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# A new global standard on revenue

## What this means for the life sciences industry

**The International Accounting Standards Board (IASB) and US FASB have issued their new Standard on revenue – IFRS 15 'Revenue from Contracts with Customers' (ASU 2014-09 or Topic 606 in the US). This bulletin summarises the new requirements and what they will mean for the life sciences industry.**

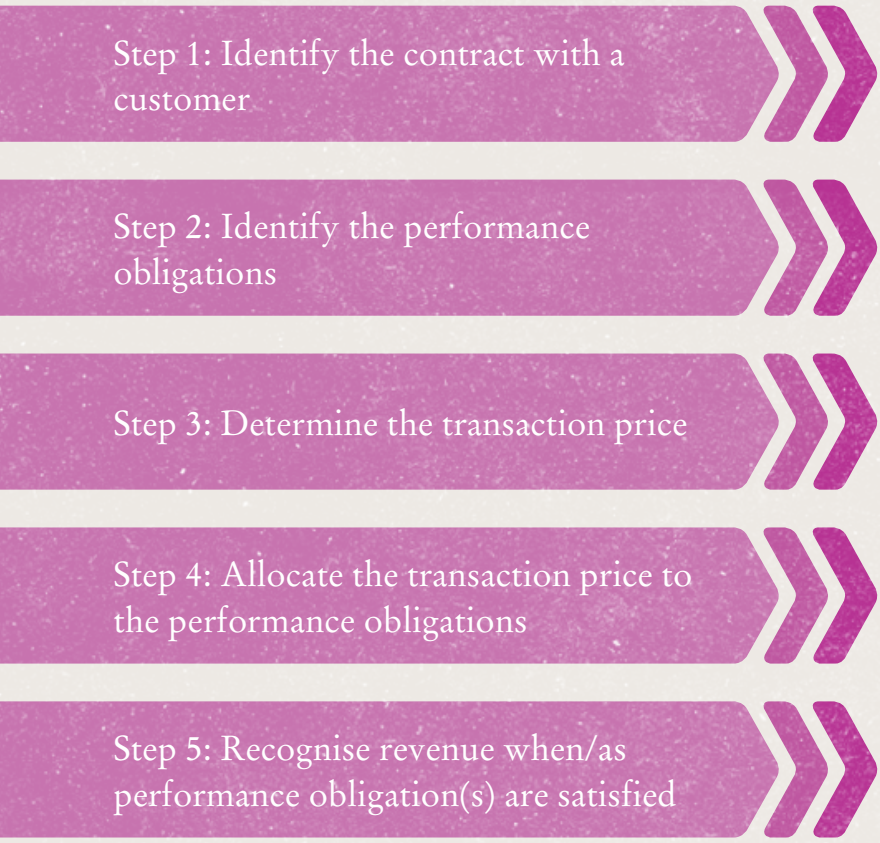
**Recently issued IFRS 15 'Revenue from Contracts with Customers' replaces IAS 18 'Revenue' and IAS 11 'Construction Contracts', and provides significant new guidance addressing key questions such as:**

- When can I include a performance-based milestone payment in revenue?
- When do bundled goods or services represent a separate performance obligation?
- How do I account for collaborative research arrangements with customers?
- Can extended payment terms affect the total amount of revenue I recognise?
- How should sales- or usage-based royalties be accounted for?
- How do I know whether I should recognise revenue from an IP licensing arrangement over time or at a point in time?

With the potential to significantly impact the timing and amount of revenue recognised, entities in the life sciences industry will want to invest time up front to ensure all critical impacts are identified and understood well in advance of implementation.

# The new Standard at a glance

**The new Standard replaces IAS 18, IAS 11 and several revenue-related Interpretations. All transactions within its scope will be analysed against a single, control-based model centred around the following 5-steps:**




IFRS 15 changes the criteria for determining whether revenue is recognised at a point in time or over time. In addition, while the following points may vary in terms of their expected impact on the life sciences industry, IFRS 15 has more guidance in many areas where current IFRSs are lacking such as:

- multiple-element arrangements
- contract modifications
- non-cash and variable consideration
- rights of return and other customer options
- seller repurchase options and agreements
- warranties
- principal versus agent (gross versus net)
- licensing intellectual property
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

IFRS 15 will require considerably more disclosure about revenue recognition including information about contract balances and changes, remaining performance obligations (backlog), and key judgements around the timing of and methods for recognising revenue.

## Transition and effective date

IFRS 15 is effective for annual periods beginning on or after 1 January 2017. Transition is retrospective, subject to some simplifications including an option not to restate comparative periods. Early application is permitted.

# What this means for the life sciences industry

**Accounting for revenue in the life sciences industry involves many unique challenges. Complex arrangements with customers can involve collaborative research arrangements, milestone-based incentive payments, licensing of intellectual property and sales of tangible product. Product expiry dates in arrangements with customer return rights further increase the need for sound professional judgement. Entities will need to carefully assess the impact of the new standard on their customer arrangements as the timing of revenue recognition may be impacted.**

## Step 1: Identify the contract with a customer

IFRS 15 applies to almost all contracts with customers to provide goods or services, although arrangements must meet additional criteria before the detailed guidance in IFRS 15 can be applied, including:

- the contract has commercial substance
- the parties have approved the contract
- the entity can identify each party's rights and the payment terms
- it is probable the entity will collect the consideration.

When amounts are received from a customer before all of the above are met, these payments must be presented as a liability either until the criteria are met, or one of the following occurs:

- performance is complete and all consideration received is non-refundable
- the arrangement has been cancelled and any consideration received is non-refundable.

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### Collaborative research arrangements

Collaborative arrangements are common in the life sciences industry and can take many forms. IFRS 15 applies to such a contract only if the counterparty is a customer. A counterparty to a collaborative arrangement is not considered to be a customer when it does not receive goods or services that are an output of the entity's ordinary activities.

While many collaborative arrangements are excluded from the scope of the new standard, judgement is required in determining whether a transaction is, in fact, with a customer.

Collaborative arrangements within the scope of IFRS 15 that grant a licence along with a promise for research and development services should be evaluated to determine whether these activities are separate performance obligations or should be combined into a single performance obligation.

An entity should continue to account for its contracts with non-customers using other existing guidance.

# Step 2: Identify the performance obligations

Purchase options may result in the customer effectively making an advance payment for future goods or services.

Contracts that include promises to sell multiple goods and/or services may be complex. For example, a contract for a medical device may include embedded software, replacement parts and other components, installation, training, service and warranty for the device. While existing standards provide almost no guidance on how to identify the separately identifiable components of a contract, IFRS 15 requires an entity to identify those performance obligations that are considered to be "distinct".

A promised good or service is 'distinct' if both:

- the customer benefits from the item on its own or along with other readily available resources
- it is 'separately identifiable' (eg the supplier does not provide a significant service integrating, modifying, or customising the various performance obligations).

Entities will need to use this new guidance to evaluate whether the medical device, replacement parts, and other components and services in the example above represent separate performance obligations or a single performance obligation. In light of the significance of this new guidance, entities will need to review their customer contracts carefully before they are able to conclude whether new or different performance obligations are identified and how the related revenue will be impacted.

### Additional purchase options

Contracts that include the right to purchase additional goods or services at a discount, or even at no charge, should be considered a separate performance obligation if the option represents a 'material right' that the customer would not receive without entering into the contract. These purchase options may result in the customer effectively making an advance payment for future goods or services. This portion should initially be deferred and then recognised once the performance obligation for the additional goods or services is satisfied (see Step 5) or the option expires.

# Step 3: Determine the transaction price

Under IFRS 15, the 'transaction price' for a contract is "…the amount of consideration to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer…". This consideration may include fixed or variable amounts or both.

### Variable consideration

Variable consideration is very common and can take many forms including performance bonuses payable only upon achievement of a specific milestone, price concessions, penalties, and other similar items. Under IFRS 15, sellers must estimate the amount of variable consideration using either an expected value (probability-weighted) or most likely amount approach. This estimate is subject to a constraint such that variable amounts are included in the transaction price only to the extent that it is highly probable that a significant reversal of cumulative revenue will not occur upon a change in the estimate. This differs from existing guidance that focuses on whether it is probable that the related performance requirements will be met and the amount can be measured reliably.

The new standard may also create more complexity and increase the need for professional judgement. Consider, for example, an all-or-nothing milestone payment to be received only when (or if) an entity successfully completes the research phase of a larger development project. A history of high failure rates for similar projects may make it difficult for an entity to establish at contract inception that it has met the threshold necessary to include the payment in its estimate of the transaction price.

### Volume discount incentives

An entity should evaluate volume discounts as variable consideration and estimate the amounts when determining the transaction price.

### Royalty arrangements

An entity should recognise revenue for a sales-based or usage-based royalty promised in exchange for a licence of intellectual property only when (or as) the later of the following events occurs:

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

### Rights of return

Pharmaceutical and medical device companies commonly provide customers (distributors) with a right of return if the product is unsold within a specific period of time or the product expires unsold. Such rights can arise from either contractual terms or established practices. In either case, the related revenue is considered to be variable and subject to the constraint.

A retailer will recognise a refund liability for the amount of product expected to be returned and a 'contract asset' for its right to the returned goods. The asset is measured by reference to the former inventory amount, adjusted for recovery costs and any expected decline in value. For pharmaceutical companies, limited value may be attributed to any asset recognised, because products returned have often expired and have no value.

A liability and related asset are also recognised under existing practice although the asset is typically presented on the balance sheet as a component of inventory, representing an entity's claim on the goods expected to be returned. Under IFRS 15 the contract asset must be presented separately from inventory and will need to be assessed for impairment under IFRS 9 'Financial Instruments' (or IAS 39 'Financial Instruments: Recognition and Measurement').

Both the estimated liability and asset amounts should be updated at the end of each reporting period, and any changes recognised as an increase or decrease in revenue and cost of sales respectively.

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## Time value of money

In the life sciences industry, payment terms may vary depending on the nature of the agreement, the financial resources of the customer, and many other factors. Under IFRS 15, the transaction price is adjusted if payment terms give rise to a 'significant financing component'. IFRS 15 provides indicators to help an entity determine whether a significant financing component exists in a contract, including (among other things) the relationship between the promised consideration and the cash selling price, and the length of time between delivery of the promised goods or services and when the customer pays. Where the length of time between performance and collection is less than one year, the effects of financing may be ignored. Otherwise, the effects of a significant financing component are accounted for separately from revenue. Under IAS 18, the focus is on measuring the fair value of the consideration to be received, while under IFRS 15 the objective is to recognise revenue equal to the price the customer would have paid had they paid in cash.

## Step 4: Allocate the transaction price to the performance obligations

The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price.

When an entity determines that a contract contains more than one performance obligation, it is required to allocate the transaction price to each performance obligation based on its relative stand-alone selling price at contract inception.

### Estimating stand-alone selling price

IFRS 15 defines stand-alone selling price as "the price at which an entity would sell a promised good or service separately to a customer". The observable selling price charged by the entity, if available, provides the best evidence of stand-alone selling price. We expect, however, that in the life sciences industry a typical contract may include performance obligations that are either new or never sold on their own, or include unique elements such as one-off intellectual property licensing arrangements. If the standalone selling price is not available for a performance obligation, the entity estimates it using all available information, maximising the use of observable inputs. IFRS 15 suggests (but does not require) three possible methods:

- adjusted market assessment
- expected cost plus margin
- the residual approach.

When it comes to allocating revenue among the various performance obligations in a contract, IAS 18 provides very little guidance and IAS 11 provides even less. Therefore, the extent to which an entity will be impacted by the new guidance will depend upon the accounting policy adopted under existing literature.

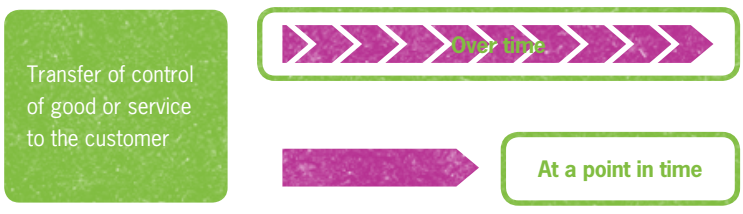
## Step 5: Recognise revenue when/as performance obligations are satisfied

Where the licence is a promise to provide 'access' to the entity's intellectual property, control is transferred over time.

Under IFRS 15 revenue for a performance obligation is recognised upon transfer of control of the promised good or service (i.e. the "asset"). An entity determines at contract inception whether each performance obligation will be satisfied (that is, control will be transferred) over time or at a point in time. Control is transferred over time if any one of the following conditions applies:

- the customer receives and consumes the benefits as the entity performs
- the customer controls the asset as it is created or enhanced

**Transfer over time or at a point in time**



- the asset has no alternative use to the seller and the seller is entitled to payment for performance-to-date.

If none of these conditions are satisfied, the entity recognises revenue at a point in time.

### Intellectual property licences

IAS 18's limited guidance on licensing is consistent with IFRS 15 in that revenue is sometimes recognised over time and sometimes at a point in time, depending on the 'substance of the agreement'.

Under IFRS 15, a licence is a promise to provide 'access' to the entity's intellectual property if all of the following conditions are met:

- there is a requirement or implicit understanding that the entity will undertake activities that will significantly change the underlying intellectual property
- the customer is exposed to positive or negative effects as those activities take place
- the activities do not transfer a good or service to the customer as they occur.

Where the licence is a promise to provide 'access' to the entity's intellectual property, control is transferred over time. If these conditions are not present, the promise is a right to 'use' the intellectual property as it exists when the licence is granted and the performance obligation is satisfied at a point in time, similar to the sale of a good.

## Other guidance

### Contract costs

IFRS 15 requires an entity to capitalise the incremental costs of obtaining a contract if it expects to recover those costs. 'Incremental costs' of obtaining a contract are defined as costs that an entity would not have incurred if it had not obtained the contract (eg, some sales commissions). Costs that an entity incurs regardless of whether it obtains a contract (eg bid costs) are expensed as incurred, unless the costs are explicitly chargeable to the customer whether or not the entity obtains the contract.

### Disclosures

All entities, especially those with contracts greater than one year in duration, will need to provide additional disclosures beyond those currently required. As a result, systems and processes will need to capture and summarise the incremental information required to comply with the new standard.

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