



## TPE 2023 – Case Study Part 2

Derma

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## CASE STUDY

It's six weeks later (December Yr 38) and Derma has been working with Chemtest for four weeks on the clinical trials of RetinX6. They rejected the offer from Skindeep for Peau and are working on a business plan to raise finance to market the anti-ageing cream themselves. Much to Husain's disappointment, they have employed a larger firm to produce the plan and to help in negotiations with potential funders.

You have been away on an assignment for Cibo, a large pharmaceutical company in North West England for the last month. On your first day back, you return to your office after lunch to see a note on your desk asking you to talk to Husain as soon as possible. Pausing only to take off your jacket, you pick up a pad and pen and walk upstairs to Husain's desk. Husain sees you approach and beckons you into a meeting room beside his desk.

"Hi, Alex. Thanks for coming up so quickly. Grab a seat. You won't believe what I'm about to tell you."

"What's happened?" you say, wondering if you are going to be pulled up for something you've forgotten to do on the Cibo assignment; it was a rush to get everything done on time but you can't think of anything you forgot.

"Remember the Derma project you worked on recently?" says Husain. "Yes," you say, still feeling nervous. "Well," continues Husain, "there have been some developments and the board needs our help."

You feel relieved and can't help smiling as you say, "What do they need us to do?"

"I'll get to that," says Husain, "but let me tell you what has happened first. I'll start with the least serious issue. One of the scientists was working late on a Friday and decided to carry on working on the data at home. He logged onto his email and clicked on a link in a spam message. It just so happened that Friday evening was the time chosen by their IT consultants to install some software upgrades and so their firewalls were down."

"I think I can guess what happened next," you say.

"Yes, I think you can," said Husain. "The link had malware embedded in it and the whole system was locked down. Ransomware of course. But lucky for Derma, their IT consultants had backed everything up before they started running the upgrades and they were able to restore the systems over the weekend. The scientist lost a few hours of data analysis but it could have been much worse."

"You're right," you say. "I went to an ICAS webinar on cybercrime last year. It's terrifying to think how vulnerable clients are. Us too!"

"It's not an area I know much about," said Husain. "In my day we focussed on e-commerce risks but now cybercrime has taken over as the main risk to businesses of using internet-enabled systems. I've an idea: why don't you prepare a short slide presentation – no more than four slides – that we can present to Derma to help them understand the risks they face and what they can do to mitigate them."

You regret mentioning the ICAS webinar but agree to prepare the presentation.

“But that’s not the worst thing that has happened to Derma,” continues Husain. “The Chemtest company that is doing the clinical trials of RetinX6 has been testing the medicine on animals. It all leaked out on social media and Medsanta are furious; they stake their reputation on sustainable and cruelty-free research. But they’re also shrewd and know that this could be an opportunity to gain control over RetinX6. Under the terms of their contract, they say they can take over the IP of RetinX6 for £1 million. There is more – they are offering £2 million for the whole company on condition that Tanya stays on until RetinX6 is licensed for use. They are also offering her a substantial package to stay. She has worked so hard to get RetinX6 to this stage; I don’t think she’ll want to be excluded from the project for anything.

“In fact, I’m not sure that Tanya has the best interests of Derma on her mind at the moment. She told me that she was fully aware of the methods of testing used by Chemtest and she was very evasive when I asked her if she was considering Medsanta’s offer. If Medsanta take over the IP for RetinX6, the other projects might not be viable without the revenue Derma expects to generate from RetinX6. There is a real risk that the other products (Appendix 1) will not produce enough revenue in time to offset the total costs of development and Derma could face collapse.

“I advised Tanya to seek a second opinion and the LEC stepped in with one of their consultants who valued the whole company IP at £4 million and the IP for the RetinX6 cream at £1.5 million.”

“But what about Peau?” you ask. “What would Medsanta do with that?”

“My guess is that they will try and open up negotiations with Skindeep again. Medsanta are not interested in the cosmetic market and Skindeep might find that they will get the full rights for less than they offered earlier this year. But if Derma decides to retain the rest of the business and only sell RetinX6 to Medsanta, they can still go ahead with their plans for Peau. The modified version of RetinX6 that is used in the cosmetic cream, Peau, is not included in the IP claimed by Medsanta.”

“Wow, this is tricky,” you say. “What does the board think?”

“Well,” sighs Husain. “That is complicated. The NEDs haven’t been paid for six months and so they might be wondering if this is an offer they can’t refuse but I don’t know for sure what they think. Hywell is taking an assertive stance – he wants to reject the Medsanta bid and sue Chemtest. Imagine what that would cost, not to mention the time involved! But he’s also offering to lend Derma sufficient working capital if the RetinX6 IP is sold and the remainder of the business is viable. We need to provide the board with a report on the situation to help them to decide what to do. Use the information we have on file (Appendix 1) to value the business using a discounted cash flow over 10 years from Yr 38/39. Use 10% as the discount rate and assume a terminal multiplier of 8. Calculate a best case and worst-case valuation.”

“The board needs to act quickly: Tanya is worried that Derma hasn’t received the research and development (‘R&D’) credit yet and she is saying that no-one’s salary will be paid next month unless the R&D credit is received soon. There is some doubt about whether Derma will continue to be viable at all.”

“What about our fees?” you ask. “Good question,” replies Husain. “Tanya is offering us 12% of the R&D credit as an additional fee but I must check whether our last bill has been paid.

“I’ll forward the R&D statement from Derma to you (Appendix 2). I have some concerns that all the expenditure they are claiming may not be allowable and the types of projects might also be problematic. Tanya is insistent that we lodge the return on her behalf as it stands today and so I’d like your opinion urgently. Let me have an email on what your conclusions are. If there are any issues, recommend what needs to be done about it.”

“I don’t think I’ve seen an R&D statement,” you think to yourself and you make a mental note to check your notes on Clifton’s R&D guidance (Appendix 3).

“But before you do that,” continues Husain, “carry out an appraisal of Hywell’s offer to fund the remaining business compared to Medsanta’s offer. Around half of all of Derma’s expenses are due to the RetinX6 project but they’ll lose the income too if the IP transfers. Just make sure that you set out your assumptions clearly so that the board members can follow the logic and make informed decisions. We’ll need to include this in our report to the board and explain their legal position as well.”

“It’s not pleasant to be caught in the middle of a board and shareholder dispute, and we need to be seen to be professionally impartial. We clearly have a number of tricky issues for our firm to consider in this engagement and I can’t decide upon them alone. Prepare a memo to the ethics partner on my behalf please. Make sure you set out the ethical issues, evaluate the problems and recommend actions.” Husain sighs and rubs his chin thoughtfully, “And to think we were delighted to gain this client”.

### Required:

- prepare the draft report to the board on the options available to Derma. Prioritise the issues that the board must address;
- prepare the draft presentation on cybercrime;
- prepare the email to Husain on the R&D credits; and
- prepare the ethics memo on behalf of Husain.



## APPENDIX 1

Summary of product development costs and other financial information as at 30 June Yr 38

Project	RetinX6	Peau	HA156	BU39
Purpose	Development of an active ingredient for medical use to regenerate skin cells	Development of an anti-ageing cosmetic cream using a modified form of RetinX6	Development of a topical anti-inflammatory cream	Development of a drug to inhibit epidermal skin cell production
Estimated clinical trials completion date	June Yr 44	June Yr 39	June Yr 42	June Yr 46
Outstanding development cost to completion £'000	1,800	400	600	800
Other sources of income	Working under contract with Medsanta. Annual development fee of £250k	Offer from Skindeep to purchase rights or enter into licence arrangement rejected	Annual development fee of £50k from Medical Research Council	Grant of £100k pa received from Bristol University to fund research assistant in Yr 38/39 and 39/40
Fixed annual manufacturing costs £'000	1,200	16	90	240
Variable cost per unit £	6	6	20	3
Marketing cost per unit £	1	2	2	1
Alternative sales scenarios: estimated sales prices and units	a) 100k units at £30 each b) 300k units at £20 each	a) 2k units at £50 each b) 4k units at £40 each	a) 8k units at £100 each b) 20k units at £60 each	a) 15k units at £30 each b) 30k units at £20 each

**Notes:** Costs are incurred evenly each year until the completion date; assume sales commence on 1 July following completion.





## APPENDIX 2

### Tanya Silvertree's calculation of R&D credits

	Yr 37/38 £'000	Yr 36/37 £'000
Trading loss	199	126
Qualifying R&D expenditure	450	430
Loss able to be surrendered is the lower of:		
Unrelieved trading loss	784	685
Qualifying R&D expenditure x 230%	1,035	989
Repayable tax credit:		
Unrelieved trading loss x 14.5%	114	99

### Summary of time sheets for scientific staff (% of time allocated to research projects in Yr 37/38)

Project	S Grant	E Carter	H Chiu	N Mohamed	M Ahn	A Favotto	T Silvertree
RetinX6	100	60			40	40	20
Peau		40	100		40		15
HA156				50	20	40	5
BU39				50		20	10

## APPENDIX 3

### Notes on R&D tax relief for SMEs as produced by Alex from Clifton's R&D guidance

- Loss-making companies can claim credits at the lower of the unrelieved trading loss or 230% of the qualifying R&D expenditure
- R&D tax relief is worth 14.5% of eligible costs.
- The company must be a going concern to claim R&D tax relief.
- A research project ends when the scientific uncertainty is resolved i.e., when the product is ready to be tested in the market or go into production.
- Qualifying costs include employees working directly on the R&D and consumables.
- Only 65% of sub-contracted work can be claimed.
- An SME cannot claim R&D relief under the SME scheme for ineligible costs. These include capital expenditure, payments for patents, projects in receipt of grants which are specified subsidies, production and distribution costs.

The EU-UK Trade and Cooperation Agreement (TCA) prohibits certain specified subsidies if the subsidies concerned have, or could have, a material effect on trade or investment between the EU and the UK..

- RDEC is short for Research & Development Expenditure Credit. It is the tax credit available for large companies but in some circumstances, it can be used by small companies. It is worth 13% of eligible costs.
- Work done under contract, including under licence, for a large company is ineligible for R&D tax relief but can be eligible for RDEC instead.
- Projects funded by specified subsidies can be eligible for RDEC instead.

**END OF PAPER**