Ihre Ansprechpartner

Sehr geehrte Damen und Herren,

für Rückfragen zu der beigefügten Publikation „In brief" zur Thematik "Disposals – seller accounting for contingent consideration (Pharmaceutical and life sciences industry)" stehen Ihnen folgende Ansprechpartner gerne zur Verfügung:

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In brief
A look at current financial reporting issues

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Disposals – seller accounting for contingent consideration (Pharmaceutical and life sciences industry)

Background

Contingent consideration arrangements in acquisitions and disposals are common within the Pharmaceutical and Life Sciences industry as they can be a convenient way of validating a company's value as well as sharing economic risk between the buyer and the seller. In the industry, many acquisitions and disposals involve compounds or devices that have not yet received regulatory approval, which inherently increases the risk that the degree of commercial success of what is acquired or sold may not be known at the date of acquisition. For example, a pharmaceutical company may prefer to pay the seller of a biotech company an upfront amount at the acquisition date and then pay an additional amount if one of the compounds acquired receives regulatory approval or reaches a specified sales target.

Pharmaceutical and Life Sciences Industry Alert 2013-2 "Contingent consideration in a business combination" discussed accounting issues from the acquirer's perspective. The acquirer's accounting for contingent consideration is outlined in the business combination standards (ASC 805 and IFRS 3). Those standards define consideration transferred by the acquirer to include the acquisition date fair value of contingent consideration. Depending on the terms of the contingent consideration, the acquirer either recognises, at the acquisition date, a liability or equity, at fair value. Liability-classified contingent consideration is remeasured to its fair value through current period earnings each subsequent reporting period. Equity-classified contingent consideration is not remeasured subsequent to its initial recognition. Liability-classified contingent consideration is more common in practice.

The focus of this alert is to discuss the accounting for contingent consideration from the seller's perspective. This is an area where IFRS and US GAAP are not aligned. Although there is relevant guidance under IFRS, there is no specific guidance under US GAAP. As a result, there has been diversity in practice. This matter was discussed by the EITF a few years ago, and the EITF agreed that different views could be supported but never issued specific guidance. Due to the lack of specific US GAAP guidance, questions have arisen about the initial and subsequent measurement and recognition of a seller's right to receive contingent consideration from a buyer in a business disposition.

Issue

US GAAP

When a company sells a business in a transaction that includes contingent consideration, the seller should determine when they will recognise the contingent consideration receivable and how they will measure the amount initially and in subsequent reporting periods.

The first step in this analysis is to determine whether the contingent consideration arrangement meets the definition of a derivative, and if so, whether it meets the scope exception under the derivatives and hedging guidance in ASC 815. If the arrangement meets the definition of a derivative in ASC 815-10-15-83 and does not qualify for the scope exception in ASC 815-10-15-59, it should be recorded at fair value on the acquisition date and subsequently adjusted to fair value each reporting period. In the basis for conclusions of ASC 805, the FASB acknowledged that most contingent consideration arrangements are financial instruments and that many meet the definition of a derivative. In cases where the event is not linked to revenue, net income, or EBITDA, the arrangement would not qualify for the scope exception. Contingent consideration arrangements where the underlying is revenue, net income or EBITDA, qualify for the scope exception in ASC 815-10-15-59[1], and would therefore not be accounted for as a marked-to market derivative. In the Pharmaceutical and Life Sciences industry, many contingent consideration payments are triggered as a result of certain sales targets to be reached. Such arrangements would generally qualify for the scope exception.

If the arrangement meets the definition of a derivative, but qualifies for the scope exception, or if it does not meet the definition of a derivative, then the seller will need to make an accounting policy election to either record the contingent consideration at fair value at the transaction date, or record the contingent consideration when the consideration is determined to be realisable (i.e., account for similar to a gain contingency). If the seller elects to record the contingent consideration only when it becomes realisable, the gain or loss recognised upon sale would be measured as the difference between the non-contingent payments and the carrying value of the disposed business.

If the seller records the contingent consideration at fair value on the disposal date, the gain or loss recognised upon sale would include the effect of the fair value of the contingent consideration arrangement. In this case, the seller will need to make a second policy election regarding measurement of the contingent consideration asset in periods subsequent to the disposition. A seller may elect to account for the arrangement under the fair value option or may elect to account for it as an interest-bearing financial instrument.

Assuming the contingent consideration arrangement is a derivative, but qualifies for the scope exception, or it is not a derivative, the elections related to the initial and subsequent accounting are both considered accounting policy elections. As such, they should be applied consistently to future transactions.

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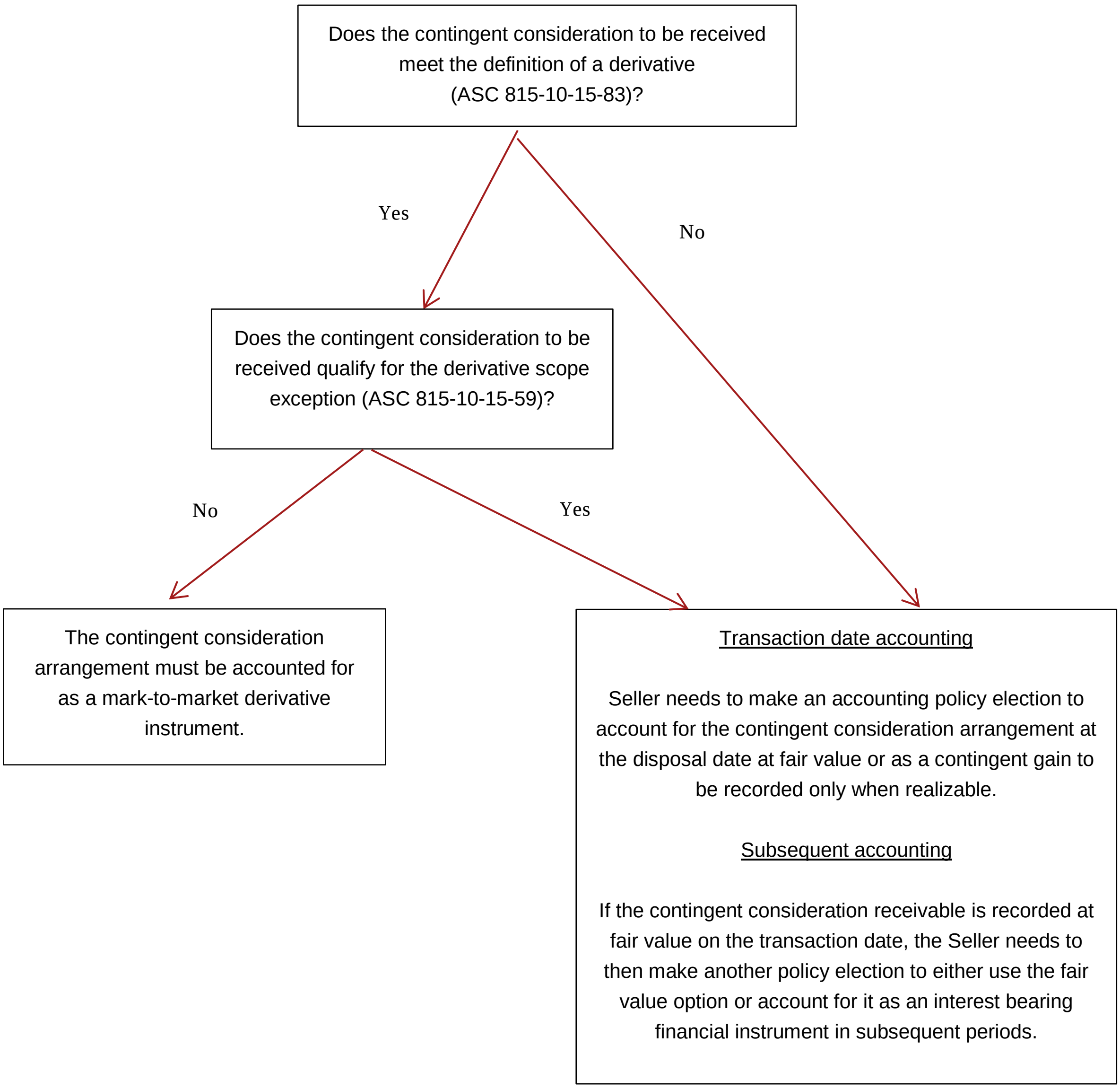
[1] Unless the income measure is due predominantly to the movement of the fair value of a portfolio of assets.

The following diagram summarizes the different scenarios



Some points for the seller to consider when making the policy election(s):

- The carrying amount (i.e., book value) of the net assets sold may be greater than the fixed portion of the sale consideration. In such cases, if the seller elects to recognise the contingent consideration asset only when realisable, this could result in a loss (or a larger loss) on the date of sale. In these circumstances, if and when the contingent consideration becomes realisable, the seller will recognise the contingent consideration and the related income statement impacts. Accordingly, recognition of the initial loss on sale may not be reflective of the aggregate economics of the transaction.

- If the seller elects to measure and record the contingent consideration asset at fair value on the transaction date, it may be difficult for the seller to obtain the necessary operating information needed to make the periodic estimates of fair value. Sellers may want to consider adding terms to the transaction agreement that require the buyer to provide the relevant information throughout the contingency period.

- The longer the term of the contingent payment arrangement, the more difficult it may be to determine the fair value of the asset on the acquisition date and thereafter.

- Electing the fair value option for measuring the contingent consideration asset may lead to more volatility in the operating results of the seller after the disposal transaction.

IFRS

Contingent consideration agreements generally grant the seller the right to receive cash or other financial assets when the contingency is resolved, and therefore meet the definition of a financial asset under IFRS. The financial asset should be included as part of consideration received at the transaction date and should be measured using one of the four measurement categories specified in IAS 39: financial assets at “fair value through profit or loss”, held to maturity investments, loans and receivables, or available-for-sale financial assets.

Determining the contingent consideration arrangement’s classification will require judgment and will be based on the specific facts and circumstances of each arrangement. Financial assets resulting from contingent consideration will generally be classified as available for sale because the uncertainty of the cash flows and timing of payments typically preclude classification in the other categories.

The classification dictates how the financial assets are subsequently measured in the financial statements. Available-for-sale assets are subsequently measured at fair value, with changes in fair value recognised through other comprehensive income except for:

- Interest calculated using the effective interest method.
- The present value of any changes in the expected cash flows (discounted at the original effective interest rate). [IAS 39 para AG8.]
- Foreign exchange gains and losses on monetary financial assets.
- Impairment.

which are recognised in profit or loss. In practice this often has the effect that most of the change in fair value is recognised in profit or loss with the amounts recognised in OCI being only the effect of discounting at a current rate rather than the original rate. Upon receipt of the payment, any amounts in other comprehensive income are recycled to the income statement.

Additional guidance

Further information can be found in section 2.6.4.8 to the 'Business combinations and Noncontrolling interests' guide (PwC 2014).

Illustrative examples

Facts

Company A sold its entire controlling stake in wholly-owned Subsidiary B on 1/1/x1. The proceeds of the sale included CU 80 million in cash paid upfront plus a contingent payment of CU 40 million if Subsidiary B's revenue reached CU 200 million by 12/31/x1. The contingent payment would be due and payable on 12/31/x1. As of the transaction date, the fair value of the contingent payment was estimated to be CU 30 million. The carrying amount of net assets of Subsidiary B on the transaction date was CU 100 million. Subsidiary B's revenue was CU 275 million by 12/31/x1. For simplicity, this example assumes no income

tax impact of the sale. Company A accounted for the contingent consideration arrangement based on the following information:

- Determined that the contingent consideration arrangement doesn't meet the criteria to be accounted for as a derivative.
- For US GAAP, the seller can make an accounting policy election to either record the contingent consideration portion of the arrangement at fair value at the transaction date or record only when the consideration is determined to be realisable.
- If US GAAP reporter elects reporting at fair value at transaction date, subsequent accounting for the financial instrument is also a policy decision to either account for the arrangement using the fair value option or as an interest bearing financial instrument.
- For IFRS, the contingent consideration arrangement is considered an available for sale debt asset.

US GAAP Analysis

Scenario 1 - Company A elects to record the contingent consideration arrangement when the consideration is determined to be realizable

Company A would not record a contingent consideration asset at the transaction date. On the transaction date, Company A would recognize a loss of CU 20 million in the income statement, which reflects the difference between the CU 100 million carrying amount of net assets and the CU 80 million proceeds received. When the asset becomes realizable, in this case on 12/31/x1, the Company would recognize a gain equal to the realizable amount. In this scenario, a gain of CU 40 million would be recognized on 12/31/x1, representing the full CU 40 million contingency payment due when revenue exceeded the target level.

Scenario 2 - Company A elects to record the contingent consideration arrangement at fair value at the transaction date

Company A would record the fair value of contingent consideration at the transaction date (CU 30 million). As a result, Company A would record a gain of CU 10 million on the transaction date (initial cash payment of CU 80 million + fair value of contingent consideration arrangement asset of CU 30 million – carrying value of net assets of CU 100 million).

Scenario 2a - Company A elects the fair value option for subsequent accounting

Company A would need to remeasure the fair value of the contingent consideration asset at each reporting period. Any changes in fair value of the contingent consideration asset would be recorded as income or loss in the income statement. In this case, the net increase from CU30 million to CU40 million would be recognized over the period leading up to 12/31/x1, although amounts may have fluctuated during the period.

Scenario 2b - Company A elects the interest bearing financial instrument option for subsequent accounting

Company A would accrete the contingent consideration asset from CU 30 million to CU40 million (the ultimate payment amount) using the effective interest method. This calculation would reflect any changes in the projected payment on a periodic basis. An assessment of impairment would be required each reporting period.

IFRS Analysis

Company A would record a financial asset at fair value at the transaction date (CU 30 million). As a result, Company A would record a gain of CU 10 million on the transaction date (initial cash payment of CU 80 million + fair value of contingent consideration arrangement asset of CU 30 million – carrying value of net assets of CU 100 million).

Subsequently, changes in fair value are recognized as follows:

- Interest, the present value of any changes in the expected cash flows (discounted at the original effective interest rate), foreign exchange gains and losses and impairment if applicable are recognised in profit or loss.
- Any remaining change in fair value is recognized in OCI.

Questions

PwC clients that have questions about this Industry Alert should contact their engagement partners. Engagement teams that have questions relating to US GAAP should contact Karen Young (1 973 236 5648), John Hayes (1 973 236 4452), Pamela Yanakopulos (1 312 298 3798), Erin Bennett (1 973 236 4623), or Eitan Zamir (1 973 236 4218). Engagement teams that have questions relating to IFRS should contact Mary Dolson (44 (0)207 804 2930) or Ruth Preedy (44 (0)207 213 2123).