New Formula of Revenue Recognition Likely To Change the Prescription for Pharma Industry

In May 2014, FASB issued Accounting Standards Update (ASU) 2014-09, Revenue from Contracts with Customers (Topic 606), and the International Accounting Standards Board (IASB) issued International Financial Reporting Standards (IFRS) 15, Revenue from Contracts with Customers that will supersede virtually all revenue recognition requirements in IFRS and US GAAP. FASB and the IASB have basically achieved convergence with these standards with some minor differences such as collectability threshold, interim disclosure requirements, early application and effective date, impairment loss reversal and nonpublic entity requirements. This paper discusses the impact of the five-step model prescribed in the new revenue standard on the entities operating in Pharma industry. It also outlines the considerations for these entities and for the entities in India during the implementation of the new standard.

New Revenue Standard: A Call of the Hour

Today's financial world puts a great emphasis on meeting targets of numbers. The most common measure used to gauge whether one has met targets is revenue. Revenue typically drives the success of most businesses, as it is a means of generating profits and increasing equity. For this reason, attaining proper revenue recognition is paramount and most of the business models revolve around it. Under the erstwhile regime, revenue was recognised when all four of the traditional revenue recognition criteria were met: 1) price can be determined, 2) collection is probable, 3) there is persuasive evidence of an arrangement, and 4) delivery has occurred. However, revenue in some of the more complicated industries like Pharma is typically contract-driven and determined on a customer-by-customer basis, and even a contract-by-contract basis. These contracts many times, include multiple-element arrangements. These are just a few examples of the

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nuances related to the industry.

Given the need for guidance and clarification on the existing and new revenue models, the Financial Accounting Standards Board (FASB) developed numerous industry-specific standards for revenue recognition. However, these standards are extremely detailed which impairs comprehensiveness and have led to inconsistent treatment of similar types of transactions across industries. In addition, companies in their initial years of operations can be overwhelmed by the various iterations of revenue recognition throughout the accounting standards, particularly when they do not fit into the cookie-cutter, industry-specific guideline categories. Although IFRS provides less guidance on revenue recognition, the flip side of that is availability of limited guidance on important topics such as revenue recognition for multiple-element arrangements.

Under the erstwhile regime, revenue recognition requirements in US GAAP differed from those in IFRS. This acts as a barrier to compare financial performance across the world among peers in the similar industry. For example, while comparing revenue numbers of two leading companies in Pharma – Pfizer and GlaxoSmithKline, we have to take into consideration the differences in accounting regime as the former reports revenue as per US GAAP, while the latter reports as per IFRS. The new revenue standard seeks to clarify the principles for recognising revenue and develop common revenue standard US GAAP and IFRS. This standard is also a response to the increasing concern in the financial world related to inconsistencies across companies and industries regarding revenue recognition.

Five-Step Model: Crossroad to Revenue Recognition

The new revenue standard contains principles that an entity will apply to determine the measurement of revenue and timing of when it is recognised. The underlying principle is that an entity will recognise revenue to depict the transfer of goods and services to customers at an amount that the entity expects to be entitled to, in exchange for those goods and services. Companies will now have specific principles and steps to follow to determine proper revenue recognition. The principles in the new revenue standard will be applied using the following five steps:

- Step 1: Identify the contracts with the customers
- Step 2: Identify the separate performance obligations in the contract
- Step 3: Determine the transaction price
- Step 4: Allocate the transaction price to separate performance obligations
- Step 5: Recognise revenue when each performance obligation is satisfied.

This principle based approach for determining revenue recognition will eliminate many of the inconsistencies brought on by the industry-specific guidance, specifically with respect to revenue generated from contracts with customers. It will serve as a uniform standard that will supersede most of the previously issued guidance and provide a framework that all industries can follow.

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Transition to New Model: Navigating the Change

IFRS 15 is effective for annual periods beginning on or after 1st January 2017. Early adoption is permitted for IFRS preparers, provided that fact is disclosed. The effective date of the standard for public entities applying US GAAP is 15th December 2016, which is essentially the same as for IFRS preparers. However, FASB is currently considering deferral of effective date by one year.

The effective date of the new standard, January 2017, may seem a long way off as of now. However, the companies will need to disclose the expected impact of the new standard right away. Also, one key decision needs to be made soon – how to transit to the new standard. The entities are allowed either 'full retrospective' adoption in which the standard is applied to all of the periods presented or a 'modified retrospective' adoption. Modified retrospective adoption in which an entity will have to recognise the cumulative effect of initially applying the standard to

the opening balance is suitable for industries that expect little change as a result of applying the new standard. For industries like Pharma, wherein the entities expect significant changes to their revenue accounting as a result of applying new standard, full retrospective adoption is a more relevant option as it would affect a presentation of comparable trend information. While implementing full retrospective adoption, the entities are also required to make decision about practical expedient available. The following table shows three practical expedients given under the standard:

Sr. No.	Particulars	Relevance
Practical expedient 1	For completed contracts an entity need not restate contracts that began and ended in the same annual reporting period.	Entities with large populations of short term contract
Practical expedient 2	For completed contracts that have variable consideration, an entity may use the transaction price at the date on which the contract was completed.	Entities with long-term contracts that include variable consideration
Practical expedient 3	For all periods presented before the date of initial application, an entity neither needs to disclose the amount of the transaction price allocated to remaining performance obligation, nor an explanation of when it expects to recognise that amount as revenue.	Entities that have long-term contracts where performance is delivered over time.

In the Pharma industry, the entities have a number of contracts or combination of contracts for which the above mentioned practical expedients are useful. Therefore, the entities require to carefully assess the contracts and make relevant decision about the implementation.

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New Formula for Pharma

The entities in the Pharma industry may need to change certain revenue recognition practices as a result of the new revenue recognition standard. These entities may also want to monitor the discussions of the Boards' Joint Transition Resource Group for Revenue Recognition (TRG). The Boards created the TRG to help them determine whether more implementation guidance or education is needed. Separately, the American Institute of Certified Public Accountants (AICPA) has established 16 industry task forces including therein Pharma industry to help develop a new Accounting Guide on Revenue Recognition and to aid industry stakeholders in implementing the standard. Following are the key considerations for the Pharma industry while implementing the new revenue recognition standard.

	Revenue Model	Implication Considerations	Conside-rations
Step 1	Identify contract with the customer	• Collaborations for pharmaceutical development	• Part or all of collaboration may not be revenue
Step 2	Identify separate performance obligation	• Other services/goods combined with contract	• Determine if separate or combined with other services/ goods impacts remaining steps
Step 3	Determine transaction price	• IP sales licenses • Royalties, bonus, returns, milestones, discount	• License exception may be applicable only in limited cases • Dealing with bundles of services may create issues

	Revenue Model	Implication Considerations	Conside-rations
Step 4	Allocate transaction price	• Milestones/ other variable consideration	• Recognition vs. payment patterns • Allocation to different performance obligations
Step 5	Recognise revenue when performance obligation is satisfied	• Licensing • Distribution	• May impact timing of revenue recognition for licenses • Sell-in vs. Sell-through may create some practice changes

Collaboration and Licensing Arrangements

The entities operating in Pharma industry frequently enter into strategic collaborations and licensing arrangements. For example, two Pharma entities collaborate on the development of an experimental product candidate. The new standard requires entities to assess whether the counterparty to the arrangement is 1) a customer or 2) a collaborator sharing in the risks and benefits of the arrangement. If such arrangements are outside the scope of revenue standard, the related income might not meet the definition of revenue, but instead be recorded as a reduction of R&D expenses or as other income. Identifying the customer can be difficult, especially when multiple parties are involved and the evaluation may require significant judgment.

Licenses and Rights to Use

Revenue recognition for licenses could be challenging under the new revenue standard. The new revenue standard requires the entity to determine whether a license is distinct from other goods and services in an arrangement. If the license is not distinct, then the license is combined with other goods or services for the purpose of recognition of revenue and therefore, the revenue is recognised as the entity satisfies the combined contract. For example, certain biotechnology entities do not sell licenses without R&D services for early-stage products. In this case, the license may not be a separate contract because the customer cannot benefit from the license without the R&D services and the total transaction price is recognised as revenue as the contract is satisfied over the period R&D services are performed.

There are two types of licenses described in the new standard. 1) The first is a license that provides a customer the right to use an entity's IP as it exists at the point in time the license is granted. For these licenses, revenue is recognised at a point in time when control transfers to the licensee and the license period begins. These licenses provide the customer with a right to IP and the IP does not change after the license transfers to the customer. 2) The second type is a license that provides access to an entity's IP as it exists throughout the license period. Licenses that provide access are performance obligations satisfied over time and, therefore, revenue is recognised over time.

Variable Consideration

Common examples of arrangements with variable consideration in Pharma industry include licensing arrangement with milestone payments and sales-based royalties and distributor arrangements with rebates, price protection or other incentives. Under the new standard, revenue will be recognised on contingent milestones when the performance obligation is satisfied and the entity determines that it is "likely to occur" (IFRS) or "more likely than not" (US GAAP) that there will not be a significant reversal of revenue in future periods. Entities will need to evaluate each milestone in contract, to determine whether including a variable consideration in the transaction price could result in a significant reversal of revenue in the future. For example, milestones based on a specific clinical outcome are subject to factors outside the control of entity, such as clinical trial results and regulatory approval; therefore, entities may conclude that amounts related to these milestones are subject to significant revenue reversal in the future. On the other hand, revenue recognition is likely to accelerate by recognising variable consideration prior to achieving a milestone

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in case where the entity has established history of providing service in similar contracts without a significant reversal.

Royalties

Under the new revenue recognition standard, there is specific exception for license of IP with consideration that varies entirely based on the customer's subsequent sales or usage of the IP – for example – a sales-or usage-based royalty. For these licenses, the consideration is not included in the transaction price until it is no longer variable. The complexity for the Pharma industry relates to evaluating how exception applies to a contract with multiple performance obligations. The boundaries for determining when the sales- and usage-based exception applies might be an area of significant judgment under the new revenue standard.

Distributor Sales and Consignment Stock

Many entities operating in the Pharma industry recognise revenue using a 'sell-through' approach. Under the sell-through approach, revenue is not recognised until the product is sold to the end customer. Under the new standard, revenue is recognised upon the transfer of control to customer. Entities that previously accounted for arrangements using a sell-through approach will need to consider at what point control has passed to the customer based on the indicators provided in the standard, which could impact the timing of revenue recognition. The entity would evaluate the return right as variable consideration. This might result in earlier revenue recognition than under current standards, which focus on the transfer of risks and rewards.

Summary of Impact of Change in Accounting on EBITDA

Change in Accounting	Impact on EBITDA	Reason
If the licence is not distinct, then the license is combined with other goods or services for the purpose of recognition of revenue and therefore, the revenue is recognised as the entity satisfies the combined contract.	Decrease	Decrease due to deferment of revenue

An Indian subsidiary of a global parent company reporting under new revenue recognition standard is likely to be required to alter its business practices in order to facilitate consolidation with its parent company.

Change in Accounting	Impact on EBITDA	Reason
Under the new standard, revenue is recognised upon the transfer of control to customer. The entity would evaluate the return right as variable consideration. This might result in earlier revenue recognition than under current standards, which focus on the transfer of risks and rewards.	Increase	Increase due to early recognition of revenue
The entities might recognise revenue earlier, if there is an amount of variable consideration that is not subject to significant reversal in the future.	Increase	Increase due to early recognition of revenue
Royalty revenue is a form of variable consideration that is not subject to significant reversal in the future and therefore, revenue might be recognised earlier. There is specific exception for sales or usage based royalty for IP in which case the revenue is not recognised until it is no longer variable.	Increase / Decrease	Increase or decrease based on terms of contract

Enhanced Transparency in Disclosures

The new revenue standard provides explicit presentation and disclosure requirements. It requires a number of disclosures intended to enable users of financial statements to understand the nature, amount, timing and uncertainty of revenue and related cash flows. The following are the key considerations for the entities operating in Pharma industry while implementing new disclosure requirements:

Disclosure Requirements	Considerations
Disaggregation of revenue to illustrate how the nature, amount, timing and uncertainty about revenue and cash flows are affected by economic factors.	The Boards decided not to prescribe a specific characteristic of revenue as the basis for disaggregation because entities are encouraged to make this determination based on entity-specific and/or industry-specific factors. The entities in Pharma industry are required to exercise significant judgment in this area due to number of entity-specific and/or industry-specific factors.
Significant judgment and changes in judgments made in applying the guidance to those contracts	The entities could face challenges in estimating stand-alone selling price for certain deliverables such as licences as well as determining the transaction price for variable consideration and the judgments and methods used to make the estimates will have to be disclosed.
The amount of remaining performance obligation and the expected timing of the satisfaction of those performance obligations for contracts with duration of greater than one year	This could have significant impact on Pharma industry where long term contracts are a significant portion of an entity's business.

The disclosure requirements are significantly greater than existing disclosure requirements for revenue under IFRS and US GAAP. This could require the entities in Pharma industry to implement new systems, processes and internal control to capture information that has historically not been needed for financial reporting purposes.

Preparing for the change

Although the new standard is not effective until 2017, now is the time to evaluate potential impacts on the entities and to prepare for a change. Gaining an understanding of the effect of the standard, providing early communication to stakeholders and planning ahead are crucial for a successful implementation. The entities in the Pharma industry may consider entering into new contracts or revising the existing contract that may help the entities in the revenue acceleration. The new standard may bring into practice changes in inventory stocking for entities in the Pharma industry. Since an entity's objective is to generate revenue, it is not surprising that changes to the accounting requirements for revenue could affect multiple business functions and capabilities. The following are the actions that the entities may consider during implementation.

Investor relations	• Consider early communication on impact for key constituents • Anticipate potential changes to underlying key metrics, including gross margins
Processes and systems	• Update key processes and controls for any changes in accounting • Develop IT systems and manual processes for data accumulation and expanded reporting requirements • Plan for financial statement presentation changes including expanded note disclosures
Tax planning	• Identify any impact on existing tax strategies and planning • Consider whether any changes to transfer pricing are necessary
Management information	• Plan for potential adjustments to key performance indicators • Consider changes to internal management reporting to better align with new external disclosures • Adjust financial planning and analysis based on effect of new standard

Business operations	• Modify contracting procedures • Understand any effect on existing regulatory requirements • Communicate information needed for estimates and judgment to finance function.

Impact on Indian Pharma Industry

An application of the new revenue recognition standard across the globe will have its repercussions on Indian entities which are required to report their revenues as per Indian GAAP (AS-9) in which revenue recognition is mainly based on general principles that are applied to different types of transactions. The entities operating in the Indian pharma industry will have an impact of the application of the new revenue recognition standard in two different scenarios: 1) An Indian entity like Cipla which competes in the global market is likely to face challenges in comparison with its global peers which will henceforth have consistency in their reported revenue. 2) An Indian subsidiary of a global parent company reporting under new revenue recognition standard is likely to be required to alter its business practices in order to facilitate consolidation with its parent company. Therefore, while there are winds of changes across the globe, Indian pharma entities cannot just shut the windows and stay calmly inside the regime of current reporting requirements. They also have to gear up for upcoming changes proactively. For example, an Indian pharma entity competing in global market may be required to go ahead and provide additional disclosures as per new revenue recognition standard in order to gain confidence of the stakeholders in a global market. Also, with a consideration of transition of Indian Accounting Standards into IFRS, Indian pharma entities may also get directly impacted by these winds of changes. Therefore, it would be helpful to closely observe the changes and challenges faced by their global peers, in order to prepare themselves for smooth transition in the near future time.

Conclusion

The new revenue standard has potential impact of changing revenue line numbers for the entities in the Pharma industry. These entities are encouraged to assess their business model and terms of contract in order to clearly assess and communicate the impact of new standard to their stakeholders. This standard is likely to alter some business practices in terms of key deliverables such as licences in the Pharma industry. The greater amount of estimates and judgments in revenue recognition procedure may call upon enhanced operational controls and disclosures in the Pharma industry. ■