# EBITDA

## Q 14.1 What is EBITDA and how does it impact valuation?

EBITDA, or earnings before interest, income taxes, depreciation, and amortization, is a commonly used and important measure of profitability and performance within the health care industry for companies or businesses other than startups or early-stage ventures and growth entities. EBITDA is generally used as a proxy for a company's free cash flow and measures the company's ability to service debt and how much leverage the company could conceivably maintain. Credit agreements typically include a covenant based on achieving minimum EBITDA. Business valuations are frequently calculated as a multiple of EBITDA; the multiple used is determined by looking at industry comparisons and is adjusted up or down to reflect the size and growth prospects of the business being acquired.

EBITDA is generally not disclosed in a company's basic financial statements as required by U.S. GAAP, but it can be derived from the financial statements. EBITDA and adjusted EBITDA are non-GAAP measures and might not be comparable across targets if not consistently calculated. EBITDA is calculated starting with a company's net income (E) and adding back:

**TABLE 14-1**

**Parties to Health Care Services Transactions**

| Party | Role |
|---|---|
| Patient | Individual who requires care and may be legally responsible for payment (but, in certain cases, may not make payment or may be incapable of making payment) for care received |
| Physician | Individual who orders (and potentially performs, installs, or prescribes) the services, devices, and pharmaceuticals on behalf of the patient |
| Health care services provider | Physician, hospital, long-term care facility, ambulatory surgical center, home health agency, etc. that provides health care services to the patient |
| Payor | Entity that pays for the health care services; may be the patient ("self-pay") or an employer, contractor, managed care organization, state or federal government, or other third party |

Particular parties may have various unique arrangements with other parties, resulting in different obligations, service costs, reimbursement rates, incentives, and other considerations that impact revenue and expense recognition and the quality of the respective assets and liabilities on the balance sheet.

Life sciences companies include entities with commercial sales of products and services to patients and providers, and entities focused on drug and product development. Entities in the latter category commonly enter into collaborative research arrangements, such as a biotech company's licensing to a pharmaceutical company commercialization rights of a product candidate in exchange for:

- An up-front payment;
- Ongoing payments for R&D service;
- Future payments contingent upon the achievement of specified development and sales milestones; and/or
- Royalties on commercial sales.

## Revenue Recognition

### Q 14.3 What are the primary considerations with respect to proper revenue recognition?

Revenue recognition in the health care industry is varied and complex and requires a complete understanding of the rights and obligations of each party in revenue-generating transactions. Errors or irregularities in the recognition of revenue result in misstated (or otherwise unusual) revenues and operating results, potentially impacting the value of the company to be acquired. In addition, as noted below, in general, U.S. public companies have begun reporting revenue under a new accounting standard that private companies are not yet required to adopt, making comparison more difficult.

Revenue recognition in health care services related companies relates primarily to the manner in which providers are paid. Health care revenues are classified based on the services rendered or contractually obligated to be performed by payors and/or providers under agreements that are typically negotiated on an annual basis. Common types of health care revenues include:

(1) patient services revenues (historically, primarily based on the volume of services provided; more recently, including payments based on outcomes and related measures);

(2) resident services revenues (for example, daily charges for long-term care or assisted living facilities);

(3) capitation revenue, which is a periodic amount paid by payors to providers for services to qualified customers or patients regardless of the level of services provided during the period; and

(4) premium revenues, which are amounts paid directly by customers (often individuals or employers) to payors to receive covered health care–related services, should the customers require such services.

Agreements between parties may also include cost-based adjustments, outcome-related bonuses, or other incentive-type provisions that require management estimates. The expected trend in health care reimbursement is toward increased outcome-related reimbursement.

The typical challenge in due diligence for health care services related companies is evaluating the estimates made by management for necessary charity care and contractual allowances, bad debt provisions and other gross-to-net revenue adjustments and whether or not these adjustments appropriately present net revenue and whether net revenue–related accounts receivable are properly valued.

In recent years, there have been certain temporary health care services reimbursement programs (for example, related to meaningful use of electronic health records and for reporting health care quality metrics). Buyers should carefully evaluate the accounting presentation of reimbursements as revenue and consider the propriety of such treatment. In addition, as many of these reimbursement programs will not continue, buyers should evaluate whether to consider such reimbursement as nonrecurring. Buyers should also consider the potential loss of or decrease in reimbursement if certain quality and other patient-outcome-related targets are not achieved.

For many medical device, life sciences, and pharmaceutical companies, revenues typically comprise either sales of products and services or revenues related to product or drug development and licensing. Annual or longer-term contractual arrangements are often entered into between parties with respect to product or drug development and licensing. These contractual arrangements include:

(1) multiple-element contracts;

(2) contracts including milestones or performance-related payments;

(3) sales incentives or volume discounts;

(4) other contractual obligations and opportunities; and

(5) gross sales to net sales deductions, including chargebacks, rebates, government discounts, and product returns.

Other revenue-related issues to consider in evaluating revenue trends of life sciences product sales include (1) the impact of new contracts or customers (such as with a retail pharmacy chain and the initial stocking), (2) sales to distributors that then sell to customers under direct contractual arrangements at prices less than those charged to the distributors, and (3) the potential for channel-stuffing

with distributors through the offering of favorable payment terms or discounts at period-ends with unique rights of return. The accounting requirements for revenue recognition under these types of contracts can be very complex, depending on the specific contractual terms.

During 2014, the FASB and IASB issued a new joint revenue recognition standard, codified as ASC Topic 606 and Topic 340-40 ("Other Assets and Deferred Costs") and IFRS 16, respectively. The new revenue standard supersedes virtually all existing revenue guidance, including substantially all existing health care industry-specific guidance. The new revenue standard requires entities to use more judgment and make more estimates than under legacy guidance (that is, ASC Topic 605, Revenue Recognition and International Accounting Standard (IAS) 18 Revenue). The new standards provide accounting guidance for all revenue arising from contracts with customers and affect all entities that enter into contracts to provide goods or services to their customers (unless the contracts are in the scope of other U.S. GAAP or IFRS requirements, such as lease requirements). The standards also specify the accounting for costs an entity incurs to obtain (that is, incremental costs such as sales commission) and fulfill a contract to provide goods and services to customers and provide a model for the measurement and recognition of gains and losses on the sale of certain nonfinancial assets, such as property and equipment, including real estate. Since the new revenue guidance is now effective for calendar year-end public companies, companies using IFRS are required to apply the revenue standard for reporting periods beginning on or after January 1, 2018 (early application is permitted); public companies using GAAP are required to apply it for annual reporting periods beginning after December 15, 2017, including interim reporting periods therein. Early adoption is permitted for public entities reporting under GAAP beginning after December 15, 2016. Additionally, U.S. nonpublic companies and organizations are to apply the revenue standard for annual reporting periods beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019, and may adopt it as early as the public entity effective date.

Applying the guidance of the new standard will likely affect how an entity measures, recognizes, and makes disclosures about revenue and incremental costs (see QQ 14.6 to 14.6.4).

## Q 14.4 What are the gross-to-net revenue reconciling items impacting revenue recognition in health care services companies?

For health care providers, adjustments to reconcile from gross-to-net revenues include adjustments for charity care, contractual allowances, and bad debts. These adjustments are based on subjective, as well as objective, factors that often take a long time until final resolution. They are often significant and can have material impacts on financial statements if not calculated appropriately and, due to management judgment, are subject to manipulation. It is critical to understand the nature of these adjustments.

*Charity care*. Charity care is care provided to patients that do not have insurance coverage (or sufficient insurance coverage) and are unable to pay for services provided. Health care entities provide charity care consistent with their missions, legal requirements, and the individual service settings. Charity care can involve preapproved uncompensated care or care provided in an emergency setting where it is not possible to confirm patient financial resources.

*Contractual allowances.* Health care services providers typically have standard established rates and fee schedules (i.e., gross charges) for services rendered to patients and customers. These providers are often contractually obligated to perform such services by unique agreements (typically negotiated on an annual basis) with payors, government programs, insurers, and/or other providers. The discounts from the standard fee schedules are referred to as contractual allowances, and are estimated based on the payors involved, the nature of the payment types, empirical information on cash collections, and other relevant factors.

*Bad debts*. Some health care services entities may perform services for self-pay patients for which the ultimate collection of all or a portion of the amounts billed or billable cannot be determined at the time services are rendered. The predominant industry practice for reporting revenue from self-pay patients is to recognize gross service revenue for those patients at the health care entity's full established billing rates when the services are provided and adjust for bad debts based on an assessment of historical collections. This is of increasing importance given the rapid rise over the past few years in high-deductible health plans, which

pushes the service collection risk to providers. The new revenue recognition standard will require providers to estimate collectability at the time the service is provided and change the revenue presentation to reflect the implied price concession in providing care to uninsured or underinsured customers as a reduction in revenue.

Given that these adjustments are based on estimates and the time lag between the date of service and the final determination of the ultimate adjustment with respect to some government payment programs can take years to finalize, it is important to understand the critical assumptions used in the calculations and evaluate them against the historical accuracy of such estimates. Such analysis typically involves using actual cash collections to assess the quality of historical estimates.

## Q 14.5 What are the gross-to-net-revenue adjustments impacting revenue recognition in life sciences companies?

For life sciences companies, reconciling items from gross-to-net-revenues primarily represent rebates and discounts to government agencies, wholesalers, distributors, and managed care organizations, adjustments for sales and product returns, and chargebacks for defined terms and conditions.

Rebates and discounts are calculated considering a number of factors. For example, for Medicaid, Medicare, and contract rebates, companies use experience ratios, which are adjusted periodically to better match current or expected future experience. For contractual or legislatively mandated deductions (typically outside of the United States), companies use estimated allocation factors based on government actions and legislation, historical payment patterns, and third-party reports, if available, to determine the appropriate adjustments.

For sales and product returns, companies typically perform calculations in each market in which they operate, for each product they sell, to incorporate the following, as appropriate: (1) local returns policies and practices, (2) returns as a percentage of the applicable product's sales, (3) estimated shelf life by product, (4) an estimate of the time between shipment and return, or lag time, and (5) any other

factors that could impact the estimate of future returns, such as loss of exclusivity, product recalls, or a changing competitive environment.

For sales incentives and volume discounts, companies typically use historical experience with similar incentives programs to determine appropriate customer obligations and adjustments.

If any of these ratios, factors, assessments, experiences, or judgments are not indicative or accurate predictors of future experience, the results of operations of the target company could be materially affected. Some of the adjustments may not be definitively known until years later. With the benefit of a lookback, a party conducting due diligence may be able to look at historical results to determine the accuracy of the company's historical assumptions and estimation process to judge the amounts currently recorded.

### Q 14.5.1 How are product returns handled?

Life sciences companies with a history of commercializing products often provide rights of return to customers, wholesalers, or distributors due to product expiration or safety reasons. Returns are more common for pharmaceutical organizations and less typical for medical device companies. If life sciences companies offer such rights of returns, revenue recognition at the time of the sale to the customer or distributor may be impacted. Under legacy guidance, the criteria to evaluate are many, and to recognize revenue on delivery, the life sciences company must, at a minimum, be able to make a reasonable estimate of the amount of future returns or defer the recognition of the revenue until the right of return has passed.

### Q 14.5.2 How are chargebacks handled?

Chargebacks primarily relate to reimbursements by pharmaceutical companies to drug wholesalers for honoring contracted prices to third parties that are negotiated directly with the manufacturer at rates less than the wholesaler pricing. It also relates to what is referred to as "most favored nation" pricing, where a customer contracts to receive a price equal to the best price offered to any other customer (such arrangements are seen primarily in connection with government contracts). Liabilities must be recognized for any amounts owed under each of the above scenarios until settled, including any potential liability for product that is in the distribution chain.

## Q 14.6 What is the potential impact of the new revenue recognition standard on life sciences transactions?

The new revenue recognition standard is more principles-based than the prior revenue guidance and will require life sciences entities to exercise more judgment. Life sciences entities may have to change their processes, systems, and controls for making estimates. Entities may have to change how they estimate variable consideration and, as a result, may recognize revenue earlier than they do today in order to comply with the new revenue recognition standard, ASC Topic 606 (see Q 14.3). Entities also may need to change the way they account for reseller arrangements and recognize revenue for licenses.

An entity must identify the promised goods and services within the contract and determine which of those goods and services (or bundles of goods and services) are separate performance obligations (that is, the unit of accounting for purposes of applying the standard). In addition, complex arrangements with multiple promised goods and services (for example, a license of a product candidate combined with R&D services, or a medical device combined with installation services and a maintenance agreement) will require careful consideration to determine whether they have separate performance obligations.

Entities likely will have to exercise significant judgment to determine whether a significant financing component exists when there is more than one year between the transfer of goods or services and the receipt of contract consideration and adjust the promised amount of consideration for the effects of the time value of money.

Additionally, certain aspects of the incremental cost guidance will require entities to apply significant judgment to analyze the facts and circumstances and to determine the appropriate accounting. The new guidance will require a significant change in practice for entities that historically have expensed the costs of obtaining a contract and now will be required to capitalize them subject to certain conditions.

### Q 14.6.1 What is the potential impact on collaboration arrangements?

Life sciences entities frequently enter into collaboration agreements with other parties in which the counterparty may be a collaborator that shares in the risks and benefits of developing a product to be marketed, rather than a customer. An example would be two pharmaceutical companies that collaborate on the development of an experimental product candidate.

Life sciences entities may find it challenging to determine whether their collaboration agreements are in the scope of the new revenue standard. Identifying the customer can be difficult, especially when multiple parties are involved. This evaluation may require significant judgment, and the new guidance does not provide any additional considerations in this area. A life sciences entity's collaboration agreement may contain a vendor-customer aspect that would be at least partially within the scope of the new revenue guidance if that collaborator or partner meets the definition of a customer.

Today, these arrangements generally are in the scope of Accounting Standards Codification (ASC) 808, Collaborative Arrangements, which allows an entity to make a policy election to apply legacy revenue recognition guidance by analogy for the income statement classification of collaboration arrangements. The implementation guidance in the consequential amendments states that entities will have to determine whether they can apply the new revenue guidance by analogy even though arrangements with counterparties that are not customers (that is, some arrangements within the scope of ASC 808) are not in the scope of the new standard. Today, many life sciences entities apply legacy revenue guidance by analogy to certain transactions with a collaboration partner. Absent further guidance from the FASB, ASC 808 would allow an entity to apply the new revenue guidance by analogy to these types of arrangements if it makes a policy election to do so. The FASB project to clarify when transactions between parties to collaborative arrangements should be accounted for under the new revenue standard is in the early stages, and it is unclear if or when additional guidance will be issued. Therefore, life sciences entities with collaborative arrangements should monitor developments.

## Q 14.6.2 What is the potential impact on estimating variable consideration?

In life sciences arrangements, a portion of the transaction price can often vary in amount and timing due to discounts, rebates, reimbursements under Medicare and Medicaid programs, incentives, rights of return, outcome-based pricing, performance bonuses, milestones, other contingencies (for example, future royalties), or concessions. The new standard requires an entity to estimate variable consideration and include in the transaction price amounts for which it is probable that a significant revenue reversal will not occur (that is, they apply a constraint on variable consideration).

Variable consideration can result from explicit contract terms or can be implied by a life sciences entity's past business practices or intentions when it entered into a contract. It is important for a life sciences entity to appropriately identify and evaluate the different instances of variable consideration included in a contract, because it will need to separately estimate and apply a constraint to all variable consideration.

Under the old guidance, an entity cannot recognize consideration that is contingent on a future event (for example, a performance bonus, a milestone payment) until that event occurs. Under the new standard, life sciences entities will have to estimate the consideration to which they expect to be entitled from these bonuses and milestone payments and, after considering the constraint, may recognize some portion of these payments before they achieve the performance metric or milestone. As a result, a life sciences entity may recognize revenue related to some of these items sooner than it does today.

The requirement to estimate variable consideration will likely require changes to a life sciences entity's accounting policies, accounting systems, and/or internal controls over financial reporting. For example, life sciences entities may need to adjust their processes and controls for calculating rebates on product sales due to the requirement in the new standard to estimate these rebates using a most-likely-amount or expected-value approach.

A right of return creates variable consideration that an entity will estimate and include in the transaction price. In doing so, an entity

will consider the products it expects to be returned and exclude the consideration associated with those products to determine the amount to which it expects to be entitled. While an entity may need to change the method it uses to make this estimate, it is unclear whether the estimate amount will change significantly.

An entity will recognize the amount of expected returns as a refund liability, representing its obligation to return the customer's consideration. The standard also requires a return asset to be recognized for the right to recover the product, but this requirement likely will not affect pharmaceutical companies because returns frequently have no value due to product expiration or requirements to destroy returned inventory. Entities must present the return asset (if recognized) separately from both the refund liability (that is, on a gross basis) and inventory.

Additionally, life sciences entities that provide rebates and/or discounts to customers whose orders meet specific volume thresholds have to determine whether to apply the guidance on variable consideration referred to above or the guidance on customer options as defined in new guidance, which are a separate performance obligation.

### Q 14.6.3 What is the potential impact on reseller and distributor arrangements?

Under the new standard, life sciences entities that sell their products through distributors or resellers (collectively, resellers) may recognize revenue sooner than they historically recognized such revenue. Historically, some entities that used resellers waited until the product was sold to the end customer to recognize revenue (under the sell-through method) because they did not meet all of the criteria to recognize revenue when they deliver the product to the reseller (that is, sales price was not "fixed or determinable"). They may switch, in certain circumstances, to recognizing revenue when they transfer the products to the reseller (under the sell-in method) once they gain enough experience to estimate returns and other variable components of pricing (for example, chargebacks).

Under the new standard, the practice of using a sell-through method is no longer acceptable if the only uncertainty is the variability in the

pricing. This is because the standard requires an entity to estimate the variable consideration (that is, the end sales price) based on the information available, taking into consideration the effect of the constraint on variable consideration. That said, in some cases, the outcomes under the new and legacy methods may be similar if a significant portion of the estimated revenue is constrained.

Applying the new guidance to reseller arrangements will require significant judgment. Entities may also have to change their processes and information systems.

### Q 14.6.4 What is the potential impact on licenses of intellectual property?

Life sciences entities' arrangements frequently include licenses of intellectual property (IP) with other goods and services, such as R&D or manufacturing services. Entities will have to consider whether such contracts include distinct licenses of IP in order to apply the guidance appropriately. This evaluation will require significant judgment. Example 56 in the standard (ASC 606-10-55-367 through 55-374) walks through the accounting for a life sciences arrangement for a license of IP and manufacturing services.

After determining that an IP license is distinct, an entity will have to analyze whether the license is a right to access the IP or a right to use the IP. Revenue allocated to a license that conveys a right to access will be recognized over the license period. Revenue allocated to a license that conveys a right to use will be recognized when the license is provided. The determination will be based on the facts and circumstances. In response to implementation questions, the FASB has published amended original guidance that would require classification of IP into one of two categories:

- *Functional*. This IP would have standalone functionality (for example, biological compounds or drug formulas). Revenue from these licenses would be recognized at the point in time when the IP is made available for the customer's use and benefit if the functionality is not expected to change substantially as a result of the licensor's ongoing activities that do not transfer another good or service to the customer. However, see below for exception.

- *Symbolic*. This IP would not have significant standalone functionality (for example, brands or trade names). The utility of symbolic IP would be derived from the licensor's ongoing or past support (for example, activities that support the value of a licensed brand). Revenue from these licenses would be recognized over time as the performance obligation is satisfied (for example, over the license period).

The new guidance created an exception to the variable consideration requirements for sales- and usage-based royalties from licenses of IP, which generally will be recognized when the sales or usage occurs. This will likely result in accounting that is consistent with current practice.

While many believe it was originally unclear in the new guidance whether this exception would apply to royalties that relate to both licensed IP and other goods or services in a contract (for example, a contract with two performance obligations, a distinct product candidate license and R&D services that would be provided over time and would affect the amount of royalties earned), the FASB included clarifying language in its amendment in 2016. This guidance clarified that the sales- and usage-based royalty exception would be applied to the overall royalty stream when the sole or predominant item to which the royalty relates is a license of IP. The guidance also clarified that the sales- or usage-based royalty in these types of contracts will be either entirely in the scope of royalty recognition constraint guidance or entirely in the scope of the general variable consideration constraint guidance.

## Q 14.7 What are the general revenue recognition considerations related to research and development arrangements between life sciences entities?

In the biotech and pharmaceutical industries, companies often enter into research and development (R&D) arrangements with other parties to develop a wide variety of products or services. The terms of R&D arrangements vary as widely as the products and entities involved, reflecting the trade-offs between the interests of the parties.

Companies enter into R&D arrangements through multiple legal forms or structures. For example, some are established through the creation of separate legal entities such as limited partnerships or S corporations that, by design, will contract and transact with parties to the arrangement. Alternatively, legal rights and obligations may be established more directly through executory contracts between the parties to the arrangement.

The objectives of entering into R&D arrangements vary, but include the following, among others:

- Sharing R&D investment risk with others;
- Pooling of intellectual capital or technology resources;
- Increasing management and operations flexibility for the R&D project (that is, reduction of bureaucracies inherent in large corporate cultures); and
- Providing attractive financing or investment alternatives made economically advantageous because of tax benefits to investors.

Many R&D arrangements are in substance financing arrangements where one party (the R&D company) performs or manages all R&D activities while other parties (the funding parties) fund those activities. These arrangements are common in emerging or development-stage companies that are developing products or technology but lack the internal financial resources necessary to fund their activities.

Other R&D arrangements are more collaborative: the parties contribute and share complementary intellectual properties, research, marketing, and management resources. The terms of these arrangements vary significantly, but most collaborations involve sharing the ongoing rights to the results of the R&D activities. For example, a small start-up R&D company may have a promising drug or formula; however, due to the lack of infrastructure, it could benefit from the commercialization and marketing resources of a larger pharmaceutical company.

The substance of other R&D arrangements is contracted services. In these arrangements, the funding party (or parties) maintains all or

substantially all of the rights to the results of the R&D activities, and contracts with others for R&D and related services.

Identifying the substance of the arrangement is the key to determining the appropriate accounting for R&D arrangements, which can be difficult even for less-complicated arrangements. For example, many R&D arrangements have facets of all three types of the structures discussed above—financing, collaboration, and contracted services. And the existence of related parties, common in R&D arrangements, further complicates the identification of the substance of an arrangement. A careful analysis of all rights and obligations of all parties is essential to understanding the substance of a R&D arrangement.

## Q 14.8 How can one determine the substance of a R&D arrangement?

The substance of a company's rights and obligations determines the appropriate accounting for a R&D arrangement. For example, when evaluating how to account for transactions occurring pursuant to a R&D arrangement, a company must determine whether it is obligated to repay any funds received from third parties regardless of the ultimate success of the R&D activities. A company should account for its obligation as a contract to perform R&D for the funding parties to the extent that the financial risk associated with the R&D has been transferred to those parties. To conclude that a liability does not exist, the financial risk involved with R&D activities must be transferred to the other parties and the transfer of risk must be "substantive."

The risk has been transferred if repayment of the funds provided by the funding parties depends solely on the results of the R&D having future economic benefit. To the extent that the company is committed to repay any of the amounts provided by the funding parties regardless of the outcome of the R&D, all, or part, of the risk has not been transferred; and the arrangement should, at least in part, be accounted for as a financing transaction.

The following are examples of arrangements in which all or part of the risk related to R&D activities has not been transferred to the funding parties:

- The company guarantees, or has a contractual commitment that assures, repayment of the funds provided by the funding parties regardless of the outcome of the R&D.
- The funding parties can require the enterprise to purchase its interest in the R&D regardless of the outcome.
- The funding parties will automatically receive debt or equity securities of the enterprise upon termination or completion of the R&D regardless of the outcome.

In these cases, it is obvious that the arrangement is in essence a financing arrangement because the company is obligated to transfer consideration to the funding parties regardless of the outcome of the R&D activities.

In some situations, however, the written agreements or contracts may not require the enterprise to repay the funding parties, but other conditions may indicate that the company still bears the risk of failure of the R&D activities. If conditions suggest that it is probable that the enterprise will repay any of the funds regardless of the outcome of the R&D, there is a presumption that the company has an obligation to repay the funding parties, and the arrangement should be accounted for as a financing arrangement. That presumption can be overcome only by substantial evidence to the contrary.

The following are examples of conditions leading to the presumption that the company will repay the funding parties:

- The company has indicated that it intends to repay all or a portion of the funds provided regardless of the outcome of the R&D activities.
- The arrangement includes an express or implied economic penalty to the company such that it would more likely pay the funding parties than incur the penalty. For example, if the company has transferred the right to use core technology to a partnership formed to conduct R&D activities and that technology is significant to its ongoing operations, the absence of a cross-license arrangement or other provisions that permit the company to reacquire or use its core technology is evidence of a financing. This scenario creates a presumption that the company would be compelled to purchase the other parties'

interest in the partnership to effectively reacquire its core technology.

- A significant related-party relationship exists between the company and the funding parties at the time the arrangement is entered into. A significant related-party relationship exists when 10% or more of a funding party is owned by parties related to the enterprise performing the R&D activities. In some cases, even though related-party ownership is less than 10%, it may be appropriate to account for a R&D relationship as a contract for services. Among other factors, the degree of influence or control exerted by the related parties over the enterprise receiving the funds would need to be considered. Specifically, funds received from a related party in a R&D arrangement should be accounted for as a liability to repay the funding party and not as a contract to perform R&D for others, if:
  - The company is required to make royalty payments to the related funding party based on the company's revenue as a whole and not just on the revenue stemming from the products developed with funds provided by the related funding party, or
  - The company has an option, other than a fair value purchase option, to acquire the results of the R&D arrangement.
- The company has essentially completed the R&D activities before entering into the arrangement. In such a case, the funding parties may be in essence purchasing a future revenue stream and are not funding R&D activities. Such transactions should also be evaluated to determine whether the substance of the funding is debt.

Additionally, consideration must be given to the intentions of the parties to the arrangement at the time the contract was negotiated. For example, despite the form of the contractual arrangements, a company may intend to purchase the other parties' interests in the arrangement regardless of the success of the R&D activities. Indicators that such implicit obligations exist may include side letters; a company's historical practice of purchasing partnership interests

in unsuccessful R&D endeavors; or an anticipated after-tax rate of return to the funding parties that is not representative of the returns normally associated with speculative investments.

The acquirers should be aware of other indicators that could create a similar presumption that the substance of the arrangement is, at least in part, a financing transaction.

In the SEC's view, the mere fact that a company cannot reasonably be expected to repay the funds, based on its current and projected future financial condition, does not overcome the presumption that an obligation exists requiring the R&D arrangement to be accounted for as a financing transaction. A company may settle the liability by paying cash, issuing securities, or by other means. Thus, while a company may not be in a position to pay cash or issue debt (which would eventually be settled in cash), it could issue stock or settle the liability by other means.

When evaluating the accounting for a R&D arrangement, the entity performing the activities must evaluate how it should account for amounts received from the funding parties. Additionally, the parties funding the R&D activities must determine how to account for their relationship to the party conducting the R&D activities (see Q 14.9).

## Q 14.9 What are the accounting considerations for R&D arrangements from the point of view of the entities involved?

An entity performing R&D activities that are being funded by others, either wholly or in part, must determine if the amounts received from the funding parties should be accounted for as (1) a financing arrangement, (2) a collaborative arrangement to perform R&D activities, or (3) a contracted R&D services arrangement. Additionally, a party performing R&D activities that are being funded by others, either wholly or in part, must carefully evaluate the terms of the arrangement to determine if variable interests in the funding parties exist which could result in consolidation with the funding party.

Parties funding R&D activities must determine how to account for the funds advanced to the entity performing the activities. The first step in such an analysis is to determine whether the entity performing the R&D activities should be consolidated by the funding party.

Potential variable interests in a R&D entity may include borrowings, equity investments, puts and calls on intellectual property rights or the entity, and service contracts, among others. These entities may be deemed to be variable interest entities (VIEs). VIEs are commonly utilized in R&D arrangements because separate legal entities are often created and designed for the specific purpose of conducting activities on behalf of certain parties to an arrangement. These entities need to be evaluated for consolidation by any variable interest holder.

If the funded entity is not required to be consolidated under accounting guidelines, the funding is typically accounted for as a financing transaction, a loan, or an equity investment, depending on the nature of the interest in the funded entity, but may need to be expensed when incurred. The determination of the appropriate accounting treatment for funding arrangements is complicated and requires consultation with accountants who are experts in such analyses.

Entities involved in R&D activities often make advance payments to vendors for goods or services that will be received in the future for use in R&D activities. For example, contract research organizations (CROs) may require biotech companies to make nonrefundable payments to secure future delivery of clinical trial management services. Alternatively, a pharmaceutical company may contract with a third party to manufacture active ingredients or products that will be used in clinical trials. In connection with such an arrangement, the company may be required to make a prepayment to secure manufacturing capacity at the contracted facility or to cover the manufacturer's startup costs. Generally, such arrangements relate to a specific R&D project, and if the research activities do not successfully advance to the point that the contracted-for goods or services can be utilized by the company, there is no alternative use.

Typically, some portion of such advance payments is nonrefundable in the event the company contracting for the goods or services does not ultimately require their delivery. There is general agreement that refundable payments for goods or services to be received in the future for use in R&D activities may be capitalized until such goods or services are received or the advance payment is refunded.

Nonrefundable advance payments for goods or services to be received in the future for use in R&D activities are usually capitalized initially. The capitalized amounts are typically expensed as the related goods are delivered or the services are performed. If an entity's expectations change such that it does not expect it will need the goods to be delivered or the services to be rendered, capitalized nonrefundable advance payments should be charged to expense.

A company with either an explicit or implicit obligation to repay other parties pursuant to a R&D funding arrangement should charge R&D costs to expense as incurred. Amounts received from the funding parties should be recorded as a liability, regardless of the method of repayment (cash, stock, or otherwise).

In cases where only a portion of the funding is required or expected to be repaid, the funding should be accounted for as a financing. For example, the company might be required or expected to reacquire core technology for less than the funding parties' investment or to make certain minimum royalty payments that are less than the funding parties' investment, regardless of the outcome of the R&D.

After completion of the R&D activities in an arrangement accounted for as a financing, the funding from investors may be "repaid" by the R&D company through royalties on future sales of the newly developed products. There are two acceptable accounting methods in practice:

- Treat the accrued liability for repayment as an accrued royalty. Prorate estimated future royalty payments between the accrued liability and royalty expense on the basis of the ratio of the accrued liability to total estimated royalty payments.
- Use an "interest method" to prorate future royalty payments between the accrued liability and interest expense. Using the implicit interest rate, compute the "interest" on the accrued liability and charge this amount to interest expense. The remainder of the royalty payment would reduce the "principal" amount of the accrued liability.

## Q 14.10 How are collaborations or arrangements to perform R&D services that are not financing arrangements accounted for?

If it is determined that an arrangement to perform R&D services is not a financing arrangement, the company performing the R&D should account for the arrangement as a service contract or collaboration. Amounts received from the funding parties should be recognized in the income statement as services are performed, assuming that the basic revenue recognition criteria have been met.

Generally, contracts to perform R&D services should be accounted for using a proportional performance model, recognizing revenue as services are performed. However, the pattern in which services are provided may not be apparent. Additionally, in many cases, payments from the funding parties may not be provided in a manner consistent with the pattern of performance. The arrangements may include the payment of a nonrefundable fee at the inception of the arrangement, scheduled payments during its term, and additional payments to be made only if and when specific milestones are reached in the R&D activities, or some combination of these terms. Further, accounting guidance when there are multiple deliverables is more complex, as an allocation of the total arrangement consideration may be necessary, or deliverables may need to be combined for purposes of revenue recognition.

Assuming that the basic requirements for revenue recognition have been met, under legacy guidance, the following methods generally are used to account for amounts received from funding parties pursuant to single deliverable R&D arrangements not accounted for as financings. These methods can be broadly characterized as performance-based or milestone-based. Which method is applied depends on the facts and circumstances (for example, a performance-based method should not be used when the total amount of services to be provided pursuant to a R&D arrangement cannot be estimated).

- *Performance-based methods of revenue recognition*. The performance-based methods of accounting for arrangements to perform R&D services address situations in which payments do not mirror performance under the contract. Revenue is generally recognized based on the lesser of the amount of

nonrefundable cash received or the amounts due based on the proportional amount of the total effort expected to be expended on the contract that has been provided to date. Accordingly, if one-half of the total service has been rendered, but only one-third of the total payments have become due (because, for example, a contractually specified milestone has not yet been achieved), the amount of revenue that may be recognized is limited to the one-third of the total payments that are due.

- *Milestone methods of revenue recognition*. Under the milestone method, an entity recognizes contingent consideration earned from the achievement of a substantive milestone—most often relating to R&D, product commercialization, and sales goals—in its entirety in the period in which the milestone is achieved. This is based on the premise that the additional consideration earned from the achievement of the milestone is indicative of the additional value provided to the customer through either (1) the efforts performed to date by the entity or (2) a specific outcome resulting from the entity's performance to achieve that specific milestone.

  It is not uncommon for some life sciences companies to have fifty or more individual milestones related to products under development.

- *Contract-term deferral method of revenue recognition*. Under the contract-term deferral method, payments received on achievement of milestones are deferred and amortized into income over the remaining contract period, either ratably or based on a proportional performance methodology. This method accounts for the milestone payments in a manner similar to up-front nonrefundable fees, which are recognized over the remaining performance period.

  Additionally, this method considers the milestone payment to be inseparable from the ongoing R&D services, thus requiring the payments to be recognized as the remaining services are rendered. However, the SEC staff in certain circumstances may object to the application of this method if it significantly back-ends recognition of payments under a R&D arrangement.

Life sciences entities also may need to change the way they account for performance bonuses and milestone payments under the new revenue guidance. Entities may recognize revenue related to some bonuses and milestone payments sooner than they do under legacy GAAP, because the new standard requires them to include in the transaction price the consideration to which they expect to be entitled, after applying the variable consideration constraint. This will be a change in practice for life sciences entities that, under legacy GAAP, generally did not recognize revenue that is contingent on a future event, such as achieving a milestone, until that event occurred, because the sales price was not "fixed or determinable," as required by SEC Staff Accounting Bulletin Topic 13 (see Q 14.6.2).

The recognition of revenue under these types of arrangements could materially impact reported earnings and business valuations, so the arrangements need to be thoroughly understood and diligenced, including the impacts of the recently released guidance on revenue recognition discussed earlier.

## Q 14.11 How should up-front fees be recognized for R&D activity?

Many arrangements involving the performance of R&D activities also include arrangements or contracts for follow-on services, if and when a commercially viable product has been developed. Common examples include supply or contract manufacturing contracts. These arrangements raise questions relating to the period over which any up-front fees received by the company performing the R&D services should be recognized (regardless of whether a performance-based or milestone-based method is used). If substantive R&D activities must be performed, and substantial risks are associated with whether those activities will result in a commercially viable product, then the up-front fees should be recognized over the period that the R&D services are performed.

However, if, at the date the up-front fees are received, there is little risk associated with successful completion of the remaining R&D activities, and it is clear that the completion of those activities will result in a commercially viable product, then the up-front fee should be recognized over the estimated economic life of the arrangement.

Additionally in such cases, careful consideration should be given as to whether the company has essentially completed the R&D activities before entering into the arrangement. If the funding parties are in essence purchasing a future revenue stream, the arrangement should be accounted for as sales of future revenues, which would result in the payments from the funding parties potentially being accounted for as debt.

## Q 14.12 What are multiple-element contracts?

Life sciences companies commonly enter into multiple-element revenue arrangements. These arrangements are defined as contractually binding agreements, whether written, oral, or implied, which involve the delivery of multiple products, services, or rights to use assets, and for which performance may occur at different points or over different periods of time. For example, R&D collaboration arrangements may include a license to use certain intellectual property for a product candidate, R&D services, and manufacturing services. The consideration for such arrangements may include a combination of up-front license fees, payments for R&D services, milestone payments, future royalties, and payments for manufacturing services. These arrangements are considered multiple-element revenue arrangements for accounting purposes. The factors to consider in determining whether or not the appropriate accounting has been applied to multiple-element arrangements include an understanding of:

- The significant deliverables within the multiple-element arrangements and how they are determined;
- The general timing of delivery or performance of service for the deliverables within the arrangements;
- The existence of performance, cancellation, termination, and refund-type provisions;
- The significant factors, inputs, assumptions, and methods used by the company to determine the selling price (whether vendor-specific objective evidence, third-party evidence, or estimated selling price) for the significant deliverables;

- Whether or not the significant deliverables in the arrangements qualify as separate units of accounting;
- The general timing of revenue recognition for significant units of accounting; and
- The effect of changes in either the selling price or the method or assumptions used to determine selling price for a specific unit of accounting, if either one of those changes has a significant effect on the allocation of arrangement consideration.

The recognition of revenue under these types of arrangements could materially impact reported earnings and business valuations, so the arrangements need to be thoroughly understood and diligenced, including the impacts of the recently released guidance on revenue recognition discussed earlier.

## Q 14.13 What are important revenue recognition issues related to intellectual property licensing?

For revenue to be recognized under intellectual property licensing, the following are some key considerations:

- The licensor executed a noncancelable agreement;
- The licensor has agreed to a fixed fee;
- The licensor has received the rights without restriction as to exercise; and
- The licensor has met all significant obligations to furnish the property.

Typically in such arrangements, a licensee will pay a minimum guarantee to licensor for the right to sell or distribute the product. Such a minimum guarantee is unearned (deferred) revenue and is earned and recognized under the specific terms and conditions of the associated licensing agreement. Buyers must understand the nature of the agreement to ensure appropriate revenue recognition (also see Q 14.6.4) and determine whether there are change-in-control considerations.

## Balance Sheet Considerations

### Q 14.14 What balance sheet considerations are particularly important during due diligence?

In preparing the balance sheet, certain estimates and assumptions are used that affect reported amounts and disclosures and can impact all elements of the financial statements, including the results of operations. Significant estimates are used to determine the valuation and recoverability of assets, such as accounts receivable, inventories, fixed assets, and intangible assets (including acquired in-process research and development (IPR&D) assets and goodwill). Estimates are used to determine the reported amounts of liabilities, such as accruals for self-insurance risks, taxes payable, pension and other benefit obligations, the impact of contingencies, and restructuring reserves. Changes or errors in the calculations of the related assets and liabilities all impact a company's results of operations and ultimately the valuation that a willing buyer places on the company.

Estimates are often based on complex judgments and assumptions and are assigned probabilities that management believes to be reasonable but that can be inherently unpredictable. Companies are subject to a variety of risks and uncertainties that may cause actual results to differ significantly from estimated amounts, especially if the processes the company undertakes are not strong. In diligence, one must evaluate the company's estimates and assumptions through a look-back and evaluation of the historical accuracy and completeness of the company's previous estimates and benchmarking the company's historical experience and expectations about the future against other comparable companies.

### Q 14.15 What is unique about patient receivables in a health care services setting?

Patient receivables for health care providers include amounts due from patients and third-party payors (for example, Medicare, Medicaid, commercial insurers, employers). Charity care and contractual adjustments, discounts, and an allowance for uncollectible accounts are initially estimated to record the receivables at the net realizable value.

Estimates of contractual adjustments, other adjustments, and the allowance for uncollectible balances are complex. The estimates of contractual allowances are to be reported in the period during which the services are provided. The adjustments will periodically be trued- up when the actual amounts become known, often as the result of a look-back analysis, based in large part on the comparison of historical cash collections and recorded revenues.

## Q 14.16 What are third-party settlements?

A health care entity may be entitled to receive additional payments or may be required to refund amounts received in excess of that allowed based on performance, contract incentives, or reimbursement of allowable costs in the performance of the required services. This often results in differences in what may initially be recorded and that which is ultimately recorded.

Retrospective payment systems with respect to Medicare or Medicaid can result in final settlement amounts that may be due to or from government health care payors. Because government reimbursement rules are complex, the actual final settlement amounts can differ significantly from estimated amounts. The accumulation, allocation, and determination of allowable costs and other factors result in final settlements that are different from the interim payment rates and the amounts that may have initially been recorded by the company. In due diligence, it is important to determine the historical period to which the adjustments relate, in order to more accurately reflect the results of operations for the periods under analysis.

## Q 14.17 What are medical claims liabilities?

If a health care entity receives premium or capitation revenues from employers or other payors, the company receiving the premium or capitation revenue is typically contractually obligated to arrange for the provision of services or to directly provide covered services to qualified beneficiaries.

Patients or health care service providers will file a reimbursement or payment claim with payors after performance of the covered services. There is generally a time lag between the provision of the obligated services and the filing of the reimbursement or payment claim

which is an obligation of the payor. A liability for unpaid claims, including incurred but not reported (IBNR) claims, is estimated and recognized to reflect the obligated services.

Lag tables matching the date of services and actual payments or reimbursements are prepared by a company's underwriters and/or actuaries. Using the lag tables and other empirical and economic data, an estimate of the related medical claims liability is determined using actuarial methodologies reflecting the underlying medical cost and utilization trends. Changes in the estimated medical claims liability from period to period are recorded directly to medical cost expenses. Misstatement of this obligation may have a significant impact on the financial results of the related entity. Buyers often hire their own actuarial advisers to review critical assumptions and determine the adequacy of recorded liabilities.

## Q 14.18 What risks arise in analyzing medical malpractice, workers' compensation, and other self-insured claims?

Commercial insurance is typically used by health care service providers in part to manage the risk of loss from medical malpractice, workers' compensation, and employee health claims. Medical malpractice coverage is generally purchased on either a "claims made" or a "claims paid" basis. Most health care companies use various levels of deductibles, employee contributions, and self-insurance to combat the cost of managing risk. Some start their own insurance companies, commonly referred to as captive insurance companies.

Companies must evaluate the exposures to losses arising from claims and record a liability for the best estimates of the ultimate costs that will be incurred, including consideration for any insurance recoveries. The recorded liability should include costs for IBNR claims, estimated costs associated with litigating and settling the claims, and contingencies related to the claims. Loss accruals are often actuarially determined, and recommended funding amounts will often be different and will need to be analyzed for their impact on future cash flows. Long-term liabilities are sometimes discounted and may not represent the ultimate liability. Buyers usually seek their own advisors to challenge the views of a seller or its advisors, as these matters involve a high degree of judgment.

## Q 14.19 What are key considerations with respect to product warranties with life sciences companies?

Many medical device product sales arrangements include warranty provisions guaranteeing that the product will perform as expected or perform according to published specifications. These provisions protect the customer against defects in a product's workmanship or performance. They require the seller to make repairs or replacements for products that do not meet the original performance specifications during a certain time period subsequent to purchase or installation.

Warranties may be explicitly included in the contractual arrangement with a customer, they may be required by law or regulation, or a vendor may have established an implicit policy of providing warranty services to maintain a desired satisfaction level among its customers. Whether explicit or implicit, warranty obligations extend a seller's obligations beyond the initial physical transfer of the product, requiring it to stand ready to perform on the warranty over the life of the warranty obligations.

Under legacy guidance, how warranty provisions should be accounted for depends on the terms of the arrangement with the customer and the substance of the warranty obligations. For standard warranties, the estimated costs of honoring the warranty obligations should be accrued as additional costs of sales when revenue for the product sale is recognized. The estimated accrued costs of future warranty obligations should be recorded as a liability. (If costs cannot be estimated, revenue recognition may not be appropriate.) Once recorded, the warranty liability should be assessed on a continual basis to ensure that changes in the seller's environment or obligations are reflected in the recorded liability. The liability should be adjusted (with the offset recorded as an adjustment to costs of sales) as changes in estimates occur. For other types of warranties, the accounting result may differ based on the specific terms and conditions. For example, an extended warranty usually results in a deferral of the amounts collected, with the revenue being recorded over the warranty period and the costs recorded as incurred. Careful consideration must be given to ascertain that the appropriate costs have been accrued related to

future warranty costs. Further, the new guidance on revenue recognition clarified the treatment of warranties, and the treatment differs depending upon the type of warranty that is offered. Companies may need to exercise significant judgment when determining whether a warranty is an assurance-type or service-type warranty as defined in new guidance and are separate performance obligations.

## Q 14.20 How should research and development costs be treated in target financial statements?

All R&D costs are expensed when incurred, with certain exceptions. R&D activities include, but are not limited to:

- Laboratory research aimed at discovery of new knowledge;
- Modification of the formulation or design of a product or process;
- Design, construction, and testing of pre-production prototypes and models;
- Design of tools, jigs, molds, and dies involving new technology;
- Design, construction, and operation of a pilot plant that is not of a scale economically feasible to the enterprise for commercial production; and
- Engineering activity required to advance the design of a product to the point that it meets specific functional and economic requirements and is ready for manufacture.

If the R&D costs incurred relate to materials, equipment, and facilities costs that have an alternative future use, these costs may be capitalized and depreciated. In addition, if the costs incurred relate to nonrefundable advance payments for goods or services that will be used in future R&D activities, these costs may be deferred until the goods or services are used, at which time these costs would be expensed. Such costs may include, but are not limited to:

- Materials, equipment, and facilities costs: Entire cost, unless the items have alternative future uses;
- Personnel costs: Salaries, wages, and other related costs of personnel engaged in R&D;

- Intangibles purchased from others, directly or in connection with a business combination: Entire cost, unless the items have alternative future uses;
- Contract services: R&D conducted by others and services performed by others in connection with the reporting company's R&D; and
- Indirect costs: Reasonable allocation of indirect costs, excluding general and administrative costs that are not clearly related to R&D activities.

Equipment or facilities that are acquired or constructed for R&D activities and that have alternative future uses (in R&D projects or otherwise) are capitalized and depreciated as tangible assets. Likewise, the cost of intangibles that are purchased from others for use in R&D activities and that have alternative future uses (in R&D projects or otherwise) are capitalized and amortized as intangible assets. However, the costs of intangibles that are purchased from others for a particular R&D project and that have no alternative future uses and therefore no separate economic values are considered R&D costs and are expensed when incurred (unless these assets are acquired in a business combination). Alternative future uses should be currently identifiable and commercially viable, and in an application currently available to the company. Potential future uses that are not reasonably expected to be utilized by the company would not meet the alternative future use test and would be expensed.

There may be in-process R&D (IPR&D) costs that relate to previous business combinations that are reflected on the balance sheet. These balances are discussed later in this chapter.

## Q 14.21 What other liabilities should be considered in conducting due diligence of health care entities?

Other liabilities to be considered in acquiring health care–related entities include (1) deferred revenue obligations for cash received and accounts receivable recognized in advance of services rendered (for example, premium revenues) to ensure that revenue recognition was not accelerated; (2) losses arising from litigation and other regulatory

matters, such as Medicare and Medicaid fraud and abuse settlements or FDA fines or penalties; (3) accruals related to the obligation by continuing care retirement communities to provide future services and the use of facilities to current residents; (4) contingent consideration obligations from previous acquisitions (that is, earn-out obligations); (5) environmental remediation-related obligations; (6) estimated risk pool settlements arising from managed care contracting; (7) amounts reported for long-term obligations, such as amounts reported for pensions and postemployment benefits and deferred stock compensation; (8) hedging positions, interest rate swaps, derivatives, and other financial instruments; (9) straight-line rent accruals; (10) asset retirement obligations; and (11) foreign exchange contracts. It is important to understand the nature and assess the adequacy of the recorded amounts. Certain such liabilities may be considered reductions of enterprise value.

## Q 14.22 What are restructuring reserves and expenses?

Companies often choose to restructure underperforming businesses to address changes in the market or attempt to improve performance. Restructuring costs are incurred periodically for cost-reduction and productivity initiatives, which include site closings and other facility rationalization actions, workforce reductions, and the expansion of shared services, including the development of global systems.

Costs are also incurred for divestitures and integration of acquisitions. Integration costs (such as expenditures for consulting and the integration of systems and processes) are typically one-time costs and charges, related to employees, assets, and activities that will not continue in the combined company.

This includes costs related to the closing of duplicative facilities and other site rationalization actions company-wide, including R&D facilities, manufacturing plants, sales offices, and other corporate facilities. Acquisition-related restructuring costs include workforce reductions and severance-related costs and other organizational changes. In the past, reserves were recorded as part of the acquisition accounting and the related expenses were not included in results of operations.

This is no longer allowed, and costs related to restructuring should not include any costs expected to be ongoing beyond the completion of the restructuring activities.

Buyers need to distinguish between nonrecurring restructuring costs and those that could occur on a more regular basis, in the normal ebbs and flows of a continuing operation.

## Commitments and Contingencies

### Q 14.23 What are commitments and contingencies?

Commitments are obligations the company has entered into that may not be reflected (or fully reflected) in the financial statements of the company. They can include (1) unconditional or minimum purchase obligations, (2) obligations under earnout agreements from prior acquisitions, (3) unused letters of credit, (4) preferred stock dividends in arrears, (5) construction commitments, (6) commitments for equipment acquisitions, (7) operating leases, and (8) obligations to reduce debts, maintain working capital, or restrict dividends.

Contingencies are defined as existing conditions, situations, or sets of circumstances involving uncertainty as to possible loss or gain to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.

It is important to understand the target entity's full scope of commitments and other potential obligations and the related risks, as commitments and contingencies are not all required to be recorded in the reported financial statements.

#### Q 14.23.1 How are commitments and contingencies quantified?

In determining whether the amount recorded is appropriate or, if not recorded, an accrual is required for a loss contingency, it is first necessary to assess the outcome of the contingency in terms of the likelihood of occurrence of the future event or events that will confirm the loss. Loss contingencies (under U.S. GAAP) are categorized using three terms based on the likelihood of occurrence:

- Probable: The future event or events are likely to occur.
- Reasonably possible: The chance of the future event or events occurring is more than remote but less than likely.
- Remote: The chance of the future event or events occurring is slight.

If it is probable that a loss will result from a contingency and the amount of the loss can be reasonably estimated, the estimated loss is accrued by a charge to income. Both conditions must be met for a loss contingency to be accrued.

If a loss is probable and the reasonable estimate of the loss is a range, then the amount of the loss can be reasonably estimated and an amount should be accrued for the loss. If some amount within the range appears at the time to be a better estimate than any other amount within the range, that best estimate should be accrued. However, if no amount within the range is a better estimate than any other amount, the minimum amount in the range should be accrued. IFRS requirements can lead to differences from the above.

Gain contingencies usually are not recognized in the financial statements until the period in which all contingencies are resolved and the gain is realized. Examples of gain contingencies include claims against others for patent infringement, claims for reimbursement under condemnation proceedings, and potential insurance recoveries that exceed the loss recognized in the financial statements.

## Q 14.24 What types of commitments and contingencies are common in health care services entities?

In health care services entities, other types of commitments and contingencies to be aware of relate to items such as (1) loss contracts, (2) physician guarantees and employment agreements, (3) litigation, (4) losses arising from regulatory matters, such as Medicare and Medicaid fraud and abuse settlements or FDA fines or penalties, (5) contingent consideration, or earn-out, obligations, and (6) change-in-control obligations.

### Q 14.24.1 What risks relate to managed care agreements with employers or subcontract agreements with payors?

Managed care organizations and health care providers may enter into annual or multiyear contracts with employers or other groups that may have not been underwritten properly or where facts and circumstances have changed that result in current or future losses in excess of premium revenues received. If a contract is expected to result in ultimate losses for the company, then the estimated losses are required to be recorded in the financial statements. It is important to review the contract economics during due diligence to determine whether such contracts exist and, if so, adjust the target valuation accordingly. Similar risks can exist with respect to capitation agreements between care providers and specialty care providers.

### Q 14.24.2 What risks relate to physician guarantees?

Under a variety of arrangements, entered into in accordance with regulatory requirements, physicians may provide services to patients of health care entities. Some arrangements are structured as minimum revenue or income guarantees and some are treated as financing transactions. For example, physicians may be recruited to a geographical area to establish a practice or to provide specific expertise and adequate coverage to support operations. The health care entity agrees to make payments to the physician based on gross revenues or other performance parameters. It is important to understand the substance of the agreements and ensure that the agreements are properly reported and accounted for.

## Change in Control

### Q 14.25 What change-in-control considerations are there with respect to share-based compensation?

Merger and acquisition transactions involving a change of control of the target company often trigger accelerated payments and employee benefit vesting, among other items.

Many companies have deferred compensation arrangements which are intended to retain employees over an extended period of time during which the arrangement will vest. Share-based deferred compensation includes options to acquire company stock, restricted stock units, or other equity issuances that are in the form of shares characterized as "redeemable" equity instruments, such that redemption can be required upon the occurrence of a change in control, at the option of the holder or the issuer at a predetermined price for a specified period of time. Most share options granted to employees under share-based compensation arrangements are call options, but some may be put options.

There are also share-based payment arrangements to external suppliers of goods or services who receive awards of equity shares, equity share options, or other equity instruments. The amounts are based, at least in part, on the price of the entity's shares or other equity instruments. The phrase "at least in part" is used because an award may be indexed to both the price of the entity's shares and something other than either the price of the entity's shares or a market, performance, or service condition.

The term "shares" includes various forms of ownership interest that may not take the legal form of securities (for example, partnership interests), as well as other interests, including those that are liabilities in substance but not in form. "Equity shares" refers only to shares that are accounted for as equity. Share-based payments granted to most independent directors (for their services as directors) are considered share-based awards and are subject to the accounting model for employee awards.

While a share-based payment agreement and related plan documents often specify all the terms of a share-based payment, other agreements between the employee and employer and between the company and suppliers also should be reviewed to determine whether those agreements affect the terms of a share-based payment in the event of a change in control. For example, an executive may have an employment contract that effectively amends the share-based payment. The employment contract may specify that vesting of share-based payments will be accelerated in a change in control. It is important to establish that the seller will be liable for such awards, which are

generally paid for out of the sale proceeds. Depending upon the terms of the awards, it is possible for a post-close earnings charge to the acquirer, even if "funded" by the seller.

## Q 14.26 What change-in-control considerations are there with respect to employment contracts?

Companies often enter into employment contracts with key executives and other employees that provide for defined severance compensation. Some employment contracts contain so-called "walk-away" clauses, which allow key executives and other employees to leave with full severance compensation and accelerated vesting of unvested share-based payment awards based on minor changes in responsibilities. Buyers should understand the severance and vesting provisions that exist and the post-closing compensation implications. Employment contracts often include noncompete clauses if employees leave during a predetermined period of time or as a condition of severance payment. Walk-away clauses with respect to key executives and other employees of acquired entities should be renegotiated with executives of acquired entities, if so desired, and/or noncompete clauses should be aggressively enforced.

## Q 14.27 What change-in-control considerations are raised by debt and financing agreements?

Debt and financing agreements may contain change-in-control provisions impacting interest rates, payment schedules, or penalties. This may lead to accelerated payment requirements, prepayment penalties, or increases in interest rates.

## Q 14.28 What change-in-control considerations are specific to joint ventures and alliances?

Most joint venture and alliances contain change-in-control provisions whereby the partners have the ability to terminate the joint venture or alliance in the event of a change of control. It is important to understand the terms and conditions of all joint venture and alliance agreements and any liabilities or cash or funding obligations that may result from unwinding a joint venture or alliance, as well as any resulting changes in earnings.

### Q 14.29 What change-in-control considerations are raised by licenses and service contracts?

Information technology license and service contracts often have change-in-control provisions which require approval by the vendors prior to transfer of the IT licenses. Issues may also exist for other service contracts that have favorable rates that may not transfer to the acquirer.

## Risk-Based Capital

### Q 14.30 What is risk-based capital?

Risk-based capital (RBC) represents the estimated amount of statutory net worth (SNW) that regulators believe a health insurer should hold to protect against adverse deviation based on the insurer's assessment of its risks. Regulators, rating agencies, and health insurers may each use different methods, formulas, and procedures to estimate a health insurer's RBC. From an M&A perspective, potential buyers, creditors, and investors should assess the financial strength and liquidity of an insurer based on its RBC and RBC ratio. In the purchase of a managed care organization or other regulated insurance enterprise, a buyer should require the seller to deliver an agreed-upon level of RBC (that is, an amount in excess of statutory net worth). The delivery of a certain level of RBC is akin to the delivery of a minimum level of working capital in noninsurance transactions.

### Q 14.31 What is statutory net worth?

Statutory net worth is the excess of the insurer's assets over its liabilities adjusted for defined, nonadmitted assets. For regulatory reporting purposes, an insurer's statutory net worth is calculated using statutory accounting principles (SAP). Such principles were developed and are maintained by the National Association of Insurance Commissioners (NAIC).

## Q 14.32 How does SAP accounting impact statutory net worth?

The focus of SAP is to assess the company's solvency and liquidity, and, therefore, disallows an insurer from including assets that have little or no value if the company were unable to pay its claims or becomes insolvent and is required to liquidate assets to pay claims. Such assets are often referred to as nonadmitted assets. Typically, they consist of certain types of prepaid expenses, furniture and equipment, software development costs, deferred income tax assets, certain equity investments, and intangible assets.

The types of investments held by an insurer can also have a major impact on the insurer's statutory net worth. Investments in equities may fluctuate in value more than high-grade bonds or cash or cash equivalents. The accounting relative to how such assets should be valued for regulatory purposes can amplify the effects of an insurer's statutory net worth (for example, equities are typically carried at market value, leading to higher or lower levels of statutory net worth). It should be noted too that recent changes to U.S. GAAP will generally result in more equity securities being marked to market on a recurring basis.

## Q 14.33 What calculations are typically used to assess the adequacy of an insurer's statutory net worth?

Calculations related to an insurer's statutory net worth include the following:

- Statutory net worth as a percentage of premium revenue: Amount is calculated by dividing insurer's statutory net worth at the end of the year by its annual premium revenues.
- Statutory net worth per member month: Amount is calculated by dividing insurer's year-end statutory net worth by the number of its member months (annually).
- Statutory net worth divided by average medical expenses: Amount is calculated by dividing insurer's year-end statutory net worth by its average monthly medical expense during the year.

- RBC: Developed by the NAIC, RBC is the most widely accepted measure of the adequacy of an insurer's net worth. RBC applies various factors to the insurer's statutory financial statements accounting for different types of risks faced by the insurer and establishes minimum levels of surplus (that is, statutory net worth) based on these risks. For example, the RBC considers various risks such as (1) product mix sold by the insurer (for example, commercial products are more risky than HMO products), (2) provider payment arrangements (for example, fee for service payments are riskier than capitation), and (3) types of investments (for example, equities are riskier than bonds). Riskier factors negatively impact the insurer's RBC.

### Q 14.33.1 What measure do most advisors use to assess an insurer's statutory net worth?

Most advisors, including state insurance regulators, view RBC as one of the best tools to evaluate the adequacy of an insurer's statutory net worth, as it takes into consideration various risks associated with the insurer's operations. For this reason, most state regulators, rating agencies, creditors, and investors use RBC to track and assess the financial strength and liquidity of an insurer.

## Q 14.34 How are the insurer's RBC ratio and authorized control level calculated?

The NAIC RBC formula generates the regulatory minimum amount of statutory net worth an insurer is required to maintain to avoid regulatory action. Using the RBC formula, a health insurer calculates its RBC amount, which is divided by two to produce its authorized control level (ACL). An insurer divides its statutory net worth by its ACL to calculate its RBC ratio. The RBC ratio is used to assess the adequacy of its statutory net worth by comparing it to thresholds set by NAIC and state regulators. If an insurer's statutory net worth drops below its ACL, state regulators typically place the insurer under regulatory control.

### Q 14.35 Why are RBC and statutory net worth relevant in health care M&A?

From an M&A perspective, potential buyers of health insurers should consider, among many factors, (1) the impact of nonadmitted assets on the insurer's statutory financials, (2) amount of the insurer's overall statutory net worth, (3) amount and adequacy of insurer's statutory net worth compared to its RBC, and (4) its RBC ratio compared to NAIC and state regulatory requirements. Potential buyers should assess the impact of such items relative to the purchase price of the insurer, its solvency, cash flows, and working capital. Also, such buyers should assess the insurer's existing relationship with state regulators and its ability to meet its capital requirement and pay dividends to investors. In many managed care M&A transactions, the parties agree that the seller is required to deliver a negotiated level of RBC or statutory net worth rather than a negotiated level of net working capital.

## Financial Statements Needed to Finance and Complete an Acquisition

### Q 14.36 What are the SEC reporting requirements for public companies in connection with acquisitions?

Audited annual financial statements of significant acquired businesses must be reported in 1934 Act reports on Form 8-K and in certain 1933 Act filings and proxy statements. The number of years (that is, one, two, or three years) that audited financial statements must be presented generally depends on the significance of the acquired business. Interim financial statements may also be required, depending on the acquisition date. Rule 3-05 (Financial Statements of Businesses Acquired or To Be Acquired) of Regulation S-X describes the SEC's requirements for registrants to provide audited financial statements of acquired or to-be-acquired businesses. The definition of what constitutes a business for SEC reporting purposes is included in SEC Rule 11-01(d).

In addition to acquisitions that result in the registrant's obtaining control of an acquired business, the acquisition of an investment

that will be accounted for under the equity method of accounting is deemed to be an acquisition of a business for purposes of reporting under Rule 3-05.

Audited financial statements of significant acquired companies or businesses must be reported in 1934 Act reports on Form 8-K and in certain 1933 Act filings to ensure that shareholders and potential investors have sufficient information to make investment decisions. However, acquired business financial statements are not required in annual reports on Form 10-K, annual shareholders reports, or interim reports on Form 10-Q, because the acquisition of a significant business must be reported timely on Form 8-K. However, if the acquisition occurs within four business days of filing a Form 10-Q or Form 10-K, the acquisition instead may be reported in that periodic report.

The number of years that audited financial statements must be presented depends on the highest significance level of the acquired or to-be-acquired business, as summarized in Table 14-2.

**TABLE 14-2**

**Number of Years of Audited Financial Statements to Be Presented Under Regulation S-X**

| Highest level of significance | Number of years of audited financial statements |
|---|---|
| Less than 20% | None required |
| Between 20% and 40% | One year |
| Between 40% and 50% | Two years |
| Greater than 50% | Three years of income statements and statements of cash flows and two years of balance sheets.<br>(Exception: If in the most recent of the three years, net revenues of the acquired business are less than $50 million, the earliest year can be omitted.) |

## Q 14.37 What tests are used to determine whether an acquisition is considered to be a significant subsidiary?

The significance of an acquired or to-be-acquired business is based on the "significant subsidiary" tests (that is, the asset test, the investment test, and the income test) specified in S-X Rule 1-02(w).

According to S-X Rule 3-05(b)(3), significance should generally be determined by comparing the most recent annual preacquisition audited financial statements of the acquired business, or group of businesses, to the registrant's most recent annual preacquisition audited financial statements filed with the SEC. If the registrant or acquiree has been in existence for less than one year, the registrant or acquiree should not annualize its historical financial statements.

Significance tests must be computed using both the numerator and denominator. In general, the tests are as follows:

- *Asset test*. The registrant's proportionate share of the total assets (after intercompany eliminations) of the acquired business compared to consolidated total assets of the registrant.
- *Investment test*. The registrant's investments in and advances to the acquired business compared to consolidated total assets. The investment test is generally computed by comparing the consideration transferred, determined under GAAP, to the registrant's consolidated assets.
- *Income test*. The registrant's equity in the acquired business income from continuing operations before income taxes, extraordinary items, and cumulative effect of a change in accounting principle compared to the registrant's income on a consolidated basis. In some circumstances, registrants are permitted to use their average income for the last five fiscal years as opposed to income for their most recent fiscal year, as the denominator for the income test. Additional guidance for when this exception applies can be found in computational note two to Rule 1-02(w).

## Q 14.38 What are the timing requirements for filing?

A Form 8-K reporting the business acquisition must be filed within four business days of the acquisition date. The information required by Item 9.01 of Form 8-K (that is, the audited financial statements and pro forma financial information) may be filed with the initial report or by amendment on Form 8-K/A within seventy-one calendar days of the original Form 8-K due date. If the financial statements and pro forma financial information are not included in the initial report, the registrant must state when the required financial information will be filed. The SEC staff will not consider requests for further extensions.

With respect to filings under the Securities Act, if the significance of the acquired business or group of "related businesses" exceeds 50%, the SEC staff will not allow most registration statements or post-effective amendments to go effective until the audited financial statements required by S-X Rule 3-05 are filed. For acquisitions less than or equal to 50% significant, financial statements of acquired businesses are not required unless the registration statement is declared effective seventy-five days or more after the date of the acquisition. However, the age of financial statements for any required acquired businesses should be determined based on the effective date of the registration statement. Therefore, there may be circumstances in which financial statements of a significant acquired business were previously provided on Form 8-K but require updating to the most recent preacquisition annual or interim period. If the registrant is eligible for incorporation by reference, any updated financial statements required in the registration statement can be provided on Form 8-K. However, the following securities offerings may proceed notwithstanding the fact that financial statements of the acquired business have not been filed: (1) offerings or sale of securities upon the conversion of outstanding convertible securities or upon the exercise of outstanding warrants or rights, (2) dividend or interest reinvestment plans, (3) employee benefit plans, (4) secondary offerings, and (5) sales of securities pursuant to Rule 144.

## Q 14.39 What are the requirements with respect to foreign acquisitions?

If financial statements are required for a business that is acquired from an entity located in a foreign jurisdiction, it is important to understand whether the acquired business meets the definition of a foreign business under Regulation S-X. Financial statements of an acquired foreign business may be prepared on a comprehensive basis other than U.S. GAAP or IFRS as issued by the IASB. Reconciliations to U.S. GAAP (from a local GAAP) must be provided when the significance of the foreign business exceeds 30%.

However, if the financial statements of the foreign business are presented in accordance with IFRS as issued by the IASB, those statements may omit all reconciling information referred to above (and as further described below). The financial statements of the foreign business may be presented in the reporting currency of the registrant or that which the foreign business normally uses in preparing its financial statements.

If a reconciliation is required, the financial statements of the foreign business need only comply with the reconciliation requirements of Item 17 of Form 20-F, rather than Item 18. Even though the significance level of an acquisition may require the presentation of three years of audited financial statements, if the financial statements for the foreign business have not previously been required in a SEC filing, the U.S. GAAP reconciliation only needs to be provided for the most recent two years and any required interim period.

If three years of audited financial statements of an acquired foreign business would be required based on the level of significance, a registrant may elect to present the acquired business's statements for only two years if they are prepared using U.S. GAAP, rather than home-country GAAP with a reconciliation. The registrant's primary financial statements must also be prepared in accordance with U.S. GAAP if post-acquisition periods are considered in determining the years presented. If a foreign incorporated acquiree does not qualify as a foreign business, the financial statements required under Rule 3-05 must either be presented under U.S. GAAP, home-country GAAP

reconciled to U.S. GAAP in accordance with Item 18 of Form 20-F, or IFRS (as issued by the IASB) reconciled to U.S. GAAP in accordance with Item 18 of Form 20-F.[1]

## Q 14.40 What is pro forma financial information as required by the SEC?

Article 11 of Regulation S-X describes the SEC's requirements for registrants to provide pro forma financial information. Article 11 applies to registration statements, certain proxy statements, and Form 8-K filings. Pro forma information pursuant to Article 11 of Regulation S-X is not required in Form 10-K or in the annual shareholders report.

Pro forma financial information is intended to help investors understand the impact of a significant transaction, such as a business combination or disposition, by showing how the transaction might have affected the historical financial statements. Pro forma financial information generally includes a condensed income statement for the registrant's latest year and any subsequent interim period, a condensed balance sheet as of the end of the latest period presented, and accompanying explanatory notes.

Companies must present pro forma financial information when financial statements for a recently acquired business are required. As discussed in Q 14.36, the definition of a business for purposes of Regulation S-X also includes the acquisition of an investment that will be accounted for under the equity method of accounting.

## Q 14.41 For what period is pro forma financial information required?

In general, pro forma financial statements should include only the latest fiscal year and interim period. However, when pro forma information is presented to reflect a significant disposition or for a transaction accounted for as a reorganization of entities under common control, pro forma financial information for all periods is required.

The pro forma balance sheet and pro forma income statement periods should correspond to the registrant's latest annual and interim balance sheet dates. Accordingly, in a registration statement, the pro forma financial statements are required to be updated whenever the registrant's financial statements must be updated.

A pro forma balance sheet must be presented as of the date of the latest balance sheet in the filing. However, if the transaction is reflected in the latest consolidated balance sheet in the filing, a pro forma balance sheet is not required.

A company must file pro forma income statements for the most recent fiscal year and for any subsequent interim period to the date of the interim balance sheet presented. The pro forma income statements should be prepared as if the transaction occurred at the beginning of the full fiscal year presented. A pro forma income statement for the corresponding interim period of the preceding fiscal year is optional. However, once the transaction has been reflected in the consolidated income statement included in the filing for an entire fiscal year, a pro forma income statement should not be presented.[2]

Companies should present the pro forma income statements through income (or loss) from continuing operations before nonrecurring charges or credits directly attributable to the transaction. If the historical financial statements report discontinued operations, extraordinary items, or the cumulative effects of accounting changes, these items can be excluded from the pro forma income statement.[3]

## Q 14.42 What are pro forma adjustments?

Pro forma adjustments to the balance sheet should be computed assuming the transaction occurred on the date of the latest balance sheet included in the filing. Pro forma adjustments should give effect to events that are directly attributable to each specific transaction and factually supportable. In addition, adjustments should include those items that have both a continuing impact and those that are nonrecurring.

Pro forma adjustments to the income statement should be computed assuming the transaction occurred at the beginning of the fiscal year presented and carried forward through any interim period presented. Pro forma adjustments should give effect to events that are (1) directly attributable to each specific transaction, (2) factually supportable, and (3) expected to have a continuing impact.

Generally, pro forma adjustments should be presented gross on the face of the pro forma statements. Alternatively, components of the

adjustments should be broken out in a sufficiently detailed manner in the notes to the pro forma statements.

Material nonrecurring items should not be presented as adjustments when preparing the pro forma income statement, but must be separately disclosed in the notes to the pro forma financial information. Rule 11-02(b)(5) provides that nonrecurring items are those that will be included in the income of the registrant within the twelve months subsequent to the transaction. However, income statement items not reflected in the historical financial statements that are directly attributable to the transaction and are factually supportable, but nonrecurring (for example, gain on sale), normally should be reflected in the pro forma balance sheet as pro forma adjustments to equity.

For example, for a purchase business combination, depreciation and other adjustments based on the purchase price allocation are pro forma adjustments. The rules state that

> in some transactions, such as in financial institution acquisitions, the purchase adjustments may include significant discounts of the historical cost of the acquired assets to their fair value at the acquisition date. When such adjustments will result in a significant effect on earnings (losses) in periods immediately subsequent to the acquisition which will be progressively eliminated over a relatively short period, the effect of the purchase adjustments on reported results of operations for each of the next five years should be discussed in a note.

In addition, pro forma adjustments often are necessary to conform the acquired business's accounting policies to the registrant's. Where the registrant has adopted a change in an accounting principle, the pro forma information should consistently apply the newly adopted accounting principle to all periods presented if GAAP required pro forma information regarding the accounting change to be disclosed in the registrant's financial statements.

It is not appropriate to remove the effects of material nonrecurring items included in a historical income statement from which the pro forma income statement is derived. For example, if the historical

income statement included a material restructuring provision (which did not result directly from the transaction), it is not appropriate to remove the historical restructuring provision as a pro forma adjustment. Such an adjustment would generally not be directly attributable to the transaction that the pro forma financial information is giving effect to.

The tax effect, if any, of pro forma adjustments should be reflected as a separate pro forma adjustment. The tax adjustment normally should be calculated at the statutory rate(s) in effect during the income statement period(s). If taxes are calculated on another basis, or if unusual effects of loss carryforwards or other aspects of tax accounting are depicted, explanation should be provided in a note to the pro forma financial statements.

### Q 14.42.1 When are pro forma adjustments factually supportable?

It may be difficult to determine whether a pro forma adjustment is factually supportable. The SEC staff generally follows these administrative policies:

- Generally, adjustment for projected cost savings following a business combination should not be made. Pro forma adjustments usually should not give effect to actions taken (or expected to be taken) by management after a business combination related to the integration and management of the acquired business. The SEC staff views those types of adjustments as forecasts or projections, which are distinguishable from pro forma information. If the registrant expects cost savings that are not reflected in the pro formas, a discussion of the expected cost savings may be included in the notes to the pro formas or in MD&A.
- For adjustments requiring assumptions as to interest rate (for example, where proceeds from issuance of debt security are to be used to effect the purchase of another company and the pro forma income statement must include interest expense on debt), the rate at the time of the business combination generally should be used, not the rate at the beginning of the

year when the transaction was assumed to have occurred for purposes of preparing the pro forma income statement. For variable-rate financing, the pro forma presentation generally should assume an interest rate based on the index at the time of the transaction or at the time the registrant has a commitment. However, in limited circumstances, such as where the acquired assets are variable-rate instruments, the SEC staff will expect the pro forma presentation to use rates based on the underlying interest rate index during the periods for which pro forma operating results are presented (for example, interest expense on prime + 1% debt could be computed based on the prime rate in existence during the previous fiscal year and subsequent interim periods). When a rate other than the current or expected rate is used, the SEC staff expects prominent disclosure, in the introduction to the pro forma financial statements and wherever pro forma information is provided, of the basis of presentation and the anticipated effects of the current interest rate environment. If actual interest rates in the transaction can vary from those depicted, the registrant should disclose the effect on pro forma income of a 1/8% variance in interest rates.

### Q 14.42.2 How are purchase price allocations handled?

Business combinations result in the assets acquired and liabilities assumed of the acquired company generally being adjusted to their fair values. Therefore, the pro forma adjustments should reflect (1) the company's plans for allocating the purchase price, including adjusting assets and liabilities to fair value or otherwise and recognizing intangibles, all as required by the acquisition method of accounting, and (2) the effects of additional financing necessary to complete the acquisition. Acquisition costs incurred by the acquiree may be eliminated in a pro forma adjustment if the acquisition costs are non-recurring charges directly attributable to the business combination.

Rule 11-02(b)(6) of Regulation S-X requires that pro forma adjustments to the pro forma income statement be computed assuming the transaction occurred at the beginning of the fiscal year presented. However, estimated purchase accounting adjustments (for example,

to record a step-up to fair value of property, plant, and equipment) should be based on the most recent balance sheet and the depreciation and amortization of such adjustments should be reflected from the beginning of the year in the pro forma income statement.

The pro forma balance sheet should include a pro forma adjustment to adjust the inventory balance to fair value, consistent with the purchase price allocation. However, when preparing the pro forma income statement, companies should only present an adjustment for items with a continuing impact (i.e., generally those that affect the results of operations for a period greater than twelve months). Therefore, increased expense associated with any inventory step-up that will be fully recognized within a year (based on expected inventory turnover) would not require an adjustment in the pro forma income statement.

An acquired company may have recorded deferred revenue in its historical, pre-acquisition financial statements for a number of reasons. For example, these amounts could represent up-front payments for services or products the acquired company has not yet delivered or payments for delivered goods or services sold as a part of a multiple-element arrangement that could not be accounted for separately. In a business combination, the acquiring entity recognizes the acquired company's deferred revenue only if it relates to a legal performance obligation assumed by the acquiring entity. The measurement of the assumed performance obligation is at fair value at the date of acquisition. Therefore, in certain situations, the acquirer may write off the entire deferred revenue balance of the acquired company.

It is important to know whether the transaction is taxable or nontaxable, and if the latter, the tax basis of assets acquired and liabilities assumed. Often this determination will require involvement of accounting, valuation, and tax professionals.

If the purchase price allocation has not been finalized, U.S. GAAP specifies that the registrant should disclose that the purchase price allocation has not been finalized and the reasons why it has not. The registrant should identify the information that the registrant has arranged to obtain before the allocation can be finalized, and furnish other available information that will enable the reader to understand

the magnitude of any potential change to the allocation. The pro forma financial information should include similar disclosures.

If the fair value of contingencies acquired in a business combination is not determinable at the date of acquisition, the registrant should describe the nature of the contingency, identify the information that the registrant has arranged to obtain before the allocation can be finalized, and furnish other available information that will enable the reader to understand the magnitude of any potential accrual and the range of reasonable possible loss.

### Q 14.42.3 What new arrangements should be presented as pro forma adjustments?

Generally, new contractual arrangements entered into in connection with a business combination, such as new compensation contracts with management, would require a pro forma adjustment. New arrangements such as new distribution, cost sharing, management agreements, or benefit plans only may be reflected as pro forma adjustments if amounts can be factually supported, are directly attributable to the transaction, and are expected to have a continuing impact on the statement of operations.

### Q 14.42.4 What adjustments are inappropriate in pro forma financial statements?

The following adjustments generally are not appropriate on the face of the respective pro forma financial statements, but could be included in the notes thereto:

- Interest income from the investment of proceeds of the transaction.
- Income statement presentation of gains and losses directly attributable to the transaction. However, such amounts should be presented as an adjustment to pro forma retained earnings (in the pro forma balance sheet) with an appropriate explanation in the notes.
- Elimination of operating results of a disposal made during the year that is not directly attributable to the transaction.

Alternatively, an additional pro forma column reflecting the disposition or other transactions may be appropriate.

- Alternative measures of performance or liquidity and the financial statements showing the related effect of pro forma adjustments.

### Q 14.43 What financial statements do banks require in connection with an acquisition?

To fund a company acquisition, buyers typically arrange for financing with a bank or a syndicate of banks and receive a commitment letter that includes a set of draft terms and conditions that are intended to be in the loan once the acquisition is closed and funded. Depending on the size of the funding commitment and other considerations related to the borrower such as credit rating and cash flow generating ability, banks may require GAAP-compliant or SEC-compliant financial statements at funding, the requirements of which are discussed above. Often the definition of pro forma EBITDA in a bank loan or high-yield agreement will differ from pro forma EBITDA or pro forma operating earnings as defined under article 11 and will allow certain addbacks that do not meet the SEC's requirements for inclusion. The nature and extent of the addbacks are subject to negotiation between the lender and the borrower and will include both amounts related to historical events and the pushback of expected events and synergies post-closing.

## Other Bank Requirements

### Q 14.44 What should I consider in negotiating bank covenants?

Often in connection with an acquisition, the acquirer will obtain bank loans or high-yield loan financing to fund all or part of the total transaction cost. The key financing terms typically include positive and negative covenants with which the borrower is required to comply. This may include covenants such as those shown in Table 14-3.

**TABLE 14-3**

**Borrower Covenants**

| Covenant | Purpose/rationale |
|---|---|
| Limitations on indebtedness | Limit the amount of debt a company can incur unless cash flow is sufficient to service all debt and the company can maintain or improve its existing credit rating |
| Limitations on restricted payments | Prevent cash and assets from leaving the consolidated group and prevent the company from prioritizing its cash flow to other capital participants |
| Limitations on capital expenditures | Ensure that the borrower has sufficient cash flow to service all debt |
| Limitation on asset sales | Maintain "asset coverage" of debt and ensure assets remain dedicated to operations for which borrowings were made |
| Limitations on mergers, consolidations, sales, change in control | Restrict transactions that would result in an impaired credit from the lender's perspective |
| Mandatory prepayments related to excess cash flows, allowed asset sales, debt and equity issuances | Paydowns required due to smaller collateral base and claims on assets from other capital holders |
| Financial covenant: EBITDA/Interest | Measure of adequacy of cash flow coverage of interest charges while continuing to sustain operations |
| Financial covenant: Total debt/EBITDA | Measure of adequacy of EBITDA to support debt levels and repayment obligations |
| Financial covenant: Minimum working capital | Measure of adequacy of working capital to cover "peak-to-trough" periods and enough cushion to cover a minimum level of unexpected operating cash requirements |

There are limited statutory requirements for bank loans and high-yield offerings. Covenants are individually negotiated between lenders and borrowers and depend in part on liquidity in the market and the strength of the borrower.

Additional consideration should be given to removing the impacts of purchase accounting from the reported financial statements, as adjustments to opening balance sheets may create noncash charges going forward that may negatively impact covenant compliance. Similarly, covenants should be negotiated based on static GAAP for the duration of the loan agreement, such that subsequent changes in GAAP do not impact covenants.

## Q 14.45 What are reasonable financial reporting requirements?

Banks typically require monthly or quarterly internal financial reporting by borrowers. Sometimes banks require certification by the chief executive officer and chief financial officer. Banks also require annual audited financial statements to be prepared and submitted to the bank or bank consortium, typically within ninety to 120 days after a company's year-end.

## Q 14.46 What is minimum working capital?

Working capital is the net amount of liquid assets that are necessary to normally operate the company through the regular operating cycles, that is, current assets minus current liabilities. Banks normally set a working capital peg as the minimum amount that a company must have on hand as of each reporting period.

Working capital used in negotiations is usually defined as the difference between current assets, excluding cash and income tax–related receivables, and current liabilities, excluding overdrafts and income tax–related payables.

For stable businesses, minimum working capital levels are calculated from the monthly or quarterly financial statements over the trailing twelve or twenty-four months. It is important to take into consideration normal seasonal or intramonth working capital peaks and troughs to ensure that adequate working capital is on hand post-acquisition.

For rapidly growing or seasonal businesses, buyers and sellers may negotiate a working capital peg based on a projected balance.

## Acquisition Method

### Q 14.47 Under what circumstances does the acquisition method of accounting apply?

There are several matters to consider from an accounting perspective for various acquisition and investment alternatives in health care companies. Investments can take the form of straight loans or cash advances, senior or junior debt with equity participation, direct less-than-control investments in common or preferred stock, joint ventures, mergers, or outright acquisitions of controlling positions through friendly or hostile purchases of outstanding common and/or preferred stock. The nature and structure of the investment can result in different accounting implications, which, due to nuances in accounting rules, may differ from that which was anticipated. In some situations, investments are made with no intention of controlling the investee, however, accounting rules may require consolidation.

A business combination includes all transactions or other events in which control of one or more businesses is obtained. Transactions sometimes referred to as true mergers or mergers of equals also are business combinations. Therefore, although a business combination typically occurs through the purchase of the net assets or equity interests of a business, a business combination could also occur without the transfer of consideration. Examples include:

- The lapse of minority participating rights that previously prevented a majority owner from controlling (and therefore consolidating) a business;
- An investee's purchase of its shares that results in an existing investor's obtaining control of the investee's business;
- Control of a business obtained pursuant to a contractual arrangement; and
- The initial consolidation of a variable interest entity (VIE).

The determination of whether or not a transaction is considered a business combination is important because different accounting

guidance applies to transactions that are not considered business combinations. For example, goodwill can arise only in a business combination.

The new basis of accounting is important to understand in a business combination as it can materially impact the results of the operations of the entity being acquired, which in turn can impact bank covenant calculations and compliance related to operating earnings, EBITDA, and various measurements calculated based on financial performance.

## Q 14.48 How does the acquirer determine whether or not a transaction is considered a business combination?

A business generally consists of three elements: (1) inputs, (2) processes applied to those inputs, and (3) outputs that are used to generate revenues. However, to be considered a business, a set of activities and assets is required to have only the first two of those three elements (that is, inputs and processes), which together are or will be used to create outputs. That is, outputs need not be present at the acquisition date for an integrated set of activities and assets to be a business.

Additionally, if an acquired set of activities and assets are capable of being operated as a business from the viewpoint of a market participant, the assets acquired and liabilities assumed are a business subject to the accounting requirements. Back-office processes (that is, accounting, billing, payroll, etc.) generally are not considered processes used to create outputs. These concepts make the definition of a business broad, resulting in many transactions being business combinations. The FASB has been considering whether this definition should be tightened by requiring the presence of at least one substantive process for the transaction to be a business combination. As a result, FASB issued a new guidance on the definition of business in 2017. Under the new guidance, the company first determines whether substantially all of the fair value of the gross assets acquired is concentrated in a single identifiable asset or a group of similar identifiable assets. If this threshold is met, the set is not a business. If it is not met, the entity then evaluates whether the set meets the requirement that a business include, at a minimum, an input and a substantive process

that together significantly contribute to the ability to create outputs. The new guidance will likely result in more life sciences acquisitions being accounted for as asset acquisitions rather than business combinations. The guidance is effective for public entities for fiscal years beginning after December 15, 2017, and interim periods within those years. For all other entities, it is effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted.

When the company adopts the new guidance, it must consider how the change in the definition of a business affects its application of other guidance in U.S. GAAP as of the beginning of the period of adoption. For example, the company must evaluate whether the change in the definition of a business affects its conclusions about reporting units. The company also must use the new definition of a business to apply the consolidation guidance to new transactions and reconsideration events. Further, due to differences in accounting requirements for business combinations and asset acquisitions, the initial and ongoing accounting implications may differ significantly. For example, in a business combination accounted for under U.S. GAAP, an acquirer would record on the balance sheet the fair value of acquired IFR&D, while such amount would be immediately expensed in an asset acquisition.

The SEC has a low threshold for what is considered to be a business.

## Q 14.49 What are the accounting considerations in assessing the valuation of the balance sheet?

One of the primary principles is that obtaining control is a new basis recognition event. That is, the assets acquired and liabilities assumed, including any noncontrolling interests, are recognized at 100% of their fair value, with limited exceptions, regardless of the percentage of the equity interests acquired to obtain control. The acquirer's cost of the acquisition is relevant only in the determination of the acquirer's share of the full goodwill.

In a business combination, the target entity's carrying value of the assets acquired and liabilities assumed is not relevant in the measurement that results from the application of the acquisition

method of accounting by the acquiring entity. Similarly, except with limited exceptions, any prior classifications or designations of assets acquired and liabilities assumed are reconsidered in connection with their remeasurement. Classification and designation should also be reconsidered for assets held for sale. The acquirer's classification and designation should be based on all relevant factors at the acquisition date, including contractual terms, economic conditions, accounting policies of the acquirer, and any other relevant factors.

## Q 14.50 What is pushdown accounting?

The FASB issued final guidance in 2014 that gives acquired entities (for example, public, nonpublic) that are businesses or nonprofit activities the option to apply pushdown accounting in their separate financial statements when an acquirer obtains control of them. In pushdown accounting, an acquired entity's separate financial statements reflect the acquirer's new basis of accounting for the target's assets and liabilities. The guidance also allows any subsidiary of an acquired entity to apply pushdown accounting to its separate financial statements, regardless of whether the acquired entity elects to apply pushdown accounting. The SEC staff rescinded its guidance on pushdown accounting, which had required registrants to apply pushdown accounting in certain circumstances. As a result, the new U.S. GAAP guidance will apply to both SEC registrants and nonregistrants. The FASB noted that, until now, U.S. GAAP has offered limited guidance on the topic and that there has been diversity in practice among entities that are not SEC registrants.

## Q 14.51 When can pushdown accounting be applied?

The guidance gives all acquirees the option of applying pushdown accounting in their separate financial statements when an acquirer obtains control of them. An acquired entity can elect to apply pushdown accounting upon each event in which an acquirer obtains control of it. If the acquired entity elects not to apply pushdown accounting at the time an acquirer obtains control of it, the acquired entity can later elect to apply pushdown accounting retrospectively to the most recent event in which an acquirer obtained control of the acquired entity. Such an election will be treated as a change in accounting principle in

accordance with ASC 250. The EITF concluded that if the acquired entity's circumstances change (for example, if there is a significant change in the investor mix that would make pushdown accounting more relevant to current investors), the acquired entity should not be prohibited from applying pushdown accounting to the most recent event in which an acquirer obtained control of the acquired entity. Once an entity elects to apply pushdown accounting, its decision is irrevocable. The EITF concluded that a threshold of obtaining control is the most appropriate trigger for applying pushdown accounting because it is consistent with the thresholds of obtaining control in ASC 810 and ASC 805.

## Q 14.52 What are the most important measurement and recognition concepts and what are the exceptions?

The FASB believes fair value is the most relevant attribute for assets acquired and liabilities assumed in a business combination and provides information that is more complete, relevant, and understandable to financial statement users. The guidance requires all assets acquired, liabilities assumed, and any noncontrolling interests to be recorded at their acquisition-date fair values, with limited exceptions.

The accounting guidance includes certain recognition and measurement exceptions. The exceptions include those shown in Table 14-4.

**TABLE 14-4**

**Exceptions to Fair Value**

| Asset/Liability | Recognition Exception | Measurement Exception |
|---|---|---|
| Preacquisition contingencies | X | X |
| Income taxes | X | X |
| Employee benefit obligations | X | X |
| Indemnification assets | X | X |

| Asset/Liability | Recognition Exception | Measurement Exception |
|---|---|---|
| Assets held for sale | | X |
| Reacquired rights | | X |
| Share-based payment awards | | X |
| Goodwill/bargain purchase | | X |

## Q 14.53 How does the acquisition method of accounting impact inventory?

Inventories acquired in a business combination are recognized at fair value. The fair value of the acquired finished goods inventory should be close to the inventory's net realizable value (NRV), which results in the acquirer's recognizing a profit only from its selling effort.

The fair value of acquired inventory is a function of its stage of production. Inventory values are established separately for finished goods, work in process, and raw materials, such that the acquirer should not be expected to generate a profit or loss on the ultimate disposition of the inventory based on value added in manufacturing processes completed by the acquired company before its acquisition. Also, as the objective of accounting for acquired inventories in a business combination is to recognize the acquired inventories at their fair values on the date of acquisition, the inventory accounting method (FIFO, LIFO, weighted-average cost, etc.) of the acquired company is not relevant to the determination of the fair value of inventory of an acquired company.

The principles for valuing inventory acquired in a business combination should be followed even if the target company's inventories include amounts purchased from the acquirer; however, consideration should also be given to whether the transaction involves the settlement of a preexisting relationship and the substance of those inventory purchases.

## Q 14.54 What are considerations in a business combination when an acquirer has a preexisting relationship with the target?

The acquirer may have a preexisting relationship with a target that existed before they contemplated the business combination. Examples of preexisting relationships include previously held equity interests (for example, a cost or equity method investment), contractual arrangements (for example, collaboration arrangements), and noncontractual arrangements (for example, pending lawsuits or other litigation). When an acquirer obtains control of a target with which it has a preexisting relationship, that preexisting relationship is effectively settled as a result of the acquisition. The acquirer accounts for the settlement of the relationship separately from the business combination and recognizes a gain or loss.

## Q 14.55 How does the acquisition method of accounting impact leases?

A lease agreement conveys the right to use an asset from one party (the lessor) to another (the lessee). Lease arrangements that exist at the acquisition date may result in various assets and liabilities being recognized in a business combination. The classification of a lease is determined at lease inception and should not be changed as a result of a business combination, and as such, the acquiree's classification of its leases is not reconsidered in a business combination unless the agreement is modified as part of the acquisition and is deemed a new lease.

The principles governing the measurement of assets and liabilities in a business combination apply to acquired lease arrangements. That is, fair value is the basis for measurement of acquired lease assets and obligations.

In addition, the new lease guidance requires the acquiring entity in a business combination to retain the acquiree's previous lease classification. However, if the business combination results in changes to the contractual terms and conditions of the lease (i.e., a modification) and the modification is not accounted for as a separate contract, the acquirer would classify the lease on the basis of the modified terms.

On the effective date of the new guidance, any assets and liabilities related to favorable or unfavorable terms of an operating lease that resulted from prior business combinations would be derecognized upon transition (except for those arising from operating leases under which the entity is a lessor). A lessee would adjust the carrying amount of the asset by a corresponding amount.

## Q 14.56 How does the acquisition method of accounting impact research and development assets?

Acquired in-process research and development (IPR&D) assets are not permitted to be written off upon the closing of a business combination.

Acquisition accounting guidance requires the recognition of tangible and intangible assets that result from or are to be used in R&D activities as assets, irrespective of whether the acquired assets have an alternative future use. Acquired IPR&D assets are required to be measured at their acquisition-date fair value. Uncertainty about the outcome of an individual project does not affect the recognition of an IPR&D asset, but is reflected in its fair value.

Examples of IPR&D assets include patents, blueprints, formulae, and designs associated with a specific IPR&D project and the associated values derived from productive results of target company R&D activities conducted before the acquisition.

## Q 14.57 What is the subsequent accounting for IPR&D acquired in a business combination?

After capitalizing acquired IPR&D in a business combination, accounting guidance requires that intangible assets acquired in a business combination for use in a particular R&D project are considered indefinite-lived intangible assets until the completion or abandonment of the associated R&D efforts. Accordingly, during the development period after the acquisition, these assets should not be amortized but, instead, should be subject to the impairment review and testing for indefinite-lived intangibles.

These requirements make it necessary for companies to track capitalized R&D project costs for impairment testing purposes. As projects evolve or multiple projects are combined, such tracking is needed for companies to properly test assets for impairment and determine the point of project completion or abandonment. Impairment of acquired IPR&D assets immediately after acquisition would not be expected.

Upon completion of the development process for the acquired R&D, an acquirer will be required to make a determination of the useful life of the results of the R&D process; at that time, the associated asset should be considered to be a finite-lived intangible asset and amortized over its useful life.

## Q 14.58 What should an acquirer consider in evaluating a target company's deferred revenue?

Deferred revenue of an acquired company could represent up-front payments for services or products that have yet to be delivered, or payments for delivered goods or services sold as part of a multiple-element arrangement that could not be accounted for separately from undelivered items included in the same arrangement.

In a business combination, the acquiring entity should recognize deferred revenue of the acquired company only if it relates to a legal performance obligation assumed by the acquiring entity. Examples of legal performance obligations include an obligation to provide goods or services and a customer's right to receive concessions (such as credits in the event that the customer decides to return product) or other consideration after the date of acquisition. For instance, an acquirer of a medical device company may assume an obligation to provide postcontract customer support (PCS) consisting of the right to receive services, unspecified product upgrades or enhancements, or both.

When a legal performance obligation is assumed by the acquirer, the provision of goods or services required under the obligation would trigger derecognition of the deferred revenue liability and recognition of revenue.

The measurement of the assumed performance obligation should be at fair value at the date of acquisition. There are generally two acceptable methods of measuring the fair value of the assumed deferred revenue obligation. The first method is a cost build-up approach, which is based on a market participant's estimate of the costs that will be incurred to fulfill the obligation plus a "normal" profit margin for the level of effort or assumption of risk by the acquirer after the acquisition date. The normal profit margin also should be from the perspective of a market participant and should not include any profit related to selling or other efforts completed prior to the acquisition date. The second and less frequently used method for measuring the fair value of an assumed deferred revenue obligation is by obtaining evidence from market information about the amount of revenues an entity would receive in a transaction to provide the remaining obligation under the contract, less the selling effort (which has already been performed by the acquiree prior to the acquisition date) and the profit margin on that selling effort. As noted previously, the normal profit margin should be from the perspective of a market participant. While market information, when available, generally provides the most reliable and best evidence of fair value, that information may be difficult to obtain for the remaining obligation under the contract.

Normally, the fair value of an assumed performance obligation is less than the amount recognized by the acquired entity's preacquisition financial statements. As a result, in the periods following transaction close and the application of purchase accounting, a company may recognize less revenue than it did preacquisition. A buyer should consider this effect when negotiating debt covenants.

## Earnouts

### Q 14.59 When are earnouts used in acquisitions and what are the accounting implications?

Earnouts are agreements to pay the seller additional consideration over a period of time, generally only a few years, if the acquired business achieves predetermined targets for sales, cost reductions, or working capital. Earnouts are typically used to bridge valuation gaps between buyers and sellers when there is uncertainty in achieving

forecast or planned results or to support premium pricing. While well-intended, earnouts are difficult to execute for extended periods of time as they often restrict the buyer from restructuring or making any changes to the acquired business or capturing any of the synergies that may have initially driven the acquisition.

Accounting for earnouts can be either additional purchase consideration or compensation depending on the structure of the agreement and the involvement of the earnout recipient. If the earnout recipient remains employed by the acquired entity, the arrangement should be evaluated to determine if it is compensatory. An earnout in which the payments are automatically forfeited if employment terminates is recorded as compensation expense in the postcombination financial statements. In those cases, a liability typically is not recorded in purchase accounting, but rather is built up over time as the services are provided. When earnouts are considered part of the purchase price, they are typically classified as liabilities and recognized at fair value on the acquisition date, with such amounts being marked to market through income each reporting period until settlement. In certain circumstances when earnouts meet the restrictive criteria for classification as equity, the obligation for the earnout is measured at fair value and recognized in equity at the acquisition date, but there is no further adjustment each reporting period.

# Notes to Chapter 14

1. "If the foreign acquiree does not meet the definition of a foreign business but would qualify as a foreign private issuer, the SEC staff will consider requests for relief from the reconciliation requirement if the foreign acquiree's financial statements are prepared following IFRS (as issued by the IASB)."
2. Regulation S-X, Rule 11-02(c)(2)(i).
3. Regulation S-X, instr. 1 to Rule 11-02(b).