July 2017

Building a better working world

Accounting for financing arrangements in the life sciences sector

IFRS accounting considerations for option-based structures

Financing is fundamental to the life sciences sector, and accounting considerations may affect how a transaction is structured. This publication discusses some of the accounting considerations for a typical option-based structure involving an initial equity investment in an investee and an option to purchase additional shares in the investee. The accounting in this area is complex and depends on the facts and circumstances of the individual structure. As a result, transactions that seem similar may have different accounting implications. While biotechnology (biotech) companies can be investors or investees in these transactions, we refer to the investor in this publication as a pharmaceutical (pharma) company and the investee as a biotechnology (biotech) company to distinguish between the parties.

Option-based structures

Option-based structures have become more prevalent in the life sciences sector in recent years. The common thread is that an investor makes an initial payment to obtain the right, but not the obligation, to acquire the underlying (e.g., specific research and development (R&D) assets or shares of the investee) for a predefined exercise price. An option-based structure may provide the following benefits:

For a **biotech** company (the investee):

- A fixed amount of cash when the option is issued, allowing the biotech company to secure short-term financing
- Improved balance sheet leverage due to initial equity injection
- Market credibility that may help the biotech company attract other investors (e.g., other large pharma companies) for future deals
- A shorter time to market for the R&D asset if the option holder is required to take on the late-stage development or commercialisation activities

For a **pharma** company (the investor):

- An expanded portfolio for a relatively small up-front fee (i.e., the biotech company has the R&D risk and the pharma company has a right, not an obligation, to acquire the underlying at a future date (e.g., when key clinical/technical outcomes are known))
- Additional time (i.e., the option period) to conduct further due diligence about the R&D asset's viability
- An advantage over competitors that do not have access to the R&D asset during the option period

Option-based structure illustration

Biotech A	Pharma B
Receives US$80 million up-front cash consideration	Makes up-front payment of US$80 million for a 10% equity interest, plus an option to acquire an additional 60% equity interest in Biotech A
Issues equity: Issues 10% equity interest in Biotech A without any redemption feature	Receives 10% equity interest in Biotech A
Writes option: An obligation to issue an additional 60% equity interest for a fixed price of US$400 million if Pharma B exercises its option	Receives an option to acquire an additional 60% of Biotech A's equity interest for a fixed price of US$400 million

Accounting considerations

Biotech A

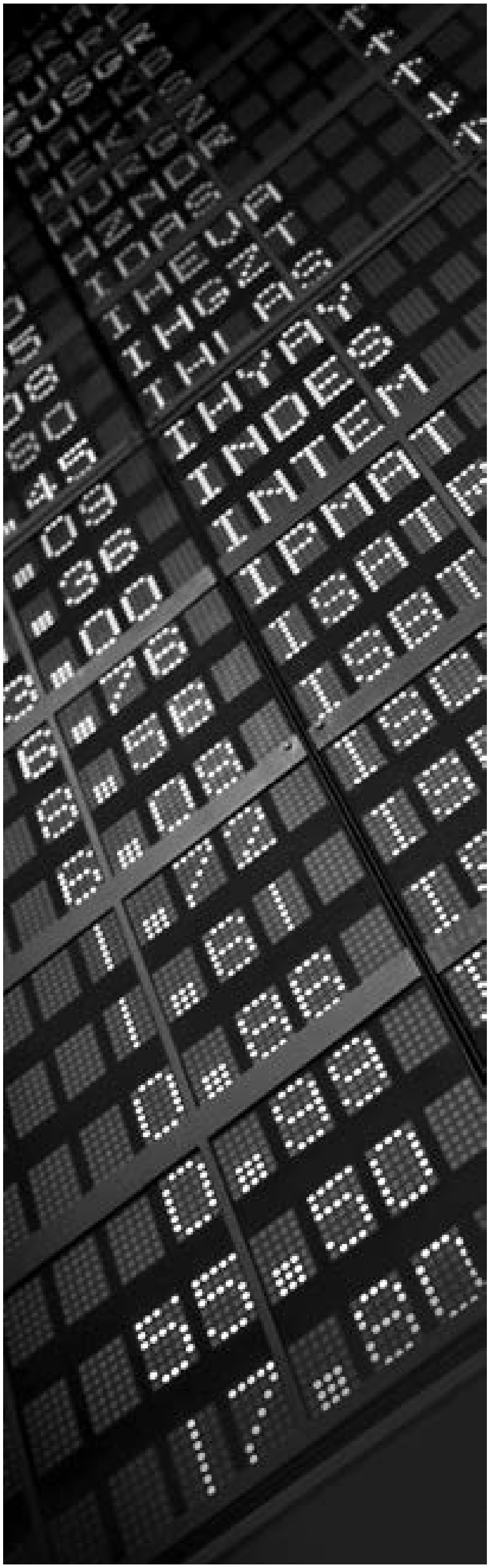
1. Biotech A will need to identify the units of account to allocate the proceeds received. Possible units may include:
   - The 10% equity interest
   - The written option to acquire an additional 60% equity interest of Biotech A for a fixed price
   - Any other implicit or explicit rights/obligations (facts and circumstances based)
2. After all units of account have been identified, Biotech A needs to determine which units of account are financial instruments and which are not:
   - Financial instruments are accounted for based on relevant literature (IAS 32 *Financial Instruments: Presentation* and IAS 39 *Financial Instruments: Recognition and Measurement*, or IFRS 9 *Financial Instruments*, as applicable).
   - Non-financial instruments are accounted for based on other applicable standards.
3. Generally, the initial equity interest (10% in this example) and the written option to acquire additional shares (60% of Biotech A shares in this example) are considered financial instruments.
4. Any consideration viewed as consideration for the 10% equity interest issued is added to equity.
5. The written call option meets the definition of a financial instrument because it gives rise to a financial asset of Pharma B and an equity instrument of Biotech A.

   Based on IAS 32.22, and assuming the functional currency of Biotech A is USD, such option should be accounted for as an equity instrument, as it represents a contract that will be settled by the entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash or another financial asset ('fixed for fixed' criterion).
   - Changes in the fair value of the contract arising from variations in market interest rates that do not affect the amount of cash or other financial assets to be received, or the number of equity instruments to be delivered, on settlement of the contract do not preclude the contract from being an equity instrument (IAS 32.22).
6. Any consideration viewed as consideration for the written option is added directly to equity (IAS 32.22, IAS 32.IE20).
   - There is no concept of 'temporary equity' or 'mezzanine classification' in IFRS.

Pharma B

1. Pharma B needs to first assess whether it controls Biotech A (i.e., beginning with an assessment of the IFRS 10 *Consolidated Financial Statements* control model).
   - As part of the assessment, Pharma B should consider the option to acquire an additional 60% of the shares of Biotech A, the 10% equity interest in Biotech A, and any other implicit or explicit rights/obligations that may exist.
2. Assume for purposes of this example that Pharma B controls Biotech A only from the time it exercises the option.
3. Pharma B will need to identify the units of account in order to allocate the proceeds transferred. Possible units that may require allocation include:
   - Consideration for the 10% equity interest in Biotech A
   - Consideration for the option issued by Biotech A
   - Other implicit or explicit rights/obligations (facts and circumstances based)
4. The 10% equity interest is accounted for as a financial asset because it meets the definition of a financial asset in IAS 32.11. Both the initial and subsequent measurement of the equity interest are based on the guidance in IAS 39.43-46, which means the subsequent measurement of the 10% equity instrument will be at fair value except when the 10% equity instrument does not have a quoted price in an active market and whose fair value cannot be reliably measured.

   The option to acquire the additional 60% of the shares of Biotech A is accounted for as a derivative financial instrument, which is initially recognised at fair value and subsequently measured at fair value through profit or loss.
5. When obtaining control over Biotech A upon exercise of the option, Pharma B needs to determine how to account for the change in control (based on whether Biotech A meets the definition of a business as described in IFRS 3 *Business Combinations*).
   - If Biotech A meets the definition of a business at the time of the exercise of the option, this would be considered a "business combination achieved in stages", because of the preexisting 10% equity interest. Pharma B would have to remeasure the 10% equity interest in Biotech A as well as the option to their acquisition date fair values and recognise the resulting gain or loss, if any, in earnings.



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As populations age and chronic diseases become commonplace, health care will take an ever larger share of GDP. Scientific progress, augmented intelligence and a more empowered patient are driving changes in the delivery of health care to a personalized experience that demands health outcomes as the core metric. This is causing a power shift among traditional stakeholder groups, with new entrants (often not driven by profit) disrupting incumbents. Innovation, productivity and access to patients remain the industry's biggest challenges. These trends challenge the capital strategy of every link in the life sciences value chain, from R&D and product supply to product launch and patient-centric operating models.

Our Global Life Sciences Sector brings together a worldwide network of 11,000 sector-focused professionals to anticipate trends, identify their implications and help our clients create competitive advantage. We can help you navigate your way forward and achieve sustainable success in the new health-outcomes-driven ecosystem.

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EYG no: 02037-163GBL

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July 2017