Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In brief“ zur Thematik
“Buyer’s accounting for royalties and milestones payable to a seller in a business combination”
stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In brief

A look at current financial reporting issues

Buyer's accounting for royalties and milestones payable to a seller in a business combination

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Background

Acquisitions and divestitures have been headline news in the pharmaceutical and life sciences industry lately. With expiring patents on blockbuster products and downward pricing pressure, many companies have increased their M&A activity and turned to acquisitions to expand research pipelines in order to fuel innovation. In addition, companies have also looked to sell businesses or assets as part of R&D portfolio decisions to streamline operations and focus their efforts on faster growing areas of the business.

A common theme in acquisitions is that part of the purchase consideration may be in the form of future payments, such as royalties (i.e., the buyer has an obligation to make future royalty payments to the seller) or milestones. Payments related to these contingent obligations are often triggered by regulatory approval of in-process research and development (IPR&D) projects, or based on future performance measures, such as a percentage of sales.

Issue

There are various complex accounting judgments to consider under US GAAP and IFRS when a company purchases a compound or group of assets that meets the definition of a business and the consideration transferred includes an obligation to pay future royalties or milestone payments.

The first key judgment is to evaluate whether the transaction should be accounted for as a business combination or an asset acquisition. These types of transactions can be structured in a variety of ways, including outright acquisitions of legal entities, acquisitions of compounds or groups of assets, or licensing arrangements. Often, the determination of whether the buyer has acquired an asset or a business is complex and judgmental. The accounting for a business combination varies significantly from the accounting for an asset acquisition, particularly related to the treatment of future royalties or milestone payments and the treatment of IPR&D.

IFRS 3 and ASC 805 provide guidance for determining whether the buyer has acquired a business or an asset (or group of assets). Refer to *INT2015-03 Distinguishing a business from an asset or a group of assets (pharmaceutical and life sciences industry),* for further information regarding the accounting guidance, illustrations, and related implications. Whether the purchase or license of intellectual property meets the accounting definition of a business is a hot topic, and in many cases, arrangements that on the surface appear to convey only assets include other elements that, when combined, may meet the accounting definition of a business (and therefore are accounted for as a business combination). Because many acquisitions or licenses of intellectual property, particularly those still in development, include milestone or royalty payments to the seller/licensor, the accounting and valuation of those contingent payments is often complex[1].

Contingent consideration in a business combination

Under IFRS and US GAAP, in a business combination, contingent consideration represents an obligation of the acquirer to transfer additional assets or equity interests to the selling shareholders if future events occur or conditions are met. In evaluating whether future obligations to the selling shareholders represent contingent consideration, it is important to determine whether the payments represent part of the consideration transferred to acquire the business or represent a transaction separate from the business combination. Understanding the nature of the obligation, why the obligation exists, and whether there are other assets or benefits the buyer is receiving, will play a part in this analysis.

Generally, in a business combination, future royalty or milestone payments owed to the seller are treated as contingent consideration. The buyer should classify contingent consideration as a liability, an asset[2], or equity depending on its terms. All contingent consideration arrangements are initially measured at fair value on the acquisition date. Contingent consideration that is classified as a liability or asset is remeasured to fair value at each reporting date, with changes included in the income statement in the post-combination period until the uncertainty is resolved. Contingent consideration that is classified as equity is not remeasured, and is accounted for within equity upon settlement.

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[1] The FASB has undertaken a new project to reconsider the definition of a "business." The IASB has added the definition of a business to its research projects based on comments received from the post-implementation review of IFRS 3. Any changes to the definition may significantly impact the pharmaceutical and life sciences industry.

[2] Contingent consideration arrangements that represent an acquirer's right to receive a return of some consideration paid based on future events (i.e., contingently returnable consideration) would be recognized as an asset and measured at fair value [ASC 805-30-25-5, ASC 805-30-25-7]

Most contingent consideration arrangements in the pharmaceutical and life sciences industry are classified as liabilities, including both those settled in cash and certain equity-settled arrangements[3].

Assumed contingent consideration

Under US GAAP, any pre-existing contingent consideration arrangements of the acquiree assumed by the acquirer in a business combination should be accounted for by the acquirer as part of the consideration transferred and measured at acquisition date fair value. Consistent with the treatment of new contingent consideration arrangements, the accounting for assumed contingent consideration in the post-combination period is impacted by its classification as either an asset, liability, or equity.

Accounting under IFRS differs from US GAAP. An assumed contingent consideration arrangement is accounted for as an assumed liability (or in some instances, an asset) of the acquired business under IFRS. As these arrangements would almost always be established by a contract, they would fall within the scope of IAS 32 and 39 and be recognized at fair value on the acquisition date. Subsequently, they would be remeasured at fair value, with changes in value reflected in the income statement. The IASB concluded that such pre-existing arrangements do not constitute contingent consideration under IFRS 3 because the consideration does not arise from the current transaction between the acquirer and the former owners of the acquiree.

Compensation

The selling shareholders may become employees of the combined entity. It is important to determine whether any portion of the future royalty payments represents compensation to those selling shareholders/employees. When there is a requirement for continuing employment in order to be entitled to the future royalty payments, the cost of the arrangement is reflected as compensation expense in the buyer's financial statements in the post-combination period. When there is no requirement for continuing employment, a buyer must consider a number of indicators to determine whether the future royalty payments represent part of the purchase price or are separate transactions designed to compensate employees. These indicators include whether all selling shareholders receive the same per share payment regardless of employment, and whether employee compensation other than the contingent payments is at reasonable levels. If the arrangement is deemed to be compensation, the arrangement would not be contingent consideration under ASC 805 and IFRS 3R.

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[3] Determining the classification of a contingent consideration arrangement that is expected to be settled in an entity's own shares as a liability or equity at the acquisition date can be complex and will require an analysis of ASC 480, ASC 815-40 and ASC 815-40-15 before a company can determine the appropriate classification of an equity-settled contingent consideration arrangement.

Impact

Scenario: Acquisition of a business that includes future royalties payable to a seller

Background

Company A is a large pharmaceutical business that owns several compounds, including Compound X. Compound X recently received regulatory approval and Company A has contracted with a third party to manufacture Compound X. In addition, Company A has other contracts to purchase raw materials, has specific employees responsible for regulatory issues, and a dedicated sales force related to Compound X.

Company B enters into an agreement to acquire Compound X from Company A. The acquisition of Compound X includes transfer of the third-party manufacturing agreement and existing contracts for raw materials, and the fixed assets specific to Compound X, as well as certain employees dedicated to sales of Compound X. Company B determines that the set of acquired assets includes inputs, processes, and outputs and therefore concludes that the purchase of Company X constitutes a business.

Company B makes an up-front cash payment to Company A. Company B also agrees to pay Company A future royalties of 5% of the net sales of Compound X for the next three years.

How should Company B account for the royalty payments due to Company A?

Analysis –IFRS and US GAAP

Because it is the acquisition of a business, the future royalty payments to Company A (the seller) meet the definition of contingent consideration under both US GAAP and IFRS. Company B would record a liability equal to the fair value of the expected future royalty payments on the date of acquisition.

Company B would need to consider the key inputs of the arrangement and market participant assumptions when determining the fair value of the contingent consideration, including estimates of the amount, timing, and likelihood of expected royalties. The estimated fair value of the future royalty payments would be marked to market through earnings until the contingency is resolved.

Note that the valuation of acquired Compound X, if determined using a discounted cash flow model, would need to exclude any estimated future cash outflows already accrued as contingent consideration.

Further information can be found in *INT2015-01 Disposals – seller accounting for contingent consideration (pharmaceutical and life sciences industry)* for further accounting considerations in a disposition that includes future royalties.

Questions

PwC clients that have questions about this Industry Alert should contact their engagement partners.