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Building a leading specialty pharmaceutical company

Knight Therapeutics Inc.
Illustrative Example of Hyperinflation Accounting
(TSX: GUD)

June 2020

Introduction

Indicators of hyperinflation under IFRS:

1. The cumulative inflation rate over three years is approaching or exceeds 100 percent.

2. Interest rates, wages and prices are linked to a price index.

3. The general population prefers to keep its wealth in nonmonetary assets or in a relatively stable foreign currency. Amounts of local currency held are invested immediately to maintain purchasing power.

4. The general population regards monetary amounts not in terms of the local currency but in terms of a relatively stable foreign currency. Prices may be quoted in that currency.

5. Sales and purchases on credit take place at prices that compensate for the expected loss of purchasing power during the credit period, even if the period is short.

Argentina:

- In July 2018, the 3-year cumulative rate of inflation for consumer prices and wholesale prices reached a level of about 123% and 119%, respectively

- On that basis, Argentina was considered hyperinflationary

   – Therefore operations in Argentina accounted under *IAS 29: Financial Reporting in Hyperinflationary Economies*

Accounting under IAS 29

Methodology:

- Indexation to reflect purchasing power using inflation rate in Argentina at each reporting date (March 31, June 30, September 30, December 31)

- Indexation performed on the Argentinian financial statements in Argentinian Pesos ("ARS")

  - Through the gross up of the accounting values (under historical accounting) of all income statement accounts & non-monetary balance sheet accounts using the inflation rate of Argentina

- Leads to an increase in P&L and balance sheet items values in ARS

- Indexation is followed by translation to presentation currency ("CAD")

  - Both balance sheets and income statements converted to CAD using the **FX RATE at the end of the reporting quarter**

Accounting under IAS 29

Income Statement Accounts

- Revenues: Adjusted for changes in the general price index from the month of the sales to the reporting month
  - Example: Revenues in January will be restated for inflation to March 31, June 30, September 30 and December 31

- Cost of sales: Adjusted for changes in the general price index from the month of the purchase of the inventory to the reporting month
  - Example: Inventory purchased in June 2019 and sold in January 2020 will have to be first restated using the inflation index from July 2019 to January 2020 & subsequently restated at every reporting period (March 31, June 30, Sept 30 & Dec 31)

- Operating Expenses: Adjusted for changes in the general price index from the month the expenses were incurred to the reporting date
  - Example: Salary expenses of January will be restated for inflation to March 31, June 30, September 30 and December 31

- Indexation adjustments leads to a lower gross margin and operating results
  - Primarily due to indexation of inventory purchases from the original purchase date

Walkthrough example

Consider the below illustrative income statement of a hypothetical company distributing Product A and incurring certain operating expenses. Adjustments are further explained through notes 1 to 5.

Illustrative Income Statement In ARS	Historical	Adjusments / Indexation	Hyperinflation (IFRS)	Note	IFRS CAD (5)
Revenues	500,000	125,000	624,999	1	12,019
Cost of Sales	227,756	108,184	335,939	2	6,460
Gross Profit	**272,244**	**16,816**	**289,060**		**5,559**
	54%		46%		46%
Selling & Marketing	106,693	21,372	128,065	3	2,463
General & Administrative	88,215	28,331	116,546	3	2,241
Research & Develoment Expenses	26,326	5,596	31,922	3	614
EBITDA	**51,010**	**(38,482)**	**12,528**		**241**
Loss on hyperinflation			50,000	4	962
Net Income (loss)	**51,010**		**(37,472)**		**(721)**

Walkthrough example (continued)

	Historical	Adjusments / Indexation	Hyperinflation (IFRS)	Note	IFRS CAD (5)
Revenues	500,000	125,000	624,999	1	12,019
Cost of Sales	227,756	108,184	335,939	2	6,460
Gross Profit	**272,244**	**16,816**	**289,060**		**5,559**

1   Historical amount adjusted using the monthly inflation index from month of sales to the reporting date

Example: Product A is sold for 500,000 ARS in January 2020:

Revenues Historical in Q1-2020	**ARS 500,000**
Inflation from January to March 2020	15.0%
Revenues IFRS in Q1-2020 Financial Statements	ARS 575,000
Inflation from January to June 2020	25.0%
Revenues IFRS in Q2-2020 Financial Statements	**ARS 624,999**

2   Cost of sales amount adjusted using the acquisition date of the inventory to the reporting date

Example: Product A was acquired in June 2019 for ARS 227,756:

Cost of Sales Historical in Q1-2020	**ARS 227,756**
Inflation from June 2019 to March 2020	30.0%
Cost of Sales IFRS in Q1-2020 Financial Statements	ARS 296,082
Inflation from June 2019 to June 2020	47.5%
Cost of Sales IFRS in Q2-2020 Financial Statements	**ARS 335,939**

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Walkthrough example (continued)

	Historical	Adjusments / Indexation	Hyperinflation (IFRS)	Note	IFRS CAD (5)
Selling & Marketing	106,693	21,372	128,065	3	2,463
General & Administrative	88,215	28,331	116,546	3	2,241
Research & Develoment Expenses	26,326	5,596	31,922	3	614
EBITDA	**51,010**	**(38,482)**	**12,528**		**241**
Loss on hyperinflation			50,000	4	962
Net Income (loss)	**51,010**		**(37,472)**		**(721)**

3	Restated from transaction date to reporting date using the cumulative inflation index (similar to adjustment 1)
4	Represents the net monetary position of the Company (Monetary Assets LESS Monetary Liabilities as at the end of each reporting period)
5	Converted to CAD using closing FX rate on June 30, 2020 (Q2)

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Accounting under IAS 29

Balance Sheet Accounts

- Monetary Items (e.g. Cash, Accounts Receivables, Accounts payable etc.)
  - No indexation required due to monetary nature
  - Net monetary position (total monetary assets less monetary liabilities) recognized as a gain or loss in the income statement
    - Excess of assets over liabilities leads to a loss as it indicate loss of purchasing power in a hyperinflation environment
- Non-Monetary Items (e.g. Inventory, Intangibles, Shareholder Equity etc.)
  - Adjusted for changes in the general price index from the date of acquisition, contribution or revaluation
  - Leads to an increase in reported value under hyperinflation accounting

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