Deloitte.

June 2014

Life Sciences Spotlight

Navigating the New Revenue Standard

In This Issue:

- Background
- Key Accounting Issues
- Effective Date and Transition
- Transition Considerations
- Thinking Ahead

The Bottom Line

The ASU's guidance on licenses could result in significant changes to the timing of revenue recognition for arrangements in the industry.

- On May 28, 2014, the FASB and IASB issued their final standard on revenue from contracts with customers. The standard, issued by the FASB as ASU 2014-09,[1] outlines a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance.
- In applying the ASU's provisions on determining the goods or services in an arrangement that are to be accounted for individually (i.e., as performance obligations), an entity may combine more goods and services for accounting purposes than it did previously. However, the presence of contract options in certain arrangements in the life sciences industry (e.g., licenses) could result in additional performance obligations to which revenue may be attributed.
- The ASU's requirements related to variable consideration may change the manner in which revenue is recognized for arrangements in the life sciences industry (e.g., revenue recognition for milestones may be accelerated); in such cases, management may need to use significant judgment when applying the ASU.
- The ASU's guidance on licenses, including whether license revenue should be recognized at a point in time or over time, could result in significant changes to the timing of revenue recognition for arrangements in the industry. When the consideration consists of sales-based royalties or payments, however, the timing of revenue recognition is not likely to differ significantly from current practice.
- In addition to considering the ASU's potential impact on accounting policies, entities should begin assessing which transition approach — and, for private companies, which adoption date — is most appropriate for them. This assessment should weigh factors such as resource requirements and the needs of financial statement users.

[1] FASB Accounting Standards Update No. 2014-09, *Revenue From Contracts With Customers.*

Beyond the Bottom Line

This *Life Sciences Spotlight* discusses the new revenue model and highlights key accounting issues and potential challenges for life sciences entities that account for revenue under U.S. GAAP. For additional information about the new standard, see Deloitte's May 28, 2014, *Heads Up*.

Background

The goal of the revenue recognition project is to clarify and converge the revenue recognition principles under U.S. GAAP and IFRSs and to develop guidance that would streamline and enhance revenue recognition requirements while also providing "a more robust framework for addressing revenue issues." The boards believe that the standard will improve the consistency of requirements, comparability of revenue recognition practices, and usefulness of disclosures.

The ASU retains the overall model originally proposed, which outlines five sequential steps to recognizing revenue:

1. Identify the contract(s) with a customer.
2. Identify the performance obligations in the contract.
3. Determine the transaction price.
4. Allocate the transaction price to the performance obligations in the contract.
5. Recognize revenue when (or as) the entity satisfies a performance obligation.

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary.

The ASU states that the core principle of the new revenue recognition guidance is that an "entity shall recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."

Thinking It Through

As a result of the ASU, entities will need to comprehensively reassess their current revenue accounting and determine whether changes are necessary. In addition, the ASU requires significantly expanded disclosures about revenue recognition, including both quantitative and qualitative information about (1) the amount, timing, and uncertainty of revenue (and related cash flows) from contracts with customers; (2) the judgment, and changes in judgment, exercised in applying the revenue model; and (3) the assets recognized from costs to obtain or fulfill a contract with a customer.

Key Accounting Issues

Identifying the Performance Obligations in the Contract (Step 2)

Many arrangements in the life sciences industry involve multiple goods or services. For example, a biotechnology company may perform contract research services in connection with the license of intellectual property (IP) or a medical device company may sell a medical device along with consumables, maintenance, or training. These goods and services may be promised in a single contract or in separate contracts. The ASU provides guidance on evaluating the promised "goods or services"[2] in a contract to determine each performance obligation (i.e., the unit of account). A performance obligation is each promise to transfer either of the following to a customer:

- "A good or service (or a bundle of goods or services) that is distinct."
- "A series of distinct goods or services that are substantially the same and that have the same pattern of transfer to the customer."[3]

[2] Although the ASU does not define goods or services, it includes several examples, such as goods produced (purchased) for sale (resale), granting a license, and performing contractually agreed-upon tasks.

[3] A series of distinct goods or services has the same pattern of transfer if both of the following criteria are met: (1) each distinct good or service in the series would meet the criteria for recognition over time and (2) the same measure of progress would be used to depict performance in the contract.

A promised good or service is distinct (and therefore a performance obligation) if both of the following criteria are met:

- *Capable of being distinct* — "The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer."
- *Distinct in the context of the contract* — "The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract." The ASU provides the following indicators for evaluating whether a promised good or service is separable from other promises in a contract:
    - "The entity does not provide a significant service of integrating the good or service with other goods or services promised in the contract. . . . In other words, the entity is not using the good or service as an input to produce or deliver the combined output specified by the customer."
    - "The good or service does not significantly modify or customize another good or service promised in the contract."
    - "The good or service is not highly dependent on, or highly interrelated with, other goods or services promised in the contract. For example, . . . a customer could decide to not purchase the good or service without significantly affecting the other promised goods or services."

The requirement that a good or service be "separately identifiable from other promises in the contract" is a new concept under which entities must further evaluate a good or service for separability.

Thinking It Through

The ASU's guidance on determining whether a customer can benefit from a good or service on its own, or with other readily available resources, is generally consistent with the current guidance in ASC 605-25[4] on determining whether a good or service has stand-alone value. However, the requirement that a good or service be "separately identifiable from other promises in the contract" is a new concept under which entities must further evaluate a good or service for separability. For example, life sciences entities that sell a license bundled with contract research services may need to use significant judgment when determining whether the goods or services in a contract are "highly dependent on, or highly interrelated with" or "significantly modify or customize" each other. This new concept may require entities to account for a bundle of goods or services, which may qualify for separate accounting under current U.S. GAAP, as a single performance obligation (unit of account).

Options

License arrangements in the life sciences industry often contain options (e.g., use of a specific formulation for additional indications or territories, conversion of a nonexclusive license to exclusive, or extension of a license's term). Under the ASU, an option given to a customer to acquire additional goods or services represents a performance obligation if it provides a customer with a "material right" that the customer otherwise would not have received without entering into the contract. If an option is deemed a performance obligation, an entity must allocate a portion of the transaction price to the option and recognize revenue when control of the goods or services underlying the option is transferred to the customer or when the option expires.

Thinking It Through

Life sciences entities may need to use significant judgment in evaluating whether options, in the context of license arrangements in the industry, convey a material right to a customer. Options that are deemed performance obligations would result in a deferral of revenue.

[4] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*."

Determining the Transaction Price (Step 3)

The ASU requires an entity to determine the transaction price, which is the amount of consideration to which it expects to be entitled in exchange for the promised goods or services in the contract. The transaction price can be a fixed amount or can vary because of "discounts, rebates, refunds, credits, price concessions, incentives, performance bonuses, penalties, or other similar items."

Variable Consideration

Arrangements in the life sciences industry often contain substantial amounts of variable consideration, including deductions (e.g., rebates, chargebacks, and returns) and contingent payments (e.g., milestones and royalties). When the transaction price includes a variable amount, an entity is required to estimate the variable consideration by using either an "expected value" (probability-weighted) approach or a "most likely amount" approach, whichever is more predictive of the amount to which the entity expects to be entitled (subject to the "constraint" discussed below).

Under the ASU, some or all of an estimate of variable consideration is only included in the transaction price (i.e., the amount to be allocated to each unit of account and recognized as revenue) to the extent that it is probable[5] that subsequent changes in the estimate would not result in a "significant reversal" of revenue (this concept is commonly referred to as the "constraint"). The ASU requires entities to perform a qualitative assessment that takes into account both the likelihood and magnitude of a potential revenue reversal and provides factors that could indicate that an estimate of variable consideration is subject to significant reversal (e.g., susceptibility to factors outside the entity's influence, a long period before uncertainty is resolved, limited experience with similar types of contracts, practices of providing concessions, or a broad range of possible consideration amounts). This estimate and the consideration of the constraint would be updated in each reporting period to reflect changes in facts and circumstances.

The ASU's less restrictive guidance on variable consideration will most likely result in earlier recognition of revenue under the ASU than under current U.S. GAAP.

Thinking It Through

The ASU's less restrictive guidance on variable consideration will most likely result in earlier recognition of revenue under the ASU than under current U.S. GAAP. The following are some specific instances in which revenue may be recognized earlier:

- *Milestones* — An entity may determine that the constraint has been satisfied before the milestone is achieved (i.e., the current recognition requirement under ASC 605-28). However, in such instances, the actual recognition of the consideration included in the transaction price would still depend on the treatment of the milestone under the remaining steps of the model. First, an entity must determine whether a milestone payment is associated with a separate performance obligation or the contract as a whole (i.e., all the performance obligations) and allocate the associated consideration in such a manner. Then, under step 5 of the revenue recognition model, the actual recognition of the consideration included in the transaction price would depend on whether and, if so, how the underlying performance obligation is satisfied.

[5] Like the term "probable" related to the collectibility threshold in step 1, "probable" in this context has the same meaning as in ASC 450-20: "the event or events are likely to occur." In IFRS 15, the IASB uses the term "highly probable," which has the same meaning as the FASB's "probable."

- *Product sales currently accounted for under the sell-through method* — An entity may conclude that there is a basis on which to recognize some amount of revenue in circumstances in which it would currently be deferred (e.g., because of the inability to reasonably estimate returns under ASC 605-15 or the lack of a determinable sales price under SAB Topic 13[6]); thus, revenue recognition in such situations may no longer be an "all or nothing" proposition. However, in such instances, the actual recognition of the consideration included in the transaction price would still primarily depend on whether the underlying performance obligation is satisfied (i.e., a transfer-of-control assessment under step 5).
- *Sales of IP* — An entity eligible to receive a future stream of payments in connection with the *sale* of IP would need to assess whether the threshold for inclusion in the transaction price has been satisfied, both at inception and throughout the arrangement. For example, an entity may determine that there is a minimum amount of future royalties to be collected under the arrangement and that the reversal of this amount is not probable if it were to be recognized up front. Royalties related to the *license* of IP, however, are subject to a different constraint, described in the Licenses section below. Therefore, distinguishing between the *sale* and *license* of IP will be critical to determining when sales- or usage-based payments are included in the transaction price.

To comply with the ASU's requirements for estimating the transaction price and determining what amount, if any, is subject to potential reversal (and should be excluded from the transaction price), management will (for some arrangements in the life sciences industry) need to use significant judgment, particularly since the transaction price must be updated in each reporting period. Furthermore, for each arrangement, management will need to consider which measurement approach (i.e., expected value vs. most likely amount) is most predictive.

Distinguishing between the *sale* and *license* of IP will be critical to determining when sales- or usage-based payments are included in the transaction price.

Significant Financing Component

Adjustments for the time value of money are required if the contract includes a "significant financing component" (as defined by the ASU). No adjustment is necessary if payment is expected to be received within one year of the transfer of the goods or services to the customer. However, when an entity concludes that a significant financing component exists on the basis of the payment terms, the entity should adjust the sales price when recording revenue to present the amount that would have been attained had the buyer paid cash for the goods or services on the date of sale.

Thinking It Through

For life sciences entities, a significant financing component may exist in arrangements involving the license or sale of IP because of variations in the timing of payments versus the satisfaction of the performance obligation. For example, a financing component could exist when a significant up-front fee is received in connection with the license of IP for which revenue is being recognized over time. However, the ASU also indicates that when a "substantial amount" of consideration is variable and not "substantially within the control" of either party to the contract, a contract would not have a significant financing component. Therefore, if such a license arrangement also requires the payment of sales-based royalties (that are viewed to be a substantial portion of the total consideration), a significant financing component would not be present under the ASU. Management may need to use significant judgment in applying the notions of "substantial amount" and "substantially within the control."

[6] SEC Staff Accounting Bulletin No. 13, *Revenue Recognition*.

Recognize Revenue When (or as) the Entity Satisfies a Performance Obligation (Step 5)

Under the ASU, a performance obligation is satisfied (and the related revenue recognized) when control of the underlying goods or services (the "assets") related to the performance obligation is transferred to the customer. The ASU defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset." An entity must first determine whether control of a good or service is transferred over time. If so, the related revenue is recognized over time as the good or service is transferred to the customer. If not, control of the good or service is transferred at a point in time.

Recognizing Revenue Over Time

Control of a good or service (and therefore satisfaction of the related performance obligation) is transferred over time when at least one of the following criteria is met:

- "The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs."
- "The entity's performance creates or enhances an asset . . . that the customer controls as the asset is created or enhanced."
- "The entity's performance does not create an asset with an alternative use to the entity . . . and the entity has an enforceable right to payment for performance completed to date."

If a performance obligation is satisfied over time, an entity recognizes revenue by measuring progress toward satisfying the performance obligation in a manner that best depicts the transfer of goods or services to the customer. The ASU provides specific guidance on measuring progress toward completion, including the use of output and input methods.

The ASU defines "control" as "the ability to direct the use of, and obtain substantially all of the remaining benefits from, the asset."

Thinking It Through

Life sciences entities may enter into arrangements, such as contract research, that are accounted for under the proportional performance method. Under the ASU, an entity cannot automatically use similar accounting to recognize revenue; instead, one of the above three criteria must be satisfied for revenue to be recognized over time. Arrangements that fail to meet any of these criteria would be recognized at a point in time, as they would be under the completed-contract method in current practice.

Recognizing Revenue at a Point in Time

If a performance obligation is not satisfied over time, it is deemed satisfied at a point in time. Under the ASU, entities would consider the following indicators in evaluating the point at which control of an asset has been transferred to a customer:

- "The entity has a present right to payment for the asset."
- "The customer has legal title to the asset."
- "The entity has transferred physical possession of the asset."
- "The customer has the significant risks and rewards of ownership of the asset."
- "The customer has accepted the asset."

The ASU also contains implementation guidance related to consignment arrangements, bill-and-hold arrangements, and customer acceptance conditions.

Thinking It Through

The ASU requires entities to recognize revenue by using a control-based model rather than the risks-and-rewards model of current U.S. GAAP. While this requirement will generally not affect the timing of revenue recognition in the industry, exceptions may exist. For example, life sciences entities may ship goods under conditions commonly described as "synthetic FOB destination," whereby the goods are shipped FOB shipping point but the seller continues to bear the risk of loss while the product is in transit. Under current U.S. GAAP, it is not appropriate to recognize revenue in such cases before the goods are ultimately delivered to the buyer. Under the ASU, however, such an arrangement may give rise to two performance obligations (e.g., if products are frequently lost or damaged during shipping): (1) the sale of a product and (2) protection against the risk of loss during transit, in which case the transaction price would need to be allocated to each performance obligation and the satisfaction of each performance obligation would be separately assessed. As a result, revenue recognition in these circumstances could be accelerated, depending on the determination of when control is transferred for the underlying performance obligations.

In addition, life sciences entities will need to carefully review contract terms and practices related to product returns. In doing so, an entity would first evaluate whether control of the product has been transferred to the customer and would then consider the requirements for assessing variable consideration.

The ASU requires entities to recognize revenue by using a control-based model rather than the risks-and-rewards model of current U.S. GAAP.

Licenses

Licenses of IP are prevalent in the life sciences industry. The ASU contains specific guidance on licenses, including when the consideration should be included in the transaction price and when that transaction price should be recognized as revenue.

Including Sales-Based License Fees in the Transaction Price (Step 3)

Under the ASU, the variable consideration constraint does not apply to sales- or usage-based royalties derived from IP licensing; rather, such contingent consideration is only recognized as revenue at the later of when the performance obligation is satisfied or when the uncertainty is resolved (e.g., when subsequent sales or usage occurs).

Thinking It Through

This constraint will generally result in the recognition of sales-based royalties and payments in a manner consistent with current practice. However, certain exceptions may arise, including:

- *Minimum royalties* — An entity may conclude that a portion of the consideration under the arrangement, because of its fixed nature (e.g., a guaranteed minimum), does not constitute a sales- or usage-based royalty and therefore may be included in the transaction price at the inception of the arrangement (if the constraint is satisfied) and recognized as revenue up front (if the license represents a performance obligation satisfied at a point in time for which a transfer of control has occurred).
- *Perpetual licenses* — Because contingent payments related to *sales* of IP are treated differently than those related to *licenses* of IP, questions may arise regarding whether a perpetual license constitutes an in-substance sale under the ASU and, as a result, whether the sales-based royalty exception to the constraint is applicable.

For the items described above, the actual recognition of the consideration included in the transaction price would still depend on whether and, if so, how the underlying performance obligation is satisfied, as described below.

Recognizing Transaction Price Attributable to Licenses as Revenue (Step 5)

The ASU's guidance on determining whether a license represents a performance obligation satisfied over time or at a point in time is applicable if the license is distinct from other promised goods or services in the contract, as determined under step 2. If a license is not distinct (i.e., the license is combined with other goods or services into a unit of account), an entity would apply the general criteria in step 5, discussed previously, for evaluating whether control of that unit of account is transferred over time or at a point in time.

For distinct licenses, an entity must determine whether the license gives the customer the "right to use the entity's [IP] as it exists at the point in time at which the license is granted" (a "static" license for which control is transferred at a point in time) or "a right to access the entity's [IP] as it exists throughout the license period" (a "dynamic" license for which control is transferred over time).

For a distinct license to represent a right to access the entity's IP, all of the following criteria must be met:

- "The contract requires, or the customer reasonably expects, that the entity will undertake activities that significantly affect the [IP]."
- "The rights granted by the license directly expose the customer to any positive or negative effects of the entity's activities."
- "Those activities do not result in the transfer of a good or a service to the customer."

Even when licenses in the industry qualify for revenue recognition at a point in time, the variable consideration constraint may still result in the recognition of revenue over time.

If these criteria are met, the consideration allocated to the license is recognized as revenue over time. If the criteria are not met, the license is deemed a right to use and the consideration allocated to it is recognized at a point in time.

The ASU's implementation guidance contains illustrations (examples 54–61) of the application of this guidance to licensing arrangements.

Thinking It Through

To determine whether a license is transferred to a customer at a point in time (right of use) or over time (right to access), life sciences entities must first determine whether a license is distinct (under step 2) before considering the above criteria. If a license is not distinct (i.e., it is combined with other goods or services into a performance obligation), entities would use the general criteria for assessing whether a performance obligation is satisfied over time.

Even when licenses in the industry qualify for revenue recognition at a point in time, the variable consideration constraint — and, more specifically, the exemption from including sales-based royalties and payments in the transaction price as described in the section above — may still result in the recognition of revenue over time. For example, if a license represents a performance obligation satisfied at a point in time (i.e., at inception) but payments under the license are sales-based royalties, revenue would still be recognized over time (i.e., as the royalty payments are triggered). However, if fixed up-front payments are present, the assessment of whether a license is "static" or "dynamic" will be particularly significant to determining the pattern of recognition for those payments.

Other Accounting Issues

Collaborative Arrangements

Life sciences entities often use collaborative arrangements to spread risk and leverage outside expertise. The ASU broadly applies to contracts with customers and defines a

customer as "a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration." The ASU notes:

> A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities.

Thinking It Through

The ASU does not change the guidance in ASC 808-10 on the income statement presentation and classification, and disclosures, applicable to collaborative arrangements within the ASU's scope. While entities will need to evaluate whether the counterparty to a collaborative arrangement meets the ASU's definition of a customer, the activities currently accounted for under ASC 808-10 are generally not likely to be within the scope of the ASU since ASC 808-10 currently requires that entities share in "significant risks and rewards." However, the extent to which the ASU would be applied, by analogy, to activities in a collaborative arrangement remains to be seen.

Collectibility

Life sciences entities may experience unusually high rates of collection issues with specific types of customers or in certain geographic regions (e.g., southern Europe). Under the ASU, an entity must determine whether it is probable that it will collect the consideration to which it expects to be entitled before accounting for the contract. Any amounts received before collectibility is considered probable would only be recorded as revenue if the consideration received is nonrefundable and either (1) all performance obligations in the contract have been satisfied and substantially all the promised consideration has been received or (2) the contract has been terminated or canceled. If either of those conditions is not met, any consideration received would be recognized as a liability.

The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract.

Thinking It Through

This collectibility threshold is similar to that in SAB Topic 13. However, arrangements in the life sciences industry may contain significant amounts of variable consideration (e.g., discounts, concessions). Under the ASU, entities would first need to estimate the transaction price under the contract (step 3) and then apply the collectibility threshold to the transaction price before accounting for the arrangement further.

Contract Costs

Some life sciences entities, such as medical device companies, may incur contract acquisition costs in connection with long-term contracts. The ASU contains criteria for determining when to capitalize costs associated with obtaining and fulfilling a contract. Specifically, entities are required to recognize an asset for incremental costs of obtaining a contract (e.g., sales commissions) when those costs are expected to be recovered (as a practical expedient, a recognized asset with an amortization period of less than a year can be expensed as incurred). Costs of fulfilling a contract (that are not within the scope of other standards) would be capitalized only when they (1) are directly related to a contract, (2) generate or enhance resources that will be used to satisfy performance obligations, and (3) are expected to be recovered. The ASU also requires entities to expense certain costs, such as those related to satisfied (or partially satisfied) performance obligations. Capitalized costs would be amortized in a manner consistent with the pattern of transfer of the goods or services to which the asset is related (which may extend beyond the original contract term in certain circumstances).

Thinking It Through

Life sciences entities may need to consider the impact of this guidance on their current cost capitalization practices, if any. Some contracts in the industry may not qualify for the practical expedient (i.e., exemption from capitalization) because of their duration, including expected renewals. As a result, some life sciences entities may be required to capitalize qualifying costs and thus may need to use judgment in determining (1) which acquisition costs are incremental to a contract with a customer (e.g., questions may arise regarding complex commission structures), (2) the period over which capitalized costs will be amortized (i.e., periods of expected contract renewals would be included), and (3) the approach to monitoring the resulting assets for impairment on an ongoing basis (this may be challenging when there is a large volume of underlying contracts).

Disclosures

The ASU requires entities to disclose both quantitative and qualitative information that enables "users of financial statements to understand the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers." The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards. For additional information about the new disclosure requirements, see Deloitte's May 28, 2014, *Heads Up*.

Effective Date and Transition

The ASU's disclosure requirements are significantly more comprehensive than those in existing revenue standards.

The ASU is effective for annual reporting periods (including interim reporting periods within those periods) beginning after December 15, 2016, for public entities. Early application is not permitted (however, early adoption is optional for entities reporting under IFRSs). Nonpublic entities can use the same effective date as public entities (regardless of whether interim periods are included) or postpone adoption for one year from the effective date for public entities.

Entities have the option of using either a full retrospective or a modified approach to adopt the guidance in the ASU. Retrospective application would take into account the requirements in ASC 250 (with certain practical expedients). Under the modified approach, an entity recognizes "the cumulative effect of initially applying [the ASU] as an adjustment to the opening balance of retained earnings . . . of the annual reporting period that includes the date of initial application" (revenue in periods presented in the financial statements before that date is reported under guidance in effect before the change). Under the modified approach, the guidance in the ASU is only applied to existing contracts (those for which the entity has remaining performance obligations) as of, and new contracts after, the date of initial application. The ASU is not applied to contracts that were completed before the effective date (i.e., an entity has no remaining performance obligations to fulfill). Entities that elect the modified approach must disclose an explanation of the impact of adopting the ASU, including the financial statement line items and respective amounts directly affected by the standard's application.

Thinking It Through

The modified transition approach provides entities relief from having to restate and present comparable prior-year financial statement information; however, entities will still need to evaluate existing contracts as of the date of initial adoption under the ASU to determine whether a cumulative adjustment is necessary. Therefore, entities may want to begin considering the typical nature and duration of their contracts to understand the impact of applying the ASU and to determine the transition approach that is practical to apply and most beneficial to financial statement users.

Transition Considerations

Increased Use of Judgment

Management will need to exercise significant judgment in applying certain of the ASU's requirements, including those related to the identification of performance obligations and allocation of revenue to each performance obligation. It is important for life sciences entities to consider how the standard specifically applies to them so that they can prepare for any changes in revenue recognition patterns.

Retrospective Application

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion. As a result, life sciences entities may need to assess contracts that commenced several years before the ASU's effective date. In addition, life sciences entities will most likely be required to perform dual tracking of revenue balances during the retrospective period given the potential difficulty of retroactively recalculating revenue balances when the ASU becomes effective.

Systems, Processes, and Controls

To comply with the ASU's new practice and disclosure requirements, life sciences entities will have to gather and track information that they may not have previously monitored. The systems and processes associated with such information may need to be modified to support the capture of additional data elements that may not currently be supported by legacy systems. Further, to ensure the effectiveness of internal controls over financial reporting, management will want to assess whether it should implement additional controls. Life sciences entities may also need to begin aggregating essential data from new and existing contracts since many of these contracts will most likely be subject to the ASU.

The ASU allows entities to apply the standard retrospectively and use certain optional practical expedients at their discretion.

Note that the above are only a few examples of changes life sciences entities may need to make to their systems, processes, and controls; such entities should evaluate all aspects of the ASU's requirements to determine whether any other modifications may be necessary.

Income Taxes

Federal income tax law provides both general and specific rules for recognizing revenue on certain types of transactions (e.g., long-term contracts and arrangements that include advance payments for goods and services). These rules are often similar to the method a taxpayer uses for financial reporting purposes and, if so, the taxpayer employs the revenue recognition method it applies in maintaining its books and records (e.g., cash basis, U.S. GAAP, IFRSs). Although the Internal Revenue Code (IRC) does not require entities to use any particular underlying financial accounting method to determine their taxable income (such as U.S. GAAP), entities must make appropriate adjustments (on Schedule M) to their financial accounting pretax income to determine taxable income under the IRC.

The ASU may change the timing of revenue recognition and, in some cases, the amount of revenue recognized for entities that maintain their books and records under U.S. GAAP or IFRSs. These changes may also affect taxable income. Thus, it will be important for tax professionals to understand the detailed financial reporting implications of the standard so that they can analyze the tax ramifications and facilitate the selection of any alternative tax accounting methods that may be available.

If a change in a tax accounting method is advantageous or expedient (including circumstances in which the book method has historically been used), the taxpayer will most likely be required to obtain approval from the relevant tax authorities to use the new method. Similar requirements may arise in foreign jurisdictions that maintain statutory accounting records under U.S. GAAP or IFRSs. Additional record keeping will also be required when entities are not permitted to use the standard's revenue recognition method for tax purposes.

Thinking Ahead

Although the ASU is not effective until annual reporting periods beginning after December 15, 2016 (with a maximum deferral of one year for nonpublic entities that apply U.S. GAAP), life sciences entities should start carefully examining the ASU and assessing the impact it may have on their current accounting policies, procedures, systems, and processes.

Subscriptions

Don't miss an issue! Register to receive Spotlight and other Deloitte publications by going to www.deloitte.com/us/subscriptions, choosing the Industry Interests category, and checking the boxes next to your particular interests. Publications pertaining to your selected industry (or industries), along with any other Deloitte publications or webcast invitations you choose, will be sent to you by e-mail.

Dbriefs for Financial Executives

We invite you to participate in *Dbriefs*, Deloitte's webcast series that delivers practical strategies you need to stay on top of important issues. Gain access to valuable ideas and critical information from webcasts in the "Financial Executives" series on the following topics:

- Business strategy and tax.
- Driving enterprise value.
- Financial reporting.
- Financial reporting for taxes.
- Governance and risk.
- Technology.
- Transactions and business events.

Dbriefs also provides a convenient and flexible way to earn CPE credit — right at your desk. Join *Dbriefs* to receive notifications about future webcasts at www.deloitte.com/us/dbriefs.

Registration is available for this upcoming *Dbriefs* webcast. Use the link below to register:

- Quarterly Accounting Roundup: An Update on Important Developments (June 25, 2 p.m. (EDT))

Technical Library and US GAAP Plus

Deloitte makes available, on a subscription basis, access to its online library of accounting and financial disclosure literature. Called Technical Library: The Deloitte Accounting Research Tool, the library includes material from the FASB, the EITF, the AICPA, the PCAOB, the IASB, and the SEC, in addition to Deloitte's own accounting and SEC manuals and other interpretive accounting and SEC guidance.

Updated every business day, Technical Library has an intuitive design and navigation system that, together with its powerful search features, enable users to quickly locate information anytime, from any computer. Technical Library subscribers also receive *Technically Speaking*, the weekly publication that highlights recent additions to the library. For more information, including subscription details and an online demonstration, visit www.deloitte.com/us/techlibrary.

In addition, be sure to visit US GAAP Plus, our new free Web site that features accounting news, information, and publications with a U.S. GAAP focus. It contains articles on FASB activities and updates to the *FASB Accounting Standards Codification*™ as well as developments of other U.S. and international standard setters and regulators, such as the PCAOB, the AICPA, the SEC, the IASB, and the IFRS Interpretations Committee. Check it out today!

The Spotlight series is prepared by the National Office Accounting Standards and Communications Group of Deloitte. New issues in the series are released as developments warrant. This publication contains general information only and Deloitte is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor.

Deloitte shall not be responsible for any loss sustained by any person who relies on this publication.

As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of the legal structure of Deloitte LLP and its subsidiaries. Certain services may not be available to attest clients under the rules and regulations of public accounting.

Copyright © 2014 Deloitte Development LLC. All rights reserved.
Member of Deloitte Touche Tohmatsu Limited.