**ASSESSMENT OF PROFESSIONAL COMPETENCE**
**November 2016**

**EXAMPLES OF VARIOUS LEVEL OF COMPETENCE**
**IN EACH OF THE TASKS**

To assist all candidates in preparation for the Assessment of Professional Competence, SAICA has made these examples (specimen answers) available, to illustrate examples of candidate responses deemed LC (limited competent), C (competent) or HC (highly competent) for each of the sections of the case, along with examiner comments (on each of the sections of the case study) on our website.

The objective of allowing candidates access to this information is to assist unsuccessful candidates and first-time candidates by providing insights into what APC Examco deemed as LC, C and HC attempts to the various sections of the 2016 assessment. This may assist in preparation for the 2017 APC.

We recommend that the 2016 case study be reviewed in detail prior to reviewing examples of LC, C and HC attempts to sections. Thereafter, review the examiner's comments on each attempt and absorb this for the purposes of your preparation for 2017.

No illustrated examples of candidate responses deemed BC for each of the sections of the case study has been included, but rather examples of LC and C. BC attempts would have features of both LC and C attempts but would not be distinguishable as either.

 

## *PART (a)*

*(a) Respond to Harry Mnisi's email request in document F.*

**DOCUMENT F**

**EMAIL TRAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

**From:** Harry Mnisi
**Sent:** Wednesday, 16 November 2016, 05:45 AM
**To:** Financial Accountant
**CC:**
**Subject:** RE: Internal audit

Hi

Please have a look at the email trail below, as well as the WhatsApp messages I received from Bill Marx which I forwarded to you. I would like you to draft the memorandum requested by Sally Whiteley in her email on my behalf.

Thanks
Harry

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**From:** Sally Whiteley
**Sent:** Tuesday, 15 November 2016, 03:47 PM
**To:** Harry Mnisi
**CC:**
**Subject:** RE: Internal audit

Hi Harry

Please refer to the email from Gavin below, as well as my email of 9 November 2016.

Could you please prepare a memorandum to be tabled at our next Board meeting dealing with –

- the key considerations in deciding whether to establish an internal audit function for żinga Fashions within the next couple of months; and
- Bill Marx's suitability as a potential candidate as head of internal audit in the event that the Board does decide to appoint one.

Regards
Sal

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**From:** Gavin Marx
**Sent:** Friday, 11 November 2016, 01:30 PM
**To:** Sally Whiteley
**CC:**
**Subject:** RE: Internal audit

Dear Sally

I know that you have asked Harry to report on the desirability of establishing an internal audit function for our company.

Refer below to the email I received from my nephew, Bill Marx, who has recently qualified as an internal auditor. I took the liberty of providing him with Harry's contact details. I think that Bill may be a good option to be our company's first internal auditor. Not only is Bill suitably qualified, but he has some very good ideas which I believe will be of great benefit to żinga Fashions.

In the interests of transparency, I thought that I should inform you of this fact.

Regards
Gavin

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**From:** Bill Marx
**Sent:** Friday, 11 November 2016, 11:00 AM
**To:** Gavin Marx
**CC:**
**Subject:** Internal audit

Dear Uncle Gav

As you are aware, I have now completed my university studies, and I am ready to start my career as an internal auditor. From what you have told me about żinga Fashions (Pty) Ltd, it sounds like an exciting company to work for, and I would now like to take you up on your offer to assist with securing me a job at żinga Fashions.

At this stage I have the following internal audit projects in mind:

- Undertaking work in areas that will contribute to a reduced external audit fee, e.g. by evaluating the effectiveness of your company's internal control systems; and
- Detecting fraudulent conduct at żinga Fashions by establishing and rolling out a whistleblower's hotline – which will use my cell phone number, and which I am willing to man on a 24 hours a day basis. I will investigate all reported frauds, and present the findings to the CEO / CFO.

But, of course, the exact nature of my work can only be finalised following discussions with your company's executives, and once I have a better understanding of the needs of żinga Fashions.

Cheers
Bill

## Highly competent

To: The board of Directors
From: Financial Accountant
Date: 16 November 2016
Subject: Internal audit

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The below memorandum regarding Internal audit at Zinga includes the following:
1) Key considerations on whether to establish an internal audit department
2) Bill Marx's suitability as a potential candidate as head of internal audit

**<u>1) Key considerations on whether to establish an internal audit department:</u>**

When determining whether to establish an internal audit department both the key advantages and disadvantages must be considered as follows:

1.1) Advantages:

- By utilising internal audit, it may lead to the discovery of errors made in Zinga's internal controls and processes that have not been uncovered by the external auditors. Internal audit could therefore assist by providing consultation to reduce or possibly eliminate the aforementioned errors.
- Utilising internal audit would reduce the likelihood / opportunity of fraud occurring at management and employee level. As management do not always have the time to monitor and evaluate all the entities processes, internal audit can perform this task, being trained professionals and apply their knowledge and skill to determine any weaknesses in processes and controls and advise management on solutions to reduce the likelihood of fraud occurring.

- Internal audit would be a constant feature where records, controls and processes are checked regularly, and ensures that management are constantly kept up to date regarding the effectiveness of the processes and controls specifically relating to financial reporting. This will ensure that Zinga staff follows the correct procedures, are always vigilant and reduce the likelihood of errors.
- A well-functioning internal audit department may also lead to improved negotiations of the external audit fee. This may be the case should external audit be able to rely on controls in terms of ISA 610. This will only occur where the internal audit department have implemented a strong control environment that external audit test, and deem effective. In this event, it would lead to a reduction of substantive audit procedures to be performed at final audit, less time spent on the audit engagement, and as such could lead to a reduction in the fee. As the fee reduction is dependent on a number of variables, the reduction in fee may not be significant when compared to the costs of setting up and maintaining an internal audit department.

1.2) Disadvantages:

- Internal audits are not fool proof, as they will be unable to eliminate all errors / identify all instances of fraud if any at Zinga. Therefore the possibility of mistakes and fraud would never be 100% eliminated if an internal audit department was established.
- Internal audit reports are only intended for management and are therefore not accepted by shareholders. Further to this the internal audit department will be paid by Zinga, and therefore cannot be seen to be 100% independent of the organisation. Zinga would have to conduct an external audit irrespective of the fact that it has an internal audit department - and although this may lead to a reduction in external audit fees, this may not necessarily be significant as noted above.
- The cost of setting up and maintaining an internal audit department may be significant. These costs would include monthly employee salaries, capital expenditures and would also lead to a significant amount of time spent by the other employees in dealing with internal audit. The costs may potentially outweigh the benefit of having an internal audit function and must be assessed through a cost benefit analysis that takes into account quantitative and qualitative considerations.
- Internal audit can fail to disclose the correct information of what is happening at Zinga. The background of the entity may not be clear to the internal audit staff and management of Zinga may be vague on their clarifications. This may lead to the true picture of operations within Zinga not being reflected, and this would defeat the point of having an internal audit department.

From the above it can be determined that although there are both key advantages and disadvantages to establishing an internal audit department, if the internal audit department is set-up to be effective, could lead to significant benefits for Zinga that may outweigh the financial cost of setting up and maintaining the department. As noted above this will have to be determined through a cost benefit analysis that considers both the qualitative and quantitative considerations identified.

**2) Bill Marx's suitability as a potential candidate as head of internal audit:**

When assessing whether Bill Marx is suitable to be the head of internal audit, the following factors should be considered:

- Relevant years' experience in the internal audit environment
- Level of qualification, skills and resources of the individual
- Ability to be independent

- Bill is only 25 years old and a recent graduate from university. He has had no relevant years' experience in the internal audit environment. Further to this, it has been noted that he seeks to gain practical experience through employment as Head of internal audit. Therefore may not be sufficiently experienced to be the head of internal audit.

- Based on correspondence with Bill, he holds a BCom Honours (Internal Auditing) qualification from the University of Gauteng. As such he appears to have the level of qualification necessary.
- Bill Marx is the nephew of Gavin Marx (Executive Director: Buying and merchandise). This poses the problem of independence of Bill, as there would be a familiarity threat due to his relationship with his uncle.
- King III determines that an internal audit function must be independent and objective from management. Although King III is not a requirement for Zinga as an unlisted entity, it is a requirement of the JSE to meet the requirements of King III (and if not, sufficiently explain why non-compliance occurred). As Zinga is looking to list within the next 3 years, hiring Bill as head of internal audit may result in the internal audit department not being independent, and therefore not being in compliance with King III and the JSE listing requirements.
- As part of ISA 610: Use of internal audit, the external auditors will be required to assess the level of independence and objectivity of the internal audit department. This will determine whether the work of internal audit can be relied upon to reduce the amount of work performed by them. This will therefore largely determine whether the audit fee may be reduced. As Bill is not independent of the board, it is likely that the external auditors will conclude that the work of internal audit cannot be relied upon, and will unlikely lead to a reduction in the audit fee.
- Bill has noted that he would implement a whistle blower hot line that is linked to his personal cell phone and all findings would be reported to the CEO/ CFO. Due to his close relationship with Gavin, Zinga would not be able to consider Bill as independent, and could not be 100% certain that all instances of fraud would be reported.
- The fact that Bill wishes to work on a contingency basis is concerning. Internal audit departments should be paid a salary regardless of the findings that they have. Although this may incentives him to identify and report any findings, the internal audits function is not to identify concerns solely, but rather to implement controls to prevent instances of error and fraud, amongst others.

From the above it can be determined that although Bill may be suitably qualified for the position, but he appears to lack the relevant years' experience in the internal audit environment, and does not have the ability to be independent from management. It is therefore recommended that Bill Marx is not considered as a suitable candidate for Head of the internal audit department in the event that the board decides to appoint one.

The attempt is potentially too long winded however, the candidate identified all the key issues to be considered. The discussion of the potential benefits and negatives of establishing an internal audit division was balanced. The discussion regarding the suitability of appointing Bill Marx as head of internal audit was tactful and identified the core issues. The following issues raised elevated the attempt from a solid C to highly competent:

- External audit's limited reliance on zinga internal audit if Bill Marx appointed to head the division;
- Discussion of zinga's potential listing and the need to comply with King III;
- Inappropriateness of Bill Marx manning the whistle blowing hotline; and
- Inappropriateness of Bill Marx working on a contingency basis.

**Competent**

From: Financial Accountant
Sent: Today
To: Sally Whitely
Cc: Harry Mnisi
Subject: Internal Audit
Attachment: Memorandum Internal Audit

Hi Sally

Trust you are well

As requested by yourself, please find attached a memorandum on behalf of Harry regarding the internal audit to be presented at our next board meeting.

Included in this memorandum is:
1. The key considerations in deciding whether to establish an internal audit function
2. Potential Candidates

Kind regards,

Financial Accountant

MEMORANDUM REGARDING INTERNAL AUDIT
(CONFIDENTIAL) - FOR INTERNAL PURPOSES ONLY

To the Board of Directors of Zinga Fashions

This memorandum sets out the key considerations in deciding whether Zinga Fashions should establish an internal audit function within the next couple of months. It also provides an assessment of the potential candidate as head of internal audit, Bill Marx

**Value of Internal Audit**

The role of the internal auditor has become pivotal to evaluating the effectiveness of policies and procedures, and informing senior management of any improvements that may assist in achieving the objectives of the company

Internal audit provides a number of important services. These include:

*Detecting and Preventing Fraud*
The economic uncertainty and increased focus on certain organisations' management of fraud risk has made an internal audit function key in ensuring fraud risk management by way of preventing, detecting and investigating fraud.

*Assess the effectiveness and design of the system of internal control*
This will limit the exposure to possible losses due to fraud or operational efficiencies or simply ensure that there are no errors in the system

*Monitor compliance with company policy and government regulation*
This will reduce possible exposure to fines and losses which can impact the business negatively. This will become even more import should Zinga decide to list in the near future as internal audit

 

function can help monitor compliance with JSE listing requirements. The internal audit function will also assist with the new KING IV requirements that are set to become effective in 2017

*Assist management in the effective discharge of their duties*
Their board based perspective of the organisation uniquely position them as a valuable resource to strong corporate governance. As a result, senior management and boards can rely on internal auditors for advice and counsel on everything from analysis of operations and assessment of risks

*Assist with effective and efficient external audits*
This is particular important for Zinga, given the concern of the high audit fees. By having an internal audit, might reduce such external audit fee should the external auditors decide to rely on them.

*Integral part of strategic cost reduction*
Internal audit ensure that the redesigned business processes, activities and structures remain responsive to risk. The internal audit can assist with the possible implementation of the distribution centre in Johannesburg by ensuring proper controls exist over inventory management

**Potential Candidate as Head of Internal Audit**

Per the requirements of KINGIII, the board of directors are responsible to ensure that there is an effective risk based internal audit function

In order to comply with this requirements, the board of directors are required to appoint a Chief Audit Executive or Head of Internal Audit

The KINGIII requires the internal audit to be sufficiently skilled given the complexity and volume of risk and assurance needed.

The KINGIII also requires the internal audit to be independent and objective in the carrying out of its functions

A potential candidate was brought to the attention of management by Gavin Marx and his suitability is assessed below

The potential candidate recently completed his BCom Honours (Internal Auditing) qualification, but lacks sufficient experience as he is only 25 years old. If appointed, it will be his first job post university

He has direct family ties with Gavin Marx (Director of Purchasing), which might compromise his objectivity as required by the KINGIII. The potential candidate is the nephew of Gavin. It might also lead to nepotism, which does not reflect good corporate governance on the side of the board of directors. If the board of directors were to decide to appoint the candidate, the companies act will require Gavin Marx to declare his interest in this matter, and leave the meeting immediately and not part take in voting

The potential candidate, set out the following possible projects that he will implement as internal audit head:

*Evaluating internal control to reduce external audit fees.*
Although it would assist, the internal audit's main objective should not be to reduce external audit fee, but rather to assess internal controls to address risks.

*Establishing a whistleblower's hot line*

 

Although a very good initiative, the manner in which the potential candidate attempts to implement this hot line is not appropriate. He wants to make use of his own personal cell phone number. This might not be appropriate as it will compromise the anonymous element thereof. It would be more suitable to have a dedicate whistleblower's charter in place to deal with potential misconduct at Zinga.

The potential candidate also indicated that he will report all reported frauds to the CEO/CFO which is not appropriate. The internal audit report should report directly to the audit committee

Other Areas of Concern Regarding Appointment
The potential candidate approached Harry Mnisi directly via Whatsapp, which is indicative of unprofessional behaviour. He should have followed the normal hiring channels for possible consideration.

The candidate has a sense of desperation to be appointed. This is substantiated by the fact that he messaged Harry multiple times a day to convince Harry to consider him for appointment. This is gives an idea of unprofessional behaviour, and might suggest that the candidate's only objective is to be appointed, rather than to assist Zinga to implement an effective internal audit department.

**Conclusion**
Internal auditors deal with issues that are fundamentally important to the survival and prosperity of any organisation. Unlike external auditors, they look beyond financial risk and statements to consider wider issues such as organisation's reputation, growth, its impact on the environment and way it treats its employees. It would therefore strongly suggest that Zinga implement an effective and independent risk based audit. This is mainly due to the requirements that will be impeded on Zinga once they decide to list in three years

As for the potential candidate as head of internal audit, I would suggest that the board of directors carefully considers the appointment as the candidate is clearly not independent, lacks experience, and has an sense of unprofessional behaviour.

The language used could be more professional but this is forgivable. The candidate identified all the key issues to be considered. It was a pity that some of the 'negative' aspects of establishing an internal audit division was not covered for example, the costs and limitations.

We were impressed that the candidate suggested Gavin Marx recuses himself from discussions regarding the appointment of his nephew – not many candidates mentioned this.

The attempt displayed the required competence in completing the task. The concluding paragraphs were weak and put a damper on a very good attempt.

**Limited competent**

**CONFIDENTIAL MEMORANDUM**

**DRAFT**

To: Board
From: Financial Accountant
Date: 16 November 2016
Subject: Establishment of Internal audit function for Zinga Fashions

**Introduction**

Management is considering to establish the Internal Audit function within the next couple of months and suitable candidate to appoint as head of Internal audit in the event that the board does decide to appoint one.

**Background**

What is internal audit function.
Definition of internal audit
Internal audit has two roles as define: To provide an independent assurance service to the board, audit committee and management , focusing on reviewing the effective of the governance, risk management and control processes that management has put into place

Define internal audit function as per internal audit profession (IIA): Internal audit is an independence , objective assurance and consulting activity designed to add value and improve an organisation operations .Its helps an organisation accomplish its objectives by bringing a systematic , disciplined approach to evaluate and improve the effectiveness of risk management control and government processes.

ZInga is consider to listing at JSE one of the requirement is comply with King 3 and King 4 , as well company act.

King 3 and 4

**Key consideration in deciding whether to establish an internal audit function**

- Internal audit function is vital component of good corporate governance, as we are considering to list with JSE, that one of the requirement we need to comply with KING 3 require the company to have internal audit. Note that King 3 has been replaced by King 4 from 1 Nov 2016 we need to ensure that our Internal audit is line with KING4 principle
- Internal audit function will provide board, audit committee and management with independent assurance of the operation of organisation such as areas not limited. Risk management and control, assurance, assessment of internal control effectiveness and efficiency, effective management of audit fees through coordination with the external audit firm.
- The functionally of the internal audit is oversee by the Audit committee, even thou administrative report to the CEO in term of King 3/4 . This is to manage independence and objective of the function
- The head of internal have standing invite on all the executive committee meeting

- The audit committee ensures that internal audit is well resources and function by approved their internal audit plan annual basis.
- Internal audit report should be reported to audit committee
- Audit committee is responsible for the appointment, performance assessment and dismissal of the CAE(Chief audit executive) Similar title is head of internal audit. The head of internal audit report to the audit committee chairperson on functionally
- The internal audit staff require to be skilled and professional
- The internal audit function adhere to IIA standards and code of ethics

Based on the above i think we should establish the internal audit function as this will provide support to board as the leadership of the organisation and management and sub-committee of the board audit committee.

The benefit such as reduce external audit fees will see. As we having concern on the high audit fees

**Potential candidate as head of internal audit in the event that the board decide to appoint one**

Gavin Marx has nephew (Bill Marx) who has completed BCOM Honours internal auditing which he think may be a good option as company first internal auditor(Head of internal audit) Not only is Bill Marx suitably qualified , but he has some very good ideas which he believe will be great benefit to Zinga Fashions. Recent completed his degree.

**Brief Internal audit project by Bill Marx**

1. Undertaking work in the areas that will contribute to a reduced external audit fee
2. Detecting fraudulent conduct at Zinga
3. Establishment and rolling out whisteblower hotline, use his own cell phone and managed it himself on 24 hours basis.
4. Investigate all the report frauds and present to the CEO/CFO

**Employment conditions (Bill Marx)**

5. Also willing to work on contingency basis, i.e. no cost unless able to yield benefits to Zinga
6. Available to start 1 Dec 2016

The profile of the Head of internal audit, someone with 6 to 10 executive management experience in internal audit and belong to a professional body such (SAICA, SAIGA, IIA, ACCA) but we financial background and enable to deal with board, management, etc. I have compared to Mr Price Head of internal audit experience on the website, Also check the invite when for internal audit head position on the requirement.

**Conclusion**

**Establishment of internal audit**

Based on the above i think the Board must establish an audit committee first and Appoint of Head of internal audit can be followed to ensure that proper governance structure are followed.

The decision to appoint Internal if board decide to appoint can only be decided after the governance process is done.

The is also option of starting by co outsourcing the internal audit function.

**Bill Marx appointment as head of internal audit**

My assessment is that Bill Marx has financial qualification but lack adequate experience to be the Head of internal audit. As he was recently graduated

The person need to be strategic and able to deal with Senior management, audit committee and board. Able to deal with team management and confidentially.

All the plan that he has can be done by the internal audit. We need to build capacity in order to ensure that internal audit function is working. At initial phase will not see significant result on overall we will see.

In relation to audit fees reduce, it can reduce but, Audit fees of external audit depend on the time spend and as well experience of the staff. If they can rely on the work of the internal audit the audit fees will be lower .But i to note that the is certain requirement external need to satisfied if rely on the internal auditor work.

The language used creates a very poor impression. Dumping definitions of internal audit into a draft board memorandum is inappropriate. Most of the bullet points listed relating to the key considerations in establishing an internal audit division were not considerations but rather functional and implementation issues.

The major concern with the attempt at the task was that Bill Marx's independence issue was not identified and discussed. Furthermore, the candidate promoted the appointment of Bill Marx and then raised his lack of experience as an issue. This seemed contradictory.

In practice, the candidate would have been asked to redo the task or someone else would have been asked to do so.

 

*PART (b)*

*(b) Harry Mnisi asked for your opinion on the issues raised in document H. Respond via email.*

**DOCUMENT H**

**EMAIL FROM HARRY MNISI TO REFILWE MAPOE**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday,16 November 2016, 06:15 AM |
| **To:** | Refilwe Mapoe |
| **CC:** | Financial Accountant |
| **Subject:** | Tweets |

Hi Refilwe

My daughter referred me to some tweets made by Gavin Marx on Twitter recently. I logged onto Twitter and can confirm the following posts were made by Gavin. They are still on Twitter:

So bored in the board meeting, blah blah … only interesting thing is the talk of our possible JSE listing and maybe an acquisition before then
Gavin Marx (@Gavżinga) November 7, 2016

You know you live a boring life if you aren't nervous about others looking at pictures on your phone – I just have photos of models wearing żinga clothes lol
Gavin Marx (@Gavżinga) November 12, 2016

#FeesMustFall getting boring. It's amazing how often these protests start just before university exams
Gavin Marx (@Gavżinga) November 14, 2016

Refilwe, I am not sure these tweets are appropriate? What should we do as a company?

Regards
Harry

PS: I have copied our Financial Accountant on this email as I think the younger generation may provide some different insights into social media.

**Highly competent**

To: Harry Mnisi
From: Financial Accountant
CC: Refilwe Mapoe
Subject: Tweets

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Hi Harry

I hope you are well.

I have read the email you CC'd me in regarding the tweets sent out by Gavin Marx on Twitter recently.

I would have to agree with you. I feel the tweets do not display appropriate actions by Gavin as a director of Zinga.

I noted in your email to me with the presentation to First Regional Investment bank that you said the discussions of listing on the JSE are confidential in nature. As Twitter is a public platform that anyone can have access to (including Zinga's competition!), the information he disclosed of a possible listing may no longer be confidential. This also includes the confidential nature of the possible acquisition of GBC before listing.

As Gavin has openly disclosed this and it may compromise the smooth proceeding of the JSE listing, I feel that he has not acted in the best interest of the company, nor has he acted with a degree of care, skill and diligence that may reasonably be expected of a person carrying out the same functions as a director with the same knowledge, skill and experience as him. I therefore think that Gavin may have breached the standards of duty imposed on him by the companies act (section 76), and if there are any financial repercussions due to him sending out the tweet, it is likely that he should be held accountable for them, due to his breach in fiduciary duty.

The impact of disclosing the listing and acquisition on Twitter will have to be considered to determine its significance. We may need to consider how many Twitter followers he has, and investigate whether any of them have spotted his post. We will need to request Gavin to immediately delete this post off his account to ensure the confidentiality of these transactions.

I believe his comments regarding having photos of models wearing Zinga clothes was certainly not appropriate and not in line with Zinga's business model of taking responsibility. If customers / other Twitter users saw the Tweet regarding this, it may cause reputational damage to Zinga, as he specifically mentioned Zinga in the tweet. From my understanding of our social media, we have a significant social media following that may have seen these posts. His comments may result in frustrated Zinga customers that share his Tweet, and can quickly become a viral internet post that is exposed to the media and brought to light of the public.

We will need to assess once again how many people shared his Tweet, and how many people saw it - this will determine the significance of the risk of reputational damage to Zinga. We will certainly need to request Gavin to delete this post off his account immediately.

Gavin’s post on #feesmustfall is certainly not appropriate, as this is a topic that has captured not only the youth of South Africa, but the nation at large. This post has the potential to go viral as he has tagged Feesmustfall in the post, and it may be seen by thousands of supporters of Feesmustfall.

 

The risk is that if any supporters saw the post, they may become outraged at his lack of sympathy for those that are for the movement. These supporters have been known to cause significant damage to buildings and other infrastructure at universities and therefore there is a risk that these followers may do the same to Zinga stores. Our staff and specifically our customers have been noted in our business model as the life blood of our business, and putting them at risk like this could be significant to the on-going success and continuity of the business.

We will have to assess how many people shared this Tweet, and how many people saw it - this will determine the significance and likelihood of supporters of FeesMustFall damaging our property and putting our customers and staff at risk. Gavin will have to delete this post off his account immediately.

I believe that the above general responses may assist in minimising the impact of Gavin's tweets for now, however I believe it is vital that the following responses should be made specifically:

- Request Gavin to delete his Twitter account permanently until the matters have been resolved.

- Depending on the reach of his post to users of Twitter, we should consider posting a press release on our website and social media accounts, to explain the situation and how the company's vision does not align with those thoughts expressed by Gavin previously, and that Zinga will be performing a detailed investigation into the matter to ensure the reasons for the post are identified and that controls are put in place to ensure that it does not happen again. This will potentially limit the company's exposure to risk and confirm with our customers and employees that Zinga does not agree with those thoughts expressed.

- We must inform each store of the potential outrage by FeesMustFall supporters, and request them to be extra vigilant over the security both outside and inside the stores. In addition, our insurance policies should be reviewed to ensure that we are covered for all intentional damage to our property to prevent financial loss to the company due to damages.

- First Regional Investment bank should be contacted and reassured that the situation of events is under control to prevent the impact on the listing & acquisitions. Advice from them should be sought to determine the impact on the potential listing.

- A meeting for the board should be held where Gavin is given a chance to explain the Twitter posts he made. In this meeting the board should assess controls in place to prevent this from happening again, as well as to assess whether Gavin is suitable to continue representing Zinga as a Executive Director. Refilwe should be present at this meeting in her capacity as director but especially as the director of Human resources.

- If it is deemed appropriate that Gavin remains on the board of executive directors, it may be necessary to have Gavin attend training courses to prevent this from happening again. This will of course be at the discretion of the board.

Although the above measures may be considered drastic, I feel that the posts may cause significant reputational damage to Zinga if this is not dealt with appropriately. Social media has the ability to both build a business's reputation, but conversely can almost instantly ruin such reputation with the likes of such tweets.

I hope you consider the above insights and recommendations meaningful. Please let me know if I can be of any additional assistance?

Kind regards

Financial Accountant

The candidate identified all the key issues to be considered. The candidate has addressed the appropriateness of the three tweets and provided Harry Mnisi and Refilwe Mapoe with appropriate actions that the company could take. The candidate discussed the confidentiality issues and the breach of fiduciary duties related to Tweet 1. In terms of Tweet 2 and 3 the candidate has identified and discussed the possible negative impact that the tweets would have on żinga. The discussion was tactful and well balanced and showed an unique understanding of social media.

The following issues raised elevated the attempt from a solid C to highly competent:

- Addressing the risks and dangers of social media;
- Identifying that Gavin's twitter handle would be linked to żinga;
- That Gavin had used the FeesMustFall hastag;
- Integration of on the day information and pre-released information making reference to żinga's business model.
- The detailed and insightful appropriate actions that the company could take.

 

**Competent**

**From:** Financial Accountant
**Sent:** Wednesday, 16 November 2016, 10:00 AM
**To:** Harry Mnisis
**CC:** Refilwe Mapoe
**Subject:** Tweets

Good day Harry,

I trust this email finds you well.

Thank you for asking my opinion in this matter. We are living in world of rapidly changing technology where social media is quickly becoming the best (or worst) kind of advertising any company can get, depending on how it is used. I will discuss each of the tweets that concern you individually, but would like to start off by highlighting the fact that thousands of users make use of social media platforms such as twitter, facebook and instagram, even more so than watching television. It is therefore important for Zinga to protect and promote their brand on these platforms. It is the responsibility of each employee, manager and director of Zinga to not do anything that can potentially harm the Zinga brand or bring the entity into disrepute.

With regards to the first tweet you mentioned of 7 November, I do not believe that this is appropriate for a number of reasons. Firstly, it does not look good for Zinga and the directors if another director claims that the board meeting is boring. This can signal a lack of interest from the specific director, which in turn can signal a board that is not driven and enthusiastic about the company. I realise that this comment was only made by one director but it is very easy for the general public to jump to conclusions and assume this sentiment is shared by the entire board. In addition to this, I think the bigger issue we might have is the leaked information on the potential listing and the acquisition. From what I understood, the potential listing as well as the acquisition was still very confidential and not yet public knowledge. Gavin is therefore in breach of his duty as director to keep such information confidential. If Zinga does decide to list and this information was used by any stakeholder to make economic decisions, it can be seen as insider trading. The information he (most likely unthinkingly) leaked can influence the decisions made by other players in the market.

The second tweet is a bit more difficult to assess than the first one. Although the tweet is seemingly harmless, it can be interpreted in the wrong way by the public. Firstly, Gavin is referring to his life being boring again - which can be interpreted as a lack of interest by others, as explained with the previous tweet. However, I think the public eye will fall on the mention of the models with Zinga clothing pictures on his phone. The question of why he has these pictures on his phone can very easily be asked. I realise that he might have this for business and marketing purposes (although he does not work in the marketing division directly) but we must look at it from the public's point of view. It can very easily be perceived that they had these pictures for an ulterior motive rather than just purely for business purposes. This does not mean that everyone must delete all pictures they have for any business reasons, I just think we need to take care in how we say these things and not broadcast it in a way that can be incorrectly interpreted by the general public.

With regards to the last tweet, I do not believe that it is inappropriate in a sense that it could bring any direct harm to the entity itself. I do however believe that it is prudent in the country we live in with the current events to stay diplomatic and not get involved in political sagas. Everyone has the constitutional right to voice their opinion, but at the same time we must respect other's opinions. My fear with the last post is that there might be some of our clients that are in favour of the fees must fall protests that will read this tweet and take it to be the opinion of the entire Zinga and decide to not support our store anymore. In this way, although not directly, it can still affect our entity through loss of customers.

I would like to apologise if these are not the answers you were hoping for but I have to be honest and keep the best interest of Zinga at heart. A good idea might be to have a session where we educate all employees on what is appropriate to post on social media and what is not appropriate. We can also educate the staff on the affect their activity on social media can have on the entity as a whole. Often the person making the posts have no malicious intent with it but just doesn't realise how it can affect the entity. There are a lot of corporate marketing entities that specialise in things like this that might be able to help with training on what is appropriate for social media. With regards to Gavin, I believe it is worth giving him the benefit of the doubt and confronting him about the tweets he posted. Make him aware of the fact that his twitter account links him directly to Zinga (his name on twitter is @Gavzinga) and remind him of the repercussions of his actions. Should this happen again, management can decide on the appropriate disciplinary action.

I hope the above assist you in deciding on the correct course of action.

Kind regards
Financial Accountant.

The candidate identified and discussed all 3 tweets and provided actions. Although the candidate did not address the fiduciary issues related to tweet 1, the answer addressed the issues of confidentiality. We were impressed that in discussing Tweet 2, the candidate recognized that it would be appropriate for Gavin to have pictures of models on his phone for marketing purposes in his role within the company but warns that the public might perceive it differently. The discussion on the appropriateness of Tweet 3 while addressing the possible negative implications for żinga the solution acknowledges the right to freedom of speech which admittedly Gavin has.

The candidate made a clear link to Gavin's username and żinga.

While the candidate has answered all components of the task there could have been more depth in the remedial actions provided. That being said the attempt displayed the required competence in completing the task.

**Limited competent**

From: Financial Accountant
To: Harry Mnisi, CFO
Date: Today
Subject: Tweets
Attachment: None

Dear Sir

My opinion
The twitter handle has our company name on it, so it would be difficult to convince me that Zinga is not strongly associated with Gavin, or that Gavin has not created some kind of link between himself and the company.

The tweets are very unfortunate. They do not show much enthusiasm from Gavin regarding his work.

<u>Appropriateness of the tweets</u>
Confidentiality
"... only interesting thing is the talk of our possible JSE listing and maybe an acquisition before then"
Gavin appears to inform the public that we are considering a public listing, a matter of strict confidentiality. It is purely illegal and unethical to do so because this information might be used for insider trading by the public.
Gavin does not appear to have the necessary respect for confidentiality of information acquired as a result of his directorship at Zinga Fashions by the looks of this wild disclosure; 'wild' because it came out of nowhere, apparently mid-discussion, without proper, prior approval, and without any professional or legal right or duty to do so.
It could undermine the corporate action and, frankly, it is plain reckless of him to have done this.

Sexual nuances
"... photos of models wearing Zinga clothes lol"
Improper, improper, improper.
Once again, he links the company to a debasing statement; to what appears to be clearly a diminishing statement on his character.

#FeesMustFall protests
It appears that Gavin is making a case that these protests are aimed at interrupting university examinations.
I noted that during December 2015, the protests were elevated after the students wrote the exams. Some protests continued over the registration period, late registrations and well into the mid year in some universities. A lot of students actually calm down and write the exams, studying at night and protesting at day.
Gavin's is quite free to express his opinions on social media, but it should be with an understanding that he links Zinga Fashions Group by his handle, and that it is the people he broadcasts his biases to that buy the company clothes (the casual urban, big font fashion usually influenced by popular R&B and rap groups of America, is usually bought by a lot of young people, including protesting students), so he must just be careful and exercise caution/restraint.

<u>What do we do as a company?</u>
Social media policy - We should develop this policy to help guide the conduct of our directors and staff in relation to social media participation.
Discipline - Gavin should be held responsible for his actions, in line with other policies and

 

procedures, and company laws and regulations. This transgression could be fertile ground to lodge an application to the court to have him declared delinquent and removed as a director by order of court.
Official account - We could set up an official Twitter account to be used appropriately, and only by an authorised person.
Depression or other mental disorder - We compel our staff to go through mandatory checks/analyses for depression, narcissism, etc.. Maybe there is an underlying problem of some sort.

I trust you will find the above in order. Please let me know if anything is uncertain and we can discuss it.

Kind regards
Financial Accountant

The candidate identified and discussed the appropriateness of all 3 tweets and provided actions.

However the candidate did not address the seriousness of social media and did not make a direct link to the negative impact that tweet 3 could have on żinga.

This candidate is assessed as LC because of the inappropriate and unprofessional language and tone. This task required candidates to use professional skills and judgement. The use of phrases like 'wild disclosure' and 'Improper, improper, improper' is not appropriate language and tone in an email from a newly qualified CA(SA) to a superior in relation to another director.

The suggestion to apply for a court order to have Marx declared delinquent and removed as a director by the court is completely inappropriate.

Finally the actions of having staff assessed for depression or other mental disorder is unacceptable.

*PART (c)*

*(c) Prepare a document for Harry Mnisi setting out your comments in response to his request to review the draft workings (see document E).*

**DOCUMENT E**

**EMAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday, 16 November 2016, 05:39 AM |
| **To:** | Financial Accountant |
| **CC:** | |
| **Subject:** | Current and deferred tax: Sale and leaseback |

Hi

I need your assistance please. One of the outstanding matters in the financial statement preparation process is the sale and leaseback transaction and the tax computations. I played around with the deferred tax consequences of the sale and leaseback so that I can incorporate it into the draft deferred tax calculation for the auditors. With all my current work pressures, I do not have time to get it perfect right now, and would appreciate your input. Please also check my calculation of the base cost of the building for CGT purposes – I am not sure if I used the most appropriate basis. I cannot get the deferred tax proof to work yet!

In my calculations I've used a lease term of ten years as we are definitely not certain that we will be renewing the lease. We might be moving offices in the long term. I used a discount rate of 5,5% per annum (nominal), as this is a fair estimate of the interest we would have paid on a bank loan to finance this particular transaction.

I forgot to mention this to you previously, but there is some additional information that might affect the numbers: before we sold the head office building, its residual value had always been estimated to be equal to the carrying amount, and the auditors agreed based on the information that was reasonably available at the time. However, during the sale and leaseback negotiations we did some market research and it came to light that other office buildings in the same area and the same age as ours will be at the end of the lease term, currently sell for around R58 million. That is in today's money terms, so I think we were lucky to negotiate a guaranteed residual of only R70 million, considering that property prices in the area generally grow by about 2,5% from year to year! I am also aware that the lessor did not incur any costs to secure the lease.

I attach my draft workings for your review. Just comment on any errors or omissions – we can finalise the correct workings later.

Thanks in advance.

Regards
Harry

**Highly competent**

Report:

To: Harry Msini
From: Candidate
RE: Review of the deferred tax and base cost calculation

As requested, please see my feedback regarding the sale and leaseback transaction with the calculations attached.

 

I would like to clarify the following:
Due to lack of further information I assumed the following:

- The residual value includes VAT
- The original purchase excluded VAT

The assumption to utilise a lease term of 10 years is in line with IFRS which states that the renewal period can only be included if is reasonably certain that the company exercise this option.

<u>I would like to point out a few matters to take into consideration in your calculation:</u>

1. A finance lease is generally an instalment credit agreement however there are certain criteria that should be met.

   The Vat Act states that an instalment credit agreement is any agreement consisting corporeal moveable goods or of any machinery or plant whether moveable or immoveable. Due to the fact that the head office building cannot be classified as plant (as no manufacturing takes place) the agreement cannot be classified as an instalment credit agreement.

   Instead this will be a rental agreement with Vat input being claimed upon each instalment with the full 200 000 lease payment being deductible for tax purposes

2. To clarify, the above sales and leaseback arrangement will qualify as a finance lease due to the fact that the PV of minimum lease payments is almost substantially equal to the fair value of R73 500 000. (As the sale takes place between unrelated third parties; it is assumed to be sold at a price relative to the market value)

   Alternatively, the Fair value one month later is R74 670 000 therefore causing the PV of minimum lease payments to be 98% of the fair value.

   Therefore a finance lease asset and finance lease liability should be recognised with the profit on the lease being deferred over the lease term.

3. The interest rate used to determine the present value of the minimum lease payments should be the interest rate implicit in the lease used as a first resort. As we have all the information available for the transaction it will be possible to calculate this and not necessary to resort to a similar arrangement. This is calculated as 3.32% rather than the 5.5% used in your calculation (please see calculations attached). This will result in the present value of minimum lease payments being equal to R 73 500 000

4. The monthly payment including VAT (R228 000) was used to determine the interest rate implicit in the lease

5. The guaranteed residual value relates to the amount the company will pay at the end of the lease term as a part of the minimum lease payments. The residual value is the estimated amount that the entity would obtain for disposal of the asset in its current condition if it were at the age and condition expected at the end of the useful life. This should be used to determine the depreciation and deferred tax implications of the asset.

6. The gain on sale was recorded based on the selling price inclusive of VAT. The VAT output should be recognised at a value of R9 026 315 on the sale as both Zinga and the third party are vat vendors resulting in a gain on sale of R473 684.

7. To calculate the correct movement in deferred tax; the balance at the beginning of the year should also be calculated and the difference between the beginning and end of the year will be the income tax impact.

   The original carrying amount of 19 900 000 will not have deferred tax implications. It is initially exempt due to the fact that there are no tax allowances on this building. The commercial building was acquired in 1999 and the S13 Quin deduction is only available for buildings constructed on or after 1 April 2007.

   The revalued portion will however have deferred tax implications at 28% therefore amounting to R11 22 8000 deferred tax liability.

8. On the date that the intention changed from use to sale, there will be a deferred tax implication due to the fact that before the future benefits were taxed at 28%; however now there will be capital gains tax incurred at 28% of 80% of the capital gain. This causes the deferred tax to reduce by R3 550 152 in OCI as it relates to a revalued asset

   Upon sale the remaining revaluation surplus is realised causing the deferred tax to be released from OCI into profit and loss.

   Therefore the balance of R 7 877 848 is released from deferred tax liability to income tax in the statement of profit and loss.

   In total the deferred tax liability is reduced by 11 228 000

   The current overall movement for 2016 is the reduction of the deferred tax liability of 11 22 8000

9. On the sale and leaseback the company no longer has an item of property plant and equipment but rather a leased asset. Therefore there will no longer be a split between historical cost and the revaluation as the item is seen to have a lease value equal to the present value of the minimum lease payments of R64 473 684

   This will be depreciated over the lease term with a residual value of R58 000 000 for a period of 2 months.

   This result in depreciation of R107 894.

   As there are no wear and tear allowances on this asset; the deferred tax implication will be 28% of
   the depreciation, namely R 30 210.

   The asset should be revalued by taking the fair value of R65.5m less the Carrying Value at that stage. This will be a movement through Other Comprehensive Income (OCI) and not profit and loss as it relates to a revaluation surplus recognised in OCI.

   Therefore the total balance in deferred tax liability for the year relating to the leased asset is 18 340 000

10. The lease liability value should be adjusted to the Present Value of minimum lease payments excluding VAT (as no obligation to pay the VAT upfront) of 64 473 684. The interest should be calculated on this value at using the interest rate implicit in the lease.

The balance at year end will be including Interest, less the instalments of R200 000 each resulting in an overall movement in the deferred tax asset of 18 040 514. The movement on the finance lease to be recognised an increase to the income tax expense in Profit and loss is R12 117.

There will be no tax base as due to the fact that this is a rental agreement. The VAT is not included in the initial liability therefore the entire instalment is deductible.

11. Another item which has not been accounted for in the deferred tax calculation is the deferred profit.

    The deferred profit must be amortised over the lease period. Therefore a portion of the profit will be included in profit before tax over the years. However, as tax sees this transaction as an actual sale; capital gains tax will be incurred. A deferred tax asset is raised which, together with the reversal of the deferred tax on the revaluation surplus, will net off against the capital gains tax paid to SARS. The release of the deferred tax asset over the period will cause the profit to have a corresponding amount in income tax.

    It must be noted that 20% of the profit in the income statement will not be taxable and therefore must be included in the tax base.

    A deferred Tax Asset of R106 105 must be raised with R1768 reducing the balance upon amortisation of the profit for two months in the period resulting in an overall deferred tax asset movement of R104 336

12. In terms of the capital gains tax calculation:
    - The capital gain will be realised on the difference between the proceeds excluding VAT of R
      64 473 684 less base cost and not merely the difference between the selling price and original cost.
    - The base cost should be calculated at the highest of three items namely:
      1. Market Value at 1 October= 25 143 962
      2. 20%*(proceeds) =12 894 736
      3. TABC Method =25143962

    - Since 1 March 2016 the inclusion rate for capital gains tax was increased to 80% and is no longer 66.66%
    - Therefore taking the above changes into account, a taxable capital gain of R31 463 777 is incurred
    - In your current tax consequences calculation there were no amounts included under permanent differences however the 20% portion of the capital gain should be included here.
    - This will create a deferred tax impact

    The following additional considerations were noted in the temporary difference calculation:

- The overall movement for the year in deferred Tax, taking everything into account should be a deferred tax asset increase of R 7 682 699

I hope the above addresses your concerns. Please let me know should you require any further assistance in finalising the calculation and I will gladly assist

Regards

Candidate

| **Task C – Excel attachment** | |
|---|---|
| | |
| Calulation of interest rate implicit in the lease | |
| | |
| Months | 120 |
| Monthly Payment | 228 000 |
| Residual value | 70 000 000 |
| Present Value (fair value) | 73 500 000 |
| interest Rate implicit in the lease | 3.32% |
| As there is no unguaranteed residual value; the PV of the minimum lease payments will be equal to the fair value | |
| 3 500 000 | |
| The value exclusive of VAT= 64 473 684 | (73 500 000*100/114) |
| Historical Carrying Amount at 1 August 2016 | 60000000 |
| Proceeds on sale excluding VAT | 64473684 |
| Gain on sale | 4473684 |

| **Before Sale and Lease Back** | | | | | |
|---|---|---|---|---|---|
| | CA | TB | TD | DT | |
| Cost | 19900000 | 19900000 | 0 | Initial exemption applies | |
| Revaluation | 40100000 | 0 | 40100000 | 11228000 | Def Tax Liability |
| (60mil-19.9m) | | | | | |
| | | | | | |
| **Change in Intention 1 Aug 2016** | | | | | |
| | | | | | |
| Balance of deferred tax liability before change in use | 11228000 | | | | |
| Proceeds | 40100000 | | | | |
| Base Cost | 25143962 | | | | |
| Capital Gain | 14956038 | | | | |
| Deferred Tax Liability Balance | 3350152 | 28% of 80% of Capital Gain | | 3350152 | Def Tax Liability |
| | | | | | |
| **Therefore deferred tax movement** | | | | **-7877848** | |
| | | | | | |
| **1-Aug-16** | | | | | |
| | CA | TB | TD | DT | |
| **Leased Asset (64473684-58000000/120*118)+1134210** | **65500000** | **0** | **65500000** | **18340000** | **@ 28%** |
| **Leased Liability (64473683-356726)** | **64430410** | **0** | **64430410** | **-18040514.8** | **@ 28%** |
| **Deferred Profit** | **465790** | **93158** | **372632** | **-104336.96** | **@ 28%** |
| *Deferred Profit* | *473684* | *94736.8* | *378947.2* | *-106105.216* | |
| *Less Realisation (473684/10*2/12)* | *7894* | *1578.8* | *6315.2* | *1768.256* | |

| | | | | | |
|---|---|---|---|---|---|
| | | | | | |
| Deferred Tax Balance | | | | 195148.24 | Deferred Tax Liability |
| Therefore deferred tax movement | | | | -7682699.76 | |
| **Amortisation** | **PMT** | **Int** | **Principal** | **Balance** | |
| 1-Aug-16 | | | | 64473684 | |
| 31-Aug-16 | 200000 | 178392 | 21607 | 64452076 | |
| 30-Sep-16 | 200000 | 178333 | 21666.8 | 64430410 | |
| | | | | | |

| | |
|---|---|
| **Capital Gains tax** | |
| Selling Price (64 473 684-0) | 64473684 |
| Base cost higher of: | |
| MV at 1 October | 24250000 |
| 20% of proceeds | 12894736.8 |
| **TABC** | **25143962.82** |
| | |
| Therefore Base cost is | 25143962.82 |
| Capital Gain | 39329721.18 |
| 80% of gain taxable | 31463776.94 |
| Y=B+ ((P-B)*N)/(N+T) | 25143962.82 |
| | |
| Y=VDV | |
| B=predate expenditure-allowances | 19900000 |
| N=number of years until 1 October 2001 | 2 |
| T=Number of years until sale | 15 |
| | |
| **Revaluation of Asset** | |
| | |
| Leased Asset Balance on 30 September | **64365789.27** |
| Cost | 64473684 |
| Residual Value | 58000000 |
| Dep | 107894.7333 |
| Fair Value | 65500000 |
| **Revaluation** | **1134210** |
| | |

 

The candidate identified all the key issues to be considered. The tone was courteous. The following issues raised elevated the attempt from a solid C to highly competent:

- Identified that the lease was not an instalment credit agreement as it related to immovable property and included an appropriate treatment for a rental agreement;
- This was accompanied by the correct technical treatment of the tax base relating to the finance lease liability;
- Calculated the time apportionment base cost correctly;
- Recognised that a portion of the deferred profit is a permanent difference; and
- Overall, the candidate identified sufficient errors and omissions in the assets and liabilities listed, tax bases, temporary and permanent difference calculations to demonstrate a good understanding of deferred tax.

**Competent**

**To: Harry Mnisi**
**From: Financial accountant**
**Date 16 November 2016**

**Subject: Current and deferred tax: Sale and leaseback**

**Deferred tax workings FY 2016**

> Firstly, based on IAS 12 para 15 subnote E4 it must be noted that there is no guidance issued over the recognition of a finance lease as per IAS 17 but with text *(sic)* deductions based on rental payments. As a result there are two methods of determining the deferred tax.

**Method 1:** Method 1 suggests that you look at the requirements of a leased asset and leased liability separately. Thus the lease asset and liability has a tax base of zero because Zinga is no longer the owner of building and because all lease payments are deductible in future this giving rise a temporary differences that are not recognised due to the application of initial recognition exemption IAS 12:22(c).

Thus there is no deferred tax recognised on either the leased asset or liability.

**Method 2:** Method 2 suggests you apply the leasing transaction as a whole, thus it seeks to link the lease asset and liability and recognise deferred tax on aggregate temporary differences.

**>** At inception of the lease there is no net lease asset or liability and thus no temporary difference. Subsequently as depreciation initially exceed the rate at which the debt reduces (due to lease payments made less interest) a net liability arises resulting in a deductible temporary difference. Thus there will be deferred tax.

Based on the working provided it is evident that we are applying the second method whereby we are assessing the deferred tax of the transaction as a whole, thus both the lease asset and liability are required to be recognised for deferred tax.

There is an error in the rate regarding the revaluation, as it is stated that the revaluation surplus is realised through use, thus the appropriate tax rate would be 28%.

**Calculation Notes**

**Calculation 3:**

> In order to determine the present value of the finance lease obligations, you have currently completed the discounting based on an applicable financing rate. However as we have sold this building and leased it back at the fair value, a fair value of the transaction would be equal to the transaction value exclusive of VAT. This in effect would be equal to the present value of minimum lease payments. As such we would be required to determine the implicit rate in the lease which is the rate that "causes the aggregate present value of the minimum lease payments to be equal to the fair value of the leased asset". Thus a present value annuity with the transaction value exclusive of VAT should be included as the PV term and determine interest. The period of 120 months is appropriate as per IAS 17: 27 as there is no "reasonable certainty" evidenced through your indication of "defiantly not certain" and thus the shorter of the lease period or useful life shall be utilised.

**>** The interest and amortisation table at the bottom of the calculation is incorrect due to the following.

> **1.** The interest has been calculated on the nominal financing rate rather than the implicit rate included within the lease. This implicit rate shall be a monthly rate and thus should be multiplied by the present value of the lease liability in order to determine the finance charges. (This rate shall be determined as per the above)
>
> **2.** The amortisation schedule has been inappropriately compiled as it has been seemingly compiled based on an annual basis converted to monthly payment. The appropriate manner would be to allocate interest/ financing costs each month to the lease liability (i.e. add the interest to the lease liability) and reduce this liability by the monthly payment of R200 000. Then use the closing balance of the lease liability to compile the interest for the next period (month).

**Tax base and rental VAT deduction**

You have recorded the finance lease as an instalment credit agreement (ICA) for VAT purposes within your calculation. This however is inappropriate. As per the definition of an ICA as per VAT Act the definition strictly states that ICA's are applicable to all "corporeal movable goods or if any machinery or plant, whether moveable or immovable". This however does not include "fixed property". In addition plant relates to manufacturing capabilities and as the building is a office building fails to meet the definition of an ICA. Based on the failure to meet the ICA definition the building is treated as an operating lease for VAT purposes and thus VAT will be payable of each monthly instalment and a s11(a) income tax deduction may be claimed for the R200,000 monthly payment.

**Calculation 4:**

There has been a gain on sale of building realised for the 2016 financial period. However as per IAS 17 if the lease is a finance lease the substance of the transaction is that there is no sale and the asset has been used as security of the loan (lease liability). Thus the proceeds received should be recognised as a liability, the asset should be restated and the excess proceeds over the carrying value should be deferred and amortised over the lease term, i.e. the 120 months.
Thus your recognition of the gain must be deferred and realised over the period, the carrying value is appropriate under the basis that residual value has been equal to the carrying value. Hence 2 months, being August and September, would be realised and incurred on the income statement whilst the remaining portion be included in deferred profit on the statement of financial position.

**Temporary differences**

The capital gain calculation has been incorrectly processed.

- **>** Firstly the base cost of R19.9m is inappropriate as you have not considered the 3 alternative options in determining base cost, being the value date value of 1 October 2001. This will be determined by either the higher of.
  **1.** The market value on the date of 1 October 2001 - R24 250 000
  **2.** 20% of proceeds less expenditure after the valuation date
  **3.** Time apportioned base cost (TABC) as per the formula outlined in the tax act.

I briefly reperformed these calculations and TABC provides me with the highest tax base, thus we should utilise TABC rather than the original purchase price, which you have incorrectly utilised.

**Tax rate**

I noticed that you have utilised an inclusion rate of 66.6% this however was amended to 80% effective 1 March 2016. Thus an effective inclusion of 80% shall be included which shall be multiplied by the applicable tax rate of 28%, thus a net inclusion of 22.4% taxed.

Additionally the inclusion of the full capital gain being realised through OCI is incorrect. This should be realised in Profit and loss and the revalued portion relating to OCI. Hence these should be split.

**Inclusion of deferred profit**

You have failed to include the deferred tax on the deferred profit in the original deferred tax workings. This shall give rise to deferred tax as per IAS 12.7 whereby the tax base of income received in advance is the carrying value less any amounts not taxable in the future**.** There shall be no future tax consequence and thus the tax base is null *(sic)* (as these have been taxed by CGT already) thus a temporary difference and deferred tax shall arise based on 28% as we realise this income throughout the lease period.

The remaining inclusions within the temporary differences should all be excluded. The s11(a) deduction is considered within the lease liability calculation and the appropriate tax base thereof. There is no reduction from s23C as per the incorrect classification of VAT discussed above
There is no inclusion of finance charges as these are included within the finance asset and lease considerations.

The language used could be more courteous but this is forgivable. It was a pity that some of the basic 'errors/omissions' were missing. However, the candidate identified enough errors/omissions to be considered competent. We were impressed that the candidate was aware that there are 2 methods to the deferred tax on a finance lease – not many candidates mentioned this. The candidate also identified that this was not an installment credit agreement.

 

**Limited competent**

From: Financial Accountant
To: Harry Mnisi
Subject: RE: Current tax and deferred tax: Sale and leaseback
Date: 16 November 09:30am

Good day

Please find my responds on your request:

Discount rate: The discount rate used is a nominal rate and an implicit interest rate should be used when calculating the lease present value, minimum lease payments.
Deferred tax: The asset which is being leased is a building. The deferred tax for buildings is exempt in terms of the Income Tax Act.
Revaluation: It is not appropriate to revalue a leased as its subsequent measurement must only be present value of leased asset minus depreciation.
Lease liability: The finance lease obligation value is incorrect as it excludes the VAT and the measurement has to be the higher of fair value of the lease property or minimum lease payments.
The carrying amount:

- Depreciation has to be accounted for irrespective of residual value exceeding the carrying amount.
- The carrying amount of the asset should be the higher between the fair value of building and minimum lease payments. In this case the fair value of the building is higher than minimum lease payments.

Revaluation of building

- Lease assets cannot be revalued as their subsequent measurements is carrying value less depreciation.

Calculation 3

- The period of 120 months is incorrect as it is stated that lease term has to be the non-cancellable period for which the lease has contracted to lease the asset together with any further terms for which the lessee has the option to continue to lease the asset.
- Monthly payment should include VAT as payment to the lessor will incorporate VAT.

Calculation 4
Carrying amount used on gain on sale of building is incorrect as they used the revaluation amount of 2014 and we have to use the 1 Aug 2016 carrying value of the building.
Capital Gains Tax

- The based cost used in correct as it has to be the after valuation date of 1 October 2001 of 2 425 000
- The inclusion rate has been used incorrectly as is must used on profit.
- The incorrect inclusion rate has been used its supposed to be 80% not 66,6%.
- The non-taxable portion capital gains is incorrect it's supposed to be 20% not 33,4%.
- Interest of finance lease is not a temporary difference as interest are fully deductible as per section 11a of the Income Tax.
- The capital portion paid should exclude VAT. Therefore the reduced rental deduction is incorrect.

Lease liability

- The VAT portion has be calculated incorrectly as the total VAT on the lease must utilised with the useful life of the asset.

Feel free to contact me if there is any question on the comments made above.

Kind regards
Financial Accountant

The language used creates a poor impression. The brevity of the points raised also creates a poor impression. These are not supported with meaningful explanations. The major concern about this response is the technical incorrectness of many of the points. Many of the points also do not make sense. This is a poor response and the technical knowledge of this candidate is in question and accordingly this is a limited competent response.

In practice, the candidate would have been asked to redo the task or someone else would have been asked to do so.

 

*PART (d)*

*(d) In response to Harry Mnisi's email (document G) –*

*(i) describe the additional reports that you would ask Barbara Byte to extract from the inventory management system; and*

*(ii) list the key questions you would ask Belinda Jantjies*

*to enable Harry Mnisi to evaluate the reasonableness of the inventory obsolescence allowance at 30 September 2016 for financial reporting purposes..*

**DOCUMENT G**

**EMAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday, 16 November 2016, 06:05 AM |
| **To:** | Financial accountant |
| **CC:** | |
| **Subject:** | Inventory obsolescence allowance |

Hi there

I mentioned last week that I needed you to help with the preparations for the discussions with the external auditors regarding the reasonability of the obsolescence allowance for inventories. Belinda Jantjies was responsible for calculating the obsolescence allowance amount – see attached for her notes and the workings that she sent me.

Please could you review Belinda's notes and think about what additional reports we should ask Barbara Byte to extract to help us assess the reasonability of the obsolescence allowance. Also, let me know what questions we should ask Belinda when we meet with her to discuss the obsolescence allowance workings – bearing in mind that you and I will have to justify the approach and workings to the external auditors.

Thanks in advance.

Regards
Harry

**Highly competent**

**<u>Additional reports and key questions with regards to the inventory obsolescence allowance</u>**

The following additional reports will be needed from Barbara Byte in order to assess the calculation of the inventory obsolescence allowance:

- For H&S Stores I will need the most recent cost price list for various goods as well as the report used by Belinda for all the instances of items sold below cost price. This report will be used to confirm that all items on the list that was sold at below the most recent cost price was included in this report.
- For H&S stores I will need the inventory aging to identify items that have not sold in the past 6 months (6 months is appropriate for H&S stores as leather products are not seasonal and can therefore have a longer shelf life). This report will be used in order to determine whether the allowance calculated based on goods sold at below cost price would approximate the allowance that would have been calculated had we adopted the same method as with Zinga stores merchandise. With this report we will also identify products that would have been included in the allowance had we used the aging report that was not included in the alternative method applied.
- A report broken down into the different sizes for each item of clothing that shows which inventory items have not sold in the past 3 months or longer. 3 Months is used as a season is typically 3 months long. This report will be used to determine the value of stock older than 3

 

months but not older than 6 months to determine if it will be material in for the auditors. If it is material we might need to adjust our calculation or increase the allowance.

- A report broken down in different sizes for each item of clothing that shows for which inventory items we have made purchases of these items after they had not sold for 30 days.
- A report that indicates which stock is nearing its end of season that will most likely be sold on sale at the next 'end of season' sale. This report will be used to determine which inventory items can likely still be sold at the end of season sale to confirm that this has not been included in the inventory obsolescence allowance or that it has been included at the correct value.
- A report detailing the cost of sales for the year in order to perform the days' sales of inventory ratio calculation as well as the inventory turnover ratio calculation.
- Most recent approved price lists for all goods (both Zinga and H&S stores): This report will be used to compare the costs of goods to their most recent prices (Net Realisable Value) in order to ensure that goods are not carried in excess of what they are worth.
- Documentation relating to the stock count: I would require either the count sheets, or count instructions, or whichever documents were used to identify any damaged, old or slow moving stock. This document will be used to identify any stock that should be specifically included in the inventory obsolescence allowance.

The following questions will be asked to Belinda to ensure that we understand the calculation and can justify it to the auditors:

- Have you calculated the allowance for inventory obsolescence before or is this your first exposure to calculating such an allowance?
- Do you work closely with the inventory and are you aware of the movements and trends in inventory? Would you be able to identify slow moving stock against normal stock?
- Did you ensure that the method you used to calculate the allowance for inventory obsolescence is in line with the company policy? What measures did you take to ensure that the calculation is in line with company policy?
- Did you attend the annual stock count to identify any possible damaged, slow moving or obsolete inventory that will need to be written down or sold at reduced prices for specific inclusion in the allowance for inventory obsolescence? If you did not attend the stock count, did you have the relevant discussions with those that were in charge of the stock count about any such inventory items identified? Is it possible for you to get written confirmation from those in charge of the stock count with regards to any inventory items that need to be specifically included in the allowance for inventory obsolescence?
- Why are we using two different methods for calculating the allowance of inventory obsolescence of the Zinga Stores merchandise and the H&S stores merchandise? How do we justify using different methods. Which method is in line with our accounting policy?
- For Zinga stores merchandise, how do we know it is correct to base the calculation only on inventory older than 180 days? The fashion industry is seasonal and given that each season is roughly only 3 months, we would have to justify why it is appropriate to only base the allowance on goods older than 6 months.
- How do we know that it is appropriate to calculate the allowance as 25% of all balances of inventory held longer than 6 months? The auditors will only accept a calculation based on such a percentage if it is supported by strong historical evidence. Is this how we calculated the allowance for obsolete stock in the past? If it isn't, why did we calculate the allowance in this manner?
- If we are calculating the allowance for obsolete inventory in the same way as in prior years, did you compare the prior year allowance with the actual write off in the current year to determine how accurate our allowance is?
- If we are calculating the allowance for obsolete inventory in the same way as in prior years, did you compare the current year allowance with the prior year allowance to see what the

difference is? I would imagine that the difference in the allowance would approximate the difference in the year-end inventory balance when used as a percentage.

- Did we take into account the inventory that might be sold on the 'end of season' sales and the effect that would have on the calculation (i.e. did we exclude this inventory if we expect to sell it at a normal price or include this inventory at a sufficiently low value of we expect to sell it a lower price)?
- For H&S stores, why are we not interested in using the inventory aging as a basis for our calculation like we do with the Zinga stores merchandise?
- Is there external factors that should be considered for the allowance for H&S inventory? As this is headware I imagine it is not as sensitive to seasonality as our clothing merchandise, but are there other external factors to which H&S inventory is sensitive to?
- Has there been any specific events in the current year (for example floods, fires, etc.) at any of our stores or storage facilities that would lead us to believe that we need to specifically include certain items when calculating the allowance for obsolete inventory?

This was a difficult task as it required candidates to apply themselves practically. This candidate impressed with the breadth and depth of response. Reports were requested to identify slow moving items, high-risk items (seasonal clothing and unusual sizes), damaged stock and incidences of selling products at below cost. The practical application was evident for example, referring to different obsolescence risks of leather products versus clothing. Reference to inventory days/turnover was also insightful and relevant.

The list of questions would be useful in practice. Overall, this candidate responded to the task and would have impressed the CFO.

**Competent**

From: Financial accountant
Sent: Wednesday, 16 November 14:00 pm
To: Harry Mnisi
CC:
Subject: Inventory obsolescence allowance

Hi Harry,

I trust this email finds you well

I response to your query on reviewing the inventory obsolescence calculation and additional reports to be requested, please find attached a summary I have made for your use, covering all your questions and concerns.

Please let me know should you have any questions, then we can clarify and finalise our response before we meet with the external auditors.

Kind regards

Financial Accountant

**Email Attachment:**
**Additional reports to be obtained from Barbara Byte:**

- I think it would be beneficial for us to obtain a report of actual inventory write-downs during the past 2 years. We would require a report detailing the exact descriptions of the items written down and the reasons for the write down (eg slow selling or damaged as these could be 2 separate criteria we could use to evaluate the history of write-downs. We will require 2 separate reports, one for Zinga stock and one for H&S stock. As the inventory is rather different and clothing is more susceptible to seasonality than leather goods, we would benefit from assessing the write downs of the 2 different companies separately. We could then assess past write down trends and the reasons for the write-downs, which could enable us to better predict the future write-downs (which is what the allowance contains).
- We should obtain a report for any inventory on hand which were purchased more than 1 season ago (ie Winter 2016) that is still on hand. In this same report it should be a item description as well as an indication of whether that particular item has been written down or not. Whilst I think that most winter 2016 stock would probably need to be written down, we could motivate perhaps not writing down items such as jeans and other "basic" items which do not change as feverishly with fashion trends and could be sold again in the next season.
- We should request a report detailing the percentage of stock, per season, for the past 2 years, which was subjected to the end of season sale for each season. This report should also detail the average discount given on the season's items. In conjunction with this report we should also establish how much inventory is actually written down before the sale time (this would most likely only indicate faulty/damaged inventory). Thirdly we would need a report showing us, of the items that were put on sale, how many were not sold at all/were written down from the sale stock for other reasons. Motivation for these reports being that we can assess exactly what the historical write-downs have been for each season ie if 20% of stock go on sale at an average discount and then a certain percentage of those sale items are also written down, we can come up with an accurate trend/historical write down percentage.
- For all reports, we will need a separate report for H&S and Zinga as these companies have inventory which will age very differently.

**Questions for Belinda Jantjies:**

For Zinga:

1. What is the 25% allowance (as in the actual percentage) based on? Did you use historical write downs of inventory? Have we historically written down about 25% of inventory items over 6 months old? Have we considered creating a provision for inventory younger than 180 days, seeing as 6 months would typically represent 2 seasons, should we not perhaps have considered creating an allowance per season, or is it because in South Africa, we climatically mostly only have 2 seasons as summer and spring and winter and autumn do not have vastly different temperatures?
2. Have we assessed historical write downs at all? Are we sure that inventory over 180 days (disregarding season neutral items) are sellable at all? Also, what is the balance of inventory that is older than 180 days? (the auditors will most definitely be assessing this balance against their materiality figures to determine whether us writing down this inventory will have a material impact on our financials.
3. Did you do a reasonability check where you compared historical allowance for obsolete inventory to the actual inventory write down (inventory written down that was listed in the ageing that was used to calculate the allowance). If so did the allowance approximate the write-down? If not was it due to unforeseen circumstances (such as a building fire) or just because the allowance was not necessarily accurate? (If the allowance and the actual write-down approximate each other we will have grounds to defend our allowance to the auditor).

For H&S:

1. Do we have any information prior to year end that would have enabled us to predict that the inventory items in question would be sold below cost?
2. Have you perhaps done any calculations or have any data on previous write-downs of H&S

inventory? Would these write downs, as a percentage, approximate the write down made to the inventory after the report you used was pulled in October?

3. Do we regularly have sales on H&S stock? What conditions would cause us to sell stock at below cost (ie slow moving, perhaps damaged goods)?
4. As a note, we should technically provide for obsolete inventory given the known circumstances at year end. It would therefore actually be incorrect to raise an allowance based on information we obtained after year end if the conditions were not present at year end (in this instance, the inventory was only sold below cost after year end). We should consider whether we knew these items would be discounted before year end, and whether historically we do discount H&S inventory. If we don't normally give discounts and the inventory was sold below cost because of circumstances we could not anticipate before year end (eg a flood in the storeroom slightly damaged some goods and they were sold at a mark down) then we should not have raised an allowance at all as events after the reporting period should not be adjusted for and the allowance will actually be overstated in terms of H&S.

In general, did we have a look at the year end stock counts and all inventory that was considered obsolete or slow moving at the counts. The auditor was present at the stock counts and they'll definately be asking about whether we have provided for these items identified

This candidate provided a reasonable list of reports and questions to be asked. In reading the list of reports and questions to be asked, it is evident that the candidate understands inventory obsolescence. The reports could have been described with more clarity – Barbara Byte may ask for clarification on certain reports. Some reports may be too historically focused and not on current inventory items and potential write-downs.

Separating the questions for zing and H&S inventory was an excellent initiative. Some of the questions would have challenged Belinda Jantjies.

**Limited competent**

Email response

From: Financialaccountant@zinga.com
To: Haryyminisi@zinga.com
Sent: 18 November, 08h00
Subject: Inventory obsolescence allowance

Good day Harry,

Please find attached: document on inventory allowance addressing
- Belinda's calculation review notes
- Additional reports to ask for
- What questions to ask Belinda.

Please contact me if you have any further queries.

Kind regards
Financial accountant

**ATTACHMENT: INVENTORY OBSOLESCENCE ALLOWANCE**

A. REVIEW NOTES ON BELINDA'S NOTES ON INVENTORY ALLOWANCE

1 She stated the incorrect percentage (%) used to calculate the allowance for Zinga stores and H&S stores.
   - Zinga's stores percentage should be documented as 7%, instead of 25%.
   - H&S stores' percentage used should be documented as 1% and not on the basis stated by Belinda.
   - For H&S Stores calculated the allowance as the difference between cost prices and selling prices in incorrect application of principle/principle error.
   - For Zinga Stores Belinda stated that the allowance was calculated based on the inventory balance in the 180 days or more column instead of on the total inventory balance as per age analysis.

2 Belinda provided insightful information on the inventory management system used by Zinga and important operations related information.

**B. ADDITIONAL REPORTS REQUIRED**

In addition to the detail of inventory balance report and age analysis we require the following reports to assist us in assessing reasonability of the obsolescence allowance:

1 Inventory write-downs report: Inventory is recorded at the lower of cost or net realisable value, if the cost is lower than inventory it is written down to net realisable value.
Description of report: Write-downs report which indicates the costs, net realisable values and write-down amounts for each individual inventory items. The report must also include condition of inventory items at write-down date to determine reason for write down of the inventory items.

2 Inventory signed stock count sheet at year end: This report must include all inventory items held at year end, quantities, value, asset number and quantities counted as per stock count performed. This report will provide me with the complete and accurate inventory balance at year end which should match the balance per the age analysis.

3 Inventory net realisable values report: This report should reflect all selling prices, estimated selling costs per inventory item at the different dates.

4 Unique stock-keeping unit report: This report should outline all inventory items, the unique SKU code per item, the unit cost and quantities at each store on hand and season when inventory was recorded in order to differentiate the different inventory items based on its particular size to determine which sizes are slow-moving stock.

5 Marked down prices report: This report should include all inventory items, unique asset numbers, cost price and marked down prices. To determine the total marked down prices on inventory value and whether this was adjusted for at year end.

6 Exception report: This report should include all exceptions identified in the inventory system relating to –

- Errors in recording of inventory items
- Inventory items with duplicate asset numbers
- Inventory items recorded that had variance during the stock count and reasons.

The exception report must include reasons and remedial action taken by management.

C QUESTIONS TO ASK BELINDA WITH REGARD TO INVENTORY OBSOLESCENCE ALLOWANCE

Key questions for Belinda

1 Did you take into account historic information related to sales and trends in determining the percentage to be applied to calculate the allowance? This could be obtained from the historical sales data analysis.

2 Was there any occurrences of fire, flood, damage not reported on Zinga's inventory warehouses? What is the impact on age analysis balance?

3 Was there any instance of inventory theft that occurred and was this taken into account to adjust the inventory balance?

4 Does Zinga hold any consignment stock with third parties? And was this excluded from the inventory balance?

5 Was the inventory age analysis accurately calculate? Did you check for sold inventory items that were not derecognised and are therefore still accounted for?

6 Who reviewed the allowance workings and prepared for accuracy of workings to be determined?

7 Were the previous allowances raised, cleared for inventory items sold?

Financial Accountant

It may be unwise to make statements that Belinda Jantjies' inventory obsolescence calculations are incorrect. This may be construed as unprofessional and rude.

The reports listed were far too generic. Barbara Byte may respond that many reports are not practically possible – listing the condition of all inventory that was provided for? Byte may also take offence to producing a report that lists recording errors. The list of reports requested is likely to irritate Byte.

The questions for Jantjies are weak and provide limited evidence regarding inventory obsolescence. Most of the questions can be answered with a simple 'Yes' or 'No' reply.

## *PART (e)*

*(e) Prepare the memorandum for the Board of Directors as requested by Harry Mnisi in document I.*

**DOCUMENT I**

**EMAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday, 16 November 2016, 07:35 AM |
| **To:** | Financial Accountant |
| **CC:** | |
| **Subject:** | Revenue ratios |

Hi

I need to calculate relevant revenue ratios for FY2016, together with comparatives, and discuss these at our Board meeting later this month. The context is that our directors want to review our historical revenue growth and evaluate where our growth has come from and what strategies to follow to address any issues.

You would have seen the revenue breakdown per year in which stores were opened in the PowerPoint presentation to First Regional Investment Bank – see particularly slide 12. I have attached some additional information that I have extracted from our management information system, which may be useful in calculating relevant revenue ratios. Assume that the attached information is accurate – our management information system provides detailed and valid data!

Please prepare a memorandum on my behalf that I can distribute to the Board. The Board prefers concise memorandums that summarise the key issues. The memorandum should deal with the most relevant revenue ratios together with commentary on these numbers.

Bear in mind that we did not close or renovate any stores in FY2016 and FY2015. Also, we did not open any new stores in FY2013.

Regards
Harry

**Highly competent**

To: The board of Directors
From: Financial Accountant
Date: 16 Novemeber 2016
Re: Revenue Ratios

---

The below key historical Sales growth Ratios are necessary to be analysed when determining where Zinga growth originates and what strategies to follow to address any issues:

Refer to ***attachment 1 (excel)*** for calculation of these key ratios.

**<u>1) Comparable Sales Growth Ratio (Rands and Units):</u>**

- This ratio seeks to compare the amount of revenue generated in an accounting period relative to the amount of revenue it generated in a similar period in the past. Therefore it is used to determine what amount of new sales comes from actual sales growth or merely comes from new store openings.

- Based on the assessment it can be seen that existing stores revenue grew 7.57% in 2015, and grew 7.55% in 2016. This represents stable growth and should be rather satisfying when compared to industry rivals (Truworths: 7.3%, Foschini: 5.7% and Mr Price 4.2% - 2016). Further this growth is greater than inflation (+/- 6%) and therefore represents growth in excess of mere inflationary increases.
- These growth levels are significantly lower than those portrayed of 18.8% for 2015 and 17.92% for 2016. This is as the total revenue growth is largely driven by new store openings rather than expanding sales in current stores.
- The growth figures of 114.29% (2015) and 110.12% (2016) for new stores appears to be rather high, however is most likely as the stores were opened during the financial years, and are not comparable to the respective prior year as sales were only made for a portion of the year.
- Although total sales growth appears fantastic, it must be noted that this driven mostly through the new store opening growth, rather than existing, and therefore at some point Zinga will not simply be able to open new stores in South Africa to enable significant sales growth.

**2) Unit sales per store**

- Similarly to noted above, it is clear from an analysis of unit stores sales that there is not a significant growth in the current stores sales volumes, rather only growth in sales units experienced through opening new stores.
- This is evidenced by existing stores revenue unit growth of 0.42% (2016) and 1% (2015). The revenue unit growth in new stores of 101.3% (2016) and 96% (2015) is expected, as not all the stores would have been opened at the beginning of the year, but rather during the year.

**3) Comparable average Sales prices per unit:**

- This is determined as Total sales/Unit sales per year. As evidenced from the table, the overall change in average unit selling prices has increased from 5.5% (2014), 6.5% (2015) to 7% (2016). These increases in average selling price is estimated to be greater than that of inflation for each of the years, and therefore represents actual net growth in sales prices higher than that dictated by general inflationary increases.
- It is important to note that this ratio should be strictly monitored, as growth that far exceeds inflation may be caused by unreasonably increasing prices and can push Zinga out of the "reasonably priced" category and into a different target market.
- Growth in average sales prices for 2016 of 7% does however approximate inflationary levels of +/- 6% and therefore appears reasonable.
- When comparing the average sales price between stores opening in 2016, 2015, and 2014, the average prices appear to reasonably approximate each other. This is expected, as selling prices for like-for-like items should be the same regardless of whether a new store or not. This should be monitored to determine significant fluctuations and the cause thereof to be investigated.

**4) Average Revenue per store**

- This ratio provides insight into the growth of each stores revenue year-on-year, based on total Revenue.
- From the table attached, it can be noted that stores opened pre 2014 grew in sales by 8% (2015: 7.3%), store opened during 2014 grew 6.1% (2015: 6.5%), stores that were opened in 2015 grew in sales by 4.7%.

- Although this does indicate that on a annual basis the stores are growing their average revenue, it does highlight that for all the new stores opened, the revenue does not appear to be growing as significantly (eg: pre 2014 stores grew 8%, and 2015 opened store grew 4.75%). This is a potential indication that the market is saturated, and for every new store that is opened, its future growth will be limited due to the existing number of stores.
- It is advised that management should continue to monitor this ratio to determine if this trend continues and adapt its store growth strategy appropriately.

Based on the above it must be noted that Revenue should be analysed in 4 key ways. From the analysis above it can be noted that Zinga's sales growth is predominantly through increasing store numbers, rather than through increased volumes (as volumes per store has remained almost stagnant). The Revenue growth in prices has moved in line with inflation and therefore does not expose Zinga to the risk of entering into a different target market. These insights need to be considered as part of managements strategy decision for the financial year going forward.

Thank you.

| ***1) Comparable sales growth ratio (rands):*** | | | | | | | |
|---|---|---|---|---|---|---|---|
| | **2014** | | **2015** | | **2016** | | |
| **Sale of merchandise (Rm)** | | | | | | | |
| Stores opened pre 2014 | 575 | ***a*** | 618.5 | ***b*** | 665.7 | | |
| Stores opened in 2014 | 15.4 | ***c*** | 33 | ***d*** | 35 | ***X*** | |
| Stores opened pre 2015 | 590.4 | | 651.5 | ***g*** | 700.7 | ***h*** | |
| Stores opened in 2015 | 0 | | 50.4 | ***i*** | 105.9 | ***J*** | |
| Stores opened pre 2016 | 590.4 | ***e*** | 701.9 | ***f*** | 806.6 | | |
| Stores opened in 2016 | 0 | | 0 | | 21.1 | | |
| **Total for the year** | **590.4** | | **701.9** | ***k*** | **827.7** | ***L*** | |
| | | | | | | | |
| **2015 growth** | | | 2015 | | | | Calculation |
| Existing stores | | | 7.57% | | | | ***(b-a)/a*** |
| Stores opened in 2014 | | | 114.29% | | | | ***(d-c)/c*** |
| Stores opened in 2015 | | | 100.00% | | | | |
| Total Growth | | | **18.89%** | | | | ***(f-e)/e*** |
| **2016 Growth** | | | | | 2016 | | |
| Existing stores | | | | | 7.55% | | ***(h-g)/g)*** |
| Stores opened in 2015 | | | | | 110.12% | | ***(j-i)/i*** |
| Stores opened in 2016 | | | | | 100.00% | | |
| Total Growth | | | | | **17.92%** | | ***(l-k)/k*** |
| ***2) Comparable sales growth ratio (units):*** | | | | | | | |
| | **2014** | | **2015** | | **2016** | | |
| **Sale of merchandise units** | | | | | | | |
| Stores opened pre 2014 | 3958.6 | ***a*** | 3998.2 | ***b*** | 4018.2 | | |
| Stores opened in 2014 | 106.6 | ***c*** | 214.3 | ***d*** | 212.1 | ***X*** | |
| Stores opened pre 2015 | 4065.2 | | 4212.5 | ***g*** | 4230.3 | ***H*** | |
| Stores opened in 2015 | 0 | | 327.5 | ***i*** | 641.9 | ***J*** | |
| Stores opened pre 2016 | 4065.2 | ***e*** | 4540 | ***f*** | 4872.2 | | |
| Stores opened in 2016 | 0 | | 0 | | 128.9 | | |
| **Total for the year** | **4065.2** | | **4540** | ***k*** | **5001.1** | ***L*** | |
| **2015 growth** | | | 2015 | | | | Calculation |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Existing stores | | | 1% | | | | ***(b-a)/a*** |
| Stores opened in 2014 | | | 101.03% | | | | ***(d-c)/c*** |
| Stores opened in 2015 | | | 100.00% | | | | |
| Total Growth | | | 11.67% | | | | ***(f-e)/e*** |
| **2016 Growth** | | | | | 2016 | | |
| Existing stores | | | | | 0.42% | | ***(h-g)/g)*** |
| Stores opened in 2015 | | | | | 96% | | ***(j-i)/i*** |
| Stores opened in 2016 | | | | | 100% | | |
| Total Growth | | | | | 10.15% | | ***(l-k)/k*** |
| ***3) Comparable average sales price per unit:*** | | | | | | | |
| | **2014** | | **2015** | | **2016** | | |
| Average sales price | | | | | | | |
| Stores opened pre 2014 | 145.23 | a | 154.69 | b | 165.68 | C | |
| Stores opened in 2014 | 144.47 | | 153.86 | | 164.78 | | |
| Stores opened in 2015 | | | 154 | | 164.93 | | |
| Stores opened in 2016 | | | | | 164.09 | | |
| | 5.50% | | 6.50% | | 7% | | |
| | | | ***(b-a)/a*** | | ***(c-b)/b*** | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| ***4) Average revenue per store:*** | | | | | | |
| | **2014** | | **2015** | *{(2015-2014)/2014}* | **2016** | |
| Stores opened pre 2014 | 8.2 | | 8.8 | 0.073170732 | 9.5 | 0.079545 |
| Stores opened in 2014 | 7.7 | | 8.2 | 0.064935065 | 8.7 | 0.060976 |
| Stores opened in 2015 | | | 8.4 | | 8.8 | 0.047619 |
| Stores opened in 2016 | | | | | 7.1 | |
| Total average revenue | 15.9 | | 25.4 | | 34.1 | |

 

The candidate's attempt is superb! The following indicators are indicative of a highly competent answer:

- The task required a brief answer – the candidate effectively addressed this by attaching the calculation of the ratios in a separate attachment.
- The candidate addressed the task effectively by calculating **relevant revenue ratios** only and not dumping a number of irrelevant ratios not related to revenue.
- The candidate's clarity of expression is impressive. The candidate **communicates clearly** and reading between the lines is unnecessary.
- The candidate addressed all the drivers of growth; understanding that the crux of the task was to differentiate between **same store growth** and **growth from new stores**.
- The candidate correctly compared the same store growth (like-for-like growth) of Zinga's competitors.
- The candidate correctly identified that zinga's revenue growth has been driven by a strategy of opening new stores rather than growing organically, with existing store growth primarily being driven by inflationary increases in selling prices.
- The candidate furthermore **correctly** calculates that the organic growth as evidenced by the low growth in volumes (of existing stores).
- The candidate, by calculating the revenue per store on a same stores basis, also correctly identified that the growth in stores opened before FY2014 in fact outperformed the new stores.
- The candidate's professional communication skills displayed are good in respect of the referencing of the ratios calculated – one is able to follows the candidate's calculations and reasoning.
- Finally, the candidate displayed the ability to **very effectively think on their feet** on the day of the assessment.

**Competent**

MEMORANDUM

Board of Directors of Zinga Fashion

Given the need arising from the board of directors to review Zinga's historical revenue growth and to perform an evaluation where growth originates from, the following memorandum deems appropriate

Zinga has been facing various challenges over the couple of years, which include a though economic environment with growth of less than 1 per cent in South Africa, increased competition from international retailers such as H&M and ZARA, and ever fashion trends

In order to assess the impact of the above factors on growth for Zinga, the Comparable Growth Rate Ratio was used. This metric is used to determine what amount of new sales comes from actual sales growth or merely comes from new stores opening. This is very relevant for Zinga given their recent expansions of new stores from 74 in 2014 to 92 in 2016

Please refer to attached calculations on which the below assessment is performed

Stores Opened Pre 2014

From the analysis is can be seen that the stores opened in 2014 has a positive contribution to actual growth fuelled by the growth rate of 7% and 8% in 2015 and 2016 respectively.

However, if we look at growth from a unit perspective and price increase perspective, it depicts a different outlook.

Units sales for stores opened pre-2014 was almost 0% in 2015 and 0.5% in 2016 whilst the average sales price increase was 6.5% in 2015 and 7.1% in 2016.

This means that although the stores opened in 2014 is showing growth, it does not translate to actual volume growth, it is mere the inflationary increases pushed onto consumers.

The average revenue per store opened pre 2014 also increased 7.3% in 2015 and 7.9% in 2016 respectively, but again this is mainly due to price increases and not actual growth in volumes

Stores Opened Pre 2015

The growth for unit sales for stores opened pre 2015 was 0.4% to 2015 whilst the average sales price increase was 7.1%.

This again shows that growth is being experienced from a price perspective, but not from a volume perspective.

Actual Growth vs. Growth due to New Stores

Growth for 2015 amounted to 18.9% year on year for revenue. However this has to be broken down between growth achieved due to volume growth and growth due to increase in the number of stores. Actual volume growth amounted to 7% This means that 11.9% relates to growth as a result of new stores opening and not actual growth in terms of volume

The same has to be done for 2016 revenue growth of 17.9%. Actual volume growth amounted to 6.9%. This means that 10.9% relates to growth as a result of new stores opening and not growth in terms of volume

It can be seen that although revenue growth is still high, it does not purely relate to volume growth that adds value of the business. A significant portion of revenue growth is rather as a result of new stores opening, rather than old stores growing in volumes.

The growth rates are showing signs of decrease, and the following strategies can be implemented to ensure volume growth is experienced, instead of growth as a result of new stores opening

Limit New Stores Openings

It was suggested that there is still potential for another 35 new Zinga stores in the near future. It would be advisable to hold off on this expansion to prevent new stores cannibalising on current stores volumes as the market is starting to reach optimal level of supply from Zinga's side.

This will also help reduce capital expenditure, which will allow available for other capital projects such as investing in Africa, or the distribution centre that can reduce cost in future

Increase Trading Density

The only way actual volume growth can be experienced is to increase trading density. This means squeezing out as much revenue as possible per square meter of floor space. This can be achieved through effective marketing strategies, modern store layouts and loyally reward programs to attract new customers

Conclusion

From the above analysis, it can be seen that growth rates can be deceiving. It is of a concern that a significant portion of growth is rather as a result of new stores opening, than actual growth of existing stores that hamper value. However, the growth rates are still very competitive and above industry norms of 3% and strategies are available to increase volume growth, such as limiting new store openings.

| | | | | |
|---|---|---|---|---|
| Opened in 2014 | | 17.6 | 2 | |
| | | | -88.6364 | (2016-2015)/(2015) x 100 |
| | | | | |
| Opened in 2015 | | 50.4 | 55.5 | |
| | | | 10.11905 | (2016-2015)/(2015) x 100 |
| | | | | |
| | **2014** | **2015** | **2016** | |
| Revenue generated by stores in 2014 | 590.4 | 0 | 0 | |
| Revenue generated by stored in 2015 | 651.5 | 701.9 | 0 | |
| Revenue generated by stores in 2016 | 700.7 | 806.6 | 827.7 | |
| | | | | |
| Number of Stores Opened | 74 | 86 | 92 | |
| Average Number | 72 | 80 | 89 | |
| | | | | |
| Stores Opened in 2014 | Per Store Revenue | Growth | | |
| 2014 | 8.2 | | | (Revenue/Number of Stores Opened) |
| 2015 | 8.804054054 | 7.366513 | | |
| 2016 | 9.468918919 | 7.551804 | | |
| | | | | |
| Stores Opened in 2015 | | | | |
| 2015 | | 8.77375 | | (Revenue/Number of Stores Opened) |
| 2016 | | 9.37907 | 6.899214 | |
| | | | | |
| | | | | |
| Actual Growth 2015 | | 18.8 | | |
| Growth due to volumes | | 7.366513 | | |
| Growth due to new stores | | 11.43349 | (18.8-7.3) | |
| | | | | |
| Actual Growth 2016 | | 17.9 | | |
| Growth due to volumes | | 6.899214 | | |
| Growth due to new stores | | 11.00079 | (17.9-6.9) | |
| | | | | |

The candidate displays competence in a number of ways:

- Firstly by integrating the information provide in the pre-released information with that on the day. This is definitely an attribute which is important in a competent candidate.
- The candidate addresses the task, although the explanation of what like-for-like sales (comparable sales growth) entails, could have been explained with more clarity.
- The candidate correctly attempts to split the overall growth between organic growth and new store growth, by identifying that the difference between the overall revenue growth and the comparable stores growth must be the organic growth of the company.
- In respect of the latter, the candidate correctly identifies that Zinga's organic growth (growth in volumes) from the existing stores (those opened pre FY2014) is very low and hence that the growth arises from new store openings.
- The candidate correctly identifies that the strategy of creating growth through opening new stores is not sustainable and should be revisited.
- The candidate's suggestion of attempting to increase sales trading density is relevant to Zinga, and hence a further attribute of competency.
- A downside of the candidate's attempt is that they did not split the growth in revenue from existing stores between volume increases and price increases (inflationary growth).
- Finally, notwithstanding the previous point, the candidate's answer was brief (in accordance with the instructions contained in the task) and limited to ratios relevant to assessing revenue performance.

**Limited competent**

MEMORANDUM

TO: The Board of Zinga (Pty) Ltd
FROM: Harry Mnisi
DATE: 16 November 2016
SUBJECT: Revenue Analysis

INTRODUCTION

Below is a summarised analysis of the entity's revenue performance. The primary focus of the memorandum is to analyse the sales growth and the source of the growth. Please refer to Attachment A for further calculations

COMMENTARY ON RATIOS

<u>Contribution to sales per Store</u>

2015 Stores are contributing a disproportionate amount (12.8% of the revenue from 4.7% of the store numbers) of revenue as compared to the 2016 stores (2.5% of the sales from 14% of the stores). This may simply be a reflection of the 2016 stores not having reached their full sales potential due to their infancy. Refer to Calculation A for further details

 

This further indicated by a direct comparison to the weighted number of stores added in 2016 to the sales by the stores. The sales make up 2.5% from 3% of the (weighted) stores (Calculation D)

<u>Growth in Unit Sales per store (Calculation G)</u>

The 2015 stores have increased the number of units they have sold per store by 24% as compared to 6% by the Pre 2015 stores.
Furthermore the 2015 stores are selling 160,250 units per store as compared to 60,433 and 42,967 by the pre-2015 and 2016 stores respectively

This indicates that the 2015 stores are more competitive per store as opposed to the other stores

There average selling price of each store is within R2 of R164 therefore the major comparative advantage of the 2015 stores is the sales volume

<u>Revenue Growth per Store (Calculation E)</u>

In FY2016 the stores opened in 2015 outperformed the other stores in terms of growing the revenue per store. These stores increase revenue by R13,875,000 per store as opposed to R7,033,333 and R702,857 in 2016 and Pre-2015 stores respectively. The poor sales increase from Pre-2015 is a reflection of the stores reaching their maturity in the growth cycle while the 2016 stores performance is a reflection of the startup nature of the stores

<u>Trading Density</u>

The trading density increased to R35,496 in 2016 from R33,616 in 2015(2014: R31,538)
This is a reflection of the fact that we are obtaining more revenue per square meter each successive year. This reflects that the stores added are not having a dilutive effect on the value of the sales we produce per square meter . The reason is due to Zinga being able to maintain a relatively consistent sales price per unit in each store

CONCLUSION

The source of the biggest growth is the 2015 stores as they have neither reached a sales plateau due to them reaching maturity (like the 2014) and are not in the start-up phases (like the 2016 stores). Based on this it can be expected that revenue growth will come from the 2016 store in the 2017 financial year. Furthermore the entity has maintained a growth in the trading sales density despite adding new stores

| | | | | | | |
|---|---|---|---|---|---|---|
| Note 1 | | | | | | |
| =(89-86) | | | | | | |
| Assumption that all Pre-2016 stores were open throughout 2016 while 2016 stores were open for only a portion of the year that reflects their weighting (in 2016 only) as provided in the information | | | | | | |
| Revenue Growth per number of stores | | | | | | |
| 2016 | | | Number of stores | | | |
| Pre 2015 | 49200000 | (700.7-651.5)*1000000 | 70 | 702857.1429 | | i |
| 2015 | 55500000 | (105.9-50.4)*1000000 | 4 | 13875000 | | |
| 2016 | 21100000 | (21100000-0) | 3 | 7033333.333 | Note 2 | |
| | **125800000** | | **77** | **21611190.48** | | |
| Note 2 | | | | | | |
| =(89-86) | | | | | | |
| Assumption that all Pre-2016 stores were open throughout 2016 while 2016 stores were open for only a | | | | | | |

| | | | | | | |
|---|---|---|---|---|---|---|
| portion of the year that reflects their weighting (in 2016 only) as provided in the information | | | | | | |
| Sales price per unit | | | | | | |
| Pre 2014 | (165.68-154.69)/154.69 | | | | | |
| 2014 | (164.7 | | | | | |
| 2015 | | | | | | |
| 2016 | | | | | | |
| Number of units per store | | | | | | |
| | 2016 Units | Increase in units sold | No. of stores | Increase in Units/ Store | Increase in Units/Store (%) | Units per store (Units/Number of stores) |
| Pre 2015 | 4230.3 | 17700 (4230.2-4212.5)*1000 | 70 | 252.8571429 | 6.002373887 (252850/4212500) | 60.43286 |
| 2015 | 641 | 314400 (641.9-327.5)*1000 | 4 | 78600 | 24 (78600/327500) | 160.25 |
| 2016 | 128.9 | 128900 (128.9-0)*1000 | 3 | 42966.66667 | 100 | 42.96667 |
| | | | **77** | **121819.5238** | | |
| Note | | | | | | |
| Assumption that all Pre-2016 stores were open throughout 2016 while 2016 stores were open for only a portion of the year that reflects their weighting (in 2016 only) as provided in the information | | | | | | |

The candidate displays limited competence as evidenced by the following:

- The candidate firstly did not exhibit evidence of understanding the comparable sales ratio. Per the instructions in the email, this was in fact a key aspect of the task.
- The candidate does not address the comparability issue resulting from stores opening **during the course of one year** and having a **full year's sales being included in revenue** in the year thereafter.
- A task such as this calls for the candidate to provide meaningful commentary on the ratios – not to state the obvious which is the growth calculated in the ratios.
- No attempt was made to calculate the comparable sales growth ratio, and the candidate did not split the growth in revenue into the respective components here – being new store growth, organic growth in existing store sales (volume) and growth in selling prices (inflationary growth).
- The assumption made by the candidate regarding the length of time that stores were opened clearly indicates that the candidate does not grasp the key focus of the task and hence cannot be competent on this task.
- The final, yet most important conclusion to be drawn is that this memorandum cannot be sent to the board as is. It requires major reworking to address the issues required in the email. The latter is the most damning attribute of any limited competent attempt, and definitely the case here.

PART (f)

*(f) Draft a memorandum for discussion in response to Harry Mnisi's email requests in document J.*

**DOCUMENT J**

**EMAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday, 16 November 2016, 07:45 AM |
| **To:** | Financial Accountant |
| **CC:** | |
| **Subject:** | Growth strategies |

Hi

With regard to that presentation to First Regional Investment Bank which I forwarded to you last week, please go to section 9 (slide 17). I know that I am going to be asked by the other directors which of the growth opportunities we should prioritise. All those initiatives and opportunities look good but we have to focus on those that will deliver the <u>most long-term value</u> to our shareholders and focus on them first.

Please prepare a brief memorandum (for my attention only at this point in time). In it, rank the seven growth opportunities per the First Regional presentation from 1 (highest priority) to 7 (lowest priority), together with your reasons for your assessment.

We also need to be cognisant of the major trends in consumer behaviour and retailing. What are two of the major trends (apart from those implicit in the seven growth strategies above) that żinga needs to be aware of and adapt to? Please include some brief notes in the memorandum on this aspect.

The document does not have to be too formal – feel free to use bullet points to explain your rationale.

Thanks
Harry

**Highly competent**

To: Harry Mnisi
From: Financial Accountant
Date: 16 November 2016

Subject: Growth strategies

Dear Harry

The opportunities for growth are ranked and discussed with reasons below.

Rankings:

1. <u>On-going investment in Zinga online channel and collaborate with other online retailers</u>

- The industry has become very intense, especially with international brands moving into South Africa. Fighting for mall space and consumers will continue to be difficult.
- Tough economic climates around the world prevail and the local consumer is facing economic struggles, especially with high debt levels.

- However with the rising middle class in the country being fast to adopt technology (especially mobile).
- On-line sales are growing rapidly, Dirk Prinsloo (CEO of Urban Studies), recently stated that in the clothing industry, 57% of consumers buy both online and in stores compared to 20% three years ago. This shows massive growth in this trend.
- The total online spend is only 1.2% of total retail in South Africa, compared to a global average of 9% and the UK with 16.8%. Dirk Prinsloo also said that the a recent study showed that online shoppers worldwide share similar demographics and socioeconomic profiles. The profiles of South African online shoppers correspond closely to that of the UK. This gives a good probability of online sale growth.
- Using an established third party online retailer would mean Zinga could immediately start growing revenue by selling online, which could also result in new loyal customers that have never shopped at Zinga before.
- Zando, and Spree were in some of the most popular online retailers in the country for the first three months of the year. These retailers have already mastered most processes on the online world. They are very trusted and already have a loyal customer base that is rapidly growing.
- It is essential that Zinga could offer its products online, as the demanding consumer looks to cheaper prices and convenience.
- Zinga would only need to deliver products to the distribution centre of the online retailer, the rest is not Zinga's direct problem. This allows Zinga to focus on its core competencies, instead of taking on a large and expensive project.

<u>2. Start a Zinga owned distribution centre.</u>

- In this economic climate as mentioned above, it is wise for Zinga to focus more on cost control. Keeping costs low allow the company to keep margins reasonable whilst surviving the economic hardships in order to capitalise on the economic rebound.
- This can be seen by the rise of Shoprite as the largest African retailer, this company has invested in distribution and supply chain management systems for over twenty years, which helped them leapfrog Pick n Pay to be the largest local retailer.
- This would be a large investment at first, but it would certainly assist in controlling costs. Suppliers only have to deliver to one place, bringing down product costs. It also allows Zinga to control what is sent, how much is sent and where it is sent in order to ensure the most efficient means of supply chain management. It also lowers the risk of being out of stock which customers do not enjoy and reduces potential sales.
- This centre should be placed in a central position, but it should be placed closest to the most demanding area of stores (stores that require stock the most in frequency and amount).
- This would certainly positively affect the company's bottom line with cost savings and increased sales from less out of stock situations.
- The real issue would be ensuring it is not too capital intensive and that Zinga has the sufficient capacity to oversee such a large project. It could perhaps be outsourced to a large extent, to ensure the project is sufficiently capitalised, and effectively implemented without long delays. The correct systems and methods would need to be chosen, and professionals should be consulted to ensure the best is chosen at the best value for money.

<u>3. Acquire GBC</u>

- Given the intense competition and negative economic story line, it would be highly suggested to diversify the product offering and entering into a more defensive market segment.
- Kids clothing is more defensive than adults, as parents are widely known to put their kids needs before their own. These clothing items also outgrow children much faster, which ensure the clothes are purchased more frequently than normal. Kids clothing is also seen as a more compelling gift to buy than for giving clothing to adults, adults usually buy gifts for kids in the

form of clothing. There are more reasons to buy kids clothing.

- The major competitors, Truworths and The Foschini Group have both started diversifying into the younger market segments as testament to the segment's strength.
- This market segment is also known to command higher margins and passing on inflation is easier. Less fabric is used in kids clothing and more products fit into containers/trucks (cutting costs), however prices are often similar or more than adults clothing.
- This acquisition could ensure Zinga easily increases revenue in a sustainable manner.
- It worth it given the company can acquire GBC at an attractive price. If the deal could be reasonable it would certainly add value.
- It is also in the retail space, it is not uncommon to Zinga's leadership.
- The addition of 35 stores would increase Zinga's reach. It could also be determined if some stores could be consolidated in the same malls/shopping centres, meaning less operating expenses for Zinga for possibly the same/similar sales. Zinga could also sell GBC products/brands in existing stores and vice versa in some areas, this could also increase potential sales.

<u>4. Sell Sala headwear range through other groups (store in store)</u>

- This could be a viable option in order to increase revenue without much effort.
- Given that Zinga has the master license (the agreement/license would need to be inspected to ensure this is plausible), it could sell the well-known products by entering into agreements with other groups.
- It would be suggested to approach groups that are not direct competitors of Zinga, perhaps Massmart (in Game stores) or Shoprite (in Checkers Hyper stores) who also have major reach to the consumer. This could allow Zinga to increase retail footprint rapidly at a significantly smaller cost than opening new stores.
- A reasonable profit arrangement/split would need to be negotiated with the other group.
- This also does not take much effort/focus away from running the core competencies of the business.
- Store in store concepts have not proven very successful for Edcon, with TopShop and other brands. It was very expensive and has not yielded great results for either parties. Self cannabilism took place, and thus my suggestion to approach none direct competitor groups.

5. <u>New store openings in selected African countries</u>

- Africa is a very difficult trading environment. Economic hardships are worse in most cases that South Africa.
- Many South African companies have ventured into Africa with little success. Tiger Brands and Truworths recently exited Nigeria which cost them hugely. MTN's shock fine also made companies realise that the legal framework is important.
- Most African nations are suffering economically. However the growth fundamentals are still there. East Africa is still growing due to them not being reliant on resources. However these countries are very far and logistically could prove very difficult.
- This option would need to be carefully considered before attempting.
- Namibia and Botswana is still growing and economically healthy. It would be advisable to enter Botswana and Namibia initially, as they are both close enough and if Zinga builds the distribution centre in Gauteng, it would certainly add more value.
- There is also a Free trade agreement within Southern Africa, which include Botswana and Namibia, this could certainly ensure easier and cheaper moving of goods to these countries.
- This would certainly need good skills and knowledge of the area to implement successfully, but Truworth's largest revenue producer outside South Africa is Namibia. This means it is possible for Zinga to do the same.
-

6. Add another 15 Zinga stores and 10 H&S stores in South Africa

- Given the intense competition and difficult economic climate in South Africa, I would say this is perhaps not the most important option to focus on.
- It can be seen from the comparable sales growth, that current established stores are not producing much growth each year, and that new stores have been providing most sales growth. This is however not sustainable and it should be asked whether the extra store openings will contribute sustainable revenue growth.
- Concentrating the company's product offering in one geographic region would also not be wise, and diversification into other regions and even other product offerings (such as GBC) would be a better option at this point in time.
- With the new international competitors coming in to the local marker, it has been evident that they are driving the rental space significantly higher and signing longer leases, making it more difficult for Zinga to obtain affordable space. There is also not much more retail malls/space being added to the country given that South Africa has the sixth most malls in the world, with many seeing it as oversaturated with mall space.
- Perhaps it would be easier to expand H&S stores, given less competition and less space required, given that it is beneficial from a capital budgeting point of view.

7. Increase our market share while competitors focus on offshore expansion.

- Even though competitors are focusing on offshore expansion (for good reason), they would certainly not give up focus of their local operations. Their local operations are still the most significant part of their business and a loss of market share impacts them significantly, giving more reason to believe their focus will not be off the local market.
- It was noted in recent news articles that the competitors such as Foschini and Truworths have not shifted all their focus, but they are seeking better growth opportunities.
- This would indicate that Zinga should also consider this offshore expansion option, should a viable opportunity be sought.
- This would be the least important opportunity given the current situation and the reasons above.

There are also two major trends in the industry to take note of. The first trend is the rise of instant demand from the consumer and the rise of "fast fashion" in response. Zara has been a major pioneer in this area. The consumer has access to social media and the internet, from which they can all see major global trends and fashion all over the world. This means that the consumer does not want to wait six months for the trendy garments to hit the shelves. The fast fashion trend is a model where retailer get items in store fast and react to demand quick, this is also known as the quick response system.

Zara has adopted a major technological system where they have fashion scouts who go to fashion hot spots all over the world, take pictures and send them to a design team who analyse the trends and adapt for commercial use. This is then sent to the producers who get a sample immediately made, and production starts the same day. Zara is known for getting the products into store within two to four weeks of taking the pictures or designing an item.

Zara also have a live data system where they analyse sales at every store, to ensure that the right items are delivered to the right stores in the right quantities. They also adjust production rates according to live demand. Zara have an inter store logistical system where they move goods between stores in close proximity to ensure the right quantities are held the right stores. This allows Zara to have very little inventory build ups.

The other trend is consolidation in the industry. Many retailers are purchasing other groups in order to consolidate their positions in the market and increase efficiencies. This can be seen with

Truworths buying Naartjie and Earthchild. This is a very intense industry and consolidation is the natural route to follow. The acquisition of GBC is therefore a good option to consider.

I would highly recommend Zinga explore these trends and adapt where possible to remain relevant to the consumer.

A good suggestion would be to consult with management consultants who are experienced in this field. I am no professional but I do think the information I provided is of a good standard.

I sincerely hope this addresses your requirements sufficiently. Please feel free to contact me for any further information or queries.

Prepared by: Financial Accountant.

There were numerous impressive aspects to this candidate's response:

- Strong evidence of industry research which was relevant;
- Convincing arguments for the top 3 strategies; and
- Linking analysis from part (e) - opening new stores not a viable long-term option because of limited growth at existing stores.

This candidate would be an asset to zinga in its strategic deliberations.

**Competent**

To: Harry Mnisi
From: Financial Accountant
Date: 17 November 2016
Re: Growth Strategies

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This memorandum seeks to rank the 7 growth strategies identified by management as part of their presentation to First Regional Investment Bank, with reasons, as well as to identify and explain two of the major trends in Consumer behaviour and Retailing that Zinga needs to be aware of.

***1) Ranking of 7 growth Strategies identified by management:***

1. Starting own distribution centre
2. Acquiring GBC
3. On-going investment in Online Channel and Collaboration with other retail channels
4. New store openings in African countries
5. Sell Sala headgear range through other groups (store within store concept)
6. Increasing market share in RSA while competitors expand offshore
7. Potential for more stores increasing both Zinga and H&S brands

*Starting own distribution centre:*

- South Africa is currently experiencing tough economic times. Price increases are sky high, and consumer spending is declining due to high levels of unemployment, increasing inflation and interest rates. Consumers are therefore likely to reduce spending on fashion wear clothing, and as a result any significant increases in Zinga's operational costs are unlikely to be passed on to their customers.

- Starting Zinga's own distribution centre would lead to cutting out the outsourced costs of distribution, and gives Zinga the opportunity to managed these costs themselves more effectively. This will place less pressure on EBIT and cost savings can be passed onto customers.
- Profits cannot always be generated through increasing sales volumes and numbers, therefore this ranks as a top priority in all the growth strategies.

*Acquiring GBC:*

- Such acquisition will lead to exposing Zinga to a whole new target market that they currently do not cater for, and will therefore diversify the business model within the existing retail industry.
- This has been ranked at 2nd as sales cannot always be increased within the same target market due to the current high market concentration, however diversifying can ensure large increases in sales growth, especially where South Africa has such a high growth rate in young population.

*On-going investment in Online Channel and Collaboration with other retail channels*

- In this modern day and age, technology is rapidly changing. Up to date websites, cell phone applications and collaboration with other retail channels allows Zinga to compete with the likes of Truworths, Foschini and Mr Price who's online sales are growing significantly.
- Such investment will ensure that Zinga maintain and grow its current online presence, and will lead to increase sales. Moving away from traditional stores to online sales will emphasise cost savings (and less expensive than leasing more stores, staff costs etc), and may also provide significant data to predict trends and manage inventory.
- As this may lead to an improvement in Zingas market position, drive down costs and provide greater data for which to predict fashion trends and buying patterns, this has been determined to be a high priority of 3.

*New store openings in African countries:*

- Zinga currently only operates within South Africa. A number of closest competitors have already opened new stores across Africa and seen significant returns. As the market in South Africa is potentially saturated (as evidenced from declining total sales per new store openings - in my sales analysis performed 16 November 2016), opening new stores within Africa may be the strategy to follow to ensure continued growth in revenue.
- As the standard of living increases in Africa, and with its nearest countries to South Africa following similar fashion trends as in South Africa, this poses an opportunity for significant growth in a market that other South African retailers are only beginning to tap into.
- For the above reasons this has been ranked as a highly significant growth opportunity.

*Sell Sala headgear range through other groups (store within store concept):*

- The store within store concept may lead to increased sales numbers, and increased awareness of the brand amongst consumers. Such venture would not lead to significant capital outlays but rather a commission % arrangement that is far less risky.
- The head gear range is however a rather limited market when compared to the retail market in general and as Zinga is looking to expand operations and invest significant cash into such

expansion, this growth opportunity is only ranked as 5th priority.

*Increasing market share in RSA while competitors expand offshore:*

- As noted above, the retail market within South Africa is rather saturated, with competitors already seeking to explore growth opportunities overseas. It would be unwise for Zinga to completely ignore the opportunity of growing stores in an untapped market that is only now being explored by competitors.
- If Zinga were to wait until its competitors have already expanded into Africa, they may lose the opportunity to grow sales significantly and have a further African footprint. This is particularly relevant as average store revenue appear to be declining as further stores are opened within South Africa. Therefore this opportunity has been ranked as 6th.

*Potential for more stores increasing both Zinga and H&S brands:*

- As noted above, the market appears to be rather saturated. Revenue growth per store is on the decline as Zinga opens more and more stores. This is likely due to Cannibalising of their sales.
- From the above there are numerous other alternative growth strategies that would not result in Cannibalised store sales and should therefore potentially be pursued before opening more stores within South Africa.

***2) Major trends in consumer behaviour and retailing:***

The below trends have been identified apart from those above, that Zinga must be aware of and adapt their strategy to:

<u>2.1) Sales made to customers on credit - consumer behaviour:</u>

- The general economy in South Africa is under pressure. As noted above, consumer spending is on the decline due to high unemployment rates, inflation, interest rates that entered an upward cycle, increased cost of living and low growth in consumer income.
- This therefore has resulted in a major trend of customers seeking to purchase both necessities and luxuries on store credit, to improve their cash flow and make such purchases accessible.
- Zinga currently does not provide store credit, and sales are made 100% cash. A significant number of key competitors sales are derived from credit purchases (only Queenspark does not provide store credit). This therefore indicates that there is the potential to introduce store credit in order to drive sales in this tough economic climate.
- Zinga should look to providing customers with store credit, after implementing stringent processes and controls to minimise the likelihood of non-recovery of amounts.
- Although there are negatives to such trend (including bad debts, increased recovery costs, downward pressure on cash flows), the positives are more than likely to outweigh these negatives - this is as Revenue would significantly increase per customer, as they are no longer refined to spend what they have now, but rather leverage their future income to purchase immediately.
- As Zinga is currently struggling to maintain increasing levels of Revenue per Store, this trend in consumer behaviour is likely to result in significant increases in Zinga revenue without significant capital outlay.

<u>2.2) Overseas purchasing of inventory - retail behaviour:</u>

- Competitors are tending more towards purchasing their fashion wear inventory overseas. This is as there is a significantly larger variety of products that are available globally. Further, they are able to purchase the goods at a much lower cost than local producers are able to supply.

- Foreign suppliers have the latest technology, improved efficiencies and are leading in safety and industry best practices. These are but some of the benefits that Retail giants have come to discover with importing a significant amount of their inventory from overseas.
- Zinga currently purchase most products from South African suppliers due to the shorter lead times and lower import duties. Although buying local does have its advantages, buying a significant amount of higher quality inventory overseas at a cheaper rate would certainly be advantageous for Zinga. This therefore represents a major trend in retail behaviour that Zinga should be aware of, and potentially adapt its inventory buying to.

Based on the above analysis, there are a significant number of growth opportunities for Zinga to explore, not only to increase revenue, but also to keep costs at a minimum and to pass on these costs to consumers. Zinga must keep up to date on the major trends in consumer behaviour and adapt their strategy appropriately in order to capitalise on the benefits of these trends.

Thank you.

The ranking of strategies was compelling although reasons could have been expanded upon. The evidence of industry research was also impressive. This was a competent attempt, which was slightly marred by the two trends listed. There are many more pressing issues and trends than credit sales and offshore procurement.

**Limited competent**

Memorandum

To: Board
From: Accountant
Date: 16 November 2016

<u>Growth opportunities</u>

The objective of this memorandum is to provide a list of the growth opportunities that should be prioritised by zinga Fashions.

1. Establish our own distribution centre

- This will improve significantly or lead time and limit our reliance on third parties
- This will allow us to introduce Just In Time inventory approach which will limit overstocking
- Improve customer satisfaction and give is a competitive edge

2.Increase market share

- This growth opportunity can be attainable as indicated majority of our competitor retailers are now focused on moving their brands to the Europe and Australia. This could be an opportune time to increase our brand presence and improve market share

3. Expansion into Africa

- The South African market has become highly competitive especially with the entry of international clothing retailers in the market
- Economic growth rate in South Africa has been significantly low, with it growth expectation

decreased to 0.5% in November.

- Need to consider other markets to increase our sales

4. Online Channels

- This is determined to be the way of shopping the future as it is fast and easy
- To improve our growth prospects for the future we will need to invest in this.
- The online channels for selling in South Africa have not reached the levels of the West.

5. Acquiring GBC, kidswear business

- This will increase or customer base, resulting in an increase in sales
- Encourages brand loyalty as the kids who purchased GBC clothing may later purchase adult clothes from zinga

6.Opening new store in South Africa

- The opening of new stores should result in an increase in customer levels and increased sales.
- The new Mall of Africa can also be considered as a mall where we may open new stores both zinga and H&S.

7. Sala headwear

- Partnering with other brands may drive traffic and improve our profits

<u>Conclusion</u>
These are the growth opportunities identified in terms of priority.

This attempt was at risk of being assessed as lower than LC. The reasons for rankings were not apparent – no convincing arguments or reasons were provided. The task was to identify which strategies zinga should pursue to deliver long-term value. The CFO would not have been impressed with this response.

The candidate also failed to complete the task and list two major trends in retailing and consumer behavior. This alone would result in the candidate being assessed as lower than C. The lack of depth in the rankings ultimately made it irrefutably a LC.

*PART (g)*

*(g) Respond via email to Harry Mnisi's queries in document K.*

**DOCUMENT K**

**EMAIL FROM HARRY MNISI TO FINANCIAL ACCOUNTANT**

| | |
|---|---|
| **From:** | Harry Mnisi |
| **Sent:** | Wednesday, 16 November 2016, 07:59 AM |
| **To:** | Financial Accountant |
| **CC:** | |
| **Subject:** | Cost of sales |

Hi again

You will recall our earlier discussion where I mentioned to you that Sally and I are wondering whether our GP% is actually comparable to that of the listed groups, because they might be including certain income and expenses in different line items. I re-read IAS 2 yesterday and I am not sure that I agree with all of the principles from a management decision making and control perspective.

I have three specific issues:

(a) **Storage costs** – IAS 2 states that we should exclude these from the cost of inventories. That makes no sense from a management decision making and control perspective. Our business is seasonal and we need to order and store large quantities of products every couple of months. The cost of storage is inextricably linked to the cost of merchandise – to include these costs in other operating costs would not be reflecting the true cost of our merchandise.

(b) **Inventory write-offs** – IAS 2 requires us to include the obsolescence allowance, inventory write-offs and shrinkage in the cost of inventories expensed. To my mind, inventory write-offs are the result of poor planning by the fashion buyers. So why should sales be punished for higher inventory costs when the fashion buyers made the mistake? I would prefer to reflect inventory write-offs as a separate line item in other operating costs in our monthly management accounts. Also, inventory write-offs are so easy to manipulate from year to year – we can vary our procedures for identifying slow moving inventory and achieve a different GP%.

(c) **Royalties** – IAS 2 states that royalties paid to our foreign suppliers (we have numerous licencing agreements with foreign brands) be included in the cost of inventories. Royalties are paid when we sell products and not when we order and store merchandise. If we do not sell the merchandise, we do not pay royalties. I think we should reflect royalties paid as a selling expense in our management accounts.

I would like your thoughts on where żinga should reflect the above costs in our monthly management accounts. Obviously we will need to comply with IFRS for our financial reporting purposes but we do not have to manage our business using illogical principles.

Please could you double check that I have interpreted IAS 2 correctly for the above three items.

Thanks once again! I'm sure things will get quieter as soon as the audit is done.

Regards
Harry

## Highly competent

Question (g)
To: Harry Mnisi
From: Financial Accountant
Subject: Cost of sales

---

Hi Harry

I hope you are well.

Thank you for your enquiry regarding the determination of cost of sales.

I have prepared an attachment for your perusal on the matter. Please find it attached to this email. If you have any further questions on this, I would be happy to assist you.

Kind regards

Financial Accountant

**Cost of sales attachment**:

It is important to note that IFRS is only applicable to external reporting of financial figures. Therefore when applying the definition of IAS 2 Inventories to the below mentioned costs, these requirements are only for reporting externally.

Management accounts are to be maintained in accordance with the judgements of management at Zinga, and therefore for management accounting purposes, where the judgements of Zinga differ to the requirements of IFRS, management must keep track of these differences to be able to ensure that for financial reporting purposes, compliance with IFRS is achieved.

***Accounting treatment:***

IAS 2 states that the cost of inventories shall comprise all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their ***present*** location and condition.

When applying the definition to each of storage costs, inventory write-offs and royalties, the following can be noted:

***1) Storage costs:***

- Large storage costs incurred for inventory that is bought in bulk every two months are incurred and do relate to the inventory specifically. However, per the definition of IAS 2, only costs incurred in getting the inventory to its present location can be capitalised in the cost of inventory and subsequently recognised in cost of sales when sold.
- As the storage costs are incurred after the inventory has been received and is sitting in the warehouse (ie: its present location), for external reporting in line with IFRS, the costs can not be capitalised to inventory & subsequently brought to cost of sales when inventory is sold.
- Further to this, IAS 2 explicitly excludes the cost of storage as part of other costs, unless necessary in the production process before a further production stage. As this is not applicable, your application of IAS 2 in this instance is correct, and the costs may not be capitalised.

***2) Inventory write-offs***:

- Per IAS 2, inventory should be shown at the lower of net realisable value, and cost. Therefore any write downs due to obsolescence and shrinkage should be brought to inventories corresponding cost of sales account.
- Therefore your application of IAS 2 is correct, and these write offs of inventory should be taken to cost of sales.

*3) Royalties:*

- Although IAS 2 does not explicitly include royalties in the cost of purchase of inventory, when applying the definition, it includes other costs that are directly attributable to the acquisition of the finished goods. If royalties were to be paid up front when the goods were received, they should be included in the cost of inventory and subsequently brought to cost of sales when sold. However, as these costs are only incurred when the product is sold, for financial reporting purposes there is no obligation to include these costs in the cost of inventory and subsequently in cost of sales. Therefore for financial reporting purposes, the cost should be included as a selling expense.
- From this, I therefore do not agree with your application of IAS 2, and would recommend that the costs are recognised as selling expenses for financial reporting purposes.

***<u>Management accounting treatment:</u>***

*1) Storage costs:*

- I would tend to agree with you on this matter. For management accounting purposes, it is important to include in cost of sales those costs of storage that relate specifically to inventory that has been sold during the year. This would therefore better reflect the timing with corresponding sales that have been made during the year.
- It is however important to note that when performing the adjustment to management accounts for analysis by management, that comparing the GP% to Zinga's competitors would not be comparing apples with apples. This is as their records will be per IFRS and therefore will not be adjusted for this.

*2) Inventory write-offs:*

- I do not agree with your statement that sales would be punished for higher inventory costs. The costs would be included in cost of sales and therefore would not touch on the sales account.
- I also do not agree that the expense should be included as a separate expense line item outside of cost of sales for management accounting purposes. This is as the cost is inextricably linked to poor planning on behalf of the purchasing department, and would lead to sales that are made at a lower price. Therefore the sales are inclusive of the poor planning of management, and thus in my opinion the expense should also be included in the cost of sales for analysis of gross profit margins.
- Further to this, I do not believe that the management accounts would be significantly effected by this adjustment, as the provision for obsolete stock amounts to only 6% of inventory balance at year-end (R131m x 6% = R7.86m), and is only 0.95% of total sales for the year.

*3) Royalties:*

- I tend to disagree with your recommendation that the royalty expense is included in the selling expenses rather than in cost of sales. As the expense is variable on the number/value of sales made, for management accounting purposes it would be beneficial to include the cost as part of cost of sales for analysis. Failure to do so would distort the GP%, as it would not be reflective of the cost to sell the products.

To summarise, it is important to apply the definitions within IAS 2 strictly to meet financial reporting requirements, and to be comparable to other retailers for analysis of GP%. However, management accounts may be adjusted to take into account what management believe relates to separate line items, and items that should be included in cost of sales. Although this is at management's discretion for internal reporting purposes, the above recommendations have been made on the treatment for the most relevant and useful internal reporting analysis.

What impressed about the response is the balanced approach taken by the candidate. A short extract from IAS 2 highlight the essence of the issues under consideration. Then addressing each aspect from an IFRS perspective and then from a MDMC perspective.

The candidate shows a clear understanding of IFRS requirements and the different application for Management Decision making purposes. Also showing a keen understanding of the necessity of industry comparisons.

**Competent**

From: Financial Accountant
Sent: Wednesday, 16 November 2016, 15:00pm
To: Harry Mnisi
Subject: RE: Cost of sales

Hi Harry

Trust you are well.

Thank you for providing me with the opportunity to assess your queries on the IAS 2 costs. Below I have assessed your interpretation of each of the three issues:

1. Storage costs:

IAS 2 allows for costs incurred in order to bring the inventories to their present location and condition. Thus the costs to bring the items from the wholesaler till the relevant store it is been purchased from would in essence be the present location and condition. The storage costs incurred by the individual stores would not be cost of sales as they can be sold from the store. The storage costs however incurred from a distribution centre would however be regarded as cost of sales as the goods are not necessarily in the present location and condition. As with Truworths costs relating to depreciation, employment, occupancy and operating costs for transport and distribution are included in cost of sales. It would thus show the benefit of obtaining a distribution centre instead of holding excess inventory at stores as well as ensuring better management of inventory in purchasing the correct quantities so that items are not on the shelf life long. If such storage costs were to be allocated to inventory, it would be hard to quantify at what point in time what stock was there and how much actually related to storing that item.

I do believe it would be useful to include the costs in cost of sales in the management accounts if they can be quantified as it would show if possibly storing the items are resulting in huge costs, the company could then consider having better deals with suppliers to deliver as needed and not hold excess quantities in store.

2. Inventory write-off

The inventory write-off stems from IAS 2 requiring inventory to be measured at the lower of cost and net realisable value. In essence costs of inventory cannot be carried at a value in excess of what they are expected to be realised at, thus from a statement of financial position perspective you would be overstating your assets. In order to decrease the value, an expense need to be processed. If we do not include the write-off in cost of sales we would in essence be showing users of the financial that the cost of the goods sold is less than it actually was.

Inventory write-offs are not necessarily as a result of poor planning by buyers, write-offs include expenses relating to damaged goods or obsolete inventory. It must be remembered that fashion buyers are part of the entity, even if the write off is due to them purchasing at a high price which can't be sold or too large quantities, the entity incurred these costs at the end of the day to sell or get rid of the stock. It would be useful to show these costs separately in management accounts in order to see the true correlation of the cost to revenue and if gross profit margins are been attained. The write-offs can then be assessed separately based on the occurrence of them, such as considering evaluating fashion buyers on the write-offs incurred.

3. Royalties

IAS 2 requires costs incurred in bringing the goods to its present location and condition. The foreign suppliers that provide the merchandise would most probably not have supplied these goods had we not agreed to pay the royalties. Thus the royalties are a necessary expense incurred in order to bring the goods to its present location and condition. The costs incurred are important to be included in cost of sales as they are a true expense in the cost prior to sale, thus when comparing costs of local versus foreign suppliers we would need to include the royalties or else we are not showing the true reflection of the cost incurred. I do not see how we could include these as a selling expense separately seen as we are only incurring them because we obtained specific foreign suppliers. These should be included in obtaining management report gross profit margins.

It should be noted that management accounts do not need to be consistent with IFRS. Thus as mentioned it could be useful to indicate storage and inventory write-offs separately. For financial reporting purposes we need to look at the true nature of the expense and whether it was actually incurred to obtain the stock or is it merely excess costs incurred which can be saved through other ways.

Please feel free to request any further details on the above.

Thank you for your time in advance.

Kind regards
Financial Accountant

The candidate covered the aspects of IRFS application very well for each of the three aspects. We would have like a stronger attempt at the application for management decision making and control. This was a competent attempt addressing both aspects required in the task.

 

**Limited competent**

From: Financial Accountant
Sent: Wednesday, 16 November 2016, 02:00 PM
To: Harry Mnisi
Subject: Re: Cost of sales

Good day Harry

I have a re-look at IAS 2 and what it says about the different cost elements to be included in the valuing of inventory and what you have concluded above it correct.

Storage cost is not a cost that is incurred to bring the inventory to its current location and condition,that is why it is excluded.

I also did some industry research on what the other major retailers in the market is saying in the financial statements.

Truworths had the best accounting policy ......." cost of sales includes all cost of purchase, cost of conversion and other costs incurred in bringing the inventories to their present location and condition. Cost of purchase includes purchase price, royalties paid, import duties and other taxes, as well as relevant depreciation, employment, occupancy, and other operating cost relating to transport and distribution. Inventory write downs are included in cost of sales when recognised. ...."

All the other player in the industry had similar policies.

With regards on how to present the cost in our monthly management account I have the following suggestions.

We want to ensure that management at all times have the same number in mind when talking to people inside the organisation as well as outside the organisation.

Thus I believe we need to report the same number for cost of sales in our financial accounts as in our management accounts, not to confuse management.

In the financial statements we currently only show one number for cost of sales.

However, for management account we need to break it down into the different components

We can have cost of sales broken up into:
- Purchase price
- Royalties paid
- Inventory write-offs
- Import duties
- Transportation cost
- etc.

This will then also create the opportunity for us to reconcile our management accounts to our financial accounts.

This will assist us in providing better commentary to the market as well as management. We will further be able to identify cost elements that start to increase more than what we expected and start to investigate those.

Storage cost should then still be a separate cost on our management accounts. This will highlight the cost for better management.

Should you which to discuss any points further you are welcome to contact me

Kind regards
Financial Accountant

The candidate did not adequately respond to the task. No opinion, together with reasons, is expressed regarding the financial accounting treatment of storage costs and royalties. Lower of cost and NRV is ignored.

The focus on accounting policies of competitors was interesting but provides little guidance to zinga. The suggestions for internal reporting are not properly explained and management will struggle to comprehend what the purpose of the report is. Stating that MDMC treatment should be the same as that for financial accounting purposes is too convenient and may be construed as insulting the intelligence of management?

 