Life Sciences
Accounting and Financial Reporting Update — Interpretive Guidance on Acquisitions and Divestitures
March 2017
Acquisitions and Divestitures

Introduction

Worldwide, the growing demand for health care services, fueled by aging populations and burgeoning middle classes — along with expectations of higher-quality care and a squeeze on funding — is driving a need for new business models. With public finances stretched and austerity measures in place in the aftermath of the global financial crisis, governments in countries from the United States and the United Kingdom to Japan, China, and Brazil 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, tap into alternative sources of innovation, and acquire new customers. 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 associated with the “patent cliff.”

An entity must use significant judgment in applying the guidance on accounting for M&A transactions. 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.

Industry Issues

Acquisitions

Determining Whether an Asset Group Constitutes 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 evaluating whether a transaction represents the acquisition of a business.

Thinking It Through

The discussion below is based on the definition of a business under the current guidance in ASC 805. However, in January 2017, the FASB issued ASU 2017-01 to clarify the definition of a business. The ASU affects all entities that must determine whether they have acquired or sold a business. For public business entities, the ASU is effective for annual periods beginning after

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1 For a list of abbreviations used in this publication, see Appendix B.
2 For the full titles of standards and other literature referred to in this publication, see Appendix A.
December 15, 2017, including interim periods therein. For all other entities, the ASU is effective for annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. Early application is permitted as follows:

1. For transactions for which the acquisition date occurs before the issuance date or effective date of the amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance.

2. For transactions in which a subsidiary is deconsolidated or a group of assets is derecognized that occur before the issuance date or effective date of the amendments, only when the transaction has not been reported in financial statements that have been issued or made available for issuance.

See the Clarifying the Definition of a Business section below for further information.

**Question**

What asset groups constitute a business?

**Answer**

In a business combination, the net assets acquired (if the acquisition is of net assets) or the entity over which control is obtained (if the acquisition is of equity interests) must constitute a business. ASC 805-10-20 defines a business as follows:

An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.

ASC 805-10-55-4 through 55-9 provide implementation guidance to help entities identify what constitutes a business:

<table>
<thead>
<tr>
<th>ASC 805-10</th>
<th>55-4</th>
<th>A business consists of inputs and processes applied to those inputs that have the ability to create outputs. Although businesses usually have outputs, outputs are not required for an integrated set to qualify as a business. The three elements of a business are defined as follows:</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a. Input. Any economic resource that creates, or has the ability to create, outputs when one or more processes are applied to it. Examples include long-lived assets (including intangible assets or rights to use long-lived assets), intellectual property, the ability to obtain access to necessary materials or rights, and employees.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>b. Process. Any system, standard, protocol, convention, or rule that when applied to an input or inputs, creates or has the ability to create outputs. Examples include strategic management processes, operational processes, and resource management processes. These processes typically are documented, but an organized workforce having the necessary skills and experience following rules and conventions may provide the necessary processes that are capable of being applied to inputs to create outputs. Accounting, billing, payroll, and other administrative systems typically are not processes used to create outputs.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>c. Output. The result of inputs and processes applied to those inputs that provide or have the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants.</td>
<td></td>
</tr>
</tbody>
</table>

**55-5** To be capable of being conducted and managed for the purposes defined, an integrated set of activities and assets requires two essential elements — inputs and processes applied to those inputs, which together are or will be used to create outputs. However, a business need not include all of the inputs or processes that the seller used in operating that business if market participants are capable of acquiring the business and continuing to produce outputs, for example, by integrating the business with their own inputs and processes.
The nature of the elements of a business varies by industry and by the structure of an entity's operations (activities), including the entity's stage of development. Established businesses often have many different types of inputs, processes, and outputs, whereas new businesses often have few inputs and processes and sometimes only a single output (product). Nearly all businesses also have liabilities, but a business need not have liabilities.

An integrated set of activities and assets in the development stage might not have outputs. If not, the acquirer should consider other factors to determine whether the set is a business. Those factors include, but are not limited to, whether the set:

- Has begun planned principal activities
- Has employees, intellectual property, and other inputs and processes that could be applied to those inputs
- Is pursuing a plan to produce outputs
- Will be able to obtain access to customers that will purchase the outputs.

Not all of those factors need to be present for a particular integrated set of activities and assets in the development stage to qualify as a business.

Determining whether a particular set of assets and activities is a business should be based on whether the integrated set is capable of being conducted and managed as a business by a market participant. Thus, in evaluating whether a particular set is a business, it is not relevant whether a seller operated the set as a business or whether the acquirer intends to operate the set as a business.

In the absence of evidence to the contrary, a particular set of assets and activities in which goodwill is present shall be presumed to be a business. However, a business need not have goodwill.

The guidance in ASC 805-10-55 does not constitute a definitive checklist; an entity must use significant judgment and consider all facts and circumstances when assessing whether a group of assets constitutes a business. When it is not clear whether an integrated set of assets and activities meets the definition of a business, it may be helpful to first identify all of the inputs, processes, and outputs that were acquired. If all of the inputs and processes necessary to create outputs were acquired, the set is likely to be a business. However, if all of the inputs and processes necessary to create outputs were not acquired, or if the set is not currently producing outputs, further consideration is necessary. For the set to qualify as a business, an entity does not necessarily have to acquire all of the inputs and processes necessary to make outputs. If the set can be easily integrated into a market participant's operations, or the missing inputs or processes can be readily acquired without significant delay or effort, the set may qualify as a business. If the set is not yet producing outputs, it may still qualify as a business. Development-stage entities might not yet have outputs, but if the set has begun operations, has inputs and processes, and is following a plan to produce outputs and reach customers, it is likely to qualify as a business.

**Example 1**

Pharma Co. enters into a worldwide license, manufacturing, and distribution agreement with Biotech Co. for a compound in preclinical development. Pharma Co. receives the right to manufacture, market, and distribute the compound in perpetuity if or when regulatory approval is obtained; however, Pharma Co. does not acquire any tangible manufacturing assets, employees, or contract manufacturing or research arrangements.
Pharma Co. identifies numerous missing elements for producing outputs, including (1) inputs (e.g., regulatory-approved compound, equipment and facilities, R&D personnel) and (2) processes (e.g., contract or other manufacturing). A market participant cannot acquire the missing inputs/processes to develop and produce the compound without significant delay or effort. Pharma Co. concludes that the group of assets is not a business.

**Example 2**

Pharma Co. enters into a worldwide license, manufacturing, and distribution agreement with Biotech Co. for an approved drug. Pharma Co. receives the right to manufacture, market, and distribute the newly developed drug in perpetuity and obtains manufacturing know-how and documentation from Biotech Co. However, Pharma Co. does not acquire any tangible manufacturing assets, employees, or contract manufacturing arrangements and expects that obtaining regulatory approval to manufacture the drug will take significant time.

Pharma Co. identifies numerous missing elements for producing outputs, including (1) inputs (e.g., regulatory-approved equipment and facilities, personnel) and (2) processes (e.g., standard operating procedures, contract manufacturing).

A market participant cannot acquire the missing inputs/processes to produce the developed drug without significant delay or effort. Pharma Co. concludes that the group of assets is not a business.

**Example 3**

Pharma Co. acquires a manufacturing plant. Acquisition of the plant includes the plant's tangible assets, employees, and business licenses/registrations. Pharma Co. intends to immediately modify the facility to produce active pharmaceutical ingredients (e.g., raw materials) instead of finished dosage forms (e.g., finished goods). Because of the planned modifications, Pharma Co. does not acquire the facility's existing customer contracts and will not continue to sell any of the products previously manufactured in the facility.

Pharma Co. concludes that the facility contains the elements necessary for producing outputs, including (1) inputs (i.e., tangible assets, intangible assets, employees) and (2) processes (i.e., the production of finished dosage forms). Pharma Co.’s intended use for the facility is not a factor — the assessment is from the perspective of a market participant. Because the plant was operating and producing outputs upon acquisition, a market participant could have acquired the plant and continued to operate it in that manner. Pharma Co. concludes that the group of assets is a business.

**Example 4**

Pharma Co. acquires the outstanding shares of Biotech Co., a small entity that does not yet have a marketed product. Biotech Co.’s operations include R&D activities on several preclinical compounds that it is researching. Biotech Co. has employees performing the R&D activities who have previously demonstrated the ability to generate additional preclinical compounds through their research.

Pharma Co. concludes that Biotech Co.’s ability to generate additional compounds is an important factor in demonstrating that processes, in addition to inputs, were acquired. Although the acquired compounds may not be “capable of” generating a return individually because of the low probability of technical and regulatory success associated with early-stage compounds, Pharma Co. concludes that because of the inputs and processes obtained, the acquired set of assets and activities are capable of generating a return and the acquired set is a business.
Example 5

Pharma Co. acquires the outstanding shares of Biotech Co., a small entity that does not yet have a marketed product. Biotech Co.’s operations consist solely of researching one compound that has completed phase 1 clinical trials. Pharma Co. acquires only the intellectual property and know-how related to phase 1 activities and a manufacturing agreement for clinical supply of the active pharmaceutical ingredient. Pharma Co. does not acquire any employees or other assets and will need to design and conduct phase 2 clinical trials.

Because Pharma Co. did not acquire any employees or any inputs other than the intellectual property and clinical supply manufacturing agreement, Pharma Co. concludes that the acquired set is not a business.

Thinking It Through

For life sciences entities, some of the more challenging aspects of analyzing a transaction include comparing the acquired inputs and processes with the inputs and processes that, together, are needed to produce outputs. Further, in the absence of key inputs and processes, entities must consider whether those inputs are already available to, or could be easily acquired by, a market participant.

Acquiring Net Assets or Equity Interests That Do Not Meet the Definition of a Business

M&A transactions that do not meet the definition of a business must be accounted for as an asset acquisition. As discussed below, in such transactions, the accounting requirements related to transaction costs, measurement of assets acquired and liabilities assumed, and recognition of intangible assets may differ from those for a business combination.

ASC 805-10-25-1 states, in part:

An entity shall determine whether a transaction or other event is a business combination by applying the definition in [ASC 805-10], which requires that the assets acquired and liabilities assumed constitute a business. If the assets acquired are not a business, the reporting entity shall account for the transaction or other event as an asset acquisition.

In addition, ASC 350-30-25-2 states that “the cost of a group of assets acquired in a transaction other than a business combination or an acquisition by a not-for-profit entity shall be allocated to the individual assets acquired based on their relative fair values and shall not give rise to goodwill” (emphasis added).

The accounting requirements for an acquisition of net assets or equity interests that is not deemed to be a business combination will differ in certain respects from the accounting requirements for a business combination.

Question 1

What are the key differences between the accounting for a business combination and the accounting for an acquisition of an asset group determined not to be a business?
The following table summarizes these differences:

<table>
<thead>
<tr>
<th>Subject</th>
<th>Business Combination</th>
<th>Acquisition of an Asset Group Determined Not to Be a Business</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost of the acquisition</td>
<td>ASC 805-30-30-7 states: The consideration transferred in a business combination shall be measured at fair value, which shall be calculated as the sum of the acquisition-date fair values of the assets transferred by the acquirer, the liabilities incurred by the acquirer to former owners of the acquiree, and the equity interests issued by the acquirer. (However, any portion of the acquirer’s share-based payment awards exchanged for awards held by the acquiree’s employees that is included in consideration transferred in the business combination shall be measured in accordance with [ASC] 805-20-30-21 rather than at fair value.) Examples of potential forms of consideration include the following:</td>
<td>ASC 805-50-30-1 states, in part: Assets are recognized based on their cost to the acquiring entity, which generally includes the transaction costs of the asset acquisition, and no gain or loss is recognized unless the fair value of noncash assets given as consideration differs from the assets’ carrying amounts on the acquiring entity’s books. [Emphasis added]</td>
</tr>
</tbody>
</table>

a. Cash
b. Other assets
c. A business or a subsidiary of the acquirer
d. Contingent consideration (see [ASC] 805-30-25-5 through 25-7)
e. Common or preferred equity instruments
f. Options
g. Warrants
h. Member interests of mutual entities.
Subject | Business Combination | Acquisition of an Asset Group Determined Not to Be a Business
--- | --- | ---
Measuring the assets acquired and liabilities assumed | ASC 805-20-30-1 states that the “acquirer shall measure the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree at their acquisition-date fair values.” ASC 805-30-30-1 indicates that goodwill should be recorded as the sum of the (1) consideration transferred, (2) fair value of any noncontrolling interest, and (3) fair value of the acquirer’s previously held interest in the acquiree, if any, less the acquisition-date fair value of the net assets acquired. | ASC 805-50-30-3 states, in part:
    
    Acquiring assets in groups requires not only ascertaining the cost of the asset (or net asset) group but also allocating that cost to the individual assets (or individual assets and liabilities) that make up the group. The cost of such a group is determined using the concepts described in [ASC 805-50-30-1 and 30-2]. The cost of a group of assets acquired in an asset acquisition shall be allocated to the individual assets acquired or liabilities assumed based on their relative fair values and shall not give rise to goodwill.

Recognition of intangible assets | ASC 805-20-25-10 states, in part, that the “acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion described in the definition of identifiable” (emphasis added). | ASC 350-30-25-1 states that an “intangible asset that is acquired either individually or with a group of other assets [but not those acquired in a business combination] shall be recognized.” Further, ASC 350-30-25-4 states that “[i]ntangible assets that are acquired individually or with a group of assets in a transaction other than a business combination or an acquisition by a not-for-profit entity may meet asset recognition criteria in FASB Concepts Statement No. 5, Recognition and Measurement in Financial Statements of Business Enterprises, even though they do not meet either the contractual-legal criterion or the separability criterion (for example, specially-trained employees or a unique manufacturing process related to an acquired manufacturing plant). . . . Thus, those assets shall be recognized as intangible assets.”

Cost of the Acquisition
In a business combination, the fair value of the consideration transferred excludes the transaction costs; in an asset acquisition, transaction costs are generally included in the cost of the acquisition. In addition, contingent consideration in an asset acquisition is not accounted for in accordance with ASC 805-30-25-5 through 25-7. Contingent consideration is measured in accordance with other applicable GAAP, such as ASC 450 and ASC 815.
Measuring the Assets Acquired and Liabilities Assumed

In accordance with ASC 805, an acquirer measures assets acquired and liabilities assumed in a business combination that arise from contingencies at their acquisition-date fair value if it can be determined during the measurement period. If fair value cannot be determined, the asset or liability should be measured in accordance with ASC 450. ASC 805-20-25-20B states that if the criteria for recognition at fair value or in accordance with ASC 450 are not met “at the acquisition date using information that is available during the measurement period about facts and circumstances that existed as of the acquisition date, the acquirer shall not recognize an asset or liability as of the acquisition date.” In addition, “[i]n periods after the acquisition date, the acquirer shall account for an asset or a liability arising from a contingency that does not meet the recognition criteria at the acquisition date in accordance with other applicable GAAP, including [ASC] 450, as appropriate.”

In an asset acquisition, acquired contingent assets and assumed contingent liabilities are accounted for in accordance with ASC 450, generally resulting in (1) no recognition of acquired contingent assets and (2) recognition of a contingent liability only if it is probable that a liability has been incurred and the amount can be reasonably estimated.

Further, in an asset acquisition, an entity allocates the cost of the assets and liabilities (asset group) on the basis of their relative fair values and is not permitted to recognize any goodwill. If the cost exceeds the fair value of the asset group, the entity allocates the difference pro rata on the basis of relative fair values to increase the assets acquired, except for financial assets (other than investments accounted for under the equity method) and assets subject to fair value impairment testing, such as inventories and indefinite-lived intangible assets, since increasing the value of such assets would most likely result in an impairment as of the next testing date.

If the fair value of the asset group exceeds its cost, the entity allocates the difference pro rata on the basis of relative fair values to decrease the assets acquired, except for financial assets (other than investments accounted for under the equity method) and assets subject to fair value impairment testing. If, however, the asset acquisition in which the fair value of the asset group exceeds its cost also involves a contingent consideration arrangement, the entity should 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). The guidance in ASC 323-10-25-2A and ASC 323-10-30-2B states that if an entity acquires an equity method investment in which the fair value of its share of the investee's net assets exceeds its initial cost and the agreement includes contingent consideration, the entity must recognize a liability equal to the lesser of:

- The maximum amount of contingent consideration.
- The excess of its share of the investee's net assets over the initial cost measurement.

As with acquisitions of equity method investments, a cost accumulation model applies to asset acquisitions. Thus, the guidance above also applies to asset acquisitions by analogy. Therefore, 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, the entity must 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.
Once recognized, the contingent consideration liability is not derecognized until the contingency is resolved and the consideration is issued or becomes issuable. In accordance with the requirements of ASC 323-10-35-14A for equity method investments, the entity recognizes any excess 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. If the amount initially recognized as a liability exceeds the contingent consideration issued or issuable, the entity recognizes that amount as a reduction of the cost of the asset acquisition.

Recognition of Intangible Assets

Under ASC 805, an assembled workforce is not an intangible asset that can be recognized apart from goodwill. In an asset acquisition, however, an assembled workforce may exist and may have to be recognized.

ASC 805 requires assets acquired in a business combination that are used in R&D activities (i.e., IPR&D) to be (1) initially recognized as indefinite-lived intangible assets and (2) measured at fair value. In an asset acquisition, the cost of acquired intangible assets obtained from others, when these assets are to be used in R&D activities that do not have an alternative future use, is charged to expense in accordance with ASC 730.

Example 1 — Allocating the Cost of an Asset Acquisition When Cost Exceeds Fair Value

Company A acquires two assets from Company B for $120. The collective fair value of the assets is $100. Because the assets acquired were determined not to constitute a business, the $20 excess of the cost of the acquired assets ($120) over the amounts assigned to the identifiable assets ($100) must be allocated to the assets and cannot be recognized as goodwill.

The following table illustrates the allocation of the cost of the assets on the basis of relative fair values:

<table>
<thead>
<tr>
<th>Initial Fair Value Measurement</th>
<th>Allocation</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset A</td>
<td>$ 10</td>
<td>$ 2</td>
</tr>
<tr>
<td>Asset B</td>
<td>$ 90</td>
<td>$ 18</td>
</tr>
<tr>
<td>Total</td>
<td>$ 100</td>
<td>$ 20</td>
</tr>
</tbody>
</table>
Example 2 — Allocating the Cost of an Asset Acquisition When Fair Value Exceeds Cost

Company A acquires two assets from Company B for $120 and an agreement to provide additional cash consideration of $30 in one year if a specified future event occurs. The fair value of the assets is $140, collectively, and the assets acquired do not constitute a business. Company A recognizes a contingent consideration liability of $20, which is the lesser of the (1) maximum amount of the contingent consideration or (2) excess of the fair value of the net assets over the initial cost. The following table shows the amounts recognized as of the acquisition date:

<table>
<thead>
<tr>
<th>Initial Fair Value Measurement</th>
<th>Difference</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset A</td>
<td>$ 40</td>
<td>$ 40</td>
</tr>
<tr>
<td>Asset B</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>Contingent consideration</td>
<td>—</td>
<td>(20)</td>
</tr>
<tr>
<td>Total</td>
<td>$ 140</td>
<td>$ 120</td>
</tr>
</tbody>
</table>

Example 3 — Allocating the Cost of an Asset Acquisition of IPR&D When Fair Value Exceeds Cost

Company A acquired exclusive license rights for a compound from Company B in a transaction accounted for as an asset acquisition. Company A paid an up-front fee of $1 million and agreed to make a milestone payment of $2 million to B upon regulatory approval of the compound.

Company A determined that the milestone payment does not represent a derivative. In addition, the fair value of the compound was determined to be in excess of the up-front consideration transferred as of the acquisition date.

Company A accounted 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, Company A concluded 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.

Question 2

In Example 3 above, given that the fair value of the compound acquired was greater than the up-front consideration transferred, how should A account for the contingent milestone payment upon acquisition?

Answer

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 should 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.
Under existing guidance, 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 was greater than the up-front consideration transferred. However, A concluded that such guidance is not applicable 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 the existing guidance would result in an unintended outcome in which the future milestone payment that otherwise would have been recorded upon the triggering event of the milestone (and most likely would be capitalized since the milestone payment is only triggered upon regulatory approval) would need to be expensed as IPR&D as of the acquisition date. 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. However, such a conclusion would generally not be appropriate when an asset acquisition involves (1) elements in addition to IPR&D and (2) a contingent consideration arrangement. In such cases, an entity would need to carefully assess all facts and circumstances.

**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.

**Question**

Should an entity recognize intangible assets apart from goodwill for IPR&D activities acquired in a business combination?

**Answer**

Yes. Under ASC 805 and ASC 350, the acquiring entity recognizes acquired IPR&D at fair value as of the acquisition date and subsequently accounts for it as an indefinite-lived intangible asset until completion or abandonment of the associated R&D efforts.

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. 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. Further, questions have arisen regarding whether a fully outlicensed R&D project acquired in a business combination constitutes acquired IPR&D.
Example
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 incurs significant costs related to the R&D of a new line of products, all of which it expensed as incurred under ASC 730. Company A plans to continue these R&D efforts in hopes of releasing the new line of products 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).

Identifying IPR&D

Question
What considerations should an entity take into account when identifying IPR&D?

Answer
The AICPA's Accounting and Valuation Guide Assets Acquired to Be Used in Research and Development Activities (the “guide”), issued in 2013, includes guidance on identifying IPR&D. The guide observes that “incompleteness” is an essential characteristic of IPR&D. Paragraphs 2.54 and 2.55 of the guide state:

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.

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.

Further, paragraph 2.56 of the 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 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.

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.

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3 “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.”
**Example**

Company A enters into a distribution agreement with Company B for the rights to a generic version of the branded product. In addition, A enters into a supply agreement with a third party to manufacture the product. The product's Abbreviated New Drug Application has been submitted to the FDA for approval, which is expected in the current fiscal period. Company A does not anticipate incurring any additional expense to bring the product to commercialization.

The guide provides the following Q&A in paragraph 2.62:

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**? [Emphasis added]

**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.

Therefore, A 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).

**Evaluating Acquired Intangible Assets That May Be Outlicensed to Others**

**Question**

What considerations should an entity take into account when evaluating acquired intangible assets that may be outlicensed to others?

**Answer**

The AICPA guide specifically addresses outlicensing arrangements. Paragraph 2.10 states, in part:

- **Outlicensed.** 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 contrast, a contract-based intangible would typically be accounted for as a definite-lived intangible asset (subject to amortization).
For example, assume that the intellectual property 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 intellectual property 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.

**Thinking It Through**

To reach such accounting conclusions, an entity must carefully analyze the nature and extent of the licensor’s ongoing involvement with the R&D project. In certain outlicensing arrangements, the licensor retains some level of continuing involvement with the intellectual property. 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).

**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. Judgment is required in the determination of the unit of account to be used for acquired IPR&D given that certain separately identifiable IPR&D assets that share similar characteristics can sometimes 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 should 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.”
Example

On September 30, 20X7, 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. All clinical trials have been completed in the European Union (EU) and the appropriate applications have been filed, but the product is awaiting regulatory approval. However, the same product is under development in the United States and is not as far advanced there. In the United States, the product has only just commenced Phase III clinical trials. In addition, if the product is approved, patent protection is expected to expire significantly later than in the EU.

Given the above factors, X determines that two IPR&D assets should be recognized: one for the EU 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 remained 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.

Accounting for Acquired IPR&D Assets After Recognition in a Business Combination

Question

Under ASC 805, the acquiring entity recognizes IPR&D assets at fair value as of the acquisition date. How does an entity account for acquired IPR&D assets after those assets are recognized in a business combination?

Answer

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 [ASC] 350-30-35-18 [and] 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 [ASC] 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 1**

On June 30, 20X1, 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, 20Y2, 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, 20X1, to June 30, 20Y2, 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, 20Y2 (the date of abandonment), in the income statement.

**Example 2**

Assume the same facts as in Example 1, except that A successfully completes its IPR&D project on July 1, 20Y2, 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, 20Y2 (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, 20Y2.

**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:

<table>
<thead>
<tr>
<th><strong>ASC 350-30</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>35-17</strong> 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.</td>
</tr>
</tbody>
</table>
ASC 350-30 (continued)

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.

Question
What factors may be relevant to life sciences entities when they perform a qualitative impairment assessment of IPR&D assets?

Answer
Life sciences entities may encounter various challenges in performing an impairment assessment of IPR&D assets. The entities may 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 communication suggesting delay)? Have there been any negative results since the previous analysis either internally or through public sources (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? Is there any change in the amount and timing of the projected operating costs or projected revenues? Is there any change in the estimated probability of technical and regulatory success (PTTR)? Is there sufficient funding available to complete the development of and 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.

Refer to the AICPA guide for additional considerations related to performing a quantitative impairment analysis.

**Accounting for the Settlement of Preexisting Relationships**

In a business combination, the acquirer and acquiree may have a preexisting relationship, such as a collaboration agreement to codevelop or copromote a particular compound.

**Question**

How should an entity account for a business combination's settlement of a preexisting relationship?

**Answer**

ASC 805-10-55-21 states the following:

<table>
<thead>
<tr>
<th>ASC 805-10</th>
</tr>
</thead>
<tbody>
<tr>
<td>55-21 If the business combination in effect settles a preexisting relationship, the acquirer recognizes a gain or loss, measured as follows:</td>
</tr>
<tr>
<td>a. For a preexisting noncontractual relationship, such as a lawsuit, fair value</td>
</tr>
<tr>
<td>b. For a preexisting contractual relationship, the lesser of the following:</td>
</tr>
<tr>
<td>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.</td>
</tr>
<tr>
<td>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.</td>
</tr>
</tbody>
</table>

The gain or loss on the preexisting relationship is considered a transaction that is separate and apart from the business combination.

**Thinking It Through**

Companies should assess whether the preexisting relationship is held at fair value before acquisition. If so, no gain or loss would be recognized. In making this determination, a company must carefully assess both fair value and what is being acquired. For example, 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.

**Accounting for Contingent Consideration**

**Question**

How should an entity account for contingent consideration in a business combination?
**Answer**

In accordance with ASC 805-30-25, contingent consideration is recorded at fair value as part of the total consideration transferred by the acquirer. The acquirer must distinguish between contingent consideration (see ASC 805-10-20) and preexisting contingencies assumed in the acquisition (see ASC 450-10-20). The fair value of contingent consideration is considered part of the purchase price and recorded on the balance sheet either as a liability or within equity (or, less commonly, as an asset). Contingent consideration arrangements classified as liabilities must be remeasured in each reporting period, with gains and losses recorded in earnings. Contingent consideration arrangements classified in equity are not remeasured, even if the contingent event does not occur.

**Thinking It Through**

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.

**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, a company has the option of electing different accounting alternatives and using them as a precedent for future transactions. The accounting policy described in the Q&A below is relevant only to groups of assets that meet the definition of a business. If assets are sold, it would not be appropriate to recognize contingent consideration before it is realized.

**Seller’s (Parent’s) Accounting for Contingent Consideration Upon Deconsolidation of a Subsidiary or Derecognition of a Group of Assets That Is a Business**

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.

The Q&A below does not address contingent payment arrangements that are separate transactions. That is, the Q&A addresses only arrangements in which the payment is otherwise determined to represent contingent consideration.

Further, it is assumed in the Q&A that the seller has determined that the arrangement does not meet the definition of a derivative instrument. If the arrangement met the definition of a derivative, it would be accounted for under ASC 815.

**Question**

How should a seller account for the contingent consideration arrangement upon deconsolidation of its subsidiary or derecognition of a group of assets that is a business?
Answer

This topic is discussed in EITF Issue 09-4. At the EITF’s September 9-10, 2009, meeting, the EITF considered the two approaches discussed below 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, there may be diversity in practice regarding a seller’s accounting for a contingent consideration arrangement. Nevertheless, entities should establish an accounting policy for the initial and subsequent measurement of these types of arrangements. 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.

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

Parent A has a wholly owned subsidiary with 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:

<table>
<thead>
<tr>
<th></th>
<th>Approach 1</th>
<th>Approach 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash proceeds</td>
<td>$150</td>
<td>$150</td>
</tr>
<tr>
<td>Contingent consideration receivable</td>
<td>30</td>
<td>—</td>
</tr>
<tr>
<td>Total consideration</td>
<td>180</td>
<td>150</td>
</tr>
<tr>
<td>Less: subsidiary's carrying amount</td>
<td>(100)</td>
<td>(100)</td>
</tr>
<tr>
<td>Initial gain on sale</td>
<td>$80</td>
<td>$50</td>
</tr>
</tbody>
</table>

**Recently Issued Accounting Standards Updates**

**Simplifying the Accounting for Measurement-Period Adjustments**

**Background**

In September 2015, the FASB issued ASU 2015-16, which amends the guidance in ASC 805 on the accounting for measurement-period adjustments. The ASU was issued as part of the FASB’s simplification initiative in response to stakeholder feedback that restating prior periods to reflect adjustments made to provisional amounts recognized in a business combination adds cost and complexity to financial reporting but does not significantly improve the usefulness of the information provided to users.

For more information about the ASU, see Deloitte’s September 30, 2015, Heads Up.

**Key Provisions of the ASU**

Under previous guidance, when an acquirer identified an adjustment to provisional amounts during the measurement period, the acquirer was required to revise comparative information for prior periods, including making any change in depreciation, amortization, or other income effects recognized in completing the initial accounting, as if the accounting for the business combination had been completed as of the acquisition date.

The ASU requires an acquirer to recognize adjustments to provisional amounts that are identified during the measurement period in the reporting period in which the adjustment amounts are determined. The effect on earnings of changes in depreciation or amortization, or other income effects (if any) as a result of the change to the provisional amounts, calculated as if the accounting had been completed as of the acquisition date, must be recorded in the reporting period in which the adjustment amounts are determined rather than retrospectively.
Thinking It Through

Although the ASU changes the accounting for measurement-period adjustments, it does not change what is considered to represent a measurement-period adjustment, which is an adjustment to the amounts provisionally recognized for the consideration transferred, the assets acquired, and the liabilities assumed as a result of “new information obtained about facts and circumstances that existed as of the acquisition date that, if known, would have affected the measurement of the amounts recognized as of that date.” Errors, information received after the measurement period ends, or information received about events or circumstances that did not exist as of the acquisition date do not represent measurement-period adjustments.

Disclosure Requirements

The ASU also requires that the acquirer present separately on the face of the income statement, or disclose in the notes, the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date.

Effective Date and Transition

For public business entities, the ASU became effective for fiscal years beginning after December 15, 2015, including interim periods within those fiscal years. For all other entities, the ASU is effective for fiscal years beginning after December 15, 2016, and interim periods within fiscal years beginning after December 15, 2017. The ASU must be applied prospectively to adjustments to provisional amounts that occur after the effective date. Early application is permitted for financial statements that have not been issued.

The only disclosures required at transition are the nature of and reason for the change in accounting principle. An entity should disclose that information in the first annual period of adoption and in the interim periods within the first annual period if there is a measurement-period adjustment during the first annual period in which the changes are effective.

Clarifying the Definition of a Business

In January 2017, the FASB issued ASU 2017-01, which clarifies the definition of a business in ASC 805 and provides a framework that an entity can use to determine whether a set of activities and assets (collectively, a “set”) constitutes a business.

The FASB issued the ASU in response to stakeholder feedback indicating that the definition of a business in ASC 805 is too broad and that too many transactions are qualifying as business combinations even though many of these transactions may more closely resemble asset acquisitions. Because the current definition has been interpreted broadly, it can be difficult and costly to analyze transactions. The amendments are intended to make the application of the guidance more consistent and cost-efficient.

The ASU’s Basis for Conclusions indicates that the amendments are intended to “narrow the definition of a business and provide a framework that gives entities a basis for making reasonable judgments about whether a transaction involves an asset or a business.” In addition, the ASU provides examples that illustrate how an entity should apply the amendments in determining whether a set is a business.

For more information about the ASU, see Deloitte’s January 13, 2017, Heads Up.
Thinking It Through

Concerns about the definition of a business were among the primary issues raised in connection with the Financial Accounting Foundation’s May 2013 post-implementation review report on FASB Statement No. 141(R), Business Combinations (codified in ASC 805).

Significance of the ASU

An entity uses the definition of a business in ASC 805 in many areas of accounting, including acquisitions, disposals, goodwill, and consolidation. For example, this distinction is important because the accounting for an asset acquisition significantly differs from the accounting for a business combination, as described in the Determining Whether an Asset Group Constitutes a Business section above.

The FASB considered addressing the concern about the definition of a business more directly by attempting to reduce or eliminate differences in accounting where the definition is relevant. However, to respond to stakeholder concerns in a timely fashion, the FASB decided to begin this project by clarifying the definition of a business. In a future phase of the project, the FASB plans to consider whether there are differences in the acquisition and derecognition guidance for assets and businesses that could be aligned.

The current implementation guidance in ASC 805-10-55-4 states that a “business consists of inputs and processes applied to those inputs that have the ability to create outputs.” A business has three elements — inputs, processes, and outputs. All businesses have inputs and processes, and most have outputs, but outputs are not required for a set to be a business. Further, ASC 805-10-55-5 states that “all of the inputs or processes that the seller used” in operating the set do not need to be part of the transaction “if market participants are capable of acquiring the [set] and continuing to produce outputs, for example, by integrating the [acquired set] with their own inputs and processes.”

Since the current implementation guidance does not specify the minimum inputs and processes required for a set to meet the definition of a business, some have interpreted the definition of a business broadly. Some have said that a set may qualify as a business even if no processes are acquired when revenue-generating activities continue after an acquisition or if a market participant would be capable of integrating the acquired set with its own processes. For example, some believe that the acquisition of a product right with an in-place supply arrangement meets the definition of a business because a market participant is capable of acquiring an input (intellectual property with a supply arrangement) and combining it with the market participant’s own processes (processes to commercialize the product) to continue generating outputs (product sales). Others have said that the presence of any process can give rise to a business, regardless of the significance of that process.

In addition, ASC 805-10-55-4(c) refers to an output as having “the ability to provide a return in the form of dividends, lower costs, or other economic benefits directly to investors or other owners, members, or participants” (emphasis added). Many transactions can provide a return in some form (e.g., the acquisition of a new machine might lower costs). Thus, the definition of outputs has further contributed to broad interpretations of the definition of a business.

The amendments in the ASU address these concerns by (1) providing a “screen” for determining when a set is not a business, (2) adding guidance on the minimum inputs and processes that are needed for an acquired set to be considered a business when the screen’s threshold is not met, (3) removing the evaluation of whether a market participant could replace missing elements, and (4) narrowing the definition of the term “output” to make it consistent with how outputs are described in ASC 606.
Single or Similar Asset Threshold

The ASU provides a practical way to determine when a set is not a business. That is, “[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.” When this threshold is met, an entity does not need to evaluate the rest of the implementation guidance. The Basis for Conclusions of the ASU notes that the assessment may be either qualitative or quantitative. Sometimes, an entity may be able to qualitatively determine that all of the fair value of the acquisition would be assigned to a single asset or a group of similar assets. Paragraph BC19 of ASU 2017-01 offers the following example:

“If the acquisition includes a license for a drug candidate and an at-market contract and the entity concludes that the at-market contract has at the date of assessment little or no fair value assigned to it or the fair value of a single identifiable asset or group of similar identifiable assets is so significant that it is very clear that the threshold will be met, the entity may conclude that the threshold has been met.

An entity may also be able to qualitatively determine that the fair value of the acquisition would be assigned to multiple dissimilar assets, in which case the threshold would not be met. In other cases, an entity may need to perform a quantitative assessment.

In addition, the FASB “decided 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”). 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.”

To avoid inappropriate groupings of assets, the ASU adds ASC 805-10-55-5C. This paragraph indicates that when 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).” Further, ASC 805-10-55-5C notes that “the following should not be considered similar assets”:

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 (added by the ASU) illustrate how a life sciences entity would apply the guidance discussed in ASC 805-10-55-5C above:

<table>
<thead>
<tr>
<th>Case B: Acquisition of a Drug Candidate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1</strong></td>
</tr>
<tr>
<td><strong>55-65</strong> 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.</td>
</tr>
<tr>
<td><strong>55-66</strong> 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.</td>
</tr>
<tr>
<td><strong>Scenario 2</strong></td>
</tr>
<tr>
<td><strong>55-67</strong> 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.</td>
</tr>
<tr>
<td><strong>55-68</strong> 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.</td>
</tr>
</tbody>
</table>

**Substantive Process**

As noted in paragraph BC35 of the ASU, the amendments also “clarify that an input and a substantive process together are required to significantly contribute to the ability to create outputs. The Board wanted to emphasize that the process must be important to the ability to create outputs to make sure that the bar is not set too low.”

The amendments provide different criteria for entities to evaluate in determining whether a set has a substantive process, depending on whether a set has outputs.
A Set With No 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. The ASU 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, to qualify as a business, a set that does not have outputs “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. The ASU 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 and ASC 805-10-55-72 (added by the ASU) illustrates the assessment a life sciences entity would perform when a set has no outputs:

<table>
<thead>
<tr>
<th>ASC 805-10</th>
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<tbody>
<tr>
<td><strong>Case C: Acquisition of Biotech</strong></td>
</tr>
</tbody>
</table>
| **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.

[Omitted paragraph]

**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.
A Set With Outputs

The ASU's Basis for Conclusions 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 (added by the ASU) indicates that the set would include a substantive process if any of the following criteria are met:

- 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.

- 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).

- 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.

- 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.

An organized workforce may signify the existence of a substantive process but would not be required if outputs are present. The ASU's Basis for Conclusions states, for example, that "an organized workforce might not be required if the set includes automated processes (for example, through acquired technology, infrastructure, or specialized equipment) or other significant processes that contribute to the ability to continue producing outputs."

Further, ASC 805-10-55-5F (added by the ASU) states the following:

<table>
<thead>
<tr>
<th>ASC 805-10</th>
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</thead>
<tbody>
<tr>
<td><strong>55-5F</strong> 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.</td>
</tr>
</tbody>
</table>
ASC 810-10-55-82 and ASC 810-10-55-84 (added by the ASU) illustrate the application of the above guidance to arrangements that involve licensing and distribution rights, which are common among life sciences entities:

**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.

[Omitted paragraph]

**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.

**Thinking It Through**

When the set has outputs, the presence of an acquired contract that provides access to an organized workforce could meet the less stringent criteria to support the idea 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 (1) the acquisition of 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 clinical research organization or a clinical manufacturing organization). In such a circumstance, the presence of the acquired contract is not relevant to the determination of whether the set has a substantive process. Instead, for the acquired set to represent a business, the acquired set would need to include employees who form an organized workforce and an input that the workforce could develop or convert into output.

**Definition of Output**

The amendments change the definition of an output to 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.” As explained in the ASU’s Basis for Conclusions, the definition of outputs was narrowed to be consistent with ASC 606, which “describes goods or services that are an output of the entity’s ordinary activities.” However, not every entity has revenues within the scope of ASC 606. Therefore, the Board decided to incorporate into the definition of output other types of revenues. For example, the reference to investment income in the amendments’ definition of an output was included to ensure that the purchase of an investment company could still qualify as a business combination.
Convergence With IFRSs

The definition of a business in ASC 805 is currently identical to that in IFRS 3. Nevertheless, the interpretation and application of this term in jurisdictions that apply U.S. GAAP do not appear consistent with those in jurisdictions that apply IFRSs (i.e., the definition of a business in IFRS jurisdictions is not applied as broadly). Although the ASU adds implementation guidance to U.S. GAAP that is not found in IFRSs, the FASB intends to more closely align practice under U.S. GAAP with that under IFRSs by narrowing application of the U.S. GAAP definition. Further, the IASB has added to its agenda a project on the definition of a business and issued an exposure draft, which proposes amendments similar to those described herein for U.S. GAAP.

Effective Date and Transition

The ASU is effective for public business entities in annual periods beginning after December 15, 2017, including interim periods therein. For all other entities, the ASU is effective in annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The ASU must be applied prospectively on or after the effective date, and no disclosures for a change in accounting principle are required at transition.

Early application is allowed for transactions for which the acquisition or disposal date occurs in a period for which financial statements have not been issued or made available for issuance.

Accounting for Goodwill Impairment

In 2014, the FASB amended the Codification to allow private companies an alternative accounting treatment for subsequently measuring goodwill. The Board then added a project to its agenda to determine whether similar amendments should be considered for other entities, including public business entities and not-for-profits. In May 2016, the FASB issued a proposed ASU that would remove step 2 from the goodwill impairment test.

In January 2017, the FASB issued ASU 2017-04. The ASU removes “step 2” from the impairment model, thus eliminating the requirement for entities to complete a hypothetical purchase-price allocation. The FASB also determined not to give entities the option to perform step 2 and to instead require them to adopt the simplified impairment test prospectively. Therefore, under the amendments, entities would perform their annual (or any necessary interim) goodwill test by comparing the fair value of a reporting unit with its carrying amount. Entities would recognize any impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value (not to exceed the carrying amount of goodwill allocated to the reporting unit). Entities still have the option to perform the qualitative assessment for reporting units to determine whether a quantitative impairment test is necessary.

The ASU also requires entities to apply the same impairment model for a reporting unit with a zero or negative carrying amount as the model for a reporting unit with a positive carrying amount by comparing the fair value of the reporting unit with its carrying amount. In addition, an entity is required to quantitatively disclose the amount of goodwill allocated to reporting units with zero or negative carrying amounts.

For more information about the ASU, see Deloitte’s February 1, 2017, Heads Up.
**Effective Date and Transition**

For public business entities that are SEC filers, the ASU is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Public business entities that are not SEC filers should apply the new guidance for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. For all other entities, including not-for-profits, the ASU is effective for annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. Early adoption is allowed for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The ASU must be adopted on a prospective basis.

**Simplifying the Transition to the Equity Method of Accounting**

In March 2016, the FASB issued ASU 2016-07 as part of the Board’s simplification initiative.

The standard eliminates the requirement for an investor to retroactively account for an investment that becomes newly qualified for use of the equity method because of an increased ownership interest, as if the equity method had been applied during all previous periods in which the investment was held. The ASU also requires a company that holds an available-for-sale equity security that becomes qualified for the equity method of accounting to recognize through earnings the unrealized holding gain or loss residing in accumulated other comprehensive income as of the date the investment qualifies for equity method treatment.

**Effective Date and Transition**

The ASU is effective for all entities for fiscal years beginning after December 15, 2016, as well as interim periods therein. The guidance should be applied prospectively upon its effective date to increases in the level of ownership interest (or degree of influence) that result in the adoption of the equity method, but earlier adoption is permitted. No additional transition disclosures are required upon adoption.

**Effective Date and Transition Guidance in Certain Private-Company ASUs**

In March 2016, the FASB issued ASU 2016-03, which gives private companies a one-time unconditional option to forgo a preferability assessment the first time they elect a private-company accounting alternative within the ASU’s scope. The ASU also eliminates the effective dates of private-company accounting alternatives that are within its scope and extends the transition guidance for such alternatives indefinitely.

The new guidance is effective immediately and affects all private companies within the scope of ASUs 2014-02, 2014-03, 2014-07, and 2014-18. While the new standard extends the transition guidance in ASUs 2014-07 and 2014-18, it does not change the manner in which such guidance is applied. See Deloitte’s March 16, 2016, *Heads Up* for more information.

**SEC Comment Letter Themes Related to Business Combinations**

Below are examples of SEC staff comments that registrants in the life sciences industry and other industries have received regarding their accounting for business combinations. For more information about SEC comment letter themes that pertain to the life sciences industry, see Deloitte’s *SEC Comment Letters — Including Industry Insights: What “Edgar” Told Us (Ninth Edition)*, as well as Deloitte’s *SEC Comment Letters — Statistics According to “Edgar”: Supplement to the Ninth Edition*. 

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Comments to Registrants in the Life Sciences Industry

Example of an SEC Comment

You state that you acquired no significant processes in your . . . acquisition of all of the outstanding shares of [Company A]. Please provide your analysis supporting this conclusion and that this was not an acquisition of a business. Refer to ASC 805-10-55-4 through [55-9].

As previously noted, the life sciences industry in recent years has seen an increase in M&A activity. While many entities in the industry have sought ways to expand their pipeline of products in development or acquire additional commercial products, others have explored how to generate additional returns on assets that are no longer a strategic focus.

Accounting for a transaction as a business combination differs significantly from accounting for a transaction as an asset acquisition, as described in the Determining Whether an Asset Group Constitutes a Business section above. Consequently, when acquisitions occur, it is important to determine whether what is being acquired meets the definition of a business under ASC 805. Accordingly, the SEC staff often issues comments related to whether the acquired set meets the definition of a business and further inquires about the basis for the registrant’s conclusion.

In addition, in business combinations involving the acquisition of intangible assets, acquirers must determine the useful life of each intangible asset acquired. Because the intangible assets acquired are typically the patent rights to a product or potential product, most life sciences companies begin their analysis by considering the patent life of the underlying product. However, useful life could be affected by other factors, such as the risk of competition from branded or generic products before the company’s patent expires or a high barrier to market entry even after the company’s patent expires. Therefore, the SEC staff has asked registrants to provide additional analysis that explains the basis for their conclusions about the useful lives of acquired intangible assets.

Comments to Registrants Across Industries

Purchase Price Allocation

Example of an SEC Comment

In regard to your preliminary purchase price allocation . . . , please provide further supporting disclosure for each purchase price adjustment to each tangible and intangible asset acquired and liability assumed. This disclosure should explain in greater detail what the adjustment represents and how the increase or decrease was determined, including a brief explanation of the factors and assumptions involved in the calculation. For example, please disclose and explain how you determined the increase in property, plant and equipment, franchises and customer relationships.
The SEC staff frequently asks registrants how they have assigned amounts to assets acquired and liabilities assumed in business combinations. In particular, the staff asks registrants that have recorded a significant amount of goodwill why they have not attributed value to identifiable intangible assets. The staff also compares disclosures provided in press releases, the business section, and MD&A to the purchase price allocation in the financial statements. For example, the SEC staff may ask why a registrant did not recognize a customer-related intangible asset if it discloses in MD&A that it acquired customers in a business combination. In addition, the SEC staff may ask detailed questions about (1) how a registrant determined that intangible assets would have finite or indefinite useful lives; (2) the useful lives of identified intangible assets determined to have finite useful lives; and (3) material revisions to the initial accounting for a business combination, including what significant assumptions have changed to support a revision to the value of intangible assets.

**Contingent Consideration**

**Example of an SEC Comment**

Please note that ASC 805-30-50-1(c) requires a description of contingent consideration arrangements in the financial statements including the basis for determining the amount of any payments. Also, disclosure of the changes in the range of outcomes and reasons for those changes is required to be disclosed in accordance with ASC 805-30-50-4. Given these disclosure requirements, please provide draft disclosure to be included in future filings to disclose both the nature and terms of the contingent consideration arrangement including the metrics which must be achieved for payments to occur, and the nature and timing of the changes in facts and circumstances that resulted in your reversal of the previously recorded expense for future incentive payments of $[X] during the fourth quarter of the fiscal year ended February 1, 2014. As part of your revised disclosure, please also explain why your determination that the financial metrics would not be achieved did not occur until the fourth quarter of your fiscal year ended February 1, 2014.

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, 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 contingent consideration should be reflected as a retrospective adjustment to the amount of goodwill (i.e., if the adjustment is made because of new information obtained during the measurement period about 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. The staff may also ask for disclosure of the total amount of contingent consideration that could become payable under the terms of the arrangement.

**Bargain Purchases**

**Example of an SEC Comment**

Please fully explain to us how you determined the fair value of the property, plant and equipment you acquired from [Company A]. Please specifically address why the gain on bargain purchase you recognized was so significant relative to the purchase price. Please also address if you have performed any subsequent impairment analysis for the assets you acquired and, if applicable, tell us the significant assumptions you used.
When a registrant recognizes a gain related to a bargain purchase, the SEC staff will typically issue comments on how the registrant determined and reassessed the purchase price allocation. A gain from a bargain purchase occurs when the net of the acquisition-date fair value of the identifiable assets acquired and the liabilities assumed is greater than the sum of the acquisition-date fair value of (1) the consideration transferred, (2) the noncontrolling interest in the acquiree, and (3) any equity interests previously held by the acquirer. Before recognizing the gain, a registrant is required to perform a reassessment of the bargain purchase gain by verifying that all assets acquired and liabilities assumed were properly identified. The SEC staff has asked registrants to (1) explain their process, (2) provide the results of the reassessment, and (3) disclose that a reassessment was performed. In addition, the staff has inquired about whether any subsequent impairment analyses for the assets acquired have been performed.

**Disclosures**

**Example of an SEC Comment**

Please revise [the notes] to disclose the amounts of revenue and earnings of [Company A] and [Company B] since the acquisition date which have been included in the consolidated income statement for the reporting period in which the acquisitions occurred. Also, please revise to disclose the revenue and earnings of the combined entity for the current reporting period as though the acquisition date for all business combinations that occurred during the period had been as of the beginning of the annual reporting period. Comparable information for the prior annual period should also be presented as if these acquisitions had occurred at the beginning of the comparable prior annual reporting period. Refer to the disclosure requirements outlined in ASC 805-10-50-2(h).

The SEC staff has commented when a registrant fails to provide pro forma disclosures under ASC 805-10-50 about the effects of an acquisition as of the beginning of a reporting period. ASC 805-10-50-2(h)(3) states that the disclosure requirements for comparative financial statements are as follows:

[F]or a calendar year-end entity, disclosures would be provided for a business combination that occurs in 20X2, as if it occurred on January 1, 20X1. Such disclosures would not be revised if 20X2 is presented for comparative purposes with the 20X3 financial statements (even if 20X2 is the earliest period presented).

In accordance with ASC 805-10-50, registrants must also disclose the nature and amount of material, nonrecurring pro forma adjustments directly attributable to the business combinations that are recognized in the reported pro forma information.

If certain criteria are met (e.g., if a significant business combination has occurred or is probable), registrants may also be required to (1) comply with Regulation S-X, Rule 3-05, and (2) provide pro forma financial information that complies with Regulation S-X, Article 11, in a registration statement, proxy statement, or Form 8-K.

In addition to the above themes, the SEC staff has also asked registrants:

- To indicate which specific elements related to their use of the acquisition method of accounting are not yet complete and why they have not been finalized.
- To identify and disclose the income statement classification of acquisition-related costs they incurred (e.g., due diligence fees, legal fees).
- Whether individually immaterial acquisitions are collectively material, which would require the disclosure of certain information.
- Whether a transaction is considered to be an acquisition of an entity under common control.
On the Horizon — Accounting for Identifiable Intangible Assets in a Business Combination by Public Business Entities and Not-for-Profit Entities

In November 2014, the FASB agreed to add a project to its agenda to explore potential changes to the existing model on accounting for identifiable intangible assets in a business combination for public business entities and not-for-profit entities, including whether certain intangible assets should be subsumed into goodwill. At the FASB’s October 28, 2015, meeting, the Board decided to continue further research in conjunction with the IASB’s project on this topic.

Current Status and Next Steps

On October 10, 2016, the FASB decided to suspend deliberations on this project and move it to the research agenda while (1) evaluating the effectiveness of the changes to the accounting for goodwill impairment in meeting the Board’s objective and (2) continuing to monitor the IASB’s projects on goodwill and intangibles.
Appendix A — Glossary of Standards and Other Literature

The standards and other literature below were cited or linked to in this publication.

**AICPA Literature**
Accounting and Valuation Guide *Assets Acquired to Be Used in Research and Development Activities*

**FASB Accounting Standards Updates**

ASU 2017-05, *Other Income — Gains and Losses From the Derecognition of Nonfinancial Assets (Subtopic 610-20): Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets*

ASU 2017-04, *Intangibles — Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*

ASU 2017-01, *Business Combinations (Topic 805): Clarifying the Definition of a Business*

ASU 2016-20, *Technical Corrections and Improvements to Topic 606, Revenue From Contracts With Customers*


ASU 2016-17, *Consolidation (Topic 810): Interests Held Through Related Parties That Are Under Common Control*

ASU 2016-16, *Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory*


ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

ASU 2016-12, *Revenue From Contracts With Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*

ASU 2016-11, *Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting*

ASU 2016-10, *Revenue From Contracts With Customers (Topic 606): Identifying Performance Obligations and Licensing*

ASU 2016-09, *Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting*
ASU 2016-08, Revenue From Contracts With Customers (Topic 606): Principal Versus Agent Considerations (Reporting Revenue Gross Versus Net)

ASU 2016-07, Investments — Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting

ASU 2016-03, Intangibles — Goodwill and Other (Topic 350), Business Combinations (Topic 805), Consolidation (Topic 810), Derivatives and Hedging (Topic 815): Effective Date and Transition Guidance — a consensus of the Private Company Council

ASU 2016-02, Leases (Topic 842)


ASU 2015-16, Business Combinations (Topic 805): Simplifying the Accounting for Measurement-Period Adjustments

ASU 2015-14, Revenue From Contracts With Customers (Topic 606): Deferral of the Effective Date

ASU 2015-11, Inventory (Topic 330): Simplifying the Measurement of Inventory

ASU 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis

ASU 2014-18, Business Combinations (Topic 805): Accounting for Identifiable Intangible Assets in a Business Combination — a consensus of the Private Company Council

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 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 2014-10, Development Stage Entities (Topic 915): Elimination of Certain Financial Reporting Requirements, Including an Amendment to Variable Interest Entities Guidance in Topic 810, Consolidation

ASU 2014-09, Revenue From Contracts With Customers (Topic 606)

ASU 2014-08, Presentation of Financial Statements (Topic 205) and Property, Plant, and Equipment (Topic 360): Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

ASU 2014-07, Consolidation (Topic 810): Applying Variable Interest Entities Guidance to Common Control Leasing Arrangements — a consensus of the Private Company Council

ASU 2014-03, Derivatives and Hedging (Topic 815): Accounting for Certain Receive-Variable, Pay-Fixed Interest Rate Swaps — Simplified Hedge Accounting Approach — a consensus of the Private Company Council

ASU 2014-02, Intangibles — Goodwill and Other (Topic 350): Accounting for Goodwill — a consensus of the Private Company Council

ASU 2009-13, Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements — a consensus of the FASB Emerging Issues Task Force
FASB ASC Topics and Subtopics

ASC 205, Presentation of Financial Statements
ASC 205-20, Presentation of Financial Statements: Discontinued Operations
ASC 230, Statement of Cash Flows
ASC 230-10, Statement of Cash Flows: Overall
ASC 235, Notes to Financial Statements
ASC 250, Accounting Changes and Error Corrections
ASC 250-10, Accounting Changes and Error Corrections: Overall
ASC 280-10, Segment Reporting: Overall
ASC 320, Investments — Debt and Equity Securities
ASC 321-10, Investments — Equity Securities: Overall
ASC 323-10, Investments — Equity Method and Joint Ventures: Overall
ASC 325-10, Investments — Other: Overall
ASC 325-40, Investments — Other: Beneficial Interests in Securitized Financial Assets
ASC 326-10, Financial Instruments — Credit Losses: Measured at Amortized Cost
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**FASB Proposed Accounting Standards Updates**

Proposed ASU 2017-200, *Debt (Topic 470): Simplifying the Classification of Debt in a Classified Balance Sheet (Current Versus Noncurrent)*

Proposed ASU 2017-210, *Inventory (Topic 330): Disclosure Framework — Changes to the Disclosure Requirements for Inventory*


Proposed ASU 2015-310, *Notes to Financial Statements (Topic 235): Assessing Whether Disclosures Are Material*

**Other FASB Proposal**


**FASB Statements (Pre-Codification Literature)**

Statement No. 167, *Amendments to FASB Interpretation No. 46(R)*

Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements — an amendment of ARB No. 51*

Statement No. 141(R), *Business Combinations*

**FASB Interpretation (Pre-Codification Literature)**

FASB Interpretation No. 46 (revised December 2003), *Consolidation of Variable Interest Entities*

**FASB Concepts Statements**

No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*

No. 6, *Elements of Financial Statements*
EITF Issues
Issue 09-4, “Seller Accounting for Contingent Consideration”
Issue 08-1, “Revenue Arrangements With Multiple Deliverables”
Issue 04-5, “Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights”
Issue 01-8, “Determining Whether an Arrangement Contains a Lease”
Issue 00-21, “Revenue Arrangements With Multiple Deliverables”

SEC C&DI Topic
Non-GAAP Financial Measures

SEC Regulation G
“Conditions for Use of Non-GAAP Financial Measures”

SEC Regulation S-K
Item 10(e), “General; Use of Non-GAAP Financial Measures in Commission Filings”
Item 601(b)(10), “Exhibits; Description of Exhibits; Material Contracts”

SEC Regulation S-X
Rule 3-05, “Financial Statements of Businesses Acquired or to Be Acquired”
Rule 4-08(h), “General Notes to Financial Statements; Income Tax Expense”
Article 11, “Pro Forma Financial Information”

SEC Staff Accounting Bulletin
SAB Topic 1.M, “Financial Statements; Materiality”
SAB Topic 13, “Revenue Recognition”
SAB Topic 13.A.4, “Revenue Recognition; Selected Revenue Recognition Issues; Fixed or Determinable Sales Price”

International Standards
IFRS 15, Revenue From Contracts With Customers
IFRS 11, Joint Arrangements
IFRS 3, Business Combinations
IAS 20, Accounting for Government Grants and Disclosure of Government Assistance
Exposure Draft ED/2016/1, Definition of a Business and Accounting for Previously Held Interests — Proposed amendments to IFRS 3 and IFRS 11
## Appendix B — Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>AFS</td>
<td>available for sale</td>
</tr>
<tr>
<td>AICPA</td>
<td>American Institute of Certified Public Accountants</td>
</tr>
<tr>
<td>ANDA</td>
<td>abbreviated new drug application</td>
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<tr>
<td>API</td>
<td>active pharmaceutical ingredient</td>
</tr>
<tr>
<td>APIC</td>
<td>additional paid-in capital</td>
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<tr>
<td>ASC</td>
<td>FASB Accounting Standards Codification</td>
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<tr>
<td>ASU</td>
<td>FASB Accounting Standards Update</td>
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<tr>
<td>BOLI</td>
<td>bank-owned life insurance</td>
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<tr>
<td>C&amp;DI</td>
<td>SEC Compliance and Disclosure Interpretation</td>
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<tr>
<td>CECL</td>
<td>current expected credit loss</td>
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<tr>
<td>CODM</td>
<td>chief operating decision maker</td>
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<tr>
<td>COLI</td>
<td>corporate-owned life insurance</td>
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<td>CRO</td>
<td>contract research organization</td>
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<td>DCP</td>
<td>disclosure control procedure</td>
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<tr>
<td>DTA</td>
<td>deferred tax asset</td>
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<tr>
<td>DTL</td>
<td>deferred tax liability</td>
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<tr>
<td>EBITDA</td>
<td>earnings before interest, taxes, depreciation, and amortization</td>
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<tr>
<td>EITF</td>
<td>Emerging Issues Task Force</td>
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<tr>
<td>EPS</td>
<td>earnings per share</td>
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<tr>
<td>EU</td>
<td>European Union</td>
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<tr>
<td>FAQ</td>
<td>frequently asked question</td>
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<td>FASB</td>
<td>Financial Accounting Standards Board</td>
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<tr>
<td>FDA</td>
<td>Food and Drug Administration</td>
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<tr>
<td>FIFO</td>
<td>first in, first out</td>
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<table>
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<tr>
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<tbody>
<tr>
<td>FIN</td>
<td>FASB Interpretation Number (superseded)</td>
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<tr>
<td>FOB</td>
<td>free on board</td>
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<tr>
<td>GAAP</td>
<td>generally accepted accounting principles</td>
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<td>IAS</td>
<td>International Accounting Standard</td>
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<td>IASB</td>
<td>International Accounting Standards Board</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standard</td>
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<tr>
<td>IIR</td>
<td>investigator-initiated research</td>
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<tr>
<td>IPR&amp;D</td>
<td>in-process research and development</td>
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<tr>
<td>LIFO</td>
<td>last in, first out</td>
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<tr>
<td>LLC</td>
<td>limited liability company</td>
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<td>LP</td>
<td>limited partnership</td>
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<tr>
<td>M&amp;A</td>
<td>merger and acquisition</td>
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<td>MD&amp;A</td>
<td>Management's Discussion and Analysis</td>
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<td>MDET</td>
<td>medical device excise tax</td>
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<td>MSL</td>
<td>medical science liaison</td>
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<td>NDA</td>
<td>new drug application</td>
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<td>OCI</td>
<td>other comprehensive income</td>
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<td>OEM</td>
<td>original equipment manufacturer</td>
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<tr>
<td>PCAOB</td>
<td>Public Company Accounting Oversight Board</td>
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<tr>
<td>PCD asset</td>
<td>purchased financial asset with credit deterioration</td>
</tr>
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<td>PMA</td>
<td>premarket approval</td>
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<tr>
<td>PTRS</td>
<td>probability of technical and regulatory success</td>
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<tr>
<td>Q&amp;A</td>
<td>question and answer</td>
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<td>Abbreviation</td>
<td>Description</td>
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<td>--------------------------------------------------</td>
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<tr>
<td>R&amp;D</td>
<td>research and development</td>
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<td>REMS</td>
<td>risk evaluation and mitigation strategy</td>
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<td>ROU</td>
<td>right of use</td>
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<tr>
<td>SAB</td>
<td>SEC Staff Accounting Bulletin</td>
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<td>SAC</td>
<td>subjective acceleration clause</td>
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<tr>
<td>SEC</td>
<td>Securities and Exchange Commission</td>
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<td>TRG</td>
<td>transition resource group</td>
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<tr>
<td>VIE</td>
<td>variable interest entity</td>
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<td>WAC</td>
<td>wholesaler acquisition cost</td>
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