

## SUGGESTED SOLUTION

### Question 1

#### Part 1

<b>MEMORANDUM</b>	
Date: 17 April 2019 To: Financial Director of Nepsa Pharmaceuticals Ltd From: Clever Student Re: Revenue recognition of government contracts	
Thank you for your query regarding the revenue to be recognised in terms of the contracts from the Department of Health. Please see my responses below.	
<b>Contract A</b> In this contract with the Department of Health, there is an <u>explicit option</u> to acquire additional units over and above the 500 000 units in terms of the contract for free. The <u>guidance in IFRS 15 related to “customer options for additional goods or services” is applicable</u> in this case. The option provides the Department of Health a <u>right which they would not have received had they not entered into this contract</u> . The Department is effectively <u>paying in advance for the ‘free’ medication</u> during the period in which they are paying for the ‘paid’ medication in terms of the contract.  If the option in the contract was simply providing the Department with the ability to acquire additional goods or services <u>at a price reflective of the stand-alone selling price, then this option does not provide a “material right”</u> . This is not the case in this particular case and <u>therefore this option provides the Department of Health with a “material right”, which should be accounted for as a separate performance obligation</u> .  As this is a separate performance obligation, a portion of the total <u>transaction price must be allocated to this right</u> . In this case, the stand-alone selling price of the material right <u>is not directly observable and therefore it must be estimated</u> . On 1 March 2018, Nepsa must <u>first estimate the number of free units which will granted to the Department over the life of the contract and then allocate and defer a portion of the transaction price to the ‘free’ units</u> . Therefore, as the ‘paid’ units are provided <u>the full R100 would not be recognised as revenue, but a portion would be recognised as a liability as deferred revenue</u> .  Once these free units are granted to the Department, the <u>deferred revenue liability is derecognised and the related revenue is recognised</u> . If the material right expires (i.e. the Department does not take the full estimate of the free medication) then Nepsa should <u>recognise the deferred revenue on expiry</u> . Should the Department take more ‘free’ units than Nepsa allocated at inception of the contract, then <u>no additional revenue should be recognised</u> . i.e ultimately, revenue of R100 x 500 000 will be recognised, regardless of whether the department takes more or less than the estimated free units, as this is a matter of the timing of the recognition of revenue.	
<b>Contract B</b> In this particular case, revenue is recognised <u>over time</u> because there is <u>not an alternative use for the medication and there is an enforceable right to payment</u> for performance completed to date. In assessing whether an asset has an alternative use, Nepsa needs to <u>consider both the practical limitations and contractual restrictions on redirecting the</u>	

medication for another use. In this case, Nepsa has a contractual obligation with the international pharmaceutical company to not provide the medication to any other customer, and therefore the medication effectively has no alternative use to Nepsa. There is an enforceable right to payment, as Nepsa has included this in its contract with the Department and it is entitled at all times during the contract to compensation for performance completed to date. The compensation that Nepsa is entitled to is the selling prices for the medicine, irrespective of whether it has been delivered or not.

Nepsa should recognise the revenue when control of the medicine has passed to the Department. Due to the fact that Nepsa has an enforceable right to payment irrespective of whether the medicine is delivered or not, control passes at the time that the medicine is manufactured, not delivered to the Department. Therefore revenue should be recognised as the medicine is manufactured, as the manufacturing rate is the best measure of progress.

**Contract C**

Price concessions are referred to in Step 3 of the revenue model (determining the transaction price) and are a form of variable consideration. Variable consideration is considered to be a component of the transaction price. It is part of the consideration to which an entity expects to be entitled in exchange for transferring promised goods or services and therefore should be estimated and included in the transaction price for revenue recognition purposes.

Nepsa should perform an analysis of expected price concessions at inception of the contract in order to determine the consideration to which the entity expects to be entitled. In this case, the transaction price should be R2 million, and not R5 million, due to the history that Nepsa has with the Department.

Once Nepsa has determined the amount of consideration (including the variable component because of a price concession) then this consideration should be assessed in the context of a Department's ability and intention to pay. Determining whether collectability is probable is a very important assessment under IFRS 15. If this criterion is not met, then revenue cannot be recognised (effectively precluding the use of the cash basis of accounting) and any consideration received is recorded as a liability (e.g., unearned revenue).

Some or all of the estimated amount of variable consideration is included in the transaction price but only to the extent that it is highly probable a significant reversal in the amount of cumulative revenue recognised will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

Due to the fact that the Department has historically taken up to two years to pay, it is likely that there is a significant financing component in the contract with the Department. Nepsa should therefore present value the consideration of R2 million when determining the revenue to be recognised in 2019.

I hope this provides some guidance regarding the revenue to be recognised for the contracts with the Department of Health.

Kind regards,  
Clever Student


## Part 2

<p>The measles vaccine which has been acquired is an <u>intangible asset</u>, as it is <u>an identifiable, non-monetary asset without physical substance</u>. This intangible asset has been acquired in exchange for a non-monetary asset. The cost of an intangible asset is measured at <u>fair value</u>, <u>unless the transaction has no commercial substance, or the fair value of either asset isn't reliably measurable</u>.</p> <p>In this case, the transaction has commercial substance as both entities are still going to be <u>developing the respective vaccines</u>. In addition, the <u>timing and value of cash flows arising from the development of these two vaccines differ</u>. The market and need for the two vaccines <u>probably differs, and they may not be sold for the same price</u>. The <u>fair value of the asset being given up (hepatitis vaccine) is assumed to be reliably measureable, as it has been given</u>.</p> <p>In this case, the measles vaccine should be recognised at the <u>fair value of the asset given up (the hepatitis vaccine), being R30 million</u>. The value of the measles vaccine is <u>not more clearly evident</u> (IAS 38.47). However, the <u>R2 million related to the marketing rights for the hepatitis vaccine should be excluded as this portion has not been given up</u>. Therefore, the intangible asset related to the measles vaccine should be recognised on the Statement of financial position at <u>R28 million as at 28 February 2019</u>. The marketing rights would also still be represented on the statement of financial position at <u>R333 333 (2m/30m x 5m)</u>.</p> <p>In the statement of profit or loss, Nepsa should recognise a <u>gain on disposal</u> of the hepatitis vaccine of <u>R23 333 333 (28m – (5m - 0.333m))</u>. (<i>Alternative answer: hepatitis vaccine should be impaired down to R333K, and then income recognised for the R28m, however, this results in the same net effect on profit or loss</i>)</p> <p>The intangible assets related to measles vaccine and the marketing rights for the hepatitis vaccine should be <u>tested for impairment annually</u>.</p>	

## Part 3

<p>IAS 19 has specific requirements in respect of <u>termination benefits</u>. A liability and expense for termination benefits can only be recognised if, at the reporting date, either the entity <u>can no longer withdraw the benefits or the entity has recognised a restructuring within the scope of IAS 37</u>. Due to the fact that Nepsa has a <u>detailed formal plan and has raised a valid expectation by announcing the plan through the SENS announcement</u>, the entity can recognise a <u>restructuring provision</u>. Nepsa should therefore recognise <u>the R2 million liability, as well as a related expense for the termination benefits</u> in 2019.</p>	

## Question 2

### Part 1

Dr Depreciation expense (p/l)	76 500		
Dr PPE – machine (gross carrying amount)	1 530 000		
Cr Accumulated depreciation		382 500	
Cr Non-current asset held-for-sale		1 190 000	
Cr Impairment expense reversal (p/l)		34 000	

Dr Depreciation expense (p/l)	76 500		
Cr Accumulated depreciation		76 500	

Dr Deferred Tax (P/L)	52 360		
Cr Deferred Tax (SFP)		52 360	

### Workings:

	As at 31/03/2018	Movement	As at 1/10/2018	Movement	As at 31/03/2019	
PPE – GCA	1 530 000		1 530 000		1 530 000	
Acc. Depr	(306 000)	(76 500)	(382 500)	(76 500)	(459 000)	
CA	1 224 000		1 147 500		1 071 000	
FV/RA	1 190 000		1 210 000		1 180 000	
Impairment	(34 000)	34 000	-	-	-	
Tax base	612 000				306 000	
TD	578 000				765 000	
DT (L) at 28%	161 840		52 360		214 200	

**Part 2a**

Perimeter Technology Ltd

Statement of financial position as at 31 March 2019

**Non-current assets**

Property, plant and equipment	0
Deferred Tax	27 090

**Non-current liabilities**

Lease liability	50 459	<b>W3</b>
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**Current liabilities**

Lease liability	46 292	<b>W2</b>
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**Part 2b**

Perimeter Technology Ltd

Statement of profit or loss for the year ended 31 March 2019

Depreciation expense	(73 988)	<b>W4</b>
Interest expense	(33 567)	<b>W5</b>
Re-measurement gain	5 445	<b>W6</b>
<b>Profit/(loss) before tax</b>	<u>(102 109)</u>	<i>Not required</i>
Tax (expense)/income	28 591	
Current tax	15 400	55 000 x 28%
Deferred tax	13 190	<b>W7</b>
<b>Profit/(loss) after tax</b>	(73 518)	<i>Not required</i>

**Calculations for parts 2 & 3:**

<u>Lease liability</u>				
At inception of lease	Pmt=55 000, n=4, i=8% fv=350 000	R439 427		
Balance at 31/03/2018	Amort p1=1, p2=1 calc bal	R419 582		
Interest for 2019	Amort p1=2, p2=2 calc i	R33 566	<b>W5</b>	
Balance at 31/03/2019	Amort p1=2, p2=2 calc bal	R398 148		
New lease liability at 31/03/2019	Pmt=55 000, n=2, i=9% fv=0	R96 751		
Adjustment required		R301 397		
Current portion	Amort p1=1, p2=1 calc principal	R46 292	<b>W2</b>	
Non-current portion	96 751 – 46 292	R50 459	<b>W3</b>	

<u>Right of use asset</u>				
At inception of lease	439 427 + 4 500	R443 927		
Depreciation per year	443 927 / 6	R73 988	<b>W4</b>	
Balance at 31/03/2018	443 927 – 73 988	R369 952		
Balance at 31/03/2019	369 952 – 73 988	R295 952		
Adjustment required	Per above	R301 397		
p/l	301 397 – 295 952	R5 445	<b>W6</b>	
New RoU balance		R0		

<u>Deferred tax</u>	CA	TB	TD				
As at 31/03/2018							
Right-of-use asset	R369 952	-	R369 952				
Lease liability	(R419 582)	-	(R419 582)				
			(R49 642)	28%	13 900 dr		
Mvt					13 191 (cr to p/l)	<b>W7</b>	
As at 31/03/2019							
Right-of-use asset	R0	-	R0				
Lease liability	(R96 751)	-	(R96 751)				
			(R96 751)	28%	27 090 dr		