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This month's issues:

- A Pharmaceutical & Life Science Industry Focus on COVID-19 Accounting Considerations
- IASB issues a number of narrow-scope amendments

COVID-19: Top 5 Accounting Issues for Pharmaceutical & Life Science entities

At a glance

The coronavirus (COVID-19) pandemic has developed rapidly in 2020. Measures taken to contain the virus have affected economic activity, which in turn has implications for financial reporting.

Measures to prevent transmission of COVID-19 include limiting the movement of people, restricting flights and other travel, and temporarily closing businesses. Hospitals and health care professionals are focusing their efforts and resources on treating COVID-19 patients, resulting in some 'non- essential' treatments being deferred. Clinical trials might be stopped, or delayed, and active ingredients might be harder to ascertain.

COVID-19 will impact many areas of accounting and reporting for all industries, as outlined in our publication: In depth: Accounting Implications of the Effects of Coronavirus.

In this Spotlight we provide our insights into the top accounting issues that Pharmaceutical & Life Science ('PLS') entities might face. While this Spotlight focuses on issues that are likely to be the most frequently encountered, many others are certain to arise. As the situation continues to evolve, so too will the consequential accounting issues. For these reasons the following is not an exhaustive list of all relevant accounting considerations.

We believe that management should carefully consider the impact on each line item in the financial statements for both interim and annual reporting purposes. Several key issues that we expect to see impacting PLS entities are:

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1. Asset impairment

IAS 36, 'Impairment of assets', requires goodwill and indefinite-lived intangible assets to be tested for impairment at a minimum every year, and other non-financial assets whenever there is an indicator that those assets might be impaired. PLS companies should assess whether the COVID-19 pandemic has led to an indicator of impairment. Some examples might be:

- A significant delay in the drug development cycle or approval process.
- A reduction in sales of new drugs due to sales representatives not being able to carry out in-person meetings with doctors, and those doctors reprioritising their time to treatment related to COVID-19.
- A reduction in sales of 'non-essential' or elective treatments and drugs due to reprioritisation.
- Laboratories and manufacturing sites closed due to lockdown provisions.
- Active Pharmaceutical Ingredients (API) supply disruption and increase in clinical trial costs.
- Significant or prolonged decrease in the entity's stock price.

An impairment test would be required where there is an indicator of impairment. Management should revise the assumptions and cash flow forecasts used to test for impairment, to reflect the potential impact of COVID-19.

2. Revenue & collectability

PLS entities are often required to provide products to both governments and private customers who might be impacted to varying degrees by the pandemic. Customers might lack the ability to pay, or pay on time – in particular, smaller distributors, hospitals and other institutions. A PLS entity might choose to continue to supply a customer even where it is aware that the customer might not be able to pay for some or all of the goods being supplied. Revenue is recognised where it is probable that the customer will pay the transaction price when it is due, net of any price concession. Slow payment does not, on its own, preclude revenue recognition.

Many countries have pricing regulation models in the PLS industry to control public spending in health care. Each scheme is different, but it often requires an amount to be paid back to the government. The amount of Pharma payback is unlikely to be known at the point when revenue is recognised, and so an estimate is made which reduces the transaction price. Historical assumptions that have been used to estimate government and private rebates and other revenue reductions might no longer be appropriate. PLS entities should reassess this estimate and only recognise revenue when it is highly probable that amounts recognised will not result in a significant reversal of cumulative revenue recognised when the uncertainty is resolved.

The amount of returns might increase. Many governments have required increased stock levels at hospitals and there has been panic buying of certain drugs. The estimate of expected returns should be calculated in the same way as other variable consideration. The transaction price should include amounts subject to return only if it is highly probable that there will not be a significant reversal of cumulative revenue if the estimate of expected returns changes.

3. Liquidity

In certain PLS entities, forecasted revenue, operating results and cash flow might decrease as a result of COVID-19 (for example, reduction of non-essential medical procedures, supply chain disruption, price concessions and overall decline in customer demand). In addition, the ability to access bank loans and capital markets is more limited as a result of the economic downturn, especially for smaller and start-up businesses.

Management should consider whether the liquidity situation causes substantial doubt about whether the entity will be able to continue as a going concern. The entity should also review arrangements with collaboration partners, to understand their going concern and liquidity positions and to assess whether this has any impacts on their own drug development pipelines and ability to do business.

4. Inventory

Inventory is measured at the lower of cost and net realisable value. A slowdown of the inventory cycle and decreased demand might make it necessary to write-down inventories to net realisable value. In certain PLS entities, inventory levels (including consignment inventory) might increase as a result of decreases in demand. 'Non-essential' drugs with a shorter shelf life might be required to be written off if they cannot be used in time. APIs and raw materials might be harder to access, due to lockdown and social distancing provisions further slowing down the supply chain. Supply chain and manufacturing costs might increase as a result of safety measures related to COVID-19. Supply chain disruptions could result in a corresponding reduction in sales and profitability

5. Disclosures

The impact of COVID-19 will likely require expanded and pervasive disclosures in footnotes. Disclosures might need to be updated more frequently as a result of the rapidly changing environment.

Management should consider the specific requirements in IAS 1 to disclose significant accounting policies, the most significant judgements made in applying those accounting policies, and the estimates that are most likely to result in an adjustment to profits in future periods. All of these disclosures might be different as a result of the impact of the virus. The extent of disclosures regarding estimation uncertainty might need to be increased, such as liquidity and going concern analysis, variable consideration assumptions, credit risk and expected credit loss calculation, and impairment.

Conclusion

COVID-19 has given rise to unprecedented challenges that have affected virtually every aspect of modern life. The economic implications of this coronavirus will have a consequent impact on many aspects of accounting and financial reporting. We hope that this Spotlight will help you and your advisors as you navigate the key issues.

Further information on the impacts of COVID-19 can be found in: In depth: Accounting Implications of the Effects of Coronavirus.

IASB issues a number of narrow-scope amendments

At a glance

The IASB ('Board') issued a bundle of narrow-scope amendments on 14 May 2020:

- IAS 16: 'Property, Plant and Equipment – Proceeds before Intended Use';
- IAS 37: 'Onerous Contracts – Cost of Fulfilling a Contract';
- IFRS 3: 'Reference to the Conceptual Framework'; and
- Annual Improvements to IFRS Standards 2018–2020 affecting IFRS 1, IFRS 9, IFRS 16 and IAS 41.

All of the amendments are effective 1 January 2022.

What is the issue?

The following is a summary of the amendments:

IAS 16: 'Property, Plant and Equipment (PP&E) – Proceeds before Intended Use'

IAS 16 requires that the cost of an asset includes any costs attributable to bringing the asset to the location and condition necessary for it to be capable of operating in the manner intended by management. One of those costs is testing whether the asset is functioning properly.

The amendment to IAS 16 prohibits an entity from deducting from the cost of an item of PP&E any proceeds received from selling items produced while the entity is preparing the asset for its intended use (for example, the proceeds from selling samples produced when testing a machine to see if it is functioning properly). The proceeds from selling such samples, together with the costs of producing them, are now recognised in profit or loss. An entity will use IAS 2, 'Inventories', to measure the cost of those items. Cost will not include depreciation of the asset being tested because it is not ready for its intended use.

The amendment also clarifies that an entity is 'testing whether the asset is functioning properly' when it assesses the technical and physical performance of the asset. The financial performance of the asset is not relevant to this assessment. An asset might therefore be capable of operating as intended by management and subject to depreciation before it has achieved the level of operating performance expected by management.

The amendment requires entities to separately disclose the amounts of proceeds and costs relating to items produced that are not an output of the entity's ordinary activities. An entity should also disclose the line item in the statement of comprehensive income where the proceeds are included.

This amendment could have a significant impact on entities where items are produced and sold as part of bringing an item of PP&E to the location and condition necessary for its intended use, and where management has previously considered an asset's operating performance in its assessment of whether the asset is ready for use (for example, in the mining industry). Management might need to introduce processes to track the cost of items sold and to account for an asset as ready for its intended use earlier than before.

IAS 37: 'Onerous Contracts – Cost of Fulfilling a Contract'

IAS 37 defines an onerous contract as one in which the unavoidable costs of meeting the entity's obligations exceed the economic benefits to be received under that contract. Unavoidable costs are the lower of the net cost of exiting the contract and the costs to fulfil the contract. The amendment clarifies the meaning of 'costs to fulfil a contract'.

The amendment explains that the direct cost of fulfilling a contract comprises:

- the incremental costs of fulfilling that contract (for example, direct labour and materials); and
- an allocation of other costs that relate directly to fulfilling contracts (for example, an allocation of the depreciation charge for an item of PP&E used to fulfil the contract).

The amendment also clarifies that, before a separate provision for an onerous contract is established, an entity recognises any impairment loss that has occurred on assets used in fulfilling the contract, rather than on assets dedicated to that contract.

The amendment could result in the recognition of more onerous contract provisions, because previously some entities only included incremental costs in the costs to fulfil a contract.

IFRS 3: ‘Reference to the ptuaConcel Framework’

The Board has updated IFRS 3, 'Business combinations', to refer to the 2018 Conceptual Framework for Financial Reporting, in order to determine what constitutes an asset or a liability in a business combination. Prior to the amendment, IFRS 3 referred to the 2001 Conceptual Framework for Financial Reporting.

In addition, the Board added a new exception in IFRS 3 for liabilities and contingent liabilities. The exception specifies that, for some types of liabilities and contingent liabilities, an entity applying IFRS 3 should instead refer to IAS 37, ‘Provisions, Contingent Liabilities and Contingent Assets’, or IFRIC 21, ‘Levies’, rather than the 2018 Conceptual Framework. Without this new exception, an entity would have recognised some liabilities in a business combination that it would not recognise under IAS 37. Therefore, immediately after the acquisition, the entity would have had to derecognise such liabilities and recognise a gain that did not depict an economic gain.

The Board has also clarified that the acquirer should not recognise contingent assets, as defined in IAS 37, at the acquisition date.

Annual Improvements to IFRS Standards 2018–2020

- Fees included in the 10% test for derecognition of financial liabilities

  The amendment to IFRS 9 addresses which fees should be included in the 10% test for derecognition of financial liabilities. Costs or fees could be paid to either third parties or the lender. Under the amendment, costs or fees paid to third parties will not be included in the 10% test.

- Illustrative examples accompanying IFRS 16, ‘Leases’

  The Board has amended Illustrative Example 13 that accompanies IFRS 16 to remove the illustration of payments from the lessor relating to leasehold improvements. The reason for the amendment is to remove any potential confusion about the treatment of lease incentives.

- Subsidiary as a first-time adopter

  IFRS 1 allows an exemption if a subsidiary adopts IFRS at a later date than its parent. The subsidiary can measure its assets and liabilities at the carrying amounts that would be included in its parent’s consolidated financial statements, based on the parent’s date of transition to IFRS, if no adjustments were made for consolidation procedures and for the effects of the business combination in which the parent acquired the subsidiary.

  The Board has amended IFRS 1 to allow entities that have taken this IFRS 1 exemption to also measure cumulative translation differences using the amounts reported by the parent, based on the parent’s date of transition to IFRS. The amendment to IFRS 1 extends the above exemption to cumulative translation differences, in order to reduce costs for first-time adopters. This amendment will also apply to associates and joint ventures that have taken the same IFRS 1 exemption.

- Taxation in fair value measurements

  The Board has removed the requirement for entities to exclude cash flows for taxation when measuring fair value under IAS 41, ‘Agriculture’. This amendment is intended to align with the requirement in the standard to discount cash flows on a post-tax basis.

When do the amendments apply?

All of the amendments are effective 1 January 2022. Earlier application is permitted. The transitional provisions are as follows:

Amendment	Transitional provisions
IAS 16	Applied retrospectively, but only to items of PP&E that are brought to the location and condition necessary for them to be capable of operating in the manner intended by management on or after the beginning of the earliest period presented in the financial statements in which the entity first applies the amendments. The entity should recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings (or other component of equity, as appropriate) at the beginning of that earliest period presented.
IAS 37	An entity should apply those amendments to contracts for which it has not yet fulfilled all of its obligations at the beginning of the annual reporting period in which it first applies the amendments (the date of initial application). The entity should not restate comparative information. The entity should recognise the cumulative effect of initially applying the amendments as an adjustment to the opening balance of retained earnings or other component of equity at the date of initial application.
IFRS 3	Applies to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.
IFRS 1	No specific transitional provisions.
IFRS 9	Applies to financial liabilities that are modified or exchanged on or after the beginning of the annual reporting period in which the entity first applies the amendment.
IFRS 16	No specific transitional provisions.
IAS 41	Applies to fair value measurements on or after the beginning of the first annual reporting period beginning on or after 1 January 2022.

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