

QUESTION 1

(50 Marks)

Nepsa Pharmaceuticals Ltd (“Nepsa”) is a large, JSE-listed South African pharmaceutical company which develops, manufactures and distributes a diverse array of pharmaceuticals locally. The primary business model of the company is to acquire a license from an international pharmaceutical company which allows Nepsa to produce the particular medication and then sell and distribute it locally. Nepsa is currently preparing its financial statements for the year ended 28 February 2019, which are prepared in accordance with the IFRS standards.

The company’s current largest customer is the South African Department of Health with which it has several contracts to supply pharmaceuticals which are used in public clinics and hospitals around the country. In addition, Nepsa also provides pharmaceuticals to private hospital groups and pharmacy chains. Recently, the Department of Health has begun to support smaller manufacturing entities in order to drive development in the sector, and has also begun to rather import some medicines from countries where they can be produced at a lower cost. As a result, Nepsa is currently experiencing some financial difficulties as they have lost a number of government contracts over the last two years.

Contracts with the Department of Health

The following are details of some of the contracts that Nepsa has entered into with the Department of Health (“the Department”) during the 2019 financial year:

1. Contract A for Ambimed¹

Nepsa has historically always produced and sold Ambimed to the Department. During Nepsa’s 2018 financial year, the contract with the Department expired and the Department issued a tender for a new supplier of the medication. Due to the severe budgetary constraints of the Department, combined with the large need for the medication, the Department set a cap of R50 million on the amount that it was willing to spend on the medication per three year period. As a result, Nepsa’s proposal indicated that it would sell up to 500 000 units of Ambimed at a price of R100 per unit to the Department and if any more of the medication was required over the three year period once the 500 000 units were bought, Nepsa would provide additional units of the medication at no charge to the Department. The Department accepted the proposal and the three year contract was entered into on 1 March 2018. The Department pays for the medication when received (up to the 500 000 unit cap). Nepsa provided the Department with 200 000 units of Ambimed during the 2019 financial year.

2. Contract B for Benflu¹

Nepsa entered into a contract with the Department on 1 March 2018 to produce 100 000 units of Benflu over the next three years. In terms of the license agreement that Nepsa has with the international pharmaceutical company that developed Benflu, Nepsa is only allowed to sell this medication to the Department of Health, and not to any other private entity in the country. The number of units that Nepsa produces and the number that are taken by the Department annually can vary significantly. However, all the 100 000 units will be taken by the Department by the end of the three year period. Nepsa negotiated in terms of its contract with the Department, that Nepsa will have a right to payment for any units of Benflu that it has produced to date, even if the contract is cancelled (for any reason other than breach or non-performance).

¹ Any medication referred to in this scenario is completely hypothetical for the purpose of this assessment.

3. Contract C for Catalan¹

Nepesa has always had a rolling contract to sell Catalan medication to the Oncology division within the Department for R5 million per year and this contract was once again renewed for the 2019 financial year. Nepesa has historically experienced long delays (usually up to two years) in payment for sales to the Oncology division. Despite this, Nepesa has continued to sell Catalan to the Oncology division at its normal market price. In the past, Nepesa has ultimately been paid but only after agreeing to significant price concessions. Based on prior experience, Nepesa expects to issue a price concession of R3 million on their contract for the 2019 financial year.

Agreement with Sandoz Pharma GmbH

Nepesa has been developing a new vaccine for hepatitis over the last few years. The development of this vaccine has met all the requirements to be capitalised as an intangible asset and by 28 February 2019, this intangible asset had a carrying amount of R5 million.

Sandoz Pharma GmbH is an unrelated German-based pharmaceutical company which has been developing a measles vaccine. Due to the differing skillsets of the employees of the two companies, Nepesa and Sandoz entered into an agreement on 28 February 2019 whereby they will swap the intellectual property of the two vaccines. After this swap occurs, Nepesa will continue developing the measles vaccine and Sandoz will continue developing the hepatitis vaccine. However, in terms of the agreement, Nepesa will retain the marketing rights of the hepatitis vaccine in South Africa only.

The fair value of the intellectual property of the hepatitis vaccine has been determined to be R30 million as at 28 February 2019 and the fair value of the measles vaccine is not clearly evident. The fair value of the marketing rights of the hepatitis vaccine in South Africa has been determined to be R2 million as at 28 February 2019.

Closing of Port Elizabeth factory

Due to the fact that Nepesa is currently experiencing financial difficulties, it has decided to close its Port Elizabeth manufacturing facility. On 31 January 2019, Nepesa issued a SENS announcement indicating that the factory will be closed and the affected employees will be retrenched. In terms of the agreement with the employees' union, Nepesa will pay termination benefits of R2 million in total to the affected employees on their last day of work on 31 May 2019.

QUESTION 2

(40 Marks)

Perimeter Technologies Ltd (“Perimeter”) is a South African company based in Cape Town which was started by a group of former UCT scientists. Perimeter is involved in the research, development and production of components that form part of telescopes around the world, including the new MeerKAT telescope currently being constructed near Carnavon in the Northern Cape. Even though the company operates in a highly specialised industry, and only has competitors internationally, most of the components are produced using standard metalworking machines, such as metal lathes and drill presses. There is a market for these machines locally, such as manufacturers of metal components in other industries.

As a newly qualified Chartered Accountant who has recently been employed by Perimeter, you have been asked to assist with the reporting for two assets that the company currently owns/leases for the financial statements for the year ended 31 March 2019. Perimeter prepares their financial statements in accordance with International Financial Reporting Standards (IFRS). Details of these two assets are as follows:

Metal Lathe

A lathe is a machine that rotates a piece of metal around an axis to perform various operations (such as cutting and sanding etc.). Perimeter currently has a lathe which they purchased new and unused on 1 April 2016 for R1 530 000 and it was ready for use, and brought into use, on that date. The lathe had an estimated useful life of 10 years and a residual value of zero and these estimates have never changed. SARS allows a tax allowance on the lathe in terms of S12C of the Income Tax Act.

On 31 March 2018, Perimeter assessed that it would no longer need the lathe going forward. The lathe met all the criteria to be classified as held-for-sale in terms of IFRS 5 and was therefore classified as such on 31 March 2018. However, on 1 October 2018, Perimeter was awarded a new contract to manufacture a component for a telescope in Chile and therefore assessed that it would have a use for the lathe. The lathe therefore no longer met the requirement to be classified as held-for-sale from that date onwards.

The following amounts apply to the lathe:

Date	Value in use	Fair value less cost to sell
31 March 2018	R1 260 000	R1 190 000
1 October 2018	R1 210 000	R1 150 000
31 March 2019	R1 180 000	R1 100 000

No journal entries related to the lathe have been processed in the 2019 financial year.

Drill Press

Perimeter entered into a lease agreement whereby it leased a large, industrial drill press from a metalworking equipment supplier. The lease term commenced on 1 April 2017, and the lease was for period of four years. Lease payments of R55 000 are made annually in arrears on the 31st of March of each year. On 1 April 2017 the drill press was installed on Perimeter’s premises and Perimeter paid R4 500 to an engineering consulting firm for the installation of the drill press. The drill press was ready for use on this date. These costs were immediately deductible for tax purposes. The drill press was expected to have a useful life of six years and a residual value of zero and these estimates have never changed.

In terms of the lease agreement, Perimeter has the option to purchase the drill press from the supplier at the end of the lease term for R350 000. As the drill press is used frequently by the company, the company assessed at inception of the lease term that they were likely to exercise this option at the end of the lease term. On 31 March 2019 the company reassessed their requirement for a drill press and realised that they would need a larger drill press to be able to tender for larger projects in the future, and therefore they came to the conclusion that they are unlikely to purchase the drill press at the end of the lease term. Perimeter has not yet informed the supplier of their intentions.

Additional information

- Perimeter uses the historic cost model for all items of property, plant and equipment.
- Perimeter had an incremental borrowing rate of 8% p.a. up until 1 April 2018, and 9% p.a. thereafter.
- Assume that the market related short-term interest rate is (and has always been) 10% p.a.
- SARS allows a deduction for lease payments in the year in which they are incurred.
- Assume that Perimeter will have sufficient taxable income in the future against which any deductions can be utilised.