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Revenue Recognition:
Life Sciences

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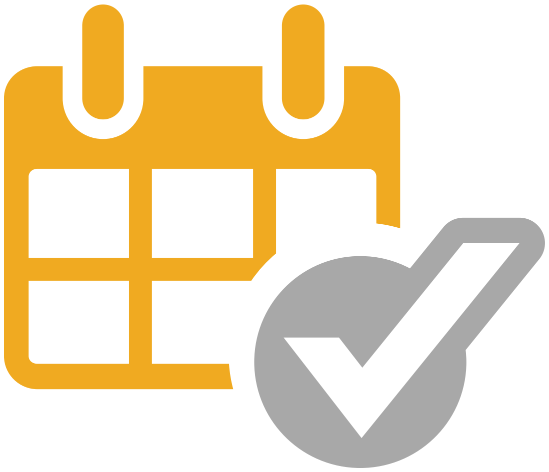
Agenda

- License Agreements
  - Intellectual Property
  - Rights to Access
  - Rights to Use
- Royalties
- Milestone Payments
- Multiple-Element Arrangements
- Right of Return
  - Expected Value Method



Objectives

As a result of participating in this session, you should be able to:

- Identify the potential impact on accounting for;
  - License agreements
  - Royalties
  - Milestone Payments
  - Multiple-element arrangements
  - Rights of return
- Discuss areas of judgment and related issues
- Identify what you need to do to gather data and the steps that you need to take to implement the standard
- Apply the intricacies of the standard needed in your evaluation process based on our discussion of the relevant industry examples

Considerations for Life Sciences Companies

License Agreements / Intellectual property

- Within step two: Identify each performance obligation in the contract
  - Licenses of intellectual property.
    - Is the license agreement a distinct and separate performance obligation?
    - To be considered a distinct good or service the following criteria must be met:
      - The licensee can benefit from the IP on its own or together with other resources that are readily available to the licensee.
      - The licensor promise to transfer the IP to the customer is separately identifiable from other promises in the contract.

License Agreements / Intellectual property – Example #1

Example #1

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

Result

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

License Agreements / Intellectual property – Example #2

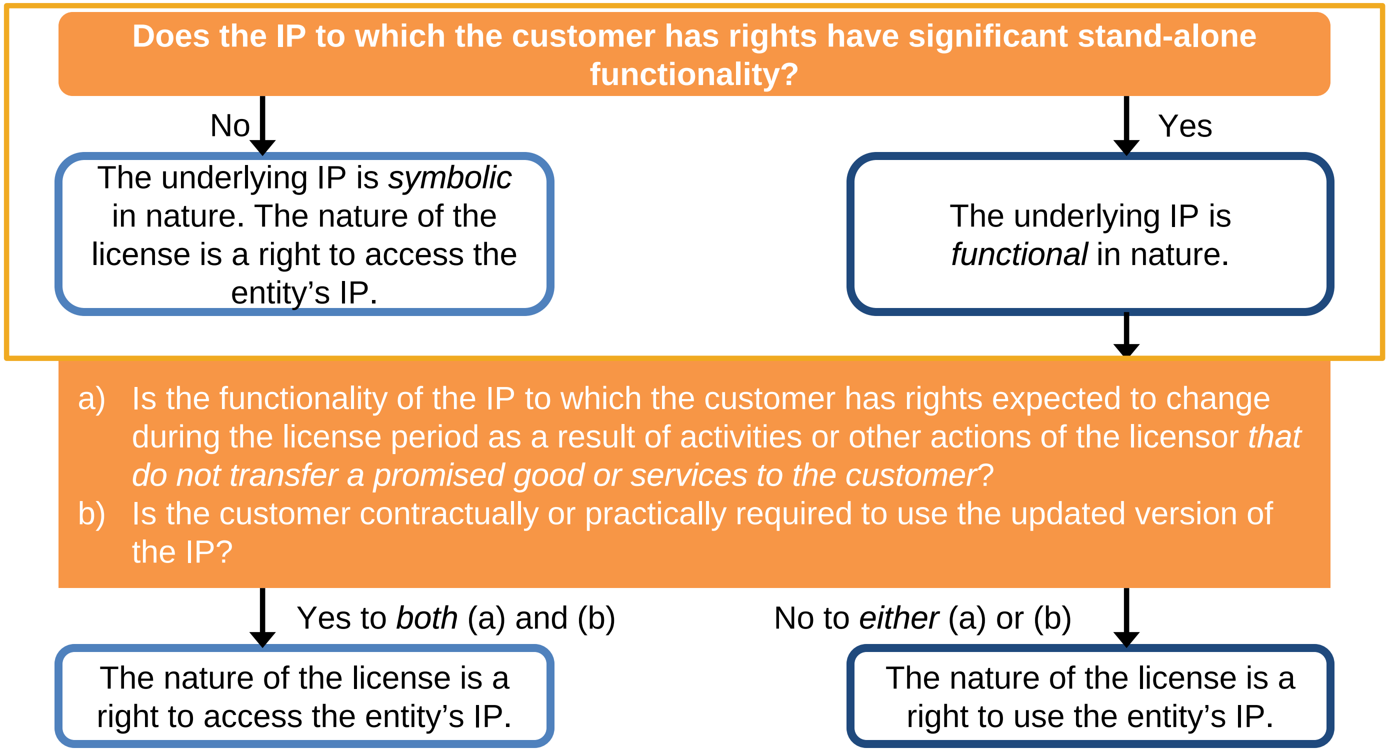
Example #2

- A Pharma company licenses to a customer its patent rights to an approved drug compound for 10 years and also promises to manufacture the drug for the customer for 5 years, while the customer develops its own manufacturing capability.
- The manufacturing process is not unique or specialized, and several other companies can also manufacture the drug for the customer.
- The drug is a mature product; therefore, there is no expectation that the entity will undertake activities to change the drug.
- There are no other promised goods or services in the contract.

Result

- The separate performance criteria has been met for each the license and the manufacturing service. The customer can benefit from the good or service either on its own or together with resources readily available other than the entity's manufacturing service, and can benefit from the manufacturing service together with the license transferred to the customer at the start of the contract.

Functional vs. Symbolic IP



License Agreements – Right to Access

Does the IP to which the customer has rights have significant stand-alone functionality?

No

The underlying IP is *symbolic* in nature. The nature of the license is a right to access the entity's IP.

Yes

The underlying IP is *functional* in nature.

a) Is the functionality of the IP to which the customer has rights expected to change during the license period as a result of activities or other actions of the licensor *that do not transfer a promised good or services to the customer*?
b) Is the customer contractually or practically required to use the updated version of the IP?

Yes to *both* (a) and (b)

The nature of the license is a right to access the entity's IP.

No to *either* (a) or (b)

The nature of the license is a right to use the entity's IP.

License Agreements – Right to Use

Does the IP to which the customer has rights have significant stand-alone functionality?

No

The underlying IP is *symbolic* in nature. The nature of the license is a right to access the entity's IP.

Yes

The underlying IP is *functional* in nature.

a) Is the functionality of the IP to which the customer has rights expected to change during the license period as a result of activities or other actions of the licensor *that do not transfer a promised good or services to the customer*?

b) Is the customer contractually or practically required to use the updated version of the IP?

Yes to *both* (a) and (b)

The nature of the license is a right to access the entity's IP.

No to *either* (a) or (b)

The nature of the license is a right to use the entity's IP.

Other License Considerations

- Contract Attributes - explicitly or implicitly require an entity to transfer control of additional goods or services

  Examples
  - Restrictions on time
  - Geographical region
  - Use

- Valid IP Guarantees

License Agreements – Summary

When evaluating license agreements the following must be looked at:

- Is the license agreement a separate performance obligation = a license of IP that is *distinct* from other goods and services in the contract.

- Determine the nature of the license
  - Right to access (symbolic intellectual property = brands, trade names, logos, and franchise rights.)
  - Right to use (functional intellectual property = software, biological compounds and drug formulas)

Polling Question #1

For a license agreement to be considered a distinct good or service the following criteria must be met:

A. The licensee can benefit from the IP on its own or together with other resources that are readily available to the licensee.

B. The licensor promise to transfer the IP to the customer is separately identifiable from other promises in the contract.

C. Both A and B

D. Neither A or B

Royalties

- A Company should recognize revenue for a sales-based or usage-based royalty promised in exchange for a license of intellectual property only when (or as) the later of the following occurs:
    - The subsequent sale or usage occurs
    - The performance obligation to which some or all of the sales-based or usage-based royalty has been allocated has been satisfied (or partially satisfied)
- The above guidance only applies to a license of intellectual property or when the license of intellectual property is the predominant item to which the royalty relates

Variable Consideration

- Under ASC 606, variable consideration, such as milestone payments, is included in the transaction price using a probability-weighted or most-likely-amount approach.
  - The transaction price is allocated to separate performance obligations based on relative standalone selling prices.
  - Payment is allocated when certain conditions are met

Variable Consideration - Continued

- Recognizing milestone income - Recognized as revenue when:
  - Related performance obligation is satisfied
  - Company determines that it is probable that there will not be a significant reversal of revenue recognized in future periods

- New standard may create more complexity and the need for more judgment when estimating revenue
  - High failure rates for product development projects may make it difficult to evaluate the likelihood of success for a project

Polling Question #2

Based on your current understanding of the New Revenue Recognition Standard, how significant do you believe the changes will be to your organization?

A. The changes will have a significant impact on both our financial statements and disclosures.

B. The changes will only have a significant impact on our financial statement disclosures.

C. The changes will have little impact on our financial statements and disclosures.

D. I need more time to fully evaluate the impacts.

Allocate the Transaction Price

- A customer contract may cover a bundle of goods or services. The new ASC 606 standard requires performance obligations to be accounted for separately if ***distinct***. For example:
  - The customer benefits from the item on its own or along with other readily available resources
  - The supplier does not provide a significant service of integrating the various performance obligations

- If performance obligations are distinct, the contract price is allocated between them based on the estimated standalone selling price of each performance obligation.

Allocate the Transaction Price

- The basic allocation principle has not changed under the new guidance; however, there are three specific differences that could affect allocation:
  - No contingent revenue cap under the revenue standards, although variable consideration could be constrained.
  - Allocation of discounts and variable consideration amounts to specific performance obligations if certain criteria are met.
  - Residual approach

Polling Question #3

Company A has licensed a FDA approved drug from company B. In performing the analysis of the agreement by company A to determine the proper accounting it was noted in the agreement the license contains a restriction on where company B can sell the products. This would be considered *what* in performing the analysis under the new standard:

A. Contract Attribute

B. Automatic classification of the contract as symbolic

C. Both A and B

D. Neither A or B

Right of Return

- Applies to both goods and service contracts when customer has a right to:
  - A full or partial refund of any amounts paid
  - A credit against amounts owed or will be owed
  - A credit to be applied to future purchase

- Consider as part of variable consideration and the revenue constraint
- Recognize a refund liability and recovery asset for goods it expects to be returned
- Restocking fees are included as part of the transaction price
  - Refund liability is reduced by any expected restocking fee
  - Recovery asset is reduced by any expected costs related to restocking.

- Does NOT apply to:
  - Exchanges of the same type, quality, condition and price are not considered returns
  - Returns of faulty or damaged products

Right of Return - Continued

- **Estimation methodology -** estimate sales returns using the more predictive of the expected-value method (e.g. probability-weighted estimates) or the most-likely-amount method

- **New product launch -** If a reasonable estimate cannot be made, revenue recognition is deferred until the return period lapses or a reasonable estimate can be made

- **Presentation -** The return is presented gross as a refund liability and an asset for recovery

Example: Expected Value Method

Dempsy research is a contract research organization providing services services for McGraw Medical Device company. Dempsy receives an annual fee of $100,000 for providing such research and is also eligible to receive an additional $50,000 performance bonus if it completes contracted research ahead of schedule:

Months again of schedule	Performance Bonus	% Chance of Achieving
5 Months	$50,000	5%
4 Months	$40,000	20%
3 Months	$30,000	45%
2 Months	$20,000	20%
1 Month	$10,000	10%

How much performance bonus revenue should be included in the transaction price?

Example: Expected Value Method - Continued

- Expected Value Approach:

  50,000 X 5%: \$2,500
  40,000 X 20%: \$8,000
  30,000 X 45%: \$13,500
  20,000 X 20%: \$4,000
  <u>10,000 X 10%: \$1,000</u>
  \$29,000

An entity needs to consider the constraint. In the case, the constraint likely limits the amount of revenue to one of the stated bonus amounts.

Example: Right of Return Scenario

McGraw Medical Devices sells various types of braces. McGraw has a 30-day return policy that allows customers to:

- Exchange a brace for another brace of the same type, quality, condition and price
- Return the brace for a full refund

The policy requires that all braces exchanged or returned must be "like new" with original packaging

During the year, McGraw sells 10,000 braces for $50 each, with a cost of $25 each. McGraw estimates:

- 25% probability that no braces will be returned
- 25% probability that 1% of its braces will be returned
- 25% probability that 2% of its braces will be returned
- 25% probability that 3% of its braces will be returned.

How much revenue should the company recognize for the sale of these units under the new standard?

Example: Right of Return Scenario - Solution

<u>Estimates</u>

.25 X 0%: 0%

.25 X 1%: .25%

.25 X 2%: .5%

<u>.25 X 3%: .75%</u>

1.5%

- 98.5% of braces will not be returned.
- The company will recognize $492,500 of revenue: (10,000 units x $50/unit) x 98.5% = $492,500

Recent Accounting Pronouncements

- ASC 808 – Collaborative Arrangements
  - Provides guidance for income statement presentation, classification, and disclosures related to collaborative arrangements

Objectives:

- Define collaborative arrangements
- Establish reporting requirements for transactions between participants in a collaborative arrangement and between participants in the arrangement and third parties

Polling Question #4

Based on the changes in the new standard, do you expect your company will need to make significant IT and software updates / upgrades?

A. We will need to make significant changes / updates to our software and systems

B. We will need to make minor changes to our existing systems

C. We will not need to make any significant changes

D. I need more time to figure out the IT impact

Questions

For additional resources, including industry specific information, visit the **Crowe Horwath LLP Revenue Recognition Resource Center:**

http://www.crowehorwath.com/

Thank you

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