Mini Mock Exam – Answer Plan

Management Case Study – November 2023 / February 2024

Answer Planning Technique

Please refer to the recorded version of Webinar "Answering Technique" for an in-depth guide on answer planning. Visit https://www.studyattcs.com/product/mcs_packages and check out the "Free Content" tab to access the video tutorial.

Replicate the same technique when practicing the five mock exams and when attempting the real exam.

Steps to follow

1. Read the scenario & reference material: 5 minutes.
2. Reiterate each requirement in your own words. Keep it simple.
3. Develop headings and sub-headings.
    a. Headings: Bold & Underlined format
    b. Subheadings: Bold format
4. Develop each answer plan on the answer screen: 20 minutes.
5. Type the final answer. Simply expand the answer plan: 20 minutes.

Requirements

TASK 01

- Challenges of complying with dealership conditions & how to overcome (56% = 21 marks)
- Characteristics of debt and equity (44% = 16.5 marks)

TASK 02

- Presenting informative investment appraisal & addressing HRD's concern (56% = 21 marks)
- Accounting treatment for lease (44% = 16.5 marks)

TASK 01

<u>Challenges Cuppcar will face in complying with the three main dealership conditions of KMW and how we can overcome those challenges</u> *(21 marks)*

- Challenge: Marketing alignment
  - Maintaining Cuppcar's brand identity while promoting KMW's hybrid vehicles
    - Issues: brand consistency, target market identification, resource allocation.
  - How to overcome:
    - Collaborative discussions: identify common goals and values
    - Establish clear branding: highlighting both Cuppcar and KMW
    - Establish cross-functional teams from both companies for coordination
    - Regular reviews and adjustment of strategies

- Challenge: Complexity in communication
  - Issues: Differences in corporate culture, decision making, working hours, language.
  - How to overcome:
    - Cross-cultural training for employees of both companies
    - Structured approach for communication:
      - Define communication protocols and channels
      - Virtual meetings and document sharing
      - Hire bilingual staff, use translation services or language training

- Challenge: Costs of sustainable operations:
  - Issues: Significant initial investments, trained workforce.
  - How to overcome:
    - Phased approach to investment: balance short-term costs with long-term benefits
      - Focus on high-impact projects for quick returns
    - Employee training
    - Explore financial support: government grants, incentives, or tax breaks

<u>Characteristics of debt and equity that should be considered when sourcing the funds for the investment</u> *(16.5 marks)*

Debt

- Pros
    - Relatively cheaper source of finance: less risk than equity for lenders
    - Interest is tax deductible

- Cons
    - Security/Collateral must be given
        - Cuppcar can pledge cars
    - Gearing (D/D+E) will increase from 22.5% to 26.6%
        - Increases the financial risk
            - But not significant here
            - Increase is just 4.1 percentage points (26.6% – 22.5%)

Equity

- Pro
    - No need to repay the capital
    - Raising equity: decreases gearing
            - Decreases financial risk:

- Cons
    - Relatively more expensive source of finance
    - Dividend is not tax deductible
    - Legal formalities need to be complied with
    - Shareholders expect a convincing business proposal to invest further
        - Questionable whether investors would invest W$ 160M based on the KMW proposal

TASK 02

<u>How we can present a more informative investment appraisal to the board and addressing HR director's concerns</u> *(21 marks)*

<u>Regarding the NPV:</u>

- Positive NPV:
  - Increases shareholder wealth

- Cash flows:
  - Based on a moderate level of demand – incorrect
    - When there are multiple outcomes
      - Expected value should be calculated and incorporated into NPV
  - If demand is low, NPV will be lower or negative
    - Calculate NPV considering a worst-case scenario
    - Perform sensitivity analysis
      - How a change in one variable can affect the NPV
- Discount factor:
  - Inaccurate to use the interest rate: WACC must be used
  - WACC represents the average cost of an entity's total pool of funds
    - New funds are being put into Cuppcar's total pool of funds
    - Company uses the pool of funds to operate all aspects of business
      - Hence, appropriate to use the WACC

<u>In addition to the NPV:</u>

- Calculate the IRR: The relative return (% return)
  - Indicates by how much CoC can fall before the NPV of the project becomes zero
    - Similar to margin of safety

Addressing HR director's concerns

- Financial perspective: NPV is superior to payback
- Payback
    - The length of time it takes to recover the initial investment
    - Measure of liquidity and risk
        - Quicker the recovery, lower the risk
    - Does not consider the entire life or the ultimate return from the project
        - Ultimate return should be considered when determining a project's viability

- NPV
    - Net return from an investment considering
        - Relevant cash inflows and outflows
        - The entire project's life
        - Discounted to present value at the company's CoC
    - Positive NPV
        - Increases shareholder wealth
        - Project with a positive NPV is financially viable

<u>Accounting Treatment: Lease</u> *(16.5 marks)*

- IFRS 16 Leases
    - Cuppcar is the lessor (asset's owner): Lessor accounting applies

- Finance or operating lease? *(Included to teach theory. Should not be included in the answer)*
    - Ownership is transferred to the lessee at the end of the lease.
    - The lessee has the option to purchase the asset for a price substantially below the FV of the asset and it is reasonably certain the option will be exercised.
    - The lease term is for a major part of the asset's useful life (75% or more).
    - The present value of the minimum lease payments amounts to substantially the FV of the asset.
    - The leased assets are of such a specialized nature that only the lessee can use them without major modifications.
    - The lessee bears losses arising from cancelling the lease.
    - Lessee can continue the lease for a secondary period at a rate below market rent.

- Application: Finance or operating lease?
    - Characteristics indicative of a finance lease:
        - Characteristic: Lease term is for a major part of the asset's useful life
            - Application: Lease is NOT for a major part of the assets UEL (just 25%)
                - Cars have a UEL of 8 years but lease is for 2 years
        - Characteristic: Lessee can renew the lease for another period at below the market rent
            - Application: United Holdings (lessee) can renew, but NOT below market rent
        - Characteristic: Lessee bears losses arising from cancelling the lease
            - Application: United Holdings (lessee) bears the cost
    - Overall conclusion: Treat as an operating lease

- Accounting treatment: operating lease
    - Lease receipts: shown as income in the SOPL on SLM over the 2 year term
        - Cuppcar should recognize a lease income of $ 240,000 p.a.
    - Any difference between amounts charged and amounts received
        - Recognize as accrued income or deferred income in the SOFP

- Accounting treatment: finance lease*(Included to teach theory. Should not be included in the answer)*
    - Derecognize from NCA (SOFP)
    - Recognize under receivables, as finance lease receivable (SOFP)
        - Lease receivable is equal to the net investment of the lease
        - Net investment calculation: PV of unreceived;
            - Fixed & variable rental payments
            - Residual value guarantees/ ungranted residual values
            - Termination penalties
        - Discounted at the lease rate
    - Annually;
        - Decreased by cash receipts (SOFP)
        - Increased by finance income (SOPL)
            - Calculation: Opening balance * Discount rate