in the statement of financial position for those items. If an entity uses an alternative description for a contract asset, the entity shall provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets.



Paragraph BC321 of ASU 2014-09 notes the FASB's and IASB's observation that "some industries have historically used different labels to describe contract assets and contract liabilities or may recognize them in more than one line item either in the financial statements or in the notes." ASC 606 does not prohibit an entity from using alternative terms or from using additional line items to present the assets and liabilities, but it requires an entity to provide appropriate disclosures that adequately describe the assets and liabilities.

Terms that are commonly used in practice to describe contract assets and contract liabilities include, but are not limited to, the following:

- *Contract assets* — Unbilled receivables, progress payments to be billed.
- *Contract liabilities* — Deferred revenue, unearned revenue.



### Connecting the Dots

In the life sciences industry, CROs typically enter into long-term contracts with their customers to perform clinical trial management services. Revenue from these services is generally recognized over time. It is not uncommon for a CRO to perform under a contract in such a way that performance to date exceeds the amounts of consideration received (or receivable) and the CRO records a contract asset. For example, a CRO may have to meet certain contractual milestones, such as patient enrollment metrics or investigator site approval, before having a right to bill.

There is diversity in practice on how CROs present these amounts in the statement of financial position and the descriptions used for these amounts. ASC 606 indicates that an entity should provide sufficient information for a user of the financial statements to distinguish between receivables and contract assets. One presentation option is to present accounts receivable, unbilled services (i.e., services for which the right to bill is contingent solely on the passage of time), and contract assets (contingent on a future event) as individual line items in the statement of financial position. Alternatively, certain CROs may present one line item in the statement of financial position for amounts that are contingent solely on the passage of time (e.g., accounts receivable and unbilled services) and another line item for amounts that are contingent on events other than the passage of time (e.g., contract assets), then disclose the composition of the balance in the financial statement footnotes. Either approach is acceptable provided that the disclosures are sufficiently clear to enable a financial statement user to understand the nature and composition of the entity's accounts receivable and contract assets, including whether contract assets are conditioned on something other than the passage of time.

## 2.11.2 Government Grants

In the life sciences industry, it is common for an entity that is not an NFP to receive government grants in support of R&D activities of the entity that are not associated with a customer-vendor relationship and are therefore outside the scope of the revenue standard. Because there is no authoritative guidance under U.S. GAAP on accounting for government grants received, life sciences entities have considered applying sources of nonauthoritative accounting guidance and literature by analogy when accounting for government grants. With respect to recognition, measurement, and income statement presentation, some entities may have adopted an accounting policy of applying IAS 20 by analogy; depending on the nature of the grant, such a policy may have resulted in accounting for a particular grant as (1) a reduction of an asset, (2) an offset to an operating expense, or (3) income. In light of the lack of authoritative U.S. GAAP related to the accounting for government grants, it is critical for an entity to disclose its accounting policy for government grants when such amounts are material to the entity's financial statements. See [Section 13.1](#) for more information, including a discussion of recent standard-setting activity related to disclosures about government assistance.

### 2.11.3 Principal-Versus-Agent Considerations

As noted in [Section 2.2.1](#), ASC 808 requires that each collaboration participant report costs incurred and revenue generated from transactions with third parties in its income statement in accordance with the principal-versus-agent guidance in ASC 606-10-55-36 through 55-40. The entity that is identified as the principal in a transaction will recognize revenue based on the *gross* amount of consideration to which the entity expects to be entitled in exchange for the specified good or service transferred. In contrast, the entity that is identified as the agent in a transaction will recognize revenue based on the *net* amount of consideration to which the entity expects to be entitled in exchange for the specified good or service transferred.

Application of the principal-versus-agent guidance that affects whether a life sciences entity recognizes revenue based on gross or net amounts is not limited to collaborative arrangements. For example, business development transactions in the life sciences industry frequently involve transition service arrangements in which the seller performs certain transition services for the buyer (e.g., distribution, billing, and collections) while marketing authorizations are obtained by the buyer to sell pharmaceutical product in the jurisdiction. To determine whether the buyer should report revenues on a gross or a net basis during the transition period, the buyer should assess whether the nature of the seller's promise to the customer is a performance obligation to provide the specified goods or services itself (i.e., the seller is a principal) or to arrange for those goods or services to be provided by the buyer (i.e., the seller is an agent), as indicated in ASC 606-10-55-36.

In accordance with ASC 606-10-55-36A, an entity should determine the nature of its promise by identifying the specified goods or services to be provided to the customer and assessing whether it controls each specified good or service before that good or service is transferred to the customer. When making this determination under the revenue standard, the entity may be required to use significant judgment.

#### Example 2-13

##### Transition Services Agreement

Company X acquires Subsidiary Y from Company Z in exchange for cash consideration. The acquisition is accounted for as a business combination under ASC 805. Subsidiary Y is a manufacturer of pharmaceutical products, and Z is the distributor of those products. Company Z has the necessary licenses and authorizations required to distribute the products, whereas X does not.

Companies X and Z enter into a transition services agreement (TSA) under which Z will continue performing distribution services for Y's products for one year following the acquisition. Under the TSA, Z will hold legal title to, and have physical possession of, the products before they are distributed to customers. Company X has discretion in establishing the prices for the products, has the right to determine which customers the products are sold to, and bears the risk of loss for the inventory of the products.

Company X determines that it is the principal in the TSA with Z because X controls the products before they are transferred to customers. Company X has the right to direct the use of, and obtain substantially all of the remaining benefits from, the products.

**Example 2-14****Direct Title Arrangement**

Company A recently received FDA approval for Product X but does not yet have all of the state distribution licenses required to sell their product throughout the United States. While waiting to receive all of the state distribution licenses, A enters into an agreement with a third-party logistics company (the “3PL”) to use the 3PL’s distribution licenses to sell Product X. The 3PL will take legal title to, and physical possession of, the product. However, A has the right to determine which customers Product X is sold to, has the right to determine the price at which Product X is sold, and is primarily responsible for fulfilling the promise to provide Product X to its customers.

Company A determines that it is the principal in the arrangement with the 3PL because A controls Product X before it is transferred to the customer. Company A has the right to direct the use of, and obtain substantially all of the remaining benefits from, the asset (i.e., Product X).

**2.12 Disclosure Requirements**

As discussed in paragraph BC327 of ASU 2014-09, some of the main criticisms of the prior revenue guidance from regulators and users of the financial statements were related to disclosure requirements. Many entities’ disclosures contained boilerplate language that, broadly speaking, regulators and users found to be inadequate and lacking in cohesion with other disclosures, thus making it difficult for users to understand entities’ revenues, judgments related to revenue, and how revenue was related to an entity’s overall financial position. In addition, while disclosure has been a focus of the FASB and SEC in recent years, that focus has been primarily related to disclosure overload and extensive disclosures required on topics such as pensions, stock compensation, fair value, and income taxes. In response to stakeholder feedback, the FASB has aimed to make disclosures more effective, better coordinated, and less redundant. Although this has been an overall focus of the FASB and SEC, the lack of disclosure on revenue was highlighted as a key area for improvement during the development of the revenue standard.

As a result, one of the goals of the FASB and IASB in the revenue project was to provide financial statement users with more useful information through improved disclosures. ASC 606-10-50-1 outlines the objective of the revenue standard’s disclosure requirements as follows:

**ASC 606-10**

**50-1** The objective of the disclosure requirements in this Topic is for an entity to disclose sufficient information to enable users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. To achieve that objective, an entity shall disclose qualitative and quantitative information about all of the following:

- a. Its contracts with customers (see paragraphs 606-10-50-4 through 50-16)
- b. The significant judgments, and changes in the judgments, made in applying the guidance in this Topic to those contracts (see paragraphs 606-10-50-17 through 50-21)
- c. Any assets recognized from the costs to obtain or fulfill a contract with a customer in accordance with paragraph 340-40-25-1 or 340-40-25-5 (see paragraphs 340-40-50-1 through 50-6).

Some of the more common issues that life sciences entities have addressed when considering the disclosure requirements of the revenue standard are discussed below.

### 2.12.1 Level of Aggregation or Disaggregation

To comply with the “entity-wide” disclosure requirements of ASC 280, many life sciences companies disclose revenues from products for major medical treatments, revenues from different types of services (e.g., clinical development services vs. commercial services), revenues attributed to the entity's home country and foreign countries, and the individual customers (e.g., wholesalers) whose purchases constitute 10 percent or more of the entity's revenues. Entities are encouraged to document their consideration of the disaggregation categories outlined in ASC 606.

### 2.12.2 Satisfied Performance Obligations

ASC 606 requires disclosure of the amount of revenue recognized in the current period that is related to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods (e.g., because of changes in the variable consideration constraint). For example, development- or approval-based milestone payments related to the delivery of a functional license of IP may have been fully constrained because of the uncertainty of achieving the milestones. Once the milestone payments are no longer constrained, an entity would be required to disclose the milestone payments recognized in the current period that are related to amounts allocated to performance obligations that were satisfied (or partially satisfied) in previous periods.

### 2.12.3 Gross-to-Net Disclosures

Many pharmaceutical companies currently disclose a rollforward of gross-to-net balance sheet reserves in MD&A. Some registrants also disclose a reconciliation of gross and net sales as reported in the income statement. Some life sciences companies have considered including these types of disclosures in the footnotes to the financial statements to meet certain variable consideration disclosure requirements of the revenue standard, such as those related to disclosure of changes in estimates associated with the transaction price and estimates associated with the variable consideration.

### 2.12.4 SEC Comment Letter Themes Related to Disclosures

The SEC staff's comments to registrants in the life sciences industry regarding revenue recognition have primarily focused on (1) gross-to-net adjustments and (2) multiple-element arrangements.

#### 2.12.4.1 Gross-to-Net Adjustments

##### Examples of SEC Comments

- To the extent that re-estimates of prior year gross-to-net variable consideration [are] significant in future periods, please represent to us that you will disclose herein the impact on your product sales and operating results and include in your financial statements the disclosure required by ASC 606-10-50-12A.
- Please explain to us why adjustments to prior year estimates of gross-to-net variable consideration in the aggregate of up to [X]% of total revenues are not material to your financial statements taken as a whole. In this regard, [X]% of your total revenues for the first half of [year 2] equating to approximately \$[X] million appears that it could at least be quantitatively material to operating loss and pre-tax loss for the first half of [year 2] and to your customer allowances liability at December 31, [year 1]. In addition, prior period adjustments of that magnitude could significantly impact trends and explanation thereof could be meaningful disclosure for investors.

**Examples of SEC Comments (continued)**

- You identify product revenue recognition as a critical accounting estimate. Given the magnitude of your net product sales and your gross-to-net adjustments as previously conveyed in your quarterly earnings conference calls, please address the following:
  - Provide us a roll forward of the accrual of each gross-to-net adjustment type (whether reflected as an allowance against accounts receivable or a liability) that depicts the following for each annual period from [date 1] to [date 2] and for the six-month period from [date 3] to [date 4]:
    - Beginning balance;
    - Current provision related to sales made in current period;
    - Current provision related to sales made in prior periods;
    - Actual returns or credits in current period related to sales made in current period;
    - Actual returns or credits in current period related to sales made in prior periods; and
    - Ending balance.
  - Tell us the amount of and reason for significant fluctuations in the provision from period to period for each type of gross-to-net adjustment, and the amount and reason that changes in your estimates of these items had on your revenues and operations.
- Please revise future filings to include all of the disclosures required by ASC 606-10-50, as applicable. For example, provide the qualitative and quantitative disclosure about the significant judgments and changes in judgments, including inputs and assumptions, related to your accounting for returns, rebates and discounts, as set forth in ASC 606-10-50-1(b), 50-17, and 50-20, a description of the payment terms under 50-12, and disaggregated revenue under 50-5.

The recognition of revenue in the life sciences industry relies heavily on estimates and assumptions related to returns, chargebacks, rebates, discounts, promotions, shelf stock adjustments, and other adjustments to transaction prices that affect revenue. ASC 606-10-50-12A requires an entity to “disclose revenue recognized in the reporting period from performance obligations satisfied (or partially satisfied) in previous periods (for example, changes in transaction price).” The SEC staff has commented on registrants’ disclosures of these types of changes in estimates in variable consideration, including the magnitude and nature of any current-period adjustments to estimates made in prior periods. The staff has also requested that registrants provide a rollforward of the accruals for each gross-to-net adjustment in MD&A, including similar disclosures of current-period adjustments related to sales made in prior periods.

## 2.12.4.2 Multiple-Element Arrangements

### Examples of SEC Comments

- You state that the development and manufacturing services for the [X] agreements are viewed as a single performance obligation and therefore the upfront payments, future research and development reimbursement payments and any potential additional development milestone payments under each agreement will be deferred until the commencement of commercial manufacturing. Please address the following:
  - Identify for us each of the promised goods or services in these agreements including the transfers of licenses and explain how you determined that you only had a single performance obligation under the guidance in ASC 606-10-25-14.
  - With reference to ASC 606-10-25-23 to 25-26, explain to us why revenue is deferred until commencement of commercial manufacturing and how you considered that you have already transferred the licenses and begun providing development services.
  - Explain to us whether you intend to recognize revenue over time or at a point in time, and why with reference to ASC 606-10-25-30 or 25-31, as applicable.
- Please address the following as it relates to your determination that the performance obligations represented a single performance obligation since the license, clinical development and manufacturing and supply obligations were not distinct:
  - [H]ow your statement . . . that [Customer X] was not granted any other rights to, or benefits from, the intellectual property is consistent with . . . the agreements. The agreements appear to give [X] the right to use [Product A] as necessary to . . . seek and obtain Regulatory Approval for the Licensed Product in the Field in the Territory.
  - [W]hy the license and research and development services, either alone or combined, are not capable of being distinct from the manufacturing services pursuant to ASC 606-10-25-19a. In this respect, the subcontracting and sublicensing rights . . . and step-in rights in . . . the agreements appear to indicate there may be available resources outside of the company that could provide the research and development services and supplies. Refer also to Example 56, Case B in ASC 606-10-55-371 through 55-372. In this regard, we note in Case A that an approved drug is provided in the contract with manufacturing services, for which no other promised goods or services are included in the contract, which appears to be contrary to the company's facts and circumstances.
  - [W]hy the license and research and development services, either alone or combined, are not separately identifiable from the supply obligation and thus do not meet the criteria in ASC 606-10-25-19b. In this regard, it appears due to the subcontracting and sublicensing rights, the license and research and development services are not inter-related with the manufacturing services pursuant to ASC 606-10-25-21c. Refer also to Example 56, Case B, ASC 606-10-55-372A.

### Examples of SEC Comments (continued)

- As it relates to your determination that revenue from the combined performance obligation should be recognized at a point in time upon the supply of the drug, please address the following:
  - Your response states that you intend to recognize revenue at the point in time in which [Customer X] achieves control over batches supplied. However, you also state that you will recognize revenue as product is delivered to [X] based on the quantity supplied compared to the forecasted quantity of the drug to be supplied over the term of the agreements, which would appear to be an over time measurement. Please clarify this apparent inconsistency. Please also explain how you intend to estimate the forecasted quantity of the drug to be supplied over the term of the agreements and how this estimate would be deemed to be a reasonable measure of progress considering the guidance in ASC 606-10-25-36.
  - Your response [to the initial comment letter] states that [the company] will “start satisfying its performance obligation only upon supply of the drug after issuance of regulatory marketing approvals.” Explain how you considered the contract duration guidance in ASC 606-10-25-3 which states that the guidance in this Topic should be applied to the duration of the contract (that is, the contractual period) in which the parties to the contract have present enforceable rights and obligations. In this regard, it would appear that the enforceable rights and obligations under these contracts began at their effective dates . . . Accordingly, it is unclear to us why an over time measurement of your performance obligation would not be recognized over the entire contractual period.
  - Explain how you considered the guidance in ASC 606-10-25-27(c) in determining whether your performance obligation is being satisfied over time. In this regard, address the following:
    - Clarify whether your performance under the contracts [creates] an asset with alternative future use. In this regard, explain whether you are contractually restricted from developing [Compound A] for your or any other entity's benefit as long as the [X] agreements are in effect.
    - Explain whether you have an enforceable right to payment for performance completed to date under the contracts. In this regard, it would appear that you would have the full right to the non-refundable upfront payments (at a minimum) even in the event that the drug does not receive regulatory approval and enter the commercialization phase.
- We acknowledge your . . . determination that the performance obligations represented a single performance obligation since they were not distinct. Please tell us the following information so we may further evaluate your response:
  - [W]hy you did not identify the research and development services, which appear to be required under the contract to get [Product A] through regulatory approval, as a separate performance obligation. . . .
  - [W]hy the license and research and development services, either alone or combined, are not capable of being distinct from the manufacturing services pursuant to ASC 606-10-25-19a. In this respect, the subcontracting rights under . . . the agreement appear to indicate that there may be available resources outside the company that could provide the research and development services and supplies. Refer also to Example 56, Case B in ASC 606-10-55-371 through 55-372.
  - [W]hy the license and research services, either alone or combined, are not separately identifiable from the manufacturing obligation and thus do not meet the criteria in ASC 606-10-25-19b. In this regard, it appears due to the subcontracting rights, the license and research services are not inter-related with the manufacturing services pursuant to ASC 606-10-25-21c. Refer also to Example 56, Case B, ASC 606-10-55-372A.
  - [I]f you will be compensated separately for any research and development services, such as the technical development activities discussed in . . . the agreement, how you intend to account for those payments.
  - [I]f you will be compensated separately for the supply of goods under the Supply agreement beyond the upfront fee and milestone payments received, and if so, whether or not the compensation includes a normal profit margin.



**Examples of SEC Comments (continued)**

- [W]hy control has transferred upon manufacturing the vials for [Customer A] pursuant to ASC 606-10-25-23.
- [H]ow you intend to estimate the expected vials to be produced during the contract term of the supply agreement and how the estimate would be deemed to be a reasonable measure of progress pursuant to ASC 606-10-25-36.
- Regarding the [agreement], for which you determined the total transaction price to be \$[X] million, please provide us your analysis of the accounting for the agreement which explains why you did not recognize any portion of the consideration for the license upon transfer of the license at inception of the agreement. Address:
  - If you concluded the license was distinct from the other obligations and why or why not,
  - If you concluded the license was a right to use license or a right to access license and why,
  - The standalone selling prices determined for each performance obligation and how you determined such,
  - Why you did not recognize the guaranteed minimum royalty payments as fixed consideration upon transfer of the license at inception of the agreement, and
  - Why you combined the license with the services to arrange for supplies.
- [Y]ou disclose that if you are unable to reasonably estimate royalty revenue or if you do not have access to the information, you record royalty revenue when the information needed for a reliable estimate becomes available. Please tell us how this policy complies with the requirement in ASC 606-10-55-65 to reflect royalties upon the later of subsequent sale or the satisfaction of the performance obligation to which the royalty has been allocated. In your response, tell us when the information needed for a reliable estimate becomes available in comparison to the period of actual sale.
- We note you have identified certain complementary products as separate performance obligations that are satisfied over the [X-] year warranty period. Please address the following:
  - Explain in more detail the nature of the complementary products and how you evaluated these arrangements under ASC 606-10-25-19 to 25-22.
  - Tell us the time period over which these performance obligations are recognized. In this regard we note your disclosure the performance obligations are satisfied over the [X-] year warranty period. However we note that all of your deferred revenue is classified as a current liability on your balance sheet.

As discussed in [Section 2.10](#), licensing arrangements in which an entity transfers a license of IP along with other services (e.g., R&D or manufacturing services) are common in the life sciences industry. Application of the revenue standard's accounting and disclosure requirements to such licensing arrangements has been a topic of focus for the SEC staff. Registrants in the life sciences industry have received staff comments asking them about how they determined (1) the number of performance obligations in a licensing arrangement and (2) the period(s) in which consideration allocated to each performance obligation should be recognized. In addition, the staff has inquired about the significant judgments made in the determination of whether a registrant provided a customer with a right-to-use or a right-to-access license, as well as about a registrant's considerations related to the application of the sales- or usage-based royalty exception (e.g., in arrangements involving guaranteed or minimum royalty payments).

## 2.12.5 Elective Relief for Nonpublic Entities

The Background Information and Basis for Conclusions of ASU 2014-09 explains that one of the goals of ASC 606 is to improve the revenue disclosure guidance under U.S. GAAP. As a result of the disclosure requirements in ASC 606, financial statement users will have better information to help them make financial decisions. However, when the FASB was developing the revenue standard, it received feedback from nonpublic entities related to (1) the increased costs that nonpublic entities would incur to meet the improved disclosure requirements and (2) questions about why nonpublic entities should be required to provide the same level of disclosure as public business entities (PBEs) given that users of nonpublic-entity financial statements, typically debt holders, have greater access to management. The FASB considered the costs and benefits of its disclosure package and decided to provide various relief to nonpublic entities.

The table below summarizes the disclosure requirements of ASU 2014-09 that a nonpublic entity may elect not to apply.

Category	Disclosure Requirements	Election Available to Nonpublic Entities
Disaggregation of revenue	Disaggregate revenue into categories that depict how revenue and cash flows are affected by economic factors.	Yes <sup>5</sup>
	Sufficient information to understand the relationship between disaggregated revenue and each disclosed segment's revenue information.	Yes
Contract balances	Opening and closing balances (receivable, contract assets, and contract liabilities).	No
	Amount of revenue recognized from beginning contract liability balance.	Yes
	Explanation of significant changes in contract balances (using qualitative and quantitative information).	Yes
Performance obligations (including remaining performance obligations)	Qualitative information about (1) when performance obligations are typically satisfied, (2) significant payment terms, (3) the nature of goods or services promised, (4) obligations for returns or refunds, and (5) warranties.	No
	Amount of revenue recognized from performance obligations satisfied in prior periods (e.g., changes in transaction price estimates).	Yes
	Transaction price allocated to the remaining performance obligations:	
	<ul style="list-style-type: none"> <li>• Disclosure of quantitative amounts.</li> <li>• Quantitative or qualitative explanation of when remaining performance obligation amounts will be recognized as revenue.</li> </ul>	Yes Yes

<sup>5</sup> At a minimum, a nonpublic entity must disclose revenue that is disaggregated in accordance with the timing of transfer of goods or services (e.g., goods transferred at a point in time and services transferred over time) and qualitative information about how economic factors affect revenue and cash flows.

(Table continued)

Category	Disclosure Requirements	Election Available to Nonpublic Entities
Significant judgments and estimates	Qualitative information about determining the timing of:	
	<ul style="list-style-type: none"> <li>Performance obligations satisfied over time (e.g., methods of measuring progress, why methods are representative of the transfer of goods or services, judgments used in the evaluation of when a customer obtains control of goods or services).</li> </ul>	Yes <sup>6</sup>
	<ul style="list-style-type: none"> <li>Performance obligations satisfied at a point in time — specifically, the significant judgments used in the evaluation of when a customer obtains control.</li> </ul>	Yes
	Qualitative and quantitative information <sup>7</sup> about:	
	<ul style="list-style-type: none"> <li>Determining the transaction price (e.g., estimating variable consideration, adjusting for the time value of money, noncash consideration).</li> <li>Constraining estimates of variable consideration.</li> <li>Allocating the transaction price, including estimating stand-alone selling prices and allocating discounts and variable consideration.</li> <li>Measuring obligations for returns, refunds, and other similar obligations.</li> </ul>	Yes No Yes Yes
Contract costs	Qualitative information about:	
	<ul style="list-style-type: none"> <li>Judgments made in determining the amount of the costs incurred to obtain or fulfill a contract.</li> </ul>	Yes
	<ul style="list-style-type: none"> <li>The method the entity uses to determine the amortization for each reporting period.</li> </ul>	Yes
	Quantitative information about:	
<ul style="list-style-type: none"> <li>The closing balances of assets recognized from the costs incurred to obtain or fulfill a contract, by main category of asset.</li> <li>The amount of amortization and any impairment losses recognized in the reporting period.</li> </ul>	Yes Yes	
Practical expedients	Disclosure of practical expedients used.	Yes <sup>8</sup>

See [Chapters 15](#) and [16](#) of Deloitte's Roadmap *Revenue Recognition* for more information about the revenue standard's disclosure requirements, including those that nonpublic entities may elect not to apply. In addition, see Deloitte's April 11, 2018, *Heads Up* for more information about what private companies should know about the revenue standard.

<sup>6</sup> The election available to nonpublic entities applies only to the requirement to disclose information about why the methods used to recognize revenue over time provide a faithful depiction of the transfer of goods or services to a customer. Nonpublic entities are still required to disclose the information about the methods used to recognize revenue over time in accordance with ASC 606-10-50-18(a).

<sup>7</sup> This includes the methods, inputs, and assumptions used in an entity's assessment.

<sup>8</sup> However, nonpublic entities that have elected the practical expedient or policy election in [ASU 2021-02](#) are required to disclose the practical expedient or policy election used.

# Chapter 3 — Research and Development

## 3.1 Introduction

New product development in the life sciences industry can be both time-consuming and costly. As markets have evolved over recent years, profitability has been constrained as a result of pricing challenges and scrutiny, rising materials and development costs, increased difficulty in sourcing innovative solutions, and more stringent government regulations.

In response to these pressures, companies are focusing on specialized R&D models that require enhanced capabilities to promote greater R&D efficiency. Life sciences companies are working to reduce research costs by outsourcing research to external partners, making acquisitions of promising products in preclinical and clinical-stage development, enhancing drug discovery and development platforms, and optimizing product approval timelines. In addition, companies are entering into various funding relationships to reduce the burden of R&D expenses through collaborations, licensing arrangements, partnerships, and other alliances.

As these R&D arrangements become more complex, so do the accounting requirements and considerations that entities must evaluate. Companies need to consider the substance of the R&D relationship, risks associated with such arrangements, and related deliverables to determine the appropriate accounting models and literature that will apply.

In this chapter, we explore various R&D issues that many life sciences companies encounter; the related accounting guidance; and recent SEC observations regarding registrants' accounting for and disclosure of R&D costs, including considerations related to accounting for prelaunch inventory.

## 3.2 Industry Issues

### 3.2.1 R&D Funding Arrangements

The need for new sources of capital in the life sciences industry has led to innovative R&D funding arrangements with diverse terms and conditions. In these arrangements, passive third-party investors often provide funds to offset the cost of R&D programs in exchange for milestone payments or other forms of consideration (typically sales-based royalties) that are contingent on the successful completion of such R&D programs and the related approval for the compound or compounds being developed. Typically, life sciences companies retain all IP rights to any compounds resulting from the R&D efforts, and the investor does not receive repayment or any other forms of consideration if the compound or compounds subject to the R&D arrangement are not successfully developed and commercialized.

Life sciences companies may consider funding arrangements to help offset some of the costs associated with an R&D program. To determine the appropriate accounting treatment, entities should first consider whether the arrangement includes elements that need to be accounted for under the guidance on derivatives in ASC 815.

ASC 815-10-15-83 defines a derivative instrument as follows:

#### ASC 815-10

**15-83** A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
  1. One or more underlyings
  2. One or more notional amounts or payment provisions or both.
- b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Net settlement. The contract can be settled net by any of the following means:
  1. Its terms implicitly or explicitly require or permit net settlement.
  2. It can readily be settled net by a means outside the contract.
  3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

Depending on the terms of the transaction, an R&D funding arrangement may contain an underlying (e.g., the underlying net sales, which are dependent on regulatory approval) and a payment provision (e.g., sales-based royalty payments to the investor, which are based on future levels of net sales of the compound being developed) without an initial net investment (i.e., the investor may only be required to fund the R&D costs as such costs are incurred). In addition, R&D funding arrangements often contain the characteristic of explicit net settlement since they are settled in cash.

If the life sciences company determines that its R&D funding arrangement meets the definition of a derivative instrument, it should assess whether the arrangement represents a contract that would meet any of the scope exceptions in ASC 815. For example, in certain transactions, the life sciences company is only required to make royalty payments to the investor if the compound is approved and net sales occur. In these circumstances, the scope exception described in ASC 815-10-15-13(e) and ASC 815-10-15-59(d) for certain contracts that are not traded on an exchange may apply. ASC 815-10-15-13(e) and ASC 815-10-15-59(d) state the following:

#### **Instruments Not Within Scope**

**15-13** Notwithstanding the conditions in paragraphs 815-10-15-83 through 15-139, the following contracts are not subject to the requirements of this Subtopic if specified criteria are met: . . .

- e. Certain contracts that are not traded on an exchange

#### ***Certain Contracts That Are Not Traded on an Exchange***

**15-59** Contracts that are not exchange-traded are not subject to the requirements of this Subtopic **if the underlying on which the settlement is based is any one of the following:** . . .

- d. Specified volumes of sales or service revenues of one of the parties to the contract. **(This scope exception applies to contracts with settlements based on the volume of items sold or services rendered, for example, royalty agreements. This scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.)** [Emphasis added]



### Connecting the Dots

R&D funding arrangements may include multiple payment provisions to the investor such as a payment upon regulatory approval of the compound that was subject to the R&D funding, as well as sales-based royalty payments from commercialization of the associated drug that received regulatory approval. When performing a derivative accounting assessment under ASC 815 in such cases, an entity will need to determine whether the payment provisions in the arrangement should be accounted for as a single unit of account or as multiple units of account. In situations in which the payment provisions should be accounted for as multiple units of account, each unit of account is individually assessed to determine whether it should be accounted for as a derivative. In situations in which the payment provisions should be accounted for as a single unit of account, the combined unit of account is assessed to determine whether it should be accounted for as a derivative. Such analysis becomes complex when certain payment provisions (underlyings) contained in the combined unit of account would have otherwise met one or more of the scope exceptions to the derivative accounting guidance in ASC 815 had they each been accounted for as a stand-alone unit of account (e.g., sales-based royalty) while other payment provisions would not have otherwise met any of those scope exceptions (e.g., payment based on regulatory approval). Regarding such a scenario, ASC 815-10-15-60 notes the following:

If a contract has more than one underlying and some, but not all, of them qualify for one of the scope exceptions in the preceding paragraph, the application of this Subtopic to that contract depends on its predominant characteristics. That is, the contract is subject to the requirements of this Subtopic if all of its underlyings, considered in combination, behave in a manner that is highly correlated with the behavior of any of the component variables that do not qualify for a scope exception.

The determination of whether the multiple payment provisions (underlyings) considered together behave in a manner that is highly correlated with a component variable that does not qualify for a scope exception to the derivative accounting guidance can be challenging in practice and is likely to require both a qualitative and a quantitative assessment. Accordingly, entities are encouraged to consult with their accounting advisers.

If the life sciences company determines that its R&D funding arrangement does not include elements that need to be accounted for under the guidance on derivatives in ASC 815, it should consider, among other things, the risks associated with the R&D program being funded as well as the deliverable(s) (i.e., license rights to IP subject to the R&D program) to be provided to the funding party. Such factors may inform the company's decision about which accounting literature to consider next, particularly if the company concludes that the arrangement is a contract to perform services that should be accounted for under ASC 606.

A critical assessment is whether the life sciences company has an obligation to repay the funding party or is under a contract to perform R&D services. If a determination is made at the onset of the arrangement that successful completion of the R&D is probable, it may be more appropriate to treat the arrangement as the sale of future revenues under ASC 470-10-25 than as an R&D funding arrangement under ASC 730-20. The application of ASC 470-10-25 would generally result in debt classification for the funding because of the life sciences company's continuing involvement with the associated R&D.

If a conclusion is reached that ASC 470-10-25 does not apply, the life sciences company should next evaluate ASC 730-20 to determine whether the arrangement represents an obligation to repay the funding party or a contract to perform services. ASC 730-20-25-3 notes that "[i]f the entity is obligated to repay any of the funds provided by the other parties regardless of the outcome of the research and development, the entity shall estimate and recognize that liability. This requirement applies whether the entity may settle the liability by paying cash, by issuing securities, or by some other means."

ASC 730-20-25-4 cautions preparers that to support a conclusion that a liability does not exist, “the transfer of the financial risk involved with research and development from the entity to the other parties must be substantive and genuine.” The provision also states that “[t]o the extent that the entity is committed to repay any of the funds provided by the other parties regardless of the outcome of the research and development, all or part of the risk has not been transferred.”

In addition, ASC 730-20-25-4 lists the following examples of circumstances in which risk has not been transferred:

- a. The entity guarantees, or has a contractual commitment that assures, repayment of the funds provided by the other parties regardless of the outcome of the research and development.
- b. The other parties can require the entity to purchase their interest in the research and development regardless of the outcome.
- c. The other parties automatically will receive debt or equity securities of the entity upon termination or completion of the research and development regardless of the outcome.

Even in the absence of an explicit requirement for repayment, there may be other circumstances in which the entity will most likely bear the risk associated with the failure of the R&D activities. ASC 730-20-25-5 states, in part, that “[i]f those conditions suggest that it is probable that the entity will repay any of the funds regardless of the outcome of the research and development, there is a presumption that the entity has an obligation to repay the other parties.” Further, such a presumption “can be overcome only by substantial evidence to the contrary.” ASC 730-20-25-6 describes the following circumstances as leading to the presumption that the entity will repay the other parties:

- a. The entity has indicated an intent to repay all or a portion of the funds provided regardless of the outcome of the research and development.
- b. The entity would suffer a severe economic penalty if it failed to repay any of the funds provided to it regardless of the outcome of the research and development. . . .
- c. A significant related party relationship between the entity and the parties funding the research and development exists at the time the entity enters into the arrangement.
- d. The entity has essentially completed the project before entering into the arrangement.



### Connecting the Dots

Companies in the life sciences industry typically assign probability of technical and regulatory success (PTRS) rates to development-stage compounds on the basis of estimates of the likelihood that such compounds eventually will be approved by the FDA or other regulatory organizations. Because companies often use PTRS rates to determine resource and capital allocation strategies, it is often important for companies to consider the PTRS rate for a respective compound in evaluating whether successful completion of the R&D is probable at the onset of the arrangement. However, there is no “bright line” PTRS rate for determining whether successful completion of the R&D is considered probable. Therefore, companies should consider all facts and circumstances in making such a determination.



In practice, investors often desire certain terms and conditions that reduce risk. Such terms and conditions can complicate an analysis under ASC 730-20 and could ultimately trigger liability accounting for an R&D funding arrangement. Various deal structures favored by investors can therefore raise significant doubt regarding whether a transfer of R&D risk is substantive and genuine:

- *Multiple products (the “basket approach”)* — An investor’s risk is reduced by having an increased number of covered products as well as by other factors (e.g., number of products, stage of development of each, payment mechanisms).
- *Repayment upon achievement of clinical development milestones* — An investor’s risk is reduced if repayment is triggered upon achievement of an event before regulatory approval (e.g., upon “proof of concept” demonstrating that the drug may be efficacious).
- *Substitution rights* — An investor’s risk is reduced by the right to replace a failed molecule or project in the R&D arrangement with one or more other molecules or projects that still have the potential to be commercialized.
- *Royalty rates based on commercialization sequence* — An investor’s risk is reduced by assigning a royalty rate (typically the highest) to the first successful outcome within a portfolio of products, with lower rates assigned to each successive outcome that has no direct economic correlation to product market potential or probability of success.
- *Rights to unrelated revenue streams* — An investor’s risk is reduced by incorporating rights to cash flows from an unrelated revenue stream, such as a royalty on a separate and distinct product for which the investor did not fund the related R&D. If cash flows associated with an unrelated revenue stream (i.e., milestone or royalty payments related to sales of developed products unrelated to the compounds that were subject to the R&D funding arrangement) are included in accordance with the terms of the arrangement, the guidance in ASC 470-10-25 on sales of future revenue streams should be considered. For further discussion of this guidance, see [Section 7.2](#) of Deloitte’s Roadmap *Issuer’s Accounting for Debt*.



### Connecting the Dots

Because of the inherent uncertainty associated with compounds in the R&D process, life sciences companies often perform clinical trials, hoping to obtain approval to treat multiple disease types (commonly referred to as “indications” or “labels”). While such R&D programs are often developed specifically to determine the effectiveness and safety of a compound to treat a particular indication, companies typically are unable to track sales of a product by indication when the product has been granted approval for more than one indication. Therefore, in light of the guidance above, a life sciences company should assess whether sales-based royalties to be paid on overall product sales should be considered an unrelated revenue stream if the company’s R&D funding arrangement was specific to certain indications and did not include R&D activities for all indications for which the respective compound is approved and marketed. Such evaluation is critical if the compound is already approved and marketed for certain indications.

In addition, life sciences companies often conduct R&D programs to obtain regulatory approval in certain jurisdictions (or markets). If a life sciences company’s R&D funding arrangement is specifically related to R&D studies to obtain approval in a certain jurisdiction, but the arrangement calls for future sales-based royalties on global product sales (if and when such a compound is approved), the company should evaluate whether such sales-based royalties to be paid on overall product sales should be considered an unrelated revenue stream. This evaluation is particularly important if the compound is already approved and marketed in certain jurisdictions.

If an entity concludes that substantive and genuine risk transfer has occurred, questions may then arise about the appropriate income statement classification of the funding received from the investor since ASC 730-20 does not provide guidance on the income statement classification for funding accounted for as an obligation to perform contractual services for others. ASC 808 provides guidance on classification of payments for transactions between collaboration partners, and ASC 606 provides guidance on gross versus net presentation of revenue.

We believe that entities should consider the nature of their ordinary activities in determining the appropriate income statement classification. If an entity's arrangement is consistent with the entity's ordinary activities (i.e., the entity regularly performs R&D on behalf of others who are generally viewed as customers), classification as revenue may be appropriate. If the arrangement is inconsistent with the entity's ordinary activities, classification as contra-R&D expense or other income may be more appropriate.

In determining whether to classify funding from an investor as contra-R&D expense or as other income, a life sciences entity might consider the extent of involvement of the counterparty in the R&D effort. For example, if the counterparty is actively involved through participation on a joint steering committee or in the performance of certain R&D activities, classification as contra-R&D expense may be appropriate. This classification may be further supported by analogy to ASC 410-30-45-4, which states, in part, that "[c]redits arising from recoveries of environmental losses from other parties shall be reflected in the same income statement line." That is, the life sciences entity might conclude that the funding to be received from the investor (i.e., the "credits") should be reflected in the same income statement line item as the expenses to which the funding is related. Alternatively, if the counterparty is only passively involved, the entity might conclude that classification as other income may be more appropriate.

### **3.2.1.1 R&D Funding Arrangements Involving New Legal Entities**

Historically, it was not common for separate legal entities to be created to facilitate R&D funding arrangements; however, some recent arrangements have included the formation of a new legal entity. Typically, the new legal entity is 100 percent owned by a financial investor, and the life sciences company may be involved through participation on a committee (e.g., steering committee) or by performing R&D services through an outsourcing arrangement. The life sciences company may also have the right or option to reacquire the rights to the compound(s) at a later date.

When an R&D arrangement involves the formation of a new legal entity, the life sciences company must also consider the consolidation guidance in ASC 810 to determine whether it is required to consolidate the legal entity. Typically, the R&D legal entity is a variable interest entity (VIE) because of any of the following:

- The equity investors with equity at risk are "capped" on receipt of the expected residual returns as a result of the R&D legal entity's arrangements with other variable interest holders. For example, a life sciences company's right or option to reacquire the rights to a compound effectively limits the returns that the equity investors can receive in such a way that the equity investors do not participate significantly in the profits.
- The R&D legal entity does not have sufficient equity to finance its operations (i.e., it is not sufficiently capitalized through its equity investment at risk). This situation is common because R&D legal entities often require additional subordinated financial support as a means to finance their activities.
- The equity investors with equity at risk do not have the power to direct the activities of the R&D legal entity that most significantly affect the R&D legal entity's economic performance.

In these situations, the evaluation should include consideration of whether the life sciences company has the power to direct the activities most significant to the legal entity's economic performance. For example, the power to make decisions related to the design or operation of clinical studies may indicate that the life sciences company has power over the entity's most significant activities and that therefore, consolidation may be required.

The power to make the most significant decisions could reside with different parties depending on a product candidate's stage of development and should be considered in the consolidation analysis. Further, careful consideration should also be given when either the decisions of the financial investor(s) are passive or predetermined, or the life sciences company has a fixed-price call option to acquire the legal entity since these types of circumstances could suggest that (1) the financial investors lack the characteristics of a controlling financial interest and (2) the life sciences company controls and should consolidate the legal entity.

If a life sciences company concludes that consolidation of an R&D entity is required, the percentage of equity not owned by the life sciences company would be presented as a noncontrolling interest (which could be 100 percent of the legal entity's equity). Further, it is important to determine whether the financial investor's equity investment has all of the characteristics of equity. If it does not, temporary equity or liability classification of the noncontrolling interest may be required depending on the facts and circumstances.

### 3.2.2 R&D Cost Classification

R&D costs are pivotal to life sciences entities as they fuel the future pipeline. Entities can spend billions of dollars on R&D costs in hopes of developing and gaining approval for their next blockbuster drug or therapy. These costs are generally classified separately in the income statement and are often a focus of financial statement users since they may provide insight into the entity's future revenues.

ASC 730-10-20 defines "research and development" as follows:

#### ASC 730-10 — Glossary

##### Research and Development

Research is planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service (referred to as product) or a new process or technique (referred to as process) or in bringing about a significant improvement to an existing product or process.

Development is the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use. It includes the conceptual formulation, design, and testing of product alternatives, construction of prototypes, and operation of pilot plants.

ASC 730-10-25-2 explains the elements of costs to be identified with R&D activities.

**ASC 730-10**

**25-2** Elements of costs shall be identified with research and development activities as follows . . . :

- a. Materials, equipment, and facilities. The costs of materials (whether from the entity's normal inventory or acquired specially for research and development activities) and equipment or facilities that are acquired or constructed for research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be capitalized as tangible assets when acquired or constructed. The cost of such materials consumed in research and development activities and the depreciation of such equipment or facilities used in those activities are research and development costs. However, the costs of materials, equipment, or facilities that are acquired or constructed for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred. . . .
- b. Personnel. Salaries, wages, and other related costs of personnel engaged in research and development activities shall be included in research and development costs.
- c. Intangible assets purchased from others. The costs of intangible assets that are purchased from others for use in research and development activities and that have alternative future uses (in research and development projects or otherwise) shall be accounted for in accordance with Topic 350. The amortization of those intangible assets used in research and development activities is a research and development cost. However, the costs of intangibles that are purchased from others for a particular research and development project and that have no alternative future uses (in other research and development projects or otherwise) and therefore no separate economic values are research and development costs at the time the costs are incurred.
- d. Contract services. The costs of services performed by others in connection with the research and development activities of an entity, including research and development conducted by others in behalf of the entity, shall be included in research and development costs.
- e. Indirect costs. Research and development costs shall include a reasonable allocation of indirect costs. However, general and administrative costs that are not clearly related to research and development activities shall not be included as research and development costs.



### Connecting the Dots

#### **Assets Acquired or Constructed for Use in R&D Activities**

A life sciences company may need to acquire facilities and equipment to contribute to the development of a product candidate currently proceeding through the stages of clinical development.

In a manner consistent with ASC 730-10-25-2(a) and (c), tangible assets that are acquired or constructed, and intangible assets that are acquired, for use in R&D activities in a transaction other than a business combination are capitalized only if they have alternative future uses. Otherwise, the costs for such assets are R&D costs at the time such costs are incurred and are charged to expense in accordance with ASC 730-10-25-1.

Paragraph 3.17 of the AICPA Accounting and Valuation Guide *Assets Acquired to Be Used in Research and Development Activities* discusses the determination of whether such assets have an alternative future use:

The [AICPA IPR&D Task Force (the “task force”)] believes that the determination of whether an alternative future use exists for an asset is based on specific facts and circumstances. However, for an acquired tangible asset to be used in R&D activities (for example, computer testing equipment used in an R&D department), the task force believes that there is a rebuttable presumption that such asset has an alternative future use because that asset generally has separate economic value (other than scrap or insignificant value) independent of the successful completion and commercialization of the IPR&D project. This presumption would be overcome, for example, if it were reasonably expected that the reporting entity will use that asset only in a specific IPR&D project that had commenced before the acquisition date.

To illustrate the application of this guidance, suppose that Company X acquires a phase III drug in an asset acquisition and separately purchases various equipment (e.g., tanks, mixers, centrifuges) to be used in connection with the development of the drug. Although X acquires the equipment to support a specific product candidate, the nature of the equipment is common to pharmaceutical preparation and may have economic value apart from the specific IPR&D project (i.e., the equipment could be sold in a secondary market for an amount other than scrap value). Consequently, it may be appropriate to capitalize the cost of the equipment.

Conversely, suppose that X acquires (or internally develops) certain medical testing equipment that (1) is reasonably expected to be used only in a specific IPR&D project and (2) does not have any further use or separate economic benefit to the company or others. In accordance with ASC 730-10-25-2(a), X would immediately expense the cost, less salvage value, of the medical testing equipment since there is no alternative future use. Similarly, if a life sciences company acquires a comparator drug that will only be used in one of its ongoing clinical trials, the cost of the comparator drug should be expensed when incurred because the comparator drug has no alternative future use in other R&D projects.

Alternatively, if a life sciences company uses a debt facility to fund R&D activities whose costs are required to be expensed as incurred, the interest associated with that debt facility would not be capitalized since it does not meet the criteria in ASC 835-20-15-5, which states that interest should be capitalized for the following types of assets:

- a. Assets that are constructed or otherwise produced for an entity's own use, including assets constructed or produced for the entity by others for which deposits or progress payments have been made.
- b. Assets intended for sale or lease that are constructed or otherwise produced as discrete projects . . . .
- c. Investments (equity, loans, and advances) accounted for by the equity method while the investee has activities in progress necessary to commence its planned principal operations provided that the investee's activities include the use of funds to acquire qualifying assets for its operations. The investor's investment in the investee, not the individual assets or projects of the investee, is the qualifying asset for purposes of interest capitalization.

#### ***Costs Incurred to Hire R&D Personnel***

Life sciences companies may incur expenses, such as headhunting fees or signing bonuses, when hiring R&D personnel for R&D activities. In accordance with ASC 730-10-25-1 and 25-2(b), the costs incurred in connection with other related costs of personnel engaged in R&D activities should be accounted for as R&D costs of the entity and should be expensed as the entity becomes contractually obligated for such costs.

#### ***Costs Incurred to Obtain Regulatory Approval of Equipment That Has an Alternative Future Use***

Life sciences companies may incur costs associated with the regulatory approval of manufacturing equipment that has an alternative future use. An entity may be required to produce multiple batches of a finished product in connection with the regulatory approval process of the manufacturing equipment.

In assessing whether the costs associated with obtaining regulatory approval of the manufacturing equipment should be capitalized, the entity should consider analogizing to the guidance in ASC 835-20-05-1, which states, in part, that the "historical cost of acquiring an asset includes the costs necessarily incurred to bring it to the condition and location necessary for its intended use." Accordingly, if activities performed as part of the regulatory approval process (i.e., the production of multiple batches of a finished product) are required to bring

manufacturing equipment to the condition necessary for its intended use, the associated costs may be capitalized. Abnormal costs incurred during the regulatory approval process, such as costs associated with rework, should be expensed as incurred since they do not represent costs that are “necessarily incurred to bring [the asset] to the condition and location necessary for its intended use.”

See [Section 3.2.3](#) for considerations related to the capitalization of prelaunch inventory, which could include batches of inventory produced during the validation process.

### **Costs of Services Performed by Others in Connection With R&D Activities**

Life sciences companies frequently enter into contract research arrangements with third parties (i.e., CROs) to perform research on compounds under development. The payment terms under these arrangements may be based on defined milestones (e.g., upon delivery of the research services) rather than on time incurred.

In a manner consistent with ASC 730-10-25-1 and 25-2(d), the costs of services performed by others in connection with an entity's R&D activities should be accounted for as R&D costs of the entity and should be expensed as the entity becomes contractually obligated for such costs. To properly expense the contract research costs under the arrangement, the entity may need to (1) obtain periodic progress reports from the vendors on the level of services provided to date for which the entity is contractually obligated to pay and (2) engage with its regulatory affairs and clinical development teams for help in understanding when those costs were incurred. This is because the timing of payments would not necessarily indicate the entity's contractual obligation to pay for services performed by the vendors at a particular point in time. Instead, estimates are often based on contracted amounts adjusted for the percentage of work completed to date, which may be measured on the basis of patient enrollments, the number of clinical sites opened, the duration for which patients will be enrolled in the study, patient visits, or some other reasonable measure of progress.

In addition, ASC 730-10-55-1 and 55-2 list examples of activities that are commonly included in, or excluded from, R&D activities.

#### **ASC 730-10**

##### **Examples of Activities Typically Included in Research and Development**

**55-1** The following activities typically would be considered research and development within the scope of this Topic (unless conducted for others under a contractual arrangement — see paragraph 730-10-15-4[a]):

- a. Laboratory research aimed at discovery of new knowledge
- b. Searching for applications of new research findings or other knowledge
- c. Conceptual formulation and design of possible product or process alternatives
- d. Testing in search for or evaluation of product or process alternatives
- e. Modification of the formulation or design of a product or process
- f. Design, construction, and testing of preproduction prototypes and models
- g. Design of tools, jigs, molds, and dies involving new technology
- h. Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the entity for commercial production
- i. Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture
- j. Design and development of tools used to facilitate research and development or components of a product or process that are undergoing research and development activities.

**ASC 730-10 (continued)****Examples of Activities Typically Excluded From Research and Development**

**55-2** The following activities typically would not be considered research and development within the scope of this Topic:

- a. Engineering follow-through in an early phase of commercial production
- b. Quality control during commercial production including routine testing of products
- c. Trouble-shooting in connection with break-downs during commercial production
- d. Routine, ongoing efforts to refine, enrich, or otherwise improve upon the qualities of an existing product
- e. Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity
- f. Seasonal or other periodic design changes to existing products
- g. Routine design of tools, jigs, molds, and dies
- h. Activity, including design and construction engineering, related to the construction, relocation, rearrangement, or start-up of facilities or equipment other than the following:
  1. Pilot plants (see [h] in the preceding paragraph)
  2. Facilities or equipment whose sole use is for a particular research and development project (see paragraph 730-10-25-2[a]).
- i. Legal work in connection with patent applications or litigation, and the sale or licensing of patents.

**Connecting the Dots**

As noted in the above examples, legal work in connection with patent applications or litigation does not meet the definition of R&D. However, questions about whether an entity may capitalize costs related to such legal work sometimes arise.

For example, suppose that Company X is sued for patent infringement and is incurring legal costs to defend the patent. [FASB Concepts Statement 8, Chapter 4](#), which supersedes FASB Concepts Statement 6, defines an asset as follows:

*Assets*

E16. An asset is a present right of an entity to an economic benefit.

*Characteristics of Assets*

E17. An asset has the following two essential characteristics:

- a. It is a present right.
- b. The right is to an economic benefit.

The combination of those two characteristics allows an entity to obtain the economic benefit and control others' access to the benefit. A present right of an entity to an economic benefit entitles the entity to the economic benefit and the ability to restrict others' access to the benefit to which the entity is entitled.



Paragraph E23 of FASB Concepts Statement 8, Chapter 4, further observes that “the right to use a patent” is an example of a present right to an economic benefit and therefore gives rise to an asset. Accordingly, if legal costs incurred in successfully defending a patent create a present right to an economic benefit, capitalization of patent defense costs would be appropriate. In such a case, we would expect an entity to have sufficient, compelling evidence to support that conclusion. However, we believe that it may be challenging for an entity to support a conclusion that the legal defense costs meet the definition of an asset; if so, such costs should be expensed as incurred. Note that legal costs related to an unsuccessful outcome should be expensed.

In addition, because of the uncertainty associated with the successful development of IP rights, legal costs incurred in connection with a patent application are generally expensed as incurred.

ASC 730-10-15-4(c) and (e) exclude from the scope of ASC 730 the “acquisition, development, or improvement of a process by an entity for use in its selling or administrative activities” and “[m]arket research or market testing activities,” respectively. Therefore, such transactions and activities should not be classified as R&D.

Determining the classification of certain costs may be straightforward when the costs align closely with the definition and examples of R&D in ASC 730. However, certain costs associated with some activities require more judgment since the activities can have characteristics of both R&D and selling and marketing expenses. Costs associated with certain activities that might require further judgment for classification as R&D expenses under ASC 730 include, but are not limited to, the following:

- *Phase IV studies* — Conducted after the drug or treatment has been marketed, these studies are frequently performed to gather information on the drug’s effect in various populations and any side effects associated with long-term use.
- *Investigator-initiated research (IIR)* — IIR projects are similar to phase IV studies but are conducted by third-party investigators with oversight provided by the entity. Both phase IV studies and IIR provide a framework for research to increase the understanding of diseases, disease management, or drug use and effects in various patient populations.
- *Grants* — Grants fund independent medical education programs that are intended to enhance the knowledge base of health care professionals and provide a forum for discussion of new data, information, and other knowledge that could generate ideas related to the development of other products.
- *Pharmacovigilance* — Entities incur pharmacovigilance costs to collect, analyze, and report safety data associated with the use of a drug. Information obtained through pharmacovigilance could lead to new knowledge that may result in the significant modification of existing products, modifications to the method of use for existing products, or the development of new products to curb adverse reactions in patient populations.
- *Medical science liaison (MSL)* — An MSL organization delivers to key thought leaders, professional societies, and practitioners clinical and scientific data and clinical education associated with an entity’s products and various disease states.
- *Risk evaluation and mitigation strategy (REMS)* — A REMS is a safety strategy that entities use to manage a known or potentially serious risk associated with a medication and to enable patients to have continued access to the medication by managing its safe use. The FDA may require a REMS as part of the approval of a new product, or for an approved product when new safety information arises. Activities under a REMS may include (1) providing training on proper prescribing and (2) monitoring improper activities associated with the products related to the program.



### Connecting the Dots

Certain costs are incurred to facilitate the development of new products or the enhancement/alternative use of existing products, which can lead to new regulatory approvals or the extension of patent protection. These types of costs may be consistent with those involved with “[s]earching for applications of new research findings or other knowledge” (ASC 730-10-55-1(b)) or the “[c]onceptual formulation and design of possible product or process alternatives” (ASC 730-10-55-1(c)) and therefore may be classified as R&D costs. Other types of costs, however, are incurred primarily to yield information (1) that may be useful for expanding access to or the understanding of currently marketed products or (2) as a result of an ongoing compliance program that does not provide significant information that can be used in future R&D. These types of costs may be more appropriately classified as marketing, selling, general, or administrative expenses. It is important for entities to consider all facts and circumstances in determining the proper income statement classification.

#### 3.2.2.1 SEC Comment Letter Themes Related to R&D and Cost Classification

##### Examples of SEC Comments

- Please tell us whether you track any component of your research and development expenses by drug candidate . . . . If so represent to us that you will revise your disclosure in future filings to disaggregate research and development expenses by drug candidate for each period presented. If not, tell us whether you can provide more granular information, perhaps by nature, such as manufacturing expenses, clinical trial costs, preclinical study expenses, etc. in order to provide more insight into your research and development activities. Otherwise tell us why you cannot provide such additional detail or why its disclosure is not warranted.
- You make several assertions regarding the safety and efficacy of certain of your product candidates. For example, in your discussion . . . regarding an ongoing Phase I/II study of [Candidate], you disclose that “the data demonstrated that [Candidate] continues to be safe and well-tolerated, with no new serious adverse events and no development of inhibitors.” In addition, in your discussion . . . of your preclinical [X] program, you disclose that these preclinical studies “demonstrate that [Candidate] appears to be safe due to a lack of off-target activity.” Safety and efficacy determinations are solely within the authority of the FDA (or applicable foreign regulator). Please revise your future filings to remove statements/inferences that your product candidates are safe and/or effective. You may provide the objective results of the clinical trial in relation to the stated end points and indicate whether the candidates were well tolerated.
- We note the significant increase in your research and development expenses in [the fiscal year] and that you have multiple programs/products in varying stages of development and clinical testing, and note that you expect your research and development expenses to increase. Please confirm that you will revise future filings to provide more details about your research and development expenses for each period presented, including but not limited to by product/program, internal versus external, as well as by the nature of the expenses. For example, in discussing the specific reasons for significant changes in research and development expenses, quantify the change by each product candidate for which significant investments were made during the periods. Refer to Item 303(b) of Regulation S-K. To the extent that you do not track expenses by product candidate, please disclose as such.
- Please provide us a breakdown of your research and development (“R&D”) expenses incurred for each year presented by product candidate or project. To the extent that you do not track costs by project, please explain how your R&D costs are managed and how they are reported within the organization. To the extent that you can distinguish your R&D costs by discovery, preclinical and clinical development categories and/or therapeutic class or by the type of cost, please provide us with this information. Please also tell us your consideration of disclosing this information given that you consider research and development to be essential to your business.

### Examples of SEC Comments (continued)

- [Y]ou indicate that your external research and development costs include legal fees. Please tell us:
  - The nature of these legal fees;
  - The amount of legal fees included in research and development expenses in each of the last three fiscal years and the [first through third quarters of the current fiscal year]; and
  - How these legal fees meet the definition of either research or development in ASC 730-10-20 and your consideration of the guidance in ASC 730-10-55-2i.
- Please disclose your accounting policies for research and development expenses and intellectual property intangible assets. With reference to the nature of the intellectual property rights acquired as disclosed . . . , please address how you determined there is an alternative future use for these assets, such that it was appropriate to capitalize the cost of these assets. Refer to ASC 730-10-25-2(c).

The SEC staff often asks registrants with significant R&D costs to support the classification of the costs comprising the amounts disclosed and explain how the classification is in accordance with ASC 730-10-20. Registrants should be prepared to support their R&D classification by demonstrating careful evaluation of costs under ASC 730. For more information about themes we have identified in our review of SEC comment letters issued to registrants in the life sciences industry, see [Section 6.4](#) of Deloitte’s Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

### 3.2.3 Capitalization of Prelaunch Inventory

Because of the inherent complexities related to product development and manufacturing, life sciences companies may start producing product well in advance of the anticipated product launch date to ensure that there is sufficient plant capacity and available stock to meet forecasted demand. However, the success of new drug (and abbreviated new drug) applications is inherently uncertain, and companies may experience delays in achieving regulatory approval. Consider the following scenarios:

Branded Product	Generic Product	Medical Device
A new drug application (NDA) has been submitted to the FDA for review, and phase III clinical trials have been completed.	An abbreviated new drug application (ANDA) has been submitted to and accepted by the FDA for review.	A 510(k) premarket approval application has been submitted to and accepted by the FDA for review.

In each of the above scenarios, a life sciences entity must use judgment in determining whether costs incurred to manufacture a product in advance of FDA approval should be capitalized as inventory or expensed as incurred. To qualify for capitalization, the prelaunch inventory must qualify as an asset, which, as previously noted, is defined in paragraphs E16 and E17 of FASB Concepts Statement 8, Chapter 4. Paragraph E17 states, in part:

An asset has the following two essential characteristics:

- a. It is a present right.
- b. The right is to an economic benefit.

When a life sciences entity is evaluating whether prelaunch inventory (i.e., before regulatory approval) is a present right to an economic benefit and therefore meets the definition of an asset, the entity may consider:

- The entity's prior history with approvals of similar products.
- The estimated timing of obtaining regulatory approval.
- Threatened or anticipated litigation challenges (e.g., patent infringement lawsuits).
- FDA correspondence (or other appropriate regulatory agencies) regarding the safety and efficacy of the product.
- Current market factors, including the competitive landscape and pricing.

If capitalization is deemed appropriate, a life sciences entity should continue to monitor the status of the above factors to assess whether capitalization of the product remains appropriate.

In addition, a life sciences company engaging in clinical trials may require manufactured products for patients enrolled in a trial. Such products may only be used to support the ongoing clinical trial and may include raw materials acquired for production. Management should evaluate whether raw materials acquired for production should be accounted for as inventory if they would have an alternative future use, as discussed in [Section 3.2.2](#) (i.e., the raw materials could be used in the production of multiple drugs). The costs of materials acquired for a particular R&D project that have no alternative future use (e.g., in other R&D projects) and, therefore, no separate economic value are R&D costs at the time the costs are incurred. Further, the costs of raw materials consumed in R&D activities are R&D costs.

### **3.2.3.1 SEC Comment Letter Themes Related to Capitalization of Prelaunch Inventory**

#### **Example of an SEC Comment**

You disclose that inventory costs incurred prior to receipt of regulatory approval are charged to research and development costs when incurred. You also disclose . . . that inventories on your period end balance sheets are comprised primarily of raw materials purchased subsequent to FDA approval of [Product A]. Please tell us the following:

- The dollar value of pre-approval inventory costs charged to research and development costs and the calendar years in which those costs were expensed.
- An estimate of what cost of sales as a percentage of product revenue, net would have been for each quarter from the third quarter of [fiscal year 1] through the third quarter of [fiscal year 2] if you had not charged pre-approval inventory costs to research and development expenses.
- The estimated amount of future product revenue, net from sales of the zero-cost/low-cost inventory (i.e. inventory that excludes costs charged to expense prior to regulatory approval) on hand at September 30, [fiscal year 2] and the expected period of time over which it will be sold.

It is important for life sciences companies to provide robust disclosures about capitalizing prelaunch inventory since the SEC staff has historically focused on the capitalization of prelaunch inventory that has not been approved by the FDA. Specifically, the staff has asked registrants to quantify the total amount of capitalized unapproved inventory and clarify their accounting policy for the capitalization of unapproved products. In addition, the staff may ask a registrant to indicate (1) when during the FDA approval process it was concluded that a probable future benefit exists and (2) the status of the FDA's consideration of the safety and efficacy of the product and evaluation of the manufacturing process at that point. Further, a registrant may be asked to explain how its costs qualify as inventory under ASC 330-10-20 and as an asset under paragraph E16 of FASB Concepts Statement 8, Chapter 4.

The SEC staff may also request the following additional information or disclosures:

- A description of the overall FDA approval process, including current status, estimated timing of approval, and related risks affecting the approval outcome.
- The remaining shelf life of each capitalized product and why the registrant believes that it will realize the asset's economic benefit before the expiration of the shelf life.
- The risks and uncertainties associated with market acceptance of the product, once approved, and how these risks and uncertainties will affect the realization of the asset.

### 3.2.4 Nonrefundable Advance Payments

Life sciences entities may prepay for goods or services that will be used in future R&D activities. Payments are often required by CROs in advance of performing clinical trial management services, or by third-party manufacturers to secure manufacturing capacity for the production of a company's pharmaceutical products. Often, these payments are nonrefundable so that the life sciences entity will not be reimbursed if the CRO's or manufacturer's services are unnecessary.

ASC 730-20-25-13, ASC 730-20-25-14, and ASC 730-20-35-1 provide guidance on nonrefundable advance payments for goods or services that have the characteristics that will be used or rendered for future R&D activities under an executory contractual arrangement. Specifically, ASC 730-20 notes that nonrefundable advance payments for future R&D activities should be (1) deferred and capitalized and (2) subsequently "recognized as an expense as the related goods are delivered or the related services are performed."

Further, ASC 730-20 requires an entity to (1) "continue to evaluate whether it expects the goods to be delivered or services to be rendered" and (2) charge to expense any portion of the advance payment that has been capitalized when the entity no longer expects the goods to be delivered or services to be rendered. For example, when a company makes a nonrefundable advance payment to a CRO for the performance of certain R&D services and subsequently decides to abandon the pursuit, management would need to evaluate whether the company will continue to receive R&D services from the CRO and whether the related service period over which the capitalized asset is being amortized remains appropriate. If the CRO will not perform future services, any remaining asset should be expensed. Entities should also note that nonrefundable advance payments for future R&D activities related to materials, equipment, facilities, and purchased intangible assets that have an alternative future use (in R&D projects or otherwise) should be recognized in accordance with the guidance in ASC 730-10.



#### Connecting the Dots

In addition to evaluating the recoverability of any nonrefundable advance payments made to CROs, a life sciences company may need to consider certain external costs incurred after deciding to abandon a clinical trial. For example, the company may owe a CRO additional costs for wind-down activities, termination penalties, and investigator payments. Under ASC 420, for a contract within the scope of that guidance, an entity is required to recognize and measure at fair value a liability for the costs of terminating the contract before the end of the contract term when the entity terminates the contract in accordance with the contract's provisions (e.g., when the entity gives written notice to the CRO within the notification period specified in the contract or has otherwise negotiated a termination with the CRO).

### 3.2.4.1 Donations to Fund R&D

A life sciences entity may commit to making a donation to an NFP (e.g., a community organization, college or university, museum, or other organization listed in ASC 958-10-15-3) to fund research activities of the NFP. In such a situation, the life sciences entity should consider whether a contribution has been made and, if so, when the contribution should be recognized. In the ASC 720-25 glossary, a contribution is defined, in part, as an **“unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity . . . in a voluntary nonreciprocal transfer by another entity acting other than as an owner”** (emphasis added). With respect to recognition, ASC 720-25-25-1 states, in part, that “[c]ontributions made shall be recognized as expenses in the period made,” and “unconditional promises to give cash are recognized as payables and contribution expenses.” Further, ASC 720-25-30-1 requires contributions made to “be measured at the fair values of the assets given or, if made in the form of a settlement or cancellation of a donee’s liabilities, at the fair value of the liabilities cancelled.”

### 3.2.5 Refundable Tax Credits for Qualifying R&D Expenditures

To promote innovation and spending in their tax jurisdictions, governments frequently provide tax credits to entities with qualifying R&D expenditures. Sometimes these credits ultimately depend on taxable income, in which case the credits are generally recognized as a reduction of income tax regardless of whether they are accounted for under the flow-through method or the deferral method (as described in ASC 740-10-25-45 and 25-46). However, certain tax jurisdictions provide refundable credits for qualifying R&D that do not depend on the entity’s ongoing tax status or tax position (e.g., an entity may receive a refund despite being in a taxable loss position). Refer to [Chapter 8](#) for additional guidance on when refundable tax credits are within the scope of ASC 740 and accordingly classified within income tax expense (benefit) in the financial statements.



#### Connecting the Dots

In Australia, certain companies are eligible for a tax offset under the Australian government’s R&D Tax Incentive program, a strategic initiative designed to encourage and support businesses engaged in R&D activities. The nature of the tax offset, the determination of whether it is refundable or nonrefundable, and the applicable rate depend on the aggregated sales of the R&D entity.

To qualify for the tax offset, companies incorporated in Australia must incur eligible expenses exceeding AUD 20,000 per year and engage in at least one eligible core R&D activity. The government program offers eligible companies a refundable tax credit of either 43.5 percent or 48.5 percent of R&D expenses if their aggregated sales are less than AUD 20 million per year. For companies whose aggregated sales meet or exceed this threshold, a nonrefundable tax credit on eligible expenses is available.

Companies considering tax planning strategies associated with Australia’s R&D Tax Incentive program are encouraged to consult with their accounting and tax advisers.

### 3.2.6 FDA Priority Review Vouchers

Sections 524 and 529 of the Federal Food, Drug, and Cosmetic Act authorize the FDA to award priority review vouchers (PRVs) to drug applications for the treatment or prevention of certain tropical<sup>1</sup> or rare pediatric<sup>2</sup> diseases, respectively. Once the sponsor obtains a PRV, there is no timeline for use or

<sup>1</sup> As defined in Sections 524(a)(3) and (a)(4) of the Federal Food, Drug, and Cosmetic Act.

<sup>2</sup> As defined in Section 529(a)(3) of the Federal Food, Drug, and Cosmetic Act.



expiration of the award. While PRVs provide for an expedited review period, they do not guarantee product approval.

When initiating the FDA review process, holders of these vouchers can submit them along with their product applications and thereby qualify for a 6-month FDA review period, as opposed to the standard 10-month process. However, companies that plan to use PRVs are required to provide notice to the FDA at least 90 days before they intend to submit their applications and must include in the notice the date by which they expect to deliver their formal applications. Both the tropical and rare pediatric disease PRVs can be transferred (e.g., sold) between companies an unlimited number of times before the FDA review process begins. In recent years, PRV exchanges between companies have ranged in value, with some PRVs commanding prices as high as \$350 million.

Questions often arise about whether the amounts paid for these vouchers should be capitalized as an asset or expensed as R&D when such costs are incurred. In determining the appropriate accounting for a PRV, a preparer should consider how the voucher is expected to be used. For example, if a company acquires a PRV specifically to “fast track” the FDA’s review of an existing product in the company’s pipeline, the voucher may not have an alternative future use (e.g., it may be unlikely that the voucher will be sold to another entity). In contrast, if the voucher is acquired with the intent to resell, it may provide for a present right to an economic benefit (i.e., meet the definition of an asset). Companies should carefully consider management’s intent and whether a present right to an economic benefit exists when determining how to account for the acquisition of PRVs.

Similarly, life sciences companies will need to consider how to account for the sale of PRVs. Specifically, a life sciences company that sells PRVs will have to assess whether the PRVs are outputs of the company’s ordinary activities to determine whether to account for the sale under ASC 606 or under ASC 610-20. We recommend that life sciences companies work with their accounting advisers and external auditors on the appropriate approach and accounting treatment for this type of transaction.

### **3.2.7 On the Horizon — Potential Refinements to the Scope of the Derivative Guidance in ASC 815**

As discussed in [Section 3.2.1](#), certain R&D funding arrangements may meet the definition of a derivative instrument, thereby requiring life sciences entities to assess whether the arrangement represents a contract that would meet any of the scope exceptions in ASC 815.

At the FASB’s December 6, 2023, meeting, the Board discussed its staff’s preagenda research, including stakeholder feedback received on the application of the definition of a derivative and derivative scope exceptions in response to the FASB’s June 2021 [invitation to comment](#) (ITC). A frequently cited challenge identified by respondents to the ITC was the application of the definition of a derivative and derivative scope exceptions to certain transactions and arrangements, including R&D funding arrangements. The FASB agreed to add a [project](#) to its technical agenda to refine the scope of ASC 815 by incorporating a scope exception for contracts with underlyings based on the operations or activities that are specific to one of the parties to the contract. In addition, the FASB directed its staff to perform research to develop alternatives for refining the predominant characteristics test in ASC 815-10-15-60. Because these potential changes could affect the accounting for R&D funding arrangements, entities are encouraged to monitor activity at the FASB for further standard-setting developments.

Note that these potential changes to ASC 815 could also affect the accounting for other arrangements, including arrangements with environmentally linked terms such as sustainability-linked debt instruments. For more information on sustainability-linked debt instruments, see [Section 13.11.11.1](#).



# Chapter 4 — Acquisitions and Divestitures

## 4.1 Introduction

Demand for health care services has grown worldwide, fueled by aging populations and burgeoning middle classes with expectations of higher-quality care. This, combined with a squeeze on funding, has driven the need for new business models. With public finances stretched, governments across the globe are rethinking their health care strategies. In such an environment, companies must find new ways to improve the efficiency of their operations, increase their R&D capabilities, and tap into alternative sources of innovation. As a result of these challenges, significant merger and acquisition (M&A) activity has occurred in the life sciences industry in recent years. Manufacturers have continued to search for opportunities to access new markets, mitigate risk, and replace revenues and cash flows lost as a result of pricing pressures and patent expirations.

It is important for entities to correctly apply the guidance on accounting for M&A transactions because of the significantly different accounting outcomes that exist in this area of financial reporting. For example, the application of the guidance in ASC 805 on accounting for business combinations can differ significantly depending on whether the acquired entity is considered a “business” or an “asset.” Similarly, application of the guidance in ASC 205 on the presentation and disclosure of discontinued operations related to divestiture transactions fundamentally affects financial statement presentation.

The sections below discuss some of the accounting issues related to acquisitions and divestitures that life sciences entities frequently encounter, as well as recent SEC comment letter feedback and FASB standard-setting developments related to this topic.

## 4.2 Industry Issues

### 4.2.1 Definition of a Business

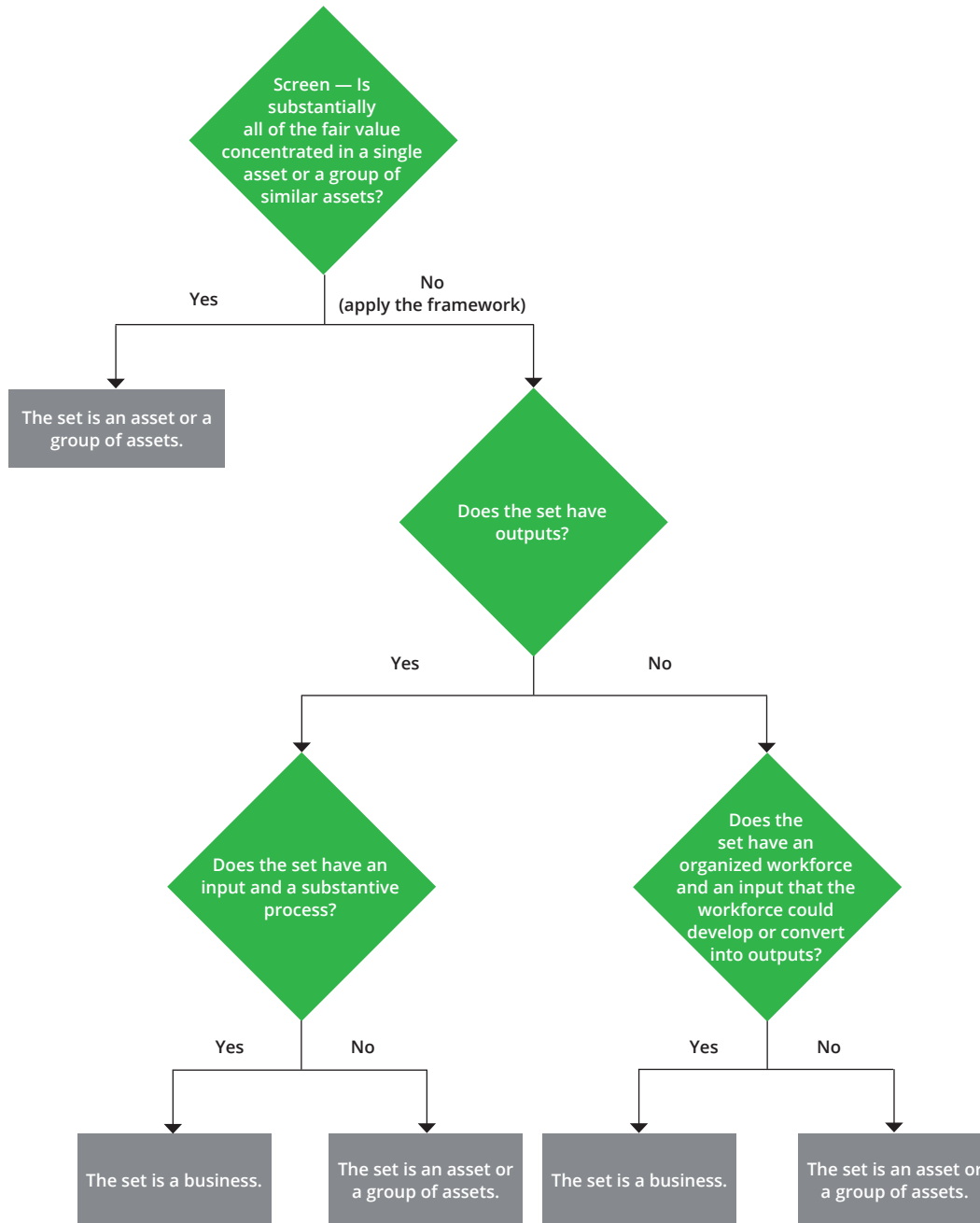
In recent years, M&A activity has increased in the life sciences industry as entities have continued to look for ways to expand their pipeline of products in development. An entity must use significant judgment in (1) evaluating whether a transaction represents the acquisition of a “business” as defined in ASC 805-10 and (2) accounting for transactions after that determination has been made.

ASC 805-10, ASC 805-20, and ASC 805-30 address the accounting for a business combination, which is defined in the ASC master glossary as “[a] transaction or other event in which an acquirer obtains control of one or more businesses.” Typically, a business combination occurs when an entity purchases the equity interests or the net assets of one or more businesses in exchange for cash, equity interests of the acquirer, or other consideration. However, the definition of a business combination applies to more than just purchase transactions; it incorporates all transactions or events in which an entity or individual obtains control of a business.

If the acquisition does not meet the definition of a business combination, the entity must determine whether it should be accounted for as an asset acquisition under ASC 805-50. Distinguishing between the acquisition of a business and the acquisition of an asset or a group of assets is important because there are many differences between the accounting for each. Alternatively, if the assets acquired consist of primarily cash or investments, the substance of the transaction may be a capital transaction (a recapitalization) rather than a business combination or an asset acquisition.

To determine whether an acquisition should be accounted for as a business combination, an entity must evaluate whether the acquired set of assets and activities together meet the definition of a business in ASC 805.

An entity first uses a “screen” as prescribed by ASC 805-10-55-5A through 55-5C to assess whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. If the screen is not met, the entity must apply a “framework” for determining whether the acquired set includes, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. If so, the acquired set is a business. The decision tree below illustrates how to determine whether an acquisition represents a business combination or an asset acquisition.



**SEC Considerations**

SEC registrants are required to use the definition of a business in SEC Regulation S-X, Rule 11-01(d), when evaluating the requirements of SEC Regulation S-X, Rule 3-05, and SEC Regulation S-X, Article 11. The definition of a business in Rule 11-01(d) is different from the definition of a business in ASC 805-10.

Entities apply the definition of a business in ASC 805 in many areas of accounting, including acquisitions, disposals, reporting-unit determinations, and consolidation.

Some of the more common issues that life sciences entities have faced when applying the definition of a business are discussed below. For more information on any of these topics, see Deloitte's Roadmap [Business Combinations](#).

#### 4.2.1.1 *Single or Similar Assets*

As shown in the decision tree above, the definition of a business provides a practical “screen” to determine when a set is not a business. Once an entity has identified the acquired set, it then evaluates whether that set is not a business on the basis of the screen in ASC 805-10-55-5A through 55-5C. ASC 805-10-55-5A provides that under the screen, “[i]f substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets, the set is not considered a business.” An entity can evaluate whether the screen is met by applying the following steps:

- *Step 1* — Combine the identifiable assets into a single identifiable asset.
- *Step 2* — Combine the assets into similar assets.
- *Step 3* — Measure the fair value of the gross assets acquired.
- *Step 4* — Determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets.

If a set is determined not to be a business under the screen, an entity does not need to evaluate the rest of the implementation guidance.

For purposes of applying steps 1 and 2 above, the FASB “decided that an entity should use the same unit of account when assessing the [screen] that it would use for identifying assets recognized in a business combination” and “that the threshold could be met if the fair value is concentrated in a group of similar identifiable assets” (e.g., when “an entity acquires . . . multiple versions of substantially the same asset type instead of precisely one asset”).<sup>1</sup> The Board further noted that although it intended “to make the analysis practical, the criteria are intended to weigh the need for practicality with the risk that too many items are grouped together to avoid being considered a business.”<sup>2</sup>

To avoid grouping too many assets together, ASC 805-10-55-5C indicates that “[w]hen evaluating whether assets are similar, an entity should consider the nature of each single identifiable asset and the risks associated with managing and creating outputs from the assets (that is, the risk characteristics).” Although the FASB does not define the term “similar” in ASC 805-10-55-5C, the guidance in that Codification paragraph provides examples of assets that cannot be considered similar:

- a. A tangible asset and an intangible asset
- b. Identifiable intangible assets in different major **intangible asset classes** (for example, customer-related intangibles, trademarks, and in-process research and development)
- c. A financial asset and a nonfinancial asset
- d. Different major classes of financial assets (for example, accounts receivable and marketable securities)
- e. Different major classes of tangible assets (for example, inventory, manufacturing equipment, and automobiles)
- f. Identifiable assets within the same major asset class that have significantly different risk characteristics. [Emphasis added]

ASC 805-10-55-65 through 55-68 illustrate how life sciences entities would apply the guidance discussed above.

<sup>1</sup> See paragraphs BC24 and BC28 of [ASU 2017-01](#).

<sup>2</sup> See paragraph BC29 of [ASU 2017-01](#).

**ASC 805-10****Example 6: Illustrations of the Definition of a Business****Case B: Acquisition of a Drug Candidate***Scenario 1*

**55-65** Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 (in the clinical research phase) compound being developed to treat diabetes (the in-process research and development project). Included in the in-process research and development project [are] the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds an at-market clinical research organization contract and an at-market clinical manufacturing organization contract. No employees, other assets, or other activities are transferred.

**55-66** Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. Pharma Co. concludes that the in-process research and development project is an identifiable intangible asset that would be accounted for as a single asset in a business combination. Pharma Co. also qualitatively concludes that there is no fair value associated with the clinical research organization contract and the clinical manufacturing organization contract because the services are being provided at market rates and could be provided by multiple vendors in the marketplace. Therefore, all of the consideration in the transaction will be allocated to the in-process research and development project. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is concentrated in the single in-process research and development asset and the set is not a business.

*Scenario 2*

**55-67** Pharma Co. purchases from Biotech a legal entity that contains the rights to a Phase 3 compound being developed to treat diabetes (Project 1) and a Phase 3 compound being developed to treat Alzheimer's disease (Project 2). Included with each project are the historical know-how, formula protocols, designs, and procedures expected to be needed to complete the related phase of testing. The legal entity also holds at-market clinical research organization contracts and at-market clinical manufacturing organization contracts associated with each project. Assume that Project 1 and Project 2 have equal fair value. No employees, other assets, or other activities are transferred.

**55-68** Pharma Co. concludes that Project 1 and Project 2 are each separately identifiable intangible assets, both of which would be accounted for as a single asset in a business combination. Pharma Co. then considers whether Project 1 and Project 2 are similar assets. Pharma Co. notes that the nature of the assets is similar in that both Project 1 and Project 2 are in-process research and development assets in the same major asset class. However, Pharma Co. concludes that Project 1 and Project 2 have significantly different risks associated with creating outputs from each asset because each project has different risks associated with developing and marketing the compound to customers. The projects are intended to treat significantly different medical conditions, and each project has a significantly different potential customer base and expected market and regulatory risks associated with the assets. Thus, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

In some instances, an entity may be able to determine that the screen has been met solely on the basis of qualitative factors. For example, if the acquisition is limited to a single compound being studied to treat different indications that will be accounted for as a single unit of account, the screen has been met because the unit of account that the entity uses when assessing the screen should be the same as the unit of account that the entity determines when identifying assets recognized in a business combination. Similarly, if the acquisition includes a license for a drug candidate and an at-market contract that would have no fair value assigned to it, it may be clear that the screen has been met. By contrast, an entity may often be able to qualitatively determine that the screen has not been met if there is clearly significant value in assets that are not similar. Paragraph BC19 of [ASU 2017-01](#) states, in part:

In addition, an entity also could conclude that **the set is not a business** by assessing the guidance in paragraphs 805-10-55-5D through 55-6 and 805-10-55-8 through 55-9. The Board noted that **if the set is not a business**, an entity could choose to document its conclusion in the most cost-effective manner depending on its situation. [Emphasis added]

Therefore, entities may bypass the screen and proceed directly to the framework (see [Section 4.2.1.2](#)) as long as the set is determined not to be a business under the framework. However, entities may not bypass the screen and apply the framework to conclude that a set is a business since that determination may contradict the conclusion that would have been made by applying the screen.



### Connecting the Dots

Life sciences entities may need to exercise significant judgment in performing a qualitative assessment to determine whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For example, judgment may be required to determine whether:

- Compounds within the same major asset class possess “significantly different risk characteristics.” For example, Scenario 2 of Example 6, Case B, describes two phase III compounds in different therapeutic specialties as possessing significantly different risk characteristics because each project (1) “has different risks associated with developing and marketing the compound to customers,” (2) is “intended to treat significantly different medical conditions,” and (3) “has a significantly different potential customer base and expected market and regulatory risks associated with the assets.” In contrast, the acquisition of multiple approved generic products in the same therapeutic specialty might be considered to be similar assets because they require no further development, are marketed to the same customers, treat similar medical conditions, and may possess similar market and regulatory risks.
- Substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets. For example, judgment may be necessary in the following circumstances:
  - When CRO contracts or CMO contracts are assumed, the reporting entity may have to use judgment to determine whether the services are being provided at market rates in such a manner that all of the consideration in a transaction would be allocated to an IPR&D project.
  - If an acquired product has received regulatory approval for a specific indication but certain other indications are still under development, the reporting entity may have to use judgment to determine whether substantially all of the fair value is concentrated in the approved indication or the unapproved indications, given that these assets may not be grouped because they represent different classes of intangible assets. Similar judgments would be required if an acquired product has received regulatory approval in one jurisdiction but not in another jurisdiction.

- When entities determine whether the “substantially all” threshold is met. The term “substantially all” is used throughout GAAP (e.g., in ASC 810, ASC 606, and ASC 842) and is generally interpreted to mean 90 percent or more. However, the FASB did not intend that entities treat the term as a bright line; thus, judgment must be applied in circumstances in which the quantitative result of the screen is close to 90 percent. In such cases, entities might consider other evidence to support their evaluation. For example, the following may be indicators that a set is a business:
  - The set includes many different types of assets (whereas a set with only a few assets may be more indicative of a group of assets).
  - The set includes an organized workforce or other substantive processes.
  - The set has outputs.
  - The set includes a significant amount of goodwill.
  - The set can operate independently on a stand-alone basis.

If the quantitative result is close to 90 percent, the presence of one or more of these indicators might warrant a determination that the screen is not met. In that case, entities should apply the framework to determine whether the set is a business.

For more information on any of these topics — specifically, details of applying steps 1–4 and an illustration of the screen — see [Section 2.4.2](#) of Deloitte’s Roadmap *Business Combinations*.

#### **4.2.1.2 Framework for Assessing Whether an Input and a Substantive Process Are Present**

If the screen is not met, entities must determine whether the acquired set includes, at a minimum, an input and a substantive process that together significantly contribute to the ability to create outputs. ASC 805-10-55 provides a framework for making that judgment. ASC 805-10-55-4(c) defines output as the “result of inputs and processes applied to those inputs that provide goods or services to customers, investment income (such as dividends or interest), or other revenues.” Paragraph BC59 of ASU 2017-01 explains the FASB’s basis for this definition:

The Board decided to narrow the definition of outputs by aligning it with the ability to generate goods or services provided to customers. That is consistent with how outputs are discussed in Topic 606, which describes goods or services that are an output of the entity’s ordinary activities. However, the Board noted that not all entities have revenues within the scope of Topic 606 and, therefore, decided to incorporate other types of revenues in the definition. For example, the Board decided to include the reference to investment income in the definition of outputs . . . to ensure that the purchase of an investment company can still qualify as a business combination.

The assessment of whether a set meets the definition of a business under the framework should be based on whether a market participant would be capable of conducting and managing the set as a business. Neither how the seller operated the set nor how the acquirer intends to operate the set is relevant in making the determination. For example, if an acquirer obtains a set with operations that are similar to its own, its plans to integrate the set into its operations and use its own processes to continue the production of outputs are not relevant in the determination of whether a substantive process was acquired.

ASU 2017-01 eliminated the need to assess whether a market participant is capable of replacing any missing elements to continue the production of outputs. Therefore, entities must now focus their analysis on what was acquired and no longer on whether a market participant could potentially replace missing elements.



The amendments in ASU 2017-01 provide criteria for entities to evaluate in determining whether a set has a substantive process. Those criteria vary depending on whether the set has outputs, as discussed below. In both instances, the set is a business if it includes, at a minimum, both an input and a substantive process that together significantly contribute to the ability to create outputs.

For more information on identifying the elements of a business, see [Section 2.4.3.1](#) of Deloitte's Roadmap *Business Combinations*.

#### 4.2.1.2.1 Sets Without Outputs

When outputs are not present (e.g., an early-stage company that has not generated revenues), an entity will need to apply more stringent criteria when determining whether a set has a substantive process. Paragraph BC38 of ASU 2017-01 points out that “[b]ecause outputs are a key element of a business and [because] a business usually has outputs, . . . when that key element is missing, the other elements should be more significant.” Therefore, as explained in paragraph BC39 of ASU 2017-01, for a set that does not have outputs to qualify as a business, it “must include an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into output.” The existence of any employee does not mean that a set without outputs should be considered a business. ASC 805-10-55-5D notes that in the evaluation of whether an acquired workforce is performing a substantive process, the following factors should be considered:

- a. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all the processes required to create outputs.
- b. Inputs that employees who form an organized workforce could develop (or are developing) or convert into outputs could include the following:
  1. Intellectual property that could be used to develop a good or service
  2. Resources that could be developed to create outputs
  3. Access to necessary materials or rights that enable the creation of future outputs.

Examples of inputs that could be developed include technology, mineral interests, real estate, and in-process research and development.

ASC 805-10-55-70 through 55-72 illustrate the assessment that a life sciences entity would perform when a set has no outputs.

#### ASC 805-10

##### **Example 6: Illustrations of the Definition of a Business**

###### Case C: Acquisition of Biotech

**55-70** Pharma Co. buys all of the outstanding shares of Biotech. Biotech's operations include research and development activities on several drug compounds that it is developing (in-process research and development projects). The in-process research and development projects are in different phases of the U.S. Food and Drug Administration approval process and would treat significantly different diseases. The set includes senior management and scientists that have the necessary skills, knowledge, or experience to perform research and development activities. In addition, Biotech has long-lived tangible assets such as a corporate headquarters, a research lab, and lab equipment. Biotech does not yet have a marketable product and, therefore, has not generated revenues. Assume that each research and development project has a significant amount of fair value.

**ASC 805-10 (continued)**

**55-71** Pharma Co. first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets in the set include multiple in-process research and development projects and tangible assets (the corporate headquarters, the research lab, and the lab equipment). Pharma Co. concludes that the in-process research and development projects are not similar assets because the projects have significantly different risks associated with managing the assets and creating the outputs (that is, because there are significantly different development risks in the different phases of development, market risks related to the different customer base, and potential markets for the compounds). In addition, Pharma Co. concludes that there is fair value associated with the acquired workforce because of the proprietary knowledge of and experience with Biotech's ongoing development projects and the potential for creation of new development projects that the workforce embodies. As such, Pharma Co. concludes that substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets and that it must further evaluate whether the set has the minimum requirements to be considered a business.

**55-72** Because the set does not have outputs, Pharma Co. evaluates the criteria in paragraph 805-10-55-5D to determine whether the set has both an input and a substantive process that together significantly contribute to the ability to create outputs. Pharma Co. concludes that the criteria are met because the scientists make up an organized workforce that has the necessary skills, knowledge, or experience to perform processes that when applied to the in-process research and development inputs is critical to the ability to develop those inputs into a product that can be provided to a customer. Pharma Co. also determines that there is a more-than-insignificant amount of goodwill (including the fair value associated with the workforce), which is another indicator that the workforce is performing a critical process. Thus, the set includes both inputs and substantive processes and is a business.

For more information on analyzing sets without outputs, see [Section 2.4.3.2](#) of Deloitte's Roadmap *Business Combinations*.

#### 4.2.1.2.2 Sets With Outputs

Paragraph BC51 of ASU 2017-01 indicates that when a set has outputs (i.e., there is a continuation of revenues before and after the transaction), "it is more likely that the set includes both an input and a substantive process when compared with a set that is not generating outputs." Therefore, the criteria for determining whether a set with outputs has a substantive process are less stringent. ASC 805-10-55-5E indicates that the set would include a substantive process if any of the following criteria are met:

- a. Employees that form an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. A process (or group of processes) is not critical if, for example, it is considered ancillary or minor in the context of all of the processes required to continue producing outputs.
- b. An acquired contract that provides access to an organized workforce that has the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to an acquired input or inputs is critical to the ability to continue producing outputs. An entity should assess the substance of an acquired contract and whether it has effectively acquired an organized workforce that performs a substantive process (for example, considering the duration and the renewal terms of the contract).
- c. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and cannot be replaced without significant cost, effort, or delay in the ability to continue producing outputs.
- d. The acquired process (or group of processes) when applied to an acquired input or inputs significantly contributes to the ability to continue producing outputs and is considered unique or scarce.

As indicated by that guidance, an organized workforce “must have the necessary skills, knowledge, or experience to perform an acquired process (or group of processes) that when applied to another acquired input or inputs is critical to the ability to develop or convert that acquired input or inputs into outputs.” The determination of whether an organized workforce is performing a critical process requires judgment and varies from transaction to transaction.

A substantive process may also be present without an organized workforce when a set has outputs. For example, a set may have automated processes through acquired technology or infrastructure (e.g., automated technology, or a manufacturing or production line). In accordance with ASC 805-10-55-5E, for an automated process to be considered substantive, (1) it must significantly contribute “to the ability to continue producing outputs” when applied to an input or inputs and (2) the acquirer cannot have the ability to replace it “without significant cost, effort, or delay in the ability to continue producing outputs,” or it must be “unique or scarce.”

Further, ASC 805-10-55-5F states the following:

#### ASC 805-10

**55-5F** If a set has outputs, continuation of revenues does not on its own indicate that both an input and a substantive process have been acquired. Accordingly, assumed contractual arrangements that provide for the continuation of revenues (for example, customer contracts, customer lists, and leases [when the set is the lessor]) should be excluded from the analysis in paragraph 805-10-55-5E of whether a process has been acquired.

ASC 805-10-55-82 through 55-84 illustrate the application of the above guidance to arrangements that involve licensing and distribution rights, which are common among life sciences entities.

#### ASC 805-10

##### **Example 6: Illustrations of the Definition of a Business**

###### Case F: License of Distribution Rights

**55-82** Company A is a distributor of food and beverages. Company A enters into an agreement to sublicense the Latin American distribution rights of Yogurt Brand F to Company B, whereby Company B will distribute Yogurt Brand F in Latin America. As part of the agreement, Company A transfers the existing customer contracts in Latin America to Company B and an at-market supply contract with the producer of Yogurt Brand F. Company A retains all of its employees and distribution capabilities.

**55-83** Company B first considers the guidance in paragraphs 805-10-55-5A through 55-5C. The identifiable assets that could be recognized in a business combination include the license to distribute Yogurt Brand F, customer contracts, and the supply agreement. Company B concludes that the license and customer contracts will have fair value assigned to them. Company B concludes that neither asset represents substantially all of the fair value of the gross assets. Company B then considers whether the license and customer contracts are a group of similar intangible assets. Because the license and customer contracts are in different major classes of identifiable intangible assets, they are not considered similar assets. Therefore, substantially all of the fair value of the gross assets acquired is not concentrated in a single identifiable asset or group of similar identifiable assets, and Company B must evaluate whether the set has both an input and a substantive process.

**ASC 805-10 (continued)**

**55-84** The set has outputs through the continuation of revenues with customers in Latin America. As such, Company B must evaluate the criteria in paragraph 805-10-55-5E to determine whether the set includes an input and a substantive process that together significantly contribute to the ability to create outputs. Company B considers whether the acquired contracts are providing access to an organized workforce that performs a substantive process. However, because the contracts are not providing a service that applies a process to another acquired input, Company B concludes that the substance of the contracts are only that of acquiring inputs. The set is not a business because:

- a. It does not include an organized workforce that could meet the criteria in paragraph 805-10-55-5E(a) through (b).
- b. There are no acquired processes that could meet the criteria in paragraph 805-10-55-5E(c) through (d).
- c. It does not include both an input and a substantive process.

For more information on analyzing sets with outputs, see [Section 2.4.3.3](#) of Deloitte's Roadmap *Business Combinations*.



### Connecting the Dots

When the set has outputs, the presence of an acquired contract that provides access to an organized workforce could meet the less stringent criteria for determining that a substantive process has been acquired and therefore result in a conclusion that the set represents a business. It is important to note that the assessment of an acquired contract is relevant only if the set has outputs. In the life sciences industry, transactions may be limited to the acquisition of (1) an early-stage product candidate or (2) an entity that does not have outputs but may include an acquired service provider contract (e.g., with a CRO or a CMO). In such circumstances, the presence of the acquired contract cannot represent a substantive process. Instead, for the acquired set to represent a business, it would need to include employees who form an organized workforce and an input that the workforce could develop or convert into outputs.

#### 4.2.1.3 SEC Considerations

A registrant must also consider certain SEC reporting requirements when it acquires an asset or a group of assets. For instance, the registrant must separately evaluate whether the asset or group of assets meets the definition of a business for SEC reporting purposes under SEC Regulation S-X, Rule 11-01(d), since this definition differs from the U.S. GAAP definition of a business under ASC 805-10. For more information about the SEC's reporting requirements for an asset acquisition, see [Section C.5](#) of Deloitte's Roadmap *Business Combinations*.

#### 4.2.2 Asset Acquisitions

In applying the framework in ASC 805, entities must account for transactions that do not meet the definition of a business as asset acquisitions. An asset acquisition is accounted for in accordance with the "Acquisition of Assets Rather Than a Business" subsections of ASC 805-50 by using a cost accumulation model. In such a model, the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values. By contrast, a business combination is accounted for by using a fair value model under which (1) the assets and liabilities are generally recognized at their fair values and (2) the difference between the consideration transferred, excluding acquisition-related costs, and the fair values of the assets and liabilities is recognized as goodwill. As a result, there are significant differences between the accounting for an asset acquisition and the accounting for a business combination, as summarized below.

Issue	Accounting in a Business Combination	Accounting in an Asset Acquisition
General principle	Fair value model: assets and liabilities are recognized at fair value, with certain exceptions.	Cost accumulation model: the cost of the acquisition, including certain transaction costs, is allocated to the assets acquired on the basis of relative fair values, with some exceptions. This allocation results in the recognition of those assets at other than their fair values.
Scope	Acquisition of a business as defined in ASC 805-10.	Acquisition of an asset or a group of assets (and liabilities) that does not meet the definition of a business in ASC 805-10.
Acquisition-related costs or transaction costs	Acquisition-related costs are expensed as incurred, except for costs of issuing debt and equity securities, which are accounted for under other GAAP.	Direct and incremental costs are included in the cost of the acquisition, except for costs of issuing debt and equity securities, which are accounted for under other GAAP. Indirect costs are expensed as incurred.
Contingent consideration	Recognized at fair value and classified as a liability, equity, or an asset on the acquisition date on the basis of the terms of the arrangement. Subsequently, any changes in the fair value of contingent consideration classified as a liability or as an asset are recognized in earnings until settled.	Contingent consideration that is accounted for as a derivative is recognized at fair value under ASC 815. Otherwise, such consideration generally is recognized under ASC 450 when it becomes probable and reasonably estimable or when the contingency is resolved by analogy to FASB Statement 141.
Goodwill	If the sum of the consideration transferred, the fair value of any noncontrolling interests, and the fair value of any previously held interests exceeds the sum of the identifiable assets acquired and liabilities assumed, goodwill is recognized as the amount of the excess.	Goodwill is not recognized. Instead, any excess of the cost of the acquisition over the fair value of the net assets acquired is allocated to certain assets on the basis of relative fair values.
Gain from bargain purchase	Recognized in earnings on the acquisition date.	Generally not recognized in earnings. Instead, any excess of the fair value of the net assets acquired over the cost of the acquisition is typically allocated to certain assets on the basis of relative fair values.
Contingencies	Measured at fair value, if determinable; otherwise, measured at their estimated amounts if probable and reasonably estimable. If such assets or liabilities cannot be measured during the measurement period, they are accounted for separately from the business combination in accordance with ASC 450.	Accounted for in accordance with ASC 450 on the acquisition date and subsequently. Loss contingencies are recognized when they are probable and reasonably estimable. Gain contingencies are recognized when realized and are thus not recognizable in an asset acquisition.
Intangible assets	Recognized at fair value if they are identifiable (i.e., if they are separable or arise from contractual rights).	Finite-lived intangible assets recognized on the basis of relative fair value under ASC 350-10 if they meet the asset recognition criteria in FASB Concepts Statement 5. Indefinite-lived intangible assets are recognized at amounts that do not exceed fair value.

(Table continued)

Issue	Accounting in a Business Combination	Accounting in an Asset Acquisition
Assembled workforce	Not recognized because it is presumed not to be identifiable.	Recognized because it is presumed to meet the asset recognition criteria in FASB Concepts Statement 5.
IPR&D	Measured at fair value and recognized as an indefinite-lived intangible asset until completion or abandonment of the related project, then reclassified as a finite-lived intangible asset and amortized.	Expensed under ASC 730 unless the IPR&D has an alternative future use.
Deferred taxes	Generally recognized for most temporary book/tax differences related to assets acquired and liabilities assumed under ASC 740.	Generally recognized for temporary book/tax differences in an asset acquisition by using the simultaneous equations method in accordance with ASC 740.
Lease classification	Under ASC 840-10-25-27, the acquirer retains the acquiree's previous lease classification "unless the provisions of the lease are modified as indicated in paragraph 840-10-35-5."  Under ASC 842-10-55-11, the acquirer retains the acquiree's previous lease classification "unless there is a lease modification and that modification is not accounted for as a separate contract in accordance with paragraph 842-10-25-8."	ASC 805-50 does not provide guidance on an entity's classification of a lease acquired in an asset acquisition.
Measurement period	In accordance with ASC 805-10-25-13, the acquirer reports provisional amounts for the items for which the accounting "is incomplete by the end of the reporting period in which the combination occurs" and is allowed up to one year to adjust those provisional amounts. This time frame is referred to as the measurement period.	ASC 805-50 does not address a measurement period in the context of an asset acquisition.

See [Appendix C](#) of Deloitte's Roadmap *Business Combinations* for detailed accounting considerations related to asset acquisitions, including the scope of ASC 805-50 and scope exceptions for VIEs.

#### 4.2.2.1 Cost of the Acquisition

An asset acquisition is an exchange transaction that triggers the acquiring entity's initial recognition of the assets acquired or liabilities assumed and the derecognition of any consideration given on the date of the acquisition. ASC 805-50-30-2 provides the general principle for measuring the cost of an asset acquisition and specifies, in part, that an asset acquisition should be recognized at cost, which is measured on the basis of either (1) "the fair value of the consideration given" or (2) "the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable."

In many asset acquisitions, the consideration is cash and, therefore, determining the cost of the acquisition is relatively straightforward. If the consideration given is wholly in the form of cash, the cost of the asset acquisition is measured on the basis of the cash paid plus the direct transaction costs incurred to effect the acquisition.

In some asset acquisitions, part or all of the consideration given may consist of noncash assets, equity interests, or liabilities incurred by the seller (e.g., contingent consideration). When consideration other than cash is used, entities should first determine whether the exchange is within the scope of other GAAP and, if so, apply the applicable standard's guidance. See [Section C.2](#) of Deloitte's Roadmap *Business Combinations* for types of noncash consideration and the U.S. GAAP that entities should apply to measure the cost of the assets acquired. Of these types of noncash consideration, contingent consideration is very common in the life sciences industry (see [Section 4.2.2.2](#) for further discussion).

In instances in which the form of the consideration given is the acquiring entity's equity instruments, we are aware of two views in practice regarding the date on which the acquiring entity should measure such equity instruments in an asset acquisition. The first view is that the guidance in ASC 805-50-25-1 requires the acquiring entity's equity instruments to be measured on the date of the asset acquisition. The second view is that the issuance of shares as consideration in an asset acquisition represents a share-based payment to nonemployees in exchange for goods. Under that view, the acquiring entity would apply ASC 718 when measuring the equity instruments it issued as consideration in an asset acquisition. Applying ASC 718 may result in a measurement date (i.e., the grant date) that precedes the acquisition date for the shares issued. In addition, to the extent that an entity applies the guidance in ASC 805, it should consider the guidance in ASC 815-10, ASC 480, and ASC 815-40 in determining whether to classify the shares to be issued as part of the asset acquisition as a liability or as equity. However, an entity that applies the ASC 718 framework should consider the guidance in ASC 718-10-25-9, which may result in a different classification outcome.

At the FASB's March 3, 2021, agenda prioritization meeting, the Board decided not to add an agenda item related to the clarification of guidance on certain asset acquisition and nonemployee share-based payment transactions. However, on the basis of the discussion at that meeting, we believe that either view is acceptable provided that entities apply a consistent view. Given the complexities associated with such transactions, entities should consult with their accounting advisers when dealing with these matters.

#### **4.2.2.2 Contingent Consideration**

The ASC master glossary defines contingent consideration as follows:

Usually an obligation of the acquirer to transfer additional assets or equity interests to the former owners of an acquiree as part of the exchange for control of the acquiree if specified future events occur or conditions are met. However, contingent consideration also may give the acquirer the right to the return of previously transferred consideration if specified conditions are met.

While that definition applies to contingent consideration issued in a business combination, contingent consideration may also be issued in an asset acquisition. The acquiring entity should assess the terms of the transaction to determine whether consideration payable at a future date is contingent consideration or seller financing. If the payment depends on the occurrence of a specified future event or the meeting of a condition and the event or condition is substantive, the additional consideration should be accounted for as contingent consideration. If the additional payment depends only on the passage of time or is based on a future event or the meeting of a condition that is not substantive, the arrangement should be accounted for as seller financing.

ASC 805-50 states that any liabilities incurred by the acquiring entity are part of the cost of the asset acquisition, but it does not provide any specific guidance on accounting for contingent consideration in an asset acquisition. However, in EITF Issue 09-2, the Task Force addressed contingent consideration in an asset acquisition. While a final consensus was not reached, the [minutes](#) from the September 9-10, 2009, EITF meeting state that "the Task Force reached a consensus-for-exposure that contingent



consideration in an asset acquisition shall be accounted for in accordance with existing U.S. GAAP.” The following examples (not all-inclusive) were provided:

- “[I]f the contingent consideration meets the definition of a derivative, Topic 815 (formerly Statement 133) would require that it be recognized at fair value.”
- “Topic 450 (formerly Statement 5) may require recognition of the contingent consideration if it is probable that a liability has been incurred and the amount of that liability can be reasonably estimated.”
- “Subtopic 323-10 (formerly Issue 08-6) may require the recognition of the contingent consideration if it relates to the acquisition of an investment that is accounted for under the equity method.”

Another example would be if the contingent consideration arrangement is settleable in, or is indexed to, the acquirer’s equity shares, the acquirer may be required to measure the contingent consideration arrangement at its acquisition-date fair value in accordance with the guidance in ASC 480 or ASC 815. See Deloitte’s Roadmap [Contracts on an Entity’s Own Equity](#) for more information.

The minutes also state that when contingent consideration related to an asset acquisition is recognized at inception, “such [an] amount would be included in the initial measurement of the cost of the acquired assets. . . . However, if the contingent consideration arrangement is a derivative, changes in the carrying value of a derivative instrument subsequent to inception [would be recognized in accordance with ASC 815 and] would not be recognized as part of the cost of the asset.”

ASC 815-10-15-83 defines a derivative instrument as follows:

#### ASC 815-10

**15-83** A derivative instrument is a financial instrument or other contract with all of the following characteristics:

- a. Underlying, notional amount, payment provision. The contract has both of the following terms, which determine the amount of the settlement or settlements, and, in some cases, whether or not a settlement is required:
  1. One or more underlyings
  2. One or more notional amounts or payment provisions or both.
- b. Initial net investment. The contract requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- c. Net settlement. The contract can be settled net by any of the following means:
  1. Its terms implicitly or explicitly require or permit net settlement.
  2. It can readily be settled net by a means outside the contract.
  3. It provides for delivery of an asset that puts the recipient in a position not substantially different from net settlement.

In the life sciences industry, companies often enter into arrangements that include required cash payments associated with various milestones (e.g., development milestones, regulatory milestones, sales-based milestones). Many of these contingent arrangements may meet all of the characteristics of a derivative in that they have an underlying (i.e., the occurrence of certain events), a payment provision (i.e., fixed cash payment if certain events occur), and no initial net investment. Further, we believe that

the payments made in accordance with the behavior of the underlying are contractually net settleable if the terms of the agreements call for the payment of cash upon the occurrence of an event.<sup>3</sup>

While certain contingent consideration may meet all of the characteristics of a derivative, further assessment is required to inform the accounting. ASC 815-10-15-13 lists the types of contracts that are not subject to ASC 815-10 **even if** they have the characteristics of a derivative instrument. Among those types of contracts are “[c]ertain contracts that are not traded on an exchange.”

Since the milestone payment arrangements described herein are not traded on an exchange, further evaluation is required for entities to determine whether a scope exception for such contracts is applicable. ASC 815-10-15-59 provides that contracts that are not exchange-traded are not subject to the requirements of ASC 815-10 if the underlying on which the settlement is based qualifies for one of four scope exceptions, the following two of which are commonly observed in practice in the life sciences industry:

- *ASC 815-10-15-59(b)* — Provides a scope exception for non-exchange-traded contracts with an underlying that is the “price or value of a nonfinancial asset of one of the parties to the contract provided that the asset is not readily convertible to cash.” This scope exception applies only if both of the following conditions exist:
  - “The nonfinancial assets are unique.”
  - “The nonfinancial asset related to the underlying is owned by the party that would not benefit under the contract from an increase in the fair value of the nonfinancial asset.”

For example, suppose that Company X enters into a contract to acquire IP (e.g., a license) from Company Y that represents a development platform designed to provide drug developers with a revolutionary approach to delivering a particular medicine (the “Product”). In connection with the acquisition of the IP, X is required to make milestone payments to Y related to clinical development milestones and subsequent product approvals that leverage the acquired platform in the development of the Product.

The underlying on which the settlement is based is related to a nonfinancial asset — the acquired IP. The milestone payments become due after clinical development milestones and the successful Product approvals that leverage the acquired IP. Although there may or may not be an asset recorded on the balance sheet for each milestone payment (i.e., all of the payments may not qualify for capitalization), the achievement of the milestones is highly correlated to the fair value of the IP (i.e., once the milestones are achieved, the fair value of the IP increases).

In this example, the acquired IP is considered a unique nonfinancial asset because any products that leverage this technology represent complex, scientifically engineered therapies supported by a one-of-a-kind platform that are not readily interchangeable with similar products in the market (i.e., the products are not “assembly line widgets”). Further, the product rights are owned by X, and X would not benefit under the terms of the contract from an increase in the fair value of the acquired IP. This is because the *contract*, for purposes of evaluating whether the scope exception in ASC 815-10-15-59(b) applies, is the milestone payment arrangement between X and Y. Since X can only make a payment to the counterparty under this arrangement, it cannot benefit under the contract. While X does benefit from the achievement of reaching clinical development milestones and the ultimate regulatory approval of new product offerings that leverage the acquired IP, the benefit to X arises from owning the underlying nonfinancial asset and not from the contract that results in milestone payments to Y.

<sup>3</sup> ASC 815-10-15-100 states, in part, that in a net settlement under contract terms, “neither party is required to deliver an asset that is associated with the underlying and that has a principal amount, stated amount, face value, number of shares, or other denomination that is equal to the notional amount (or the notional amount plus a premium or minus a discount). . . . Net settlement may be made in cash or by delivery of any other asset . . . , whether or not that asset is readily convertible to cash.”

We would most likely not reach the same conclusion regarding the applicability of the scope exception if the above fact pattern applied to an R&D funding arrangement, as opposed to the acquisition of a license.

- *ASC 815-10-15-59(d)* — Provides a scope exception for non-exchange-traded contracts in which settlement is based on “[s]pecified volumes of sales or service revenues of one of the parties to the contract.” The guidance states that “[t]his scope exception does not apply to contracts based on changes in sales or revenues due to changes in market prices.”

Contingent consideration arrangements in the life sciences industry commonly include sales-based milestones that obligate the acquirer to remit a stated amount corresponding to a predetermined sales volume. In these cases, the underlying on which the settlement is based is a specified volume of sales (as opposed to changes in sales based only on changes in market prices).

Upon concluding that the contingent consideration under a milestone payment arrangement meets one of the scope exceptions in ASC 815, an entity would proceed with accounting for the contingent consideration in accordance with its accounting policy (see *Connecting the Dots* below for a discussion of accounting policy alternatives). If the entity is required to account for the contingent consideration as a derivative, the fair value of the contingent consideration recognized would be included in the consideration transferred and would become part of the cost basis of the asset(s) acquired.



### Connecting the Dots

We understand that in the absence of a final consensus on EITF Issue 09-2, diversity in practice exists for contingent consideration that is outside the scope of ASC 815 and ASC 323-10 (i.e., contingent consideration that is neither a derivative nor related to the acquisition of an equity method investment). While some practitioners refer to the guidance in ASC 450, others continue to analogize to the guidance in FASB Statement 141, paragraph 27, which states that “contingent consideration usually should be recorded when the contingency is resolved and consideration is issued or becomes issuable.” Given the lack of authoritative guidance, we believe that either approach would be acceptable. Regardless of which approach is applied, because of the inherent uncertainties associated with the regulatory approval process, contingent consideration based on regulatory approval is generally not considered probable until the contingency is met.

The example below illustrates how an entity may account for a sales-based milestone payment in an asset purchase agreement.

**Example 4-1**

Company A enters into an asset purchase agreement with Company B to acquire IP rights to an approved pharmaceutical product in exchange for an up-front cash payment of \$10,000 and an additional cash payment of \$20,000 upon achieving \$200,000 in net sales for the product (i.e., a sales-based milestone payment). No other assets or liabilities are exchanged as part of the asset purchase agreement. Company A determines the following:

- The acquisition of the product does not meet the definition a business under ASC 805 and therefore should be accounted for as an asset acquisition under ASC 805-50.
- The additional cash payment of \$20,000 represents contingent consideration as defined in ASC 805-10-20 (i.e., the payment does not depend solely on the passage of time).
- The contingent consideration meets the definition of a derivative instrument in ASC 815-10-15-83. However, the contingent consideration is subject to ASC 815-10-15-59's scope exception to the guidance on derivative accounting.
- Company A has not previously established an accounting policy for recognizing contingent consideration payments associated with an asset acquisition.

To account for the asset acquisition, A capitalizes the up-front cash payment of \$10,000 as an intangible asset because the IP rights are related to an approved product and the cost is recoverable on the basis of expected future cash flows. To account for the contingent consideration of \$20,000, A makes an accounting policy election to account for contingent consideration in an asset acquisition under the guidance in ASC 450. That is, A will recognize the contingent consideration when (1) it is probable that the sales-based milestone will be achieved and (2) the contingent consideration is reasonably estimable.

In Example 4-1, A makes an accounting policy election to account for contingent consideration in an asset acquisition under the guidance in ASC 450. However, A could make an alternative policy election to account for contingent consideration in an asset acquisition under the guidance in FASB Statement 141, paragraph 27. Under this guidance, A would recognize contingent consideration in an asset acquisition when the contingency is resolved and the amount becomes payable (i.e., when the \$200,000 sales milestone is achieved and the \$20,000 cash payment is due). Company A should consistently apply its accounting policy election to future transactions.

Contingent consideration that is recognized at a later date (i.e., not recognized as of the acquisition date) should be capitalized as part of the cost of the assets acquired and allocated to increase the eligible assets on a relative fair value basis. (However, if the contingent consideration is related to IPR&D assets with no alternative future use, the amount of the contingent payment should be expensed.) Similarly, we believe that if the acquiring entity receives a payment from the seller for the return of previously transferred consideration (i.e., a contingent consideration asset), the entity should allocate that amount to reduce the eligible assets on a relative fair value basis.

Diversity in practice has been observed regarding how entities that recognize contingent consideration at a later date make the resulting adjustments to amortizable or depreciable identifiable assets (e.g., PP&E or a finite-lived intangible asset). Some entities have recognized a cumulative catch-up in the amortization or depreciation of the asset as if the amount had been capitalized as of the date of acquisition, and other entities have accounted for the adjustment prospectively in a manner similar to a change in estimate. In the absence of guidance, we believe that either approach is acceptable.

#### 4.2.2.2.1 Contingent Consideration When the Fair Value of the Assets Acquired Exceeds the Initial Consideration Paid

We believe that if the fair value of the assets acquired exceeds the initial consideration paid as of the date of acquisition, but the arrangement includes contingent consideration, an entity may either apply the guidance described in [Section 4.2.2.2](#) or analogize to the guidance in ASC 323-10-25-2A and ASC 323-10-30-2B on recognizing contingent consideration in the acquisition of an equity method investment (unless the contingent consideration arrangement meets the definition of a derivative, in which case it would be accounted for in accordance with ASC 815).

Like acquisitions of equity method investments, asset acquisitions are accounted for under a cost accumulation model. Accordingly, if an entity acquires a group of assets in which the fair value of the net assets exceeds its initial cost, and the agreement includes contingent consideration that does not meet the definition of a derivative, the entity could recognize a liability equal to the lesser of:

- The maximum amount of contingent consideration.
- The excess of the fair value of the net assets acquired over the initial consideration paid.

Once recognized, the contingent consideration liability is not derecognized until the contingency is resolved or the consideration is issued. In accordance with the requirements of ASC 323-10-35-14A for equity method investments, the entity recognizes “any excess of the fair value of the contingent consideration issued or issuable over the amount that was [initially] recognized as a liability . . . as an additional cost” of the asset acquisition (i.e., the amount is allocated to increase the eligible assets on a relative fair value basis). Further, “[i]f the amount initially recognized as a liability exceeds the fair value of the [contingent] consideration issued or issuable,” the entity recognizes that amount as a reduction of the cost of the asset acquisition (i.e., the amount is allocated to reduce the eligible assets on a relative fair value basis). See [Section 4.2.2.5.4](#) for additional accounting considerations when the fair value of an asset group that represents IPR&D exceeds its cost and the acquisition involves contingent consideration.

Note that before an entity elects to apply the guidance in ASC 323-10 by analogy, it should consider (1) consulting with its accounting advisers and (2) discussing its approach with the SEC staff on a prefiling basis (if the entity is an SEC registrant).

#### **4.2.2.3 Consideration in the Form of Nonmonetary Assets or Nonfinancial Assets (After Adoption of ASC 606 and ASC 610-20)**

In recent years, some life sciences companies have entered into transactions to swap products with other life sciences companies to build critical mass in a specialty such as oncology or diabetes care.

While ASC 805-50 provides a general principle for measuring the cost of an asset acquisition, it refers to other GAAP if the noncash consideration is in the form of nonmonetary assets, nonfinancial assets, or in-substance nonfinancial assets. ASC 805-50-30-1 states, in part:

For transactions involving nonmonetary consideration within the scope of Topic 845, an acquirer must first determine if any of the conditions in paragraph 845-10-30-3 apply. If the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.

Therefore, an entity begins its evaluation by determining whether the transaction meets any of the exceptions in ASC 845-10-30-3, which states:

A nonmonetary exchange shall be measured based on the recorded amount (after reduction, if appropriate, for an indicated impairment of value as discussed in paragraph 360-10-40-4) of the nonmonetary asset(s) relinquished, and not on the fair values of the exchanged assets, if any of the following conditions apply:

- a. The fair value of neither the asset(s) received nor the asset(s) relinquished is determinable within reasonable limits.
- b. The transaction is an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange.
- c. The transaction lacks commercial substance (see [ASC 845-10-30-4]).

We believe that it is unlikely that the condition in ASC 845-10-30-3(a) would be met because the fair value of either or both of the assets that were surrendered or the assets (or net assets) that were received should be determinable “within reasonable limits.” Entities therefore should consider whether the transaction (1) represents “an exchange of a product or property held for sale in the ordinary course of business for a product or property to be sold in the same line of business to facilitate sales to customers other than the parties to the exchange” or (2) lacks commercial substance. Entities should consider the guidance in ASC 845-10 in making that determination. If the transaction meets any of the three conditions in ASC 845-10-30-3, the acquiring entity accounts for the transaction on the basis of the carrying amount of the nonmonetary asset given and recognizes no gain or loss (other than for impairment, if necessary).

If the transaction does not meet any of the three conditions in ASC 845-10-30-3, we believe that entities should then consider whether the consideration given is in the form of nonfinancial assets (or in-substance nonfinancial assets). If so, the transaction is within the scope of ASC 610-20 if the transaction is with a noncustomer (or ASC 606 if the transaction is with a customer).

ASC 805-50-30-1 states, in part, that “[i]f the consideration given is nonfinancial assets or in substance nonfinancial assets within the scope of Subtopic 610-20 on gains and losses from the derecognition of nonfinancial assets, the assets acquired shall be treated as noncash consideration and any gain or loss shall be recognized in accordance with Subtopic 610-20.” Therefore, regardless of whether the assets are being received from a customer or a noncustomer, an entity applies the guidance in ASC 606-10-32-21 and 32-22 for measuring noncash consideration. However, the guidance an entity applies for recognizing the gain or loss depends on whether the assets are being received from a noncustomer or a customer. If the assets are received from a noncustomer, the entity applies the guidance in ASC 610-20 for recognizing the gain or loss, whereas if the assets are received from a customer in exchange for goods or services and the transaction is within the scope of ASC 606, the entity applies the guidance in ASC 606 on recognizing the gain or loss.

ASC 610-20-15-2 indicates that “[n]onfinancial assets . . . include intangible assets, land, buildings, or materials and supplies and may have a zero carrying value.” ASC 610-20-15-2 also indicates that, subject to certain exceptions described in ASC 610-20-15-4, the guidance in ASC 610-20 “applies to gains or losses recognized upon the derecognition of nonfinancial assets and in substance nonfinancial assets.” ASC 610-20-15-5 describes an in-substance nonfinancial asset as follows:

[A] financial asset (for example, a receivable) promised to a counterparty in a contract if substantially all of the fair value of the assets (recognized and unrecognized) that are promised to the counterparty in the contract is concentrated in nonfinancial assets. If substantially all of the fair value of the assets that are promised to a counterparty in a contract is concentrated in nonfinancial assets, then all of the financial assets promised to the counterparty in the contract are in substance nonfinancial assets. For purposes of this evaluation, when a contract includes the transfer of ownership interests in one or more consolidated subsidiaries that is not a business, an entity shall evaluate the underlying assets in those subsidiaries.

According to ASC 610-20-15-4(g), ASC 610-20 does not apply to a “nonmonetary transaction within the scope of Topic 845 on nonmonetary transactions.” Therefore, if the assets are not nonfinancial assets (or in-substance nonfinancial assets), entities should consider whether the assets are nonmonetary assets. The ASC master glossary defines nonmonetary assets and liabilities as “assets and liabilities other than monetary ones” and notes that examples of such assets and liabilities include “inventories; investments in common stocks; property, plant, and equipment; and liabilities for rent collected in advance.” We believe that it may be challenging for entities to determine whether an exchange of noncash assets is an exchange of nonfinancial assets within the scope of ASC 610-20 or a nonmonetary exchange within the scope of ASC 845, and there is no additional guidance in U.S. GAAP on how to make this determination. However, we believe that the definition of nonmonetary assets and liabilities is broader than the definitions of nonfinancial assets and in-substance nonfinancial assets.

Entities were required to adopt ASC 610-20 at the same time that they adopted ASC 606. See [Chapter 17](#) of Deloitte’s Roadmap *Revenue Recognition* for more information.



### Connecting the Dots

In many cases, the fair value of the asset given up is determinable within reasonable limits, the transaction is not an exchange to facilitate sales to customers, and the transaction has commercial substance. Consequently, companies will often use the fair value of the asset given up to determine the gain or loss on sale. Because internally developed assets frequently have no carrying value, a gain on these types of transactions is often realized. However, companies should also consider whether they have any continuing involvement with the asset given up (e.g., retained marketing rights in a certain jurisdiction), which may affect the determination of whether control has been transferred and whether any such gain has been realized.

Note also that certain transactions involving the exchange of inventory between life sciences companies may not meet the exceptions prohibiting the use of fair value and gain or loss recognition. For example, life sciences companies may exchange inventory for use in their respective clinical R&D programs. In these circumstances, life sciences entities should consider the guidance in ASC 845-10-30-15 and 30-16, which state the following:

**30-15** A nonmonetary exchange whereby an entity transfers finished goods inventory in exchange for the receipt of raw materials or work-in-process inventory within the same line of business is not an exchange transaction to facilitate sales to customers for the entity transferring the finished goods, as described in paragraph 845-10-30-3(b), and, therefore, shall be recognized by that entity at fair value if both of the following conditions are met:

- a. Fair value is determinable within reasonable limits.
- b. The transaction has commercial substance (see paragraph 845-10-30-4).

**30-16** All other nonmonetary exchanges of inventory **within the same line of business** shall be recognized at the carrying amount of the inventory transferred. That is, a nonmonetary exchange **within the same line of business** involving either of the following shall not be recognized at fair value:

- a. The transfer of raw materials or work-in-process inventory in exchange for the receipt of raw materials, work-in-process, or finished goods inventory
- b. The transfer of finished goods inventory for the receipt of finished goods inventory. [Emphasis added]



In particular, life sciences entities should consider the classification of inventory (i.e., raw materials, work-in-process, or finished goods) and whether the inventory is “within the same line of business,” since these considerations affect the determination of whether to recognize the inventory given up and received at fair value or at cost. In addition, life sciences entities should evaluate whether the assets received will be used as inventory (e.g., can be resold to customers) or for another purpose (e.g., will be used in R&D studies) when determining the applicability of the guidance in ASC 845 and, thus, whether the assets received are recorded at cost or at fair value.

#### **4.2.2.4 Equity Instruments Issued as Consideration**

To complete the acquisition of various assets (e.g., patents, licensing arrangements) accounted for as asset acquisitions, a life sciences entity may finance the arrangement by transferring its own equity instruments rather than paying cash or other consideration.

ASC 805-50-30-2 states, in part, that “if the consideration given is not in the form of cash . . . and no other generally accepted accounting principles (GAAP) apply . . . , measurement is based on either the cost which shall be measured based on the fair value of the consideration given or the fair value of the assets (or net assets) acquired, whichever is more clearly evident and, thus, more reliably measurable.” As noted above, we are aware of two views in practice regarding the date upon which the acquiring entity should measure the equity instruments it issues in an asset acquisition. The first view is that the guidance in ASC 805-50-25-1 requires the acquiring entity’s equity instruments to be measured on the date of the asset acquisition. The second view is that the issuance of shares as consideration in an asset acquisition represents a share-based payment to nonemployees in exchange for goods. Under that view, the acquiring entity would apply ASC 718 when measuring the equity instruments it issued as consideration in an asset acquisition. Applying ASC 718 may result in a measurement date (i.e., the grant date) that precedes the acquisition date for the shares issued.

At its March 3, 2021, agenda prioritization meeting, the FASB decided not to add an agenda item related to the clarification of guidance on certain asset acquisition and nonemployee share-based payment transactions. However, on the basis of the discussion at that meeting, we believe that either view is acceptable provided that entities apply a consistent view.

#### **4.2.2.5 Allocating the Cost**

As described in [Section C.3](#) of Deloitte’s Roadmap *Business Combinations*, an acquiring entity allocates the cost of an asset acquisition to the assets acquired (and liabilities assumed) on the basis of their relative fair values and is not permitted to recognize goodwill. However, if the fair values of the assets acquired and liabilities assumed are more reliably determinable (e.g., because the consideration is in the form of noncash assets), the entity measures the cost of the transaction by using these fair values. Fair value is measured in accordance with ASC 820.

Goodwill is recognized only if a business is acquired. Thus, no goodwill is recognized in an asset acquisition. Because goodwill represents the expected synergies and other benefits of combining two businesses, one would not expect goodwill to arise in an asset acquisition. If the acquiring entity’s cost exceeds the fair value of the net assets acquired, the acquiring entity allocates the difference pro rata on the basis of relative fair values to increase certain of the assets acquired.

Bargain purchase gains are generally not recognized in an asset acquisition. If the fair value of the net assets acquired exceeds the acquiring entity's cost, the acquiring entity allocates the difference pro rata on the basis of relative fair values to reduce certain of the assets acquired. However, such pro rata allocation cannot reduce monetary assets below their fair values. In unusual cases, either pro rata allocation reduces the eligible assets to zero or there are no eligible assets to reduce; we do not believe that an entity should reduce monetary assets below their fair values in such circumstances. However, before recognizing a gain, the entity should consider whether (1) it has appropriately recognized all of the liabilities assumed, any contingent consideration, and any separate transactions or (2) whether the assets received are more reliably measurable than the assets given. If only monetary assets are acquired, the entity should also consider whether the transaction is, in substance, an asset acquisition. For example, if the assets being acquired are primarily cash, the substance of the transaction may be a recapitalization.

#### 4.2.2.5.1 Exceptions to Pro Rata Allocation

As described in [Section C.3](#) of Deloitte's Roadmap *Business Combinations*, pro rata allocation of the acquiring entity's cost to the assets acquired on a relative fair value basis results in the recognition of assets at amounts that are more (or less if a bargain purchase) than their fair values. In deliberating ASC 805-10, ASC 805-20, and ASC 805-30, the FASB discussed a number of exceptions to the recognition and fair value measurement principles in a business combination for assets or liabilities for which the subsequent accounting is prescribed by other GAAP and application of such GAAP would result in the acquirer's recognition of an immediate gain or loss. Examples of such exceptions include assets held for sale, employee benefits, and income taxes. ASC 805-50 provides only general guidance on allocating cost in an asset acquisition. However, we believe that the same principles should apply to an asset acquisition. That is, an acquiring entity should not recognize an asset at an amount that would result in the entity's recognition of an immediate gain or loss as a result of the subsequent application of GAAP if no economic gain or loss has occurred (with the exception of IPR&D assets with no alternative future use, as illustrated in [Example 4-5](#)).

Therefore, we believe that certain assets should be recognized at the amounts required by applicable U.S. GAAP or should not be recognized at amounts that exceed their fair values. Such assets (and liabilities) include:

- Cash and other financial assets (other than equity method investments).
- Other current assets.
- Assets subject to fair value impairment testing, such as indefinite-lived intangible assets.
- Assets held for sale.
- Income taxes.
- Employee benefits.
- Indemnification assets.
- Indefinite-lived intangible assets.
- Contract assets measured in accordance with ASC 606 (after adoption of [ASU 2021-08](#)).

**Example 4-2****Excess of Cost Over the Fair Values of the Assets Acquired**

Company A acquires three assets from Company B: machinery and equipment with a fair value of \$20,000, a building with a fair value of \$50,000, and an indefinite-lived intangible asset with a fair value of \$30,000. The total cost of the acquisition, including transaction costs, is \$120,000. Company A has determined that the assets do not constitute a business and allocates the cost as follows:

	Fair Value (ASC 820)	Percentage of Fair Value*	Cost of the Acquisition Less Ineligible Asset	Allocated Cost
Machinery and equipment	\$ 20,000	29%	\$ 90,000	\$ 25,714
Building	50,000	71%	90,000	64,286
Indefinite-lived intangible asset	<u>30,000</u>			<u>30,000</u>
	<u>\$ 100,000</u>			<u>\$ 120,000</u>

\* Because the indefinite-lived intangible asset is not recognized at an amount that exceeds its fair value, the percentages are calculated on the basis of only the eligible assets ( $\$20,000 \div \$70,000$  and  $\$50,000 \div \$70,000$ ).

Sometimes the fair value of the net assets acquired exceeds the acquiring entity's cost (i.e., a bargain purchase), though this is unusual. Allocation of a bargain purchase will reduce the values of assets below their fair values. In such cases, we generally believe that in the allocation of the acquiring entity's cost, any asset that is ineligible for pro rata allocation when the acquiring entity's cost exceeds the fair value of the assets acquired should also be ineligible for pro rata allocation in a bargain purchase. However, in the case of a potential bargain purchase, we believe that an allocation to indefinite-lived intangibles or assets held for sale (see [Example 4-3](#)) would also be allowable. This is because unlike the above scenario in which the acquiring entity's cost exceeds the fair value of the assets acquired, a write-down of such assets in a bargain purchase would not lead to an immediate gain or loss as a result of the subsequent application of GAAP. That said, we acknowledge that diversity in practice may exist, and discussion with accounting advisers is encouraged.

**Example 4-3****Excess of Fair Values of the Assets Acquired Over Cost**

Assume the same facts as in [Example 4-2](#), except that the total cost of the acquisition, including transaction costs, is \$90,000. Company A's cost is allocated as follows:

	Fair Value (ASC 820)	Percentage of Fair Value*	Cost of the Acquisition	Allocated Cost
Machinery and equipment	\$ 20,000	20%	\$ 90,000	\$ 18,000
Building	50,000	50%	90,000	45,000
Indefinite-lived intangible asset	<u>30,000</u>	30%	90,000	<u>27,000</u>
	<u>\$ 100,000</u>			<u>\$ 90,000</u>

\* This example assumes that an indefinite-lived intangible asset can be recognized at less than its fair value (but not at greater than its fair value), so the total cost must be allocated to all of the acquired assets.

[Example 4-4 has been deleted.]

#### 4.2.2.5.2 Contingencies

An entity accounts for gain or loss contingencies acquired or assumed in an asset acquisition in accordance with ASC 450. A loss contingency is recognized when it is probable that a loss has been incurred and the loss can be reasonably estimated. A gain contingency is not recognized until the gain is realized and therefore is not recognizable in an asset acquisition. If an acquiring entity acquires a gain or loss contingency in an asset acquisition, but the contingency does not qualify for recognition on the date of acquisition, the entity will allocate the cost of the acquisition only to the recognizable assets acquired and may initially recognize certain assets at more or less than their fair values because of the nonrecognition of the contingency.

#### 4.2.2.5.3 Intangible Assets

An entity recognizes intangible assets that are acquired in an asset acquisition if they meet the asset recognition criteria in FASB Concepts Statement 5, even if they are not separable or do not arise from contractual rights. There is a lower threshold for recognizing intangible assets in an asset acquisition than in a business combination (with the exception of IPR&D, which is discussed in [Section 4.2.2.5.4](#)). In a business combination, if the consideration transferred includes amounts for intangible assets that do not qualify for recognition (e.g., an assembled workforce), those unrecognized intangible assets are subsumed into goodwill while the assets acquired are still generally recognized at their fair values. However, in an asset acquisition, no goodwill is recognized. If the consideration paid includes amounts for intangible assets that were not separately recognized, the cost of the acquisition would be allocated to the recognizable assets and those assets may be recognized at amounts that exceed their fair values. Since there is no residual into which unrecognized intangible assets could be subsumed, the FASB decided that the threshold for recognizing intangible assets in an asset acquisition should be lower than in a business combination.

Entities recognize finite-lived intangible assets acquired in an asset acquisition on the basis of relative fair values. However, because indefinite-lived intangible assets are subject to fair value impairment testing after the acquisition date, we believe that they should not be recognized at an amount that exceeds fair value, as discussed in [Section 4.2.2.5.1](#).

#### 4.2.2.5.4 IPR&D Assets

An acquiring entity must allocate, on the basis of relative fair values, the cost of the acquisition to both the tangible and intangible R&D assets acquired. On the date of acquisition, the acquiring entity expenses IPR&D assets with no alternative future use and capitalizes those with an alternative future use in accordance with ASC 730.

One of the most significant differences between the accounting for an asset acquisition and that for a business combination lies in the accounting for IPR&D assets. In a business combination, the acquirer must recognize all IPR&D assets at fair value and initially characterize them as indefinite-lived intangible assets, regardless of whether the IPR&D assets have an alternative future use. In EITF Issue 09-2, the Task Force considered amending ASC 730 with respect to IPR&D assets acquired in an asset acquisition; however, the Task Force was unable to reach a consensus and removed the project from its agenda. Therefore, entities continue to apply the guidance in ASC 730 in accounting for IPR&D assets acquired in an asset acquisition.



### Connecting the Dots

A life sciences entity may acquire an equity interest in an entity that is engaged in R&D activities. When the equity method of accounting is applied to the investment, the entity should evaluate whether the investee meets the definition of a business. If the investee meets the definition of a business, the entity allocates cost to IPR&D under the acquisition method principles of ASC 805-20 and accounts for the basis difference as if the investee were a consolidated subsidiary. If the investee does not meet the definition of a business, the entity allocates cost to IPR&D under the asset acquisition principles of ASC 805-50 but immediately expenses that amount if the IPR&D has no alternative future use.

The example below illustrates how to allocate the cost of an asset acquisition of IPR&D when fair value exceeds cost.

#### Example 4-5

Company A acquires exclusive license rights for a compound from Company B in a transaction accounted for as an asset acquisition. Company A pays an up-front fee of \$1 million and agrees to make a milestone payment of \$2 million to B upon regulatory approval of the compound.

Company A determines that the milestone payment does not represent a derivative. In addition, the fair value of the compound is determined to be in excess of the up-front consideration transferred as of the acquisition date.

Company A accounts for the acquisition of the license as IPR&D (i.e., expensed) because the compound is in early-stage development and has not received regulatory approval. Further, A concludes that it would not be appropriate to record any portion of the contingent milestone payment as of the acquisition date given the conclusion that the acquired license should be accounted for as IPR&D and expensed as of the acquisition date.

In the example above, when an asset acquisition causes the fair value of an asset group to exceed its cost and the acquisition involves a contingent consideration arrangement, the entity could analogize to the guidance in ASC 323-10-25-2A and ASC 323-10-30-2B on recognizing contingent consideration in the acquisition of equity method investments (i.e., assuming that the contingent consideration arrangement does not meet the definition of a derivative; if the arrangement meets the definition of a derivative, it would be accounted for in accordance with ASC 815). Accordingly, the entity could recognize a liability equal to the lesser of:

- The maximum amount of contingent consideration.
- The excess of the fair value of the net assets acquired over the initial cost measurement.

If this guidance were applied, it would appear that some portion of the milestone payment would be recorded as of the acquisition date given that the fair value of the compound is greater than the up-front consideration transferred. However, Company A has concluded that applying such guidance by analogy would not be appropriate in this case because the acquisition of the license will be accounted for as IPR&D and therefore will be expensed as of the acquisition date. Further, applying this guidance would result in an unintended outcome. Specifically, it would cause the future milestone payment to be expensed as IPR&D as of the acquisition date. In contrast, if this guidance were not applied, the future milestone payment would potentially be recorded on a later date (i.e., when it is otherwise probable that the milestone will be achieved and will most likely be capitalized, since the milestone payment is triggered only upon regulatory approval). In such a narrow fact pattern, in which the acquisition is entirely attributable to IPR&D that must be expensed as of the acquisition date, A's conclusion not to recognize the contingent milestone payment is reasonable under the circumstances.

### 4.2.2.6 Transactions That Are Separate From an Asset Acquisition

An acquiring entity and the seller of the assets may have a preexisting relationship or other arrangement before negotiations for the acquisition begin, or they may enter into an arrangement during the negotiations that is separate from the acquisition of the assets (e.g., a life sciences entity may enter into contemporaneous supply arrangements for a product during a specified period while the acquiring entity completes certain regulatory requirements to manufacture and commercialize the product). ASC 805-50 includes only general principles related to accounting for an asset acquisition. While the guidance does not explicitly state so, we believe that those principles presume that the cost of the acquisition includes only amounts related to the acquisition of the asset or group of assets and not amounts related to separate transactions. Further, we believe that in the absence of specific guidance, an entity should analogize to ASC 805-10-25-20 and ASC 805-10-25-22, which provide guidance on identifying and accounting for transactions that are separate from a business combination. Under this guidance, the acquirer must, when applying the acquisition method, recognize “only the consideration transferred for the acquiree and the assets acquired and liabilities assumed in the exchange for the acquiree.” Any separate transactions must be accounted for separately from the business combination in accordance with the relevant GAAP.

#### Example 4-6

##### Asset Acquisition and Related Supply Agreement

Company A enters into an agreement with Company B to acquire machinery and equipment that will be used to manufacture Product X. The machinery and equipment do not meet the definition of a business in ASC 805-10. In addition to stipulating a cash amount to be paid by A upon transfer of the machinery and equipment, the agreement specifies that A will provide B with a specified number of units of Product X for two years after the acquisition at a fixed per-unit price that is determined to be below market.

In determining the cost of the asset acquisition, A should take into account both the amount it paid upon transfer of the machinery and equipment and the value transferred to B under the below-market fixed-price supply agreement. Company A would recognize a balance sheet credit on the date of acquisition for the unfavorable supply contract; the credit would be recognized in income as units of Product X are delivered.

#### Example 4-7

##### Asset Acquisition That Settles a Dispute

Company A has an agreement with Company B that gives B the exclusive right to distribute A's goods in a specific region. Company B asserts that A has inappropriately given the distribution right to B's competitor. Company A and B decide to settle the dispute so that A reacquires the distribution right from B. The distribution right does not meet the definition of a business in ASC 805-10. Company A believes that if it does not reacquire the distribution right, it is liable to B for breach of contract.

In determining the cost of the asset acquisition, A should exclude from this cost any amount related to the dispute's settlement to avoid the capitalization of what would otherwise be an operating expense if paid separately from the asset acquisition.

See [Section 6.2.1.2](#) for further discussion related to identifying elements in a litigation settlement, including SEC staff views expressed in a speech delivered at the 2007 AICPA Conference on Current SEC and PCAOB Developments.

## 4.2.3 Business Combinations

See Deloitte's Roadmap [Business Combinations](#) for insights into and interpretations of the guidance in ASC 805 on business combinations, including, among other acquisition method guidance, that on measurement of (1) assets acquired and liabilities assumed and (2) goodwill and consideration transferred. Some of the more common issues that life sciences entities have faced when accounting for business combination transactions are discussed below.

### 4.2.3.1 IPR&D Intangible Assets Acquired in a Business Combination

Life sciences entities often contemplate opportunities for expanding their current portfolio of development-stage products by making strategic acquisitions. The accounting for costs associated with the purchase of such product rights currently in development as part of a business combination may vary significantly from the typical accounting treatment of R&D costs incurred by life sciences entities as part of their normal operations.

Before a business combination, an acquired entity may incur R&D expenditures that could result in the acquired entity's development of certain intangible assets that would be expensed as incurred in accordance with ASC 730 unless they had an alternative future use. That is, an acquired entity would probably not record any assets on its books before the consummation of a business combination related to R&D.

To the extent that the acquired entity was using, or was planning to use, these unrecognized assets for R&D activities, the assets would represent acquired IPR&D to the acquirer. Specifically, under ASC 805 and ASC 350, an acquirer recognizes all tangible and intangible R&D assets acquired in a business combination (IPR&D) at fair value as of the acquisition date and subsequently accounts for them as indefinite-lived intangible assets until completion or abandonment of the associated R&D efforts. An acquirer recognizes and measures such assets independently of (1) whether the acquiree had previously capitalized any amounts related to its R&D activities or (2) the amounts previously expended by the acquiree in connection with those activities.

In addition, an acquirer recognizes tangible and intangible assets that result from, or are to be used in, R&D activities as assets regardless of whether the acquired assets have an alternative future use. Acquired IPR&D assets must be measured at their acquisition-date fair values. Uncertainty about the outcome of an individual project does not affect the recognition of IPR&D but does affect its fair value measurement.

For IPR&D to be recognized as of the acquisition date, the costs incurred by the acquiree must be for R&D activities within the scope of ASC 730. (Refer to [Chapter 3](#) for additional discussion of the types of costs that meet the definition of R&D.) R&D activities are considered to be within the scope of ASC 730 only if such activities are not "conducted for others under a contractual arrangement." If R&D activities are conducted for others under a contractual arrangement, the costs of such activities should not be recognized as part of the acquired IPR&D.



**Example 4-8**

On June 30, 20X9, Company A, a calendar-year-end company, acquires Company B in a transaction accounted for as a business combination. Before the acquisition, B incurred significant costs related to the R&D of a drug compound, all of which it expensed as incurred under ASC 730. Company A plans to continue these R&D efforts in hopes of obtaining regulatory approval for the drug compound and launching it into the market.

Using the acquisition method of accounting, and in a manner consistent with the fair value measurement guidance in ASC 820, A determines that the fair value of the acquired IPR&D assets is \$10 million. Therefore, as of the acquisition date, A would record an indefinite-lived intangible asset of \$10 million.

After the acquisition date, A would account for all additional costs it incurs in connection with this project under ASC 730 (i.e., such costs would generally be expensed as incurred).

**4.2.3.2 Identifying IPR&D**

The AICPA Accounting and Valuation Guide *Assets Acquired to Be Used in Research and Development Activities* (the “AICPA Guide”) includes guidance on identifying IPR&D. The AICPA Guide observes that “incompleteness” is an essential characteristic of IPR&D. Paragraphs 2.54 and 2.55 of the AICPA Guide state the following:

**2.54** At some point before commercialization (that is, before earning revenue), and possibly before the end of the development or preproduction stages, the [AICPA IPR&D Task Force (the “task force”)] believes that the IPR&D project is no longer considered incomplete for accounting purposes (that is, ultimate completion of the project has occurred), and an asset resulting from R&D emerges from what was previously an asset used in R&D.

**2.55** The attribute of incompleteness with respect to a specific IPR&D project acquired as part of a business combination suggests that there are remaining technological or engineering risks or regulatory approvals.

**Example 4-9**

Company T is the owner of patented IP related to a developed product that it currently markets and sells to customers. Company T also uses the IP in certain ongoing R&D activities.

Company A acquires T in a business combination. Company A expects to continue using the IP in the sale of the currently commercialized product as well as in ongoing and identified future R&D activities.

In accounting for the acquisition of the patented IP, A would not assign the acquired IP an indefinite life upon acquisition because the IP (1) is not being used solely for the purpose of an ongoing R&D activity, (2) is already a completed asset that is being used as intended (i.e., it does not exhibit the characteristics of “incompleteness” as defined in the AICPA Guide), and (3) may reasonably be expected to produce economic benefits for a finite period. The fact that the patent is also being used in certain ongoing R&D activities and will be used in identified future R&D activities does not necessarily mean that the patent itself should be assigned an indefinite life. In this fact pattern, the acquired patent would be accounted for as a finite-lived intangible asset in accordance with ASC 350-30-25 and amortized over its assigned life.

However, paragraph 2.37 of the AICPA Guide clarifies that “to the extent that individually completed intangible assets are solely and directly related to IPR&D projects that are still in development (for example, in the pharmaceutical industry, a patent on a compound that has not yet been approved), such assets may be aggregated with other intangible assets used in R&D activities. That is, an acquirer would recognize one asset for each IPR&D project, which would comprise all the intangible assets used exclusively in that project, and that asset would be assigned an indefinite useful life.”

Further, paragraph 2.56 of the AICPA Guide states:

Both of the following factors would need to be considered when evaluating whether activities making up a specific R&D project are incomplete at the acquisition date:

- a. Whether the reporting entity expects<sup>fn 9</sup> to incur more than *de minimis* future costs related to the acquired project that would qualify as R&D costs under FASB ASC 730-10
- b. Whether additional steps or milestones in a specific R&D project remain for the reporting entity, such as successfully overcoming the remaining risks or obtaining regulatory approvals related to the results of the R&D activities.

<sup>fn 9</sup> An entity may choose to evaluate its expectations, but is not required to do so, by employing a probability-weighted expected cash flow method. For example, an entity may believe that it is 50-percent likely that it will obtain regulatory approval for the product derived from its [R&D] efforts; if such approval is obtained, the entity does not expect further cash outflows for additional R&D activities. The same entity believes that if regulatory approval is not obtained (also a 50-percent likely outcome) that it will incur \$100 of additional R&D costs. In this simple example, the entity expects to spend \$50 on future R&D costs. That amount may or may not be *de minimis*.

In evaluating these factors, entities have raised questions about whether a product can be considered incomplete if all activities have been completed other than obtaining regulatory approval.

#### Example 4-10

Company X enters into an agreement to acquire Company Y that will be accounted for as a business combination. The agreement includes the acquisition of rights to a generic version of a branded product. The product's ANDA has been submitted to the FDA for approval, which is expected in the current fiscal period. Company X does not anticipate incurring any additional expense to bring the product to commercialization.

The AICPA Guide provides the following Q&A in paragraph 2.62:

*Question 3:* Company A acquired Company T in a business combination. At the acquisition date, Company T had an application to market a new drug pending FDA approval. Both Company A and T believe that Company T had completed all necessary tasks related to the filing (including having obtained satisfactory test results), and they believe that they will ultimately obtain FDA approval. Is the project **incomplete**?

*Answer:* Yes. Industry experience shows that there are uncertainties about obtaining approval for a new drug upon filing with the FDA. FASB ASC 730-10 does not specifically address whether costs of obtaining FDA approval are R&D; however, the task force believes that such future expenditures satisfy the condition that, to be considered incomplete, additional R&D costs must be expected to be incurred by the reporting entity. [Emphasis added]

Therefore, in the fact pattern involving X and Y, X would classify the related product rights as an IPR&D asset until final approval is received from the regulator, at which point the IPR&D asset would become a finite-lived asset (i.e., an asset that resulted from R&D activities).



### Connecting the Dots

Through business development activities, companies acquire assets in various stages of product life cycles. These assets may include products under “discontinued” status with the FDA at the time of acquisition that the acquirer subsequently intends to commercialize. As **defined** by the FDA, discontinued drug products represent “approved products that have never been marketed, have been discontinued from marketing, are for military use, are for export only, or have had their approvals withdrawn for reasons other than safety or efficacy after being discontinued from marketing.”

In determining the accounting for purchased assets under “discontinued” FDA status (i.e., IPR&D vs. product rights), acquirers should consider the extent of activities required to commercialize those products as included in ASC 730-10-55-1 (activities typically included in R&D) and ASC 730-10-55-2 (activities typically excluded from R&D).

For example, when an acquired discontinued product has been “kept up-to-date” to meet regulatory requirements (e.g., labeling, packaging), it may be a relatively straightforward administrative effort to bring the product back to market. In this case, preparers might consider it appropriate to capitalize the acquired product rights on the balance sheet (with the intent to classify the product as a finite-lived intangible asset) and defer amortization expense until the product is commercialized. In accordance with ASC 350, amortization of definite-lived intangible assets should be recorded on the basis of the pattern in which the economic benefits are consumed or otherwise used — or, in this case, when the product is sold to a customer (in a manner similar to how an entity would account for construction-in-process assets, the depreciation of which is not recorded until the assets are placed into service).

#### 4.2.3.3 *Defensive IPR&D Acquired in a Business Combination*

In completing a business combination, a life sciences entity may acquire an IPR&D asset even though it does not intend to pursue the R&D project to completion. Instead, the entity may have strategic intentions to hold or “lock up” the IPR&D asset to prevent competitors from obtaining access to the asset and thereby “defend” the value of other IPR&D assets or developed products in the entity’s portfolio.

Chapter 2 of the AICPA Guide addresses relevant considerations related to defensive assets. It notes that while ASC 350-30-35-5A and 35-5B generally govern the accounting treatment for defensive intangible assets, IPR&D is specifically excluded from the scope of that guidance. Accordingly, paragraph 2.31 of the AICPA Guide discusses defensive IPR&D as follows:

[I]f the reporting entity intends to hold (or lock up) an acquired intangible asset to prevent others from obtaining access to the asset in order to “defend” the value of other intangible assets used in R&D activities, the task force believes that such asset would be considered “used in R&D activities.” Therefore, in accordance with guidance in FASB ASC 350-30-35-17A, the task force recommends that such assets be assigned an indefinite life until the “defended” IPR&D project is completed or abandoned.

At the time of acquisition, the acquiring entity would assign the IPR&D asset’s fair value as of the measurement date based on the perspective of a market participant.

The AICPA Guide highlights that there may be situations in which individually *completed* intangible assets are used in R&D activities. In general, the task force believes that “incompleteness” (as defined in paragraph 2.17 of the AICPA Guide) is an essential characteristic of IPR&D assets. Therefore, the task force believes that when intangible assets used in R&D activities lack that characteristic (i.e., the assets are complete) but are being used in the way they were intended, the intangible assets should not be considered IPR&D assets and should be accounted for in accordance with their nature (and not assigned an indefinite useful life). However, in a manner specific to the pharmaceutical industry, paragraph 2.37 of the AICPA Guide provides the following clarification that preparers may consider in the context of identifying and accounting for the assets:

[T]o the extent that individually completed intangible assets are solely and directly related to IPR&D projects that are still in development (for example, in the pharmaceutical industry, a patent on a compound that has not yet been approved), such assets may be aggregated with other intangible assets used in R&D activities. That is, an acquirer would recognize one asset for each IPR&D project, which would comprise all the intangible assets used exclusively in that project, and that asset would be assigned an indefinite useful life.

For further insight into the accounting for defensive IPR&D assets, consider the example below, which is adapted from paragraph 2.33 of the AICPA Guide.

#### Example 4-11

Company A acquires Company B. At the time of the acquisition, B owns patented technology and know-how that are in development and, if successfully completed, would compete with an existing pharmaceutical technology under development by A. Company A does not intend to pursue further development of the patented technology and know-how of B. Rather, A will hold B's patented technology and know-how to “protect” the value of the technology under development by A.

To record and subsequently measure the patented technology and know-how of B, A would perform “day 1” and “day 2” activities as follows:

- *Day 1* — Company A would assign to the IPR&D assets acquired from B a fair value (in a manner consistent with how a market participant would do so), as well as an indefinite life.
- *Day 2* — Company A would begin amortizing the acquired assets upon completing the development of its technology. However, if the development efforts were abandoned, A would expense the carrying amount of the acquired technology in the period of abandonment (unless A intended to develop the acquired technology in the event that the development of its existing technology were unsuccessful). Note that although A acquired and held the patented technology and know-how for defensive purposes, A would need to continue evaluating the acquired assets for impairment during the period in which it was developing its own patented technology and know-how.



#### Connecting the Dots

In assessing the accounting impact of an acquired IPR&D asset, preparers should collaborate cross-functionally within their organization to fully understand the strategic objectives related to the project as well as in context within the existing asset portfolio. The AICPA Guide cautions preparers that when an entity assesses the complement of acquired IPR&D, it may take time for the acquirer to determine what it might ultimately do with certain assets (in evaluating defensive relevance) to inform the appropriate accounting. The task force notes that before concluding that certain acquired IPR&D (that does not constitute the primary asset in a transaction) has no further use, the acquirer would need to determine that continued ownership of the asset will not contribute to an increase in (or maintenance of) the value of other assets that the acquirer owns.

### 4.2.3.4 Outlicensing Arrangements

Life sciences companies may acquire intangible assets that have been, or will be, outlicensed to others. The AICPA Guide specifically addresses outlicensing arrangements. Paragraph 2.10 states, in part:

If the reporting entity intends to outlicense an acquired intangible asset (or acquires an already outlicensed intangible asset) but plans to play an active role in the development of the outlicensed asset (for example, under a *collaborative arrangement* with another party), the task force believes that such asset would be considered “used in R&D activities.” [Footnote omitted] This is because the reporting entity will use the acquired asset in its R&D activities jointly with another party.

However, the task force believes that if the reporting entity intends to outlicense an acquired intangible asset and does not plan to be actively involved in its development, then such asset would not be considered “used in R&D activities.” If such *outlicensing arrangement* was in place at the time of business combination, the outlicensed asset would not be considered “used in R&D activities;” it would be considered a contract-based intangible asset, provided it meets the recognition criteria described in the “Asset Recognition Criteria” section in paragraphs 2.06–.07.

In light of the above, we expect that there will be circumstances in which an outlicensed R&D project should be accounted for as a contract-based intangible asset (as defined in ASC 805-20-55-31) rather than an IPR&D asset. This determination is important because an R&D activity that constitutes IPR&D is accounted for as an indefinite-lived intangible asset (until completion or abandonment of the R&D efforts) in connection with a business combination. In contrast, a contract-based intangible would typically be accounted for as a finite-lived intangible asset (i.e., it would be subject to amortization).

For example, assume that the IP associated with an R&D project has been fully outlicensed to a third party upon acquisition. The third party is responsible for planning and executing the remaining R&D activities, achieving the R&D advances, and directly incurring the related R&D costs. The acquirer’s (and the combined enterprise’s) interest in the IP is passive since the acquirer stands only to receive contractually obligated milestones and royalties on the basis of the success of the third party’s R&D efforts. In this example, the acquirer will not have any input into the R&D activities, R&D protocols, regulatory approval process, or any aspects of commercialization (e.g., manufacturing, sales, marketing, pricing) being performed by the third party. Further, the acquirer will not incur any costs related to the outlicensed property that meet the definition of R&D under ASC 730. It would therefore be appropriate to account for the R&D project as a contract-based intangible asset; accordingly, the acquirer would determine the useful life of the asset and the method of amortization.



#### Connecting the Dots

To reach such accounting conclusions, the licensor must carefully analyze the nature and extent of its ongoing involvement with the R&D project. In certain outlicensing arrangements, the licensor retains some level of continuing involvement with the IP. For example, the licensor may have some obligation to reimburse R&D costs incurred by the third party or may continue to have input into the ongoing R&D activities. In such cases, it might be appropriate to account for the R&D activities as IPR&D (provided that all other facts and circumstances have been considered).

### 4.2.3.5 Determining the Unit of Account for IPR&D

Under ASC 805, an acquiring entity recognizes acquired IPR&D in a business combination at fair value as of the acquisition date. However, because ASC 805 does not provide any specific guidance on identifying the unit of account for identifiable assets, the acquiring entity must use judgment to determine whether separately identifiable IPR&D assets that share similar characteristics may be aggregated into a single unit of account.

The determination of a unit of account will depend on the relevant facts and circumstances of each acquisition. When making that determination, an entity may consider the following factors in paragraph 2.20 of the AICPA Guide:

- “The phase of development of the related IPR&D project.”
- “The nature of the activities and costs necessary to further develop the related IPR&D project.”
- “The risks associated with the further development of the related IPR&D project.”
- “The amount and timing of benefits expected to be derived in the future from the developed asset(s).”
- “The expected economic life of the developed asset(s).”
- “Whether there is an intent to manage costs for the developed asset(s) separately or on a combined basis in areas such as strategy, manufacturing, advertising, selling, and so on.”
- “Whether the asset, whether an incomplete IPR&D project or when ultimately completed, would be transferred by itself or with other separately identifiable assets.”

The example below illustrates the application of these factors.

#### Example 4-12

On September 30, 20X8, Company X acquires Company Y in a transaction accounted for as a business combination. Company Y has been pursuing a new therapy designed to help patients suffering from Crohn’s disease. In the European Union, all clinical trials have been completed and the appropriate applications have been filed, but the product is awaiting regulatory approval. In the United States, the same product is under development and not as far advanced; the product has only just commenced phase III clinical trials. In addition, if the product is approved in both the European Union and the United States, patent protection is expected to expire significantly later in the United States.

Given the above factors, X determines that two IPR&D assets should be recognized: one for the European Union and another for the United States. In reaching this determination, X considered that the IPR&D project is in different stages of development in the jurisdictions, remaining costs are expected to be significantly higher in the United States as a result of the additional studies that remain to be completed, and the useful life of the asset is expected to be greater in the United States as a result of the patent protection period.

Refer to the AICPA Guide for additional examples.

The example below, which is adapted from paragraph 2.21 of the AICPA Guide, further illustrates the application of these factors.

#### Example 4-13

Company A acquired Company T in a business combination. As of the acquisition date, T was pursuing completion of an IPR&D project that, if successful, would result in a drug for which A would seek regulatory approval in the United States, Europe, and Japan.

**Example 4-13 (continued)**

Regarding the unit of account for the acquired incomplete IPR&D project, A's determination of whether to recognize one IPR&D asset (representing the compound) or three IPR&D assets (representing the compound in each of the jurisdictions in which it is expected to be sold in) requires considerable judgment because it is likely that the IPR&D project is "separable" as either a "global" or a "jurisdictional" asset.

To determine the appropriate unit of account for the acquired incomplete IPR&D project, A may consider the factors in the table below.

<b>Factors Indicating That Recording a Single (Global) IPR&amp;D Asset May Be Appropriate</b>	<b>Factors Indicating That Recording Three Separate Jurisdictional IPR&amp;D Assets May Be Appropriate<sup>4</sup></b>
<ul style="list-style-type: none"> <li>The IPR&amp;D project is still in the early development phase, at which point it may be less likely to have separate units of account for different jurisdictions than in later phases of development.</li> </ul>	<ul style="list-style-type: none"> <li>The IPR&amp;D project is in a later phase of development (e.g., the product phase for the pharmaceutical industry), and development risks associated with different jurisdictions are known.</li> </ul>
<ul style="list-style-type: none"> <li>The nature of the activities and costs necessary to further develop the IPR&amp;D project are substantially the same (e.g., the development of the project will occur centrally, and A intends to incur only a small portion of the total development costs to obtain approval within each regulatory jurisdiction toward the later stages of testing).</li> </ul>	<ul style="list-style-type: none"> <li>The nature of the activities and costs necessary to further develop the IPR&amp;D project are not substantially the same. For example, the development of the project will occur centrally for a portion of the process; however, the extent of separate regulatory approval costs is expected to be a significant portion of the overall development cost.</li> </ul>
<ul style="list-style-type: none"> <li>On the basis of historical experience or expectations, the risks associated with the further development of the IPR&amp;D project are substantially the same (e.g., A believes that it will most likely obtain approval in all three jurisdictions or in none of the jurisdictions, although the timing of approval may differ).</li> </ul>	<ul style="list-style-type: none"> <li>The risks associated with the further development of the IPR&amp;D project are not substantially the same. For example, A believes that the risk of obtaining approval in each jurisdiction is different, and it does not believe that approval in one jurisdiction is relevant to approval in other jurisdictions.</li> </ul>
<ul style="list-style-type: none"> <li>The amount and timing of benefits expected to be derived in the future from the developed asset(s) and the expected economic life of the developed asset(s) are substantially the same (e.g., if the patent applications are approved, the patent is expected to have approximately the same life in all three jurisdictions).</li> </ul>	<ul style="list-style-type: none"> <li>The amount and timing of benefits expected to be derived in the future from the developed asset(s) and the expected economic life of the developed asset(s) are not substantially the same. For example, if the patent applications are approved, the patent life is expected to be different for each of the three jurisdictions.</li> </ul>
<ul style="list-style-type: none"> <li>Company A intends to manage strategy, manufacturing, advertising, and selling costs from the perspective of the global brand, not the individual jurisdictions where the product will be sold.</li> </ul>	<ul style="list-style-type: none"> <li>Company A intends to manage strategy, manufacturing, advertising, and selling costs separately in each jurisdiction in which the compound is sold.</li> </ul>
<ul style="list-style-type: none"> <li>On the basis of historical experience and current intentions, A believes that once completed, the compound (if ever transferred) would be transferred in one worldwide arrangement.</li> </ul>	<ul style="list-style-type: none"> <li>On the basis of historical experience and current intentions, A believes that once completed, the compound (if ever transferred) would not be transferred as a single asset.</li> </ul>

<sup>4</sup> Footnote 5 in paragraph 2.21 of the AICPA Guide points out that "[a]lthough . . . the unit of account determination [illustrated] is based on different geographic locations, the same logic can be applied to different drug indications (for example, physical ailment, disease state, treatment regime)."



Other questions about determining the unit of account frequently arise when IPR&D assets acquired in a business combination are associated with a preexisting contingent consideration arrangement. Examples of business combinations involving such IPR&D assets are addressed in the Q&As below, which are reproduced from paragraphs 2.14 and 2.15 of the AICPA Guide.

**2.14 Question 1:** Company A acquired Company T in a business combination. Prior to the date of the acquisition, Company T had entered into a licensing arrangement with Company L. Pursuant to the terms of the license, Company T acquired rights related to a drug candidate that had been patented by Company L. At the time of Company T's license, the drug candidate had not yet been approved for marketing. Under the terms of the license, Company T acquired all of the rights to develop, manufacture, and sell the drug candidate. In exchange for these rights, Company T made a payment at the inception of the agreement and is obligated to make additional payments if certain substantive milestones are achieved (for example, initiation of phase III clinical trials), as well as royalties based on a percentage of sales of the drug if it is approved for marketing. Should the milestone and royalty payments be considered elements of the acquired contract-based intangible or a separate unit of account?

*Answer:* Provided that separation is not required by accounting literature, the milestone and royalty obligations may be considered elements of the acquired contract-based intangible, rather than a separate unit of account. In determining the fair value of this contract-based intangible asset, Company A will most likely use an income approach, such as a discounted cash flow method, that will consider all the anticipated cash flows associated with this contract that a market participant would consider. Accordingly, in addition to the anticipated development costs, revenues, cost of product, commercialization costs, and other cash flows, Company A would also consider the anticipated milestones and royalties and, if necessary, would adjust the cash flows to reflect market participant assumptions. The milestone and royalty obligations would, therefore, reduce the fair value of the licensed IPR&D asset.

**2.15 Question 2:** Company T acquired Company L in a business combination. At the acquisition date, Company L was developing a patented drug candidate, which Company T recorded as an IPR&D asset. The terms of the acquisition agreement required Company T to make a cash payment at the acquisition date, as well as additional cash payments to the former shareholders of Company L if certain substantive milestones were achieved in the future relating to the acquired drug candidate (for example, initiation of phase III clinical trials). Company T accounted for the contingent milestone payments as contingent consideration and, therefore, recorded a contingent consideration liability at fair value at the acquisition date. Company A subsequently acquired Company T in a business combination. At the time of the acquisition, none of the milestones had been achieved. Company A recorded the IPR&D asset relating to the patented drug candidate that was previously recorded by Company T at fair value at the acquisition date. When determining the fair value of the IPR&D asset, should Company A consider the preexisting contingent consideration arrangement as an element of the IPR&D asset or as a separate unit of account?

*Answer:* Because FASB ASC 805 requires contingent consideration arrangements of an acquiree that have been assumed by the acquirer in a business combination to be separately recognized, Company A should treat the preexisting contingent consideration arrangement as a separate unit of account. Thus, when determining the fair value of the IPR&D asset, Company A should not include the future milestone payments in the discounted cash flow analysis to avoid double-counting.

### 4.2.3.6 Subsequent Accounting for Acquired IPR&D Assets

Under ASC 805, the acquiring entity recognizes IPR&D assets at fair value as of the acquisition date. After those acquired IPR&D assets are recognized in a business combination, the acquiring entity should apply the guidance in ASC 350. Under ASC 350, the entity subsequently accounts for the acquired IPR&D assets as indefinite-lived intangible assets until completion or abandonment of the associated R&D efforts. ASC 350-30-35-17A further states, in part:

During the period that [the acquired IPR&D intangible] assets are considered indefinite lived, they shall not be amortized but shall be tested for impairment in accordance with paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in [ASC 350-30-35]. Consistent with the guidance in paragraph 360-10-35-49, intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that have been temporarily idled shall not be accounted for as if abandoned.

While acquired assets related to IPR&D activities of an acquiree in a business combination may be recognized as intangible assets, ASC 805 and ASC 350 do not change the accounting for R&D expenditures incurred outside of a business combination. Therefore, subsequent R&D expenditures related to the acquired IPR&D intangible assets should generally be expensed as incurred.

Also, if an entity acquires IPR&D in a business combination that it does not intend to put to the highest and best use (e.g., it has plans to discontinue the R&D project after the acquisition even though a marketplace participant would continue the R&D efforts), it would still be required to recognize an intangible asset at fair value in applying acquisition-method accounting.

#### Example 4-14

On June 30, 20X8, Company A acquires Company B in a transaction accounted for as a business combination. Before the acquisition, B had incurred significant costs related to the R&D of a new product, all of which it expensed as incurred in accordance with ASC 730. Company A plans to continue these R&D efforts in hopes of commercializing the product in the future.

Using the acquisition method of accounting, and in a manner consistent with the fair value measurement guidance in ASC 820, A determines that the fair value of the acquired IPR&D assets is \$10 million. Therefore, as of the acquisition date, A would record an indefinite-lived intangible asset of \$10 million.

On July 1, 20Y1, A concludes that development of the new product is no longer feasible and decides to abandon its project because there is no alternative future use for the acquired IPR&D assets.

From June 30, 20X8, to June 30, 20Y1, A appropriately tested the acquired IPR&D assets (\$10 million) for impairment in accordance with ASC 350-30-35-18 and did not record any impairment losses.

Because of A's plans to abandon the project and the fact that the IPR&D assets have no alternative future use, A would expense the entire IPR&D asset balance of \$10 million on July 1, 20Y1 (the date of abandonment), in the income statement.

#### Example 4-15

Assume the same facts as in the example above except that A successfully completes its IPR&D project on July 1, 20Y1, and has developed a commercially viable product that it intends to sell in the marketplace.

In this case, A must assess the useful life of the acquired IPR&D asset as of July 1, 20Y1 (the date the IPR&D project is successfully completed), and amortize the asset over the related product's useful life. That is, the acquired IPR&D asset's useful life is now finite rather than indefinite. In addition, the reclassification to a finite useful life triggers a required impairment test in accordance with ASC 350-30-35-17 as of July 1, 20Y1.

### 4.2.3.7 IPR&D Impairment Considerations

After a business combination, events or conditions may arise that result in a decrease in the value of indefinite-lived IPR&D assets, potentially leading to impairment. Under U.S. GAAP, guidance is provided on when to test for impairment, how to determine whether impairment should be recognized, and how to measure and record such impairment in the financial statements.

ASC 350-30-35-17 through 35-18A note the following about impairment testing of IPR&D assets:

#### ASC 350-30

**35-17** If an intangible asset that is not being amortized is subsequently determined to have a finite useful life, the asset shall be tested for impairment in accordance with paragraphs 350-30-35-18 through 35-19. That intangible asset shall then be amortized prospectively over its estimated remaining useful life and accounted for in the same manner as other intangible assets that are subject to amortization.

**35-17A** Intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that are used in research and development activities (regardless of whether they have an alternative future use) shall be considered indefinite lived until the completion or abandonment of the associated research and development efforts. During the period that those assets are considered indefinite lived, they shall not be amortized but shall be tested for impairment in accordance with paragraphs 350-30-35-18 through 35-19. Once the research and development efforts are completed or abandoned, the entity shall determine the useful life of the assets based on the guidance in this Section. Consistent with the guidance in paragraph 360-10-35-49, intangible assets acquired in a business combination or an acquisition by a not-for-profit entity that have been temporarily idled shall not be accounted for as if abandoned.

**35-18** An intangible asset that is not subject to amortization shall be tested for impairment annually and more frequently if events or changes in circumstances indicate that it is more likely than not that the asset is impaired.

**35-18A** An entity may first perform a qualitative assessment, as described in this paragraph and paragraphs 350-30-35-18B through 35-18F, to determine whether it is necessary to perform the quantitative impairment test as described in paragraph 350-30-35-19. An entity has an unconditional option to bypass the qualitative assessment for any indefinite-lived intangible asset in any period and proceed directly to performing the quantitative impairment test as described in paragraph 350-30-35-19. An entity may resume performing the qualitative assessment in any subsequent period. If an entity elects to perform a qualitative assessment, it first shall assess qualitative factors to determine whether it is more likely than not (that is, a likelihood of more than 50 percent) that an indefinite-lived intangible asset is impaired.

Life sciences entities may encounter various challenges in performing an impairment assessment of IPR&D assets. Entities should consider the following questions when performing a qualitative assessment:

- *Regulatory considerations* — Has the product received approval in any markets since the previous analysis? Are there changes to the regulatory environment or matters that suggest any loss of value for the asset (e.g., FDA or other regulatory communication suggesting delay)? Have there been any negative results since the previous analysis either internally or through public sources ([clinicaltrials.gov](https://clinicaltrials.gov))? What is the status of clinical testing, and is the estimated launch date still achievable? Is there any delay in the next expected regulatory milestone or indication according to plan?

- *Commercial and legal considerations* — Are there any major changes in the competitive landscape for the IPR&D product (e.g., competitive product launched or filed/delayed, price decrease of existing product)? Is the projected market share still realistic? Have there been any changes to the patents or other exclusive rights? Are there changes to the commercial or legal environment that may suggest any loss of value for the asset?
- *Financial and strategic considerations* — Are there future strategic plans to continue/discontinue clinical testing? Is there any change in the amount and timing of the expected future R&D costs? Are any competing products in development expected to affect product launch determinations or subsequent market opportunity? Is there any previous analysis? Are there any changes in the amount and timing of the projected operating costs or projected revenues? Is there any change in the estimated PTRS? Is there sufficient funding available to complete the development of the product and to launch the product? Are there any other financial or strategic reasons that may suggest loss of use or another decline in value?

For further description of the qualitative assessment and relevant impairment considerations, see ASC 350-30-35-18A through 35-18F. Also, refer to the AICPA Guide for additional considerations related to performing a quantitative impairment analysis.

#### **4.2.3.8 Settlement of Preexisting Relationships**

In a business combination, the acquirer and acquiree may have a preexisting relationship, such as a collaborative agreement to jointly develop or promote a particular compound.

If a business combination effectively results in the settlement of a preexisting relationship between an acquirer and an acquiree, the acquirer would recognize a gain or loss. ASC 805-10-55-21 indicates how such a gain or loss should be measured.

#### **ASC 805-10**

**55-21** If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:

- a. For a preexisting noncontractual relationship, such as a lawsuit, fair value
- b. For a preexisting contractual relationship, the lesser of the following:
  1. The amount by which the contract is favorable or unfavorable from the perspective of the acquirer when compared with pricing for current market transactions for the same or similar items. An unfavorable contract is a contract that is unfavorable in terms of current market terms. It is not necessarily a loss contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
  2. The amount of any stated settlement provisions in the contract available to the counterparty to whom the contract is unfavorable. If this amount is less than the amount in (b)(1), the difference is included as part of the business combination accounting.

Note that if a preexisting contract is otherwise cancelable without penalty, no settlement gain or loss would be recognized. The acquirer's recognition of an asset or liability related to the relationship before the business combination will affect the calculation of the settlement.

When a business combination results in the settlement of a noncontractual relationship, such as a lawsuit or threatened litigation, the gain or loss should be recognized and measured at fair value. This settlement gain or loss may differ from any amount previously recorded under the contingency guidance in ASC 450.



### Connecting the Dots

Certain collaborative arrangements may not be held at fair value (e.g., when there are equity investments in the acquiree). In such cases, a gain or loss should be recognized for the difference between the fair value and carrying value recorded.

See [Section 6.2.2](#) of Deloitte's Roadmap *Business Combinations* for additional information on settlement of preexisting relationships.

#### 4.2.3.9 Initial and Subsequent Accounting for Contingent Consideration

The acquirer must distinguish between contingent consideration (see ASC 805-10-20) and preexisting contingencies assumed in the acquisition (see the definition of a contingency in ASC 450-10-20). In accordance with ASC 805-30-25, contingent consideration is recorded at fair value as part of the total consideration transferred by the acquirer in a business combination. The fair value of contingent consideration is considered to be part of the purchase price and is recorded on the balance sheet either as a liability or within equity (or, less commonly, as an asset). Key inputs may include estimated timing and the probability that the conditions or milestones in the arrangement will be met. Acquirers also need to apply judgment when assessing the probability that each potential outcome will be achieved.



### Connecting the Dots

A contingent consideration arrangement in a business combination between two life sciences companies could involve future FDA approval of a pharmaceutical product. In this case, a company may need to use considerable judgment in determining the fair value of the consideration, particularly when assessing the probability of the FDA approval.

After the acquisition date, if the acquirer classifies a contingent consideration arrangement as an asset or a liability, the asset or liability is remeasured to fair value each reporting period until the contingency is resolved. The acquirer recognizes changes in fair value in earnings each period unless the acquirer designates the arrangement as a cash flow hedging instrument to which the provisions of ASC 815-10 apply.

However, if the contingent consideration is classified as an equity instrument, it is not remeasured. The initial amount recognized for contingent consideration classified as equity is not adjusted, even if the fair value of the arrangement changes. The subsequent settlement of the arrangement on the date the contingency is resolved is accounted for within equity.

Adjustments made during the measurement period that pertain to facts and circumstances that existed as of the acquisition date are recognized as adjustments to goodwill. The acquirer must consider all pertinent factors in determining whether information obtained after the acquisition date should result in an adjustment to the provisional amounts recognized or whether that information results from events that occurred after the acquisition date. For example, earnings targets that are met, changes in share prices, and FDA approvals are all changes that occur after the acquisition date. Changes in fair value resulting from these items are recognized in earnings and not as adjustments to goodwill.

When a contingency related to contingent consideration is not met (e.g., earnings targets specified in an arrangement are not achieved), the acquirer should consider whether this factor represents an indicator that goodwill associated with the business combination should be tested for impairment.

#### Example 4-16

Company A acquires Company B for \$15 million in a transaction accounted for as a business combination. The parties further agree that if the FDA approves B's lead compound, A will pay the former owners of B an additional \$6 million as well as a royalty equal to 2 percent of future net sales in the United States. The contingent consideration arrangement is classified as a liability and has an acquisition-date fair value of \$14 million.

At the end of each reporting period after the acquisition date, the arrangement is remeasured to its fair value, with changes in fair value recorded in earnings. For example, if the likelihood of achieving FDA approval increases, the fair value of the contingent consideration would most likely increase, resulting in an additional charge in the income statement. Conversely, if the contingency is not met or its fair value declines, any accrued liability would be reversed into income.



#### Connecting the Dots

After the balance sheet date but before financial statements are issued or are available to be issued, events may occur that affect the value of contingent consideration recognized as a liability on the balance sheet as part of a business combination. For example, contingent consideration may exist in the form of a regulatory approval-based milestone payment due to the seller, and such approval may occur, or notification of regulatory denial may be received, after the balance sheet date. Questions often arise about whether this type of event should be treated as a recognized or nonrecognized subsequent event. ASC 855-10-55-2(f) notes that changes in the fair value of assets or liabilities (financial or nonfinancial) after the balance sheet date but before financial statements are issued or are available to be issued represent nonrecognized subsequent events. Because contingent consideration liabilities are recognized at fair value, any change in fair value after the balance sheet date but before financial statements are issued or are available to be issued would be treated as a nonrecognized subsequent event. In such circumstances, preparers should evaluate the significance of the change in fair value of the contingent consideration and consider whether it may be of such a nature that it must be disclosed to keep the financial statements from being misleading. For such matters, ASC 855-10-50-2 notes that companies should disclose the nature of the event as well as an estimate of its financial effect (or a statement that such an estimate cannot be made).

See [Section 5.7](#) of Deloitte's Roadmap *Business Combinations* for additional information on recognition and measurement of contingent consideration in a business combination.

#### 4.2.4 SEC Comment Letter Themes Related to Business Combinations and Asset Acquisitions

Below are examples of certain SEC staff comments that registrants in the life sciences industry and other industries have received regarding their accounting for business combinations and asset acquisitions.

For more information about SEC comment letter themes that pertain to the life sciences industry, see Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*.

#### 4.2.4.1 Business Combination Versus Asset Acquisition Accounting Determination

##### Examples of SEC Comments

- You recorded the . . . acquisitions as asset acquisitions. Please tell us, for each acquisition, why you believe the acquisitions are not required to be recorded as an acquisition of a business pursuant to ASU 2017-01 [as codified in ASC 805]. In this regard, please specifically address the following:
  - As it appears you acquired both tangible and intangible assets in the [first acquisition] and the [subsequent] acquisition appears to relate to assets with significantly different risks, please confirm our understanding that the acquisitions did not meet the “practical screen” in ASC 805-10-55-5A through 55-5C as the term is used in ASC 805-10-55-5. Refer also to the example in ASC 805-10-55-68.
  - Please address each of the criteria in ASC 805-10-55-5E in determining whether or not a substantive process was acquired, that together with the input acquired, significantly contribute to the ability to create outputs.
- With respect to the [p]roduct [r]ights [a]cquired from [Company A], your response does not consider risks, other than marketing and promotional risks. At a minimum, please address the following potential risks:
  - The drugs are intended to treat significantly different conditions which bear the risk of potentially different long-term side effects. Branded drugs are subject to litigation which may not occur for years after being marketed;
  - Each drug has a significantly different potential customer base with different regulatory risks;
  - Each drug has different risks with respect to being on drug formulary lists; and
  - Although the products have been marketed for more than [X] years, the competition differs for each of the different drugs, despite the lack of promotional activity for the drugs.

In light of the risks, other than marketing and promotional risk, please tell us why you believe the product rights acquired from [A] do not have significantly different risk characteristics and thus meet the “practical screen” test in ASC 805-10-55-5A through 55-5C. If the acquisitions do not meet the “practical screen test” please address each of the criteria in ASC 805-10-55-5E in determining whether or not a substantive process was acquired, that together with the input acquired, significantly contribute to the ability to create outputs.
- We note that . . . you acquired IPR&D and hired staff to expand . . . and this resulted in \$[X] million of IPR&D and \$[X] million of goodwill. As this appears to be an asset acquisition rather than a business combination, please clarify for us how this represents a business combination under ASC 805. Specifically refer to ASC 805-10-55-3A through 9.

Accounting for a transaction as a business combination differs significantly from accounting for a transaction as an asset acquisition, as discussed in [Section 4.2.2](#). Consequently, when acquisitions occur, it is important to determine whether what is being acquired meets the definition of a business under ASC 805. Given the SEC staff's historical focus on how life sciences companies have applied the definition of a business, registrants in the life sciences industry should be mindful that the SEC staff may ask questions about (1) whether an acquired set meets the definition of a business and (2) the basis for the registrant's conclusions.



#### 4.2.4.2 Recognition of Assets and Liabilities

##### Examples of SEC Comments

- You disclose . . . that you acquired the legal rights, permits, licenses and assets of [various entities]. However, it appears the purchase prices were allocated entirely to licenses. Please tell us why the purchase prices were not allocated to other assets and/or liabilities acquired.
- We note your acquisition of [Entity B] and Subsidiaries and your disclosure that it will expand your [product offering] in North America and allow you to diversify your business, leverage your distribution network and infrastructure and increase your market reach. Additionally, you stated the transaction is expected to provide synergies, enhancing your ability to better serve your combined customers' needs . . . . Given the magnitude of the amount of goodwill recognized, please explain further the specific synergies you identified, relative magnitude of each, and consideration for including such discussion in your disclosures. Also, please explain to us in performing the purchase price allocation, how you evaluated the purchase for the existence of any other intangible assets.

Registrants need to consider the provisions of ASC 805 in making the appropriate accounting determination of whether a transaction represents a business combination or an asset acquisition. Upon completing this assessment, registrants need to assign amounts to assets acquired and liabilities assumed in a manner consistent with the accounting model that applies to the transaction. When a transaction is accounted for as an asset acquisition, registrants should keep in mind that R&D costs are only capitalized if the IPR&D asset has an alternative future use. Paragraph 3.14 of the AICPA Guide states that for an asset to have alternative future use, both of the following conditions must be met:

- “[I]t is reasonably expected that the reporting entity will use the asset acquired in the alternative manner and anticipates economic benefit from that alternative use” (footnote omitted).
- The acquired asset “can be used in the alternative manner in the condition in which it existed at the acquisition date.”

The determination of whether an acquired intangible asset to be used in R&D activities has an alternative future use depends on specific facts and circumstances. Registrants should carefully consider the specific facts regarding the completed transaction to ensure that they prepare a robust accounting analysis that supports the overall conclusion.

#### 4.2.4.3 Useful Life and Impairment of Intangible Assets

##### Examples of SEC Comments

- Please explain to us your basis for determining [an X-year] useful life for the currently marketed products rights intangible assets. In your response, tell us the estimated fair value of each such intangible asset acquired, as well as the useful life you assign to each and explain why the assigned life is reasonable. In addition, please tell us why it is appropriate to use straight line amortization, given the likely impact of future competition from branded and generic drug products over this period.
- Please provide us proposed revised disclosure discussing your impairment to be included in your upcoming Form 10-K that provides more insight into what new information was received during the third quarter prompting your impairment charge and reassessment of the useful life of [the product]. In your revised disclosure discuss the general reasons you reassessed the level and timing of [additional] competition.

**Examples of SEC Comments (continued)**

- Subsequent to the immediate recognition of the license fee [from Customer A], you determined that the license had no future economic value and accelerated the amortization of the remaining balance of this intangible asset . . . . Please provide us additional analysis supporting this accounting treatment. Also elaborate for us on the following factors you noted in your response:
  - [T]he contract term of exclusivity and any termination provisions; and
  - [A] description of current and future market conditions you considered.
- We note you impaired your product rights, developed technologies and IPR&D by \$[X] million, \$[Y] million and \$[Z] million respectively in [the fiscal year]. In order to provide investors with a better understanding of your financial condition and results of operations, please expand your disclosure to separately identify the underlying products or projects that are associated with these impairments . . . , quantify the charge taken, and expand your disclosure to address the underlying causes, including trends, demands, events or uncertainties that gave rise to the impairment.
- Please tell us how you considered the results of the . . . litigation, which was settled prior to the issuance of your most recent Form 10-Q and could potentially negatively impact future sales of [Product A], in assessing your goodwill and intangible assets (including your developed product rights for [Product A]) for potential impairment as of the [end of the fiscal quarter].

Life sciences entities frequently acquire patent rights to approved products in business combinations and asset acquisitions. To determine the useful life of intangible assets, most life sciences companies begin their analysis by considering the patent life of the underlying product (if any). Entities should also consider whether the useful life could be affected by other factors, including, but not limited to, the following:

- Risk of competition.
- High barrier to market entry, including after the entity's patent expires.
- Regulatory or court decisions related to the patent rights.
- Changes to insurance, government reimbursement policies, or both.

In accordance with ASC 350-30-35-4, “[i]f no legal, regulatory, contractual, competitive, economic, or other factors limit the useful life of an intangible asset to the reporting entity, the useful life of the asset shall be considered to be indefinite.” In the life sciences industry, finite useful lives are commonly assigned to internally developed or acquired intangible assets that align with the duration of a patent. In contrast, over-the-counter or generic products may have the characteristics of an indefinite-lived intangible asset.

ASC 350-30-35-15 provides that when an entity determines that an intangible asset has an indefinite useful life, the entity should not amortize the asset until it determines that the asset’s useful life is no longer indefinite. In accordance with ASC 350-30-35-16, the entity is required to evaluate in each reporting period the remaining useful life of the indefinite-lived intangible asset “to determine whether events and circumstances continue to support an indefinite useful life.” If the entity subsequently determines that the asset has a finite useful life, ASC 350-30-35-17 requires the entity to (1) test the asset for impairment in accordance with ASC 350-30-35-18 through 35-19 (i.e., qualitatively and, if necessary, quantitatively) and (2) subsequently amortize the asset “prospectively over its estimated remaining useful life.”

ASC 360-10-35-21 provides examples of events or changes in circumstances that management should consider when assessing whether an intangible long-lived asset should be tested for impairment, including a “significant decrease in the market price of [the] long-lived asset,” a “significant adverse change in the extent or manner in which [the] long lived asset . . . is being used,” and a “significant adverse change in [relevant] legal factors or in the business climate.” Life sciences companies may look to other industry-specific indicators when determining whether an intangible asset should be tested for impairment, including:

- Development progression of a competing product (when the company’s competitor may be “first to market” or may render the company’s product in development obsolete).
- Failure of the drug’s efficacy in clinical trials.
- Regulatory rejection of NDAs or ANDAs, with significant findings.
- A change in the economic lives of similar assets.
- Current or expected changes in participation rates, formulary structure, or reimbursement policies of insurance providers.

The SEC staff has asked registrants to provide additional analysis that explains the basis for their conclusions about the useful life of internally developed and acquired intangible assets and how their determination of useful life aligns with the period of economic benefit from the assets. Further, regarding impairment analyses, the staff has required registrants to provide expanded disclosures about their impairment testing policies, including descriptions of (1) the key assumptions used, (2) how the key assumptions are determined, (3) any uncertainties associated with the key assumptions, and (4) any potential events or circumstances that could adversely affect the key inputs to their impairment tests.

#### 4.2.4.4 *Contingent Consideration*

##### Examples of SEC Comments

- It appears based on the table of your contingent consideration liability . . . that your liability only includes [an \$X million] milestone due [to Company A] upon regulatory approval occurring in March [20XX]. Please tell us why your contingent consideration liability is zero at June 30, [20XX] when you appear to owe [Company A] up to an additional [\$X million] in regulatory and sales-based milestones and also owe them royalties of [X]% of future net sales. Reference for us the authoritative literature you rely upon to support your accounting.
- We note that you recorded net income of [\$X million] and [\$Y million] in [year 3] and [year 2] respectively, due to changes in the fair value of your contingent consideration . . . Please describe to us the valuation technique and inputs used to determine the fair value as of December 31, [year 1, year 2], and [year 3] and explain to us the reasons for the changes in fair value. Include quantitative information about the significant unobservable inputs used in the fair value measurement. In future filings provide the disclosures required by ASC 820-10-50-2(bbb) and ASC 805-30-50-4.
- Please tell us the unobservable inputs used to fair value your contingent consideration obligation and provide us the quantified information about these inputs as stipulated in ASC 820-10-50-2bbb. Separately tell us your consideration for disclosing this information in your filing.
- You state . . . that you have entered into, and may in the future enter into, agreements that require you to make significant milestone payments. Please disclose the aggregate amount of potential milestone payments and the triggering points of each significant milestone.

Contingent consideration arrangements are common in business combinations and asset acquisitions between life sciences companies. For example, the buyer may owe the seller (1) future development milestones, (2) sales-based milestones, and (3) royalties. Uncertainty associated with these payments arises from a number of factors:

- Before regulatory approval, uncertainty may arise from potential delays with clinical trials, success of competitor trials, or an inability to obtain regulatory approvals.
- After regulatory approval, uncertainty may arise from product safety concerns, manufacturing issues, potential product recalls, the introduction of competitor products, or possible sales and distribution channel issues.

The SEC staff often asks registrants to provide additional disclosures about the nature and terms of a contingent consideration arrangement and the conditions that must be met for the arrangement to become payable. Since ASC 805 requires entities to recognize contingent consideration at fair value as of the acquisition date in a transaction accounted for as a business combination, the staff may ask registrants to disclose how they determined the fair value of the contingent consideration. In addition, the staff may ask whether the change in the fair value of the contingent consideration should be reflected as a measurement-period adjustment to the amount of goodwill (i.e., if the adjustment is made because of new information obtained during the measurement period pertaining to facts or circumstances that existed as of the acquisition date) or in current earnings under ASC 805-10-25-13 through 25-19 and ASC 805-10-30-3. Further, the staff may ask for disclosure of the total amount of contingent consideration that could become payable under the terms of the arrangement.

#### 4.2.4.5 *Non-GAAP Measures*

##### Examples of SEC Comments

- Describe the nature and purpose of the following non-GAAP adjustments and explain the factors that you considered in excluding them from the non-GAAP financial measures: re-measurement of royalties for medicines acquired through business combinations, drug substance harmonization costs, upfront and milestone payments related to license agreements, accretion of royalty liabilities and royalties for medicines acquired through business combinations.
- We note your non-GAAP adjustment for In-process research and development in the [fiscal third quarter]. We believe the adjustment is inconsistent with Question 100.01 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretation. Please confirm to us you will no longer include the adjustment in any non-GAAP financial measure presented in accordance with Item 10(e) of Regulation S-K or Regulation G.
- We note that you have excluded upfront payments and premiums paid for the acquisition of related common stock to arrive at non-GAAP R&D expense and non-GAAP net income attributable to [Company A]. Please tell us your consideration of the guidance in Question 100.01 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations for this adjustment. In this regard, you state . . . that in connection with your business strategy, you enter into these collaboration agreements, which are detailed as part of your key business developments on . . . your Form 10-K.

**Examples of SEC Comments (continued)**

- Please disclose your purpose for including the adjustments for “milestones received from new or existing partners” and “upfront consideration and milestones paid to new or existing partners” in calculating the non-GAAP net income and non-GAAP net income per share measures. Also, tell us how you determined these adjustments do not substitute individually-tailored income or expense recognition methods for those of GAAP. Refer to Question 100.04 of the Division’s Non-GAAP Financial Measures Compliance and Disclosure Interpretations.
- In your determination of net earnings . . . on a non-GAAP basis, you exclude “R&D charges or other income resulting from upfront or contingent milestone payments in connection with the acquisition or licensing of third-party intellectual property rights.” In this regard, your statement that “similar charges or gains were recognized in prior periods and will likely occur in future periods” appears to indicate that these R&D charges are inherently recurring in nature. Please explain the factors that you considered in concluding that exclusion of these charges complied with Question 100.01 of the Non-GAAP Financial Measures Compliance and Disclosure Interpretations. Revise your non-GAAP presentation accordingly.

The SEC staff has continued to evaluate the form of preparers’ non-GAAP disclosures in the context of its C&DIs. Recently, the staff has focused more acutely on the appropriateness and usefulness of the metrics presented and the nature and description of the adjustments included therein. For example, some companies in the life sciences industry make adjustments for up-front, milestone, and royalty payments made to or received from other parties to business development transactions, including collaborative arrangements and the acquisition or licensing of third-party IP rights. The SEC staff has commented on the nature and purpose of these adjustments and has sometimes informed registrants that they should no longer include these adjustments in their non-GAAP financial measures because, in the staff’s view, costs related to these arrangements are recurring or are a normal part of business activities or strategies of such registrants.

For additional discussion of non-GAAP comment letter trends, see Deloitte’s Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).

## 4.2.5 Divestitures

The determination of whether a group of assets represents a business is important not only in acquisitions but also in divestitures. Specifically, in divestiture transactions related to the disposal of a business, there has been diversity in practice related to the treatment of contingent consideration. Note that the accounting policy considerations discussed below are relevant only to groups of assets that meet the definition of a business. For considerations related to the sale of assets, see [Section 2.2.3](#), which discusses the accounting for asset dispositions under the revenue standard, including the need, under certain circumstances, to record variable consideration associated with an asset disposition that otherwise is not considered a revenue activity.

Under a contingent consideration arrangement, a buyer is obligated to transfer additional consideration to a seller as part of the exchange for control of the acquiree if a specified future event occurs or a condition is met. Entities must evaluate the nature of each arrangement to determine whether contingent future payments are (1) part of the exchange for control (i.e., contingent consideration) or (2) separate transactions. Examples of contingent payment arrangements that are separate transactions include, but are not limited to, payments related to compensation for services, consulting contracts, profit-sharing agreements, property lease agreements, and executory contracts.

In arrangements in which the payment is determined to be contingent consideration (i.e., not separate transactions), the seller should determine whether the arrangement meets the definition of a derivative instrument. If the arrangement meets the definition of a derivative, it should be accounted for under

ASC 815. For contingent consideration arrangements that do not meet the definition of a derivative, the entity may consider the discussions related to EITF Issue No. 09-4. At the EITF's [meeting](#) on September 9–10, 2009, the Task Force considered two approaches with respect to a seller's accounting for a contingent consideration arrangement upon deconsolidation of a subsidiary or derecognition of a group of assets that meets the definition of a business; however, the Task Force did not reach a consensus on this Issue. Accordingly, in the absence of future standard setting, diversity in practice related to a seller's accounting for a contingent consideration arrangement may continue. Nevertheless, entities should establish an accounting policy for the initial and subsequent measurement of this type of arrangement. The seller should apply the chosen option to all future transactions. In addition, if an entity believes that it can support an alternative accounting treatment for a specific contingent consideration arrangement (other than the two approaches considered by the EITF), it should consult its accounting advisers.

The two approaches considered by the EITF are as follows:

- *Approach 1* — The seller includes the initial fair value of any contingent consideration arrangement in the overall gain or loss on deconsolidation of a subsidiary. Supporters of this approach point to ASC 810-10-40-5, which states that the seller (parent) should include the “fair value of **any** consideration received” (emphasis added) when calculating the gain or loss on deconsolidation of a subsidiary. Accordingly, the “consideration received” should include the fair value of any contingent consideration arrangements between the seller and buyer. Under this approach, the seller would recognize a contingent consideration receivable for the future amounts due from the buyer.

If the seller adopts this approach to initially account for a contingent consideration agreement, it should elect an accounting policy to (1) subsequently remeasure the contingent consideration at fair value as of the end of each reporting period or (2) subsequently apply the gain contingency guidance in ASC 450-30.

- *Approach 2* — The seller accounts for the contingent consideration arrangement as a gain (or loss) contingency in accordance with ASC 450. This approach is consistent with the accounting that entities applied to such transactions before the FASB issued Statement 160. Under this approach, the seller typically recognizes the contingent consideration receivable in earnings after the contingency is resolved. Accordingly, to determine the initial gain or loss on deconsolidation of a subsidiary, the seller would not include an amount related to the contingent consideration arrangement as part of the consideration received unless the criteria in ASC 450 are met. Supporters of this approach believe that the FASB did not intend to change practice when it issued Statement 160.

If the seller selects this approach to initially account for a contingent consideration agreement, it should continue to apply this approach in subsequent periods until the contingency is resolved.

**Example 4-17**

Parent A has a wholly owned subsidiary that represents a business and has a carrying amount of \$100. Parent A decides to sell 100 percent of this subsidiary to Company B, a third-party buyer. As part of the purchase agreement, B agrees to pay A (1) \$150 upon the close of the transaction and (2) an additional \$50 if the subsidiary's earnings exceed a specified level for the 12-month period after the close of the transaction. Upon the close of the transaction, A calculates the fair value of the contingent consideration portion of the arrangement to be \$30. In addition, the arrangement does not meet the definition of a derivative.

Parent A would compute its initial gain on the sale, which would be recognized upon the close of the transaction, under the two approaches as follows:

	Approach 1	Approach 2
Cash proceeds	\$ 150	\$ 150
Contingent consideration	<u>30</u>	<u>—</u>
Total consideration	180	150
Less: subsidiary's carrying amount	<u>(100)</u>	<u>(100)</u>
Initial gain on sale	<u>\$ 80</u>	<u>\$ 50</u>

**4.2.6 Reverse Acquisitions**

A reverse acquisition is a common type of business combination in the life sciences industry. A reverse acquisition occurs when the entity that issues its shares or gives other consideration to effect the transaction is determined for accounting purposes to be the acquiree (also called the accounting acquiree or legal acquirer), while the entity whose shares are acquired is for accounting purposes the acquirer (also called the accounting acquirer or legal acquiree). The accounting acquiree/legal acquirer generally continues in existence as the legal entity whose shares represent the outstanding common shares of the combined company. While the accounting acquiree/legal acquirer continues to issue its own financial statements, those statements are often in the name of the accounting acquirer/legal acquiree because the legal acquirer often adopts the name of the legal acquiree. The financial reporting reflects the accounting acquirer's/legal acquiree's financial information, except for its equity, which is retroactively adjusted to reflect the equity of the accounting acquiree/legal acquirer.

**Example 4-18**

Company A, a public company with substantive operations and a December 31 year-end, has 1 million common shares outstanding as of June 30, 20X9. On July 1, 20X9, in a transaction accounted for as a business combination, A issues 4 million of its newly registered common shares to Company B, a private entity, in exchange for all of B's 2 million outstanding common shares (an exchange rate of 2:1). After the transaction, B controls A's voting rights through its 80 percent ownership interest (4 million common shares held ÷ 5 million total common shares outstanding) and its ability to elect the majority of the combined entity's board members.

Although A issued common shares to effect the business combination, B would be considered the accounting acquirer under ASC 805, provided that there are no other existing pertinent facts and circumstances to the contrary after consideration of the factors in ASC 805-10-55-12 through 55-14.

For more information about how to account for reverse acquisitions, see [Section 6.8](#) of Deloitte's Roadmap *Business Combinations*.



### 4.2.6.1 Reverse Acquisition of a Public Company by a Private Company

As an alternative to undertaking a traditional IPO as a means of becoming a public company, it has become common in the life sciences industry for a private company to acquire a public company through a reverse acquisition. Often, the public company has failed clinical trials for one or more R&D projects. In a typical reverse acquisition of a public company by a private company:

- The private company is legally acquired by the public company.
- The preacquisition stockholders of the private company own a majority of the voting stock of the combined postacquisition company.
- The management and other key employees of the private company become the management and key employees of the combined postacquisition company.
- The composition of the combined postacquisition company's board of directors reflects representation proportional to the postacquisition ownership split of the voting stock.
- The business operations of the private company become the business operations of the public company.
- The combined postacquisition company changes its name to the name of the private company.

In a reverse acquisition, one of the key accounting judgments is the determination of which entity is the accounting acquirer. ASC 805-10-25-4 requires entities to identify an acquirer in every business combination. The ASC master glossary defines an acquirer as follows:

The entity that obtains control of the acquiree. However, in a business combination in which a variable interest entity (VIE) is acquired, the primary beneficiary of that entity always is the acquirer.

If the legal acquiree in a business combination is a VIE, the primary beneficiary of the VIE is considered the accounting acquirer in accordance with the guidance in ASC 805-10-25-5. Consequently, entities must consider whether the legal acquiree is a VIE on the basis of the guidance in ASC 810-10-15-14. If a private life sciences company is deemed to be the legal acquiree and a VIE, the entity that is the primary beneficiary of the VIE is the accounting acquirer. Because of the judgment involved in the determination of whether the private company is a VIE, including the evaluation of the sufficiency of equity as required under ASC 810-10-15-14(a), discussion with accounting advisers is encouraged.

If the acquiree in a business combination is a voting interest entity rather than a VIE, entities should first consider the guidance in the general subsections of ASC 810-10 related to determining the existence of a controlling financial interest to identify the accounting acquirer. In many cases, entities can clearly identify the accounting acquirer by applying that guidance. If they cannot, the identification of the accounting acquirer should be based on an evaluation of "pertinent facts and circumstances." ASC 805-10-55-11 through 55-15 provide guidance to assist in this evaluation. In a business combination effected primarily by exchanging equity interests, the identification of the accounting acquirer is based on an evaluation of pertinent facts and circumstances, including the following:

- "The relative voting rights in the combined entity after the business combination" (ASC 805-10-55-12(a)).
- "The existence of a large minority voting interest in the combined entity" (ASC 805-10-55-12(b)).
- "The composition of the governing body of the combined entity" (ASC 805-10-55-12(c)).
- "The composition of the senior management of the combined entity" (ASC 805-10-55-12(d)).
- "The terms of the exchange of equity interests" (ASC 805-10-55-12(e)).
- The relative size of the combining entities (ASC 805-10-55-13).
- Other considerations.

Further, if the private company is determined to be the accounting acquirer of the public company, the transaction could be accounted for as:

- A reverse recapitalization of the private company if the public company's assets represent only net monetary assets such as cash.
- A reverse asset acquisition if the public company's net assets acquired do not meet the definition of a business under ASC 805.
- A reverse acquisition if the public company's net assets acquired meet the definition of a business under ASC 805.

See [Section 3.1](#) of Deloitte's Roadmap *Business Combinations* for more information about identifying the acquirer. Because of the judgment involved, discussion with accounting advisers is encouraged.

### 4.3 New Accounting Standard — Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities From Contracts With Customers (ASU 2021-08)

#### 4.3.1 Background

In October 2021, the FASB issued [ASU 2021-08](#), which amends ASC 805 to “require acquiring entities to apply Topic 606 to recognize and measure contract assets and contract liabilities in a business combination.” Under current GAAP, an acquirer generally recognizes such items at fair value on the acquisition date.

The ASU's stated purpose is “to improve the accounting for acquired revenue contracts with customers in a business combination by addressing diversity in practice and inconsistency related to the following:

1. Recognition of an acquired contract liability
2. Payment terms and their effect on subsequent revenue recognized by the acquirer.”

The ASU further notes that its amendments will:

- “[I]mprove comparability for both the recognition and measurement of acquired revenue contracts with customers at the date of and after a business combination.”
- “[I]mprove comparability by specifying for all acquired revenue contracts regardless of their timing of payment (1) the circumstances in which the acquirer should recognize contract assets and contract liabilities that are acquired in a business combination and (2) how to measure those contract assets and contract liabilities.”
- “[I]mprove comparability after the business combination by providing consistent recognition and measurement guidance for revenue contracts with customers acquired in a business combination and revenue contracts with customers not acquired in a business combination.”

#### 4.3.2 Key Provisions

ASU 2021-08 amends ASC 805 to add contract assets and contract liabilities to the list of exceptions to the recognition and measurement principles that apply to business combinations and to “require that an entity (acquirer) recognize and measure contract assets and contract liabilities acquired in a business combination in accordance with Topic 606.” While primarily related to contract assets and contract liabilities that were accounted for by the acquiree in accordance with ASC 606, “the amendments also apply to contract assets and contract liabilities from other contracts to which the provisions of Topic 606 apply, such as contract liabilities from the sale of nonfinancial assets within the scope of Subtopic 610-20.”

As a result of the amendments made by the ASU, it is expected that an acquirer will generally recognize and measure acquired contract assets and contract liabilities in a manner consistent with how the acquiree recognized and measured them in its preacquisition financial statements.

For more information about ASU 2021-08, including its practical expedients, see Deloitte's November 2, 2021, *Heads Up* and [Section 4.3.13](#) of Deloitte's Roadmap *Business Combinations*.

### 4.3.3 Effective Dates and Transition

The effective dates of ASU 2021-08 are as follows:

- For PBEs, fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, including interim periods within those fiscal years.

The ASU's amendments should be applied prospectively to business combinations occurring on or after the effective date of the amendments.

The ASU clarifies that “[e]arly adoption of the amendments is permitted, including adoption in an interim period. An entity that early adopts in an interim period should apply the amendments (1) retrospectively to all business combinations for which the acquisition date occurs on or after the beginning of the fiscal year that includes the interim period of early application and (2) prospectively to all business combinations that occur on or after the date of initial application.” For example, assume that an entity with a calendar year-end had one business combination in the second quarter of 2020 and another business combination in the third quarter of 2021. If the entity adopted the amendments in the fourth quarter of 2021, it would apply the amendments retrospectively to the acquisition that occurred in the third quarter of 2021 but would not apply the amendments retrospectively to the acquisition that occurred in the second quarter of 2020 even if it had not yet issued financial statements for the year ended December 31, 2020.

# Chapter 5 — Consolidation

## 5.1 Introduction

Life sciences entities enter into a variety of arrangements with other parties to facilitate the research, development, or sale of their IP or products. Because life sciences entities may absorb the risks and rewards of other parties through interests other than those based on traditional voting equity, they must carefully analyze their arrangements with those parties to determine whether to consolidate them. However, it is important to note that the guidance discussed in this chapter is only applicable to arrangements that are structured in a separate legal entity and is not applicable to collaborative arrangements because those arrangements are not primarily conducted through a separate legal entity. See [Section 2.2.1](#) for accounting considerations relevant to collaborative arrangements.

The dual consolidation model under U.S. GAAP, which comprises the VIE model and the voting interest entity model, is designed to ensure that the reporting entity that consolidates another legal entity has a controlling financial interest in that legal entity. Under the VIE model, the evaluation of whether the reporting entity has a controlling financial interest in a VIE focuses on (1) the power to direct the activities that most significantly affect the legal entity's economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the legal entity that could potentially be significant to the legal entity. Under the voting interest entity model, a reporting entity with ownership of a majority of the voting interests of a legal entity is generally considered to have a controlling financial interest in the legal entity.

## 5.2 Consolidation Decision Trees

ASC 810-10-05-6 contains a flowchart that consists of a series of decision trees to help reporting entities identify (1) which consolidation model to apply, if any; (2) whether a reporting entity should consolidate a VIE; and (3) whether a reporting entity should consolidate a voting interest entity. See Deloitte's Roadmap [Consolidation — Identifying a Controlling Financial Interest](#) for a [flowchart](#) that incorporates the concepts in the FASB's flowchart and serves as a guide to the consolidation accounting literature.

## 5.3 Industry Issues

The discussions and examples below contain guidance on consolidation matters that frequently affect life sciences entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, it provides targeted considerations that are most relevant to the industry. To complete a consolidation analysis, entities must consider all facts and circumstances and use significant judgment. The examples cited will be beneficial in introducing concepts as you approach the evaluation of variable interests.

### 5.3.1 Business Scope Exception to the VIE Model

When determining whether it is required to consolidate a legal entity under ASC 810-10, a reporting entity should evaluate whether (1) it qualifies for a general scope exception to the consolidation guidance or (2) the legal entity qualifies for a scope exception to the VIE model. The most frequently cited scope exception in ASC 810-10 is the so-called business scope exception to the VIE model provided in ASC 810-10-15-17(d). If a legal entity qualifies for a scope exception to the VIE model, the reporting entity should perform a consolidation analysis under the voting interest entity model. (For a list of all general scope exceptions to the consolidation guidance and a list of all scope exceptions to the VIE model, see [Chapter 3](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.)

The business scope exception is two-pronged and premised on both (1) the legal entity's characteristics (i.e., whether it is a business as defined in ASC 805, and its activities) and (2) the reporting entity's relationship with the legal entity (i.e., the extent of involvement by the reporting entity in the design or redesign of the legal entity, whether the legal entity is designed so that substantially all of its activities either involve or are conducted on behalf of the reporting entity and its related parties, whether the reporting entity and its related parties provided more than half of the subordinated financial support, and whether the activities of the legal entity are primarily related to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements). A common oversight in evaluating the applicability of the business scope exception is merely assessing whether a legal entity meets the definition of a business and failing to determine whether any of the four conditions in ASC 810-10-15-17(d) are met. In practice, it is not uncommon for a reporting entity to be involved in the design or redesign of a legal entity, which is one condition that would prohibit a reporting entity from meeting this scope exception. Two other conditions in ASC 810-10-15-17(d), which may be especially relevant to life sciences entities, are further discussed in Sections 5.3.1.1 and 5.3.1.2 below.

#### 5.3.1.1 *Whether Substantially All of the Activities Either Involve or Are Conducted on Behalf of the Reporting Entity and Its Related Parties*

A reporting entity should base its determination of whether substantially all of a legal entity's activities either involve or are conducted on behalf of the reporting entity and its related parties on the design of the legal entity and should compare the nature and extent of the activities between the reporting entity and the legal entity with the **entire set** of the legal entity's activities. That said, in the life sciences industry, it is also important to consider whether there is substantial uncertainty about whether the legal entity will advance to the next stage of development. If such substantial uncertainty exists, the involvement of the reporting entity with the legal entity's current set of activities should then be considered in the determination of (1) the legal entity's purpose and design, (2) whether the legal entity is a VIE, and (3) the primary beneficiary. See [Section 5.3.3.1.4](#) for a discussion of development-stage entities.

In the determination of whether substantially all of a legal entity's activities either involve or are conducted on behalf of the reporting entity and its related parties, related parties include all parties identified in ASC 850 and ASC 810-10-25-43 except for de facto agents as described in ASC 810-10-25-43(d). Generally, if 90 percent or more of the legal entity's activities are conducted on behalf of a reporting entity and its related parties, it is presumed to be "substantially all" of the legal entity's activities. However, less than 90 percent is not a safe harbor. While a variety of conditions may indicate that substantially all of the activities of a legal entity are conducted on behalf of a reporting entity and its related parties, in the context of the life sciences industry, one such condition would be when a reporting entity holds the rights to products that result from the R&D of a legal entity.

**Example 5-1**

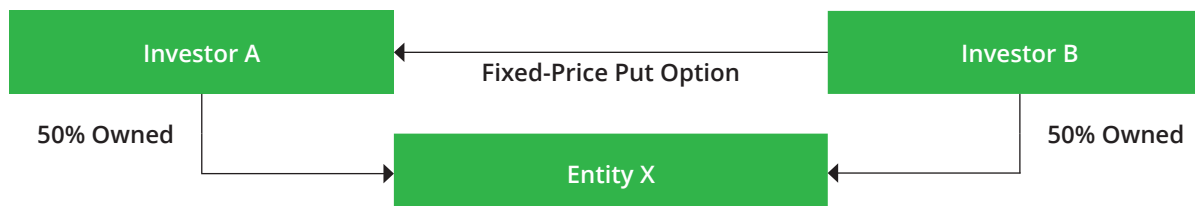
A joint venture entity (Entity P) is formed by two unrelated parties, Enterprises U and G. Each investor has a 50 percent equity interest. Entity P's activities consist solely of developing pharmaceutical products, and the reporting entity, U, has the rights to the resulting products. As currently designed, P represents a development arm of U's business because it is so closely aligned with U in appearance and purpose. Therefore, substantially all of P's activities either involve or are conducted on behalf of U and, accordingly, the business scope exception cannot be applied by U.

**5.3.1.2 Additional Subordinated Financial Support — Put and Call Options**

A put or call option between equity owners of a life sciences legal entity (e.g., between joint venture partners) can have an impact on whether a reporting entity meets the condition in ASC 810-10-15-17(d)(3) and, therefore, on whether it can apply the business scope exception. The examples below illustrate situations in which (1) a put option (purchased by one investor from the reporting entity) results in the reporting entity's ineligibility for the business scope exception since the reporting entity effectively provides more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity and (2) a call option would not have the same impact.

**Example 5-2****Put Option**

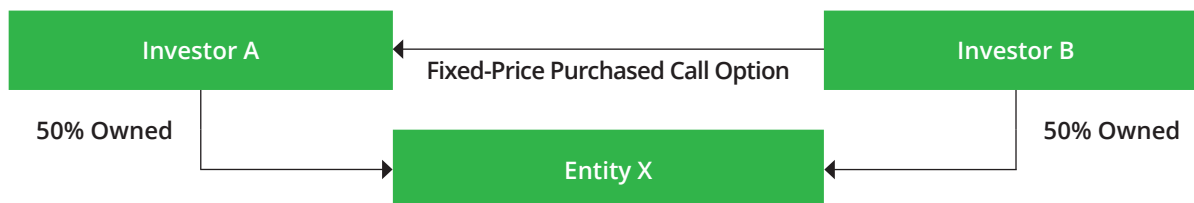
Investor A and Investor B form Entity X with equal contributions of equity. Investor B purchases a put option from A that permits it to put its interest in X to A at a fixed price.



The fair value of the fixed-price put option should be considered additional subordinated financial support provided by A to X because A will absorb expected losses of X upon exercise of that put option (i.e., it meets the definition of subordinated financial support in ASC 810-10-20). Therefore, A would consider the fair value of the fixed-price put option (presumably the price paid) in determining whether the condition in ASC 810-10-15-17(d)(3) is met. If the fair value of the put option is greater than zero, A would meet this condition and therefore would not be able to use the business scope exception since the fair value of the equity provided by A and the fair value of the put option written by A would constitute more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity.

**Example 5-3****Call Option**

Investor A and Investor B form Entity X with equal contributions of equity. Investor A purchases a call option from B that permits it to call B's interest at a fixed price (the call option's strike price is at or above the fair value of the equity interest at inception of the option).



The fair value of the fixed-price call option should not be considered additional subordinated financial support to X because A will not absorb expected losses of X until exercise of that call option (i.e., the option does not meet the definition of subordinated financial support in ASC 810-10-20). Investor A can exercise its call option and obtain additional residual returns of X, but the call option does not expose it to additional expected losses. Therefore, A would not consider the fair value of the fixed-price call option in determining whether it meets the condition in ASC 810-10-15-17(d)(3). Investors A and B would not meet this condition since the fair value of the equity provided by each investor would not constitute more than half of the total of the equity, subordinated debt, and other forms of subordinated financial support to the legal entity. To use the business scope exception, A and B must determine whether the other conditions in ASC 810-10-15-17(d) are met.

**5.3.2 Identifying Variable Interests**

One of the first steps in assessing whether a reporting entity is required to consolidate another legal entity is to determine whether the reporting entity holds a variable interest in the legal entity being evaluated for consolidation. If a reporting entity determines that it does not have a variable interest in the legal entity, no further analysis is required. That is, the reporting entity is not required to consolidate the legal entity or provide any of the VIE disclosures related to the legal entity; however, other GAAP may be relevant to the determination of recognition, measurement, and disclosure. ASC 810-10-20 defines variable interests in a legal entity as “contractual, ownership, or other pecuniary interests in a VIE that change with changes in the fair value of the VIE’s net assets exclusive of variable interests.” While there are many forms of variable interests, all variable interests will **absorb** portions of a VIE’s variability (changes in the fair value of the VIE’s net assets exclusive of variable interests) that the legal entity was designed to create. An interest that **creates** variability would not be considered a variable interest.

It is often simple to identify whether a contract or arrangement is a variable interest. A good rule of thumb is that most arrangements on the credit side of the balance sheet (e.g., equity and debt) are variable interests because they absorb variability as a result of the performance of the legal entity. However, identifying whether other arrangements (e.g., derivatives, leases, and decision-maker and other service-provider contracts) are variable interests can be more complex.

As a result, the FASB established a two-step “by-design” approach for the identification of variable interests. Under this approach as outlined in ASC 810-10-25-22, the reporting entity would (1) “[a]nalyze the nature of the risks in the legal entity” and (2) “[d]etermine the purpose(s) for which the legal entity was created and determine the variability (created by the risks identified in Step 1) the legal entity is designed to create and pass along to its interest holders.” The by-design principle is relevant because while a contract or arrangement may absorb certain variability from a legal entity, the contract or arrangement would generally not be a variable interest if the variability absorbed is related to a risk the legal entity was not “designed” to pass on to the interest holder.



The table below contains a very limited list of examples of what may be considered variable interests.

Examples of Variable Interests	Illustrative Fact Patterns
Long-term liabilities of a legal entity (e.g., fixed-rate debt, floating-rate debt, mandatorily redeemable preferred stock)	Company A (the reporting entity) lends Company D, a biotech firm, \$50 million in the form of a five-year fixed-rate unsecured loan. Company A, as a debt holder, absorbs the variability in the value of D's net assets exclusive of variable interests because A is exposed to D's ability to pay (i.e., credit risk) and may also be exposed to interest rate risk depending on the design of the legal entity.
Equity of a legal entity (e.g., mezzanine equity, preferred stock, common stock, partnership capital)	Company S (the reporting entity) invests \$89 million in Company M, a CRO. The equity investment was made in common stock and is considered equity at risk under ASC 810-10-15-14(a) (which is further discussed below). Company S's interest in M is a variable interest that absorbs the variability associated with changes in M's net assets exclusive of variable interests.
Guarantees written by a reporting entity <sup>1</sup>	Company C (the reporting entity) provides a guarantee to a medical device company, Company B, on the \$2 billion fair value of medical device IP held by B. The fair value of the medical device IP is greater than 50 percent of the fair value of B's assets. Company C must pay B for any decreases in value of this IP. The guarantee agreement transfers all or a portion of the risk of specified assets (IP) to C; thus, C has a variable interest in B.
Put options written by a reporting entity for a price other than fair value (e.g., fixed-price) and similar arrangements on specified assets owned by the legal entity <sup>2</sup>	Company H (the reporting entity) writes a put option to Company W allowing W to sell its medicinal compound in development for a fixed price at a later date. The fair value of the medicinal compound is greater than 50 percent of W's assets. Company H has a variable interest in the specified assets of W since H is exposed to variability in the values of the medicinal compound.
Stand-alone call options written by the legal entity on specified assets owned by that legal entity <sup>3</sup>	Company S writes a call option on its IPR&D asset for a treatment in phase II clinical trials to Company D (the reporting entity), allowing D to acquire the interest for a fixed price at a later date. The fair value of the IPR&D asset is greater than 50 percent of S's assets. Because D participates in the positive variability of a specified asset of S, D possesses a variable interest in the specified asset.
Fees paid to a decision maker or service provider	Company S pays a fee to Company R (the reporting entity) to distribute S's products. The fee arrangement requires S to pay all profits earned on the distribution of the products to R. The fee arrangement is designed to transfer substantially all of the residual returns and risks of ownership of S's products to R, the decision maker. In accordance with ASC 810-10-55-37C, R's earned fee represents a variable interest in S.
Contingent payments made to a reporting entity	Company C (the reporting entity) holds rights to a pharmaceutical drug. Company W obtains a license from C to produce, market, and sell the drug, and C will earn a royalty based on W's sales. Company C holds a variable interest in W because it absorbs variability through the royalty.

<sup>1</sup> ASC 810-10-25-55 and 25-56 indicate that variable interests in a specified asset whose value is less than half of the total fair value of a VIE's assets are not considered variable interests in that legal entity unless the reporting entity also holds another interest in the legal entity. In addition, a variable interest in a specified asset of a VIE could result in consolidation of a "silo" within the VIE. For further discussion, see [Section 4.3.11](#) and [Chapter 6](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

<sup>2</sup> See footnote 1.

<sup>3</sup> See footnote 1.

The table below lists examples (not all-inclusive) of what generally would not be considered variable interests.

Examples of Arrangements That Are Not Variable Interests	Illustrative Fact Patterns
Assets of the legal entity	Company D (the reporting entity) owes \$100 million to Company P as part of an existing loan agreement. Although the loan receivable asset generates value to the investors of P, the loan receivable is not a variable interest to D. Assets typically are the major source of a legal entity's variability and are therefore not considered variable interests.
Contingent payments made to a legal entity	Company E (the reporting entity) enters into a license (or purchase) agreement with Company C to (1) continue the R&D of a phase I drug that had been under development by C before the agreement and (2) commercialize the drug when and if regulatory approval is received. In exchange for the drug's achievement of milestones, such as FDA approval and the achievement of specified sales levels, E will make milestone payments and pay C royalties. Company E is not exposed to the variability in C and therefore does not possess a variable interest through its milestone or royalty payments.

Discussion of the by-design approach for identifying variable interests, along with a more expansive list of examples of variable interests, is included in [Chapter 4](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

### 5.3.3 Determining Whether a Legal Entity Is a VIE

To determine which consolidation model to apply when evaluating its variable interest in a legal entity, the reporting entity must determine whether the legal entity is a VIE. This determination must be made upon the reporting entity's initial involvement with a legal entity and reassessed upon the occurrence of a reconsideration event.

Legal entities can differ in structure as well as legal form (e.g., corporations compared with limited partnerships and similar entities), which affects the method used to understand their design and purpose. In simple terms, the evaluation is based on the nature and amount of the equity investment and the rights and obligations of the equity investors. If a legal entity has sufficient equity investment at risk to finance its operations, and those equity investors, through their equity investment at risk, make decisions that direct the significant activities of the legal entity, consolidation based on majority voting interest is generally appropriate. However, if equity is not sufficient, or the equity investors do not control the legal entity through their equity investment, the VIE model is used to identify the appropriate party, if any, to consolidate.

To qualify as a VIE, a legal entity needs to satisfy only one of the following characteristics:

- The legal entity does not have sufficient equity investment at risk.
- The equity investors at risk, as a group, lack the characteristics of a controlling financial interest.
- The legal entity is structured with disproportionate voting rights, and substantially all of the activities are conducted on behalf of an investor with disproportionately few voting rights.

Sections 5.3.3.1 through 5.3.3.3 below discuss a brief list of considerations specifically relevant to life sciences entities for determining whether a legal entity is a VIE. Since this list is not all-encompassing, we encourage you to refer to [Chapter 5](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* during your analysis.

### 5.3.3.1 Sufficiency of Equity

A legal entity is not a VIE under this criterion if its total equity investment at risk is sufficient to finance its activities without additional subordinated financial support. To determine whether there is sufficient equity investment at risk to permit the legal entity to finance its activities without additional subordinated financial support, a reporting entity must perform the following three steps:

- *Step 1* — Identify whether an interest in a legal entity is considered GAAP equity.
- *Step 2* — Determine whether the equity investment is “at risk” on the basis of the equity investment population.
- *Step 3* — Determine whether the identified equity investment at risk is sufficient to finance the legal entity’s operations without additional subordinated financial support.

For step 1, it is important to remember that only an equity interest can be considered equity investment at risk, although not all equity interests will be considered equity investment at risk. That is, an interest classified outside the equity section (permanent or temporary) of a legal entity’s balance sheet is not an equity investment that would be considered as part of step 1. Sections 5.3.3.1.1 through 5.3.3.1.4 below highlight certain considerations related to steps 2 and 3.

#### 5.3.3.1.1 Determining Whether the Equity Investment Is “At Risk”

An interest classified as equity may not have the substantive characteristics of equity. Since the VIE consolidation framework is intended to apply to entities whose voting interests may not be the most appropriate determining factor in the identification of which party should consolidate, the FASB reasoned that equity interests that are not “at risk” should not be included in the sufficiency-of-equity test. To be considered part of the equity investment at risk, equity interests must:

- Participate significantly in profits and losses.
- Not be issued in exchange for subordinated interests in other VIEs.
- Not be received from the legal entity or by parties involved with the legal entity unless that party is a parent, a subsidiary, or an affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.
- Not be financed by the legal entity or other parties involved with the legal entity unless that party is a parent, a subsidiary, or an affiliate of the investor that is required to be included in the same set of consolidated financial statements as the investor.

Further, equity investments acquired by an equity investor in exchange for promising to perform services, commonly referred to as “sweat equity,” cannot be included in equity investment at risk, because the equity is received in lieu of a fee for services performed. Similarly, equity investments acquired as a result of past services performed are not considered equity investment at risk.

#### Example 5-4

Three investors form Entity X to conduct R&D activities. Entity X issues equity with a par amount of \$15 million (\$5 million to each investor). Investor A contributes \$5 million in cash. Investor B issues a guarantee that the fair value of the compound at the completion of the R&D activities will be at least \$90 million. Investor C enters into an agreement with X to provide research scientists who will each work for 500 hours to complete the activities.

Only A’s \$5 million in equity is considered equity at risk because B and C received their equity as payment from X for the guarantee (promise to stand ready) and the performance of services, respectively.

### 5.3.3.1.2 Determining Whether the Identified Equity Investment at Risk Is Sufficient to Finance the Legal Entity's Operations Without Additional Subordinated Financial Support

Once the amount of equity investment at risk is quantified, a reporting entity must determine whether the equity investment at risk is sufficient to finance the legal entity's operations without additional subordinated financial support. If not, the legal entity is a VIE. The purpose of this assessment is to identify whether a legal entity is sufficiently capitalized. Merely having at-risk equity is not enough; the legal entity must be able to finance its operations with the equity investment at risk. The reporting entity must use judgment, considering qualitative or quantitative factors in isolation or a combination of the two, to determine sufficiency since the various risk tolerances, investment objectives, and liquidity requirements of investing can influence the level of capital in a legal entity.

Note that if any amount has only been guaranteed or committed (and not funded) by the equity holder as of the date of the VIE analysis, neither the amount guaranteed nor the fair value of the guarantee is considered equity investment at risk. See [Section 5.2](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* for more guidance on evaluating sufficiency of equity.

### 5.3.3.1.3 Existence of Subordinated Debt

In a qualitative assessment of the sufficiency of equity investment at risk, the existence of subordinated debt is a factor indicating that a legal entity's total equity investment at risk may not be sufficient to absorb expected losses. That is, by virtue of its subordination, subordinated debt is expected to absorb expected losses beyond a legal entity's equity investment at risk. However, the existence of subordinated debt should not be considered determinative in itself; an evaluation of the sufficiency of equity at risk should be based on all facts and circumstances.

In the evaluation of whether equity investment at risk is sufficient, consideration should also be given to whether the entity has outstanding, or could issue, investment-grade debt since such debt is typically issued only when third parties deem a legal entity to be sufficiently capitalized. If debt is subordinated to other variable interests, equity investment at risk may be insufficient to finance the legal entity's operations. The determination of whether debt represents subordinated financial support is based on how that debt absorbs expected losses compared with other variable interests in the legal entity. If the terms of the debt arrangement cause the debt to absorb expected losses before or at the same level as the most subordinated interests (e.g., equity, other subordinated debt), or the most subordinated interests are not large enough to absorb the legal entity's expected losses, the debt would generally be considered subordinated financial support. However, investment-grade debt is a variable interest that would generally not be considered subordinated financial support because investment-grade debt generally indicates that third parties deem the legal entity to be sufficiently capitalized.

#### Example 5-5

Entity D is formed with \$50 of equity and \$50 of long-term debt. The long-term debt consists of two issuances: Debt A, \$45, and Debt B, \$5. Debt B is subordinate to Debt A. Because D was recently formed, it could not obtain senior debt (Debt A) in an investment-grade form.

In a qualitative assessment, the existence of subordinated debt is a factor indicating that D does not have sufficient equity at risk. That factor should be considered along with all other facts and circumstances (e.g., a 50 percent ratio of equity at risk frequently exceeds expected losses). If the qualitative assessment is inconclusive, a quantitative analysis (i.e., calculation of expected losses/residual returns) should be performed to determine whether D is a VIE.

**Example 5-5 (continued)**

Assume that D was a VIE at formation. Two years after its formation, D engages in additional business activities beyond those that were considered at formation and is an established, profitable business. Given its desire to further expand its business, D issues a new tranche of debt (Debt C) whose rank is identical in seniority (e.g., priority in liquidation) to that of Debt B. Because of D's stable financial condition, the tranche of debt is rated investment-grade. Given the identical priority in liquidation of Debt B and Debt C, one can infer that Debt A (which is senior to Debt B) and Debt B would be rated investment-grade as well. No other debt securities are outstanding, and no other evidence of subordinated financial support (e.g., guarantees) is noted. Assume that a reconsideration event under ASC 810-10-35-4(c) has occurred because the additional business activities increase D's expected losses. Therefore, the variable interest holders must determine whether D is still a VIE.

In a qualitative assessment, D's ability to issue investment-grade debt that has the same priority in liquidation as Debt B is one factor indicating that D, as of the reconsideration date, has sufficient equity at risk. That is, in the absence of other forms of subordinated financial support, D would not have been able to obtain an investment-grade rating on the new debt if its existing equity at risk was not sufficient. However, all other facts and circumstances existing as of the reconsideration date should be considered. If the qualitative assessment is not conclusive, a quantitative analysis should be performed to determine whether D is a VIE as of the reconsideration date.

**5.3.3.1.4 Development-Stage Entities**

Since life sciences entities frequently require varying levels of funding to complete a product candidate's R&D, it is important for such entities to understand the "sufficiency of the equity investment at risk" characteristic in the VIE analysis when evaluating the funding of each R&D phase.

Before the adoption of [ASU 2014-10](#),<sup>4</sup> certain entities could qualify for specialized accounting under ASC 915 as development-stage entities. Such entities were, by definition, in a stage of development as opposed to conducting operations in accordance with their principal plan. Accordingly, those qualifying entities differed in nature from other entities, often being capitalized only to the extent required to perform a specific task related to development.

Although ASU 2014-10 removed the concept of a development-stage entity, we believe that it is still necessary to consider the design of a legal entity in the determination of whether its equity investment at risk is sufficient. That is, considering only the legal entity's current stage of development may be appropriate in the assessment of sufficiency of equity. Specifically, if a legal entity is in the development stage **and** there is substantial uncertainty about whether the legal entity will proceed to the next stage, it may be appropriate to consider only the current stage in the sufficiency assessment. This approach is consistent with the assessment of power of a multiple-stage entity.

A reporting entity should initially assess whether a development-stage entity is a VIE on the date on which it first becomes involved with the legal entity. This assessment must be reconsidered upon the occurrence of any of the events in ASC 810-10-35-4. For a development-stage entity, this would include, but not be limited to:

- Funding of additional equity.
- Commencement of additional activities (e.g., entering a subsequent "phase" of development).

<sup>4</sup> ASU 2014-10 eliminated the specialized approach for considering sufficiency of equity investment at risk for development-stage entities. The ASU is effective for PBEs for annual periods beginning after December 15, 2015, and interim periods therein. For entities other than PBEs, the guidance is effective for annual periods beginning after December 15, 2016, and interim periods beginning after December 15, 2017. As a result of these effective dates and early adoption, virtually all entities have adopted the ASU. Reporting entities that have historically applied this exception should consider the impact of ASU 2014-10 on their historical conclusions.

**Example 5-6**

Entity D is a development-stage entity. Investor A and Investor B each contributed \$1 million of equity financing to D. Entity D's current activities consist of product development and marketing surveys ("phase I"). Upon successful completion of phase I, D plans to commence test marketing (i.e., selling the products in selected areas) ("phase II"). During the final phase of D's development stage, it plans to engage in limited-scale production and selling efforts ("phase III"). Entity D's by-laws allow A and B to fund additional equity upon the completion of phase I and phase II. However, there is substantial uncertainty that D will proceed to phase II.

In the assessment of whether D has sufficient equity at risk under ASC 810-10-15-14(a), only the current phase of D's development needs to be considered. Thus, if, at inception, the \$2 million of equity capital is deemed sufficient to finance phase I, D would be considered to have sufficient equity investment at risk. This determination should be reassessed at the commencement of phase II and phase III, upon the funding of additional equity financing, or upon the occurrence of any of the events in ASC 810-10-35-4.

**Example 5-7**

Entity A is a biopharmaceutical entity whose purpose and design is to complete phase III clinical trials. Currently, A is developing a drug candidate that is in phase I clinical trials. At the inception of the phase I clinical trials, A received an additional equity investment from Company X. Upon making that investment in A, X determined that it should assess whether, under ASC 810-10-15-14(a), A has sufficient equity for completing the phase I clinical trials. Although X expects that A will need additional subordinated financial support to conduct phase II and phase III clinical trials, those trials represent the next stages for A as a development-stage entity. There is substantial uncertainty that A will advance to phase II clinical trials for the drug candidate that is currently in phase I trials. Accordingly, any additional subordinated financial support needed for phase II and phase III clinical trials would not be considered in the assessment of the sufficiency of equity for phase I clinical trials given the purpose and design of A.

It may be appropriate for X to consider only the current clinical trial phase of A (i.e., I, II, or III) when assessing whether A has sufficient equity at risk under ASC 810-10-15-14(a) on the basis of A's purpose and design. However, we do not believe that it is appropriate for a reporting entity to bifurcate a clinical development stage into distinct phases (e.g., viewing phase IIa and phase IIb as distinct development stages, respectively) for this evaluation. Also, a reporting entity should take into account the overall purpose and design of the legal entity that is being evaluated for consolidation and the associated risks when performing such an assessment.

### **5.3.3.2 Equity Investors, as a Group, Lack the Characteristics of a Controlling Financial Interest**

A reporting entity determines whether it holds a **controlling financial interest** in a legal entity differently under the VIE model than it does under the voting interest entity model. The voting interest entity model focuses on the voting rights conveyed by equity interests. Since the holder of an interest other than equity may control the legal entity, the voting interest entity model may not yield an appropriate consolidation conclusion if the equity interests collectively do not possess the characteristics that are typical of equity interests. Accordingly, a legal entity is considered a VIE if the at-risk holders **as a group**, through their equity investment at risk, lack any of the following three qualities, which are the "typical" characteristics of an equity investment:

- The power to direct the most significant activities of the legal entity.
- The obligation to absorb the expected losses of the legal entity.
- The right to receive the expected residual returns of the legal entity.

The rights of the equity investor group must be a characteristic of the equity interest itself and not a characteristic of other interests held by the current holders of the equity interest at risk. For example, an interest outside the equity investment at risk may permit its holder to direct the most significant activities of the legal entity. If that substantively separate interest is held by a party that is also an owner of equity investment at risk, it should not be combined with the equity investment at risk in this analysis because by design, the rights and obligations do not inure to the equity interest itself. Each individual equity investment at risk need not possess all three characteristics, but the total equity investment at risk must possess them all. By implication, as long as the group of equity investors possesses these three characteristics, the failure of any one at-risk equity investor to possess the characteristics would not make the legal entity a VIE.

#### Example 5-8

Company S holds the patent to a phase II drug, which represents 80 percent of the fair value of the assets held by S. Company S issues to Entity B a fixed-price call option on the phase II drug that is exercisable in one year. The right of S to receive the expected residual returns is effectively capped because of B's ability to participate in the upside through its call option. Consequently, S is a VIE.

For additional interpretive guidance on the three characteristics discussed above, see [Sections 5.3.1 through 5.3.3](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

#### 5.3.3.3 Nonsubstantive Voting Rights

Although intended to clarify ASC 810-10-15-14(b)(1), ASC 810-10-15-14(c) is generally considered a separate condition in the assessment of a VIE. ASC 810-10-15-14(c)(2) explains that the provision "is necessary to prevent a primary beneficiary from avoiding consolidation of a VIE by organizing the legal entity with nonsubstantive voting interests." Thus, ASC 810-10-15-14(c) is often referred to as the "anti-abuse provision" since it aims to prevent a legal entity from being structured in a manner in which (1) a reporting entity has disproportionately few voting rights and (2) substantially all of the legal entity's activities either involve or are conducted on behalf of the reporting entity (and its related parties except for related parties under ASC 810-10-25-43(d)). A legal entity structured in such a manner would be evaluated under the VIE model. See [Section 5.4](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* for more interpretive guidance on evaluating this criterion.

#### 5.3.3.4 SEC Comment Letter Themes Related to the Determination of Whether a Legal Entity Is a VIE

##### Examples of SEC Comments

- We note from your prior response that you believe you should consolidate [the legal entity] under either the variable interest or voting interest models. Please tell us how you considered ASC 810-10-15-14 in determining whether [the legal entity] has the characteristics of a variable interest entity.
- We note that [you, as the reporting entity,] completed the acquisition of an 80% noncontrolling ownership interest in [the legal entity] and that you are accounting for such acquisition using the equity method of accounting. In order to better understand the Company's accounting for this transaction please further tell us the following:
  - How the Company considered the variable interest guidance in ASC 810-10-15-14 and whether the acquisition resulted in an acquired VIE; and
  - If the acquisition did not result in the acquisition of a VIE, how the Company considered the guidance under ASC 810-10-15-8, ASC 810-10-15-8A and ASC 810-10-15-10a such that it resulted in the Company owning 80% of the [legal entity] but not consolidating the [legal entity].



Recent SEC comments on ASC 810 have focused primarily on the VIE model. The SEC staff often asks registrants to (1) explain their involvement with, and the structure of, VIEs; (2) provide detailed support for their conclusions about whether an entity is a VIE (including the consolidation model they ultimately used); (3) discuss the basis for their determination of whether they are the primary beneficiary of a VIE (see Section 5.3.4 below); and (4) discuss any events affecting their previous consolidation conclusion (e.g., events that result in deconsolidation). If a registrant determines that a legal entity does not fall under the VIE model, the registrant should then perform a consolidation evaluation under the voting interest entity model.

### 5.3.4 Determining the Primary Beneficiary of a VIE

The primary beneficiary of a VIE is the party required to consolidate the VIE (i.e., the party with a controlling financial interest in the VIE). The analysis for identifying the primary beneficiary is consistent for all VIEs. Specifically, ASC 810-10-25-38A requires the reporting entity to perform a qualitative assessment that focuses on whether the reporting entity has both of the following characteristics of a controlling financial interest in a VIE:

- *Power* — The power to direct the activities of the VIE that most significantly affect the VIE's economic performance.
- *Economics* — The obligation to absorb losses or the right to receive benefits of the VIE that could potentially be significant to the VIE.

These two concepts are discussed below. For more detailed information, see [Chapter 7](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*.

#### 5.3.4.1 Power Criterion

Although identification of the primary beneficiary requires an evaluation of both characteristics of a controlling financial interest in a VIE, the determination is often based on which variable interest holder satisfies the power criterion since generally more than one variable interest holder meets the economics criterion.

To determine whether it meets the power criterion, the reporting entity must identify the activities that most significantly affect the VIE's economic performance and then determine which variable interest holder has the power to direct those activities. The reporting entity would take the following steps to identify the party with the power to direct the activities that most significantly affect the VIE's economic performance:

- *Step 1* — Evaluate the purpose and design of the VIE and the risks the VIE was designed to create and pass along to its variable interest holders.
- *Step 2* — Identify the activities related to the risks identified in step 1 that most significantly affect the economic performance of the VIE. In certain situations in which multiple unrelated variable interest holders direct different activities, the reporting entity must determine which activity most significantly affects the VIE's economic performance. The party that has the power to direct such activity will meet the power criterion. When making this determination, the reporting entity should consider the activity that results in the most economic variability for the VIE (e.g., expected losses and expected residual returns).
- *Step 3* — Identify the party that makes the significant decisions or controls the activity or activities that most significantly affect the VIE's economic performance. Consider whether any other parties have involvement in those decisions (shared power or substantive participating rights) or can remove the decision maker (kick-out rights).

While a VIE often performs a variety of activities, the key to determining whether the power criterion has been satisfied is identifying the activities that are most significant to the VIE's economic performance.

### 5.3.4.1.1 Contingencies

In situations involving the conveyance of future power to a variable interest holder only upon the occurrence of a contingent event, questions have arisen about whether such a variable interest holder can be the primary beneficiary of the VIE before the occurrence of that contingent event. When a party can direct activities only upon the occurrence of a contingent event, the determination of which party has power will require an assessment of whether the contingent event results in a **change in power** (i.e., power shifts from one party to another upon the occurrence of a contingent event) over the most significant activities of the VIE (in addition, the contingent event may change what the most significant activities of the VIE are) or whether the contingent event **initiates** the most significant activities of the VIE (i.e., the VIE's most significant activities only occur when the contingent event happens).

See [Section 7.2.9.2](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest* for further discussion of contingencies in the power analysis.

#### Example 5-9

Entity X is formed by two investors (A and B) to develop and manufacture a new drug. Assume that X is a VIE and that each investor holds a variable interest in X. Investor A has power over the R&D activities to develop and obtain FDA approval for the drug (stage 1), and those activities most significantly affect X's economic performance during that stage. Investor B has the power over the manufacturing process, distribution, and marketing of the drug (as well as protecting its patented formula) if and when FDA approval is obtained (stage 2), and those activities would most significantly affect X's economic performance during that stage. In determining which investor has the power to direct the activities that most significantly affect the economic performance of X, each investor should assess whether the contingent event (FDA approval) results in a **change in power** over the most significant activities of X (in addition, the contingent event may change what the most significant activities of X are) or whether the contingent event **initiates** the most significant activities of X.

Entity X was designed in such a way that there are two distinct stages during its life, and the variable interest holders expect that the second stage will begin only upon FDA approval. Also, the activities and decisions before and after FDA approval are significant to the economic performance of X (in this example, they are different activities directed by different parties). In addition, the variable interest holders conclude that there is substantial uncertainty about whether FDA approval will be obtained and that the approval is outside their control. For these reasons, in the absence of evidence to the contrary, FDA approval would be considered a substantive contingent event that results in a **change in power** from A to B. Therefore, the primary-beneficiary determination should focus on stage 1 activities until the contingent event occurs, and A (the investor that has the power over the R&D activities) would initially have the power to direct the most significant activities of X. If FDA approval is obtained, the primary-beneficiary determination would focus on stage 2 activities, and B (the variable interest holder that has the power over the manufacturing process, distribution, and marketing of the drug) would have the power to direct the most significant activities of X.

### 5.3.4.2 Economics Criterion

To satisfy the economics criterion in the analysis of the primary beneficiary of a VIE, the variable interest holder must have the obligation to absorb losses of the VIE, or the right to receive benefits from the VIE, that could potentially be significant to the VIE. Said simply, the variable interest holder must have an exposure to the economics of the VIE that is more than insignificant. As a general guideline, the economics criterion would be met if the losses **or** returns absorbed through the reporting entity's variable interests in the VIE exceed, either individually or in the aggregate, 10 percent of the losses or returns of the VIE under any scenario. However, 10 percent should not be viewed as a bright-line or safe harbor definition of "insignificant." That is, as a result of facts and circumstances, a reporting entity may conclude that the economics condition is met even if the losses or returns absorbed by the reporting entity's interests in the VIE are less than 10 percent. Because more than one variable interest holder typically meets the economics criterion, most of the primary-beneficiary analysis is focused on assessing which variable interest holder or holders have power over the activities that most significantly affect the VIE's economic performance.

### 5.3.4.3 SEC Comment Letter Themes Related to the Primary-Beneficiary Assessment

#### Examples of SEC Comments

- Provide your analysis under ASC 810 supporting your conclusions that (a) [Company A] meets the definition of a variable interest entity and (b) that you are the primary beneficiary.
- Please describe to us the changes in the capital structure of [the legal entity] and in its contractual relationships with [you, as the reporting entity,] that resulted in your conclusion that you are no longer its primary beneficiary and that you should deconsolidate [the legal entity]. Explain to us in appropriate detail how these specific changes support your conclusion that you are no longer the primary beneficiary of the variable interest entity. Refer to the guidance provided in ASC 810-10, including ASC 810-10-35-4.
- Please tell us how you concluded you are the primary beneficiary of [the VIEs] considering your disclosure that the power to direct the activities of the VIEs is shared. In addition, tell us why the general partners of the limited partnerships do not have standalone power given that they only need your consent over certain activities. Please refer to FASB ASC 810-10-25-38D.
- It appears that your conclusion for being the primary beneficiary of the subject entities is based upon your power arising from your capacity as a decision maker ("manager"). Please explain to us, in detail, your consideration of the guidance in ASC 810-10-55-37 to 37D and 55-38.

Given that the SEC staff continues to focus on consolidation conclusions under ASC 810-10, it often asks registrants to discuss the basis for their determination of whether they are the primary beneficiary of a VIE.

### 5.3.4.4 Initial Measurement of Noncontrolling Interests

For a reporting entity that is deemed to be the primary beneficiary of a VIE, ASC 810-10-30 describes how the assets, liabilities, and noncontrolling interests of the VIE should be initially measured, which can differ depending on the relationship between the primary beneficiary and the VIE. For example, the amount of a noncontrolling interest initially recognized depends on whether the acquired controlling financial interest is in a business, an asset acquisition, or a legal entity under common control.

If a reporting entity obtains control of a legal entity that meets the definition of a business, the reporting entity should account for the transaction as a business combination under ASC 805. Under the business combination guidance, the reporting entity is required to initially recognize the assets and liabilities of, and noncontrolling interests in, the acquired business at fair value. For more information, see [Section 5.2.1](#) of Deloitte's Roadmap *Noncontrolling Interests*.

If the reporting entity acquires a controlling financial interest in a VIE that does not meet the definition of a business, the transaction should be treated as an asset acquisition and accounted for under ASC 810-10-30-4, which requires noncontrolling interests to be initially measured at fair value.

For non-VIE asset acquisitions, we believe that if the legal entity is not a VIE, the acquiring entity in an asset acquisition should include the fair value of any noncontrolling interests remaining as of the date of acquisition in determining the cost to allocate to the assets or group of assets acquired by analogy to the guidance on business combinations in ASC 805-30-30-1. Under that guidance, an acquirer in a business combination must add the fair value of any noncontrolling interests remaining as of the date of acquisition to the consideration transferred to determine the amount recognized for the assets acquired and liabilities assumed. If the acquiring entity in an asset acquisition does not include the fair value of any noncontrolling interests remaining as of the date of acquisition, the assets or group of assets acquired may be recognized at an amount lower than their current fair value. Further, if a reporting entity acquires less than 100 percent of the net assets of a non-VIE legal entity, it should recognize a noncontrolling interest in the legal entity at an amount equal to the noncontrolling interest's proportionate share of the relative fair value of any assets and liabilities acquired. For more information, see [Section 5.2.2](#) of Deloitte's Roadmap *Noncontrolling Interests* and [Section C.2.5](#) of Deloitte's Roadmap *Business Combinations*.

When a reporting entity is deemed to be the primary beneficiary of a VIE and the VIE and reporting entity are under common control, the assets, liabilities, and noncontrolling interests of the VIE should generally be recorded initially at their previous carrying amounts (i.e., a carryover basis should be used with no adjustment to current fair values, and no gain or loss should be recognized) in a manner consistent with the accounting under ASC 805-50-30 for transactions between legal entities under common control. For more information, see [Section B.3](#) of Deloitte's Roadmap *Business Combinations*.

#### **5.3.4.5 Subsequent Measurement of Noncontrolling Interests, Including the Allocation of Income or Loss**

As defined in the ASC master glossary, a noncontrolling interest represents the "portion of equity (net assets) in a subsidiary not attributable, directly or indirectly, to a parent." It follows then that the measurement of noncontrolling interests on the reporting entity's balance sheet is affected, in part, by the manner in which a subsidiary's items of income and comprehensive income are attributed to the parent's controlling interest and the noncontrolling interests held by parties other than the parent.

While ASC 810-10 requires a reporting entity to allocate a subsidiary's income or loss and comprehensive income or loss between the controlling and noncontrolling interests, it does not prescribe a specific means for doing so. This lack of detail was acknowledged by the FASB in paragraph B38 of the Background Information and Basis for Conclusions of FASB Statement 160:

[E]ntities were making attributions before [FASB Statement 160] was issued and . . . those attributions generally were reasonable and appropriate. Therefore, the Board decided that detailed guidance was not needed.

Although items of income or loss and comprehensive income or loss are commonly attributed on the basis of the relative ownership interests of the parent and noncontrolling interests, there are many instances in which it would be inappropriate to attribute income or loss solely on the basis of relative ownership percentages. In the life sciences industry, those instances often include when the controlling interest is in the form of preferred stock. For more information, see [Sections 6.2.1 through 6.3](#) of Deloitte's Roadmap *Noncontrolling Interests*.

### 5.3.4.5.1 Attributions Disproportionate to Ownership Interests

#### ASC 970-323

**35-16** Venture agreements may designate different allocations among the investors for any of the following:

- a. Profits and losses
- b. Specified costs and expenses
- c. Distributions of cash from operations
- d. Distributions of cash proceeds from liquidation.

**35-17** Such agreements may also provide for changes in the allocations at specified times or on the occurrence of specified events. Accounting by the investors for their equity in the venture's earnings under such agreements requires careful consideration of substance over form and consideration of underlying values as discussed in paragraph 970-323-35-10. To determine the investor's share of venture net income or loss, such agreements or arrangements shall be analyzed to determine how an increase or decrease in net assets of the venture (determined in conformity with GAAP) will affect cash payments to the investor over the life of the venture and on its liquidation. Specified profit and loss allocation ratios shall not be used to determine an investor's equity in venture earnings if the allocation of cash distributions and liquidating distributions are determined on some other basis. For example, if a venture agreement between two investors purports to allocate all depreciation expense to one investor and to allocate all other revenues and expenses equally, but further provides that irrespective of such allocations, distributions to the investors will be made simultaneously and divided equally between them, there is no substance to the purported allocation of depreciation expense.

Contractual agreements often specify attributions of a subsidiary's profits and losses, costs and expenses, distributions from operations, or distributions upon liquidation that are different from investors' relative ownership percentages.

Although ASC 970-323 was written for equity method investments in the real estate industry, we believe that it is appropriate to refer to this literature for guidance on developing an appropriate method of allocating a subsidiary's economic results between controlling and noncontrolling interests when a contractual agreement, rather than relative ownership percentages, governs the economic attribution of items of income or loss. ASC 970-323 implies that for the attribution of (comprehensive) income or loss to be substantive from a financial reporting perspective, it must hold true and best represent cash distributions over the life of the subsidiary. Reporting entities should focus on substance over form. Further, the reference to the allocation of depreciation expense in the last sentence of ASC 970-323-35-17 is also instructive when guidance in other Codification topics (e.g., the guidance on reporting current-period items of profit or loss related to "partial goodwill" arising from business combinations that occurred before the effective date of ASC 805-10) may result in attribution of specific items of (comprehensive) income or loss on a basis other than the relative ownership percentages of the controlling and noncontrolling interests. For more information, see [Sections 6.2.2 through 6.2.2.1](#) of Deloitte's Roadmap [Noncontrolling Interests](#).

Given the potential impact of contractual arrangements (or financial reporting requirements of other Codification topics) on each party's absorption of items of income or loss, we believe that reporting entities should generally perform the following three steps to allocate a subsidiary's income or loss between the parent and noncontrolling interest holders in a manner that reflects the substance of the arrangements:

- *Step 1* — Identify all contractual arrangements between the parent, noncontrolling interest holders, subsidiary, and third parties (or financial reporting requirements of other Codification topics) that have the potential to shift the allocation of income or loss between the parties on a basis other than their relative equity ownership percentages.

- *Step 2* — Allocate the economic results of the subsidiary between the controlling and noncontrolling interests to reflect the contractual arrangements (or the financial reporting requirements of other Codification topics) identified in step 1.
- *Step 3* — Allocate residual items of income and loss (which may differ from net income because of the adjustments made in step 2) between the controlling and noncontrolling interest holders in accordance with each party's pro rata equity ownership interest in the subsidiary.

Note that the sum of the allocations in steps 2 and 3 should equal the reported income or loss of the subsidiary.

In some instances, reporting entities may use the hypothetical liquidation at book value (HLBV) method to achieve the result intended by steps 1, 2, and 3. For further discussion of the HLBV method, see [Section 6.2.1](#) of Deloitte's Roadmap *Noncontrolling Interests*.



### Connecting the Dots

We believe that the guiding principle for attributing (comprehensive) income or loss to controlling and noncontrolling interests is to ascertain whether attributions that would otherwise be made in the current year are at significant risk of being unwound in subsequent periods on the basis of a different attribution method being used for subsequent cash distributions. In such instances, professional judgment must be used, and consideration should be given to the facts and circumstances at hand. Preparers should consider consulting with professional accounting advisers.

## 5.3.5 Primary Beneficiary's Accounting for IPR&D and Contingent Consideration Recognized Upon Initial Consolidation of a VIE That Is Not a Business

As discussed in [Section 10.1.2](#) of Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*, the primary beneficiary of a VIE that is not a business should initially measure and recognize the assets and liabilities of the VIE in accordance with ASC 805-20-25 and ASC 805-20-30, and no goodwill should be recognized. Because goodwill is not recognized, the primary beneficiary recognizes a gain or loss calculated on the basis of the requirements in ASC 810-10-30-4. As further noted in [Section C.1.2.1](#) of Deloitte's Roadmap *Business Combinations*, the primary beneficiary recognizes the identifiable assets acquired (excluding goodwill), the liabilities assumed, and any noncontrolling interests as though the VIE were a business and subject to the guidance on recognition and measurement in a business combination. As a result, the assets acquired (excluding goodwill), liabilities assumed, and any noncontrolling interests are measured and recognized the same way as they would be in a business combination. IPR&D and contingent consideration therefore would be recognized at fair value upon acquisition, and the applicable recognition and fair value measurement exceptions would be the same as those for a business combination. However, ASC 810 does not provide guidance on the subsequent accounting for IPR&D and contingent consideration, and the absence of such guidance has led to diversity in practice.

For example, a reporting entity may apply the subsequent accounting guidance for intangible assets acquired in a business combination in ASC 350. Alternatively, a reporting entity may conclude that because the VIE is not a business, it should subsequently account for IPR&D under ASC 730. That is, IPR&D with no alternative future use is recognized as an expense on the acquisition date. Similarly, a reporting entity may subsequently measure contingent consideration initially measured at fair value by applying either the guidance on asset acquisitions or the guidance specific to contingent consideration in a business combination.



### 5.3.6 Other Considerations

#### Examples of SEC Comments

- We note you consolidate entities in which you have a variable interest and of which you are the primary beneficiary. Please tell us what consideration you gave to disclosing the information required by ASC 810-10-50-2AA regarding your involvement with variable interest entities, the information required by ASC 810-10-50-3 with respect to variable interest entities you consolidate as the primary beneficiary and the information required by ASC 810-10-50-4 with respect to variable interest entities you do not consolidate because you are not the primary beneficiary.
- Please revise to include all of the disclosures required by ASC 810-10-50 regarding variable interest entities for which you have determined you are the primary beneficiary as well as for those entities for which you are not the primary beneficiary. Include in your disclosures the carrying amounts and classification of the VIE's assets and liabilities in the statement of financial position that are consolidated as well as terms of arrangements that could require you to provide financial support to the VIE, including events or circumstances that could expose the reporting entity to a loss in accordance with ASC 810-10-50-3.

All reporting entities that have a variable interest in a VIE are subject to the disclosure requirements of ASC 810-10. Reporting entities should consider the overall objectives of ASC 810-10-50-2AA and, depending on the circumstances, may need to supplement their disclosures to meet these objectives. Meeting the disclosure requirements can sometimes be challenging because a reporting entity might not be privy to all information about a VIE, especially if the reporting entity is not the primary beneficiary of the VIE but has a variable interest in the VIE and is subject to some of the VIE's disclosure requirements. In light of the nature of variable interests often held by life sciences entities in VIEs, it is important for life sciences entities to keep these disclosure requirements in mind when preparing financial statements.

Because this chapter is intended to highlight only some of the complex consolidation issues frequently encountered by life sciences entities, not all consolidation topics are discussed herein. For a comprehensive discussion of consolidation, see Deloitte's Roadmap *Consolidation — Identifying a Controlling Financial Interest*, which elaborates on the topics covered herein and also addresses additional topics that include, but are not limited to, (1) the assessment of related parties in the identification of variable interests and performance of the primary-beneficiary analyses, (2) consolidation evaluations under the voting interest entity model, and (3) special considerations related to limited partnerships and similar entities.

Further, for additional discussion of R&D funding arrangements that involve legal entities, see [Section 3.2.1](#).

## 5.4 Targeted Improvements to the Related-Party Guidance for VIEs (ASU 2018-17)

In October 2018, the FASB issued [ASU 2018-17](#), which amends two aspects of the related-party guidance in ASC 810. The ASU (1) adds an elective private-company scope exception to the VIE guidance for entities under common control and (2) removes a sentence from ASC 810-10-55-37D regarding the evaluation of fees paid to decision makers to conform that Codification paragraph with the amendments in [ASU 2016-17](#).



### 5.4.1 Private-Company Alternative

ASU 2018-17 broadens the existing accounting alternative available to private companies by allowing all legal entities under common control to elect not to apply the VIE guidance as long as the reporting entity, the common-control parent, and the legal entity being evaluated for consolidation are not PBEs and meet the criteria in ASC 810-10-15-17AD (added by the ASU). ASC 810-10-15-17AD states, in part:

A legal entity need not be evaluated by a private company (reporting entity) under the guidance in the Variable Interest Entities Subsections if all of the following criteria are met:

- a. The reporting entity and the legal entity are under common control.
- b. The reporting entity and the legal entity are not under common control of a public business entity.
- c. The legal entity under common control is not a public business entity.
- d. The reporting entity does not directly or indirectly have a controlling financial interest in the legal entity when considering the General Subsections of this Topic. The Variable Interest Entities Subsections shall not be applied when making this determination.

ASC 810-10-15-17AE (added by the ASU) provides guidance on applying criterion (a) above and establishes that *solely* for the purpose of applying criterion (a), a private-company reporting entity should consider *only* the voting interest entity model when determining whether the reporting entity and the legal entity are under common control. That is, a private-company reporting entity should not consider the VIE guidance when determining whether criterion (a) is met.

### 5.4.2 Evaluation of Fees Paid to a Decision Maker

ASU 2018-17 removes a sentence from ASC 810-10-55-37D to conform the guidance on the consideration of indirect interests held by related parties under common control in the variable interest analysis with the guidance on the consideration of those interests in the primary-beneficiary analysis. Under the amended guidance, such indirect interests should be considered on a proportionate basis rather than considered in their entirety.

## 5.5 On the Horizon — Developments Related to Reorganization of the Consolidation Guidance

In September 2017, the FASB issued a [proposed ASU](#) that would reorganize the consolidation guidance in ASC 810 by creating a new Codification topic, ASC 812, with separate subtopics for the guidance on (1) the VIE model and (2) the voting interest entity model. The proposed ASU states that its goal is to make “navigating and understanding consolidation guidance easier without affecting how consolidation analyses are currently performed.” For additional information, see Deloitte’s October 5, 2017, [Heads Up](#).

On June 27, 2018, the FASB met to discuss comment letter feedback on the proposed ASU and decided to continue its existing project on reorganizing ASC 810. In addition, as stated in the meeting [minutes](#), the Board instructed its staff “to develop nonauthoritative educational material to address the more difficult parts of consolidation guidance with the goal of supporting and supplementing the reorganized authoritative consolidation guidance.” Subsequently, however, as stated in the [minutes](#) of the FASB’s April 20, 2022, meeting, the Board removed this reorganization project from its technical agenda on the basis of feedback received and added a research project to consider whether a single consolidation model can be established for business entities. Stakeholders are encouraged to monitor activity at the FASB for further developments related to the potential reorganization of the consolidation guidance.

# Chapter 6 — Contingencies and Loss Recoveries

## 6.1 Introduction

ASC 450 defines a contingency as an “existing condition, situation, or set of circumstances involving uncertainty . . . that will ultimately be resolved when . . . future events occur or fail to occur.” In the life sciences industry, contingencies often arise as a result of product liability issues; patent litigation cases, such as suits filed against the entity for patent infringement (e.g., generic at-risk launches); and compliance issues related to pricing, promotions, or manufacturing standards. In addition, for biotech and pharmaceutical firms, environmental issues and remediation proceedings have been the subject of considerable public and legislative discussion and initiatives. As a result, accounting standard setters such as the FASB, AICPA, and SEC have emphasized the accounting for and disclosure of environmental liabilities in the financial statements.

In the life sciences industry, a single event could trigger multiple contingencies or other elements, requiring an entity to separately evaluate each element to determine its appropriate recognition, measurement, and classification. For example, a regulatory action may result in the incurrence of incremental costs related to product recalls, leading to a change in product strategy, adjustments to customer sales allowances, or other events. Further, a litigation settlement may contain multiple elements, including cash payments, required future services, rights to IP, and other agreements or concessions between the parties.

The accounting for and disclosures about contingencies under ASC 450 differ depending on whether the contingency could result in a gain or a loss. The ASC master glossary defines a loss contingency as follows:

### ASC Master Glossary

#### Loss Contingency

An existing condition, situation, or set of circumstances involving uncertainty as to possible loss to an entity that will ultimately be resolved when one or more future events occur or fail to occur. The term loss is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses.

Contingent liabilities are liabilities for which the possible loss outcome is unknown or uncertain, such as from pending litigation. The likelihood that a liability has been incurred ranges from “remote” to “reasonably possible” to “probable.” The ASC master glossary’s definitions of these terms provide no quantitative thresholds (see below), and accordingly, entities may need to exercise judgment when applying the terms. [Section 6.2.2.1.1](#) provides additional guidance on the determination of whether an event is “remote,” “reasonably possible,” or “probable.”

**ASC Master Glossary****Probable**

The future event or events are likely to occur.

**Reasonably Possible**

The chance of the future event or events occurring is more than remote but less than likely.

**Remote**

The chance of the future event or events occurring is slight.

A gain contingency also includes characteristics of uncertainty but differs from a loss contingency in that the resolution of the uncertainty could potentially result in a gain. The recognition threshold for a gain contingency is substantially higher than that of a loss contingency. The ASC master glossary defines a gain contingency as follows:

**ASC Master Glossary****Gain Contingency**

An existing condition, situation, or set of circumstances involving uncertainty as to possible gain to an entity that will ultimately be resolved when one or more future events occur or fail to occur.

Because the accounting for a contingency involves the evaluation of the likelihood of occurrence or nonoccurrence of a future event that may confirm a previous loss, impairment of an asset, or incurrence of a liability, contingencies may be at risk of being overlooked for recognition or disclosure purposes. It is important to disclose certain contingencies, even those that are not recognized, so that financial statement users can understand an entity's risks and how they could potentially affect the financial statements.

The remainder of this chapter highlights accounting and disclosure issues commonly encountered by life sciences entities that are associated with contingencies. For more information as well as insights into topics not addressed below, see Deloitte's Roadmaps [Contingencies, Loss Recoveries, and Guarantees](#) and [SEC Comment Letter Considerations, Including Industry Insights](#).

## 6.2 Loss Contingencies

Accrual of a loss contingency is required when (1) it is probable that a loss has been incurred and (2) the amount can be reasonably estimated. An entity must determine the probability of the uncertain event and demonstrate its ability to reasonably estimate the loss from that event to accrue a loss contingency. Loss contingencies that do not meet both of these criteria for recognition may need to be disclosed in the financial statements.

Typically, under the accounting literature, an entity uses either a probability-based model or a fair value model when dealing with uncertainty related to losses. The probability-based recognition guidance in ASC 450-20 differs from that in other Codification topics under which an entity measures liabilities in accordance with a fair value objective. To measure a liability at fair value, an entity must consider events whose occurrence is less than probable. Therefore, a fair value measurement will result in the recognition of a liability for a conditional obligation for which the likelihood of future settlement, although more than zero, is less than probable; a liability would not be recognized in this situation under the guidance in ASC 450-20 that applies to loss contingencies.

## 6.2.1 Scope

All loss contingencies should be evaluated under ASC 450-20 unless they are within the scope of other authoritative literature that specifically prescribes an alternate accounting model. The table below contains a nonexhaustive list of examples of contingencies or uncertainties that are within the scope of other authoritative literature.

ASC 270	"[C]ontingencies and other uncertainties that could be expected to affect the fairness of presentation of financial data at an interim date." (ASC 450-10-60-1)
ASC 275	"[D]isclosure of certain risks and uncertainties that stem from the nature of an entity's operations and from significant concentrations in certain aspects of an entity's operations, many of which are noninsured or underinsured risks." (ASC 450-20-60-1)
ASC 326	<ul style="list-style-type: none"> <li>• Collectibility of receivables or a loan portfolio.</li> <li>• Measurement of credit losses.</li> </ul>
ASC 330-10	<ul style="list-style-type: none"> <li>• "[I]nventories that are impaired by damage, deterioration, obsolescence, changes in price levels, or other causes." (ASC 450-20-60-4)</li> <li>• "[L]osses that are expected to arise from firm, uncancelable, and unhedged commitments for the future purchase of inventory." (ASC 450-20-60-5)</li> </ul>
ASC 340-30	Contingencies related to "insurance and reinsurance contracts that do not transfer insurance risk." (ASC 450-10-60-2)
ASC 405-30	"[A]ssessments by state guaranty funds and workers' compensation second-injury funds and other assessments related to insurance activities, including insurance activities of an entity that self-insures." (ASC 450-20-60-6)
ASC 410-20	"[C]ontingencies associated with the retirement of a tangible long-lived asset" resulting "from the acquisition, construction, or development and/or the normal operation of a long-lived asset." (ASC 450-20-60-7)
ASC 410-30	Environmental remediation liabilities that are otherwise not within the scope of ASC 410-20.
ASC 460-10	"[C]ontingencies related to [p]roduct warranties and product defects," "guarantees of indebtedness of others," and "obligations of commercial banks under financial standby letters of credit." (ASC 450-20-60-9 through 60-11)
ASC 470-60	"[C]ontingent payments of a troubled debt restructuring." (ASC 450-20-60-12)
ASC 606	For contracts with customers, estimating and constraining variable consideration (e.g., a sale with a right of return) included in the transaction price.

(Table continued)

ASC 610-20	For contracts with counterparties that are not customers, estimating and constraining variable consideration included in the transaction price.
ASC 610-30	When the amount of monetary assets to be received is uncertain in an involuntary conversion (destruction or damage of a nonmonetary asset).
ASC 710, 712, 715, and 718	Contingencies and uncertainties related to stock issued to employees, employment-related costs, including deferred compensation contracts and withdrawal from multiemployer plans. However, certain postemployment benefits are within the scope of ASC 450.
ASC 720-20	<ul style="list-style-type: none"> <li>• “[C]ontingencies associated with a multiple-year retrospectively rated insurance contract accounted for as insurance.” (ASC 450-10-60-5)</li> <li>• “[C]ontingencies related to an insurance contract or reinsurance contract that does not, despite its form, provide for indemnification of the insured or the ceding company by the insurer or reinsurer against loss or liability.” (ASC 450-20-60-14)</li> </ul>
ASC 740-10	Income tax uncertainty.
ASC 805-20	<ul style="list-style-type: none"> <li>• “[C]ontingent obligations for contractual termination benefits and curtailment losses under employee benefit plans that will be triggered by the consummation of the business combination.” (ASC 450-10-60-7)</li> <li>• Contingencies recorded at fair value, if determinable.</li> </ul>
ASC 840	<ul style="list-style-type: none"> <li>• “[C]ontingent rent.” (ASC 450-20-60-15)</li> <li>• “[C]lassification effects of a provision in a lease that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property.” (ASC 450-20-60-16)</li> </ul>
ASC 842	<ul style="list-style-type: none"> <li>• “[V]ariable lease payments.” (ASC 450-20-60-15)</li> <li>• “[C]lassification effects of a provision in a lease that requires lessee indemnifications for environmental contamination caused by the lessee during its use of the property.” (ASC 450-20-60-16)</li> </ul>
ASC 860-10	“[C]ontingencies related to agreements to repurchase receivables (or to repurchase the related property) that have been sold or otherwise assigned.” (ASC 450-20-60-17)
ASC 930-715	“Contingencies resulting from the Coal Industry Retiree Health Benefit Act of 1992.” (ASC 450-20-60-18)
ASC 944-20 and ASC 944-40	<ul style="list-style-type: none"> <li>• “[C]ontingencies associated with multiple-year retrospectively rated contracts.” (ASC 450-10-60-11)</li> <li>• “[C]ontingencies related to the risk of loss that is assumed by a property and casualty insurance entity or reinsurance entity when it issues an insurance policy covering risk of loss from catastrophes.” (ASC 450-20-60-19)</li> </ul>
ASC 954-450	“[C]ontingencies related to malpractice claims.” (ASC 450-20-60-21)

### 6.2.1.1 Differentiating Between Contingent Liabilities and Contractual or Legal Liabilities

Contingent liabilities involve uncertainty about whether a loss has been incurred and differ from contractual liabilities. Therefore, an entity must distinguish between a contingent liability, which is within the scope of ASC 450-20, and a contractual or legal liability, which is not. Contingent liabilities comprise only liabilities in which an entity's obligation to pay another entity is uncertain. Contractual or legal liabilities are debts or obligations between two or more parties that are typically settled by the transfer of cash, assets, or services; for these liabilities, there is generally little to no uncertainty about the likelihood of occurrence of the future settlement. A liability is not an unasserted claim or assessment under ASC 450-20 if the settlement of the liability is required by law or by contract.

Liabilities established by law or by contract are recorded at the stated amounts due unless otherwise indicated in U.S. GAAP.<sup>1</sup> The probability of payment is not relevant to the accounting for such liabilities. If an entity is required by law, regulation, or contract to make a future payment associated with an event that has already occurred, that event imposes a present duty upon the entity. An entity's uncertainty about whether an obligee will require performance does not allow the entity to choose to avoid the future sacrifice, nor does the uncertainty relieve the entity of the obligation. That is, when the obligating event has occurred, the entity has incurred a liability; accordingly, there is no contingency. For example, an entity must recognize accounts payable on the basis of the amount that it is contractually required to pay. The entity may not recognize accounts payable on the basis of the amount that it would expect to ultimately pay if the creditor filed suit to collect the liability. This conclusion is supported by analogy to ASC 410-20-25-15, which states that an "unambiguous requirement that gives rise to an asset retirement obligation coupled with a low likelihood of required performance still requires recognition of a liability." Once recognized, a contractual or legal liability that is not deferred revenue (i.e., a contract liability under ASC 606) should be derecognized only when the conditions for liability derecognition in ASC 405-20-40-1 have been met.

#### ASC 405-20

**40-1** Unless addressed by other guidance (for example, paragraphs 405-20-40-3 through 40-4 or paragraphs 606-10-55-46 through 55-49), a debtor shall derecognize a liability if and only if it has been extinguished. A liability has been extinguished if either of the following conditions is met:

- a. The debtor pays the creditor and is relieved of its obligation for the liability. Paying the creditor includes the following:
  1. Delivery of cash
  2. Delivery of other financial assets
  3. Delivery of goods or services
  4. Reacquisition by the debtor of its outstanding debt securities whether the securities are cancelled or held as so-called treasury bonds.
- b. The debtor is legally released from being the primary obligor under the liability, either judicially or by the creditor. For purposes of applying this Subtopic, a sale and related assumption effectively accomplish a legal release if nonrecourse debt (such as certain mortgage loans) is assumed by a third party in conjunction with the sale of an asset that serves as sole collateral for that debt.

<sup>1</sup> For example, the issue of how an entity should account for uncertain tax positions and breakage when a customer is not expected to exercise all of its contractual rights to goods or services in a revenue contract is specifically addressed in U.S. GAAP. [Chapter 4](#) of Deloitte's Roadmap *Income Taxes* addresses uncertain tax positions. [Section 8.8](#) of Deloitte's Roadmap *Revenue Recognition* addresses breakage associated with certain revenue contracts.

A contractual or legal liability is subject to the above liability derecognition guidance regardless of whether an entity believes that on the basis of a probability assessment, such a liability can be settled for less than the stated legal obligation.

The examples below illustrate the accounting for a liability for which payment is required by law or contract but detection and settlement are uncertain.

### Example 6-1

#### **Probability Assessment Related to Sales Tax Liability for Which Payment Is Required by Law, but Detection and Settlement Are Uncertain**

Entity Z has sold goods in Jurisdiction Y for 15 years and continues to sell them. By law, those sales would be subject to sales tax in Y if Z had nexus there. To assess whether Z has sales tax nexus in Y and should record a sales tax liability, Z diligently reviews prior-period sales records and interviews sales managers. Through this analysis, Z determines and documents that sales tax nexus in Y has existed for the past 15 years. Therefore, Z's products have always been taxable and subject to sales tax collection; however, Z has never collected sales tax or filed sales tax returns in Y. Entity Z has never been audited or contacted regarding a sales tax audit by tax authorities in Y. Entity Z believes that the risk of detection by the tax authorities in Y is low. However, Z believes that if the tax authorities in Y were presented with all of the facts about Z's activities, it is probable that Y would assert that Z is liable for uncollected sales taxes and demand payment. Entity Z believes that Y would settle for an amount less than the full liability.

Entity Z should record a sales tax liability on the basis of its sales activities for the full amount that it is legally obligated to remit to the tax authorities in Y. The sale of goods triggers the obligation to make the related sales tax payments. In measuring its sales tax liability, Z may not consider that the risk of detection by the tax authorities in Y is low. Further, Z must assume that the tax authorities in Y have all of the relevant facts about Z's operations in Y. Interest and penalties should also be included in the estimate of the liability if the imposition of interest and penalties is required by law.

Note that some state tax authorities may have a widely understood administrative practice and precedent in which, in the event of an examination and in the absence of a voluntary disclosure agreement, the tax authority would look back no more than a certain number of years to determine the amount of sales tax deficiency due. Alternatively, a statute of limitations may exist. Thus, Z should evaluate whether the tax authorities in Y will assess Z back to the first year of taxable sales (i.e., the full 15 years) or whether the liability will be limited by a statute of limitations or Y's administrative policies. In performing this evaluation, Z must use judgment to determine what constitutes "widely understood." If Z asserts that an administrative practice and precedent is widely understood, Z should document the basis of that assertion as well as any evidence to support it. Such evidence may include reliable knowledge of the tax authority's past dealings with Z on the same tax matter when the facts and circumstances were similar. An assessment of what Z believes it could negotiate as a settlement with the tax authority would generally not represent a "widely understood" administrative practice and precedent.

Similarly, Z should also adjust its liability to the extent that its customers have paid use tax on any portion of Z's sales during any part of the look-back period. However, because the obligating event is the sale of goods, Z should not record a sales tax liability for future sales until those sales actually occur.

Entity Z should regularly assess its sales tax obligations in the jurisdictions in which it conducts business. If Z has any uncertainty about those obligations, Z might need to obtain legal opinions. Sales tax liabilities should be adjusted upward as sales are made and should be adjusted downward only when the liability is paid or otherwise extinguished. (Note that sales taxes are not within the scope of ASC 740.)



### Example 6-2

#### Royalty Liability for Which Payment Is Required by Contract, but Detection and Settlement Are Uncertain

Company Y manufactures medical equipment and has a contractual obligation to pay, on the basis of sales volume, royalties to various patent holders. The amount of royalties paid each period is calculated by Y. In accordance with this obligation, patent holders have the right to audit Y's sales volume, but they have rarely exercised this right.

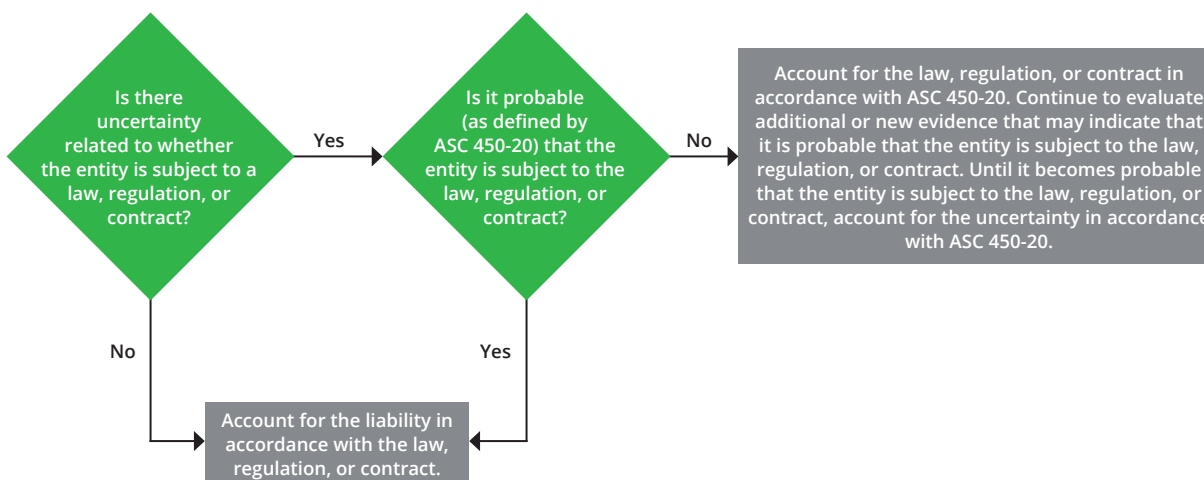
Company Y should record a royalty liability for the full amount that it is contractually obligated to pay according to the royalty agreements. The contracts require Y to make royalty payments on the basis of sales volume. Therefore, Y is under an obligation to the patent holders as the equipment is sold (i.e., Y has a present duty to the patent holders). The liability should be adjusted upward as sales are made and should be adjusted downward only when the liability is paid or otherwise extinguished in accordance with ASC 405-20-40-1.

In a scenario in which a patent holder cannot be located, Y should consider whether liability derecognition has occurred once the escheat laws of the relevant jurisdiction are complied with and the obligation no longer exists. Company Y's uncertainty about whether a patent holder will audit the sales volume does not allow it to avoid future payment. Finally, Y should not record a royalty liability for future sales until those sales actually occur.



#### Connecting the Dots

There may be uncertainty about whether an entity is subject to or within the scope of a current law, regulation, or contract owing to ambiguity about the interpretation of the current law, regulation, or contract. Examples include uncertainties related to a tax based on gross receipts, revenue, or capital. In these circumstances, an entity should evaluate the uncertainty in accordance with the flowchart below.



#### 6.2.1.2 Elements of a Litigation Settlement

There may be litigation settlements in which the settlement agreement includes past obligations and disputes and modifies the ongoing contractual terms of the business relationship. When accounting for a litigation settlement that also includes a separate element (such as a revenue element) and bifurcating the elements, an entity should consider a [speech](#) made by Eric West, associate chief accountant in the SEC's Office of the Chief Accountant, at the 2007 AICPA Conference on Current SEC and PCAOB

Developments. We consider the interpretive guidance shared by Mr. West to be relevant and useful to private companies in addition to SEC registrants. Mr. West summarized a settlement arrangement as follows:

[A] company pays cash and conveys licenses to a plaintiff in order to settle a patent infringement and misappropriation of trade secrets claim. In exchange for the payment and licenses given, the company receives a promise to drop the patent infringement lawsuit, a covenant not to sue with respect to the misappropriation of trade secrets claim, and a license to use the patents subject to the litigation.

Mr. West noted that the different elements of the arrangement should be identified and that an entity will need to understand the nature of each item to make this identification. In addition to the litigation settlement component, there could be recognizable intangible assets related to the covenant not to sue and for patent licenses received. Regarding the license to patents given to the plaintiff, Mr. West noted:

If the licenses are expected to be used by the plaintiff in their operations, it may be appropriate for the company to recognize revenue or income with a corresponding increase in litigation settlement expense. However, if the licenses are given as part of a litigation defense strategy and don't have value to the plaintiff, it seems unlikely that any revenue should be recognized.

With respect to the amount of consideration to allocate to each element of the transaction, Mr. West noted the following:

While EITF 00-21 was written for multiple element revenue arrangements, we believe that its allocation guidance is also useful to determine how to allocate consideration paid in a multiple element legal settlement. In this regard, we believe that it would be acceptable to value each element of the arrangement and allocate the consideration paid to each element using relative fair values. [Footnote omitted]

Even though Mr. West was speaking about the separation guidance in EITF Issue 00-21, which was codified in ASC 605-25 and has been superseded by ASC 606, it is still appropriate for an entity to consider the principles of separation of performance obligations within the context of the revenue guidance in ASC 606. Specifically, as shown below, ASC 606 includes guidance on how to allocate consideration to different elements of a contract with a customer that are partially within the scope of ASC 606 and partially within the scope of another topic.

#### ASC 606-10

**15-4** A contract with a customer may be partially within the scope of this Topic and partially within the scope of other Topics listed in paragraph 606-10-15-2.

- a. If the other Topics specify how to separate and/or initially measure one or more parts of the contract, then an entity shall first apply the separation and/or measurement guidance in those Topics. An entity shall exclude from the transaction price the amount of the part (or parts) of the contract that are initially measured in accordance with other Topics and shall apply paragraphs 606-10-32-28 through 32-41 to allocate the amount of the transaction price that remains (if any) to each performance obligation within the scope of this Topic and to any other parts of the contract identified by paragraph 606-10-15-4(b).
- b. If the other Topics do not specify how to separate and/or initially measure one or more parts of the contract, then the entity shall apply the guidance in this Topic to separate and/or initially measure the part (or parts) of the contract.



### Connecting the Dots

In an agreement that contains a settlement of a litigation component and a revenue contract with a customer, an entity should bifurcate the revenue element and the nonrevenue element (i.e., litigation) and allocate the consideration to both elements in a manner consistent with Mr. West's remarks and ASC 606. There may be situations in which the entity has clear, compelling evidence that there is little to no value related to the litigation settlement; in those situations, the entire arrangement should be accounted for as a single element under ASC 606. When the entity determines that the entire arrangement should be accounted for as a single element under ASC 606, allocating consideration for the entire arrangement to the revenue element may be appropriate; however, the entity should not apply the residual method and allocate all of the proceeds to the revenue element by default.

The discussion above applies to both gain and loss contingencies that are settled by entering into a revenue contract with a customer. See [Chapter 3](#) of Deloitte's Roadmap *Revenue Recognition* for further discussion of contracts that include both revenue and nonrevenue elements. [Chapter 7](#) of that Roadmap addresses estimating stand-alone selling prices, including application of the residual method.

Further, the same allocation principle applies when the settlement does not contain a revenue element and is therefore entirely outside the scope of ASC 606 (i.e., the settlement is not with a customer, and none of the components constitute an output of the entity's ordinary activities). In those circumstances, an entity should still consider the allocation principle described in Mr. West's remarks and ASC 606 by analogy.

#### 6.2.1.3 *Income Statement Classification for Settlements With Customers and Vendors*

When determining the appropriate income statement classification of a litigation settlement when the settlement counterparty is a customer, the entity should first look to the guidance on consideration payable to a customer in ASC 606-10-32-25 through 32-27 to determine whether the consideration is for a distinct good or service for which the entity can reasonably estimate fair value and, if so, classify such settlement payments in accordance with applicable U.S. GAAP. For example, a litigation element may be accounted for in accordance with ASC 450, or inventory purchases may be accounted for in accordance with ASC 330.

In a situation in which the settlement counterparty is a customer and the entity is able to determine the distinct litigation settlement benefit and can reasonably estimate the fair value of the litigation settlement benefit, the entity may recognize some or all of the settlement amount as an expense. To determine the appropriate amount to recognize as an expense, entities should consider the factors that Mr. West discussed in his [speech](#) at the 2007 AICPA Conference on Current SEC and PCAOB Developments. Mr. West summarized the classification of a settlement arrangement as follows:

##### **Classification of the Settlement**

In the fact pattern that I've talked about so far it would be appropriate to record the consideration allocated to the litigation within operating expenses since the company did not have a prior relationship with the plaintiff. However, we believe that a different answer may result if the plaintiff is also a customer of the defendant.

**Assume a company settles a claim for over billing its customers for an amount that is in excess of the amounts they over billed. The company believed that the excess payment was necessary to preserve the customer relationship and had induced the customer to settle the claim. In this case we do not believe that classification of the entire payment as a settlement expense would be consistent with existing GAAP. Since the settlement payment was made to the company's customers, we believe that the payment is within the scope of EITF 01-9. [Footnote omitted] As you may know, this EITF addresses the accounting for consideration given by a vendor to a customer.**

**The scope is broadly written and includes all consideration given by a vendor to a customer. It also requires that cash consideration paid be classified as a reduction of revenues unless the vendor receives an identifiable benefit and the fair value of that benefit can be reliably measured.** In this fact pattern, we believe that the excess amount paid to the customer represents both a payment to retain the customer and settle the litigation. However, if the company is unable to determine the fair value of each of these components, we believe that EITF 01-9 requires the entire payment to be classified as a reduction of revenues. **Had the company been able to directly value the litigation, classification of that portion of the settlement payment as an expense may have been appropriate.** [Emphasis added]

Even though Mr. West was speaking about the guidance in EITF Issue 01-9 on consideration payable to a customer, which was codified in ASC 605-25 and has been superseded by ASC 606, it is still appropriate for an entity to consider the principles outlined in the speech since the principle underlying the guidance in ASC 605-25 remains relatively consistent under ASC 606. Mr. West acknowledged that classification of a litigation component as an expense is appropriate in certain circumstances, specifically when (1) a prior customer/vendor relationship with the plaintiff does not exist or (2) a prior customer/vendor relationship does exist and the vendor receives an identifiable benefit for which the fair value of that benefit can be reliably measured.

Further, in evaluating the income statement classification of a litigation settlement in situations in which the counterparty is a vendor or customer, the entity should consider whether the settlement amount was based on an agreed-upon formula (e.g., whether it was based on total product sales to a customer or supplies purchased from a vendor) in such a way that there is a direct and observable correlation between the settlement amount and the previous revenue or purchase transaction. Such a correlation may be an indication that the settlement amount should be recognized as an adjustment to the transaction price received from a customer or to the cost of goods or services purchased from a vendor.

If settlement consideration payable to a customer is in exchange for a distinct good or service but the fair value cannot be reasonably estimated, the settlement consideration should be recognized entirely as a reduction in transaction price. For example, in a litigation settlement with a customer, an entity may determine that an element of the consideration pertains to settling the litigation and therefore is representative of a distinct benefit. The entity may have historical experience in settling similar cases and therefore may be able to readily determine the distinct litigation settlement benefit; however, unless the entity can reasonably estimate the fair value of the litigation settlement element, the entire settlement amount should be accounted for as a reduction in transaction price. For additional information regarding consideration payable to a customer, see [Chapter 6](#) of Deloitte's Roadmap *Revenue Recognition*.



### Connecting the Dots

In certain circumstances, life sciences entities may need to exercise significant judgment in determining whether a litigation settlement involves a customer. For example, when the plaintiff is a governmental entity and the life sciences entity participates in governmental programs (e.g., Medicare or Medicaid), the life sciences entity (1) should consider whether the payment made to the governmental entity represents a payment made to a customer and (2) is encouraged to document its judgments related to income statement classification of the settlement contemporaneously.

Similarly, regarding classification of the settlement when payments are received from a vendor, entities should consider ASC 705-20, as discussed in [Chapter 6](#) of Deloitte's Roadmap *Revenue Recognition*, as well as the gain contingency recognition guidance, addressed below and in [Chapter 3](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

## 6.2.2 Recognition

### ASC 450-20

**25-1** When a loss contingency exists, the likelihood that the future event or events will confirm the loss or impairment of an asset or the incurrence of a liability can range from probable to remote. As indicated in the definition of contingency, the term *loss* is used for convenience to include many charges against income that are commonly referred to as expenses and others that are commonly referred to as losses. The Contingencies Topic uses the terms *probable*, *reasonably possible*, and *remote* to identify three areas within that range.

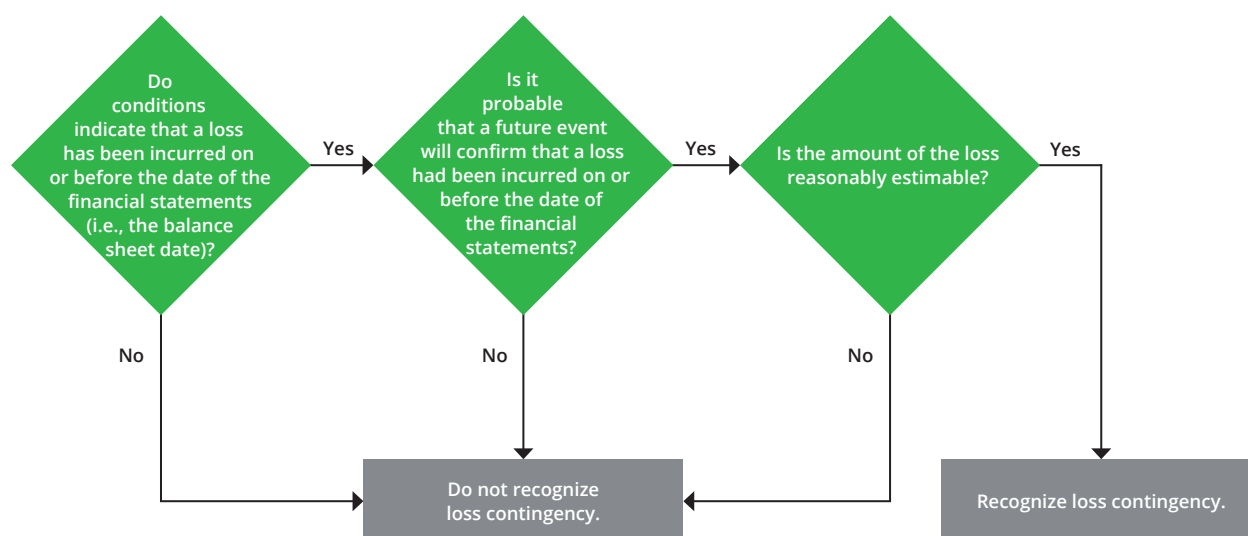
**25-2** An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

- a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of the conditions. As discussed in paragraph 450-20-50-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

When an entity obtains information before the financial statements are issued or available to be issued indicating that it is probable that a future event will confirm a financial statement loss that occurred on or before the date of the financial statements, the entity should accrue such a loss contingency provided that the loss can be reasonably estimated.

The flowchart below provides an overview of the contingent liability recognition criteria, taking into consideration all information about the loss that becomes available before the financial statements are issued (or are available to be issued).



A contingent liability is not recognized when either (1) it is not probable that a future event will confirm that a loss had been incurred on or before the date of the financial statements or (2) the amount of the loss is not reasonably estimable. The entity should carefully evaluate whether appropriate disclosure is necessary to keep the financial statements from being misleading. See additional disclosure requirements in [Section 6.2.5](#) of this Guide and [Chapter 2](#) of Deloitte’s Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

### 6.2.2.1 Assessing the Probability of Whether a Loss Has Been Incurred

#### 6.2.2.1.1 “Probable,” “Reasonably Possible,” and “Remote”

For an entity to recognize a loss contingency under ASC 450-20, it must be probable that one or more future events will occur or fail to occur, thereby confirming a loss. In the ASC 450-20 glossary, loss contingencies are categorized on the basis of the likelihood of occurrence as follows:

ASC 450-20 — Glossary	
<b>Probable</b>	The future event or events are likely to occur.
<b>Reasonably Possible</b>	The chance of the future event or events occurring is more than remote but less than likely.
<b>Remote</b>	The chance of the future event or events occurring is slight.

Although ASC 450-20 defines each of these terms, it provides no quantitative thresholds. The word “probable” is not intended to mean that virtual certainty is required before a loss is accrued. However, “likely to occur” is a higher threshold than “more likely than not,” which is generally considered to be a minimum of a 50.1 percent chance of occurrence.

While no codified guidance defines the quantitative thresholds, an entity that is evaluating these thresholds may find it useful to consider interpretive guidance from paragraph 160 of AICPA Statement of Position 96-1, which states, in part:

If the FASB Statement No. 5 criteria of remote, reasonably possible, and probable were mapped onto a range of likelihood of the existence of a loss spanning from zero to 100 percent, the reasonably possible portion would span a significant breadth of the range starting from remote and ending with probable.

“Probable” is discussed in paragraph 49 of the Background Information and Basis for Conclusions of FASB Statement 114, which states, in part:

“[P]robable’ . . . has, in the case of banks, come to mean ‘virtually certain,’ rather than ‘more likely than not,’ and “the ‘probable’ requirement as it is sometimes applied has unduly delayed loss recognition . . . of problem assets.” The Board did not intend “probable” to mean “virtually certain to occur.” The Statement 5 definition of probable states that “the future event or events are *likely to occur*” (emphasis added). The Board recognizes that application of the term probable in practice requires judgment, and to clarify its intent the Board has reiterated the guidance in paragraph 84 of Statement 5 in paragraph 10 of this Statement. The term probable is used in this Statement consistent with its use in Statement 5. This Statement does not specify how a creditor should determine that it is probable that it will be unable to collect all amounts due according to a loan’s contractual terms.

In addition, the SEC's November 16, 2011, [staff paper](#) comparing U.S. GAAP with IFRS Accounting Standards states the following regarding the quantitative threshold used to recognize environmental obligations:

Both IFRS and U.S. GAAP contain a "probable" threshold for the recognition of an environmental liability. Probable within IFRS is defined as more likely than not (i.e., more than 50%), whereas probable is not as clearly defined under U.S. GAAP (but is interpreted in this context to be a percentage somewhat greater than 50%).

[ASU 2014-15](#) discusses "probable" in the context of determining what constitutes substantial doubt about an entity's ability to continue as a going concern. In ASU 2014-15, the FASB observes that "probable" in the ASC master glossary's definition of "substantial doubt about an entity's ability to continue as a going concern" carries the same meaning that it does in ASC 450's definition of the word. The ASU's general discussion of a Board member's dissenting view indicates, in part:

As mentioned in paragraph BC17, a commonly cited academic paper (Boritz, 1991) noted that the threshold for the substantial doubt likelihood of an entity being unable to meet its obligations is between 50 and 70 percent. The guidance in this Update increases that threshold to probable, which many assert as being in the 70–75 percent range.

While there is diversity in practice related to the likelihood percentage that entities consider "probable" to represent, in a manner consistent with the discussion in ASU 2014-15, the threshold for "probable" would need to be at least 70 percent. Although "remote" is not discussed quantitatively in any guidance issued by the FASB, in practice, this term is used to indicate a likelihood of 10 percent or less.

A loss contingency is recognized only when the likelihood of a future event's occurrence indicates that it is probable that a loss has occurred (provided that the loss contingency is also reasonably estimable). If the likelihood of a future event's occurrence is only reasonably possible, entities should provide appropriate disclosures in accordance with ASC 450-20-50, although loss accrual is not appropriate. For events for which the likelihood that a loss has been incurred is remote, recognition is not appropriate and disclosure is not required under ASC 450-20; however, entities should use judgment in determining whether omitting disclosures would cause the financial statements to be misleading. For additional discussion of disclosure considerations, see [Section 6.2.5](#) of this Guide and [Chapter 2](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

Entities may need to consider various factors and apply considerable judgment in determining the likelihood of occurrence of a future event or the nonoccurrence of a future event that will confirm whether a loss has been incurred on the date of the financial statements. Specifically, in the case of class action lawsuits or litigation, entities may need to consider (among other things) the opinion of in-house or external legal counsel, the entity's history and experience with similar cases, prior case law, how the entity intends to respond, and the nature of the settlement mechanism.

Certain contingencies are not considered probable until the underlying future events occur because of various external factors associated with the determination of the probability threshold. Examples of such underlying future events include casualty events, the enactment of proposed legislation, the successful completion of an initial public offering (IPO), and the occurrence of a business combination. For further discussion on these topics, see [Chapter 2](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

#### 6.2.2.1.2 Occurrence of a Business Combination or Successful Completion of an IPO

Certain liabilities are contingent on the occurrence of a business combination or the successful completion of an IPO. For example, an amount may be payable upon completion of an IPO, or a restructuring plan may be adopted upon consummation of a business combination.



There are many external factors and uncertainties that can affect the successful completion of an IPO. These external factors and uncertainties make it difficult to determine whether the probability threshold has been met before the effective date of an IPO. Therefore, the incurrence of a liability contingent on an IPO cannot be considered probable until the IPO is effective.

In a manner similar to the successful completion of an IPO, the consummation of a business combination is contingent on numerous circumstances, including the completion of due diligence and the obtaining of any necessary shareholder or regulatory approval. In addition, a business combination is an event for which discrete accounting is required when the combination is consummated. Accordingly, one of the events that obligates the entity and therefore gives rise to the liability has not occurred until the combination has occurred. Because of the uncertainties involved in, and the discrete nature of, business combinations, a liability should not be accrued until the business combination is consummated. This position is consistent with the guidance in ASC 420 and ASC 805-20-55-50 and 55-51, which indicate that the liability for termination benefits and curtailment losses that will be triggered by the consummation of a business combination should be recognized upon completion of the business combination, not when the business combination becomes probable.

This position does not affect or apply to freestanding derivative contracts or embedded derivative features that are within the scope of ASC 815 (e.g., a put option contingent on an IPO or a conversion feature contingent on a target stock price).

### 6.2.2.1.3 Assessing Whether a Loss Is Reasonably Estimable

When accruing a loss, an entity must determine, in accordance with the recognition criteria in ASC 450-20-25-2, whether the loss is probable and reasonably estimable. Recognition of a loss that cannot be reasonably estimated, even if it is probable that the loss has been incurred, would impair the integrity of the financial statements. Alternatively, the entity should not delay accrual of a loss because of the inability to estimate a single amount. The ability to estimate a loss within a range would indicate that some amount of a loss has occurred and that the entity should therefore accrue a liability in accordance with ASC 450-20-25-2(b). The entity may use past experience or other information to demonstrate its ability to reasonably estimate the loss.

If both recognition criteria under ASC 450-20-25-2 are met, the estimated loss will be charged to income. ASC 450-20-25-7 indicates that if a loss cannot be accrued in the period in which it is determined that it is probable that a loss has been incurred “because the amount of loss cannot be reasonably estimated, the loss shall be charged to the income of the period in which the loss can be reasonably estimated and shall not be charged retroactively to an earlier period. All estimated losses for loss contingencies shall be charged to income rather than charging some to income and others to retained earnings as prior period adjustments.”

## 6.2.2.2 Other Recognition Considerations

### 6.2.2.2.1 Litigation, Claims, and Assessments

A common uncertainty that many life sciences entities will encounter is the risk of litigation. Class actions, product liabilities, lawsuits, and actions brought by government agencies are not uncommon, and an entity may need to accrue or disclose contingencies related to the risk of such litigation (e.g., the potential future obligation to pay an uncertain amount as a result of past activities) in the financial statements.

Adverse consequences of litigation could include the obligation to pay damages, the imposition of fines and penalties, the need to repay consideration from a revenue contract that was previously received, and even discontinuation of certain operations. Further, the entire nature of the entity may change as a result of the litigation (e.g., the entity may seek protection from the litigation through bankruptcy).

Types of litigation that an entity may face include the following:

- Antitrust.
- Restraint of trade.
- Breach of contract.
- Patent infringement.
- Product liability.
- Violation of federal securities laws.
- Government actions.
- Discrimination.
- Environmental protection matters.
- Violation of wage and price guidelines or controls.
- Renegotiation of government contracts.
- Income tax disputes.
- Violation of other laws and regulations (e.g., the Foreign Corrupt Practices Act).

In determining whether an accrual is required in connection with litigation, claims, and assessments, an entity should consider various factors that include, but are not limited to, the following:

- *The nature of the settlement mechanism* — The parties involved may have agreed to use a settlement mechanism other than the court system that is binding on the parties. Accordingly, it is necessary to evaluate, on the basis of the specific facts and circumstances, the ability of the party that is subject to an adverse legal judgment to appeal the matter.
- *The progress of the case* — If the planned appeal is not the entity's first appeal of an adverse judgment (i.e., the entity has been unsuccessful in prior appeals of the judgment), the entity should consider the results, findings, or both of the earlier rulings when assessing its evidence for and against liability recognition.
- *The opinions or views of legal counsel and other advisers:*
  - A legal analysis usually will include counsel's opinion regarding the likelihood that the entity will prevail on appeal. For example, a legal opinion may state counsel's belief that the entity's chance for a successful appeal is probable, more likely than not, or reasonably possible. The terms "probable" and "reasonably possible" do not signify precise quantitative thresholds and may be interpreted and applied differently by different parties, as described above. The meaning of such terms should be understood in the context of the legal opinion related to the entity's specific facts and circumstances so that management's assertions about the likelihood of success on appeal can be compared with those of counsel.
  - Management should review the basis for counsel's conclusions and assess whether the reasons cited by counsel to support its assessment are consistent with the evidence used by the entity to support its decision about whether to record a loss contingency.

- Management should fully consider any qualifications or conditions that counsel identified as affecting its assessment. In interpreting language used by counsel to explain its conclusion, management may find it helpful to consider the guidance applicable to audits of financial statements contained in AU-C Sections 620 and 501 of the AICPA's auditing standards, which apply to financial statement audits.
- Counsel's opinion is a critical piece of evidence that needs to be analyzed carefully. Counsel's expression of an opinion that an entity will be successful on appeal does not, in itself, support a conclusion that an accrual of a loss is not warranted. In addition, ASC 450-20-55-12(c) notes that "the fact that legal counsel is unable to express an opinion that the outcome will be favorable to the entity should not necessarily be interpreted to mean that the condition in paragraph 450-20-25-2(a) is met." However, when the entity has received an adverse legal judgment, counsel's inability to express an opinion may leave the entity with insufficient positive evidence to overcome the judgment.
- *The experience of the entity or other entities in similar cases* — The prior experiences of the entity or other entities with similar litigation may serve as additional evidence of the entity's likelihood of success. For example, management could consider possible outcomes specific to (1) certain jurisdictions, (2) certain courts, (3) the use of certain defense strategies, or (4) other related aspects of the litigation.
- *Prior case law for similar cases* — Gaining an understanding of prior case law may enable the entity to identify certain precedents that could affect the likelihood of its success.
- *Management's decision regarding how the entity intends to respond:*
  - Although certain adverse legal judgments may be appealed, the entity's decision to appeal will depend on a variety of factors. The entity should consider its specific facts and circumstances when assessing the likelihood that it will seek an appeal.
  - Because an adverse legal judgment may involve multiple components, the entity should analyze each component thoroughly to determine whether a litigation accrual should be recorded. For example, the entity should determine whether it will appeal all components of the judgment or only selected components.
- *The entity's intended basis for an appeal* — As discussed above, an understanding of the legal basis for the entity's appeal, combined with a review of prior case law or the experiences of the entity or other entities in similar cases, may serve as evidence that helps the entity gauge the likelihood that it will prevail on appeal.
- *The audit committee's assessment of the entity's opportunity for appeal* — The audit committee's assessment of the entity's opportunity for appeal, considered along with the assessments of internal or outside counsel and the entity's management, may constitute additional information about the entity's defense strategy and its chances for success on appeal.

Example 1 in ASC 450-20-55-18 through 55-21 and Cases A through D of Example 2 in ASC 450-20-55-22 through 55-35 illustrate the accounting for various litigation scenarios. For further discussion on these topics, including the evaluation of an adverse legal judgment's impact on the recognition and measurement of a loss contingency, see [Chapter 2](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

### 6.2.2.2.2 Injury or Damage Caused by Products Sold

#### ASC 450-20

**55-2** If it is probable that a claim resulting from injury or damage caused by a product defect will arise with respect to products or services that have been sold, accrual for losses may be appropriate. The condition in paragraph 450-20-25-2(a) would be met, for instance, with respect to a drug product or toys that have been sold if a health or safety hazard related to those products is discovered and as a result it is considered probable that liabilities have been incurred. The condition in paragraph 450-20-25-2(b) would be met if experience or other information enables the entity to make a reasonable estimate of the loss with respect to the drug product or the toys.

Life sciences entities may be subject to recalls on their products (e.g., medical devices, pharmaceutical drugs). While some product recalls are voluntary (e.g., the drug manufacturer has chosen to remove the drug from the shelves or has notified consumers and doctors to stop using the product or return it), other recalls may be required by law or a regulator (e.g., the FDA).

If an entity is not otherwise required by law or a regulator to initiate a product recall, the obligating event triggering liability recognition for the costs (i.e., repurchasing inventory) associated with a voluntary product recall would generally be the announcement of the recall. Except as provided for in a warranty arrangement, an entity has no legal obligation or duty associated with product design or manufacturing defects after the product is sold. Because there is no legal obligation, there is no event that gives rise to a probable loss until a recall is announced voluntarily. If, however, a warranty arrangement exists, the obligating event is the identification of a problem with the product or the need for product recall, not the voluntary recall announcement.

Alternatively, an entity may conclude, on the basis of current laws or regulations, that it is probable that such a law or regulation will require the entity to initiate a product recall as a result of adverse events or conditions associated with the product in the distribution channel (i.e., inventory that has been sold but has not yet been consumed). In such a situation, the obligating event triggering liability recognition for the costs of the recall is the existence of the current law or regulation, and liability recognition for the estimated costs of the recall would generally be required once the entity has concluded that it is probable that such a law or regulation will require a recall and the associated costs can be reasonably estimated. Further, such a conclusion could be reached before formal notification by a regulator that a recall will be mandated.



#### Connecting the Dots

Entities may need to exercise significant judgment when determining whether a product recall is mandated by current law or regulation or should be considered voluntary. This distinction is critical since the timing of liability recognition for the recall may vary depending on the determination.

Given the complexity and the significant judgment that may be required, entities are encouraged to consult with their legal and accounting advisers when making this determination.

The above discussion regarding the obligation associated with a product recall does not take into account situations in which a product may have caused harm or damage that could result in potential loss against a company. In such a situation, a loss contingency would be recorded once the loss is deemed probable and reasonably estimable in accordance with ASC 450-20-25-2. Further, entities should consider whether the nature of a product recall calls into question the potential impairment of any inventory on hand.

Unless other authoritative literature requires entities to classify costs of fulfilling product recalls in a particular manner (i.e., in accordance with the guidance in ASC 606 on consideration for a product returned from a customer), such costs should be classified as operating costs in the financial statements because they result from an inherent business risk.

### Example 6-3

#### Voluntary Recall Initiated by an Entity

Big Pharma develops and manufactures health care products, including medicines and vaccines to advance wellness, prevention, treatments, and cures. In May and June, Big Pharma distributes 25,000 bottles of a pediatric drug to various distributors. The drug is commonly used to reduce fever and relieve symptoms from conditions such as the flu and a common head cold.

In August, Big Pharma discovers that 8,500 of the bottles, specifically the 3 oz. cherry flavor, were distributed with the incorrect dosage cups. The dosage instruction provides dosing in teaspoons, while the dosage cups included in the packaging were labeled in tablespoons. Since 1 tablespoon contains 3 teaspoons, Big Pharma is concerned that the usage of the tablespoon dosage cups could result in dangerous overdoses if the cups' labeling was overlooked.

There is no law or regulation in place requiring Big Pharma to recall the drugs for including the incorrect dosage cups. In addition, no consumer lawsuits have been brought against Big Pharma regarding this matter. However, Big Pharma weighs the potential overdose risks of consumers' overlooking the measurement metric on the dosage cup and decides to voluntarily recall the product. On August 11, 20X9, Big Pharma announces the recall for the 8,500 affected bottles. Upon announcing the recall, Big Pharma recognizes a liability for the estimated costs of removing the bottles from distributors and retail stores, replacing them, and notifying consumers. Because Big Pharma was not otherwise required by law to initiate the product recall, the obligating event triggering the liability recognition is the announcement of the recall on August 11, 20X9. Any liability related to potential consumer lawsuits would be accounted for in accordance with ASC 450-20. Such accounting would be separate from that for the costs Big Pharma expects to incur in connection with the recall.

### Example 6-4

#### Recall Required by a Regulator

Medical Device Co. develops and manufactures infusion pumps that are sold to various hospitals and clinics. The devices are used to infuse certain medication into a patient's circulatory system.

In March, Medical Device Co. discovers that one of its products, Infusion Y, was prone to malfunction because of a faulty liquid-crystal display (LCD). Although there have been no incidents reported or litigation brought against Medical Device Co., the Infusion Y devices are unsafe for use in the LCD's current state, and if the faulty LCD were reported to the FDA, the FDA would mandate a product recall and bar Medical Device Co. from selling the Infusion Y product.

In April, Medical Device Co. announces a product recall to (1) refund the hospitals and clinics that bought the Infusion Y product and (2) reacquire all sold inventory.

Although the recall is announced in April and the regulator has not yet provided formal notification of a mandated recall for the Infusion Y product, Medical Device Co. had determined in March that it was probable that the FDA would require the company to recall the product upon discovery of the faulty LCD. Further, Medical Device Co. concluded that sufficient information was available in March to make a reasonable estimate for the cost of the recall. Accordingly, Medical Device Co. should record a liability for the product recall in March, before the April recall announcement or a regulator-mandated recall. Any liability related to potential lawsuits would be accounted for in accordance with ASC 450-20. Such accounting would be separate from that for the costs Medical Device Co. expects to incur in connection with the recall.

## 6.2.3 Measurement

### ASC 450-20

**30-1** If some amount within a range of loss appears at the time to be a better estimate than any other amount within the range, that amount shall be accrued. When no amount within the range is a better estimate than any other amount, however, the minimum amount in the range shall be accrued. Even though the minimum amount in the range is not necessarily the amount of loss that will be ultimately determined, it is not likely that the ultimate loss will be less than the minimum amount. Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of these initial measurement standards.

Once the recognition criteria under ASC 450-20-25-2 are met, entities should accrue the estimated loss by a charge to income. If the amount of the loss is a range, the amount that appears to be a better estimate within that range should be accrued. If no amount within the range is a better estimate, the minimum amount within the range should be accrued, even though the minimum amount may not represent the ultimate settlement amount.

A contingent liability should be estimated independently from any possible claim for recovery (see [Section 6.4](#) for the accounting for loss recoveries). For example, entities may enter into certain insurance contracts to protect themselves from a litigation loss, but the presence of insurance does not relieve the entity from being the primary obligor, since an entity generally would be unable to transfer to an insurance company its primary obligation to a potential claimant without the claimant's consent. Because a potential claimant typically is not asked to consent to an insurance contract between the entity and an insurance company, the entity may be unclear about the circumstances in which its primary obligation to a potential claimant could shift to the insurance company under an insurance contract.

### 6.2.3.1 Offer to Settle Litigation

Entities will often make offers to settle litigation. An offer by management to settle litigation creates a presumption that it is probable that a liability has been incurred. The settlement offer establishes a low end of the range under ASC 450-20-30-1, resulting in accrual of a liability. Withdrawal of a settlement offer before acceptance and before issuance of the financial statements generally would not change this conclusion since the existence of the offer provides evidence that the company may be willing to settle the litigation for at least that amount.

The presumption that a settlement offer triggers accrual of a liability and the establishment of a low end of the range is generally considered to be a high hurdle to overcome, and its rebuttal should be based on persuasive evidence. The evidence should substantiate that it is not probable that the offer will be accepted. In addition, the evidence should substantiate that it is not probable that further negotiations will lead to an out-of-court settlement for which the entity will owe payment to the counterparty. In certain circumstances, an out-of-court settlement may be the only realistic litigation strategy because a trial is deemed too risky. In such circumstances, the extension of an offer to settle out of court is a strong indicator that the entity will ultimately settle with the counterparty for an equal or greater amount. Accordingly, when an offer has been extended to settle out of court, it must be at least reasonably possible that the litigation will ultimately be settled via court proceedings or arbitration and the entity will not be obligated to make a payment. An entity that believes that the presumption has been overcome should consider consulting with its accounting advisers.

It may not always be appropriate to accrue a contingent liability at the amount of a settlement offer. For example, if the counterparty to the settlement offer has rejected the offer and proposed a higher settlement amount, the amount an entity should accrue for the loss may exceed the settlement offer made by the entity. In such situations, an entity should use judgment and consider the relevant facts and circumstances.



### Connecting the Dots

An entity should carefully consider all facts and circumstances when assessing whether an “offer” has been extended to settle litigation. Questions may arise about distinguishing when a formal offer has been made from when parties have explored potential settlement amounts. In determining whether there is a formal offer to settle, an entity should consider whether approval from additional members of management or the board of directors is required. Further, the evidence available to substantiate that an offer does not constitute the low end of the range is often subjective, and the entity should be careful when evaluating whether the presumption can be overcome.

#### Example 6-5

##### Offer to Settle Litigation

Company X is in the medical device business and has been named as the defendant in a lawsuit alleging personal injury resulting from use of one of its surgical devices. After year-end but before issuance of the financial statements, X offers to settle the litigation for \$10 million. The plaintiff has not responded to the offer, and X believes that if the matter ultimately goes to trial, the outcome is uncertain. Company X's management believes that the parties are still far from deciding on a settlement value and therefore that the plaintiff is not likely to accept the offer. However, given the significant exposure X faces in a trial, it is probable that the matter will eventually be settled.

The offer to settle is significant objective evidence that it is probable that a liability has been incurred as of the date of the financial statements and that the amount of the offer constitutes the minimum amount in the range and should be accrued in the financial statements in accordance with ASC 450-20-30-1. Company X must also disclose any additional reasonably possible exposure to loss in its financial statements if the disclosure requirements in ASC 450-20-50-3 are met.

## 6.2.4 Remeasurement and Derecognition of a Contingent Liability

### 6.2.4.1 Remeasurement

Unlike a contractual or legal liability (discussed above), whose measurement is established on the basis of the contract or law, the initial and subsequent measurement of a contingent liability in accordance with ASC 450-20-30 may involve a number of judgments. These uncertainties may necessitate the continual evaluation and remeasurement of the contingent liability as new information becomes available. Such remeasurement in accordance with ASC 450-20-30 could produce an estimated amount that is lower or higher when compared with the amount previously recognized, thereby resulting in a reduction or increase, respectively, of the contingent liability. If the new information indicates a reduction of the previously recognized liability, such a reduction should not be viewed as tantamount to derecognition of the contingent liability. That is, the remeasurement of a previously recognized contingent liability on the basis of new information that supports a lower estimated probable loss should not be viewed as a partial derecognition of a loss whose occurrence was and continues to be considered probable; rather, it should be viewed and accounted for as a change in estimate in accordance with ASC 250.



There may also be circumstances in which sufficient and reliable data no longer are available to support an estimate that was previously made for a contingent liability whose occurrence remains probable. For example, an entity may recognize a contingent liability on the basis of an actuarial analysis of historical loss data, but the availability of settlement data during recent periods may have declined significantly because of external factors. The decrease in the availability of recent loss data may have diminished the entity's ability to reasonably estimate the amount of the previously recognized contingent liability. However, the entity may believe that it is still probable that one or more future events will confirm that a liability has been incurred. Therefore, while the entity concludes that a loss associated with the contingent liability remains probable, it will nonetheless need to assess whether the previously accrued amount continues to represent an appropriate estimate or whether another estimate should be made on the basis of the recent circumstances associated with the availability of recent data, which could result in a reduction, or even a complete reversal, of the previously recognized loss. When the entity is evaluating whether it is appropriate to remeasure a contingent liability in such a circumstance, it should carefully support remeasurement with compelling and sufficiently reliable evidence that provides a reasonable basis for concluding that there has been a change in its previous judgment regarding the amount of the estimated loss to accrue. Further, clear disclosure of the change in facts and circumstances should be considered.

#### **6.2.4.2 *Derecognition When Settlement Is No Longer Considered Probable***

A contingency that fails to meet one or both of the two criteria in ASC 450-20-25-2 does not reach the threshold for recognition in the financial statements. However, questions may arise about when it is appropriate for an entity to derecognize a previously recognized contingent liability when settlement is no longer considered probable.

For example, an entity may recognize a contingent liability related to the probable incurrence of a loss because of pending litigation. Subsequently and on the basis of the facts and circumstances related to the litigation, the entity may conclude that such a loss is no longer considered probable, even though the matter is not subject to legal release or the statute of limitations given the noncontractual nature of the contingency. In such a scenario, derecognition of the contingent liability would be reasonable given the conclusion that a loss is no longer considered probable. However, the assessment of whether a contingency is likely to occur often involves considerable subjectivity. In those cases, it may be prudent to reduce or reverse an existing accrual only when there is reasonably clear or compelling evidence that a loss is no longer considered probable. When determining the sufficiency of evidence to support derecognition, an entity should consider the potential that derecognition in certain circumstances could be misleading to financial statement users because it could inappropriately communicate that the liability has been extinguished when the contingency still exists. The entity should clearly disclose the change in the accrual and the underlying facts and circumstances.

The example below illustrates a scenario in which derecognition of a contingent liability may be appropriate when settlement is no longer considered probable.

**Example 6-6****Derecognition of a Contingent Liability**

Company S is a defendant in a lawsuit filed in 20X2 by a competitor, Company Z. In 20X4, a jury finds in favor of Z and awards damages of \$10 million. Company S's management determines that it is probable that a liability has been incurred despite its intent to appeal the verdict, and S recognizes a loss in the 20X4 financial statements. In December 20X8, the appeals court sets aside the previous jury verdict and remands the case back to the lower court for another trial. Company S has obtained an opinion from its legal counsel that says S has meritorious defenses and that the outcome of the new trial is uncertain after taking into account the reasons for the findings of the appeals court. Company S therefore derecognizes the previously recognized contingent liability given that it has determined that the evidence supported a conclusion that it was no longer probable that it would incur a loss in accordance with the litigation.

Company S should ensure that it has properly disclosed the change in facts and circumstances in the financial statements. In addition, although this illustrative example is provided to present the analysis an entity may undertake to determine when to derecognize a contingent liability, as a practical matter, entities may often find it challenging to obtain sufficiently compelling evidence to support a conclusion to reverse some or all of an existing contingent liability before complete elimination of the uncertainty. Company S will need to consider the totality of evidence available, including counsel's views.

**6.2.5 Disclosures****6.2.5.1 Disclosure Considerations Under ASC 450-20 and ASC 275**

Disclosures of loss contingencies required under ASC 450-20 are intended to provide users of financial statements with an understanding of risks and how they could potentially affect the financial statements.

Under U.S. GAAP, an entity must make estimates in current-period financial statements to reflect current events and transactions, the effects of which may not be precisely determinable until some future period. The final results may not match original expectations. Uncertainty about the outcome of future events is inherent in economics, and an entity should understand that fact when reading reports on economic activities, such as published financial statements. A business is largely a function of the environment in which it operates. Thus, it can be affected by changing social, political, and economic factors. In addition, every entity is subject to uncertain future events that may affect the entity or the industry in which it operates. These uncertainties may or may not be considered contingencies as defined by ASC 450-10-20. As a result, the disclosures required by ASC 275-10-50 supplement and, in many cases, overlap the disclosures required by ASC 450-20-50.

Not all uncertainties inherent in the accounting process give rise to contingencies as that word is used in ASC 450. Estimates are required in financial statements for many of an entity's ongoing and recurring activities. The fact that an estimate is involved does not by itself constitute the type of uncertainty referred to in the definition of a contingency in ASC 450-10-20. For example, the fact that estimates are used to allocate the known cost of a depreciable asset over the asset's useful life does not make depreciation a contingency; the eventual expiration of the use of the asset is not uncertain. Thus, depreciation of assets is not a contingency as discussed in ASC 450-10-55-2. In addition, matters related to depreciation (e.g., recurring repairs, maintenance, and overhauls) are similarly outside the scope of ASC 450. Amounts owed for services received, such as advertising and utilities, are not contingencies even though the accrued amounts may have been estimated; there is nothing uncertain about the fact that those obligations have been incurred.

Some degree of estimation is required for nearly all financial statement amounts. For example, inventories measured by using any method other than LIFO or the retail inventory method are measured at the lower of cost or net realizable value, estimation of services received or amounts due is required for various accrued liabilities, and accounts payable are subject to future adjustment because of such possibilities as improper billing or inadequate product quality or performance. All of these amounts usually are subject to reasonable estimation. However, many lawsuits that may create a material liability are not recorded because one or both conditions for recognizing a contingent liability are not met; they nonetheless should be disclosed to the extent that a loss is reasonably possible.

Neither ASC 450-20 nor any other authoritative literature contains definitive guidelines on measuring the difference between estimates that are affected by uncertainty that can be estimated reasonably and those that cannot be estimated reasonably. Although estimates generally include some level of uncertainty, they are not necessarily loss contingencies. Thus, estimates regarding events in the normal course of business have frequently been included in the financial statements without specific disclosure since ASC 450-20-50 requires disclosure of only contingencies. ASC 275-10-50 extends disclosure requirements to numerous risks and uncertainties, many of which are not considered contingencies.

## ASC 450-20

### Accruals for Loss Contingencies

**50-1** Disclosure of the nature of an accrual made pursuant to the provisions of paragraph 450-20-25-2, and in some circumstances the amount accrued, may be necessary for the financial statements not to be misleading. Terminology used shall be descriptive of the nature of the accrual, such as estimated liability or liability of an estimated amount. The term *reserve* shall not be used for an accrual made pursuant to paragraph 450-20-25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose. Examples 1 (see paragraph 450-20-55-18) and 2, Cases A, B, and D (see paragraphs 450-20-55-23, 450-20-55-27, and 450-20-55-32) illustrate the application of these disclosure standards.

**50-2** If the criteria in paragraph 275-10-50-8 are met, paragraph 275-10-50-9 requires disclosure of an indication that it is at least reasonably possible that a change in an entity's estimate of its probable liability could occur in the near term. Example 3 (see paragraph 450-20-55-36) illustrates this disclosure for an entity involved in litigation.

### Unrecognized Contingencies

**50-2A** The disclosures required by paragraphs 450-20-50-3 through 50-6 do not apply to loss contingencies arising from an entity's recurring estimation of its allowance for credit losses. (See paragraph 310-10-50-21.)

### Pending Content (Transition Guidance: ASC 326-10-65-1)

**50-2A** The disclosures required by paragraphs 450-20-50-3 through 50-6 do not apply to credit losses on instruments within the scope of Topic 326 on measurement of credit losses. (See paragraph 310-10-50-21.)

**50-3** Disclosure of the contingency shall be made if there is at least a reasonable possibility that a loss or an additional loss may have been incurred and either of the following conditions exists:

- a. An accrual is not made for a loss contingency because any of the conditions in paragraph 450-20-25-2 are not met.
- b. An exposure to loss exists in excess of the amount accrued pursuant to the provisions of paragraph 450-20-30-1.

Examples 1–3 (see paragraphs 450-20-55-18 through 55-37) illustrate the application of these disclosure standards.

**ASC 450-20 (continued)**

**50-4** The disclosure in the preceding paragraph shall include both of the following:

- a. The nature of the contingency
- b. An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.

**50-5** Disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. For example, disclosure shall be made of any loss contingency that meets the condition in paragraph 450-20-25-2(a) but that is not accrued because the amount of loss cannot be reasonably estimated (the condition in paragraph 450-20-25-2(b)). Disclosure also shall be made of some loss contingencies that do not meet the condition in paragraph 450-20-25-2(a) — namely, those contingencies for which there is a reasonable possibility that a loss may have been incurred even though information may not indicate that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

**50-6** Disclosure is not required of a loss contingency involving an unasserted claim or assessment if there has been no manifestation by a potential claimant of an awareness of a possible claim or assessment unless both of the following conditions are met:

- a. It is considered probable that a claim will be asserted.
- b. There is a reasonable possibility that the outcome will be unfavorable.

**50-7** Disclosure of noninsured or underinsured risks is not required by this Subtopic. However, disclosure in appropriate circumstances is not discouraged.

**ASC 275-10**

**50-7** Various Topics require disclosures about uncertainties addressed by those Topics. In particular, Subtopic 450-20 specifies disclosures to be made about contingencies that exist at the date of the financial statements. In addition to disclosures required by Topic 450 and other accounting Topics, this Subtopic requires disclosures regarding estimates used in the determination of the carrying amounts of assets or liabilities or in disclosure of gain or loss contingencies, as described below.

**50-8** Disclosure regarding an estimate shall be made when known information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that both of the following criteria are met:

- a. It is at least reasonably possible that the estimate of the effect on the financial statements of a condition, situation, or set of circumstances that existed at the date of the financial statements will change in the near term due to one or more future confirming events.
- b. The effect of the change would be material to the financial statements.

**50-9** The disclosure shall indicate the nature of the uncertainty and include an indication that it is at least reasonably possible that a change in the estimate will occur in the near term. If the estimate involves a loss contingency covered by Subtopic 450-20, the disclosure also shall include an estimate of the possible loss or range of loss, or state that such an estimate cannot be made. Disclosure of the factors that cause the estimate to be sensitive to change is encouraged but not required. The words reasonably possible need not be used in the disclosures required by this Subtopic.

**ASC 275-10 (continued)**

**50-11** This Subtopic’s disclosure requirements are separate from and do not change in any way the disclosure requirements or criteria of Topic 450; rather, the disclosures required under this Subtopic supplement the disclosures required under that Topic as follows:

- a. If an estimate (including estimates that involve contingencies covered by Topic 450) meets the criteria for disclosure under paragraph 275-10-50-8, this Subtopic requires disclosure of an indication that it is at least reasonably possible that a change in the estimate will occur in the near term; Topic 450 does not distinguish between near-term and long-term contingencies.
- b. An estimate that does not involve a contingency covered by Topic 450, such as estimates associated with long-term operating assets and amounts reported under profitable long-term contracts, may meet the criteria in paragraph 275-10-50-8. This Subtopic requires disclosure of the nature of the estimate and an indication that it is at least reasonably possible that a change in the estimate will occur in the near term.

**50-12** If a loss contingency meets the criteria for disclosure under both Topic 450 and paragraph 275-10-50-8, this Subtopic requires disclosure that it is at least reasonably possible that future events confirming the fact of the loss or the change in the estimated amount of the loss will occur in the near term.

In addition to being required to provide the primary disclosures under ASC 450-20, an entity must provide certain additional disclosures under ASC 275 when it is reasonably possible that a change in estimate will occur in the near term. The disclosure requirements under ASC 450-20 and ASC 275 are summarized in the table below.

Possibility That a Loss Has Been Incurred	Ability to Estimate a Loss	Disclosure Requirements of ASC 450-20 and ASC 275
Reasonably possible	May or may not be reasonably estimable	Disclose all of the following: <ul style="list-style-type: none"> <li>• “The nature of the contingency” (e.g., a description of the patent infringement). See ASC 450-20-50-4(a).</li> <li>• “An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” See ASC 450-20-50-4(b).</li> <li>• A statement indicating that it is at least reasonably possible that the estimated amount of the loss will change in the near term if (1) “[i]t is at least reasonably possible that the estimate . . . will change in the near term” and (2) “the effect of the change would be material.” See ASC 275-10-50-8.</li> </ul>
Probable	Not reasonably estimable	Disclose both of the following: <ul style="list-style-type: none"> <li>• “The nature of the contingency” (e.g., a description of the patent infringement). See ASC 450-20-50-4(a).</li> <li>• A statement that the amount of the loss cannot be reasonably estimated. See ASC 450-20-50-4(b).</li> </ul>

(Table continued)

Possibility That a Loss Has Been Incurred	Ability to Estimate a Loss	Disclosure Requirements of ASC 450-20 and ASC 275
Probable	Reasonably estimable	Disclose all of the following: <ul style="list-style-type: none"> <li>• “The nature of the contingency” (e.g., a description of the patent infringement). “The term <i>reserve</i> shall not be used for an accrual made pursuant to paragraph 450-20-25-2; that term is limited to an amount of unidentified or unsegregated assets held or retained for a specific purpose.” See ASC 450-20-50-1 and ASC 450-20-50-4(a).</li> <li>• The total amount of the loss that has been recognized (if such disclosure must be provided to ensure that the financial statements are not misleading). See ASC 450-20-50-1.</li> <li>• A statement indicating that it is at least reasonably possible that the estimated amount of the loss will change in the near term if (1) “[i]t is at least reasonably possible that the estimate . . . will change in the near term” and (2) “the effect of the change would be material.” See ASC 275-10-50-8.</li> <li>• The exposure to loss in excess of the amount accrued under ASC 450-20 if there is at least a reasonable possibility that such an excess loss may have been incurred. The disclosure should include both of the following:               <ul style="list-style-type: none"> <li>◦ “The nature of the contingency.”</li> <li>◦ “An estimate of the possible loss or range of loss or a statement that such an estimate cannot be made.” See ASC 450-20-50-3 and 50-4.</li> </ul> </li> </ul>
Remote	Not reasonably estimable	No specific disclosure requirements related to remote contingencies; however, disclosures may be provided if their omission could cause the financial statements to be misleading.



### Connecting the Dots

In the life sciences industry, a substantial portion of the commercial value of an innovative product is usually realized during the period in which the product has market exclusivity. A product’s market exclusivity is generally determined by patent rights held by the innovator company and the regulatory forms of exclusivity to which the innovative drug or device is entitled, which vary by jurisdiction. Once the period of market exclusivity lapses, generic or competitor versions of a product are frequently approved and marketed, potentially resulting in a significant and rapid decline in sales for the innovator company.

Because of the complexities involved in patent law and regulatory exclusivity, patent infringement litigation is common in the industry. Defendants in such litigation (which are often generics companies) frequently consider the above provisions of ASC 450-20 and ASC 275 in determining the accounting and disclosure related to these matters. Plaintiffs in such litigation (which are often branded companies) should also consider the disclosure requirements of ASC 275-10-50-16, under which an entity must disclose a concentration that exists on the date of the financial statements when (1) the “concentration makes the entity vulnerable to the risk of a near-term severe impact” and (2) “[i]t is at least reasonably possible that the events that could cause the severe impact will occur in the near term.” Example 6 in ASC 275-10-55-13 and 55-14, which is reproduced below, illustrates the application of the disclosure guidance in ASC 275-10-50-16.

**ASC 275-10****Example 6: Patent Expiration**

**55-13** This Example illustrates the disclosures required by paragraph 275-10-50-16. Felt Pharmaceutical Company is a national pharmaceutical manufacturer headquartered in Atlanta, Georgia. Felt markets a wide range of pharmaceutical products. One of its better-known name-brand products, a significant source of profits and cash flow, is an antibiotic on which there is a patent that will expire in six months. Competitors are preparing to enter the market with generic alternatives when Felt's patent expires, and the concentration therefore has the potential for a severe impact. The following illustrates the disclosure required by this Subtopic.

Felt Pharmaceutical Company is a national pharmaceutical manufacturer with sales throughout the United States. The patent on one of its major products expires next year. This product accounts for approximately one-third [or "a significant portion"] of the entity's revenues and a higher percentage of its gross profit.

**55-14** The disclosure focuses on the nature of the business and on Felt's current vulnerability due to a concentration of its patented products. Disclosure is required because the concentration exists at the date of the financial statements, because the effect on Felt's cash flows and profitability of competitors entering the market when the patent expires could be a severe impact, and because it is considered at least reasonably possible that the events that could cause the severe impact will occur in the near term. Because the risk is evident from the description of the concentration, no further explanation of the risk is necessary.

Example 3 in ASC 450-20-55-36 and 55-37 illustrates the determination and disclosure of a range of estimates.

**ASC 450-20****Example 3: Illustrative Disclosure**

**55-36** Entity A is the defendant in litigation involving a major competitor claiming patent infringement (Entity B). The suit claims damages of \$200 million. Discovery has been completed, and Entity A is engaged in settlement discussions with the plaintiff. Entity A has made an offer of \$5 million to settle the case, which offer was rejected by the plaintiff; the plaintiff has made an offer of \$35 million to settle the case, which offer was rejected by Entity A. Based on the expressed willingness of the plaintiff to settle the case along with information revealed during discovery and the likely cost and risk to both sides of litigating, Entity A believes that it is probable the case will not come to trial. Accordingly, Entity A has determined that it is probable that it has some liability. Entity A's reasonable estimate of this liability is a range between \$10 million and \$35 million, with no amount within that range a better estimate than any other amount; accordingly, \$10 million was accrued.

**55-37** Entity A provides the following disclosure in accordance with Section 450-20-50.

On March 15, 19X1, Entity B filed a suit against the company claiming patent infringement. While the company believes it has meritorious defenses against the suit, the ultimate resolution of the matter, which is expected to occur within one year, could result in a loss of up to \$25 million in excess of the amount accrued.

**SEC Considerations**

ASC 450-20-50-4 requires disclosures about the nature of any material contingency, including the amounts that might be paid, if a loss is at least reasonably possible. In addition, SEC Regulation S-K, Item 303, requires discussion of items that might affect a company's liquidity or financial position in the future, including contingent liabilities.



The SEC staff has consistently commented on and challenged registrants' compliance with the disclosure requirements in ASC 450-20. For example, Scott Taub, deputy chief accountant in the SEC's Office of the Chief Accountant, noted the following in a [speech](#) at the 2004 AICPA Conference on Current SEC and PCAOB Developments:

Given [the requirement to record an accrual if payment is both probable and estimable and the requirement to disclose the nature of any material contingency, including the amounts that might be paid, if a loss is at least reasonably possible], the recording of a material accrual for a contingent liability related to an event that occurred several years before should not be the first disclosure regarding that contingency. Rather, disclosures regarding the nature of the contingency and the amounts at stake should, in most cases, have already been provided. Disclosures should discuss the nature of the contingency and the possible range of losses for any item where the maximum reasonably possible loss is material. Vague or overly broad disclosures that speak merely to litigation, tax, or other risks in general, without providing any information about the specific kinds of loss contingencies being evaluated are not sufficient.

Furthermore, I should point out that Statement 5 and Interpretation 14 [codified as ASC 450-20] require accrual for probable losses of the most likely amount of the loss. While the low end of a range of possible losses is the right number if no amount within the range is more likely than any other, I find it somewhat surprising how often "zero" is the recorded loss right up until a large settlement is announced. [Footnote omitted]

The SEC staff made similar remarks at subsequent conferences, including the 2010 AICPA Conference on Current SEC and PCAOB Developments. To ensure compliance with the requirements in ASC 450-20, registrants should continually review their disclosures and update them as additional information becomes available.

Non-SEC registrants may also consider the preceding SEC staff remarks given that the disclosure objectives outlined by the staff would generally be expected to apply to these entities' financial statements as well.

### **6.2.5.2 Disclosure of Unasserted Claims**

ASC 450-20-50-6 indicates that a disclosure of a loss contingency involving an unasserted claim is not required unless both of the following conditions are met:

- a. It is considered probable that a claim will be asserted.
- b. There is a reasonable possibility that the outcome will be unfavorable.

This exception is specific to unasserted claims and should not be applied by analogy to claims other than unasserted claims. An entity must evaluate all the facts and circumstances in determining whether to disclose such a loss contingency.

### **6.2.5.3 Disclosure of Loss Contingencies Occurring After Year-End**

ASC 855-10-50-2 requires an entity to disclose a nonrecognized subsequent event if it is "of such a nature that [it] must be disclosed to keep the financial statements from being misleading." Although the determination of whether to provide such a disclosure is a matter of judgment, it would seem prudent for an entity to disclose any matter that could materially affect its financial position, results of operations, or trend of operations. In addition, an entity should consider disclosing any accruals made in the subsequent reporting period as a nonrecognized subsequent event within the current-period financial statements if the accruals (1) are unusual or material to earnings of the current reporting period or (2) materially affect the trend of earnings.

Disclosures about a loss or loss contingency occurring after year-end should include (1) the nature of the loss or loss contingency and (2) an estimate of the amount or range of loss or possible loss or a statement that such an estimate cannot be made. If the effect on the entity's financial position is material, it may be useful for the entity to provide supplemental pro forma financial data reflecting the loss as if it had occurred as of the date of the financial statements.

#### **6.2.5.4 Disclosure of Firmly Committed Executory Contracts**

Although the ASC master glossary does not define "executory contract," an entity may find the following considerations useful in assessing the meaning of this term:

- Although never finalized and ultimately removed from the EITF's agenda, EITF Issue 03-17 refers to an executory contract as "a contract that remains wholly unperformed or for which there remains something to be done by either or both parties of the contract."
- IAS 37 refers to an executory contract as a contract "under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent."

The ASC master glossary defines a firm purchase commitment as "an agreement with an unrelated party, binding on both parties and usually legally enforceable," that is both (1) specific in "all significant terms, including the price and timing of the transaction," and (2) "includes a disincentive for nonperformance that is sufficiently large to make performance probable." Disincentives for nonperformance may be, for example, in the form of (1) a fixed payment requirement for each period under the agreement regardless of whether the purchaser takes delivery or (2) the inability of a purchaser to change the contractual delivery and payment terms with a supplier without a penalty payment for nonperformance.

Life sciences entities should consider the need for disclosure of a firmly committed executory contract to prevent the financial statements from being misleading. In addition, SEC registrants should consider whether commitments related to executory contracts should be included in their SEC Regulation S-K disclosures (e.g., within MD&A as a known "trend, event, or uncertainty" that may affect future earnings or other measures of performance).

#### **ASC 440-10**

**50-2** An unconditional purchase obligation that has all of the following characteristics shall be disclosed in accordance with paragraph 440-10-50-4 (if not recorded on the purchaser's balance sheet) or in accordance with paragraph 440-10-50-6 (if recorded on the purchaser's balance sheet):

- a. It is noncancelable, or cancelable only in any of the following circumstances:
  1. Upon the occurrence of some remote contingency
  2. With the permission of the other party
  3. If a replacement agreement is signed between the same parties
  4. Upon payment of a penalty in an amount such that continuation of the agreement appears reasonably assured.
- b. It was negotiated as part of arranging financing for the facilities that will provide the contracted goods or services or for costs related to those goods or services (for example, carrying costs for contracted goods). A purchaser is not required to investigate whether a supplier used an unconditional purchase obligation to help secure financing, if the purchaser would otherwise be unaware of that fact.
- c. It has a remaining term in excess of one year.

**ASC 440-10 (continued)****Unrecognized Commitments**

**50-4** A purchaser shall disclose unconditional purchase obligations that meet the criteria of paragraph 440-10-50-2 and that have not been recognized on its balance sheet. Disclosures of similar or related unconditional purchase obligations may be combined. The disclosures shall include all of the following:

- a. The nature and term of the obligation(s)
- b. The amount of the fixed and determinable portion of the obligation(s) as of the date of the latest balance sheet presented, in the aggregate and, if determinable, for each of the five succeeding fiscal years
- c. The nature of any variable components of the obligation(s)
- d. The amounts purchased under the obligation(s) (for example, the take-or-pay or throughput contract) for each period for which an income statement is presented.

The preceding disclosures may be omitted only if the aggregate commitment for all such obligations not disclosed is immaterial.

**50-5** Disclosure of the amount of imputed interest necessary to reduce the unconditional purchase obligation(s) to present value is encouraged but not required. The discount rate shall be the effective initial interest rate of the borrowings that financed the facility (or facilities) that will provide the contracted goods or services, if known by the purchaser. If not, the discount rate shall be the purchaser's incremental borrowing rate at the date the obligation is entered into.

**Recognized Commitments**

**50-6** A purchaser shall disclose for each of the five years following the date of the latest balance sheet presented the aggregate amount of payments for unconditional purchase obligations that meet the criteria of paragraph 440-10-50-2 and that have been recognized on the purchaser's balance sheet.

An entity should provide the incremental disclosures required by ASC 440-10-50-2 that pertain to unconditional purchase obligations or firmly committed executory contracts. Specifically, when an executory contract is material and has not been recognized in the financial statements, the entity should comply with the disclosure requirements of ASC 440-10-50-4(a)–(d). When the entity has recognized an executory contract on the balance sheet, it should disclose total payments for each of the five years after the date of the latest balance sheet.

**SEC Considerations**

In addition to providing the footnote disclosures required by ASC 440-10-50, an entity must provide incremental disclosures within MD&A under SEC Regulation S-K, Item 303. Because the disclosures required by SEC Regulation S-K may be broader than those required by ASC 440-10-50-2, SEC registrants may reflect different amounts related to purchase obligations in the notes to the financial statements than they do in MD&A.

For further discussion on the accounting for firmly committed executory contracts, see [Chapter 2](#) of Deloitte's Roadmap *Contingencies, Loss Recoveries, and Guarantees*.

## 6.2.6 Subsequent-Event Considerations

Entities should have processes in place to capture and evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in current-period or subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to loss contingencies described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.

ASC 450-20 includes guidance related to the accounting for subsequent events.

### ASC 450-20

**25-2** An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

- a. Information available before the financial statements are issued or are available to be issued (as discussed in Section 855-10-25) indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements. Date of the financial statements means the end of the most recent accounting period for which financial statements are being presented. It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss.
- b. The amount of loss can be reasonably estimated.

The purpose of those conditions is to require accrual of losses when they are reasonably estimable and relate to the current or a prior period. Paragraphs 450-20-55-1 through 55-17 and Examples 1–2 (see paragraphs 450-20-55-18 through 55-35) illustrate the application of the conditions. As discussed in paragraph 450-20-50-5, disclosure is preferable to accrual when a reasonable estimate of loss cannot be made. Further, even losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period. Attribution of a loss to events or activities of the current or prior periods is an element of asset impairment or liability incurrence.

**25-6** After the date of an entity's financial statements but before those financial statements are issued or are available to be issued (as discussed in Section 855-10-25), information may become available indicating that an asset was impaired or a liability was incurred after the date of the financial statements or that there is at least a reasonable possibility that an asset was impaired or a liability was incurred after that date. The information may relate to a loss contingency that existed at the date of the financial statements, for example, an asset that was not insured at the date of the financial statements. On the other hand, the information may relate to a loss contingency that did not exist at the date of the financial statements, for example, threat of expropriation of assets after the date of the financial statements or the filing for bankruptcy by an entity whose debt was guaranteed after the date of the financial statements. In none of the cases cited in this paragraph was an asset impaired or a liability incurred at the date of the financial statements, and the condition for accrual in paragraph 450-20-25-2(a) is, therefore, not met.

The guidance in ASC 450 indicates that entities should consider information available before the financial statements are issued or are available to be issued when determining whether it is probable that an asset has been impaired or a loss event has occurred as of the balance sheet date. ASC 450 does not specifically address events occurring after the balance sheet date that provide additional information related to the measurement of a loss contingency; however, entities should consider the subsequent-event guidance that is codified in ASC 855-10.

**ASC 855-10****Recognized Subsequent Events*****Evidence About Conditions That Existed at the Date of the Balance Sheet***

**25-1** An entity shall recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. See paragraph 855-10-55-1 for examples of recognized subsequent events.

**55-1** The following are examples of recognized subsequent events addressed in paragraph 855-10-25-1:

- a. If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.
- b. Subsequent events affecting the realization of assets, such as receivables and inventories or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time. For example, a loss on an uncollectible trade account receivable as a result of a customer's deteriorating financial condition leading to bankruptcy after the balance sheet date but before the financial statements are issued or are available to be issued ordinarily will be indicative of conditions existing at the balance sheet date. Thus, the effects of the customer's bankruptcy filing shall be considered in determining the amount of uncollectible trade accounts receivable recognized in the financial statements at balance sheet date.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

**55-1** The following are examples of recognized subsequent events addressed in paragraph 855-10-25-1:

- a. If the events that gave rise to litigation had taken place before the balance sheet date and that litigation is settled after the balance sheet date but before the financial statements are issued or are available to be issued, for an amount different from the liability recorded in the accounts, then the settlement amount should be considered in estimating the amount of liability recognized in the financial statements at the balance sheet date.
- b. Subsequent events affecting the realization of assets, such as inventories, or the settlement of estimated liabilities, should be recognized in the financial statements when those events represent the culmination of conditions that existed over a relatively long period of time.

**Nonrecognized Subsequent Events*****Evidence About Conditions That Did Not Exist at the Date of the Balance Sheet***

**25-3** An entity shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. See paragraph 855-10-55-2 for examples of nonrecognized subsequent events.

**ASC 855-10 (continued)**

**55-2** The following are examples of nonrecognized subsequent events addressed in paragraph 855-10-25-3:

- a. Sale of a bond or capital stock issued after the balance sheet date but before financial statements are issued or are available to be issued
- b. A business combination that occurs after the balance sheet date but before financial statements are issued or are available to be issued (Topic 805 requires specific disclosures in such cases.)
- c. Settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued
- d. Loss of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued
- e. Losses on receivables resulting from conditions (such as a customer's major casualty) arising after the balance sheet date but before financial statements are issued or are available to be issued
- f. Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates after the balance sheet date but before financial statements are issued or are available to be issued
- g. Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the balance sheet date but before financial statements are issued or are available to be issued.

**Pending Content (Transition Guidance: ASC 326-10-65-1)**

**55-2** The following are examples of nonrecognized subsequent events addressed in paragraph 855-10-25-3:

- a. Sale of a bond or capital stock issued after the balance sheet date but before financial statements are issued or are available to be issued
- b. A business combination that occurs after the balance sheet date but before financial statements are issued or are available to be issued (Topic 805 requires specific disclosures in such cases.)
- c. Settlement of litigation when the event giving rise to the claim took place after the balance sheet date but before financial statements are issued or are available to be issued
- d. Loss of plant or inventories as a result of fire or natural disaster that occurred after the balance sheet date but before financial statements are issued or are available to be issued
- e. Changes in estimated credit losses on receivables arising after the balance sheet date but before financial statements are issued or are available to be issued
- f. Changes in the fair value of assets or liabilities (financial or nonfinancial) or foreign exchange rates after the balance sheet date but before financial statements are issued or are available to be issued
- g. Entering into significant commitments or contingent liabilities, for example, by issuing significant guarantees after the balance sheet date but before financial statements are issued or are available to be issued.

**50-2** Some nonrecognized subsequent events may be of such a nature that they must be disclosed to keep the financial statements from being misleading. For such events, an entity shall disclose the following:

- a. The nature of the event
- b. An estimate of its financial effect, or a statement that such an estimate cannot be made.



### Connecting the Dots

ASC 450 and ASC 855 provide guidance on how to evaluate events occurring after the balance sheet date. The period through which subsequent events must be evaluated differs for (1) SEC filers and “conduit bond obligor[s] for conduit debt securities that are traded in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local or regional markets)” and (2) entities that are neither SEC filers nor conduit bond obligors. SEC filers and conduit bond obligors should evaluate events that occur through the date on which the financial statements are issued, whereas entities that are neither SEC filers nor conduit bond obligors should evaluate events that occur through the date on which the financial statements are available to be issued. To determine whether an entity is a conduit bond obligor, entities should refer to the definitions of “SEC filer” and “conduit debt securities” in the ASC master glossary.

If an event takes place after the balance sheet date but before the financial statements are issued or are available to be issued, and the event indicates that it is probable that an asset has been impaired or a liability has been incurred as of the balance sheet date, the event is considered a recognized subsequent event. The event provides additional evidence of the loss incurred before the balance sheet date and should be reflected in the financial statements.

Examples of events that provide additional information about conditions that existed as of the balance sheet date and therefore should be accounted for as recognized subsequent events include the following:

- An unfavorable court ruling in a lawsuit. The company had previously determined that the likelihood of an unfavorable outcome would be remote or reasonably possible but now considers it probable.
- A litigation settlement that indicates a loss amount different from that previously recognized in the financial statements.
- The identification of asset misappropriation that occurred on or before the balance sheet date for which no loss had previously been recognized.

If events constitute additional information that an asset had been impaired or a liability had been incurred as of the balance sheet date, but the amount of the loss cannot be reasonably estimated before the financial statements are issued or are available to be issued, the entity should consider whether disclosures are provided in accordance with [Section 6.2.5.1](#).

A loss should be recognized only when events confirm that an asset had been impaired or a liability existed as of the balance sheet date. If a loss contingency that did not exist as of the balance sheet date occurs after the balance sheet date but before the financial statements are issued or are available to be issued, the entity would not recognize the loss as of the balance sheet date but may need to disclose it as a subsequent event to keep the financial statements from being misleading.

The enactment of a law that gives rise to a liability after the balance sheet date but before the financial statements are issued or are available to be issued is a nonrecognized subsequent event. The newly enacted law does not provide evidence of conditions that existed as of the balance sheet date. However, the entity should consider whether it is required to disclose the event to keep the financial statements from being misleading. For additional information on the enactment of a law or legislation, see [Chapter 2](#) of Deloitte’s Roadmap *Contingencies, Loss Recoveries, and Guarantees*.



### Example 6-7

#### Legislation Enacted After the Balance Sheet Date

Company A, a public entity with a December 31, 20X1, year-end, operates in the health tech industry and is subject to proposed legislation that will impose an excise tax on software-related revenue transactions commencing on or after June 30, 20X1. The legislation is expected to be enacted after year-end but before the issuance of the financial statements. Company A believes that because the legislation is probable and is related to revenue transactions for the year ended December 31, 20X1, a liability should be accrued. However, the obligating event in this case is the enactment of the legislation, before which A did not incur a liability even though a tax is expected to be assessed on 20X1 sales; thus, no liability should be accrued as of December 31, 20X1. Instead, the impact of the new legislation is a nonrecognized subsequent event, and A should consider whether it is required to disclose the event to keep the financial statements from being misleading.

If a recognized contingent liability is settled after the balance sheet date but before the financial statements are issued or are available to be issued, a contingent liability should be reversed as of the balance sheet date to the extent that the recognized liability exceeds the settlement amount. The settlement constitutes additional evidence of conditions that existed as of the balance sheet date and would be considered a recognized subsequent event.

## 6.3 Gain Contingencies

The standard for recognition of gain contingencies is substantially higher than that for recognition of loss contingencies. ASC 450-30 indicates that a gain contingency should usually not be recognized before realization.

### ASC 450-30

**25-1** A contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization.

A gain contingency should not be recognized even if realization is considered probable. The notion of “probable” is relevant in accounting for a loss contingency, but it is not relevant in accounting for a gain contingency.

### 6.3.1 Scope

All gain contingencies should be evaluated under ASC 450-30-25-1 unless another source of authoritative literature specifically prescribes a different accounting model. The table below provides a nonexhaustive list of examples of uncertainties related to the timing or amounts of future cash flows to be received that are within the scope of other literature.

#### ASC 606

Seller's estimation and constraint of estimates of the transaction price related to variable consideration (including a sale with a right of return) promised in a contract with a customer. (ASC 450-10-60-3)

#### ASC 610-20

Seller's estimation and constraint of estimates of the transaction price in a contract for the sale of a nonfinancial asset or in-substance nonfinancial asset in a contract with a party other than a customer. (ASC 450-10-60-3)

(Table continued)

ASC 720-20	"[R]ecognition of insurance recoveries by an entity insured through a purchased retroactive insurance contract," other than for core insurance operations of an insurance entity. (ASC 450-30-60-4)
ASC 805-20	Indemnification assets acquired as part of a business combination. If an acquirer cannot determine the acquisition-date fair value of a contingency during the measurement period, it recognizes the contingency at its estimated amount if (1) "it is probable that an asset existed or that a liability had been incurred at the acquisition date" and (2) "[t]he amount of the asset or liability can be reasonably estimated." These requirements are similar to those in ASC 450 related to loss contingencies.
ASC 805-30	Contingent consideration related to the receipt of previously transferred consideration for the purchase of a business.
ASC 815-10	Contingent consideration arrangements accounted for as a derivative.
ASC 840-10	Lessor accounting for contingent rental income. (ASC 450-30-60-5)
ASC 842-30	Lessor accounting for variable lease payments for sales-type leases, direct financing leases, or operating leases. (ASC 450-30-60-5)
Section F.3.4 of Deloitte's Roadmap <i>Consolidation — Identifying a Controlling Financial Interest</i>	Contingent consideration accounting by the seller upon a subsidiary's deconsolidation or derecognition of a group of assets that is a business.

### 6.3.2 Application of the Gain Contingency Model

ASC 450-30-25-1 indicates that a gain contingency should not be recognized "before its realization." The realization of a gain occurs at the earlier of when the gain is realized or when it is realizable.

This view is based on paragraph 83 of FASB Concepts Statement 5 (codified in ASC 450), which states, in part:

Revenues and gains of an enterprise during a period are generally measured by the exchange values of the assets (goods or services) or liabilities involved, and recognition involves consideration of two factors, (a) being realized or realizable and (b) being earned, with sometimes one and sometimes the other being the more important consideration.

- a. *Realized or realizable.* Revenues and gains generally are not recognized until realized or realizable. Revenues and gains are realized when products (goods or services), merchandise, or other assets are exchanged for cash or claims to cash. Revenues and gains are realizable when related assets received or held are readily convertible to known amounts of cash or claims to cash. Readily convertible assets have (i) interchangeable (fungible) units and (ii) quoted prices available in an active market that can rapidly absorb the quantity held by the entity without significantly affecting the price. [Footnote omitted]

**Recognition of a gain contingency occurs at the earlier of when:**

**The gain has been realized**

**The gain is realizable**

An entity must often use significant judgment to determine when realization of a gain has occurred. Substantially all uncertainties about the realization of a gain contingency should be resolved before the gain contingency is considered realized or realizable and recognized in the financial statements. A gain is realized when cash or a claim to cash has been received and the cash (or claim to cash) is not subject to refund or clawback. A claim to cash supporting realization of a gain will often be in the form of a receivable. Such receivables may arise through (1) legally binding contractual arrangements detailing payment terms or (2) evidence provided by an insurer that all contingencies have been resolved and that the insurer will pay the insured party's claim with no right to repayment. It may be appropriate to recognize a gain contingency when it is realizable, although we would generally not expect this to be a common occurrence. A gain is realizable when assets received or held are readily convertible to a known amount of cash (or claim to cash).

An entity must thoroughly analyze all relevant facts and circumstances related to the gain contingency to support a conclusion that (1) a gain has been realized or (2) assets are readily convertible to cash in a known amount and the gain is therefore realizable. For an entity to recognize a gain contingency, the claim to cash must meet the definition of an asset in paragraphs E16 and E17 of FASB Concepts Statement 8, Chapter 4. Paragraph E17 states, in part:

An asset has the following two essential characteristics:

- a. It is a present right.
- b. The right is to an economic benefit.

**Connecting the Dots**

Upon a litigation settlement determined by the courts or other authoritative bodies, an agreement often is executed that outlines the payments to be made by one or both of the parties and the timing thereof. In these situations, there is no longer a gain contingency because the agreement represents a claim to cash and the gain therefore has been realized. The executed agreement represents a contractual receivable since there are no contingencies remaining. The party with the right to receive cash proceeds would assess the contractual receivable for impairment.

In concluding that a gain has been realized or is realizable, an entity should consider the nonexhaustive list of factors in the illustration below.



Besides the factors identified above, the entity should consider additional facts and circumstances, the nature of the agreement, and consultation with accounting advisers, as further discussed below.

<b>Additional Facts and Circumstances</b>	An entity that meets all of the above criteria should consider its individual facts and circumstances to determine whether any additional factors indicate that realization or realizability has not yet occurred.
<b>Nature of the Agreement</b>	An oral agreement may be legally binding in certain situations. For example, to recognize revenue within the scope of ASC 606, an entity must have a contract with a customer that is agreed to “in writing, orally, or in accordance with other customary business practices.” This requirement is based on the FASB’s conclusion that a revenue contract must be enforceable by law for an entity to recognize the rights and obligations arising from the contract. Because gain contingencies, by their nature, are generally expected to occur less frequently than revenue transactions, it is considerably less likely that oral evidence of, or a history of establishing, a customary business practice would be sufficient for the agreement to constitute a legally binding contract. Therefore, a written agreement would generally need to be in place for a gain contingency to be recognized.
<b>Consultation With Accounting Advisers</b>	Given the high threshold for recognizing a gain contingency, entities may determine that consultation with their accounting advisers is warranted when evaluating exactly when realization or realizability of a gain contingency has occurred. For example, while the realization principle described above does not mandate that cash be received before realization is considered to have occurred, the timing of receipt of cash often may coincide with when all remaining uncertainties associated with the gain contingency have been resolved.

### 6.3.3 Legal Disputes and Legislative or Regulatory Approval

Because of the number of uncertainties inherent in a litigation proceeding, gain contingencies resulting from favorable legal settlements generally cannot be recognized in income until cash or other forms of payment are received. Gain recognition is not appropriate when a favorable legal settlement remains subject to appeal or other potential reversals. Often, gain contingency recognition will be deferred even after a court rules in favor of a plaintiff.

#### Example 6-8

##### Legal Dispute — Declaration of Award

Company W, a drug manufacturer, has a dispute with Company O, a third party it engaged to perform clinical research services. Company O ceases the work before its completion, and W subsequently declares the contract canceled because of various issues concerning O's performance of its obligations under the contract. Company W files a claim against O, and the parties enter into arbitration. The arbitrator declares that O is to pay W \$4 million. The arbitrator's judgment may be appealed to a higher court. Because there is no direct linkage between the arbitration award granted and the costs W previously incurred under the contract with O, the arbitration award is a gain contingency rather than the recovery of a previously incurred loss, and W should not recognize the \$4 million award before its realization or when it is considered realizable.



#### Connecting the Dots

In the example above, Company W should not recognize the \$4 million gain contingency award because all possible appeals have not yet been exhausted and W's gain contingency therefore is not considered realized or realizable. This threshold for recognizing a gain contingency is higher than the "probable and reasonably estimable" threshold required for recognition of a loss contingency (see [Section 6.2](#)) or a loss recovery (see [Section 6.4](#)).

Separately, Company O would recognize a loss contingency after the arbitrator's judgment because the criteria in ASC 450-20 have been met. The arbitrator's ruling is significant objective evidence of the probability that O has incurred a liability, and O concludes that it does not have sufficient evidence to counterbalance this adverse ruling. Further, the \$4 million that O will pay to W for settlement of the dispute is reasonably estimable on the basis of the arbitrator's ruling. Because the thresholds for recognition of gain contingencies differ from those for recognition of loss contingencies or loss recoveries, it is not uncommon for one party in a dispute to recognize a loss contingency while the counterparty does not recognize the gain contingency.

Although an entity may be certain that it will receive proceeds from a legal settlement because there is no possibility of additional appeals, there may still be other uncertainties that indicate that the gain has not yet been realized. The examples below illustrate contrasting scenarios in which the ultimate amount to be received is not estimable in one case and is known in the other.

#### Example 6-9

##### Legal Dispute — Cash Is Received in Escrow: Amount Not Estimable

Company R is a plaintiff in a class action lawsuit against several drug manufacturers. After a lengthy appeals process, a final settlement is reached. The drug manufacturers place the funds in an escrow account because there is no agreement on how to allocate the settlement among the attorneys and each respective plaintiff. Because R does not know the amount of cash to be received, gain recognition is inappropriate.

**Example 6-10****Legal Dispute — Cash Is Received in Escrow: Amount Known**

Assume the same facts as in the example above except that the amount to be paid to Company R and to all other plaintiffs is known. In addition, the cash has already been placed in escrow and will be paid by the court-appointed escrow holder after it performs various administrative tasks (i.e., preparing and processing the wire payments to plaintiffs). None of the other plaintiffs are contesting the outcome or allocation of the settlement. The cash is nonrefundable, and there is no potential for appeal or reversal. Company R has not identified any additional facts or circumstances related to this gain contingency that call into question whether the gain has been realized. After consulting with its accounting advisers, R concludes that gain recognition is appropriate if sufficient disclosure is provided about the status of realization. Company R's realized claim to payment, as detailed in the agreement, would represent a contractual receivable subject to an impairment assessment.

If a legal settlement is reached but is pending regulatory or legislative approval, gain recognition is not appropriate until all required levels of regulatory and legislative approval have been obtained. This is the case even if the entity can demonstrate that the settlement meets all criteria that are evaluated by a regulatory body when it is determining whether to grant approval.

**6.3.4 Settling Litigation by Entering Into an Ongoing Business Relationship**

An entity may recognize gains related to the settlement of litigation achieved by entering into an ongoing business relationship when the revenue recognition criteria for such a relationship have been met. Such a situation may exist when a litigation settlement agreement includes past obligations and disputes and modifies the ongoing contractual terms of the business relationship. When the contractual relationship is with a customer, the entity should apply ASC 606; otherwise, the entity may find it appropriate to apply ASC 610-20. In accounting for a litigation settlement that also includes a revenue element, an entity should consider bifurcating the settlement into its different elements, as described in an SEC staff [speech](#) at the 2007 AICPA Conference on Current SEC and PCAOB Developments (see [Section 6.2.1.2](#) for further discussion).

In addition, regarding classification of the settlement, entities should consider the guidance in ASC 606 when making payments to a customer and in ASC 705-20 when receiving payments from a vendor. See [Section 6.2.1.3](#) for further discussion.

**6.3.5 Gain Realization Contingent on Future Performance Requirements**

An entity's realization of a gain may be contingent on whether the entity meets a future performance requirement. Alternatively, realization of a gain may be contingent on future events outside the entity's control. In both cases, uncertainty remains and recognition of the gain contingency is not appropriate.

Other Codification topics (e.g., ASC 718) prescribe different accounting treatment when uncertainty or contingent events are outside or within the entity's control. As long as the uncertainty is within the scope of the gain contingency guidance in ASC 450-30, the entity should not analogize to other areas of guidance in U.S. GAAP when evaluating the appropriateness of recognizing a gain contingency.

### 6.3.6 Gain Contingency Disclosures

#### ASC 450-30

**50-1** Adequate disclosure shall be made of a contingency that might result in a gain, but care shall be exercised to avoid misleading implications as to the likelihood of realization.

Even if insurance proceeds resulting in a gain or other gain contingencies are not recognized in the financial statements because of unresolved uncertainties, timely disclosure of the insurance gain contingency should be considered. Information disclosed might include (1) the nature of the gain contingency, including a description of any remaining uncertainties; (2) the parties involved; (3) the timeline of previous events; (4) an expected timeline for resolving the remaining uncertainties; and (5) the amount of the gain contingency, including consideration of uncertainties in the determination of the amount. If the entity is unable to determine the timeline for resolution or an estimate of the amount that will ultimately be realized, the entity may need to disclose the factors it considered in reaching these conclusions and update these disclosures in future financial statements as additional information becomes available.

The entity should take care to avoid providing misleading disclosures about the likelihood, timing, or amount of the potential gain contingency. Disclosures should also include the entity's accounting policy for recognizing recovery proceeds of previously recognized losses as well as proceeds expected to be received in excess of previously recognized losses.

For considerations related to gain contingency classification, see [Section 6.4.7](#).

### 6.3.7 Subsequent-Event Considerations

Entities should evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in the current-period or subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to gain contingencies that are described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.

The resolution of a gain contingency that results in a gain after the balance sheet date but before the financial statements are issued or are available to be issued generally should not be considered a recognized subsequent event. ASC 855-10-15-5(c) indicates that gain contingencies "are rarely recognized after the balance sheet date but before the financial statements are issued or are available to be issued" and provides a cross-reference to ASC 450-30-25-1, which states that "[a] contingency that might result in a gain usually should not be reflected in the financial statements because to do so might be to recognize revenue before its realization."



## 6.4 Loss Recoveries

### 6.4.1 Overview

Previous sections of this chapter address the accounting for loss and gain contingencies. This section addresses the accounting for recoveries pertaining to a previously recognized financial statement loss (e.g., an impairment of an asset or incurrence of a liability), as well as recoveries from business interruption insurance. Insured losses might result from partial or full destruction of an entity's property or equipment because of fire, earthquake, hurricane, or other natural disasters, as well as losses that arise from asbestos exposure or environmental matters. Insured losses can also take the form of insured director and officer costs and result from fraudulent activities undertaken by employees. Loss recoveries may be received from litigation settlements, insurance proceeds, or reimbursement of an employee's fraudulent activities through liquidation of the employee's assets.

An entity should consider four accounting models when determining the recognition and measurement of expected insurance or other proceeds related to a recovery: (1) the loss recovery model, (2) the gain contingency model, (3) a determinable mix of the loss recovery and gain contingency models, and (4) an indeterminable mix of the loss recovery and gain contingency models.

Loss recovery model	An asset for which realization is probable should be recognized only up to the amount of the previously recognized loss. The analysis of whether recovery is probable is consistent with the guidance on loss contingency recognition in <a href="#">Section 6.2</a> .
Gain contingency model	Recovery proceeds related to a loss that has not been recognized in the financial statements should be accounted for as a gain contingency as described in <a href="#">Section 6.3</a> .
Determinable mix of loss recovery and gain contingency models	A combination of the loss recovery and gain contingency models is applied when recovery proceeds are expected to exceed the amount of the previously recognized loss. The probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. The expected proceeds in excess of the recognized loss should be accounted for by using the gain contingency model. For an entity to apply the determinable mix model, there must be a direct linkage between the recovery proceeds and the specifically identifiable recognized loss. See <a href="#">Section 6.4.4</a> for additional information.
Indeterminable mix of loss recovery and gain contingency models	An indeterminable mix of the loss recovery and gain contingency models results from a situation in which there is no clear evidence that the amount of the recovery proceeds is a recovery of previously recognized losses or costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., the losses or costs are not specific, incremental, identifiable costs or losses). Under these circumstances, the application of the gain contingency model would be appropriate for the entire amount of the recovery proceeds. See <a href="#">Section 6.4.4</a> for additional information.

These four models are based on the loss contingency model and the gain contingency model, both of which are codified in ASC 450. In addition, the accounting for recovery proceeds builds upon ASC 450, drawing from other parts of U.S. GAAP, including guidance on involuntary conversions (ASC 610-30); how to account for the impact of the September 11, 2001, terrorist attacks (EITF Issue 01-10); and environmental obligations (ASC 410-30). Sections 6.4.2 (below) and [6.4.3](#) describe how these additional sources of U.S. GAAP form the basis for the accounting for recovery proceeds.

## 6.4.2 Involuntary Conversions

Insurance is often maintained to mitigate losses in the event of property damage or casualty losses. The recognized loss and the associated recovery proceeds (through insurance proceeds or other sources of recovery) are treated as two separate events and therefore two separate units of account. The principle underlying this separation, which is the basis for the accounting models described in [Sections 6.4.3](#) and [6.4.4](#), is derived from the involuntary conversion guidance codified in ASC 610-30.

### ASC 610-30

**25-2** An involuntary conversion of a nonmonetary asset to monetary assets and the subsequent reinvestment of the monetary assets is not equivalent to an exchange transaction between an entity and another entity. The conversion of a nonmonetary asset to monetary assets is a monetary transaction, whether the conversion is voluntary or involuntary, and such a conversion differs from exchange transactions that involve only nonmonetary assets. To the extent the cost of a nonmonetary asset differs from the amount of monetary assets received, the transaction results in the realization of a gain or loss that shall be recognized.

**25-3** Involuntary conversions of nonmonetary assets to monetary assets are monetary transactions for which gain or loss shall be recognized even though an entity reinvests or is obligated to reinvest the monetary assets in replacement nonmonetary assets. However, the requirement of this Subtopic with respect to gain recognition does not apply to an involuntary conversion of a last-in, first-out (LIFO) inventory for which replacement is intended but not made by year-end and the taxpayer does not recognize gain for income tax reporting purposes. Paragraph 270-10-45-6(b) provides an exception for the liquidation of a LIFO inventory at an interim date if replacement is expected by year-end. Accordingly, that exception applies to an involuntary conversion of a LIFO inventory if replacement is expected by year-end.

**25-4** In some cases, a nonmonetary asset may be destroyed or damaged in one accounting period, and the amount of monetary assets to be received is not determinable until a subsequent accounting period. In those cases, gain or loss shall be recognized in accordance with Topic 450.

When a nonmonetary asset (e.g., property) is involuntarily converted to a monetary asset (e.g., an insurance receivable), an entity must recognize the effects of the monetary transaction even if the proceeds are reinvested (voluntarily or by requirement) in the replacement or repair of the nonmonetary asset. The loss of a nonmonetary asset and subsequent monetary recovery through insurance are therefore accounted for as two separate units of account.

### Example 6-11

#### Involuntary Conversion

A fire destroys Company X's operating plant. Company X must write off the plant, recognizing a loss, regardless of its decision or the insurance company's requirements to use the proceeds to replace or repair the plant. Any insurance proceeds received are accounted for separately and apart from the incurred loss.

If the property or equipment is destroyed or damaged in one period and the recovery proceeds are not determinable until a subsequent period, X recognizes the loss when incurred without considering possible recognition of a monetary recovery (e.g., cash proceeds).

### 6.4.3 Loss Recovery and Gain Contingency Models

In determining whether an asset can be recognized for expected proceeds (e.g., proceeds from an insurance policy), an entity must first consider the amount of the expected proceeds in comparison to the related previously recognized loss, if any. This comparison is illustrated below in the context of the loss recovery and gain contingency models.

#### Loss Recovery Model



- \* The ultimate net income statement effect of the recognized loss and the insurance proceeds directly related to the recognized loss to the income statement is zero; however, the period in which the loss and the insurance proceeds are recognized may differ.

#### Gain Contingency Model



Although not codified, paragraph 16 of EITF Issue 01-10 notes that a gain is “a recovery of a loss not yet recognized in the financial statements or an amount recovered in excess of a loss recognized in the financial statements.” Consequently, a loss recovery could be defined as the inverse: recovery proceeds up to the amount of the financial statement loss incurred. The recognition threshold for a loss recovery is that it is probable, as indicated by ASC 410-30-35-8, which states, in part, that “an asset relating to the recovery shall be recognized only when realization of the claim for recovery is deemed probable.”

An asset related to a recovery should be recognized for a previously recognized financial statement loss when the recovery is probable. The amount greater than the previously recognized loss or a recovery of a loss not yet recognized in the financial statements should be treated as a gain contingency.

ASC 410-30 addresses the accounting for recovery proceeds related to environmental remediation liabilities. Although that guidance is specific to environmental matters, an entity should apply the recognition and measurement principles in ASC 410-30-35-8 and 35-9 when determining the appropriate recognition of other loss recoveries unrelated to environmental matters.

**ASC 410-30**

**35-8** . . . The amount of an environmental remediation liability should be determined independently from any potential claim for recovery, and an asset relating to the recovery shall be recognized only when realization of the claim for recovery is deemed probable. The term *probable* is used in this Subtopic with the specific technical meaning in paragraph 450-20-25-1.

**35-9** If the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.

An entity that incurs a loss attributable to impairment of an asset or incurrence of a liability and expects to recover all or a portion of that loss by filing a claim with an insurance carrier or a claim against other third parties should record an asset for the amount for which the recovery from the claim (not to exceed the amount of the total losses recognized) is considered probable. Amounts greater than an amount for which recovery from the claim was initially considered probable should be subsequently recognized only to the extent that they do not exceed actual additional covered losses or direct, incremental costs incurred to obtain the recovery. Any expected recovery that is greater than covered losses or direct, incremental costs incurred represents a gain contingency; therefore, a higher recognition threshold is required for such a recovery, as described throughout this section.

A conclusion that a potential recovery is probable may involve significant judgment and should be based on all relevant facts and circumstances. Claim proceeds that will result in a gain should be recognized at the earlier of when the proceeds are realized or realizable. For example, insurance proceeds may be considered realized when the insurance carrier settles the claim and no longer contests payment. Payment alone does not mean that realization has occurred if such payment is made but is being contested or is subject to refund. Recognition of the proceeds may be appropriate after consideration of the conditions outlined in [Section 6.3.2](#). Further, an entity should analyze proceeds accounted for as a loss recovery by applying the “probable” criterion used to determine a loss contingency (whether an asset has been impaired or a liability has been incurred), as outlined in [Section 6.2.2.1.1](#).

When recognizing potential loss recoveries from insurance carriers or other third parties, entities should consider both internal and external evidence related to the claim, including:

- Direct confirmation from the insurance carrier or other third parties that they would agree with the claim.
- In the absence of direct evidence from the insurance carrier or other third parties that they would agree with the claim, an opinion from legal counsel that it is “probable,” as that term is used in ASC 450, that:
  - The claim under the policy is enforceable.
  - Any loss events are covered.

Before recognizing a potential loss recovery, entities should consider the guidance in ASC 410-30-35-9, which indicates that “[i]f the claim is the subject of litigation, a rebuttable presumption exists that realization of the claim is not probable.”



### SEC Considerations

The guidance in ASC 410-30-35-9 is consistent with the SEC staff's interpretive guidance in Question 2 of [SAB Topic 5.Y](#) (codified in ASC 450-20-S99-1). However, additional disclosure requirements are included in footnote 49 of that guidance, which addresses uncertainties regarding the legal sufficiency of claims filed against insurance carriers or other third parties and the solvency of such insurance carriers and other third parties:

The staff believes there is a rebuttable presumption that no asset should be recognized for a claim for recovery from a party that is asserting that it is not liable to indemnify the registrant. Registrants that overcome that presumption should disclose the amount of recorded recoveries that are being contested and discuss the reasons for concluding that the amounts are probable of recovery.

For an entity to determine whether its receipt of a recovery is probable, it will most likely need to (1) understand, among other factors, the solvency of the insurance carrier or other third parties and (2) have sufficient dialogue and historical experience with the insurance carrier or other third parties related to the type of claim in question to assess the likelihood of payment.

#### Example 6-12

##### Insurance Recovery of Replacement Cost

A fire destroys Company H's main operating plant. Immediately after the fire, H recognizes a loss for the net book value of the plant and meets with the insurance adjuster to evaluate the loss and expedite the claim. Given a similar fire loss three years earlier, both parties are familiar with H's plant and the process by which the adjuster will determine H's claim settlement amount.

Because H is constructing a similar plant, H and the adjuster are also familiar with the replacement cost of the plant. Accordingly, the adjuster is able to quickly estimate the minimum property damage claim and implement appropriate procedures to process the claim and establish a schedule of reimbursements. The adjuster computes and the insurance carrier approves (settles) a minimum reimbursement for the cost of replacement; the amount is greater than the net book value of the old plant. Company H appropriately recognizes a gain for the excess of the minimum reimbursement over the net book value of the property since the amount was considered realized when the insurance carrier settled the claim and no longer contested the payment to be made to H.



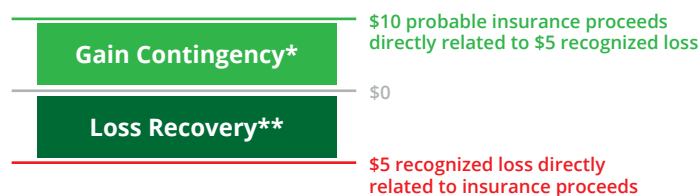
### Connecting the Dots

Some incurred losses may be related to past events spanning multiple years or decades, such as losses that arise from asbestos exposure or environmental matters. In these situations, the losses may span periods covered by several insurance carriers, some of which may no longer be solvent, or various policies. Therefore, it may be challenging for an entity to determine whether the incurred loss is a covered event, whether because of vague language used in prior insurance policies or the number of policies or insurance carriers that may have existed at any given time. The entity should consider these potential limitations and factor them into its calculation of the probability that it will receive an insurance recovery for losses spanning multiple years.

### 6.4.4 Determinable and Indeterminable Mix of Loss Recovery and Gain Contingency Models

Under the determinable mix model, the probable recovery proceeds equal to the amount of the recognized loss should be accounted for by using the loss recovery model. Any expected proceeds in excess of the recognized loss should be accounted for as a gain contingency. When there is no clear evidence that the amount of the proceeds is a recovery of previously recognized losses or incremental costs (i.e., there is no direct linkage) or the amount of the loss or costs previously incurred is not objectively quantifiable (i.e., specifically identifiable), the gain contingency model would be applied to the entire amount of the recovery proceeds (also referred to as the indeterminable mix model). The determinable mix model, which encompasses both the loss recovery model and the gain contingency model, and the indeterminable mix model, which results in the application of the gain contingency model to probable recovery proceeds, are further illustrated below.

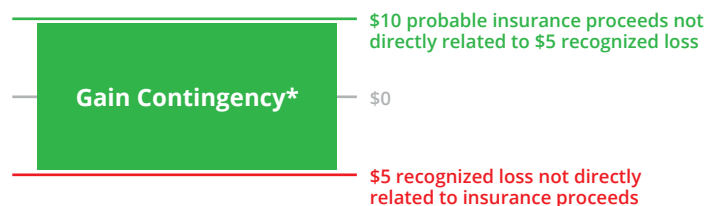
#### Determinable Mix Model



\* Gain contingency model for \$5 proceeds in excess of \$5 recognized loss.

\*\* Loss recovery model for \$5 proceeds up to \$5 recognized loss.

#### Indeterminable Mix Model



\* Gain contingency model for all probable proceeds.

The examples below illustrate the application of the determinable mix model and the indeterminable mix model.

**Example 6-13****Determinable Mix Model**

An earthquake destroys Company R's corporate headquarters. At the time of the earthquake, the net book value of the corporate headquarters is \$350,000. Company R's insurance policy covers fair market value of the property, and R has a \$50,000 deductible. In accordance with the insurance policy, the fair market value of the corporate headquarters is based on a third-party appraisal before the earthquake. Company R carefully analyzes the provisions of the insurance policy regarding the deductible. Using an external expert, R determines that the fair value of the corporate headquarters before the earthquake was \$500,000.

In the same period as the earthquake, the insurance adjuster communicates to R that once the fair value is determined, an amount equal to the fair market value of the property, reduced by the deductible, will be paid to R, and the amount will not be subject to refund. Because this is a determinable mix of a loss recovery and a gain contingency, in the current period in which the earthquake occurs, R recognizes a loss of \$350,000 for the net book value of the destroyed corporate headquarters and a corresponding insurance recovery receivable of \$350,000. The loss recovery receivable is recognized because R concludes that it is probable that the insurance recovery will be realized.

Because it is probable that the insurance recovery will be realized and the fair value of the facility was determined to be well above the net book value of the corporate headquarters, we believe that it would be appropriate for R to recognize the entire \$350,000 loss recovery in the period in which the loss on the property is recognized. In a scenario in which there is sufficient evidence to support the insurance payment (in this case, \$450,000, which represents the \$500,000 fair market value of the property reduced by the \$50,000 deductible) will exceed the amount of recognized loss (in this case, \$350,000), it would be appropriate for R to recognize an insurance recovery receivable in an amount of \$350,000 and apply the deductible to the deferred gain, which represents the excess amount of fair market value over the net book value of the property.

The deferred gain is the \$100,000 difference between (1) the expected insurance proceeds of \$450,000 and (2) the \$350,000 recognized recovery receivable. Such a gain contingency should not be recognized until all contingencies are resolved and the insurance proceeds are realized. In this example, R may conclude that the \$100,000 is realized once the adjuster pays or confirms the related covered amount (the fair value of the corporate headquarters) and the amount is no longer contested or subject to refund.

***Evidence to Support Probable Receipt of \$350,000 Insurance Proceeds***

To recognize the \$350,000 recovery receivable, R considered whether it had sufficient evidence to support recognition of the full amount of the loss recovery receivable. If, for example, the external expert had determined the fair value of the corporate headquarters to be \$400,000 rather than \$500,000, it may have been more difficult for R to conclude that the full \$350,000 loss recovery asset would have been received because there would have been no excess (i.e., cushion) of fair value over the net book value of the property. In these situations, an entity could consider consulting with its accounting advisers.

**Example 6-14****Indeterminable Mix Model**

Company T joins a class action lawsuit against Wholesaler Y because Y has overcharged for various service fee transactions over the past 10 years. Wholesaler Y and T enter into a settlement agreement, subject to the final approval of the claims administrator, for an estimated amount of \$35 million payable to T over the next 5 years. Company T concludes that it is probable that T will receive at least \$35 million from the settlement. The settlement agreement includes the recovery of actual and estimated overcharges, punitive damages, payment to avoid further cost of litigation, and payment to restore a collaborative business relationship.

The recovery of the overcharges amount is based on actual and estimated overcharges over the past 10 years. Company T is unable to determine a direct linkage between (1) what represents cost recovery of the previously recognized overcharges and (2) punitive damages. Further, Y contends in all legal proceedings that the lawsuit is without merit and that T has not previously incurred any losses. From Y's perspective, it is settling the lawsuit to restore a collaborative business relationship rather than to repay T's incurred losses. Accordingly, the amount of the loss previously incurred is not objectively quantifiable.



**Example 6-14 (continued)**

For T to characterize an amount as a loss recovery, the amount should represent the reimbursement of specific, incremental, identifiable costs previously incurred. Company T determines that it is unable to objectively determine how much of the settlement represents recovery of previously recognized overcharges. Therefore, T applies the gain contingency model to the entire amount of the settlement. Uncertainties remain regarding the settlement's approval; therefore, T should defer recognition of the gain until sufficient information is available for T to conclude that the gain is realized or realizable.

**6.4.5 Business Interruption Insurance**

ASC 220-30-20 defines business interruption insurance as “[i]nsurance that provides coverage if business operations are suspended due to the loss of use of property and equipment resulting from a covered cause of loss. Business interruption insurance coverage generally provides for reimbursement of certain costs and losses incurred during the reasonable period required to rebuild, repair, or replace damaged property.” ASC 220-30-05-2 further notes the following regarding business interruption insurance:

**ASC 220-30**

**05-2** The types of costs and losses covered by business interruption insurance typically include the following:

- a. Gross margin that was lost or not earned due to the suspension of normal operations
- b. A portion of fixed charges and expenses in relation to that lost gross margin
- c. Other expenses incurred to reduce the loss from business interruption (for example, rent of temporary facilities and equipment, use of subcontractors, and so forth).

The guidance in [Section 6.4.3](#) on loss recoveries and gain contingencies applies to the accounting for business interruption insurance. That is, certain fixed costs incurred during the interruption period may be analogous to losses from property damage; accordingly, it may be appropriate to recognize a receivable (not to exceed the amount of costs incurred) for amounts whose recovery is considered probable. A recovery receivable should be recognized into income when the direct and incremental losses are incurred if the entity concludes that receipt of the recovery proceeds is probable. A recovery receivable should be recognized only up to the amount of the financial statement loss incurred (e.g., the fixed costs incurred). The possible recovery of lost profit margin should be considered a gain contingency since the absence of expected profit margin would not be considered a previously recognized financial statement loss. Therefore, the recovery of lost profit margin should be recognized into income when the gain contingency is resolved (i.e., the proceeds are realized or realizable). Because of the usually complex and uncertain nature of the settlement negotiations process, recognition of the lost profit margin (i.e., the gain contingency) may occur at the time of final settlement or when nonrefundable cash advances are made.

Because business interruption insurance may be paid in a lump-sum amount to the insured, including reimbursement for both property damage and lost profit margin, it may be difficult to determine whether the recovery is for losses previously recognized in the financial statements (i.e., whether the recovery should be considered a determinable mix or an indeterminable mix of loss recovery and gain contingency). We encourage entities to consult with their independent accountants when evaluating whether a receivable may be recognized for expected insurance recoveries associated with fixed costs incurred during the interruption period.



### Connecting the Dots

There may be situations in which business interruption insurance is paid as an advance, lump-sum, nonrefundable final settlement amount for both future estimated fixed costs (e.g., continued labor, utilities) and estimated future lost profit margin for a claim period that covers future reporting periods. Under these circumstances, the amount received in advance related to future estimated fixed costs or future estimated lost profit margin is treated as a gain contingency. Therefore, because the advanced payment is final and nonrefundable, the gain is considered realized even though the future fixed costs or lost profit margin has not yet occurred. There is no remaining contingency; the gain is therefore recognized in the financial statements given that there is no basis for deferring and amortizing the insurance proceeds over the future anticipated periods of continuing fixed costs or lost profit margin.

ASC 220-30-45-1 addresses the income statement presentation related to business interruption insurance and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles (GAAP).” In addition, in a period in which business interruption insurance recoveries are recognized, ASC 220-30-50-1 requires further disclosures in the notes to financial statements.

#### ASC 220-30

**50-1** The following information shall be disclosed in the notes to financial statements in the period(s) in which business interruption insurance recoveries are recognized:

- a. The nature of the event resulting in business interruption losses
- b. The aggregate amount of business interruption insurance recoveries recognized during the period and the line item(s) in the statement of operations in which those recoveries are classified.

### 6.4.6 Balance Sheet Presentation — Offsetting

ASC 210-20-20 defines a right of setoff as “a debtor’s legal right, by contract or otherwise, to discharge all or a portion of the debt owed to another party by applying against the debt an amount that the other party owes to the debtor.” A right of setoff exists when all of the criteria in ASC 210-20-45-1 are met.

#### ASC 210-20

**45-1** A right of setoff exists when all of the following conditions are met:

- a. Each of two parties owes the other determinable amounts.
- b. The reporting party has the right to set off the amount owed with the amount owed by the other party.
- c. The reporting party intends to set off.
- d. The right of setoff is enforceable at law.

An entity that purchases insurance from a third-party insurer generally remains primarily obligated for insured liabilities; however, the entity should carefully evaluate the insurance contract and applicable laws. Under U.S. GAAP, it is only appropriate to offset assets and liabilities when the four above conditions in ASC 210-20-45-1 for the existence of a right of setoff are met.

It is not appropriate to offset a receivable for a probable insurance recovery against a contingent liability unless the requirements of ASC 210-20 are met. In such circumstances, the conditions for offsetting would typically not be met because an insurance receivable and claim liability generally would be with different counterparties. For example, insurance proceeds received by the reporting entity are usually from a third-party insurer, whereas the contingent liability related to claim liabilities would be to a party other than the third-party insurer.

#### **6.4.7 Income Statement Classification of Loss Recoveries and Gain Contingencies**

ASC 220-30-45-1 addresses the income statement presentation related to business interruption insurance and allows an entity to “choose how to classify business interruption insurance recoveries in the statement of operations, as long as that classification is not contrary to existing generally accepted accounting principles (GAAP).” Further, ASC 410-30 provides guidance on the income statement presentation of environmental remediation costs and related recoveries, such as insurance recoveries. ASC 410-30-45-4 states, in part, that “environmental remediation-related expenses shall be reported as a component of operating income in income statements that classify items as operating or nonoperating. Credits arising from recoveries of environmental losses from other parties shall be reflected in the same income statement line.”

Although authoritative income statement classification guidance does not exist for many other types of loss recoveries, such as involuntary conversions, in practice, entities have generally applied the guidance in ASC 410-30 by analogy when determining the appropriate classification of other loss recoveries.

For recoveries in which the recovery proceeds exceed the incurred loss, resulting in a gain, an entity should consider other authoritative literature, including applicable SEC regulations (e.g., SEC Regulation S-X), when determining whether it is appropriate to classify the gain within the related income statement line item as the loss recovery. Depending on the nature of the gain, entities should consider whether it is appropriate to classify the gain as operating or nonoperating. In determining whether it is appropriate to classify a loss, a loss recovery, or a gain as operating or nonoperating, entities may consider SEC Regulation S-X, Rule 5-03. Although Rule 5-03 does not define items that should be classified as operating, it does provide examples of items that should be classified as nonoperating.

Entities should provide sufficient disclosure, if material, to enable financial statement users to determine in which financial statement line item the gain has been recognized.

#### **6.4.8 Subsequent-Event Considerations**

Entities should evaluate events that occur after the balance sheet date but before the financial statements are issued or are available to be issued to determine whether the events should be recognized in the current-period financial statements or in the subsequent-period financial statements.

The recognition, measurement, and disclosure principles related to loss recoveries that are described in this chapter apply to the period after the balance sheet date but before the financial statements are issued or are available to be issued.

After the balance sheet date, there may be a recovery of a loss that exceeds the amount of a loss previously recognized on or before the balance sheet date, resulting in a gain after the balance sheet date. The recovery should be treated as two separate units of account:

- *Loss recovery* — The amount of the recovery equal to the previously recognized loss.
- *Gain contingency* — The amount of the recovery in excess of the previously recognized loss.

The recognition of these two units of account will differ in a manner that is consistent with the different loss recovery models described in this chapter. A recovery asset (e.g., a receivable) for the amount of the recovery equal to the previously recognized loss should be accounted for as a recognized or nonrecognized subsequent event in a manner that is consistent with the recognition threshold for loss contingencies.

If an event occurs after the balance sheet date but before the financial statements are issued or are available to be issued, and the event indicates that a loss recovery is probable (or the loss recovery has been received) for a loss incurred on or before the balance sheet date, the event provides additional evidence of the recovery and should be accounted for as a recognized subsequent event. Examples might include (1) the probable receipt of insurance proceeds equaling the loss incurred related to a plant that was destroyed on or before the balance sheet date or (2) proceeds from a lawsuit settlement in the amount of a previous loss incurred for litigation that arose on or before the balance sheet date.

The amount of the recovery in excess of the previously recognized loss would be accounted for as a nonrecognized subsequent event because to realize the gain recovery would be to recognize income before it is realized as described in ASC 450-30-25-1. Accounting for the two units of account by using separate recognition thresholds is consistent with the subsequent-event treatment of loss contingencies and gain contingencies discussed earlier in this chapter. Further, the treatment of the loss recovery and the gain contingency as two separate units of account is consistent with the involuntary conversion guidance in [Section 6.4.2](#).

## 6.5 SEC Comment Letter Themes Related to Contingencies

The SEC staff continues to closely monitor registrants' contingency disclosures, and it comments when such disclosures do not comply with U.S. GAAP or SEC rules and regulations.

The staff frequently comments on:

- Lack of specificity regarding the nature of the matter.
- Lack of quantification of amounts accrued, if any, and possible loss or range of loss and/or disclosure about why such an estimate cannot be made.
- Insufficient detail about judgments and assumptions underlying significant accruals.
- Unclear language in disclosures (e.g., not using terms that are consistent with accounting literature, such as "probable" or "reasonably possible") and failure to consider the disclosure requirements of ASC 450, SAB Topic 5.Y, and SEC Regulation S-K, Item 103.
- Lack of disclosure of an accounting policy related to accounting for legal costs (when material) and uncertainties in loss contingency recoveries, including (1) whether ranges of reasonably possible losses are disclosed gross or net of anticipated recoveries from third parties, (2) risks regarding the collectibility of anticipated recoveries, and (3) the accounting policy for uncertain recoveries.

Below are examples of certain SEC staff comments that registrants in the life sciences industry and other industries have received regarding their accounting for contingencies. For more information about SEC comment letter themes that are relevant to the life sciences industry, see Deloitte’s Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).

### 6.5.1 Loss Contingencies

#### Examples of SEC Comments

- You disclose that as of any given date you could have exposure to losses under proceedings as to which no liability has been accrued or as to which the accrued liability is inaccurate. Please revise to clarify for all matters whether you believe there [is] at least a reasonable possibility that a loss may have been incurred or incurred in excess of amounts already accrued and if so, disclose an estimate of such loss or a range of loss or state that such estimate of possible losses cannot be made. Refer to ASC 450-20-50-4.
- With respect to the cyber-security incident and related assessments and litigation, please tell us your consideration of the requirement in ASC 450-20-50-4.b. to disclose an estimate of the possible loss or range of loss or to disclose that such an estimate cannot be made.
- We note your disclosure regarding the . . . claims that the litigation trust filed against you and certain of your current and former officers and directors relating to [Matter A]. . . .  
Please expand your disclosure to specify your estimate of reasonably possible loss or the range of reasonably possible loss pertaining to this matter. If you have not prepared an estimate and are unable to estimate such amount or range, you must include a statement that such an estimate cannot be made to comply with FASB ASC 450-20-50-3 and 4. If this is the case, disclose the amount of damages that are being sought and which have been quantified, and identify any aspects of the litigation for which the amount of damages claimed remain unspecified. Also revise your disclosure to conform to the terminology guidance in FASB ASC 450-20-50-1, or clarify your reserve reference.

The SEC staff often asks about estimates of reasonably possible losses or comments when a registrant omits disclosure of a loss or range of losses because its estimates lack precision and confidence. If an estimate of the loss or range of losses cannot be made, the staff expects registrants to (1) disclose, in accordance with ASC 450-20-50-4, that such an estimate cannot be made and (2) demonstrate that they at least attempted to estimate the loss or range of losses before concluding that an estimate cannot be made. In such cases, the staff has commented that registrants should disclose the specific factors that limited their ability to reasonably estimate the loss or range of losses and has asked about registrants’ quarterly procedures related to such estimates. The factors disclosed should be specific to the loss contingency in question and could include representations that (1) claims do not specify an amount of damages, (2) there are a large number of plaintiffs, or (3) the case is in its early stages.

If a registrant discusses a potential contingency in its earnings calls, the SEC staff is likely to seek more information about the contingency and to inquire about whether the related disclosures are appropriate. The staff encourages registrants to clearly disclose the “full story” regarding their loss contingencies because recognition of such contingencies requires a high degree of professional judgment.

Further, the SEC staff has noted that disclosures related to loss contingencies should be continually evaluated over time as facts and circumstances change. As stated in [Section 6.2.5.1](#), in addition to being required to provide the primary disclosures under ASC 450-20, an entity must provide certain additional disclosures under ASC 275 when it is reasonably possible that a change in estimate will occur in the near term. For discussion of the disclosure requirements of ASC 450-20 and ASC 275, see [Section 2.8.1](#) of Deloitte’s Roadmap [Contingencies, Loss Recoveries, and Guarantees](#).

The SEC staff may also ask about (1) the basis for a registrant's accrual (e.g., factors supporting an accrual, such as trends in claims received and rejected), (2) the timing of a loss contingency's recognition, and (3) the disclosure of a loss contingency. In addition, when a material settlement is disclosed during the period, the staff may review prior-period disclosures to determine whether such disclosures were appropriate (i.e., whether the registrant should have provided early-warning disclosures about the possibility of incurring or settling a loss in future periods to help financial statement users understand these risks and how they could potentially affect the financial statements) or whether an accrual should have been recognized in a prior period.

## 6.5.2 Litigation Contingencies

In addition to complying with ASC 450, when disclosing litigation matters, public entities must separately meet the requirements of SEC Regulation S-K, Item 103, because while those requirements are similar to the requirements of ASC 450, they are not identical. Item 103 requires disclosure of an environmental proceeding to which the government is a party if the proceeding is generally expected to result in sanctions of \$300,000 or more. However, a registrant may elect an alternative higher threshold if the registrant determines that such threshold is more reasonably designed to result in the disclosure of material environmental proceedings. If so, the alternative threshold is limited to the lesser of \$1 million or 1 percent of the current assets of the registrant and its subsidiaries on a consolidated basis. A registrant must disclose this alternative threshold in each annual and quarterly report. Also, to address potential concerns related to a registrant's assertion that providing too much information may be detrimental to litigation or settlement efforts, the SEC staff has indicated that registrants do not need to separately disclose each asserted claim; rather, asserted claims may be aggregated in a logical manner as long as the disclosure complies with ASC 450.



### Connecting the Dots

SEC rules and regulations permit the use of hyperlinks or cross-references to disclosures about legal proceedings that were included elsewhere in the document (e.g., in the financial statement footnotes). However, registrants may not make reference from the financial statements (e.g., the financial statement footnotes) to other areas outside of the financial statements (e.g., Item 103) to satisfy financial statement disclosure requirements (unless permitted by the SEC's rules or the applicable accounting standards).

# Chapter 7 — Statement of Cash Flows

## 7.1 Introduction

While the accounting principles underlying the statement of cash flows have been in place for many years, challenges in interpretation and preparation have consistently made the statement of cash flows one of the leading causes of restatements and comments from the SEC staff for life sciences entities. In Section 7.2 below, we highlight issues commonly encountered by life sciences entities that are associated with the classification of cash flows as operating, investing, or financing. For more information as well as insights into topics not addressed below, see Deloitte's Roadmap [Statement of Cash Flows](#).

## 7.2 Industry Issues

### 7.2.1 Foreign Currency Cash Flows

The global nature of life sciences entities often gives rise to transactions that are denominated in a foreign currency and to businesses that operate in foreign functional currency environments. For example, the product supply chain structure for many life sciences entities involves the movement of materials and products across international borders throughout the manufacturing life cycle, giving rise to many transactions that are exposed to changes in the exchange rate.

For transactions denominated in a foreign currency, an entity should report the cash flow effects on changes in cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents by using the exchange rates in effect on the date of such cash flows. As noted in ASC 830-230-45-1, instead of using the actual exchange rate on the date of a foreign currency transaction, an entity may use an "appropriately weighted average exchange rate" for translation "if the result is substantially the same as if the rates at the dates of the cash flows were used."

A consolidated entity with operations whose functional currencies are foreign currencies may use the following approach when preparing its consolidated statement of cash flows:

- Prepare a separate statement of cash flows for each foreign entity by using the operation's functional currency.
- Translate the stand-alone cash flow statement prepared in the functional currency of each foreign entity into the reporting currency of the parent entity.
- Consolidate the individual translated statements of cash flows.

The effects of exchange rate changes, or translation gains and losses, are not the same as the effects of transaction gains and losses and should not be presented or calculated in the same manner. Effects of exchange rate changes may directly affect cash receipts and payments but do not directly result in cash flows themselves.



Because unrealized transaction gains and losses arising from the remeasurement of foreign-currency-denominated monetary assets and liabilities on the balance sheet date are included in the determination of net income, such amounts should be presented as a reconciling item between net income and net cash from operating activities (either on the face of the statement under the indirect method or in a separate schedule under the direct method). Subsequently, any cash flows arising from the settlement of the foreign-currency-denominated asset and liability should be presented in the statement of cash flows as an operating, investing, or financing activity on the basis of the nature of such cash flows.

Translation gains and losses, however, are recognized in other comprehensive income (OCI) and are not included in cash flows from operating, investing, or financing activities.

The effects of exchange rate changes on cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents should be shown as a separate line item in the statement of cash flows as part of the reconciliation of beginning and ending cash balances. This issue was discussed in paragraph 101 of the Basis for Conclusions of FASB Statement 95, which stated, in part:

The effects of exchange rate changes on assets and liabilities denominated in foreign currencies, like those of other price changes, may affect the amount of a cash receipt or payment. **But exchange rate changes do not themselves give rise to cash flows, and their effects on items other than cash thus have no place in a statement of cash flows.** To achieve its objective, a statement of cash flows should reflect the reporting currency equivalent of cash receipts and payments that occur in a foreign currency. Because the effect of exchange rate changes on the reporting currency equivalent of cash held in foreign currencies affects the change in an enterprise's cash balance during a period but is not a cash receipt or payment, the Board decided that **the effect of exchange rate changes on cash should be reported as a separate item in the reconciliation of beginning and ending balances of cash.** [Emphasis added]

In a manner consistent with the implementation guidance in ASC 830-230-55-15, the effect of exchange rate changes on cash and cash equivalents is the sum of the following two components:

1. For each foreign entity, the difference between the exchange rates used in translating functional currency cash flows and the exchange rate at year-end multiplied by the net cash flow activity for the period measured in the functional currency.
2. The fluctuation in the exchange rates from the beginning of the year to the end of the year multiplied by the beginning cash balance denominated in currencies other than the reporting currency.

For more information about foreign currency accounting and reporting matters, see Deloitte's Roadmap [Foreign Currency Matters](#).

## 7.2.2 Transactions Associated With Acquisitions

The life sciences industry continues to experience significant M&A activity, and transactions associated with acquisitions affect a company's statement of cash flows in a number of ways.

Cash flows related to the acquisitions of businesses, PP&E, and other productive assets are presented as investing activities in the statement of cash flows. For a business combination, all cash paid to purchase a business is shown as a single line item, net of any cash acquired. After an acquisition, the cash flows of the acquirer and acquiree are combined and presented in a consolidated statement of cash flows.

An entity may also need to consider other financial reporting implications of a business combination, depending on the nature and terms of the transaction. For example, any noncash effects of an acquisition that involves noncash consideration must be disclosed in a narrative format or summarized in a schedule.

For additional considerations related to an entity's accounting for a business combination, see Deloitte's Roadmap [Business Combinations](#).

### **7.2.2.1 Presentation of Acquisition-Related Costs**

When consummating a business combination, an acquirer frequently incurs acquisition-related costs such as advisory, legal, accounting, valuation, and professional and consulting fees. Except for certain debt and equity issuance costs, ASC 805 requires that an entity expense all such acquisition-related costs as incurred. The costs of issuing debt or equity securities as part of a business combination are recognized in accordance with other applicable accounting literature.

In the deliberations before the issuance of FASB Statement 141(R) (codified in ASC 805), the FASB determined that acquisition-related costs are not considered part of the fair value exchange between the buyer and seller of the business; rather, they are separate transactions in which the buyer pays for services that it receives. Further, the definition of "operating activities" in the ASC master glossary states, in part, that "[c]ash flows from operating activities are generally the cash effects of transactions and other events that enter into the determination of net income." Because acquisition-related costs accounted for under ASC 805 are expensed and affect net income, these costs should be reflected as operating cash outflows in the statement of cash flows.

### **7.2.2.2 Debt in a Business Combination**

An acquirer may sometimes pay cash to settle all or a portion of the acquiree's outstanding debt on, or shortly after, the acquisition date. Generally, only amounts given to former owners of the acquiree are reported as consideration transferred. However, if the acquiree's preacquisition debt includes a change-in-control provision as described below, cash paid to settle the acquiree's outstanding debt is sometimes presented as consideration transferred rather than as a liability assumed in the acquisition.

An acquiree's preacquisition debt agreement may include a provision that requires, or is at the discretion of the lender, that the debt be repaid upon a change in control of the acquiree so that the acquirer has no discretion regarding whether the debt can remain outstanding after the acquisition date. In that case, the acquirer may consider whether the repayment of the debt could be reported as part of the consideration transferred rather than as a liability assumed in the accounting for the acquisition. If it is determined that the acquiree's debt with the preexisting change-in-control provision was not assumed by the acquirer, the debt repayment may be considered part of the consideration transferred in the accounting for the acquisition (i.e., as if the acquirer repaid the debt on the acquiree's behalf). However, if it is determined that the debt was assumed by the acquirer, the debt is accounted for as a liability assumed in the accounting for the acquisition.

In some cases, there may be a short administrative delay (i.e., one or two days) in the acquirer's repayment of the acquiree's debt when such repayment is required. We believe that in such cases, the cash paid to settle the acquiree's debt might also be reported as consideration transferred if the acquirer is deemed to not have assumed the risks inherent in the debt.

Regardless of whether the repayment of the acquiree's debt is presented as consideration transferred or as a liability assumed, the amount of goodwill reported will not change (see [Examples 7-1](#) and [7-2](#)), but the acquirer should ensure that its financial statements are presented consistently throughout. That is, if the acquirer concludes that it did not assume the acquiree's debt, the amount paid to settle the debt should be accounted for and disclosed as part of the consideration transferred. In addition, in such a case, the acquirer should present the repayment as an investing cash outflow in a manner consistent with how it would present cash consideration paid in a business combination.

By contrast, if the acquirer concludes that it assumed the acquiree's debt, the debt should be accounted for and disclosed as a liability assumed in the acquisition accounting. The acquirer would present the repayment as a financing cash outflow in a manner consistent with how it would present the repayment of its own debt obligations outside of a business combination.

### Example 7-1

#### Acquirer Does Not Assume Acquiree's Debt

Company A acquires Company B in a business combination. Before the acquisition, B had \$1 million in outstanding debt owed to a third-party bank that it was required to settle upon a change in control of B. Company A pays the seller \$5 million in cash and repays the \$1 million directly to the bank at the closing of the business combination. Company A concludes that it did not assume B's debt (i.e., that it repaid the debt on B's behalf). As of the acquisition date, B's net assets recognized in accordance with ASC 805 are \$4 million. Company A calculates the goodwill resulting from the acquisition of B as follows:

Cash consideration paid to the seller	\$ 5,000,000
Repayment of B's debt	<u>1,000,000</u>
Total consideration transferred to acquire B	6,000,000
Less: B's net assets under ASC 805	<u>(4,000,000)</u>
Goodwill	<u>\$ 2,000,000</u>

Because A did not assume B's debt, the total consideration transferred is \$6 million in cash. Therefore, A should present the \$6 million as an investing outflow in its statement of cash flows.

### Example 7-2

#### Acquirer Assumes Acquiree's Debt

Assume the same facts as in the example above, except that Company A concludes that it assumed Company B's debt. As a result, B's net assets recognized in accordance with ASC 805 are \$3 million (i.e., \$4 million less \$1 million in debt). Company A calculates the goodwill resulting from the acquisition of B as follows:

Consideration transferred to acquire B	\$ 5,000,000
Less: B's total net assets under ASC 805:	
B's net assets under ASC 805, excluding debt assumed	\$ 4,000,000
Liability assumed for B's debt	<u>(1,000,000)</u>
	<u>3,000,000</u>
Goodwill	<u>\$ 2,000,000</u>

Because A assumed B's debt, the consideration transferred is \$5 million in cash paid to the seller, and the \$1 million to repay B's debt is a liability assumed in the acquisition accounting. Therefore, A should present \$5 million as an investing outflow and \$1 million as a financing outflow in its statement of cash flows.

For additional considerations related to an entity's accounting for debt in a business combination, see Deloitte's Roadmap [Business Combinations](#).

### 7.2.2.3 *Contingent Consideration Classified as a Liability*

It is common in business combinations entered into by life sciences companies for a portion of the consideration to be contingent on future events. ASC 805 requires the acquirer to recognize the acquisition-date fair value of the contingent consideration arrangement as part of the consideration transferred in exchange for the acquiree. The contingent consideration arrangement is classified either as a liability or as equity in accordance with applicable U.S. GAAP. In transactions involving life sciences companies, contingent consideration is frequently classified as a liability. See [Section 4.2.2.2](#) for further discussion of contingent consideration.

If the acquiring entity determines that the contingent consideration arrangement should be classified as a liability, the initial fair value of the contingent consideration as of the acquisition date should be reflected as a **noncash** investing activity. In accordance with ASC 230-10-50-3, this arrangement should be either disclosed narratively or summarized in a schedule because no cash consideration is transferred on the acquisition date. It should not be reflected in investing activities. In subsequent periods, the contingent consideration liability must be remeasured at fair value as of each reporting date until the contingency is resolved, with the changes recognized as an expense in the determination of earnings (unless the change is the result of a measurement-period adjustment or the arrangement is a hedging instrument for which ASC 815 requires changes to be recognized in OCI). Because the subsequent fair value adjustment enters into the determination of the acquiring entity's net income and is a noncash item, it should be reflected as a reconciling item between net income and cash flows from operating activities in the statement of cash flows.

If the contingent consideration is satisfied in either cash or cash equivalents upon resolution of the contingency, the classification of payments made to settle the contingent consideration liability should be determined on the basis of when such payments are made in relation to the date of the business combination. Essentially, classification of the payments depends on whether they are made soon after the acquisition in a business combination transaction. While ASC 230 does not define the term "soon after," we generally believe that this term would apply to payments made within three months or less of the acquisition date. This view is also consistent with paragraph BC16 of [ASU 2016-15](#), which states, in part, that "some Task Force members believe that a payment for contingent consideration that was made soon after a business combination is an extension of the cash paid for the business acquisition (an investing activity), if that payment for contingent consideration was made within a relatively short period of time after the acquisition date (for example, three months or less)." Therefore, because a payment made on or soon after the business combination date (to settle the liability related to contingent consideration) is viewed as an extension of the business combination, such payments made soon after the date of the business combination are presented as investing activities in the acquirer's statement of cash flows in accordance with ASC 230-10-45-13(d).

Conversely, contingent consideration payments that are not made on the acquisition date or soon after the business combination are not viewed as an extension of the business combination. Therefore, such payments should be separated and presented as:

- *Financing cash flows* — The cash paid to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments), less payments made soon after the business combination date, should be reflected as a cash outflow for financing activities in accordance with ASC 230-10-45-15(f).
- *Operating cash flows* — The cash payments not made soon after the business combination date that exceed those classified as financing activities should be reflected as a cash outflow for operating activities in accordance with ASC 230-10-45-17(ee).

As indicated in paragraph BC14 of ASU 2016-15, the separation of contingent consideration payments not made soon after the business combination date is consistent with the approach most entities used before the ASU was issued. Paragraph BC14 further notes that this approach is the one that is most closely aligned with certain principles in ASC 230.

These principles include the following:

- The cash paid to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) should be reflected as a cash outflow for financing activities in the statement of cash flows. Effectively, the acquiring entity financed the acquisition and the cash outflow therefore represents a subsequent payment of principal on the borrowing and should be reflected in accordance with ASC 230-10-45-15(f).
- The remaining portion of the amount received/paid (i.e., the changes in fair value of the contingent consideration liability after the acquisition date) should be reflected as a cash inflow/outflow from operating activities because the fair value adjustments were recognized in earnings. If the amount paid to settle the contingent consideration liability is less than the amount recorded on the acquisition date (i.e., the fair value of the contingent consideration decreased), the entity would only reflect the portion of the liability that was paid as a cash outflow for financing activities. The difference between the liability and the amount paid is a fair value adjustment. This adjustment enters into the determination of the acquiring entity's net income and is a noncash item, so it should be reflected as a reconciling item between net income and cash flows from operating activities in the consolidated statement of cash flows.

### Example 7-3

On December 1, 20X2, Company A (a calendar-year-end private company) acquires 100 percent of Company B for \$1 million. The purchase agreement includes a contingent consideration arrangement under which A agrees to pay additional cash consideration if the earnings of B (which will be operated as a separate subsidiary of A) exceed a specified target for the year ended December 31, 20X3. Company A classifies the contingent consideration arrangement as a liability and records the contingent consideration liability at its acquisition-date fair value amount, provisionally determined to be \$500,000.

On April 15, 20X3, A finalizes its valuation of the contingent consideration liability. Therefore, A estimates the acquisition-date fair value of the contingent consideration liability to be \$600,000 and records a measurement-period adjustment of \$100,000 (the measurement-period adjustment related to facts and circumstances that existed as of the acquisition date), with an offsetting adjustment to goodwill.

Company B achieves the performance target for the year ended December 31, 20X3; accordingly, A determines that it must pay \$750,000 to B's former owners to settle the contingent consideration arrangement. For the year ended December 31, 20X3, A recognizes \$150,000 (\$750,000 – \$600,000) in earnings to reflect the subsequent remeasurement of the contingent consideration liability to fair value. On January 31, 20X4, A settles the obligation.

No payments to settle the liability for contingent consideration were made soon after the business acquisition date.

**Example 7-3 (continued)**

Company A would present the following amounts in its statement of cash flows for the years ended:

- *December 31, 20X2* — The provisional accrual of \$500,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule.
- *December 31, 20X3* — The adjustment to the provisional accrual of \$100,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule. The subsequent remeasurement adjustment to the contingent consideration liability of \$150,000 would be reflected as a reconciling item between net income and cash flows from operating activities.
- *December 31, 20X4* — Of the \$750,000 paid, \$600,000 represents the amount to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) and should be reflected as a cash outflow for financing activities. The remaining portion of the \$750,000 paid (i.e., the \$150,000 change in fair value of the contingent consideration liability after the acquisition date) should be reflected as a cash outflow for operating activities because the fair value adjustments were recognized in earnings.

**Example 7-4**

Assume the same facts as in the example above except that when B achieves the performance target for the year ended December 31, 20X3, A determines that it only needs to pay \$550,000 to B's former owners to settle the contingent consideration arrangement. For the year ended December 31, 20X3, A recognizes a credit of \$50,000 (\$550,000 – \$600,000) in earnings to reflect the subsequent remeasurement of the contingent consideration liability to fair value.

Company A would present the same amounts as those in the example above in its statement of cash flows for the year ended December 31, 20X2. Company A would then present the following amounts for the years ended:

- *December 31, 20X3* — The adjustment to the provisional accrual of \$100,000 would be reflected as a **noncash** investing activity and would be either disclosed narratively or summarized in a schedule. The subsequent remeasurement adjustment to the contingent consideration liability of \$50,000 would be reflected as a reconciling item between net income and cash flows from operating activities.
- *December 31, 20X4* — The entire amount of the \$550,000 paid represents the amount to settle the contingent consideration liability recognized at fair value as of the acquisition date (including measurement-period adjustments) and should be reflected as a cash outflow for financing activities.

**Connecting the Dots**

Life sciences companies sometimes acquire intangible assets (e.g., product rights) in transactions accounted for as asset acquisitions that may also provide the buyer extended payment terms for consideration payable that is otherwise fixed. Because these transactions are accounted for as asset acquisitions, the above guidance does not apply. Instead, we believe that entities should look to the guidance in ASC 230-10-45-29, which states that the reconciliation of net income to net cash flows from operating activities must separately report all major classes of reconciling items, “including, at a minimum, changes during the period . . . in payables pertaining to operating activities,” and ASC 230-10-45-13(c), which characterizes payments “at the time of purchase or soon before or after purchase to acquire property, plant, and equipment and other productive assets” as cash outflows for investing activities. The SEC staff has informally interpreted the term “soon” in this context as indicating a period of three months or less, which is consistent with the period used for other ASC 230 considerations (e.g., the definition of cash equivalents in ASC 230-10-20, the determination of net or gross presentation in ASC 230-10-45-9, and contingent consideration classified as a liability).

Therefore, the change in accounts payable included in the reconciliation of net income to net cash flows from operating activities should exclude changes in payables related to investing or financing transactions (e.g., the change in payables incurred in the current and previous reporting periods to acquire such assets). Further, in the period in which the payable is settled, the amount paid should be classified as a cash outflow for investing activities or financing activities, depending on the payment terms of the transaction. If the terms of the transaction require payment within three months of the transaction date, the payment would be classified as an investing outflow. Generally, if the payment terms of the transaction extend beyond three months, any payment made after three months would be classified as a financing outflow. However, there may be limited circumstances in which payments made after three months (but less than one year) could be classified as investing outflows — for example, if payment terms extend beyond three months but such terms are consistent with standard industry practice as well as with terms that are customary for the vendor. Entities are encouraged to discuss these circumstances with their accounting advisers. Payments made in connection with terms that require discounting under ASC 835 (i.e., generally of more than one year) should be classified as financing outflows even if the payment terms are consistent with industry practice and considered customary for the vendor.

#### **7.2.2.4 Acquired IPR&D Assets With No Alternative Future Use**

The acquisition of IPR&D assets as part of either a business combination or an asset acquisition is common in the life sciences industry. In accordance with ASC 730, IPR&D assets acquired in an asset acquisition rather than in a business combination should be expensed as of the acquisition date unless such assets have an alternative future use, in which case they should be capitalized. All IPR&D assets acquired in a business combination should initially be capitalized regardless of whether they have an alternative future use. See [Chapter 4](#) for additional information.

We have observed diversity in practice related to how cash payments for IPR&D assets acquired in an asset acquisition are reported in the statement of cash flows when such assets have no alternative future use. While some entities classify the cash payments in operating activities, other entities classify them in investing activities. Given the lack of authoritative guidance on this matter and the diversity in practice, we believe that it is acceptable for an entity to present cash payments related to the IPR&D assets acquired in an asset acquisition that have no alternative use as either operating or investing activities. This election is an accounting policy matter that an entity should consistently apply to similar arrangements and disclose if material.

Considerations related to the classification as operating or investing activities include:

- *Operating activities* — Classification in operating activities of cash outflows for IPR&D assets acquired in an asset acquisition that do not have an alternative future use is supported by the following:
  - ASC 230 does not specifically define such cash outflows as investing or financing activities.
  - Since such cash outflows are immediately expensed, they represent “the cash effects of transactions and other events that enter into the determination of net income” in a manner consistent with the definition of operating activities in the ASC master glossary.



- *Investing activities* — Classification in investing activities of cash outflows for IPR&D assets acquired in an asset acquisition that do not have an alternative future use is supported by the following Q&A in paragraph 5.12 of the AICPA Accounting and Valuation Guide *Assets Acquired to Be Used in Research and Development Activities*:

*Question 1:* How should an acquiring entity classify in its statement of cash flows an R&D charge associated with the costs of IPR&D projects acquired as part of an asset acquisition that have no alternative future use?

*Answer:* Best practices suggest that an acquiring entity should report its cash acquisition of assets to be used in R&D activities as an investing outflow in its statement of cash flows. In this regard, an acquiring entity should treat assets acquired to be used in R&D activities similar to how it reports other acquired assets in the statement of cash flows. Although acquired IPR&D may lack an alternative future use and, therefore, would be expensed immediately, it is still an asset for cash flow statement purposes.

When arriving at cash flows from operating activities under the indirect method of reporting cash flows, best practices suggest that an acquiring entity should add back to net income the costs of assets acquired to be used in R&D activities that are charged to expense. That adjustment is necessary to eliminate from operating cash flows those cash outflows of assets acquired to be used in R&D activities that are reflected in investing activities.

In addition, if the cash outflows are treated as investing activities, the cash flow reporting of IPR&D assets acquired in a business combination would be aligned with that of IPR&D assets acquired in an asset acquisition.

### **7.2.2.5 Settlement of Acquired Liabilities After a Business Combination**

After an acquisition, the acquirer may make payments to settle a liability legally assumed in a business combination. The cash outflow related to the settlement of the liability could be classified as an operating, investing, or financing activity depending on the nature of the payment. The payment should be classified as it would have been in the absence of the business combination. For example:

- If the payment was for inventory purchased on account, it would represent an operating cash outflow.
- If the payment was for PP&E that was purchased on account and was paid within three months of its original purchase date, it would represent an investing cash outflow.
- If the payment was in connection with a debt obligation legally assumed in an acquisition that remained outstanding after the acquisition, it would represent a financing cash outflow. However, as described in [Section 7.2.2.2](#), if the payment is related to debt extinguished in conjunction with a business combination, the entity must consider certain facts and circumstances of the business combination to determine the appropriate presentation in its statement of cash flows.

### **7.2.3 Stock Compensation**

The complexity of stock compensation arrangements often leads to additional presentation issues related to a life sciences entity's statement of cash flows. Two of the more common issues encountered by life sciences entities are addressed below.

### 7.2.3.1 Settlement of Equity-Classified Share-Based Payment Awards

When settling an equity-classified share-based payment award, an entity presents the settlement in its statement of cash flows on the basis of whether the amount paid to settle the award is greater than or less than the fair-value-based measure of the award on the settlement date:

- *Amount paid to settle the award does not exceed the fair-value-based measure of the award on the settlement date* — In accordance with ASC 718-20-35-7, if the cash paid to repurchase the equity-classified award does not exceed the fair-value-based measure of the award on the repurchase date, the cash paid to repurchase the award is charged to equity. That is, repurchase of the equity-classified award is viewed as reacquisition of the entity's equity instruments. Accordingly, the cash paid to reacquire the entity's equity instruments is presented as a cash outflow for financing activities under ASC 230-10-45-15(a), which indicates that payments of dividends or other distributions to owners, including outlays to reacquire the entity's equity instruments, are cash outflows for financing activities.
- *Amount paid to settle the award exceeds the fair-value-based measure of the award on the settlement date* — If the cash paid to repurchase the equity-classified award exceeds the fair-value-based measure of the award on the repurchase date, the cash paid in excess of the fair-value-based measure of the award is viewed as compensation for additional employee services and is recognized as additional compensation cost. Accordingly, if the equity-classified award is repurchased for an amount in excess of the fair-value-based measure, the portion of the cash paid to reacquire the entity's equity instruments that equals the fair-value-based measure of the award is presented as a cash outflow for financing activities under ASC 230-10-45-15(a). The portion of the cash paid in excess of the fair-value-based measure, for additional employee services, is presented as a cash outflow for operating activities under ASC 230-10-45-17(b), which notes that cash payments to employees for services are cash outflows for operating activities.

#### Example 7-5

Company A is making a tender offer to repurchase \$20 million of common stock in the aggregate (the stock was originally distributed as share-based compensation awards) from its current employees. On the basis of an independent third-party valuation, A concludes that the purchase price paid to the employees for the common stock exceeds the fair value of the common stock by a total of \$4.5 million. In accordance with ASC 718-20-35-7, the amount paid to employees up to the fair value of common stock acquired should be recognized in equity as a treasury stock transaction and should therefore be presented as a cash outflow for financing activities. The \$4.5 million that was paid in excess of the fair value of the common stock constitutes compensation expense and is therefore presented as a cash outflow for operating activities.

### 7.2.3.2 Settlement of Liability-Classified Share-Based Payment Awards

In accordance with ASC 718-30, the grant-date fair-value-based measure and any subsequent changes in the fair-value-based measure of a liability-classified award through the date of settlement are recognized as compensation cost. Accordingly, the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities under ASC 230-10-45-17(b).

Note that an entity may enter into an agreement to repurchase (or offer to repurchase) an equity-classified award for cash. Depending on the facts and circumstances, the agreement to repurchase (or offer to repurchase) may be accounted for as either (1) a settlement of the equity-classified award or (2) a modification of the equity-classified award that changes the award's classification from equity to liability, followed by a settlement of the now liability-classified award.

If the agreement to repurchase (or offer to repurchase) is considered a settlement of an equity-classified award, the cash paid to reacquire the entity's equity instruments is presented in a manner consistent with the equity awards discussed in [Section 7.2.3.1](#). If the agreement to repurchase (or offer to repurchase) is considered a modification of the equity-classified award that changes the award's classification from equity to liability, the cash paid to settle the liability-classified award should be presented in the statement of cash flows in a manner similar to the conclusion above. That is, under ASC 230-10-45-17(b), the cash paid to settle the liability-classified award is effectively payment for employee services and is presented as a cash outflow for operating activities.

## 7.2.4 Government Grants

Government grants are a form of government assistance that may be granted to entities, either to encourage those entities to fulfill certain objectives (e.g., providing a financial grant to an entity to fund cancer research) or to assist them during times of crisis (e.g., the Coronavirus Aid, Relief, and Economic Security Act [the "CARES Act"]). Generally, a recipient of a government grant is not expected to repay the grant provided that the recipient complies with the grant's conditions.

Not all government assistance is provided to a recipient in the form of a cash payment. For example, a government grant could be in the form of tax credits. In these situations, an entity must determine whether the tax credits are refundable.

Refundable tax credits (e.g., qualifying R&D credits in certain countries and state jurisdictions and alternative fuel tax credits for U.S. federal income tax) do not depend on an entity's ongoing tax status or tax position, allowing an entity to receive a refund despite being in a taxable loss position. Consequently, the refundable tax credits are similar to government grants and are generally accounted for similarly. This section discusses such tax credits as well as other government grants. For more information on the accounting for refundable tax credits, see [Section 2.7](#) of Deloitte's Roadmap *Income Taxes*.

Tax credits whose realization ultimately depends on taxable income (e.g., investment tax credits and R&D) are not refundable. Such tax credits are recognized as a reduction of income tax, should be accounted for in accordance with ASC 740, and are not discussed in this section. Entities are encouraged to consult with their accounting advisers when it is not clear whether tax credits are refundable.

In determining the appropriate cash flow presentation of government grants (that are not tax credits recognized as a reduction of income tax and accounted for in accordance with ASC 740), it is important to consider the nature of the grants since government assistance can take many different forms. We consider government grants related to long-lived assets to be capital grants and grants related to income to be income grants, as discussed below. However, some government grants may have aspects of both capital grants and income grants (i.e., the grant may be intended to subsidize the purchase of long-lived assets and certain operating costs). Therefore, entities subject to multiple conditions should carefully assess the grant received and should consider the guidance in [Section 7.2.6.1](#) of this Guide.

### 7.2.4.1 Capital Grant

The classification of a capital grant in the statement of cash flows depends on the timing of the cash receipt compared with the timing of the associated costs to which the grant is related. If an entity receives the cash from the grant after it has incurred the capital costs, it would be appropriate to present the cash inflow from the government in the same category (i.e., investing) as the original payment for the associated long-lived asset.

However, if the grant funding is received before the expenditures have been incurred, it would be appropriate for the entity to present that cash inflow as a financing activity, because receiving the cash before incurring the related cost would be similar to receiving a refundable loan advance or to an NFP's receipt of a contribution of a refundable advance that, according to the donor's stipulation, is restricted for capital investment. ASC 230-10-45-14(c) requires that the following be classified as cash inflows from financing activities:

Receipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a donor-restricted endowment fund.

In addition, when the entity incurs the costs in accordance with the conditions of the government grant, it should disclose the existence of a noncash financing activity resulting from the fulfillment of the grant requirements.

#### Example 7-6

Entity C is entitled to receive \$100 million in tax credits upon completing a new manufacturing facility and obtaining a certificate of occupancy from the local authority. Because C does not need to incur a tax liability to collect the tax credits, the tax credits are refundable and are not within the scope of ASC 740.

On December 31, 20X1, C starts the construction of the facility and presents the capital expenditures as an investing activity in its statement of cash flows. On December 31, 20X2, C completes the manufacturing facility and pays the remaining total construction costs. On January 1, 20X3, C obtains the certificate of occupancy and receives the \$100 million in tax credits.

In this example, because the construction costs are classified as an investing activity in C's statement of cash flows and the payments are made before the receipt of the grant, C would present the grant monies as an investing activity in its statement of cash flows for 20X3.

#### Example 7-7

Assume the same facts as in the example above except that the grant monies are received before any capital expenditures are incurred. Entity C would record the grant monies as an asset with a corresponding liability on the balance sheet. The receipt of the grant would be reflected as a financing cash inflow in the statement of cash flows in accordance with ASC 230-10-45-14(c).



#### Connecting the Dots

When a for-profit entity applies the IAS 20 framework, the classification of cash flows associated with a capital grant is generally determined on the basis of when the entity receives the grant. The entity should classify cash received for a capital grant as a financing cash inflow if the entity receives the cash before incurring the cost of the long-term construction project to which the grant is related. In contrast, the entity should classify the cash proceeds from a capital grant as an investing cash inflow if the entity receives the grant after incurring the cost of the project.

However, in accordance with ASC 958-605, an NFP must recognize all government grants as contributions received. Therefore, we believe that such an entity should apply the guidance in ASC 230-10-45-14(c), which states that the entity should present as a financing cash inflow any "[r]eceipts from contributions and investment income that by donor stipulation are restricted for the purposes of acquiring, constructing, or improving property, plant, equipment, or other long-lived assets or establishing or increasing a donor-restricted endowment fund." Accordingly, an NFP applying this guidance would classify the cash received from a government grant contribution as a financing cash inflow, without regard to the timing of when it receives the grant proceeds.

Although NFPs are required to apply the guidance above, for-profit entities can also apply the framework in ASC 958-605 — and, accordingly, the guidance in ASC 230-10-45-14(c) — by analogy in accounting for capital grants.

### 7.2.4.2 *Income Grant*

Similarly, if an entity receives an income grant as reimbursement for qualifying operating expenses, the grant would be presented in the statement of cash flows as an operating activity if it was received after the operating expenses were incurred. However, some entities may believe that when cash is received before the qualifying operating expenses are incurred, it would be appropriate to present the cash inflow as a financing activity for the advance in a manner consistent with the guidance for capital grants above. Alternatively, others may believe that it is acceptable to present the cash inflow as an operating activity if the entity expects to comply with the terms of the grant (e.g., an advance on future payroll taxes credit) so that both the inflow and outflow are presented in the operating category. Given the absence of explicit guidance, we believe that either approach is acceptable. An entity's election of one of the above approaches is a matter of accounting policy that the entity should disclose and apply consistently in similar arrangements.

#### Example 7-8

Entity P is awarded a government grant to receive up to \$50 million of aggregate funding for certain R&D activities. The intent of the government grant is for P to perform R&D activities to achieve the grant's stated objectives. Grant funding is provided after qualifying R&D costs are incurred by P.

Entity P records R&D expenses as period expenses and classifies the cash outflows for the R&D expenses as an operating activity in its statement of cash flows. Therefore, P should classify the cash inflows from receipt of grant monies as an operating activity in its statement of cash flows.

### 7.2.5 *Cash Proceeds From Insurance Claims*

ASC 230-10-45-21B states that “[c]ash receipts resulting from the settlement of insurance claims, excluding proceeds received from corporate-owned life insurance policies and bank-owned life insurance policies, shall be classified on the basis of the related insurance coverage (that is, the nature of the loss).” In addition, for lump-sum settlements, “an entity shall determine the classification on the basis of the nature of each loss included in the settlement.” The purpose of such clarifications is to provide financial statement users with more relevant information.

For example, insurance settlement proceeds received as a result of a claim made in connection with the destruction of productive assets should be classified as cash inflows from investing activities because the settlement proceeds could be analogous to proceeds received on the sale of such assets. However, proceeds received as a result of claims related to a business interruption should be classified as operating activities.

### 7.2.6 *Classification of Certain Cash Receipts and Cash Payments*

#### 7.2.6.1 *More Than One Class of Cash Flows*

Certain cash receipts and payments may have aspects of more than one class of cash flows. Paragraph BC39 of ASU 2016-15 provides guidance on “when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows . . . and when an entity should classify the aggregate of those cash receipts and payments into one class of cash flows based on predominance.” The classification of cash receipts and payments that have aspects of more than one class of cash flows should be determined by first applying specific guidance in U.S. GAAP. When such

guidance is not available, financial statement preparers should separate each identifiable source or use of cash flows within the cash receipts and cash payments on the basis of the nature of the underlying cash flows. Each separately identified source or use of cash receipts or payments should then be classified on the basis of its nature. Classification based on the activity that is most likely to be the predominant source or use of cash flows is only appropriate when the source or use of cash receipts and payments has multiple characteristics and is not separately identifiable.

In accordance with ASC 230, the classification of cash flows with characteristics of more than one class of cash flows is a three-step process and, as noted above, an entity should not default to classification based on predominance. Unless an entity can conclude that sources or uses of cash payments or receipts are not separately identifiable, the entity must first allocate amounts of each cash receipt or payment that has aspects of more than one class of cash flows on the basis of the nature of the underlying cash flows for each separately identifiable source or use of cash. However, because the guidance does not define the term “separately identifiable,” entities must use judgment when applying the guidance.

For additional information on the application of this three-step approach, see [Section 6.4](#) of Deloitte’s Roadmap *Statement of Cash Flows*.

### **7.2.6.2 Classification of Cash Flows of Repayments of Zero-Coupon Bonds and Other Debt Instruments With Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing**

An entity that issues zero-coupon bonds to an investor records the proceeds from the bonds’ issuance as a financing cash inflow. The bonds are accreted to their redemption value in accordance with the “interest” method,<sup>1</sup> as described in ASC 835 (i.e., the carrying amount of the bonds increases from issuance until maturity [or earlier if prepayment is allowed] for the accrued interest to arrive at the bonds’ redemption value). On the maturity date (or earlier if prepayment is allowed), the entity repays (1) the original proceeds (the principal amount of the bonds) and (2) the accrued interest from the date of issuance. Before the bonds’ maturity (or the date of prepayment, if earlier), the interest expense is presented in the statement of cash flows as a reconciling item between net income and cash flows from operating activities, since no interim cash payments are made for the periodic accrual of interest.

At redemption, the cash paid to settle the interest component is reflected as a cash outflow from operating activities in the statement of cash flows in accordance with ASC 230-10-45-17 and ASC 230-10-45-25 as the accrued interest is recognized in earnings. The cash paid to settle the principal is reflected as a cash outflow from financing activities in the statement of cash flows in accordance with ASC 230-10-45-15.

In addition to zero-coupon bonds, the guidance in ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-45-25 also applies to other debt instruments “with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to the principal.” The objective of including these other debt instruments (rather than all debt instruments) is to improve comparability related to entities’ presentation of economically similar transactions.

<sup>1</sup> ASC 835-30-35-4 states that “[o]ther methods of amortization may be used if the results obtained are not materially different from those that would result from the interest method.”





### Connecting the Dots

ASC 230 does not define the term “insignificant” or otherwise provide guidance on what would constitute insignificant coupon rates. Consequently, entities that issue other debt instruments with coupon rates that are insignificant in relation to the effective interest rate attributable to the principal will most likely need to exercise greater judgment in evaluating the portion of the rates that is insignificant. We generally believe that an entity should determine whether an interest rate is insignificant by looking to the market. For example, a 1 percent coupon rate may not be insignificant if the market rate is 2 percent. However, an entity may conclude that a 1 percent coupon rate is insignificant compared with a market rate of 10 percent and that the 1 percent rate is therefore within the scope of ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-45-25.

While the guidance in ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-45-25 specifically addresses only the debtor’s cash flow statement classification, we believe that it is also relevant to the investor’s cash flow statement classification. Therefore, we think that the following payments should be classified as operating activities: (1) the portion of payments received upon settlement of zero-coupon debt instruments that is attributable to accreted interest and (2) the portion of payments received upon settlement of other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing that is attributable to accreted interest (including debt instruments that contain periodic interest coupons that are payable in kind). The principal portion received on these debt instruments would continue to be classified as investing activities.

#### **7.2.6.3 Distributions From Equity Method Investments**

ASC 230 distinguishes between returns of investment, which should be classified as cash inflows from investing activities (see ASC 230-10-45-12(b)), and returns on investment, which should be classified as cash inflows from operating activities (see ASC 230-10-45-16(b)). Accordingly, to make the appropriate classification in the statement of cash flows, entities must determine whether distributions received from an equity method investee represent a “return on” or a “return of” the related investment.

ASC 230-10-45-21D indicates that there are two acceptable methods for determining whether distributions from equity method investments are returns on investment or returns of investment. Under the first method (the “cumulative earnings” approach), distributions are presumed to be returns on investment. When classifying the related cash flows under this approach, an entity should compare cumulative (i.e., since inception) distributions received by the investor, less distributions received in prior periods that were determined to be returns of investment, with the investor’s cumulative equity in earnings. Cumulative distributions received that do not exceed cumulative equity in earnings represent returns on investment and should be classified as cash inflows from operating activities. Cumulative distributions received in excess of the investor’s cumulative equity in earnings represent returns of investment and therefore should be classified as cash inflows from investing activities.

Under the second method (the “nature-of-the-distribution” approach), an entity evaluates the specific facts and circumstances of each distribution to determine its nature. Unlike the cumulative earnings approach, the nature-of-the-distribution approach does not presume that a distribution is a return on investment; rather, an entity using this approach must conduct an analysis to determine the nature of each distribution and may be required to use significant judgment in making this determination. Examples of distributions that may represent returns of investment include, but are not limited to, liquidating dividends and dividends representing proceeds from the sale of PP&E. These distributions should be classified as cash inflows from investing activities to the extent that they are considered to represent returns of investment.



An entity can elect to apply either of these approaches as an accounting policy and must select a single method for all of its equity method investments. Under either approach, an entity should comply with the disclosure requirements in ASC 235-10-50-1 through 50-6. However, if an entity selects the nature-of-the-distribution approach for its equity method investments but cannot obtain the information it needs to evaluate the nature of the distributions for any individual equity method investment, the entity must report a change in accounting principle retrospectively by applying the “cumulative earnings” approach to any such equity method investment. In other words, an entity is not required to apply the cumulative earnings approach to all of its equity method investments when it is unable to obtain adequate information for certain equity method investments; rather, this approach must only be applied to the equity method investments for which the information could not be obtained.



### Connecting the Dots

Although entities are permitted to elect the approach under which distributions may be evaluated, it does not remove the requirement for entities to evaluate whether each distribution from an equity method investment represents a return on investment or a return of investment, particularly when entities elect the nature-of-the-distribution approach. In other words, because the nature-of-the-distribution approach does not presume that a distribution is a return on investment, it requires that an entity analyze each distribution to determine its nature. Further, entities that elect the cumulative earnings approach may generally presume distributions to represent a return on investment, unless such distributions represent returns of investment (i.e., they exceed the investor’s cumulative equity in earnings).

In addition, because ASC 230 does not provide guidance on how much information (e.g., the type and sufficiency of investee information) an entity needs to determine the nature of a distribution, an entity that applies the nature-of-the-distribution approach will most likely need to use significant judgment in making this determination. We generally believe that such information should be sufficiently reliable and that the degree of reliability is likely to increase in proportion to the materiality of the distribution.

#### **7.2.6.4 Contracts With Customers That Include Both Revenue and Nonrevenue Elements**

Life sciences entities may enter into contracts with customers that include both revenue and nonrevenue elements. [Example 2-2](#) illustrates a life sciences entity’s accounting for a contract that includes (1) performance obligations accounted for under ASC 606 and (2) an equity component within the scope of other authoritative literature.

As discussed in [Section 2.2.4](#), ASC 606-10-15-4(a) provides that when a contract includes both revenue and nonrevenue elements, some of which are within the scope of other standards, any separation and initial measurement requirements of the other standards are applied first and the deliverables within the scope of the revenue model are ascribed any residual amount. In accordance with ASC 606-10-15-4(b), if there are no separation or initial measurement requirements in those other standards, the requirements in ASC 606 are applied.

In a manner consistent with ASC 606-10-15-4 and ASC 230-10-45-22, when an entity enters into a contract with a customer that contains both revenue and nonrevenue elements, the entity should present the cash received from the customer in the statement of cash flows on the basis of the underlying nature of the transactions.

**Example 7-9**

Biotech X enters into two contemporaneous arrangements with Pharmaceutical Company Y: (1) a license and collaboration arrangement and (2) a share purchase arrangement whereby X sells shares of its common stock to Y for \$14 million.

The total consideration for the arrangements is \$50 million, which X collects in full. Biotech X determines that the license and collaboration arrangement is within the scope of ASC 606. In addition, X determines that the common stock purchased by Y should be accounted for under other authoritative literature (i.e., the shares should be accounted for at fair value as of their issuance date). The fair value of the shares on their issuance date was \$15 million.

The fair value of the common shares should be excluded from the consideration that is allocated to the revenue unit of account. To the extent that the contractual consideration for the common shares is higher or lower than their fair value on the issuance date, the difference, positive or negative, should be allocated to the revenue unit of account. Accordingly, \$15 million of the total consideration for the two arrangements is allocated to the sale of the common stock to Y for accounting purposes even though the legal contract price of the shares is \$14 million. The remaining \$35 million is allocated to the revenue unit of account and accounted for under ASC 606.

Regarding the presentation in the statement of cash flows of cash receipts and cash payments that have aspects of more than one class of cash flows, ASC 230-10-45-22 states, in part, that “[i]n the absence of specific guidance, a reporting entity shall determine each separately identifiable source or each separately identifiable use within the cash receipts and cash payments on the basis of the nature of the underlying cash flows” and “shall then classify each separately identifiable source or use within the cash receipts and payments on the basis of their nature in financing, investing, or operating activities.” Accordingly, in X’s statement of cash flows, X should recognize (1) the consideration allocated to the sale of common stock (\$15 million) as a financing cash inflow and (2) the consideration allocated to the ASC 606 revenue contract (\$35 million) as an operating cash inflow.

**7.2.7 Restricted Cash****7.2.7.1 Balance Sheet Presentation of Restricted Cash**

Cash available for general operations is distinguishable from cash restricted in accordance with third-party special-purpose agreements. When a cash account is restricted, the ability of the account’s owner to withdraw funds at any time is contractually or legally restricted. Since an entity cannot withdraw restricted cash without prior notice or penalty, the entity should not present such cash in cash and cash equivalents. While the terms “restricted cash” and “restricted cash equivalents” are not defined in U.S. GAAP, SEC Regulation S-X, Rule 5-02(1), requires registrants to separately disclose account balances whose withdrawal or usage is restricted. As a result, registrants typically present restricted cash and restricted cash equivalents separately from cash and cash equivalents on their balance sheet, and many nonpublic entities elect similar balance sheet presentation. However, entities may include restricted cash and restricted cash equivalents in other balance sheet line items. Accordingly, an entity’s definition of restricted cash and restricted cash equivalents is typically an accounting policy matter. Such a policy should be applied consistently and will need to take into account the nature of both the financial instruments and the restrictions.

Paragraph BC9 of [ASU 2016-18](#) indicates that the Board's clarifications related to presenting restricted cash and restricted cash equivalents in the statement of cash flows were not intended to change an entity's practice for identifying and reporting restricted cash or restricted cash equivalents. Specifically, paragraph BC9 states:

Although the Master Glossary does not include specific definitions of restricted cash or restricted cash equivalents, some Task Force members believe that only those financial instruments that first meet the definition of cash or cash equivalents before considering the restrictions that exist in a separate provision outside those financial instruments should be included in the beginning-of-period and end-of-period reconciliation of the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents on the statement of cash flows. Other Task Force members believe that the nature of the restrictions on cash or cash equivalents should be considered and that in certain cases the restrictions could be so severe that the financial instrument would not meet the definition of cash or cash equivalents, thereby preventing those balances from being included in the beginning-of-period and end-of-period reconciliation of total cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents on the statement of cash flows. The Task Force considered defining restricted cash; however, it ultimately decided that the issue resulting in diversity in practice is the presentation of changes in restricted cash on the statement of cash flows. The Task Force's intent is not to change practice for what an entity reports as restricted cash or restricted cash equivalents.

Further, paragraph BC19 of ASU 2016-18 notes that (1) an entity should apply the guidance on a change in an accounting principle in ASC 250 "if [the] entity is considering changing its accounting policy for determining restricted cash and restricted cash equivalents" and (2) "[s]uch evaluation would be separate from adoption of the amendments in [ASU 2016-18]."

In addition, in accordance with ASC 230-10-50-7, an entity should disclose information about the nature of restrictions on its cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Further, when cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are presented in more than one line item in the statement of financial position, an entity should also apply the requirements in ASC 230-10-50-8, as discussed below.

### **7.2.7.2 Presentation of Restricted Cash in the Statement of Cash Flows**

In a manner consistent with the guidance in ASC 230-10-45-4, an entity should include in the beginning and ending cash and cash-equivalent balances of the statement of cash flows those amounts that are generally described as restricted cash and restricted cash equivalents, regardless of where such amounts may be included on an entity's balance sheet (e.g., cash, restricted cash, other assets, collections from servicing). The concept of reconciling "total cash" in the statement of cash flows is discussed in paragraph BC5 of ASU 2016-18, which states:

The Task Force reached a consensus that a statement of cash flows should explain the change during the period in the **total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents**. That is, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows under the amendments in this Update. The Task Force recognizes that some entities present cash and cash equivalents with restrictions in multiple line items on the statement of financial position and that in some cases those line items are titled something other than restricted cash or restricted cash equivalents; therefore, the phrase *amounts generally described as restricted cash or restricted cash equivalents* is used throughout this Update. This consensus requires that those amounts also be included in the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. [Emphasis added]

Changes in restricted cash and restricted cash equivalents that result from transfers between cash, cash equivalents, and restricted cash and restricted cash equivalents should not be presented as cash flow activities in an entity's statement of cash flows. This stipulation is consistent with paragraph BC8 of ASU 2016-18, which states, in part:

The Task Force believes that internal transfers between cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents do not represent a cash inflow or outflow of the entity because there is no cash receipt or cash payment with a source outside of the entity that affects the sum of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents.

### **7.2.7.3 Reconciliation of Cash, Cash Equivalents, and Amounts Generally Described as Restricted Cash or Restricted Cash Equivalents for an Interim Reporting Period**

ASC 230 requires the reconciliation of (1) the ending cash, cash equivalents, and amounts generally described as restricted cash or the restricted cash equivalents balance presented in the statement of cash flows to (2) the statement of financial position when such amounts are presented in more than one line item in the statement of financial position. Such information must be provided on the face of the statement of cash flows or disclosed in the notes to the financial statements and can be in narrative or tabular form. However, ASC 230 does not specify how to apply this requirement to comparative periods when interim periods presented in the statement of cash flows do not correspond to the periods presented in the statement of financial position. Specifically, while ASC 230-10-50-8 states, in part, that the reconciliation is required for “each period that a **statement of financial position** is presented” (e.g., as of March 31, 20X1, and December 31, 20X0), ASC 230-10-50-8 then goes on to indicate that those amounts “shall sum to the total amount of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents at the end of the corresponding period shown in the **statement of cash flows**” (e.g., March 31, 20X1, and March 31, 20X0). [Emphasis added]

The lack of specific guidance on this matter has led to diversity in how entities have applied this reporting requirement for interim reporting periods. We believe that it is acceptable for an entity to use one of the following alternatives to meet ASC 230's reconciliation requirement for interim reporting periods (for illustrative purposes, we have assumed that in the interim financial statements, the statements of financial position are as of March 31, 20X1, and December 31, 20X0, and the three months ended March 31, 20X1, and March 31, 20X0, for the statement of cash flows):

- Provide the reconciliation for each period presented in the statement of financial position (e.g., March 31, 20X1, and December 31, 20X0).
- Provide the reconciliation for each period presented in the statement of cash flows (e.g., March 31, 20X1, and March 31, 20X0).
- Provide the reconciliation for each period presented in the statement of financial position as well as each period presented in the statement of cash flows (e.g., March 31, 20X1; December 31, 20X0; and March 31, 20X0).

### 7.3 SEC Reporting Considerations

At the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, several speakers commented on statement of cash flow matters. For example, SEC Chief Accountant Paul Munter discussed his December 4, 2023, [statement](#) regarding the statement of cash flows, in which he highlighted the need for preparers and auditors to apply the same level of scrutiny to the statement of cash flows as they do to the other primary financial statements. Mr. Munter noted that investors, when evaluating an entity's future cash flows, emphasize the statement of cash flows to better understand the cash-generating activities from the entity's operations as well as the entity's financing and investing activities during the period. Further, he emphasized the importance of classification within the statement of cash flows. For instance, he indicated that when correcting errors in classification among the various types of cash flows and determining the materiality of those errors, an entity should evaluate both quantitative and qualitative factors. Mr. Munter noted that the evaluation of a classification error's materiality would be expected to be similar to that for other errors in the financial statements.

For more information about statement of cash flow matters discussed at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, see Deloitte's December 10, 2023, [Heads Up](#).

# Chapter 8 — Income Taxes

## 8.1 Introduction

The accounting for income taxes under ASC 740 is sometimes very specific and can be complex. The overall objective of accounting for income taxes is to reflect (1) the amount an entity currently owes to tax authorities (current tax payable) and (2) DTAs and deferred tax liabilities (DTLs) for the tax effects of transactions or events that have occurred but that have not yet been reflected in a tax return or vice versa (also referred to as “basis differences” or “temporary differences”). A DTA will be recorded for items that will result in future tax deductions (sometimes referred to as a benefit or a deductible temporary difference), and DTLs are recorded for items that will result in the inclusion of future taxable income in an entity’s tax return (taxable temporary difference). This balance sheet approach is used to calculate temporary differences and, in effect, takes into account the total tax that would be payable (or receivable) if all of an entity’s assets and liabilities were realized at their carrying value at a specific time (the reporting date).

In accordance with ASC 740, the critical event for recognition of a DTA is the event that gives rise to the deductible temporary difference, tax credit, or net operating loss (NOL) carryforward. Once that event occurs, those tax benefits should be recognized, subject to a realizability assessment. In effect, earning taxable income in future years is treated as a confirmation of realizability and not as a prerequisite to asset recognition. At the same time, management should consider future events to record those DTAs at amounts that are more likely than not to be realized in future tax returns. In the case of DTLs, ASC 740 requires an entity to include in its balance sheet an obligation for the tax consequences of taxable temporary differences, even when losses are expected in future years.

The following is a brief, general summary of deferred tax accounting under ASC 740:

- DTLs are recognized for future taxable amounts.
- DTAs are recognized for future deductions, operating losses, and tax credit carryforwards.
- The enacted tax rate expected to apply is used to measure DTAs and DTLs.
- A valuation allowance is recognized to reduce DTAs to the amounts that are more likely than not to be realized.
- The amount of the valuation allowance is based on all available positive and negative evidence about the future. The more objective the positive or negative evidence, the more weight the evidence carries in supporting the determination of whether DTAs will or will not be realized.
- Deferred tax expense or benefit is computed as the difference between the beginning and ending balance of the net DTA or DTL for the period.
- Entities present DTAs and DTLs as noncurrent in a classified balance sheet.
- The effects of changes in rates or laws are recognized in the period of enactment.

## 8.2 Industry Issues

The discussions and examples below contain guidance on income tax matters that frequently affect life sciences entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, it provides targeted considerations related to the application of ASC 740 that are most relevant to the industry.

For more information about the topics summarized below, see Deloitte's Roadmap [Income Taxes](#).

### 8.2.1 Scope Considerations

The scope of ASC 740 is limited to "taxes based on income" when income is determined after revenues and gains are reduced by some amount of expenses and losses allowed by the jurisdiction. Therefore, a tax based solely on revenues would not be within the scope of ASC 740 because the taxable base amount is not reduced by any expenses. A tax based on gross receipts, revenue, or capital should be accounted for under other applicable literature (e.g., ASC 450). In contrast, a tax whose base takes into account both income and expense is within the scope of ASC 740. A common question for life sciences entities to consider is whether certain R&D credits are within the scope of ASC 740.

Certain tax jurisdictions provide refundable credits (e.g., qualifying R&D credits in certain countries and state jurisdictions and alternative fuel tax credits for U.S. federal income tax) that do not depend on the entity's ongoing tax status or tax position (e.g., an entity may receive a refund despite being in a taxable loss position). Tax credits, such as refundable credits, whose realization does not depend on the entity's generation of taxable income or the entity's ongoing tax status or tax position, are not considered an element of income tax accounting under ASC 740. Thus, even if the credit claims are filed in connection with a tax return, the refunds are not considered to be part of income taxes and therefore are not within the scope of ASC 740. In such cases, an entity would not record the credit as a reduction of income tax expense; rather, the entity should determine the credit's classification on the basis of its nature.

When determining the classification of these credits, an entity may consider them to be a form of government grant or assistance. There is no specific authoritative guidance under U.S. GAAP on the recognition and measurement of government assistance received by business entities. Accordingly, diversity in practice exists, and multiple models under U.S. GAAP with respect to accounting for government assistance may be acceptable. See [Section 13.1.1.2](#) for more information.

In rare circumstances, a tax law may change the way a tax credit is realized. For example, a jurisdiction may have historically required that a credit be realized on the tax return as a reduction in taxes payable but subsequently changes the law so that the credit can be realized without an entity's first incurring a tax liability (i.e., the credit amount becomes refundable but was not when it arose). In this situation, an entity would generally continue to apply ASC 740 to the credits recognized at the time of the law change. Any new refundable credits earned after the tax law change would be accounted for in accordance with the guidance in this section.

Credits whose realization ultimately depends on taxable income (e.g., investment tax credits and nonrefundable R&D credits) are generally recognized as a reduction of income tax expense, regardless of whether they are accounted for under the flow-through method or the deferral method (as described in ASC 740-10-25-45 and 25-46).





### Connecting the Dots

The Creating Helpful Incentives to Produce Semiconductors and Science Act of 2022 (the “CHIPS Act”) and the Inflation Reduction Act of 2022 (IRA), both signed into law in August 2022, have a number of tax-related provisions, including a plethora of clean energy tax incentives in the form of tax credits, some of which include direct-pay options, transferability provisions, or both. The accounting for the receipt of the credits varies depending on the type of the credit (i.e., refundable or transferable credits). Accordingly, it is critical for entities to carefully analyze the type of credit, which will indicate the appropriate accounting framework and accounting policy elections available. For more information, see Deloitte’s April 3, 2023, [Financial Reporting Alert](#).

## 8.2.2 Intra-Entity Transfers of IP

Life sciences entities often develop IP such as drug formulas, trade secrets, know-how, and other proprietary information. This IP may be developed in one jurisdiction but subsequently transferred to a subsidiary in another jurisdiction. Such transfers are often tax-motivated, and both the initial and subsequent accounting for them has historically been complex. An entity should record the current and deferred tax effects of intra-entity transfers of assets other than inventory, including the tax consequences of intra-entity asset transfers involving IP.

ASC 740-10-25-3(e) prohibits recognition of the deferred tax consequences of intra-entity transfers of inventory. However, this prohibition does not apply to noninventory assets. Under ASC 740-10-25-20(i), the selling (transferring) entity in an intra-entity transfer of an asset other than inventory is required to recognize any current tax expense or benefit upon transfer of the asset. Similarly, the purchasing (receiving) entity is required to recognize a DTA or DTL, as well as the related deferred tax benefit or expense, upon receipt of the asset.

The example below compares the income tax accounting for intra-entity transfers of assets other than inventory.

**Example 8-1**

Consider the following:

In accordance with ASC 740-10-25-20(i), since the transferred asset is an asset other than inventory (IP in this case), A is required to recognize the current tax expense associated with the taxable gain on the sale of the IP by recording the following journal entry:

Current tax expense	30,000,000	
Current taxes payable		30,000,000

**Example 8-1 (continued)**

In addition, B is required to recognize the deferred tax effects associated with its purchase of the IP by recording the following journal entry:

DTA	10,000,000	
Deferred tax benefit		10,000,000

**8.2.2.1 Interim Reporting Considerations**

There is no explicit guidance in ASC 740-270 on whether the tax effects of intra-entity transfers of assets other than inventory should be recognized as discrete items or included in the estimated annual effective tax rate (AETR) for interim reporting purposes. Paragraph BC13 of [ASU 2016-16](#) states, in part:

Because of the variety of intra-entity asset transfers, the Board did not want to preclude an entity from making its own assessment about how to treat an intra-entity asset transfer for purposes of the estimate. The Board also agreed with stakeholders who indicated that if the Board had decided that all intra-entity asset transfers should be treated similarly for purposes of the estimate, it would have created an exception to the model in Topic 740. The Board's view is that it would not be unusual for entities following the guidance to conclude that many intra-entity transfers of assets other than inventory would be treated as discrete items for purposes of the computation. However, the Board understands from stakeholders' input that because the nature of, frequency of, and ability to estimate these transfers vary among entities, there are circumstances in which an entity could conclude that the transaction should be included in the computation of the estimated annual effective tax rate. The Board understands that an entity will need to apply judgment on the basis of the facts and circumstances to conclude whether the tax consequences of an intra-entity asset transfer other than inventory should be included in the computation of the estimated annual effective tax rate or treated as a discrete item in the interim period in which the transfer occurs.

**Connecting the Dots**

Entities should carefully consider all of the provisions and exceptions in ASC 740-270 to determine whether the tax effects of intra-entity asset transfers should be treated as discrete or included in the estimated AETR for interim reporting purposes.

**8.2.3 Transfer Pricing**

Many life sciences entities are global and operate legal entities in multiple countries. This may simply be owing to the size and scale of the business or may be the result of regulatory requirements. For example, life sciences entities are frequently required to have regulatory approval to manufacture or distribute products in each country in which their products are manufactured or sold. Similarly, CROs are often required to perform R&D services on different patient populations in multiple geographic locations. Because of the global nature of many life sciences entities, income tax accounting issues regarding the use of transfer pricing for intra-entity and related-party transactions arise. Generally, transfer pricing is the pricing used for transfers of tangible property, intangible property, services, or financing between affiliated entities in different tax jurisdictions. These transactions include transfers between domestic or international entities, such as (1) U.S. to foreign, (2) foreign to foreign, (3) U.S. to U.S., and (4) U.S. state to state.

The general transfer pricing principle is that the pricing of a related-party transaction should be consistent with the pricing of similar transactions between independent entities under similar circumstances (i.e., an arm's-length transaction). Transfer pricing tax regulations are intended to prevent entities from using intra-entity charges to evade taxes by inflating or deflating the profits of a particular jurisdiction in which the larger consolidated group does business. Even if a parent corporation or its subsidiaries are in tax jurisdictions with similar tax rates, an entity may have tax positions that are subject to the recognition and measurement principles in ASC 740-10-25-6 and ASC 740-10-30-7.

An entity's exposure to transfer pricing primarily occurs when the entity includes in its tax return the benefit received from a related-party transaction that was determined to have not been conducted as though it was at arm's length. An unrecognized tax benefit (UTB) results when one of the related parties reports either lower revenue or higher costs than it can sustain under examination with the taxing authority (depending on the type of transaction). While it is likely that a portion of the revenue or costs will be allowed in these situations, the amount of benefit is often uncertain because of the subjectivity of valuing the related-party transaction. The UTB is recorded to reflect this uncertainty.

An entity must perform two steps in applying ASC 740 to all uncertain tax positions within its scope: (1) recognition and (2) measurement. The requirements of ASC 740 in the context of transfer pricing arrangements, including related considerations, are outlined below.

### **8.2.3.1 Determining the Unit of Account**

Before applying the recognition and measurement criteria, an entity must identify all material uncertain tax positions and determine the appropriate unit of account for assessment. As noted in ASC 740-10-20, a tax position encompasses an "allocation or a shift of income between jurisdictions" (i.e., a transfer pricing arrangement). Therefore, intra-entity and related-party transactions under transfer pricing arrangements are within the scope of ASC 740.

Further, tax positions related to transfer pricing generally should be evaluated individually, since two entities and two tax jurisdictions are involved in each transaction. Such an evaluation should be performed even when the transaction is supported by a transfer pricing study prepared by one of the entities. Typically, there would be at least two units of account. For example, the price at which one entity will sell goods to another entity will ultimately be the basis the second entity will use to determine its cost of goods sold. In addition, some transfer pricing arrangements could be made up of multiple components that could be challenged individually or in aggregate by a tax authority. Therefore, there could be multiple units of account associated with a particular transfer pricing arrangement.

### **8.2.3.2 Recognition**

ASC 740-10-25-6 indicates that the threshold for recognition has been met "when it is more likely than not, based on the technical merits, that the position will be sustained upon examination." An entity should apply the recognition threshold and guidance in ASC 740 to each unit of account in a transfer pricing arrangement. In some cases, a tax position will be determined to have met the recognition threshold if a transaction has taken place to generate the tax positions and some level of benefit will therefore be sustained. For example, assume that a U.S. parent entity receives a royalty for the use of intangibles by a foreign subsidiary that results in taxable income for the parent and a tax deduction for the foreign subsidiary. The initial tax filing (income in the receiving jurisdiction and expense/deduction in the paying jurisdiction) may typically meet the more-likely-than-not recognition threshold on the basis of its technical merits, since a transaction between two parties has occurred. However, because there are two entities and two tax jurisdictions involved, the tax jurisdictions could question whether the income is sufficient, whether the deduction is excessive, or both. Such factors should generally be considered during the recognition phase as part of the determination of what the tax jurisdictions are more likely than not to accept on the basis of the technical merits.

### 8.2.3.3 Measurement

After an entity has assessed the recognition criteria in ASC 740 and has concluded that it is more likely than not that the tax position taken will be sustained upon examination, the entity should measure the associated tax benefit. This measurement should take into account all relevant information, including tax treaties and arrangements between tax authorities. As discussed above, each tax position should be assessed individually and a minimum of two tax positions should be assessed for recognition and measurement in each transfer pricing transaction.

For measurement purposes, ASC 740-10-30-7 requires that the tax benefit be based on the largest amount that is more than 50 percent likely to be realized upon settlement with a tax jurisdiction “that has full knowledge of all relevant information.” Intra-entity or transfer pricing assessments present some unique measurement-related challenges that are based on the existence of tax treaties or other arrangements (or the lack of such arrangements) between two tax jurisdictions.

Measurement of uncertain tax positions is typically based on facts and circumstances. The following are some general considerations (not all-inclusive):

- *Transfer pricing studies* — An entity will often conduct a transfer pricing study with the objective of documenting the appropriate arm’s-length pricing for the transactions. The entity should consider the following when using a transfer pricing study to support the tax positions taken:
  - The qualifications and independence of third-party specialists involved (if any).
  - The type of study performed (e.g., benchmarking analysis, limited or specified method analysis, U.S. documentation report, Organisation for Economic Co-operation and Development [OECD] report).
  - The specific transactions and tax jurisdictions covered in the study.
  - The period covered by the study.
  - The reasonableness of the model(s) and the underlying assumptions used in the study (i.e., comparability of companies or transactions used, risks borne, any adjustments made to input data).
  - Any changes in the current environment, including new tax laws in effect.
- *Historical experience* — An entity should consider previous settlement outcomes of similar tax positions in the same tax jurisdictions. Information about similar tax positions, in the same tax jurisdictions, that the entity has settled in previous years may serve as a good indicator of the expected settlement of current positions.
- *Applicability of tax treaties or other arrangements* — An entity should consider whether a tax treaty applies to a particular tax position and, if so, how the treaty would affect the negotiation and settlement with the tax authorities involved.
- *Symmetry of positions* — Even though each tax position should be evaluated individually for appropriate measurement, if there is a high likelihood of settlement through “competent-authority” procedures under the tax treaty or other agreement, an entity should generally use the same assumptions about such a settlement to measure both positions (i.e., the measurement assumptions are similar, but the positions are not offset). Under the terms of certain tax treaties entered into by the United States and foreign jurisdictions, countries mutually agree to competent-authority procedures to relieve companies of double taxation created by transfer pricing adjustments to previously filed returns.

An entity should carefully consider whether the tax jurisdictions involved strictly follow the arm's-length principle. For example, Brazil has a mandated statutory margin that may or may not equate to what is considered arm's length by another reciprocal taxing jurisdiction. Other jurisdictions may not strictly follow the arm's-length principle. In such situations, it may be inappropriate for an entity to assume symmetry of positions when measuring the positions.

#### **8.2.3.4 Presentation**

Sometimes, if two governments follow the OECD's transfer pricing guidelines to resolve substantive issues related to transfer pricing transactions between units of the same entity, an asset could be recognized in one jurisdiction because of the application of competent-authority procedures, and a liability could be recognized for UTBs from another tax jurisdiction that arose because of transactions between the entity's affiliates that are not considered at arm's length.

In this case, an entity should present the liability for UTBs and the tax benefit on a gross basis in its balance sheet. In addition, a public entity would include only the gross liability for UTBs in the tabular reconciliation disclosure. However, in the disclosure required by ASC 740-10-50-15A(b), the public entity would include the liability for UTBs and the tax benefit on a net basis in the amount of UTBs that, if recognized, would affect the effective tax rate.



#### **Changing Lanes**

The OECD released Pillar One and Pillar Two model rules, which expand a jurisdiction's ability to tax a company that operates without a physical presence and introduce a global minimum tax, respectively. These provisions, when adopted, are expected to have significant implications for multinational companies. Each jurisdiction is expected to adopt rules that comply with the model framework, with the implementation process under way in many jurisdictions. Entities should continue to monitor the development of these rules as related to both tax compliance and financial reporting matters. For more information, see [Section 8.8](#).

### **8.2.4 Research and Development**

For many life sciences entities, R&D activities represent a significant focus and expenditure. Beyond the above-mentioned scope considerations related to refundable R&D tax credits, these activities may result in various income tax accounting impacts that should be accounted for in accordance with ASC 740. For example, R&D cost-sharing agreements may affect an entity's accounting for the income tax effects of share-based payments. In addition, an entity may acquire R&D assets in a business combination that result in the creation of temporary differences. These issues are summarized below.

#### **8.2.4.1 R&D Cost-Sharing Arrangements**

A reporting entity may enter into an arrangement with a related entity (typically a foreign subsidiary) to share the cost of developing certain intangible assets. Under such an arrangement, which is often referred to as a cost-sharing arrangement, one company bears expenses on behalf of another company and is subsequently reimbursed for those costs. The shared costs may include the cost of share-based payments issued to employees of the reporting entity. Regarding the tax impact of the sharing of share-based payment costs, the discussion document for the FASB Statement 123(R) Resource Group's July 21, 2005, meeting states, in part:

Related companies that plan to share the cost of developing intangible property may choose to enter into what is called a cost-sharing agreement whereby one company bears certain expenses on behalf of another company and is reimbursed for those expenses. U.S. tax regulations specify the expenses that must be included in a pool of shared costs; such expenses include costs related to stock-based compensation awards granted in tax years beginning after August 26, 2003.

The tax regulations provide two methods for determining the amount and timing of share-based compensation that is to be included in the pool of shared costs: the “exercise method” and the “grant method.” Under the exercise method, the timing and amount of the allocated expense is based on the intrinsic value that the award has on the exercise date. Companies that elect to follow the grant method use grant-date fair values that are determined based on the amount of U.S. GAAP compensation costs that are to be included in a pool of shared costs. Companies must include such costs in U.S. taxable income regardless of whether the options are ultimately exercised by the holder and result in an actual U.S. tax deduction.

Cost-sharing agreements affect the U.S. company's accounting for the income tax effects of share-based compensation. Companies should consider the impact of cost-sharing arrangements when measuring, on the basis of the tax election they have made or plan to make, the initial and subsequent deferred tax effects.

### Example 8-2

Company A, which is located in the United States, enters into a cost-sharing arrangement with its subsidiary, Company B, which is located in Switzerland. Under the arrangement, the two companies share costs associated with the R&D of certain technology. Company B reimburses A for 30 percent of the R&D costs incurred by A. The U.S. tax rate is 25 percent. Cumulative book compensation for a fully vested option issued to a U.S. employee is \$100 for the year ending on December 31, 20X6. The award is exercised during 20X7, when the intrinsic value of the option is \$150.

The tax accounting impact discussed below.

#### Exercise Method

On December 31, 20X6, A records \$18 as the DTA related to the option (rounded for \$100 book compensation expense  $\times$  70% not subject to reimbursement  $\times$  25% tax rate). When, in 20X7, the option is exercised, any net tax benefit that exceeds the DTA is an excess tax benefit and is recorded in the income statement. The company is entitled to a U.S. tax deduction resulting in a benefit (net of the inclusion) of \$26 (rounded for \$150 intrinsic value when the option is exercised  $\times$  70% not reimbursed  $\times$  25%). Accordingly, \$8 (\$26 – \$18) would be recorded in the income statement as an excess tax benefit.

#### Grant Method

The cost-sharing impact is an increase of currently payable U.S. taxes each period; however, in contrast to the exercise method, the cost-sharing method should have no direct impact on the carrying amount of the U.S. DTA related to share-based compensation. If there was \$100 of stock-based compensation during 20X6, the impact on the December 31, 20X6, current tax provision would be \$8 (rounded for \$100 book compensation expense  $\times$  30% reimbursed  $\times$  25%). If the stock-based charge under ASC 718 is considered a deductible temporary difference, a DTA also should be recorded in 20X6 for the financial statement expense, in the amount of \$25 (\$100 book compensation expense  $\times$  25%). The net impact on the 20X6 income statement is a tax benefit of \$17 (\$25 – \$8). At settlement, the excess tax deduction of \$13 (rounded for excess of intrinsic value over \$50 book compensation expense  $\times$  25%) would be recorded in the income statement.

### 8.2.4.2 R&D Assets Acquired in a Business Combination

Acquired R&D assets will be separately recognized and measured at their acquisition-date fair values. ASC 350-30-35-17A states that an R&D asset acquired in a business combination must be considered an indefinite-lived intangible asset until completion or abandonment of the associated R&D efforts. Once the R&D efforts are complete or abandoned, an entity should apply the guidance in ASC 350 to determine the useful life of the R&D assets and should amortize these assets accordingly in the financial statements. If the project is abandoned, the asset would be written off if it has no alternative use.

In accordance with ASC 740, deferred taxes should be recorded for temporary differences related to acquired R&D assets as of the business combination's acquisition date. As with all acquired assets and assumed liabilities, an entity must compare the amount recorded for an R&D intangible asset with its tax basis to determine whether a temporary difference exists. If the tax basis of the R&D intangible asset is zero, as it will be in a typical nontaxable business combination, a DTL will be recorded for that basis difference.

### 8.2.5 Valuation Allowances and Tax-Planning Strategies

A life sciences entity that has recurring losses or other negative evidence must consider all available evidence, both positive and negative, to determine whether a valuation allowance against its DTAs is needed. In assessing positive and negative evidence, an entity must consider the following four possible sources of taxable income discussed in ASC 740-10-30-18:

1. "Future reversals of existing taxable temporary differences."
2. "Future taxable income exclusive of reversing temporary differences and carryforwards."
3. "Taxable income in prior carryback year(s) if carryback is permitted under the tax law."
4. "Tax-planning strategies."

This analysis can be quite complex depending on the entity's facts and circumstances. Significant judgment is often required, particularly in the evaluation of items (2) and (4) above. It is difficult to assert that the entity will have future taxable income exclusive of reversing taxable temporary differences when it has cumulative losses in recent years. Further, tax-planning strategies must meet certain criteria to be treated as a source of taxable income, and evaluation of those criteria is often not straightforward.

### 8.2.6 Prescription Drug Fees

The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Affordability Reconciliation Act, imposed an annual fee, payable to the U.S. Treasury, on the pharmaceutical manufacturing industry for each calendar year beginning on or after January 1, 2011. The amount of the fee to be paid by a given entity is based on the entity's branded prescription drug (BPD) sales for the preceding year as a percentage of the industry's BPD sales for the same period. Under current U.S. tax law, the fee is not tax deductible and will therefore result in a permanent difference between an entity's income for financial reporting purposes and its taxable income. This permanent difference will result in an increase in the entity's overall effective tax rate.

### 8.2.7 Section 382 Limitations on NOL Carryforwards

Because of the significant up-front costs required for companies to bring a new drug through regulatory approval and ultimately to market, it is common for companies in the life sciences industry to generate losses in the early stage of their life cycle. Companies can generally benefit from these losses in the form of NOL carryforwards that offset future taxable income.

However, Internal Revenue Code (IRC) Section 382 provides that loss corporations may be subject to a limitation on the amount of the NOL carryforward that can be realized in periods after a change in ownership (the "Section 382 limitation"). While ownership changes can result from a business combination or an IPO transaction, they can also be driven by a new round of equity financing that affects the company's ownership structure when certain thresholds are met. Companies should assess all changes to their ownership structure to determine whether any Section 382 limitation is required.



The determination of a Section 382 limitation involves a high degree of complexity and requires careful evaluation. An assessment of potential limitations on NOL carryforwards should be included as part of a company's ongoing tax-planning and tax-forecasting strategies, and the impacts of such limitations on potential funding, exit plans, or acquisition portfolio strategies should also be considered. Companies that may be subject to Section 382 limitations are encouraged to consult with their tax advisers.

In September 2019, the U.S. Treasury and the IRS issued [proposed Treasury regulations](#) on the items of income and deduction that are treated as built-in gains and losses under IRC Section 382. The proposed regulations would significantly modify existing guidance on the determination of built-in gains and losses. While the proposed regulations have not been formally withdrawn, IRS officials have publicly stated that any guidance in this area would be repropounded. Nevertheless, we expect that any future guidance would be less favorable than existing guidance. Accordingly, companies should continue monitoring the status of IRC Section 382 guidance and consult with their tax advisers to understand how the proposals could affect their income tax profile.

## **8.2.8 Tax Deductibility of Patent Infringement Litigation Costs**

Patent infringement litigation costs incurred after the actual sale of a product, which are expensed for book purposes, are generally tax deductible as “ordinary and necessary” business expenses under IRC Section 162(a). However, for generic drug companies filing ANDAs under the Hatch-Waxman Act, the treatment of these costs (i.e., expensed vs. capitalized) can result in a temporary difference. This is because the IRS has challenged the tax deductibility of costs incurred by generic drug companies to navigate the “paragraph IV” process (i.e., the process in which a generic drug company seeks FDA approval of an ANDA by certifying, in accordance with 21 U.S.C. Section 355(j)(2)(A)(vii)(IV), that it believes that a third party's patent is invalid or will not be infringed by the generic drug company's new product).

### **8.2.8.1 Background**

On March 8, 2013, the IRS Office of Chief Counsel issued a [memorandum](#) clarifying the capitalization of incurred legal fees related to NDAs and ANDAs, including patent litigation costs arising from paragraph IV patent certification. The memorandum states that legal costs associated with the paragraph IV process should be capitalized.

In a manner consistent with the memorandum, the IRS confirmed that FDA-approved ANDAs are amortizable intangibles under IRC Section 197 and should be amortized ratably over a 15-year period. Further, the IRS argued that patent litigation costs are part of the ANDA approval process (the intangible asset). Accordingly, the IRS issued notices of proposed adjustments (NOPAs) to companies that had immediately expensed (deducted) these costs in their annual tax returns.

### **8.2.8.2 U.S. Tax Court Ruling**

Many generic pharmaceutical companies challenged the NOPAs by issuing protest statements to the IRS or bringing lawsuits to the U.S. Tax Court. In April 2021, after years of litigation, the U.S. Tax Court issued a ruling (*Mylan Inc. and Subsidiaries vs. Commissioner of Internal Revenue*) that was partly favorable to Mylan Inc., a generic pharmaceutical company.

In its ruling, the U.S. Tax Court held, in part, that the generic pharmaceutical company could immediately deduct the legal fees it had incurred to defend patent infringement lawsuits as “ordinary and necessary business expenses,” and did not need to capitalize those expenses as the IRS argued, because the patent litigation was separate from the ANDA approval process. The IRS appealed the U.S. Tax Court's ruling to the U.S. Court of Appeals for the Third Circuit, and the Tax Court's ruling was upheld. This matter is closed, establishing a precedent.

## 8.2.9 Selling Income Tax Credits to Monetize Them

Income tax credits that can be used only to reduce an income tax liability and would never be refundable by the government are within the scope of ASC 740. Some tax jurisdictions might, however, allow an entity that generates certain types of income tax credits to either use a credit to reduce its own income tax liability or effectively “sell” all or a portion of the credit by assigning the right to claim the credit to another qualified entity. One such situation is illustrated in the example below, which is adapted from the summary in the New Jersey Economic Development Authority’s (NJEDA’s) [FAQs](#) on the New Jersey Technology Business Tax Certificate Transfer Program.

### Example 8-3

The New Jersey Technology Business Tax Certificate Transfer Program enables approved technology and biotechnology businesses with NOLs to sell their unused NOL carryover and unused R&D tax credits for at least 80 percent of the value of the tax benefits to a profitable corporate taxpayer in New Jersey that is not an affiliated business. This allows technology and biotechnology businesses with NOLs to turn their tax losses and credits into cash to buy equipment or facilities, or for other allowable expenditures. The NJEDA determines eligibility, and the New Jersey Division of Taxation determines the value of the tax benefits (unused NOL carryover and unused R&D tax credits).

In those situations, if an entity does not have sufficient taxable income to use all or a portion of the income tax credit or in which using it might take multiple tax years, the entity might achieve a better economic benefit (i.e., present value benefit) by selling the credit. Regardless of intent, if the credit can be used only to reduce an income tax liability either of the entity that generated it or the entity to which it is transferred and would never be refundable by the government, we believe that the credit should remain within the scope of ASC 740. In such situations, the entity that generated the credit would recognize and measure it in accordance with the recognition and measurement criteria of ASC 740. To the extent that the income tax credit does not reduce income taxes currently payable, the entity would recognize a DTA for the carryforward and assess it for realizability in a manner consistent with the sources of income cited in ASC 740-10-30-18. While we believe that such an assessment would generally be predicated upon the normal course of business (i.e., an entity would not factor in its ability to sell the underlying credit as a basis for realizing the related DTA), we understand on the basis of a technical inquiry with the FASB staff that it would also be acceptable to consider the expected sales proceeds when assessing realizability.

If the entity were to subsequently sell the income tax credit, we understand on the basis of the same FASB staff technical inquiry that it would be most appropriate to reflect any proceeds and resulting gain/loss on the sale as a component of the tax provision. Alternatively, we believe that the sale could be treated no differently than the sale of any other asset, with gain or loss recognized in pretax earnings for any difference between the proceeds received and the recorded carrying value of the DTA for the income tax credit that was recognized in accordance with the guidance in ASC 740 on recognition and measurement.<sup>1</sup>

<sup>1</sup> If an entity’s policy is to reflect gain or loss in pretax earnings, it would not be appropriate to consider the expected proceeds when assessing realizability of the related DTA.

### 8.3 Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act of 2017 (the “2017 Act”) includes the following provisions that are relevant to life sciences entities:

- *Global intangible low-taxed income (GILTI)* — The 2017 Act requires certain income (i.e., GILTI) earned by controlled foreign corporations (CFCs) to be included currently in the gross income of the CFCs’ U.S. shareholder. GILTI is the excess of the shareholder’s “net CFC tested income” over the net deemed tangible income return (the “routine return”), which is defined as the excess of (1) 10 percent of the aggregate of the U.S. shareholder’s pro rata share of the qualified business asset investment of each CFC with respect to which it is a U.S. shareholder over (2) the amount of certain interest expense taken into account in the determination of net CFC-tested income.

A deduction is permitted to a domestic corporation in an amount equal to 50 percent of the sum of the GILTI inclusion and the amount treated as a dividend because the corporation has claimed a foreign tax credit as a result of the inclusion of the GILTI amount in income (“IRC Section 78 gross-up”). If the sum of the GILTI inclusion (and related IRC Section 78 gross-up) and the corporation’s foreign-derived intangible income (FDII) exceeds the corporation’s taxable income, the deductions for GILTI and for FDII are reduced by the excess. As a result, the GILTI deduction can be no more than 50 percent of the corporation’s taxable income (and will be less if the corporation is also entitled to an FDII deduction). The maximum GILTI deduction is reduced to 37.5 percent for taxable years beginning after December 31, 2025.

- *Deduction for FDII* — The 2017 Act allows a domestic corporation a deduction for a portion of its FDII. The amount of the deduction depends, in part, on U.S. taxable income. The percentage of income that can be deducted is reduced in taxable years beginning after December 31, 2025.
- *Base erosion anti-abuse tax (BEAT)* — A corporation is potentially subject to tax under the BEAT provision if the controlled group of which it is a part has sufficient gross receipts and derives a sufficient level of “base erosion tax benefits.” Under the BEAT provision, a corporation must pay a base erosion minimum tax amount (BEMTA) in addition to its regular tax liability after credits. The BEMTA is generally equal to the excess of (1) a fixed percentage of a corporation’s modified taxable income (taxable income determined without regard to any base erosion tax benefit related to any base erosion payment, and without regard to a portion of its NOL deduction) over (2) its regular tax liability (reduced by certain credits). The fixed percentage is generally 5 percent for taxable years beginning in 2018, 10 percent for years beginning after 2018 and before 2026, and 12.5 percent for years after 2025.
- *Capital expensing* — The 2017 Act permits 100 percent immediate expensing for qualified property through 2022, which is phased down each subsequent year through 2026 (80 percent in 2023, 60 percent in 2024, 40 percent in 2025, 20 percent in 2026).
- *Orphan drug credit* — The 2017 Act halved the credit for research on rare diseases, known as the orphan drug credit.
- *Research and experimental (R&E) expenses* — The 2017 Act requires R&E costs to be amortized over 5 years for R&E activities performed in the United States (or 15 years for R&E activities performed outside the United States).



#### Changing Lanes

On December 12, 2022, the U.S. Treasury and IRS released [Revenue Procedure 2023-8](#), which provides procedural guidance that allows taxpayers to make an automatic change in method of accounting so that they can comply with the provision of [IRC Section 174](#) that requires capitalization of specified R&E expenses (the “Required Section 174 Method”). The Required

Section 174 Method, which resulted from the 2017 Act's amendments to IRC Section 174, is effective for tax years beginning after December 31, 2021. Before the effective date of the Required Section 174 Method, taxpayers could deduct R&E expenses immediately in the year in which those costs were incurred or elect to capitalize or amortize those costs over a 60-month period.

A taxpayer is generally precluded from obtaining automatic consent for a change in method of accounting if it has made or requested a change for the same item during any of the prior five taxable years ending with the year of change. However, Revenue Procedure 2023-8 waives this requirement for a change to the Required Section 174 Method for a taxpayer's first taxable year beginning after December 31, 2021.<sup>2</sup> For more information, see Deloitte's December 14, 2022, Tax Alert [IRS Issues Procedural Guidance for Method Changes to Comply With Section 174](#) and January 3, 2023, Tax Alert [IRS Issues Modified Procedural Guidance for Method Changes to Comply With Section 174](#).

For a discussion of other matters related to the income tax accounting consequences of the 2017 Act's provisions, see Deloitte's January 3, 2018 (updated August 30, 2018), [Financial Reporting Alert](#).

## 8.4 CARES Act

On March 27, 2020, President Trump signed into law the CARES Act, a massive tax-and-spending package intended to provide additional economic relief to address the impact of the COVID-19 pandemic. Several significant business tax provisions in the CARES Act that are intended to improve cash flow and liquidity could affect a company's accounting for income taxes. Under ASC 740, the effects of new legislation are recognized upon enactment, which (for federal legislation) is the date the president signs the bill into law. Accordingly, recognition of the tax effects of the CARES Act was required in the interim and annual periods that included March 27, 2020.

The following provisions of the CARES Act are most likely to affect life sciences entities:

- *Modifications to limitations on deductibility of NOLs (Section 2303)* — The 2017 Act eliminated, with certain exceptions, the NOL carryback period and permits an indefinite carryforward period while limiting the NOL deduction to 80 percent of taxable income (computed without regard to the NOL deduction). The CARES Act repeals the 80 percent limitation for taxable years beginning before January 1, 2021.
- *Modifications to limitations on deductibility of business interest (Section 2306)* — The CARES Act amends IRC Section 163(j) as applied to taxable years beginning in 2019 and 2020. IRC Section 163(j) limits the deduction for business interest expense to the sum of (1) the taxpayer's business interest income, (2) 30 percent of the taxpayer's adjusted taxable income, and (3) the taxpayer's floor plan financing interest expense for the taxable year. The CARES Act increases the 30 percent adjusted taxable income threshold to 50 percent for taxable years beginning in 2019 and 2020.<sup>3</sup>
- *Alternative minimum tax credit acceleration (Section 2305)* — The 2017 Act repealed the corporate alternative minimum tax (AMT), which operated in parallel with the regular tax system. The CARES Act amends Section 53(e) of the 2017 Act so that all prior-year minimum tax credits are

<sup>2</sup> On December 29, 2022, the U.S. Treasury and IRS released [Revenue Procedure 2023-11](#), which modifies Revenue Procedure 2023-8 by providing that a taxpayer will not be granted audit protection if a change in method is made for the taxable year immediately after the first taxable year in which the Required Section 174 Method becomes effective. That is, a calendar-year taxpayer that did not apply the Required Section 174 Method in its 2022 taxable year tax return would not obtain audit protection by filing a Form 3115 that is effective for taxable year 2023. However, Revenue Procedure 2023-11 otherwise retains the same eligibility and audit protection terms as Revenue Procedure 2023-8.

<sup>3</sup> Special rules also apply for partnerships and short taxable years in 2019 and 2020. For additional information, see Deloitte's [COVID-19 Stimulus: A Taxpayer Guide](#).

potentially available for refund for the first taxable year of a corporation beginning in 2018. Companies will need to adjust the classification of any remaining AMT credits as a result of the AMT credit acceleration.

- *Expensing of qualified improvement property (Section 2307)* — The 2017 Act inadvertently failed to include qualified improvement property (QIP) in the 15-year property classification. Accordingly, QIP was classified by default as 39-year property and was consequently ineligible for the additional first-year bonus depreciation. To fix these inadvertent oversights, the CARES Act includes technical amendments that are retroactive to the effective date of the 2017 Act. Companies will need to consider (1) how the QIP technical correction affects their assessment of uncertain tax positions, including the impacts of interest and penalties; (2) the possibility of having to file amended tax returns; and (3) the related impact on current taxes payable and DTAs and DTLs.
- *Other tax considerations* — Depending on an entity's facts and circumstances, certain of the aforementioned sections of the CARES Act (e.g., those related to the NOL carryback and the QIP technical correction) could also affect various other aspects of an entity's tax provision (e.g., GILTI, BEAT, FDII). Accordingly, an entity will need to carefully consider its facts and circumstances to determine the appropriate accounting.
- *Interim reporting considerations* — An entity uses an estimated AETR to compute its taxes for interim periods related to ordinary income (or loss). Generally, the provisions of the CARES Act that affect ordinary income (e.g., credits that are not related to income taxes) should be considered and estimated as part of an entity's estimated AETR.

For more information about the CARES Act and its impacts, see Deloitte's April 9, 2020 (updated September 18, 2020), [Heads Up](#).

## 8.5 Inflation Reduction Act of 2022

On August 16, 2022, President Biden signed the IRA into law. The IRA has a number of tax-related provisions, including:

- A 15 percent book minimum tax ("corporate AMT") on the adjusted financial statement income (AFSI) of applicable corporations (see [Section 8.5.1](#)).
- A plethora of clean energy tax incentives in the form of tax credits, some of which include a direct-pay option or transferability provisions (see Deloitte's August 12, 2022, Tax Alert [Clean Energy Credits and Incentives in the Inflation Reduction Act of 2022 — Details and Observations](#)).
- A 1 percent excise tax on certain corporate stock buybacks (see [Section 8.5.2](#)).
- A redesign of Medicare (see [Section 2.4.9.1](#)).

For more information about the IRA and its impacts, see Deloitte's November 9, 2022, [Emerging ASC 740 Issues: Recent Tax Legislation](#).

The clean energy tax credit changes in the IRA are not expected to have a significant impact on the life sciences industry.

## 8.5.1 Corporate AMT

The corporate AMT has many similarities to the since repealed, pre-2018 U.S. AMT system applicable to corporations. ASC 740 addressed that tax law and provided that (1) “[i]n the U.S. federal tax jurisdiction, the applicable tax rate [for measuring U.S. federal deferred taxes] is the regular tax rate” and (2) a DTA would be recognized for AMT credit carryforwards available under the legislation, which would then be assessed for realization.

We believe that similar accounting will be applied to the corporate AMT. Accordingly, under this approach, no remeasurement of existing DTAs and DTLs would be needed in the period of enactment. Rather, the tax effects of the corporate AMT (i.e., increase in tax payable and related credit) would only be reflected in an entity’s financial statements after the law is actually effective (i.e., beginning in an entity’s first reporting period and tax year that begins after December 31, 2022). More specifically, an entity that expects to owe corporate AMT for tax years beginning after December 31, 2022, would recognize an increase in current tax payable for such years along with a DTA for AMT credit carryforwards that would then need to be assessed for realization (i.e., assessed for a valuation allowance). The resulting tax effects would be considered in determining the entity’s AETR in such future years.

For more information, see Deloitte’s August 10, 2022, U.S. International Tax Alert [Corporate AMT Included in Inflation Reduction Act of 2022](#).

### 8.5.1.1 Potential Interaction With Valuation Allowance

While deferred taxes will continue to be measured at the regular tax rate, the introduction of corporate AMT will have an effect on existing DTAs in the regular tax system if an entity expects to be perpetually paying corporate AMT (e.g., while an NOL for an entity that is expected to perpetually pay corporate AMT might result in a reduction in tax under the regular system, the NOL may not be available for corporate AMT purposes, and the entity might pay corporate AMT on the income sheltered by the NOL in the regular tax system).

We believe that there are two acceptable approaches to assessing the realizability of DTAs in the regular system for perpetual corporate AMT taxpayers. Under the first approach, the entity would assess the realizability of its DTAs on the basis of all available information. If, for example, the expected tax benefit of an NOL is less than the reported amount because the utilization of the NOL will result in incremental corporate AMT, a valuation allowance would be required to reflect the actual amount of tax benefit that will be realized with respect to the NOL. Alternatively, the entity could assess the realizability of its DTAs solely on the basis of the regular tax system without taking into account amounts due under the corporate AMT system (i.e., any incremental impact of the corporate AMT would be accounted for in the period the corporate AMT is incurred).

These approaches are illustrated in the example below.



**Example 8-4**

Assume the following:

- Entity A had USD 1,000 of pre-2018 NOL carryforwards and no corporate AMT credit or NOL carryforward.
- Entity A expects sufficient future income to fully utilize its pre-2018 NOL carryforward.
- Entity A expects to perpetually be a corporate AMT taxpayer and, accordingly, will need to record a full valuation allowance against any corporate AMT credit carryforwards that arise in future years.

For simplicity, further assume that there are no other permanent or temporary differences or attributes.

These assumptions are reflected in the table below.

	Regular Tax		Corporate AMT	
Future pre-NOL AFSI and taxable income <b>A</b>	USD	1,000	USD	1,000
NOL deduction		<u>(1,000)</u>		<u>0</u>
Taxable income/AFSI <b>B</b>	USD	0	USD	1,000
Tax rate <b>C</b>		<u>21%</u>		<u>15%</u>
Taxes payable with NOL carryforward ( <b>B × C</b> )	USD	0	USD	150
Taxes payable without NOL carryforward ( <b>A × C</b> )	USD	210	USD	150

The available approaches are as follows:

- *Approach 1* — The utilization of the NOL reduces the regular tax liability of USD 210 down to the corporate AMT liability of USD 150. As a result, the NOL only results in a reduction of future cash outflows of USD 60, necessitating a USD 150 valuation allowance against the USD 210 NOL DTA.
- *Approach 2* — The USD 150 incremental cost of corporate AMT would be accounted for in the period in which it arises, and no valuation allowance would be recorded against the USD 210 NOL DTA since there is sufficient regular taxable income expected in future years.

Entities that elect to follow the first approach would need to consider whether the impact of the new corporate AMT will require an adjustment to their valuation allowance against their DTAs; any such adjustment would be recorded in the period of enactment (i.e., August 2022). In addition, the IRA allows entities to reduce their corporate AMT tax liability by certain general business credits. Entities following the first approach that have a valuation allowance because of an inability to use such credits in the regular tax system would need to consider whether such credits may now be realizable as a result of corporate AMT.



### Connecting the Dots

Many of the income tax impacts of the IRA are effective for financial reporting periods and tax years beginning on or after January 1, 2023. For more information, see Deloitte's April 3, 2023, [Financial Reporting Alert](#).

## 8.5.2 Stock Buyback 1 Percent Excise Tax

The IRA adds a new IRC section, Section 4501, that imposes a 1 percent excise tax on stock repurchases by publicly traded companies that occur after December 31, 2022. Specifically, under new IRC Section 4501, a covered corporation would be subject to a tax equal to 1 percent of (1) the fair market value of any stock of the corporation that is repurchased by this corporation (or certain affiliates) during any taxable year, with limited exceptions, less (2) the fair market value of any stock issued by the covered corporation (or certain affiliates) during the taxable year (including compensatory stock issuances). The 1 percent excise tax may also be imposed on acquisitions of stock in certain mergers or acquisitions involving covered corporations.



Because the tax is not based on a measure of income, the excise tax is not an income tax and, therefore, is not within the scope of ASC 740. The accounting for taxes paid in connection with the repurchase of stock is not specifically addressed in U.S. GAAP. However, entities may consider the guidance in AICPA Technical Q&As Section 4110.09, which indicates that direct and incremental legal and accounting costs associated with the acquisition of treasury stock may be added to the cost of the treasury stock. Therefore, it is acceptable to account for the IRC Section 4501 excise tax obligation that results from the repurchase of common stock classified within permanent equity as a cost of the treasury stock transaction. Any reductions in the excise tax obligation associated with share issuances would also be recognized as part of the original treasury stock transaction even if the share issuance is a different type of instrument than the share that was repurchased. Additional considerations are necessary when the excise tax obligation that arises is related to redemptions of preferred stock. Such an excise tax obligation would be recognized as a cost of redeeming the preferred stock. The accounting for redemptions of preferred stock differs depending on the classification of the preferred stock as permanent equity, temporary equity, or a liability. An entity would need to use a systematic and rational allocation approach to account for the effect of share issuances on the excise tax obligation when the entity has repurchases of both common stock and preferred stock during a taxable period.

For more information about the stock buyback tax under the IRA, see Deloitte's April 27, 2023, [Heads Up](#) and August 12, 2022, Tax Alert [Excise Tax on Repurchases of Stock](#).

## 8.6 SEC Comment Letter Themes Related to Income Taxes

Overall, the themes of SEC staff comments issued to registrants on financial reporting and disclosures related to income taxes have remained consistent year over year. Such comments continue to focus on (1) valuation allowances, (2) disclosures related to the income tax rate, (3) tax effects of significant or unusual transactions that occurred during the period, and (4) noncompliance with disclosure requirements (e.g., omission of required disclosures).

The SEC staff continues to ask registrants to provide early-warning disclosures to help financial statement users understand key estimates and assumptions in recording these items and how changes to those estimates and assumptions could potentially affect the financial statements in the future. The SEC staff also continues to issue comments on non-GAAP measures with a particular focus on the income tax impact of the adjustments made to the GAAP measures. For additional information about non-GAAP measures, see Deloitte's Roadmap [Non-GAAP Financial Measures and Metrics](#).

Historically, the SEC staff has stated that boilerplate language should be avoided with respect to income tax disclosures within MD&A and that approaches more conducive to effective disclosure would include:

- Using the income tax rate reconciliation as a starting point and describing the details of the material items.
- Discussing significant foreign jurisdictions, including statutory rates, effective rates, and the current and future impact of reconciling items.
- Providing meaningful disclosures about known trends and uncertainties, including expectations regarding the countries where registrants operate.

For more information about SEC comment letter themes that are relevant to the life sciences industry, see Deloitte's Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#).



### Connecting the Dots

In 2022, the SEC issued updates to certain non-GAAP CD&I Q&As. However, Question 102.11 as issued on May 17, 2016, remains applicable in providing clarification on the presentation of the income tax effects of certain metrics based on the nature of the measure:

#### Question 102.11

**Question:** How should income tax effects related to adjustments to arrive at a non-GAAP measure be calculated and presented?

**Answer:** A registrant should provide income tax effects on its non-GAAP measures depending on the nature of the measures. If a measure is a liquidity measure that includes income taxes, it might be acceptable to adjust GAAP taxes to show taxes paid in cash. If a measure is a performance measure, the registrant should include current and deferred income tax expense commensurate with the non-GAAP measure of profitability. In addition, adjustments to arrive at a non-GAAP measure should not be presented “net of tax.” Rather, income taxes should be shown as a separate adjustment and clearly explained.

## 8.7 New Accounting Standard — Improvements to Income Tax Disclosures (ASU 2023-09)

In December 2023, the FASB issued [ASU 2023-09](#), which establishes new income tax disclosure requirements in addition to modifying and eliminating certain existing requirements. The new guidance is aimed at addressing what the ASU describes as stakeholder feedback indicating that “the existing income tax disclosures should be enhanced to provide information to better assess how an entity’s operations and related tax risks and tax planning and operational opportunities affect its tax rate and prospects for future cash flows.”

Under the new guidance, entities must consistently categorize and provide greater disaggregation of information in the rate reconciliation. They must also further disaggregate income taxes paid. The disclosure requirements of ASU 2023-09 apply to all entities subject to ASC 740.

The rate reconciliation requirements for PBEs differ from those for non-PBEs as follows:

- *PBEs* — Under the current guidance in ASC 740, public entities<sup>4</sup> are required to reconcile the income tax expense (or benefit) from continuing operations with the amount that would result from applying the domestic federal statutory rate to pretax income (loss) from continuing operations. In addition to the existing requirement, under ASU 2023-09, PBEs must annually “(1) disclose specific categories in the rate reconciliation and (2) provide additional information for reconciling items that meet a quantitative threshold (if the effect of those reconciling items is equal to or greater than 5 percent of the amount computed by multiplying pretax income [or loss] by the applicable statutory income tax rate).”
- *Non-PBEs* — Under the current guidance in ASC 740, nonpublic entities are required to provide disclosure of the nature of significant reconciling items, but a numerical reconciliation of income tax expense is not required. Under ASU 2023-09, although a numerical reconciliation is not required, non-PBEs are required to disclose (1) the nature and effect of the specific categories of reconciling items introduced by the new guidance and (2) individual jurisdictions resulting in a significant difference between the effective tax rate and the statutory tax rate.

<sup>4</sup> ASU 2023-09 replaces the term “public entity” throughout ASC 740 with the term “public business entity” as defined in the ASC master glossary.

In addition to requiring compliance with the new rate reconciliation disclosure requirements, ASU 2023-09 requires all entities within the scope of ASC 740 to provide annual disclosure of income taxes paid by disaggregating those amounts by foreign, domestic, and state taxes, with further disaggregation by jurisdiction on the basis of a quantitative threshold of 5 percent “of total income taxes paid (net of refunds received).” However, comparative information for all periods presented is not required for the disclosures related to income taxes paid in an individual jurisdiction under ASC 740-10-50-23.

The amendments in ASU 2023-09 are effective for PBEs for annual periods beginning after December 15, 2024. For entities other than PBEs, the amendments are effective for annual periods beginning after December 15, 2025. The ASU permits entities to early adopt the amendments “for annual financial statements that have not yet been issued or made available for issuance.”

For more information about ASU 2023-09, see Deloitte’s January 18, 2024, [Heads Up](#).

## 8.8 OECD Pillar Two

In October 2021, more than 135 countries and jurisdictions agreed to participate in a “two-pillar” international tax approach developed by the OECD, which includes establishing a global minimum corporate tax rate of 15 percent. The OECD published *Tax Challenges Arising From the Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two)*<sup>5</sup> in December 2021 and subsequently issued additional commentary and administrative guidance<sup>6</sup> clarifying several aspects of the model rules (collectively, the “GloBE rules”).

The Pillar Two rules are intended to ensure that large multinational enterprise (MNE) groups pay a minimum level of tax on the income arising in each of the jurisdictions in which they operate. The rules do so by imposing a top-up tax on profits arising in a jurisdiction whenever the effective tax rate, determined on a jurisdictional basis, is below the 15 percent minimum rate. The Pillar Two rules include:<sup>7</sup>

- “[A]n Income Inclusion Rule (IIR), which imposes top-up tax on a parent entity in respect of the low taxed income of a constituent entity.”
- “[A]n Undertaxed Payment Rule (UTPR), which denies deductions or requires an equivalent adjustment to the extent the low tax income of a constituent entity is not subject to tax under an IIR.”
- A Qualified Domestic Minimum Top-up Tax (QDMTT) that applies to local constituent entities of in-scope MNEs and produces outcomes that are consistent with the GloBE rules.
- A Subject to Tax Rule (STTR) that allows source jurisdictions to “tax back” when defined categories of intra-group covered income are subject to nominal corporate income tax rates below the STTR minimum rate and domestic taxing rights over that income have been ceded under a treaty.

<sup>5</sup> OECD (2021), *Tax Challenges Arising From Digitalisation of the Economy — Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, <https://doi.org/10.1787/782bac33-en>.

<sup>6</sup> The OECD periodically publishes [commentary](#), [administrative guidance](#), and [information](#) about the GloBE rules on its Web site.

<sup>7</sup> Quoted text in the first two bullet points is from OECD/G20 Base Erosion and Profit Shifting Project, *Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*, October 2021.

At the FASB's February 1, 2023, meeting, the FASB staff announced that the global minimum tax imposed under the Pillar Two rules, as published by the OECD,<sup>8</sup> is an AMT and that deferred taxes would not be recognized or adjusted for the effect of global minimum taxes that conform to such Pillar Two rules. As support for its conclusion, the FASB staff cited the guidance in ASC 740-10-30-10 and ASC 740-10-30-12 as well as in ASC 740-10-55-31 and 55-32. Accordingly, the incremental effects of such taxes would be accounted for as a period cost (i.e., the increase in tax payable would only be reflected in an entity's financial statements after a law is actually effective).

For more information about Pillar Two generally, see Deloitte's December 22, 2021, U.S. International Tax Alert [Pillar Two: OECD Inclusive Framework Global Minimum Tax Model Rules](#). For more information about the accounting and disclosure implications of Pillar Two, see Deloitte's [February 1, 2023](#), and [March 5, 2024](#), *Financial Reporting Alert* newsletters.

<sup>8</sup> As jurisdictions enact laws in response to the Pillar Two rules, each jurisdiction's enacted law will ultimately need to be separately evaluated for consistency with the framework.

# Chapter 9 — Compensation

## 9.1 Industry Issues

### 9.1.1 Stock Repurchase Transactions

Various stock transactions with grantees<sup>1</sup> of an emerging nonpublic entity (the “nonpublic entity”) involve significant judgment and complexities that may have a material impact on the nonpublic entity’s financial statements. In addition, such transactions often have certain tax implications for both the nonpublic entity and its grantees. These stock transactions can be between the nonpublic entity and its grantees, a preexisting investor and the nonpublic entity’s grantees, or a new investor and the nonpublic entity’s grantees.

#### 9.1.1.1 Accounting Considerations

##### 9.1.1.1.1 Transactions Directly Between a Nonpublic Entity and Its Grantees

To provide liquidity or for other reasons, entities may sometimes repurchase vested common stock from their share-based payment award grantees. In some cases, the price paid for the shares exceeds their fair value at the time of the transaction, and the excess would generally be recognized as additional compensation cost.

ASC 718-20-35-7 states the following:

The amount of cash or other assets transferred (or liabilities incurred) to repurchase an equity award shall be charged to equity, to the extent that the amount paid does not exceed the fair value of the equity instruments repurchased at the repurchase date. **Any excess of the repurchase price over the fair value of the instruments repurchased shall be recognized as additional compensation cost.** An entity that repurchases an award for which the promised goods have not been delivered or the service has not been rendered has, in effect, modified the employee’s requisite service period or nonemployee’s vesting period to the period for which goods have already been delivered or service already has been rendered, and thus the amount of compensation cost measured at the grant date but not yet recognized shall be recognized at the repurchase date. [Emphasis added]

For example, a nonpublic entity may repurchase shares from its existing employees in connection with a convertible preferred stock financing, whereby the entity may set aside a specified amount of the financing proceeds to repurchase common stock from its existing employees and thereby provide liquidity to its employees. It is not unusual for an entity to repurchase common shares by using the price established for the preferred stock in the most recent round of financing. Accordingly, a nonpublic entity would need to evaluate whether the price of the preferred stock is equal to the value of the common stock. Typically, the value of preferred shares will exceed the value of common shares (under the assumption that there is one-to-one conversion) because of preferential rights normally associated with preferred shares. As a result, the excess amount would be reflected in the nonpublic entity’s financial statements as compensation cost in accordance with ASC 718-20-35-7.

<sup>1</sup> The term “grantees” applies to all transactions in which an entity receives goods or services to be used or consumed in the entity’s own operations in exchange for share-based instruments.

### 9.1.1.1.2 Transactions Directly Between a Preexisting Investor and the Nonpublic Entity's Grantees as Part of a Financing Transaction

On occasion, existing investors (such as private equity or venture capital investors) intending to increase their stake in an emerging nonpublic entity may undertake transactions with other shareholders in connection with or separately from a recent financing round. These transactions may include the purchase of common or preferred stock by investors from the founders of the nonpublic entity or other individuals who are also considered employees. Because the transactions are between grantees of the nonpublic entity and existing shareholders and are related to the transfer of outstanding shares, the nonpublic entity may not be directly involved in them (though it may become indirectly involved by facilitating the exchange or not exercising a right of first refusal). If the price paid for the shares exceeds their fair value at the time of the transaction, it may be difficult to demonstrate that the transaction is not compensatory and the nonpublic entity would most likely be required to recognize compensation cost for the excess, even if the nonpublic entity is not directly involved in the transaction. It is important for a nonpublic entity to recognize that transactions such as these may be subject to the guidance in ASC 718-10-15-4 because the investors are considered holders of an economic interest in the entity.

ASC 718-10-15-4 states the following:

**Share-based payments awarded to a grantee by a related party or other holder of an economic interest in the entity<sup>2</sup> as compensation for goods or services provided to the reporting entity are share-based payment transactions to be accounted for under this Topic unless the transfer is clearly for a purpose other than compensation for goods or services to the reporting entity.**

The substance of such a transaction is that the economic interest holder makes a capital contribution to the reporting entity, and that entity makes a share-based payment to the grantee in exchange for services rendered or goods received. An example of a situation in which such a transfer is not compensation is a transfer to settle an obligation of the economic interest holder to the grantee that is unrelated to goods or services to be used or consumed in a grantor's own operations. [Emphasis added]

Although the presumption in such transactions is that any consideration in excess of the fair value of the shares is compensation paid to employees, entities should consider whether the amount paid is related to an existing relationship or to an obligation that is unrelated to the employees' services to the entity in assessing whether the payment is "clearly for a purpose other than compensation for goods or services to the reporting entity." Even though it is difficult to demonstrate that a non-fair value transaction with employees is *clearly* for other purposes, AIN-APB 25 (codified in ASC 718) describes situations when doing so may be possible, including those in which:

- "[T]he relationship between the stockholder and the corporation's employee is one which would normally result in generosity (i.e., an immediate family relationship)."
- "[T]he stockholder has an obligation to the employee which is completely unrelated to the latter's employment (e.g., the stockholder transfers shares to the employee because of personal business relationships in the past, unrelated to the present employment situation)."

In all situations, the determination of whether a transaction should be accounted for under ASC 718 should be based on an entity's specific facts and circumstances.

<sup>2</sup> ASC 718-10-20 defines an economic interest in an entity as "[a]ny type or form of pecuniary interest or arrangement that an entity could issue or be a party to, including equity securities; financial instruments with characteristics of equity, liabilities, or both; long-term debt and other debt-financing arrangements; leases; and contractual arrangements such as management contracts, service contracts, or intellectual property licenses."

### 9.1.1.1.3 Transactions Directly Between a New Investor and the Nonpublic Entity's Grantees as Part of a Financing Transaction

There may be situations in which, as part of a financing transaction between a nonpublic entity and a new investor that is acquiring a significant ownership interest in the nonpublic entity, the new investor repurchases common shares in the nonpublic entity from employees of the nonpublic entity. For example, the investor may not have participated in a prior financing arrangement and may be purchasing convertible preferred stock from the nonpublic entity and common stock from the nonpublic entity's existing employees. In this scenario, the investor pays the same price to purchase the preferred stock from the nonpublic entity and the common stock from the employees. While it did not hold an economic interest before entering into the transaction with the nonpublic entity, the new investor is not unlike a party that already holds such an interest and may be similarly motivated to compensate employees.

As noted in ASC 718-10-15-4, a share-based payment arrangement between the holder of an economic interest in a nonpublic entity and an employee of the nonpublic entity should be accounted for under ASC 718 unless the arrangement "is clearly for a purpose other than compensation for goods or services." If a new investor purchases common stock valued at an amount based on the value of the preferred stock, we would generally expect the analysis to be similar to that performed by a preexisting investor that purchases common stock from a nonpublic entity's employees.

### 9.1.1.2 Valuation Considerations

While the examples above describe situations in which it is likely that the nonpublic entity would recognize additional compensation cost, we are aware of circumstances in which a secondary market transaction between an investor and a nonpublic entity's employees represents an orderly arm's-length transaction conducted at fair value. In such cases, the nonpublic entity has adequate support for a conclusion that the transaction was conducted at fair value and therefore did not result in additional compensation cost. Such secondary transactions are likely to be relevant in the nonpublic entity's common stock valuation, which is typically performed by a third-party valuation firm to ensure compliance with IRC Section 409A and determine the fair-value-based measure of the nonpublic entity's share-based payment arrangements. See [Section 4.12.2](#) of Deloitte's Roadmap *Share-Based Payment Awards* for further discussion of the applicability of IRC Section 409A.

When an entity does conclude that a secondary transaction includes a compensatory element that must be recognized, there may have also been indicators that the secondary transaction was conducted at fair value. In such situations (i.e., there are indicators that (1) the transaction was conducted at fair value and (2) there is a compensatory element), an entity should consider whether to give some weight to the transaction when determining the fair value of the common shares.

### 9.1.1.3 Tax Considerations

For tax purposes, stock repurchases are generally treated either as capital (e.g., capital gain) or as dividend-equivalent redemptions (e.g., ordinary dividend income to the extent that the entity has earnings and profits). Repurchases from current or former service providers (i.e., current or former employees or independent contractors) give rise to questions about whether any of the proceeds should be treated as compensation for tax purposes.



In the assessment of whether a portion of the payment is compensation, a critical tax issue is what value is appropriate for the nonpublic entity to use when determining the effect of the capital redemption. That is, the nonpublic entity must determine whether some portion of the consideration for the repurchase represents something other than fair value for the common stock (e.g., compensation cost). When a repurchase exceeds the fair value of the common stock, there is risk that some of the purchase consideration is compensation for tax purposes. The determination of whether such excess is compensatory depends on the facts and circumstances, and there can be disparate treatment for book and tax purposes with respect to compensation transactions as well as ambiguity in the existing tax code. Relevant factors include whether the repurchase is (1) performed by the nonpublic entity or an existing investor or (2) part of arm's-length negotiations with a new investor that may not have the same information as the nonpublic entity about what is considered to be the fair market value of the stock. If the purchaser is not the nonpublic entity, it is relevant whether the shares will be held by the buyer, or whether they can be converted into a different class of stock or put back to the nonpublic entity. Another factor is whether an offer to sell at a higher price is limited to service providers or is available to shareholders more generally.

If the repurchase resulted in compensation for tax purposes, the nonpublic entity would include such compensation on Form W-2 (for employees) or Form 1099-MISC (for independent contractors). While any tax liability resulting from additional compensation is the obligation of the individual, the nonpublic entity has an obligation to (1) withhold income and payroll taxes from payments to employees and (2) remit the employer share of payroll tax. A nonpublic entity that does not withhold payroll taxes from an employee in a transaction in which the excess purchase price is compensatory becomes responsible for the tax and should evaluate whether to accrue a liability in accordance with the guidance in ASC 450. That guidance addresses the proper accounting treatment of non-income-tax contingencies such as sales and use taxes, property taxes, and payroll taxes.

An estimated loss contingency, such as a payroll tax liability, is accrued (i.e., expensed) if (1) it is probable that the liability has been incurred as of the date of the financial statements and (2) the amount of the liability is reasonably estimable. A loss contingency must be disclosed if (1) the loss is probable as of the date of the financial statements or it is reasonably possible that the liability has been incurred and (2) the amount is material to the financial statements. See [Section 6.2.3](#) for a discussion of the measurement of a loss contingency.

With respect to a payroll tax liability, the liability recorded as a tax transaction should be the best estimate of the probable amount due to the tax authority under the applicable law, which would include interest and penalties. In addition, the nonpublic entity would need to evaluate whether it has any arrangements in place with its employees that would make it responsible for its employees' tax liability. If the best estimate of the liability is a range, and if one amount in the range represents a better estimate than any other amount in the range, that amount should be recorded in accordance with ASC 450-20-30-1. If no amount in the range is a better estimate than any other amount, the minimum amount in the range should be used to record the liability in accordance with ASC 450-20-30-1.

An entity has a legal right to seek reimbursement for the payroll tax liability (although not for income tax withholding, penalties, or interest) from employees if the IRS makes a determination to seek the withholdings from the entity. Accordingly, an entity could record an offsetting receivable from the employees for the payroll tax withholdings. However, the entity will need to assess the collectibility of such a receivable, including whether the entity has sufficient evidence of an employee's ability to reimburse the entity for the payroll tax liability and whether the entity has the intent to collect this liability from the employee.

Given the complexities of this type of transaction, including the evaluation of existing tax law, entities should consult with their auditors and tax specialists when quantifying the liability under ASC 450.

Note that if a payment is considered compensation, a deduction of the same amount would also be allowed (subject to all applicable rules related to deductions for compensation expense).

For further considerations related to common-stock repurchase transactions, see [Section 4.12.3](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

## 9.2 Staff Accounting Bulletin on "Spring-Loaded" Awards (SAB 120)

In November 2021, the SEC staff issued [SAB 120](#), which amends [SAB Topic 14.D](#) and provides the SEC staff's views on the measurement and disclosure of certain share-based payment awards granted when entities possess material nonpublic information (i.e., "spring-loaded" awards).

For more information about SAB 120, see [Section 12.2.4.6](#) of this Guide and [Sections 4.9.2.6](#) and [13.10](#) of Deloitte's Roadmap *Share-Based Payment Awards*.

## 9.3 SEC's Final Rule Related to Pay Versus Performance

The SEC issued its [final rule](#) on pay versus performance on August 25, 2022, and registrants began providing the disclosures required by the final rule in their proxy statements in 2023. Under the final rule, both prescribed and free-form disclosures regarding the relationship between executive compensation amounts actually paid by a registrant and the performance of the registrant are required for the registrant's principal executive officer as well as other named executive officers. The disclosure requirements apply to all registrants other than emerging growth companies (EGCs), registered investment companies, and foreign private issuers (FPIs). Smaller reporting companies (SRCs) are exempt from certain of the requirements.

While the final rule's requirements do not apply to EGCs, they include transition provisions for newly public companies that are not EGCs. Because the disclosures are not required in registration statements, they do not have to be provided during the IPO process. Also, the requirements apply only for years in which a registrant (i.e., a public company) was subject to reporting requirements under the Securities Exchange Act of 1934 (the "Exchange Act"). For example, if a non-EGC registrant completes its IPO in 2023, the proxy statement for fiscal year 2023 would provide disclosure for only fiscal year 2023. The registrant would add subsequent years to each annual proxy filing until it includes five years (i.e., in the proxy filing for fiscal year 2027, which would be the year that includes the fourth anniversary of its IPO).

In a manner similar to the SEC staff's review of registrants' compliance with other new disclosure rules, the staff performed targeted reviews of registrants' disclosures under the pay-versus-performance rule and issued comments asking registrants to confirm that the concerns raised in those comments will be addressed in future filings. Key observations from the staff on the implementation of pay-versus-performance disclosures included the following:

- *The relationship disclosure* — Registrants may disclose the relationship between company performance and compensation actually paid in graphical form, narrative form, or a combination of both. The staff noted that this disclosure is at the core of the rulemaking and in some instances was omitted entirely. In addition, the staff observed that registrants that provided relationship disclosures in graphical form generally described the relationship more effectively than those that provided the disclosures in narrative form.

- *Non-GAAP company-selected measures* — If a registrant’s company-selected measure is a non-GAAP measure, the registrant should clearly describe how the measure is calculated from the financial statements. The staff expects this disclosure to be included either within the proxy statement or in an appendix to the proxy statement. It should not be provided as simply a cross-reference to the registrant’s Form 10-K or other SEC filings.
- *Changes in assumptions* — Registrants must clearly disclose any material changes in assumptions related to the valuation for compensation actually paid from those that were disclosed on the grant date of the equity award in the financial statements. The staff noted that some disclosures were unclear about whether they represented material changes in assumptions or were supplemental to the assumptions disclosed on the grant date of the equity award. Registrants should ensure that their disclosures clearly identify whether there have been material changes in assumptions.
- *Tabular list* — The pay-versus-performance disclosure must include tabular disclosure of the three to seven most important performance measures used by a registrant to link executive compensation and company performance. While the registrant’s company-selected measure must be included on the list, the registrant should also ensure that the performance measures disclosed are consistent with those described in the compensation discussion and analysis.
- *Inline extensible Business Reporting Language (Inline XBRL) tagging* — The staff observed that although Inline XBRL tagging of pay-versus-performance disclosures is required, many registrants did not provide it.

The SEC has released C&DIs on the final rule’s requirements. Many of these C&DIs address questions about measuring the fair value of certain awards. While legal counsel often addresses proxy statement and executive compensation requirements, the SEC staff has emphasized the importance of including accountants in the preparation of the pay-versus-performance disclosures because their experience with developing assumptions, fair values, and disclosures for share-based compensation awards in the financial statements positions them well for preparing or reviewing the pay-versus-performance disclosures.

For more information about the SEC’s final rule related to pay versus performance, see Deloitte’s [September 2, 2022](#), and [December 10, 2023](#), *Heads Up* newsletters.

## 9.4 SEC’s Final Rule on the Recovery of Erroneously Awarded Compensation (“Clawback Policies”)

On October 26, 2022, the SEC issued a [final rule](#) aimed at ensuring that executive officers do not receive “excess compensation” if the financial results on which previous awards of compensation were based are subsequently restated because of material noncompliance with financial reporting requirements. Such restatements would include those correcting an error that either (1) “is material to the previously issued financial statements” (a “Big R” restatement) or (2) “would result in a material misstatement if the error were corrected in or left uncorrected in the current period” (a “little r” restatement). The final rule implements the mandate in Section 954 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”) under which the SEC is required “to adopt rules directing the national securities exchanges . . . and the national securities associations . . . to prohibit the listing of any security of an issuer” that has not adopted and implemented a written policy providing for the recovery of incentive-based compensation under certain circumstances.

The final rule requires issuers to “claw back” excess compensation for the three fiscal years before the determination of a restatement regardless of whether an executive officer had any involvement in the restatement. The final rule also requires an issuer to disclose its recovery policy in an exhibit to its annual report and to include new checkboxes on the cover page of its annual report to indicate whether the financial statements “reflect correction of an error to previously issued financial statements and whether [such] corrections are restatements that required a recovery analysis.” Additional disclosures are required in the proxy statement or annual report when a clawback occurs. Such disclosures include the date of the restatement, the amount of excess compensation to be clawed back, and any amounts outstanding that have not yet been clawed back.

With very limited exceptions, the final rule requires exchanges to apply the disclosure and recovery requirements to all listed issuers. Note that the final rule applies to EGCs, SRCs, FPIs, and controlled companies, since the SEC believes that the objective of recovering excess compensation is as relevant for these types of companies as it is for any other listed issuer. While some exchanges currently allow FPIs to follow the rules of their home countries in lieu of certain U.S. corporate governance requirements, the final rule does not permit the exchanges to exempt FPIs from complying with the rule’s disclosure and recovery requirements.

For more information about the SEC’s final rule related to clawback policies, see [Section 3.9.1](#) of Deloitte’s Roadmap *Share-Based Payment Awards* and Deloitte’s [November 14, 2022](#), and [December 10, 2023](#), *Heads Up* newsletters.

# Chapter 10 — Financial Instruments

## 10.1 Introduction

Drug development is challenging, complex, time-consuming, and costly. Even though the average cost of developing a compound from discovery to launch has declined in recent years as the industry has begun to capitalize on the development of novel trial designs and realize efficiencies from the digitalization of drug discovery and development, billions of dollars are spent each year developing new drugs.<sup>1</sup> To fund the cost of drug development, life sciences entities frequently seek external financing. Many of the financing transactions include complex terms and conditions that require a careful accounting analysis.

The SEC staff historically has focused on the classification of liabilities and equity on the balance sheet when equity instruments have redemption provisions or financial instruments possess characteristics of both liabilities and equity. For example, classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.

In addition, prospective SEC registrants in the life sciences industry may have previously outstanding instruments with characteristics of both liabilities and equity at the time they are approaching a potential IPO, or life sciences entities may issue new instruments in connection with a potential IPO. Even if certain instruments are already outstanding before an IPO, it may be appropriate for an instrument to be classified outside of permanent equity in accordance with SEC rules when public financial statements are initially filed. Further, for a life sciences entity that becomes a public company, there can be other accounting consequences that did not exist while the entity was private.

## 10.2 Industry Issues

The discussion below highlights guidance on the accounting for financial instruments that frequently affects life sciences entities. The guidance cited is not intended to be all-inclusive or comprehensive; rather, the discussion focuses on targeted considerations related to the application of the guidance most relevant to the industry. To complete an analysis of the accounting for financial instruments, entities must consider all facts and circumstances and use significant judgment. For additional guidance on the topics highlighted below, see Deloitte's Roadmaps [Distinguishing Liabilities From Equity, Contracts on an Entity's Own Equity](#), and [Convertible Debt \(Before Adoption of ASU 2020-06\)](#).

<sup>1</sup> See, for example, the Deloitte Centre for Health Solutions' 13th annual pharmaceutical report, [Seize the Digital Momentum: Measuring the Return From Pharmaceutical Innovation 2022](#).

## 10.2.1 Sequence of Decision-Making

Upon the issuance of an equity instrument, a life sciences entity should first evaluate whether the instrument meets the definition of a liability in accordance with ASC 480, which applies to both PBEs (including SEC registrants) and private companies that are issuers of financial instruments within its scope. ASC 480 provides guidance on determining whether (1) certain financial instruments with both debt-like and equity-like characteristics should be accounted for “outside of equity” (i.e., as liabilities or, in some cases, assets) by the issuer and (2) SEC registrants should present certain redeemable equity instruments as temporary equity.

Examples of contracts and transactions that may require evaluation under ASC 480 include:

- Redeemable shares.
- Redeemable noncontrolling interests.
- Forward contracts to repurchase own shares.
- Forward contracts to sell redeemable shares.
- Written put options on own stock.
- Warrants (and written call options) on redeemable equity shares.
- Warrants on shares with deemed liquidation provisions.
- Puttable warrants on own stock.
- Equity collars.
- Share-settled debt (i.e., a share-settled obligation that is not in the legal form of debt but has the same economic payoff profile as debt).
- Preferred shares that are mandatorily convertible into a variable number of common shares.
- Unsettled treasury stock transactions.
- Accelerated share repurchase (ASR) programs.
- Hybrid equity units.

However, ASC 480 does not apply to legal-form debt, which is always classified as a liability by the issuer. If the legal form of an instrument is equity, further evaluation is necessary.

ASC 480 applies only to items that have all of the following characteristics:

- They embody one or more obligations of the issuer. An obligation can be either unconditional or conditional. An obligation is unconditional if no condition needs to be satisfied (other than the passage of time) to trigger a duty or responsibility for the obligated party to perform. Examples of unconditional obligations include:
  - Mandatorily redeemable financial instruments (as defined in ASC 480-10-20).
  - Physically settled forward contracts that require the issuer to repurchase equity shares by transferring assets or a variable number of shares.
  - Preferred stock that mandatorily converts into a variable number of common shares.

An obligation is conditional if the obligated party only has a duty or responsibility to perform if a specified condition is met (e.g., the occurrence or nonoccurrence of an uncertain future event or the counterparty's election to exercise an option). Examples of conditional obligations include:

- Physically settled written put options that, if exercised, could require the issuer to purchase equity shares and transfer assets.
- Physically settled forward contracts that require the issuer to purchase equity shares upon the occurrence or nonoccurrence of an event that is outside the issuer's control.
- Net-settled forward contracts to purchase equity shares that could require the issuer to transfer cash or a variable number of equity shares to settle the contracts' fair value if they are in a loss position.
- Net-settled written options that require the issuer to transfer assets or shares if the counterparty elects to exercise the options.

ASC 480 does not address the accounting for financial instruments that do not embody any obligation of the issuer. Examples of such instruments include:

- Outstanding equity shares that do not have any redemption or conversion provisions.
- Purchased call options that permit but do not require the issuer to purchase equity shares for cash (see ASC 480-10-55-35).
- Purchased put options that permit but do not require the issuer to sell equity shares for cash.
- They meet the definition of a financial instrument. The scope of ASC 480 is limited to financial instruments, which include:
  - Ownership interests (e.g., common or preferred shares or interests in a partnership or limited liability company).
  - Contracts to deliver cash (e.g., net-cash-settled options or forward contracts).
  - Contracts to deliver shares (e.g., share-settled debt or net-share-settled options or forward contracts).
  - Contracts to exchange financial instruments (e.g., physically settled written options or forward contracts that involve the exchange of equity shares for cash or another financial asset).
- They meet the definition of a freestanding financial instrument; that is, they are not features embedded in a freestanding financial instrument. ASC 480-10-20 defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable."
- Their legal form is that of a share, or they could result in the receipt or delivery of shares or are indexed to an obligation to repurchase shares.



ASC 480 requires an instrument that has all of the above characteristics to be classified outside of equity if it falls within one of the following classes of instruments:

- *Mandatorily redeemable financial instruments* — The issuer of a financial instrument that is in the form of a share must classify the share as a liability if it embodies an unconditional obligation requiring the issuer to redeem the share by transferring assets unless redemption would occur only upon the liquidation or termination of the reporting entity. Examples of mandatorily redeemable financial instruments include those mandatorily redeemable shares and mandatorily redeemable noncontrolling interests that do not contain any substantive conversion features.
- *Obligations to repurchase the issuer's shares by transferring assets (or financial instruments indexed to such obligations)* — A financial instrument other than an outstanding share is classified as an asset or a liability if it both (1) embodies an obligation to repurchase the issuer's equity shares (or is indexed to such an obligation) and (2) requires (or may require) the issuer to settle the obligation by transferring assets. Examples of financial instruments that meet these criteria include those forward purchase contracts and written put options on the entity's own equity shares that are either physically settled or net cash settled.
- *Certain obligations to issue a variable number of shares* — An outstanding share that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies an obligation, is classified as an asset or a liability if the issuer must or may settle the obligation by issuing a variable number of its equity shares and the obligation's monetary value is based solely or predominantly on one of the following: (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares. Examples of instruments in this category include share-settled debt and those forward purchase contracts and written put options on the entity's own equity shares that are net share settled.

Financial instruments that are accounted for as assets or liabilities under ASC 480 are initially recognized at fair value, with one exception. A forward contract that requires the entity to repurchase a fixed number of its equity shares for cash is initially measured at the fair value of the shares at inception (i.e., not the fair value of the forward contract), with certain adjustments, and the offsetting entry is presented in equity (i.e., the transaction is treated as if the repurchase had already occurred with borrowed funds).

In subsequent periods, financial instruments classified as assets or liabilities under ASC 480 are remeasured at their then-current fair value, and changes in fair value are recorded in earnings, with two exceptions. ASC 480-10-35-3 states that physically settled forward contracts to repurchase "a fixed number of the issuer's equity shares in exchange for cash and mandatorily redeemable financial instruments shall be measured subsequently in either of the following ways," as applicable:

- a. If both the amount to be paid and the settlement date are fixed, those instruments shall be measured subsequently at the present value of the amount to be paid at settlement, accruing interest cost using the rate implicit at inception.
- b. If either the amount to be paid or the settlement date varies based on specified conditions, those instruments shall be measured subsequently at the amount of cash that would be paid under the conditions specified in the contract if settlement occurred at the reporting date, recognizing the resulting change in that amount from the previous reporting date as interest cost.

The fact that an instrument does not need to be classified as an asset or a liability under ASC 480 does not necessarily mean that it qualifies for equity classification. To determine whether an instrument qualifies for classification in equity in whole or in part, an entity must also consider other GAAP (e.g., ASC 470-20, ASC 815-10, ASC 815-15, and ASC 815-40). Further, under ASC 480-10-S99-3A, an entity that is subject to SEC guidance should consider whether an equity-classified instrument must be classified outside of permanent equity.

Once an issuer has determined that the appropriate balance sheet classification for the equity instrument is liability, temporary equity, or permanent equity, the issuer should further evaluate the instrument to identify any embedded features that may need to be bifurcated and accounted for separately as derivative instruments.

The sections below outline some of the more common types of securities that life sciences entities issue, together with the related accounting considerations.

## 10.2.2 Redeemable Equity Securities

The SEC staff believes that redeemable equity securities are significantly different from conventional equity capital because such securities possess characteristics similar to debt as a result of the redemption obligation attached to the securities. The guidance in ASC 480-10-S99-3A requires instruments to be classified outside of permanent equity in “temporary equity” if they are redeemable (1) at a fixed or determinable price on a fixed or determinable date, (2) at the option of the holder, or (3) upon the occurrence of an event that is not solely within the issuer’s control. To determine the appropriate classification, SEC registrants must evaluate all facts and circumstances related to events that could trigger redemption of the securities.<sup>2</sup> Issuers should evaluate whether equity instruments that do not meet the definition of a liability under ASC 480 nevertheless must be presented outside of permanent equity because of any of these provisions.

Because only public entities are required to present certain equity instruments as temporary equity (sometimes referred to as mezzanine equity) instead of permanent equity, the SEC staff frequently comments on this topic during the IPO process.

### 10.2.2.1 Mandatorily Redeemable Equity Securities

ASC 480 requires mandatorily redeemable securities to be reported as liabilities. Other redeemable equity securities are classified outside of shareholders’ equity in “temporary equity” under the SEC staff’s guidance. More specifically, for a redeemable equity security to be classified as a liability under ASC 480, it must be certain that redemption will occur; redeemable equity securities whose redemption is not certain are classified as temporary equity under the SEC staff’s guidance. Therefore, mandatorily redeemable preferred securities that have substantive conversion options at issuance would not be considered liabilities under ASC 480 even though such securities are called mandatorily redeemable convertible securities. This is because as long as the conversion option is substantive, it is not certain that redemption will occur. If the issuer does not have control over any event that could trigger redemption of the security, the security would be classified as temporary equity under the SEC staff’s guidance.

The treatment of the return paid to the holder of redeemable securities differs depending on whether the securities are classified as liabilities or as temporary equity. For securities classified as liabilities under ASC 480, such a return is treated as an expense. For redeemable securities classified as temporary equity, such a return is treated as a dividend.

<sup>2</sup> See ASC 480-10-S99-3A(5).



### Connecting the Dots

In general, an entity should first apply the guidance in ASC 480 when determining the appropriate presentation of redeemable securities on the balance sheet. If the securities are not classified as liabilities under ASC 480, the entity should examine them under SEC staff guidance to determine whether it is appropriate to classify them as temporary equity. In addition, registrants should be familiar with the SEC staff's views on the applicability of its guidance in certain situations. For example, if redemption is required only upon the liquidation of the reporting entity, an instrument is not considered redeemable. This situation and others are described in ASC 480-10-S99-3A.

#### 10.2.2.2 Redeemable Securities Whose Redemption Is Outside the Issuer's Control

The analysis of whether a security's redemption is not solely within the issuer's control could be complicated depending on the triggering events associated with redemption. The SEC staff believes that the issuer should evaluate each triggering event separately, along with relevant facts and circumstances, to determine whether it is outside the issuer's control. If *any* triggering events are outside the issuer's control, the security should be classified outside of permanent equity regardless of the probability of such events.<sup>3</sup> ASC 480-10-S99-3A-6 through S99-3A-9 provide examples of events that are outside the issuer's control.



### Connecting the Dots

Nonpublic life sciences entities, including start-ups and other entities financed by private equity or venture capital firms, often have one or more series of convertible preferred stock issued and outstanding. In evaluating the appropriate classification in the statement of financial position of convertible preferred stock, a life sciences entity should first consider whether the convertible preferred stock represents a mandatorily redeemable financial instrument that is required to be classified as a liability under ASC 480-10-25-4. If a preferred stock instrument contains an embedded conversion option that is considered a substantive feature as of the issuance date,<sup>4</sup> the convertible preferred stock instrument would not qualify as a mandatorily redeemable financial instrument.<sup>5</sup>

When convertible preferred stock is not required to be classified as a liability, life sciences entities should consider the SEC staff's guidance in ASC 480-10-S99-3A to determine whether it is appropriate to classify the convertible preferred stock in permanent equity. Convertible preferred stock should be classified in temporary equity if the instrument contains (1) a stated redemption feature that allows or requires the holder to put the security to the issuer on a specified date (or dates) or (2) a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event that is not solely within the issuer's control. Therefore, when the holders of convertible preferred stock have control over the entity, the following convertible preferred stock instruments must also be classified in temporary equity:

- Convertible preferred stock that contains a stated redemption feature that allows the issuer to call the security on a specified date (or dates).

<sup>3</sup> See [footnote 2](#).

<sup>4</sup> A conversion feature that results in settlement of the instrument through the issuance of a variable number of shares of common stock equal to a fixed monetary amount is equivalent to "share-settled" debt and would not represent a substantive conversion option. For additional guidance, see ASC 470-20-40-5 through 40-10.

<sup>5</sup> See ASC 480-10-55-11 and 55-12.

- Convertible preferred stock that contains a stated redemption feature that allows the holder to put the security to the issuer upon the occurrence of a specified event or circumstance that can be controlled by the vote of the entity's stockholders or by actions of the entity's board of directors.

Even if a convertible preferred stock instrument does not contain an explicit redemption feature (i.e., a stated call option or a stated put option), the instrument's liquidation provisions must still be considered, including whether those provisions are considered "ordinary liquidation" or "deemed liquidation" provisions. An ordinary liquidation provision does not trigger the requirement to classify the convertible preferred equity in temporary equity; a deemed liquidation provision will typically trigger the requirement to classify the convertible preferred equity in temporary equity. See [Chapter 9](#) of Deloitte's Roadmap *Distinguishing Liabilities From Equity* for additional guidance.

### **10.2.2.3 Measurement of Instruments Classified in Temporary Equity**

If an instrument classified in temporary equity is currently redeemable, it should be adjusted to its maximum redemption amount as of the balance sheet date. However, if an instrument classified in temporary equity is not currently redeemable and the registrant determines that its redeemability is not probable, subsequent adjustment of the carrying amount is not necessary until it is probable that the security will become redeemable.<sup>6</sup>

### **10.2.3 Preferred Stock That Is Nonredeemable or Is Redeemable Solely at the Option of the Issuer**

When securities are not redeemable or are redeemable solely at the option of the issuer, those securities are generally classified in permanent equity on the balance sheet. All relevant facts and circumstances should be considered in the determination of whether the redemption is solely at the option of the issuer.<sup>7</sup> The SEC staff often emphasizes that issuers should examine the redemption provision of all securities classified in permanent equity to ensure their proper classification. For example, an instrument may not be redeemable for cash but may be convertible into another class of equity. Unless management can assert that it has the ability to settle the conversion with shares, it could be forced to redeem the instrument for cash, resulting in classification of that instrument outside of permanent equity. In addition, according to its terms, a security may be redeemable solely at the option of the issuer; however, if the holder of the security controls the issuer's board of directors, that security would be considered redeemable at the option of the holder and would be classified as temporary equity.<sup>8</sup>

If classification of securities as temporary equity is no longer appropriate because of a change in the redemption feature, the outstanding carrying amount of securities should be reclassified as permanent equity on the date of the event that causes the reclassification.

Even if the entire instrument should be classified in permanent equity under ASC 480-10-S99-3A, the issuer may be required to perform further analysis to determine whether the equity instrument contains embedded derivatives that must be bifurcated and accounted for separately as derivative instruments in accordance with ASC 815-15.

<sup>6</sup> See ASC 480-10-S99-3A(15).

<sup>7</sup> See ASC 480-10-S99-3A(11).

<sup>8</sup> See ASC 480-10-S99-3A(7).

## 10.2.4 Conversion Features of Preferred Stock and Debt

As discussed in [Section 10.2.6.2](#), an issuer should perform an evaluation under ASC 815 to determine whether contracts, such as those involving convertible preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. If an embedded conversion feature does not need to be bifurcated from the hybrid instrument as an embedded derivative, but the convertible instrument contains beneficial conversion features (BCFs) or may be settled entirely or partially in cash, the instrument may need to be separated into a liability component and an equity component. After concluding that a conversion option does not need to be bifurcated under ASC 815, an issuer should consider whether the cash conversion guidance in ASC 470-20 applies. If the hybrid instrument is not within the scope of the cash conversion guidance, the issuer should consider the BCF guidance in ASC 470-20. Both the cash conversion guidance and the BCF guidance in ASC 470-20 are discussed below.



### Connecting the Dots

In August 2020, the FASB issued [ASU 2020-06](#), which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. The ASU is part of the FASB's simplification initiative, which aims to reduce unnecessary complexity in U.S. GAAP. ASU 2020-06 removes the separation models in ASC 470-20 for (1) convertible debt with a cash conversion feature (CCF) and (2) convertible instruments with a BCF. As a result, after adopting the ASU's guidance, entities will not separately present in equity an embedded conversion feature in such debt. Instead, they will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium. Under current guidance, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The elimination of these models will reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument that was within the scope of those models before the adoption of ASU 2020-06.

For more information about ASU 2020-06, see [Section 10.3.5](#).

### 10.2.4.1 Cash Conversion Features

As discussed above, an issuer should evaluate whether a convertible instrument must be accounted for under the cash conversion guidance in ASC 470-20 if the conversion feature did not need to be bifurcated in accordance with ASC 815-15. The cash conversion guidance applies only to convertible debt that may be settled in whole or in part in cash upon conversion. Typically, the convertible debt will allow the issuer to settle the par amount in cash and to deliver shares with a fair value equal to the intrinsic value of the conversion option.

Issuers of both convertible debt and convertible preferred stock should consider the cash conversion guidance in ASC 470-20; however, since this guidance applies only to convertible debt, all of the following four conditions must be met for the guidance to apply to convertible preferred stock:

- Upon conversion, the preferred stock may be settled either fully or partially in cash or assets in accordance with its stated terms.
- The convertible preferred stock meets the definition of a mandatorily redeemable financial instrument in ASC 480.

- The convertible preferred stock is classified as a liability under ASC 480 (i.e., it is a mandatorily redeemable financial instrument that is not excluded from the scope of ASC 480).
- The CCF is not required to be separately accounted for as a derivative instrument under ASC 815-15.

Equity-classified convertible preferred stock (including preferred stock classified in temporary equity) is outside the scope of the cash conversion guidance in ASC 470-20. In general, mandatorily convertible preferred stock is also outside the scope of the cash conversion guidance in ASC 470-20 because it will be classified as a liability only if (1) the conversion option is not considered substantive at issuance or (2) the issuer, upon conversion, had to settle a portion of that conversion in cash (the issuance of cash for fractional shares can be ignored).

A convertible debt instrument would not be within the scope of the ASC 470-20 cash conversion guidance if cash settlement would occur only when all other holders of the underlying shares also receive cash. Further, convertible debt that provides for the settlement of fractional shares in cash upon conversion would not be within the scope of the cash conversion guidance.

The debt and equity components of instruments within the scope of the cash conversion guidance must be accounted for separately. To account for those components, the issuer first determines the fair value of a similar liability without the conversion option, which represents the liability (debt) portion of the instrument. The remainder of any proceeds allocated to the convertible instrument is allocated to the conversion (equity) portion. The method used to determine the value of a CCF (i.e., based on the fair value of the debt component) differs from the approach discussed below to determine the value of a BCF (i.e., based on the intrinsic value of the equity component).

#### 10.2.4.2 **Beneficial Conversion Features**

ASC 470-20-20 defines a BCF as a “nondetachable conversion feature that is in the money at the commitment date.” If the conversion price embedded in preferred stock or debt is lower than the fair value of the stock into which the preferred stock or debt is convertible as of the commitment date and the conversion feature does not need to be bifurcated as an embedded derivative, the conversion feature may be “beneficial.” If the conversion feature is beneficial, the effect of the difference between the conversion price and the fair value of the stock should reduce the carrying amount of the convertible instrument and be recognized in equity.



#### **Connecting the Dots**

In determining whether a BCF exists, an entity should consider the “effective conversion price” that an investor effectively would pay for a share upon conversion. For instance, if convertible debt was issued at a discount or a portion of the proceeds was allocated to detachable warrants, an entity would calculate the effective conversion price of the debt by using the amount allocated to the debt for accounting purposes.

The SEC staff frequently seeks to identify embedded BCFs by analyzing the conversion price in convertible instruments issued within one year of an IPO filing. When the conversion price is lower than the IPO price, the SEC staff may require a prospective registrant to recognize an expense related to a BCF and may sometimes require it to use the IPO price as a base in measuring the BCF. If the prospective registrant believes that the conversion price represented the stock’s fair value at the time the instrument was issued, it should be prepared to present sufficient evidence to support its assertion.



### Connecting the Dots

Identifying a BCF can be complex because it is directly related to the appropriateness of the fair value assigned to the underlying stock when that stock is not actively traded.

Once an entity identifies a BCF, the entity would recognize that embedded feature separately at issuance by allocating a portion of the proceeds equal to the intrinsic value of the embedded feature to additional paid-in capital. If a BCF is contingent on the occurrence of a future event such as an IPO, an entity would measure the BCF in the same way but would not recognize it in earnings until the contingency is resolved.

## 10.2.5 Accelerated Share Repurchase Programs

Several life sciences companies have considered or executed ASR programs in recent years. As described in ASC 505-30-25-5, an ASR program is “a combination of transactions that permits an entity to repurchase a targeted number of shares immediately with the final repurchase price of those shares determined by an average market price over a fixed period of time. An accelerated share repurchase program is intended to combine the immediate share retirement benefits of a tender offer with the market impact and pricing benefits of a disciplined daily open market stock repurchase program.”

ASC 505-30 contains unit-of-account guidance that applies to ASR programs. Under ASC 505-30-25-6, an entity accounts for an ASR as two separate units of account: a treasury stock repurchase and a separate forward contract on the entity's shares. An entity should analyze the treasury stock repurchase and forward contract separately to determine whether ASC 480 applies.

The terms of ASRs vary. In a traditional ASR, an entity (1) repurchases a targeted number of its own shares at the current stock price up front for cash and (2) simultaneously enters into a net-settled forward sale of the same number of shares. Economically, the forward serves as a true-up mechanism to adjust the price ultimately paid for the shares purchased. The purpose is to reduce the number of outstanding shares immediately at a repurchase price that reflects the average stock market price over an extended period (e.g., the volume-weighted average price on each trading day during the contract period). On a combined basis, the initial share repurchase and the forward sale put the issuer in an economic position similar to that of having conducted a series of open market purchases of its own stock over a specified period.

### Example 10-1

#### ASR Analysis — Determination of Units of Account

An entity makes an up-front cash payment and receives a specific number of shares from the counterparty (usually an investment bank). Upon settlement of the forward contract (typically within three to six months), the entity either (1) pays the counterparty an amount equal to any excess of the volume-weighted average daily market price (VWAP) of the entity's shares over the initial purchase price or (2) receives from the counterparty an amount equal to any excess of the initial purchase price over the VWAP. Often, the entity can choose to settle the forward contract with the counterparty in either cash or a variable number of shares. Under ASC 505-30, this transaction is analyzed as two units of account: a treasury stock repurchase and a net-settled forward contract to sell the entity's stock over the contract period.



In practice, the settlement of the treasury stock repurchase often takes place one or a few days after the execution of the ASR (e.g., the initial share delivery date may be three business days after the transaction date), at which time the issuer pays cash and receives an initial number of shares. If so, the obligation to repurchase shares in exchange for cash is classified as a liability under ASC 480-10-25-8 (see [Chapter 5](#) of Deloitte's Roadmap *Distinguishing Liabilities From Equity*) during the period between the ASR transaction date and the settlement date of the treasury stock repurchase (sometimes described as the "initial share delivery date" or the "prepayment date"). Note that in some ASR transactions, the payment of cash in the treasury stock repurchase occurs before the receipt of the initial shares, in which case ASC 480 may cease to apply once the obligation to pay cash has been settled.

In evaluating whether the forward component of an ASR is within the scope of ASC 480, the issuer should consider whether it embodies an obligation to transfer assets or a variable number of shares that meet the criteria in ASC 480-10-25-8 or ASC 480-10-25-14 (see [Chapters 5](#) and [6](#), respectively, of Deloitte's Roadmap *Distinguishing Liabilities From Equity*). Usually, an issuer is not required to classify as a liability under ASC 480 the forward contract component in a traditional ASR because it does not embody an obligation to repurchase shares for assets and does not involve an obligation to deliver a variable number of shares with a monetary value that moves inversely with — or is based on something other than — the price of the issuer's stock. However, an issuer cannot assume that the forward contract component of an ASR is outside the scope of ASC 480 without analyzing its specific terms and features.

In some ASR transactions, a portion of the prepayment amount on the initial share delivery date represents a premium paid by the issuer to increase the forward sale price that the issuer will receive in the forward component of the transaction (relative to an at-market forward) rather than a payment for the shares to be received in the initial treasury stock repurchase. For example, the issuer may apply 20 percent of the prepayment amount to the forward component to reduce the likelihood that the forward component will ever dilute earnings per share (EPS). In this case, the issuer may be required to account for the forward component as an asset or liability under ASC 480-10-25-8 in the period between the transaction date and the prepayment date (which may be the initial share delivery date) if the forward component permits net share settlement, because the forward component embodies an obligation to pay cash (on the initial share delivery date) to repurchase shares (the issuer will receive shares on the forward settlement date if the stock price is less than the forward price).

If the forward component is outside the scope of ASC 480, the issuer should evaluate it under ASC 815-40 to determine whether it must be accounted for as an asset or a liability. The terms of an ASR often include rights for the counterparty to end the ASR early upon termination events defined by reference to the International Swaps and Derivatives Association's equity derivatives definitions (e.g., merger events, tender offers, nationalization, insolvency, delisting, change in law, failure to deliver, loss of stock borrowings, increased cost of stock borrowings, extraordinary dividends). Further, the contractual provisions often specify or permit the counterparty to make adjustments to the settlement terms upon the occurrence of such events (e.g., calculation agent adjustments, cancellation, and payment) and might require the entity to settle the contract net in cash. In evaluating an ASR's forward-contract component under ASC 815-40, the entity should be mindful of the need to assess such terms under the indexation guidance and other equity classification conditions in ASC 815-40.

**Example 10-2****ASR Analysis — Accounting Between Trade Date and Settlement Date**

On December 30, an issuer enters into an ASR transaction that requires it to transfer a fixed amount of cash (a prepayment amount of \$500 million) in exchange for a fixed number of its common shares (10 million initial shares) on the initial share delivery date (January 2). On the transaction's final settlement date (March 31), the issuer will either deliver or receive shares. If the VWAP of the issuer's common shares exceeds \$50, the issuer will deliver shares; if the VWAP is less than \$50, the issuer will receive shares. The number of shares that will be received or delivered is calculated as the prepayment amount (\$500 million) divided by the VWAP over the contract period less the initial shares (10 million) already delivered.

In these circumstances, the treasury stock repurchase must be accounted for as a liability under ASC 480-10-25-8. In accordance with ASC 480-10-30-3, the issuer recognizes the liability on the ASR transaction date, which was initially measured "at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges." Simultaneously, in accordance with ASC 480-10-30-5, equity is "reduced by an amount equal to the fair value of the shares at inception." Because under ASC 480-10-35-3(a) both the amount to be paid (\$500 million) and the settlement date (January 2) are fixed, the liability is measured at the present value of the amount to be paid at settlement (\$500 million), with interest cost accruing at the rate implicit at inception during the period from the transaction date to the initial share delivery date. (Further, if any part of the prepayment amount represents a premium payment for the forward component of the ASR transaction, that portion would be accounted for separately as a liability measured at fair value under ASC 480-10-35-1, ASC 480-10-35-4A, or ASC 480-10-35-5 between the transaction date and the initial share delivery date, as discussed above.)

On the initial share delivery date, the liability for the treasury stock repurchase is extinguished by delivery of the prepayment amount. After the initial share delivery date, the transaction is outside the scope of ASC 480 and is therefore evaluated under other GAAP (including ASC 815-10 and ASC 815-40; see [Section 3.2.5](#) of Deloitte's Roadmap *Contracts on an Entity's Own Equity*).

**10.2.6 Derivatives**

Common financing arrangements issued by life sciences entities in the form of debt or equity capital may be considered to be or may contain equity derivatives (i.e., equity derivatives may be freestanding or embedded). Examples of common equity derivatives are stock warrants, stock options, and forward contracts to buy or sell an entity's shares. Equity derivatives may be classified as liabilities (or, in some cases, as assets) and measured at fair value on the balance sheet, with changes in fair value recognized in earnings. It is important to be aware of these instruments, how they are accounted for, and subsequent events that could affect such accounting. Sometimes, the measurement attribute for such instruments could be fair value as a result of an IPO or subsequent financing.

The first step in the analysis is to consider whether the equity derivative is a freestanding instrument or whether it is embedded in another instrument. If the instrument is freestanding, the guidance in ASC 815-40 will govern the classification and measurement of the instrument unless the instrument is a liability within the scope of ASC 480, as discussed above. It is important to note that the guidance in ASC 815-40 is applicable to freestanding contracts on an entity's own equity regardless of whether those contracts meet the definition of a derivative in ASC 815-10. Contracts on an entity's own equity may need to be classified as assets and liabilities (and remeasured at fair value every reporting period) even if they are not considered derivatives within the scope of ASC 815-10. Also, contracts that meet the conditions for classification in equity under ASC 815-40 are excluded from the scope of ASC 815-10 even if they meet the definition of a derivative.

If an equity derivative is embedded in a hybrid instrument, the guidance in ASC 815-40 will be applicable only to embedded features that meet the definition of a derivative and meet the other criteria for bifurcation. That is, if an embedded equity derivative is not clearly and closely related to the host contract, the hybrid instrument is not remeasured at fair value with changes in fair value recognized in earnings, and the embedded derivative meets the definition of a derivative in ASC 815-10, the guidance in ASC 815-40 will be relevant in the determination of whether the equity derivative needs to be bifurcated because of the scope exception in ASC 815-10, as discussed above.

### **10.2.6.1 ASC 815-40 — Contracts on an Entity's Own Equity**

ASC 815-40 provides guidance on the accounting for contracts (and features embedded in contracts) that are indexed to, and potentially settled in, an entity's own equity (also known as contracts on own equity or equity-linked financial instruments). The analysis under ASC 815-40 can be complex; in performing this analysis, an entity often must consult with its legal counsel regarding the various terms associated with the contract. The SEC staff has noted common issues related to applying the guidance in ASC 815-40, including the following:

- Cash settlement provisions.
- Requirement to settle in registered shares.
- Insufficient number of authorized but unissued shares.
- No limit on the number of shares to be delivered.
- Incorrect conclusion regarding whether the instrument is indexed to an entity's own stock.

In general, a contract on an entity's own equity can be classified in equity (and not remeasured while it is classified in equity) as long as it is considered to be indexed to the entity's own stock **and** the issuer has the ability to settle the contract by issuing its own shares under all scenarios. This determination requires an evaluation of all events that could change the settlement value (e.g., adjustments to strike price) and all events that would affect the form of settlement. For additional guidance on ASC 815-40, see Deloitte's Roadmap [Contracts on an Entity's Own Equity](#).

For example, as the result of a provision to adjust the conversion price (other than a standard antidilution provision that applies to all shareholders), an entity may consider an instrument not to be indexed to the issuer's own stock. This type of situation has often been problematic for entities that provide certain investors with price protection by adjusting the strike price if there is a subsequent round of equity or convertible instrument financing at a strike price that is lower than theirs. Under a provision that triggers such price protection (a "down-round provision"), the strike price would usually be adjusted to the strike price of the subsequent transaction. As a result, an instrument or embedded derivative would be accounted for as an asset or liability. However, in July 2017, the FASB issued [ASU 2017-11](#), which makes limited changes to the guidance in ASC 815-40. In addition, ASU 2020-06, issued in August 2020, removes three of the conditions required to avoid derivative accounting, including the condition that settlement is permitted in unregistered shares. (For a discussion of new guidance on financial instruments, see [Section 10.3](#).)

Before the adoption of ASU 2017-11, a contract (or embedded equity conversion feature) containing a down-round provision did not qualify as equity because such an arrangement precluded a conclusion that the contract was indexed to the entity's own stock under ASC 815-40-15. Therefore, freestanding contracts on an entity's own equity containing a down-round feature were accounted for at fair value, with changes in fair value recognized in earnings. Similarly, embedded equity conversion features containing down-round provisions were separated and accounted for as derivative instruments at fair value when the bifurcation criteria in ASC 815-15 were met.

ASU 2017-11 applies to issuers of financial instruments with down-round features. It amended (1) the classification of many of such instruments as liabilities by revising the guidance in ASC 815 on the evaluation of whether instruments with down-round provisions may meet the conditions to be considered indexed to the issuer's own equity and (2) the guidance on recognition and measurement of the value transferred upon the triggering of a down-round feature for equity-classified instruments by revising ASC 260.

For additional details, see Deloitte's July 21, 2017, [Heads Up](#).



### Connecting the Dots

If a freestanding contract on an entity's own equity does not meet the conditions for being considered indexed to the entity's own stock under ASC 815-40-15, ASC 815-40 precludes classification of the contract as equity but does not otherwise address the accounting for the contract. Accordingly, the entity should consult other accounting literature.

The long-standing position of the SEC staff is that if the contract is a written option (e.g., a warrant or call option) that does not qualify for equity classification, and the subsequent accounting is not specifically addressed in other U.S. GAAP (including ASC 480, ASC 505-50, ASC 718, ASC 805-30, and ASC 815-10), registrants should account for the contract at fair value with changes in fair value recorded in earnings in each reporting period (ASC 815-10-S99-4).

## 10.2.6.2 Considerations Related to Embedded Derivatives

In addition to the considerations related to freestanding instruments (e.g., warrants or stock options) under ASC 815, an entity should evaluate whether other contracts, such as those involving preferred stock or convertible debt, contain embedded equity derivatives that may need to be bifurcated and accounted for separately from the host contract under ASC 815's bifurcation requirements. A reporting entity identifies the terms of each embedded feature on the basis of the feature's economic payoff profile (underlying)<sup>9</sup> rather than on the basis of how the feature has been formally documented. In identifying the embedded features, the entity should consider all terms of the convertible instrument. Common examples of embedded features include conversion options and redemption provisions.

An identified embedded feature generally<sup>10</sup> must be bifurcated and accounted for separately from the host contract if the following three conditions are met:

- The embedded feature is not clearly and closely related to the host contract.
- The host instrument (e.g., preferred stock or debt) is not remeasured at fair value, with changes in fair value recognized in earnings, under other applicable GAAP.
- A separate instrument with the same terms as the embedded feature meets the definition of a derivative instrument under ASC 815-10.<sup>11</sup>

<sup>9</sup> Although there is no explicit guidance under U.S. GAAP on how to determine the unit of account for embedded features in a hybrid instrument, the approach described herein is commonly applied. Under the payoff-profile approach, each embedded derivative feature in a hybrid instrument is defined on the basis of the monetary or economic value that the feature conveys to the instrument's counterparty upon settlement. This approach is consistent with the definition of an embedded derivative in ASC 815-15-20, which focuses on the effect of an implicit or explicit term on the cash flows or values of other exchanges required under a contract. For more information on the payoff-profile approach, see Deloitte's Roadmap [Derivatives](#).

<sup>10</sup> Subject to the scope exceptions in ASC 815-10.

<sup>11</sup> See ASC 815-10-15-83.

### 10.2.6.2.1 Clearly and Closely Related to the Host Contract

#### 10.2.6.2.1.1 *Determining the Nature of the Host Contract*

When determining whether the embedded feature being analyzed is clearly and closely related to the host contract, an entity must first decide whether the nature of the host contract is more debt-like or equity-like. [ASU 2014-16](#), issued in November 2014, clarifies that the only acceptable method for determining the nature of the host contract in a hybrid instrument issued in the form of a share is a method commonly referred to as the “whole-instrument” approach. Under the whole-instrument approach, the nature of the host contract is the same for each embedded feature being analyzed. Determining the nature of the host contract under the whole-instrument approach involves the following steps:

- Identify all of the hybrid financial instrument’s stated and implied substantive terms and features.
- Determine whether the identified terms and features are more debt-like or equity-like.
- Identify the relative weight of the identified terms and features “on the basis of the relevant facts and circumstances.”<sup>12</sup>
- Reach a conclusion about the nature of the host contract.

Further, ASC 815-15-25-17A states, in part:

In evaluating the stated and implied substantive terms and features, the existence or omission of any single term or feature does not necessarily determine the economic characteristics and risks of the host contract. Although an individual term or feature may weigh more heavily in the evaluation on the basis of the facts and circumstances, **an entity should use judgment based on an evaluation of all of the relevant terms and features.** For example, an entity shall not presume that the presence of a fixed-price, noncontingent redemption option held by the investor in a convertible preferred stock contract, in and of itself, determines whether the nature of the host contract is more akin to a debt instrument or more akin to an equity instrument. Rather, the nature of the host contract depends on the economic characteristics and risks of the entire hybrid financial instrument. [Emphasis added]

If a reporting entity is still unclear about the nature of the host contract after performing this analysis, it should consider the anticipated outcome for the holder of the hybrid financial instrument in reaching its final conclusion. Given the complexity of determining the nature of a host contract of a hybrid instrument with both conversion and redemption features, entities are encouraged to consult with their accounting advisers.

The method described above for determining the nature of the host contract applies only to hybrid instruments issued in the form of a share. A legal-form debt instrument will typically be considered to be a debt host contract.

#### 10.2.6.2.1.2 *Determining Whether the Feature Is Clearly and Closely Related to the Host Contract*

Once the reporting entity has determined the nature of the host contract, it should, in accordance with ASC 815-15-25-1(a), evaluate each embedded feature separately to determine whether the economic characteristics and risks of the embedded feature are clearly and closely related to those of the host contract. If the embedded feature is clearly and closely related to the host contract, the embedded feature should not be bifurcated. If the embedded feature is not clearly and closely related to the host contract, the reporting entity must analyze the other two conditions described above to determine whether bifurcation of the embedded feature is required.

<sup>12</sup> See ASC 815-15-25-17C.

Commonly identified embedded features that an entity would evaluate to determine whether they are clearly and closely related to a debt or equity host contract include the following:

- *Redemption features* — A redemption feature enables the holder to receive cash to settle the equity instrument. A redemption feature may be held by the issuer or the holder and may be exercisable upon the occurrence of certain events or at any time. If an equity host contract has a redemption feature, the redemption is explicitly not considered clearly and closely related to that contract in accordance with ASC 815-15-25-20. Therefore, in such cases, an entity would need to perform additional analysis to determine whether it is required to bifurcate the redemption feature.

Under ASC 815-15-25-42, if a debt host contract has a redemption feature, an entity must perform a four-step test to determine whether the redemption feature is clearly and closely related to the debt host.

- *Conversion features* — Conversion features enable an entity to convert an existing instrument into another form of the entity's equity (e.g., convertible preferred stock, convertible debt). ASC 815-15-25-16 indicates that a conversion feature in an equity host contract would be clearly and closely related to the equity host contract since it provides the holder with another residual interest in the same entity. Accordingly, a conversion feature in an equity host contract would not be bifurcated and accounted for separately as a derivative instrument.

However, ASC 815-15-25-51 indicates that a conversion option in a debt host contract is not clearly and closely related to the contract. Therefore, the entity would have to perform further analysis to determine whether the other bifurcation criteria are met.

- *Changing interest/dividend rates* — Contracts may include provisions under which stated interest or dividend rates increase or decrease as a result of the occurrence or nonoccurrence of specific events. An embedded derivative that resets the interest rate of a debt host contract (i.e., a debt instrument or an equity instrument that was determined to represent a debt host) is generally clearly and closely related to the debt host if it is based on changes in interest rates,<sup>13</sup> the issuer's creditworthiness, or inflation. However, if, for example, an entity's bonds include a provision under which the interest rate must be reset to a different rate if an unrelated party's credit rating is downgraded at any time during the term of the bonds, the reset feature is not clearly and closely related to the debt host. An embedded derivative that changes an instrument's interest rate because of changes to the rate of inflation in the economic environment for the currency in which a debt instrument is denominated would be considered clearly and closely related to the debt host. Further, changes to an interest rate based on changes in an entity's operating performance (e.g., EBITDA) may be considered clearly and closely related to the debt host if the operating performance metric is related to the entity's creditworthiness.<sup>14</sup>

Such interest rate reset provisions are generally not considered clearly and closely related to an equity host, however.

<sup>13</sup> See ASC 815-15-25-26.

<sup>14</sup> See ASC 815-15-25-46 and 25-47.



### 10.2.6.2.2 Separate Instrument With Same Terms Meets the Definition of a Derivative

An embedded equity derivative (e.g., a conversion option) that meets the first two conditions outlined above for bifurcating embedded equity derivatives would require further evaluation for an entity to determine whether the embedded feature should be separately accounted for as a derivative under ASC 815-10. ASC 815-10-15-83 defines a derivative as a financial instrument or other contract that (1) has an underlying as well as a notional amount or payment provision, (2) requires little or no initial net investment, and (3) can be net settled.

Equity instruments will generally meet the first and second criteria in the definition of a derivative but may not meet the third. For instance, a contract on a nonpublic entity's own stock (e.g., a warrant or stock option) may not qualify as a derivative because the entity's equity shares are not publicly traded. In such cases, unless the contract provides for net share settlement or cash settlement, the contract generally would not meet the net settlement criterion because the equity shares would not be readily convertible to cash. However, upon an IPO, the entity would need to reevaluate the contract under ASC 815 to determine whether the contract is or contains an accounting derivative now that the entity's shares are publicly traded. If the post-IPO shares or an embedded conversion feature is readily convertible to cash, the net settlement criterion would be met, resulting in an accounting derivative that may need to be recognized unless it qualifies for a scope exception to derivative accounting (discussed further below).

For example, a warrant to acquire common-stock shares that explicitly permits net settlement (e.g., cashless exercise) would meet the net settlement criterion. However, a warrant to acquire common-stock shares of a nonpublic entity for which gross exercise is required (i.e., the warrant holder pays the exercise price in cash to acquire common shares) would generally not meet the net settlement criterion since the contract would be settled in shares that are not readily convertible to cash. If that nonpublic entity went public, however, the warrant that previously did not meet the net settlement criterion might now satisfy the criterion since common-stock shares of a publicly traded entity are generally readily convertible to cash.

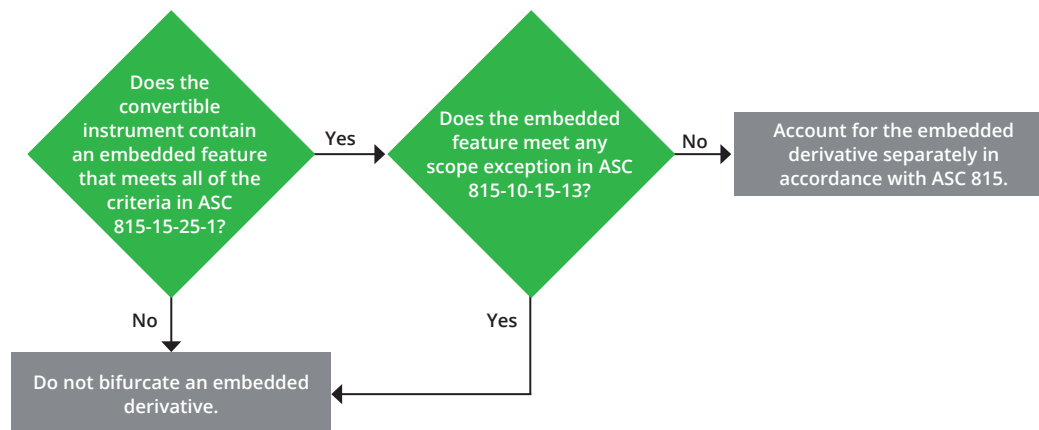
A contract that meets the definition of a derivative under the above criteria may not need to be accounted for as a derivative if it qualifies for any of the scope exceptions in ASC 815-10-15-13. One of these scope exceptions involves contracts on an entity's own equity. Generally, the value of an equity derivative is linked to the entity's own stock (i.e., the underlying of the derivative). If the derivative is indexed to the entity's own stock and would not require the entity to settle the derivative by paying cash or other assets, it would qualify for classification as equity and be outside of the scope of ASC 815.

Some equity derivatives may qualify for the scope exception in ASC 815-10-15-74(a) for certain contracts indexed to the company's own stock. If this scope exception applies, such equity derivatives would not have to be bifurcated. ASU 2020-06 removes certain conditions required for a contract to qualify for the scope exception. (For further discussion of other new guidance on financial instruments, see [Section 10.3.](#))

However, an embedded feature that meets the definition of a derivative and does not qualify for an explicit scope exception would need to be bifurcated from the host instrument and accounted for separately as a derivative (if the other two conditions for bifurcation are also met). A bifurcated derivative (e.g., a conversion feature) would be measured initially and subsequently at fair value, with changes in fair value recognized in earnings.



The accounting for convertible debt instruments and convertible preferred stock is complex, and the SEC staff frequently asks about the classification of such instruments in entities' registration statements. The flowchart below illustrates the multistep evaluation that entities are required to perform for any hybrid instrument with a conversion feature.



### 10.2.6.3 Tranche Preferred Stock Agreement

#### Example 10-3

Entity X enters into a preferred stock purchase agreement with unrelated investors to sell two tranches of convertible redeemable preferred stock (the "preferred stock"). The purchase agreement stipulates the following:

- On the first closing date, which is the date of the purchase agreement, the investors will acquire 50,000 shares of preferred stock for \$50 million.
- On the second closing date, the investors will acquire 25,000 additional shares of preferred stock for \$25 million subject to a specified condition. The second closing will occur only if (1) a specific milestone related to X's research and clinical development is achieved two years from the first closing date or (2) the specific milestone related to X's research and clinical development is not achieved two years from the first closing date but the holders waive the milestone requirement and elect to purchase the additional shares of preferred stock (the "contingent purchase option").

The purchase agreement stipulates that the holders of preferred stock issued in the first closing cannot transfer their contingent purchase options separately from the preferred shares acquired in the first closing (or vice versa). However, such holders have the right to convert those preferred shares into common stock before the date that is two years from the first closing date. The purchase agreement does not restrict the holders that convert preferred shares into common stock from selling those common shares. The only restrictions on selling common stock stem from restrictions under U.S. securities laws.

In this example, the contingent purchase option would be considered a freestanding financial instrument because it meets the "legally detachable and separately exercisable" condition. The holders can "detach" the two instruments because they can convert the preferred stock into common stock and sell those shares while retaining the contingent purchase option (i.e., the two instruments are capable of being separated). This would be the case even if the contingent purchase option may not be separately transferred after the conversion into common stock of the preferred shares obtained in the first closing. It would not be appropriate to consider the preferred shares and the contingent purchase option a single combined financial instrument, because the contingent purchase option would not become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing.

**Example 10-3 (continued)**

Note that the conclusion in this example would not change even if:

- The holders could not sell the common shares received upon conversion of the preferred stock purchased in the first closing before satisfaction or expiration of the contingent purchase option. At the inception of the arrangement, the two instruments still meet the legally detachable and separately exercisable condition because the contingent purchase option (1) cannot become embedded in the common shares received upon conversion of the preferred stock purchased in the first closing and (2) does not become freestanding only if the preferred stock purchased in the first closing is converted into common stock (instead, the ability to convert the preferred stock purchased in the first closing is evidence that the contingent purchase option is capable of being separated at the inception of the arrangement).
- The preferred stock purchased on the first closing date cannot be transferred or converted before the contingent purchase option is satisfied or expires and the holders have the right to acquire the additional shares related to the contingent purchase option at their option at any time before two years from the closing date. The two instruments still meet the legally detachable and separately exercisable condition because the investor can separate the two components by early exercising the contingent purchase option while retaining the preferred shares acquired on the first closing date.

As this example illustrates, and in a manner consistent with practice, an option or commitment to issue additional preferred shares is almost always a freestanding financial instrument because the separate exercisability of the option or commitment is sufficient to demonstrate that the feature is capable of being separated.

#### **10.2.6.4 Multiple Freestanding Instruments in a Tranche Debt Issuance**

Often, an entity will issue debt instruments that include tranche issuances (i.e., an initial debt issuance followed by subsequent debt issuances that are triggered by a debtor requisition right or contingent on the occurrence of certain events). It is common to see warrants contemporaneously issued to the creditor of such tranche financings as part of the transaction. These warrants may include terms such that upon the closing of the initial debt issuance, an initial warrant is issued, followed by the issuance of additional warrants upon the closing of subsequent debt issuances.

The first step in evaluating the debtor's accounting for a tranche debt arrangement with contemporaneously issued warrants is to understand whether the debt and the warrants are freestanding from one another as defined in ASC 480-10-20. As noted in [Section 10.2.1](#), ASC 480-10-20 defines a freestanding financial instrument as a financial instrument that either (1) "is entered into separately and apart from any of the entity's other financial instruments or equity transactions" or (2) "is entered into in conjunction with some other transaction and is legally detachable and separately exercisable." Typically, aside from the tranche debt arrangement and the contemporaneous warrants, the counterparties would not enter into any other concurrent transactions. However, since these instruments would be entered into at the same time and executed on the same date, it is necessary to evaluate whether they are legally detachable and separately exercisable and, therefore, are freestanding in accordance with the second condition above. The following are common indicators that the tranche debt arrangement and the contemporaneous warrants are legally detachable and separately exercisable:

- The warrants are transferable by the creditors in whole or in part in accordance with U.S. securities law.
- The expiration date of the warrants extends beyond the maturity date of the tranche debt arrangement.
- Repayment of the tranche debt arrangement does not result in termination of the warrants.

Upon a determination that the tranche debt arrangement and the contemporaneous warrants are freestanding instruments, the next step in evaluating how to account for these instruments is to determine whether the initial debt issuance is freestanding from the commitment related to subsequent debt issuances. Since the tranche debt arrangement encompasses both the initial debt issuance and the subsequent debt issuances, they are considered to have been entered into at the same time and executed on the same date. Consequently, they should also be evaluated to determine whether they are legally detachable and separately exercisable. The following are common indicators that the initial debt issuance and the commitment related to subsequent debt issuances are legally detachable and separately exercisable:

- The creditor has the right, without the consent of or notice to the debtor, to sell, transfer, assign, negotiate, or grant participation in all or any part of, or any interest in, such creditor's obligations, rights, and benefits.
- The debtor can repay any or all of the initial debt offering/issuance and the subsequent debt offerings/issuances without affecting the terms of any other outstanding debt offerings/issuances. That is, any portion of the initial debt offering/issuance and the subsequent debt offerings/issuances can be settled without terminating the other portions of the initial debt offering/issuance and the subsequent debt offerings/issuances. This suggests that the initial debt offering/issuance and the subsequent debt offerings/issuances are separately exercisable and can "be sold or traded separately from the contract."<sup>15</sup>

See [Example 3-2](#) in [Section 3.3.2.1.2](#) of Deloitte's Roadmap *Issuer's Accounting for Debt* for an illustration of how to account for debt issued with additional term loan commitments from a freestanding instrument perspective.

If the debtor determines that the initial debt issuance and the subsequent debt issuances are freestanding from one another, the next step is to evaluate the initial accounting for the commitments related to subsequent debt issuances and determine whether those commitments should be accounted for as derivatives under ASC 815-10 or qualify for any derivative accounting scope exceptions. In fact, the commitments would qualify for the derivative accounting scope exception in ASC 815-10-15-69, which states, in part, that "[f]or the holder of a commitment to originate a loan (that is, the potential borrower), that commitment is not subject to the requirements of [ASC 815-10]." The subsequent debt issuances represent a commitment to originate a loan (i.e., a loan commitment), and that commitment is held by the debtor.

There is no guidance under U.S. GAAP that directly addresses a debtor's accounting for a purchased loan commitment. However, a loan commitment meets the definition of a financial asset, and the loan commitments in this case represent proceeds from the issuance of debt (i.e., the initial debt issuance) and equity-linked instruments (i.e., the warrants). Consequently, the loan commitments should be initially recognized at fair value. Generally, when a debt transaction involves both the issuance of financial instruments and the receipt of noncash financial assets (e.g., tranche debt financings that include the issuance of debt and the receipt of loan commitments), the fair value of the noncash financial assets received may be treated as part of the total proceeds received.

Regarding the mechanics of the debtor's accounting for the loan commitment, it is generally appropriate for an entity to defer fees and costs it has paid for a commitment to obtain nonrevolving debt as an asset until the related debt is drawn. The potential debtor's deferral of loan commitment costs and fees as an asset is analogous to the creditor's treatment of fees received for a loan commitment under ASC 310-20-25-11, which generally requires commitment fees to be deferred. If all or a portion of the total commitment amount is funded, a proportionate amount of the commitment asset reduces the initial net

<sup>15</sup> Quoted from ASC 815-10-15-5.

carrying amount of the funded debt. See [Section 3.5.3.2](#) of Deloitte's Roadmap *Issuer's Accounting for Debt* for a discussion of the different methods for allocating fees/issuance costs in a bundled transaction such as this one.

The debtor is next required to determine how to account for the warrants that were issued contemporaneously with the tranche debt arrangement (under the assumption that the warrants are freestanding instruments). Note that before the issuance of the initial tranche of debt, the warrants (i.e., both the initial warrant and the additional warrants) would be viewed as one unit of account that would not qualify for equity classification since the number of shares of common stock that may be purchased under the warrants varies on the basis of debt issuances that have not yet occurred.

Once the initial debt issuance occurs, the first step in the debtor's accounting for the contemporaneously issued warrants is to determine whether the initial warrant, which is issued upon the closing of the initial debt issuance, is freestanding from the additional warrants, which are issued only upon the closings of the subsequent debt issuances. Since the warrant agreement most likely encompasses both the initial warrant and the additional warrants, all of the warrants are considered to have been entered into at the same time and executed on the same date. Consequently, the debtor should evaluate whether the initial warrant and the additional warrants are legally detachable and separately exercisable and, therefore, qualify as freestanding financial instruments under ASC 480-10-20. The following are common indicators that the initial warrant and the additional warrants are legally detachable and separately exercisable:

- The warrants are individually transferable by the warrant holders, subject to compliance with applicable federal and state securities laws. In other words, the warrants can be transferred separately from one another at the warrant holder's discretion.
- The warrant holders' choice to exercise the initial warrant does not cause the additional warrants to be automatically exercised or otherwise terminated.

Assuming that the initial warrants and the additional warrants are freestanding from one another, the debtor must determine whether the warrants should be classified as liabilities under ASC 480. ASC 480 describes three types of instruments that require liability classification:

- *Mandatorily redeemable financial instruments* — ASC 480-10-20 defines a mandatorily redeemable financial instrument as “[a]ny of various financial instruments issued in the form of shares that embody an unconditional obligation requiring the issuer to redeem the instrument by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.” Warrants are not financial instruments in the form of shares (i.e., while they are financial instruments that will result in the delivery of shares, they are not shares themselves). Thus, warrants typically are not mandatorily redeemable financial instruments.
- *Obligations to repurchase issuer's equity shares by transferring assets (or financial instruments indexed to such obligations)* — Most commonly, if exercised, the warrants require the debtor to issue common shares, which are not redeemable in cash other than upon an ordinary liquidation of the debtor. Accordingly, upon exercise, the warrants require the debtor to deliver its equity shares. Further, there are typically no provisions in the warrants that could require the debtor to settle the warrants in cash or other assets because each situation that would result in such a settlement of the warrants (1) is within the control of the debtor or (2) occurs when all other holders of the common units will receive (or have the right to receive) cash or other assets for their units. Accordingly, the warrants most commonly do not obligate the debtor to settle by repurchasing common units for cash or other assets.
- *Certain obligations to issue a variable number of shares* — Warrants typically do not represent a conditional obligation that must or may be settled by issuing a variable number of shares.

In light of the above, warrants on common share most commonly do not need to be classified as liabilities under ASC 480.

Next, the debtor must consider whether the warrants meet the definition of a derivative under ASC 815-10-15-83. As previously noted, ASC 815-10-15-83 defines a derivative as a financial instrument or other contract that (1) has an underlying as well as a notional amount or payment provision, (2) requires little or no initial net investment, and (3) can be net settled. Typically:

- Warrants have an underlying (the fair value of the debtor's common stock) and a notional amount (the number of shares of common stock issuable).
- Warrants require an initial net investment that is less, by more than a nominal amount, than the initial net investment that would be required to acquire the number of shares of common stock into which the warrants are exercisable.
- Warrant holders can elect net share settlement by cashless exercise.

In light of the above, warrants most commonly possess all three characteristics of a derivative.

Assuming that the initial warrant and the additional warrants meet the definition of a derivative, the debtor must then determine whether those warrants qualify for the equity scope exception in ASC 815-10-15-74(a), which states that contracts issued or held by a reporting entity that are both indexed to its own stock and classified in stockholders' equity in its statement of financial position are not considered to be derivative instruments under ASC 815.

Often, in arrangements in which warrants are issued contemporaneously with tranche debt arrangements, the initial warrant will be considered to be indexed to the debtor's own stock since it is (1) issued and outstanding immediately as of the execution of the arrangement (i.e., upon the closing of the initial debt issuance) and (2) exercisable for a fixed number of shares of common stock at a fixed exercise price (i.e., a fixed-for-fixed forward or option under ASC 815-40-15-7E). In addition, the initial warrant is likely meet the conditions for equity classification under ASC 815-40-25. Accordingly, the initial warrant typically will qualify for the equity scope exception and be classified in the debtor's equity rather than as a derivative liability.

Conversely, the additional warrants will not be considered to be indexed to the debtor's own stock since the number of shares of common stock that may be purchased under the additional warrants varies on the basis of the amount of subsequent debt issuances that occur after funding of the initial debt issuance. Because subsequent debt issuances do not represent an input into the pricing of a fixed-for-fixed option on equity shares under ASC 815-40-15-7E, the additional warrants are not considered to be indexed to the debtor's stock and must be classified as derivative liabilities and initially measured, and subsequently remeasured, at fair value with changes in fair value recognized in earnings in accordance with ASC 815-10-35-1. Upon the occurrence of subsequent debt issuances, the additional warrants associated with such issuances would become fixed for fixed under ASC 815-40-15-7E in the same way as the initial warrant, as described above. Accordingly, as soon as the additional warrants qualify as fixed for fixed, they will be reclassified from derivative liabilities to equity instruments.

### **10.2.6.5 Standby Equity Purchase Agreements**

Financial instruments known as standby equity purchase agreements (SEPAs) have become more common in the life sciences industry as industry participants look for additional ways to provide liquidity while avoiding exposure to rising interest rates. A SEPA is an equity-linked instrument for which the issuing entity has the right, but not the obligation, to sell the entity's common stock to third-party investors over a specified period. In exchange for its access to capital through the SEPA, the entity typically provides up-front consideration to the investor in the form of cash or shares of the entity's common stock. Economically, before the entity has elected to sell shares, a SEPA represents a purchased put option on the entity's own equity. However, once the entity "draws" on the SEPA, the related number of shares issuable constitutes a forward contract to issue common stock. Thus, SEPAs contain both a purchased put option element and a forward share issuance element. Generally, neither element qualifies for equity classification under ASC 815. See [Section 6.2.5](#) of Deloitte's Roadmap *Contracts on an Entity's Own Equity* for a detailed description of an issuer's accounting for a SEPA.

Note that in practice, SEPAs may also be referred to as common stock purchase agreements or equity lines of credit (ELOCs).

### **10.2.7 Fair Value**

Many Codification topics require or permit the subsequent measurement of assets or liabilities at fair value. ASC 820-10-35 provides guidance on the subsequent measurement of items at fair value and applies to both recurring and nonrecurring measurements. The definition of fair value is based on an exit price notion. An asset, liability, or equity instrument is measured at fair value on the basis of market-participant assumptions; such measurement is not entity-specific. Entities must consider all characteristics of the asset, liability, or equity instrument that a market participant would consider in determining an exit price in the principal or most advantageous market.

#### **10.2.7.1 Restrictions on the Sale or Use of an Asset**

In some cases, it is appropriate to consider a restriction on the sale or use of an asset as a characteristic of the asset that affects its fair value. Only a legal or contractual restriction on the sale or use of an asset that is specific to the asset (an instrument-specific restriction) and that would be transferred to market participants should be incorporated into the asset's fair value measurement. Thus, an entity should consider the effect of a restriction on the sale or use of an asset that it owns only if market participants would consider such a restriction in pricing the asset because they would also be subject to the restriction if they acquired the asset. Entity-specific restrictions that would not be transferred to market participants should not be considered in the determination of the asset's fair value, since doing so would be inconsistent with the exit price notion underlying the definition of fair value. The table below gives examples of restrictions on the sale of assets and addresses whether they are instrument-specific or entity-specific.

### Examples of Restrictions on the Sale of Assets

Nature of Restriction	Description of Restriction	Impact of Restriction on Fair Value
Restriction on the sale of securities offered in a private offering in accordance with Rule 144 of the Securities Act of 1933 ("Securities Act Rule 144") or similar rules (private placements)	Securities Act Rule 144 legally restricts the sale of certain securities to buyers that meet specified criteria.	<p>As discussed in ASC 820-10-55-52, this type of restriction is a characteristic of the security and would be transferred to market participants. Therefore, the fair value measurement of the security should take this instrument-specific restriction into account.</p> <p>An instrument-specific restriction on a security affects a fair value measurement by the amount that a market participant would demand because of the inability to access a public market for the security for the specified period. As discussed in ASC 820-10-55-52, that amount depends on the nature and duration of the restriction, the extent to which buyers are limited by the restriction, and qualitative and quantitative factors specific to both the instrument and the issuer. Quoted prices for such securities would reflect the resale restriction; therefore, there should be no further adjustment to reflect the restriction.</p>
Founder's shares in an IPO of equity securities	Founders may be contractually restricted from selling their shares for a period after an IPO. Such restrictions may be outlined in the IPO prospectus.	<p>If this restriction is not embedded in the contractual terms of the shares (which it generally is not) and thus would not be transferred in a hypothetical sale of the shares, the restriction is specific to the founders and not a characteristic of the security. Therefore, the founders should not consider this restriction in determining fair value.</p> <p>Note that in June 2022, the FASB issued <a href="#">ASU 2022-03</a>, which improves financial reporting for investors and other financial statement users by increasing comparability of financial information across reporting entities that have investments in equity securities measured at fair value that are subject to contractual restrictions preventing the sale of those securities.</p>



(Table continued)

<b>Examples of Restrictions on the Sale of Assets</b>		
<b>Nature of Restriction</b>	<b>Description of Restriction</b>	<b>Impact of Restriction on Fair Value</b>
Security sale restriction related to a seat on the board of directors	An entity (Entity A) has an equity investment in another entity (Entity B) and is represented on its board of directors. Because officers of A are directors of B, A is restricted from selling any of its investment securities in B during each period that is two weeks before the end of each quarter through 48 hours after B's earnings are released (also referred to as a "blackout period").	Other market participants would not face this restriction. Because the restriction is entity-specific (i.e., it is not a characteristic of the security) and would not be transferred with the security, an entity should not consider the restriction in measuring the security at fair value.
Assets pledged as collateral	An entity has a borrowing arrangement in which assets must be pledged as collateral.	Other market participants would not face this restriction. Because the restriction is entity-specific (i.e., it is not a characteristic of the assets) and would not be transferred with the assets, an entity should not consider the restriction in measuring the assets at fair value.

The determination of whether a contractual or legal restriction on the sale or use of an asset is instrument-specific or entity-specific is sometimes straightforward; other times, an entity may need to exercise judgment or consult a legal specialist in making this determination.

### **10.2.7.2 Premiums or Discounts Based on Size of a Position**

ASC 820-10-35-36B addresses when a fair value measurement should include a premium or discount as a result of the size of an asset, liability, or instrument classified in an entity's stockholders' equity. In a manner consistent with the guidance on transfer restrictions (see above), a fair value measurement includes a premium or discount that reflects the size of the item only if size is a characteristic of the asset, liability, or instrument classified in stockholders' equity. A fair value measurement cannot include "[p]remiums or discounts that reflect size as a characteristic of the . . . entity's holding" (i.e., a blockage factor) rather than as a characteristic of the asset, liability, or instrument classified in stockholders' equity that is determined on the basis of its unit of account under other Codification topics (e.g., a control premium or minority interest discount that is appropriate on the basis of its unit of account). ASC 820-10-35-36B indicates that when "there is a quoted price in an active market . . . for an asset or a liability" (i.e., a Level 1 input), an entity must "use that quoted price without adjustment when measuring fair value, except as specified in paragraph 820-10-35-41C." However, even if a fair value measurement is categorized within Level 2 or Level 3 of the fair value hierarchy in its entirety, the fair value measurement cannot include a premium or discount for size (e.g., a blockage factor) when this premium or discount results from the size of an entity's holding rather than from a characteristic of the item being valued.

### 10.2.7.2.1 Blockage Factors

As described in ASC 820-10-35-36B, a blockage factor represents a discount that “adjusts the quoted price of an asset or a liability because the market’s normal daily trading volume is not sufficient to absorb the quantity held by the entity.” The basic principle in ASC 820-10-35-36B is that blockage factors are prohibited at all levels of the fair value hierarchy. An adjustment to a quoted price of an individual asset or liability to reflect a blockage factor is not permitted under ASC 820 when the unit of account for the asset or liability is the individual instrument (i.e., the unit of account for the holding under U.S. GAAP is aligned with the unit of account related to the quoted price). For example, if an entity holds a large position in a publicly traded common stock and would expect to sell the position in a single transaction (i.e., a large block), the price it would receive would reflect a discount to the product of the quoted market price and the number of shares held; however, that discount should not be reflected in a fair value measurement because it reflects the size of the entity’s holding as opposed to a characteristic of the asset held.

However, if the unit of account for fair value measurement purposes is the entire holding (i.e., entire position), an adjustment to reflect the size of the holding may be appropriate. Further, if the unit of valuation reflects the entire holding, an adjustment to reflect the size of the holding may be appropriate even if the unit of account differs from the unit of valuation and application of a blockage factor at the unit-of-account level would be inappropriate. Thus, a discount that adjusts a quoted price of an asset or liability to reflect a blockage factor could, in certain circumstances, be consistent with the definition of fair value in ASC 820.

## 10.3 New Accounting Standards

### 10.3.1 Impairment (ASUs 2016-13, 2019-04, 2019-05, 2019-10, 2019-11, 2020-03, 2022-01, and 2022-02)

#### 10.3.1.1 Background

In June 2016, the FASB issued [ASU 2016-13](#) (the “new credit losses standard,” codified in ASC 326), which amends guidance on the impairment of financial instruments. The ASU adds to U.S. GAAP an impairment model (known as the current expected credit loss [CECL] model) that is based on expected losses rather than incurred losses. Under the new guidance, an entity recognizes as an allowance its estimate of expected credit losses, which is presented as either (1) an offset to the amortized cost basis of the related asset (for on-balance-sheet exposures) or (2) a separate liability (for off-balance-sheet exposures). That is, the expected credit losses estimated over the lifetime of a financial instrument are recognized at inception (i.e., on day 1).

Key provisions of ASU 2016-13 are discussed below. For more information about the new credit losses standard, see Deloitte’s Roadmap [Current Expected Credit Losses](#).

#### 10.3.1.2 The CECL Model

##### 10.3.1.2.1 Scope

The CECL model applies to most<sup>16</sup> debt instruments (other than those measured at fair value), trade receivables, net investments in leases, reinsurance receivables that result from insurance transactions,

<sup>16</sup> The following debt instruments would not be accounted for under the CECL model:

- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of an NFP.
- Loans and receivables between entities under common control.

financial guarantee contracts,<sup>17</sup> and loan commitments. However, available-for-sale (AFS) debt securities are excluded from the model's scope and will continue to be assessed for impairment under the guidance in ASC 320 (the FASB moved the impairment model for AFS debt securities from ASC 320 to ASC 326-30 and has made limited amendments to the impairment model for AFS debt securities).

### 10.3.1.2.2 Recognition of Expected Credit Losses

Unlike the incurred loss models in legacy U.S. GAAP, the CECL model does not specify a threshold for the recognition of an impairment allowance. Rather, an entity will recognize its estimate of expected credit losses for financial assets as of the end of the reporting period. Credit impairment will be recognized as an allowance — or contra-asset — rather than as a direct write-down of a financial asset's amortized cost basis. However, the carrying amount of a financial asset that is deemed uncollectible will be written off in a manner consistent with legacy U.S. GAAP.

### 10.3.1.2.3 Measurement of Expected Credit Losses

ASU 2016-13 describes the impairment allowance as a “valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net carrying value at the amount expected to be collected on the financial asset.” An entity can use various measurement approaches to determine the impairment allowance. Some approaches project future principal and interest cash flows (i.e., a discounted cash flow method), while others project only future principal losses. Regardless of the measurement method used, an entity's estimate of expected credit losses should reflect the losses that occur over the contractual life of the financial asset.

When determining the contractual life of a financial asset, an entity is required to consider expected prepayments either as a separate input in the method used to estimate expected credit losses or as an amount embedded in the credit loss experience that it uses to estimate such losses. The entity is not allowed to consider expected extensions of the contractual life unless (1) extensions are a contractual right of the borrower or (2) the entity has a reasonable expectation as of the reporting date that it will execute a troubled debt restructuring (TDR) with the borrower.<sup>18</sup>

An entity must consider all available relevant information when estimating expected credit losses, including details about past events, current conditions, and reasonable and supportable forecasts. That is, while an entity can use historical charge-off rates as a starting point for determining expected credit losses, it must evaluate how conditions that existed during the historical charge-off period may differ from its current expectations and revise its estimate of expected credit losses accordingly. However, the entity is not required to forecast conditions over the entire contractual life of the asset. Rather, for the period beyond that for which the entity can make reasonable and supportable forecasts, the entity should revert to historical credit loss experience.

### 10.3.1.2.4 Unit of Account

The CECL model does not prescribe a unit of account (e.g., an individual asset or a group of financial assets) in the measurement of expected credit losses. However, an entity is required to evaluate financial assets within the scope of the model on a collective (i.e., pool) basis when assets share similar risk characteristics. If a financial asset's risk characteristics are not similar to those of any of the entity's other financial assets, the entity would evaluate that asset individually. If the financial asset is individually

<sup>17</sup> The CECL model does not apply to financial guarantee contracts that are accounted for as insurance or measured at fair value through net income.

<sup>18</sup> ASU 2022-02, issued in March 2022, eliminates the concept of a TDR from a creditor's accounting. As a result, an entity that has adopted ASU 2022-02 will no longer be able to extend the contractual term for expected extensions, renewals, and modifications when it reasonably expects, as of the reporting date, that a TDR will be executed with the borrower.

evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics.

### 10.3.1.2.5 Write-Offs

In a manner similar to legacy guidance, ASU 2016-13 requires an entity to write off the carrying amount of a financial asset when the asset is deemed uncollectible. However, unlike legacy guidance, the ASU's write-off guidance also applies to AFS debt securities.

### 10.3.1.2.6 Application of the CECL Model to Trade Receivables

Receivables that result from revenue transactions under ASC 606 are subject to the CECL model. ASU 2016-13 includes the following example illustrating how an entity could use a provision matrix to apply the guidance to trade receivables:

#### ASC 326-20

##### **Example 5: Estimating Expected Credit Losses for Trade Receivables Using an Aging Schedule**

**55-37** This Example illustrates one way an entity may estimate expected credit losses for trade receivables using an aging schedule.

**55-38** Entity E manufactures and sells products to a broad range of customers, primarily retail stores. Customers typically are provided with payment terms of 90 days with a 2 percent discount if payments are received within 60 days. Entity E has tracked historical loss information for its trade receivables and compiled the following historical credit loss percentages:

- a. 0.3 percent for receivables that are current
- b. 8 percent for receivables that are 1–30 days past due
- c. 26 percent for receivables that are 31–60 days past due
- d. 58 percent for receivables that are 61–90 days past due
- e. 82 percent for receivables that are more than 90 days past due.

**55-39** Entity E believes that this historical loss information is a reasonable base on which to determine expected credit losses for trade receivables held at the reporting date because the composition of the trade receivables at the reporting date is consistent with that used in developing the historical credit-loss percentages (that is, the similar risk characteristics of its customers and its lending practices have not changed significantly over time). However, Entity E has determined that the current and reasonable and supportable forecasted economic conditions have improved as compared with the economic conditions included in the historical information. Specifically, Entity E has observed that unemployment has decreased as of the current reporting date, and Entity E expects there will be an additional decrease in unemployment over the next year. To adjust the historical loss rates to reflect the effects of those differences in current conditions and forecasted changes, Entity E estimates the loss rate to decrease by approximately 10 percent in each age bucket. Entity E developed this estimate based on its knowledge of past experience for which there were similar improvements in the economy.

**ASC 326-20 (continued)**

**55-40** At the reporting date, Entity E develops the following aging schedule to estimate expected credit losses.

<b>Past-Due Status</b>	<b>Amortized Cost Basis</b>	<b>Credit Loss Rate</b>	<b>Expected Credit Loss Estimate</b>
Current	\$ 5,984,698	0.27%	\$ 16,159
1–30 days past due	8,272	7.2%	596
31–60 days past due	2,882	23.4%	674
61–90 days past due	842	52.2%	440
More than 90 days past due	<u>1,100</u>	73.8%	<u>812</u>
	<u>\$ 5,997,794</u>		<u>\$ 18,681</u>



### Connecting the Dots

The example above from ASU 2016-13 illustrates that an entity's use of a provision matrix to apply the CECL model to trade receivables may not differ significantly from its methods under legacy guidance for determining the allowance for doubtful accounts. However, the example also shows that when using such a matrix, the entity is required to consider the following:

- Whether expected credit losses should be recognized for trade receivables that are considered “current” (i.e., not past due). In the example above, a historical loss rate of 0.3 percent is adjusted to 0.27 percent on the basis of the current and reasonable and supportable forecasted economic conditions and is applied to the trade receivables that are classified as current. This may be a change from practice under legacy guidance for many life sciences companies.
- When using historical loss rates in a provision matrix, the entity must assess whether and, if so, how the historical loss rates differ from what is currently expected over the life of the trade receivables (on the basis of current conditions and reasonable and supportable forecasts).

### 10.3.1.3 Technical Corrections and Amendments

Since the release of ASU 2016-13, the FASB has issued [ASUs 2019-04](#), [2019-05](#), [2019-10](#), [2019-11](#), [2020-03](#), [2022-01](#), and [2022-02](#) to provide various technical corrections and amendments to the guidance on credit losses in ASC 326. For an in-depth discussion of those technical corrections and amendments, see Deloitte's Roadmap [Current Expected Credit Losses](#).

## 10.3.2 Hedge Accounting (ASUs 2017-12, 2019-04, 2019-10, and 2022-01)

### 10.3.2.1 Background

In August 2017, the FASB issued [ASU 2017-12](#), which amends the hedge accounting recognition and presentation requirements in ASC 815. The Board's objectives in issuing the ASU were to (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities and (2) reduce the complexity, and simplify the application, of hedge accounting by preparers. However, as a result of subsequent stakeholder feedback

on the ASU, the FASB decided to make certain Codification improvements, some of which the Board incorporated into [ASU 2019-04](#).

### **10.3.2.2 Key Changes to the Hedge Accounting Model**

ASU 2019-04 clarifies various aspects of ASU 2017-12, including its guidance on the following:

- Certain aspects of partial-term fair value hedges of interest rate and foreign exchange risk.
- The amortization period for fair value hedge basis adjustments.
- Disclosure requirements for fair value hedge basis adjustments when the hedged item is an AFS debt instrument.
- Consideration of the hedged contractually specified interest rate for measuring hedge effectiveness for a cash flow hedge when the hypothetical derivative method is used.
- Application of a first-payments-received cash flow hedging technique to overall cash flows on a group of variable interest payments.
- The requirements for NFPs related to the treatment of an excluded component in a fair value hedge.
- The transition relief provided for certain NFPs.
- Transition for all entities.

### **10.3.2.3 Effective Date and Transition**

As noted in ASU 2019-04, “[f]or entities that have not yet adopted the amendments in Update 2017-12 as of the issuance date of this Update, the effective dates and transition requirements for the amendments to Topic 815 are the same as the effective dates and transition requirements in Update 2017-12.” See Section 10.3.2.4 below.

For entities that have adopted ASU 2017-12, ASU 2019-04 is effective “as of the beginning of the first annual reporting period beginning after the date of issuance of Update 2019-04.” Those entities may early adopt ASU 2019-04 at any time after its issuance.

For more information about ASU 2019-04, see Deloitte’s May 7, 2019, [Heads Up](#).

### **10.3.2.4 Changes to Effective Dates**

In November 2019, the FASB issued [ASU 2019-10](#), which (1) provides a framework to stagger effective dates for future major accounting standards and (2) gives private companies, NFPs, and certain small public companies additional time to implement the FASB’s major standards on credit losses, leasing, and hedging. For more information about ASU 2019-10, see Deloitte’s November 19, 2019, [Heads Up](#).

### **10.3.2.5 Implementation Developments**

The FASB is continuing its efforts to improve ASU 2017-12. For example, in November 2019, the Board issued a [proposed ASU](#) that would clarify certain aspects of the ASU, including (1) changes in hedged risk in a cash flow hedge, (2) contractually specified components in cash flow hedges of nonfinancial forecasted transactions, (3) foreign-currency-denominated debt instruments designated as hedging instruments and hedged items, and (4) use of the term “prepayable” under the shortcut method. The comment period for the proposed ASU ended on January 13, 2020.

In March 2022, the FASB issued ASU 2022-01, which clarifies the guidance in ASC 815 on fair value hedge accounting of interest rate risk for portfolios of financial assets. The ASU amends the guidance in ASU 2017-12 that, among other things, established the last-of-layer method for making the fair value hedge accounting for these portfolios more accessible. ASU 2022-01 renames that method the “portfolio layer” method and addresses feedback from stakeholders regarding its application. For more information about ASU 2022-01, see Deloitte’s March 29, 2022, [Heads Up](#).

### **10.3.3 Clarifying the Interactions Between ASC 321, ASC 323, and ASC 815 (ASU 2020-01)**

In January 2020, as a result of subsequent stakeholder feedback on ASU 2016-01, the FASB issued [ASU 2020-01](#), which clarifies the interactions between (1) the accounting for equity securities under ASC 321, (2) the accounting for investments under the equity method in accordance with ASC 323, and (3) the accounting for certain forward contracts and purchased options under ASC 815. The amendments in ASU 2020-01 include the following provisions:

- Immediately before applying or upon discontinuing the equity method of accounting, an entity that applies the ASC 321 measurement alternative should consider observable transactions that require it to either apply or discontinue the equity method.
- In applying ASC 815-10-15-141(a), an entity should not consider whether, upon the settlement of a forward contract or exercise of a purchased option, the underlying securities individually or with existing investments would be accounted for under the equity method in accordance with ASC 323 or the fair value option in accordance with the financial instruments guidance in ASC 825. However, the entity should evaluate the remaining characteristics in ASC 815-10-15-141 to determine the accounting for its forward contracts and purchased options.

For more information, see Deloitte’s November 2019 [EITF Snapshot](#).

#### **10.3.3.1 Effective Date and Transition**

ASU 2020-01 is effective for PBEs for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.

Early adoption is permitted, including in an interim period. ASU 2020-01 should be applied prospectively.

### **10.3.4 Reference Rate Reform (ASU 2020-04)**

#### **10.3.4.1 Background**

In response to the market-wide migration away from the London Interbank Offered Rate (LIBOR) and other interbank offered rates, the FASB initiated a project on reference rate reform. The Board held several meetings in 2019 to discuss the project and to consider hedge accounting relief and broader transition implications.

As a result of the meetings, in March 2020, the FASB issued [ASU 2020-04](#). The relief provided by the ASU (in ASC 848, added by the ASU) is elective and applies “to all entities, subject to meeting certain criteria, that have contracts, hedging relationships, and other transactions that reference LIBOR or another reference rate expected to be discontinued because of reference rate reform.” The ASU establishes a general contract modification principle that entities can apply in other areas that may be affected by reference rate reform, as well as (1) elective contract modification expedients for specific areas of the Codification, (2) certain elective hedge accounting expedients, and (3) held-to-maturity debt security classification relief. See below for further information.



The FASB is not acting alone in its efforts to address issues related to reference rate reform. In July 2019, the SEC staff issued a [statement](#) that provides additional guidance related to reference rate reform. For more information about the staff's statement, see Deloitte's August 6, 2019, [Heads Up](#).

### 10.3.4.2 Contract Modifications

The elective guidance in ASU 2020-04 applies to modifications of contract terms that will directly replace, or have the potential to replace, an affected rate with another interest rate index, as well as certain contemporaneous modifications of other contract terms related to the replacement of an affected rate. When contemporaneous modifications are made, an entity's eligibility to use the relief provided by ASC 848-20 (added by the ASU) depends on whether the contemporaneous modifications to the other terms (1) could affect the amount or timing of contractual cash flows and (2) are related to reference rate reform.

The table below summarizes the optional expedients provided by the ASU for specific areas of the Codification that an entity could elect to apply to qualifying contract modifications.

Codification Topic	Optional Expedients
Receivables (ASC 310)	Account for the modification as if it were only minor (and not an extinguishment) in accordance with ASC 310-20-35-10.
Debt (ASC 470)	Account for the modification as if it were not substantial (i.e., do not treat as an extinguishment).  In applying the 10 percent cash flow test in ASC 470-50-40-10 for any subsequent contract modifications made within a year, entities should consider only terms and provisions that were in effect immediately following the election of the optional expedient.
Leases (ASC 840 or ASC 842)	The modification will not (1) trigger reassessment of lease classification and the discount rate or (2) require the entity to remeasure lease payments or perform the other reassessments or remeasurements that would otherwise be triggered by a modification under ASC 840 or ASC 842 when that modification is not accounted for as a separate contract.  The modification of terms on which variable lease payments depend will not cause the lessee to remeasure the lease liability. The effects of such changes will instead be recognized in profit or loss in the period in which the obligation for those payments is incurred.
Embedded derivatives (ASC 815-15)	The modification of the contract terms will not cause an entity to reconsider its conclusion about whether that contract contains an embedded derivative that is clearly and closely related to the economic characteristics and risks of the host contract.
Other contracts	Account for the modification "as an event that does not require contract remeasurement at the modification date or reassessment of a previous accounting determination required under the relevant Topic or Industry Subtopic."

### 10.3.4.3 Hedging Relationships

ASU 2020-04 also allows entities to amend their formal designation and documentation of hedging relationships in certain circumstances as a result of reference rate reform. Under the ASU, if specified criteria are met, entities may change certain critical terms of existing hedging relationships that are affected or expected to be affected by reference rate reform, and these changes would not, in and of themselves, cause an entity to dedesignate the hedging relationship. An entity may elect to apply (1) expedients related to hedge accounting to each individual hedging relationship (and not necessarily to other similar hedging relationships) and (2) multiple optional expedients for a single hedging relationship and in different reporting periods.

When an entity elects to apply an expedient, it must update its hedge documentation to note any changes. Hedge documentation must be updated no later than when the entity performs its first hedge effectiveness assessment after the change is made in accordance with ASC 815.

#### 10.3.4.3.1 Fair Value Hedges

For existing hedges, an entity may change the designated benchmark interest rate and the component of cash flows if (1) the rate referenced by the hedging instrument changes or (2) the designation of the hedging instrument is changed to a combination of derivatives. Further, (1) the benchmark interest rate designated at hedge inception should be an affected rate, (2) the newly designated rate should be an eligible benchmark interest rate, and (3) the entity must expect that the hedging relationship will be highly effective prospectively.

Further, for existing hedges for which the shortcut method is applied, when an entity assesses whether the hedging relationship continues to meet the shortcut criteria, it can, for the remainder of the hedging relationship (including for periods after December 31, 2022), disregard the requirements that (1) the formula for computing net settlements under the interest rate swap is the same for each net settlement and (2) the hedging relationship does not contain any atypical terms or terms that would invalidate an assumption of perfect effectiveness.

#### 10.3.4.3.2 Cash Flow Hedges

If the designated hedged risk in a cash flow hedge of a forecasted transaction is an affected rate, an entity can continue to assert that the forecasted transaction's occurrence is probable despite the entity's expectations about the reference rate's discontinuance; however, the entity must continue to assess whether it is probable that the underlying forecasted transaction (e.g., future interest payments) will occur.

Further, if an entity applies the change in hedged risk guidance to a hedging relationship affected by reference rate reform, it may determine that the hedging relationship can continue by electing an optional expedient method to assess hedge effectiveness.

ASU 2020-04 also notes that if a forecasted transaction in a hedged group of forecasted transactions references an affected rate, the entity may disregard the requirement that the group of individual transactions share the same risk exposure for which they are designated as being hedged; however, the other requirements for hedging a group of forecasted transactions still must be met (e.g., forecasted purchases cannot be combined in a group with forecasted sales).

The ASU allows entities to apply certain optional expedients to change a cash flow hedging relationship's critical terms in certain circumstances. It provides additional cash flow hedge expedients that offer relief to entities when they perform effectiveness assessments for new or existing cash flow hedging relationships in which either the hedged forecasted transaction or the hedging instrument references an affected rate. These expedients allow an entity to ignore certain requirements that a hedging relationship would have otherwise been required to satisfy to qualify for application of the specified method of assessing hedge effectiveness. For existing hedging relationships, an entity should apply the optional practical expedient prospectively from the date on which it first applies the expedient. An entity would use the expedient for both prospective and retrospective effectiveness assessments (retrospective assessments would go back only to the date on which the entity first applied the expedient). An entity that elects to apply an expedient must also amend its hedge documentation to reflect its new effectiveness assessment method.

#### **10.3.4.4 Held-to-Maturity Debt Securities**

Under ASU 2020-04, an entity may make a one-time election to sell, or to transfer to the AFS or trading classifications (or both sell and transfer), debt securities that both (1) reference an affected rate and (2) were classified as held to maturity before January 1, 2020. An entity that makes this election is not required to apply it to all debt securities meeting these criteria. Such sales or transfers would not call into question the entity's previous assertions about its intent and ability to hold those securities to maturity. An entity making such a transfer is required to apply the measurement guidance governing transfers in ASC 320-10-35-10 through 35-16 and provide the disclosures required by ASC 320-10-50-10.

#### **10.3.4.5 Effective Date and Transition**

Originally, the FASB provided that the optional amendments in ASU 2020-04 are effective for all entities as of March 12, 2020, through December 31, 2022. However, in December 2022, the FASB issued [ASU 2022-06](#) to defer the sunset date of ASC 848 until December 31, 2024. Accordingly, the optional amendments in ASU 2020-04, as amended by ASU 2022-06, are effective for all entities as of March 12, 2020, through December 31, 2024, as shown in the table below.

Type	Effective Date/Expiration Date
Contract modifications	<ul style="list-style-type: none"> <li>• The amendments are effective for eligible contract modifications by topic and industry subtopic in accordance with either of the following:               <ul style="list-style-type: none"> <li>◦ As of any date from the beginning of an interim period that includes or is subsequent to March 12, 2020.</li> <li>◦ Prospectively from a date within an interim period that includes or is subsequent to March 12, 2020, up to the date that the financial statements are available to be issued.</li> </ul> </li> <li>• The amendments do not apply to contract modifications made after December 31, 2024.</li> </ul>

(Table continued)

Type	Effective Date/Expiration Date
Hedging relationships	<ul style="list-style-type: none"> <li>• The amendments are effective for either of the following eligible hedging relationships:               <ul style="list-style-type: none"> <li>◦ Those existing as of the beginning of the interim period that includes March 12, 2020.</li> <li>◦ Those entered into after the beginning of the interim period that includes March 12, 2020.</li> </ul> </li> <li>• The amendments do not apply to either of the following:               <ul style="list-style-type: none"> <li>◦ New hedging relationships entered into after December 31, 2024.</li> <li>◦ Hedging relationships evaluated for periods after December 31, 2024.<sup>19</sup></li> </ul> </li> </ul>
Sale or transfer of held-to-maturity securities	The one-time election to sell or transfer eligible held-to-maturity securities may be made at any time after March 12, 2020, but no later than December 31, 2024.



### Connecting the Dots

In January 2021, the FASB issued [ASU 2021-01](#), which refines the scope of ASC 848 and clarifies some of its guidance as part of the Board's monitoring of global reference rate reform activities. The ASU permits entities to elect certain optional expedients and exceptions when accounting for derivative contracts and certain hedging relationships affected by changes in the interest rates used for discounting cash flows, for computing variation margin settlements, and for calculating price alignment interest in connection with reference rate reform activities under way in global financial markets. For more information, see Deloitte's January 11, 2021, [Heads Up](#). Note, however, that the guidance in ASU 2021-01 is amended to the extent that ASU 2022-06 defers the sunset date of ASC 848 until December 31, 2024.

For more information about ASU 2020-04, see Deloitte's March 23, 2020, [Heads Up](#). For more information about ASU 2022-06, see Deloitte's December 21, 2022, [Heads Up](#).

## 10.3.5 Simplifying the Accounting for Convertible Instruments and Contracts on an Entity's Own Equity (ASU 2020-06)

### 10.3.5.1 Background

As noted in [Section 10.2.4](#), in August 2020, the FASB issued ASU 2020-06, which simplifies the accounting for certain financial instruments with characteristics of liabilities and equity, including convertible instruments and contracts on an entity's own equity. In addition, the ASU affects the diluted EPS calculation for (1) instruments that may be settled in cash or shares and (2) convertible instruments.

<sup>19</sup> Under ASU 2020-04, as amended by ASU 2022-06, if any of the following expedients are elected for hedging relationships existing as of December 31, 2024, they will be retained through the end of the hedging relationship:

- "An optional expedient to the systematic and rational method used to recognize in earnings the components excluded from the assessment of effectiveness."
- "An optional expedient to the rate to discount cash flows associated with the hedged item and any adjustment to the cash flows for the designated term or the partial term of the designated hedged item in a fair value hedge."
- "An optional expedient to not periodically evaluate [the specified] conditions in [ASC] 815-20-25-104(d) and (g) when using the shortcut method for a fair value hedge."

### 10.3.5.2 Convertible Instruments

There are currently five accounting models in ASC 470-20 for the allocation of proceeds attributable to the issuance of a convertible debt instrument. The table below outlines those models and their status under ASU 2020-06.

Instrument	Allocation Approach	Allocation Objective	Approach Retained Under ASU 2020-06?
Convertible instrument with a bifurcated embedded derivative	With-and-without method. The embedded derivative is measured first at fair value, and the residual amount is allocated to the host contract.	To measure the embedded derivative at fair value in a manner similar to how a freestanding derivative instrument is measured	Yes
Traditional convertible debt	No separation. All proceeds are recorded as debt.	To reflect the mutual exclusivity of debt repayment and conversion option exercise (i.e., both cannot happen)	Yes
Convertible debt issued at a substantial premium	With-and-without method. The debt is measured first at its principal amount, and the residual amount is allocated to equity.	To record a substantial premium received in equity	Yes
Convertible debt with a CCF	With-and-without method. The nonconvertible debt component is measured first at its fair value, and the residual amount is allocated to equity.	To reflect interest cost that is paid with the conversion feature	No
Convertible instrument with a BCF	With-and-without method. The BCF is measured first at its intrinsic value and allocated to equity, and the residual amount is allocated to the host contract.	To record the intrinsic value of the conversion feature in equity	No

As the table above notes, ASU 2020-06 removes from U.S. GAAP the separation models for (1) convertible debt with a CCF and (2) convertible instruments with a BCF. As a result, after adopting the ASU's guidance, entities will not separately present in equity an embedded conversion feature in such debt. Instead, they will account for a convertible debt instrument wholly as debt, and for convertible preferred stock wholly as preferred stock (i.e., as a single unit of account), unless (1) a convertible instrument contains features that require bifurcation as a derivative under ASC 815 or (2) a convertible debt instrument was issued at a substantial premium.



### Connecting the Dots

Under current guidance, applying the separation models in ASC 470-20 to convertible instruments with a BCF or CCF involves the recognition of a debt discount, which is amortized to interest expense. The elimination of these models will reduce reported interest expense and increase reported net income for entities that have issued a convertible instrument that was within the scope of those models before the adoption of ASU 2020-06.

For an in-depth discussion of the application of the separation models in ASC 470-20, see Deloitte's Roadmap [Convertible Debt \(Before Adoption of ASU 2020-06\)](#).

#### 10.3.5.3 Contracts on an Entity's Own Equity

Under current U.S. GAAP, a freestanding contract on an entity's own equity (e.g., a warrant) is accounted for as an asset or a liability unless it (1) is considered to be indexed to the entity's own equity under ASC 815-40-15 and (2) meets the equity classification conditions in ASC 815-40-25, in which case it is accounted for as equity.

For a contract to qualify for equity classification under ASC 815-40-25, it must require or permit the issuing entity to share settle it (either physically or net in shares). Any provision that could require the issuer to net cash settle the contract precludes equity classification with limited exceptions. For an entity to conclude that it cannot be required to net cash settle a contract, the entity must ensure that the equity classification conditions in ASC 815-40-25 are met. Existing guidance includes seven other conditions that address whether there are any circumstances under which the issuer could be forced to net cash settle the contract given the contract's terms and the regulatory and legal framework.

ASU 2020-06 removes from ASC 815-40-25-10 three of the conditions that currently must be met to avoid derivative accounting: (1) the ability to deliver unregistered shares upon settlement, (2) neither party is required to post collateral, and (3) certain counterparty rights. In addition, the ASU clarifies that the condition regarding failure to timely file with the SEC does not preclude equity classification when an instrument requires penalty payments for such failure.

Further, ASU 2020-06 requires freestanding contracts on an entity's own equity that do not qualify as equity under ASC 815-40 to be accounted for at fair value, with changes in fair value recognized in earnings, irrespective of whether such contracts meet the definition of a derivative in ASC 815.



### Connecting the Dots

The FASB decided not to proceed with proposed amendments that would have (1) added a remote-likelihood threshold to the indexation and classification guidance in ASC 815-40 and (2) changed the reassessment frequency. Instead, it has added to its agenda a separate project to explore improvements to this guidance.

#### 10.3.5.4 Earnings per Share

ASU 2020-06 provides the following clarifications to improve the consistency of EPS calculations:

- Entities must apply the if-converted method to all convertible instruments; the treasury stock method is no longer available.
- If the financial instrument can be settled in shares or cash, an entity must presume that the instrument will be settled in shares when calculating diluted EPS. ASU 2020-06 removes an entity's ability to rebut the presumption of share settlement, thus affecting the diluted EPS calculation for both convertible instruments and contracts on an entity's own equity.

- ASU 2020-06 extends the scope of the recognition and measurement guidance in ASC 260 on financial instruments that include down-round features to include equity-classified convertible preferred stock that contains such features. If the down-round feature is triggered, its effect “is treated as a dividend and as a reduction of income available to common shareholders in basic EPS.” However, the scope of this guidance does not include convertible debt with down-round features.
- ASU 2020-06 clarifies that the “average market price should be used to calculate the diluted EPS denominator” when the exercise price or the number of shares that may be issued is variable, except for certain contingently issuable shares.



### Connecting the Dots

ASC 260 contains specific diluted EPS guidance that applies to contracts that may be settled in cash or stock. This guidance applies regardless of whether the option to elect the form of settlement is controlled by the entity or by the counterparty to the contract. Before the adoption of ASU 2020-06, if certain conditions were met, an entity could overcome the presumption of share settlement for contracts that may be settled in cash or stock. In such cases, the entity would not include the dilutive effect of such contracts in the denominator of diluted EPS. However, after the ASU's adoption, except for certain share-based payment arrangements, an entity must assume that in the calculation of diluted EPS, any contract that allows for settlement in shares will be settled in shares. As a result, the entity would include potential common shares in the denominator of diluted EPS by using the treasury stock method, reverse treasury stock method, if-converted method, or contingently issuable share method, as applicable. In some situations, the entity may also need to adjust the numerator in the calculation of diluted EPS.

Arrangements that commonly allow for settlement in cash or shares include convertible instruments and warrants on common stock. However, ASC 260-10-45-45 applies to all contracts that allow for settlement in cash or shares at the option of the entity or the counterparty. Therefore, other contracts, such as redeemable noncontrolling interests that may be settled in parent shares or lease agreements that permit rent to be paid in shares, are also subject to this guidance.

Even if share settlement is unlikely, the guidance in ASC 260-10-45-45 applies. That is, the intent of the party that may elect the form of settlement is not relevant in the application of this guidance. Therefore, to comply with ASC 260-10-45-45, entities will need to inventory all of their contracts that allow for settlement in shares.

For an in-depth discussion of the application of ASC 260, see Deloitte's Roadmap [Earnings per Share](#).

### 10.3.5.5 Effective Date and Transition

The amendments in ASU 2020-06 are effective as follows:

- For PBEs that are not smaller reporting companies as defined by the SEC, fiscal years beginning after December 15, 2021, and interim periods within those fiscal years.
- For all other entities, fiscal years beginning after December 15, 2023, and interim periods within those fiscal years.

The guidance may be early adopted for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. For convertible instruments that include a down-round feature, entities may early adopt the amendments that apply to down-round features if they have not yet adopted the amendments in [ASU 2017-11](#).



For more information about ASU 2020-06, see Deloitte's August 5, 2020, [Heads Up](#).

### 10.3.6 Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options (ASU 2021-04)

In May 2021, the FASB issued [ASU 2021-04](#), which addresses an issuer's accounting for certain modifications and exchanges of freestanding equity-classified written call options. Under the ASU, an entity accounts for a modification or exchange of a freestanding equity-classified written call option that remains equity classified after the modification or exchange by recognizing "the excess, if any, of the fair value of the modified or exchanged written call option over the fair value of that written call option immediately before it is modified or exchanged . . . on the basis of the substance of the transaction, in the same manner as if cash had been paid as consideration." Accordingly, an entity accounts for any incremental fair value provided to the counterparty in a modification or exchange of an equity-classified written call option.

The accounting applied depends on the reason for the modification or exchange (e.g., whether other transactions were entered into contemporaneously or in contemplation of the modification or exchange of the option, and whether any other rights or privileges were exchanged). An entity therefore accounts for the effect of the modification or exchange in the same manner as if cash had been paid as consideration. Such effect is measured as the difference between the option's fair value immediately before and immediately after the modification or exchange. The table below summarizes how to apply this guidance in different scenarios.

Transaction	Accounting for Incremental Fair Value	Guidance
Financing transaction to issue equity (ASC 815-40-35-17(a))	Treat the amount as equity issuance cost.	ASC 340-10-S99-1
Financing transaction to issue debt (ASC 815-40-35-17(b))	If the instrument is held by the creditor, treat the amount as a debt discount. If the instrument is held by a third party, treat the amount as a debt issuance cost.	ASC 835-30
Nontroubled debt modification or exchange (ASC 815-40-35-17(c))	If the instrument is held by the creditor, treat the amount as day 1 cash flow in the performance of the 10 percent test and as a fee paid to the creditor in the accounting for the modification or exchange. If the instrument is held by a third party, treat the amount as a third-party cost in the accounting for the modification or exchange.	ASC 470-50
Troubled debt restructuring (ASC 815-40-35-17(c))	If the instrument is held by the creditor, treat the amount as a fee paid to the creditor. If the instrument is held by a third party, treat the amount as a third-party cost.	ASC 470-60
Other	Treat the amount in accordance with other GAAP (e.g., ASC 606 or ASC 718). If the transaction is not within the scope of other GAAP, recognize as a dividend under ASC 260-10.	Other relevant topics or subtopics

ASC 815-40-35-17 (as added by ASU 2021-04) specifies that an entity should recognize as a dividend the effect of a modification or exchange that is not related to a financing transaction and is not within the scope of other GAAP (e.g., ASC 606 or ASC 718). An entity cannot assume that dividend recognition is appropriate for a transaction that is not specifically mentioned in ASC 815-40-35-17. Rather, it must carefully consider the related facts and circumstances and the substance of the transaction. Generally, the recognition of an expense is appropriate if the modification or exchange of the option represents compensation for other stated or unstated transaction elements (e.g., a standstill agreement or settlement of litigation). Paragraph BC19 of ASU 2021-04 states:

Additionally, the [EITF] noted that if a modification or an exchange is executed in exchange for an agreement by the holder of the written call option to abandon certain acquisition plans, forgo other planned transactions, settle litigation, settle employment contracts, or voluntarily restrict its purchase of shares of the issuing entity or the issuing entity's affiliates within a stated time period, those rights and privileges obtained, both stated and unstated, or other elements of the transaction should be accounted for according to their substance (that is, as a cost to the issuing entity) rather than as a dividend distribution.

If the modification or exchange involves more than one of the categories identified above (i.e., it involves multiple elements), the amount is allocated among those categories.

#### **10.3.6.1 Effective Date and Transition**

ASU 2021-04 is effective for all entities for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years, with early adoption permitted. The ASU is applied on a prospective basis.

# Chapter 11 — Leases

## 11.1 New Leasing Standard (Codified in ASC 842)

### 11.1.1 Background

In February 2016, the FASB issued [ASU 2016-02](#) (the “new leasing standard,” which, as subsequently amended, is codified in ASC 842). The primary objective of the new standard was to address the off-balance-sheet financing concerns related to lessees’ operating leases. Accordingly, except for those leases that qualify for the short-term lease exemption under ASC 842 (i.e., certain leases with a lease term of 12 months or less), the standard’s lessee model requires lessees to adopt a right-of-use (ROU) asset approach that brings substantially all leases onto the balance sheet. Under this approach, a lessee records an ROU asset representing its right to use the underlying asset during the lease term and a corresponding lease liability in a manner similar to the current approach for capital leases.

The FASB also addressed questions such as:

- Whether an arrangement is a service or a lease.
- What amounts should be initially recorded on the lessee’s balance sheet for the arrangement.
- How to reflect the effects of leases in the statement of comprehensive income.
- How to apply the resulting accounting in a cost-effective manner.

The new leasing standard also aligns certain underlying principles of the new lessor model with those in ASC 606, the FASB’s revenue recognition standard, including those related to the evaluation of how collectibility should be considered and the determination of when profit should be recognized.

### 11.1.2 Scope

The new leasing standard applies to leases, including subleases, of all PP&E. It does not apply to leases of or for the following:

- Intangible assets.
- Exploration for or use of minerals, oil, natural gas, and similar nonregenerative resources.
- Biological assets.
- Inventory.
- Assets under construction.

### 11.1.3 Definition of a Lease

The new leasing standard states that a contract is, or contains, a lease if the contract gives a customer “the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.” Control is considered to exist if the customer has both of the following:

- “The right to obtain substantially all of the economic benefits from use of [an] identified asset.”
- “The right to direct the use of the identified asset.”

An entity is required at inception to identify whether a contract is, or contains, a lease. The entity will reassess whether the contract is, or contains, a lease only in the event of a modification to the terms and conditions of the contract.

The table below summarizes key concepts related to the definition of a lease.

Concept	Requirement	Observation
Use of an identified asset	An asset is typically considered to be an identified asset if it is explicitly specified in a contract or implicitly specified at the time the asset is made available for use by the customer. However, if the supplier has substantive rights to substitute the asset throughout the period of use <b>and</b> would benefit economically from substituting that asset, the asset is not considered “identified,” and there is no lease for accounting purposes (see below).	<p>This requirement is similar to the guidance in ASC 840-10-15 (formerly EITF Issue 01-8). An entity does not need to be able to identify the particular asset (e.g., by serial number) but must instead determine whether an identified asset is needed to fulfill the contract.</p> <p>Distinguishing between a lease and a capacity contract requires significant judgment. The standard clarifies that a capacity portion of an asset is an identified asset if it is physically distinct (e.g., a specific floor of a building). On the other hand, a capacity portion of a larger asset that is not physically distinct (e.g., a percentage of a pipeline) is not an identified asset unless that portion represents substantially all of the asset’s capacity.</p>
Substantive substitution rights	<p>A supplier’s right to substitute an asset is substantive only if both of the following conditions exist:</p> <ul style="list-style-type: none"> <li>• The supplier has the practical ability to substitute alternative assets throughout the period of use.</li> <li>• The supplier would benefit economically from the exercise of its right to substitute the asset.</li> </ul>	<p>The FASB established this requirement because it reasoned that if a supplier has a substantive right to substitute the asset throughout the period of use, the supplier — not the customer — controls the use of the asset.</p> <p>It is often difficult for a customer to determine whether a supplier’s substitution right is substantive. A customer should presume that a substitution right is not substantive if it is impractical to prove otherwise.</p>

(Table continued)

Concept	Requirement	Observation
Right to obtain economic benefits from use of the identified asset	To control the use of an identified asset, a customer must have the right to obtain substantially all of the economic benefits from use of the asset throughout the period of use. The term “substantially all” is generally 90 percent of the economic benefits of the asset.	The economic benefits from use of an asset include the primary output and by-products of the asset as well as other economic benefits from using the asset that could be realized from a commercial transaction with a third party.
Right to direct the use of the identified asset	<p>A customer has the right to direct the use of an identified asset throughout the period of use if either of the following conditions exists:</p> <ul style="list-style-type: none"> <li>• The customer has the right to direct “how and for what purpose” the asset is used throughout the period of use.</li> <li>• The relevant decisions about how and for what purpose the asset is used are predetermined and (1) the customer has the right to operate (or direct others to operate) the asset throughout the period of use and the supplier does not have the right to change the operating instructions or (2) the customer designed the asset in a way that predetermines how and for what purpose the asset will be used.</li> </ul>	<p>The relevant rights to be considered are those that affect the economic benefits derived from the use of the asset. Customers’ rights to direct the use of the identified asset include the rights to change:</p> <ul style="list-style-type: none"> <li>• The type of output produced by the asset.</li> <li>• When the output is produced.</li> <li>• Where the output is produced.</li> <li>• Whether the output is produced and the quantity of that output.</li> </ul> <p>On the other hand, rights that are limited to maintaining or operating the asset may not grant a right to direct how and for what purpose the asset is used.</p>

### 11.1.4 Embedded Leases

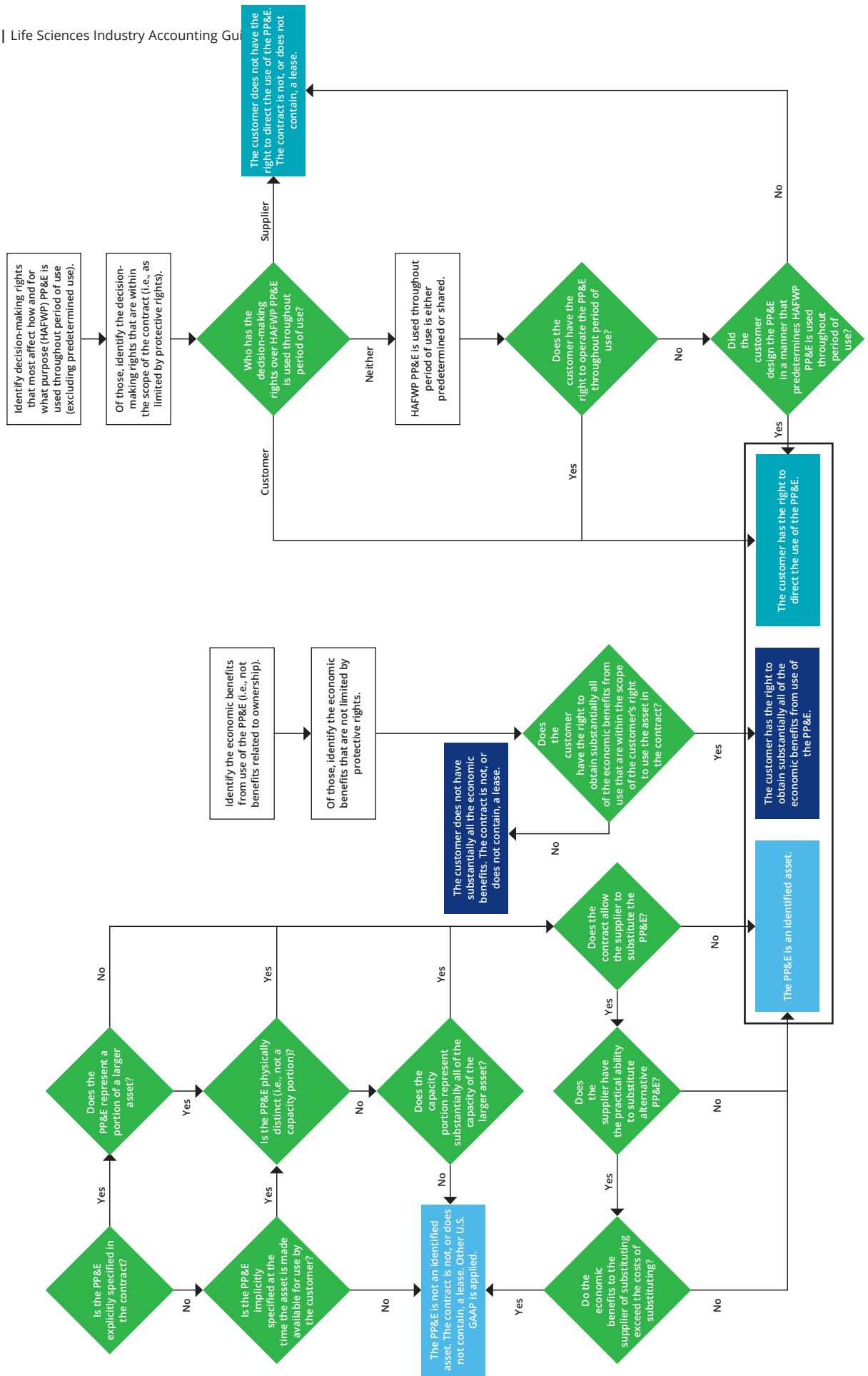
Often, the assessment of whether a contract is, or contains, a lease will be straightforward. However, the evaluation will be more complicated when an arrangement involves both a service component and a leasing component or when both the customer and the supplier make decisions about the use of the underlying asset. An asset typically is identified by being explicitly specified in a contract. However, an asset also can be identified by being implicitly specified at the time the asset is made available for the customer’s use.



#### Connecting the Dots

As discussed further in [Chapter 16](#) of Deloitte’s Roadmap *Leases*, entities in transition to ASC 842 may elect a package of transition relief (commonly referred to as “the package of three”) that, among other things, permits entities to retain historical assessments of whether contracts are, or contain, leases. This means that on the effective date of the standard, for those contracts existing as of the date of adoption, the initial ASC 842 accounting is based on those contracts that meet the definition of a lease under ASC 840. Therefore, if entities elect the transition relief package, they should evaluate embedded leases that may not have been identified under legacy U.S. GAAP in accordance with ASC 840. If entities do not elect the transition relief package, they should evaluate whether contracts are, or contain, leases under ASC 842.

The following decision tree illustrates how to evaluate whether an arrangement is, or contains, a lease:



**Example 11-1****Contract Manufacturing Arrangement**

Entity A, a pharmaceutical company, enters into an arrangement with a contract manufacturer, Entity B, to purchase a particular type, quality, and quantity of the API needed to manufacture drug compound X. Entity B has only one factory that can meet the requirements of the contract with A, and B is prohibited from supplying A through another factory or third-party suppliers. Entity A has not contracted for substantially all of B's factory's capacity.

The required quantities of API are established in the contract at inception. Entity B makes all of the decisions about the factory's operations, including when to run the factory to satisfy the required quantities and which customer orders to fulfill.

The contract does not contain a lease. The factory is an identified asset because it is implicit that B can fulfill the contract only through the use of the specific factory. However, A does not have the "right to obtain substantially all of the economic benefits from use of [an] identified asset" since the amount of capacity A has contracted for does not represent substantially all of the factory's capacity. In addition, A does not have the "right to direct the use of the identified asset." While A may specify quantities of product, B has the right to direct the factory's use because it can determine when to run the factory and which customer contracts to fulfill. As a result, A does not meet the new leasing standard's criterion of directing "how and for what purpose" the factory is being used, and the arrangement does not contain a lease.

In accordance with ASC 842-10-15-2, an entity is required at contract inception to identify whether a contract contains a lease. Not all contracts that contain accounting leases will be labeled as such, and accounting leases may be embedded in larger service arrangements.

Failure to identify accounting leases, including those embedded in service arrangements, could lead to a financial statement error. On the other hand, if a customer concludes that a contract is a service arrangement and that contract does not contain an embedded lease, the customer is not required to reflect the contract on its balance sheet (unless required to do so by other U.S. GAAP). The outcome of the accounting assessment of the contract may be more material to the financial statements under ASC 842 than under ASC 840 since the impact of operating leases on the financial statements is often the same as that of service arrangements under ASC 840.

**Connecting the Dots**

Historically, the accounting for operating leases under ASC 840 has generally not been materially different from the accounting for service contracts. However, under ASC 842, since most leases will be recognized on the balance sheet, the financial statement implications of not identifying a lease in a service contract could be more significant than under ASC 840.

For example, under ASC 840, "placed equipment" by a medical device entity may not have represented an identified asset if it was demonstrated that substitution rights existed, which could result in a conclusion that the placed equipment did not represent a lease. Under ASC 842, however, for a medical device entity to conclude that it has a substantive substitution right, it would have to demonstrate not only that it has the practical ability to substitute the placed equipment but also that it would benefit economically from the exercise of its right to substitute the asset. As a result, it is possible that more arrangements that allow for placed equipment will represent an identified asset under ASC 842.



### Example 11-2

#### Placement of Medical Device With Sale of Consumables

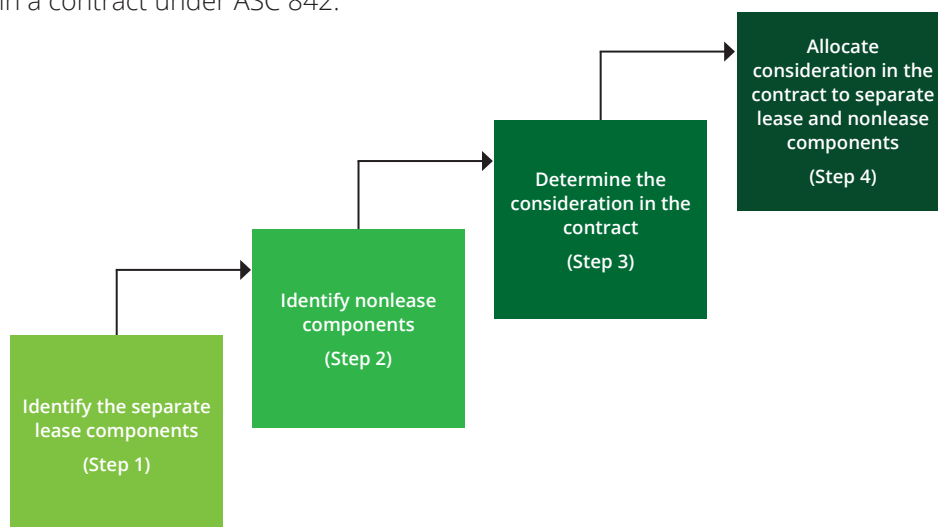
Entity C is a medical device manufacturer that supplies diagnostic kits to customers. The kits can be used only on instruments manufactured by C. Entity C provides its customers with the right to use its instruments at no separate cost to the customer in exchange for a multiyear agreement to purchase annual minimum quantities of diagnostic kits. The term of the agreement generally corresponds to the expected useful life of the instruments. Entity C retains title to the instruments and is permitted to substitute them under the terms of the contract, although historically these instruments have been substituted only when they malfunction since C does not benefit economically from the exercise of its right to substitute the asset.

The multiyear agreement to purchase diagnostic kits contains an embedded lease for the instrument system. The instrument system is an identified asset because it is implicit that C can fulfill the contract only through the customers' use of the specific instruments. Although C has the right to substitute the instruments, the substitution right is not substantive because of the lack of economic benefit from doing so. In addition, customers have the right to control the instruments' use because they have the right to obtain substantially all of the economic benefits from the use of the instruments during the multiyear term of the contract, which corresponds to the useful life of the instruments. Further, customers can make decisions about how and when the instruments are used when the customers perform diagnostic testing procedures.

### 11.1.5 Components of a Contract

A contract can contain both lease and nonlease components. Generally, the nonlease components are services that the supplier is also performing for the customer. For example, in a single contract, the supplier could be leasing a lab facility and related laboratory equipment to a biotechnology customer while also agreeing to provide ongoing maintenance services for the equipment throughout the period of use. Contracts may contain multiple lease components (e.g., leases of land, buildings, and equipment).

The graphic below outlines steps related to considering how to separate, and allocate consideration to, components in a contract under ASC 842.



Identify the  
separate lease  
components  
(Step 1)

Once an entity (a customer or supplier) determines that a contract is, or contains, a lease (i.e., part or all of the contract is a lease), the entity must assess whether the contract contains multiple lease components (i.e., when the contract conveys the rights to use multiple underlying assets). ASC 842-10-15-28(a) and (b) prescribe criteria for identifying whether one lease component is considered separate from other lease components in the contract.

However, land is considered an exception to the guidance in ASC 842-10-15-28. ASC 842-10-15-29 requires an entity to separate a right to use land from the rights to use other underlying assets (e.g., from the right to use a building that sits on top of the land) unless the effect of separating the land is insignificant to the resulting lease accounting.

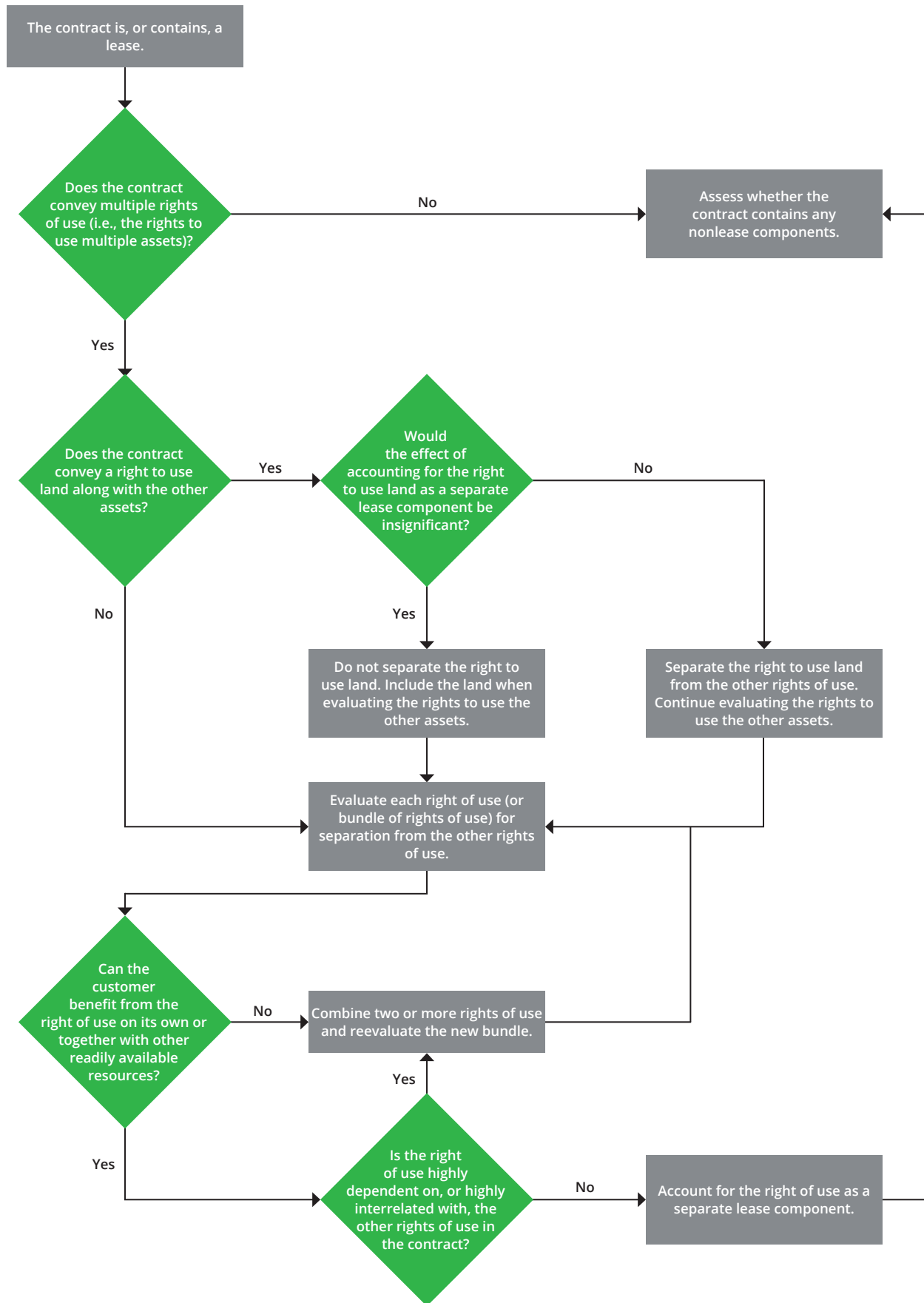


### Connecting the Dots

The new leasing standard indicates that it is important for an entity to identify the appropriate unit of account when applying the lessee or lessor accounting model since the unit of account can affect the allocation of consideration to the components in the contract. Paragraph BC145 of ASU 2016-02 states, in part:

By way of example, regarding allocation, the Board noted that the standalone price (observable or estimated) for a bundled offering (for example, the lease of a data center) may be substantially different from the sum of the standalone prices for separate leases of the items within a bundled offering (for example, the lease of each asset in the data center). Given the substantially different accounting for lease and nonlease components in Topic 842, the allocation of contract consideration carries additional importance as compared with previous GAAP. Consequently, the Board concluded that including separate lease components guidance in Topic 842 will result in more accurate accounting that also is more consistent among entities.




The decision tree on the following page illustrates how an entity might think about the guidance in ASC 842-10-15-28 and 15-29 for each contract containing a lease.



**Identify nonlease components**  
(Step 2)

Once the separate lease components are identified, entities must determine whether there are any nonlease components to be separated. An allocation of contract consideration is required for both lease and nonlease components since they transfer a good or service to the customer. However, allocation of contract consideration does not extend to activities that do not transfer a good or service to the customer, which are referred to as “noncomponents” (e.g., administrative tasks and reimbursement or payment of the lessor’s costs).

Understanding the difference between lease components, nonlease components, and noncomponents is critical. The table below outlines these concepts in greater detail.

<p><b>Lease Component</b></p> 	<p>The right to use an underlying asset is considered a separate lease component if (1) a lessee can benefit from the use of the underlying asset either on its own or with other resources that are readily available and (2) the underlying asset is not highly dependent on or highly interrelated with other assets in the arrangement.</p>
<p><b>Nonlease Component</b></p> 	<p>An activity that transfers a separate good or service to the customer is a nonlease component. For example, maintenance services consumed by the customer and bundled with the lease component in the contract would be a separate nonlease component because the performance of the maintenance transfers a service to the customer that is separate from the right to use the asset.</p>
<p><b>Noncomponent</b></p> 	<p>Any activity in a contract that does not transfer a separate good or service to the lessee is neither a lease component nor a nonlease component; therefore, consideration in the contract would not be allocated to such an activity. For example, payments made by the customer for property taxes or insurance that covers the supplier’s interests would not represent a component in the contract.</p>

ASC 842 affords lessees a practical expedient related to separating (and allocating consideration to) lease and nonlease components. That is, lessees may elect to account for the nonlease components in a contract as part of the single lease component to which they are related. The practical expedient is an accounting policy election that must be made by class of underlying asset (e.g., vehicles, IT equipment — see the Connecting the Dots discussion below).

Accordingly, when a lessee elects the practical expedient, any portion of consideration in the contract that would otherwise be allocated to the nonlease components will instead be accounted for as part of the related lease component for classification, recognition, and measurement purposes. In addition, any payments related to noncomponents would be accounted for as part of the related lease component (i.e., the associated payments would not be allocated between the lease and nonlease components).



### Connecting the Dots

ASC 842 provides lessees with two practical expedients that may be elected as an accounting policy by “class of underlying asset”:

- ASC 842-10-15-37 allows lessees not to separate lease and nonlease components.
- ASC 842-20-25-2 allows lessees not to recognize lease liabilities and ROU assets for short-term leases (i.e., leases with a term of 12 months or less).

However, ASC 842 does not address what is meant by the phrase “class of underlying asset.” We have received a number of questions about this topic from various stakeholders, and two views have emerged:

- *View 1* — The class of underlying asset is determined on the basis of the physical nature and characteristics of the asset. For example, real estate, manufacturing equipment, and vehicles would all be reasonable classes of underlying assets given their differences in physical nature. Therefore, irrespective of whether there are different types of similar assets (e.g., within the real estate class, there may be retail stores, warehouses, and distribution centers), the class of underlying asset would be limited to the physical nature as described above.
- *View 2* — The class of underlying asset is determined on the basis of the risks associated with the asset. While an asset’s physical nature may be similar to that of other assets (e.g., retail stores, warehouses, and distribution centers are all real estate, as discussed above), each has a different purpose and use to the lessee and would therefore have a separate risk profile. Consequently, for example, it could be appropriate for the lessee to disaggregate real estate assets into separate asset classes by “type” of real estate — to the extent that the different types are subject to different risks — when applying the practical expedients in ASC 842-10-15-37 and ASC 842-20-25-2.

To support their position, proponents of View 2 refer to paragraph BC341 of ASU 2016-02, which states:

The Board decided that a lessor should treat assets subject to operating leases as a major class of depreciable assets, further distinguished by significant class of underlying asset. Accordingly, a lessor should provide the required property, plant, and equipment disclosures for assets subject to operating leases separately from owned assets held and used by the lessor. **In the Board’s view, leased assets often are subject to different risks than owned assets that are held and used** (for example, the decrease in the value of the underlying asset in a lease could be due to several factors that are not within the control of the lessor), and, therefore, users will benefit from lessors segregating their disclosures related to assets subject to operating leases from disclosures related to other owned property, plant, and equipment. **The Board further considered that to provide useful information to users, the lessor should disaggregate its disclosures in this regard by significant class of underlying asset subject to lease because the risk related to one class of underlying asset (for example, airplanes) may be very different from another (for example, land or buildings).** [Emphasis added]

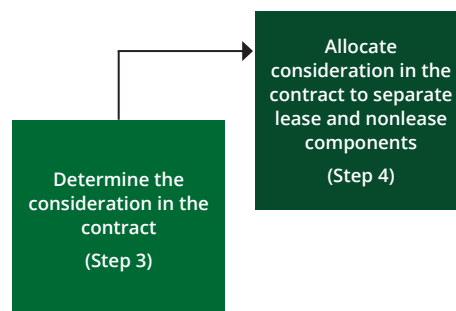
Irrespective of the views noted above, we do not think that it would be appropriate to determine the “class of underlying asset” on the basis of the lease contract with which it is associated. For example, we believe that it would be inappropriate to break real estate assets into different classes on the basis of whether they are related to gross leases or triple net leases. In that situation, the asset underlying the contract could be the same while the contract terms differ. We do not believe that such an approach is consistent with the intent of the guidance in ASC 842-10-15-37 or ASC 842-20-25-2.

In addition to the practical expedient available to lessees, lessors can elect not to separate lease and nonlease components. This election is made by each class of underlying asset and can only be made if certain criteria are met. Specifically, a lessor can elect to combine a lease component with a nonlease component provided that (1) the timing and pattern of transfer for the lease component are the same as those for the nonlease component associated with that lease component and (2) the lease component would be classified as an operating lease if accounted for separately from the nonlease component. See [ASU 2018-11](#) and [Section 4.3.3.2](#) of Deloitte’s Roadmap *Leases* for more information.

At this point, entities have identified their separate lease and nonlease components to which consideration in the contract will be allocated. Noncomponents have also been identified to ensure that consideration in the contract is not allocated to them.

Next, entities must:

- Determine the consideration in the contract.
- Allocate the consideration in the contract to the separate lease and nonlease components.



The matrix below summarizes the requirements related to measuring and allocating the consideration in the contract for lessees and lessors.

	<b>Lessee</b>	<b>Lessor</b>
Determining the consideration in the contract	Includes: <ul style="list-style-type: none"> <li>• Lease payments.</li> <li>• Any other fixed payments.</li> <li>• Any other variable payments based on index or rate.</li> </ul>	Includes: <ul style="list-style-type: none"> <li>• Lessee consideration in the contract (i.e., everything in the column at left).</li> <li>• Estimate of variable consideration (determined under ASC 606) when it is related only to the nonlease component(s).</li> </ul>
Allocating the consideration in the contract to lease and nonlease components	When practical expedient is elected, no allocation is performed.  When practical expedient is not elected, allocate on the basis of: <ul style="list-style-type: none"> <li>• Observable stand-alone price, if readily available.</li> <li>• Otherwise, estimated stand-alone price (maximizing use of observable inputs).</li> </ul>	When practical expedient is elected for eligible nonlease components, no allocation is performed.  When practical expedient is not elected, allocate on the basis of stand-alone selling price in accordance with ASC 606 (see <a href="#">Chapter 7</a> of Deloitte's Roadmap <i>Revenue Recognition</i> ).

### Example 11-3

#### Accounting for an Embedded Lease With Lease and Nonlease Components

Entity A, a pharmaceutical company, enters into an arrangement with Entity B, a CMO, to produce a drug substance by using a dedicated production line designed specifically for the exclusive use of A. Assume that key operating decisions are predetermined by A and that A must approve any changes to production plans.

This arrangement is likely to contain a lease accounted for under ASC 842. The production line is an explicitly identified asset in the contract, there are no substitution rights, and A has the right to obtain substantially all of the economic benefit from the use of the identified asset. In addition, A directs the use of the identified asset because B does not have the right to make operating decisions without A's prior approval.

**Example 11-3 (continued)**

As a result, A should allocate the expected consideration between the leased production line (the lease component) and the services required to produce the drug substance (the nonlease component) on the basis of their relative stand-alone selling prices at the inception of the contract. If the arrangement includes fixed consideration (including minimum monthly volumes at fixed prices), A would record on its balance sheet (1) a lease liability at the present value of the amount of fixed consideration allocated to the lease and (2) a corresponding ROU asset. If the contract contains no minimum volumes, the arrangement would still contain an embedded lease, but the consideration would be 100 percent variable. Because variable consideration is excluded from the measurement of the lease liability, there would be no initial accounting for this agreement. Instead, A would allocate and record a portion of each payment as variable lease expense for the embedded lease component and a portion as the cost of the contract manufacturing. Alternatively, A may elect to use the practical expedient in ASC 842 of not separating the lease component from the nonlease component and accordingly may account for the consideration in the arrangement entirely as lease expense.

In a similar manner, B, the CMO and lessor, may be required to identify two components in this contract: use of the dedicated space (a lease component) and the drug substance output of the contract manufacturing line (a nonlease component).

### **11.1.5.1 Allocating Consideration in Arrangements Involving the Use of an Asset for “Free”**

Vendors in certain industries (e.g., med tech) often provide customers with the right to use, for a specified period, a piece of equipment for no charge (“free equipment”) in exchange for exclusive rights to supply related products (i.e., consumables). The equipment typically can be used only to dispense consumables that are sold by the vendor. In many cases, the customer has the right, but not the obligation, to purchase consumables from the vendor at a specified price. These arrangements may be referred to as “free lease” arrangements because they often contain no explicit consideration related to the use of the equipment; rather, the consideration in the contract consists of a charge per unit of consumable purchased by the customer. Examples of such arrangements may include a contract that conveys the use of an X-ray scanner to a hospital (the hospital may purchase contrast dyes only from the vendor).

When a vendor enters into a free lease arrangement, there must be a determination of whether to allocate the consideration in the contract between the use of the equipment (i.e., a lease component) and the purchase of the consumables (i.e., a nonlease component). In general, we would expect the consideration in the contract (even if the consideration is all variable) to be allocated among the contract components. We would not normally expect a vendor to provide equipment to a customer without expecting compensation. This would suggest that some of the per-unit price of the consumables should be allocated to the use of the equipment.

However, in some limited circumstances, allocating 100 percent of the per-unit price to the consumable sales is permitted if the following criteria are met:

- The contract only includes variable payments not based on an index or rate; that is, the contract does not contain any fixed or in-substance fixed payments.
- The consumables are priced at (or below) their stand-alone selling price.
- The equipment is insignificant in the context of the contract.



If the contract contains a fixed or in-substance fixed payment, as described in ASC 842-10-30-5 and ASC 842-10-15-35 (e.g., a minimum commitment to purchase consumables), such amounts must be allocated between the identified equipment in the arrangement and any nonlease components. In these situations, provided that the customer has the right to control the use of the identified equipment, such a contract contains a lease of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time **in exchange for consideration**” [emphasis added].)

The second criterion is designed to identify scenarios in which a vendor has not “marked up” the consumables to compensate itself for providing the customer with use of the equipment. To the extent that the per-unit price is at or below the vendor’s stand-alone selling price for the consumables (i.e., the per-unit price is the same as or lower than the per-unit price for a customer that purchases the equipment), this fact constitutes evidence that the vendor is not seeking or receiving incremental compensation for the equipment.

If the first two criteria are met, the vendor should evaluate the equipment’s value in relation to the overall combined value of the arrangement (including an estimate of the consumable value by using its best projection of consumables to be purchased over the contract term). The vendor should also consider other relevant factors (qualitative and quantitative) to determine whether the equipment is insignificant in the context of the contract.

The fact that an arrangement satisfies these three criteria may suggest that the vendor has provided the right to use its asset over the term of the contract for no compensation. While future consumable purchases are expected, there are no enforceable rights to require future purchases. Therefore, in a manner consistent with an optional purchase model for a revenue transaction (as described in [TRG Agenda Paper 48](#)), those future consumable purchases are not enforceable and do not create additional consideration in the arrangement, and the customer thus obtains use of the vendor’s asset without any obligation to make payments. This outcome is consistent with a revenue transaction in which a vendor provides its customer with an up-front deliverable (e.g., a razor) for no consideration and expects (but is not able to require) the customer to make subsequent purchases of consumables (razor blades). In this revenue transaction, the vendor would record no revenue for the up-front deliverable (razor) and would incur a day 1 loss upon the transfer of control of the deliverable (razor) to the customer.

#### Example 11-4

Vendor L provides Customer H with “free” diagnostic equipment for a stated noncancelable term of five years. The equipment has no use other than in combination with consumables sold by L to produce a testing result. The equipment is explicitly specified in the contract, and H controls the use of the equipment during the five-year contract term through its exclusive use and ability to direct the use of the equipment. Customer H is required to return the equipment to L at the end of the contract term. The contract contains no explicit consideration for the use of the equipment; the consideration consists of a cost per unit of consumable purchased by H.

Throughout the five-year contract term, H has the right, but not the obligation, to purchase consumables from L to use in operating the equipment. The contract does not contain any minimum purchase commitments related to the consumables. Customer H may only use the consumables with the equipment provided by L and may not use a third-party vendor’s consumables with the equipment.

Vendor L has determined that the stand-alone selling price for the use of the equipment over a five-year term is \$200,000.

**Example 11-4 (continued)****Scenario 1 (Before the Adoption of ASU 2021-05)**

At contract inception, L estimates that H will purchase 100,000 consumables during the five-year contract term. The stand-alone selling price of consumables is \$6 per unit and the selling price within the contract is \$7.50 per unit, yielding an estimated \$750,000 of contract consideration.

On the basis of these additional facts, the contractual price of consumables (i.e., \$7.50 per unit) is higher than the stand-alone selling price of the consumables (i.e., \$6 per unit). The higher contractual price is most likely established to compensate L for the use of the equipment. Even though there are no fixed or in-substance fixed payments, since the price of the consumables is higher than the stand-alone selling price, L would conclude that this contract includes both a lease component and a nonlease component.

Vendor L would be required to allocate consideration between the use of the equipment (a lease) and the sale of consumables. Vendor L will allocate the consideration between the equipment and the estimated future consumable purchases on the basis of their respective stand-alone selling prices, as determined at lease inception. The consideration in the contract is allocated as follows:

Component	Consideration in the Contract	Stand-Alone Selling Price	Allocation Percentage	Allocated Consideration
Five-year lease of equipment (i.e., variable lease income)	\$ —	\$ 200,000	25%	\$ 187,500 (\$1.88 per consumable)
Consumables (i.e., revenue)	<u>750,000</u>	<u>600,000</u>	75%	<u>562,500</u> (\$5.63 per consumable)
Total	<u>\$ 750,000</u>	<u>\$ 800,000</u>	100%	<u>\$ 750,000</u>

Since consideration must be allocated to the use of the equipment, this component of the arrangement will generally meet the definition of a lease (i.e., the right to control the use of identified PP&E for a period of time in exchange for consideration). For each consumable purchased by H, L will recognize \$1.88 as variable lease income and \$5.63 as revenue.

This scenario resulted in a conclusion that a lease exists because the contractual price of consumables is higher than the stand-alone selling price. However, even if this were not the case, because the equipment value is quantitatively assessed as 25 percent of the total contract value, a lease component would most likely still be identified given the significance of the equipment to the overall contract.

Depending on the life of the equipment compared with the contract term (i.e., if the contract term is greater than 75 percent of the useful life of the equipment), these arrangements may qualify as sales-type leases and could lead to commencement losses because of their dependence on variable consideration.

With respect to operating leases of equipment, note that vendors will generally not qualify to use the lessor practical expedient related to not separating the lease (i.e., equipment) and nonlease (i.e., consumables) components in the contract because the transfer of consumables occurs at a point in time whereas the transfer of the leased equipment is over time.

**Scenario 2 (After the Adoption of ASU 2021-05)**

Assume the same facts as Scenario 1. The contractual price of consumables (i.e., \$7.50 per unit) is higher than the stand-alone selling price of the consumables (i.e., \$6 per unit). The higher contractual price is most likely established to compensate L for the use of the equipment. Even though there are no fixed or in-substance fixed payments, since the price of the consumables is higher than the stand-alone selling price, L would conclude that this contract includes both a lease component and a nonlease component.

**Example 11-4 (continued)**

Vendor L would be required to allocate consideration between the use of the equipment (a lease) and the sale of consumables. Vendor L will allocate the consideration between the equipment and the estimated future consumable purchases on the basis of their respective stand-alone selling prices, as determined at lease inception. The consideration in the contract is allocated as follows:

Component	Consideration in the Contract	Stand-Alone Selling Price	Allocation Percentage	Allocated Consideration
Five-year lease of equipment (i.e., variable lease income)	\$ —	\$ 200,000	25%	\$ 187,500 (\$1.88 per consumable)
Consumables (i.e., revenue)	<u>750,000</u>	<u>600,000</u>	75%	<u>562,500</u> (\$5.63 per consumable)
Total	<u>\$ 750,000</u>	<u>\$ 800,000</u>	100%	<u>\$ 750,000</u>

Since consideration must be allocated to the use of the equipment, this component of the arrangement will generally meet the definition of a lease (i.e., the right to control the use of identified PP&E for a period of time in exchange for consideration). For each consumable purchased by H, L will recognize \$1.88 as variable lease income and \$5.63 as revenue.

This scenario resulted in a conclusion that a lease exists because the contractual price of consumables is higher than the stand-alone selling price. However, even if this were not the case, because the equipment value is quantitatively assessed as 25 percent of the total contract value, a lease component would most likely still be identified given the significance of the equipment to the overall contract.

**Before the adoption of ASU 2021-05, the arrangement in the scenario described above may qualify as a sales-type lease depending on the life of the equipment compared with the contract term (i.e., if the contract term is greater than 75 percent of the useful life of the equipment). After the adoption of ASU 2021-05, however, if treating the lease as a sales-type lease would result in the recognition of a selling loss at lease commencement, the lease would be classified as an operating lease in accordance with ASC 842-10-25-3A because of the inclusion of variable consideration.**

(See [Connecting the Dots](#) in [Section 9.3.7.1.2](#) of Deloitte's Roadmap *Leases* for more information about commencement losses related to sales-type leases and [Section 11.2.1](#) of this Guide for further discussion of ASU 2021-05.)

**Example 11-5**

Assume the same initial facts as in the example above. At contract inception, Vendor L estimates that Customer H will purchase 450,000 consumables during the five-year contract term. The stand-alone selling price of consumables is \$7.50 per unit, as evidenced by separate observable sales of consumables within contracts in which L sells the equipment to customers. Use of the contractual price of \$7.50 per unit yields an estimated \$3.375 million of contract consideration.

First, L observes that the contract does not include any fixed or in-substance fixed payments throughout the contract term. Then, L considers that its business model is to provide the equipment for free to drive consumable sales, which is corroborated by the fact that the contractual price of consumables is identical to the stand-alone selling price of the consumables (i.e., a customer that purchases the equipment would pay the same price as a customer that signs this contract); L's primary objective is to sell consumables, not to sell the insignificant equipment.

**Example 11-5 (continued)**

The table below illustrates how L may assess the relative value within the contract and how it would allocate the consideration to the potential components.

<b>Component</b>	<b>Stand-Alone Selling Price</b>	<b>Allocation Percentage</b>
Equipment	\$ 200,000	5.6%
Consumables	<u>3,375,000</u>	94.4%
Total	<u>\$ 3,575,000</u>	100%

On the basis of this calculation, L concludes that the equipment value is approximately 5.6 percent of the total contract value. Upon considering this quantitative factor as well as other qualitative factors, L determines that the equipment is insignificant to the overall contract.

Accordingly, in this scenario, it may be acceptable for L to conclude that this contract does not include a lease since L has determined that **no** consideration is provided for the use of the equipment. (A lease is defined as the “right to control the use of identified [PP&E] for a period of time **in exchange for consideration**” (emphasis added).) As a result, 100 percent of the consideration would be allocated to the sale of the consumables (i.e., revenue). Compared with the conclusion reached in Scenarios 1 and 2 of Example 11-4 above, this conclusion does not result in a timing difference for revenue recognition purposes but could result in a different presentation and disclosure outcome: revenue from contracts with customers and variable lease income would be presented in Scenarios 1 and 2, whereas only revenue from contracts with customers would be presented in this example.

In addition, L should assess whether H obtains control of the equipment (not just the right to use it for five years). If control has been transferred, L would incur a day 1 loss upon delivery of the equipment to H, in a manner similar to the above example involving razors and razor blades.

Conversely, if L determines that H did not obtain control of the equipment, L would continue to recognize the equipment as PP&E subject to the guidance in ASC 360 on subsequent measurement (e.g., depreciation and impairment). Generally, control of the equipment is transferred to the customer when the term of the arrangement constitutes the major part of the remaining useful life of the equipment. However, if the vendor has a right to reclaim the equipment during the term of the arrangement without the customer’s permission (e.g., in cases in which the customer is not purchasing as many consumables as expected), this reclamation right may indicate that control of the equipment has not been transferred.

### 11.1.6 Lease Classification — Lessee

Under ASC 842, at lease commencement, a lease is classified as a finance lease (for a lessee) or a sales-type lease (for a lessor<sup>1</sup>) if any of the following criteria are met:

- “The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.”
- “The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.”
- “The lease term is for the major part of the remaining economic life of the underlying asset.”
- “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”
- “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.”

<sup>1</sup> Refer to [Section 11.2.1](#) for discussion of ASU 2021-05, which creates an exception to these lease classification criteria for lessors.

Finance leases are accounted for in a manner similar to how entities account for a financed purchase arrangement. The lessee recognizes interest expense and amortization of the ROU asset, which result in a greater expense in the early years of the lease than in the later years of the lease. The single lease cost related to an operating lease is recognized on a straight-line basis over the lease term unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the right to use the underlying asset. Thus, the amortization of an ROU asset related to an operating lease takes into account the interest on the liability so that the expense amount remains constant. That is, the amortization of the ROU asset will increase or decrease proportionally to the change in interest expense on the liability to maintain a straight-line expense throughout the term of the lease. For both types of leases, the lessee recognizes an ROU asset for its interest in the underlying asset and a corresponding lease liability.



### Connecting the Dots

While many aspects of the lease classification criteria under ASC 842 are consistent with legacy lease accounting guidance, bright-line tests (i.e., whether the lease term is for 75 percent or more of the remaining economic life of the asset or whether the present value of the lease payments, including any guaranteed residual value, is at least 90 percent of the fair value of the underlying asset) are noticeably absent. However, ASC 842-10-55-2 states that these tests are “one reasonable approach to assessing the criteria.” On the basis of this implementation guidance, entities often can use bright-line thresholds as policy elections when evaluating the classification of a lease arrangement under the new leasing standard. However, as with all policy elections, it is important for entities to consider the full range of impact and the need for policy elections to be consistently applied.

## 11.1.7 Lessor Accounting

After proposing different amendments to lessor accounting, the FASB ultimately decided to make only minor modifications to the lessor model. The most significant changes (1) align the profit recognition requirements under the lessor model with the revenue standard and (2) amend the lease classification criteria for a lessor to make them consistent with those for a lessee. Accordingly, the new leasing standard requires a lessor to use the classification criteria discussed above to classify a lease, at its commencement, as a sales-type, direct financing, or operating lease.

Regarding leveraged leases (i.e., leases that met the criteria in ASC 840-10-25-43(c)), paragraph BC397 of ASU 2016-02 explains that the FASB decided to grandfather in existing leveraged leases given that “there would be significant complexities relating to unwinding existing leveraged leases” during transition. Therefore, a lessor must continue to apply the accounting in ASC 840 for such a lease (as carried forward in ASC 842) and classify the lease as a leveraged lease provided that it enters into the lease before the effective date of ASC 842. Otherwise, leveraged lease accounting is eliminated as of the date of adoption.

While the FASB’s goal was to align lessor accounting with the revenue guidance in ASC 606, an important distinction between the two may affect lessors in the life sciences industry. Under ASC 606, variable payments are estimated and included in the transaction price subject to a constraint. By contrast, under ASC 842, variable lease payments not linked to an index or rate are generally excluded from the determination of a lessor’s lease receivable. Accordingly, under the guidance in ASC 842 as originally issued, sales-type or direct financing leases that have significant variable lease payments may result in recognition of a loss at commencement because the measurement of the lease receivable plus the unguaranteed residual asset is less than the net carrying value of the underlying asset.

For example, it is not uncommon for a hospital to contract with a medical device owner for the use of specific medical equipment for a major part of the economic life of the equipment. This type of arrangement is often priced in such a way that the consideration is based entirely on the hospital's ongoing purchase of "consumables," which allow the equipment to function as designed, and may have no minimum volume requirement. The medical device owner is willing to accept variable consideration in the arrangement because demand for the associated health care services suggests that a sufficient volume of consumables will be purchased by the hospital over the term of the contract to make the arrangement profitable. See [Section 11.1.5.1](#) for more accounting considerations related to this type of arrangement.

In July 2021, the FASB issued [ASU 2021-05](#), which requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate as an operating lease on the commencement date of the lease if specified criteria are met. The Board issued the ASU in response to stakeholder feedback indicating that the accounting for such a lease was not faithfully representing the underlying economics of the transaction at lease commencement or over the lease term. When a lease is classified as operating, the lessor does not recognize a net investment in the lease and does not derecognize the underlying asset; therefore, the lessor does not recognize selling profit or loss. See [Section 11.2.1](#) for more information.

### 11.1.8 Real Estate Rationalization

The COVID-19 pandemic ignited a shift in how entities in almost every industry sector are doing business. Many entities are reevaluating where their employees conduct their required business activities and to what extent they will rely on the use of brick-and-mortar real estate assets on a go-forward basis. Specifically, many entities initiated a real estate rationalization program to reevaluate their organization-wide real estate footprint. The goal of initiating such programs may be for entities to rightsize their real estate portfolios to manage costs while adequately supporting their evolving business needs.

We have also observed an increase in entities abandoning properties, subleasing space they are no longer using, or modifying existing leases to change the amount of space or the lease term. Further, as a financing method to improve their liquidity, entities are increasingly entering into sale-and-leaseback transactions involving real estate. As a result of these real estate rationalization efforts, entities are also more frequently evaluating leases for impairment. For more information about these topics, see Sections 11.1.9 through 11.1.12 below and Deloitte's March 30, 2021, [Accounting Spotlight](#).

### 11.1.9 Lease Modifications

A lease modification is any change to the contractual terms and conditions of a lease. Under the new leasing standard, a lease modification is accounted for as follows:

- A lessee or lessor accounts for a lease modification as a separate contract (i.e., separate from the original lease) when the modification (1) grants the lessee an additional ROU asset and (2) the price of the additional ROU asset is commensurate with its stand-alone price.
- A lessee accounts for a lease modification that is not a separate contract by using the discount rate as of the modification's effective date to adjust the lease liability and ROU asset for the change in the lease payments. The modification may result in a gain or loss if the modification results in a full or partial termination of an existing lease.
- A lessor accounts for a lease modification in a manner that is generally consistent with the contract modification guidance in ASC 606.

**Example 11-6****Lease Modifications****Scenario 1 — Modification Resulting in a Separate Contract**

Company A, a pharmaceutical entity (the lessee), enters into an arrangement to lease 15,000 square feet of office space in a complex for 20 years. At the beginning of year 10, A and the lessor agree to amend the original lease to include an additional 5,000 square feet of space adjacent to the existing space currently being leased when the current tenant vacates the property in 18 months. The increase in lease consideration as a result of the amendment is commensurate with the market rate for the additional 5,000 square feet of space in the complex. Company A would account for this modification (i.e., the lease of the additional 5,000 square feet) as a separate contract because the modification provides A with a new ROU asset at a price that reflects that asset's stand-alone price. While A would be required to disclose certain information about the lease modification, it would not be required to separately record any amounts in its statement of financial position until the separate lease's commencement date (i.e., 18 months from entering into the modification).

**Scenario 2 — Modification Not Resulting in a Separate Contract**

Company A, a pharmaceutical entity (the lessee), enters into an arrangement to lease 15,000 square feet of office space in a complex for 20 years. At the end of year 10, A and the lessor agree to amend the original lease by reducing the annual rental payments from \$60,000 to \$50,000 for the remaining 10 years of the agreement. Because the modification results in a change only to the lease consideration (i.e., the modification does not result in an additional ROU asset), A would remeasure its lease liability to reflect (1) a 10-year lease term, (2) annual lease payments of \$50,000, and (3) A's incremental borrowing rate (or the rate the lessor charges the lessee if such rate is readily determinable) as of the modification's effective date. Company A would recognize the difference between the new and old lease liabilities as an adjustment to the ROU asset. Since the modification does not result in a full or partial termination of the lease, there is no gain or loss on the modification.

**Connecting the Dots**

In response to the COVID-19 pandemic, the FASB provided both lessees and lessors with relief related to accounting for rent concessions resulting from COVID-19. An entity that elects to apply the relief to qualifying concessions may choose to account for the concessions by either (1) applying the modification framework for these concessions in accordance with ASC 840 or ASC 842 as applicable or (2) accounting for the concessions as if they were made under the enforceable rights included in the original agreement and are thus outside of the modification framework.

**11.1.10 Subleases**

When the original lessee subleases the leased asset to an unrelated third party, the lessee becomes the intermediate lessor in the sublease arrangement. As the intermediate lessor of a leased asset, the entity would determine the classification of the sublease independently from its determination of the classification of the original lease (i.e., the head lease). Under the new leasing standard, the intermediate lessor would classify the sublease on the basis of the underlying asset (i.e., it would assess the term of the sublease relative to the remaining economic life of the underlying asset). When evaluating lease classification and measuring the net investment in a sublease classified as a sales-type or direct financing lease, the original lessee (as a sublessor) should use the rate implicit in the lease if it is determinable. If the implicit rate is not determinable, the original lessee would use the discount rate that it used to determine the classification of the original lease.

In addition, offsetting is generally prohibited on the balance sheet unless the arrangement meets the offsetting requirements of ASC 210-20. However, it may be appropriate in certain instances to net sublease activity in the income statement. See [Section 14.3.1.2.1](#) of Deloitte's Roadmap *Leases* for additional considerations related to when net presentation in the income statement may be appropriate.



**Example 11-7****Accounting for a Sublease Under ASC 842**

As a lessee, Company A, a life sciences entity, enters into a building lease with a 30-year term. The building has an estimated economic life of 40 years. At the end of year 5, A enters into an agreement with Company B, a generics and consumer health entity, under which A subleases the building to B for 20 years. There is no residual value guarantee, and A determines that the present value of the sublease payments received from B does not represent substantially all of the fair value of the building.

As the lessor in its agreement with B, A would account for the lease to B (the sublease) as an operating lease because (1) the term of the sublease is not for a major part of the remaining life of the underlying asset of the sublease (i.e., the sublease term of 20 years represents only 57 percent of the remaining 35-year life of the building) and (2) A has concluded that no other classification criteria would result in the transfer of control of the underlying asset.

**11.1.11 Sale-and-Leaseback Transactions**

The seller-lessee in a sale-and-leaseback transaction must evaluate the transfer of the underlying asset (sale) under the requirements of ASC 606 to determine whether the transfer qualifies as a sale (i.e., whether control has been transferred to the customer). The existence of a leaseback by itself would not preclude the transaction from qualifying as a sale (i.e., it would not indicate that control has not been transferred) unless the leaseback is classified as a finance lease. In addition, if the arrangement includes an option for the seller-lessee to repurchase the asset, the transaction would not qualify as a sale unless both of the following criteria are met:

- The option is priced at the fair value of the asset on the date of exercise.
- There are alternative assets that are substantially the same as the transferred asset and readily available in the marketplace.

If the transaction does not qualify as a sale, the seller-lessee and buyer-lessor would account for the transaction as a financing arrangement (i.e., the buyer-lessor would account for its payment as a financial asset and the seller-lessee would record a financial liability).

If the transaction qualifies as a sale, the leaseback is accounted for in the same manner as all other leases (i.e., the seller-lessee and buyer-lessor would account for the leaseback under the guidance in ASC 842).

Transactions in which a lessee controls an underlying asset before the commencement date of the lease are within the scope of the sale-and-leaseback guidance in ASC 842-40. These transactions include transactions in which the lessee is involved with an asset before that asset is transferred to the lessor and transactions in which the lessee is involved with the construction of the asset (e.g., build-to-suit arrangements). For further discussion of these transactions, see [Chapter 11](#) of Deloitte's Roadmap *Leases*.

Sale-and-leaseback transactions involving real estate that include a repurchase option will not meet the criteria of a sale under ASC 606 regardless of whether the repurchase option is priced at fair value. During the FASB's redeliberation on ASU 2016-02, the Board noted that sale-and-leaseback transactions involving real estate that include a repurchase option would not meet the second criterion in ASC 842-40-25-3. Paragraph BC352(c) of ASU 2016-02 states, in part:

When the Board discussed [ASC 842-40-25-3], Board members generally observed that real estate assets would not meet criterion (2). This is because real estate is, by nature, "unique" (that is, no two pieces of land occupy the same space on this planet) such that no other similar real estate asset is "substantially the same."

Therefore, regardless of whether the repurchase option is priced at fair value, the unique nature of real estate would prevent a sale-and-leaseback transaction involving real estate that includes a repurchase option from satisfying the second criterion in ASC 842-40-25-3 since there would be no alternative asset that is substantially the same as the one being leased. Accordingly, in a manner similar to legacy U.S. GAAP, the new leasing standard would preclude sale-and-leaseback accounting for transactions involving any repurchase options on real estate.

### 11.1.12 Impairment and Abandonment

The ROU assets recorded on a lessee's balance sheet under ASC 842 are subject to the ASC 360-10 impairment guidance applicable to long-lived assets. When events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable (i.e., impairment indicators exist), the asset group should be tested to determine whether an impairment exists. The decision to change the use of a property subject to a lease could be an impairment indicator. See [Section 8.4.4](#) of Deloitte's Roadmap *Leases* for more information about the two-step impairment test.

Although the existence of an impairment indicator would not itself be a reason for a lessee to reevaluate the lease term for accounting purposes, an entity should consider whether any of the reassessment events in ASC 842-10-35-1 have occurred simultaneously with the impairment indicator. See [Example 5-10](#) in [Section 5.4.1.2](#) of Deloitte's Roadmap *Leases* for further discussion of the relationship between these concepts.

The guidance in ASC 360-10 on accounting for abandoned long-lived assets also applies to ROU assets. In the context of a real estate lease, when a lessee decides that it will no longer need a property to support its business requirements but still has a contractual obligation under the underlying lease, the lessee needs to evaluate whether the ROU asset has been or will be abandoned. Abandonment accounting only applies when the underlying property subject to a lease is no longer used for **any** business purposes, including storage. If the lessee intends to use the space at a future time or retains the **intent** and **ability** to sublease the property, abandonment accounting would be inappropriate.

### 11.1.13 Effective Date and Transition

For public companies,<sup>2</sup> the new leasing standard is effective for fiscal years beginning after December 15, 2018 (i.e., calendar periods beginning on January 1, 2019), and interim periods therein.

<sup>2</sup> That is, (1) PBEs; (2) NFPs that have issued, or are conduit bond obligors for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market; and (3) employee benefit plans that file or furnish financial statements with or to the SEC.

For all other entities, the amendments in ASU 2016-02 were originally effective for annual periods beginning after December 15, 2019 (i.e., calendar periods beginning on January 1, 2020), and interim periods beginning after December 15, 2020. However, in November 2019, the FASB issued [ASU 2019-10](#), which (1) provided a framework for staggering the effective dates of future major accounting standards and (2) amended the effective dates of certain major new accounting standards to give implementation relief to certain types of entities. In June 2020, the FASB issued [ASU 2020-05](#), which further amended the effective dates to give implementation relief to certain types of entities in response to the COVID-19 pandemic. ASU 2020-05 amended the effective dates of ASU 2016-02 as follows:

	Public Companies <sup>3</sup>	Public NFPs <sup>4</sup>	All Other Entities
As originally issued (ASU 2016-02)	Fiscal years beginning after December 15, 2018, and interim periods therein	Fiscal years beginning after December 15, 2018, and interim periods therein	Fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020
As amended by ASU 2019-10	No changes	No changes	Fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021
As amended by ASU 2020-05	No changes	Fiscal years beginning after December 15, 2019, and interim periods therein	Fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022

Entities are required to use a modified retrospective transition method of adoption. The FASB also issued [ASU 2018-11](#) so that entities may elect not to recast their comparative periods in transition (the “Comparatives Under 840 Option”). For more information, see [Section 16.1](#) of Deloitte’s Roadmap [Leases](#).

### 11.1.13.1 Additional Implementation Considerations

Discussed below are some of the additional implementation considerations that life sciences entities should thoughtfully address while transitioning to ASC 842. For further discussion, see Deloitte’s [March 28, 2023](#); [July 1, 2019](#); [October 17, 2018](#); [August 7, 2018](#); [April 25, 2017](#); and [July 12, 2016 \(originally issued March 1, 2016\)](#), *Heads Up* newsletters.

#### 11.1.13.1.1 Operational Considerations

For the lessee accounting requirements to be implemented, information about all individual contracts and arrangements will need to be collected, maintained, and evaluated, including information related to real estate contracts and equipment contracts (e.g., manufacturing equipment, laboratory equipment). In addition, it may be necessary to obtain information outside of contractual arrangements, including (1) the fair value of an asset, (2) the asset’s estimated useful life, (3) the incremental borrowing rate, and (4) certain judgments related to lease options. The ability to acquire such data may be particularly challenging when contract documentation is prepared in a foreign language and could vary as a result of local business practices.

<sup>3</sup> See [footnote 2](#).

<sup>4</sup> The deferral in ASU 2020-05 applies to public NFPs that have not issued financial statements or made financial statements available for issuance as of June 3, 2020. Public NFPs that have issued financial statements or have made financial statements available for issuance before that date must comply with the effective dates prescribed for public companies above.

### 11.1.13.1.1 *Materiality Threshold*

When implementing the lessee accounting requirements, life sciences companies are likely to consider a materiality threshold, especially for high-volume, low-value leased assets (e.g., laptops). As discussed further in [Section 2.2.5.2](#) of Deloitte’s Roadmap *Leases*, ASC 842 does not contain a “small-ticket item” exception similar to that in IFRS 16. Although materiality is generally a consideration in the application of all accounting standards, life sciences entities should not simply default to their existing capitalization threshold for PP&E for the following reasons:

- The pre-ASC 842 capitalization threshold for PP&E is unlikely to include the effect of the additional asset base introduced by ASU 2016-02. That is, the addition of another set of assets not recognized on an entity’s balance sheet may require a refreshed analysis of the entity’s capitalization thresholds to ensure that the aggregated amounts will not become material.
- The pre-ASC 842 capitalization threshold for PP&E does not take into account the liability side of the balance sheet. Under ASC 842, if an entity wishes to establish a threshold that will be used to avoid accounting for both ROU assets and lease liabilities on the balance sheet, it must consider the materiality, in the aggregate, of all of its ROU assets and related lease liabilities that would be excluded when it adopts such a threshold.

One reasonable approach to developing a capitalization threshold for leases is to use the **lesser** of the following:

- A capitalization threshold for PP&E, including ROU assets (i.e., the threshold takes into account the effect of leased assets determined in accordance with ASU 2016-02).
- A recognition threshold for liabilities that takes into account the effect of lease liabilities determined in accordance with the ASU.

Another reasonable approach to developing a capitalization threshold for leases is to record all lease liabilities but to subject the related ROU assets to such a threshold. Under this approach, if an ROU asset is below the established capitalization threshold, it would immediately be recognized as an expense. In subsequent periods, entities would amortize the lease liability by using the effective interest method, under which a portion of the periodic lease payments would reduce the liability and the remainder would be recognized as interest expense.

### 11.1.13.1.2 *Variable Expense*

Life sciences entities will most likely have contracts with variable lease payments (e.g., real estate contracts with index-based escalators or equipment rental payments based on usage). Entities may find it necessary to create a new general ledger account to track variable lease costs for disclosure purposes in accordance with ASC 842-20-50-4 and to consider impacts of variable lease payments on the accounts payable process.

### 11.1.13.1.2 *Application of Judgment and Estimation*

Entities must use judgment and make estimates under a number of the new as well as legacy lease accounting requirements. Judgment is often required in the assessment of a lease’s term, which would affect whether the lease qualifies for the short-term exemption and therefore for off-balance-sheet treatment. In addition, since almost all leases will be recognized on the balance sheet, judgment in distinguishing between leases and services becomes more critical under the new guidance.

### 11.1.13.1.2.1 Discount Rates

Entities will need to recognize ROU assets and lease obligations by using an appropriate discount rate at transition and on an ongoing basis. Compliance with this requirement may be difficult for entities with a significant number of leases since they will need to identify the appropriate incremental borrowing rate for each lease on the basis of factors associated with the underlying lease terms (e.g., lease tenor, asset type, residual value guarantees). That is, entities would not be permitted to use the same discount rate for all of their leases unless the leased assets and related terms are similar.

Additional considerations include:

- *Secured versus unsecured rate* — The definition of the incremental borrowing rate under ASC 842 requires lessees to obtain a collateralized or secured borrowing rate. Unsecured rates are likely to be higher and, therefore, to result in a lower lease liability. If a lessee does not borrow on a secured basis, it will most likely need to make adjustments to its unsecured borrowing rates to reflect a rate of a secured borrowing.
- *Parent versus subsidiary rate* — Sometimes it may be appropriate for a subsidiary to use an incremental borrowing rate other than its own. This will depend on the nature of the lease negotiations and the resulting terms and conditions (e.g., a consolidated group with a centralized treasury function that negotiates on behalf of all of its subsidiaries to benefit from its superior credit).
- *Leases denominated in a foreign currency* — When determining an incremental borrowing rate for a lease denominated in a foreign currency, entities should use assumptions that are consistent with a rate that the entities would obtain to borrow in the same currency in which the lease is denominated. The incremental borrowing rate should still reflect a collateralized rate in the relevant foreign environment.
- *Discount rate in transition* — Entities should determine the discount rate as of the effective date of ASC 842 when initially measuring lease liabilities (under the assumption that the entities continue to account for comparative periods under ASC 840). When selecting a discount rate, entities should elect, as an accounting policy consistently applied to all contracts, to use an interest rate that corresponds to either (1) the original lease term or (2) the remaining lease term.
- *Developing a method* — Life sciences entities should define a method for calculating the incremental borrowing rate that is auditable and supportable at transition and on an ongoing basis.

### 11.1.13.1.3 IT Systems

As a result of implementing the requirements of the new leasing standard, life sciences entities will most likely need to enhance their existing IT systems. The extent of the enhancements will be based on the size and complexity of an entity's lease portfolio and its existing leasing systems. As with any change to existing systems, an entity will need to consider the business ramifications (i.e., the potential impact on existing processes, systems, and controls) and the requirements of system users (e.g., the entity's legal, tax, financial planning and analysis, real estate, treasury, and financial reporting functions). Also, management may need to consider system changes that will enable the entity to estimate, before adoption of ASC 842, the new leasing standard's effect on key performance indicators and metrics, tax filings, debt covenants, or other filings. In addition, to the extent that an entity prepares IFRS statutory reports for foreign subsidiaries, its systems will need to distinguish between ASC 842 and IFRS 16 and will need to be equipped to handle the differences between the two standards.

#### 11.1.13.1.4 Income Taxes

A lease's classification for accounting purposes does not affect its classification for tax purposes. A life sciences entity will therefore continue to be required to determine the tax classification of a lease under the applicable tax laws. While the classification may be similar for either purpose, the differences in tax and accounting principles and guidance often result in book/tax differences. Thus, once an entity implements the new leasing standard, it will need to establish a process to account for these differences. The requirement that entities reevaluate their leases under the new guidance also presents an opportunity for entities to reassess the tax treatment of such leases as well as their data collection and processes. Since the IRS considers a taxpayer's tax treatment of leases to be a method of accounting, any changes to existing methods may require IRS consent. Entities should also consider the potential state tax issues that may arise as a result of the new guidance, including how the classification of the ROU asset may affect the apportionment formula in the determination of state taxable income and how the significant increase in recorded lease assets could affect the determination of franchise tax payable.

#### 11.1.13.1.5 Covenant Considerations

Given the requirement to bring most leases onto the balance sheet, many companies, including those in the life sciences industry, will reflect additional liabilities on their balance sheets after adopting the new leasing standard. An entity's determination of whether the increased leverage will negatively affect any key metrics or potentially cause debt covenant violations is a critical aspect of its planning for the new standard's implementation. This determination may depend, in part, on how various debt agreements define and limit indebtedness as well as on whether the debt agreements use "frozen GAAP" covenants (i.e., covenants based on the GAAP that applied at the time the debt was issued). ASC 842 requires presentation of operating lease liabilities outside traditional debt, which may provide relief. Regardless, we believe that it will be critical for all life sciences entities to determine the potential effects of the new leasing standard on debt covenants and begin discussions with lenders early if they believe that violations are likely to occur as a result of adopting ASC 842.

## 11.2 Amendments to the New Leasing Standard

The FASB has been working with stakeholders throughout the implementation of ASC 842 to clarify the guidance in the new leasing standard and identify aspects of that guidance that could pose challenges for entities. In response to stakeholders' comments and in a manner consistent with its ongoing Codification improvements project, the Board has issued additional ASUs to clarify the guidance in ASC 842, correct unintended application of the standard, or provide certain relief to entities. To make stakeholders more aware of its amendments to ASC 842, the Board decided to incorporate those amendments into ASUs developed outside of its project on Codification improvements in general.

ASUs issued to date that amend certain aspects of ASC 842 are broadly applicable to the life sciences industry and include the following:

- **ASU 2018-10 on improvements to ASC 842** — In July 2018, the FASB issued ASU 2018-10, which makes 16 narrow-scope amendments (i.e., minor changes and clarifications) to certain aspects of ASC 842.
- **ASU 2018-11 on targeted improvements to ASC 842** — In July 2018, the FASB issued ASU 2018-11 to provide entities with relief from the costs of implementing certain aspects of the new leasing standard. Specifically, under the amendments in ASU 2018-11:
  - Entities may elect not to recast the comparative periods presented when transitioning to ASC 842.
  - Lessors may elect not to separate lease and nonlease components when certain conditions are met.

For further discussion of ASU 2018-10 and ASU 2018-11, see Deloitte's August 7, 2018, [Heads Up](#).

- **ASU 2019-01 on Codification improvements to ASC 842** — In March 2019, the FASB issued ASU 2019-01 to amend certain guidance in ASC 842 in response to feedback from stakeholders. The ASU includes:
  - Guidance on determining the fair value of the underlying asset for lessors other than manufacturers or dealers that aligns with certain legacy guidance in ASC 840.
  - A clarifying amendment that exempts lessees and lessors from providing certain interim disclosures in the fiscal year in which they adopt the new leasing standard.
- **ASU 2019-10 on effective dates of ASC 842 (and those of other Codification topics)** — In November 2019, the FASB issued ASU 2019-10 to change, among other effective dates, those of ASC 842 for non-PBEs to fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021.<sup>5</sup> At the 2019 AICPA Conference on Current SEC and PCAOB Developments, the SEC staff announced that it would not object if specified PBEs adopt ASC 842 by using ASU 2019-10's timelines that apply to non-PBEs (the "SEC staff position").
- **ASU 2020-02 on an amendment to the SEC paragraph in ASC 842 (and the addition of an SEC paragraph in ASC 326)** — In February 2020, the FASB issued ASU 2020-02 to codify, among other SEC staff guidance, the SEC staff position permitting specified PBEs to use the non-PBE effective dates of ASC 842 provided for in ASU 2019-10. ASU 2020-02 codifies the SEC staff position by adding a note to ASC 842-10-S65-1.
- **ASU 2021-05 on lessor's accounting for certain leases with variable lease payments, ASU 2021-09 on the discount rate for lessees that are not PBEs, and ASU 2023-01 on common-control arrangements** — These ASUs are discussed in greater detail below.

For a complete list of ASUs issued to amend and clarify the guidance in ASC 842, see [Section 17.3.1](#) of Deloitte's Roadmap [Leases](#).

<sup>5</sup> In June 2020, the FASB issued [ASU 2020-05](#), which further amends the effective dates of ASC 842. See [Section 11.1.13](#) for more information.



## 11.2.1 ASU 2021-05 on Lessor's Accounting for Certain Leases With Variable Lease Payments

### 11.2.1.1 Background

In July 2021, the FASB issued [ASU 2021-05](#), which requires a lessor to classify a lease with variable lease payments that do not depend on an index or rate (hereafter referred to as “variable payments”) as an operating lease on the commencement date if specified criteria are met.

Before the release of the ASU, sales-type leases or direct financing leases with significant variable payments may have resulted in a day 1 loss on the arrangement even if the overall economics of the arrangement were expected to be profitable. This is because, under ASC 842, variable payments are excluded from the definition of lease payments for both lessees and lessors. Accordingly, lessors exclude variable payments when measuring the net investment in the lease. As a result, the amount recognized for the net investment in the lease may be less than that derecognized for the underlying asset. The example below illustrates this concept.

#### Example 11-8

Assume that a hospital (as lessee) enters into a 20-year contract with a medical device owner (as lessor) for the use of specific medical equipment for a major part of the economic life of the equipment. All payments are variable since they are based entirely on the hospital's ongoing purchase of consumables, which allow the equipment to function as designed, and there is no minimum volume requirement. The carrying value of the medical equipment is \$10 million just before the commencement of the arrangement, and the present value of the expected residual asset value is \$500,000. Because the hospital is involved in the ongoing purchase of consumables and use of the medical equipment, the hospital controls the right to direct the use of the asset. The results of the useful-life test reveal that the lease of the medical equipment should be accounted for as a sales-type lease by the lessor. The medical device owner would therefore be required to record a day 1 loss for the arrangement, as indicated in the following journal entries:

Net investment in lease	500,000	
Loss on sales-type lease	9,500,000	
Medical equipment		10,000,000

The FASB issued ASU 2021-05 to address the uneconomic outcome illustrated above. The amendments in the ASU affect only lessor accounting and will have no impact on lessees.

### 11.2.1.2 Key Provisions

ASC 842-10-25-3A (added by ASU 2021-05) requires a lessor to classify a lease with variable payments as an operating lease at lease commencement if both of the following conditions are met:

- The lease would have been classified as a sales-type lease or direct financing lease in accordance with the classification criteria in ASC 842-10-25-2 and 25-3, respectively.
- The lessor would have recognized a selling loss at lease commencement.

When applying the guidance in ASC 842-10-25-3A, the lessor would not derecognize the underlying asset upon lease commencement but would continue to depreciate the underlying asset over its useful life. Further, in accordance with ASC 842-30-25-11(a), the lessor would recognize fixed lease payments as “income . . . over the lease term on a straight-line basis unless another systematic and rational basis is more representative of the pattern in which benefit is expected to be derived from the use of the underlying asset.” Variable lease payments would be recognized as “income in profit or loss in the period in which the changes in facts and circumstances on which the variable lease payments are based occur,” as indicated in ASC 842-30-25-11(b).

Note that the ASU does not prescribe a threshold for the amount of variable payments; for an entity to apply the ASU’s guidance, a lease only needs to contain some amount of variable payments.



### Connecting the Dots

We expect that under ASU 2021-05, more lessors will be required to classify leases as operating leases rather than as sales-type leases or direct financing leases. Accordingly, additional leases will qualify for the lessor practical expedient in ASC 842-10-15-42A,<sup>6</sup> which allows lessors to combine lease and nonlease components into a single component if certain scope requirements are met. One of these requirements is that the underlying lease component must be classified as an operating lease. Therefore, as a result of the ASU, additional leases will qualify for the lessor practical expedient.

#### 11.2.1.3 Effective Date and Transition

Lessors that did not adopt ASC 842 on or before July 19, 2021, should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-05. Those entities should adopt the ASU on the same date on which they adopt ASC 842.

Lessors that have adopted ASC 842 as of July 19, 2021, should apply the transition requirements for fiscal years beginning after December 15, 2021.<sup>7</sup> Entities should use either of the following approaches to apply the ASU’s amendments:

- Retrospective application to leases that commence or are modified on or after the adoption of ASC 842, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).
- Prospective application to leases that commence or are modified on or after the date on which a lessor first applies the amendments in ASU 2021-05, when the modification does not meet the conditions to be accounted for as a separate contract (as defined in ASC 842-10-25-8).

An entity is permitted to early adopt ASU 2021-05 as long as it does not do so before adopting ASC 842.

<sup>6</sup> ASC 842-10-15-42A, as amended by ASU 2021-05, states, “As a practical expedient, a lessor may, as an accounting policy election, by class of underlying asset, choose to not separate nonlease components from lease components and, instead, to account for each separate lease component and the nonlease components associated with that lease component as a single component if the nonlease components otherwise would be accounted for under Topic 606 on revenue from contracts with customers and both of the following are met:

- a. The timing and pattern of transfer for the lease component and nonlease components associated with that lease component are the same.
- b. The lease component, if accounted for separately, would be classified as an operating lease in accordance with paragraphs 842-10-25-2 through 25-3A.”

<sup>7</sup> For PBEs and entities within the scope of ASC 842-10-65-1(a), ASU 2021-05 is effective for fiscal years beginning after December 15, 2021, and interim periods within those fiscal years. For all other entities within the scope of ASC 842-10-65-1(b), the ASU is effective for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022.

## 11.2.2 ASU 2021-09 on the Discount Rate for Lessees That Are Not PBEs

### 11.2.2.1 Background and Key Provisions

In November 2021, the FASB issued [ASU 2021-09](#), which allows lessees that are not PBEs to make an accounting policy election by class of underlying asset, rather than on an entity-wide basis, to use a risk-free rate as the discount rate when measuring and classifying leases.

Before the issuance of ASU 2021-09, ASC 842-20-30-3 permitted non-PBE lessees to “use a risk-free discount rate for the lease, determined using a period comparable with that of the lease term, as an accounting policy election **for all leases**” (emphasis added). However, during the two public roundtables that the FASB held in September 2020 to discuss challenges with implementing ASC 842, the Board learned that many entities would not benefit from electing this practical expedient because such entities did not want to use the risk-free rate for **all** of their leases for which they are a lessee. In response, private-company stakeholders proposed a more practicable alternative that would allow lessees to elect to use the risk-free rate as their discount rate for certain classes of underlying assets, as opposed to only having the option of making that election at an entity-wide level.<sup>8</sup>

In addition to allowing lessees to elect to use the risk-free rate as an accounting policy by asset class rather than on an entity-wide level, ASU 2021-09 requires lessees to:

- Disclose their election, including the asset class(es) for which they have elected the accounting policy.<sup>9</sup>
- Use the rate implicit in the lease instead of the risk-free rate when the former is readily determinable, regardless of whether the practical expedient has been elected.

### 11.2.2.2 Effective Date and Transition

Lessees that did not adopt ASC 842 on or before November 11, 2021, should apply the transition requirements in ASC 842-10-65-1 when adopting ASU 2021-09. The ASU should be adopted on the same date on which an entity adopts ASC 842.

Lessees that have adopted ASC 842 as of November 11, 2021, should apply the transition requirements described in the ASU.

Early adoption of ASU 2021-09 is permitted, as long as an entity does not adopt the ASU before adopting ASC 842.

For more information about ASU 2021-09, see Deloitte’s November 12, 2021, [Heads Up](#).

<sup>8</sup> ASC 842 does not address what is meant by the phrase “class of underlying asset.” Before ASU 2021-09, entities were allowed to make other accounting policy elections by class of underlying asset, so entities may already have policies in place on how they define asset class. See [Section 4.3.3.1](#) of Deloitte’s Roadmap [Leases](#) for information about applying this concept.

<sup>9</sup> As amended by the ASU, ASC 842-20-50-10 states, “A lessee that makes the accounting policy election in paragraph 842-20-30-3 to use a risk-free rate as the discount rate shall disclose its election and the class or classes of underlying assets to which the election has been applied.”

## 11.2.3 ASU 2023-01 on Common-Control Arrangements

### 11.2.3.1 Background and Key Provisions

In March 2023, the FASB issued [ASU 2023-01](#), which amends certain provisions of ASC 842 that apply to arrangements between related parties under common control. Specifically, the ASU:

- Offers private companies, as well as NFPs that are not conduit bond obligors, a practical expedient that gives them the option of using the written terms and conditions of a common-control arrangement when determining whether a lease exists and the subsequent accounting for the lease, including the lease's classification.
- Amends the accounting for leasehold improvements in common-control arrangements for all entities.

#### 11.2.3.1.1 Practical Expedient That Allows the Evaluation of Written Terms and Conditions of a Common-Control Arrangement

ASC 842 requires entities to determine whether a related-party arrangement between entities under common control is a lease on the basis of the legally enforceable terms and conditions of the arrangement. The accounting for a lease depends on the enforceable rights and obligations of each party as a result of the contract. This principle applies irrespective of whether such rights or obligations are included in the contract or explicitly or implicitly provided outside of the contract (i.e., there may be enforceable rights or obligations that extend beyond the written lease contract).

As part of the FASB's postimplementation review of ASC 842, private companies asserted that this requirement creates unnecessary cost and complexity for financial statement preparers, since the terms and conditions of such common-control lease arrangements may lack sufficient details, may be uneconomic, or may be changed without approval, given that one party in the common-control group generally controls the arrangement. Therefore, stakeholders have indicated that it is challenging to determine the legally enforceable terms and conditions of these arrangements and that legal counsel may need to be involved in making this determination, thereby incurring additional cost.

In response to that feedback, ASU 2023-01 provides an optional practical expedient under which private companies, as well as not-for-profit entities that are not conduit bond obligors, can use the written terms and conditions of an arrangement between entities under common control to determine (1) whether a lease exists and (2) the subsequent accounting for (and classification of) the lease. This practical expedient can be applied on an arrangement-by-arrangement basis, and an entity is not required to consider the legal enforceability of such written terms and conditions. However, if no written terms and conditions of an arrangement between entities under common control exist, an entity is not allowed to elect the practical expedient and is required to apply ASC 842 in a manner consistent with how it is applied to other arrangements.

#### 11.2.3.1.2 Accounting for Leasehold Improvements in Common-Control Arrangements

Under ASC 842, a lessee is generally required to amortize leasehold improvements that it owns over the shorter of the useful life of those improvements or the lease term. As part of the FASB's postimplementation review of ASC 842, private-company stakeholders have noted that in a lease arrangement between entities under common control, the amortization requirements of ASC 842 are inconsistent with the underlying economics of the arrangement since (1) the lessee may continue to control the use of the underlying asset after the lease term and (2) another party in the common-control group may benefit from the leasehold improvements after the lessee no longer controls the use of the underlying asset.

In response to that feedback, ASU 2023-01 requires a lessee in a common-control lease arrangement to amortize leasehold improvements that it owns over the improvements' useful life to the common-control group, regardless of the lease term, if the lessee continues to control the use of the underlying asset through a lease. This amendment applies to all entities.

In situations in which a lessee obtains control of an underlying asset through a lease with an unrelated party not under common control and subsequently subleases the asset to an entity under common control, the sublessee would generally amortize the leasehold improvements over a period that does not exceed the term of the lease between the lessee/intermediate lessor and the unrelated party. However, if the lease between the lessee/intermediate lessor and the unrelated party contains an option to purchase the underlying asset and the lessee/intermediate lessor is reasonably certain to exercise that option, the leasehold improvements should be amortized over the useful life to the common-control group.

Further, a lessee that no longer controls the use of the underlying asset will account for the transfer of the underlying asset as an adjustment to equity (i.e., as with a transfer of assets between entities under common control).

For more information about ASU 2023-01, see Deloitte's March 28, 2023, [Heads Up](#).

### **11.2.3.2 Effective Date and Transition**

ASU 2023-01 is effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted in any annual or interim period as of the beginning of the related fiscal year.

In relation to the practical expedient offered by ASU 2023-01, entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 must apply the transition requirements of ASU 2016-02. Entities that have adopted ASC 842 before the effective date of ASU 2023-01 can apply the amendments in either of the following ways:

- Prospectively to arrangements that commence or are modified on or after when the entity first applies ASU 2023-01.
- Retrospectively to the beginning period in which an entity applied ASC 842 for arrangements that existed as of the adoption date of ASU 2023-01. The practical expedient cannot be applied to common-control arrangements that no longer exist as of the adoption date.

Regarding the amendment related to accounting for leasehold improvements in common-control arrangements, entities that have not adopted ASC 842 on or before the effective date of ASU 2023-01 may apply the transition requirements of ASU 2016-02. However, entities that elect to retrospectively apply ASU 2016-02 to the beginning period of adoption are allowed to apply either of the prospective approaches described below to avoid retrospectively accounting for leasehold improvements associated with common-control leases.

Entities that have adopted ASC 842 before the effective date of ASU 2023-01 have the option of using one of the following adoption methods:

- Prospective application to all new leasehold improvements recognized on or after the date on which the entity first applies the amendments in ASU 2023-01.
- Prospective application to all new and existing leasehold improvements recognized on or after the date on which the entity first applies the amendments in ASU 2023-01, with any remaining balance of leasehold improvements amortized over their remaining useful life to the common-control group determined as of that date.
- Retrospective application to the beginning of the period in which an entity first applied ASC 842, with any leasehold improvements that otherwise would not have been amortized or impaired recognized through a cumulative-effect adjustment to opening retained earnings at the beginning of the earliest period presented in accordance with ASC 842.

### 11.3 SEC Comment Letter Themes Related to Leases

The focus of the SEC staff's comments on leasing transactions is shifting from registrants' accounting under the legacy leasing guidance (codified in ASC 840) to their application of the new leasing standard. Although relatively few SEC staff comments on the application of ASC 842 have been issued thus far, some observations in comments related to its application have emerged. For example, registrants have received comments on (1) how ASC 842 applies or does not apply in certain arrangements and (2) the discount rate used to calculate the amount of the lease liability and corresponding ROU asset. Other topics addressed in SEC staff comments on ASC 842 include, but are not limited to, the nature of expenses treated as initial direct costs; the determination of lease classification; accounting for leasehold improvements, including amortization; and impairment considerations related to ROU assets. Given the relatively low volume of SEC staff comments related to ASC 842 that have been issued thus far, registrants should continue monitoring staff comments to identify any new comments or trends related to the new leasing standard that may emerge in the future.

For more information about SEC comment letter themes that are relevant to life sciences companies, see Deloitte's Roadmap [SEC Comment Letter Considerations, Including Industry Insights](#). In addition, see Deloitte's January 7, 2020, [Heads Up](#), which outlines the ASC 842 disclosure requirements, elaborates on some of those requirements, and provides examples of related SEC comments issued to registrants.

# Chapter 12 — Initial Public Offerings

## 12.1 Introduction

In recent years, life sciences companies have represented a significant portion of IPOs in the marketplace. Approximately 44 percent of all IPOs from 2019 through 2023 were in the life sciences industry.<sup>1</sup> The majority of those life sciences IPOs were in the biotechnology subsector, with many qualifying for EGC and SRC filing status.

### 12.1.1 Emerging Growth Companies

#### 12.1.1.1 Definition of EGCs

An EGC is a category of issuer that was established in 2012 under the Jumpstart Our Business Startups Act (commonly referred to as the JOBS Act) and was granted additional accommodations in 2015 under the Fixing America's Surface Transportation Act (commonly referred to as the FAST Act). The less stringent regulatory and reporting requirements for EGCs are intended to encourage such companies to undertake public offerings. A private company undertaking an IPO will generally qualify as an EGC if it (1) has total annual gross revenues of less than \$1.235 billion during its most recently completed fiscal year and (2) has not issued more than \$1 billion of nonconvertible debt over the past three years. Once a company completes its IPO, it must meet additional criteria to retain EGC status.

#### 12.1.1.2 Accommodations Applicable to EGCs

There are many potential benefits for registrants that file an IPO as an EGC. For example, EGCs:

- Need only two years of audited financial statements in an IPO of common equity.<sup>2</sup>
- May omit financial information (including audited financial statements) from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective (see [Section 12.1.4.1](#))
- May elect not to adopt new or revised accounting standards until they become effective for private companies.
- Are eligible for reduced executive compensation disclosures.

<sup>1</sup> Statistics compiled from publicly available historical IPO information furnished by Nasdaq and Yahoo.

<sup>2</sup> This accommodation is limited to an IPO of common equity. As the SEC clarifies in [paragraph 10220.1](#) of the SEC Financial Reporting Manual (FRM), an entity that does not qualify as an SRC will generally need to include three years of audited financial statements when entering into an IPO of debt securities or filing an Exchange Act registration statement, such as a Form 10, to register securities.



EGCs are not *required* to apply the above accommodations and may choose to provide some scaled disclosures but not others. However, if an EGC has elected to opt out of the extended transition period for complying with new or revised accounting standards, this election is irrevocable. Therefore, the registrant, its advisers, and the underwriters should consider which EGC accommodations to use early in the IPO process. The SEC expects EGCs to disclose, in their IPO registration statements, their EGC status and to address related topics, such as the exemptions available to them, risks related to the use of those exemptions, and how and when they may lose EGC status.

Certain scaled disclosure provisions that apply to EGCs may also be available for other entities' financial statements. For example, financial statements required under SEC Regulation S-X, Rule 3-05 or Rule 3-09, may be omitted from an IPO registration statement if that financial information is related to periods that are not reasonably expected to be required at the time the registration statement becomes effective.

In addition, an entity that was an EGC at the time it initially submitted its IPO registration statement for SEC review but that subsequently ceased to be an EGC before it completed its IPO is allowed to continue to use the accommodations provided to EGCs until the earlier of either the date it completes its IPO under that registration statement or one year after it ceased to be an EGC.

After the entity's IPO, provided that the entity retains its EGC status, additional accommodations are available for its ongoing reporting obligations. One of the most significant of these accommodations exempts EGCs from the requirement to obtain, from the entity's independent registered public accounting firm, an auditor's report on the entity's internal control over financial reporting (ICFR). EGCs are also exempt, unless the SEC deems it is necessary, from any future PCAOB rules that may require (1) rotation of independent registered public accounting firms or (2) supplements to the auditor's report, such as communications regarding critical audit matters (CAMs), which have been required for certain other issuers since 2019.

After going public, a registrant will retain its EGC status until the earliest of:

- The last day of the fiscal year in which its total annual gross revenues exceed \$1.235 billion.
- The date on which it has issued more than \$1 billion in nonconvertible debt securities during the previous three years.
- The date on which it becomes a large accelerated filer (which is an annual assessment performed on the last day of the fiscal year on the basis of public float as of the end of the second fiscal quarter). To be considered a large accelerated filer, the registrant must have filed at least one annual report and must have been subject to the requirements of Sections 13(a) and 15(d) of the Exchange Act for at least 12 months. Accordingly, the registrant generally cannot be considered a large accelerated filer for its first Form 10-K filing as a public company.
- The last day of the fiscal year after the fifth anniversary of the date of the first sale of common equity securities under an effective Securities Act registration statement for an EGC.

**Topic 10** of the FRM summarizes many of the SEC staff's views on EGC-related issues. To further assist registrants, the SEC's Division of Corporation Finance (the "Division") has issued [FAQs](#) on numerous aspects of the JOBS Act, many of which address matters related to qualifying for EGC status and the filing requirements for EGCs.

### 12.1.1.3 *Loss of EGC Status and Impact on Adoption Dates for New Accounting Standards*

An EGC may elect to adopt new accounting standards on the basis of effective dates that apply to non-PBEs (e.g., the option to first adopt a new standard in annual financial statements). However, such an election is available only for as long as the entity qualifies as an EGC. An entity may lose EGC status after the effective date for PBEs but before the effective date for non-PBEs. As discussed in [paragraph 10230.1](#) of the FRM, the SEC staff generally expects an EGC that loses its EGC status to comply with the PBE requirements in the first filing after loss of EGC status. Accordingly, a registrant that loses EGC status before adopting a new standard should reflect such adoption as of the beginning of the current fiscal year. Previously issued financial statements do not need to be amended unless the standard requires full retrospective application. Entities that lose EGC status during the IPO process would reflect adoption of any deferred standards in their first periodic report (i.e., on Form 10-Q or Form 10-K) after the IPO. Entities that lose EGC status after their IPO would reflect adoption of any deferred standards in their next periodic report (i.e., on Form 10-Q or Form 10-K) after loss of EGC status.

The staff encourages EGCs to (1) review their plans to adopt accounting standards upon the loss of EGC status and (2) consult with the Division if they do not believe that they will be able to comply with the requirement to reflect new accounting standards on a timely basis.

## 12.1.2 *Smaller Reporting Companies*

### 12.1.2.1 *Qualifications of SRCs*

A registrant may qualify as an SRC on the basis of either a public float test or a revenue test. The thresholds for qualification as an SRC are as follows:

Criteria	Definition
Public float test	Less than \$250 million of public float as of the last business day of the registrant's second fiscal quarter.
Revenue test	Less than \$100 million of revenue as of the most recently completed fiscal year for which audited financial statements are available and public float less than \$700 million as of the last business day of the registrant's second fiscal quarter.

For initial Securities Act or Exchange Act registration statements, public float is measured as of a date within 30 days of the filing and is computed by multiplying the estimated public offering price of shares by the sum of (1) the aggregate worldwide number of all shares outstanding held by nonaffiliates before the filing of the registration statement and, in the case of a Securities Act registration statement, (2) the number of such shares included in the registration statement.

A company may qualify as both an SRC and an EGC (see [Section 12.1.1.1](#)); however, unlike the five-year limit for qualifying as an EGC, there is no time limit for qualifying as an SRC. Investment companies, asset-backed issuers, and subsidiaries that are majority-owned by non-SRC registrants cannot qualify as SRCs. An issuer that becomes an investment company or qualifies as an asset-backed issuer is disqualified from being considered an SRC for its next filing. Registrants should consider consulting with their legal counsel when determining whether they qualify as SRCs.

### 12.1.2.2 *Accommodations Applicable to SRCs*

A key feature of reducing the reporting burden on SRCs is the scaling back of the requirements in both SEC Regulation S-K and SEC Regulation S-X.

SRCs may be eligible to apply the scaled disclosure requirements as part of their IPO; those requirements are summarized in the tables below. Under those requirements, SRCs do not have to disclose as many years of audited financial statements and MD&A as non-SRCs. After adoption of the SEC's November 19, 2020, [final rule](#) that modernizes certain financial disclosure requirements in Regulation S-K, the remaining financial reporting requirements for SRCs are largely aligned with those for other registrants. However, SRCs continue to be exempt from the amended requirements for unaudited quarterly financial information as well as qualitative and quantitative information about market risk. [Topic 5](#) of the FRM also discusses the SEC staff's views on many SRC-related issues. Note that aside from the within section, this Guide generally does not specifically address SRC requirements.

### Disclosure Requirements Under SEC Regulation S-K

Regulation S-K Item	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs <sup>3</sup>
Item 101, "Description of Business"	Description of business developments, including principal products and services rendered	SRCs may elect to provide the alternative business disclosure (which may be less detailed) under Item 101(h)	Required
Item 201, "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters"	A graph depicting share performance over the past five years against market indexes	Not required	Required
Item 302, "Supplementary Financial Information"	Under Item 302(a), if a registrant reports a material retrospective change (or changes) for any of the quarters within the two most recent fiscal years, the registrant must disclose (1) an explanation for the material change(s) and (2) select financial information reflecting such change(s) for the affected quarterly periods, including the fourth quarter	Not required	Required
Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"	Discussion of results of operations	Discuss prior two years	Discuss prior three years, but may refer to discussion of earliest period in prior filing
Item 305, "Quantitative and Qualitative Disclosures About Market Risk"	Disclosure of information about market-sensitive instruments and related exposure, including sensitivity analysis	Not required	Required

<sup>3</sup> The disclosures identified in the "Registrants Other Than SRCs" column do not contemplate certain scaled disclosure requirements available to EGCs.

(Table continued)

<b>Regulation S-K Item</b>	<b>Summary of Disclosure</b>	<b>SRC Scaled Disclosure</b>	<b>Registrants Other Than SRCs</b>
Item 402, "Executive Compensation"	Number of named executive officers	Three	Five
	Scope of summary compensation table	Two years	Three years
	Compensation discussion and analysis, grants of plan-based awards table, option exercises and stock vested table, pension benefits table, nonqualified deferred compensation table, disclosure of compensation policies and practices related to risk management, pay ratio disclosure	Not required	Required
Item 404, "Transactions With Related Persons, Promoters and Certain Control Persons"	Description of policies/procedures for the review, approval, or ratification of related-party transactions	Not required	Required
Item 407, "Corporate Governance"	Disclosure of audit committee financial expert	Not required in first annual report	Required
	Disclosure of compensation committee interlocks and insider participation	Not required	Required
	Compensation committee report	Not required	Required
Item 503, "Prospectus Summary"	Discussion of the most significant risk factors facing the company	Not required in Exchange Act filings (e.g., annual or interim reports); required in a registration statement	Required

## Financial Statement Requirements Under SEC Regulation S-X

Financial Statement Requirements <sup>4</sup>	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs
Annual financial statements	Annual audited financial statements	Two years balance sheet, income statement, cash flow, and shareholders' equity	Three years income statement, cash flow, and shareholders' equity, two years balance sheet
	Compliance with presentation and disclosure requirements of SEC Regulation S-X, including, but not limited to, separate disclosure of revenue and costs from products and services and separate presentation of related-party transactions	Generally not required	Required
	Disclosure of accounting policy related to certain derivative instruments (Rule 4-08(n))	Required	Required
Footnote and other disclosures	Adoption date for new or revised accounting standards <sup>5</sup>	Use "Bucket 2" adoption dates (i.e., those applicable to nonpublic entities, generally two years after "Bucket 1" adoption dates)	Use "Bucket 1" adoption dates (unless the registrant is an EGC that has elected to defer adoption dates for new standards)
	Disclosure of certain information related to guaranteed or collateralized securities (Rule 3-10 and Rule 3-16)	Required	Required
	Compliance with auditor independence requirements (Article 2)	Required	Required
	Supplemental financial statement schedules	Not required	Required

<sup>4</sup> SRCs apply the requirements in SEC Regulation S-X, Article 8, when preparing their financial statements. SRCs typically are not required to apply the disclosure provisions of SEC Regulation S-X in their entirety unless Article 8 indicates otherwise. Registrants other than SRCs should apply SEC Regulation S-X in its entirety, as applicable.

<sup>5</sup> As a result of [ASU 2019-10](#), SRCs can adopt [ASU 2016-13](#) (as amended) and [ASU 2017-04](#) in a manner consistent with private-company adoption dates. In addition, the FASB intends to use the two-bucket framework to stagger effective dates for future major accounting standards.

(Table continued)

Financial Statement Requirements	Summary of Disclosure	SRC Scaled Disclosure	Registrants Other Than SRCs
Financial information of equity method investees	Summarized financial data of the equity method investee disclosed in the registrant's financial statements	Required if the equity method investee exceeds 20 percent significance in both interim and annual periods	Required if the equity method investee exceeds 20 percent significance at interim periods or 10 percent significance for the annual period <sup>6</sup>
	Audited historical financial statements of the equity method investee	Only required if equity method investee financial statements would be "material to investors" <sup>7</sup>	Required if the equity method investee exceeds 20 percent significance <sup>8</sup>

Companies that qualify as SRCs may choose to apply the scaled disclosure requirements on an item-by-item (or an "à la carte") basis. However, their disclosures should be consistent from year to year and must comply with federal securities laws, including those that require disclosures not to be misleading.



### Connecting the Dots

In determining which scaled disclosure requirements to apply, eligible companies may wish to conduct outreach and consider the information needs of their investors and other financial statement users. Thus, eligible companies may consider weighing any potential cost savings associated with the scaled disclosure requirements against not disclosing information that investors may consider valuable.

If an SRC is a nonaccelerated filer, not only is it eligible to apply the scaled disclosure requirements available to all SRCs, but it is also exempt from the requirement under Section 404(b) of the Sarbanes-Oxley Act of 2002 (SOX) to obtain an audit report on ICFR from its independent auditor. The following table summarizes the criteria on the basis of public float and revenue levels in the context of the SOX Section 404(b) requirements:

Status	Definition		Requirement
	Public Float	Annual Revenues	SOX Section 404(b)
SRC and nonaccelerated filer	Less than \$75 million	No limit	No
	\$75 million to less than \$700 million	Less than \$100 million	No
SRC and accelerated filer	\$75 million to less than \$250 million	\$100 million or more	Yes for non-EGCs; no for EGCs

<sup>6</sup> SEC Regulation S-X, Rule 4-08(g) and Rule 10-01(b)(1), prescribe the annual requirements for summarized financial information and the interim requirements for summarized income statement information, respectively.

<sup>7</sup> See [paragraph 5330.2](#) of the FRM.

<sup>8</sup> SEC Regulation S-X, Rule 3-09, prescribes the annual requirements for financial statements of an equity method investee. See Deloitte's Roadmap [SEC Reporting Considerations for Equity Method Investees](#) for further guidance on evaluating the significance of equity method investees.

### 12.1.3 Special-Purpose Acquisition Companies

Many private operating companies have merged with special-purpose acquisition companies (SPACs) to raise capital rather than using traditional IPOs or other financing activities. After a SPAC merges with a private operating company (the “target”), the target’s financial statements generally become those of the combined public company (the “combined company”). Therefore, a target will need to devote a considerable amount of time and resources to technical accounting and reporting matters.

A SPAC is a newly formed company that raises cash in an IPO and uses it to fund the acquisition of one or more private operating companies. After the IPO, the SPAC’s management looks to complete an acquisition of a target company within the period specified in its governing documents (e.g., 24 months). If an acquisition cannot be completed within this time frame, the cash raised in the IPO must generally be returned to investors. Because SPACs hold no assets other than cash before completing an acquisition, they are nonoperating public “shell companies” as defined by the SEC (see [paragraph 1160.2](#) of the FRM). If a target is identified and the SPAC is able to successfully complete the acquisition transaction, the private operating company target will succeed to the SPAC’s filing status as a result of the merger. On the closing date of the acquisition, the former private operating company, as the predecessor to the SPAC registrant, becomes a public company and must be able to meet all the public-company reporting requirements applicable to the combined company.

A SPAC’s shareholders are often required to vote on the merger transaction, so the SPAC may file a proxy statement on Schedule 14A or a combined proxy and registration statement on Form S-4 to effect the transaction. These documents must include audited financial statements of the private operating target. The target’s financial statements must comply with SEC rules and regulations, including SEC Regulation S-X and SEC Staff Accounting Bulletins, both of which govern presentation and disclosures in the financial statements. At the September 2018 CAQ SEC Regulations Committee joint [meeting](#) with the SEC staff, the SEC indicated that private operating company SPAC target financial statements are expected to comply with public-company GAAP disclosure requirements, including those related to segments and EPS. Further, the SEC noted that such financial statements should include any required financial statements for significant probable and consummated acquisitions under SEC Regulation S-X, Rule 3-05, “as if it were the private operating company’s [IPO].” Further, because the private operating company is considered the predecessor to the registrant, financial statements included in Form S-4 or the merger proxy must be audited in accordance with PCAOB standards. In addition, the target’s financial statements cannot reflect Private Company Council (PCC) accounting alternatives or practical expedients applicable to non-PBEs and generally must reflect the adoption of new accounting standards on the basis of the dates required for public companies. However, we understand that the SEC staff will not object if a target uses private-company (non-PBE) adoption dates if (1) the SPAC is an EGC that has elected to defer the adoption of accounting standards by applying private-company adoption dates, (2) the target would qualify as an EGC if it were conducting its own IPO of common equity securities, and (3) the combined company will qualify as an EGC after the transaction (see [paragraph 10120.2](#) of the FRM for a discussion of assessing EGC eligibility after the transaction).



Audited financial statements should generally be presented for both the SPAC and the target entity (or entities) for the three most recent fiscal years. However, there are two scenarios in which the SEC staff would not object when a registrant presents two years of annual financial statements, rather than the otherwise required three years:

- *SRCs* — In a manner consistent with [paragraph 1140.3](#) of the FRM, a target may provide **two** years of audited financial statements rather than three years if the target (1) is not an SEC reporting company **and** (2) would otherwise meet the definition of an SRC (e.g., it reported less than \$100 million in annual revenues in its most recent fiscal year for which financial statements are available).
- *EGCs* — In a manner consistent with [paragraph 10220.7](#) of the FRM, a target may provide **two** years of audited financial statements rather than three years if all of the following apply: (1) the SPAC is an EGC, (2) the SPAC has not yet filed or been required to file its first Form 10-K, and (3) the target would qualify as an EGC if it were conducting its own IPO of common equity securities.

The SPAC and its target must also comply with the requirements related to the age of financial statements in SEC filings. (See [Section 12.1.5](#) for further guidance on the age of financial statements.) Within four days of the closing of the acquisition, the combined company must file a Form 8-K (referred to as a “Super Form 8-K”) that includes all the information that would be required if the former private operating company had registered securities on Form 10. There is no 71-day grace period for providing audited financial statements of the formerly private operating company in the Super Form 8-K, as there may have been if the acquisition had been between two operating companies.<sup>9</sup> Accordingly, the SPAC and the private operating target should take care to ensure that the acquisition is not closed until all the financial information required for the Super Form 8-K is available, including financial statements that comply with the SEC’s age requirements and are audited in accordance with PCAOB standards. [Paragraph 12220.1](#) of the FRM provides more information about the requirements related to the Super Form 8-K.

In addition, to avoid a gap or lapse in the target’s financial statement periods after a transaction, the combined company may need to amend its Super Form 8-K to provide updated financial statements of the target. For example, if the transaction closes soon after the target’s fiscal quarter or year-end, the Super 8-K generally will not include the target’s financial statements for the most recently completed period. In such a case, the combined company will need to amend its Super 8-K to provide the recently completed annual or interim period on or before the registrant’s due date for its Form 10-K or Form 10-Q for that same period.

It can be complex to determine the ICFR attestation requirements that apply to management and the auditor after the close of a SPAC transaction. The phase-in exception in SEC Regulation S-K, Item 308, for an IPO, under which management’s report and the auditor’s attestation on ICFR are not required before the second annual report, typically does not apply in a transaction with a SPAC. Further, if the SPAC is an EGC, the EGC status of the combined entity would also have to be assessed after the close of the transaction to determine whether the combined company could continue to qualify for the scaled disclosure requirements applicable to EGCs, including relief from the auditor’s attestation report. These transactions often involve a change in auditors, and if the SPAC’s year-end differs from that of the target, they may also involve a change in fiscal year-end. Given the complex reporting requirements associated with SPAC acquisitions, private operating companies contemplating such transactions should consider consulting with legal and financial reporting advisers as early as possible.

<sup>9</sup> Under Item 2.01 of Form 8-K, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements within 71 calendar days.



## Changing Lanes

On January 24, 2024, the SEC issued a **final rule** to (1) “enhance investor protections in [IPOs] by [SPACs] and in subsequent business combination transactions between SPACs and private operating companies [also known as de-SPAC transactions]” and (2) “more closely align the treatment of private operating companies [target companies] entering the public markets through de-SPAC transactions with that of companies conducting traditional IPOs.” In summary, the final rule:

- Provides new requirements related to a SPAC’s IPO registration statement and its subsequent de-SPAC registration/proxy statement, such as additional disclosure requirements related to the SPAC sponsor and financial projections.
- Addresses certain liability matters by requiring the target company in a de-SPAC transaction to be a co-registrant with the SPAC in the de-SPAC registration/proxy statement.
- Codifies, through new Article 15 of Regulation S-X, various requirements related to the financial statements included in SPAC IPO registration statements and de-SPAC registration/proxy statements as well as filings made after the de-SPAC transaction.

When planning for SPAC transactions, entities should be mindful of the unique considerations noted above as well as other specific accounting and SEC reporting considerations. For more information about the final rule related to SPAC transactions, see Deloitte’s February 6, 2024, [Heads Up](#).

### **12.1.3.1 Transactions Entered Into in Connection With a SPAC Merger**

Entities going public via a SPAC often raise additional capital through a structure known as a private investment in public equity (PIPE). We have observed several transactions in which an unrelated third-party vendor enters into a stock subscription agreement with the SPAC to purchase a fixed number of shares for \$10.00 per share as part of the PIPE. Concurrently, the SPAC’s target enters into a vendor contract with the same unrelated third-party vendor to receive the vendor’s services. Often the customer begins to receive the vendor’s services before the PIPE closes, and the termination and payment provisions in the vendor contract are adjusted on the basis of whether the PIPE closes.

When evaluating these arrangements, an entity should consider whether the stock subscription agreement and vendor contract are accounted for as a combined arrangement and whether the consideration in the stock subscription agreement and vendor contract should be allocated in a manner that differs from what is contractually specified. An entity should also consider the nature of the vendor contract and carefully consider the appropriate expense recognition. Given the complexities of these arrangements, entities should consult with their accounting advisers on the appropriate accounting treatment.

### 12.1.3.2 Accounting for Shares and Warrants Issued by a SPAC

The guidance in this section is based on the typical terms and conditions that have been observed in practice. Since the specific terms can affect the accounting, consultation with an entity's accounting advisers is recommended.

In its IPO, a SPAC typically issues units to third-party investors at \$10.00 per unit. Each unit generally contains both of the following:

- One Class A ordinary share (a "Class A Share").
- A fraction of a warrant to purchase one Class A Share at an exercise price of \$11.50 (a "Public Warrant").

The sponsor and its affiliates generally receive Class B ordinary shares ("Class B Shares") in return for forming the SPAC. They may also purchase warrants ("Private Placement Warrants") to acquire Class A Shares at an exercise price of \$11.50 per share. Alternatively, a so-called "anchor investor" may purchase Private Placement Warrants in lieu of their being purchased by the sponsor. The Private Placement Warrants are generally purchased at \$1.00 or \$1.50 per warrant, and the proceeds received by the SPAC are used to pay the underwriting fees incurred in conjunction with the SPAC's IPO.

Although initially issued as a unit, the Class A Shares and Public Warrants become separately tradable shortly after the IPO. In addition, upon exercise, the Public Warrants do not alter the terms of the Class A Shares previously issued. Therefore, the Public Warrants (1) are legally detachable and separately exercisable from the Class A Shares issued as part of the units and (2) meet the definition of a freestanding financial instrument in ASC 480-10-20.

Since the Class A Shares and Public Warrants constitute separate units of account, the proceeds from the issuance of these units (net of any direct and incremental offering costs paid to the investors) must be allocated between the two components. The appropriate allocation method depends on how the Public Warrants are classified.

The Class B Shares and any Private Placement Warrants issued by the SPAC also generally represent separate units of account. If the Private Placement Warrants were purchased by the sponsor in contemplation of the formation of the SPAC, the entity should consider (1) the need to allocate the amount it paid for these warrants between the Class B Shares and Private Placement Warrants and (2) whether such warrants represent share-based payment awards to the sponsor.

To perform the allocations discussed above, entities must measure the fair value of the instruments in accordance with ASC 820. For more information about the allocation of proceeds to multiple freestanding financial instruments, see [Section 3.4](#) of Deloitte's Roadmap *Issuer's Accounting for Debt*. For more information about fair value measurements, see Deloitte's Roadmap *Fair Value Measurements and Disclosures (Including the Fair Value Option)*.

SPACs must then determine the appropriate classification of Class A Shares, Class B Shares, Public Warrants and Private Placement Warrants as equity, temporary equity, or liabilities.

In addition, there may be other arrangements that entities enter into upon the formation of a SPAC or at a later date before the SPAC completes a merger. Those may include the following:

- Forward contracts that (1) obligate the SPAC to issue additional Class A Shares to a counterparty at a fixed price and (2) are settled immediately before the SPAC completes a merger with a target.
- Warrants on Class A Shares or on Class B Shares that are issued to the sponsor, its affiliates, or third parties in return for providing financing to the SPAC.
- Classes of preferred stock issued to third-party investors, the sponsor, or the sponsor's affiliates.
- Class A Shares or Class B Shares (or warrants on such shares) that are issued to the SPAC's employees or third-party service providers as compensation for services provided.

The accounting analysis of some of these arrangements (e.g., the forward contracts and warrants described in the first two bullet points) may be similar to that of Public Warrants or Private Placement Warrants. SPACs that issue preferred shares or enter into share-based payment arrangements should consider other applicable GAAP to determine the appropriate accounting, including the potential effect of those instruments on reported EPS. Any shares or warrants issued as a share-based payment arrangement must be accounted for in accordance with ASC 718.

### 12.1.3.2.1 SEC Comment Letter Themes Related to the Classification of Warrants

#### Example of an SEC Comment

We note you have classified the . . . private placement warrants as equity. Please provide us with your analysis under ASC 815-40 to support your accounting treatment for these warrants. As part of your analysis, please address whether there are any terms or provisions in the warrant agreement that provide for potential changes to the settlement amounts that are dependent upon the characteristics of the holder of the warrant, and if so, how you analyzed those provisions in accordance with the guidance in ASC 815-40.

Entities should evaluate financial instruments that have both debt- and equity-like characteristics to determine whether the instruments should be classified as liabilities or equities in the financial statements. An entity should first determine whether a financial instrument should be classified as a liability in accordance with ASC 480. If the financial instrument is not classified as a liability under ASC 480, the entity should analyze the financial instrument under other accounting guidance, such as ASC 815. The SEC staff has asked registrants to explain the basis for their determination of how financial instruments should be classified, including the application of relevant accounting literature. Such comments are especially common for SPACs or companies that have merged with SPACs since complex financial instruments are often issued to raise capital for SPACs and SPAC transactions.

### 12.1.3.3 Differences in SEC Reporting Requirements — IPOs Versus SPACs

In addition to the matters discussed above, entities considering a SPAC transaction should take into account key differences between the SEC reporting requirements related to traditional IPOs (sale of newly issued common shares to the public) and those for SPAC transactions, some of which are summarized in the table below.

Topic	Traditional IPOs (Sale of Newly Issued Common Shares)	SPAC Transactions <sup>10</sup>
Financial statement periods required in the IPO document	Two years of financial statements are required for SRCs and EGCs.  Three years of financial statements are required for all other registrants.	Two years of financial statements are required if: <ol style="list-style-type: none"> <li>1. The operating company would separately be an SRC, or</li> <li>2. All of the following apply:               <ol style="list-style-type: none"> <li>a. The SPAC is an EGC;</li> <li>b. The SPAC has not yet filed or been required to file its first Form 10-K; and</li> <li>c. The target would qualify as an EGC.</li> </ol> </li> </ol> Three years of financial statements are required in all other scenarios.
Adoption dates of accounting standards	EGCs can irrevocably elect to defer adoption of new accounting standards on the basis of adoption dates used for private companies (non-PBEs).	The target company may defer adoption of new accounting standards only if (1) the SPAC is an EGC that has elected to defer the adoption of accounting standards by applying private-company adoption dates, (2) the target would qualify as an EGC if it were conducting its own IPO of common equity securities, and (3) the combined company will qualify as an EGC after the transaction.
Confidential or nonpublic submissions of the IPO document	Confidential or nonpublic submissions to the SEC staff are allowed for all companies undertaking an IPO (i.e., EGCs and non-EGCs). Such submissions, and any associated SEC comment letter responses, may continue to be submitted confidentially until they must be filed publicly as described in <a href="#">Section 12.1.4</a> .	If a registrant files on Form S-4, the SEC staff may agree to review the initial nonpublic draft Form S-4 if it is submitted within 12 months of the SPAC's IPO. However, SEC comment letter responses and all subsequent amendments must be filed publicly.

<sup>10</sup> The discussion herein applies to SPAC transactions in which (1) a domestic SPAC merges with a domestic target and (2) the SPAC has identified only one target for the transaction. SPAC transactions result in additional complexity when foreign entities or multiple targets are involved. In addition, we have recently observed new structures in which either the target or a newly formed company acquires the SPAC (e.g., a structure frequently referred to as a “double dummy” transaction). Such transactions may be viewed as the IPO of the target and, thus, different considerations may apply (e.g., two years of financial statements may be appropriate if the target qualifies as an EGC, and the confidential filing process may be available for a longer period).

(Table continued)

Topic	Traditional IPOs (Sale of Newly Issued Common Shares)	SPAC Transactions
Pro forma information included in the IPO document	Pro forma information is not required unless the registrant has other transactions for which pro forma information is required in accordance with SEC Regulation S-X, Article 11.	An entity must provide pro forma information for the accounting impact of (1) the SPAC transaction and (2) any other transactions for which pro forma information is required in accordance with SEC Regulation S-X, Article 11.
Prospective financial information included in the IPO document	Prospective financial information (i.e., forecasted information) is generally not presented.	Prospective financial information generally must be presented if the boards of directors of the company and SPAC used such forecasted information in evaluating the transaction.
Initial quarterly periodic reporting obligation	<p>The registrant becomes subject to the SEC's periodic reporting requirements beginning with the first quarterly or annual period after consummation of the IPO. The first Form 10-Q, for the quarter after the most recent period included in the registration statement, is due on the later of 45 days after the effective date or the date the Form 10-Q would otherwise be due if the company had been a public filer.</p> <p>For example, if an IPO becomes effective on April 15, 20X1, and includes financial statements through December 31, 20X0, the first Form 10-Q required will be for the quarter ended March 31, 20X1, and must be filed 45 days after April 15, 20X1.</p>	<p>The combined company retains the previous SEC reporting obligations of the SPAC and must file financial statements for quarterly or annual periods that end before the close of the transaction on the basis of the SPAC's filing deadlines, without reference to the closing date of the transaction, even if not included in the Super Form 8-K.</p> <p>For example, if the SPAC transaction closes on April 15, 20X1, the Super 8-K due within four days must only include annual financial statements through December 31, 20X0. The combined company retains the SPAC's requirement to file a Form 10-Q for March 31, 20X1, for the SPAC and an amended Super Form 8-K with the financial statements of the target company for March 31, 20X1, by the relevant Form 10-Q due date (i.e., 45 days for nonaccelerated filers).</p>
Ongoing reporting requirements related to ICFR	Management's report and the auditor's attestation on ICFR are not required before the second annual report. The auditor's report may also not be required afterward to the extent that the registrant is an EGC or nonaccelerated filer.	If the SPAC filed its first annual report before the close of the transaction, management's report on ICFR is required in the next annual report after the close of the transaction. However, as noted in <a href="#">Section 215.02</a> of the C&DIs on Regulation S-K, the SEC may not object to the exclusion of management's report (and the auditor's report) on ICFR depending on the closing date of the transaction and other conditions. We recommend that management consult with its legal counsel and auditors before excluding reports on ICFR.

### 12.1.4 Nonpublic Review Process for Draft Registration Statements

Historically, registration statements filed with the SEC were immediately accessible to the public via EDGAR, the SEC's online public database. However, EGCs may confidentially submit certain IPO registration statements to the SEC. In 2017, the SEC extended a similar confidential benefit to non-EGCs, allowing them to also voluntarily submit draft IPO registration statements to the SEC staff for nonpublic review. The ability to file nonpublicly is a significant benefit because it allows companies to keep potentially sensitive information from customers or competitors until later in the IPO process. It also lets companies, on a nonpublic basis, respond to SEC comments, update the draft registration statement, and continue to assess market conditions throughout the IPO process. Companies that use this benefit can also delay or withdraw the IPO, if desired, without public scrutiny.

While draft registration statements may be initially submitted nonpublicly, a company will eventually be required to publicly file all previously submitted drafts unless it elects to withdraw the IPO. Specifically, all comments and the related responses, even if they were previously submitted nonpublicly, will be posted to the SEC's Web site no earlier than 20 days after the registration statement is declared effective. All nonpublic submissions of Securities Act registration statements must be filed publicly<sup>11</sup> no later than 15 days before (1) a road show or (2) the requested effective date of the registration statement if no road show is planned.

When submitting a draft registration statement for nonpublic review, companies should consider the following:

- The draft registration statement must be “substantially complete.” It must contain a signed audit report from the company's independent registered public accounting firm and meet all line item requirements applicable to the registration statement, unless a company is using certain permitted accommodations for omitting otherwise required information.<sup>12</sup>
- For a draft registration statement, companies do not need to include items such as the required signatures of executives and directors, the auditor's consent, and the filing fee.

At the time of a company's initial public filing, the registration statement should be:

- Devoid of any indications that the document is nonpublic.
- Complete (e.g., it should include signatures, signed audit reports, consents, exhibits, and any required filing fees).
- Accompanied by the contemporaneous filing of any previously submitted nonpublic draft registration statements.

#### 12.1.4.1 Omission of Certain Financial Information From Draft Registration Statements

While each draft of a registration statement is generally expected to contain all information required by SEC regulations, there is an accommodation available to companies that allows them to omit financial statement periods in certain circumstances. This accommodation was initially granted to EGCs as part of the JOBS Act but was subsequently expanded by the SEC to include non-EGCs as well. Specifically, under the accommodation, a company may omit financial information from a nonpublic draft registration statement (see [Section 12.1.4](#)) for historical periods currently required if the company reasonably believes that it will not be required to include these historical periods at the time of the public filing. This provision is likely to apply when the SEC's review process extends through a financial statement stale

<sup>11</sup> For Exchange Act statements, the registration statement must be filed no later than 15 days before the expected effective date of the registration statement.

<sup>12</sup> See [Question 101.05](#) of the SEC's C&DIs on Securities Act Forms.



date (see [Section 12.1.5](#)). When a company files publicly for the first time, it must include all financial information required as of the public filing date.

### Example 12-1

A non-EGC calendar-year-end company submits a draft registration statement in December 20X7 and reasonably expects to file publicly for the first time in April 20X8 when annual financial statements for 20X7, 20X6, and 20X5 will be required. In such a case, the company may omit its 20X4 annual financial statements from its nonpublic draft registration statement because the 20X4 annual financial statements will not be required at the time of the first public filing. However, for either a confidential submission or public filing more than 45 days after the 20X7 year-end, audited 20X7 financial statements must be included because those financial statements will be required at the time of the first public filing and the company must comply with the staleness requirements discussed in [Section 12.1.5](#).

For non-EGCs, [Question 101.05](#) of the SEC's C&DIs on Securities Act Forms clarifies that when evaluating which interim periods to include in a draft registration statement, companies may omit interim financial information if they reasonably believe that they will not be required to separately present such information at the time they publicly file their registration statement. As a result, many initial draft registration statements may not need to include interim financial statements when they are submitted nonpublicly.

## 12.1.5 Age of Financial Statements

In accordance with SEC Regulation S-X, Rule 3-12, the financial statements in an IPO must meet certain age requirements as of each registration-statement filing date as well as when the registration is declared effective; otherwise, the financial statements will be considered "stale." In general, the financial statements in an IPO filing must not be more than 134 days old (i.e., the gap between the date of filing or effectiveness and the date of the latest balance sheet cannot be more than 134 days). However, third-quarter financial statements are considered timely through the 45th day after the most recent fiscal year-end, after which the audited financial statements for the most recent fiscal year are required. See [Section 1220](#) of the FRM for additional details.

The table below provides the dates on which financial statements become stale for a calendar-year-end company undertaking an IPO during 2023 or 2024. That is, financial statements for the respective financial statement period can be included in an IPO registration statement up to the dates listed below. When filing an IPO registration statement after these dates, an entity must update financial statements and other financial information to comply with the SEC's age requirements (i.e., an additional unaudited interim period or audited fiscal year would be required).

	<b>First Quarter Ended March 31 (Unaudited)</b>	<b>Second Quarter Ended June 30 (Unaudited)</b>	<b>Third Quarter Ended September 30 (Unaudited)</b>	<b>Fiscal Year Ended December 31 (Audited)</b>
Fiscal/calendar year 2023	August 14, 2023	November 13, 2023	February 14, 2024	May 13, 2024
Fiscal/calendar year 2024	August 12, 2024	November 12, 2024	February 14, 2025	May 14, 2025

## 12.2 Industry Issues

The sections below highlight accounting and disclosure issues commonly encountered by life sciences entities that are associated with IPOs. For more information as well as insights into topics not addressed below, see Deloitte’s Roadmaps *Initial Public Offerings* and *SEC Comment Letter Considerations, Including Industry Insights*.

### 12.2.1 Financial Statements of Businesses Acquired or to Be Acquired (Rule 3-05)

#### Example of an SEC Comment

We note that you consummated the [Company A] acquisition . . . but to date you have not filed audited financial statements of the acquired business or pro forma information relating to the acquisition. Please provide us with your calculations of the significance tests outlined in Rule 1-02(w) of Regulation S-X that you used in applying the requirements of Rule 3-05 and Article 11 of Regulation S-X.

As discussed in [Chapter 4](#), it is common for life sciences entities to engage in significant M&A activity. Therefore, registrants in the life sciences industry should be mindful of the SEC reporting requirements when they acquire, or it is probable that they will acquire, a business. This section provides a high-level summary of the SEC reporting requirements under SEC Regulation S-X, Rule 3-05 and Article 11. For more information about the application of these requirements, see Deloitte’s Roadmap *SEC Reporting Considerations for Business Acquisitions* (including [Section 2.12](#) of that Roadmap, which discusses how to apply these requirements in an IPO).

When a significant business acquisition is consummated, or it is probable that the acquisition will be consummated, the registrant may be required to file certain financial statements of the acquired business or to be acquired business (acquiree) in accordance with Rule 3-05. While existing registrants are subject to periodic reporting requirements for significant acquisitions,<sup>13</sup> a company is not subject to such requirements before an IPO. Therefore, in the context of an initial registration statement, a company must evaluate recent acquisitions, as further described below.

The following factors govern whether and, if so, for what period the acquiree’s financial statements are required for a consummated or probable acquisition:

- *Definition of a business* — Rule 3-05 applies to an acquisition of a business. The definition of a “business” for SEC reporting purposes differs from the definition under ASC 805 for U.S. GAAP purposes and focuses primarily on the continuity of revenue-producing activities.<sup>14</sup> Note that an acquisition can take many forms (i.e., acquisition of assets vs. acquisition of a legal entity) and that such forms typically will not affect the determination of whether the acquiree is a business.
- *When the acquisition was completed* — The acquiree’s financial statements are not required once the registrant’s audited financial statements reflect the operating results of the acquiree for at least:
  - Nine months if any of the results of the significance tests are greater than 20 percent but none are greater than 40 percent.

<sup>13</sup> Under Item 2.01 of Form 8-K, a registrant is required to file a Form 8-K to announce a significant business acquisition within four business days of consummation and to include the required financial statements and related pro forma financial information within 71 calendar days.

<sup>14</sup> SEC Regulation S-X, Rule 11-01(d), states, in part, “[T]he term business should be evaluated in light of the facts and circumstances involved and whether there is sufficient continuity of the acquired entity’s operations prior to and after the transactions so that disclosure of prior financial information is material to an understanding of future operations. A presumption exists that a separate entity, a subsidiary, or a division is a business.”

- A complete fiscal year if the results of any of the significance tests are greater than 40 percent.

As a result, acquisitions that occurred in the second or third back year of annual financial statements presented by the registrant will not need to be presented in separate preacquisition financial statements.

- *Significance* — The highest level of significance based on the following three tests is used to determine the financial statements, if any, that an entity is required to provide in the registration statement:
  - *Investment test* — The GAAP purchase price is compared with the total assets of the registrant on the basis of its most recent preacquisition annual financial statements. While the investment test stipulates the use of aggregate worldwide market value (AWMV) of the registrant's common equity (i.e., market capitalization) when available rather than total assets, companies undertaking an IPO would not yet have an observable AWMV and thus must use total assets. Once an entity completes its IPO, it should use its AWMV when performing the investment test. For example, if a registrant consummates an acquisition on March 15, 2023; completes its IPO on June 15, 2023; and consummates an acquisition on November 15, 2023, it should use total assets and AWMV to perform the investment test for the March and November acquisitions, respectively.
  - *Asset test* — The registrant's share of the acquiree's total assets is compared with the registrant's total assets on the basis of the most recent preacquisition annual financial statements of each company.
  - *Income test* — The income test consists of an income component and a revenue component:
    - *Income component* — The registrant's share of the acquiree's pretax income from continuing operations<sup>15</sup> is compared with the registrant's pretax income from continuing operations on the basis of the most recent preacquisition annual financial statements of each company.
    - *Revenue component* — If both the registrant and the acquiree have material revenue in each of the two most recently completed fiscal years, the revenue component is calculated by comparing the registrant's share of the acquiree's revenue with the registrant's revenue on the basis of the most recent preacquisition annual financial statements of each company. If either the registrant or the acquiree does not have material revenue for each of the two most recently completed fiscal years, only the income component should be used.

An acquiree will only be considered significant if both the income component and the revenue component (if applicable) exceed the significance threshold (i.e., 20 percent). When both components exceed the significance threshold, the lower of the two components is used to determine the number of periods for which the acquiree's financial statements are required.

Pro forma financial information is generally required under SEC rules if the acquiree is deemed to be significant. The significance tests in Rule 1-02(w) can be quite complex. Entities are advised to consult with their independent auditors and legal counsel when applying the tests in special circumstances.

<sup>15</sup> SEC Regulation S-X, Rule 1-02(w), indicates that pretax income from continuing operations is "consolidated income or loss from continuing operations before income taxes (after intercompany eliminations) attributable to the controlling interests."

### 12.2.1.1 Preacquisition Financial Statements Required

The table below summarizes whether preacquisition financial statements are required for an acquiree on the basis of the timing of the acquisition and the significance threshold.

Significance	Acquisition Closed Before the Most Recent Full Fiscal Year Presented	Acquisition Closed During the Most Recent Full Fiscal Year Presented	Acquisition Closed After the Most Recent Full Fiscal Year Presented	Probable Acquisition (Not Yet Consummated)
20 percent or less	No	No	No	No
Exceeds 20 percent but not 40 percent	No	If the acquisition closed during the first quarter, no; otherwise yes. See <a href="#">Section 12.2.1.2</a> for further details.	Yes. See <a href="#">Section 12.2.1.2</a> for further details.	No. See <a href="#">Section 12.2.1.3</a> for further details.
Exceeds 40 percent but not 50 percent	No	Yes. See <a href="#">Section 12.2.1.2</a> for further details.	Yes. See <a href="#">Section 12.2.1.2</a> for further details.	No. See <a href="#">Section 12.2.1.3</a> for further details.
Exceeds 50 percent	No	Yes	Yes	Yes

### 12.2.1.2 Grace Period

Financial statements of a significant acquired business that are not more than 50 percent significant (on the basis of any of the three tests) are not required in a registration statement that is filed or declared effective before the 75th day after the consummation of the acquisition. (See [paragraph 2040.1](#) of the FRM and the discussion of Company D in [Example 12-2](#).) However, these requirements may be accelerated if certain acquisitions are significant in the aggregate, as noted below.

### 12.2.1.3 Aggregate

Separate financial statements are generally not required for a significant probable acquisition whose significance does not exceed 50 percent or for a significant consummated acquisition whose significance does not exceed 50 percent within the grace period discussed above. However, an entity must perform an additional test to calculate the aggregate significance of (1) probable acquisitions whose significance does not exceed 50 percent, (2) consummated acquisitions within the grace period whose significance is greater than 20 percent but not greater than 50 percent, and (3) any individually insignificant (i.e., the significance does not exceed 20 percent) businesses acquired since the end of the registrant's most recently completed fiscal year presented.

The acquirees in all three of these categories are commonly referred to as individually insignificant acquirees, and if their aggregate significance exceeds 50 percent, the registration or proxy statement must include:

- The audited preacquisition financial statements for the most recent fiscal year and interim period for any acquirees in categories 1 and 2 above whose significance exceeds 20 percent and that have not yet been filed.
- Pro forma financial information to reflect the aggregate effects of all individually insignificant acquisitions (i.e., all three categories).

See [Section 2.9](#) of Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions* for more information. In addition, companies should consult with their independent auditors and legal counsel in such circumstances.

### **12.2.1.4 Periods of Preacquisition Financial Statements Required**

If preacquisition financial statements are required, the significance level is used to determine the periods as follows:

- Significance exceeds 20 percent but not 40 percent:
  - One year of audited preacquisition financial statements.
  - Interim financial statements (1) as of the acquiree's last fiscal quarter-end completed before the closing of the acquisition and (2) for the year-to-date interim period ending on that date.
- Significance exceeds 40 percent:
  - Two years of audited preacquisition financial statements.
  - Interim financial statements (1) as of the acquiree's last fiscal quarter-end completed before the closing of the acquisition, (2) for the year-to-date interim period ending on that date, and (3) for the corresponding year-to-date interim period in the prior year.

When the registrant's audited balance sheet is for a date after the consummation of the acquisition, the separate balance sheet(s) of the acquiree may be omitted, since the acquiree's balances are included in the acquiring company's balance sheet.

#### **Example 12-2**

Assume the following:

- Registrant A, a calendar-year-end company, is planning to file its initial registration statement on or around September 15, 20X6.
- Registrant A does not qualify as an EGC.
- Registrant A will include its historical financial statements for the following periods in its initial registration statement:
  - Audited balance sheets as of December 31, 20X5, and December 31, 20X4.
  - Audited statements of operations, comprehensive income, cash flows, and changes in stockholders' equity for each of the three years in the period ended December 31, 20X5.
  - Unaudited financial statements as of and for the periods ended June 30, 20X6, and June 30, 20X5.

**Example 12-2 (continued)**

Registrant A made the following acquisitions:

<b>Company</b>	<b>Acquisition Date</b>	<b>Highest Level of Significance</b>	<b>Years Required</b>	<b>Financial Statements Required<sup>16</sup></b>
B	December 15, 20X4	60%	N/A	Because the acquisition of Company B occurred before the most recent full fiscal year presented by Registrant A, B's preacquisition financial statements are not required.
C	January 15, 20X5	55%	2	Because Company C has not been included in A's audited results for a complete fiscal year, A must provide two years of preacquisition financial statements: C's financial statements as of and for the years ending December 31, 20X4, and December 31, 20X3.
D	July 15, 20X6	25%	1	While one year of audited financial statements will eventually be needed, as of the initial filing date, no financial statements of Company D are required on the basis of the accommodation for recently consummated business acquisitions, commonly referred to as the grace period, discussed in <a href="#">Section 12.2.1.2</a> . In any amendment to the IPO registration statement filed 75 or more days after the acquisition date of July 15, 20X6, audited financial statements as of and for the years ended December 31, 20X5, as well as unaudited interim information as of and for the six-month period ended June 30, 20X6, would be required. In addition, if Company A completes its IPO during the grace period, the required financial statements and pro forma financial information must be filed on Form 8-K within 75 days of the close of the acquisition.

## 12.2.2 Pro Forma Information

A registrant in an IPO may have consummated, or may be contemplating, a transaction in which presentation of pro forma financial information is required. The objective of providing pro forma financial information is to enable investors to understand and evaluate the continuing impact of a transaction (or a group of transactions) by showing how the transaction might have affected the historical financial position and results of operations of the registrant had it been consummated at an earlier date.

The requirements related to presentation and preparation of pro forma financial information are addressed in SEC Regulation S-X, Article 11. Article 11 prohibits presentation of pro forma information in the historical financial statements unless such disclosure is required by GAAP or IFRS Accounting Standards. Therefore, the pro forma presentation is often presented in a separate section in the registration statement. Note that the requirements for pro forma financial information under Article

<sup>16</sup> Assumes that all acquired companies are calendar-year-end companies and that the registrant is not using the accommodation to omit the acquiree's balance sheet, when applicable.

11 are separate and distinct from the requirements to present supplementary pro forma information for a business combination under ASC 805. For more information about the pro forma information disclosures that ASC 805 requires for a completed business combination, see [Section 12.2.2.6](#).

### **12.2.2.1 Circumstances in Which Presentation of Pro Forma Information Is Required**

Article 11 lists several circumstances in which a registrant may need to provide pro forma financial information. Such information is most commonly required when a significant business combination or a disposition of a significant portion of a business has occurred or is probable. As part of an IPO, corporate reorganizations, changes in capitalization, and the use of proceeds may be reflected in pro forma financial information; however, a registrant needs to consider whether any other significant events or transactions that have occurred or are probable would also be meaningful to investors on a pro forma basis. Factors that may affect whether a registrant needs to provide pro forma financial information in a registration statement include (1) whether the event or transaction is significant; (2) whether it is already reflected in the historical financial statements; (3) if the event has not yet occurred, whether it is probable; and (4) in the case of the acquisition of a business, whether the separate financial statements of the acquiree are included in the registration statement.

### **12.2.2.2 Basic Presentation Requirements**

Pro forma financial information, which is unaudited, typically includes an introductory paragraph, a pro forma balance sheet, pro forma income statement(s), and accompanying explanatory notes. The introductory paragraph briefly describes the transaction(s), the entities involved, the periods for which the pro forma financial information is presented, and any other information that may help readers understand the content of the pro forma information. The pro forma balance sheet and income statement are presented in a columnar format with separate columns for the registrant, the acquiree (in the case of a business combination), transaction accounting adjustments, autonomous entity adjustments, and pro forma totals. See below for more information about the types of pro forma adjustments. Further, each adjustment should include a reference to an explanatory note that clearly discusses the assumptions involved and how the adjustments are derived or calculated. In the limited cases in which only a few adjustments are required and those adjustments are easily understood, a registrant may include a narrative presentation of the pro forma effects of a transaction in lieu of full pro forma financial information.

### **12.2.2.3 Pro Forma Periods Presented**

A pro forma balance sheet is required as of the same date as the registrant's most recent balance sheet included in the IPO registration statement (i.e., one pro forma balance sheet as of the end of the fiscal year or the subsequent interim period, whichever is later). In the computation of pro forma balance sheet adjustments, it is assumed that the transaction was consummated on the balance sheet date. A pro forma balance sheet is not required if the transaction is already reflected in the historical balance sheet.

Pro forma income statements are required for both the registrant's most recent fiscal year and any subsequent year-to-date interim period included in the IPO registration statement. In the computation of pro forma income statement adjustments, it is assumed that the transaction was consummated at the beginning of the most recently completed fiscal year (and carried forward to the interim period, if presented). The SEC normally does not permit registrants to prepare pro forma information for more than one complete fiscal year. However, a registrant must provide pro forma information for all periods presented in its historical financial statements if the pro forma information reflects the impact of a transaction that must be revised retrospectively in the historical financial statements, such as a



discontinued operation or a reorganization of entities under common control. A pro forma income statement is not required if the transaction is included in the historical financial statements for the full period covered by the pro forma income statement.

#### **12.2.2.4 Pro Forma Adjustments**

There are two categories of required pro forma adjustments:

- *Transaction accounting adjustments* — These adjustments are limited to those that reflect the accounting for the transaction in accordance with U.S. GAAP or IFRS Accounting Standards, as applicable. For an acquisition, such adjustments may include, among other items, the recognition of goodwill and intangible assets and adjustments of assets and liabilities to fair value on the balance sheet, as well as the related impacts on the income statement, under the assumption that the balance sheet adjustments were made as of the beginning of the fiscal year presented. For dispositions, the adjustments may reflect the disposal of assets and related impacts. The SEC staff has also indicated that transaction accounting adjustments should generally be shown gross rather than net so that the reader can understand the nature and amount of each adjustment. Alternatively, a more detailed explanation of the components of the adjustments may be presented in the notes to the pro forma financial information. The transaction accounting adjustments should contain references to notes that clearly explain the assumptions involved and other relevant information for each adjustment.
- *Autonomous entity adjustments* — These adjustments, which are only required if the registrant was previously part of another entity, reflect incremental expense or other changes necessary to reflect the registrant's financial condition and results of operations as if it were a separate stand-alone entity. For example, if a public entity plans to distribute a portion of its business to shareholders as a separate public company (e.g., spin-off), the spinnee's pro forma financial statements must include autonomous entity adjustments to reflect the incremental costs expected to be incurred as if it were a separate stand-alone entity.

At the 2021 AICPA & CIMA Conference on Current SEC and PCAOB Developments, the SEC staff addressed considerations related to distinguishing between autonomous entity adjustments and management's adjustments (see following paragraph). The staff noted that changes to a spinnee's cost structure that are supported by a contractual arrangement may be considered autonomous entity adjustments (e.g., a new lease agreement, a transition services agreement with the former parent). By contrast, changes in spinnee costs that are not supported by contractual arrangements generally do not represent autonomous entity adjustments. However, such changes may represent synergies or dis-synergies that may be presented as management's adjustments if they meet the conditions in SEC Regulation S-X, Rule 11-02(a)(7).

In addition to requiring the adjustments noted above, the pro forma rules give registrants the flexibility to present, in the explanatory notes to the pro forma financial information, management's adjustments that reflect synergies and dis-synergies related to acquisitions and dispositions. Management's adjustments also may provide insight into the potential effects of an acquisition or disposition and the plans that management expects to take after a transaction (which may include forward-looking information).

Registrants must provide separate columns in their pro forma financial information for (1) historical financial information, (2) transaction accounting adjustments, and (3) autonomous entity adjustments, as well as a pro forma total, which would include pro forma EPS. In the notes to the pro forma financial information, a registrant must (1) clearly explain each adjustment and (2) detail any revenues, expenses, gains and losses, and related tax effects that will not recur in the registrant's income statement beyond a year from the transaction date.

Adjustments made to the pro forma income statement are not required to have a continuing (recurring) impact. Accordingly, a pro forma income statement must reflect both the recurring and nonrecurring effects of the transaction (e.g., transaction expenses, one-time compensation charges, and adjustments to inventory). In addition, it is not appropriate to include a transaction accounting adjustment to eliminate or omit the effects of nonrecurring items reflected in the historical financial statements. Rather, a registrant should separately disclose in a note to the pro forma financial statements the amounts associated with revenues, expenses, gains and losses, and related tax effects that will not recur in the income of the registrant more than 12 months after the transaction.

For additional discussion of pro forma financial statement requirements, see [Chapter 4](#) of Deloitte's Roadmap *SEC Reporting Considerations for Business Acquisitions*.

### 12.2.2.5 Other Common IPO Considerations Related to Pro Forma Information

In addition to the information discussed above, certain pro forma information may need to be included in specific situations, as discussed in [Section 3400](#) of the FRM. Such situations include distributions to owners under [SAB Topic 1.B.3](#), changes in capitalization at or before the closing of an IPO, and changes in corporate structure that result in a change in tax status. For more information about distributions to owners, changes in capitalization, and changes in corporate structure, see [Sections 5.6.1](#), [5.6.2](#), and [5.9.2](#), respectively, of Deloitte's Roadmap *Initial Public Offerings*. Changes in capitalization are further discussed in [Section 12.2.2.6](#) below.



#### Changing Lanes

Section 3400 of the FRM required a registrant to include certain pro forma disclosures in or alongside the historical financial statements in an IPO registration statement. SEC Regulation S-X, Rule 11-02(a)(12)(i) — as amended — states that a registrant must not “[p]resent pro forma financial information on the face of the registrant’s historical financial statements or in the accompanying notes, except where such presentation is required by U.S. GAAP or IFRS-IASB, as applicable.” The guidance in FRM Section 3400 on presenting such pro forma financial information has not yet been updated to reflect the amendments to Article 11. However, we understand that the SEC staff expects that disclosure giving pro forma effect to the transactions described in Section 3400 of the FRM would be provided elsewhere (i.e., outside of the financial statements) in the IPO registration statement.

### 12.2.2.6 Changes in Capitalization

The registration statement may need to include pro forma financial information related to changes in capitalization that occur around the same time as an IPO.

The SEC staff often asks registrants to present pro forma information when changes in capitalization will occur after the date of the latest balance sheet. [Paragraph 3430.2](#) of the FRM indicates that when such changes (1) will “result in a material **reduction** of permanent equity” or (2) result from “redemption of a material amount of equity securities . . . in conjunction with the offering,” a pro forma balance sheet should be included in the filing (presented alongside the historical balance sheet) that takes into account the change in capitalization but not the effects of the offering proceeds. As previously noted, Rule 11-02(a)(12) states that a registrant must not “[p]resent pro forma financial information on the face of the registrant’s historical financial statements or in the accompanying notes, except where such presentation is required by U.S. GAAP or IFRS-IASB, as applicable.” Accordingly, registrants should determine the appropriate location of the pro forma information, which might include summary financial information, the capitalization table, or separate unaudited pro forma financial information.

The conversion of preferred stock to common stock in conjunction with an IPO is not a **reduction** of permanent equity and therefore does not need to be included in the pro forma balance sheet (see paragraph 3430.2 of the FRM). However, many entities choose to reflect such a conversion in pro forma balance sheet information.

A prospective registrant should also present pro forma EPS when outstanding securities are or will be converted after the latest balance sheet date and this conversion will cause a material reduction in EPS (excluding the effects of the offering). The pro forma EPS should reflect the securities conversion but not the effects of the offering. Such pro forma EPS should be presented for the latest fiscal year and interim period presented in the registration statement.

### 12.2.3 Predecessor Financial Information

#### Example of an SEC Comment

We note that your historical results of operations for [the fiscal year] do not include the results of [Entity A] prior to [its] acquisition . . . . Based on the significance of [A] prior to the acquisition, it appears that [A] is a predecessor to the registrant. Please expand the disclosure in Selected Financial Data to provide predecessor financial information, pro forma financial information using the guidance in Article 11 of Regulation S-X . . . . Also revise the presentation in MD&A and elsewhere in the document.

If a registrant has not had substantive operations for all periods presented in an IPO registration statement, it is important to consider whether the registrant has a “predecessor” company or business.

**Section 1170** of the FRM indicates that the designation of an acquired business as a predecessor is based on both of the following criteria:

- The registrant “succeeds to substantially all of the business (or a separately identifiable line of business) of another entity (or group of entities).”
- The “registrant’s own operations before the succession appear insignificant relative to the operations assumed or acquired.”

A predecessor’s historical financial information is considered important to an investing decision. As a result, the registrant’s financial statements and those of its predecessor must be presented in the IPO registration statement and together should typically cover all periods required by SEC Regulation S-X, with no lapse in audited periods. Further, the predecessor financial statements must be audited in accordance with PCAOB, not solely AICPA, standards and will be required not only in the IPO but also in subsequent periodic reports.

The SEC staff believes that when a newly formed company (i.e., a “newco”) is formed to acquire multiple entities in conjunction with an IPO, instances in which there is no predecessor would generally be rare, even if the newco is substantive and was deemed the accounting acquirer. The staff highlighted a number of factors for registrants to consider in determining the predecessor, including (but not limited to) (1) the order in which the entities are acquired, (2) the size of the entities, (3) the fair value of the entities, and (4) the historical and ongoing management structure. No one item is determinative on its own. In addition, the staff has encouraged registrants to evaluate their determination of predecessors in light of how management intends to discuss its business in the IPO registration statement as well as whether financial information in its subsequent Forms 10-K would provide sufficient information to investors.<sup>17</sup> The staff noted that while there may be situations in which more than one predecessor

<sup>17</sup> If a business is not identified as a predecessor, it would generally be evaluated under SEC Regulation S-X, Rule 3-05. Therefore, in an IPO registration statement, the financial statements of nonpredecessor entities may be provided under Rule 3-05. However, for subsequent Forms 10-K, only the financial statements of the registrant and its predecessor(s) would be required.

exists, it would be rare for no predecessor to be identified unless the registrant is a start-up business. Carve-out entities and entities in roll-up transactions frequently meet the criteria to be identified as predecessors.

## 12.2.4 Share-Based Compensation Valuation

An entity that is preparing for an IPO may have a share-based compensation strategy designed to retain and attract employees and nonemployees. Share-based compensation often is in the form of stock options, stock appreciation rights, restricted stock, restricted stock units, or an employee stock purchase plan (ESPP). In addition, an entity may use share-based compensation to purchase goods, IP, or services from third-party vendors or service providers. Management should consider the financial reporting implications associated with each of the various types of share-based compensation arrangements that an entity may enter into with employees and nonemployees.

ASC 718 applies to all share-based payment arrangements related to the acquisition of goods and services from employees and nonemployees. Therefore, most of the guidance in ASC 718 on employee share-based payments, including most of its requirements related to classification and measurement, applies to nonemployee share-based payment arrangements. However, it is still important to determine whether the counterparty (i.e., the grantee) is an employee or a nonemployee since there are certain differences in the respective guidance (see [Chapter 9](#) of Deloitte's Roadmap *Share-Based Payment Awards* for additional considerations specific to nonemployee awards).

As a reminder, share-based payment awards accounted for under ASC 718 must be either (1) settled by issuing the entity's equity shares or other equity instruments or (2) indexed, at least in part, to the value of the entity's equity shares or other equity instruments. Generally, equity-classified share-based payment awards are measured by using a fair-value-based measure on their grant date. Liability-classified share-based payment awards are also generally measured by using a fair-value-based measure; however, they are remeasured in each subsequent reporting period until settlement. The fair-value-based measure for share-based payment awards is recognized over the requisite service period, which often is the vesting period.

One of the most significant inputs related to measuring share-based compensation is the underlying valuation of the entity's shares. A pre-IPO entity should become familiar with the U.S. GAAP and SEC valuation requirements, including differences between valuation methods for public entities and those for nonpublic entities. The sections below summarize some of the more significant considerations related to share-based compensation for an entity contemplating an IPO.

ASC 718 identifies three ways for nonpublic entities to measure share-based compensation awards (the terms below are defined in ASC 718-20):

- By using fair value, which is the "amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale."
- By using a calculated value, which is a "measure of the value of a [stock] option or similar instrument determined by substituting the historical volatility of an appropriate industry sector index for the expected volatility of a nonpublic entity's share price in an option-pricing model."
- By using intrinsic value, which is the "amount by which the fair value of the underlying stock exceeds the exercise price of an option" or similar instrument.

### 12.2.4.1 Fair-Value-Based Measurement

Nonpublic entities should make an effort to value their equity-classified awards by using a fair-value-based measure. A nonpublic entity may look to recent sales of its common stock directly to investors or common-stock transactions in secondary markets. However, observable market prices for a nonpublic entity's equity shares may not exist. In such an instance, a nonpublic entity could apply many of the principles of ASC 820 to determine the fair value of its common stock, often by using either a market approach or an income approach (or both). A “top-down method” may be applied, which involves first valuing the entity, then subtracting the fair value of debt, and then using the resulting equity valuation as a basis for allocating the equity value among the entity's equity securities. While not authoritative, the AICPA Accounting and Valuation Guide *Valuation of Privately-Held-Company Equity Securities Issued as Compensation* (the “Cheap Stock Guide”) emphasizes the importance of contemporaneous valuations from independent valuation specialists for determining the fair value of equity securities.



#### Changing Lanes

In October 2021, the FASB issued [ASU 2021-07](#), which allows nonpublic entities to use, as a practical expedient, “the reasonable application of a reasonable valuation method” to determine the current price input of equity-classified share-based payment awards issued to both employees and nonemployees. The ASU notes that a valuation performed in accordance with specified U.S. Treasury regulations related to IRC Section 409A is an example of a reasonable valuation method under the practical expedient. The ASU also explicitly refers to other valuation approaches under IRC Section 409A that are presumed to be reasonable. The guidance in ASU 2021-07 is effective for nonpublic entities for fiscal years beginning after December 15, 2021, and interim periods within fiscal years beginning after December 15, 2022. Entities must apply the ASU's provisions prospectively and may early adopt them for interim and annual financial statements that have not yet been issued or made available for issuance as of October 25, 2021.

As discussed in [Sections 12.2.4.2](#) and [12.2.4.3](#), under ASC 718, nonpublic entities can apply other practical expedients related to the use of the calculated value and intrinsic value. In [SAB Topic 14.B](#), the SEC staff provides transition guidance for entities that elect those practical expedients and are changing from nonpublic-entity to public-entity status (see [Section 12.2.4.7](#)). However, there is no similar transition guidance in ASU 2021-07 on the use of the practical expedient. Therefore, an entity that no longer meets the criteria to be a nonpublic entity would have to reverse the practical expedient's effect in its historical financial statements. Consequently, before electing the practical expedient in ASU 2021-07, nonpublic entities that could become public entities should carefully consider the potential future costs of having to perform such a reversal.

See Deloitte's October 26, 2021, [Heads Up](#) for additional information about the ASU, including its effective dates.

### 12.2.4.2 Calculated Value

When stock options or similar instruments are granted by a nonpublic entity, the entity should try to use a fair-value-based measure to value those equity-classified awards. However, in certain instances, a nonpublic entity may not be able to reasonably estimate the fair-value-based measure of its options and similar instruments because it is not practicable for the entity to estimate the expected volatility of its share price. In these cases, the nonpublic entity should substitute the historical volatility of an appropriate industry sector index for the expected volatility of its own share price. In assessing whether

it is practicable to estimate the expected volatility of its own share price, the entity should consider the following factors:

- Whether the entity has an internal market for its shares (e.g., investors or grantees can purchase and sell shares).
- Previous issuances of equity in a private transaction or convertible debt provide indications of the historical or implied volatility of the entity's share price.
- Whether there are similarly sized public entities (including those within an index) in the same industry whose historical or implied volatilities could be used as a substitute for the nonpublic entity's expected volatility.

If, after considering the relevant factors, the nonpublic entity determines that estimating the expected volatility of its own share price is not practicable, it should use the historical volatility of an appropriate industry sector index as a substitute in estimating the fair-value-based measure of its awards.

An appropriate industry sector index would be one that is narrow enough to reflect the nonpublic entity's nature and size (if possible). For example, the use of the New York Stock Exchange Arca Pharmaceutical Index is not an appropriate industry sector index for a small nonpublic biotechnology development entity because it represents neither the industry in which the nonpublic entity operates nor the size of the entity. The volatility of an index of smaller biotechnology companies would be a more appropriate substitute for the entity's expected volatility of its own share price.

Under ASC 718-10-55-58, an entity that uses an industry sector index to determine the expected volatility of its own share price must use the index's historical volatility (rather than its implied volatility). However, ASC 718-10-55-56 states, in part, that “in **no** circumstances shall a nonpublic entity use a broad-based market index like the S&P 500, Russell 3000, or Dow Jones Wilshire 5000” (emphasis added).

A nonpublic entity's conclusion that estimating the expected volatility of its own share price is not practicable may be subject to scrutiny. Typically, a nonpublic entity that can identify an appropriate industry sector index (1) would be able to identify similar entities from the selected index to estimate the expected volatility of its own share price and (2) would therefore be required to use the fair-value-based measurement method.

In measuring awards, a nonpublic entity should switch from using a calculated value to using a fair-value-based measure when it (1) can subsequently estimate the expected volatility of its own share price or (2) becomes a public entity. ASC 718-10-55-27 states, in part, that the “valuation technique an entity selects [should] be used consistently and [should] not be changed unless a different valuation technique is expected to produce a better estimate” of a fair-value-based measure (or, in this case, a change to a fair-value-based measure). The guidance goes on to state that a change in valuation technique should be accounted for as a change in accounting estimate under ASC 250 and should be applied prospectively to new awards.<sup>18</sup> Therefore, for existing equity-classified awards (i.e., unvested equity awards that were granted before an entity switched from the calculated value method to a fair-value-based measure), an entity would continue to recognize compensation cost on the basis of the calculated value determined as of the grant date unless the award is subsequently modified. An entity should use the fair-value-based method to measure all awards granted after it switches from the calculated value method.

<sup>18</sup> A nonpublic entity's use of calculated value does not represent an accounting policy election, since a nonpublic entity must use calculated value to measure its awards if it is not practicable for the entity to estimate the expected volatility of its share price. Thus, once an entity is able to estimate the expected volatility of its own share price or it becomes a public entity, the entity should switch from using a calculated value to using a fair-value-based measure and should account for the change as a change in accounting estimate under ASC 250.



ASC 718-20-55-76 through 55-83 provide an example of when it may be appropriate for a nonpublic entity to use the calculated value method.

### 12.2.4.3 *Intrinsic Value*

Nonpublic entities can make a policy election to measure all liability-classified awards (not including awards determined to be consideration payable to a customer under ASC 606) at intrinsic value (instead of at their fair-value-based measure or calculated value) as of the end of each reporting period until the award is settled.

However, when an entity wants to change its accounting principle under ASC 250, it is preferable for the entity to use the fair-value-based method to justify such a change. Therefore, a nonpublic entity that has elected to measure its liability-classified awards at a fair-value-based measure (or calculated value) would not be permitted to subsequently change to the intrinsic-value method.

ASC 718-30-55-12 through 55-20 illustrate the application of the intrinsic value method for liability-classified awards granted by a nonpublic entity.

### 12.2.4.4 *Cheap Stock*

#### Examples of SEC Comments

- Please tell us the estimated IPO price range. To the extent there is a significant difference between the estimated grant-date fair value of your common stock during the past twelve months and the estimated IPO price, please discuss for us each significant factor contributing to the difference.
- Please disclose the dates and fair values for the third-party valuations of your common stock during the periods presented. Clarify the estimated common stock price at the time of the . . . options issuance and explain to us how it relates to the share price in the . . . convertible preferred stock financing. Once you have an estimated offering price or range, please explain to us the reasons for any differences between the recent valuations of your common stock leading up to the IPO and the estimated offering price. This information will help facilitate our review of your accounting for equity issuances including stock compensation and beneficial conversion features.

The SEC often focuses on “cheap stock”<sup>19</sup> issues in connection with a nonpublic entity’s preparation for an IPO. The SEC staff is interested in the rationale for any difference between the fair value measurements of the underlying common stock of share-based payment awards and the anticipated IPO price. In addition, the SEC staff will challenge valuations that are significantly lower than prices paid by investors to acquire similar stock. If the differences cannot be reconciled, a nonpublic entity may be required to record a cheap-stock charge. Since share-based payments are often a compensation tool to attract and retain employees or nonemployees, a cheap-stock charge could be material and, in some cases, lead to a restatement of the financial statements.

An entity preparing for an IPO should refer to [paragraph 7520.1](#) of the FRM, which outlines considerations that registrants should take into account when the “estimated fair value of the stock is substantially below the IPO price.” In such situations, registrants should be able to reconcile the change in the estimated fair value of the underlying equity between the award grant date and the IPO by taking into account, among other things, intervening events and changes in assumptions that support the change in fair value.

<sup>19</sup> Cheap stock refers to issuances of equity securities before an IPO in which the value of the shares is below the IPO price.



The SEC staff has frequently inquired about a registrant's pre-IPO valuations. Specifically, during the registration statement process, the SEC staff may ask an entity to (1) reconcile its recent fair values with the anticipated IPO price (including significant intervening events), (2) describe its valuation methods, (3) justify its significant valuation assumptions, and (4) discuss the weight it gives to stock sale transactions. We encourage entities planning an IPO in the foreseeable future to use the [Cheap Stock Guide](#) and to consult with their valuation specialists. Further, such entities should ensure that their pre-IPO valuations are appropriate and that they are prepared to respond to questions the SEC may have during the registration statement process.

The Cheap Stock Guide highlights differences between pre-IPO and post-IPO valuations. One significant difference is that the valuation of nonpublic-entity securities often includes a discount for lack of marketability (DLOM). The DLOM can be determined by using several valuation techniques and is significantly affected by the underlying volatility of the stock and the period in which the stock is illiquid.

In addition to considerations related to cheap stock, entities commonly face issues caused by obtaining independent valuations infrequently, because the dates of those valuations do not always coincide with the grant dates for share-based payment awards. As a result, management will need to assess the current fair value of the underlying shares as of the grant date. Further, an entity could evaluate the use of an interpolation or extrapolation framework to estimate the fair value of the underlying shares when equity is granted (1) on dates between two independent valuations or (2) after the date of an independent valuation. For details on interpolation and extrapolation methods, including examples, see [Section 4.12.4](#) of Deloitte's Roadmap [Share-Based Payment Awards](#).

#### **12.2.4.5 ISOs, NQSOs, and IRC Section 409A**

When granting share-based payment awards, a nonpublic entity should be mindful of the tax treatment of such awards and the related implications. IRC Section 409A contains requirements related to nonqualified deferred compensation plans that can affect the taxability of holders of share-based payment awards. If a nonqualified deferred compensation plan (e.g., one issued in the form of share-based payments) fails to comply with certain IRC rules, the tax implications and penalties at the federal level (and potentially the state level) can be significant for holders.

Under U.S. tax law, stock option awards can generally be categorized into two groups:

- Statutory options, including incentive stock options (ISOs) and ESPPs that are qualified under IRC Sections 422 and 423, respectively. The exercise of an ISO or a qualified ESPP does not result in a tax deduction for the issuing entity unless the employee or former employee makes a disqualifying disposition. While an ISO may result in favorable tax treatment for the recipient, certain eligibility conditions must be met.
- Nonstatutory options, also known as nonqualified stock options (NQSOs or NSOs). The exercise of an NQSO results in a tax deduction for the issuing entity that is equal to the intrinsic value of the option when exercised.

The ISOs and ESPPs described in IRC Sections 422 and 423, respectively, are specifically exempt from the requirements of IRC Section 409A. Other NQSOs are outside the scope of IRC Section 409A if certain requirements are met. One significant requirement is that the exercise price must not be below the fair market value of the underlying stock as of the grant date. Accordingly, it is imperative to establish a supportable fair market value of the stock to avoid unintended tax consequences for the issuer and holder. While IRC Section 409A also applies to public entities, the valuation of share-based payment awards for such entities is subject to less scrutiny because the market prices of their shares are

generally observable. Among other details, entities should understand (1) which of their compensation plans and awards are subject to the provisions of IRC Section 409A and (2) how they can ensure that those plans and awards remain compliant with IRC Section 409A and thereby avoid unintended tax consequences of noncompliance.

In addition, when recognizing compensation cost, many nonpublic entities use IRC Section 409A assessments to value share-based payments. Because those assessments are used for tax purposes, nonpublic entities should carefully consider whether they are also appropriate for measuring share-based payment awards under ASC 718.

See [Chapter 10](#) of Deloitte's Roadmap *Income Taxes* for a discussion of the income tax effects of share-based payments.

#### **12.2.4.6 Considerations Related to "Spring-Loaded" Awards**

In November 2021, the SEC staff issued [SAB 120](#), which provides the SEC staff's views on the measurement and disclosure of certain share-based payment awards granted when entities possess material nonpublic information (i.e., "spring-loaded" awards).

In SAB 120, the SEC staff describes a spring-loaded award as follows:

A share-based payment award granted when a company is in possession of material nonpublic information to which the market is likely to react positively when the information is announced is sometimes referred to as being "spring-loaded."

SAB 120 amends [SAB Topic 14.D](#) to add considerations related to spring-loaded awards. Under SAB 120, when an entity enters into a share-based payment arrangement in contemplation of or shortly before a planned release of material nonpublic information that is expected to result in a material increase in the entity's share price, the entity should consider whether adjustments to either of the following are appropriate in determining the fair-value-based measure of the award:

- The current price of the underlying share.
- The expected volatility of the price of the underlying share for the expected term of the share-based payment award.

See Deloitte's December 3, 2021, [Financial Reporting Alert](#) for additional information about SAB 120.

#### **12.2.4.7 Transition From Nonpublic-Entity to Public-Entity Status**

The measurement alternatives available to a nonpublic entity (calculated value and intrinsic value) are no longer appropriate once the entity is considered a public entity.<sup>20</sup> In addition, public entities use the expected-term practical expedient (for determining the expected term of certain options and similar instruments) differently than nonpublic entities. To estimate the expected term as a midpoint between the requisite service period and the contractual term of an award, entities will need to comply with the requirements of the SEC's simplified method (see [Section 4.9.2.2.2](#) of Deloitte's Roadmap *Share-Based Payment Awards*).

<sup>20</sup> The definition of a "public entity" in ASC 718 includes an entity that "[m]akes a filing with a regulatory agency in preparation for the sale of any class of equity securities in a public market." The definition therefore includes an entity that has filed its initial registration statement with the SEC before the effective date of an IPO.

In [SAB Topic 14.B](#), the SEC discusses various transition issues associated with the valuation of share-based payment awards related to an entity that becomes a public entity (e.g., when the entity files its initial registration statement with the SEC), including the following:

- If a nonpublic entity historically measured equity-classified share-based payment awards at their calculated value, the newly public entity should continue to use that approach for share-based payment awards granted before the date on which it becomes a public entity unless those awards are subsequently modified, repurchased, or canceled, in which case the entity would assess the event under the public-company provisions of ASC 718.
- If a nonpublic entity historically measured liability-classified share-based payment awards on the basis of their intrinsic value and the awards are still outstanding, the newly public entity should measure those liability awards at a fair-value-based measurement upon becoming a public entity.
- Upon becoming a public entity, the entity is prohibited from retrospectively applying the fair-value-based measurement to its awards if it used calculated value or intrinsic value before the date it became a public entity.
- Upon becoming a public entity, the entity should clearly describe in its MD&A the change in accounting policy that will be required by ASC 718 in subsequent periods and any reasonably likely material future effects of the change.

SAB Topic 14 does not provide transition guidance for entities that are changing from nonpublic to public status and have applied the practical expedient under ASU 2021-07 for determining the current price of their underlying shares (see [Section 4.13.1.3](#) of Deloitte's Roadmap [Share-Based Payment Awards](#)). Thus, an entity that no longer meets the criteria to be a nonpublic entity would have to reverse the effect of this practical expedient in its historical financial statements.

In addition, the SEC's guidance does not address how an entity should account for a change from the intrinsic value method for measuring liability-classified awards to the fair-value-based method. In informal discussions, the SEC staff indicated that it would be acceptable to record the effect of such a change as compensation cost in the current period or to record it as the cumulative effect of a change in accounting principle in accordance with ASC 250. While the preferred approach is to treat the effect of the change as a change in accounting principle under ASC 250, with the cumulative effect of the change recorded accordingly, recording it as compensation cost is not objectionable given the SEC's position. Under either approach, entities' financial statements should include the appropriate disclosures.

ASC 250-10-45-5 states, in part, that an "entity shall report a change in accounting principle through retrospective application of the new accounting principle to all prior periods, unless it is impracticable to do so." Retrospective application of the effects of a change from intrinsic value to fair value would be impracticable because objectively determining the assumptions an entity would have used for the prior periods would be difficult without the use of hindsight. Therefore, the change would be recorded as a cumulative-effect adjustment to retained earnings and applied prospectively, as discussed in ASC 250-10-45-6 and 45-7. This conclusion is consistent with the guidance in SAB Topic 14.B that states that entities changing from nonpublic to public status are not permitted to apply the fair-value-based method retrospectively.

### 12.2.4.8 Valuation Assumptions — Expected Term

#### Example of an SEC Comment

Please more fully explain to us why you believe it is appropriate to use the simplified method to estimate the expected life of your stock options. Please also tell us when you expect sufficient historical information to be available to you to determine expected life assumptions and address the impact that your current approach has had on your financial statements. Refer to SAB Topic 14.D.2.

ASC 718-10-55-30 states, in part:

The expected term of an employee share option or similar instrument is the period of time for which the instrument is expected to be outstanding (that is, the period of time from the service inception date to the date of expected exercise or other expected settlement).

Although ASC 718 does not specify a method for estimating the expected term of an award, such a method must be objectively supportable. Similarly, historical observations should be accompanied by information about why future observations are not expected to change, and any adjustments to these observations should be supported by objective data. ASC 718-10-55-31 identifies the following factors that an entity may consider in estimating the expected term of an award:

- *The vesting period of the award* — Options generally cannot be exercised before vesting; thus, an option's expected term cannot be less than its vesting period.
- *Historical exercise and postvesting employment termination behavior for similar grants* — Historical experience should be an entity's starting point for determining expectations of future exercise and postvesting termination behavior. Historical exercise patterns should be modified when current information suggests that future behavior will differ from past behavior. For example, rapid increases in an entity's stock price after the release of a new product in the past could have caused more grantees to exercise their options as soon as the options vested. If a similar increase in the entity's stock price is not expected, the entity should consider whether adjusting the historical exercise patterns is appropriate.
- *Expected volatility of the underlying share price* — An increase in the volatility of the underlying share price tends to result in an increase in exercise activity because more grantees take advantage of increases in an entity's share price to realize potential gains on the exercise of the option and subsequent sale of the underlying shares. ASC 718-10-55-31(c) states, "An entity also might consider whether the evolution of the share price affects [a grantee's] exercise behavior (for example, [a grantee] may be more likely to exercise a share option shortly after it becomes in-the-money if the option had been out-of-the-money for a long period of time)." The exercise behavior based on the evolution of an entity's share price can be more easily incorporated into a lattice model than into a closed-form model.
- *Blackout periods* — A blackout period is a period during which exercise of an option is contractually or legally prohibited. Blackout periods and other arrangements that affect the exercise behavior associated with options can be included in a lattice model. Unlike a closed-form model, a lattice model can be used to calculate the expected term of an option by taking into account restrictions on exercises and other postvesting exercise behavior.
- *Employees' ages, lengths of service, and home jurisdictions* — Historical exercise information could have been affected by the profile of the employee group. For example, during a bull market, some entities are more likely to have greater turnover of employees since more opportunities are available. Many such employees will exercise their options as early as possible. These historical exercise patterns should be adjusted if similar turnover rates are not expected to recur in the future.

If historical exercise and postvesting employment termination behavior are not readily available or do not provide a reasonable basis on which to estimate the expected term, alternative sources of information may be used. For example, an entity may use a lattice model to estimate the expected term (the expected term is not an input in the lattice model but rather is inferred on the basis of the output of the lattice model). In addition, an entity may consider using other relevant and supportable information such as industry averages or published academic research. When an entity takes external peer group information into account, there should be evidence that such information has been sourced from entities with comparable facts and circumstances. Further, entities may use practical expedients to estimate the expected term for certain awards. Questions 5 and 6 of [SAB Topic 14.D.2](#) note that if a public entity concludes that “its historical share option exercise experience does not provide a reasonable basis upon which to estimate expected term,” the entity may use what the SEC staff describes as a “simplified method” to develop the expected-term estimate. Under the simplified method, the public entity uses an average of the vesting term and the original contractual term of an award. The method applies only to awards that qualify as “plain-vanilla” options.

As stated in SAB Topic 14.D.2, a share-based payment award must possess all of the following characteristics to qualify as a plain-vanilla option:

- “The share options are granted at-the-money.”
- “Exercisability is conditional only on performing service through the vesting date” (i.e., the requisite service period equals the vesting period).
- “If an employee terminates service prior to vesting, the employee would forfeit the share options.”
- “If an employee terminates service after vesting, the employee would have a limited time to exercise the share options (typically 30–90 days).”
- “The share options are nontransferable and nonhedgeable.”

If an award has a performance or market condition, it would not be considered a plain-vanilla option. Entities should evaluate all awards to determine whether they qualify as plain-vanilla options.

As discussed above, an entity measures stock options under ASC 718 by using an expected term that takes into account the effects of grantees’ expected exercise and postvesting behavior. However, determining an expected term for nonemployee awards could be challenging because entities may not have sufficient historical data related to the early exercise behavior of nonemployees, particularly if nonemployee awards are not frequently granted. In addition, nonemployee stock option awards may not be exercised before the end of the contractual term if they do not contain certain features typically found in employee stock option awards (e.g., nontransferability, nonhedgeability, and truncation of the contractual term because of postvesting service termination). Accordingly, ASC 718 allows an entity to elect on an award-by-award basis to use the contractual term as the expected term for nonemployee awards. If an entity elects not to use the contractual term for a particular award, the entity must estimate the expected term. However, a nonpublic entity can make an accounting policy election to apply a practical expedient to estimate the expected term for awards that meet the conditions in ASC 718-10-30-20B (see discussion in [Section 9.4.2.1](#) of Deloitte’s Roadmap [Share-Based Payment Awards](#)). In accordance with ASC 718-10-55-29A, if an entity does not elect to use the contractual term as the expected term for a particular award and, for a nonpublic entity, does not apply the practical expedient to estimate the expected term, the entity should consider factors similar to those in ASC 718-10-55-29 when estimating the expected term for nonemployee awards.

The SEC staff believes that public entities should stop using the simplified method for stock option grants if more detailed external information about exercise behavior becomes available. In addition, the staff issues comments related to the use of the simplified method and, in certain instances, registrants have been asked to explain why they believe that they were unable to reasonably estimate the expected term on the basis of their historical stock option exercise information.

In accordance with the SEC staff's guidance in Question 6 of SAB Topic 14.D.2, a registrant that uses the simplified method should disclose in the notes to its financial statements (1) that the simplified method was used, (2) the reason the method was used, (3) the types of stock option grants for which the simplified method was used if it was not used for all stock option grants, and (4) the period(s) for which the simplified method was used if it was not used in all periods presented.

### 12.2.4.9 Valuation Assumptions — Expected Volatility

#### Example of an SEC Comment

We note that the expected volatility of your Class A common stock is based on a peer group in the industry in which the Company does business. Please tell us what consideration you gave to using the Company's historical pricing data in arriving at a volatility assumption. In addition, tell us what consideration you gave to disclosing the reason for the continued reliance on a peer group in the industry in arriving at this assumption. We refer you to ASC 718-10-55-37 and SAB Topic 14.D.1.

ASC 718-10-55-36 states, in part:

Volatility is a measure of the amount by which a financial variable, such as share price, has fluctuated (historical volatility) or is expected to fluctuate (expected volatility) during a period. Option-pricing models require expected volatility as an assumption because an option's value is dependent on potential share returns over the option's term. The higher the volatility, the more the returns on the shares can be expected to vary — up or down.

ASC 718 does not require entities to use a single method for estimating the expected volatility of the underlying share price; rather, ASC 718-10-55-35 states that the objective of estimating such volatility is “to determine the assumption about expected volatility that marketplace participants would be likely to use in determining an exchange price for an option.” ASC 718-10-55-37 lists factors that entities would consider in estimating the expected volatility of the underlying share price. The method selected to perform the estimation should be applied consistently from period to period, and entities should adjust the factors or assign more weight to an individual factor only on the basis of objective information that supports such adjustments. The Interpretive Response to Question 1 of [SAB Topic 14.D.1](#) notes that entities should incorporate into the estimate any relevant new or different information that would be useful. Further, they should “make good faith efforts to identify and use sufficient information in determining whether taking historical volatility, implied volatility or a combination of both into account will result in the best estimate of expected volatility” of the underlying share price.



Entities would consider the following factors in estimating expected volatility:

- *Historical volatility of the underlying share price* — Entities typically value stock options by using the historical volatility of the underlying share price. Under a closed-form model, such volatility is based on the most recent volatility of the share price over the expected term of the option; under a lattice model, it is based on the contractual term. ASC 718-10-55-37(a) states that an entity may disregard the volatility of the share price for an identifiable period if the volatility resulted from a condition (e.g., a failed takeover bid) specific to the entity and the condition “is not expected to recur during the expected or contractual term.” If the condition is not specific to the entity (e.g., general market declines), the entity generally would not be allowed to disregard or place less weight on the volatility of its share price during that period unless objectively verifiable evidence supports the expectation that market volatility will revert to a mean that will differ materially from the volatility during the specified period. The SEC staff believes that an entity’s decision to disregard a period of historical volatility should be based on one or more discrete and specific historical events that are not expected to occur again during the term of the option. In addition, the entity should not give recent periods more weight than earlier periods.

In certain circumstances, an entity may rely exclusively on historical volatility. However, because the objective of estimating expected volatility is to ascertain the assumptions that marketplace participants are likely to use, exclusive reliance may not be appropriate if there are future events that could reasonably affect expected volatility (e.g., a future merger that was recently announced).

In addition, an entity that is valuing a spring-loaded award would consider whether it should factor material nonpublic information into its determination of historical volatility.

- *Implied volatility of the underlying share price* — The implied volatility of the underlying share price is not the same as the historical volatility of the underlying share price because it is derived from the market prices of an entity’s traded options or other traded financial instruments with option-like features and not from the entity’s own shares. Entities can use the Black-Scholes-Merton formula to calculate implied volatility by including the fair value of the option (i.e., the market price of the traded option) and other inputs (stock price, exercise price, expected term, dividend rate, and risk-free interest rate) in the calculation and solving for volatility. When valuing employee or nonemployee stock options, entities should carefully consider whether the implied volatility of a traded option is an appropriate basis for the expected volatility of the underlying share price. For example, traded options usually have much shorter terms than employee or nonemployee stock options, and the calculated implied volatility may not take into account the possibility of mean reversion. To compensate for mean reversion, entities use statistical tools for calculating a long-term implied volatility. For example, entities with traded options whose terms range from 2 to 12 months can plot the volatility of these options on a curve and use statistical tools to plot a long-term implied volatility for a traded option with an expected or a contractual term equal to an employee or nonemployee stock option.

Generally, entities that can observe sufficiently extensive trading of options and can therefore plot an accurate long-term implied volatility curve should place greater weight on implied volatility than on the historical volatility of their own share price (particularly if they do not meet the SEC’s conditions for relying exclusively on historical volatility). That is, a traded option’s volatility is more informative in the determination of expected volatility of an entity’s stock price than historical stock price volatility, since option prices take into account the option trader’s forecasts of future stock price volatility. In determining the extent of reliance on implied volatility, an entity should consider the volume of trading in its traded options and its underlying shares,



the ability to synchronize the variables used to derive implied volatility (as close to the grant date of employee and nonemployee stock options as reasonably practicable), the similarity of the exercise prices of its traded options to its employee or nonemployee stock options, and the length of the terms of its traded options and employee or nonemployee stock options. In addition, an entity that is valuing a spring-loaded award would consider whether material nonpublic information affects the extent of reliance on implied volatility when estimating the expected volatility.

- *Limitations on availability of historical data* — Public entities should compare the length of time an entity's shares have been publicly traded with the expected or contractual term of the option. A newly public entity may also consider the expected volatility of the share prices of similar public entities. In determining comparable public entities, the newly public entity would consider factors such as industry, stage of life cycle, size, and financial leverage.

Nonpublic entities may also base the expected volatility of their share prices on the expected volatility of similar public entities' share prices, and they may consider the same factors as those described above for a newly public entity. When a nonpublic entity is unable to reasonably estimate its entity-specific volatility or that of similar public entities, it may use a calculated value.

- *Data intervals* — An entity that considers the historical volatility of its share price when estimating the expected volatility of its share price should use intervals for price observations that (1) are appropriate on the basis of its facts and circumstances (e.g., given the frequency of its trades and the length of its trading history) and (2) provide a basis for a reasonable estimate of a fair-value-based measure. Daily, weekly, or monthly price observations may be sufficient; however, if an entity's shares are thinly traded, weekly or monthly price observations may be more appropriate than daily price observations.
- *Changes in corporate and capital structure* — An entity's corporate and capital structure could affect the expected volatility of its share price (e.g., share price volatility tends to be higher for highly leveraged entities). In estimating expected volatility, an entity should take into account significant changes to its corporate and capital structure, since the historical volatility of a share price for a period in which the entity was, for example, highly leveraged may not represent future periods in which the entity is not expected to be highly leveraged (or vice versa).

As stated in the Interpretive Response to Question 1 of SAB Topic 14.D.1, the SEC staff "believes [entities] that have appropriate traded financial instruments from which they can derive an implied volatility should generally consider this measure." Further, depending on the extent to which these financial instruments are actively traded, more reliance or exclusive reliance on implied volatility may be appropriate because implied volatility reflects market expectations of future volatility.

SAB Topic 14.D.1 also addresses circumstances in which it is acceptable to rely exclusively on either historical volatility or implied volatility. To rely exclusively on historical volatility, an entity must:

- Have "no reason to believe that its future volatility over the expected or contractual term, as applicable, is likely to differ from its past."
- Perform the computation by using a "simple average calculation method."
- Use a "sequential period of historical data at least equal to the expected or contractual term . . . , as applicable."
- Apply "[a] reasonably sufficient number of price observations . . . , measured at a consistent point throughout the applicable historical period."
- Consistently apply this approach.

To rely exclusively on implied volatility, an entity must:

- Use a valuation model for employee stock options “that is based upon a constant volatility assumption.”
- Derive the implied volatility from “options that are actively traded.”
- Measure the “market prices (trades or quotes) of both the traded options and underlying shares . . . at a similar point in time to each other and on a date reasonably close to the fair value measurement date of the [employee] share options.”
- Use traded options whose (1) exercise prices “are both . . . near-the-money and . . . close to the exercise price of the [employee] share options” and (2) “remaining maturities . . . are at least one year.”
- Ensure “[m]aterial nonpublic information that would be considered in a marketplace participant’s expectation of future volatility does not exist.”
- Consistently apply this approach.

If an entity is newly public or nonpublic, it may have limited historical data and no other traded financial instruments from which to estimate expected volatility. In such cases, as discussed in the SEC staff’s guidance in SAB Topic 14.D.1, it may be appropriate for the entity to base its estimate of expected volatility on the historical, expected, or implied volatility of comparable entities.

Further, when valuing spring-loaded awards, an entity needs to determine whether a marketplace participant would consider the material nonpublic information when estimating expected volatility. As SAB Topic 14.D.1 indicates, material nonpublic information may affect the extent of reliance on implied volatility and may need to be factored into the determination of implied and historical volatility.

For more information on share-based compensation, see Deloitte’s Roadmap [Share-Based Payment Awards](#).

## 12.2.5 Liabilities, Equity, and Temporary Equity

### Example of an SEC Comment

You disclose that . . . you will be required to repurchase each share of [convertible preferred stock] that have not been converted into shares of common stock or automatically redeemed. Please tell us how you determined that your [convertible preferred stock] should be classified as mezzanine equity on your balance sheet and your consideration of the guidance in ASC 480-10-25-4.

Life sciences entities pursuing an IPO often have complex financial instruments. The SEC historically has focused on the classification of financial instruments as liabilities or equity in the balance sheet when those financial instruments have redemption provisions or possess characteristics of both liabilities and equity. For example, the classification of convertible debt instruments and freestanding warrants is often scrutinized since they may contain both liability and equity components under U.S. GAAP.<sup>21</sup>

At the time they are approaching a potential IPO, prospective registrants may have outstanding financial instruments with characteristics of both liabilities and equity, or in connection with a potential IPO, an entity may issue new financial instruments. Even if certain instruments are already outstanding before an IPO, when public financial statements are initially issued, it may be appropriate for a financial instrument to be classified as temporary equity (e.g., outside of permanent equity) in accordance with

<sup>21</sup> For more information about the classification of warrants issued in SPAC transactions, see Deloitte’s October 2, 2020 (updated April 11, 2022), [Financial Reporting Alert](#).

SEC rules even if it was acceptable for the financial instrument to be classified as permanent equity before the IPO. Further, for an entity that becomes publicly traded, there can be other accounting consequences that did not exist while the entity was private.

For more information about financial instruments, see [Chapter 10](#) of this Guide and Deloitte’s Roadmap *Distinguishing Liabilities From Equity*.

## 12.2.6 Accounting for Offering Costs

Expenses incurred during an IPO can be divided into those that occur as a direct result of an IPO and those that occur as part of an entity’s ordinary operations. [SAB Topic 5.A](#) (codified in ASC 340-10-S99-1) indicates that “[s]pecific incremental costs directly attributable to a proposed or actual offering of securities may properly be deferred and charged against the gross proceeds of the offering.” Therefore, entities undertaking an IPO should ensure that all costs earmarked for deferral are incremental costs directly resulting from the IPO as opposed to costs that are part of an entity’s ongoing operations before or after the IPO.



### Connecting the Dots

Costs incurred during an IPO may be significant. Therefore, the appropriate identification of costs that qualify for deferral is particularly important given the potential impact on reported profit or loss if such costs are incorrectly allocated. Similarly, entities should be cognizant of the risk of deferring costs that do not qualify for such treatment. In certain cases, management may need to exercise judgment to appropriately allocate costs and should consider consulting with professional advisers and auditors before making a final determination.

Costs that may qualify for deferral include registration fees, filing fees, listing fees, specific legal and accounting costs, and transfer agent and registrar fees. However, in accordance with [SAB Topic 5.A](#), costs such as management salaries or other general and administrative expenses generally are not considered incremental or directly attributable to the IPO, even though they may increase as a result of the IPO. Such costs should be accounted for under other accounting standards.

In rare instances, an IPO could consist solely of selling shareholders, with no new shares being issued by the entity. In such cases, offering costs should be expensed because there are no proceeds against which to offset the costs.

For more information about issuance costs within the scope of [SAB Topic 5.A](#), see Deloitte’s Roadmaps *Distinguishing Liabilities From Equity* and *Convertible Debt (Before Adoption of ASU 2020-06)*.

### 12.2.6.1 Aborting or Postponing an Offering

An entity that aborts an IPO can no longer defer offering costs that otherwise qualified for deferral; rather, such deferred costs should be immediately expensed. However, as indicated in [SAB Topic 5.A](#), a “short postponement (up to 90 days) does not represent an aborted offering.” In practice, postponements regularly occur in response to market fluctuations or entity-specific circumstances (e.g., delays in the finalization of a contract that is intended to form the foundation of an entity’s IPO). Judgment should be used in the determination of whether a postponement of more than 90 days represents an aborted offering.

When a delay or postponement occurs, the determination of whether costs should continue to be deferred as a result of a delay or postponement depends on whether the costs are associated with a probable, successful future offering of securities. To the extent that a cost will be incurred a second time or will not provide a future benefit, it should be charged to expense.

In determining the actual postponement date, an entity may be required to use significant judgment and consider the facts and circumstances. For example, if an offering is delayed beyond 90 days because market conditions would not yield an acceptable return, the delay would generally be considered an aborted offering and previously deferred offering costs would be charged to expense. Conversely, a delay of more than 90 days could be considered a short postponement, rather than an aborted offering, in certain circumstances. Sufficient and appropriate evidence should exist to support the assertion that the delay of an offering of securities does not constitute an aborted offering. Factors that may indicate that an offering has not been aborted include, but are not limited to:

- The resolution of the items causing the delay (e.g., accounting, legal, or operational matters) is necessary for the completion of the offering. Such resolution may include:
  - Completing new (or revising existing) contractual arrangements with shareholders or other parties.
  - Obtaining audited financial statements for other required entities (e.g., significant acquisitions under SEC Regulation S-X, Rule 3-05; significant equity method investments under SEC Regulation S-X, Rule 3-09).
- A plan for resolving the delay, including a revised timetable detailing the necessary steps to achieve a registration; such a plan should be approved by the board of directors or management.
- Continuing to undertake substantive activities in accordance with the plan, demonstrating an intent to proceed with the offering.
- Continuing to prepare financial information or updating the registration statement either to respond to SEC staff review comments or because information may become stale.

Management will need to use significant judgment in determining whether a delay is a short postponement or an aborted offering and may need to consult with accounting and legal advisers.

# Chapter 13 — Other Accounting and Financial Reporting Topics

## 13.1 Government Assistance

### 13.1.1 Considerations Related to Government Assistance

Governments provide assistance for a variety of reasons, such as to stimulate economies, support policy initiatives, and foster innovation. An example of government assistance is the package of loans, grants, tax credits, and other forms of government aid that the U.S. federal government provided under the CARES Act in response to the COVID-19 pandemic.

Although some forms of assistance may be referred to as “grants” or “credits,” entities should carefully look at the form and substance of the assistance to determine the appropriate accounting framework to apply. For example, assistance may be in the form of income-based tax credits that are dependent on taxable income, whereas other forms of government assistance are not dependent on taxable income (e.g., payroll tax credits). Income-based tax credits generally will be within the scope of ASC 740. Government assistance that is not dependent on taxable income is generally not within the scope of ASC 740 and would most likely be viewed and accounted for as a government grant.

#### 13.1.1.1 Exchange Transaction Versus Contribution

The nature and form of government assistance may vary (e.g., grants, payroll tax credits, forgivable loans, price adjustments, reimbursements of lost revenues, reimbursements of expenses). In performing its accounting analysis, an entity should first consider whether the government assistance it receives represents an exchange transaction (i.e., a reciprocal transfer in which each party receives and pays commensurate value) or a contribution, which is defined in the ASC master glossary as an “unconditional transfer of cash or other assets, as well as unconditional promises to give, to an entity or a reduction, settlement, or cancellation of its liabilities in a voluntary nonreciprocal transfer by another entity acting other than as an owner.” To determine whether the government assistance represents an exchange transaction, an entity should consider the factors in the table below, which are adapted from ASC 958-605-15-5A and 15-6.

An Exchange Transaction May Not Exist if:	An Exchange Transaction May Exist if:
(1) The benefit provided by the entity is received by the general public, (2) the government only received indirect value from the entity, or (3) the value received by the government is incidental to the potential public benefit derived from using the goods or services transferred from the entity.	The transfer of assets from a government entity is part of an existing exchange transaction between the receiving entity and an identified customer (e.g., payments under Medicare and Medicaid programs). In this circumstance, “an entity shall apply the applicable guidance (for example, Topic 606 on revenue from contracts with customers) to the underlying transaction with the customer, and the payments from the [government] would be payments on behalf of” the customer, rather than payments for benefits that were received by the general public.
The entity has provided a benefit that is related to “[e]xecution of the [government’s] mission or the positive sentiment from acting as a donor.”	The expressed intent was to exchange government funds for goods or services that are of commensurate value.
The entity solicited funds from the government “without the intent of exchanging goods or services of commensurate value” and the government had “full discretion in determining the amount of” assistance provided.	Both the entity and the government negotiated and agreed on the amount of government assistance to be transferred in exchange for goods and services that are of commensurate value.
Any penalties the entity must pay for failing “to comply with the terms of the [government assistance] are limited to the [goods] or services already provided and the return of the unspent amount.”	The entity contractually incurs economic penalties for failing to perform beyond the government assistance provided.

If an entity concludes that the government assistance it received represents an exchange transaction, it should account for such assistance in accordance with the applicable U.S. GAAP (e.g., ASC 606). As discussed further below, certain payments may be considered part of an exchange transaction between the recipient entity and its customers. Further, if an NFP concludes that the government assistance represents a contribution, such assistance would be accounted for under ASC 958-605.



### Connecting the Dots

The National Institutes of Health (NIH) is an agency of the U.S. government and the world’s **largest public funder of biomedical research**. It conducts research in its own laboratories and supports the research of nongovernment scientists in universities and research institutions, including business entities. The NIH provides financial support in the form of grants, cooperative agreements, and contracts to advance its mission of enhancing health, extending healthy lives, and reducing the burdens of illness and disability. Business entities that contract with the NIH in exchange for financial support need to assess whether such an arrangement represents (1) an exchange transaction (i.e., a reciprocal transfer in which each party receives and pays commensurate value) or (2) a nonreciprocal (nonexchange) transaction (which may be the case if the NIH does not receive commensurate value in return, apart from the advancement of its mission). In addition to funding received from the NIH, these transactions may include payments to the NIH based on commercial drug sales (e.g., reverse royalty payments). An entity will need to carefully consider the accounting treatment for such payments, including the appropriate classification on the income statement. For a discussion of consideration payable to a customer in arrangements representing exchange transactions, see [Section 2.5.6](#).

Other government assistance could include complex provisions; therefore, an entity should carefully apply judgment and consider consulting with its advisers when determining the appropriate accounting treatment. For example, an entity may conclude that assistance is (1) entirely an exchange transaction or (2) partially an exchange transaction and partially a grant. Further, some provisions may only provide for a right to defer payments (for which interest is not imputed in accordance with ASC 835-30-15-3(e)), while others may solely represent a grant from the government (e.g., reimbursement of incurred costs).

### 13.1.1.2 Government Grants

If the government assistance an entity receives is not accounted for under ASC 740 (e.g., an income-tax-based credit), an exchange transaction (e.g., loan, equity transaction, or revenue arrangement), or a contribution within the scope of ASC 958, it would most likely be viewed as a government contribution of assets and accounted for as a government grant.

NFPs should apply ASC 958-605 to the government grants they receive. However, government grants to business entities are explicitly excluded from the scope of ASC 958.<sup>1</sup> Other than the guidance in ASC 905-605-25-1 on income replacement and subsidy programs for certain entities in the agricultural industry, there is no explicit guidance in U.S. GAAP on the accounting for government grants to business entities.

ASC 105 provides a hierarchy for entities to use in determining the relevant accounting framework for the types of transactions that are not directly addressed in sources of authoritative U.S. GAAP. According to ASC 105-10-05-2, an entity should “first consider [U.S. GAAP] for similar transactions” before considering “nonauthoritative guidance from other sources,” such as IFRS Accounting Standards. As discussed further below, we understand that there may be diversity in practice.

When selecting the appropriate accounting model to apply to a government grant, a business entity should consider the specific facts and circumstances of the grant. If the entity has a preexisting acceptable accounting policy for accounting for similar government grants, it should generally apply that policy. However, if the entity does not have a preexisting accounting policy or the grant is not similar to grants it has received in the past, it should carefully consider applying a model that would faithfully depict the nature and substance of the government grant.

We believe that in the absence of either directly applicable or analogous U.S. GAAP, it may be appropriate to apply IAS 20, which has been widely used in practice by business entities to account for government grants.



#### Connecting the Dots

While IAS 20 has been widely applied in practice by business entities in accounting for government grants, the application of ASC 450-30 may also be acceptable since we are aware that some business entities may have applied a gain contingency model by analogy for certain grants (e.g., the Electronic Healthcare Records program under the American Recovery and Reinvestment Act of 2009). Under this model, income from a conditional grant is viewed as akin to a gain contingency; therefore, recognition of the grant in the income statement is deferred until all uncertainties are resolved and the income is “realized” or “realizable.” That is, an entity must meet all the conditions required for receiving the grant before recognizing income. For example, a grant that is provided on the condition that an entity cannot repurchase its own shares before a certain date may result in the deferral of income recognition until the compliance date lapses. Such a deferral may be required even if (1) the government funded

<sup>1</sup> See ASC 958-605-15-6(d).



the grant, (2) the entity incurred the costs that the funds were intended to defray, and (3) the remaining terms subject to compliance are within the entity's control and virtually certain of being met. That is, it would not be appropriate under a gain contingency model for an entity to consider the probability of complying with the requirements of the government grant when considering when to recognize income from the grant. Therefore, for many grants, the recognition of income under ASC 450-30 would most likely be later than the recognition of income under IAS 20.

In addition, it may be acceptable in practice to apply other U.S. GAAP for government grants. For example, while government grants to business entities are explicitly excluded from the scope of ASC 958, the FASB staff has noted that such entities are not precluded from applying that guidance by analogy when appropriate. Therefore, a business entity may conclude that it is acceptable to apply ASC 958 by analogy, particularly if the grant received by the business entity is similar to that received by an NFP (e.g., certain subsidies provided to both nonprofit and for-profit health care providers).

Further, some may believe that loans obtained should be accounted for as debt in their entirety under ASC 470, even if all or a portion of the loan is expected to be forgiven. Under ASC 405-20, income would not be recorded from the extinguishment of the loan until the entity is legally released from being the primary obligor. Alternatively, an entity may account for the loan as an in-substance government grant if it is probable that the loan will be forgiven.



### Changing Lanes

On June 13, 2022, the FASB staff issued an [invitation to comment](#) (ITC) on potentially incorporating the guidance of IAS 20 on accounting for government grants into U.S. GAAP for business entities. Comments on the ITC were due by September 12, 2022. The Board is considering the comment letter feedback received.

At the FASB's November 1, 2023, meeting, the Board added to its technical agenda a project on business entities' recognition, measurement, and presentation of government grants.

#### 13.1.1.3 IAS 20 Accounting Framework

An entity that elects an IAS 20 framework to account for government grants should consider that a government grant cannot be recognized (even if payment is received up front) until there is reasonable assurance that the entity will (1) comply with the conditions associated with the grant and (2) receive the grant. While "reasonable assurance" is not defined in IAS 20, for a business entity that is subject to U.S. GAAP, we believe that reasonable assurance is generally the same threshold as "probable" as defined in ASC 450-20 (i.e., "likely to occur").

When an entity has met the reasonable assurance threshold, it applies IAS 20 by recognizing government grants in its income statement on a "systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate." To help an entity meet this objective, IAS 20 provides guidance on two broad classes of government grants: (1) grants related to long-lived assets (capital grants) and (2) grants related to income (income grants).

### 13.1.1.3.1 Capital Grants

A capital grant is a grant received by an entity with conditions tied to the acquisition or construction of long-lived assets. An entity may elect an accounting policy to initially recognize such a grant as either deferred income or a reduction in the asset's carrying amount. If the entity classifies the grant as deferred income, it will recognize the grant in the income statement over the useful life of the depreciable asset that it is associated with (e.g., as an offset against depreciation expense). If the entity classifies the grant as a reduction in the asset's carrying amount, the associated asset will have a lower carrying value and a lower amount of depreciation over time. Further, with respect to nondepreciable assets, IAS 20 observes that “[g]rants related to non-depreciable assets may also require the fulfilment of certain obligations and would then be recognised in profit or loss over the periods that bear the cost of meeting the obligations. As an example, a grant of land may be conditional upon the erection of a building on the site and it may be appropriate to recognise the grant in profit or loss over the life of the building.”

### 13.1.1.3.2 Income Grants

An income grant is a grant that is not related to long-lived assets. An entity may present the receipt of such a grant in the income statement as either (1) a credit to income (in or outside of operating income) or (2) a reduction in the related expense that the grant is intended to defray. As discussed above, the main objective of the accounting for government grants under IAS 20 is for an entity to recognize a grant in the same period or periods in which it recognizes the corresponding costs in the income statement. Therefore, an entity should assess the specific compliance requirements that it must meet to receive or retain any funds from the government.



#### Connecting the Dots

Income-related government grants that are intended to compensate for expenses incurred over time may also include over time compliance requirements. Applying IAS 20 could therefore allow for recognition of the grant over time if the entity can assert that it is likely to comply with the conditions (i.e., the grant is reasonably assured).

However, if an entity instead applied the ASC 450-30 gain contingency framework to these types of grants, recognition of the government grant would generally be delayed until all conditions were met because the probability of compliance is not taken into consideration in the application of ASC 450-30.

While IAS 20 identifies two broad classes of grants, it is worth noting that some grants may include multiple requirements and have aspects of both capital grants and income grants. That is, such grants may be intended to subsidize the purchase of long-lived assets and certain operating costs. Therefore, an entity receiving a grant that is subject to multiple requirements should carefully assess how to allocate such a grant into components on a systematic and rational basis to accomplish the overall objective of matching recognition of the grant to recognition of the cost in the income statement.

### 13.1.1.4 Statement of Cash Flows

In determining the appropriate cash flow presentation of government grants (that are not tax credits recognized as a reduction of income tax and accounted for in accordance with ASC 740 and that are not accounted for in accordance with ASC 958), an entity should consider the nature of the grants since government assistance can take many different forms. See [Sections 7.2.4 through 7.2.4.2](#) for a discussion of considerations related to the treatment of government grants in the statement of cash flows.

### 13.1.1.5 Disclosures

Business entities are subject to certain disclosure requirements when they (1) have received government assistance and (2) use a grant or contribution accounting model by analogy to other accounting guidance (e.g., a grant model under IAS 20 or ASC 958-605).

Under ASC 832-10-50-3 and 50-4, a business entity that has received government assistance must provide the following disclosures for annual periods about transactions that are within the scope of ASC 832:

- a. The nature of the transactions, including a general description of the transactions and the form in which the assistance has been received (for example, cash or other assets)
- b. The accounting policies used to account for the transactions as required by paragraph 235-10-50-1
- c. The line items on the balance sheet and income statement that are affected by the transactions, and the amounts applicable to each financial statement line item in the current reporting period. . . .

[T]he significant terms and conditions of transactions with a government within the scope of this Topic. Terms and conditions that might be appropriate to disclose include, but are not limited to, any of the following:

- a. The duration or period of the agreement
- b. Commitments made by both the reporting entity and the government
- c. Provisions, if any, for recapture (for example, when the government can recapture amounts awarded), including the conditions under which recapture is allowed
- d. Other contingencies.

Further, ASC 832-10-50-5 notes that in certain situations, the terms of the government assistance may legally prohibit an entity from disclosing the required information. In such circumstances, the entity must disclose a description of the general nature of the information and indicate that it is excluding the disclosures because of legal prohibitions.

## 13.2 Common-Control Transactions

Life sciences entities seeking to balance their portfolios may undergo internal reorganizations in preparation for public offerings or sale transactions. Because such internal reorganizations do not result in a change in control over the assets and liabilities, they are accounted for as common-control transactions.

A common-control transaction is typically a transfer of net assets or an exchange of equity interests between entities under the control of the same parent. While a common-control transaction is similar to a business combination for the entity that receives the net assets or equity interests, such a transaction does not meet the definition of a business combination because there is no change in control over the net assets. Therefore, the accounting and reporting for a transaction between entities under common control is outside the scope of the business combinations guidance in ASC 805-10, ASC 805-20, and ASC 805-30 and is addressed in the “Transactions Between Entities Under Common Control” subsections of ASC 805-50. Since there is no change in control over the net assets from the parent’s perspective, there is no change in basis in the net assets. ASC 805-50 requires that the receiving entity recognize the net assets received at their historical carrying amounts, as reflected in the ultimate parent’s financial statements.

For more information and interpretive guidance on common-control transactions, see [Appendix B](#) of Deloitte’s Roadmap *Business Combinations*.

### 13.3 Discontinued-Operations Reporting

While many life sciences entities have sought ways to expand their pipeline of products in development or to acquire additional commercial products, others have explored how to generate additional returns on assets that are no longer a strategic focus. When an entity sells or abandons a business or product line, questions often arise about whether the assets and related operations should be reported as a discontinued operation. The reporting of discontinued operations separately from continuing operations is meant to provide stakeholders with information on assessing the effects of a disposal on an entity's ongoing operations.

An entity will need to use judgment when determining whether a disposition qualifies for discontinued-operations reporting. The entity's conclusion will be based on whether (1) the assets (and liabilities) meet the held-for-sale classification criteria or have been disposed of and (2) the disposal represents a strategic shift that has or will have a major effect on the entity's operations and financial results. Therefore, not all disposals qualify for discontinued-operations reporting.

#### Example 13-1

Entity B is a life sciences entity whose primary strategy is to focus on R&D for clinical-stage products, including commercialization upon regulatory approval. To provide liquidity for its ongoing R&D programs, B divests Drug X, one of its commercialized products.

To determine whether the divestment of Drug X qualifies for discontinued-operations reporting, B must first consider whether Drug X represents a component. If Drug X does not represent a component, B's divestment of Drug X is not a disposal that represents a discontinued operation.

If B determines that Drug X represents a component, it must next consider whether the disposal represents a strategic shift that has or will continue to have a major effect on B's operations and financial results. A strategic shift implies that the disposal must result from a change in the way management had intended to run the business. Therefore, if B has a history of divesting commercial products to provide a source of liquidity for ongoing R&D programs, its disposal of Drug X might not represent a strategic shift regardless of whether the disposal has a major effect on B's operations and financial results.

The determination of whether a disposal represents a strategic shift will be based on the entity's specific facts and circumstances. Because of the judgment involved, discussion with accounting advisers is encouraged.

For more information about discontinued-operations reporting, including interpretations of the accounting guidance on the topic, see [Chapter 5](#) of Deloitte's Roadmap *Impairments and Disposals of Long-Lived Assets and Discontinued Operations*.

### 13.4 Carve-Out Financial Statements

Carve-out financial statements are prepared to reflect a portion of a parent entity's balances and activities. Examples of transactions in which carve-out financial statements may be requested or required include, but are not limited to, the following:

- *Potential sale* — An entity wishing to dispose of a portion of its assets and operations may prepare carve-out financial statements to help potential acquirers evaluate a prospective transaction.
- *Completed sale* — A public entity acquires, or it is probable that it will acquire, a portion of an entity's business, and the acquisition is deemed "significant" to the acquirer under SEC Regulation S-X, Rule 3-05. Consequently, the acquiring entity may request (or need to have prepared) audited carve-out financial statements of the business acquired for inclusion in a Form 8-K filing, registration statement, or proxy statement of the acquirer.

- *Spin-off* — A public entity plans to distribute a portion of its assets that constitute a business by spinning the business off to its shareholders as a separate public company. Therefore, carve-out financial statements of the spinnee (i.e., the new legal spun-off entity) must be included in the SEC registration statement in connection with the spin-off.
- *Split-off* — A public entity plans to offer to its existing shareholders, in exchange for some or all of the existing shareholders' shares in the public entity, shares in a newly formed entity that represents a portion of its assets that constitute a business (the "splitee"). Therefore, carve-out financial statements of the new legal entity to be split off must be included in the SEC registration statement in connection with the exchange transaction.
- *IPO and SPAC transactions* — An entity wishes to segregate a portion of itself to effect an IPO of a newly created subsidiary or to enter into a transaction with a SPAC. Therefore, carve-out financial statements of the operations to be segregated and transferred to the newly created subsidiary or to a SPAC must be included in the SEC registration statement in connection with the transaction.

The carve-out entity may consist of all or part of an individual subsidiary, multiple subsidiaries, an individual segment, multiple segments, or a specific group of products. In some cases, one or more portions of a previously consolidated parent entity's subsidiaries may create the newly defined carve-out operations.

"Carve-out financial statements" is a general term used to describe financial statements derived from the financial statements of a larger parent entity. The form and content of those financial statements may vary, however, depending on the users of the financial statements and the purpose for which the financial statements are being prepared. For example, if the acquisition is small, a strategic buyer of a carve-out entity may be satisfied with an unaudited balance sheet and income statement for the most recent fiscal year. A public buyer, however, may require a full set of SEC-compliant audited financial statements, including footnotes, for the two most recent fiscal years. Further, a third buyer may require that the periods be audited but may not be concerned with SEC reporting considerations. The existence of a foreign buyer could present different requirements and challenges in addition to those noted above, such as working closely with the foreign buyer on IFRS conversion of certain financial statement line items. The purpose of the financial statements also greatly affects the timeline, since carve-out financial statements filed for a public spin-off via Form 10<sup>2</sup> would need to be available at least 60 days before the spin-off, while carve-out financial statements prepared for compliance with SEC Regulation S-X, Rule 3-05,<sup>3</sup> would need to be available within 75 days post-closing.

Accordingly, assessing the potential audience and any regulatory requirements applicable to the transaction is critical to understanding the basis of presentation, the periods of financial information required, and the level of effort and organizational focus that may be necessary to meet the needs of the potential transaction. Such an assessment can be particularly difficult when the carve-out financial statements are being prepared before any potential buyers are identified or when the potential buyer pool is numerous or diverse. SEC registrants are encouraged to consult with their legal advisers and independent accountants regarding these requirements.

<sup>2</sup> A Form 10 is used to register classes of securities for which no other form is prescribed, such as spin-off transactions in which shares are distributed to the parent company's shareholders.

<sup>3</sup> Under Rule 3-05, registrants, including entities undertaking an IPO, are required to file the separate preacquisition financial statements for a significant acquired or to be acquired business (acquiree). The significant acquisition rules focus on three principal criteria: the investment test, the asset test, and the income test. In accordance with the SEC's [final rule](#) issued on May 20, 2020, if the results of any of those tests exceed a threshold of 20 percent, at least financial statements for the most recent fiscal year (audited) and the latest year-to-date interim period that precedes the acquisition date (unaudited) — and, potentially, financial statements for the two most recent fiscal years (audited), the latest year-to-date interim period that precedes the acquisition date (unaudited), and the corresponding interim period of the prior year (unaudited) if the results of any of the tests exceed a threshold of 40 percent — will be required.

### **13.4.1 Management Considerations**

Preparing carve-out financial statements can be challenging, often requiring management to use judgment and carefully plan ahead. Below are some considerations management should take into account when preparing carve-out financial statements.

#### **13.4.1.1 *Assembling the Right Team***

Involving the appropriate personnel is an integral step in preparing accurate and complete carve-out financial statements. Management should determine which employees can help provide the information it needs to prepare such statements, which may include individuals outside accounting (e.g., in operations or human resources) as well as those involved in negotiating the transaction. In addition, management may need to engage external specialists (e.g., tax or valuation experts).

#### **13.4.1.2 *Determining the Transaction's Structure and Scope***

In many divestiture transactions, planning for and preparing carve-out financial statements starts before the final transaction structure is determined or negotiations begin. Identifying the expected structure and which entities or operations will be included within it is a key step in developing the carve-out financial statements. Carve-out financial statements may be in the form of (1) public-entity financial statements subject to SEC requirements, (2) nonpublic-entity financial statements to which certain U.S. GAAP presentation and disclosure requirements do not apply and for which reporting alternatives developed by the PCC may be elected, and (3) special-purpose financial information that a user may ask for in a specific form or may request to be prepared in accordance with another comprehensive basis of accounting. Thus, the transaction structure can affect the form and content of the financial statements, the years to be provided, and the audit procedures required.

#### **13.4.1.3 *Materiality and Evaluating Misstatements***

Because the materiality thresholds related to the carve-out financial statements will most likely be lower than those associated to the consolidated parent entity, management may need to assess the carve-out entity's accounts and balances in even more detail than they may have been subjected to during preparation of the parent entity financial statements. The parent entity's historical corrected or uncorrected misstatements and disclosures related to the carve-out entity that were previously considered immaterial to the parent's financial statements would need to be reconsidered on the basis of materiality thresholds applicable to the carve-out financial statements.

#### **13.4.1.4 *Internal Controls***

Management should design and implement processes and controls for preparing the carve-out financial statements (e.g., management may need to design, implement, and execute controls related to the appropriate determination and recording of income statement and balance sheet allocations to the carve-out financial statements). Although an entity may often be able to leverage existing financial statement preparation controls, management should evaluate whether it needs to modify such controls to accommodate process changes related to preparing the carve-out financial statements.

#### **13.4.1.5 *Supporting Documentation***

Management should consider the type of documentation necessary to support the assumptions made and results achieved in preparing carve-out financial statements. In some cases, the supporting documentation may already exist (e.g., compensation expense is usually calculated and allocated on an employee-by-employee basis). However, management may need to develop and maintain new documentation for the allocations made for the carve-out financial statements (e.g., a rational

and systematic method for allocating selling, general, and administrative expenses). In other cases, intercompany transactions may have historically been eliminated within the parent's financial statements; however, those transactions would be reported in the carve-out financial statements, and appropriate supporting documentation would be required.

Management may choose to use existing accounting systems as much as possible when preparing carve-out financial statements. However, the ability to use such systems may be limited depending on the level of detail at which the account balances are maintained as well as the structure of the carve-out entity (e.g., whether the carve-out represents a segment of the parent or only part of a segment). If the carve-out entity represents a segment or component for which discrete financial information is readily available, management may be able to readily extract information from its existing accounting records. However, if the carve-out entity includes portions of different segments, further involvement of IT specialists may be required.

#### **13.4.1.6 Significant Judgments and Estimates**

In preparing carve-out financial statements, management will often need to make significant accounting judgments and estimates related to allocating account balances and activities to the carve-out financial statements and determining the appropriate disclosures to include in these financial statements. Significant estimates include (1) the allocation of goodwill or intangible assets, employee benefits (including pension and postretirement obligations), shared assets, corporate expenses, and income taxes; (2) the identification of operating and reportable segments; and (3) the evaluation of subsequent events.

#### **13.4.1.7 Working With Auditors**

If, as part of the preparation of carve-out financial statements, external auditors need to perform an audit and issue an audit opinion, the auditors will need to understand the process undertaken by management for collecting and maintaining all supporting documentation used in such preparation. For balances in which judgment or complex estimates are required, management should ensure that its documentation contains enough detail for auditors to reach conclusions about the reasonableness of the amounts allocated to, and balances presented in, the carve-out financial statements. Topics on which up-front and regular dialogue with auditors may help include (1) identifying the carve-out entity and the carve-out entity's financial statements, (2) materiality and evaluating misstatements, (3) ICFR, and (4) significant management judgments and management estimates.

### **13.4.2 Regulatory Considerations**

In addition to defining the business and financial information required and determining the specific approach to the preparation of the financial information, management should consider any regulatory restrictions that may exist related to the divestiture of a business or the transfer of contracts to the buyer. For example, it is common in the life sciences industry for operations in a specific country to have a delayed closing whereby one or more elements of the business do not fully transfer to a buyer at the time of the divestiture. The delays are frequently linked to jurisdictional requirements for the buyer to obtain the marketing authorizations needed to distribute pharmaceutical products or to negotiate changes to government contracts when nontransferable tender agreements exist. Management may need to (1) determine which statutory financial statements are required and (2) consider the audit of those financial statements.



When transitional services agreements (TSAs) are put in place, management should also consider the financial reporting treatment of any activities performed by the seller on behalf of the buyer and how profits earned during the period that are transferred to the buyer should be reported.

### 13.4.3 “RemainCo” Considerations

Carve-out financial statements typically include an allocation of corporate costs to the business to be divested, such as those related to executive management, IT, tax, insurance, accounting, legal and treasury services, and certain employee benefits. Upon the disposal, the individuals performing these activities may not transfer to the divested business. As a result, the remaining business would retain these “stranded costs.”

Under ASC 205-20, the parent entity is required to evaluate whether the effect of a disposal resulting from a carve-out transaction should be presented as a discontinued operation. Depending on the form of the carve-out transaction, this evaluation may occur when the carve-out entity (1) meets the criteria in ASC 205-20-45-1E to be classified as held for sale, (2) is disposed of by sale, or (3) is disposed of other than by sale in accordance with ASC 360-10-45-15 (e.g., by abandonment or in a distribution to owners in a spin-off). If the disposal meets the conditions to be reported as a discontinued operation by the parent entity, it would be unlikely that amounts presented as discontinued operations for the disposal in the parent-entity financial statements would equal the operations reflected in the carve-out entity's financial statements (e.g., because of differences between how expenses may have been allocated in the carve-out financial statements and how expenses associated with the discontinued operation are determined). See [Section 13.3](#) of this Guide and Deloitte's Roadmap [Impairments and Disposals of Long-Lived Assets and Discontinued Operations](#) for further information.

Management's determination that a portion of the carve-out entity's operations should be presented in discontinued operations will also affect the carve-out entity's statement of cash flows. See [Section 3.3](#) of Deloitte's Roadmap [Statement of Cash Flows](#) for further discussion.

### 13.4.4 Form and Content of Carve-Out Financial Statements

The form and content of the carve-out financial statements depend on the needs or requirements of the users of the financial statements and any regulatory requirements applicable to the transaction for which the carve-out financial statements are being prepared.

Accordingly, the most common types of carve-out financial statements include:

- *Public-entity financial statements:*
  - *Registrant, predecessor, or Rule 3-05* — A registrant and its predecessor may need to prepare carve-out financial statements for an initial registration statement filed with the SEC as well as in Forms 10-K and 10-Q filed after the initial registration statement. If so, the financial statements must comply with the general financial statement requirements in SEC Regulation S-X, Rules 3-01 through 3-04. Carve-out financial statements may also be required for a significant acquired or to be acquired business in accordance with Rule 3-05 in certain SEC filings.
  - *Abbreviated financial information* — In accordance with Rule 3-05, abbreviated financial information may at times be provided for significant acquired or to be acquired businesses in certain SEC filings. These abbreviated financial statements typically consist of a statement of revenues and direct expenses (in lieu of a full statement of operations) and a statement of assets acquired and liabilities assumed (in lieu of a full balance sheet). Abbreviated income statements for acquired or to be acquired real estate operations in accordance with SEC Regulation S-X, Rule 3-14, may also be provided.

- *Nonpublic-entity financial statements* — Certain U.S. GAAP presentation and disclosure requirements do not apply to nonpublic entities. In addition, nonpublic entities may elect to apply reporting alternatives developed by the PCC. Nonpublic-entity carve-out financial statements in which PCC accounting alternatives have been elected may be appropriate when the financial statements are not included or expected to be included in an SEC filing.
- *Special-purpose financial information* — A user may ask for financial information in a specific form or for it to be prepared in accordance with another comprehensive basis of accounting. While such information may be prepared to suit the user's request, there will most likely be restrictions on the use of such information as well as the level of attestation available. Further, since the form and content of financial statements to be included in SEC filings are prescribed, the financial information prepared under a special-purpose framework may not be usable for SEC filings.

In addition, preparers of carve-out financial statements should discuss with their auditor the level of assurance that may be provided for the planned form and content. If the carve-out financial statements are reissued, the auditor may be required to reissue its opinion(s) or other form of attestation. Changes in the intended users of the carve-out financial statements or in the planned form and content of the carve-out entity's financial information may change the level of assurance sought or that can be provided. Accordingly, any such changes should be monitored throughout the carve-out transaction process.

For more information and interpretive guidance on preparing carve-out financial statements, see Deloitte's Roadmap [Carve-Out Financial Statements](#).

## 13.5 Cost of Doing Business

### 13.5.1 Introduction

The life sciences industry has been subject to increased regulation in recent years at both the federal and state level, particularly as overall pharmaceutical drug pricing has come under closer scrutiny. In some cases, fees have been imposed on industry participants as a result. Two examples, which are discussed below, are (1) the BPD fee under the federal Patient Protection and Affordable Care Act and (2) fees imposed on the sale of opioid-based products by various states.

### 13.5.2 Branded Prescription Drug Fee

#### 13.5.2.1 Background

The federal Patient Protection and Affordable Care Act imposes an annual fee on the pharmaceutical manufacturing industry for each calendar year beginning on or after January 1, 2011. An entity's portion of the annual fee is payable no later than September 30 of the applicable calendar year and is not tax deductible. The portion of the annual fee that is allocated to individual entities is determined on the basis of the amount of an entity's BPD sales for the current year as a percentage of the industry's BPD sales for the same period.

A pharmaceutical manufacturing entity's portion of the annual fee becomes payable to the U.S. Treasury once the entity has a gross receipt from BPD sales to any specified government program or in accordance with coverage under any government program for each calendar year beginning on or after January 1, 2011.

In December 2010, the FASB issued [ASU 2010-27](#) (codified in ASC 720-50) to provide guidance on accounting and reporting related to the BPD annual fee. ASC 720-50-25-1, which was added by ASU 2010-27 and subsequently amended by [ASU 2011-06](#), states, in part:

The liability related to the annual fee described in paragraphs 720-50-05-1 through 05-4 shall be estimated and recorded in full upon the first qualifying sale for pharmaceutical manufacturers . . . **in the applicable calendar year in which the fee is payable** with a corresponding deferred cost that is amortized to expense using a straight-line method of allocation unless another method better allocates the fee over the calendar year that it is payable. [Emphasis added]

On July 28, 2014, several years after the FASB issued ASU 2010-27, the IRS issued [final regulations](#)<sup>4</sup> related to the BPD fee that introduced a new term, “covered entity status” (see the definition and related example below). The final regulations indicate that an entity’s obligation to pay its portion of the BPD fee in any given calendar year is not triggered by the first qualifying sale in that calendar year but is triggered instead by the qualifying sales in the previous year.

On the basis of a discussion with the SEC staff, the accounting for the BPD fee should be based on the final IRS regulations, which require an entity to recognize expense for the BPD fee as qualifying sales occur. That is, the recognition guidance in ASU 2010-27 became inapplicable upon issuance of the final IRS regulations. However, the SEC staff indicated that it would not object if an entity continued to apply the income statement presentation guidance in ASC 720-50-45-1, which requires the BPD fee to be presented as an operating expense.

### 13.5.2.2 Definition of Covered Entity Status

Section 51.2(e)(5) of the final IRS regulations defines covered entity status as follows:

- (i) *Rule.* An entity’s status as a covered entity begins in the first fee year in which the entity has branded prescription drug sales and continues each subsequent fee year until there are no remaining branded prescription drug sales for that entity to be taken into account as described in §51.5(c) or used to calculate the adjustment amount described in §51.5(e).
- (ii) *Example.* The following example illustrates the rule of paragraph (e)(5)(i) of this section:
  - (A) *Facts.* Entity A is a manufacturer with gross receipts of more than \$5 million from branded prescription drugs sales in 2011. Entity A does not have any gross receipts from branded prescription drug sales before or after 2011.
  - (B) *Analysis.* Entity A is a covered entity beginning in 2011 because it had gross receipts from branded prescription drug sales in 2011. For the 2011 fee year, Entity A does not owe a fee because the 2011 fee is based on sales data from the 2009 sales year. For the 2012 fee year, Entity A does not owe a fee because the 2012 fee is based on sales data from the 2010 sales year. Entity A continues to be a covered entity for the 2012 fee year because its branded prescription drug sales from the 2011 sales year have not yet been taken into account as described in §51.5(c) and used to calculate the adjustment amount described in §51.5(e). For the 2013 fee year, Entity A continues to be a covered entity because a portion of its branded prescription drug sales from the 2011 sales year are taken into account as described in §51.5(c) for purposes of computing the 2013 fee. For the 2013 fee year, Entity A is also liable for the adjustment amount described in §51.5(e) for the difference between its 2012 fee computed using sales data from the 2010 sales year, which is \$0, and what the 2012 fee would have been using sales data from the 2011 sales year. For the 2014 fee year, Entity A continues to be a covered entity because a portion of its branded prescription drug sales for the 2011 sales year are used to calculate the adjustment amount described in §51.5(e). Therefore, for the 2014 fee year, Entity A will receive an adjustment amount for the difference between its 2013 fee computed using sales data from the 2011 sales year, and what the 2013 fee would have been using sales data from the 2012 sales year, which is \$0. After the 2014 fee year, there are no remaining branded prescription drug sales to be taken into account as described in §51.5(c) or used to calculate the adjustment amount described in §51.5(e) for Entity A. Accordingly, Entity A is not a covered entity after the 2014 fee year.

<sup>4</sup> TD 9684, *Branded Prescription Drug Fee*.

### 13.5.3 Fees on Opioid-Based Products

Entities involved in the sale of opioid-based products have most likely experienced an increased cost of doing business as various states have either enacted or considered enacting laws imposing a fee on the sale of such drugs. The nature of the fee, its amount, its effective date, and the related documentation and reporting requirements vary by state. For example, some states characterize the fee as an excise tax, while others characterize the fee as a value-based tax, gross receipts tax, or license fee. As a result, entities involved in the sale of opioid-based products will need to be cognizant of the changing regulatory landscape to ensure current compliance with enacted state laws as well as future compliance with proposed laws whose enactment is expected or at least reasonably possible.

## 13.6 Going Concern

### 13.6.1 Introduction

Much of the life sciences industry consists of small, research-focused private biotechnology firms that represent an important source of innovation. These firms are generally focused on a specific technology platform, a mechanism of action, or a handful of early-stage compounds, and many of these firms are not profitable or do not have commercial revenue streams. Given the substantial costs and timelines associated with biopharmaceutical R&D, attracting and sustaining investment remains an ongoing challenge. This landscape requires many life sciences entities to evaluate the going-concern uncertainty in their financial statements.

ASC 205-40 provides guidance on when and how to disclose going-concern uncertainties in the financial statements. It requires management to perform interim and annual assessments of an entity's ability to continue as a going concern within one year of the date the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable).<sup>5</sup> Under ASC 205-40, an entity must provide certain disclosures if conditions or events "raise substantial doubt about the entity's ability to continue as a going concern."

### 13.6.2 Disclosure Threshold

An entity is required to disclose information about its potential inability to continue as a going concern when there is "substantial doubt" about its ability to continue as a going concern, which ASC 205-40 defines as follows:

#### ASC 205-40 — Glossary

##### **Substantial Doubt About an Entity's Ability to Continue as a Going Concern**

Substantial doubt about an entity's ability to continue as a going concern exists when conditions and events, considered in the aggregate, indicate that it is probable that the entity will be unable to meet its obligations as they become due within one year after the date that the financial statements are issued (or within one year after the date that the financial statements are available to be issued when applicable). The term *probable* is used consistently with its use in Topic 450 on contingencies.

When applying this disclosure threshold, entities are required to evaluate "relevant conditions and events that are known and reasonably knowable at the date that the financial statements are issued." Reasonably knowable conditions or events are those that can be identified without undue cost and effort.

<sup>5</sup> An entity that is neither an SEC filer nor a conduit bond obligor for debt securities that are traded in a public market would use the date on which the financial statements are available to be issued (in a manner consistent with ASC 205-40's definition of the term "financial statements are available to be issued").

ASC 205-40-55-2 provides the following examples of events that suggest that an entity may be unable to meet its obligations:

- a. Negative financial trends, for example, recurring operating losses, working capital deficiencies, negative cash flows from operating activities, and other adverse key financial ratios
- b. Other indications of possible financial difficulties, for example, default on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, a need to restructure debt to avoid default, noncompliance with statutory capital requirements, and a need to seek new sources or methods of financing or to dispose of substantial assets
- c. Internal matters, for example, work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, and a need to significantly revise operations
- d. External matters, for example, legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; and an uninsured or underinsured catastrophe such as a hurricane, tornado, earthquake, or flood.

### 13.6.3 Time Horizon

In each reporting period (including interim periods), an entity is required to assess its ability to meet its obligations as they become due for one year after the date the financial statements are issued or available to be issued.<sup>6</sup>

### 13.6.4 Disclosure Content

If an entity triggers the substantial-doubt threshold, its footnote disclosures must contain the following information, as applicable:

<b>Substantial Doubt Is Raised but Is Alleviated by Management's Plans</b>	<b>Substantial Doubt Is Raised and Is Not Alleviated</b>
<ul style="list-style-type: none"> <li>• Principal conditions or events.</li> <li>• Management's evaluation.</li> <li>• Management's plans.</li> </ul>	<ul style="list-style-type: none"> <li>• Principal conditions or events.</li> <li>• Management's evaluation.</li> <li>• Management's plans.</li> <li>• Statement that there is "substantial doubt about the entity's ability to continue as a going concern."</li> </ul>

ASC 205-40 explains that these disclosures may change over time as new information becomes available and that disclosure of how the substantial doubt was resolved is required in the period in which substantial doubt no longer exists (before or after consideration of management's plans). In addition, the mitigating effects of management's plans to alleviate substantial doubt should be evaluated only if (1) the plans are approved before the financial statement issuance date and (2) both of the following conditions in ASC 205-40-50-7 are met:

- a. It is probable that management's plans will be effectively implemented within one year after the date that the financial statements are issued.
- b. It is probable that management's plans, when implemented, will mitigate the relevant conditions or events that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date that the financial statements are issued.

<sup>6</sup> See footnote 5.

### 13.6.5 Impairment Considerations Related to Long-Lived Assets and Indefinite-Lived Intangible Assets Other Than Goodwill

When an entity concludes that there is substantial doubt about its ability to continue as a going concern, it should consider whether there is an indicator of impairment of long-lived assets. ASC 360-10-35-21 requires that an entity test a long-lived asset (group) classified as held and used for impairment “whenever events or changes in circumstances indicate that its carrying amount may not be recoverable.” ASC 360-10-35-21 gives examples of events or changes in circumstances that may indicate that the carrying amount of a long-lived asset (group) may not be recoverable. Although a substantial doubt about an entity’s ability to continue as a going concern is not explicitly provided as an example of impairment, the examples in ASC 360-10-35-21 are not all-inclusive. Entities will need to assess their specific facts and circumstances in determining whether there is an indicator of impairment of long-lived assets.

If an entity determines that an indicator of impairment of long-lived assets exists, it must test its long-lived assets for recoverability. Provided that the entity’s financial statements continue to be presented on a going-concern basis (i.e., not on a liquidation basis of accounting), the cash flow estimates the entity uses for recoverability testing may extend beyond one year on the basis of the remaining useful life of the primary asset. However, an entity should ensure that its cash flow estimates are reasonable given the circumstances. In addition, if there is substantial doubt about an entity’s ability to continue as a going concern, it is more likely that the entity is considering alternative courses of action and, therefore, that use of a probability-weighted approach to estimate cash flows may be warranted.

Indicators of impairment of indefinite-lived intangible assets such as capitalized IPR&D may also exist as a result of a substantial doubt about the entity’s ability to continue as a going concern. ASC 350-30-35-18B provides examples of events and circumstances that could affect the significant inputs used to determine the fair value of an indefinite-lived intangible asset. Although substantial doubt about an entity’s ability to continue as a going concern is not explicitly listed as an example of such events and circumstances, ASC 350-30-35-18B does explicitly include in its list of examples the contemplation of bankruptcy and other relevant entity-specific events that could affect significant inputs used to determine the fair value of the indefinite-lived intangible asset, which are events and circumstances that may lead to substantial doubt about an entity’s ability to continue as a going concern.

The impairment test for indefinite-lived intangible assets other than goodwill compares an asset’s fair value with its carrying value. Under ASC 820, fair value is determined on a market-participant basis, whereas a substantial doubt about an entity’s ability to continue as a going concern is a circumstance that is specific to the entity. While the existence of substantial doubt may not directly affect the determination of an indefinite-lived intangible asset’s fair value, an entity should consider whether the events and circumstances that resulted in substantial doubt also affect any significant inputs that are used to determine the fair value of the indefinite-lived intangible asset.

## 13.7 Health Tech

The health tech marketplace is a high-growth environment in which participants provide technology and service solutions to a wide spectrum of health care incumbents, including providers, payers, life sciences organizations, and transactional players. It encompasses a wide range of digital tools, devices, and platforms designed to enhance the efficiency, accessibility, and quality of health care services. Health tech entities may provide clinical decision support, drug discovery/bioinformatics software, health care administration software, and medical imaging software. They may also offer other products or services, including clinical trial database management, decision support tools for drug discovery, online marketplaces for pharmaceuticals R&D, medicinal prediction using artificial intelligence (AI), and Web-based simulation for R&D.

Health tech entities continue to disrupt long-standing business models and methods of health care delivery as well as sources of health information and ways to access it. Emerging technologies (e.g., AI, virtual and augmented reality, telehealth, blockchain) and monitoring devices (e.g., sensors, wearables, ingestibles) are providing real-time and continuous data about our health and our environment. Such innovations are redefining the future of health care and health delivery. Health care and health tech companies can use these innovations to provide more accurate diagnoses, deliver personalized treatment, and predict risk or deterioration and intervene early.

Much of the interpretive guidance in this Guide is likely to be applicable to health tech entities. Further, given the development and use of software in connection with the product/service offerings within the health tech space, some of the more narrow-scope considerations related to the use of software that have historically been the focus of more traditional technology companies — in particular, considerations related to the capitalization of software costs and the recognition of revenue from the sale of software products and services — could be important to entities operating in the health tech space. Such considerations are discussed below.

For additional information about the technical accounting topics discussed below, see Deloitte's [Health Tech Industry Accounting Guide](#), which is aimed at providing in-depth information on these topics for our clients and industry professionals.

### 13.7.1 Capitalized Software

As technology evolves, health tech companies typically incur myriad costs related to software, since they rely on the development of proprietary software and solutions to serve their customers and clients. As a result of such innovations, health tech companies are incurring increasing amounts of software costs as they develop on-premise software products to be sold or marketed, mobile applications designed to support health and wellness, or software solutions to be provided over the Internet (e.g., cloud computing or software as a service [SaaS]).

The accounting for software costs will vary depending on whether the software involved is (1) obtained or developed for internal use ("internal-use software," such as software that will be used to provide a service, including SaaS arrangements), (2) accessed in a cloud-based (or hosting) arrangement that is a service contract, or (3) to be sold, leased, or marketed ("external use software"):

- *Internal-use software* — In determining whether software meets the definition of internal-use software, an entity should consider the guidance in ASC 350-40-15-2A, which states:

Internal-use software has both of the following characteristics:

- a. The software is acquired, internally developed, or modified solely to meet the entity's internal needs.
- b. During the software's development or modification, no substantive plan exists or is being developed to market the software externally.



In certain situations, software accessed in a hosted environment could be considered internal-use software under ASC 350-40. In determining whether hosted software meets the definition of internal-use software, a customer (i.e., the purchaser of such service) should consider the guidance in ASC 350-40-15-4A, which states:

The guidance in the General Subsections of this Subtopic applies only to internal-use software that a customer obtains access to in a hosting arrangement if both of the following criteria are met:

- a. The customer has the contractual right to take possession of the software at any time during the hosting period without significant penalty.
- b. It is feasible for the customer to either run the software on its own hardware or contract with another party unrelated to the vendor to host the software.

Health tech entities will have to carefully evaluate whether the criteria in ASC 350-40-15-4A are met. If both of the criteria are met, the related software is considered internal-use software regardless of whether it is (1) being hosted by a third-party vendor or (2) interacting with software that is subject to a cloud computing arrangement (i.e., software that the entity cannot take possession of). If either of the criteria in ASC 350-40-15-4A is not met, the software is considered part of a hosting arrangement that is a service contract.

- *Software accessed in a cloud-based (or hosting) arrangement that is a service contract* — Capitalized costs associated with a service contract differ in character from costs that are capitalized in connection with developing or obtaining internal-use software. As a result, costs that are capitalized in connection with implementing a service contract are likely to be presented differently. Many entities, including health tech companies, are implementing software solutions that combine hosted software in a service contract with owned or licensed (i.e., internal-use) software. Eligible costs incurred to implement a cloud computing arrangement that is a service contract should be deferred as a prepaid asset and presented in a company's financial statements in the same line item in the income statement as the hosting service expense (e.g., as an operating expense). Such presentation is consistent with the classification of other service costs and assets related to service contracts. That is, these costs would be capitalized as part of the service contract, and the financial statement presentation of the cash flows, the resulting asset, and the related subsequent expense would be consistent with the ongoing periodic costs of the underlying cloud computing arrangement that is a service contract.
- *External-use software* — ASC 985-10-15-3 indicates that costs of "computer software to be sold, leased, or otherwise marketed as a separate product or as part of a product or process" should be accounted for as costs of external-use software under ASC 985-20 regardless of whether the computer software is (1) purchased or (2) internally developed and produced. The guidance in ASC 350-40 does not apply to any software for which a "substantive plan exists or is being developed to market the software externally." Therefore, if an entity purchases or develops software that it intends to use internally, but it also has a substantive plan to market that software externally, the full amount of the cost of the software should be accounted for under ASC 985-20 (i.e., costs should not be allocated between customer-facing and internal solutions). In addition, if a health tech company incurs costs to develop a software product as a licensed on-premise solution and also offers the software solution as a service to its customers, it should account for such costs under ASC 985-20.

It is critical for health tech companies to properly identify software development costs and determine how to account for them since the guidance on capitalization varies significantly depending on the type of software involved. Further, if an entity begins to sell, lease, or otherwise market what it previously classified as internal-use software as a separate product or as part of a product or process, the entity should reconsider the guidance on capitalizing internal-use software costs.

### 13.7.2 Revenue Recognition

Common go-to-market products and services of health tech companies include the following:

- *SaaS* — A health tech entity's contract to sell SaaS to a customer is typically referred to as a cloud computing arrangement, in which the customer does not take possession of the product and the performance obligation is considered a service provided by the health tech entity.
- *On-premise perpetual or subscription licenses* — These are considered promises related to products sold by the health tech entity to its end customer at a point in time. Such products are commonly sold along with postcontract customer support and other goods or services.

Many health tech companies are migrating to SaaS as their preferred customer delivery mechanism as they digitize current service offerings and update current software offerings. Health tech companies often develop a SaaS platform on which they provide their services to customers via access to a hosted platform rather than giving their customers the software code. In contrast, the software delivery model, often referred to as an "on-premise" model, involves the delivery of the underlying software code to customers at a point in time.

Health tech entities should carefully assess the products and services they are providing since the nature of those products and services, and the related determination of the performance obligations in a contract, can significantly affect the timing and amount of revenue to be recognized. The core principle of the revenue standard is to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which an entity expects to be entitled in exchange for those goods and services. Significant judgments frequently need to be made when an entity evaluates the appropriate recognition of revenue from contracts with customers. These judgments are often required throughout the revenue standard's five-step process that an entity applies to determine when, and how much, revenue should be recognized.

When third parties are involved in providing goods or services to customers, health tech companies may also encounter challenges related to whether they should recognize revenue and the associated cost of services at a gross amount or record the revenue and cost on a net basis. For an entity to determine whether the nature of its promise to a customer is to transfer goods or services on its own (in which case, the entity acts as a principal) or to arrange for another party to transfer goods or services (in which case, the entity acts as an agent), the entity must first identify each specified good or service (or bundle of goods or services) that is distinct and then assess whether the entity obtains control of each specified good or service (or a right to a good or service) before it is transferred to the customer. ASC 606-10-25-25 defines control as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." Determining whether the entity controls the specified good or service before transferring it to the customer — and, therefore, is the principal in the arrangement — may be clear in some circumstances but may require significant judgment in others. In arrangements involving more than one distinct good or service, an entity could be a principal for certain aspects of a contract with a customer and an agent for others.

### 13.7.3 Costs of Obtaining a Contract

All health tech companies may need to recognize as an asset the incremental costs of obtaining a contract with a customer, such as sales commissions, if recovery of those costs is expected. Determining which items qualify as incremental costs of obtaining a contract may be complex since certain cost structures, such as commission plans, may have different terms for each health tech company that would require additional assessment. Therefore, health tech companies should refer to ASC 340-40, which contains comprehensive guidance on accounting for costs of obtaining a contract within the scope of ASC 606.

The example below illustrates an entity's accounting for sales commissions.

#### Example 13-2

Entity A's internal salespeople earn a commission based on a fixed percentage (4 percent) of sales invoiced to a customer. Half of the commission is paid when a contract with a customer is signed; the other half is paid after 12 months, but only if the salesperson is still employed by A. Entity A concludes that a substantive service period is associated with the second commission payment, and A's accounting policy is to accrue the remaining commission obligation ratably as the salesperson provides ongoing services to A.

Entity A enters into a three-year noncancelable service contract with a customer on January 1, 20X7. The total transaction price of \$3 million is invoiced on January 1, 20X7. The salesperson receives a commission payment of 2 percent of the invoice amount (\$60,000) when the contract is signed; the other half of the 4 percent commission will be paid after 12 months if the salesperson continues to be employed by A at that time. That is, if the salesperson is not employed by A on January 1, 20X8, the second commission payment will not be made. Entity A records a commission liability of \$60,000 on January 1, 20X7, and accrues the second \$60,000 commission obligation ratably over the 12-month period from January 1, 20X7, through December 31, 20X7.

Entity A concludes that only the first \$60,000 is an incremental cost incurred to obtain a contract with a customer. Because there is a substantive service condition associated with the second \$60,000 commission, A concludes that the additional cost is a compensation cost incurred in connection with the salesperson's ongoing service to A. That is, the second \$60,000 commission obligation was not incurred solely to obtain a contract with a customer but was incurred in connection with ongoing services provided by the salesperson.

If the salesperson would be paid the commission even if no longer employed, or if A otherwise concluded that the service condition was not substantive, the entire \$120,000 would be an incremental cost incurred to obtain a contract and would be capitalized in accordance with ASC 340-40-25-1. Entities will need to exercise professional judgment when determining whether a service condition is substantive.

## 13.8 PCAOB Requirements Related to Critical Audit Matters in the Auditor's Report

**PCAOB AS 3101**, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion* (the "standard"), requires critical audit matters (CAMs) to be included in the auditor's report. CAMs are intended to increase the informational value, usefulness, and relevance of the auditor's report.

### 13.8.1 Critical Audit Matters

Under the standard, a CAM is defined as "any matter arising from the audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex auditor judgment."

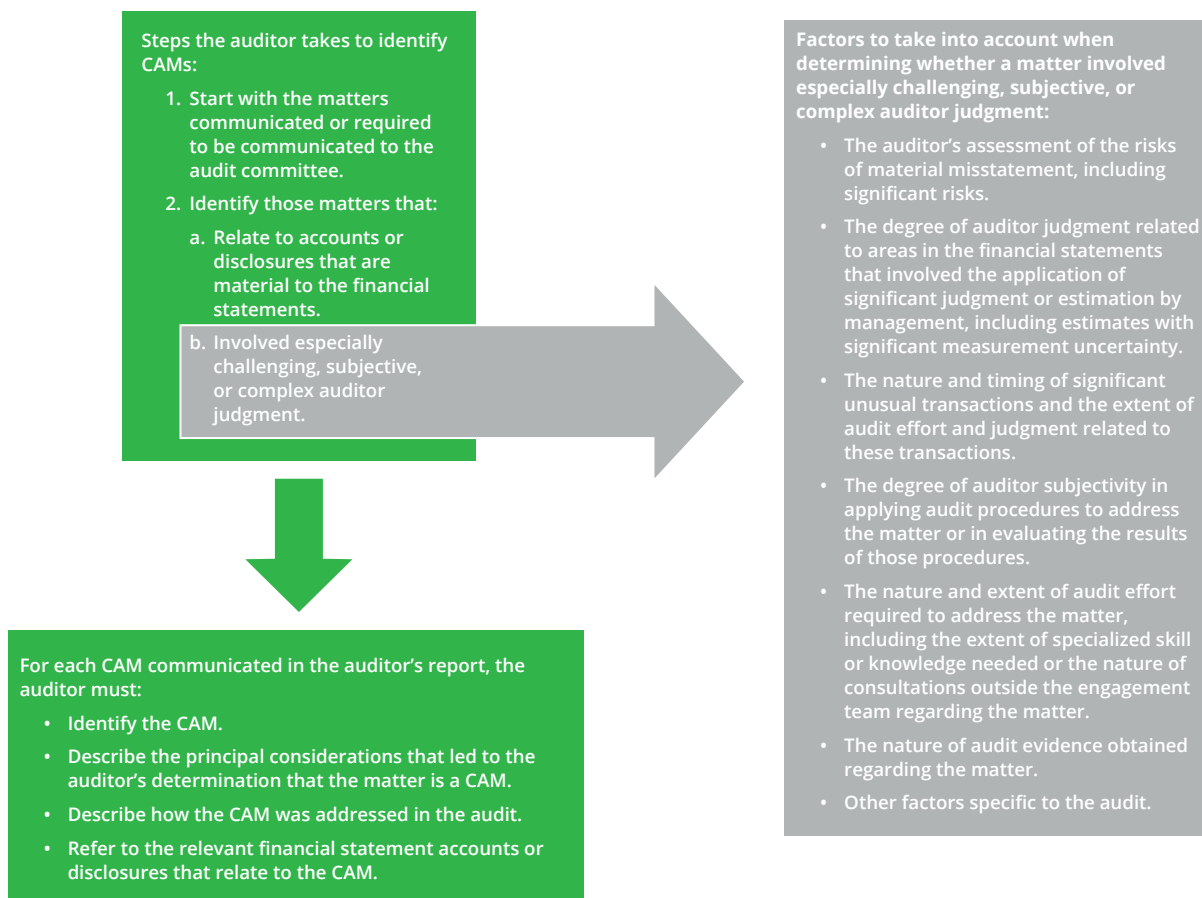
The standard includes a nonexclusive list of factors for the auditor to take into account, alone or in combination, in determining whether a matter involved especially challenging, subjective, or complex auditor judgment.

In accordance with the standard, CAMs are identified and described in a separate section of the auditor's report titled "Critical Audit Matters." Specific language precedes the description of the CAMs, stating that (1) CAMs do not alter the opinion on the financial statements and (2) the auditor is not providing a separate opinion on the CAMs or the accounts or disclosures to which they relate. For each CAM communicated in the auditor's report, the auditor is required to:

- "Identify the [CAM]."
- "Describe the principal considerations that led the auditor to determine that the matter is a [CAM]."
- "Describe how the [CAM] was addressed in the audit."
- "Refer to the relevant financial statement accounts or disclosures that relate to the [CAM]."

As stated in the PCAOB's [release](#) announcing its adoption of the standard (the "adopting release"), the determination of a CAM "should be made in the context of [a] particular audit, with the aim of providing audit-specific information rather than a discussion of generic risks." It is expected that in most audits to which the CAM requirements apply, the auditor would identify at least one CAM. If no CAMs are identified, the auditor is required to make a statement to that effect in the auditor's report.

The chart below, which is adapted from the adopting release, illustrates the auditor's decision process for identifying and communicating CAMs.



### 13.8.2 Applicability

Communication of CAMs is not required for audits of (1) brokers and dealers reporting under Rule 17a-5 of the Exchange Act; (2) investment companies registered under the Investment Company Act of 1940, other than companies that have elected to be regulated as business development companies; (3) employee stock purchase, savings, and similar plans; and (4) EGCs (as defined in Section 3(a)(80) of the Exchange Act). Auditors of these entities may consider voluntarily including communication of CAMs as described in the standard.

### 13.8.3 Considerations for Auditors, Management, and Audit Committees

The auditor is encouraged to discuss with management and the audit committee the types of matters related to the current-year audit that have been identified by the auditor and may be communicated as CAMs, including all matters communicated or required to be communicated to the audit committee.

Potential questions for management and audit committees regarding CAMs may include the following:

- What matters could be CAMs?
- How will management and audit committees engage with the auditor as CAMs are identified and the auditor's descriptions of the CAMs are developed and finalized?
- How do the auditor's statements regarding CAMs compare with management's disclosures regarding the same matters? Has management considered whether disclosures related to matters that may be CAMs need to be enhanced?

## 13.9 Structured Trade Payable Arrangements

To manage working capital more efficiently, life sciences companies may enter into arrangements with a bank or other intermediary under which the intermediary offers to purchase receivables held by the entity's suppliers. Such arrangements are known by various names, such as "structured payable arrangements," "vendor payable programs," "open account structured vendor payable programs," "reverse factoring," "supplier finance," or "supplier-chain finance."

Examples of structured payable arrangements include (1) open account platforms that permit an entity's suppliers to elect to sell trade receivables to one or more participating intermediaries, (2) an entity's use of charge cards issued by a financial institution to settle invoices, and (3) an entity's issuance of negotiable instruments (e.g., bills of exchange) to settle invoices.

Typically, open account platforms give participating suppliers the option to settle trade receivables by obtaining a payment from an intermediary either (1) before the invoice date at a discounted amount or (2) on the invoice due date for its full amount. Although the supplier may receive payment early, the purchasing entity is not required to settle its trade payable with the intermediary until the original invoice date.

Depending on its terms, a structured trade payable arrangement offers the parties various potential benefits, such as the following:

- *Suppliers' ability to monetize trade receivables and reduce the associated credit exposure* — By selling their trade receivables to an intermediary, suppliers can receive payment before the invoice due date and reduce their credit exposure.
- *Purchasers' ability to obtain extended payment terms* — Suppliers may be more willing to offer extended payment terms to purchasers if they can obtain early payment from intermediaries. Further, intermediaries may offer purchasers extended payment terms.

- *Intermediaries' ability to benefit from early-payment discounts, rebates, and transaction fees and charges* — Intermediaries earn a spread on the basis of the relationship between their funding costs and the amount of early-payment discounts, rebates, and other fees and charges received from suppliers.
- *Operational benefits* — Because of an intermediary's involvement, the arrangement may enhance the processing, administration, and control of the associated payments for purchasers and suppliers.
- *Extended early-payment discount period* — If an intermediary pays a supplier within the period during which the supplier offers an early-payment discount (e.g., a 2 percent discount for payment within 10 days of an amount due in 30 days, or 2/10 net 30), for instance, the intermediary may offer the purchasing entity a discount on the amount due for an extended period (e.g., 1/10 net 60).
- *Reduction in the amount due or other similar rebate* — The intermediary may offer the purchasing entity a reduction of the amount due or a reimbursement of part of the amount paid on the basis of net amounts paid to suppliers. (A supplier may agree to pay the intermediary a fee or reduce the amount due because of benefits it receives from the arrangement, such as a lowered credit risk exposure on the amount due or earlier payment of such amount.)

If an entity has a trade payable arrangement involving an intermediary, it should consider how to appropriately present and disclose the amount payable. SEC Regulation S-X, Rule 5-02(19)(a), requires SEC registrants to present amounts payable to trade creditors separately from borrowings on the face of the balance sheet. Accordingly, a purchasing entity that participates in a trade payable program involving an intermediary should consider whether the intermediary's involvement changes the appropriate presentation of the payable from a trade payable to a borrowing from the intermediary (e.g., bank debt). Entities often seek to achieve trade payable classification because trade payables tend to be treated more favorably than short-term indebtedness in the calculation of financial ratios (e.g., balance sheet leverage measures) and in the determination of whether financial covenants are met. Further, the determination of whether the payable should be presented as an amount owed to trade creditors or as an amount borrowed from the intermediary may affect the appropriate cash flow classification.

In speeches at the 2003 and 2004 AICPA Conferences on Current SEC and PCAOB Developments, Robert Comerford, then professional accounting fellow in the SEC's Office of the Chief Accountant (OCA), discussed the SEC staff's views about the presentation of certain trade payable arrangements involving an intermediary as trade payables or short-term borrowings. At the 2004 event, he **stated** the following:

As a general rule, the OCA Staff does not believe that it is possible to determine the appropriate accounting for structured transactions simply via reference to checklists and templates. Rather, . . . an entity must perform a thorough analysis of all the facts and circumstances specific to the individual transaction in order to ensure that the entity's accounting for the transaction serves investors well. [T]his necessitates meeting not just the letter, but the spirit of the accounting literature.

Mr. Comerford identified a number of points (summarized below) that the SEC staff encourages preparers and auditors to consider in determining whether amounts due in trade payable arrangements involving an intermediary should be classified as trade payables or borrowings.

SEC Staff Consideration Point	Related SEC Staff Observations	Deloitte Observations
What are “the roles, responsibilities and relationships of each party” to the arrangement? What is “the totality of the arrangement”?	By analogy to a supplier’s factoring of accounts receivables, the definition of factoring “does not make any mention of the [purchaser] actively or passively participating in the process.”	It can be helpful to consider whether the intermediary’s role in the arrangement is primarily that of (1) a factor of supplier receivables, (2) a finance provider to the entity, or (3) the entity’s paying agent. If the intermediary’s involvement does not change the nature, amount, and timing of the entity’s payments and does not provide the entity with any direct economic benefit, continued trade payable classification may be appropriate. See below for further discussion.
“Does the financial institution make any sort of referral or rebate payments” to the purchaser?	By analogy to a supplier’s factoring of accounts receivables, the definition of factoring “does not make any mention of [the supplier’s] customer receiving . . . any referral fees or rebates.”	If the entity receives no fees, rebates, payments, or other direct economic benefits from transactions between suppliers and the intermediary, continued trade payable classification may be appropriate. An entity’s receipt of referral or rebate payments from the intermediary (e.g., on the basis of fees, early-settlement discounts collected by the intermediary, or a dollar-volume-based rebate) suggests that continued classification of a payable as an amount owed to trade creditors may no longer be appropriate. In practice, classifying payables as trade payables has been considered unacceptable when the purchaser shares in early-settlement discounts collected by the intermediary from the supplier (e.g., the intermediary provides a rebate to the purchaser that is equivalent to half of a 2 percent early-settlement discount received from the supplier).
“Has the financial institution reduced the amount due . . . , such that the amount due is less than the amount the [entity] would have had to pay to the vendor on the original payable due date?”	By analogy to a supplier’s factoring of accounts receivables, the definition of factoring does not “make any mention of the [supplier’s] customer receiving any reductions in the amount of its obligation.”	If the entity’s original invoice terms remain the same, continued trade payable classification may be appropriate. An intermediary’s reduction of the amount due from the entity may suggest that continued classification of a payable as an amount owed to trade creditors is no longer appropriate.
“Has the financial institution extended beyond the payable’s original due date, the date on which payment is due”?	By analogy to a supplier’s factoring of accounts receivables, the definition of factoring does not “make any mention of [the supplier’s] customer receiving . . . any extension of its trade payable maturity dates beyond that which were customary prior to inception of the arrangement [e.g.,] 2/10 net 30.”	Payment terms and amounts that remain consistent with those of the entity’s other vendor payables and industry practice may suggest that continued classification as a trade payable may be appropriate. However, if the intermediary is not merely facilitating the payment of the entity’s invoice but extending the entity’s due date to a date after the original invoice due date and the date the intermediary pays suppliers, the entity’s arrangement may, in substance, be a borrowing from the intermediary.



(Table continued)

SEC Staff Consideration Point	Related SEC Staff Observations	Deloitte Observations
The literal definition of the term “trade creditor.”	“The OCA Staff believes that a trade creditor is a supplier that has provided an entity with goods and services in advance of payment.”	Generally, third-party factoring arrangements involving an entity’s payables do not preclude trade payable classification if the entity has no involvement and is not a party to contracts entered into between the supplier and the factor. If the creditor at origination is a supplier, therefore, the supplier’s subsequent sale of its receivable to a factor does not necessarily change the nature of that trade payable so that reclassification is required.

Further, the determination of whether the payable should be presented as an amount owed to trade creditors or an amount borrowed from the intermediary may affect the appropriate cash flow statement classification. If a trade payable arrangement involving an intermediary must be classified as a borrowing, the entity should consider the associated cash flow statement implications (see [Section 7.13](#) of Deloitte’s Roadmap *Statement of Cash Flows*).

### 13.9.1 Disclosure Considerations

In September 2022, the FASB issued [ASU 2022-04](#) to enhance transparency about an entity’s use of supplier finance programs. Under the ASU, all entities that use supplier finance programs in connection with the purchase of goods and services (herein described as buyer parties) are required to disclose qualitative and quantitative information about the programs. The ASU defines a supplier finance program as an arrangement that has all of the following characteristics:

- a. An entity enters into an agreement with a finance provider or an intermediary.
- b. The entity confirms supplier invoices as valid to the finance provider or intermediary under the agreement described in (a).
- c. The entity’s supplier has the option to request early payment from a party other than the entity for invoices that the entity has confirmed as valid.

At a minimum, the buyer in a supplier finance program is required to disclose the following information at least annually:

- The key terms of the program, including payment terms and assets pledged as security or other forms of guarantees.
- The amount of obligations outstanding at the end of the reporting period that the buyer has confirmed as valid and:
  - A description of where those obligations are presented in the balance sheet. (If the obligations are included in more than one line item, the amount in each line item must be disclosed.)
  - Rollforward information for the annual period showing the amount at the beginning of the period, the amount added during the period, the amount settled during the period, and the amount outstanding at the end of the period.

Further, in each interim reporting period, the buyer must disclose the outstanding confirmed amount as of the end of the interim period.

ASU 2022-04 is effective for all entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years, except for the disclosure of rollforward information, which is effective for fiscal years beginning after December 15, 2023. Early adoption is permitted. With the exception of the disclosure of rollforward information, which entities only need to apply prospectively, entities must apply the ASU retrospectively by providing the required disclosures for each period for which a balance sheet is presented. During the fiscal year of adoption, information about the key terms of the programs and the balance sheet presentation of the program obligations must be disclosed in each interim period.

In preclearance and comment letters issued before the FASB's release of ASU 2022-04, the SEC staff indicated that issuers should provide certain disclosures, if material, related to trade payable arrangements involving an intermediary. Such disclosures, if they are material (or are reasonably likely to become material) to a registrant's liquidity, include:

- A description of the relevant terms of the arrangement and why the entity entered into it.
- A description of the benefits to the entity and to the entity's suppliers.
- The amount that is eligible for factoring and the amount that has been factored (if known), including the amount owed to the financial institution or intermediary as of the balance sheet date.
- The arrangement's impact on an entity's operating cash flows, payment terms to its suppliers (including plans to further extend such terms), accounts payable days outstanding and changes in such amounts, liquidity, risks (including factors that could limit the entity's ability to continue to use similar arrangements in the future), and benefits.
- An analysis supporting classification of amounts settled under the arrangement as trade payables or bank financing, including classification and noncash disclosures considerations required by ASC 230.
- Any risks the arrangement exposes the entity to and how those risks are mitigated.
- Any guarantees provided by subsidiaries or the parent.

Entities that have not yet adopted ASU 2022-04 should consider the disclosures recommended by the SEC staff.

For more information, see [Section 14.3.1.3](#) of Deloitte's Roadmap *Issuer's Accounting for Debt*; [Section 2.9.3.3](#) of Deloitte's Roadmap *SEC Comment Letter Considerations, Including Industry Insights*; and Deloitte's September 30, 2022, *Heads Up*.

## 13.10 Foreign Currency Accounting Considerations

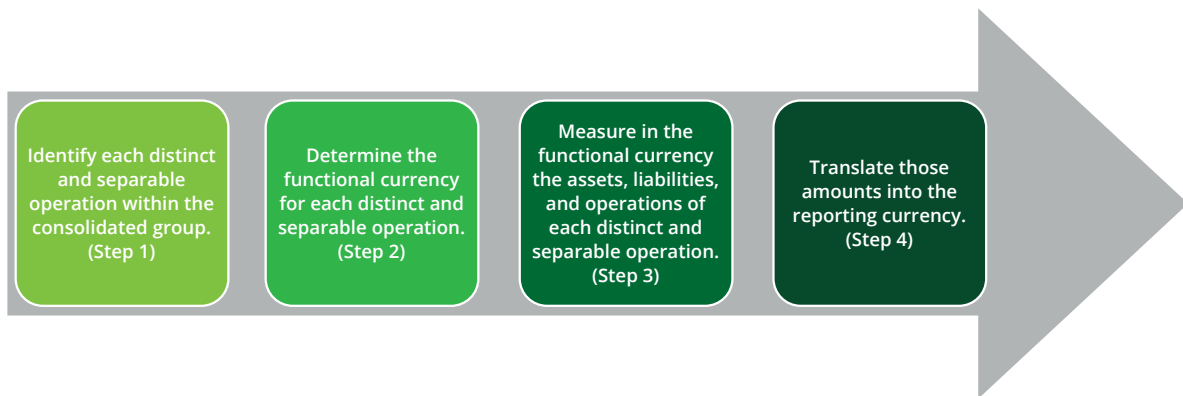
### 13.10.1 Overview

Since the issuance of FASB Statement 52 (codified in ASC 830) in 1981, domestic and international economies have become more interdependent. As a result, international operations have become more complex and generally represent a much larger portion of a company's overall financial results. This globalization has led many life sciences companies to consider strategic opportunities through international expansion, reorganize their operating models, and often transact with customers and partners in multiple currencies.

The primary objective of ASC 830 is for reporting entities to present their consolidated financial statements as though they are the financial statements of a single entity. Therefore, if a reporting entity operates in more than one currency environment, it must translate the financial results of those operations into a single currency (referred to as the reporting currency). However, this process should not affect the financial results and relationships that were created in the economic environment of those operations.

In accordance with the primary objective of ASC 830, a reporting entity must use a “functional-currency approach” in which all transactions are first measured in the currency of the primary economic environment in which the reporting entity operates (i.e., the functional currency) and then translated into the reporting currency.

Under the functional-currency approach, the reporting entity must perform four steps:



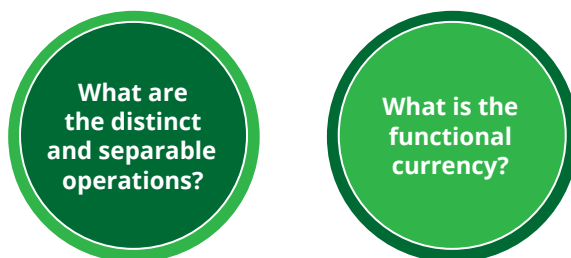
Because the functional-currency approach requires an entity to measure the assets, liabilities, and operations in the functional currency, an entity that enters into transactions in currencies other than its functional currency must first remeasure those amounts in its functional currency before they are translated into the reporting currency.



### Connecting the Dots

It is important to understand the difference between *remeasurement* and *translation* under ASC 830. By remeasuring financial results in the functional currency, an entity provides information about its future net cash flows. That is, as exchange rates fluctuate, so too will the related cash flows. For this reason, the effects of remeasurement are generally reported in the income statement. Translation, on the other hand, simply refers to the process of converting the financial statements from the functional currency into a different currency. In other words, the translation process has no impact on an entity's future cash flows. For this reason, the effects of translation are reported in equity.

### 13.10.1.1 Decision Points



The first step in applying the functional-currency approach under ASC 830 is to identify each distinct and separable operation within the consolidated group. While ASC 830 does not explicitly define “distinct and separable operation,” ASC 830-10-45-5 states:

An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

ASC 830-10-45-5 highlights that the functional currency could be different for each distinct and separable operation, even if those operations are part of the same entity. Therefore, to correctly determine the functional currency under ASC 830, reporting entities must evaluate whether a single entity contains two or more distinct operations.



#### Connecting the Dots

ASC 830-10-45-5 clarifies that each distinct and separable operation of the reporting entity is considered a separate “entity” when the requirements of ASC 830 are applied. Furthermore, ASC 830-10-20 defines a “foreign entity” and “reporting entity” as follows:

##### Foreign Entity

An operation (for example, subsidiary, division, branch, joint venture, and so forth) whose financial statements are both:

- a. Prepared in a currency other than the reporting currency of the reporting entity
- b. Combined or consolidated with or accounted for on the equity basis in the financial statements of the reporting entity.

##### Reporting Entity

An entity or group whose financial statements are being referred to. Those financial statements reflect any of the following:

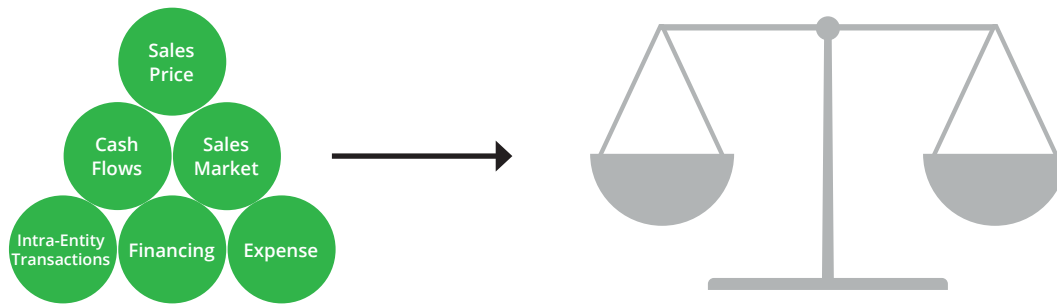
- a. The financial statements of one or more foreign operations by combination, consolidation, or equity accounting
- b. Foreign currency transactions.

Accordingly, each “distinct and separable operation” whose financial statements are prepared in a currency other than the reporting currency of the reporting entity (i.e., the direct parent entity) would be considered a “foreign entity.” Therefore, throughout this Guide’s discussion of foreign currency accounting considerations, the terms “distinct and separable operation” and “foreign entity” are used interchangeably.

After identifying the distinct and separable operations, the reporting entity must determine the functional currency of each one. This step is critical to the successful application of ASC 830 since the functional currency directly affects the identification and measurement of foreign currency transactions and the translation of the financial statements.

ASC 830 defines functional currency as “the currency of the primary economic environment in which the entity operates; normally, that is the currency of the environment in which an entity primarily generates and expends cash.” ASC 830-10-45-6 further states that the “functional currency of an entity is, in principle, a matter of fact.” That is, the functional currency of an entity is not simply an election that the reporting entity makes but a determination that is made on the basis of facts.

It can be challenging to determine an entity’s functional currency, depending on the nature of the entity’s operations. Therefore, to help reporting entities determine the functional currency of their entities, ASC 830 provides the following indicators, which must be assessed both individually and collectively:



Once an entity has determined the functional currency on the basis of evaluating the indicators above, it is generally rare that this currency would change in the future. ASC 830-10-45-7 indicates that there must be “significant changes in economic facts and circumstances” to justify changing an entity’s functional currency. However, ASC 830 also requires an entity to change its functional currency to the reporting currency of its immediate parent if the economy in which the entity operates becomes highly inflationary.

### 13.10.2 Determining the Functional Currency

The first step in the functional-currency approach is to determine which foreign entities make up the reporting entity. To be considered a foreign entity, an operation (or set of operations) should have its own financial statements or be able to produce such statements. Accordingly, a foreign entity most likely would have a management team that uses dedicated resources to run the entity’s operations. The concept of “distinct and separable operations” is important to making this determination.

From a practical standpoint, a reporting entity may begin the determination of its distinct and separable operations by identifying each legal entity in its organizational structure. Next, the reporting entity must determine whether any of those legal entities have two or more distinct and separable operations (e.g., divisions, branches, product lines).

If a legal entity has more than one distinct and separable operation, a reporting entity would consider each operation a separate entity when applying the guidance in ASC 830. Otherwise, the legal entity itself would generally be considered the entity subject to ASC 830. Judgment must be used in the determination of whether a single legal entity has more than one separate and distinct operation, and the reporting entity must thoroughly understand how and where the legal entity conducts business.



### Connecting the Dots

The term “foreign entity,” as used in ASC 830, refers to an entity that prepares its financial statements in a currency other than the reporting currency but does not refer to the entity’s geographic location. Therefore, an entity that is domiciled in the United States would meet the definition of a foreign entity under ASC 830 if it was consolidated by a reporting entity that has a reporting currency other than USD. Similarly, an entity that is domiciled in a foreign country would not meet the definition of a foreign entity under ASC 830 if it was consolidated by a reporting entity that has the same reporting currency as the entity. Therefore, the reporting entity must determine the functional currency of each distinct and separable operation (i.e., entity) within the consolidated group, regardless of where that operation is geographically located. The identification of foreign entities is important, since ASC 830 requires that the financial statements of each foreign entity be translated into the reporting currency.

#### 13.10.2.1 Identifying Distinct and Separate Operations

##### ASC 830-10

**45-5** An entity might have more than one distinct and separable operation, such as a division or branch, in which case each operation may be considered a separate entity. If those operations are conducted in different economic environments, they might have different functional currencies.

**55-6** In some instances, a foreign entity might have more than one distinct and separable operation. For example, a foreign entity might have one operation that sells parent-entity-produced products and another operation that manufactures and sells foreign-entity-produced products. If they are conducted in different economic environments, those two operations might have different functional currencies. Similarly, a single subsidiary of a financial institution might have relatively self-contained and integrated operations in each of several different countries. In those circumstances, each operation may be considered to be an entity as that term is used in this Subtopic, and, based on the facts and circumstances, each operation might have a different functional currency.

ASC 830-10-45-5 presents the notion of a “distinct and separable operation” but offers no definition of or qualifying criteria related to such an operation. Further, a distinct and separable operation may or may not meet the definition of a business in ASC 805-10. Thus, management will need to use judgment and consider all facts and circumstances in determining which operations are distinct and separable. However, the following factors, while not exhaustive, may indicate that an operation is distinct and separable for purposes of the functional-currency analysis:

- The operation has specifically identifiable assets and liabilities (i.e., not shared or commingled with other operations’ assets and liabilities).
- The operation can be managed separately and apart from other operations of the reporting entity.
- Accounting records for the operation could be produced.

As noted previously, distinct and separable operations may be identified at a lower level than the legal entity itself. For instance, divisions or branches of the same legal entity (e.g., a subsidiary) may operate in different economic environments, in which case each may be considered a distinct and separable operation.

Under ASC 830, a reporting entity is not required to separate the accounting records of its operations if doing so is impracticable. Further, just because certain operations may be separable in some way (e.g., the operations have their own set of accounting records), the operations are not necessarily distinct and separable.

Reporting entities should carefully consider all facts and circumstances when determining whether an operation is distinct and separable. The following are some factors (not all-inclusive) indicating that operations may not be distinct and separable, even if separate accounting records are maintained:

- A legal entity's foreign division is solely responsible for manufacturing certain product lines for its parent.
- A holding company is essentially an extension of its parent or affiliate.
- A subsidiary or division functions only as a foreign sales office for its parent.
- Individual retail stores are managed centrally.
- A foreign subsidiary or division operates only as the treasury or internal administrative function for its parent.

For more information, see [Section 2.2.1](#) of Deloitte's Roadmap *Foreign Currency Matters*.

### **13.10.2.2 Definition of Functional Currency and Indicators**

Once the distinct and separable operations have been identified, the next step is to determine the "currency of the primary economic environment in which the [distinct and separable operation] operates." An entity may be required to use significant judgment in making this determination, depending on the nature of the operation being evaluated. The following are two scenarios illustrating the determination of the functional currency:

- Entity A, a subsidiary of a U.S. parent, is an operating company located in France that is relatively autonomous. Entity A conducts all of its operations in France, and all of its transactions are denominated in EUR.
- Entity B, a subsidiary of a U.S. parent, is a holding company located in Germany and obtains a loan denominated in USD from its U.S. parent. In addition, B borrows additional funds denominated in EUR from an unrelated third party and invests the entire amount, denominated in EUR, in Entity C, an operating company also located in Germany. Entity B intends to use dividends received from its investment in C to remit dividends to the parent in USD.

In the first scenario, the determination of the functional currency is relatively straightforward: A's functional currency is the EUR. However, in the second scenario, it is not clear whether B's functional currency is USD or the EUR. Management would need to use judgment in determining B's functional currency in the second scenario.

Further, it should not be assumed that the functional currency is either that of the parent or that of the jurisdiction in which the distinct and separable operation operates (i.e., the local currency). Management may also conclude, on the basis of the facts and circumstances, that the functional currency is that of another jurisdiction (although such a conclusion is not as common).

In determining the appropriate functional currency, management should consider each of the economic factors in ASC 830-10-55-5(a)–(f) and thoroughly document the conclusions reached.

It should be noted that ASC 830 does not address how the economic factors in ASC 830-10-55(a)–(f) should be applied (e.g., weightings or hierarchy may differ for certain factors). Rather, ASC 830-10-55-5 states that these "factors, and possibly others, should be considered both individually and collectively when determining the functional currency."

However, because changes in functional currency are expected to be infrequent, management should place greater emphasis on long-term considerations related to each factor than it does on short-term

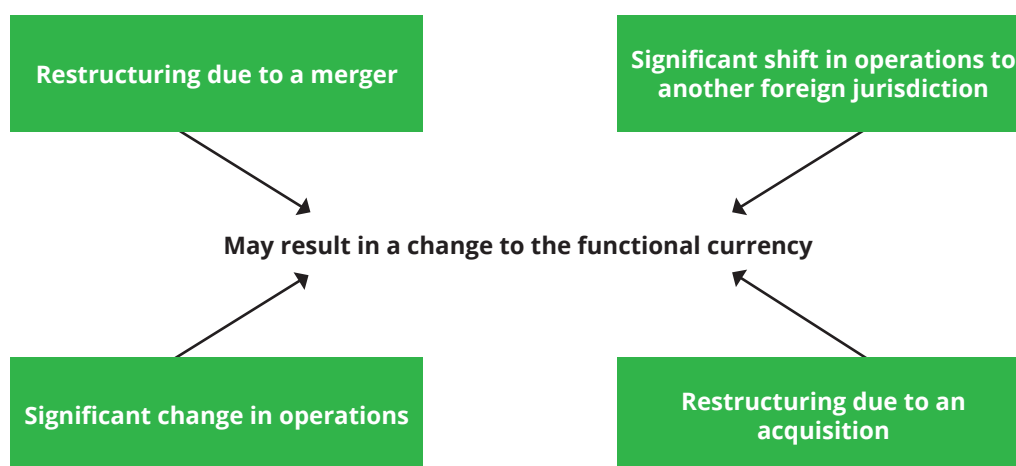


considerations. For example, start-up operations may receive significant financing from the parent in the parent's functional currency but ultimately plan to operate primarily in a foreign economic environment. In such cases, the facts and circumstances may indicate that, while the start-up operation's financing was in the currency of its parent in the short term, the start-up operation may eventually operate primarily in the foreign economic environment. Therefore, consideration of the factors in ASC 830-10-55-5(a)–(f) would most likely lead to a conclusion that the start-up operation's functional currency is, in fact, different from the parent's.

### 13.10.3 Change in Functional Currency

As previously noted, ASC 830-10-45-7 indicates that there must be "significant changes in economic facts and circumstances" to justify a change in functional currency. Except when an economy is identified as highly inflationary, ASC 830 does not define or provide examples related to what constitutes a significant change in facts and circumstances. An entity must therefore use judgment in determining whether significant changes in facts and circumstances have occurred. However, such changes are expected to be rare.

Changes in the functional currency may result from one-time transactions, such as a merger or acquisition, or from a longer-term shift in an entity's operations. Regardless of the reason, it is important that management carefully consider whether such an event is significant enough to warrant a change in the functional currency. Because ASC 830 does not provide guidance on how to determine whether a change is "significant," preparers may find it helpful to compare the indicators before and after the change in making the determination. Entities are encouraged to consult with their accounting advisers in such situations.



#### SEC Considerations

The SEC's *Frequently Requested Accounting and Financial Reporting Interpretations and Guidance*, released by the Division of Corporation Finance (the "Division"), provides an additional example in which a change in functional currency may be appropriate. This guidance states that "[r]egistrants with foreign operations in economies that have recently experienced economic turmoil should evaluate whether significant changes in economic facts and circumstances have occurred that warrant reconsideration of their functional currencies." The Division warns, however, that it may be difficult to conclude that "currency exchange rate fluctuations alone would cause a self-contained foreign operation to become an extension of the parent company." Regardless of the underlying reason for the change in functional currency, the Division suggests that, although ASC 830 does not require them to do so, "[r]egistrants should consider the need to disclose the nature and timing of the change, the actual and reasonably likely effects of the change,

and economic facts and circumstances that led management to conclude that the change was appropriate. The effects of those underlying economic facts and circumstances on the registrant's business should also be discussed in MD&A."

### **13.10.3.1 Determining When to Change the Functional Currency**

In accordance with ASC 830-10-45-7, a change in functional currency should be reported as of the date on which it is determined that "significant changes in economic facts and circumstances" have occurred. Although such a change could occur on any date during the year, it is acceptable to use a date at the beginning of the most recent reporting/accounting period.

### **13.10.3.2 Accounting for a Change in the Functional Currency**

ASC 250-10-45-1 states that the "[a]doption or modification of an accounting principle necessitated by transactions or events that are clearly different in substance from those previously occurring" is not considered a change in accounting principle. Because a change in functional currency is necessitated by a significant change in facts and circumstances that are "clearly different in substance from those previously occurring," such a change does not meet the definition of a change in accounting principle and therefore should not be accounted for as such (i.e., previously issued financial statements should not be restated).

For more information, see [Section 2.4.2](#) of Deloitte's Roadmap *Foreign Currency Matters*.

## **13.10.4 Other Special Considerations**

### **13.10.4.1 Exchange Rates**

In remeasuring foreign-currency-denominated transactions into the entity's functional currency and translating financial statements into the parent's reporting currency, an entity must identify the appropriate exchange rate. While ASC 830 provides some guidance on which exchange rates should be used, it may not always be clear that a particular exchange rate is appropriate. Significant judgment may be required when multiple legal exchange rates coexist (e.g., when an official exchange rate and an unofficial exchange rate exist).

For more information, see [Chapter 3](#) of Deloitte's Roadmap *Foreign Currency Matters*.

### **13.10.4.2 Intra-Entity Transactions**

Intra-entity foreign currency transactions can have unique effects on an entity's financial statements, including the (1) creation and transfer of foreign currency risk from one entity in a consolidated group to another, (2) creation of transaction gains and losses that "survive" consolidation, and (3) application of exceptions to the general rules outlined in ASC 830. In some situations, the remeasurement of loans between entities within a consolidated group creates transaction gains or losses that are recognized in earnings. In other situations, the remeasurement is recognized within equity.

For more information, see [Chapter 6](#) of Deloitte's Roadmap *Foreign Currency Matters*.

### 13.10.4.3 *Highly Inflationary Economies*

In economies with significant inflation, the local currency may be deemed unstable. Therefore, ASC 830 requires that entities operating in environments deemed to be highly inflationary remeasure their financial statements into the reporting currency. That is, the reporting currency of the entity's immediate parent is used as the functional currency of the foreign entity. An entity may need to use significant judgment in determining whether a foreign entity has a highly inflationary economy. If such an economy is determined to be highly inflationary, the guidance in ASC 830 on applying the functional-currency approach must be applied. The application of such guidance can be time-consuming and complex.

For more information, see [Chapter 7](#) and [Section 9.2.3](#) of Deloitte's Roadmap *Foreign Currency Matters*.

## 13.11 Financial Reporting Considerations Related to Environmental Events and Activities

### 13.11.1 Introduction

ESG matters have become common topics in the news. At the same time, investors, credit rating agencies, lenders, regulators, policymakers, and other interested parties have increasingly focused on these issues. In addition, the FASB, SEC, and CAQ have all provided public information<sup>7</sup> regarding the importance of considering environmental matters, for both preparers of financial statements and auditors.

Given the increased interest in ESG matters from various parties, entities in virtually all industries are considering how these matters will affect their business strategies, operations, and long-term value. As entities develop business strategies related to the evolving ESG landscape, they will need to incorporate ESG considerations into their preparation of financial statements. In doing so, they should ensure that any plans or commitments related to environmental initiatives are considered in a consistent manner for both sustainability reporting and the preparation of the financial statements. For example, when preparing financial statements, an entity that plans to reduce its carbon footprint should evaluate the impact of those plans, if any, on topics such as the useful life of assets, impairment of assets, asset retirement obligations (AROs), other liabilities, and disclosure requirements under current U.S. GAAP.

Entities may also pursue specific arrangements or transactions in connection with climate-related objectives that involve complex accounting issues, require significant judgment, or both. For example, entities that enter into certain types of energy service agreements (ESAs) may need to evaluate whether those arrangements contain an embedded lease. In addition, for other types of transactions with climate-related objectives, such as compensation arrangements linked to the achievement of company-specific environmental metrics, entities may be required to assess the probability of achieving such metrics.

The next sections in this chapter examine certain potential impacts of climate-related matters on a life sciences entity's financial accounting and reporting in the context of the existing accounting guidance and the current regulatory environment. While these impacts may vary depending on the nature of the entity's business, along with factors such as relevant regulatory, legal, and contractual obligations, all life sciences entities should evaluate environment-related financial accounting and reporting implications.

<sup>7</sup> See the FASB staff's March 19, 2021, educational paper [Intersection of Environmental, Social, and Governance Matters With Financial Accounting Standards](#); the SEC's February 8, 2010, interpretive release [Commission Guidance Regarding Disclosure Related to Climate Change](#) (the "2010 interpretive release") and March 15, 2021, request for input [Public Input Welcomed on Climate Change Disclosures](#); and the CAQ's September 9, 2021, white paper [Audited Financial Statements and Climate-Related Risk Considerations](#).

## 13.11.2 Regulation and Standard Setting

### 13.11.2.1 SEC Reporting Considerations

Life sciences entities should be mindful of SEC reporting requirements regarding climate-related disclosures. In recent years, the SEC staff has increased its focus on climate-related disclosures in its review of public-company filings, including assessing the extent to which the information provided by such companies is consistent with the SEC's 2010 interpretive release. On September 22, 2021, the SEC publicly released a [sample letter](#) that highlighted the types of comments the SEC staff may issue to public companies regarding climate-related disclosures. Since the release of this sample letter, the SEC staff has issued comments to public companies in a variety of industries. The SEC staff has been issuing comments to entities about their climate-related disclosures under existing requirements. These comments primarily focus on the business, risk factors, and MD&A sections of SEC filings.

On March 6, 2024, the SEC issued a [final rule](#) that requires registrants to provide climate-related disclosures in their annual reports and registration statements. Specifically, registrants must disclose certain climate information in the notes to the financial statements and outside the financial statements. For example, in the footnotes to the financial statements, a registrant must disclose (1) financial statement impacts and material impacts on its financial estimates and assumptions due to severe weather events and other natural conditions and (2) a rollforward of carbon offsets or renewable energy certificates (RECs) if the registrant's use of carbon offsets and RECs is a material component of its plan to achieve its disclosed climate-related targets or goals. Large accelerated filers and accelerated filers must provide disclosures outside the financial statements about their material Scope 1 and Scope 2 greenhouse gas (GHG) emissions, subject to assurance requirements that will be phased in. In addition, all registrants, regardless of filer status, are required to disclose outside the financial statements (1) governance and oversight of material climate-related risks; (2) the material impact of climate related risks on the company's strategy, business model, and outlook; (3) the risk management process for material climate-related risks; and (4) material climate targets and goals.

For more information about SEC communications regarding climate-related matters, see Deloitte's [March 6, 2024](#), and [March 15, 2024](#), *Heads Up* newsletters.

### 13.11.2.2 International Legislative and Standard-Setting Considerations

Entities should also be mindful of the international progress toward developing a common set of sustainability reporting standards regarding climate change and climate-related topics. In November 2022, the European Council and the European Parliament approved the final text of the Corporate Sustainability Reporting Directive (CSRD), which will require sustainability reporting by a substantial number of companies that previously were not subject to mandatory sustainability reporting.

On July 31, 2023, the European Commission adopted the European Sustainability Reporting Standards (ESRS). The ESRS provide supplementary guidance for companies within the scope of the CSRD.

The CSRD and ESRS will affect all companies with significant operations in E.U. jurisdictions, including U.S.-based companies with as little as one subsidiary or branch in the European Union. For more information about the CSRD and ESRS, see Deloitte's August, 17, 2023 (updated February 23, 2024), [Heads Up](#).

Further, the International Sustainability Standards Board issued its first two standards: [IFRS S1](#) (on disclosure requirements associated with sustainability-related financial information) and [IFRS S2](#) (on climate-related disclosures). These standards are intended to improve the alignment and interoperability of global ESG standards, reducing the reporting burden for preparers and enhancing the usefulness of sustainability disclosures for investors in making decisions. For more information about IFRS S1 and IFRS S2, see Deloitte's June 30, 2023, [Heads Up](#).

During the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments, several speakers noted that many companies are preparing to report under various climate-related disclosure frameworks. As a result of new climate and sustainability standards and regulations across the globe, life sciences entities may be within the scope of (1) the CSRD, (2) IFRS S1 and IFRS S2, or, as discussed below, (3) California's climate legislation.

### **13.11.2.3 U.S. State Regulatory Considerations**

In addition to monitoring international regulatory and standard-setting developments related to climate and sustainability, as well as preparing to implement the requirements of the SEC's final rule on climate-related disclosures, entities will need to keep abreast of climate- and sustainability-related regulatory developments in the United States at the state level.

In October 2023, three climate bills — [SB-253](#), [SB-261](#), and [AB-1305](#) — were signed into law in California. The new legislation will significantly affect certain public and private companies doing business or operating in that state. Under SB-253 and SB-261, entities will have to report GHG emissions and climate risks. AB-1305, which is intended to combat company "greenwashing" of climate-related emission claims, establishes requirements for entities that market or sell voluntary carbon offsets in California as well as entities that operate in California and make certain climate-related emission claims. For more information about California's climate legislation, see Deloitte's October 10, 2023 (updated December 19, 2023), [Heads Up](#).

Life sciences entities are encouraged to monitor legislative and rulemaking developments in their home state, as well as those in other states in which they operate or do business, for potential reporting requirements.

### **13.11.3 Potential Accounting and Reporting Implications of Environmental Objectives**

Entities from various industries have begun issuing public statements regarding their plans to address the impacts of climate change on their businesses, and recent news headlines have often highlighted these statements — for example, "Entity A commits to being carbon neutral by 2030" or "Entity B pledges to reduce greenhouse gas emissions by 90% by 2040." As a result, questions have arisen about the accounting and disclosure considerations related to such statements. While such considerations will depend on the specific facts and circumstances of an entity's climate-related public statements, plans, and actions, this section highlights certain key considerations related to evaluating the accounting and disclosure implications.

Before this evaluation is performed, it is critical to understand how the plans and actions of management (i.e., personnel with the appropriate authority) align with its specific public statements (e.g., those made by the two entities in the preceding paragraph). By obtaining such an understanding, an entity will be better able to assess the effect of its climate-related public statements and supporting plans and actions on its net assets, including whether any assets are impaired or any contractual liabilities exist. For example, Entity A may operate in a jurisdiction or industry in which it is required to provide a certain level of carbon offsets, either internally generated or purchased, as part of its plan

to become carbon neutral. Depending on the facts and circumstances of the government regulation and A's specific operation, A's obligation to provide carbon offsets for carbon emissions may result in a liability that needs to be recorded, potentially disclosed, or both.

### **13.11.3.1 Assessing the Impact on Assets**

Life sciences entities should evaluate how their climate-related public statements and supporting plans and actions affect various aspects of their businesses as well as the related accounting implications of those plans in light of existing accounting standards. For example, if Entity B plans to reduce its GHG emissions by replacing its current manufacturing equipment with new technology and equipment that emit fewer GHGs, it should evaluate whether there has been a triggering event<sup>8</sup> related to the recoverability of its existing manufacturing equipment and reassess whether the current useful life of its existing manufacturing equipment remains appropriate. Further, if B has goodwill related to a reporting unit that includes the product lines produced by the existing equipment, it should assess whether its future manufacturing process will result in a different profit margin profile. Lower future profit margins could affect the expected future cash flows of the reporting unit and ultimately could alter the results of the entity's goodwill impairment test. See [Sections 13.11.5](#), [13.11.12](#), and [13.11.13](#) for more detailed information.

### **13.11.3.2 Assessing the Incurrence of Liabilities**

In addition to considering whether it has any contractual obligations to address climate-related issues, an entity should consider whether government or regulator actions or the entity's own public statements, plans, or actions could give rise to any other legal or constructive obligations that the entity would be required to account for, disclose, or both, in its financial statements.

Paragraph E38 of FASB Concepts Statement 8, Chapter 4 (released in December 2021), identifies two essential characteristics of a liability:

- "It is a present obligation."
- "The obligation requires an entity to transfer or otherwise provide economic benefits to others."

These two characteristics are further discussed below.

#### **13.11.3.2.1 Characteristic 1 — Present Obligation**

In the assessment of whether a present obligation exists, the determination of whether there is a legal obligation is often unambiguous. However, the definition of the term legal obligation in the ASC master glossary acknowledges that such an obligation can be established by "an existing or enacted law, statute, ordinance, or written or oral contract or by legal construction of a contract under the doctrine of promissory estoppel." If an entity makes a promise to a third party, including the public at large, about its intentions to undertake certain activities, the entity may be required to use significant judgment to determine whether it has created a legal obligation under the legal doctrine of promissory estoppel, which is defined as the "principle that a promise made without consideration may nonetheless be enforced to prevent injustice if the promisor should have reasonably expected the promisee to rely on the promise and if the promisee did actually rely on the promise to his or her detriment."<sup>9</sup>

<sup>8</sup> See ASC 360-10-35-21 for examples of events or changes in circumstances that may indicate a long-lived asset (asset group) may not be recoverable.

<sup>9</sup> See ASC 410-20-20, which cites the definition of promissory estoppel that is used in *Black's Law Dictionary*, seventh edition.

Entities should evaluate the existence of legal obligations on the basis of current laws, regulations, and contractual obligations, as well as the related interpretations and facts and circumstances; they should not forecast changes in laws or in the interpretations of laws and regulations. The impacts of any changes in laws or regulations should be considered in the period in which the new or amended laws or regulations are enacted. In addition, in determining whether a public statement has created a legal obligation under the notion of promissory estoppel, entities should work closely with legal counsel to evaluate their own specific facts and circumstances. If the results of this determination are unclear, they may wish to obtain a legal opinion to support their conclusions.

According to paragraph E43 of FASB Concepts Statement 8, Chapter 4, “[l]iabilities necessarily involve other parties, society, or law. The identity of the other party or recipient need not be known to the obligated entity before the time of settlement.” Further, paragraph E45 notes that the present obligation of a liability must exist as of the financial statement date and that “[t]ransactions or other events or circumstances expected to occur in the future do not in and of themselves give rise to obligations today.” In issuing Concepts Statement 8, Chapter 4, the FASB was aiming to shift the emphasis away from identifying a past or future transaction or event and to focus instead on the term “present.”

FASB Concepts Statement 8, Chapter 4, states that to be presently obligated for a liability, “an entity must be bound, either legally or in some other way, to perform or act.” For instance, many obligations can stem from legally enforceable contracts and agreements, resulting in a recorded liability. However, the FASB also indicates that a constructive obligation may be “created, inferred, or construed from the facts in a particular situation rather than contracted by agreement.” In describing constructive obligations, FASB Concepts Statement 8, Chapter 4, further states that an “entity’s past behavior also may give rise to a present obligation.”

In assessing whether it has a constructive obligation that is not a legal obligation, an entity must employ significant judgment and consider its specific facts and circumstances. For an event or circumstance (e.g., a public statement) to rise to the level of a constructive obligation that should be recognized as a liability, the entity must, as a result of the event or circumstance, be obligated to sacrifice assets in the future and have little or no discretion to avoid the future sacrifice. The assessment of whether an entity has a constructive obligation related to its climate-related public statements, plans, or actions should not be a one-time evaluation; rather, the entity should continue to assess its facts and circumstances as its climate-related initiatives progress.

If an entity determines that it has or may have an obligation (contractual, legal, or constructive) that should be recorded in its financial statements, the entity should carefully consider (1) the point in time at which the entity’s obligation began and (2) whether the obligation exists as of the financial statement date. Liabilities arise as a result of a past event. For example, as employees render services to an entity, the entity incurs the liability to pay the employees for their services. The rendering of services in exchange for payment is an example of a reciprocal transaction in which one party exchanges a good or service with another party (in this case, the employee rendering services in exchange for payment). However, obligations arising as a result of a government action or an entity’s climate-related public statements, plans, or actions may not be reciprocal transactions but obligations to the public at large or other relevant stakeholders. In assessing the point in time at which an entity has incurred an obligation that does not result from a reciprocal transaction, an entity may need to use significant judgment and consider all relevant facts and circumstances. For example, an entity’s obligation may arise as a result of future carbon emissions, which may indicate that the obligation does not exist as of the financial statement date.



### 13.11.3.2.2 Characteristic 2 — Obligation to Provide Economic Benefits

As outlined in paragraphs E54 through E60 of FASB Concepts Statement 8, Chapter 4, a second essential characteristic of a liability is that “the obligation requires an entity to transfer or provide economic benefits to others or to be ready to do so.” Such an entity often must transfer cash or other assets to one or more other entities. However, FASB Concepts Statement 8, Chapter 4, states that an obligation “can be fulfilled, satisfied, or settled in a number of other ways, including by granting a right to use an asset, providing services, replacing that obligation with another obligation, converting the obligation to equity, or, in certain circumstances, transferring shares of the entity.”

#### 13.11.3.3 Disclosure Considerations

Entities should also evaluate whether any of their climate-related public statements, plans, or actions must be disclosed in the financial statements, even if they conclude that there is nothing to record in the current-period financial statements. ASC 275 requires an entity to disclose information that helps financial statement users assess major risks and uncertainties. Specifically, ASC 275-10-50-1 requires disclosure of risks and uncertainties related to the following:

- a. Nature of operations, including the activities in which the entity is currently engaged if principal operations have not commenced
- b. Use of estimates in the preparation of financial statements
- c. Certain significant estimates
- d. Current vulnerability due to certain concentrations.

#### Example 13-3

Pharmaceutical Entity X manufactures and distributes diabetes medicines that are administered by using fossil-based plastic pens. Entity X expects to shift to more sustainable material for its devices and to explore the ability to reclaim and reuse the plastic in these devices. In a manner consistent with its public statements, X is actively engaging with vendors of alternative fuel sources to identify a green alternative and expects such an alternative to be available for use in the near term. On the basis of its facts and circumstances, X concludes that it does not have any present obligations (contractual, legal, or constructive) or impacts on other financial statement accounts to record in its financial statements; however, X may be required to disclose the risks and uncertainties related to the future of this key product line in accordance with ASC 275.

To assess whether its plans or actions result in risks or uncertainties that must be disclosed in accordance with ASC 275, an entity must apply professional judgment after considering all relevant facts and circumstances.

In addition, an entity should assess whether any of its public statements regarding climate-related initiatives give rise to commitments that must be disclosed in the financial statements. The ASC master glossary defines a firm commitment as “[a]n agreement with an unrelated party, binding on both parties and usually legally enforceable,” that (1) is specific in “all significant terms, including . . . fixed price, and the timing of the transaction,” and (2) “includes a disincentive for nonperformance that is sufficiently large to make performance probable.”

ASC 440 requires an entity to disclose certain situations that are not recorded in the financial statements. Specifically, ASC 440-10-50-1, as amended by [ASU 2016-02](#), requires disclosure of:

- a. Unused letters of credit
- b. Leases . . .
- c. Assets pledged as security for loans
- d. Pension plans . . .

- e. The existence of cumulative preferred stock dividends in arrears
- f. Commitments, including:
  - 1. A commitment for plant acquisition
  - 2. An obligation to reduce debts
  - 3. An obligation to maintain working capital
  - 4. An obligation to restrict dividends.

In addition, ASC 440-10-50-2 requires disclosure of “unconditional purchase obligations.”

These examples are not an exhaustive list of commitments to be disclosed, and entities should evaluate their specific facts and circumstances to determine whether they have any commitments that should be disclosed in their financial statements in accordance with ASC 440.

Note that in addition to the disclosure requirements set forth by U.S. GAAP, entities should consider SEC reporting requirements, as discussed above. For further information, see Deloitte’s September 27, 2021, [Heads Up](#) and the [SEC Climate-Related Disclosures](#) section in Deloitte’s November 16, 2022, [Financial Reporting Alert](#).

#### **13.11.4 Developing Estimates and Maintaining Consistency of Assumptions and Estimates**

As life sciences entities focus on climate-related initiatives and make changes to their businesses, they may face challenges related to selecting appropriate assumptions and developing reliable estimates. Nevertheless, they will still be required by U.S. GAAP to develop estimates that underlie various accounting conclusions. To develop such estimates, entities will need to consider all available information.

Further, entities may be required to use assumptions or estimates for more than one purpose (e.g., forecasted revenues or cash flows may be an assumption that is used in multiple impairment tests, assessments of the realizability of DTAs, and the evaluation of an entity’s ability to continue as a going concern). When a single assumption is used in multiple analyses, entities should verify that the same assumption is being used in each analysis unless the guidance in U.S. GAAP permits otherwise. In addition, entities should verify that assumptions and estimates outside of the financial statements (e.g., sustainability reports) are consistent with those used when preparing estimates required by U.S. GAAP.

Life sciences entities should also consider external events and circumstances, including changes in regulatory environments, when assessing whether (1) the changes they made in assumptions and estimates from the previous period were appropriate or (2) it was appropriate in the current period *not* to have updated or changed the assumptions used in the previous period.

#### **13.11.5 Use and Recoverability of Long-Lived Assets**

As an entity considers climate-related matters, it should continue to evaluate the accounting and reporting impacts of its goals or targets with respect to its carbon footprint. Understanding how its business shifts to support these goals or targets is critical to evaluating the ongoing use and recoverability of its long-lived assets, including goodwill, as well as other indefinite-lived intangible assets and PP&E. On the basis of these business shifts, an entity may need to reassess the useful life of an asset or test an asset (asset group) for impairment.

### **13.11.5.1 Indefinite-Lived Intangible Assets Other Than Goodwill**

An entity should assess changes to its business as a result of climate-related initiatives, since these could affect the value of its indefinite-lived intangible assets. As stated in ASC 350-30-35-4, an indefinite-lived intangible asset is one for which “there is no foreseeable limit on the period of time over which it is expected to contribute to the cash flows of the reporting entity.” Brands and trademarks are common examples of indefinite-lived intangible assets.

Indefinite-lived intangible assets are tested annually for impairment and more frequently if an event or a change in circumstances indicates that it is more likely than not that the intangible asset is impaired in accordance with ASC 350-30. ASC 350-30-35-18B provides examples of these events or changes in circumstances, which include, but are not limited to, financial performance, legal or political factors, entity-specific events, and industry or market considerations. On the basis of this assessment, if an entity determines that it is more likely than not that the carrying value of the intangible asset exceeds its fair value, the entity performs a valuation to determine the fair value of the asset and recognizes an impairment loss equal to the excess of the carrying amount of the intangible asset over its fair value.

A valuation technique that is often applied to the measurement of a brand or trademark is the relief-from-royalty method. This method, which focuses primarily on expected revenues and royalty rates, requires the entity to make fewer assumptions than other income methods. However, an entity may find it challenging to project revenues because of an expected shift in demand for its product due not only to changes in consumer buying decisions, as consumers seek to purchase more environmentally friendly products, but also to a change in the entity’s ability to continue producing and selling its current products while also meeting any internal climate-related targets (such as a commitment to being carbon neutral by a certain date). Entities are expected to use their best estimate of all required business and valuation assumptions for this method or other income methods used to measure the fair value of an indefinite-lived intangible asset.

In addition to evaluating the need for an interim impairment test, an entity should consider whether there are any indicators that an intangible asset classified as indefinite-lived has become finite-lived, which might occur if the entity changes its expected use of the asset in response to its strategy to produce more environmentally friendly products.

### **13.11.5.2 Long-Lived Assets**

A life sciences entity should consider whether it expects to experience (1) a decline in revenues, (2) an increase in costs (i.e., a decline in net cash flows), or (3) both, as a result of changes to its business to undertake climate-related initiatives. If so, such changes may indicate that the entity should test its long-lived assets for recoverability.

Entities are required by ASC 360-10-35-21 to test a long-lived asset (asset group) that is classified as held and used for recoverability “whenever events or changes in circumstances indicate that its carrying amount may not be recoverable” — for example, if there is a “significant adverse change . . . in the business climate that could affect the value of a long-lived asset (asset group).” Events or changes in circumstances that prompt a recoverability test are commonly referred to as “triggering events.” As an entity adjusts its business to align with climate-focused initiatives, it may experience one or more of the triggering events listed in ASC 360-10-35-21. For example, depending on the nature of the entity’s business and its assets, it may determine that certain product lines will be phased out (as well as the related assets producing them) or that products will be produced by more environmentally friendly assets. Triggering events that may be present as a result of an entity’s response to climate-related initiatives include, but are not limited to, a “significant adverse change in the extent or manner in which a long-lived asset (asset group) is being used or in its physical condition,” a “significant adverse change

in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator,” or a “current expectation that, more likely than not, a long-lived asset (asset group) will be sold or otherwise disposed of significantly before the end of its previously estimated useful life.”

ASC 360-10-35-23 states, in part, that “a long-lived asset or assets shall be grouped with other assets and liabilities at the lowest level for which identifiable cash flows are largely independent of the cash flows of other assets and liabilities.” Such a combination is called an asset group.

An asset group may include not only long-lived assets that are within the scope of ASC 360-10 but also other assets such as receivables, inventory, indefinite-lived intangible assets, or goodwill. ASC 360-10-15-5 provides a list of assets that are not within the scope of ASC 360-10. Note that ASC 360-10 applies to long-lived assets that are not within the scope of other GAAP, such as PP&E, finite-lived intangible assets (e.g., customer relationships, technology, brands, and trade names), and ROU assets.

To test a long-lived asset (asset group) for recoverability, an entity compares the carrying value of the asset (asset group) with the undiscounted net cash flows generated from the asset's (asset group's) use and eventual disposal. While the use of undiscounted cash flows generally indicates that a long-lived asset (asset group) is less prone to impairment, a long-lived asset (asset group) may not be recoverable if reductions in the estimates of undiscounted cash flows are based on changes to the entity's business operations as it supports climate-related initiatives in response to consumer demand. For example, the net cash flows expected to be generated from the eventual disposal of a piece of machinery may decline if the machinery is not deemed environmentally friendly and demand for the related product has decreased as a result of a heightened focus on climate-related initiatives by both entities and consumers. Therefore, the decline in expected salvage value may result in an impairment of the asset (asset group).

If an entity estimates future cash flows to test the recoverability of a long-lived asset (asset group), such an estimate should include only the future cash flows (cash inflows minus associated cash outflows) that are (1) directly associated with the asset (asset group) and (2) expected to arise as a direct result of the use and eventual disposition of the asset (asset group). To estimate future cash flows, the entity must consider both cash inflows and cash outflows. Note that ASC 360-10-35-30 states, in part, that the “assumptions used in developing [cash flow estimates should] be reasonable in relation to the assumptions used in developing other information used by the entity for comparable periods, such as internal budgets and projections, accruals related to incentive compensation plans, or information communicated to others.”

In addition, ASC 360 indicates that it may be useful for the entity to apply a probability-weighted approach when considering alternative courses of action to recover the carrying amount of a long-lived asset (asset group). Such an approach may be beneficial when the entity is considering alternative courses of action it may take as a result of its climate-related initiatives.

If the entity determines that the carrying amount of the long-lived asset (asset group) is not recoverable, it performs the next step in the impairment test by recognizing an impairment loss for the amount by which the carrying amount of the long-lived asset (asset group) exceeds its fair value. Then, in accordance with ASC 360-10-35-28, it allocates that amount to the long-lived assets that are within the scope of ASC 360-10 “on a pro rata basis using the relative carrying amounts of those assets, except that the loss allocated to an individual long-lived asset of the group shall not reduce the carrying amount of that asset below its fair value whenever that fair value is determinable without undue cost and effort.”

By contrast, if an entity determines that a long-lived asset (asset group) is recoverable, it does not recognize an impairment loss, even if the carrying value of that asset (asset group) exceeds its fair value. Regardless of whether an entity recognizes an impairment loss, it should still consider whether the existence of a trigger indicates that there has been a change in the useful life or salvage value of its long-lived assets. For example, although a certain asset (asset group) is not impaired, an entity may determine that the asset (asset group) will not be in operation as long as originally intended, or that its salvage value has decreased, because it will be phased out as more environmentally friendly assets are placed into service. In that case, the entity should revise the asset's (asset group's) useful life and depreciation or amortization estimates accordingly.

Sometimes, an entity may conclude that the affected long-lived assets will be sold, abandoned, or otherwise disposed of. Under ASC 360, if the held-for-sale criteria in ASC 360-10-45-9 are met, the entity is required to measure the asset (asset group) "at the lower of its carrying amount or [its] fair value less cost to sell" in accordance with ASC 360-10-35-43. A long-lived asset that will be abandoned will continue to be classified as held and used until it is disposed of. Such an asset is disposed of when it ceases to be used. However, as indicated in ASC 360-10-35-49, a "long-lived asset that [is] temporarily idled shall not be accounted for as if abandoned." Further, ASC 360-10-35-48 states, in part, that when "a long-lived asset ceases to be used, the carrying amount of the asset should equal its salvage value, if any."

### 13.11.6 Goodwill

As an entity continues to adjust its business operations to support climate-related initiatives, it should consider whether such adjustments result in a triggering event that would require it to test the goodwill of one or more reporting units for impairment between annual testing dates. In addition, even if the entity does not identify a triggering event in between annual testing dates, it should consider its climate-related initiatives and their impacts on business operations when testing goodwill for impairment annually.

Under ASC 350-20-35-28 through 35-30, an entity is required to test goodwill for impairment at the reporting-unit level at least annually or "between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount." ASC 350-20-35-3C provides examples of events and circumstances that may meet such a threshold and hence necessitate the testing of goodwill for impairment between annual tests. These include "a deterioration in general economic conditions," "a deterioration in the environment in which an entity operates," "a change in the market for an entity's products or services," "[o]verall financial performance such as negative or declining cash flows or a decline in actual or planned revenue or earnings compared with actual and projected results of relevant prior periods," and, "[i]f applicable, a sustained decrease in share price (consider in both absolute terms and relative to peers)."

A reporting unit with only a small cushion (excess of fair value over carrying amount) at the time of its most recent quantitative test is generally more susceptible to impairment, which may have been noted in prior disclosures related to goodwill of reporting units at higher risk for impairment.

An entity may choose to qualitatively evaluate relevant events or circumstances to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. Alternatively, an entity may skip the qualitative assessment and proceed directly to step 1 of the goodwill impairment test. In step 1 of the test, the entity compares the reporting unit's carrying amount, including goodwill, with its fair value and recognizes an impairment loss for any excess.

When performing a quantitative test, an entity must develop certain business and valuation assumptions. If the entity is using an income approach to perform its fair value measurements, it must use judgment when developing its prospective financial information and consider the impacts of its climate-related initiatives as well as potential shifts in consumer behaviors. For example, an entity may have plans to shut down a manufacturing facility and build a new one with new, more environmentally friendly equipment. In such a case, the entity should consider the impact of these plans, including the costs to close the current manufacturing facility, in its business assumptions. Uncertainty regarding the changes in an entity's business and the impact of those changes to support the entity's climate-related initiatives should also be considered. The entity is expected to use its best estimates of those business and valuation assumptions.

### 13.11.7 Inventory

ASC 330 requires an entity to initially value its inventory at the cost needed to bring the inventory to its current condition and location. An entity generally determines that cost by using an acceptable cost flow method such as first in, first out or last in, first out (LIFO). Inventory that is measured by using any method other than LIFO or the retail inventory method (RIM) is subsequently valued at the lower of cost or net realizable value (i.e., the estimated selling price in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation). However, if inventory is measured by using LIFO or RIM, it is subsequently valued at the lower of cost or market.<sup>10</sup>

When estimating the net realizable value of inventory, management is required to consider all relevant facts and circumstances. If certain climate-related events occur, the estimates of net realizable value could be materially affected. For example, hurricanes could significantly damage manufacturing facilities, or floods could significantly damage goods held in a warehouse. In addition, an entity's operations may be affected by new regulations, customer preferences, or its own initiatives related to environmental concerns — for example, changes in consumer preferences for products purchased from companies that are known to be more environmentally friendly or an entity's initiatives to shift to more sustainable component parts for the production of its medical devices.

Historically, changes in regulations have typically come with enough advance notice for entities to prepare for such changes, and consumer behavior changes have in many cases been gradual. However, with the current focus on sustainability and environmental matters, both regulatory actions and changes in consumer behavior may occur more rapidly and frequently in the future; therefore, entities should closely monitor such potential developments and any related impacts on inventory values.

### 13.11.8 Taxes

The tax effects of law changes designed to bring about environmental changes (e.g., the elimination or introduction of certain environmental tax credits) should not be anticipated; rather, entities should account for a change in tax law in the period in which the change is enacted.

<sup>10</sup> ASC 330-10-20 defines market as follows: "As used in the phrase lower of cost or market, the term market means current replacement cost (by purchase or by reproduction, as the case may be) provided that it meets both of the following conditions:  
a. Market shall not exceed the net realizable value  
b. Market shall not be less than net realizable value reduced by an allowance for an approximately normal profit margin."



## 13.11.9 Leases

### 13.11.9.1 ROU Asset Impairment (Lessee Accounting)

Impairments of ROU assets could occur as a result of an entity's decision to abandon a current lease in favor of a lease for environmentally sustainable PP&E (e.g., if an entity decides to change the location of its corporate headquarters or manufacturing facilities). Such a decision could negatively affect the future cash flows expected to be derived from the original underlying PP&E.

ROU assets are subject to the impairment and disposal guidance in ASC 360; therefore, a lessee must test its ROU assets for impairment in a manner consistent with the treatment of other long-lived assets. In accordance with ASC 842-20-35-9, a "lessee shall determine whether a right-of-use asset is impaired and shall recognize any impairment loss in accordance with Section 360-10-35 on impairment or disposal of long-lived assets." Therefore, the impairment analysis of ROU assets would be included as part of the analysis for long-lived assets that are held and used.

In accordance with ASC 842-20-35-10, an impaired ROU asset should be subsequently measured at its carrying amount (after the impairment) less any accumulated amortization. Subsequent amortization of the ROU asset (for both operating and finance leases) would be on a straight-line basis unless another systematic basis is more representative of the pattern over which the lessee expects to consume the remaining economic benefits of the right to use the underlying asset.

In connection with its reevaluation of leases or lease portfolios on a go-forward basis, an entity should consider whether a decision to no longer use a leased asset constitutes an abandonment of the asset from an accounting standpoint. The entity's conclusion may represent a triggering event that prompts it to perform a recoverability test. For a leased asset to be deemed abandoned, an entity must not have the intent and ability to sublease the leased asset at any point during the remaining lease term. When determining whether it would have the intent and ability to sublease the asset, the entity should consider the economic environment and the expected demand in the sublease market. Consequently, an entity may be required to use greater judgment when assessing leases with longer remaining terms. An entity that has the intent and ability to sublease an asset at any point in the future would be precluded from considering an asset to be abandoned.

### 13.11.9.2 Energy Service Agreements That May Contain Embedded Leases

As a result of increased focus on the environment and corporate accountability, many entities have been actively seeking out ways to transform their current operations to maximize environmental sustainability while limiting up-front capital expenditures. One increasingly common method is through use of an ESA. ESAs are often marketed as an "off-balance-sheet financing solution" that will allow entities to capture the benefits of new efficient equipment without incurring the up-front capital expenditures associated with it. The typical term of an ESA is anywhere between 5 and 15 years. Under an ESA, the vendor will analyze the company's current energy infrastructure and understand its level of energy consumption. This evaluation forms the "base-line" energy consumption that the vendor promises to reduce.

In addition to performing various services in connection with the ESA, the vendor will often replace all, or a portion, of the entity's existing energy infrastructure (e.g., HVAC systems, boilers, lightbulbs) with new high-efficiency, environmentally sustainable equipment. The vendor usually bears the costs associated with the new machinery and its installation and retains title to the equipment. In many ESAs, the vendor pays for required maintenance throughout the duration of the contract. Payments to the vendor are generally based on the company's actual cost savings — for example, as a percentage of the actual savings or according to some type of formula linked to the entity's cost savings.



To determine the appropriate accounting for an ESA, an entity should consider whether the agreement includes an embedded lease for the underlying equipment. As indicated in ASC 842-10-15-3, a “contract is or contains a lease if the contract conveys the right to control the use of identified property, plant, or equipment (an identified asset) for a period of time in exchange for consideration.” The concept of “control” is expanded upon in ASC 842-10-15-4, which states, in part, that “[t]o determine whether a contract conveys the right to control the use of an identified asset . . . for a period of time, an entity shall assess whether, throughout the period of use, the customer has both of the following:” the “right to obtain substantially all of the economic benefits from use of the identified asset” and the “right to direct the use of the identified asset.” Although an entity must use judgment in determining whether an agreement includes a lease, a key indicator that an embedded lease exists within a service agreement is a situation in which the service provider conveys control of the equipment to the entity. We have observed that in many instances, ESAs will be deemed to include a lease because the entity is able to control when the equipment is actually used and at what levels, among other factors.

If, on the basis of the terms of an ESA, the entity concludes that a lease exists, it will need to determine the lease payments so that it can ascertain the lease classification and calculate the associated ROU asset and lease liability. In many ESAs, the entity only pays the vendor to the extent that there are energy cost savings, which will vary from month to month. On the surface, this may appear to be an entirely variable lease payment stream, which would result in no lease liability and therefore no ROU asset at lease inception. However, the entity must consider the specific terms of the ESA to determine whether these payments, or a portion of these payments, constitute an in-substance fixed payment. Under ASC 842-10-55-31, “in substance fixed payments are payments that may, in form, appear to contain variability but are, in effect, unavoidable;” therefore, these payments are indistinguishable from fixed payments and should be considered in the calculation of the ROU asset and lease liability. However, if all payments are determined to be variable, from a lease accounting standpoint, an entity would not record an ROU asset or a lease liability. It is essential for an entity to understand what is driving the variability in its ESA when making this determination, since different ESAs may have different drivers of variability. Relevant considerations include whether the customer has any minimum usage requirements and whether the vendor is exposed to genuine economic downside on the basis of the PP&E’s performance (e.g., downside risk if the PP&E fails to meet predefined efficiency standards). Portfolio considerations may also arise because a large volume of equipment typically is deployed and monitored in the aggregate for performance.

As ESAs continue to rise in popularity and evolve, entities are encouraged to consult with their advisers regarding the appropriate accounting treatment.

### **13.11.10 Insurance Recoveries**

Entities that incur losses stemming from climate-related events may be entitled to insurance recoveries. For example, in certain cases, losses from closed facilities or disrupted supply chains may be insured if they are associated with property damage from hurricanes, wildfires, or tornados. Furthermore, entities may have business interruption insurance that provides coverage for lost profits that are caused by a suspension of their operations due to certain weather-related events. See [Sections 1.12](#) and [6.4](#) for further discussion of the accounting for insurance recoveries.

## 13.11.11 Financial Instruments and Contract Assets

### 13.11.11.1 Sustainability-Linked Debt Instruments (Issuer's Considerations)

Entities that seek to demonstrate their corporate social responsibility may issue debt instruments tied to environmental factors (sometimes also referred to as sustainability factors). Such environmentally linked debt instruments include sustainability-linked bonds and sustainability-linked loans. With regard to structure, the terms of sustainability-linked debt instruments and conventional debt instruments may be largely similar. However, each sustainability-linked debt instrument may be issued for different purposes and have unique environmental linkage. For example, (1) debt instruments may be subject to early redemption if the borrower fails to meet a target sustainability metric (e.g., on the basis of S&P Global ESG Scores) on a specified date, (2) the contractual interest rate may be reduced if the borrower achieves predefined targets for reducing GHG emission, or (3) the contractual interest rate might increase if the borrower fails to achieve the targets. When issuing debt instruments with cash flows linked to environmental factors, an entity needs to consider whether the arrangement contains an embedded feature or features that must be separately accounted for as a derivative under ASC 815-15 (if the fair value option [FVO] is not applied).

Under ASC 815-15-25-1, an entity is required to separately account for a feature embedded within another contract (the host contract) if the following three conditions are met:

- The embedded feature and the host contract have economic characteristics and risks that are not clearly and closely related.
- The hybrid instrument (i.e., the combination of the embedded feature and its host contract) is not remeasured at fair value, with changes in fair value recorded immediately through earnings (e.g., under the FVO election in ASC 815-15-25-4 or ASC 825-10).
- The embedded feature — if issued separately — would be accounted for as a derivative instrument under ASC 815-10. In evaluating whether this condition is met, the entity considers the definition of a derivative in ASC 815-10 and the derivative accounting scope exceptions in ASC 815-10 and ASC 815-15.

The following outlines considerations related to the bifurcation analysis of certain features embedded in sustainability-linked debt instruments:<sup>11</sup>

- *Redemption features* — Debt instruments may contain features that trigger an acceleration or deferral of the due date or an adjustment of the repayment amount (1) upon the occurrence or nonoccurrence of a specified environmental event or events or (2) on the basis of an environmental metric. Generally, a redemption feature embedded in a debt host meets the definition of a derivative irrespective of whether the debt host contract is readily convertible to cash under the guidance in ASC 815-10-15-107 because neither party is required to deliver an asset associated with the underlying. The scope exceptions under ASC 815-10-15-13 and ASC 815-15-15-3 are usually not applicable for redemption features embedded in a debt host (e.g., there is no specific scope exception for sustainability-linked features). If no scope exception is available, a borrower's determination of whether a redemption feature must be bifurcated as a derivative is based on whether the feature is considered clearly and closely related to the debt host contract. Typically, the borrower should evaluate whether the redemption feature is clearly and closely related to the debt host under the four-step decision sequence in ASC 815-15-25-42.

<sup>11</sup> Note that this discussion assumes that the debt is not measured at fair value on a recurring basis (e.g., the issuer has not elected the FVO in ASC 815-15-24-4 or ASC 825-10). In addition, an entity should always consider the terms and conditions of a specific feature in light of the applicable accounting guidance before reaching a conclusion.

- *Contingent interest rate features* — Debt instruments may specify that the contractual interest rate (1) will be reduced by a certain amount if the borrower achieves predefined targets, such as reaching carbon neutral by a specified date, or will be increased if the borrower fails to achieve those targets or (2) will vary on the basis of changes in an index tied to specified environmental metrics. ASC 815-15-25-26 addresses whether an embedded feature whose only underlying is an interest rate or interest rate index should be considered clearly and closely related to a debt host contract. The guidance does not address features that are indexed to or contingent on something other than an interest rate or interest rate index, including features that are indexed to both an interest rate or interest rate index and other underlyings (e.g., environmental targets or key performance indicators). Under the existing guidance, generally, only certain features that are based on a market interest rate, an entity's credit risk, or inflation are viewed as clearly and closely related to a debt host contract. Therefore, features that adjust the interest rate of a debt instrument on the basis of an environmental factor typically are determined to be not clearly and closely related to a debt host and might have to be bifurcated as a derivative unless a specific scope exception is available.

Given the wide variety of environmentally linked terms and the evolving nature of these instruments, entities are strongly encouraged to discuss their accounting analyses with their advisers.

For more details about the manner in which specific embedded features should be evaluated to determine whether they require bifurcation as derivatives, see [Section 8.4](#) of Deloitte's Roadmap *Issuer's Accounting for Debt*.



### Changing Lanes

As discussed in [Section 3.2.7](#), at the FASB's December 6, 2023, meeting, the Board voted to add a [project](#) to its technical agenda to refine the scope of ASC 815 by incorporating a scope exception for contracts with underlyings based on the operations or activities that are specific to one of the parties to the contract. In addition, the Board directed its staff to perform research to develop alternatives for refining the predominant characteristics test in ASC 815-10-15-60. Because these potential changes could affect the accounting for arrangements with environmentally linked terms, entities are encouraged to monitor activity at the FASB for additional standard-setting developments.

If the environmental-factor-related embedded derivatives must be accounted for separately from the debt host contract, the issuing entity must appropriately allocate the proceeds between the debt instrument and the features that are accounted for separately. Specifically, under the allocation method in ASC 815-15-30-2, the borrower is required to record "the embedded derivative at fair value and [determine] the initial carrying value assigned to the [debt] host contract as the difference between the basis of the hybrid instrument and the fair value of the embedded derivative."

Note that the determination of the fair value of environmental-factor-related embedded derivatives involves complexity and often requires the involvement of valuation specialists.

Depending on the likelihood that a payment feature will be triggered and, if so, on its potential amount, the fair value of a payment feature embedded in debt host might be minimal (e.g., a feature in which a minor adjustment must be made to the interest rate upon an event whose likelihood of occurring is remote). In practice, therefore, entities sometimes determine and document that they are not required to make accounting entries upon debt issuance to recognize a feature that must be bifurcated as a derivative under ASC 815-15. Any such conclusion must be appropriately supported on the basis of materiality. A determination that a feature has a minimal fair value at inception does not negate the requirement to account for it as a derivative. Accordingly, if an entity makes such a determination,

it should also monitor its facts and circumstances in each reporting period to evaluate whether the feature's fair value or a change to it is significant and therefore must, under U.S. GAAP requirements, be reflected in the entity's financial statements.

### **13.11.11.2 Sustainability-Linked Debt Instruments (Holder's Considerations)**

Holders of sustainability-linked debt instruments (e.g., an investor or a lender) can account for such instruments at fair value by (1) applying an FVO election in accordance with ASC 815-15 or ASC 825-10 or (2) classifying the instruments as trading securities in accordance with ASC 320-10-25-1 if they qualify as debt securities. If sustainability-linked debt instruments are not accounted for at fair value (e.g., the FVO is not applied), with changes in fair value recorded immediately through earnings, holders also need to consider whether the environmental factor is an embedded feature that must be separately accounted for as a derivative under the aforementioned guidance and considerations.

### **13.11.12 Environmental Obligations**

Changes in laws and regulations may affect the timing and cost of environmental remediation obligations, which have a direct impact on the associated environmental remediation liability. An entity should consider whether changes to current laws and regulations in the jurisdictions in which it operates affect its recording of environmental remediation obligations.

ASC 410-30 provides guidance on measuring an estimated environmental remediation liability, including how to consider the effects of future developments. Specifically, ASC 410-30-35-4 requires entities to recognize the "impact of changes in laws, regulations, and policies . . . when such changes are enacted or adopted." If the estimated costs of remediation obligations change on the basis of new information, such changes are considered changes in estimates under ASC 250 and should be recognized in the period in which the laws or regulations are enacted or adopted.

For example, an entity may be remediating an environmental site in a state in which laws and regulations require it to remediate groundwater contamination and subsequently monitor water quality at the site to verify the efficacy of the remedy for a stated number of years before declaring the site closed. The recorded environmental liability would be based on (1) the remaining time and cost needed to achieve the remediation plan in accordance with the state laws and regulations, (2) costs related to postremediation monitoring, and (3) an assumption that the site would receive remedial closure or a "no further action" letter once the specific criteria are met (i.e., the environmental obligation would be zero at that point in time). If, perhaps in response to concerned citizens demanding more stringent requirements, the state amends its laws and regulations to include indefinite monitoring of the site (i.e., the site would not officially close), the entity would account for the cost of those changes in the period the new laws and regulations go into effect and should measure the environmental obligation in accordance with ASC 410-30.

Note that, as indicated in ASC 410-30-15-3(c), the guidance in ASC 410-30 does not apply to "[e]nvironmental remediation actions that are undertaken at the sole discretion of management and that are not induced by the threat . . . of litigation or of assertion of a claim or an assessment." Therefore, ASC 410-30 does not require the recognition of a liability for environmental remediation activities that are voluntarily undertaken by a reporting entity. The decision to incur the costs of performing such activities in the future does not give rise to a present liability since the entity has considerable discretion in changing its plans and avoiding the expenditure.

### 13.11.13 Asset Retirement Obligations

Unlike environmental liabilities that result from the improper use of an asset, AROs are legal or contractual obligations to perform remediation activities resulting from the proper, intended use of a long-lived asset. Entities should consider whether changes to their operations trigger a remeasurement of their AROs. Changes in operations that result in a change in management's intended use of an asset — including a change in its plans to maintain the asset, extend its useful life, or abandon the asset earlier than previously expected — may affect the recorded amount of an ARO associated with the asset, including the timing associated with the retirement activities.

ASC 410-20 provides the relevant guidance on accounting for AROs, including subsequent measurement considerations related to revising either the timing or amount of the original estimate of cash flows used for measuring the fair value of the obligation. Specifically, ASC 410-20-35-8 states, in part, that “[c]hanges resulting from revisions to the timing or the amount of the original estimate of undiscounted cash flows shall be recognized as an increase or a decrease in the carrying amount of the liability for an asset retirement obligation.”

For example, consider an entity that has pledged to reduce its carbon emissions in response to pressure from investors to transition to greener operations. To achieve this reduction, the entity plans to retire certain carbon-emitting assets and replace them with greener, low-carbon assets. If the older, carbon-emitting assets were required to be decommissioned and removed under the contractual agreement between the entity and the landowner and, as a result, the entity recorded an ARO on its books, it should consider whether (1) the early retirement of the carbon-emitting assets also results in the acceleration of the cash flows associated with retirement activities necessary to satisfy the ARO and (2) it is required to revise the ARO in accordance with ASC 410-20.

### 13.11.14 Compensation Agreements

As a means of driving sustainability, some entities link incentive pay for executives and employees to environmental metrics. For example, a life sciences entity's executives might be rewarded for achieving goals related to carbon dioxide emissions, energy consumption, environmental management, or water usage. In such cases, there may be various accounting considerations, which depend on the specific climate-related metrics used, how performance is measured against those metrics, and the terms of the bonus arrangement.

Many entities use cash bonus plans to compensate their executives and employees. Annual bonus plans may be based on specific formulas and performance targets and are communicated early in the year. In some plans, annual bonus amounts are linked to environmental targets based on metrics that are unknown until after the end of a fiscal year and, thus, the bonus amounts may not be finalized until after the financial statements are issued. In addition, bonuses may be forfeited if an employee is terminated or resigns.

Entities should have a clear method of measuring and monitoring performance related to environmental metrics that are included in an annual or multiyear compensation agreement so that they can calculate the bonus accrual and update such amounts throughout the year under ASC 450-20 and ASC 710 (when the cash bonus plan is not subject to other applicable U.S. GAAP, such as ASC 718). If the amount of the bonus that will be achieved or granted is uncertain, the entity should compute a range in accordance with ASC 450-20-30-1, which indicates that if “no amount within the range is [considered] a better estimate than any other amount,” the low end of the range should be selected. Entities must carefully evaluate bonuses that are based on achievement of a target to determine whether such achievement is probable and reasonably estimable.

Once an entity has determined the amount of the probable bonus, it should recognize that amount over the service period. Recognizing compensation expense in this manner is analogous to recognizing expense in connection with stock-based compensation arrangements over the related service period, as required by ASC 718. Under this model, the obligating event giving rise to the liability is considered the employee's performance of service. Recognition of a bonus liability should not be delayed just because the bonus would not be paid if the employee were to terminate employment before the end of the service period. Rather, if a reliable estimate of employee turnover is possible, the entity may factor this estimate into the range of estimates when determining the probable liability. Any difference between the actual bonus paid and the amount accrued is considered a change in accounting estimate. For more information, see Deloitte's Roadmap [Contingencies, Loss Recoveries, and Guarantees](#).

Similarly, the compensation arrangement could be in the form of a company's own stock instead of cash. For example, a life sciences entity may grant its senior executives a sustainability performance stock award related to environmental metrics such as reducing carbon emissions by 2 million metric tons. Entities should pay particular attention to plan details that describe how the environmental metrics are defined and how the related performance against those metrics is measured. In some instances, entities may seek assistance from appropriate environmental specialists when establishing and evaluating these type of compensation arrangements.

ASC 718 requires that the related cost be recognized over the employee's requisite service period when a service period exists. For awards with performance conditions, an entity should assess the probability of meeting the performance condition and will only recognize compensation cost if it is probable that the condition will be met. The total compensation cost recognized will ultimately be based on the outcome of the performance condition. Share-based payment transactions are recognized by using a fair-value-based measurement method under ASC 718.

Note also that when a share-based compensation award with environment-related factors is indexed to a factor other than a service, performance, or market condition, the award may be classified as a liability. Liability-classified awards are generally remeasured by using fair-value-based measurement as of each reporting date until settlement. That is, changes in the fair-value-based measure of the liability at the end of each reporting period are recognized as compensation cost, either (1) immediately or (2) over the employee's requisite service period. Therefore, companies need to carefully evaluate the classification of their share-based awards. For more information, see Deloitte's Roadmap [Share-Based Payment Awards](#).

## **13.11.15 Environmental Credits**

### **13.11.15.1 Background**

An increasing number of entities in different sectors and industries aim to reduce global GHG emissions. While some entities are taking steps to reduce their own carbon emissions, these efforts may not be sufficient to achieve required or voluntary emission commitments.

Environmental credits can help entities accomplish their carbon emission reduction targets and goals. As used in this publication, the term "environmental credit" encompasses products such as carbon credits as well as RECs and other climate- or emission-related credits. In the most basic sense, a carbon credit is a market-based or legal instrument that represents the ownership of one metric ton of carbon dioxide equivalent that can be held, sold, or retired to meet a mandatory emission cap or a voluntary emission reduction target.

The popularity of environmental credits has grown. However, questions have emerged about how to account for and report them since the treatment of environmental credits is not explicitly addressed in U.S. GAAP.



### **13.11.15.2 FASB Project on Environmental Credits**

In the absence of authoritative literature in U.S. GAAP and in response to stakeholder feedback, the FASB decided in May 2022 to add to its technical agenda a [project](#) on the recognition, measurement, presentation, and disclosure of environmental credits that are legally enforceable and tradable. The project is expected to address accounting considerations for users and producers of environmental credits and participants operating in compliance and voluntary programs.

Life sciences entities that participate in environmental credit activity should monitor the Board's ongoing deliberations for future standard-setting developments related to environmental credits. For more information about the Board's tentative decisions related to the accounting for environmental credits, see Deloitte's [October 25, 2023](#), and [February 22, 2024](#), *Heads Up* newsletters.

### **13.11.15.3 Accounting Practices Under Existing GAAP**

Pending the completion of the FASB's environmental credit project or the issuance of alternative authoritative guidance, various approaches are currently being used in practice to account for and report environmental credits. For a discussion of those approaches, see Deloitte's November 16, 2022, [Financial Reporting Alert](#).

Entities should carefully consider all relevant facts and circumstances when selecting an appropriate accounting model to use. They should then apply the selected model consistently. In addition, they should disclose their selection if it is material.

### **13.11.15.4 SEC's Final Rule on Climate-Related Disclosures**

As noted in [Section 13.11.2.1](#), the SEC's final rule on climate-related disclosures requires a registrant to disclose a rollforward of carbon offsets or RECs if the registrant's use of carbon offsets or RECs is a material component of the registrant's plan to achieve its disclosed climate-related targets or goals. In such a case, the registrant must also disclose (1) the aggregate amount expensed, (2) the aggregate amount capitalized, (3) the aggregate amount of losses incurred related to carbon offsets or RECs during the year, (4) which financial statement line items are affected, and (5) the accounting policy for the carbon offsets or RECs. For more information about the final rule's requirements, see Deloitte's [March 6, 2024](#), and [March 15, 2024](#), *Heads Up* newsletters.

### **13.11.15.5 Where to Find Additional Information**

Entities should become aware of the financial reporting considerations related to environmental credits as the use of such credits becomes more prevalent. For more information, see Deloitte's November 16, 2022, [Financial Reporting Alert](#).



# Appendix A — Differences Between U.S. GAAP and IFRS Accounting Standards

The table below summarizes some of the key differences between U.S. GAAP and IFRS Accounting Standards that are relevant to the topics discussed in this Guide. Our focus is on differences that are commonly found in practice. The differences outlined below are limited to the specific matters this Guide addresses. For additional differences, see Deloitte’s Roadmap [Comparing IFRS Accounting Standards and U.S. GAAP: Bridging the Differences](#) and the topic-specific publications in Deloitte’s Roadmap series, most of which contain an appendix or chapter devoted to such differences. For other information, including examples illustrating life sciences entities’ application of IFRS Accounting Standards, see Deloitte’s [iGAAP](#) publication (DART subscription required).

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Revenue Recognition (Chapter 2)</b>		
Scope	The primary source of guidance on the accounting for revenue is ASC 606 under U.S. GAAP.	The primary source of guidance on the accounting for revenue is IFRS 15 under the IFRS Accounting Standards.
Step 1 — the collectibility threshold for contracts	ASC 606 establishes a <i>probable collectibility</i> threshold, meaning likely to occur. <sup>1</sup>	IFRS 15 establishes a <i>probable collectibility</i> threshold, meaning more likely than not. <sup>2</sup>
Requirements for nonpublic entities	The guidance applies to nonpublic entities, with some specific relief related to disclosure, transition, and effective date.	The guidance applies to all entities reporting under IFRS Accounting Standards, including nonpublic entities.
Licensing — determining the nature of an entity’s promise (see paragraphs BC51 through BC65 of <a href="#">ASU 2016-10</a> )	An entity’s determination of whether a license is a right to use (for which revenue is recognized at a point in time) versus a right to access (for which revenue is recognized over time) is based on its classification of the IP underlying the license as either functional or symbolic.	An entity’s determination of whether a license is a right to use versus a right to access is based on whether the customer can direct the use of, and obtain substantially all of the benefits from, the license at the point in time at which the license is granted. The customer can direct the use of, and obtain substantially all of the benefits from, the license if the underlying IP is not significantly affected by the entity’s ongoing activities.

<sup>1</sup> As defined in ASC 450.

<sup>2</sup> As defined in IFRS 15 and IAS 37.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Revenue Recognition (Chapter 2) (continued)</b>		
Licensing — renewals (see paragraphs BC48 through BC50 of ASU 2016-10)	The amendment specifies that a renewal or extension is subject to the “use and benefit” guidance under U.S. GAAP, the application of which will generally result in revenue recognition at the beginning of the renewal period.	The “use and benefit” guidance does not explicitly refer to renewals. Consequently, revenue may be recognized earlier than it would be under U.S. GAAP.
Shipping and handling activities (see paragraphs BC19 through BC25 of ASU 2016-10)	The amendment provides an accounting policy election that permits an entity to account for shipping and handling activities that occur after the customer has obtained control of the related good as a fulfillment expense.	IFRS 15 does not include a similar election.
Noncash consideration (see paragraphs BC36 through BC43 of <a href="#">ASU 2016-12</a> )	Under the amendments in ASU 2016-12, noncash consideration is measured at contract inception.	IFRS 15 does not prescribe a measurement date for noncash consideration.
Presentation of sales (and other similar) taxes (see paragraphs BC29 through BC35 of ASU 2016-12)	The amendment provides an accounting policy election that permits an entity to exclude all sales (and other similar) taxes from the measurement of the transaction price.	IFRS 15 does not include a similar election.
Disclosure of remaining performance obligations	<a href="#">ASU 2016-20</a> provides entities with an optional exemption from the requirement to disclose information about remaining performance obligations (ASC 606-10-50-13) for variable consideration if either (1) the variable consideration is a sales- or usage-based royalty promised in exchange for a license of IP or (2) the variable consideration is allocated entirely to a wholly unsatisfied performance obligation or to a wholly unsatisfied promise to transfer a distinct good or service that forms part of a single performance obligation.	IFRS 15 was not amended to provide similar disclosure relief.
Collectibility — criterion explanation and examples (see paragraphs BC9 through BC20 of ASU 2016-12)	ASU 2016-12 provides an additional explanation of the collectibility threshold’s objective, as well as implementation guidance and examples.	No additional guidance provided.
Collectibility — recognition criterion for contracts that fail step 1 (see paragraphs BC21 through BC28 of ASU 2016-12)	ASU 2016-12 adds a third criterion to allow revenue recognition when a contract fails step 1 (ASC 606-10-25-1).	Additional criterion not provided.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Revenue Recognition (Chapter 2) (continued)</b>		
Immaterial goods or services (see paragraphs BC8 through BC18 of ASU 2016-10)	When identifying performance obligations, an entity is not required to assess immaterial items in the context of the contract as promised goods or services.	Overall materiality considerations should be used in the evaluation of items under IFRS Accounting Standards.
Licensing — when to consider the nature of an entity's promise in granting a license (see paragraphs BC66 through BC69 of ASU 2016-10)	ASU 2016-10 contains explicit guidance to indicate that when a bundle of goods or services is determined to be a single performance obligation that includes a license of IP, an entity should apply the license implementation guidance to determine whether revenue related to the performance obligation should be recognized over time (including an appropriate measure of progress) or at a point in time.	No guidance added to IFRS 15; however, the Basis for Conclusions on IFRS 15 explains that the licensing implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations before applying the criteria to determine the nature of an entity's promise in granting a license.
Licensing — contractual restrictions (see paragraphs BC41 through BC47 of ASU 2016-10)	ASU 2016-10 contains explicit guidance to indicate that contractual provisions that explicitly or implicitly require an entity to transfer control of additional goods or services to the customer (e.g., additional rights) should be distinguished from contractual provisions that define attributes of a single promised license (e.g., restrictions of time or geography).	No guidance added to IFRS 15; however, the Basis for Conclusions on IFRS 15 explains that the license implementation guidance does not override the general model — specifically, the requirements for identifying performance obligations before applying the criteria to determine the nature of an entity's promise in granting a license.
Disclosure of prior-period performance obligations	ASU 2016-20 provides additional guidance to clarify that the disclosure of revenue from performance obligations satisfied (or partially satisfied) in prior periods applies to all performance obligations (i.e., the disclosure is not isolated to performance obligations with corresponding contract liability balances).	No additional guidance provided.
Contract asset versus receivable	ASU 2016-20 amends Example 38, Case B, in ASC 606-10-55-285 and 55-286 to provide a better link between the analysis and the receivables presentation guidance in ASC 606.	No amendments made to Example 38, Case B, in IFRS 15.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Research and Development (Chapter 3)</b>		
Capitalization versus expense	ASC 730 requires R&D costs to be expensed as incurred unless certain incurred costs (e.g., materials, equipment, facilities, and intangible assets) have an alternative future use.	IAS 38 distinguishes between research costs and development costs. Research costs must be expensed as incurred; however, development costs must be capitalized when certain criteria are met.
Initial measurement — IPR&D	An entity is permitted to capitalize IPR&D costs in a business combination.	An entity is permitted to capitalize IPR&D costs in an asset acquisition or a business combination.
FDA priority review voucher (PRV)	An entity that purchases a PRV should consider whether the amounts paid for these vouchers should be capitalized as an asset or expensed as R&D when such costs are incurred.	In accordance with paragraph 21 of IAS 38, an entity that purchases a PRV should recognize the PRV on its balance sheet at cost if the purchase price reflects the expectation of “future economic benefits” and “the cost of the asset can be measured reliably.”
<b>Acquisitions and Divestitures (Chapter 4)</b>		
Definition of a business — screen (i.e., concentration test under IFRS 3)	ASC 805 requires an entity to evaluate whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or group of similar identifiable assets (the “screen”). If the screen is met, the set would not be considered a business. The use of the screen is mandatory.	IFRS 3 includes a concentration test that is similar to the screen in ASC 805; however, its use is optional.
Definition of a business — substantive processes	Under ASC 805, an acquired contract (e.g., outsourcing arrangement) cannot provide a substantive process if the set does not have outputs.	An acquired contract should be considered a substantive process even if the set does not have outputs if it provides access to an assembled workforce that performs a critical process that the entity controls.
Liabilities arising from contingencies (i.e., contingent liabilities under IFRS Accounting Standards) — recognition and initial measurement	Under ASC 805, a liability arising from a contingency is recognized at fair value, if determinable, as of the measurement (acquisition) date. If the fair value cannot be determined, the entity will recognize a liability if both (1) “[i]nformation available before the end of the measurement period indicates that it is probable that . . . a liability had been incurred at the acquisition date” and (2) the “amount of the . . . liability can be reasonably estimated.”	An entity recognizes a liability arising from a contingency at fair value if it (1) is a present obligation that results from a past event and (2) can be measured reliably.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Acquisitions and Divestitures (Chapter 4) (continued)</b>		
Assets arising from contingencies (i.e., contingent assets under IFRS Accounting Standards) — recognition and initial measurement	<p>Under ASC 805, an asset arising from a contingency is recognized at fair value, if determinable, as of the measurement (acquisition) date.</p> <p>If fair value cannot be determined, the entity will recognize an asset if both (1) “[i]nformation available before the end of the measurement period indicates that it is probable that an asset existed . . . at the acquisition date” and (2) the “amount of the asset . . . can be reasonably estimated.”</p>	An entity is not permitted to recognize a contingent asset in a business combination.
Liabilities arising from contingencies (i.e., contingent liabilities under IFRS Accounting Standards) — subsequent measurement	<p>There is no specific guidance in U.S. GAAP on subsequent measurement. ASC 805-20-35-3 requires entities to subsequently account for liabilities arising from contingencies on a “systematic and rational basis . . . depending on their nature.”</p>	<p>An entity recognizes a contingent liability at the higher of:</p> <ul style="list-style-type: none"> <li>• The amount calculated as the best estimate of the expenditure needed to settle the present obligation at the end of the reporting period.</li> <li>• The acquisition-date fair value less the cumulative amortization recognized in accordance with IFRS 15 (if appropriate).</li> </ul>
Assets arising from contingencies (i.e., contingent assets under IFRS Accounting Standards) — subsequent measurement	<p>There is no specific guidance in U.S. GAAP on subsequent measurement. ASC 805-20-35-3 requires entities to subsequently account for assets arising from contingencies on a “systematic and rational basis . . . depending on their nature.”</p>	Under IFRS Accounting Standards, recognition is appropriate only when realization of the income is virtually certain and therefore the related asset is no longer contingent.
Operating leases acquired in a business combination (after the adoption of ASC 842)	<p>If the acquiree is the lessor in an operating lease, the acquirer separately recognizes an intangible asset or liability if the terms of the lease are favorable or unfavorable, respectively, relative to current market terms.</p>	<p>As indicated in paragraph B42 of IFRS 3, if the acquiree is the lessor in an operating lease, any favorable or unfavorable terms of the operating lease are recognized as part of the fair value of the leased asset (i.e., no separate asset or liability is recognized), which is consistent with the guidance in IAS 40.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Acquisitions and Divestitures (Chapter 4) (continued)</b>		
Deferred taxes and uncertain tax positions	ASC 805 requires entities to recognize and measure deferred taxes and uncertain tax positions in accordance with ASC 740, which is not converged with IAS 12.	Entities must recognize and measure deferred taxes and uncertain tax positions in accordance with IAS 12, which is not converged with ASC 740. For example, IAS 12 does not provide explicit guidance on the recognition and measurement of uncertain tax positions.
Contingent consideration — initial classification	Entities must classify contingent consideration as a liability, equity, or an asset in accordance with the appropriate guidance in U.S. GAAP (e.g., ASC 480, ASC 815-10, ASC 815-40), which is not converged with IFRS Accounting Standards.	IFRS 3 requires entities to classify contingent consideration as a liability, equity, or an asset in accordance with existing IFRS Accounting Standards, such as IAS 32. Because U.S. GAAP and IFRS Accounting Standards are not converged, differences in the initial classification could lead to differences in the subsequent accounting.
Share-based payment awards — initial measurement	Entities must initially recognize and measure share-based payment awards in accordance with ASC 718.	IFRS 3 requires entities to initially recognize and measure share-based payment awards in accordance with IFRS 2, which is not converged with ASC 718. Differences between ASC 718 and IFRS 2 may lead to differences in the accounting for share-based payment awards. The two standards' implementation guidance also differs.
Measurement-period adjustments	Under ASC 805, as amended by <a href="#">ASU 2015-16</a> , an acquirer must recognize adjustments to provisional amounts identified during the measurement period in the reporting period in which the adjustments are determined rather than retrospectively.	Under paragraph 49 of IFRS 3, an acquirer must retrospectively record the adjustments to the provisional amounts identified during the measurement period as if accounting had been completed on the acquisition date. The acquirer is required to revise comparative information for prior periods presented in the financial statements.
<b>Consolidation (Chapter 5)</b>		
Scope	The primary source of guidance on consolidation is ASC 810 under U.S. GAAP.	Under IFRS Accounting Standards, the primary source of guidance on determining when and how to prepare consolidated financial statements is IFRS 10. In addition, IFRS 12 provides guidance on a wide range of disclosures about an entity's interests in subsidiaries, joint arrangements, associates, and unconsolidated "structured entities." Further, IAS 27 addresses the preparation of separate financial statements.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Scope exceptions	<p>A reporting entity may be exempt from analyzing a legal entity for consolidation as a result of a general scope exception that applies to legal entities that are (1) employee benefit plans, (2) governmental entities, or (3) money market funds (in certain cases).</p> <p>In addition, there are certain VIE scope exceptions, including the business scope exception.</p>	<p>Paragraph 4A of IFRS 10 provides a general scope exception for postemployment benefit plans or other long-term employee benefit plans.</p> <p>Investment companies present consolidated financial statements.</p> <p>As discussed below, since IFRS 10 does not have a separate VIE model, VIE scope exceptions are inapplicable.</p> <p>A parent is exempt from consolidation under paragraph 4 of IFRS 10 if (1) the parent is nonlisted, (2) it is itself a wholly owned subsidiary or a partially owned subsidiary and none of its other owners have objected to the parent's not presenting consolidated financial statements, and (3) its ultimate or intermediate parent prepares consolidated financial statements under IFRS Accounting Standards that are publicly available.</p>
Determining when to consolidate a legal entity	<p>There are two models for determining when consolidation is appropriate. If a reporting entity has an interest in a VIE, it must apply the VIE consolidation model, which is based on power and economics, under ASC 810-10. If a reporting entity has an interest in an entity that is not a VIE, it must apply the voting control-based consolidation model (the voting interest entity model) under ASC 810-10.</p>	<p>There is a single consolidation model that applies to all entities. Therefore, the concept of a VIE does not exist under IFRS 10.</p> <p>Though the VIE concept does not exist, the consolidation model and determination of who has a controlling financial interest in an entity under IFRS 10 are similar to those under ASC 810-10. Usually, the consolidation analysis under each framework will result in the same consolidation conclusion.</p>



Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Definition of control — general principle	<p>The basis for consolidating an entity depends on whether it is a VIE or a voting interest entity:</p> <ul style="list-style-type: none"> <li>• <i>VIE model</i> — An entity applies a qualitative assessment that is based on power and economics to determine which entity is the primary beneficiary of the legal entity and therefore must consolidate the VIE. The primary beneficiary has both (1) the power to direct the activities of the VIE that most significantly affect the VIE’s economic performance and (2) the obligation to absorb losses of, or the right to receive benefits from, the VIE that could potentially be significant to the VIE.</li> <li>• <i>Voting interest entity model</i> — An entity generally considers voting rights. Typically, the conditions for consolidation are that (1) the entity owns a majority voting interest (i.e., more than 50 percent of the voting shares) and (2) the noncontrolling shareholders do not have substantive participating rights. ASC 810-10 further indicates that the power to control another entity may exist in other contracts or agreements outside of the shares.</li> </ul>	<p>Consolidation is based solely on the concept of control of an investee by an investor. Paragraph 7 of IFRS 10 identifies three elements of such control:</p> <ul style="list-style-type: none"> <li>• “[P]ower over the investee.”</li> <li>• “[E]xposure, or rights, to variable returns from involvement with the investee.”</li> <li>• “[T]he ability to use its power over the investee to affect the amount of the investor’s returns.”</li> </ul> <p>The investor must possess all three elements to conclude that it controls the investee. The investor must consider all facts and circumstances when assessing whether it controls the investee.</p>
Control analysis — shared power	<p>If a reporting entity determines that power is shared among multiple unrelated parties involved with a VIE, no party consolidates the VIE.</p> <p>Under the VIE model in ASC 810-10, power is considered shared if (1) two or more unrelated parties together have the power to direct the VIE’s most significant activities and (2) decisions about those activities require the consent of each of the parties sharing power.</p>	<p>Paragraph 9 of IFRS 10 indicates that when two or more investors collectively control an investee (i.e., they must act together to direct the relevant activities of an entity), no investor individually controls the investee.</p> <p>If power is shared (i.e., joint control), IFRS 11 applies.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Control analysis — potential voting rights (e.g., warrants, call options on shares, or other instruments convertible into voting shares)	<p>Under U.S. GAAP, a reporting entity that applies the voting interest entity model is generally not required to consider the effect of potential voting rights (e.g., warrants, share call options, or other instruments convertible into voting shares) when determining whether a controlling financial interest exists.</p> <p>For example, under the voting interest entity model in ASC 810-10, a reporting entity is not required to consider the additional voting shares it would receive in an investee upon exercise of a stock purchase warrant when determining whether it holds a majority ownership interest in the investee. However, potential voting rights associated with unexercised options and unsettled forwards may be an indicator of control.</p> <p>The VIE model in ASC 810-10 also does not specifically address the impact of potential voting rights on the determination of which party has the power to direct the most significant activities of an entity. However, the reporting entity must carefully consider the effect of these rights.</p>	<p>Paragraphs B47–B50 of IFRS 10 require potential voting rights, such as those resulting from convertible instruments or options, to be considered in the assessment of control; IFRS 10 does not limit potential voting rights to those that are currently exercisable or convertible. (All relevant facts and circumstances need to be considered in the assessment of whether control exists as a result of potential voting rights.)</p> <p>Potential voting rights must be “substantive” to be considered. Paragraphs B22–B25 of IFRS 10 provide guidance on determining whether rights are substantive. A reporting entity with less than a majority of the voting shares would be required to consolidate the investee if it also has potential voting rights that, alone or in combination with its voting shares, give the reporting entity the current ability to direct the investee’s relevant activities.</p> <p>For example, assume that Entity A and Entity B hold 60 percent and 40 percent, respectively, of the outstanding voting shares of Entity C. Entity B has an option to purchase half of A’s voting rights. The option is in the money (i.e., it would be favorable for B to currently exercise the option) and there are no barriers that prevent B from exercising its option. If the combination of the voting shares and the option give B the current ability to direct C’s relevant activities, B should consolidate C.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Control analysis — de facto power	This concept does not exist under U.S. GAAP.	<p data-bbox="979 300 1421 737">An investor with less than a majority of voting rights that has not entered into additional contractual arrangements may still have power over the legal entity if its voting rights give it “the practical ability to direct the relevant activities unilaterally” (see paragraph B41 of IFRS 10). This circumstance may arise when the investor’s holdings of voting rights are significantly greater relative to the size and dispersion of holdings of the other investors. Paragraphs B42–B46 of IFRS 10 provide detailed guidance on determining whether de facto power exists.</p> <p data-bbox="979 758 1421 1228">For example, assume that Entity A acquires 46 percent of the voting rights of Entity C, and the remaining 54 percent of the voting rights are dispersed among thousands of shareholders (no other shareholder holds more than 1 percent). Upon acquiring its interest in C, A determined that, on the basis of its specific relevant facts and circumstances (including the size of its ownership relative to that of others), its 46 percent interest would be sufficient to give it a dominant voting interest that meets the power criterion regardless of whether it considers any other evidence of power.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Control analysis — related parties and agency relationships	<p>There are no prescriptive related-party rules under the voting interest entity model related to determining whether a reporting entity should consolidate a legal entity.</p> <p>However, the VIE model includes provisions that require related parties and de facto agents to be considered throughout the consolidation analysis. Interests held by related parties (regardless of whether the reporting entity can cause the related party to vote on its behalf) may result in the consolidation of the VIE by one of the related parties involved with the VIE, even if none of the parties individually have a controlling financial interest over the VIE. If a reporting entity concludes that it does not meet the primary-beneficiary criteria but that the related-party group (including de facto agents) meets the criteria as a group, the reporting entity may be required to determine which party is most closely associated with the VIE and therefore must consolidate the VIE. This determination requires the application of judgment and an evaluation of all relevant facts and circumstances, including the factors listed in ASC 810-10-25-44.</p>	<p>IFRS 10 includes a list of related parties and de facto agents; however, it does not assume that the related parties will act in concert. Instead, paragraph B73 of IFRS 10 states, “When assessing control, an investor shall consider the nature of its relationship with other parties and whether those other parties are acting on the investor’s behalf (ie they are ‘de facto agents’). The determination of whether other parties are acting as de facto agents requires judgement, considering not only the nature of the relationship but also how those parties interact with each other and the investor.”</p> <p>The practical impact is that an entity may be less likely to be consolidated by a reporting entity under IFRS 10 because the power and economics of the related party are only attributed to the reporting entity if the related party is acting as its de facto agent. Further, unlike U.S. GAAP, IFRS 10 does not require performance of the related-party tiebreaker test.</p>
Accounting policies	<p>Upon consolidation, the accounting policies of a parent and its subsidiaries should be conformed in the parent’s consolidated financial statements unless differences between the policies can be justified.</p>	<p>Upon consolidation, paragraph 19 of IFRS 10 requires the accounting policies of a parent and its subsidiaries to be conformed with respect to “using uniform accounting policies for like transactions and other events in similar circumstances.”</p>
Private-company alternatives	<p>There is an accounting alternative to the VIE model for private-company lessors<sup>3</sup> under common control.</p>	<p>The concept does not exist under IFRS Accounting Standards.</p>

<sup>3</sup> Upon the adoption of ASU 2018-17, the accounting alternative for private companies will be expanded to include all legal entities under common control that meet certain criteria.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Consolidation (Chapter 5) (continued)</b>		
Decision maker/service provider	<p>The evaluation of whether fees paid to a decision maker or service provider are a variable interest focuses on whether all of the following are met:</p> <ul style="list-style-type: none"> <li>• The fees are commensurate with the level of service provided.</li> <li>• The fees are negotiated at arm's length (i.e., they are at market).</li> <li>• The decision maker or service provider does not have any other interests (direct interests, indirect interests through its related parties, or certain interests held by its related parties under common control) in the legal entity that absorb more than an insignificant amount of the potential VIE's variability.</li> </ul> <p>If it is determined that a decision maker's fee arrangement is not a variable interest, the decision maker would be acting as a fiduciary for the legal entity. This determination could affect whether the legal entity is a VIE and whether the decision maker is required to consolidate the VIE.</p>	The concept does not exist under IFRS Accounting Standards.
<b>Contingencies and Loss Recoveries (Chapter 6)</b>		
Scope	The primary source of guidance on the accounting for contingencies is ASC 450 under U.S. GAAP.	The primary source of guidance on the accounting for contingencies is IAS 37 under IFRS Accounting Standards.
Terminology	<p>Three categories:</p> <ul style="list-style-type: none"> <li>• <b>Estimated loss</b> accrued for a loss contingency (i.e., a contingent loss that is recognized as a liability).</li> <li>• <b>Contingent loss</b> that is not recognized as a liability (e.g., when a contingent loss cannot be reasonably estimated).</li> <li>• <b>Contingent gain</b>.</li> </ul> <p>U.S. GAAP and IFRS Accounting Standards use different terminology to describe contingencies. Under U.S. GAAP, this terminology is related to financial statements' elements of performance (two key terms are "contingent gain" and "contingent loss"), whereas under IFRS Accounting Standards, the terminology used is related to financial statements' elements of financial position (the three key terms are "contingent asset," "contingent liability," and "provision"). However, the two sets of terms may be applied similarly so that no difference between them arises in practice.</p>	<p>Three categories:</p> <ul style="list-style-type: none"> <li>• <b>Provision</b> is an accrued liability or loss contingency recognized in the financial statements.</li> <li>• <b>Contingent liability</b> is a loss contingency that does not meet the criteria to be recognized in the financial statements.</li> <li>• <b>Contingent asset</b> is a concept similar to a contingent gain under U.S. GAAP.</li> </ul>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Contingencies and Loss Recoveries (Chapter 6) (continued)</b>		
Recognition of contingent losses/provisions	One of the conditions for loss accrual is that it is probable that (1) an asset has been impaired or (2) a liability has been incurred. "Probable" is defined as "likely to occur" (i.e., generally greater than 70 percent), which is a higher threshold than "more likely than not" (i.e., greater than 50 percent).	One of the conditions for recognizing a provision (as a liability) is that it is probable that an outflow of resources will be required to settle the obligation. "Probable" is defined as "more likely than not" (i.e., greater than 50 percent).  More contingencies may qualify for recognition as liabilities under IFRS Accounting Standards than under U.S. GAAP.
Onerous contracts	Unless there is specific U.S. GAAP guidance on recognizing a contingent liability related to a firmly committed executory contract, recognition of a contingent liability when the fair value of remaining contractual rights declines below the remaining costs to be incurred is not supported by U.S. GAAP.	Under IFRS Accounting Standards, an entity is required to recognize and measure the present obligation under an onerous contract as a provision. An onerous contract is one "in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it."
Measurement of contingent losses/provisions — range of estimates	If no amount in the range is more likely than any other amount in the range, the <b>minimum</b> amount in the range is used to measure the amount to be accrued for a loss contingency.	If no amount in the range is more likely than any other amount in the range, the <b>midpoint</b> of the range is used to measure the liability.
Measurement of contingent losses/provisions — discounting	Discounting is permitted only when the timing of related cash flows is fixed or reliably determinable.	Discounting is required if the effect of discounting is material.
Gain contingencies (U.S. GAAP) versus contingent assets (IFRS Accounting Standards)	At the earlier of when a gain contingency is realized or becomes realizable, recognition is appropriate.	When realization of a contingent asset is virtually certain, recognition is appropriate. Because the thresholds between U.S. GAAP and IFRS Accounting Standards are very similar, no differences are expected to arise in practice.
Disclosure of prejudicial information	Exemptions from disclosure of information that may be prejudicial to an entity are not permitted.	In extremely rare cases, if disclosure of certain information could prejudice the position of the entity in a dispute with other parties, that information does not need to be disclosed. However, an entity must disclose the nature of the dispute, along with the reason why the information has not been disclosed.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Statement of Cash Flows (Chapter 7)</b>		
Scope	Although entities are generally required to present a statement of cash flows, there are certain exceptions. Entities that are not required to present a statement of cash flows include defined benefit pension plans that prepare financial information in accordance with ASC 960, certain investment companies within the scope of ASC 946 that meet all of the conditions in ASC 230-10-15-4(c), and certain funds described in ASC 230-10-15-4(b)(3).	Under paragraph 7 of IAS 7, all entities are required to present a statement of cash flows (i.e., there are no scope exceptions).
Comparative periods	Under ASC 230, presentation of comparative periods is not required. However, SEC Regulation S-X, Rule 3-02, requires that an audited cash flow statement be presented for the previous three fiscal years.	Under the general requirements of paragraphs 38 and 38A of IAS 1, comparative information related to the preceding period should be presented for all amounts reported in the current-period statement of cash flows and the supporting notes. Consequently, an entity should present, at a minimum, two statements of cash flows.
Classification in the statement of cash flows	ASC 230-10-45-10 requires that cash flows be classified and presented in one of three categories: operating, investing, or financing. ASC 230 provides more specific guidance than IFRS Accounting Standards on items to be included in each category.	Paragraph 10 of IAS 7 requires that cash flows be classified and presented in one of three categories: operating, investing, or financing. IAS 7 is more flexible than U.S. GAAP regarding which items are to be included in each category.
Method of reporting cash flows from operating activities	Under ASC 230-10-45-25, an entity is allowed to use the direct or indirect method. Under both methods, net income must be reconciled to net cash flows from operating activities.	Under paragraph 18 of IAS 7, an entity is allowed to use the direct or indirect method. Net income must be reconciled to net cash flows from operating activities only under the indirect method.
Presentation of components of transactions with characteristics of more than one category of cash flows	Under ASC 230-10-45-22, ASC 230-10-45-22A, and ASC 230-10-45-23, an entity first needs to determine whether there are separately identifiable cash flows within a specific transaction. If so, the entity presents such cash flows on the basis of their nature in operating, investing, and financing. In the absence of separately identifiable cash flows, the entity would present such cash flows collectively on the basis of the predominant source or use of the cash flows.	Paragraph 12 of IAS 7 requires that an entity classify individual components of a single transaction separately as operating, investing, or financing depending on the nature of the transaction. IFRS Accounting Standards do not provide guidance on situations in which individual components of a single transaction cannot be separately identified.



Topic	U.S. GAAP	IFRS Accounting Standards
<b>Statement of Cash Flows (Chapter 7) (continued)</b>		
Interest and dividends paid and received	<p>Under ASC 230, interest paid and received should be classified as operating activities.</p> <p>Cash flows from interest paid must be disclosed separately if the indirect method is used.</p> <p>Dividends received are classified as operating activities because these are generally considered to be returns on an entity's investment. However, a dividend from an equity method investment may be investing if the distribution is a return of investment. That is, for distributions from equity method investments, an entity is required to determine whether the distribution is a return on or a return of the entity's investment.</p> <p>Dividends paid are classified as financing activities.</p>	<p>Under IAS 7, entities should elect accounting policies for presenting interest and dividends paid as either operating or financing activities.</p> <p>In addition, entities should elect accounting policies for presenting interest and dividends received as either operating or investing activities.</p> <p>Cash flows from interest and dividends received and paid must be disclosed separately.</p> <p>Note that IAS 7 does not include a requirement to determine whether a distribution from an equity method investment is a return on, or a return of, the entity's investment.</p>
Settlement of zero-coupon debt instruments or other debt instruments that are insignificant in relation to the effective interest rate of the borrowing	<p>As bonds are accreted from issuance to maturity, the interest expense is presented as a reconciling item between net income and cash flows from operating activities. At redemption, the cash paid to settle the interest component is classified as an operating activity and the cash paid to settle the principal is classified as a financing activity.</p>	<p>Rather than including specific guidance as is done in U.S. GAAP, IFRS Accounting Standards include principles related to assessing the classification of the cash flows as operating, investing, or financing activities.</p>
Contingent consideration payments made after the date of a business combination	<p>Contingent consideration payments that are not made soon after the acquisition date must be classified as financing activities; any excess cash payments will be classified as operating activities. Cash payments made soon after the acquisition date in a business combination transaction must be classified as investing activities.</p>	<p>IFRS Accounting Standards do not provide guidance similar to that in U.S. GAAP (under U.S. GAAP, such guidance is based on when contingent consideration payments are made in relation to the date of a business combination). Instead, an entity should assess the nature of the transaction on the basis of the general principle of classification of the cash flows as operating or financing activities.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Statement of Cash Flows (Chapter 7) (continued)</b>		
Presentation of restricted cash	Amounts generally described as restricted cash or restricted cash equivalents must be included in an entity's beginning and ending cash and cash equivalents balances as presented in the statement of cash flows regardless of whether they are included in cash and cash equivalents on the balance sheet.	There is no specific guidance on whether amounts generally described as restricted cash or restricted cash equivalents should be included in an entity's beginning and ending cash and cash equivalents balances as presented in the statement of cash flows. However, amounts generally described as restricted cash or restricted cash equivalents are not included in these balances in the statement of cash flows unless an entity classifies these amounts as cash and cash equivalents on its balance sheet.
<b>Income Taxes (Chapter 8)</b>		
Scope	Under U.S. GAAP, ASC 740 is the primary source of guidance on accounting for income taxes.	Under IFRS Accounting Standards, IAS 12 is the primary source of guidance on accounting for income taxes.
Recognition of DTAs	DTAs are recognized in full and reduced by a valuation allowance if it is more likely than not that some or all of the DTAs will not be realized.	DTAs are recognized at the amount that is probable (generally interpreted to mean more likely than not <sup>4</sup> ) to be realized on a net basis (i.e., the DTA is written down).
Tax laws and rates used for measuring DTAs and DTLs	Enacted tax laws and rates are used.	Enacted or "substantively" enacted tax laws or rates are used.
Subsequent changes in deferred taxes (e.g., because of changes in tax laws, rates, status, or valuation allowance)	Subsequent changes in deferred taxes are generally allocated to continuing operations with limited exceptions (i.e., backward tracing is generally prohibited, regardless of whether the associated tax expense or benefit was originally recognized outside of continuing operations [e.g., in equity]).	The guidance requires the income tax expense or benefit to be recognized in the same manner in which the asset or liability was originally recorded. That is, if the deferred taxes were originally recorded outside of profit or loss (e.g., in equity), subsequent changes to the beginning balance will be recorded in the same manner (i.e., backward tracing is permitted).

<sup>4</sup> While IAS 12 is silent with regard to the meaning of "probable" in the context of paragraph 24 of IAS 12, IAS 37 defines the term as "more likely than not." The footnote to paragraph 23 of IAS 37 acknowledges that this definition is not necessarily applicable to other IFRS Accounting Standards. However, in the absence of any other guidance, the term probable should be considered to mean more likely than not. In March 2009, the IASB issued an exposure draft containing proposals for an IFRS Accounting Standard that would replace IAS 12. Although a replacement standard was not finalized, the exposure draft provided useful guidance on the meaning of "probable" because it used the term "more likely than not" and noted in the Basis for Conclusions that it was consistent with the term "probable" as used in IAS 37 and IFRS 3.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Income Taxes (Chapter 8) (continued)</b>		
Tax consequences of intra-entity sales	Tax effects of intra-entity transfers of inventory are deferred until the related inventory is sold or disposed of, and no deferred taxes are recognized for the difference between the carrying value of the inventory in the consolidated financial statements and the tax basis of the inventory in the buyer's tax jurisdiction.	No exception for intra-entity transfers of inventory exists. Any current and deferred tax expense from intra-entity transfers (inventory or otherwise) is recognized at the time of the transfer. Deferred taxes are recognized for the difference between the carrying value of the transferred asset in the consolidated financial statements and the tax basis of the transferred asset in the buyer's tax jurisdiction, measured by using the statutory tax rate of the buyer's tax jurisdiction (subject to realization criteria in IAS 12 if a DTA is recognized on the basis difference).
Uncertain tax positions	Under U.S. GAAP, there is a two-step recognition and measurement approach under which an entity calculates the amount of tax benefit to recognize in the financial statements by (1) assessing whether it is more likely than not that each individual tax position will be sustained upon examination and (2) measuring a tax position that reaches the more-likely-than-not recognition threshold to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely to be realized upon settlement.	If an entity concludes that it is probable (interpreted to mean more likely than not) that the taxing authority will accept an uncertain tax treatment (including both the technical merit of the treatment and the amounts included in the tax return), recognition and measurement are consistent with the positions as taken in the tax filings. If the entity concludes that it is not probable that the taxing authority will accept the tax treatment as filed, the entity is required to reflect the uncertainty by using (1) the most likely amount or (2) the expected value.
Share-based compensation	For awards that ordinarily give rise to a tax deduction under existing tax law, deferred taxes are computed on the basis of compensation expense that is recognized for financial reporting purposes. Tax benefits in excess of or less than the related DTA are recognized in the income statement in the period in which the amount of the deduction is determined (typically when an award vests or, in the case of options, is exercised or expires).	For awards that ordinarily give rise to a tax deduction, deferred taxes are computed on the basis of the hypothetical tax deduction for the share-based payment corresponding to the percentage earned to date (i.e., the intrinsic value of the award on the reporting date multiplied by the percentage vested). Recognition of deferred taxes could be recorded either through profit or loss or through equity, on the basis of the nature of the deferred taxes.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Income Taxes (Chapter 8) (continued)</b>		
Reconciliation of actual and expected tax rate	<p>Required for public companies only; expected tax expense is computed by applying the domestic federal statutory rates to pretax income from continuing operations.</p> <p>Nonpublic companies must disclose the nature of the reconciling items but are not required to provide the amounts.</p>	<p>Required for all entities applying IFRS Accounting Standards. Entities compute expected tax expense by applying the applicable tax rate(s) to accounting profit and must disclose the basis on which any applicable tax rate is computed.</p>
Interim reporting	<p>Entities are generally required to compute tax (or benefit) for each interim period by using one overall estimated AETR. The estimated AETR is computed by dividing the estimated annual tax (or benefit) into the estimated annual pretax ordinary income (or loss).</p> <p>Entities then apply the estimated AETR to year-to-date pretax ordinary income or loss to compute the year-to-date tax (or benefit). The interim tax expense (or benefit) is the difference between the year-to-date tax (or benefit) and prior year-to-date tax (or benefit).</p>	<p>To the extent practicable, a separate estimated average annual effective income tax rate is determined for each tax jurisdiction and applied individually to the interim-period pretax income of each jurisdiction. Similarly, if different income tax rates apply to different categories of income (such as capital gains or income earned in particular industries), to the extent practicable, a separate rate is applied to each individual category of interim period pretax income.</p>
<b>Share-Based Payments (Chapter 9)</b>		
Scope	<p>ASC 718 generally applies to share-based payment awards granted to employees and nonemployees in exchange for goods or services. While the accounting for employee and nonemployee awards is largely aligned, there are some differences in the guidance.</p>	<p>IFRS 2 applies to share-based payment transactions with employees and nonemployees in exchange for goods or services. Under IFRS 2, the accounting treatment is different for (1) share-based payment awards granted to employees and nonemployees that provide services in a manner similar to an employee and (2) share-based payment awards exchanged for goods or services that are not similar to employee services.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Share-Based Payments (Chapter 9) (continued)</b>		
Measurement of awards	<p>Share-based payment awards are generally recognized at a fair-value-based measure (for both employee and nonemployee awards).</p> <p>For awards granted by a nonpublic entity, the entity is required to use a fair-value-based measure or calculated value if it is not practicable for the entity to estimate the expected volatility of its share price. In addition, a nonpublic entity can make an entity-wide accounting policy election to use either a fair-value-based measure (or a calculated value as noted above) or intrinsic value to measure its liability-classified awards.</p>	<p>Share-based payment awards issued to nonemployees in exchange for services that are similar to employee services are measured on the same basis as employee awards (i.e., grant-date fair-value-based measure).</p> <p>Share-based payment awards issued to nonemployees in exchange for goods or for services that are not similar to employee services are measured as of the date the entity obtains the goods or the counterparty renders the service. The awards should be measured on the basis of the fair value of the goods or services received unless that fair value cannot be estimated reliably. If the entity cannot estimate reliably the fair value of the goods or services received, the entity should measure their value by reference to the fair value of the equity instruments granted. However, there is a rebuttable presumption that the fair value of the goods or services received can be estimated reliably.</p> <p>There are no practical expedients for nonpublic entities. A fair-value-based measure must be used for all share-based payment awards.</p>
<b>Financial Instruments — Contracts on Entity's Own Equity (Chapter 10)</b>		
Scope	Under U.S. GAAP, ASC 815-40 is the primary source of guidance on accounting for contracts on an entity's own equity.	Under IFRS Accounting Standards, IAS 32 is the primary source of guidance on accounting for contracts on an entity's own equity.
Exercise contingencies	Exercise contingencies must be evaluated to determine whether they preclude equity classification.	Not addressed by IAS 32. In practice, exercise contingencies that would preclude equity classification under U.S. GAAP may not do so under IFRS Accounting Standards.
Settlement amount	To qualify as equity, the contract must be a fixed-for-fixed forward or option on equity shares, or the only variables that can adjust the settlement amount are inputs to a fixed-for-fixed forward or option.	A contract must be fixed for fixed to qualify as equity. Unlike U.S. GAAP, IAS 32 does not provide detailed guidance on contracts with adjustment provisions (e.g., antidilution provisions).

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Contracts on Entity's Own Equity (Chapter 10) (continued)</b>		
Net cash settlement provisions	Equity classification is precluded if the entity could be forced to net cash settle the contract. There is detailed guidance on how to assess whether an entity is able to settle in shares (e.g., whether the entity has sufficient authorized and unissued shares available to share settle the contract).	Equity classification is precluded. Unlike U.S. GAAP, IFRS Accounting Standards do not contain detailed guidance on how to evaluate whether an entity might be required to net cash settle a contract that specifies share settlement.
Net share settlement provisions	Equity classification is not precluded if the entity cannot be forced to net cash settle the contract.	Equity classification is precluded.
Settlement alternatives	Equity classification is not precluded if the entity cannot be forced to net cash settle the contract.	Equity classification is precluded (unless all settlement alternatives are consistent with equity classification).
Embedded equity-linked features that do not qualify as equity	Not separated as embedded derivatives if they do not meet the net settlement characteristic in the definition of a derivative under ASC 815-10.	May be required to be separated as embedded derivatives even if they do not meet the net settlement characteristic.
Embedded equity-linked features that qualify as equity	Not separated from liabilities except in specified circumstances.	Embedded equity-linked features that qualify as equity are separated from liabilities and accounted for as equity.
<b>Financial Instruments — Convertible Debt After Adoption of ASU 2020-06 (Chapter 10)</b>		
Scope	Under U.S. GAAP, ASC 470-20 is the primary source of guidance on accounting for convertible debt.	Under IFRS Accounting Standards, IAS 32 is the primary source of guidance on accounting for convertible debt.
Separation of equity component	A debtor accounts for convertible debt as a liability in its entirety unless the convertible debt (1) has a conversion feature that must be bifurcated as a derivative, (2) was issued at a substantial premium, (3) was modified or exchanged if extinguishment accounting did not apply and the fair value of the conversion feature increased, or (4) has a bifurcated conversion option derivative that was reclassified as equity. Different separation methods are used depending on the applicable accounting model.	A debtor separates convertible debt into liability and equity components unless the embedded conversion feature must be bifurcated as a derivative liability. The liability and equity components are separated on the basis of the fair value of the liability component.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Equity Shares (Chapter 10)</b>		
Scope	Under U.S. GAAP, ASC 480 is the primary source of guidance on accounting for equity shares and other financial instruments.	Under IFRS Accounting Standards, IAS 32 is the primary source of guidance on accounting for equity shares and other financial instruments.
Redeemable equity securities (e.g., puttable shares) and noncontrolling interests	Financial instruments in the form of shares that embody an obligation to transfer assets are classified as liabilities only if the obligation is unconditional and the transfer of assets is therefore certain to occur. SEC registrants present equity classified instruments that embody a conditional obligation to transfer assets as mezzanine or temporary equity.	Financial instruments in the form of shares that embody an obligation to transfer assets are classified as liabilities irrespective of whether the obligation is unconditional or conditional, with certain exceptions.  The concept of mezzanine or temporary equity classification does not exist under IFRS Accounting Standards.
Obligations to repurchase shares	Physically settled forward-purchase contracts that embody an obligation to repurchase the issuer's equity shares for cash are accounted for at either the present value of the redemption amount or the settlement value. Other physically settled contracts that embody an obligation to repurchase the issuer's equity shares by transferring assets (e.g., a physically settled written put option or a forward purchase contract that provides the counterparty with a right to require either physical or net settlement) are accounted for at fair value.	Contracts that embody an obligation to repurchase the issuer's equity shares by transferring assets are accounted for at the present value of the redemption amount if the issuer could be required to physically settle the contract by transferring assets in exchange for shares (e.g., a forward purchase or written put option contract that gives the counterparty the right to require either physical or net settlement).
Obligations to issue a variable number of equity shares	A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by delivering a variable number of equity shares is classified as an asset or a liability if, at inception, the obligation's monetary value is based either solely or predominantly on (1) a fixed monetary amount, (2) variations in something other than the fair value of the issuer's equity shares, or (3) variations inversely related to changes in the fair value of the issuer's equity shares.	Contracts that will be settled in a variable number of shares are accounted for as assets or liabilities.



Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Derivatives (Chapter 10)</b>		
Scope	Under U.S. GAAP, ASC 815 is the primary source of guidance on accounting for derivatives.	Under IFRS Accounting Standards, IAS 32 and IFRS 9 are the primary sources of guidance on accounting for derivatives.
"Derivative" — definition	<p>For an instrument to meet the definition of a derivative, the following characteristics must be present:</p> <ul style="list-style-type: none"> <li>• It contains "[o]ne or more underlyings" and "[o]ne or more notional amounts or payment provisions or both" (ASC 815-10).</li> <li>• It requires no or a small initial net investment.</li> <li>• It requires or permits net settlement (i.e., via contractual terms or via means outside the contract), or it provides for delivery of an asset that is readily convertible to cash.</li> </ul>	<p>For an instrument to meet the definition of a derivative, the following characteristics must be present:</p> <ul style="list-style-type: none"> <li>• Its value changes in response to an underlying (e.g., specified interest rate, commodity price, foreign currency rate, credit rating, and so forth, provided in the case of a nonfinancial variable that the variable is not specific to a party to the contract).</li> <li>• It requires no or a small initial net investment.</li> <li>• It is settled at a future date.</li> </ul> <p>Though the definition of a derivative under IFRS Accounting Standards does not include a net settlement characteristic, contracts to purchase or sell nonfinancial items are within the scope of IFRS 9 only if they can be settled net.</p>
Embedded derivatives — initial recognition	<p>The bifurcation requirements apply to both assets and liabilities, including financial assets.</p> <p>In addition, the application guidance under U.S. GAAP is more detailed than that under IFRS Accounting Standards. Accordingly, an entity may not necessarily reach the same conclusion under IFRS Accounting Standards as under U.S. GAAP about whether the conditions for bifurcation are met.</p>	While the overall criteria for bifurcation are similar to those under U.S. GAAP, the bifurcation requirements do not apply to financial assets within the scope of IFRS 9. Therefore, if a hybrid contract contains a host that is a financial asset within the scope of IFRS 9, the bifurcation requirements do not apply.
Embedded equity components — initial recognition	Embedded equity-linked features that qualify as equity are not separated from liabilities except in specified circumstances.	Embedded equity-linked features that qualify as equity are separated from liabilities and accounted for as equity.
Embedded equity components — initial measurement	Different methods may be used for initial measurement of equity components depending on the reason an amount is allocated to equity.	The with-and-without method is used for initial measurement of equity components. The liability component is measured first.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Investments in Loans and Receivables (Chapter 10)</b>		
Scope	Under U.S. GAAP, ASC 310 and ASC 326 are the primary sources of guidance on accounting for investments in loans and receivables.	Under IFRS Accounting Standards, IFRS 9 is the primary source of guidance on accounting for investments in loans and receivables.
Classification and measurement categories	Generally, loan receivables are classified on the basis of management's intent as either held for sale (HFS) or held for investment (HFI). Unless the FVO is elected, loan receivables are measured at either (1) the lower of cost or fair value (for HFS loans) or (2) amortized cost (for HFI loans).	<p>Financial assets (except those for which the FVO has been elected) are classified on the basis of both (1) the entity's business model for managing them and (2) their contractual cash flow characteristics. Three classification categories are used:</p> <ul style="list-style-type: none"> <li>• <i>Amortized cost</i> — The assets are held within a business model with the objective to collect contractual cash flows that are solely payments of principal and interest (SPPI).</li> <li>• <i>Fair value, with changes in fair value through other comprehensive income (FVTOCI)</i> — The assets have contractual cash flows that are SPPI and are held within a business model with the objective of both collecting contractual cash flows and selling financial assets.</li> <li>• <i>Fair value through profit or loss</i> — The assets have contractual cash flows that are not SPPI or are not held within a business model with the objective to (1) collect contractual cash flows or (2) both collect contractual cash flows and sell financial assets.</li> </ul>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Investments in Loans and Receivables (Chapter 10) (continued)</b>		
Recognition and measurement of impairment losses	<p><i>Current expected credit loss approach</i> — An impairment loss on a loan or receivable accounted for at amortized cost is recognized immediately on the basis of expected credit losses.</p> <p>Entities have flexibility in measuring expected credit losses as long as the measurement results in an allowance that:</p> <ul style="list-style-type: none"> <li>• Reflects a risk of loss, even if remote.</li> <li>• Reflects losses that are expected over the contractual life of the asset.</li> <li>• Takes into account historical loss experience, current conditions, and reasonable and supportable forecasts.</li> </ul> <p>Use of the discounted cash flow model is not required.</p>	<p><i>Expected-loss approach</i> — An impairment loss on a financial asset accounted for at amortized cost or at FVTOCI is recognized immediately on the basis of expected credit losses.</p> <p>Depending on the financial asset's credit risk at inception and changes in credit risk from inception, as well as the applicability of certain practical expedients, the measurement of the impairment loss will differ. The impairment loss would be measured as either (1) the 12-month credit loss or (2) the lifetime expected credit loss.</p> <p>Further, for financial assets that are credit-impaired at the time of recognition, the impairment loss will be based on the cumulative changes in the lifetime expected credit losses since initial recognition.</p>
Effective interest method	<p>The effective interest rate is computed on the basis of the contractual cash flows over the contractual term of the loan, except for (1) certain loans that are part of a group of prepayable loans and (2) purchased loans for which there is evidence of credit deterioration.</p> <p>For purchased credit-deteriorated assets, interest income is recognized on the basis of the purchase price plus the initial allowance accreting to the contractual cash flows.</p> <p>If estimated payments for certain groups of prepayable loans are revised, an entity may adjust the net investment in the group of loans, on the basis of a recalculation of the effective yield to reflect actual payments to date and anticipated future payments, to the amount that would have existed had the new effective yield been applied since the loans' origination/acquisition (retrospective approach), with a corresponding charge or credit to interest income.</p>	<p>The effective interest rate is computed on the basis of the estimated cash flows that are expected to be received over the expected life of a loan by considering all of the loan's contractual terms (e.g., prepayment, call, and similar options) but not expected credit losses.</p> <p>Interest revenue is calculated on the basis of the gross carrying amount (i.e., the amortized cost before adjusting for any loss allowance) unless the loan (1) is purchased or originated credit-impaired or (2) subsequently became credit-impaired. In those cases, interest revenue is calculated on the basis of amortized cost (i.e., net of the loss allowance).</p> <p>If estimated receipts are revised, the carrying amount is adjusted to the present value of the future estimated cash flows, discounted at the financial asset's original effective interest rate (cumulative catch-up approach). The resulting adjustment is recognized within profit or loss.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Financial Instruments — Investments in Loans and Receivables (Chapter 10) (continued)</b>		
Interest recognition on impaired loans	There is no explicit requirement in U.S. GAAP for when an entity should cease the recognition of interest income on a receivable measured at amortized cost. However, the practice of placing financial assets on nonaccrual status is acknowledged by U.S. GAAP.	IFRS Accounting Standards do not permit nonaccrual of interest. However, for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.
<b>Leases (Chapter 11)</b>		
Scope	The scope of ASC 842 includes leases of all PP&E and excludes: <ul style="list-style-type: none"> <li>• Rights to use intangible assets.</li> <li>• Rights to explore for or use nonregenerative resources.</li> <li>• Rights to use biological assets.</li> <li>• Rights to use inventory.</li> <li>• Rights to use assets under construction.</li> </ul>	The scope of IFRS 16 includes leases of all assets (not limited to PP&E). Exceptions are similar to those in ASC 842. Lessees can elect to apply the guidance to rights to use certain intangible assets.
Short-term lease definition	A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option that the lessee is reasonably certain to exercise.	A short-term lease is defined as a lease that has a lease term of 12 months or less and does not include a purchase option (i.e., the likelihood that the purchase option will be exercised is not considered).
Leases of low-value assets	There is no exemption for leases of low-value assets under U.S. GAAP. However, the FASB believes that an entity may adopt a reasonable capitalization policy based on materiality.	A lessee may elect to recognize the payments for a lease of a low-value asset on a straight-line basis over the lease term (in a manner similar to its recognition of an operating lease under IAS 17). Such a lease would not be reflected on the lessee's balance sheet. IFRS 16 does not define "low value"; however, the Basis for Conclusions refers to assets individually with a value, when new, of \$5,000 or less.  In addition, an entity may adopt a reasonable capitalization policy based on materiality.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Leases (Chapter 11) (continued)</b>		
Lease classification	<p data-bbox="516 300 951 506"><i>Lessee</i> — There are two accounting models for leases, and the model will dictate the pattern of expense recognition associated with the lease. Therefore, a lessee must perform a lease classification assessment as of the commencement date.</p> <p data-bbox="516 516 951 611">Under ASC 842-10-25-2, a lessee must classify a lease as a finance lease if any of the following criteria are met:</p> <ul data-bbox="557 621 951 1220" style="list-style-type: none"> <li>• “The lease transfers ownership of the underlying asset.”</li> <li>• “The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.”</li> <li>• “The lease term is for the major part of the remaining economic life of the underlying asset.”</li> <li>• “The present value of the sum of the lease payments and any residual value guaranteed by the lessee . . . equals or exceeds substantially all of the fair value of the underlying asset.”</li> <li>• “The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor.”</li> </ul> <p data-bbox="516 1230 951 1325">If none of these criteria are met, the lease would be classified as an operating lease.</p> <p data-bbox="516 1335 951 1430"><i>Lessor</i> — A lessor must perform a lease classification assessment as of the <b>commencement date</b>.</p> <p data-bbox="516 1440 951 1682">The criteria governing when a lessor must classify a lease as a sales-type lease are the same as those that govern when a lessee must classify a lease as a finance lease; therefore, if any of the criteria noted above apply, the lessor would classify the lease as a sales-type lease.</p>	<p data-bbox="976 300 1425 453"><i>Lessee</i> — There is only a single accounting model for leases (i.e., all leases are effectively equivalent to finance leases under ASC 842), so classification of leases is unnecessary.</p> <p data-bbox="976 464 1425 821"><i>Lessor</i> — A lessor must perform a lease classification assessment as of the <b>inception date</b>. A lease is classified as a finance lease if it transfers substantially all of the risks and rewards related to ownership; otherwise, it is classified as an operating lease. This determination is not based on meeting any criterion. However, examples of situations that individually or in combination would indicate a finance lease include the following:</p> <ul data-bbox="1016 831 1425 1335" style="list-style-type: none"> <li>• The lease transfers ownership of the underlying asset.</li> <li>• The lease grants an option to purchase the underlying asset that the lessee is reasonably certain to exercise.</li> <li>• The lease term is for the major part of the remaining economic life of the underlying asset.</li> <li>• The present value of the lease payments amounts to at least substantially all of the fair value of the underlying asset.</li> <li>• The underlying asset is of a specialized nature and has no alternative use to the lessor.</li> </ul> <p data-bbox="976 1346 1425 1409">Other situations in which a lease could be a finance lease include the following:</p> <ul data-bbox="1016 1419 1425 1703" style="list-style-type: none"> <li>• The lessee bears the lessor’s losses for early cancellation.</li> <li>• Gains or losses related to the asset at the end of the lease accrue to the lessee.</li> <li>• The lessee can renew the lease for rent at a rate that is substantially lower than the market rate.</li> </ul>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Leases (Chapter 11) (continued)</b>		
Lease classification (continued)	<p>If none of those criteria are met, the lessor would classify the lease as a direct financing lease in accordance with ASC 842-10-25-3 if (1) the sum of the lease payments and any third-party guarantee of the residual value “equals or exceeds substantially all of the fair value of the underlying asset” and (2) “[i]t is probable that the lessor will collect the lease payments plus any amount necessary to satisfy a residual value guarantee.” Otherwise, the lease would be classified as an operating lease.</p>	
Lessee’s subsequent accounting for ROU asset and lease expense	<p>The accounting depends on the lease classification:</p> <ul style="list-style-type: none"> <li>• <i>Finance leases</i> — The ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile. Interest and amortization are presented separately in the income statement.</li> <li>• <i>Operating leases</i> — Lease expense generally results in a straight-line expense profile that is presented as a single line in the income statement. As interest on the lease liability is generally declining over the lease term, amortization of the ROU asset is increasing over the lease term to provide a constant expense profile.</li> </ul>	<p>A single accounting model is used. The ROU asset is generally amortized on a straight-line basis. This amortization, when combined with the interest on the lease liability, results in a front-loaded expense profile. That is, the single lessee accounting model under IFRS 16 is similar to that of a finance lease under ASC 842. Interest expense on the lease liability and amortization of the ROU asset are presented separately in the income statement.</p>

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Leases (Chapter 11) (continued)</b>		
Lessor accounting	<p><i>Core model</i> — The model substantially retains the lessor measurement approach in ASC 840 for operating, direct financing, and sales-type leases.</p> <p>Selling profit for a sales-type lease is recognized at lease commencement. Selling profit on a direct financing lease, if any, is deferred and recognized as interest income over the lease term.</p> <p><i>Separating lease and nonlease components</i> — ASC 842-10-15-42A offers lessors a practical expedient under which they can elect not to separate lease and nonlease components when certain conditions are met.</p> <p><i>Sales tax and lessor costs</i> — ASC 842-10-15-39A offers lessors a practical expedient under which they can present sales taxes collected from lessees on a net basis. In addition, lessor costs paid directly to a third party by a lessee should be excluded from variable payments.</p> <p><i>Fair value of underlying asset</i> — ASC 842-30-55-17A amends the definition of fair value for lessors that are not manufacturers or dealers in such a way that the fair value of the underlying asset is its cost unless a significant lapse of time has occurred.</p>	<p><i>Core model</i> — The model substantially retains the lessor measurement approach in IAS 17 for operating and finance leases.</p> <p>Selling profit for a finance lease is recognized at lease commencement.</p> <p><i>Separating lease and nonlease components</i> — A similar practical expedient is not available.</p> <p><i>Sales tax and lessor costs</i> — A similar practical expedient is not available. In addition, there are no similar provisions related to lessor costs paid directly to a third party by a lessee.</p> <p><i>Fair value of the underlying asset</i> — A similar amendment to the definition of fair value has not been made.</p>
Recognition of variable lease payments that do not depend on an index or rate	A lessee should recognize variable lease payments not included in its lease liability (e.g., payments based on the achievement of a target) in the period in which achievement of the target that triggers the variable lease payments becomes probable.	A lessee should recognize variable lease payments not included in its lease liability (e.g., payments based on the achievement of a target) in the period in which the target is achieved.
Reassessment of variable lease payments that depend on an index or rate	A lessee reassesses variable payments based on an index or rate only when the lease obligation is remeasured for other reasons (e.g., a change in lease term or modification).	A lessee reassesses variable payments based on an index or rate whenever there is a change in contractual cash flows (e.g., the lease payments are adjusted for a change in the consumer price index) or when the lease obligation is remeasured for other reasons.



Topic	U.S. GAAP	IFRS Accounting Standards
<b>Leases (Chapter 11) (continued)</b>		
Lessee's incremental borrowing rate	The lessee's incremental borrowing rate is the rate a lessee would pay to borrow, on a collateralized basis over a similar term, <b>an amount equal to the lease payments</b> in a similar economic environment.	The lessee's incremental borrowing rate is the rate a lessee would pay to borrow over a similar term, and with a similar security, the funds necessary to obtain <b>an asset with a value similar to the ROU asset</b> in a similar economic environment.
Modifications that reduce the lease term for lessees	A reduction in the lease term is <b>not</b> considered a decrease in the scope of the lease. A lessee should thus remeasure the lease liability, with a corresponding reduction in the ROU asset, but should not recognize any gain or loss as of the effective date of the modification unless the ROU asset is reduced to zero.	A reduction in the lease term is considered a decrease in the scope of the lease. A lessee should thus remeasure the lease liability, with a proportionate reduction in the ROU asset, and recognize a gain or loss for any difference as of the effective date of the modification.
Sublease	The intermediate lessor would classify a sublease by considering the <b>underlying asset</b> of the head lease (instead of the ROU asset) as the leased asset in the sublease.	The intermediate lessor would classify a sublease by considering the <b>ROU asset</b> of the head lease as the leased asset in the sublease.
Sale-and-leaseback arrangements	<p>The transaction would not be considered a sale if (1) it does not qualify as a sale under ASC 606 or (2) the leaseback is a finance lease.</p> <p>A repurchase option would result in a failed sale unless (1) the exercise price of the option is at fair value and (2) alternative assets are readily available in the marketplace.</p> <p>If the transaction qualifies as a sale, the entire gain on the transaction would be recognized.</p>	<p>The transaction would not be considered a sale if it does not qualify as a sale under IFRS 15.</p> <p>A repurchase option would always result in a failed sale.</p> <p>For transactions that qualify as a sale, the gain would be limited to the amount related to the residual portion of the asset sold. The amount of the gain related to the underlying asset leased back to the lessee would be offset against the lessee's ROU asset.</p>
Balance sheet presentation	If a lessee does not separately present ROU assets and lease liabilities on the balance sheet, the lessee must disclose the line item in which its ROU assets and lease liabilities are included. This requirement applies to both finance leases and operating leases.	If a lessee does not separately present ROU assets and lease liabilities on the balance sheet, the lessee must present the ROU assets as if the underlying asset were owned and disclose the line item in which its ROU assets and lease liabilities are included.

Topic	U.S. GAAP	IFRS Accounting Standards
<b>Common-Control Transactions (Section 13.2)</b>		
Scope	ASC 805 provides that assets and liabilities transferred between entities under common control are generally recognized at historical carrying amounts.	IFRS Accounting Standards provide no authoritative guidance on the accounting for transfers of businesses between entities under common control. In practice, entities can elect to apply either the acquisition method at fair value or the predecessor's historical cost.
<b>Foreign Currency (Section 13.10)</b>		
Translations of foreign entities whose functional currency is the currency of a highly inflationary (hyperinflationary) economy	<p>Previously issued foreign entity financial statements should not be restated. That is, the effects of a highly inflationary economy are accounted for prospectively.</p> <p>Further, the financial statements of the foreign entity are remeasured for consolidation purposes as if the immediate parent's reporting currency were its functional currency.</p>	<p>Restatement of the foreign operation's financial statements is required before translation (purchasing power adjustments are made retrospectively). That is, the effects of a hyperinflationary economy are accounted for retrospectively.</p> <p>Further, the financial statements of the foreign operation are translated into the presentation currency by using the closing rate as of the balance sheet date.</p>
Determination of functional currency	There is no hierarchy of factors for entities to consider in determining the functional currency.	<p>There is a hierarchy of factors for entities to consider in determining the functional currency.</p> <p>Paragraph 9 of IAS 21 states that the two primary factors to consider are (1) the currency that mainly influences the entity's pricing of goods and services and (2) the currency that mainly influences the costs of providing goods or services. Paragraphs 10 and 11 of IAS 21 specify the secondary factors.</p>
Translations when there is a change in functional currency	The effect of a change in functional currency (that is unrelated to a highly inflationary economy) depends on whether the change is from the reporting currency to a foreign currency or vice versa. A change from the reporting currency to a foreign currency is accounted for prospectively from the date of the change. By contrast, a change from a foreign currency to the reporting currency is accounted for on the basis of the translated amounts at the end of the previous period.	<p>The effect of a change in functional currency that is unrelated to a hyperinflationary economy is accounted for prospectively from the date of the change.</p> <p>A change in functional currency should be recognized as of the date on which it is determined that there has been a change in the underlying events and circumstances relevant to the reporting entity that justifies a change in the functional currency. For convenience, and as a practical matter, there is a practice of using a date at the beginning of the most recent period (annual or interim, as the case might be).</p>

# Appendix B — Titles of Standards and Other Literature

## AICPA Literature

### Accounting and Valuation Guides

*Assets Acquired to Be Used in Research and Development Activities*

*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*

### Clarified Statements on Auditing Standards

AU-C Section 501, "Audit Evidence — Specific Considerations for Selected Items"

AU-C Section 620, "Using the Work of an Auditor's Specialist"

## FASB Literature

### ASC Topics

ASC 105, *Generally Accepted Accounting Principles*

ASC 205, *Presentation of Financial Statements*

ASC 210, *Balance Sheet*

ASC 220, *Income Statement — Reporting Comprehensive Income*

ASC 230, *Statement of Cash Flows*

ASC 235, *Notes to Financial Statements*

ASC 250, *Accounting Changes and Error Corrections*

ASC 260, *Earnings per Share*

ASC 270, *Interim Reporting*

ASC 275, *Risks and Uncertainties*

ASC 280, *Segment Reporting*

ASC 310, *Receivables*

ASC 320, *Investments — Debt Securities*

ASC 321, *Investments — Equity Securities*

ASC 323, *Investments — Equity Method and Joint Ventures*

ASC 326, *Financial Instruments — Credit Losses*

ASC 330, *Inventory*

ASC 340, *Other Assets and Deferred Costs*

ASC 350, *Intangibles — Goodwill and Other*

ASC 360, *Property, Plant, and Equipment*

ASC 405, *Liabilities*

ASC 410, *Asset Retirement and Environmental Obligations*

ASC 420, *Exit or Disposal Cost Obligations*

ASC 440, *Commitments*

ASC 450, *Contingencies*

ASC 460, *Guarantees*

ASC 470, *Debt*

ASC 480, *Distinguishing Liabilities From Equity*

ASC 505, *Equity*

ASC 605, *Revenue Recognition*

ASC 606, *Revenue From Contracts With Customers*

ASC 610, *Other Income*

ASC 705, *Cost of Sales and Services*

ASC 710, *Compensation — General*

ASC 712, *Compensation — Nonretirement Postemployment Benefits*

ASC 715, *Compensation — Retirement Benefits*

ASC 718, *Compensation — Stock Compensation*

ASC 720, *Other Expenses*

ASC 730, *Research and Development*

ASC 740, *Income Taxes*

ASC 805, *Business Combinations*

ASC 808, *Collaborative Arrangements*

ASC 810, *Consolidation*

ASC 815, *Derivatives and Hedging*

ASC 820, *Fair Value Measurement*

ASC 825, *Financial Instruments*

ASC 830, *Foreign Currency Matters*

ASC 832, *Government Assistance*

ASC 835, *Interest*  
 ASC 840, *Leases*  
 ASC 842, *Leases*  
 ASC 845, *Nonmonetary Transactions*  
 ASC 848, *Reference Rate Reform*  
 ASC 855, *Subsequent Events*  
 ASC 860, *Transfers and Servicing*  
 ASC 905, *Agriculture*  
 ASC 915, *Development Stage Entities*  
 ASC 930, *Extractive Activities — Mining*  
 ASC 944, *Financial Services — Insurance*  
 ASC 946, *Financial Services — Investment Companies*  
 ASC 948, *Financial Services — Mortgage Banking*  
 ASC 954, *Health Care Entities*  
 ASC 958, *Not-for-Profit Entities*  
 ASC 960, *Plan Accounting — Defined Benefit Pension Plans*  
 ASC 970, *Real Estate — General*  
 ASC 985, *Software*

## **ASUs**

ASU 2010-27, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Pharmaceutical Manufacturers* — a consensus of the FASB Emerging Issues Task Force

ASU 2011-06, *Other Expenses (Topic 720): Fees Paid to the Federal Government by Health Insurers* — a consensus of the FASB Emerging Issues Task Force

ASU 2014-09, *Revenue From Contracts With Customers (Topic 606)*

ASU 2014-10, *Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation*

ASU 2014-15, *Presentation of Financial Statements — Going Concern (Subtopic 205-40): Disclosure of Uncertainties About an Entity's Ability to Continue as a Going Concern*

ASU 2014-16, *Derivatives and Hedging (Topic 815): Determining Whether the Host Contract in a Hybrid Financial Instrument Issued in the Form of a Share Is More Akin to Debt or to Equity* — a consensus of the FASB Emerging Issues Task Force

ASU 2015-16, *Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments*

ASU 2016-01, *Financial Instruments — Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*

ASU 2016-02, *Leases (Topic 842)*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-15, *Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*

ASU 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

ASU 2016-18, *Statement of Cash Flows (Topic 230): Restricted Cash* — a consensus of the FASB Emerging Issues Task Force

ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*

ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

ASU 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*

ASU 2017-11, *Earnings per Share (Topic 260); Distinguishing Liabilities From Equity (Topic 480); Derivatives and Hedging (Topic 815): (Part I) Accounting for Certain Financial Instruments With Down Round Features, (Part II) Replacement of the Indefinite Deferral for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests With a Scope Exception*

ASU 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*

ASU 2018-07, *Compensation — Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*

ASU 2018-08, *Not-for-Profit Entities (Topic 958): Clarifying the Scope and the Accounting Guidance for Contributions Received and Contributions Made*

ASU 2018-10, *Codification Improvements to Topic 842, Leases*

ASU 2018-11, *Leases (Topic 842): Targeted Improvements*

ASU 2018-17, *Consolidation (Topic 810): Targeted Improvements to Related Party Guidance for Variable Interest Entities*

ASU 2018-18, *Collaborative Arrangements (Topic 808): Clarifying the Interaction Between Topic 808 and Topic 606*

ASU 2019-01, *Leases (Topic 842): Codification Improvements*

ASU 2019-04, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments*

ASU 2019-05, *Financial Instruments — Credit Losses (Topic 326): Targeted Transition Relief*

ASU 2019-10, *Financial Instruments — Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates*

- ASU 2019-11, *Codification Improvements to Topic 326, Financial Instruments — Credit Losses*
- ASU 2019-12, *Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*
- ASU 2020-01, *Investments — Equity Securities (Topic 321), Investments — Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815): Clarifying the Interactions Between Topic 321, Topic 323, and Topic 815* — a consensus of the FASB Emerging Issues Task Force
- ASU 2020-02, *Financial Instruments — Credit Losses (Topic 326) and Leases (Topic 842): Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 119 and Update to SEC Section on Effective Date Related to Accounting Standards Update No. 2016-02, Leases (Topic 842)*
- ASU 2020-03, *Codification Improvements to Financial Instruments*
- ASU 2020-04, *Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting*
- ASU 2020-05, *Revenue From Contracts With Customers (Topic 606) and Leases (Topic 842): Effective Dates for Certain Entities*
- ASU 2020-06, *Debt — Debt With Conversion and Other Options (Subtopic 470-20) and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Accounting for Convertible Instruments and Contracts in an Entity's Own Equity*
- ASU 2021-01, *Reference Rate Reform (Topic 848): Scope*
- ASU 2021-04, *Earnings per Share (Topic 260), Debt — Modifications and Extinguishments (Subtopic 470-50), Compensation — Stock Compensation (Topic 718), and Derivatives and Hedging — Contracts in Entity's Own Equity (Subtopic 815-40): Issuer's Accounting for Certain Modifications or Exchanges of Freestanding Equity-Classified Written Call Options* — a consensus of the FASB Emerging Issues Task Force
- ASU 2021-05, *Leases (Topic 842): Lessors — Certain Leases With Variable Lease Payments*
- ASU 2021-07, *Compensation — Stock Compensation (Topic 718): Determining the Current Price of an Underlying Share for Equity-Classified Share-Based Awards* — a consensus of the Private Company Council
- ASU 2021-08, *Business Combinations (Topic 805): Accounting for Contract Assets and Contract Liabilities From Contracts With Customers*
- ASU 2021-09, *Leases (Topic 842): Discount Rate for Lessees That Are Not Public Business Entities*
- ASU 2021-10, *Government Assistance (Topic 832): Disclosures by Business Entities About Government Assistance*
- ASU 2022-01, *Derivatives and Hedging (Topic 815): Fair Value Hedging — Portfolio Layer Method*
- ASU 2022-02, *Financial Instruments — Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*
- ASU 2022-03, *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*
- ASU 2022-04, *Liabilities — Supplier Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*
- ASU 2022-06, *Reference Rate Reform (Topic 848): Deferral of the Sunset Date of Topic 848*
- ASU 2023-01, *Leases (Topic 842): Common Control Arrangements*
- ASU 2023-09, *Income Taxes (Topic 740): Improvements to Income Tax Disclosures*



## Concepts Statements

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 8, *Conceptual Framework for Financial Reporting — Chapter 4, Elements of Financial Statements*

## Invitation to Comment

No. 2022-002, *Accounting for Government Grants by Business Entities: Potential Incorporation of IAS 20, Accounting for Government Grants and Disclosure of Government Assistance, Into Generally Accepted Accounting Principles*

## Proposed ASUs

No. 2017-280, *Consolidation (Topic 812): Reorganization*

No. 2019-500, *Income Taxes (Topic 740): Disclosure Framework — Changes to the Disclosure Requirements for Income Taxes (Revision of Exposure Draft Issued July 26, 2016)*

No. 2019-800, *Codification Improvements*

## Other

FASB Staff *Revenue Recognition Implementation Q&As*

## IFRS Literature

IFRS 2, *Share-Based Payment*

IFRS 3, *Business Combinations*

IFRS 9, *Financial Instruments*

IFRS 10, *Consolidated Financial Statements*

IFRS 11, *Joint Arrangements*

IFRS 12, *Disclosure of Interests in Other Entities*

IFRS 15, *Revenue From Contracts With Customers*

IFRS 16, *Leases*

IAS 1, *Presentation of Financial Statements*

IAS 7, *Statement of Cash Flows*

IAS 10, *Events After the Reporting Period*

IAS 12, *Income Taxes*

IAS 17, *Leases*

IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*

IAS 21, *The Effects of Changes in Foreign Exchange Rates*

IAS 27, *Separate Financial Statements*

IAS 32, *Financial Instruments: Presentation*

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*

IAS 38, *Intangible Assets*

IAS 40, *Investment Property*

## **IRC**

Section 78, "Gross Up for Deemed Paid Foreign Tax Credit"

Section 162(a), "Trade or Business Expenses; General"

Section 163(j), "Interest; Limitation on Business Interest"

Section 174, "Amortization of Research and Experimental Expenditures"

Section 197, "Amortization of Goodwill and Certain Other Intangibles"

Section 382, "Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change"

Section 409A "Inclusion in Gross Income of Deferred Compensation Under Nonqualified Deferred Compensation Plans"

Section 422, "Incentive Stock Options"

Section 423, "Employee Stock Purchase Plans"

## **PCAOB Literature**

Release No. 2017-001, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion and Related Amendments to PCAOB Standards*

Auditing Standard 3101, *The Auditor's Report on an Audit of Financial Statements When the Auditor Expresses an Unqualified Opinion*

## **SEC Literature**

### **CF Disclosure Guidance**

Topic No. 9, "Coronavirus (COVID-19)"

Topic No. 9A, "Coronavirus (COVID-19) — Disclosure Considerations Regarding Operations, Liquidity, and Capital Resources"

### **Final Rule Releases**

No. 33-10786, *Amendments to Financial Disclosures About Acquired and Disposed Businesses*

No. 33-10890, *Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information*

No. 33-11126, *Listing Standards for Recovery of Erroneously Awarded Compensation*

No. 33-11275, *The Enhancement and Standardization of Climate-Related Disclosures for Investors*

No. 34-95607, *Pay Versus Performance*

## **FRM**

Topic 1, "Registrant's Financial Statements"

Topic 3, "Pro Forma Financial Information"

Topic 5, "Smaller Reporting Companies"

Topic 7, "Related Party Matters"

Topic 10, "Emerging Growth Companies"

Topic 12, "Reverse Acquisitions and Reverse Recapitalizations"

## **Interpretive Releases**

No. 33-9106, *Commission Guidance Regarding Disclosure Related to Climate Change*

No. 33-10403, *Updates to Commission Guidance Regarding Accounting for Sales of Vaccines and Bioterror Countermeasures to the Federal Government for Placement Into the Pediatric Vaccine Stockpile or the Strategic National Stockpile*

## **Proposed Rule Release**

No. 33-11048, *Special Purpose Acquisition Companies, Shell Companies, and Projections*

## **Regulation S-K**

Item 101, "Description of Business"

Item 103, "Business; Legal Proceedings"

Item 201, "Market Price of and Dividends on the Registrant's Common Equity and Related Stockholder Matters"

Item 302, "Supplementary Financial Information"

Item 303, "Management's Discussion and Analysis of Financial Condition and Results of Operations"

Item 305, "Quantitative and Qualitative Disclosures About Market Risk"

Item 308, "Internal Control Over Financial Reporting"

Item 402, "Executive Compensation"

Item 404, "Transactions With Related Persons, Promoters and Certain Control Persons"

Item 407, "Corporate Governance"

Item 503, "Prospectus Summary"

## **Regulation S-X**

Rule 1-02(w), "Definitions of Terms Used in Regulation S-X (17 CFR part 210); Significant Subsidiary"

Article 2, "Qualifications and Reports of Accountants"

Rule 3-01, "Consolidated Balance Sheet"

Rule 3-02, "Consolidated Statements of Comprehensive Income and Cash Flows"

Rule 3-05, "Financial Statements of Businesses Acquired or to Be Acquired"

Rule 3-09, "Separate Financial Statements of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 3-10, "Financial Statements of Guarantors and Issuers of Guaranteed Securities Registered or Being Registered"

Rule 3-12, "Age of Financial Statements at Effective Date of Registration Statement or at Mailing Date of Proxy Statement"

Rule 3-14, "Special Instructions for Financial Statements of Real Estate Operations Acquired or to Be Acquired"

Rule 3-16, "Financial Statements of Affiliates Whose Securities Collateralize an Issue Registered or Being Registered"

Rule 4-08(g), "General Notes to Financial Statements; Summarized Financial Information of Subsidiaries Not Consolidated and 50 Percent or Less Owned Persons"

Rule 4-08(n), "General Notes to Financial Statements; Accounting Policies for Certain Derivative Instruments"

Rule 5-02, "Commercial and Industrial Companies; Balance Sheets"

Rule 5-03, "Commercial and Industrial Companies; Statements of Comprehensive Income"

Article 8, "Financial Statements of Smaller Reporting Companies"

Rule 10-01(b), "Interim Financial Statements; Other Instructions as to Content"

Article 11, "Pro Forma Financial Information"

Rule 11-01 "Presentation Requirements"

Rule 11-02(a), "Preparation Requirements; Form and Content"

Article 15, "Acquisitions of Businesses by a Shell Company (Other Than a Business Combination Related Shell Company)"

## **SAB Topics**

No. 1.B.3, "Financial Statements; Allocation of Expenses and Related Disclosure in Financial Statements of Subsidiaries, Divisions or Lesser Business Components of Another Entity; Other Matters"

No. 1.M, "Financial Statements; Materiality"

No. 5.A, "Miscellaneous Accounting; Expenses of Offering"

No. 5.Y, "Miscellaneous Accounting; Accounting and Disclosures Relating to Loss Contingencies"

No. 14.B, "Share-Based Payment; Transition From Nonpublic to Public Entity Status"

No. 14.D, "Share-Based Payments; Certain Assumptions Used in Valuation Methods"

- No. 14.D.1, "Expected Volatility"
- No. 14.D.2, "Expected Term"

## **Securities Act of 1933**

Rule 144, "Persons Deemed Not to be Engaged in a Distribution and Therefore Not Underwriters — General Guidance"

## **Securities Exchange Act of 1934**

Rule 17a-5, "Reports to Be Made by Certain Brokers and Dealers"

Section 3(a)(80), "Definitions and Application of Title; Emerging Growth Company"

Section 13(a), "Periodical and Other Reports"

Section 15(d), "Supplementary and Periodic Information"

## **TRG Agenda Papers**

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TRG Agenda Paper 11, *October 2014 Meeting — Summary of Issues Discussed and Next Steps*

TRG Agenda Paper 41, *Measuring Progress When Multiple Goods or Services Are Included in a Single Performance Obligation*

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### **AICPA Accounting Statement of Position**

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Issue No. 01-8, "Determining Whether an Arrangement Contains a Lease"

Issue No. 01-9, "Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)"

Issue No. 01-10, "Accounting for the Impact of the Terrorist Attacks of September 11, 2001"

Issue No. 03-17, "Subsequent Accounting for Executory Contracts That Have Been Recognized on an Entity's Balance Sheet"

Issue No. 08-6, "Equity Method Investment Accounting Considerations"

Issue No. 09-2, "Research and Development Assets Acquired in an Asset Acquisition"

Issue No. 09-4, "Seller Accounting for Contingent Consideration"

## **FASB Concepts Statement**

No. 6, *Elements of Financial Statements* — a replacement of FASB Concepts Statement No. 3 (incorporating an amendment of FASB Concepts Statement No. 2)

## **FASB Interpretation**

No. 14, *Reasonable Estimation of the Amount of a Loss* — an interpretation of FASB Statement No. 5

## **FASB Statements**

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No. 52, *Foreign Currency Translation*

No. 95, *Statement of Cash Flows*

No. 114, *Accounting by Creditors for Impairment of a Loan* — an amendment of FASB Statements No. 5 and 15

No. 123(R), *Share-Based Payment*

No. 133, *Accounting for Derivative Instruments and Hedging Activities*

No. 141, *Business Combinations*

No. 141(R), *Business Combinations*

No. 160, *Noncontrolling Interests in Consolidated Financial Statements* — an amendment of ARB No. 51

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### **California Climate Legislation**

AB-1305, *Voluntary Carbon Market Disclosures*

SB-253, *Climate Corporate Data Accountability Act*

SB-261, *Greenhouse Gases: Climate-Related Financial Risk*

### **IFRS® Sustainability Disclosure Standards**

IFRS S1, *General Requirements for Disclosure of Sustainability-Related Financial Information*

IFRS S2, *Climate-Related Disclosures*

## Appendix C — Abbreviations

Abbreviation	Description
<b>AETR</b>	annual effective tax rate
<b>AFS</b>	available for sale
<b>AFSI</b>	adjusted financial statement income
<b>AI</b>	artificial intelligence
<b>AICPA</b>	American Institute of Certified Public Accountants
<b>AIN</b>	AICPA Accounting Interpretation of an APB Opinion
<b>AMT</b>	alternative minimum tax
<b>ANDA</b>	abbreviated new drug application
<b>APB</b>	Accounting Principles Board
<b>API</b>	active pharmaceutical ingredient
<b>ARO</b>	asset retirement obligation
<b>ASC</b>	FASB Accounting Standards Codification
<b>ASR</b>	accelerated share repurchase
<b>ASU</b>	FASB Accounting Standards Update
<b>AUD</b>	Australian dollar
<b>BCF</b>	beneficial conversion feature
<b>BEAT</b>	base erosion anti-abuse tax
<b>BEMTA</b>	base erosion minimum tax amount
<b>BPD</b>	branded prescription drug
<b>C&amp;Dis</b>	Compliance and Disclosure Interpretations
<b>CAM</b>	critical audit matter
<b>CAQ</b>	Center for Audit Quality
<b>CARES Act</b>	Coronavirus Aid, Relief, and Economic Security Act
<b>CCF</b>	cash conversion feature

Abbreviation	Description
<b>CECL</b>	current expected credit loss
<b>CFC</b>	controlled foreign corporation
<b>CIMA</b>	Chartered Institute of Management Accountants
<b>CMO</b>	contract manufacturing organization
<b>CRO</b>	contract research organization
<b>CSRD</b>	Corporate Sustainability Reporting Directive
<b>DTA</b>	deferred tax asset
<b>DTL</b>	deferred tax liability
<b>EBITDA</b>	earnings before interest, taxes, depreciation, and amortization
<b>ED</b>	exposure draft
<b>EDGAR</b>	SEC electronic data gathering, analysis, and retrieval system
<b>EGC</b>	emerging growth company
<b>EITF</b>	Emerging Issues Task Force
<b>ELOC</b>	equity line of credit
<b>EPS</b>	earnings per share
<b>ESA</b>	energy service agreement
<b>ESG</b>	environmental, social, and governance
<b>ESPP</b>	employee stock purchase plan
<b>ESRS</b>	European Sustainability Reporting Standards
<b>EUR</b>	euros
<b>Exchange Act</b>	Securities Exchange Act of 1934
<b>FASB</b>	Financial Accounting Standards Board
<b>FAST Act</b>	Fixing America's Surface Transportation Act



Abbreviation	Description
<b>FDA</b>	U.S. Food and Drug Administration
<b>FDII</b>	foreign-derived intangible income
<b>FOB</b>	free on board
<b>FPI</b>	foreign private issuer
<b>FRM</b>	SEC Division of Corporation Finance Financial Reporting Manual
<b>FVO</b>	fair value option
<b>FVTOCI</b>	fair value through other comprehensive income
<b>GAAP</b>	generally accepted accounting principles
<b>GenAI</b>	generative artificial intelligence
<b>GHG</b>	greenhouse gas
<b>GILTI</b>	global intangible low-taxed income
<b>GloBE</b>	Global anti-Base Erosion
<b>GPO</b>	group purchasing organization
<b>HAFWP</b>	how and for what purpose
<b>HFI</b>	held for investment
<b>HFS</b>	held for sale
<b>HVAC</b>	heating, ventilation, and air conditioning
<b>IAS</b>	International Accounting Standard
<b>IASB</b>	International Accounting Standards Board
<b>IBNR</b>	incurred but not reported
<b>ICFR</b>	internal control over financial reporting
<b>IFRIC</b>	IFRS Interpretations Committee
<b>IFRS</b>	International Financial Reporting Standard
<b>IIR</b>	investigator-initiated research
<b>IP</b>	intellectual property
<b>IPO</b>	initial public offering
<b>IPR&amp;D</b>	in-process research and development
<b>IRC</b>	Internal Revenue Code
<b>IRS</b>	Internal Revenue Service
<b>ISO</b>	incentive stock option

Abbreviation	Description
<b>ISSB</b>	International Sustainability Standards Board
<b>IT</b>	information technology
<b>ITC</b>	invitation to comment
<b>JOBS Act</b>	Jumpstart Our Business Startups Act
<b>LCD</b>	liquid-crystal display
<b>LIBOR</b>	London Interbank Offered Rate
<b>LIFO</b>	last in, first out
<b>M&amp;A</b>	merger and acquisition
<b>MD&amp;A</b>	Management's Discussion & Analysis
<b>MNE</b>	multinational enterprise
<b>MSL</b>	medical science liaison
<b>NDA</b>	new drug application
<b>NFP</b>	not-for-profit (entity)
<b>NIH</b>	National Institutes of Health
<b>NOL</b>	net operating loss
<b>NOPA</b>	notice of proposed adjustment
<b>NQSO or NSO</b>	nonqualified stock option
<b>OCA</b>	SEC's Office of the Chief Accountant
<b>OCI</b>	other comprehensive income
<b>OECD</b>	Organisation for Economic Co-operation and Development
<b>OEM</b>	original equipment manufacturer
<b>PBE</b>	public business entity
<b>PCAOB</b>	Public Company Accounting Oversight Board
<b>PCC</b>	Private Company Council
<b>PIPE</b>	private investment in public equity
<b>PP&amp;E</b>	property, plant, and equipment
<b>PRV</b>	priority review voucher
<b>PTRS</b>	probability of technical and regulatory success
<b>Q&amp;A</b>	question and answer
<b>QIP</b>	qualified improvement property

Abbreviation	Description
<b>R&amp;D</b>	research and development
<b>R&amp;E</b>	research and experimental
<b>REC</b>	renewable energy certificate
<b>REMS</b>	risk evaluation and mitigation strategy
<b>RIM</b>	retail inventory method
<b>ROU</b>	right of use
<b>SaaS</b>	software as a service
<b>SAB</b>	Staff Accounting Bulletin
<b>SEC</b>	U.S. Securities and Exchange Commission
<b>Securities Act</b>	Securities Act of 1933
<b>SEPA</b>	standby equity purchase agreement
<b>SOX</b>	Sarbanes-Oxley Act of 2002
<b>SPAC</b>	special-purpose acquisition company

Abbreviation	Description
<b>SPPI</b>	solely payments of principal and interest
<b>SRC</b>	smaller reporting entity
<b>S&amp;P 500</b>	Standard & Poor's 500 Index
<b>TD</b>	Treasury Decision
<b>TDR</b>	troubled debt restructuring
<b>TRG</b>	transition resource group
<b>TRWG</b>	IFRS Foundation Technical Readiness Working Group
<b>TSA</b>	transition services agreement
<b>USD</b>	U.S. dollars
<b>UTB</b>	unrecognized tax benefit
<b>VIE</b>	variable interest entity
<b>VWAP</b>	volume-weighted average daily market price
<b>XBRL</b>	eXtensible Business Reporting Language

# Appendix D — Guide Updates for 2024

The tables below summarize the substantive changes made in the 2024 edition of this Guide.

## New Content

Section	Title	Description
1.1.1	Risk Assessment	New section (replacing former Section 1.1.1 on forecasting) that discusses risk assessment considerations related to the current macroeconomic and geopolitical environment, including the need for management to revisit its previous risk assessments.
1.1.2	Design and Operation of Internal Controls	New section that discusses the design and operation of internal controls in the current macroeconomic and geopolitical environment, including considerations related to (1) how well a company's control addresses a material risk, (2) the frequency with which the control is performed, (3) the competency and authority of those performing the control, and (4) the level of aggregation or disaggregation, predictability, and the criteria for investigation in a management review control.
2.4.5	Warranties	New section on considerations related to the determination of whether a product warranty represents a distinct service that should be accounted for as a separate performance obligation. Subsequent sections renumbered accordingly.  New <a href="#">Example 2-7</a> added; subsequent examples renumbered accordingly.
2.4.8.2	Likelihood That an Option for Additional Goods or Services Will Be Exercised	New section on whether an entity should assess optional purchases provided to customers to determine whether the customer is economically compelled — or highly likely — to exercise its option(s).

(Table continued)

Section	Title	Description
3.2.7	On the Horizon — Potential Refinements to the Scope of the Derivative Guidance in ASC 815	New section discussing the FASB's decisions to (1) add a project to its technical agenda to refine the scope of ASC 815 by incorporating a scope exception for contracts with underlyings based on the operations or activities that are specific to one of the parties to the contract and (2) direct its staff to perform research to develop alternatives for refining the predominant characteristics test in ASC 815-10-15-60.
4.2.6	Reverse Acquisitions	New section on reverse acquisitions, which are business combinations in which (1) the entity that issues its shares or gives other consideration to effect the transaction is determined for accounting purposes to be the acquiree and (2) the entity whose shares are acquired is determined for accounting purposes to be the acquirer.
7.2.6.4	Contracts With Customers That Include Both Revenue and Nonrevenue Elements	New section that clarifies that in a manner consistent with ASC 606-10-15-4 and ASC 230-10-45-22, when an entity enters into a contract with a customer that contains both revenue and nonrevenue elements, the entity should present the cash received from the customer in the statement of cash flows on the basis of the underlying nature of the transactions.
7.3	SEC Reporting Considerations	New section on statement of cash flow matters discussed by SEC Chief Accountant Paul Munter in his December 4, 2023, statement and at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments.
8.7	New Accounting Standard — Improvements to Income Tax Disclosures (ASU 2023-09)	New section (replacing former Section 8.7 on ASU 2019-12 because that ASU is now fully effective for all entities) on ASU 2023-09, under which entities within the scope of ASC 740 must (1) consistently categorize and provide greater disaggregation of information in the income tax rate reconciliation and (2) further disaggregate income taxes paid.
8.8	OECD Pillar Two	New section (replacing former Section 8.8 on the FASB's proposed ASU related to disclosure requirements for income taxes, which is superseded by ASU 2023-09) on the "two-pillar" international tax approach developed by the OECD, which includes establishing a global minimum corporate tax rate of 15 percent.

(Table continued)

Section	Title	Description
10.2.6.5	Standby Equity Purchase Agreements	New section on SEPAs, which are equity-linked instruments for which the issuing entity has the right, but not the obligation, to sell the entity's common stock to third-party investors over a specified period.
11.2.3	ASU 2023-01 on Common-Control Arrangements	New section on ASU 2023-01, which amends certain provisions of ASC 842 that apply to arrangements between related parties under common control.
12.1.3.2.1	SEC Comment Letter Themes Related to the Classification of Warrants	New section that (1) reproduces an SEC comment related to a registrant's classification of warrants and (2) notes that the SEC staff has asked registrants to explain the basis for their determination of how financial instruments should be classified (including the application of relevant accounting literature).
13.4.1.2	Determining the Transaction's Structure and Scope	New section discussing the form of carve-out financial statements and noting that the transaction structure can affect the form and content of the carve-out financial statements, the years to be provided, and the audit procedures required. Subsequent sections renumbered accordingly.
13.4.1.6	Significant Judgments and Estimates	New section on significant judgments and estimates related to allocating account balances and activities to carve-out financial statements and determining the appropriate disclosures to include in these financial statements.
13.6.5	Impairment Considerations Related to Long-Lived Assets and Indefinite-Lived Intangible Assets Other Than Goodwill	New section discussing impairment considerations related to long-lived assets and indefinite-lived intangible assets other than goodwill when there is substantial doubt about an entity's ability to continue as a going concern.
13.11.2.3	U.S. State Regulatory Considerations	New section discussing three climate bills that were signed into law in California in October 2023.

## Amended or Deleted Content

Section	Title	Description
Chapter 1	Accounting and Financial Reporting in Uncertain Times: Considerations for Navigating Macroeconomic and Geopolitical Challenges	Amended the chapter's title to reflect its focus on challenges facing life sciences entities in the aftermath of the COVID-19 pandemic.
1.1	Executive Summary	Added a summary of some of the more prominent macroeconomic and geopolitical factors affecting life sciences companies.

(Table continued)

Section	Title	Description
1.1.1	Forecasting	Deleted.
1.1.3	Supply-Chain Disruptions	Deleted.
1.1.3	Inflation	Renumbered from Section 1.1.2.
1.1.5	Communication With Stakeholders	Added considerations highlighted by the SEC staff at the 2023 AICPA & CIMA Conference on Current SEC and PCAOB Developments related to the importance of disclosures about risks and uncertainties.
2.2.1.3	SEC Comment Letter Themes Related to Collaborative Arrangements	<p>Added an example of an SEC comment issued to a registrant in the life sciences industry on accounting considerations and disclosures related to a collaborative arrangement.</p> <p>Updated the discussion of questions raised in SEC comment letters to registrants in the life sciences industry about their collaborative arrangements.</p>
2.2.4	Contracts That Include Both Revenue and Nonrevenue Elements	Added new <a href="#">Example 2-3</a> to illustrate the accounting for an arrangement in which (1) a biotech company agrees to sell shares of its common stock to a pharmaceutical company in exchange for consideration that exceeds the shares' fair value and (2) the excess of consideration over the shares' fair value is associated with another element in the arrangement that is, in substance, a contract to perform R&D services. Subsequent examples renumbered accordingly.
2.3.2	Identifying the Payment Terms	Added a discussion of the FDA's Accelerated Approval Program and new <a href="#">Example 2-5</a> , which illustrates the determination of whether a drug company that obtains advance approval under that program may recognize revenue from the sale of its product.
2.3.4.1	Termination Clauses and Penalties	Added a paragraph to note that the economic considerations related to forgoing a discount on optional purchases would not be viewed as a substantive penalty suggesting that the parties' rights and obligations extend for a longer contract term.
2.3.4.1.1	Termination Clauses in License Arrangements	Moved the discussion of factors to be considered in the determination of whether a termination is substantive from <a href="#">Example 2-6</a> (as renumbered) to the main text.
2.3.5.1	Contract Modification Accounted for as a Separate Contract	Added discussion of a life sciences entity's accounting for the modification of a collaboration arrangement to include additional compounds.

(Table continued)

Section	Title	Description
2.4.7	Framework for Identifying Immaterial Promised Goods or Services	Updated to clarify that an entity may conclude that a potential good or service is immaterial in the context of the contract if it determines that the customer would have entered into the contract and paid the same (or similar) consideration if the potential good or service was excluded from the contract.
2.6	Allocate the Transaction Price to the Performance Obligations (Step 4)	Updated to clarify potential methods for estimating the stand-alone selling price of a license under the adjusted market assessment approach when an arrangement includes a license of IP along with ongoing services that represent distinct performance obligations.
2.10.2	Determining Whether Contractual Provisions Represent Attributes of a License or Additional Rights	Added factors to be considered in the determination of whether a substitution right represents an attribute of a license or the transfer of additional rights to the customer.
2.11.3	Principal-Versus-Agent Considerations	Added <a href="#">Examples 2-13</a> and <a href="#">2-14</a> , which illustrate the application of the principal-versus-agent guidance in ASC 606 to a TSA and a direct title arrangement, respectively.
3.2.2	R&D Cost Classification	Expanded <a href="#">Connecting the Dots</a> to add that costs incurred to hire R&D personnel should be (1) accounted for as R&D costs of the entity and (2) expensed as the entity becomes contractually obligated for such costs.
3.2.2.1	SEC Comment Letter Themes Related to R&D and Cost Classification	Added examples of SEC comments issued to registrants in the life sciences industry on R&D and cost classification.
3.2.5	Refundable Tax Credits for Qualifying R&D Expenditures	Added <a href="#">Connecting the Dots</a> to discuss the eligibility of certain companies for a tax offset under the Australian government's R&D Tax Incentive program.
4.2.1.1	Single or Similar Assets	Updated to clarify the applicability of the practical screen test in ASC 805 when a single compound being studied to treat different indications is acquired and accounted for as a single unit of account.
4.2.1.2.1	Sets Without Outputs	Updated to include the guidance in ASC 805-10-55-71.
4.2.2	Asset Acquisitions	Deleted paragraph discussing a former FASB project to narrow the differences between the accounting for asset acquisitions and the accounting for business combinations. The FASB decided to remove this project from its agenda at its June 15, 2022, meeting.



(Table continued)

Section	Title	Description
4.2.2.2	Contingent Consideration	<p>Updated to clarify that it would be acceptable for an entity to account for contingent consideration in an asset acquisition when either (1) occurrence of the contingency is probable and the contingent consideration is reasonably estimable or (2) the contingency is resolved.</p> <p>Added new <b>Example 4-1</b> to address the accounting for a sales-based milestone payment in an asset purchase agreement. Subsequent examples renumbered accordingly.</p>
4.2.2.2.1	Contingent Consideration When the Fair Value of the Assets Acquired Exceeds the Initial Consideration Paid	Updated to clarify that in a situation in which the fair value of the assets acquired exceeds the initial consideration paid as of the date of acquisition but the arrangement includes contingent consideration, an entity should consider the following before it elects to apply the guidance in ASC 323-10 by analogy: (1) consulting with its accounting advisers and (2) discussing its approach with the SEC staff on a pre-filing basis (if the entity is an SEC registrant).
4.2.2.5.1	Exceptions to Pro Rata Allocation	Deleted Example 4-4.
4.2.3.5	Determining the Unit of Account for IPR&D	Added examples from the AICPA Guide related to determining the unit of account when an IPR&D asset acquired in a business combination is associated with a preexisting contingent consideration arrangement.
4.2.4.1	Business Combination Versus Asset Acquisition Accounting Determination	Added an SEC comment issued to a registrant in the life sciences industry on distinguishing between a business combination and an asset acquisition.
4.2.4.2	Recognition of Assets and Liabilities	Replaced examples of SEC comments issued to registrants in the life sciences industry on matters related to recognition of assets and liabilities in business combinations and asset acquisitions.
4.2.4.5	Non-GAAP Measures	Added an SEC comment issued to a registrant in the life sciences industry on the registrant's use of a non-GAAP adjustment for IPR&D.
5.3.1	Business Scope Exception to the VIE Model	Updated to clarify that if a legal entity qualifies for a scope exception to the VIE model, the reporting entity should perform a consolidation analysis under the voting interest entity model.
5.3.3.1.2	Determining Whether the Identified Equity Investment at Risk Is Sufficient to Finance the Legal Entity's Operations Without Additional Subordinated Financial Support	Updated to clarify equity investment at risk when amounts have been guaranteed or committed (and not yet funded).

(Table continued)

Section	Title	Description
5.3.3.1.4	Development-Stage Entities	Added new <a href="#">Example 5-7</a> to clarify that it may be appropriate for the reporting entity to consider the phase of clinical trials when assessing whether a legal entity has sufficient equity at risk on the basis of the legal entity's purpose and design. Subsequent examples renumbered accordingly.
5.3.3.4	SEC Comment Letter Themes Related to the Determination of Whether a Legal Entity Is a VIE	Updated to clarify SEC comment letter themes related to whether a legal entity is a VIE.
5.3.4.3	SEC Comment Letter Themes Related to the Primary-Beneficiary Assessment	Added an SEC comment issued to a registrant on matters related to the primary-beneficiary assessment.
5.3.4.4	Initial Measurement of Noncontrolling Interests	Updated to clarify that if a reporting entity acquires less than 100 percent of the net assets of a non-VIE legal entity, it should recognize a noncontrolling interest in the legal entity at an amount equal to the noncontrolling interest's proportionate share of the relative fair value of any assets and liabilities acquired.
5.3.5	Primary Beneficiary's Accounting for IPR&D and Contingent Consideration Recognized Upon Initial Consolidation of a VIE That Is Not a Business	Renumbered from Section 5.5.2.  Removed discussion of an agenda request considered by the FASB to address the diversity in practice related to a primary beneficiary's subsequent accounting for IPR&D and contingent consideration initially recognized upon consolidation of a VIE that is not a business. The FASB removed the project from its agenda at its June 15, 2022, meeting.
5.3.6	Other Considerations	Renumbered from Section 5.3.5.  Added an SEC comment issued to a registrant on disclosures about VIEs that are required under ASC 810-10-50, including disclosures related to carrying amounts and the classification of a VIE's assets and liabilities.
5.4.3	Effective Date and Transition	Deleted because ASU 2018-17 is now fully effective for all entities.
6.2.3.1	Offer to Settle Litigation	Added discussion of an entity's measurement of a contingent liability when the counterparty to the entity's settlement offer rejects the offer and proposes a higher settlement amount.
6.2.5.1	Disclosure Considerations Under ASC 450-20 and ASC 275	Added <a href="#">Connecting the Dots</a> to discuss disclosure considerations related to patent infringement litigation.
6.5.1	Loss Contingencies	Added an SEC comment issued to a registrant on matters related to loss contingencies.

(Table continued)

Section	Title	Description
7.2.6.2	Classification of Cash Flows of Repayments of Zero-Coupon Bonds and Other Debt Instruments With Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing	Updated to clarify that while the guidance in ASC 230-10-45-15, ASC 230-10-45-17, and ASC 230-10-45-25 specifically addresses only the debtor's cash flow statement classification, that guidance is also relevant to the investor's cash flow statement classification.
8.2.1	Scope Considerations	Added <a href="#">Connecting the Dots</a> on tax credits under the CHIPS Act and IRA.
8.2.8.2	U.S. Tax Court Ruling	Updated to note that the U.S. Court of Appeals for the Third Circuit upheld the U.S. Tax Court's ruling that legal fees incurred to defend patent infringement lawsuits could be deducted as "ordinary and necessary business expenses" and did not need to be capitalized.
8.3	Tax Cuts and Jobs Act of 2017	Added <a href="#">Changing Lanes</a> on Revenue Procedure 2023-8, which the U.S. Treasury and IRS released to provide procedural guidance that allows taxpayers to make an automatic change in method of accounting so that they can comply with the provision of IRC Section 174 that requires capitalization of specified R&E expenses.
8.5.2	Stock Buyback 1 Percent Excise Tax	Renumbered from Section 9.5.
9.1.1.1.3	Transactions Directly Between a New Investor and the Nonpublic Entity's Grantees as Part of a Financing Transaction	Updated to clarify that there may be situations in which, as part of a financing transaction between a nonpublic entity and a new investor that is acquiring a significant ownership interest in the nonpublic entity, the new investor repurchases common shares in the nonpublic entity from employees of the nonpublic entity.
9.3	SEC's Final Rule Related to Pay Versus Performance	Updated to discuss (1) key observations from the SEC staff on the implementation of pay-versus-performance disclosures and (2) the SEC's C&DIs on the requirements of its final rule related to pay versus performance.
9.4	SEC's Final Rule on the Recovery of Erroneously Awarded Compensation ("Clawback Policies")	Updated discussion of the SEC's final rule on clawback policies to clarify that restatements triggering clawback under the final rule would include those correcting an error that either (1) "is material to the previously issued financial statements" (a "Big R" restatement) or (2) "would result in a material misstatement if the error were corrected in or left uncorrected in the current period" (a "little r" restatement).
10.2.6.3	Tranche Preferred Stock Agreement	Updated <a href="#">Example 10-3</a> to expand on why the conclusion in the example would not change even if certain facts were changed.

(Table continued)

Section	Title	Description
10.3.1.3	Technical Corrections and Amendments	Updated to (1) remove discussion of the effective-date changes and transition guidance in ASU 2019-10 and (2) list ASUs that the FASB has issued since the release of ASU 2016-13 to provide various technical corrections and amendments to the guidance on credit losses in ASC 326.
10.3.1.4	Other Developments	Deleted.
11.1.5	Components of a Contract	Added a matrix that summarizes the requirements related to measuring and allocating the consideration in the contract for lessees and lessors.
11.3	On the Horizon — Proposed ASU on Related-Party Leases Under Common Control	Deleted because the proposed ASU is superseded by ASU 2023-01.
11.3	SEC Comment Letter Themes Related to Leases	Renumbered from Section 11.4.  Updated discussion of SEC comment letter themes related to the application of ASC 842 that are relevant to life sciences companies.
12.1.3	Special-Purpose Acquisition Companies	Updated <a href="#">Changing Lanes</a> to discuss the SEC's January 24, 2024, final rule on SPACs.
12.3	IPO Considerations Related to Proposed Rule on Climate Disclosure Requirements	Deleted because the SEC's proposed rule on climate-related disclosures is superseded by a final rule issued on March 6, 2024. (See <a href="#">Section 13.11</a> for discussion of climate-related topics.)
13.1.1.2	Government Grants	Updated <a href="#">Changing Lanes</a> to reflect the FASB's decision to add to its technical agenda a project on business entities' recognition, measurement, and presentation of government grants.
13.3	Discontinued-Operations Reporting	Added new <a href="#">Example 13-1</a> to illustrate a life sciences entity's consideration of a divestment's qualification for discontinued-operations reporting on the basis of whether the divested commercialized product represents a component and, if so, whether the disposal represents a strategic shift that has or will continue to have a major effect on the life sciences entity's operations and financial results. Subsequent examples renumbered accordingly.
13.4	Carve-Out Financial Statements	Added a split-off to the list of examples of transactions in which carve-out financial statements may be requested or required.
13.8.3	Considerations for Auditors, Management, and Audit Committees	Updated to clarify potential questions for management and audit committees regarding CAMs.

(Table continued)

Section	Title	Description
13.11.2.1	SEC Reporting Considerations	Updated to discuss the SEC's March 6, 2024, final rule on climate-related disclosures.
13.11.2.2	International Legislative and Standard-Setting Considerations	Updated to (1) remove discussion of the SEC's proposed rule on climate-related disclosures (which is superseded by the SEC's March 6, 2024, final rule); (2) discuss the European Commission's adoption of the ESRS; and (3) discuss the International Sustainability Standards Board's issuance of IFRS S1 and IFRS S2.
13.11.11.1	Sustainability-Linked Debt Instruments (Issuer's Considerations)	Added <b>Changing Lanes</b> to discuss the FASB's project on potential refinements to the scope of the derivative guidance in ASC 815.
13.11.15.2	What Are Environmental Credits?	Content moved to <b>Section 13.11.15.1</b> . Section 13.11.15.2 is now titled "FASB Project on Environmental Credits" (see entry below).
13.11.15.2	FASB Project on Environmental Credits	Content moved from former Section 13.11.15.3.5.
13.11.15.3.1	Environmental Credits as Assets	Deleted to streamline content.
13.11.15.3.2	Classification as Either Inventory or an Intangible Asset	Deleted to streamline content.
13.11.15.3.3	Impairment Considerations	Deleted to streamline content.
13.11.15.3.4	Timing of Expense	Deleted to streamline content.
13.11.15.3.5	FASB Project on Environmental Credits	Deleted to streamline content.
13.11.15.4	SEC's Final Rule on Climate-Related Disclosures	Title and content of section updated to reflect the issuance of the SEC's March 6, 2024, final rule on climate-related disclosures.

(Table continued)

Section	Title	Description
Appendix A	Differences Between U.S. GAAP and IFRS Accounting Standards	<p data-bbox="932 296 1414 495"><i>Financial Instruments — Equity Shares (Chapter 10), “Redeemable equity securities (e.g., puttable shares) and noncontrolling interests”</i> — Updated to clarify that the concept of mezzanine or temporary equity classification does not exist under IFRS Accounting Standards.</p> <p data-bbox="932 520 1414 604"><i>Financial Instruments — Investments in Loans and Receivables (Chapter 10), “Effective interest rate method”</i>:</p> <ul data-bbox="967 621 1414 1150" style="list-style-type: none"> <li data-bbox="967 621 1414 793">• <i>U.S. GAAP</i> — Updated to clarify that for purchased credit-deteriorated assets, interest income is recognized on the basis of the purchase price plus the initial allowance accreting to the contractual cash flows.</li> <li data-bbox="967 806 1414 1150">• <i>IFRS Accounting Standards</i> — Updated to clarify that interest revenue is calculated on the basis of the gross carrying amount (i.e., the amortized cost before adjusting for any loss allowance) unless the loan (1) is purchased or originated credit-impaired or (2) subsequently became credit-impaired. In those cases, interest revenue is calculated on the basis of amortized cost (i.e., net of the loss allowance).</li> </ul> <p data-bbox="932 1167 1414 1251"><i>Financial Instruments — Investments in Loans and Receivables (Chapter 10), “Interest recognition on impaired loans”</i>:</p> <ul data-bbox="967 1268 1414 1738" style="list-style-type: none"> <li data-bbox="967 1268 1414 1503">• <i>U.S. GAAP</i> — Updated to clarify that while there is no explicit requirement in U.S. GAAP for when an entity should cease the recognition of interest on a receivable measured at amortized cost, the practice of placing financial assets on nonaccrual status is acknowledged by U.S. GAAP.</li> <li data-bbox="967 1516 1414 1738">• <i>IFRS Accounting Standards</i> — Updated to clarify that (1) IFRS Accounting Standards do not permit nonaccrual of interest, but (2) for assets that have become credit-impaired, interest income is based on the net carrying amount of the credit-impaired financial asset.</li> </ul> <p data-bbox="932 1755 1414 1845"><i>Leases (Chapter 11), “Response to COVID-19”</i> — Deleted because the content is no longer relevant.</p>

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