Part (e) Estimate what impact the proposed restructuring in attachment 1 could have had on the profitability of Mofasa in FY2019.		**Marks**
Candidates can use either of the two alternatives below:	**R**	
Alternative 1		
The FY2019 EBITDA is expected to be as follows:		
Gross profit	56 908 000	1
Less: Salaries	(28 987 000)	1
New rent (R6 500 000 – R4 204 000)	(2 296 000)	1
Allocated rent (sunk cost) – this will have to be reallocated to the other divisions	(2 423 000)	1
Directors' remuneration	(952 000)	
Municipal charges	(712 000)	
Less: Additional municipal charges	(900 000)	1
Franchise fee	(3 125 000)	
Other costs (R9 654 000 + R165 000)	(9 819 000)	
Less: once-off cost of retrenchment	(1 100 000)	1
EBITDA	**6 594 000**	
As an initial evaluation, compared against the current EBITDA of R1,365 million, with a net increase of R5 229 000 in EBITDA / 6 329 000 (excluding the once- off cost).		1C
	Available	**7**
	Maximum	**7**
Alternative 2: Candidates may also perform a change-based calculation	**R**	
Previous EBITDA	1 365 000	
Less: Previous gross profit	(5 617 000)	1
Add: New gross profit	56 908 000	1
Less: New salaries	(28 987 000)	1
Do not add back previous rental of R2 423 000	–	
Less: R6 500 000 – R4 204 000	(2 296 000)	1
Do not add back directors' remuneration (relevant under both options)	–	
Less: Additional municipal charges	(900 000)	1
Less: Franchise fee	(3 125 000)	
Less: Other costs	(9 654 000)	
Less: once-off cost of retrenchment	(1 100 000)	1
New EBITDA	**6 594 000**	
Net change: increase in EBITDA of R 5 229 000/ 6 329 000 (excluding the once- off cost).		1C
	Available	**7**
	Maximum	**7**
	Total for part (e)	**7**

Part (f)	Discuss the issues the management of Mofasa should consider when evaluating the proposal from Pride Oil with reference to attachment 1 and the extract of the management accounts included in workpaper WP 102-1.	Marks
1	Lack of required expertise to run this type of business by existing shareholders (convenience store, bakery and coffee shop).	1
2	By venturing into this new type of business, the company will be required to comply with more / new laws and regulations (health and safety, food laws, etc.). The risk attached to and cost of compliance will need to be considered.	1 1
3	Accepting the proposal would require a long-term commitment as the lease is to be signed for a minimum of ten years. If the business does not perform as expected, the cost of exiting the lease might be significant.	1 1
4	Accepting the proposal will commit the company to a franchise agreement. This means that decision-making and control will be more limited as decisions will also be prescribed by the franchisor.	1
5	Are any other once-off costs to be considered? What about shop fittings and other items such as baking ovens, coffee machines, cash registers, etc.	1
6	How reliable is the forecast information provided by Pride Oil? This could be overstated to encourage the facilitation of the deal. The company should consider performing due diligence or engage the services of a third party to assist in performing a due diligence.	1 1
7	No proper market analysis and research have been performed. What other convenience stores are in the area – thus what is the competition? The likely target market, its preferences and spending patterns should be determined to decide whether the proposed convenience store is a good fit for the company.	1 1
8	The performance of the repair workshop will be affected, as the second-hand car dealership utilises the workshop for services. However, for the past three years between 18% and 32% (270/ 850, 297/ 943, 310/1 722) of the number of vehicles serviced related to used cars. In FY2019 the percentage was 17% based on turnover (2 329 000/13 849 000) which if lost would have resulted in a R698 000 decrease in gross profit and halved the department's net profit.	1 1
9	The performance of the petrol station will be affected, as the second-hand cars are supplied with a full tank of fuel. While this will probably not have a meaningful impact, it needs to be considered (not enough information provided). Dealership might bring additional fuel sales in from visits to the dealership, which will be lost. However, convenience store would probably bring in even more business, therefore a benefit from the new business on existing.	1 1
10	The current performance of the second-hand car division needs to be assessed in detail: • What are the future prospects for the second-hand car market in South Africa? • Can anything be done to improve the current performance of the second-hand car division, rather than closing it down?	 1 1

11	Are there any other investment options available that should be considered? (For example, rather than starting up a convenience store, focusing on shocks and tyres.)	1
12	The second-hand car department employs nine people: consider the impact of job losses and impact on the morale of staff in other business of closing down and retrenching. Can the staff be retrained (what is the cost), possible action by unions, etc.	1
13	Ability of retail partner to provide goods and services in area – Aliwal North may not be an area where the strategic partner operates currently, and this could impact on their ability to re-stock the shelves once items are sold – leading to high stock-out costs.	1
14	The proposal is subject to the company still complying with the requirements of shareholding by designated groups (i.e. more than 2/3 ownership). Mo expressed his concerns relating to the proposal and, should he leave, the threshold will no longer be met. If Mo exits the business, does Fani have sufficient resources to acquire Mo's shareholding or will they have to find an external party?	1 1
15	Does Mo and employees have a significant impact on customer loyalty? Would their departure or closure of the car sales division impact the reputation of the business?	1
16	What will the impact be on costs incurred in the admin department? Will they, for example, need to employ another person to assist with the administration of the department?	1
17	Starting with the above, the following should be considered with a view to the future: • What is the CPI expected to be, going forward? If the lease payments increase by more than the increase in gross profit, the division will become less profitable over time. • What is the likelihood of sales exceeding R200 million? The additional 1% rental should be factored into the calculation. • Are there any working capital costs required (or capital maintenance costs)? • The saving of not having to finance vehicle stock will have to be calculated and considered. • Perform a sensitivity analysis, changing key variables in the financial evaluation, e.g. Gross profit (sales), CPI.	 1 1 1 1 1
18	The shareholders should perform a detailed discounted cash flow, taking into account the above as well as the weighted average cost of capital for the company which need to be a divisional specific WACC for the new business line with new risks , in order to properly assess the decision, as it is a long-term decision.	1 1
19	Conclusion: While the proposal appears to be financially sound, there are significant other issues to consider or first investigate before a final decision can be made.	1
20	Does the retail company have its own requirements as franchisor and will Mofasa be able to comply with its requirements too?	1
21	Does the company have the cash reserves for the required capital outlay and stocking of inventory - these may put pressure on liquidity position and ability to operate)	1
22	Does the convenience store not bring about other risks (e.g. higher risk of robberies) that need to be considered? How many hours per day will the store be open? Has this been factored into the budgeted figures?	1

23	The franchisor is 'well known', but any reputational problems with the franchisor could also affect Mofasa's business.	1
24	The convenience store represents diversification into a different business segment, this will change the overall risk profile of the entire group which should be considered, also capital structure of the group may be different with the new lease funding.	1
	Available	**37**
	Maximum	**16**
	Communication skills – appropriate style	*1*
	Total for part (f)	**17**

Part (g)	**With reference to attachment 1 – (i) discuss the factors that the directors of Mofasa would consider to determine whether or not to review the lease at the end of the first ten years. No calculations are required.**	**Marks**
1	The lump sum payment of R11,2 million will need to be considered. Will management have sufficient cash on hand (according to their budgets) to be able to make the payment or access to sufficient financing?	1
2	Management will need to compare the additional five-year payments to the value of the building that will be transferred to them if the lease is renewed.	1
3	Management need to assess what they think the value of the building will be after 15 years. A detailed calculation of capital budgeting is required to evaluate the decision- they may have to employ a specialist valuation expert to assist in this regard.	1
4	Management need to consider whether they want to own a building. Maintenance and other costs (such as insurance) of ownership needs to be considered, especially for a building that will be 15 years old.	1
5	If they do not renew the lease, what will happen to the building? For example, the landlord could place another franchisee in their location. Alternatively, the company would have to move premises. What about existing loyal clients?	1 1
6	In 15 years, the current shareholders will be close to retirement age. They will have to decide whether owning the building at that stage is in line with their personal succession plans or whether they will be selling the company.	1
7	Management would take the success of their business into account – is it worthwhile continuing for another five years? This would include taking changes in environmental laws, the economy as a whole, the outlook for SA and the immediate area, etc., into account.	1 1
8	Consider closure costs of the business if the lease is not renewed and the decision is not to continue with the business.	1
	Available	**10**
	Maximum	**6**
	Total for part (g)(i)	**6**

Part (g)	**With reference to attachment 1 –** (ii) **discuss the inputs that Lana will use to determine the required present value to account for the lease of the premises in terms of IFRS 16 *Leases*;**	**Marks**
1	PMT = R7,5m/12 representing the fixed lease payments	1
2	The number of periods will be 15 x 12 (180) - the period should take the probable renewal into account or if not 10 x 12 (120) reasonably certain that they will exercise the renewal option.	1
3	Escalation: Payments will increase by 6% every 12 months. This is the minimum escalation that will be charged. There is no information that a higher escalation is applicable as it is dependent on CPI.	1
4	Escalation: Does not take into account the additional 1% of revenue in payments as this is variable.	1
5	FV = No future value / lump sum payment will be taken into account. As the renewal is reasonably certain or FV= R11.2million will be taken into account if not reasonably certain that they will exercise the renewal option. As the renewal is reasonably certain, the balloon rental payment payable after ten years is no longer relevant orAs the renewal is not reasonably certain, the balloon rental payment payable after ten years will be relevant.	1 1P
6	I = The discount rate to be used: 9,5%/12 or 9.25/12. The lease agreement is similar to a loan with a term of 15 years/ 10 years secured by fixed property – the unsecured borrowing rate or short-term rates are therefore not appropriate.	1 1
	Available	**8**
	Maximum	**4**
	Total for part (g)(ii)	**4**

Part (g) With reference to attachment 1 – (iii) prepare the relevant journal entries for Mofasa to account for the lease agreement for FY2020 on the following assumptions: • The agreement is implemented on the proposed terms; • The renewal of the lease is reasonably certain; and • The present value of the minimum lease payments is R83 920 955 on 1 December 2020. Ignore tax; and Ignore closing entries.			**Marks**
	Dr	**Cr**	
	R	**R**	
Right of use asset (SFP)	83 920 955		1
Lease liability (SFP)		R83 920 955	1
1 December 2020 – Recognising the right of use assets and corresponding lease liability on inception of the lease			
Lease Liability (SFP)	625 000		0.5
Bank (SFP)		625 000	1
1 December 2020 – Accounting for the first lease payment			
Interest expense (P/L) (83 920 955-625 000)*9.5%/12=	659 426		1
Lease liability (SFP)		659 426	1
31 December 2020 – Accounting for interest on the lease liability			
Depreciation (P/L)(R83 920 955-R3 000 000)/25/12	269 737		1+1
Accumulated depreciation/ Right of use asset (SFP)		269 737	0.5
31 December 2020 – Accounting for depreciation on the right of use asset			
Available			**8**
Maximum			**8**
Total for part (g)(iii)			**8**
Communication skills for part (g)(i) and (ii) – clarity of expression			*1*
Communication skills for part (g)(iii) – presentation			*1*
Total for part (g)			**20**

Part (h) **Calculate the taxable income of Mo for the year of assessment ended 28 February 2019 with reference to TWP 603-1.** **Provide reasons for items not included in the calculation of taxable income.**		**Marks**
	R	
Directors' remuneration	556 933	1
Use of motor vehicle		
BMW – R910 000 x 3,5% x 6 months = R191100 (R910 000 x 3.25% x 6 months =R177 450) While accurate records may have been kept of business travel, due to the loss of the logbook, it is not available, and no reduction can be made – par. 7(7)	191 100	1 1
Audi – R875 000 x 3,5% x 6 months = R183 750 (R875 000 x 3.25% x 6 months =R170 625) Business travel = 4 298/9 555 = R82 654 (par. 7(7)) The cash equivalent is R183 750 – R82654 (The cash equivalent is R170 625 – R 76 750 = R93 875)	101 096	1 1
Medical aid fund contributions (par. 2(i) and 12A)	132 432	1
Insurance premiums (no taxable benefit in respect of an insurance policy that relates to an event arising solely out of and in the course of employment of the employee) (par. 2(k) of the Seventh Schedule)	–	1
Provident fund contributions (par. 2(l) and 12D)	351 733	1
Domestic staff wages - settlement of an employee's debt	102 600	1
Interest (R32 499 * 50% = R16 250) section 10(1)(i))	32 499	1
Deduct: Exempt interest (Limited to R16 250)	(23 800)	1
Subtotal	1 444 593	
Deduct: Provident fund contribution (s11F): B/F R23 333 Current R351 733 Total: R375 066		 0.5 0.5
Lesser of: R350 000 or 27,5% of the higher of R1 444 593 X 27,5% = R397 263 (taxable income) [R556 933 + (R191 100 x 80%) + (R183 750 x 80%) + R351 733 + R102 600+ R132 432] x 27,5% = R396 984 (remuneration) *Therefore R350 000 is the lesser*	(350 000)	 1 1 1
Taxable income	**1 094 593**	
	Available	**15**
	Maximum	**15**
	Total for part (h)	**15**
TOTAL FOR PART II		**59**