

Stay Informed: **Pharmaceutical and Life Sciences** **Industry GAAP Alert**

2014-1



Potential impacts to Pharma and Life Sciences companies of the new accounting definition of an "investment company"

Background

On June 7, 2013, the FASB issued a new standard, Accounting Standards Update No. 2013-08, *Financial Services—Investment Companies (Topic 946): Amendments to the Scope, Measurement, and Disclosure Requirements* (ASU 2013-08), that clarifies the characteristics of an investment company, and provides comprehensive guidance for assessing whether an entity is an investment company. ASU 2013-08 is effective for interim and annual reporting periods in fiscal years that began after December 15, 2013. If an entity no longer qualifies as an investment company, the change in status is applied prospectively from that date and the entity would determine what accounting principles would be applicable to the accounting for the entity's investments.

Issue

Pharmaceutical, biotech, medical device and other life sciences companies (hereafter referred to as the "company") often invest through entities that are considered "investment funds". The company's strategy is often to identify investment funds that invest in early-stage development companies. Before ASU 2013-08, the definition of an investment company was broader under Topic 946 whereby more entities may have met that definition.

Investment companies account for their investments at fair value and any company that consolidates an investment company or has an equity investment in an investment company retains the specialized investment company accounting in its consolidated financial statements or equity method accounting.

While ASU 2013-08 does not change current US GAAP as it relates to a non-investment company parent's ability to retain the entity's specialized investment company accounting, the new ASU provides a revised definition of an investment company which may result in some investment funds no longer meeting the definition of an investment company. If the entity does not meet the definition of an investment company, then the company is at risk of consolidating the operating activities of the investment fund's investee or accounting for them under the equity method of accounting. The most significant financial reporting implications include reporting higher research and development ("R&D") expense or a reduction in operating income through the

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allocation of R&D through its equity method pick-up. See below for the revised definition of an investment company and illustrative industry-specific examples for consideration.

Under ASU 2013-08, there are two steps in the analysis to determine if an entity meets the definition of an investment company. The first step requires that an entity not regulated under the Investment Company Act of 1940 **must possess all of** the following fundamental characteristics¹:

- Obtains funds from one or more investors and provides the investor(s) with investment management services.
- Commits to its investor(s) that its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both.
- The entity or its affiliates do not obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

The second step in the analysis is to determine if the entity exhibits some or all of the typical characteristics of an investment company, as outlined in the standard. It is generally expected that investment companies have all of the following "typical characteristics":

- a) It has more than one investment.
- b) It has more than one investor.
- c) It has investors that are not related parties of the parent (if there is a parent) or the investment manager.
- d) It has ownership interests in the form of equity or partnership interests.
- e) It manages substantially all of its investments on a fair value basis.

Although it is expected that an investment company would exhibit all of the typical characteristics, unlike the required fundamental characteristics, the absence of one or more of these typical characteristics in the preceding paragraph does not necessarily preclude an entity from meeting the definition of an investment company. In these situations, it is important to understand and evaluate the facts and circumstances in order to evaluate whether the entity's activities continue to be consistent with those of an investment company.

Some of the more critical areas of the analysis include:

- *Does the entity provide investment management services to the company?* The standard requires that the entity is managed by professionals that provide investment management services to the company. As such, some entities that do not have investment managers may no longer be considered investment companies. This may be the case where the company sponsors its own internal fund and there are no investment management services being provided. It will be important to understand whether related parties qualify as professionally providing investment management services.

¹ An entity regulated under the Investment Company Act of 1940 is automatically an investment company under this Topic.

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- *Is the entity's business purpose and only substantive activity to invest its funds solely for returns from capital appreciation, investment income, or both?* The standard states that investment companies, as defined, are not vehicles to provide investors with strategic access to investees or other related opportunities but rather vehicles to provide investors with financial returns as may be evidenced by identified investment exit strategies. It will be important to evaluate the entity's prospectus and other related agreements or marketing materials to understand the purpose and design of the entity.
- *Does the entity have rights and returns associated with its investees that are not akin to a financial investment made solely for capital appreciation or the generation of investment income?* It will be important to understand whether there are any other business relationships between the entity and its investees in order to determine whether the investment has been made for more than capital appreciation or the generation of investment income. This may be the case if the entity or entities under its common control also provides R&D services, contract manufacturing, or others types of services to an investee.
- *Is there more than one investor in the entity and does the entity hold more than one investment?* As previously stated, it is generally expected that entities have more than one investor because this helps demonstrate that the entity has been designed for capital appreciation or the generation of investment income. However, it is not required that there is more than one investor. In cases where there is only one investor, it will be critical to understand why the entity was designed in that manner and whether third parties provide investment management services to the entity. In addition, understanding any other relationships between the company and the investees of the entity will be critical to determining if the entity's business purpose is inconsistent with an investment company, as defined in the standard.

Illustrative Examples

The following examples provide practical guidance on the application of Accounting Standards Update No. 2013-08:

Example 1 — Controlling Investment in Fund with Options

Facts: Entity A, an investment fund, is formed in 20X1 by six corporations to invest in multiple early-stage development companies for capital appreciation. Entity B, one of the corporations, holds a 70% controlling financial interest in Entity A. The remaining 30% of the investment fund is owned by the other five corporations, which are not related to each other or Entity B. Entity B holds options at amounts other than fair value to acquire controlling financial interests in the investees of the investment fund and the exclusive right to purchase assets produced by the investees, if any of the compounds in development by the investees ultimately achieves regulatory approval. No plans for exiting the investments have been identified by Entity A. Entity A is managed by an investment manager and is not related to the investors. The investors in Entity A also provide significant advice to the investment manager about potential investments.

Analysis: Based on the facts above, even though Entity A's business purpose and substantive activities include investing for returns from capital appreciation and it has many of the typical

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characteristics of an investment company, Entity A is not an investment company because of both of the following conditions:

- a) Entity B, the parent of Entity A, holds options at amounts other than fair value to acquire the investees of the fund and assets of the investees, if any of the compounds in development ultimately achieve regulatory approval. That provides Entity B with a benefit that is other than returns from capital appreciation or investment income.
- b) The investment plans of Entity A do not include exit strategies for its investments to realize returns from the capital appreciation of investees.

Example 2 — Non-Controlling Investment in Fund with Separate Equity Investment in an Investee of Fund

Facts: Entity C, an investment fund, is formed in 20X1 by four corporations in the pharmaceutical and life sciences industry to invest in multiple early-stage development companies for capital appreciation. Entity D, one of the corporations, holds a 30% non-controlling financial interest in Entity C. The remaining 70% of the fund is owned evenly by the remaining three corporations, which are not related to each other or Entity D. Separately, unrelated to its investment in Entity C, Entity D holds a strategic 10% non-controlling interest in one of the investees of the fund. Entity C is managed by an investment manager and is not related to the investors. Entity C's investment plans identify potential exit strategies for different types of investments.

Analysis: Based on the facts above, Entity C is an investment company because it obtained funds from one or more investors and provides the investor(s) with investment management services, as a fund, its business purpose and only substantive activities are investing the funds solely for returns from capital appreciation, investment income, or both, and neither Entity C nor any of its affiliates obtain or have the objective of obtaining returns or benefits from an investee or its affiliates that are not normally attributable to ownership interests or that are other than capital appreciation or investment income. Entity D's 10% non-controlling interest in one of the investees of the fund would not alone "taint" the business purpose of Entity C because it does not control Entity C and it does not receive any incremental benefits in the investee as an investor in the fund.

Example 3 — Investment Fund with Only One Investor

Facts: Entity E is an investment fund formed in 20X1 by Manager X, an entity that provides alternative investment management services to companies. Entity E's purpose is to invest in multiple early-stage development companies. Entity F, a corporation in the pharmaceutical and life sciences industry is currently the only investor in Entity E.

Analysis: While an entity may be able to overcome the fact it has only one investor in the determination of whether the entity meets the definition of an investment company, this would generally be unusual. However, based on the limited facts above, it is inconclusive whether Entity E is an investment company. While an investment company typically pools funds from multiple investors and provides them with investment management services, having a single investor does not necessarily preclude an entity from being an investment company. There may be times when an investment company has a single investor, such as in any of the following examples:

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- It is in its initial offering period, which has not expired, and it is actively identifying suitable investors.
- It is actively identifying investors but has not yet identified suitable investors to replace those that have redeemed their ownership interests.
- It is in the process of liquidation.

If there is no intention to actively find other investors, it will be important to understand why the entity is established for the one investor. Given that Entity F also makes direct investments in similar early-stage companies, it will be important to understand whether the terms and relationships/benefits that Entity F is receiving are consistent with an investment company. Further, an important part of the analysis is understanding the relationships between the investment manager and Entity F, and to consider whether the manager is providing investment management services consistent with those provided to other third parties. Clearly, having multiple investors provides more substantive evidence that the business purpose of the entity is consistent with the definition of an investment company – specifically which investors are not obtaining returns or benefits from an investee that are not normally attributable to ownership interests or that are other than capital appreciation or investment income.

Questions

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