



# Initial Assessment of Competence

## Professional Paper 1

January 2026

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Ignore value-added tax (VAT).

## 1 Background

Mzansi Trendz (Pty) Ltd ('MT') is a South African retailer. Incorporated in 1998, the company operates 75 stores across South Africa. MT offers fashionable merchandise, often including locally sourced fabrics and designs. The company caters for middle-to-upper-income customers and does not offer credit facilities.

MT is a wholly-owned subsidiary of Inala Investments Ltd ('Inala'), a diversified holding company with investments in several retail companies. Jim Isaacs, the chair and chief executive officer of Inala, is a former politician who gained significant wealth through strategic investments following his departure from public office.

All Inala Group companies are audited by Sentinal & Associates Registered Auditors ('Sentinal'), prepare their annual financial statements in accordance with IFRS<sup>®</sup> Accounting Standards and have 31 December financial year ends.

On 1 October 2019, Inala acquired MT, paying R300 million for a 100% controlling stake. The only equity balances in MT's financial statements were share capital and retained earnings amounting to R253 million. All MT assets and liabilities were fairly valued at the date of acquisition, except for owner-occupied land that had been purchased at a cost of R40 million. On 1 October 2019, the land's fair value was R46 million. The fair value of the land as at 31 December 2024 was R43 million. The land was subsequently sold during the financial year ended 31 December 2025 (FY2025), and MT recognised a profit of R3,25 million on the sale in its separate financial statements. As at 31 December 2025, the goodwill recognised on MT's acquisition had an accumulated impairment balance of R19 million.

The audits of the Inala group companies for FY2025 are currently in progress. All the auditor's reports must be issued by 25 March 2026.

The information that follows pertains to the audit of the annual financial statements of MT for FY2025, which has been prepared using the going concern basis of accounting. The audit engagement partner has approved a materiality figure for auditing MT's 2025 annual financial statements of R3 million.

## 2 Understanding the inventory account balance

Inventory is MT's largest asset. For financial reporting purposes, inventory is measured using the first-in, first-out method at the lower of cost and net realisable value (NRV).

Inventory balances at the respective financial year ends comprised the following:

	<b>FY2025</b>	<b>FY2024</b>
	<b>R'000</b>	<b>R'000</b>
Merchandise on hand	137 260	123 317
Merchandise at sea	23 900	21 731
Inventory obsolescence allowance (write down to NRV)	(10 951)	(13 025)
	<b>150 209</b>	<b>132 023</b>

Merchandise at sea is inventory in transit from several of the company's suppliers. This inventory is shipped free on board.

Sales of merchandise during FY2025 amounted to R501 million compared to R554 million in the previous financial year, yielding a gross margin of 25% (FY2024: 33%).

Due to the fast-changing nature of fashion, MT regularly marks its merchandise down to clear out slow-moving items and make way for new collections (as reflected in the inventory obsolescence allowance).

MT operates a central distribution centre in Johannesburg where all merchandise is received and inspected. It is then distributed to individual stores. Lead times between dispatch from the Johannesburg distribution centre and arrival at the stores vary from one to five days. The company uses an integrated computerised perpetual inventory management system, which can track inventory levels, cost prices and selling prices in real-time.

At year end, a physical inventory count is conducted at the distribution centre and stores to verify the accuracy of the perpetual inventory records. Differences between the quantities of inventory according to the company's perpetual inventory records and those counted were identified and resulted in a net inventory write-down of R823 390 being recognised by MT (i.e., reflected in the year-end inventory figures). Management approved this adjustment as it identified a risk of inventory shortages in an environment where staff are demotivated by having to work long hours and not being awarded salary increases or bonuses in recent years.

MT sources its merchandise from a mix of local and international suppliers. During FY2025, Watkins Shoe Manufacturers Ltd renegotiated its contract with MT to supply shoes on consignment, with amounts payable to the supplier now due at the end of the month in which the sale took place (i.e., extended credit is no longer provided). Consignment stock is inventory held by one party (the consignee) but owned by another party (the consignor) until it is sold to a customer.

The returns of previously sold merchandise to customers of MT have also increased from prior years. In total, during FY2025, merchandise costing approximately R20 million was returned by customers for a variety of reasons, including because of defects in the merchandise.

### 3 Systems description for the markdown of merchandise selling prices

The effective management of merchandise is vital to prevent financial losses due to inventory obsolescence. MT implemented a system to proactively mark down the selling prices of slow-moving merchandise a few years ago. Two types of discounts are applied to merchandise: promotional discounts (applied to improve sales for items that are still in season) and clearance sale discounts (applied to clear out end-of-season items). The following is an outline of this system:

- 1 Once merchandise is delivered by a supplier, and the goods received note (GRN) is generated, a copy of the GRN is emailed to the merchandise manager, Paul Potgieter.
- 2 For each merchandise item (e.g. 'long sleeve fit & flare knitwear dress') identified by a unique number on the GRN, Paul performs the following on the inventory management system:
  - 2.1 Reviews and, if necessary, amends the markup percentage (on cost) for the merchandise item;
  - 2.2 Captures the budgeted unit sales of the merchandise item by month, based on information given to him by the sales director; and
  - 2.3 Reviews and, if necessary, amends the start date of the final clearance sale of the merchandise item.
- 3 Once the start date of the final clearance sale of the merchandise item (as captured in step 2.3) arrives, the inventory management system automatically applies a fixed 50% clearance sale discount on the normal selling price to the merchandise item. This is implemented immediately at all stores.
- 4 Each month Sarah Smith, the merchandise director, extracts a report from the inventory management system for merchandise items where the total actual unit sales are lower than the total budgeted unit sales and imports this report into Excel. For each item on the spreadsheet, she captures the proposed promotional discount percentage as well as the start and end date for which the discount is to apply. The discounts may be implemented for short periods of time (where sales are marginally behind those anticipated) or for extended periods (where sales are lagging significantly).
- 5 A printout of this spreadsheet is discussed at the monthly executive management committee (Exco) meetings. After making the necessary revisions, the Exco approves the discount arrangement to be applied to underperforming merchandise lines.
- 6 Using decisions made at the Exco, the merchandise records administrator, Debra Dube, captures the following details on the inventory management system for all MT stores:
  - 6.1 Merchandise item code;
  - 6.2 Approved promotional discount percentage (on normal selling price);
  - 6.3 Start date of the discount; and
  - 6.4 End date of the discount.

This system has served the needs of MT well. Even though not documented in the description above, strong information processing controls have been incorporated into the system to ensure the integrity of the data captured and processed. MT has also implemented strong general IT controls, including those restricting access only to authorised individuals.

#### 4 Audit of inventory write-down to NRV

The audit team from Sentinal has commenced its audit work on the inventory account balance as at 31 December 2025. Audit procedures have been performed on the write-down to NRV and the following findings were extracted from working paper INV-104:

Audit procedure	Findings
Enquire from the chief financial officer (CFO) about the method used to compute the inventory obsolescence allowance.	<p>The CFO explained that the inventory obsolescence allowance was computed as follows:</p> <ul style="list-style-type: none"> <li>• The NRV for all inventory on hand that had a final clearance sale start date before 31 December 2025 was determined as 50% of the selling price; and</li> <li>• The NRV for all other inventory items that are still in season but remain marked down at 31 December 2025 because sales are lagging, was determined by applying the approved promotional discount % to the item's normal selling price.</li> </ul> <p>The obsolescence allowance was computed as the difference between cost and NRV for those inventory items where the item cost exceeded the item's NRV.</p>
Compare the method used to compute the obsolescence allowance in the current year with the one that was used in the previous financial year.	Done – the method used in FY2025 was consistent with that used in FY2024.
Obtain the detailed workings supporting the allowance.	Done – filed as working paper INV-106. <sup>1</sup>
Agree, by inspection, the allowance as at 31 December 2025 per the workings to the balance on the 'inventory obsolescence' account in the general ledger/trial balance.	Done – no exceptions found.
Test the operating effectiveness of the direct (key) controls in the system for inventory markdowns.	Done – the system for the markdown of merchandise selling prices (incl. the information processing controls) was found to be operating effectively during FY2025.
Request that management include reference to the reasonableness of the inventory obsolescence amount in management's written representation letter.	Done – will be filed once the audit process concludes and before the auditor's report is issued.

As the data from MT's inventory management system is compatible with the generalised audit software used by Sentinal, the audit team intends to use this software to improve the efficiency and effectiveness of the audit.

<sup>1</sup> Not included as part of the scenario.

## 5 Financing arrangement – loan from XYZ Bank

MT relies on a substantial loan facility from a major South African bank, XYZ Bank. To secure this facility, MT agreed to pledge R50 million of its inventory held in the Johannesburg distribution centre as collateral for the loan. MT remains fully obligated for the outstanding loan balance (interest plus principal), irrespective of the collateral pledged to XYZ Bank.

A total loan amount of R24 million was provided to MT on 1 February 2024. A fixed interest rate of 11,5% per annum, compounded annually, is payable on the loan.

The loan agreement between MT and XYZ Bank contains the following key covenants:

- 1 MT is required to maintain a –
  - minimum current ratio of 1,5:1,
  - maximum debt-to-equity ratio of 2:1, and
  - minimum annual earnings before interest, tax, depreciation and amortisation (EBITDA) of R15 million.
- 2 A breach of any of the above constitutes a default.
- 3 In the event of a default, XYZ Bank has the right to demand immediate repayment of the outstanding loan balance and, if not repaid, enforce the inventory collateral pledged.

MT was able to maintain the loan agreement covenant ratios for a period, but during FY2025 the entity faced significant challenges, including increased competition from international retailers establishing physical stores in South Africa and customers buying from online retailers. The FY2025 revenue projections were not met and some of MT's suppliers started to tighten their credit terms and cancelled lines of credit. This negatively impacted the entity's operating cash flows, liquidity and profitability. When finalising the FY2025 results as at 31 December 2025, the company's current ratio was calculated to be 1,2:1. EBITDA for FY2025 came in below R15 million, with the loss before tax provisionally calculated to be R1,5 million. This was the first full-year loss incurred by MT.

Upon becoming aware of the breach of the debt covenant, XYZ Bank notified MT that a default had occurred and demanded immediate repayment of the outstanding loan. MT was unable to repay the outstanding loan amount due to a lack of available cash on hand given company performance and increased inventory balances.

Accordingly, XYZ Bank formalised its right to claim the collateral pledged as security for the loan agreement, and initiated steps to obtain legal possession of the inventory in the distribution centre. XYZ Bank agreed to allow MT to continue to sell the inventory from its premises. On the subsequent sale of the pledged inventory, all amounts would be used to settle the loan obligation. In the event that the proceeds from these sales are insufficient to cover the outstanding loan balance, MT remains obligated for repaying any outstanding amounts to XYZ Bank. As at 31 December 2025, MT had not sold any of the pledged inventory relating to the outstanding loan balance. MT commenced sales of pledged inventory in January 2026 and started repaying the loan balance from these sales proceeds.

In order to settle XYZ Bank's outstanding loan balance and overdue interest, MT needed to sell the pledged inventory urgently. Therefore the inventory would have to be sold at a significant discount. MT estimated that it would take two to three months to settle the debt with XYZ Bank.

Sarah established that the inventory held at the distribution centre had a carrying value of R65 million. She asserted that the R50 million that forms part of the pledged inventory to XYZ Bank should, in her opinion, be derecognised in the financial statements at year end and the balance thereof be used to offset the carrying amount of the loan reflected as at 31 December 2025.

## **6 Going concern assessment**

The audit team from Sentinal has identified the risk of the going concern basis of accounting being incorrectly applied in the 2025 financial statements of MT as 'high'.

Audit work was undertaken on the cash flow and profit forecasts prepared by the management of MT for FY2026. Based on these forecasts, which the audit team found reasonable, the audit team concluded that the company's liquidity and profitability challenges would persist. When the audit team discussed this conclusion with the management of MT, management indicated that it was in the process of formulating an action plan to ensure that MT can continue operating as a going concern. This action plan involves the following:

- Closing five unprofitable stores;
- Reducing marketing expenditures in FY2026 by R1 million per month (or R12 million in total), compared to the expenditures in FY2025; and
- Securing loan financing of R75 million from Inala, who was in the process of raising funds from the sale of some of its shares in MT to the African Industrial Development Bank ('AID'). AID is a government-owned bank that invests in businesses and promotes economic development in South Africa and in the rest of Africa.

In January 2026 management presented the audit team with revised forecasts incorporating the effects of this action plan. Management confirmed that MT could trade profitably and that the liquidity challenges could be overcome.

Having performed further audit procedures on the action plan, the audit team concluded that material uncertainty exists that may cast significant doubt on MT's ability to continue as a going concern. With no other material uncorrected misstatements having been identified or suspected, the audit team is considering the modifications required to the auditor's report on MT's annual financial statements for FY2025.

## **7 Arrangement with AID**

Jim used his connections with several members of AID's Investment Committee to persuade them to visit his private game farm for a weekend. There he persuaded the AID Investment Committee members to invest in MT and save the jobs of MT's close to 500 employees.

The details of the arrangement between Inala and AID were finalised during December 2025. The following is an extract of the agreement that was signed by the AID and Inala representatives.

**Parties**

This agreement is between Inala (herein referred to as the 'Investee') and AID (herein referred to as the 'Investor').

**Undertaking**

Both parties undertake to enter into this agreement on the following attached terms and conditions.

**Sale of equity interest**

The Investor will acquire a 45% equity stake in MT, Inala's subsidiary. Along with the 45% equity stake, the Investor is entitled to appoint three out of the five directors on the board of MT.

**Payment arrangement**

The Investor undertakes to provide the Investee with an amount of R90 million (hereinafter referred to as 'the cash amount'). The cash amount is payable to the Investee in three equal tranches of R30 million. The first tranche will be payable to the Investee on 1 January 2026.

The two remaining tranches will be payable to the Investee on 1 March 2026 and 1 June 2026.

**Other terms**

No amounts are repayable to the Investor. MT however anticipates paying an annual ordinary dividend of R9 million, commencing in FY2026, to ordinary shareholders, subject to business performance.

The parties agree that the time value of money as it relates to the tranches that AID will pay over to Inala may be ignored.

An actuary determined the following fair values relating to MT as at 1 January 2026:

<b>Percentage holding</b>	<b>Fair value</b>
	<b>R'000</b>
45% equity stake in MT	132 000
55% equity stake in MT	168 000

When it became aware of the details of the AID agreement with Inala, the People for Democracy Party (PDP), a major opposition party in the South African government, strongly criticised this agreement in the media. The PDP argued that the agreement was only concluded because Jim used his political connections, and that there was no commercial logic to the transaction. The PDP felt that money was being diverted from other more worthy projects to the detriment of the people of South Africa.

Upon reading the media reports, the chair of AID's accounting authority (the public sector's equivalent to a board of directors) called for a meeting to formulate an action plan to deal with the matter proactively.

## 8 Impact of AID on Inala's investment in MT

The arrangement with AID was approved by Inala's board of directors during December 2025. AID thereafter appointed two non-executive directors and the chief financial officer to the board of MT. Therefore, AID became the controlling shareholder of MT.

### 8.1 Disposal of MT shares

The equity stake granted to AID triggered Inala's disposal of 45% of its MT shares. Inala recognised a profit of R6 million on the disposal of MT shares on 1 January 2026, being the date on which all suspensive conditions of the agreement with AID were met.

### 8.2 Extracts from the MT financial statements

The following are extracts from the MT financial statements for FY2025. All amounts are correct.

Statement of changes in equity as at 31 December 2025		
Share capital	Retained earnings	FVOCI reserve
R'000	R'000	R'000
100 000	178 000	See note 1

#### Note 1

This reserve relates to a listed bond that was issued by Louw Investments. MT purchased the bond on 1 January 2023 for an amount of R9,5 million, which was also its fair value.

Other details pertaining to the bond are as follows:

Description	Details
Principal amount	R9,5 million
Term	5 years
Maturity amount	R10,5 million
Coupon, paid annually on 31 December	R896 000

MT correctly classified the bond as being subsequently measured at fair value through other comprehensive income (FVOCI) in accordance with IFRS 9 *Financial Instruments*, paragraph 4.1.2A.

On 31 December 2024 and 31 December 2025, the bond's fair value was R8,4 million and R8,9 million, respectively.

Since the original recognition of the bond, it was established that there had been no significant increase in credit risk up to 31 December 2024 and 31 December 2025. The IFRS 9 expected credit losses relating to the bond are as follows:

<b>Expected credit losses as at</b>	<b>12-month expected credit losses</b>	<b>Lifetime expected credit losses</b>
	<b>R'000</b>	<b>R'000</b>
31 December 2024	612	1 670
31 December 2025	980	1 980

## **9 Additional information**

- Ignore the time value of money with regard to the agreement with AID.
- MT accounts for all its property, plant and equipment at cost in accordance with IAS 16, *Property, Plant and Equipment*.
- The Inala Group accounts for owner-occupied land using the revaluation model and uses the cost model for all other items of property, plant and equipment in accordance with IAS 16.
- There has been no changes to MT's total issued share capital since 1 October 2016.
- As at 31 December 2025, the goodwill recognised on MT's acquisition has over the years been partially impaired by R19 million.
- All amounts are material, unless stated otherwise.

**INITIAL ASSESSMENT OF COMPETENCE, JANUARY 2026**

**PROFESSIONAL PAPER 1**

**This paper consists of one scenario and two required parts.  
Answer each required part in a separate answer book.**

<b>PAPER 1 PART I – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(a)	Discuss the effect of the information provided in section 2 (Understanding the inventory account balance) on the auditor’s assessment of the risk of material misstatement for the inventory account balance in the FY2025 financial statements of MT.  <i>Y4: Judgement and decision making</i>	15  1	  16
(b)	Describe the key controls that MT should have implemented to ensure – (i) the accuracy and completeness of data captured by Paul that influence clearance sales; and (ii) the accuracy and completeness of the promotional discount details captured by Debra on the inventory management system.  <i>X1: Communication skill – clarity of expression</i>	10  8  1	    19
(c)	Formulate the additional substantive audit procedures that should be performed by Sentinel to obtain sufficient appropriate audit evidence about the inventory obsolescence allowance balance as at 31 December 2025.  <i>W1: Data analytics</i>	9  1	  10
(d)	With regard to MT’s liquidity and profitability challenges (under section 6: Going concern assessment) – (i) describe the additional audit procedures that should be performed by Sentinel on the action plan formulated by the management team of MT; and (ii) explain what modifications, if any, should be made to the auditor’s report on MT’s FY2025 financial statements.  <i>Z1: Business internal environment (for part (d)(i))</i>	13  5  1	    19
<b>Total for part I</b>			<b>64</b>

**INITIAL ASSESSMENT OF COMPETENCE JANUARY 2026**

**PROFESSIONAL PAPER 1**

**This paper consists of one scenario and two required parts.  
Answer each required part in a separate answer book.**

<b>PAPER 1 PART II – REQUIRED</b>		<b>Marks</b>	
		<b>Sub-total</b>	<b>Total</b>
(e)	Based on IFRS® Accounting Standards, evaluate, with reasons, Sarah’s statement regarding the treatment of pledged inventory and the loan from XYZ Bank.	11	
	<i>X1: Communication skill – logical argument</i>	1	12
(f)	Describe the steps that AID’s accounting authority should take following the criticism expressed in the media with regard to the agreement AID concluded with Inala.	9	
	<i>Z2: Business external environment</i>	1	10
(g)	Prepare the journal entries that MT should process in its FY2025 separate financial statements to account for the Louw Investments bond.	12	
	<ul style="list-style-type: none"> <li>• Ignore tax.</li> <li>• Do not provide journal narrations.</li> <li>• Round all calculations to the nearest rand.</li> </ul>		12
(h)	Calculate the group profit or loss, if any, that Inala should recognise in its consolidated financial statements relating to the disposal of the MT shares on 1 January 2026.	22	
	<ul style="list-style-type: none"> <li>• Ignore all tax with regard to the Louw Investments bond only.</li> <li>• Ignore the time value of money with regard to the payment tranches that AID will pay over to Inala.</li> <li>• Round all calculations to the nearest rand.</li> </ul>		22
<b>Total for part II</b>			<b>56</b>
<b>TOTAL FOR PAPER 1</b>			<b>120</b>