ASSESSMENT OF PROFESSIONAL COMPETENCE

NOVEMBER 2018

EXAMPLES
OF VARIOUS LEVEL OF COMPETENCE
IN EACH OF THE TASKS

HOW TO USE THE EXAMPLES

This report has been compiled from selection of scripts that demonstrated the level of competence in each task, which the examiners felt fairly represent the expectation for the level of competence in each task.
It is important to refer to the examiner comments on the APC for 2018 to assist in understanding the task before referring to the specimen examples below.
The examples are taken directly from candidate scripts, no effort is made to change anything on the examples, including spelling, grammar and errors.

TASK (a)	
(a)	Respond to Travis Jagger’s email by drafting a memorandum regarding *IFRS 16 Leases* as requested.

Highly competent (HC)

To: Travis Jagger
From: Junior Disruptor
Date: 21/11/2018
Subject: RE: Leasing

Good morning Travis,

Thanks for the very engaging task relating to the leases the company has, more than happy to help. Please find attached the draft memo for you to review, I have also attached my Excel workings if you want to get a more in-depth understanding of how I put together the table in the memo.

If you have any concerns or notes to update the memo, please let me know and I will be happy to take care of it.

Kind regards

Junior Disruptor

Attachment:

To: Board of Directors:
From: MHG Finance Team
Date: 21/11/2018
Subject: Impact of IFRS 16 on MHG Operating Leases

This memo serves to provide background, understanding and the high level impact to the financial statements of MHG with the adoption of IFRS 16 that will be effective from 1 January 2019, and therefore will need to be applied for MHG's FY2020 Annual Report.

Background of why IFRS 16 is applicable to MHG
The new standard that is coming into effect will have the most significant impact to any company that has a relatively high number or dependence on operating leases. MHG currently has entered into operating lease for all 10 hotels that is operates throughout the country.

The reason this standard is relevant and is coming into effect is to address prior years of dissatisfaction from investors and users of financial statements who have had great difficulty in comparing companies who rely on entering into leases to support the majority of operations. This is due to the fact that under the old standard, IAS 17, companies who acted as lessees with 'finance leases' were required to recognise the actual asset they were leasing on their statement of financial position with a corresponding liability for the payments that will be due over the lease term; however under 'operating leases' which MHG has entered into there is no requirement to recognise a similar asset or liability, and to see the effects through the income statement in the form of straight-lined lease expenses.

User of financial statements saw this as a form of off-balance sheet financing because operating leases kept the assets and liabilities off the statements reflecting the appearance of a more flexible statement of financial position. The effect of IFRS 16 is to recognise that operating leases do provide an asset that the lessee benefits from, and will follow a similar process to a finance lease now by recognising a 'right of use' asset (not the actual underlying asset) and corresponding liability on the statement of financial position.

To illustrate the difference and resulting impact to MHG of the adoption of IFRS 16, a worked example has been provided below using a hypothetical operating lease (not an actual lease currently held).

Example of impact to financial statements upon adoption of IFRS 16

Below the example has been summarised by illustrating the year on year balances and impact under IAS 17 (current standard) and then under IFRS 16 (incoming standard), with a summary of impacts in the subsequent table:

The following information is assumed for the below scenario:

1. Operating lease with 3 year term, option to renew for further 2 years.
2. Annual payments at the end of each year:
   - Initial payment: R1.1 million
   - Annual increase: 8%
3. Fair value of property assumed to be:
   - At inception of lease: R13.5 million
   - At end of lease term: R12.5 million

IAS 17 vs... IFRS 16 Impact Analysis

	At inception R'000	**Year 1 R'000**	**Year 2 R'000**	**Year 3 R'000**	**Year 4 R'000**	**Year 5 R'000**
Total Assets IAS 17	nil	nil	nil	nil	nil	nil
Total Assets IFRS 16	4,821	3,857	2,893	1,929	964	nil
Difference	**4,821**	**3,857**	**2,893**	**1,929**	**964**	**nil**
Total Liabilities IAS 17	nil	(191)	(293)	(301)	(206)	nil
Total Liabilities IFRS 16	(4,821)	(4,204)	(3,435)	(2,497)	(1,360)	nil
Difference	(4,821)	(4,013)	(3,143)	(2,196)	(1,154)	nil
Impact to Profit IAS 17	nil	1,291	1.291	1.291	1.291	1.291
Impact to Profit IFRS 16	nil	1,446	1,385	1,308	1,214	1,100
Difference	**nil**	**156**	**94**	**17**	**(77)**	**(190)**
% Difference	**nil**	**-12%**	**-1%**	**0%**	**+6%**	**+15%**

Notes to the table:

4. The lease term has been taken as 5 years as it is MHG general practice renew all leases.
5. IAS 17:
   - The impact to profit is the straight-line expense of the lease payment, determined as the sum of all lease payments divided by the lease term (5 years)
   - The liability balance each year is the cumulative effect of the difference between the actual lease payment and the straight-line expense.
   - No asset is recognised in line with the standard, MHG does not control the building.

6. IFRS 16:
   - Relevant discount rate assumed at 10% per annum, this is a market-related interest rate for new borrowings. In practice MHG leases would be assessed using the company's weighted cost of capital or incremental cost of borrowing.
   - At inception the right of use asset and lease liability are the same at the present value of the five lease payments due over the lease term.
   - Right of use asset is decreasing annually by straight-line depreciation of R964K p.a.
   - Liability is decreasing by the net of the annual lease payment and unwinding of interest at 10% p.a.
   - The impact to profit it is the sum of the fixed depreciation charge above and the interest expense (decreasing annually).
7. Percentage impact is negative showing where IFRS 16 results in a higher expense to MHG and positive where the impact is lower compared to IAS 17.

Conclusion
From the above scenario, it can be seen that over the total lease term the impact to the actual profits and earnings of MHG is nil, the difference lies in the year on year impact to profit due to the difference between the straight-line expense practice under IAS 17 and the depreciation and interest expense combination recognised under IFRS 16. With regards to the statement of financial position, under IFRS 17 MHG will benefit from a boosted asset base by recognising the right of use asset, however the corresponding liability must be brought on too for the minimum lease payments which will be substantially higher at inception compared to the operating lease accrual which is currently recognised under IAS 17. Ultimately, there should be a negligible impact to net assets through the adoption of IFRS 16, but shows a more fair representation of the assets in use and how they are being financed by MHG.

Task (a) Information per the example

Lease term:	3	years
Renewal period:	2	years
Total lease term:	5	[C2+C3]
Payments due:	Annualy	
First payment:	1100000	
Annual increase	8%	
Initial FV	13500000	
End of lease FV	12500000	

Initial Workings

	T1	**T2**	**T3**	**T4**	**T5**	**Total**
Annual Payment	1100000	1188000	1283040	1385683	1496538	6453261

IAS 17 Workings

Straight-line expense	1290652				
	T1	T2	T3	T4	T5
Lease accrual Mvmt	190652.2	102652.2	7612.211	-95031	-205886
Lease accrual Bal	190652.2	293304.4	300916.6	205885.6	6.98E-10

	T0	**T1**	**T2**	**T3**	**T4**	**T5**
Total Assets	**0**	**0**	**0**	**0**	**0**	**0**
Total Liabilities	**0**	**190652.2**	**293304.4**	**300916.6**	**205885.6**	**0**
Impact to profit	**0**	**1290652**	**1290652**	**1290652**	**1290652**	**1290652**

IFRS 16
Workings

Assumed WACC is incremental cost of borrowing:

Market-related interest rate 10%

		T1	T2	T3	T4	T5	Total Value of Minimum Lease Pmts
PV of each lease pmt		1000000	981818.2	963966.9	946440.3	929232.3	4821458
Amortisation table		OB	Interest	Payment	CB		
	T1	4821458	482145.8	-1100000	4203603		
	T2	4203603	420360.3	-1188000	3435964		
	T3	3435964	343596.4	-1283040	2496520		
	T4	2496520	249652	-1385683	1360489		
	T5	1360489	136048.9	-1496538	0		

Annual Depreciation	964291.5						
	T0	**T1**	**T2**	**T3**	**T4**	**T5**	
Total Assets	4821458	3857166	2892875	1928583	964291.5	0	
Total Liabilities	4821458	4203603	3435964	2496520	1360489	0	
Impact to profit	0	1446437	1384652	1307888	1213944	1100340	
Differntial Impact							
Total Assets	4821458	3857166	2892875	1928583	964291.5	0	
Total Liabilities	4821458	4012951	3142659	2195604	1154603	0	
Impact to Profit	0	155785.1	93999.66	17235.7	-76708.7	-190312	-1.9E-09
% Impact to Profit	0	0.120703	0.072831	0.013354	-0.05943	-0.14745	

Examiner Comments

In addressing the task, this candidate demonstrated a high degree of professional competence. Firstly, they provided the Board with some context providing precise and relevant explanations to enable the Board to understand why operating leases are now capitalised.

The candidate answered the task in the following manner:

- A table is provided with numbers based on the hypothetical example for the five-year lease term showing the impact on total assets, total liabilities and profit for the year under both IAS 17 and IFRS 16;
- Brief notes are provided explaining the table; and
- A comparison is done for the total assets, total liabilities and profit for the year and a difference is calculated in numerical terms between IAS 17 and IFRS 16.

Most of the technical principles and calculations are correct as follows:

- The operating lease accrual is reflected as a liability under IAS 17;

- The right-of-use asset decreases with depreciation to a value of nil at the end of five years;
- The lease liability reduces to a value of nil at the end of five years;
- The profit under IAS 17 reflected the equalised expense under IAS 17, whilst the profit under IFRS 16 reflected the depreciation and finance charges; and
- The lease payments were escalated by 8% annually and were taken into account as such in the time value of money calculation.

The candidate states that the company's weighted average cost of capital can be used as the relevant discount rate. This is incorrect, as the weighted average cost of capital is after tax and not necessarily the incremental cost of borrowing. Further there is some duplication between the workings and the tables provided in the memorandum. However, these errors are forgiven as there are other high-level application indicators in the response.

Overall, the task was addressed in a professional and highly competent manner and Travis would be pleased with this response.

Competent (C)

FROM: Junior Disruptor
TO: Travis Jagger
DATE: 21 November
SUBJECT: RE: Leasing

Good Morning Travis

I hope you are well this morning.

I think that using an example will definitely best illustrate the possible impact of the adoption of IFRS 16 to the Board.

I have attached a memorandum to summarize the impact of IFRS 16, using the terms and condition in your email.

I hope that the memorandum also addresses your concerns mentioned in your prior email in regards to the comments made by the CEO of a large listed company in the Business Day article. As you can see in the memorandum implementing IFRS 16 - this implementation will not result in an increase of 150% in the lease expenses recognised as noted by the article. The depreciation and interest expense will basically amount to the same amount as what was allowed to be deducted by the lease expense under IAS 17.

Please review the attached memorandum and contact me if you have any further questions or points you would like to discuss.

Kind regards
Junior Disruptor

ATTACHMENT (TASK A)

INTERNAL MEMO

TO: Travis Jagger
FROM: Junior Disruptor
DATE: 21 November
SUBJECT: IMPACT OF ADOPTION OF IFRS 16

IMPACT OF ADOPTION OF IFRS 16

The impact of the adoption of IFRS 16 using the following terms and conditions:

8. A 3 year lease with an option to renew for 2 years
9. Annual lease payments at the end of the year. Starting with R1,1 million at the end of year one and escalating yearly with 8%.
10. The initial property value is R13,5 million and the property is estimated to be worth R12,5 million at the end of the lease (after 3 years)

<u>IAS 17 vs. IFRS 16</u>

Please refer to calculation in attachment 1 (Task A).

	IAS 17	**IFRS 16**
Impact on the: a) **Total assets (excluding cash)**	Under IAS 17 there was no lease liability or right of use asset recognised for a operating lease. The only amounts that could have an effect on the assets of MHG would be prepayement's of leases and a straighlining of leases asset (although this would mostly be an liability)	*At initial measurement*: A right of use asset will be recognised equal to the lease liability plus any cost incurred to acquire the lease and the present value of dismantling costs expected. *Subsequent measurement:* These hotels are owner occupied and will therefore be classified as right of use asset under Property, Plant and Equiptment. The right of use asset can therfore be carried at either *- cost or* *- revaluation model* in accordance with IAS 16. Since MHG does not own any property they will not be able to carry the right of use assets at fair value as the revalution model is only available if an entity owns a similar class of Property, Plant and Equiptment. The right of used assets will

		therfore be carried at cost less depreciation and impairment. The depreciation will be discussed with the effect on the income statement.
b) **Total liabilities**	Under IAS 17 there was no lease liability recognised for a operating lease. The only amounts that could have an effect on the liabilites of MHG would be accruals of lease payments and a straighlining of leases liability.	*At initial measurement*: A lease liability will be recognised at the present value of the lease payments. *Subsequent measurement:* The lease liability will be measured using the effective interest rate and adjusted for all lease modifications and revised payments. The lease liability will increase with the interest accrued over the year and decrease with the capital payment received.
c) **Profit for the year**	The lease payments were expensed on a straightlining model.	The lease payments will be apportioned between interest and capital - and therefore there will be no operating expense under IFRS. There will however be depreciation recognised for the right of use asset. The depreciation expense in my calculation have been straighlined over the period of the lease. In my example attached I used the 3 year term. Ther will also be interest expense recognised that has accumulated on the lease liability.

CONCLUSION ON THE IMPACT OF IFRS 16 FOR MHG

It is important to note that the terms and conditions used in this illustrative example and that most of MHG's lease terms allow for maximum renewals of up to 10 years and therefore this would change the calculations a little.

There would not be a significant impact for MHG as we would apply the cost model as we do not currently own any property.

IFRS 16 would lead to an increase in the initial expenses that will reduce over the years as the interest expense will reduce with the lease liability. This expenses will therefore not be straighlined as in IAS 17.

This will also impact the following ratios of MHG:

11. EBITDA - this will most likely increase as the interest expense will be smaller than the lease expense under IAS 17.
12. Debt / Equity ratio - this will lead to our debt to equity ratio increasing which could have significanmt effects sind the 6vcvf loan will become repayable if this ratio exceeds 50% adn this could also effect other financial institutions considerations when we apply for a loan.

In conclusion this will most likely not have a material effect on MHG and could have benefits if MHG decides to expand and acquire some property of their own.

<u>Attachment 1 (task A)</u>

1	**IAS 17**	**Year 1**	**Year 2**	**Year 3**	
	Straighlining of lease				
	Rent paid (cash)	1,100,000.00	1,188,000.00	1,283,040.00	=previous year x 1.08
	Total paid	3,571,040.00			=SUM all 3 years)
	Straighlined	1,190,346.67			= total paid / 3
	Income Statement				
	Rent expense	-1 190 347	-1 190 347	-1 190 347	
	Balance sheet				
	Straigtlining asset / (liability)	-90,346.67	-2,346.67	92,693.33	=rent expense + rent paid
2	**IFRS 16**	**Year 1**	**Year 2**	**Year 3**	
	Rent paid (cash)	1,100,000.00	1,188,000.00	1,283,040.00	=previous year x 1.08
	Total paid	3,571,040.00			=SUM all 3 years)
	Lease liability				
	CF0	0.00			
	CF1	1,100,000.00			
	CF2	1,188,000.00			
	CF3	1,283,040.00			
	Discount rate	0.08			
	PV	3,522,749.82			
	Lease liability initialy recognised	3,522,749.82			

	Lease liability at end of year	2,440,363.57	1,264,565.39	- 12,151.79	
	<u>Interest rate implicit in lease</u>				
	assume .05%				
	Right of use asset	3,522,749.82			=lease liability
	Depreciated over 3 year	1 174 250	1 174 250	1 174 250	= righ of use asset / 3
	Right of use assert at end of year	2,348,499.88	1,174,249.94	0.00	
	Income Statement				
	Depreciation	1 174 250	1 174 250	1 174 250	
	Interest Expense	- 17,613.75	- 12,201.82	- 6,322.83	=lease liability in at start of year * .05%
	Total expense on income statement	1 191 864	1 186 452	1 180 573	
3	**IMPACT ON MHG**				
	Income statement				
		- 1,517.02	3,894.91	9,773.90	

Examiner Comments

Overall, the candidate demonstrated a good understanding of the principles of IAS 17 and IFRS 15. The candidate addressed most of the task by providing a table in his/her workings of the impact on total assets, total liabilities and profit for the period for IAS 17 and IFRS 16 separately, accompanied by some explanations and an overall narrative conclusion of the impact.

Although a good response, the following aspects of the attempt detracted from the quality of the response:

- The layout of the table in the workings was not as logical and clear and in some cases difficult to follow;
- The analysis does not compare the total assets, total liabilities and profit for the period under IAS 17 and IFRS 16 directly. Instead, the table analyses the effects of IAS 17 and IFRS 16 separately;
- There were some technical errors, which are forgivable, such as a three-year lease term was used, when it should be five years; and
- Some aspects of the response were a bit technical, but still understandable by the Board.

Overall, this attempt displayed the required competence in completing the task at hand.

Limited competent (LC)

[Company letterhead] [Draft]

Memorandum
From: The Chief Financial Officer
To: The Board of Directors
Subject: IFRS 16: Leases
Date: 21 November 2018

A. **Introduction**

This memorandum seeks to address the financial impact of IFRS 16: *Leases* on Millennial Hotel Group (MHG). The memorandum will make use of a basic example in order to provide an illustration on the accounting standard. Lastly, a comparison of the new accounting standard to the previous standard, IAS 17 will be explained with the implications of each.

B. Background

IFRS 16: Leases was issued by the International Accounting Standards Board on 1 January 2016. The implementation date for is on or after 1 January 2018, with earlier adoption permitted if IFRS 15: Revenue from contracts with customers has also been applied. The change comes into play for companies that has a lot of operating leases and requires that these be now capitalised (recognised) into the financial statements.

The following terms will be explained as in respect to leases.

B.1. Definition of a lease
In terms of the Accounting standard IFRS 16: Leases, a lease is a contract that conveys the right to use an asset for a period of time in exchange for consideration. The asset must be an identified asset and there must be a right to control the use of the identified asset. The standard also provides that an asset is typically identified if it has been explicitly specified in the contract, i.e. the signed contract between MHG and the company conveying the right to us to use its asset must specifically state the asset that is being leased, for MHG, the most useful detail that would confirm the specified asset would be the address of the building that is being leased.

B.2. Right to control use of asset
The customer (in this case MHG) has the right to control the use of the asset when it has the right to obtain substantially all the economic benefits from the asset and determine the what, where and when the output is produced. In the case of MHG, we use the building to operate our hotel from. An alternative building will not be sufficient and we can choose the manner in which the hotel should operate in terms of our operational needs, its physical appearance also for operational requirements, the events which can be hosted therein as well as the guests that can occupy the hotel at a point in time.

The definitions as per above will result in there being a lease as defined by the accounting standard and therefore, a right of use asset and a lease liability must be recognised in the

Statement of financial position, causing a substantial increase in the assets and liabilities of the company.

C. Illustration

The attachment to this memorandum (please refer to Appendix A) provides an illustration of the application of the new accounting standard, also providing a comparison to the application of the previous accounting standard (IAS 17).

The following illustrative lease terms and conditions, which are typical to MHG and its business, have been applied:

13. A three-year lease term with the option to renew for two years
14. The frequency of lease payments has been assumed to be annual, with the first lease payment at the end of year 1 assumed to be R1 million, which escalates by 8% per annum
15. The initial property value has been assumed to be R13.5 million and property will deemed to be worth R12.5 million at the end of the lease.

The following provides an explanation of the calculation performed:

1. Lease liability

The lease term was deemed to be 5 years on the basis that MHG is most likely to extend the lease as there are currently no means to source more funds through raising debt (loan financing) and thus, no planned purchase of a building is likely to arise. We have also considered the scarcity of financial and other economic resources (e.g. cash) that would fund relocation of the hotel should the lease be cancelled).

The incremental borrowing rate (interest rate) has been assumed to be the escalation rate as per the terms and conditions, of 8%.

Using a financial calculator, we have applied the time value of money principles in order to determine the value that exists as at today of the liability (total debt payable to the company providing the building to us for use). This amounts to R16 472 336.53.

2. Right of use of asset

The right of use asset was determined by calculating the sum of the initial cost of the lease liability (calculated as per above) and any other appropriate costs incurred by the company in respect of the lease.

This calculation is performed in order to determine the amount at which to capitalise the right of use asset as required by the accounting standard.

3. Finance costs

As previously explained, the lease liability is in general form, a debt that is payable on an annual basis to the lessor. Therefore, an interest expense will be payable on the debt on an annual basis as the lease term is active. The rental expense of R1 000 000 (increasing by 8% per annum) will be replaced by a depreciation expense that will most likely be lower based on the accounting policy of the company and the revalued amounts per annum.

Based on the calculation per Appendix A, a total amount of R7 739 930.03 will be paid in interest.

4. Depreciation

The right of use asset will be depreciated in accordance with the accounting policy of MHG in order to account for the unwinding of the cost thereof which occurs through use of the asset. This, in terms of our policy, will be at the revaluation model and the depreciation expense will be recognised in profit or loss.

5. Lease asset and lease liability

In terms of the previous standard, IAS 17, a lease asset and a lease liability will be recognised at the commencement of the lease at the lower of the fair value of the asset (R13 500 000) or the present value of the minimum lease payments (R16 472 337).
This therefore indicates that there will be a lower asset and liability being recognised.
6. Finance charges

In terms of IAS 17, the lease payments are apportioned between the finance charges and the reduction in the total debt owed. The calculation performed therefore is to determine the total amount of interest charges to be recognised in the profit or loss for the year.

7. Depreciation

Depreciation expense would be recognised on the lease asset as well as any impairments as per IAS 36 which deals with the reduction in the recoverable amount of the asset due to factors other than the unwinding of its estimated useful life.

D. **Conclusion on the impact of the impact of IFRS 16 for MHG**

The overall impact of IFRS on MHG will be on the key financial ratio, debt/equity ratio due to the increase in the carrying value of assets and liabilities. This may result in an increase in the debt to equity ratio which may result in MHG being in breach of the covenant held with 6CVCF. The increase in the ratio will also make it more difficult for MHG to acquire new funding through debt.

Also, the application of the accounting standard results in an increase in the current liabilities (debts settled within the next 12 months or less) while the assets stay constant. This may result in an increase in the current ratio and result in the company appearing to have a deteriorating solvency and liquidity state.

There will be no change in the asset turnover as sales will remain constant while rental expense of R1 000 000 (increasing at 8% per annum) is replaced with depreciation.

The earnings before interest and tax as well as Earnings before interest, tax, depreciation and amortisation will likely increase as rental expense will be replaced with depreciation and interest expense. If we were considering issuing new shares or selling the business, these ratios are often critical that investors will consider in the valuation of the company.

E. **Conclusion**

This memorandum addressed the impact of IFRS 16 on the MHG and its financial statements.

IFRS 16

1. Lease liability

Lease payments not yet paid at commencement date	
Year 1	1000000
Year 2 (1000000 multiplied by 1.8)	1800000
Year 3 (1800000 multiplied by 1.8)	3240000
Year 4 (3240000 multiplied by 1.8)	5832000
Year 5 (5832000 multiplied by 1.8)	10497600
Interest rate	8%
Using HP 10B 11+	
N = 3	
I = 8	
CF 0	0
CF 1	1000000
CF 2	1800000
CF 3	3240000
CF 4	5832000
CF 5	10497600
I = 8	
Compute PV	16472337

2. Right of use of asset

The right of use asset will be calculated as follows:	
Cost (initial amount of lease liability)	16472337
Lease payments made to lessor before commencement of lease	0
Lease incentives received	0
Initial estimate of restoration costs	0
Initial direct cost incurred by MHG	0
Total value of right of use of asset	**16472337**

3. Finance costs

Using HP B11+ Calculator

CF 0	0
CF 1	1000000
CF 2	1800000
CF 3	3240000

CF 4	5832000
CF 5	10497600
I = 8	
Compute PV	**16472337**
Second function Amort 1-1	1317786.92
Second function Amort 2-2	1432209.88
Second function Amort 3-3	1537066.67
Second function Amort 4-4	1660032
Second function Amort 5-5	1792834.56
	7739930.03

	Lease liability opening	**Interest**	**Lease payment**	**Lease liability CB**
Year 0	0	0	0	16472337
Year 1	16472337	1317787	1000000	16790124
Year 2	16790123.92	1432209.88	1800000	16422334
Year 3	16422333.8	1537066.67	3240000	14719400
Year 4	14719400.47	1660032	5832000	10547432
Year 5	10547432.47	1792834.56	10497600	**1842667**
		7739930.03	**22369600**	

IAS 17

5. Lease asset and lease liability

At commencement of lease

Fair value of leased asset	13500000
Total PV of minimum lease payments	16472337
Thus, lease asset and lease liability will be the lower of the two, being	13500000
Difference in the impact of the AFS on the initial measurement	-2972337

6. Interest expense and lease payments

The lease payments made on an annual basis will be apportioned between the interest charges and the reduction in the total debt owed.

Thus, this will be as follows:

	Interest charges per the debt owed	Lease payment	Interest expense
Year 1	1317786.92	1000000	317786.92
Year 2	1432209.88	1800000	-367790.12
Year 3	1537066.67	3240000	-1702933.33
Year 4	1660032	5832000	-4171968
Year 5	1792834.56	10497600	-8704765.44
			-14629669.97

Examiner Comments

Overall, this attempt did not display the required competence in the task.

The candidate addressed the definition of a lease in detail. This was not relevant in the context of the problem on the day. It was clear that this was a lease and the focus was on the financial impact of lease capitalisation.

The candidate did not provide sufficient context or explain at a high level the reason for the introduction of IFRS 16. In the information on the day, it was indicated that the Board was struggling to understand why the operating leases must all of a sudden be capitalised. There was opportunity to provide some context about why IFRS 16 was introduced and to also link it to the problem which was introduced in the pre-release information.

The candidate made the following errors in his/her computations which raised serious doubt about his/her technical understanding of lease accounting:

- The candidate accounted for the lease as a finance lease in terms of IAS 17 and not an operating lease;
- The candidate used the escalation rate of 8% as the incremental borrowing rate, which is incorrect;
- The rental expense is stated as R1 000 000. This incorrect as it has not been straight-lined;
- The candidate states that in terms of IAS 17, a lease asset and a lease liability would have been recognised. This incorrect because the lease would have been an operating lease. Further, the discussion about interest charges and depreciation in terms of IAS 17 is also incorrect;
- The 8% escalation factor has been applied incorrectly in the time value of money calculation; multiplying the lease payments by 1.8 instead of 1.08;
- The lease-term is indicated as N = 3, while the five cash flows are presented. The reasoning given for the lease term does not make sense. The reason should be that suitable properties are not easy to find;
- The lease liability balance does not come to zero at the end of the five-year lease term; and
- tTe candidate does not illustrate the financial impact of IFRS 16 on total assets and profit for the year for the full lease term.

Overall, the technical inaccuracies coupled with a lack of pervasive skills in the manner of presentation means that this attempt cannot be put forward to the Board in this condition and the task would be referred to another individual to re-perform.

TASK (b)	
(b)	Respond to Travis Jagger's email regarding the fair value assessment of the Sandton property.

Highly competent (HC)

From: Junior Disruptor
Sent: Wednesday 21 November 2018, 10:38 AM
To: Travis Jagger
Subject: Re: Leasing (again!)

Hi Travis

I hope that you are well.

I have some initial comments to make/add to the thoughts that you have expressed in your email, before I provide my review of your spreadsheet as well as any concerns.

IFRS 16 Adoption:

In terms of IFRS 16 and the effective date of adoption, you are correct in saying that FY2020 is the year that we will have to adopt the new standard, as it is our first financial year end starting after the effective date of IFRS 16 being 1 January 2019. I would like to indicate to you, that we do have the option of early adoption for the standard, and could adopt the standard for use in our FY2019 annual financial statements. This is a consideration that you can put forward to the board, at the next board meeting, bearing in mind the costs of adoption (implementing new systems and costs to investigate the required terms of our existing operating leases) and training that the accounting staff will have to receive in order to correctly account for the new standard.

IAS 1- Faithful Representation:

I would also like to mention the requirement of IAS 1 in terms of faithful representation of the financial statements of MHG, in line with the qualitative characteristics of useful financial information. This would encompass the use of IFRS 16, as well as the disclosure requirements of IAS 8. IAS 1 stresses that the financial statements and relevant disclosures must be made to faithfully represent the economic reality of the business, and that accounting policy choices should be made in line with this, rather than for the benefit of more attractive financial measures and net asset value calculations. I would stress that the use of the revaluation model under IAS 16- PPE as an accounting policy choice, must be done in the interest of more faithfully representing the economic reality of the firm by providing information that is relevant and free from any potential bias.

Use of Revaluation Model:

I would also like to raise to IFRS 16 provides the accounting policy choice to use the revaluation model for PPE (IAS 16), provided that the class of asset (hotel buildings in our case), is currently accounted for using the revaluation model. In my time at MHG, I have yet to come across any property currently accounted for in lines with IAS 16's revaluation method. Can you confirm if this policy is currently implemented? If it is not, I believe that we may not be able to revalue the hotel leases in line with IAS 16, due to this provision in IFRS 16. We can confirm this at a later stage.

Review of Fair Value Estimate of Sandton Hotel Property:

In terms of my review of your estimates and related concerns, I have applied the following principles/standards from my academic background:

- IFRS 13- Fair Value standard. This will address the method that you have used to value the building, in line with the requirements for any fair value that is included or disclosed in a company's financial statements.
- Cash flow principles in performing a valuation through use of a discounted cash flow model.

Concerns with your Fair Value Estimate:

Based on the above and your attached excel spreadsheet, I have the following concerns, that I will link to your notes when applicable:

General:

- You have implemented a discounted cash flow model, in line with the income method in IFRS 13, to estimate the value of the property. Due to the uniqueness of the hotel, I agree that this is the most appropriate method in IFRS 13 to value the property on. Sandton is over-saturated with hotels, and thus the replacement cost method is not appropriate, and due to the unique nature of hotels, the market method is furthermore not appropriate.
- The unit of account (IFRS 13) is the right of use of the hotel.
- The best and highest use is operating the land and building as a hotel.
- You have included some irrelevant/non-cash flow items in your statement that are inconsistent with the discounted free cash flow method. I will address these later.

Line item Specific:

Note 1: Agreed that the lease renewal period should be considered, however if there is any current remaining period outstanding in the original lease, this should be considered as well in the evaluation. For instance, if there are 3 years remaining, with a renewal period of 10 years to likely be chosen, then the valuation should encompass the next 13 years of discounted cash flows.

Note 2: I am concerned with the use of 5% as an annual inflation rate being applied to both expenses and revenue items. I am happy that expenses can be grown at inflation (no capacity increases), as the CPI will directly affect the expenses that the firm will incur.

- However, I believe that revenue should not be grown at inflation. Per our historic financial information, it is apparent that average room rates per night growth has slowed down dramatically.
- By dividing accommodation revenues by paid guest nights, I have calculated average room rate per night at approximately R1343, R1360, and R1400 for 2016, 2017 and 2018 respectively.
- This corresponds to 1.2% rate growth in 2017 and 2.9% rate growth in 2018.
- It is thus unrealistic to expect average room rate per night growth of 5%, when the past two years have been below 3%.
- I would expect these rate growth rates to remain low due to the current macroeconomic environment. Perhaps 2.5% would be a more conservative and accurate room rate growth rate to include.

Note 3: MHG already has above average occupancy rates in the South African hotel industry. The current average for a similar 3/4 star hotel is around the 60% mark.

- I have concerns that although our current c.70% occupancy rates may be sustainable, that despite any renovations that may take place, that occupancy rates above 75% may be unrealistic and unsustainable (from 2020- onwards in your schedule).
- Furthermore, your days per year and reflective occupancy rates do not factor in rooms that will be unavailable when the hotel is being renovated. This would have a large negative impact on revenues and occupancy rates when the renovations take place.
- Furthermore, if you include the revenues from future anticipated renovations, you will also have to include the capital expenditure estimates as cash outflows in the years that the renovations take place in.
- I would suggest all that plans for renovations are stripped out of the cash flow valuation, and that the occupancy rates are kept constant. It will be very difficult to explain the link between renovations (and a better product) and occupancy rates, with such a forward looking stance (2022).

Note 4: Size may not be an appropriate cost driver on which to allocate expenses. I would recommend that you perform an activity based costing exercise, to determine what the correct cost driver is per expense category that you have listed in your cash flow.

- I would then project expenses based on the individual cost drivers that drive the expenses. This would more accurately and relevantly depict the true future expenses that would be incurred if this building/hotel was run on a stand-alone basis from the rest of the company.
- It is highly important that the hotel must be valued as an independent asset, at its best and highest use, rather than as a profit centre in the MHG group.

Note 5: I have concerns with the assumptions you have used for booking channels in your projections.

- The hotel and tourism industry is currently experiencing a shift in traditional booking methods, from directly booking on hotel websites and through estate agents, to more booking off Online Travel Agencies (OTA's)
- This is due to OTA's offering loyalty programmes (with a portfolio of hotels around the world), that individual hotel groups and traditional travel agents simply cannot offer.
- Furthermore, millennials (our target market) are more comfortable and accustomed to using OTA's (with an ever increasing trend), due to ease of use, simplicity and loyalty programme offerings.
- I believe that this form (allocated 30% in your model), will comprise a much higher percentage of total bookings in the future and will increase each year.
- We would need to assess how the market is predicting these changes, and apply increasing proportions to this booking channel as time progresses.
- I would also potentially consider the effect of utilising AirBnb, as it is likely that this channel will be used in the future.

Note 6 and 7: With no further information on the current margins achieved for food and beverage revenues and sundry and shop revenues, I cannot list too many concerns.

- I would like to mention that food and beverage margins may not be sustainable at 35% (assuming current margins), due to increasing food and beverage costs, due to petrol price increases, inflation and sugar taxes to name a few. It is highly unlikely that MHG will be able to pass all these cost increases on to the client, and should thus project diminishing margins going forward.

Note 8: There is great risk when including fewer employees into your forecasts.

- My concern is firstly that we aren't entirely sure whether we can reduce the staff compliment for the following reasons:
- Labour laws,
- Reputational damage due to retrenchments and not employing enough staff/creating enough jobs,
- Whether the business can be run with fewer staff (operational reasons).
- It is thus more prudent to not reduce the staff compliment going forward, as there is material uncertainty as to whether this will be possible/ethical in the projected period.

Note 9: Including the lease payment is correct, as this is the relevant cost and cash flow, notwithstanding any future changes to accounting standards.

Note 10: I have no concern with increasing maintenance costs as the buildings get older. However instead of increases at 5% for 5 years and then at 9% going forward, I would recommend increasing the rate of growth of this expense more gradually over each year, as this will more accurately predict future cash flow consequences.

Note 11: I have a concern with the discount rate that you have used. The average annual yield in the SA property market is not the correct rate to use.

- The correct rate would be the weighted average cost of capital (WACC).
- The WACC would accurately be calculated by multiplying MHG's after tax cost of debt and cost of equity, by their target debt/equity weightings.
- Cost off debt appears to be 8%,
- Cost of equity would be calculated by the Capital Asset Pricing Model.

Other concerns:

- I am concerned by the inclusion of depreciation and amortisation in the cash flow forecast. These amounts are non-cash flow related expenses, and should thus be removed from the forecast as they are irrelevant to the valuation calculation.
- I have noted that there is no taxation cash outflow that has been included. As this is a relevant cash flow to valuing the building on the income method, it should be included in the valuation. This would be determined by utilising Income Tax Act provisions against the projected incomes and expenses in your schedule.

I hope these points and concerns raised have been helpful. Please don't hesitate to contact me if you have any further questions or concerns.

Kind Regards,

Junior Disruptor

Examiner Comments

Travis Jagger may be hesitant to ask this candidate to comment on his workings in future. Instead, he may simply ask the candidate to do the task himself/herself! The candidate’s response was nuanced (just enough detail without delving into technical detail) and comprehensive. A very impressive response indeed.

We were impressed with the tone of suggesting that MHG should account for economic reality without attempting to inflate assets in its financials. This was impressive. The candidate was not suggesting Travis was doing anything wrong but rather that MHG should adopt the highest ethical standards with regard to financial reporting. SAICA needs more members who embrace these values.

Other aspects that were impressive about this candidate's response:

- The reference to pre-released information (accommodation revenue growth) and comparison to the cash flow forecasts;
- Evidence of pre-research regarding average industry occupancy levels;
- Questioning the forecast revenue growth post renovations while warning that occupancy levels may in fact decrease during the renovation period;
- Insightful comments re the percentage of OTA bookings and the behaviour of millennials;
- Discussing the practical difficulties of reducing headcount;
- Recommending that WACC be used as the discount rate;
- Identifying that non-cash items were included in the cash flow forecasts; and
- Recognising that taxation needed to be included in the forecasts.

An excellent attempt in a simulated real-life environment.

Competent (C)

From:Junior Disruptor
Sent: Wednesday 21 November 2018
To: Travis Jagger
Subject: Leasing and valuations of assets

Good day

I looked at your valuation and noted down some comment/concerns regarding your valuation and ideas on the revaluation of these right to use assets.

Given the subjective nature of the valuation methods there is a bit of leeway in determining the fair value of a property. It is common for one property to be valued by different appraisers and for each appraiser to come up with different values. The valuation of properties for companies are usually performed by independent appraisers and the independent appraisers may have slightly different views on the property.
I recommend we get a professional property appraiser to do the appraisal for us on the property.

We will measure our property according to the IAS 16 standards. The fair value of assets are determined by IFRS 13.

We can decide if we want to be on the cost model or on the revaluation model according to IAS 16.

According to IFRS 13 there are three methods to value assets and we need to apply the method that will be the most realistic method to determine the value of our properties.
IFRS 13 also state we should value our property according their highest and best use.

With the Sandton property situated in Sandton an economic centre point for South Africa we may consider using the market approach to value the property.

But I agree the income based approach used in your valuation is the best way to value the property. The other approach in IFRS 13 is the cost approach.

We will have be spot on with our valuation because the auditors will focus and test our valuation amount in detail, as revaluation income might be seen as a risky area.

<u>The following are a few comments I have on the valuation:</u>
(I tried to number my comments the same way you numbered your notes in the valuation.)

2)
Looking at our JAWS ratio I am not sure if the 5% increase in revenue/income per year is the correct increase to use, the latest increase in revenue was 0.5% , and the expenses was 5.1%. This indicating that our expenses is growing by inflation but maybe our revenue is not growing by inflation.
We will have to get a better understanding on what the increase will be in the future, according to some articles read by auditing firms the hospitality industry is bound to grow, but we also need to keep in mind that there are new entrants into the market like AirBnb, and we don't know exactly what the impact of competitors and new entrants to the market will be.

3)
The occupancy rate might be a little high because of the fact that our occupancy rate in 2018 was 69% and in 2016 it was also 69% thus the 71% might be a bit high. This ratio will have a huge impact on our valuation, thus we need to be sure of what the most relevant occupancy ratio is to use.
The industry occupancy ratio for hotels is closer to the 60% and that also might be an indication for our percentage to be little high.
Even though we are planning to do big renovations in 2022 it might seem to optimistic for occupancy to increase to almost 80% in 2028.
And also something to remember usually when there are renovations done at hotels for the period of renovation the occupancy will decrease at the hotel.

On the renovation point, I do not se where we included the renovation costs in our calculation. As this will have a significant impact on our costs that year we will need to include that in our valuation.

4)
The size of the hotel is a good indication of the allocated expenses, but just to keep in mind expenses between Cape Town and Sandton might be different in some areas. So we will have to consider getting a more accurate indication of our expenses for the Sandton property.

6&7)
We will have to look at the actual cost to revenue percentage for food and beverages, as mentioned above it seems that our expenses is increasing more that our income, thus we should be careful to link our expenses directly to our income. As natural disasters like the drought in Cape Town and other water shortages we might see our expenses for food and water increase substantially more in the following years than our revenue.

8)
I understand that we are aiming to go more technology driven and thus aiming for less employees, we should just consider the following surrounding employees, the more tech driven we get the more experienced staff we will have to hire thus also increasing our costs, so we might have to revisit the drastic decrease in your calculation for employee costs.

11)
The discount rate to use in valuations need to be the weighted average cost of capital for the company, thus the 4.3% is to low.
We will have to do a detailed calculation to determine our correct discount rate.

Some extra comments not directly related to specific notes:
Depreciation and amortisation is not a cash flow, thus not to be included in the valuation.
We can definitely discuss some of the comments I made above, or if you don't agree with me please don't hesitate to contact me so that we can discuss this.

In our IAS 8, new accounting standards note we will just have to remember that we will have to disclose the related liability to.

But I again want to raise the comment that we should maybe get an expert to do our appraisal for us, this will be someone independent to the company and will help us to estimate the value of the property most accurately.

Kind regards

Examiner Comments

The introductory remarks in the email are succinct and does not delve too deeply into technical accounting jargon. The candidate did not question what was being valued, namely the hotel property, the property itself or the right of use asset. This is forgivable as the remainder of the response was more than competent. The reference to using a valuation expert is always a good idea.

The candidate provided some useful commentary on the forecast cash flows in a tone that was professional and not offensive. The reference to pre-released information (JAWS ratio and MHG's historical occupancy levels) indicates that the candidate was able to integrate information from multiple sources (pre-released information and information on the day) and this indicates good pervasive skills. Other insightful comments include suggesting that renovation costs be included and that WACC be used as the discount rate. In practice, the candidate should have been complimented on his/her attempt by Travis Jagger with some suggestions re areas for improvement.

Limited competent (LC)

From : Junior Disruptor
Sent : Wednesday 21 November 15:06 PM
To: Travis Jagger
CC:
Subject: Leasing (Again)
Attachment : **Attachment B**

Good Day Travis,

I hope you are well.

Thank you for the opportunity to discuss leases again with you, I have provided comments of your spreadsheet in the attached above.

Please have a look and inform me if there are any matters you would like us to discuss.

Kind Regards
Junior Disruptor CA(SA)

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Attachment B
Paragraph 35 From the standard states that we can use the Revaluation model for the right of use assets if it relates to a class of property, plant and equipment to which the lessee applies the revaluation model in IAS 16, however currently the entity doesn't have a class of Property which we use IAS 16 for, therefore before implementation, I would recommend that you may advise if we can move the Sandton building or one of the leased buildings to be owner occupied so that we can categorize the other leased building and value them in accordance with the revaluation model. If not then we will have to carry the buildings at Cost and this would not provide the additional funding with an improved balance sheet.

Anyway back to your question, please see below:

In terms of IFRS 13 Fair Value Measurement, there is a hierarchy to be used which has 3 levels for disclosure purposes. The categorisation within a level is based on inputs to the valuation techniques used to determine the fair value. IFRS 13 notes that valuation techniques should maximise the use of observable inputs and minimise the inputs of unobservable inputs.

Your valuation has been inputted using unobservable inputs whereas observable inputs are available for the asset being measured. This would immediately take the FV to level 3 which is the lowest level, however it doesn't mean that the quality of the asset is poor. The classification of the 3 levels is important because it increases the consistency and comparability of FV measurements. We can compute this valuation using observable inputs rather than discounting the cash flows.

Difference between observable and unobservable inputs:

Observable is publicly available information about actual events and transactions eg. Shares, Commodities
Unobservable is management's assumptions that cannot be corroborated with observable market data.

As there would be available market data for properties in Sandton which are being rented out, we could use those as they would constitute observable inputs rather than going straight to level 3 unobservable inputs.

Should we use Level 1 or 2 as they both use observable information:
*Level 1 is for an asset that has an identical asset, the price is unadjusted, quoted in an active market and the entity has access to the m*arket.
Level 2 is for a similar asset, the price can be adjusted, quoted in inactive market and price does not need to be directly observable but must be corroborated by observable market data.
There are similar buildings in Sandton, not identical because other buildings would differ in size and shape therefore we would need to adjust for these differences but the starting point will be the FV of the similar building ie. if parking spaceor the number of floors are different we would need to adjust these to reflect the building we are valuing. From your valuation you have not used a similar building, in Sandton there would be a market where we can corroborate market data that we can use and adjust for our building. There are number of properties in Sandton that are used as hotels although the frequency of transactions may not be that much to qualify as an active market but we can use observable market data of the fair value of those buildings which we can get over the internet or from property valuators. However is there is adjustments which are based on unobservable inputs and these can significantly affect the property's market price then this should go into the level 3 level.

Please provide more details for us to assess if we should go into Level 3 as I currently believe we should use the level 2 fair value level.

In your calculations you have used the following assumptions:

There are currently three valuation techniques under IFRS 13 ie. 1. Market Approach generated by market transactions involving identical or comparable assets. This is not the case with your valuation method as we don't have identical buildings which we would not need to adjust for our building. 2. Cost Approach this approach reflects the amount that would be required currently to replace the service capacity of an asset also not the case you have rather opted for the last method. 3. Income approach which converts the future amounts to a single current amount. In terms of IFRS 16 the following principles should govern the application thereof: Cash flows and discount rates should reflect assumptions that market participants would use when pricing the assets - You have incorporated market information in your discount rate as you have used the market yield in SA showing what market participants are willing to pay or get fro their investments in SA property,

Cash flows should take into account only factors attributable to the asset - Some of the cash flows are not attributable to the property ie bank charges should be excluded, interest expense for 6cvcf unless it was used to finance the property.

, to avoid double counting or omitting the effects of risk factors - all cash flows are before tax, discount rates should reflect the assumptions consistent with those inherent in the cash flows Inflation should not be used rather we can assess market trends and expectations regarding average room nights. The allocation based on size should we not rather allocate based on revenue or factors that drive expenses. 8% escalation is for the sandton building what are the escalation rates in the market? Cash flows and discount rates should be internally consistent. Discount rates should be consistent with the underlying economic factors of the currency which the cash flows are denoted. This is the case in your valuation as you have used Rands and all the rates used are applicable to factors affecting the Rand ie inflation rate used is for SA.

Examiner Comments
It was not apparent that the candidate understood what was potentially being revalued. It appeared that the candidate was discussing the potential revaluation of the Sandton property. The reality is that MHG does not own any of its properties and instead leases these. Hence, the right of use should be the focus of the discussion. This candidate embarked on an accounting theory dump. There was far too much detail on IFRS 13 principles and possible approaches to determining fair value. The actual task required a brief discussion of the context of the valuation and then detailed commentary on the spreadsheet provided by Travis Jagger. While some recommendations are provided towards the end of the candidate's response regarding principles re discounted cash flow valuations, these are generic and not specific enough to the scenario. We have a strong suspicion that this was a pre-prepared answer without considering the facts on the day of the APC assessment. In practice, Travis Jagger would probably ask someone else to assist in reviewing his workings. There was limited evidence that this candidate comprehended what was required, and therefore did not competently respond to the task.

TASK (c)	
(c)	Prepare the coaching/review notes for Jane Wyman, as requested by Brian Stewart, in order to achieve the objective stated in audit work paper DIR-01.

Highly competent (HC)

From: Junior Business Disruptor
To: Brian Stewart
Date: 21 November 2018

Subject: Internal audit queries - Coaching review notes and audit procedures

Dear Brian

I hope this email finds you well.

I have attended to your comments regarding:
1. Coaching review notes for Jane Wyman (Appendix A - Task C)
2. Procedures to be performed to ascertain the validity of the whistle blower's comments (Appendix B- Task D)

Please note I have provided my comments in two appendices to allow you to initially review my comments before sending them out to the respective parties. It may be useful to provide appendix B to Tshepo so that he can review the procedures in place to assess the likeliness of the occurrence of the allegations.

I hope you find the above in order. Should you have further queries or concerns, please do not hesitate to contact me.

Thank you and kind regards,
Junior Disruptor

Task C:
Appendix A - Review notes/ Coaching notes addressed to Jane Wyman for the attention of Jane Wyman

Please find below my initial assessment of the work performed by Jane including suggestions on improvements:

Overall comment:
You have identified valid audit procedures to address the detection of the misstatements in the loan account for the 2018 financial year however it appears that the procedures you have performed address only the following assertions on the loan account:

Procedure	Assertion addressed
Procedure 2	Accuracy/ measurement
Procedure 3	Accuracy/measurement, cut-off (to an extent)
Procedure 4	Accuracy/ measurement

As can be seen, you have covered the accuracy and measurement at which the loan balance is recorded at year end as well as the accuracy of the transactions recorded throughout the year, yet little consideration is given to the other assertions of Occurrence/Existence, Cut-off, Completeness and Presentation and disclosure of the loan balance in the financial statements.

Though you have correctly verified the amount, date and description of the transaction, this does not provide sufficient evidence that no material misstatements have occurred in the account balance. Your initial procedure to cast the general ledger account was correct as it enables us to ensure the account provided is accurate and agress to the records contained in the ERP system.

I would suggest extending the work you have performed to include procedures over the following areas:

Area of concern	Comment
Procedure 3 - already performed	You should design your procedures to include considerations as to whether the business rational for the transaction makes sense - i.e. Is the Director allowed to enter into such transactions and are agreements with MHG in place to authorise these transactions. This would assist in addressing the occurrence/existence assertion.
Procedure 3 Findings	
Finding 1: amount recorded is exclusive of VAT. (There is no evidence indicating whether you have considered that the recording of the vehicle exclusive of VAT is appropriate)	Finding 1: More work should be performed regarding the recording of the vehicle purchase excluding VAT. In terms of the VAT Act, input VAT is not claimable on a motor vehicle. Further the amount owing by Tshepo for the motor car is a liability balance and should thus include Vat. i suggest you obtain evidence why the VAT input was allowed or if an error was made. I also suggest you perform work over the inclusion of the purchase of the vehicle as a fringe benefit in the employee tax calculation on a monthly basis as Tshepo is allowed the right of use of the vehicle.
Finding 2: Transfer of furniture and fittings	Further work should be performed to ensure the furniture and fittings have been transferred at the correct carrying amount and whether this transaction was authorised. Further was the asset correctly derecognised form the fixed asset register?
Finding 3: Credit card recordings	More work should be documented regarding the appropriateness of the recording of the amounts inclusive of VAT in terms of the VAT Act. Also perform more work over ensuring the credit card charges are recorded in the correct

	financial period as the date the charge goes through on the credit card may not correspond with the date of the underlying transaction). Note that the description states that the expenses were incurred on behalf of the company. Please ensure the nature of these expenses do infact relate to company expenses otherwise MHG will be reimbursing Tshepo for personal expenses.
Hotel accommodation (support: memo from Tshepo)	The internal memorandum provided by Tshepo is not sufficient appropriate audit evidence for the transaction. This should be supported by an external invoice of some sort indicating the value of the transaction. It should also be determined whether the transaction was authorised by the board of directors.
Insufficient work has been performed over the employee tax treatment over the transactions.	As These transactions entered into with Tshepo appear to be in his capacity as an employee, a number of the transactions represent fringe benefits to Tshepo. It needs to be ensured that where applicable, these transactions are included in the employee tax monthly calculation to ensure the correct employee's tax is withheld and paid over to SARS. Also whether these fringe benefits have been noted on the payroll system to be included in the IRP5 of the employee for income tax implications. (The valuation of the fringe benefit should also be checked in accordance with the Income Tax Act).
Validity of the transactions	The legislative implications of the transactions have not been considered. As a number of these transactions reflect financial assistance provided to a director, they are required to be approved in terms of Section 45 of the Companies Act. This section of the Act should be read and procedures designed to ensure the financial assistance extended have been authorised per a special resolution, meet the liquidity and solvency test etc.
Monthly payroll report (accuracy)	The accuracy of the monthly salary offset against the loan account should be verified to original documentation authorising the salary and not only the internally generated payroll report. It appears that no consideration has been given to the fact that the salary represents the monthly salary of Mrs Umculi. Evidence of the validity of this salary expense needs to be obtained.
Completeness of the loan account	No work has been performed to ensure all transactions have been recorded with the

	director. Please design procedures that involve reviewing minutes of directors meetings, bank statements etc. that could potentially indicate transactions with the directors that have not been accounted for.
Disclosure of the loan account	One of the assertions required to be addressed includes the presentation and disclosure of the loan account. As Tshepo is a member of key management, he is a related party. Please provide evidence that the disclosures for related parties have been considered in the financial statements surrounding the loan (IAS 24)
Ensure the underlying terms of the loan are correct.	I note that no interest is charged on the outstanding balance. Please obtain evidence that the loans are accounted for in terms of agreements with Tshepo such as the interest rate, terms of loans, any maximum limits on the loans etc. and design procedures to test these conditions.

Overall, the procedures documented by you were clear and concise, however a number of assertions were not addressed. Please update your procedures and work performed accordingly. Please note that the procedures are however not sufficient for use to make the conclusion that there are no material misstatements in the financial statements relating to the tested transactions and the loan balance. Further evidence would need to be obtained. Further, we cannot be absolutely sure that there are no misstatements as the nature of an audit if such that undetected misstatamenets may always exist - something to keep in mind in the future.

Thank you for your efforts. Should any of my comments not be clear or you require further direction or explanation, please contact me.

Examiner Comments

This candidate addressed the auditing and assurance as well as the taxation technical competencies in his/her solution. The candidate's solution dealt with both tasks (c) and (d) in one email but there was good contextualisation in the written response as to the rationale for this.

The marking team was particularly impressed by the depth in the review of the working paper by this candidate. There was a clear demonstration of the pervasive and critical evaluations skills examined in this task. Furthermore, the candidate's solution showed a depth in technical understanding. The coaching/review notes are detailed, clear, unambiguous and do not describe audit procedures.

In answering this task, the candidate presented coaching/review notes that also covered the breadth of issues in the working paper.

The following issues, identified and addressed, elevated this candidate's attempt to a highly competent:

- The need to assess the risk of material misstatement in the director's loan account and the inherent risks attached to director's loan accounts.
- The potential error in claiming an input VAT on the purchase of a motor car and the credit card expense.
- The normal tax consequences in terms of fringe benefits being granted to Tshepo Umiculi.
- Questions on why Mrs Umculi's salary is processed through the loan account.
- Risks of material misstatements in other areas of the 2018 AFS, such as the balance of furniture and fittings and whether the assets have been derecognised.
- The validity of entertainment expenses using the MHG company credit card.
- The Companies Act considerations.
- Related parties' disclosure.
- Recognising the need for further audit work to be performed on the completeness of the loan account.
- Questioning the rate of interest being charged on the loan account.

Competent (C)

To: Brian Steward
From: Me
Subject: Requests related to internal audit secondment

Good day Brian

Thank you for your email. I have reviewed Jane's audit workpaper and have some comments. I have attached these to the email for your reference first. If you are satisfied, we can just send it on to her.

She has done good and thorough work on the loan account. I think she is on the first track, but I do agree with you that she might need some guidance. Hopefully my comments can nudge her in the right direction.

With regard to the audit procedures on the whistle blowing: Please see my next email.

Kind regards,
APC Candidate.

Attachment: Notes on working paper DIR-01

Notes on working paper DIR-01

Good day Jane

I hope this email finds you well. I have reviewed your work on audit paper DIR-01 as requested by Brian and wish to offer you some coaching/review notes.

Firstly, I would like to congratulate and thank you for your good work. I can see that you have taken a lot of time and care to do the work required. Keep it up! Remember that your work as internal auditor is very important and should always be done with due care and diligence.

That being said, I have a few things to consider, as mentioned below. I have listed a number of questions for you to consider when doing your work.

I would encourage you to think a little further and to not only focus on what is right in front of you... Expand your scope a little. And remember that you as internal auditor are allowed - even expected! - to ask questions, even difficult and uncomfortable ones sometimes. I encourage you to take courage and to ask these questions, even if you are afraid.

The external auditors will most likely be focussing on the directors' loan accounts during their work. It is therefore very important to do some good work here, in order to smooth out any wrinkles before they come and, if possible, to help them to decrease the amount of work that they will have to do.

<u>Adequacy and appropriateness of audit work</u>

- You have not done any audit procedures testing the completeness of the transactions in the loan account. Remember that for completeness, one has to start at the beginning of the transaction (the source documents) and follow it through to the end (the GL) to ensure that it does indeed appear there.
- Obtaining a written representation about the balance is very good. Perhaps consider expanding that to include other areas of the loan account, eg. that he is aware of all the transactions flowing through the loan account.
- You could also consider doing some system checks, to ensure that the system posts all transactions correctly to this loan account. If you can rely on the system, you know that if the input is done correctly, the output will be correct. This could also be of use to the external auditors during their year end procedures.
- There are a number of large transactions. Are there any controls regarding authorisation for these transactions? If there are, you must remember to check that they were indeed authorised by the correct people. Also think about the requirements of the Companies Act: there has to be a special resolution for directors' loans. (Section 45)

<u>Scope of work</u>
- It is correct to look at the general ledger (GL) for the loan account. Just remember that this balance does not only appear here though. Think of other 'places' where this also appears, like the trial balance, to ensure that it is correctly reflected everywhere.
- What is the impact of this loan account on the AFS? Related party transactions require substantial disclosures. As Tshepo is also a director, this will have to be included in his remuneration disclosures. Remember to include this in your audit work.
- The memorandum of incorporation dictates what the company can and cannot do. I would suggest including a check in your audit work that these types of transactions are indeed allowed by the MOI.
- Keep in mind that we follow a two-entry accounting system - meaning that there is also another side to each entry. In some cases, it is necessary to check the other side of the entry and to ensure that the whole transaction has been correctly accounted for.

<u>Specific comments</u>
- Tax requirements

Most of these transactions have tax consequences, be it VAT or income tax, that can sometimes be quite complicated. You could include some tax checks in your work too, to ensure that the transaction is wholly correctly accounted for.

- Mrs Umculi's salary
Why is this included in the loan account? Is she an employee of MHG? Was this expensed during the year? These entries raise a few questions. If she was not an employee, she should not be paid on our books, as this would essentially just be writing off the loan account. Furthermore, why is it going through her husband's loan account? He is not receiving the salary. Was there any PAYE deducted (and other deductions, eg UIF) for Mrs Umculi? These are all things you should consider. This will be one of those difficult questions that I referred to above.
- Purchase of the BMW
It seems the MHG bought Mr Umculi a car for his personal use. Was this authorised? Does the MOI allow these types of transactions? Consider the tax consequences, namely that a dividend *in specie* was distributed to him, with a 20% tax payable.
- Hotel accommodation
Is this common practise for the directors and are they allowed to do this? Consider any authorisation requirements needed.
- Furniture for Mr Umculi's holiday home
This should not appear on the fixed asset register, as it is not MHG's assets, but Mr Umculi's. This should be corrected. Further treatment should be similar to that of the BMW.
- Expenses on behalf of the company
What do these expenses consist of, and are they truly for the company? If the company is deducting these for tax purposes, you should also ensure that that is treated correctly and that nothing is deducted that should not be deducted.

I hope that sheds some light on the matter. Please remember that my door is always open to you, should you wish to discuss anything.

Kind regards,
APC Candidate

Examiner Comments

This candidate identified and addressed the auditing and assurance as well as the taxation technical competencies in his/her solution. The candidate's solution competently provided coaching/review notes that addressed the issues apparent in the working paper.

The candidate's attempt competently addressed the following:

- Professional communication and tone.
- Recognising the need for further audit work to be performed on the completeness of the loan account.
- The Companies Act considerations.
- Related parties' disclosure.
- Questions on why Mrs Umculi's salary is processed through the loan account.
- The normal tax consequences in terms of fringe benefits and PAYE.
- The validity of entertainment expenses using the MHG company credit card.
- The balance of furniture and fittings and whether the assets have been derecognised.

Although this candidate was assessed as competent in this task, the candidate's solution did lack substantiation as to why the coaching/review notes were being raised and what the issues were. Possible VAT issues were identified but no clear indication was given in terms of whether VAT was correctly accounted for or not. Similarly, the solution makes references to the tax consequences on the dividend in specie but gives no indication as to why s64E would apply and whether the loan is a result of shareholding or employment.

Furthermore, on the hotel accommodation, the candidate did not address the fact that printout of the GL made was a credit and not a debit to the loan account. The candidate's solution addressed the authorisation issue of the hotel accommodation.

Limited competent (LC)

Email
From : Junior Desriptor
To : Jane wyman
Cc : Brian Stewart
Date : 21 November 2018
Subject : Review note on Tshepo Umculi loan account

Dear Jane

As an introduction , i am a junior Distruptor of MHH a newly qualified CA (SA), i would like to provide you some couching notes on the audity procedures tou have perfomed and the findings you have also determine during your audit of the loan account to Tshepo Umculi.

Before the audit was implemented on the 15 of November 2018 you should have bear in mind that the loan to directors has incresed significantly from prior years and the external auditors will put much focus on it as it contains risk of material mistatments.

I have provided an email attachedment to assist you. Should you need more assiatance on the audit of this account please do not hesitate to contact me.

Kind regards

Junior Dispruptor

Attachment to email

Couching on Audit Procedure you have perfomed

- In auditing the loan provided to the director , you should have bear in mind that there should be a compliance to the companies act and the advisable the king IV when this loan was provided to the directors. In providing this loan to the director the companies act state that the loan provided should met the following :
- The loan shoul be have been stipulatated in the MHG MOI;
- It should have been appeoved in the past 2 years;
- Tshepo Umculi should have not taken place when this loan was granted , however should desclose nature and his involvement on the loan granted;
- The solvency and liquidity test should have beeb perfome before the loan is given to the director; and
- the loan granted should be fair to the company and based on the reasonable terms.

King IV recommends that the director should act in the best intrest of the company in receiving loan and the director would be held liable should they have not acted in the best intrest of the company.

In addressing the audit procedures above, it would be best to receive the munites of the meeting where the loan was granted to Mr Umculi to determine whether the loan granted was in line with companiers act and the king IV.

In your audit procedures i have also determine that your have only focused on the balance of the loan provided and not the other issues like the disclosure of the related party transaction per IAS 24 as mr Umculi is a related party. The effect of the intrest rate charged to Mr Umculi has not been considered as it may be an effect to a dividend inspecie and the related divident tax, it could also result to fringe benefits if it is less than the markrt related tax rate on 7.5 % (being 6.5 plus 1 %).

I am with the with the audit procedures you have provided in testing the accuracy and valuation of the balance of the loan to Umculi , would you please add all the assertions that relate to the loan account of Mr Umculi bearing in mind that he is a director and the related party of the MHG. Therefore there is a potential mistatment in the MHG related party desclosure per IAS 24 (related party) and the intrest charged on the laan account to Umculi during the year.

Couching on the audit funding perfomed

I have review the audit finding perfomed, i have determined that the audit finding has not been prepared formal. The audit finding prepared can you please make it formal as our work will be used by the external auditore and will be included in the audit pack it there fore has to be properly prepared and providing details.

Conclusion

Based on the work done you have concluded that there are no material mistatment in the loan balance ol Tshepo Umculi, however there were shortages in the audit procedures perfomed, please perfome all the audit procedures highlited by the king iv, companies act and the additional other audit procedures required to address all the assertions around the loan. For other assertion would you plaese use your third year auditing books and try to add all the applicab;le procedures required and also visit your king iv and the companies act only for procedures necessary to address loan to directors.

Examiner Comments
This candidate attempted to deal with the taxation and auditing and assurance components of this task but was assessed as LC because the solution was far too superficial. The candidate provided superficial coaching/review notes that were limited to the Companies Act considerations, related parties disclosure and possible tax consequences only. Furthermore, the candidate quoted from s45 of the Companies Act, which was not necessary. In terms of the tax consequences the candidate presented arguments for possible dividends tax and normal tax, but with no clear justification on why and which option should be considered. Inconclusive answers of this nature does not demonstrate the necessary professional competence.

It is clear that the candidate did not deal with the information on the day and did not actually critically evaluate the working paper for any issues/concerns and risks of material misstatement. The candidate placed strong reliance on pre-researched information and was not able to apply that knowledge to the information on the day.

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

TASK (d)	
(d)	Formulate the procedures that should be carried out by the internal audit team to investigate whether there is any substance to the allegations reported by the anonymous whistleblower to Tshepo Umculi.

Highly competent (HC)

To: Brian Stewart
From: Junior Disruptor
Date: 21 November 2018
Subject: Audit procedures regarding allegations

Hi Brian

Per your email I have assessed the risks and the necessary audit procedures which we should perform in order to ascertain whether the anonymous whistleblower's allegations are indeed true.

Risk identified:
Per the whistleblower the risk appears to be related to:
1. Guests staying at the hotel where they have not made a reservation. This is being facilitated by staff pocketing cash but we do not as yet know how staff is overiding the check-in system. This has resulted in theft of cash and unauhorised check-ins.
2. Staff are obtaining kick-backs through allocating unauthorised number of complementary rooms to travel agents. This has resulted in unauthorised room allocations and also engaging in fraudulent behaviour.

Audit procedures:
Regarding Risk 1, I believe we can perform the following procedures:

1. Per our understanding of the system, a room cannot be accessed without a check-in occurring as the room requires a smartphone which probably has an identification key to unlock the room.
- We should be able to obtain a report from the system showing where a smartphone is registered with our app but the cellphone number is not shown as a reservation for the room.

2. We can obtain a report from the ERP system showing rooms checked-in for which there is no reservation made.
- The ERP system is linked to the check-ins as well as the reservation system from the company's web portal. Therefore, we should be able to obtain a report from the system which identifies rooms where a check-in existed but no reservation was made.

3. We can obtain a report from the ERP system showing where hotel functions such as room services have been provided to a room (such as housekeeping or room service) for which per the reservation function - there is no room reserved for that person or for which no person was checked-in per the check-in function.

4. We can also try recalculate the revenue to be earned from rooms over the period:
- Extract list of rooms occupied per for the period from the ERP sytem along with the rate

per room for the period.
- Multiply the number of rooms occupied by the rate per room.
- Compare this amount to the amount which is currently recorded in the accommodation revenue GL.
- If the amount per the GL is lower than the recalculated amount by a material variance we will conclude that cash is being stolen by employees.

5. Another resort would be to ask Tshepo if we could speak to the anonymous whistleblower and perhaps ask him if he has any further information such as: the months over which he is aware this incured or the individuals which he is aware of who are involved in this.
- This will help us filter our procedures above based on a month or a smaller period.

6. We can also look on our social media pages or any customer complaints of customers who have checked-in and found that somebody else is occupying their room.
- This is likely because the staff providing the rooms will not be able to constantly check whether the room has been allocated to a reservation customer whilst they have provided the room to somebody else.

7. Lastly, we can pull a report from the ERP system which shows a room checked-out for which there is no payment being made for accommodation, foods, or other services.

Overall we need to obtain an understanding of how staff are able to override this system with regards to checking-in without a reservation as this is an entirely automated process. We might need to obtain IT specialists to come and see if there are instances of override ocurring in the system. We can also pull reports from the ERPsystem showing instances of manual override in these automated processed if possible.

Regarding Risk 2:

8. We can compare monthly the number of rooms which are authorised to be allocated to travel agents to the number of rooms which are actually allocated to travel agents in the month.

9. We can anonymously call the travel agents which we interact with and pretend to be an employee trying to obtain a kick-back.
- The success of this process will help us verify if our travel agents are really allowing for such engagement to occur with our employees or if they are not.

10. We can extract a report from the ERP system which details the number of complementary rooms which were provided for per month. Using the terms with travel agents e.g.: 100 nights accommodation allows for 5 free nights - we can recalculate the number of free nights which the travel agents should have obtained for the month.
- We will require the contracts with these travel agents detailing the terms of the agreements with them.

A last comment would be that we need to inspect and investigate the system as to how staff are being able to override these automated controls e.g.: the system should detail the number of complementary rooms available to travel agents and should provide warnings where excessive rooms are being allocated.

Please feel free to contact me if there are any queries with regards to the above and I will gladly assist.

Kind regards
Junior Disruptor

Examiner Comments

This candidate started off very strongly by identifying a crucial aspect of the MHG check-in system, namely that room access depends on clients' smartphones being registered in the system. Furthermore, this candidate recognised the important link between reservations and check-ins. There was strong evidence that this candidate absorbed the pre-released information and was able to apply it on the day to an unexpected task.

The analytical procedure of comparing actual revenue to occupancy multiplied by average room rate was insightful. The suggestion that MHG's social media pages be reviewed was refreshing. Consulting an IT specialist to discuss how system overrides could occur, was indicative of higher level thinking.

The procedures with regard to the complimentary nights were useful but not the best we encountered during the APC assessment. Overall, we considered this candidate's response to be higher than competent.

Competent (C)

To: Brian Stewart
From: Junior Disruptor
Subject: internal Audit Investigation

Hi Brian

Activities such as those described in the Whistle blowers email occurring at MHG is of great concern to me.

Attached please find "Appendix A", which will detail the procedures i believe should be carried out by internal Audit in order to investigate whether there is any substance to the claims being made.

Kind regards
Junior Disruptor

<u>Appendix A</u>

In order to assess whether the claims by the Whistle blower are true, a number of reports will be extracted from the ERP system, which in conjunction with other procedures should identify whether the purported activities are taking place.

1. Procedures to be performed to determine if unbooked/empty hotel rooms are being used by

guests whom have not made a reservation:

- Extract a report showing the number of reservations and subsequent check-in' s took place in 2018, and match this to the number of times a hotel room was allocated to the MHG mobile app to provide guests with access.
- Extract an exception report showing instances where the Netflix access exceeds the number of rooms per the reservation system.
- Obtain an exception report showing the number of instances over 2018 where a room was manually allocated to a guest with no reservation
- Extract a report stating the number of rooms for which room service and housekeeping were used compared against the number of actual reservations for a set day to establish if unreserved rooms were occupied.
- Extract a report showing the number of occasions upon which there were other revenues (Room Services, Food and Beverages etc) generated and charged to a room for which there were no daily room rates collected or charged.
- Extract a report which detailing reservations and subsequent check ins taking place on the same day for which there has been an adjustment to the daily rate made.
- Perform fraud inquiries of hotel employees through distributing of fraud questionnaires to employees, enquiring as to whether they are aware of any instances where employees have allowed walk-in guests to make use of the facilities, asked them to pay cash and have pocketed the cash for themselves?

2. Procedures performed to determine if an excessive number of complimentary room nights are being allocated to travel agents and other third parties in exchange for kick backs:

- Obtain a report entailing the number of complimentary room nights granted at each hotel over 2018.
- Perform analytical procedures, comparing the number of complimentary room nights granted in 2018 to the number of complimentary room nights granted in 2017.
- Extract a list of all persons whom received complimentary room nights in 2018 and compare this to the persons whom received complimentary room nights in 2017. Match any new names appearing on this listing to the list of approved Travel agents.
- Extract a report comparing the number of free room nights granted to travel agents and third parties to the number of paid room nights those same travel agents and third parties have generated in 2018.
- Perform fraud inquiries of hotel employees through distributing of fraud questionnaires to employees, enquiring as to whether they are aware of any instances where employees have offered additional complimentary room nights to travel agents or third parties in order to obtain kick-backs.

Examiner Comments

This candidate recommended extracting some useful exception reports that may provide evidence of rooms accessed by guests for which no revenue was received. Reference to Netflix access, housekeeping service and room service displayed a good understanding of the hotel operations. This response could be a good start in practice to uncovering potential fraud. It is not perfect, but candidates in the APC are not expected to be perfect. They are expected to display competence appropriate for an entry-level CA(SA).

The procedures relating to complimentary room nights were less useful although the analytical procedures were good. This was forgiven as the most difficult aspect of the task, relating to the walk-in guests who paid in cash.

Limited competent (LC)

Task d

From: junior Disruptor
To: Brian Stewart
Date : 21 November 2018
Subject : Procedures to be performed by the internal audit to investigate allegations

Dear Brian

I have received your email about the anonymous email .I would like you to know that I take these allegations seriously and hopefully the procedures below that I have designed will assist in us identifying if there is substance to the anonymous email.

I have attached an appendix A with the procedures below . I trust you will find this email beneficial .

Please do not hesitate to contact me if you require further clarifications on the procedures .

Kind Regards ,

Junior Disruptor

Appendix A

Procedures to be performed

1. Enquire from the staff if they know anything about the allegations mentioned in the email and if so obtain further information and names of the possible culprits

2. Perform weekly reconciliations between the reservations as per the system ,the check in and check out logs and the invoices to confirm accuracy that only the people on the reservation list were present for the week .

3. Enquire from the travel agents about the complimentary room nights that they were given including the terms and confirm that this is in line with the policy .

4. Inspect the list of complimentary rooms issued and confirm that it is line with the company's policy .

5. Observe walk-in guests and confirm that they are not allocated vacant rooms .

6. Choose a day and compare the reservation list to the number of check ins to ensure that the only people that checked in had made reservations .
7. Choose a day and physically inspect the vacant rooms listed on the system as vacant and confirm that they are indeed vacant .

8. For reservations made compare the rate per night to the days that the guest stayed and confirm that the invoice and amount paid are accurate .

9. Obtain a list of recent guests and enquire if any of them had not made reservations and were allocated rooms as walk in guests .

10. Inspect a sample of invoices and compare the them to the set company rates to confirm that the correct rate was used and the correct amount was paid .

11.Select a day and obtain a list of the vacant rooms and confirm that those rooms were not allocated without a reservation made on the system .

12. Inspect a sample emails between staff corresponding with the third parties and travel agents and confirm that there were no kick-backs discussed .

13. Obtain a sample of list of invoices issued to guests and compare the rates used to the company rates .

14. Inspect millenial's whistle blowing telephone line and confirm that no other allegations were made regarding these issues .

15. On a random day prepare a completeness check by confirming that guests that are occupied in the rooms had made prior reservations and have checked in via the app .

16.On the app inspect the people checking in and out of the rooms are not hotel staff who were on duty .

17. Select a sample of cancellations and confirm that those guests who cancelled were not recorded on the check in and check out report and that those rooms were indicated as vacant on the system before being re-allocated .

18. Inspect that all the complimentary rooms have been listed on reports and the reasons for the complimentary rooms have been documented and approved by the person in charge .

Examiner Comments

This candidate's response is an example of the 'throwing mud' approach to attempting the APC or ITC. 18 procedures are listed in the hope that the majority of them would be awarded 'marks'. However, no marks are awarded in the APC and the aim of the assessment is to simulate real-life tasks that trainees could be asked to do at entry level (after three years of training). In practice, Brian Steward would probably ask someone else to redo this task.

There were numerous impractical suggested procedures such as the following:

- 'Observe walk-in guests and confirm that they are not allocated vacant rooms.'
- 'Choose a day and physically inspect the vacant rooms and confirm they are indeed vacant.' [What is the probability of success of detecting fraud on one day out of 365?]
- 'Inspect the whistle-blowing telephone line and confirm that no other allegations were made.' [Not sure how one could inspect a telecommunications line?]

There were also some nonsensical procedures that were suggested:

- ‘Inspect a sample of invoices and compare them to the set company rates to confirm that the correct rate was used.’ [There would be no invoices for customers that checked in and paid cash which was pocketed by employees.]
- ‘Enquire from the travel agents about the complimentary room nights including the terms and conditions.’ [Travel agents who did receive excessive complimentary nights are unlikely to admit to this.]
- ‘For reservations made, compare the rate per night to the days that guest stayed and confirm that the invoice and amount paid are accurate.’ [There would be no reservation or invoice for guests checking in and paying cash which is pocketed by employees.]

The procedures to address the complimentary room nights to travel agents were very limited. It was not apparent that this candidate understood the potential issues and the procedures that were would probably be very ineffectual in practice.

TASK (e)	
(e)	Draft the presentation slides, including speaker/presenter notes, regarding the proposed 6CVCF loan restructuring as requested by Travis Jagger in his email.

Highly competent (HC)

From: Junior Business Disruptor
To: Travis Jagger
Date: 21 November 2018
Subject: 6CVCF loan conversion Board presentation

Good afternoon Travis

I have provided the below ideas on information to be included per slide including any speaker notes that would be appropriate. Please review and inform me if you would like further clarity on the slides or any changes made.

General note:
The presentation is to be made to the board of MHG who do not have extensive tax and accounting knowledge thus my speakers notes are provided to explain the accounting and tax implications though I have not gone into extreme detail. It is best to keep these as simple as possible, thus only the potential conversion of the loan has been discussed as I am sure the board understood the original terms of the loan as this loan was accounted for since 2016 in the financial records of MHG.

Slide 1 : 6CVCF proposal:
Update proposed
* If the loan is not converted - original loan terms apply
* Original loan terms: loan payable within 8 years (by the end of the 2024FY). Interest accrued at 8% p. a.
* R80 000 attorney's fees to be incurred to adjust loan terms

<u>Speaker's notes:</u>
It is important to remind the board of the original loan terms as well as the new proposed terms. Also mention that attorney costs will need to be incurred.
Reminder that this presentation is being made to the board of directors which includes Lain and Reginald who are representatives of the interest of 6CVCF thus remain neutral in presenting the proposal as you do not want your personal opinion of the loan conversion to imapct the views of the board.

Slide 2: Pro's
Update proposed:
* if the loan is converted - a lower capital repayment is required at the end of the 8 years of the loan term
* The interest expense on the converted portion will not be incurred (redcued interest expense)
* Debt: equity ratio will improve if loan is converted
* Continued support from valued shareholder - 6CVCF (Increased stake in the business)
* Class B shares do not share in dividends
* Immediate financing provided for expansion

Speakers notes:
* MHG would not have to fund a large capital repayment of the loan at the end of year 8. The current cash reserves of the entity only amount to R18.8 million at the end of the 2018 FY thus a large amount of cash would need to be built up to pay the full loan balance of R30 million. The conersion of the laon would reduce the payment to be made to R15 million.
* Mention that the dividends declared would not be influenced as only class A shares share in the dividends, thus the DPS (dividend per share) would not be diluted and shareholders would recieved the same proportion of returns as in the past.

Slide 3: Con's
Update proposed:
1. Dilution of control of current shareholders
2. Complicated accounting recognition (considered on next slides)
3. Increase in liabilities owing in the long term (R10 million additional loan)
4. New loan becomes outstanding
5. The EPS will decrease

Speaker's note:
* mention that - 6CVCF will hold 33.3% of the voting rights upon conversion and the founding member's will now hold 60.6% which is still a controlling share holding.
* mention that the employee share trust will now be smaller shareholder (employee's stake in the business is diminishing which is not inline with the long term strategy of MHG to actively involve and reward employees.)
* Though a cash inflow of R10 million would be received, this represents and increase in the debt of the company thus reducing the benefit of converting a portion of the loan
* Though the a portion of the original loan would no longer be payable, the new loan advanced would become payable - terms of this loan would need to be considered to determine if a benefit actually arises, what interest expense would be payable and when the repayment would be expected.
* As new shares have been issued the EPS (earnings per share) will decrease.

Slide 4 and 5: Accounting implications:
Proposed update:
1.IFRS 9 would be applicable to the 2019 FY
2. IAS 32 - convertible instrument (Liability and equity component)
3. Equity component - the amount of the loan is convertible into a fixed number of shares (3 000)
4. Fair value of the equity component = Fair value of convertible instrument - fair value of liability
5. Attorney fees - transaction costs incurred (Decrease the liability)
6. Liability recognised at amortised cost (results in an amortised interest expense)
7. Option not exercised - loan reverts to original terms
8. The R10 million - new liability recognised

General note: a technical opinion of an accounting expert should be obtained to better explain the accounting implications.

Speaker's notes:
1. Mention that IAS 39 will no longer be applicable to the accounting of the transaction. The financial liabilities classified, measured and recognised will be applied inline with IFRS 9 applicable to the 2019 FY.
2. IAS 32 would now classify the instrument as a convertible instrument. The accounting of the modification to the financial liability will result in a compound instrument - a financial liability and

an equity component as the loan is convertible at the option of the holder of the loan - 6CVCF.
3. MHG would need to determine the fair value of a similar instrument on the market which allows for a conversion of the loan into equity. This fair value of this convertible instrument less the fair value of the liability (Currently at market value of the Statement of financial position at R15 million as the interest on the loan is market related) will result in the equity component of the transaction.
4. The Attorney fees incurred in modifying the agreement will decrease the value allocated to the financial liability - i.e. DR financial liability component CR bank
5. A new interest rate would need to be determined that takes into account the attorney fees incurred as decreasing the liability balance (The balance of the liability after three years must amount to R15 million as should 6CVCF not elect to convert the loan to shares, MHG will still owe 6CVCF the R15 million of the loan)
6. The liability is classified as a liability at amortised cost which means that the interest will be recognised over the three year term on the gross value of the liability component.
7. If the option is not exercised, the loan will be recognised on the original terms of 8% p.a. until repayment - thus the original interest expense will be recognised. The equity component derecognised after thress years if the option to convert is not elected by 6CVCF.
8. The additional R10 million advanced will be recognised as a financial liability upon thus increasing the liabilities of MHG. Note should the loan not be converted the debt owed to 6CVCF will now amount to R40 million and not R30 million (original loan).

Slide 6: Income tax consequences for the potential conersion
Updates proposed:
<u>MHG:</u>
1. Loan has become a hybrid instrument - s8F Income tax Act = interest incurred is a deemed dividend in specie
2. Upon conversion of loan into shares- debt concession/ debt benefit (Recoupment of expenditure/ reduction in asset base cost)
3. The issue of the shares is not tax dedcutible
4. The interest on the remaining portion of the loan not converted continues to be tax dedcutible.
5. If the loan is not converted - the interest subsequently charged will be tax dedcutible

<u>6CVCF:</u>
1.Addition of conversion option - loan becomes a hybrid instrument: interest accrued on the loan is a deemed dividend in specie
2. The interest accrued on the remaining portion of the loan and if the loan is not converted will ocntinue to be taxable.

<u>Speaker's notes</u>
<u>MHG:</u>
1. The convertible loan becomes a hybrid instrument in terms of the Income Tax Act unless the market value of the shares which the loan may be converted into is equal to the amount owed per the liability. For a convertible instrument- the interest incurred on the loan during the year of assessment is a deemed dividend in specie - thus MHG must pay dividends tax of 20% on the interest incurred (withhold dividends tax at 20% on the interest payable to 6CVCF). The interest on the hybrid instrument is not deductible - as a result the interest payable on the loan previously allowed as a deduction under s24J will not be allowed increasing the income tax obligation of MHG.
2. As of the 1 January 2018, SARS issued an amendemnet that a debt waiver would now include situations where the terms of the debt were amended and when the debt is extinguished through the issue of shares. Upon the conversion of the loan into shares, this is defined per s19 and par

12A of the eighth schedule as a debt benefit. The benefit will equal the difference in the fair value of the debt settled (R15 million) less the market value of the shares issued (3000 shares). If the debt was used to fund capital assets, the base cost (the cost for income tax purposes) will be decreased by the debt benfit thus resulting in additional capital gains tax when the asset is eventually sold. If the asset has been sold or an excess of debt benefit remains, any allowances previously allowed on the captital asset will be recouped (i.e. included int the taxable income of MHG). If the loan was used to fund expenditure that was allowed as a deduction for income tax, a recoupment of the interest on the loan and if any additional benefit remains, a recoupment of the deductible expenditure previously allowed will be recouped in the taxable income resulting in more income tax being paid upon conversion of the loan.
3. It should be noted that on the issue of the shares, the shares will not be atax dedcutible expense.

6CVCF:
1.The interest on the loan determined will be deemed to be a dividend in specie which must be included at the gross value of the interest in the gross income of 6CVCF for income tax purposes. The dividend may be exempt per s10B as the dividend is "declared by a resident South African company"- MHG. The dividends tax withheld by MHG on the interest is a final tax.

General note: The fair value of class B shares needs to be determined in order to assess the debt benefit that would arise on the conversion of the loan. The opinion of a tax expert should be obtained to better consider the tax implications.

I hope the above suggested amendemnts as well as speaker's notes will assist you in your presnetation. Note that I kept the slides relatively simple and provided more explanation in the speaker's notes that can assist you to explain the implications to the board.

Should you have any further queries with regards to the above, please do not hesitate to contact me.

Kind rageds
Junior Business Disruptor

Examiner Comments

In addressing the task, this candidate demonstrated a high degree of professional competence. The attempt showcased a clear and exact understanding of the task at hand and the slides presented were professional and user friendly. The presented slides included the following:

- Valid pros and cons of the proposed loan restructuring from the perspective of MHG and its current shareholders;
- Accurate accounting implications of the loan restructuring for MHG considering and taking into account the fact that the loan is not convertible immediately but instead, 6CVCF now has the option to convert a portion of the loan to Class B shares in three years' time;
- Accurate taxation implications of the proposed loan restructuring for both MHG and 6CVCF; and
- Speaker/presenter notes for each slide for those points on the slides that are not self-explanatory.

The pros and cons provided showcased a critical evaluation of the impact that the loan restructuring would have on MHG and its shareholders. The approach was balanced and to the point and it was clear that the candidate obtained a comprehensive understanding of MHG and its business and the potential impact of the loan restructuring. What also further contributed to the overall quality of the response was the technical precision for both the accounting and taxation implications provided.

The following aspects also elevated the attempt to being assessed to highly competent:

- Identifying that the R15 million convertible loan is a hybrid instrument in terms of section 8F for taxation purposes.
- Identifying that 6CVCF may not convert the R15 million loan into class B shares in three years' time, resulting in no conversion taking place.
- Recommending that an expert be appointed to provide advice on the tax consequences.

The candidate did make some technically incorrect statements in connection with the taxation, such as claiming that the dividend received would be exempt in terms of section 10B. The latter error is forgivable and did not detract from the already professional and highly competent response.

Competent (C)

To: travis.jagger@millennialhg.co.za
From: junior.disruptor@millennialhg.co.za
Subject: 6CVCF loan restructuring
Date: 21 November 2018

Good day Travis

Thank you for allowing me to be involved in this interesting scenario. I have given the slides some consideration as well as the debt arrangement. I have attached my slides in the attachment below. Please let me know if you would like further clarity on any of the slides as well as any further explanation.

Kind regards
Junior Disruptor

Attachment A:

Slide 1:
6CVCF proposal

- Original loan 30 million repayable in 8 years time in 2023FY.
- Possibility to arrange their debt and extend a further 10 million
- R15 million to be converted to shares

-3000 Class B shares
-3 years from now

Notes:
I recommend you give a further explanation around the fact that even though the loan is not convertible, 6CVCF have provided this option for the boards consideration for conversion of the

loan. That R15 million will be converted into class B shares at 6CVCF's discretion otherwise normal repayment will take place in 2023. Also legal paper work of R80 000 will be incurred to reconstruct the deal, needs to also be mentioned for their consideration.

Slide 2:
Pros
- R10 million immediate cash injection
- Improved debt to equity ratio
- Potentially greater commitment from 6CVCF as they will have more ownership
- R15 million might not have to be paid in 2023.
- Control still retained in terms of the founders
- The original loan covenant could be renegotiated for IFRS 16 impact
- The loan is convertible at the option of 6CVCF
- No affect on dividend payment ratio

Notes
The 10 million can be used to repay any expensive debt now as well as potentially fund future renovations in the pipeline. The conversion will result in equity being recognised which may improve our debt to equity ratio, preventing MHG non-compliance with the original loan covenant.

There can be negotiations around increasing this loan covenant ratio as IFRS 16 is still to come into effect which will as a result of MHG having a lot of properties which are all on operating leases, leading to a lease liability being recognised which may cause MHG to exceed their loan covenants. So this can and should be part of the negotiations to allow the conversion.

The control and direction of the entity will be still in the hands of the three original founders which has been their intentions with the class B shares. As the potential conversion will give 6CVCF 33.33% of the voting rights.

There will be no impact on the dividend payment ratio as these will be class B shares, so the employee share trust will also not be disadvantaged to their share of the profits.
6CVCF will also not be prejudiced in converting for shares at a disadvantaged rate where the shares are of less value than the fair value of the loan, as they may opt not to convert.

The cash flow at the end of the loan period will also be lightened if the R15 million does not have to be repaid, however consideration must be given to when the new loan of R10 million must be paid.

Slide 3
Cons:
- Dilution of descision-making power of Class B shareholders.
- The loan is only convertible in 3 years time
- The R10 million will now also have to be paid
- There will be tax consequences if the loan is converted to shares
- Increase accounting implications

Notes
6CVCF will now have 3 000 votes of 13 000 class B shares giving them 23% of the vote, thus the original founders will still be able to affect a special resolution in terms of class B shares. We

would also have to determine who has rights to the Net Asset Value of the entity on liquidation as if class B does then they have greater rights now to these assets.
We as MHG will still need to pay finance costs at the current interest rate of 8% and would have to still keep cash on hand for the potential payout in 5 years time which could either be R30 million or R 15 million. We would thus potentially only have 2 years after the election to potentially raise the other 15 million if we did not believe that the 6CVCF would not convert.

We would also need to factor in the new terms of the R10 million in terms of interest and when the capital is repayable to manage cash flow accordingly.

Accounting implications are dealt with on the next slides as well as the tax implications.
Slide 4
Accounting (IFRS) implications:

- In terms of IAS 32 we would have to account for this arrangement
- Split between equity and debt portion on financial statements
- IFRS 13

Notes:
As we are moving from a financial instruments to a compound financial instrument we will need to recognise an equity portion for 6CVCF's rights to convert their loan.
As we as MHG have no ability to defer the payment of interest and capital, as the decision to convert lies with 6CVCF, we would have to still recognise this liability as well as interest.

We would thus, if we decided to allow the conversion have to recognise the fair value of the total instrument with a right to convert using the new terms and interest rate, discounted at a fair rate for an instrument with the right to convert and then comparing this to a liability without the right to convert in the market with similar terms and discount rate at a fair value term. The difference between the above mentioned amounts will go to equity (right to convert to shares). The liability will then be measure in terms of the fair value of the liability mentioned above.

We could essentially split the two R15 millions, keeping the 1st as we have already recognised it and the second portion recognised as above.

The legal fees of R 80 000 will then need to be split between the fair value of the equity portion and the liability portion mentioned above. The equity portion of the fees will go through equity where as the amount related to the financial liability will be offset against the principle amount of the liability (causing a decrease in the interest rate on the liability to calculate interest). **Note to Travis** (A demonstration of the accounting can be handed out before hand to allow the Directors to follow the numbers). An IFRS specialist may be considered by us the Board due to the potential complexity of this transaction and the values of the transaction.

Slide 5:
Accounting (IFRS) implications (continued)

- Related party disclosures will need to be done in terms of IAS 24
- IFRS 13 implications
- IAS 39 disclosures applicability?
- Future standards

Notes:
We would also have to disclose how we obtained the fair values of the instruments in terms of

IFRS 13. We would also have to in the financial statements reflect the related parties transactions in terms of this as 6CVCF due to 6CVCF potentially seeing MHG as an associate.

As this is a financial instrument we would have to consider the disclosures required by IAS 39, however the conversion will come into affect when IFRS 9 is applicable.

We would also have to consider how this conversion will be impacted by IFRS 9 as this standard will come into affect before the potential conversion takes place and may place further complexities in accounting and disclosures of the this transaction.

This transaction would also have to be disclosed in terms of IAS 24 which requires all related party transaction be disclosed in terms of the nature, the amount, the terms such as that the loan is convertible to 3000 class B shares in 3 years time at the option of 6CVCF and balance at year end.

Slide 6:
Tax Considerations
- MHG

-Debt reduction/concession
-Recoupment/base reduction
- 6CVCF

-Connected parties
-Capital gains

Notes:
As 6CVCF will be waiving the loan in consideration for shares a debt concession exists. So if they do end up waiving their debt through conversion, considerations per s19 of the income tax will come into affect, where the value of the debt waived (R15 million) exceeds to the difference of the market value of the shares (would be all shares of 6CVCF) after conversion vs the value of the shares prior to conversion of 6CVCF. This is applicable as 6CVCF held class A shares prior to the debt waiver. The amount calculated above if positive will then be used to, depending on what the loan was used to pay for, either reduce the base cost of an allowance or non-allowance asset first if on hand or recoup of costs if a deduction was already received. VAT implications must also be considered as we may have to pay output vat if the base cost of an asset we claimed input from is reduced as mentioned above. Note to Travis: I recommend again printing out a demonstration of the different options. Thus this may lead to lower deductions or a recoupment and thus ultimately more tax to be paid.

The legal costs (attorney fees) will have to be seen if they can be deducted in terms of s11(a) in the production of income, however I feel this will be hard to prove as we are issuing shares and thus will be capital in nature and not deductible.

In terms of 6CVCF is a connected party per the Income tax act they will be deemed to acquire the shares at a fair value namely the price of the shares, however as they only paid the value of the loan which will be less than the shares they would have a capital gain. This would then be treated in terms of normal income tax rules where the gain will be included at 80% in their taxable income taxed at 28%.

I would also recommend potentially getting a valuation specialist involved to determine the market value of the above share prices at the time of conversion, to ensure the correct tax amount is recouped or base cost reduced to ensure tax compliance. Also possibly also getting a tax specialist to have a look at the agreement and calculations we perform to ensure we are in compliance.

Any questions?

Examiner Comments

Overall, the response to this task was professional and all the components of the task that are required to be assessed as competent were of a professional standard.

On an overall basis the pros and cons provided showcased a clear understanding of the wider impact that the proposed restructuring would have on MHG and its shareholders.

The accounting and taxation implications were insightful and showcased the ability to make sense of the information presented on the day. The latter was also technically accurate in most instances. The speaker notes provided were clear and added value. The candidate therefore addressed the task competently.

There were some technically incorrect references to IAS 39. These were forgivable in view of the good quality of the rest of the response.

Overall, this was a solid attempt at the task and few issues could be identified that detracted from the quality of the response.

Limited competent (LC)

Good Day Sir,

I'll be glad to be of assitence.

Please find attached my proposed additions to your existing slide show:

Proposal:
Presentation Note: Brief explanation of the characteristics of Class B shares compared to Class A.

Pros:
- Increase "flexibility": An reduction in debt opens up the oppertunity for future debt at affordable rates.
- Opertunity to re-leverage our operation to ensure sustainable growth.

Presentation Note: We can reassess our initial funding strategy implemented with founding of MHG.
- Decrease in financial risk due to reduced finance cost to be covered.
- Increase profitability, due to decrease finance costs, and subsequent dividends.

Presentation Note: The dilution of shareholding will have a possitive impcat on dividends receivable by each shareholder.
- Increase "head room" to comply with the current loan agreement. Compliance currently narrowly achieved.

- Increase shareholder and directors relations.

Cons
- Risk of non-compliance with complex accounting and tax requirements.
- Legal costs involved (R80,000).
- Uncertainty over execution of convertion rights – difficults to budget dividends and cash flow accordingly. Debt covenants still in place.
- Dilution in Employee decision-making power – possible effect on employees' morale and attitude against MHG.
- Valuation of existing equity subjective and up for disagreement (conflict under shareholders).

Accounting
- The Attorney's fee will be expensed, reduction in profits.
- Accounting treatment will be determined by IFRS 9. IFRIC 19 provides additional guidance.
- Steps:
  Fair value of equity issued needs to be determined
  The difference between the fair value equity issued and the value debt relieved will lead to a equity adjustment (adjustment to retained earnings).
  Will **NOT** lead to a income/expense on the statement of profit and loss.

  TAX Considerations.
- *Need to be determined what the original loan was used (Capital Input / Operations) for – this will affect the tax treatment.*
- *The assumption that loan was used for **sustaining operations:***
- *The assessment whether 6CVCF is acting as shareholder or Credit Provider will have vastly different tax consequences.*

1) 6CVCF as shareholder:

MHG:

Value of shares issued > loan value = deamed dividend in specie to 6CVCF, MHG liable for dividend tax (20% on of difference in value).

Value of shares issued < loan value = no tax deduction, 6CVCF related party

6CVCF

Value of shares issued > loan value = No consequences (MHG liable)

Value of shares issued < load value = Deductable for capital gain purposes.

6CVCF as creditor:

MHG:

Examiner Comments
Overall, this attempt did not display the required competence in the task. Although the candidate did touch on all three elements that were required in terms of the slides, the points raised were in most instances superficial, technically inaccurate and not congruent with the information provided on the day. More specifically, the following detracted from the quality of the response and resulted in a limited competent assessment in this task: • The pros and cons provided were limited and in most instances not insightful. The candidate did not display an understanding of the impact that the restructuring of the loan would have on MHG and it shareholders. The pros and cons were also not balanced and focused more on the implications for MHG and limited consideration was given to the other shareholders. • The accounting implications lacked technical accuracy and coverage. The candidate failed to identify the restructuring would result in a portion of the loan becoming a compound financial instrument. The candidate also failed to address any of the other components of the transaction, i.e. the additional R10 million loan and the remaining R15 million loan. Finally, some technical errors were also made such as noting the transaction costs would be expensed. • The tax consequences were unclear. Although some reference was made to dividends in specie, it was not clear in what context this was noted. Furthermore, the candidate did not consider any specific debt reduction implications for MHG. The tax implications noted for 6CVCF were also disappointing and unclear. • No speaker notes were provided, despite the fact that a number of the points raised in the slides were not self-explanatory. Overall, the candidate displayed limited competence in all three elements of the task.

TASK (f)	
(f)	Respond to Tshepo Umculi’s email regarding the potential allocation of shareholder value between the Class A and Class B shareholders.

Highly competent (HC)
To: Tshepo Umculi CC: Travis Jagger From: Junior Disruptor Subject: Class B Shares Dear Tshepo, I hope you are well. I have given your questions some thought and this is what has come to mind so far. Factors to consider when allocating the purchase price. The first point i would suggest is to consider the reason why the class B shares were created in the first place and reasses it now as the company is being sold. You would notice that the class B shares no longer serves an importance as the company is being sold so there is no future value to those shares, as the purpose it was created (controlling the decisions) has lapsed. The second factor to consider is when dividends is being distributed, what impact does this have on class B shareholders, as you would remember there is none since they are not entitled to dividends. Based on research performed, with specific reference to Israel, when companies with dual stock sold the shares no consideration was allocated to the "Class B" shares as these shares become redundant to the new shareholder and no future value could be determined. The 1 option would be find a market value price of shares with voting powers only, such as Alphabet's (previously Google) class B shares and see how they value the shares and follow the same approach. Usually when valuating a company the information used is based on sustainable earnings and adjusted multiple and usually this information has nothing to do with the shareholding of the entity. The 2nd option would be to split the proceeds based on voting powers instead of actual shares held, this would require shareholders approval and there are provisions in the Companies Act that protect the minority shareholders that the company would consider. The alternative is to inspect the MOI to see if there was an preconditions of the Class B shares upon sale of the shares. I trust the above is in order.

Kind regards,
Junior Disruptor

Examiner Comments

This candidate's attempt was a sheer delight to read despite its brevity. Reference to Alphabet's different share classes indicated excellent pre-research. Alphabet indeed has class B shares in issue which have ten times the voting power of its class A shares.

This candidate then suggested that the proceeds could be split based on relative voting rights. Reference to the Companies Act provisions protecting minority shareholders' interests was insightful. Inspecting the provisions of the MOI was the clincher, moving this attempt from competent to HC.

Competent (C)

To: Tshepo Umculi
From: Junior Disruptor
CC: Travis Jagger
Date: 21 November 2018

Subject: RE: Class B Shares

Good afternoon all,

I have thought about the question of equitably allocating the proceeds from the disposal of shares between Class A and Class B and have highlighted my thoughts below.

As already mentioned, but I feel necessary to highlight again, the crux of the matter is how to determine which shares carry more value in cash and otherwise. Class A shares will entitle the holder to the relative percentage of equity, but they only carry 10% of the voting rights to Class B shares. However Class B shares are not entitled to equity, so we are at a cross-road.

One solution would be to allocate based purely on the number of shares i.e. 200,000 Class A shares plus 10,000 Class B shares, equally split per share. This would remove the distinction of voting rights and rights to dividends. But each share carries a different right so this may not be appropriate. The founders would be detrimentally affected by this as their combination of shares allows them to receive dividends AND excersise control over the relevant activities, which helps them direct returns. It is also clear that voting rights carry a lot of weight, given the fact that 6CVCF would like to acquire Class B shares on conversion of the loan. This means that we can't discard the weight that voting rights carry.

Alternatively, the shares could be split on voting rights. For example, Tshepo carries a 26.67% voting right when the rights of his Class A and Class B shares are totalled together. The 6CVCF carries the same portion of 26.67%, with the other founders carrying 20% each and the Employee Share Trust retaining 6.67% of voting rights. This might be a more equitable method given that the voting right percentage split for each holder of shares is fairly close (with the exception of the Trust) and thus everyone receives a similar portion of the payout. This method however doesn't consider the Class A shareholders rights to dividends and only considers voting rights.

Since there appears to be a fair value of R250m, it may be appropriate to approach the listed company and obtain their opinion on what they value more; rights to dividends or rights to voting. Both may be of benefit to the listed company, however some companies may be able to better direct their resources to vote and ultimately drive profits, whereas other companies may wish to have a passive investment with a right to dividends and may want to play less of an active role in directing the activities of MHG under the new shareholding. The proposed arrangements put forward by the listed company could be a driving force behind how the proceeds are allocated.

Conclusion

It would appear that we can place a value to these shares, so it may be useful to look to the listed market for previous examples on how such share transactions were dealt with. We may be able to adjust the market-related information slightly to better align with MHG's shareholding position.
However, in the absence of such information, my suggestion would be to split the share price on the second alternative mentioned - voting rights.
This will take into account the number of shares, rights to dividends received, and also take into accounting the voting rights, which is clearly important to the founders (as they wish to retain control) and 6CVCF, who wishes to obtain more voting rights.

I trust this information will help guide your decision?

Kind regards,

Junior Disruptor

Examiner Comments

This candidate's written expression was not ideal but we could at least understand the points being made. He/she understood the task and did not attempt to value the class A and B shares. The suggestions of potentially allocating the R250 million proceeds based on number of shares in issue or based on relative voting rights started the conversation. Reference to 6CVCF's request to convert some of its loan into class B shares, which meant that voting rights '…carry a lot of weight…' indicated good insight.

Calculating the voting rights of each shareholder provided good context. The suggestion of asking the potential buyer of MHG what they would value more (voting rights versus rights to dividends) was very insightful.

Overall, this answer was a competent attempt at a very difficult task.

Limited competent (LC)
FROM: Junior Disruptor TO: Tshepo Umculi DATE: 21 November SUBJECT: RE: Class B shares Good afternoon Tsehpo I hope that you are well today. Thank you for asking my advice on this matter. I have done some research since Travis first mailed me with the possibility of this and I must say the valuation of share rights is quite a complex matter which requires significant judgement. In my research I have found that the following key factors should be considered in such a valuation. Firstly I have noted that you should begin with valuing a share - assuming all have equal rights to vote and dividend in order to first obtain a base to work from.\ The 3 valuation tecniques that I would consider is: - Dividend growth model *Not suitable as not all shares have rights to dividend nd therfore this would not help to value B shares.* - Earnings Yield (P/E ratio) - Discounted cash flows The earnings yield seems reasonalbe as this compares the shares to other firms in the undustry using a industry related PE ratio and adjusting it for risks and varios differences between the companies. We should consider how we will adjust for instance city lodges PE ratio to apply to our valuation - in doing so we will deduct from it for our compnay being privately owned, not being as established in the industry and risk as we have no assets held. We would have to further determine the value of dividend and subtract this value from the determind value we decided on. We could even consider applying the dividend groth model to class A shares and then comparing the different valuations form all the tecqniques toe determine the value of the dividend in order for us to determine the value if shers exlcuding dividends - class B. Some studies I found online indicated that right shares as class B should be valued similiar to a dividend yielding share but adjusted for the voting-only rights. For private companies some studies show that a diskonto of 3% is reasonalble for the valuation of a single shatre right. For a share right of MHG a class A share value would therefore multplied by 10 and then multiplied by 0.7 (to exclude the diskonto effect of not earning dividends). As I mentioned earlier this would be a complex valuation and if the shareholders were to consider this option, I would definitely advise you to contact a expert for this matter.

I hope the information is of help. Please let me know if you would like to discuss the above.

Kind regards
Junior Disruptor

Examiner Comments
The task required candidates to discuss the factors to be considered in allocating a hypothetical purchase price for MHG between the class A and class B shareholders. The task explicitly stated that a valuation was not required. This candidate started off by mentioning the various valuation techniques that could be applied. This was clearly beyond the scope of the task. There was an attempt at redemption by mentioning that the fair value for MHG could then be allocated to class A shareholders first based a dividend valuation. There could be merit in that, but dividend discount models are coming under increasing criticism globally for numerous reasons. The last three paragraphs of this candidate's attempt at task (f) then created a very poor impression. The candidate mentioned that private companies trade at a discount of 3% for a single share right – not sure what that means or where this information was obtained from? The suggested valuation of class A shares by multiplying by 10 and then dividing by 0.7 was nonsensical. This candidate's attempt was assessed as LC. Task (f) was intentionally a difficult task to assess whether candidates could cope on the day and tested professional skills. For example, candidates who indicated that they had limited idea of how to allocate value between class A and class B shareholders and then mentioned a couple of points could have been competent. Sometimes it is acceptable to admit lack of knowledge as opposed to rambling on and saying little of substance.

TASK (g)	
(g)	Respond to Sarah Naidoo's email by identifying and explaining five key matters that MHG should consider in evaluating whether to pursue the strategy regarding the corporate ten-year packages.

Highly competent (HC)

From Junior Disruptor
Sent: Wednesday 21 November 2018, 16:00PM
To: Sarah Naidoo

Subject: Re: Guest for life programme

Good afternoon Sarah,

I hope you are well, and I apologize for the late response to your email.

Yes, Travis did mention his idea to introduce the guest for life programme. Your idea to focus the programme on corporates for 10 year packages, sounds very interesting, and I think could be far more profitably and better suited than the guest for life programme for individuals.

Before I get into 5 most important considerations for MHG to consider, I just wanted to comment on your mentioning that the programme may provide the business with a big income tax bonus. Although expenses are normally incurred upon payment for income tax purposes, I have a feeling that SARS may treat the corporate programme slightly differently. This may either be due to the fact that the expenditure is actually more closely linked to a capital investment, with a right of use component- potentially mirroring that of a lease. This expenditure may be limited in terms of its deductions by s23H, as the benefits from the expenditure will only be received over a 10 year period. This is potentially a provision to consider when assessing the viability of the product.

<u>5 Most Important Considerations for MHG:</u>

- **The relevant costs of implementing this programme:**

MHG must consider whether the present value of all relevant costs incurred with the programme will exceed the upfront cash received upon subscription.

Future costs would include variable expenses for those rooms for 60 days per year (assume full occupancy as businesses can use these rooms for any employees and would likely use every room), as well as the opportunity cost of issuing these rooms upfront at a discount.

The opportunity cost would relate to cannibalisation from rooms that would otherwise be occupied at slightly higher rates, as the amount paid upfront would presumable consist of both a time value of money discounting factor, and a price per room night discounting factor.

We should also include the effect of the effect of when hotels are at full capacity during peak seasons, as there is an opportunity cost of not charging peak season prices (businesses may use rooms at peak seasons, having paid discounted rates, whilst other occupants would have paid 2x rates for peak season usage potentially).

We must only go forward if the relevant future costs, present valued, are less than the amount we will receive.

- **Cash Flow Considerations- Matching Duration**

Another important consideration is what the upfront money received will be used for. This is because the programme will result in MHG committing to 10 years worth of variable costs for 60 rooms per year, without receiving any cash during these 10 years.

If the upfront money is not invested into operations/PPE that will generate sufficient cash flows per each year of the 10 year programme, then the programme will be relying on other cash flows in the firm (other room sales, snacks beverages and store sales), to pay/finance the variable costs of hosting guests on the programme.

However if the upfront amount can be used to generate additional cash flows in future, these cash flows can be used to supplement the cash flow requirements of the costs of servicing the programmes guests.

These cash flow requirements could put strain on operational and working capital cash flow management, and thus this consideration is highly important when considering the programme.

- **Will the Programme Actually Increase Occupancy?**

The reasoning around why this programme may be an NPV positive generating project, is due to the fact that the discounts provided are justifiable, based on the fact that the company has additional capacity to use and will add to the overall occupancy of the hotels.

MHG would need to consider the extent to which the programme actually would increase occupancy (throughout all periods of the year) and not just result in cannibalisation of current sales.

A key risk is that businesses only utilise the programme days during peak season, when prices are much higher than usual (ie all 60 days in peak season), and then purchases normal rooms out of peak season when the prices are low/discounted again.

These companies may ordinarily book out of peak season, and thus occupancy may not be increased, and due to capacity constraints during the peak seasons, full occupancy is achieved, as always would have been achieved- however lower prices have been received based on the programme sales.

Perhaps limiting the use of nights during peak season may assist in this regard?

- **Reputational Damages**

MHG must be highly aware and cognisant of the fact that it may cause reputational damage or harm to itself, due to the image that the programme portrays to non-programme members. As the programme will be limited, not all corporates can join. Corporates who can't join may be highly upset when they find out that their competitors or other corporates are paying discounted prices, when they are paying in full.

This may result in disgruntled corporates, who may choose another vendor for hotel service over MHG.

MHG must manage its reputation, as well as its brand, and not be seen as a discount and cheap hotel, but rather differentiate this programme away from those connotations, quoting 'loyalty' and other reasons as an explanation for the discounts and value add for programme members.

- **Ability to Sell the Business**

The shareholders of MHG must carefully consider the effect that this programme would have on the ability of them to sell the business in the future. This programme may decrease the liquidity of their shares, as new owners have to buy into a business with a programme that involves cost obligations for numerous years, with no corresponding income or cash flows.

Furthermore, depending on the use of the upfront cash, this programme may result in a decrease in the valuation of the business due to future cash outflows priced into a valuation.

The ability to sell the business would thus be in proving to new buyers, that the use of the upfront cash was responsibly invested into profitable and cash generative ventures, the returns on which can outweigh the cost obligations for the 10 year period.

I would thus not go forward with the project, unless there was a plan with what to do with the money raised upfront. Even if the money is used to extinguish the 6CVCF loan, this would prevent 8% interest being incurred and paid going forward into 2024, which is already a higher rate of return (or saving) than inflation will increase the cost obligations of providing services to the programme members.

I hope the above has been helpful. Please let me know if you need any further information.

Kind Regards,

Junior Disruptor

Examiner Comments

Candidates were not expected to discuss section 23H of the Income Tax Act (spreading of advance payments over the period of the agreement) as this was not triggered in the pre-released information. This candidate referred to section 23H and created a very good initial impression.

The first point was multi-layered and dealt with estimated future costs, cannibalisation of existing revenue and peak periods. This was acceptable because the points were all valid and insightful. The third point was possibly a repeat of issues raised in point one, but the peak period issue would potentially be a major issue in practice.

The last issue raised was very insightful and not many candidates discussed this point. The ten-year package results in MHG being obligated to provide services for a considerable amount of time. This may deter potential acquirers who would be loath to accept this responsibility. Likewise, MHG may need to renew leases for another five or ten years in order to meet its obligations in terms of the corporate packages.

Overall, this candidate’s response had both breadth (covered sufficient issues) and depth (very good insights into particular issues). We considered it to be a highly competent attempt.

Competent (C)

From: Junior Disruptor
Sent: Wednesday 21 November 2018
To: Sarah Naidoo
CC:
Subject: Guest for life program

Good Morning Sarah

It would be my pleasure to assist. I agree that the that we could target these 10 year packages to corporates.

The five most important things that MHG should consider in evaluating whether to pursue the corporate guest package strategy
1. Cost versus benefit / Pricing
Off importance when considering the 10 year packages is the pricing. MHG would be getting into a ten year obligation, receiving revenue upfront but having a contractual obligation to fulfill for the next ten years. It is difficult to forecast ten years into the future to ascertain how our expenses will fluctuate. The many varying factors that affect the hotel industry cannot be predicted easily. When we price the package we need to ensure that the price covers the cost to provide the services to the guest with a fair profit and also to ensure we don't price too high so that our program ends up being under subscribed.

2. Target Market
MHG targets milennials, corporates will have various people and generations of staff working for them, will MHG appeal to them? MHG can target start ups as they would be more suited our target market.
We would also have to ascertain if the guests that use the program would have normally booked with us or are new clientele. If they would have normally booked with us we will have to calculate the effect on our revenue, did we lose revenue with the loyalty program or did we manage to gain clients.

3. Limited Location Offering
MHG has hotels in only three provinces in SA, this limits the venues for corporates when travelling for business, will our location offering be attractive enough to corporates for the 10 year package.

4. Other Loyalty programs
Our competitors have loyalty programs that have been established for years and it would be difficult to compete, we would need to ascertain how our offering would be different to attract corporates.

5. Tax and Liquidity and IFRS
We would be taxed at the earlier of receipt of the R500 000, and this would in part offset the cash injection received. We would also need to comply with IFRS 15 and would have to change our systems to process accordingly, accounting for loyalty programs are somewhat complex.

Please contact me to discuss or if I can be of further assistance to you.

Kind Regards
Junior Disruptor

Examiner Comments

This candidate raised five valid issues, although multiple issues were embedded in the response on certain points. For example, point 5 mentioned accounting and tax issues associated with upfront receipt of R500 000. However, this was forgivable as the response was not too detailed. Other candidates listed five different issues but went into great detail about multiple issues within each of the five raised. This created the impression that candidates were 'throwing mud' in the hope of reaching five valid points.

The first two issues raised were very insightful. The costing of a ten-year package would be an important issue in practice, as would the target market be. MHG's focus is on millennials and this may not appeal to business travellers. The remaining three points raised were also valid issues. Overall, a competent response without being overly impressive.

Limited competent (LC)

To: Sarah Naidoo
From: Junior Disruptor
Date: 21 November 2018
Subject: Guest for life programme

Dear Sarah

I have to agree with you that focusing on the corporate market may be a better solution than suggested our guest for life programme to individuals. I have listed the 5 most important things MHG should consider:

- Corporate customers will generallly be able afford such a programme if interest
- It is an attractive feature that access is allowed to all the hotes in the group as corporate customers generally travel often for meeting in all the capital of South Africa.
- Our occupancy rate will improve.
- Irrespective of whether the hotel is occupied or not we anyway receive revenue for 60 nights even though it is at a discounted price it is more than nothing.
- We will have to determine the value of the package carefully to ensure that we still make a profit while keeping the package attractive

Kind Regards

Junior Disruptor

Examiner Comments
This candidate's response was too brief to justify a competent assessment. Each of the points raised needed some explanation – they were not self-explanatory. The task required candidates to identify five issues to be considered in evaluating whether to pursue the corporate guest ten-year packages. This candidate arguably only raised two valid issues (improvement of occupancy and the value of packages). Given that task (g) was the easiest task in the 2018 case study, this response was considered to be very weak.

TASK (h)	
(h)	Respond to Eileen Barkingmad's email..

Highly competent (HC)
To: Eileen@phd.co.za From: candidate@mhg.co.za Date: 21/11/2018 Subject: Mentoring Hi Eileen, Thank you for our most recent mentoring session. I always appreciate being able to talk to you about my time at MHG. Just to confirm that I may speak about confidential matters with you, I have emailed Travis to confirm whether he is happy with confidential information being discussed in mentor sessions. I hope this is okay. I first always have a responsibility to my employer and the confidentiality that entails. Travis has responded that, yes, I can speak in a mentorship capacity to you about confidential information. I have encountered a couple of ethically questionably acts by employees in the past three weeks of being employed here. They are as follows: <u>1. Letting walk-in guests stay whilst taking a direct payment:</u> Firstly, this situation is still under review and no conclusions can be made about this event as yet, as no proof has yet to be given to the fact. However, I will like to discuss this matter at our next mentorship meeting. The details of the action are that employees have allowed walk-in-guests to stay in empty rooms if they pay in cash. There are some allegations that the cash is then taken by the employee. This is in contravention of the code of conduct as in a normal situation, both per the law and conscience, this action cannot be seen to be an example of using "good judgement" at all times and certainly may not seem to be "doing the right thing". Although the code does not give further guidance above what "good judgement" entails, this situation clearly shows a lack thereof buy potentially stealing money from the company and further, allowing the company to further pay for the services provided to the guests (room service/gym/pool/jazz evenings) and not getting revenue in return. I believe that this act is in direct contravention of the code of conduct. <u>2. Employees receiving kick-backs</u> Employees have allegedly given excessive number of complementary room nights to travel agents and other third parties in exchange for kick backs. Receiving personal kickbacks on a company given complimentary room is seen as a dishonest act. As the employee is receiving a personal favour, in exchange for a company free offering. This cannot be seen to be in "good judgement" as the employee is receiving a gift for breaking the contract stipulated with the travel agent. The travel agents get a set amount of complimentary

nights accommodation, therefore, breaking the contract and giving the travel agent more than stipulated, is not "doing the right thing" and is objectively dishonest. Therefore, I believe this is in direct contravention of the code of conduct.

3. Corporate governance at MHG:

These acts have occurred (allegedly) and cannot have occurred in isolation. In my few weeks here I have seen some corporate governance issues arising at MHG. These are:

Board Composition:

11. The board composition in terms of the companies act as well as King IV (now although MHG does not have to apply King IV, being that the company wants to "strive for excellence", King IV is being used as a guide to good corporate governance). Tshepo is both the CEO and the chairman of the board. This is potentially not acting in the best interests of tall stakeholders and as good corporate citizen.
12. The board does not have majority non-executive directors: The board is mainly controlled by the original owners of the entity and only has 50% non-executive directors.
13. Of which, only 1 director - Terence, is potentially independent. Terence use to work with Travis, and depending on the circumstances, there is a chance that he is not seen to be independent in appearance or mind in these circumstances.
14. There does not appear to be enough skills on the board in total to ensure that there is sufficiently good corporate governance:

- Only Terence and Travis have financial knowledge.
- Sarah is a the business development leader which is an important job, yet she does not have qualification for this, however, more information about her background is needed to make that conclusion on her
- Tshepo is a chef, although he has been in the hotel business for 15 years and has experience.

Thus, the board composition is perhaps not in "good judgement" and should be reconsidered by the board.

Internal Audit:

15. The internal audit has not been sourced and funded adequately. This has been confirmed by management and stated outright.
16. The internal audit has also been mainly used to attempt to ensure that the audit fee is reduced by doing work the auditors may rely on.
17. This two factors, indicate that there is not good corporate governance at MHG with the push to be a good corporate citizen lacking in certain areas.
18. The King Code states that the board ensures that the internal audit has the necessary skills and resources to address the complexity of risk
19. The internal audit needed more resources as stated by both management and Brian, shows that this principle has not been adhered to .

Thus, this can be seen as not having "good judgement" about good corporate governance and what that entails.

IFRS 16 NAV valuation:

20. Being a good corporate citizen as well as living and running the company in the manners of the King code mean acting and making decisions that benefit the most stakeholders.
21. A senior executive, requested me to assist them with a NAV calculation to give the balance sheet a bit of a makeover. I completely understand that using the revaluation model is an

effective tool to ensure that accurate balances of assets are valued in the business.

22. I would just like to mention and perhaps discuss with you the sustainable development and stakeholder-inclusive approach that I would expect to be part of the executive teams management and corporate governance style, when we meet again.
23. As the potential to over-value the balance sheet may cause unsuspecting users of the financial statements, and in particular potential financiers, to get the incorrect impression. This would be disadvantaging a stakeholder. Therefore, I believe that the revaluation should be used, however, it must be used accurately and correctly within the guidelines of the IFRS 13 standard.

This cannot be seen to be done in "good judgment" and needs more consideration.

Lastly, on reviewing some auditing working papers, I discovered that there was a chance that a director was getting the company to pay for his personal use items, however, on loan account. This potential ethical and "good judgement" issue that I have, is that the VAT on the assets purchased may (not certain) be being paid by the entity. This not be an example of good corporate governance or a director acting in their fiduciary duty towards the company. However, a lot more information is still needed on this situation.

These are the main discussion points that I would like to discuss meaningfully with you the next time we meet.

Thank you again for your mentorship.

Kind regards,

Candidate.

Examiner Comments

This was an impressive response. The candidate initially dealt with the issue of confirming that he/she may indeed share confidential information with Eileen in the candidate's role as mentee. He/she indicates that having obtained confirmation, he/she is are in a position to share the issues with Eileen. The candidate displays good professional skills in this regard.

The candidate integrates the MHG Code of Conduct succinctly into his/her response. This is an important attribute in completing the APC exam. The candidate repeatedly refers to the actions not being in 'good judgement' and that the employee(s) implicated in the particular issue, did not 'do the right thing'. The candidate achieves good coverage of the issues, addressing the following:

- Whistle-blower allegations regarding cash payments by the walk-ins being pocketed by hotel staff and the granting of complementary nights' accommodation to travel agents and third parties in exchange for kick-backs.
- Corporate governance issues at MHG.
- Deficiencies in the internal audit function of MHG.
- Overstating the net asset value of MHG.

This good coverage of the ethical issues makes the candidate competent in the task. That which however elevates the candidate to highly competent, in addition to the professional skills referred to earlier, is that the candidate follows a balanced approach, indicating that the cash-for-accommodation being pocketed by hotel staff and the kick-backs received for granting complementary nights' accommodation to travel agents and third parties, are merely allegations at this stage. The candidate is also not quick to jump to conclusions regarding corporate governance issues, suggesting that more information is required regarding Sarah's background before one would be able to conclude on whether she has sufficient skills to fulfil her role as a member of the board.

Competent (C)

From: Junior Business Disruptor
To: Eileen Barkingmad
Date: 21 November 2018
Subject: Mentoring

Good afternoon Eileen

I hope this email finds you well.

Thank you for assisting me in becoming settled at MHG over the past few weeks. It is wonderful that MHG is committed to our development as employees and provide us with the opportunity to interact with mentors such as yourself.

Despite the confidentiality clause of our meetings, I have a responsibility to report any contraventions or potential contraventions of the code of conduct to my manager and to act in the best interest of MHG. As MHG has given express approval for me to share any confidential information I have acquired, our discussions are inline with the code of conduct expected from a CA(SA). As a result, I will provide a brief explanation of instances of potential contravention of the code identified but request that you do not disclose this information to anyone including anyone outside of the MHG structure. Note that I will also not elude to any employees directly as I do not intend to make any allegations against employees or key management without further investigation and discussion with appropriate senior personnel within MHG.

1. During my brief employment at MHG I have noted that the Structure of the board of directors is not in compliance with Best Practice prescribed by the King IV Code. This however would be public knowledge. It appears that the board may not have the required expertise to discharge their responsibility to act in the best interest of the company. This is evident through the lack of consideration of the implementation of IFRS 16 a new lease standard that would materially impact the operations of MHG considering all of the properties from which the hotels are operated from as accounted for as leases. This may indicate that the board has not applied good judgement.

2. I was also previously asked to comment on the application of an accounting standard that would allow MHG to increase the value of the assets recorded in the future. Though the increase in the asset value is permitted per the accounting standard, the motivation of the increase in fair value to be recognised is to reflect a stronger balance sheet position to users of the financial statements. The focus of the said executive director appears to be to improve the balance sheet in order to secure more funding for MHG despite MHG may not actually having the capacity to obtain more funding. I am concerned that this executives may misstate financial amounts to achieve this objective - though I am not yet aware of any instances of transgressions. This may however, be evidence that the executive is not applying good judgement in disclosing fair and accurate financial information of MHG.

3. I noted that MHG is paying the wife of an executive director a salary despite me having no knowledge of her providing services to MHG nor being in the employ of MHG. This appears to be an instance where the executive director is not doing the right thing unless express approval of the salary has been granted. I also noted that the same executive director appears to use his position of power to his benefit through the purchase of a company car for his own personal use but passing the transaction through the company's books as well as taking some of the MHG furniture and fittings for his own personal use. This appears to be an instance where a director is not doing the right thing inline with MHG's code of conduct as he may be using his position of authority to authorise transactions that would other wise not be allowed. These are however initial observations and before any further action is taken I would like to investigate the accuracy of my concerns.

4. Lastly, I am concerned that the internal audit committee is not sufficiently staffed to attend to its functions and responsibilities. The head of internal audit is overworked and only holds a Bcom in Hospitality Management and PGD In Risk Management which does not provide him with sufficient experience and expertise in financial reporting to effectively discharge his function as the head of internal audit. I am concerned that the board of directors did not apply good judgement is appointing the Chief audit executive nor in the establishment of the internal audit committee.

I refrain from providing any other information or details via email as a I believe a discussion in person would be more appropriate. I look forward to meeting with you and growing our mentor relationship whereby you can provide me with guidance on how to attend to my concerns noted.

Thank you and kind regards,
Junior Business Disruptor.

Examiner Comments

This is an example of a good solid competent response for this task. The candidate cleverly indicates that he/she will not be alluding to the identity of any employees directly as he/she is not in a position to make any allegations without further investigations being carried out and discussions with senior management. A cautious response such as this would be appropriate in these circumstances.

The candidate achieves good coverage of the instances in which one should feel uncomfortable regarding certain behaviour. In the discussion on the governance issues, the candidate correctly points out that shortcomings in the governance at MHG would be in the public domain, which confirms the view that this is a competent candidate. The candidate furthermore does not lash out in his/her response, choosing his/her words carefully. When referring to Tshepo’s loan account transactions, the candidate stresses these are initial observations and that before any further action is taken, he/she would like to investigate the issues further. This speaks to the candidate’s professional skills. As the APC is an assessment of professional competence, evidence of adequately developed professional skills is important. This candidate not only communicates effectively and professionally, but also command the professional skills which one would expect from a newly qualified CA(SA) at point of entry into the profession.

Limited competent (LC)
Email From : Junior descriptor To : Eilleen Barkingmad Date : 21 November 2018 Subject : Presentation of confidentil information Dea Eileen Before I can unswer your question I will like in a respect manner to inform you that as CA (SA) i am bound to code of professional conduct from SAICA   which include confidentiality of informatrion . I am not allowed to desclose any MHG confidential information unless I am required by law to do so or there is prior approval from executive for me to desclose. Currently for all the duties that I am doing here at MHG i am reporting directly to Travis being the CFO of the business, for me to desclose an matter that is considered confidential I will have to receive advise from my senior instructing me as to whether am I allowed to desclose all the information and actions that is done by the directors of the company that i deem to not be in line with the MHG current code of conduct. I am sorry that I cannot unswer all your questions today , since I will have to receive advise from my professional body to confirm i will not be in breach of the code of professional conduct if i desclose any metter and Travis to confirm that I will not breach the current MHG code of conduct by desclosing sensitive company information. You can however get the information about the conduct of MHG management from newspaper , those are the information available to the puclic but bear in mind those newspaper or other form of online resources may not always provide the reliable information about the operation of MHG. I will get back to your after I have received sufficient advise from the mention above. Kind Regards Junior Destruptor **Subsiquent thing to do :** I will send the attachment of the email I have received to Travis to assist me regarding the above email i have received. And subsiquently sent the nature of Circumstances or kind of email to SAICA, but not the actual email and ask for an advice of the metter then get back to Eileen after I am clear as to I can desclose what he want me to desclose.

Examiner Comments
This is a good example of a candidate who did not respond to Eileen's email because of the confidentiality of information. This is an unacceptable response. The email from Eileen was explicit that he/she could discuss confidential information about MHG since Eileen was bound by a confidentiality agreement. This would be the reason why using SAICA CPC as reason for not disclosing to be inappropriate. Furthermore, these types of discussions are commonplace in mentoring relationships. We repeat that SAICA would never set a trick task to trip up unsuspecting candidates' behaviour.

Suggesting that Eileen can obtain information about the conduct of MHG management by searching newspapers is condescending and potentially, rude.

