



Initial Assessment of Competence

Professional Paper 3

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1 Background information

Instore ReaFetsa Ltd ('IR') is a large South African discount retailer listed on the Johannesburg Stock Exchange. IR was established in 2002 by Calvin Mazibuko and Alvin Henderson, who identified an opportunity to offer essential goods at the lowest possible prices. Alvin serves as the chair of the board of directors. Jordan Henderson, the son of Alvin Henderson, is the chief executive officer (CEO) of the company. Michaela Dumisa is the chief financial officer (CFO). Both Jordan and Michaela are members of the board of directors.

IR has a strong national footprint and is known for affordability and accessibility. IR has a 30 September financial year end, its functional and presentation currency is the South African rand and it prepares its financial statements in accordance with IFRS[®] Accounting Standards. AudSA Auditors ('AudSA') are IR's auditors and are currently busy with the 30 September 2025 (FY2025) year-end audit.

IR retails high-volume, low-margin food and clothing to customers, aiming to drive profitability through scale rather than premium pricing. A key strategic focus is on private label¹ products to assist in protecting margins by reducing reliance on external brands. IR also has a strong relationship with external suppliers and uses its size and scale to negotiate favourable discounts and rebates. To drive efficiency and reduce operational costs, the business makes use of regional distribution hubs. Generally, the cost savings achieved are passed on to customers. IR also uses standardised low-cost store formats located in high footfall² areas to ensure optimum customer access and streamlined operations.

IR's strategy and business model are informed by its understanding of the lower living standards measure (LSM) market. Customers in this segment often shop more frequently, buying smaller baskets with a focus on household essentials. While margins in this segment are tight, the growth potential is significant.

At IR, the executive team has embraced a results-orientated culture. Performance-based bonuses, linked to the company's overall profit before tax, is a key incentive for Jordan and the other executive directors. The pressure to achieve profit targets has created a culture that prioritises short-term financial gains, sometimes at the expense of long-term strategic objectives and sound financial reporting principles.

IR directly owns and operates the individual stores across the country. This results in store managers having no autonomy over key operational decisions, such as pricing and cost structures.

¹ Products made by other companies but sold under the Instore ReaFetsa Ltd brand name.

² Footfall refers to the number of people physically entering or passing through a location, such as a retail store, shopping mall or event space, within a specific period of time.

2 Introduction of new lifestyle concept stores ('LC stores')

Early in 2024, Jordan proposed a bold strategic shift at a board meeting: the launch of a new LC store aimed at middle-LSM customers. Jordan was inspired by innovative retail formats he had encountered during a visit to China. He believed the initiative could unlock value and reposition IR beyond its traditional discount retail model.

Some board members expressed reservations, as this was a significant departure from IR's core strategy. However, Jordan remained confident about the long-term potential of the opportunity and despite the board members' reservations, proceeded with the rollout, and 17 LC stores were opened across the country on 1 October 2024. To fund the rollout, Jordan secured a R300 million capital injection from local development finance institutions and retail investment funds.

Although the middle-LSM segment in South Africa generally represents customers who value brand image, convenience and loyalty points, they remain price conscious. They are drawn to modern retail environments that offer a blend of affordability and lifestyle appeal, including premium private labels and organic food. This segment is fiercely contested by large players such as Spozena Retailers, a premium discount chain, and Kingsworth, a high-end food and fashion retailer, both of whom have well-established operations.

In preparing for the launch, IR engaged new small-scale and emerging suppliers who needed to adapt their offerings to meet the new LC stores' needs. IR introduced a customer loyalty programme for the LC stores in terms of which customers would earn loyalty points (see section 4) when shopping at the LC stores.

In 2024 and 2025, the South African economy struggled due to various factors, including high interest rates and rising electricity and medical costs, which significantly reduced consumers' disposable income.

Most of the products that are retailed in the middle-LSM segment are sourced from top-quality, well-established local suppliers or are imported. However, the weakening rand has increased the costs of such imports.

Jordan has been under significant pressure from the board of directors to deliver results on this new strategy. He was surprised at the monthly losses incurred by the new LC stores, given that his projections had shown a budgeted net profit of R25 million for FY2025. While Jordan acknowledged a loss was a possibility in the first year, he had not anticipated the extent of the underperformance.

In an attempt to replicate the success of the core discount chain, Jordan reassigned top-performing staff to the new LC stores. However, these employees were experienced in price-focused, high-volume retail rather than the personalised service and brand-driven marketing required by the LC stores. As a result, expected performance improvements did not materialise.

Furthermore, performance varies widely across the LC stores. Differences in location, store size, rental costs and product mix have made it difficult to standardise operations. Jordan believes these inconsistencies could be addressed by 'right-sizing' stores, by tailoring layouts, product selections and formats to suit local demographics and demand, and by increasing revenue per m² and reducing fixed costs.

During the first year of operations, management identified several concerning trends. To increase footfall and brand visibility, the stores relied heavily on promotional pricing, often on low-margin products, which reduced profitability. Inefficiencies in distribution and warehousing further contributed to stores operating at a net loss. IR's existing supply chain, geared to high-

volume, standardised goods, was not suited to the smaller-batch, more flexible inventory needs of the lifestyle stores. This mismatch led to increased re-labelling, and a notable increase in stock losses compared to normal group levels.

Despite these operational challenges and financial losses, Jordan has consistently presented interim results in a positive light. In quarterly updates and investor presentations, he highlighted favourable metrics such as rising revenue and growing customer engagement, placing particular emphasis on the stronger-performing LC stores. He personally oversaw the drafting of these presentations. Jordan's incentive structure, which ties his bonus to the company's share price and profitability, appears to have motivated this optimistic portrayal of performance. In addition, as a relatively young CEO his aim is to build a reputation as an innovative leader in the retail sector. Investor confidence and perceived success are also critical to his career.

With the full-year results being finalised and an audit in progress, internal tensions have surfaced. Jordan leads board meetings, and leaves little space for dissenting voices. At a recent board meeting, Michaela raised concerns about the overly optimistic assumptions Jordan used in investor briefings. Jordan dismissed her concerns.

The finance team has also identified concerns that do not support the impression of sustained revenue growth previously communicated to investors. A significant portion of revenue reported to investors in the latest quarter is from once-off transactions, such as bulk and corporate sales, rather than from ongoing customer activity. The LC stores accept large prepaid online orders, generally with a delivery date after the end of the quarter. Jordan insisted that Michaela recognise the revenue at the point the order is confirmed to 'reflect demand strength'. Micheala also voiced her concerns about other inconsistencies in the application of revenue recognition policies and the pressure to meet quarterly targets. These concerns, however, have largely gone unaddressed even though she highlighted them to Jordan before his communication to investors.

In a private strategy session, Jordan commented: 'Michaela is responsible for the financials, but I have to present the narrative to the investors during the quarterly updates to ensure I influence investor perceptions and secure consistent investment. With specific reference to revenue recognition, there is always flexibility in the interpretation of revenue recognition policies that is not only permissible but sometimes necessary in periods of change.'

Jordan, who has a background in marketing and no formal accounting training, has grown increasingly frustrated with what he refers to as the CFO's 'pessimism bias'. He continues to advocate for a more 'commercially minded' approach to financial reporting that reinforces investor confidence and supports the company's long-term vision.

The following is an extract of the financial results of the new LC stores for FY2025:

STATEMENT OF PROFIT OR LOSS: LC STORES											
	Notes	Group A			Group B			Group C			TOTAL
		Food R'000	Clothing R'000	Total R'000	Food R'000	Clothing R'000	Total R'000	Food R'000	Clothing R'000	Total R'000	
Revenue	2.1	120 000	180 000	300 000	105 000	45 000	150 000	59 500	10 500	70 000	520 000
Cost of sales	2.2	(90 000)	(105 000)	(195 000)	(78 750)	(29 250)	(108 000)	(53 550)	(7 350)	(60 900)	(363 900)
Gross profit		30 000	75 000	105 000	26 250	15 750	42 000	5 950	3 150	9 100	156 100
Store operating costs	2.2	(36 992)	(55 488)	(92 480)	(32 368)	(13 872)	(46 240)	(18 343)	(3 237)	(21 580)	(160 300)
Marketing and brand investment		(9 240)	(13 860)	(23 100)	(8 085)	(3 465)	(11 550)	(4 581)	(808)	(5 390)	(40 040)
Logistics and distributions		(13 800)	(20 700)	(34 500)	(12 075)	(5 175)	(17 250)	(6 843)	(1 207)	(8 050)	(59 800)
Head office allocations		(5 760)	(8 640)	(14 400)	(5 040)	(2 160)	(7 200)	(2 856)	(504)	(3 360)	(24 960)
Earnings before interest and tax		(35 792)	(23 688)	(59 480)	(31 318)	(8 922)	(40 240)	(26 674)	(2 606)	(29 280)	(129 000)
Finance cost							(2 000)			(3 000)	(5 000)
Profit/(loss) before tax		(35 792)	(23 688)	(59 480)	(31 318)	(8 922)	(42 240)	(26 674)	(2 606)	(32 280)	(134 000)
Tax expense		-	-	-	-	-	-	-	-	-	-
Net profit/(loss)		(35 792)	(23 688)	(59 480)	(31 318)	(8 922)	(42 240)	(26 674)	(2 606)	(32 280)	(134 000)

ADDITIONAL MANAGEMENT INFORMATION: LC STORES											
	Notes	Group A			Group B			Group C			TOTAL
		Food	Clothing	Total	Food	Clothing	Total	Food	Clothing	Total	
Number of stores				5			3			9	17
Provinces	2.3	Gauteng, Western Cape			KwaZulu-Natal, Eastern Cape			Limpopo, Free State, North West, Northern Cape			
Average store size (m ²)				1 000			1 800			2 400	
Revenue per m ² (R per m ²)				300 000			?			29 167	
Cost per m ² (R per m ²)				287 480			?			34 367	
Break-even revenue (R'000)				256 580			?			252 609	
Budgeted sales mix	2.4	30%	70%		50%	50%		40%	60%		
Budgeted gross profit		25%	49%		30%	46%		23%	43%		
Budgeted market size (R'million)				1 500			1 000			500	
Actual market size (R'million)				1 400			800			300	
Budgeted market share				20%			20%			20%	
Sales mix variance (R'000)	2.4	7 500	(14 700)	(7 200)	?	?	?	7 245	(13 545)	(6 300)	
Market size variance (R'000)	2.4			(8 360)			?			(14 000)	
Market share variance (R'000)	2.4			8 360			?			3 500	

Notes

- 2.1 Stores across all regions had high logistics costs and low sales volumes. The clothing stores had a difficult year, suffering from the rapid increase in competition from low-cost online retailers in the South African market.
- 2.2 IR accounts for all its inventory using the first-in, first-out valuation method and uses the perpetual inventory system (see section 5 below for further details). Cost of sales consists predominantly of variable costs.

Store operating costs consist of employee salaries, rental and other store-related costs. IR struggled to negotiate with new suppliers in these markets due to a lack of strong relationships and had to settle for quoted prices, with 20% of store operating costs variable in nature and the remaining 80% fixed.

- 2.3 There are three types of stores:
 - Group A stores: These are located in urban areas and economically active hubs with a higher population density and a larger middle-class presence. The customers in these areas are generally more brand-conscious and expect modern shopping experiences.
 - Group B stores: These stores have a moderate population density and a mixed urban-rural spread. Most of the customers in this group form part of the emerging middle class but are more economically constrained. The marketing campaigns to this group were not successful as they failed to meet customer expectations.
 - Group C stores: Their customers are mostly part of the lower- to middle-LSM segment of the market in the rural or peri-urban areas.³
- 2.4 Food and clothing products are sold within the same store environment, supported by shared sales teams, marketing campaigns and store infrastructure. The company had a clearly defined budgeted sales mix per product category.

Jordan had already initiated a performance review. Preliminary calculations have been correctly computed for selected regions and product segments, covering variances in sales mix, market size, market share and break-even revenue⁴. However, the analysis remains incomplete.

3 Shutdown decision

More than a year into the project, IR had invested over R300 million in the LC stores, with no tangible improvement in the performance of the business unit.

With mounting pressure from the board of directors to improve the financial result, Jordan has now decided to re-evaluate the viability of the LC stores. He has put together a proposal to reduce the number of stores to lower the total operating costs of the LC stores.

As part of this reassessment, Jordan engaged with an external marketing company, at a cost of R50 000, to assess closing all nine LC stores in Group C to minimise losses. For example, some customers from affected towns could migrate their purchases to other IR stores in nearby locations.

³ Peri-urban areas are transitional zones between fully urban and rural areas, characterised by a mix of urban and rural land uses and activities. They are located on the outskirts of cities and towns.

⁴ Fixed costs for purposes of break-even revenue include only store operating costs.

Jordan also emphasised that even after closing the nine LC stores, IR would retain a presence (through its other discount retail stores) in all major provinces. This would enable IR to scale operations in the future should the performance of the remaining LC stores improve.

Jordan has put together the following report on the impact on costs if the nine LC stores were to be closed in FY2026. In his report Jordan assumes that the FY2025 actual results are likely to be typical of the performance of the LC stores in FY2026.

**LC store operating costs
Report by the CEO, Jordan Henderson**

The following costs are included in the store operating costs set out in the statement of profit or loss on page 4:

3.1 Labour

The closure of the nine stores in Group C will result in the retrenchment of 70 staff members. This includes cashiers, shop assistants, and security personnel for the stores in locations where the complex does not provide its own security. According to the employment contracts of these employees, they are entitled to retrenchment costs equal to three months' salary only, with no payments for part months. In addition, the employee should have been employed by IR for more than five months,

All the employees that would be retrenched were employed on 1 October 2024 when the concept stores were first launched. Thus, all would have been in IR's employ for one year at the end of FY2025. The current average cost to the company per employee to be retrenched is as follows:

Position	Number of staff	Annual salary
Cashiers	32	R114 000
Shop assistants	28	R120 000
Security personnel	10	R180 000

3.2 Rental

All stores currently located in the Group C areas have active lease agreements with an average remaining lease term of one year. The stores have an average rental cost of R50 000 per month per store. If IR were to cancel these lease contracts, the company would incur a penalty of R500 000 per store. Alternatively, IR could sublet these stores to external parties for an expected rental income of R8 000 per month per store.

All other fixed costs that relate to store operating costs would be unavoidable as these contracts cannot be cancelled.

3.3 Logistics and distribution

All logistics and distribution costs related to the stores that will be closed will be saved. However, because IR has only recently entered into agreements with different logistics companies in these areas, IR would need to pay a total penalty of R900 000 for the early termination of all these agreements.

3.4 Marketing and brand investment

All marketing and brand investment costs are incurred by the head office and are allocated to the stores based on store revenue. I anticipate that this cost will decrease by 15% should these stores be closed.

4 Customer loyalty programmes

4.1 IR customer loyalty programme

IR customers can register on the IR Loyalty Mobile App to become members of the loyalty programme. The app is designed to display each customer's real-time loyalty points balance and points transaction history, but it does not store underlying sales or transactional data. Rather, it connects to the central IT system to access the relevant information, in this case, the number of loyalty points earned, redeemed or available.

When a customer makes a purchase in-store using their loyalty membership number, the transaction is processed through the sales and loyalty integration system. Each in-store terminal is linked to this centralised sales system, which records transaction data and automatically calculates loyalty points earned per transaction based on predefined terms and conditions. These terms and conditions allow customers to earn one point for every R100 spent. Points can be redeemed on future purchases at a rate of R1 for every ten points earned. Loyalty points are only valid for six months from the date they are earned, after which they automatically expire if not redeemed.

The following loyalty points details are available in the sales and loyalty integration system for each customer:

- The opening and closing points balances;
- The loyalty points awarded, expired and redeemed; and
- The total loyalty points value.

During FY2025, gross sales to customers who registered for the IR loyalty programme amounted to R240 million. These sales occurred evenly throughout the year. Of the loyalty points earned during the last six months of FY2025, 30% had already been redeemed by the end of FY2025.

The contract liability at the end of each month and financial year end is calculated with reference to the output report of closing balances and points value per customer.

The balance in the output report at the end of FY2025 has been adjusted for the 30% already redeemed, but not the estimated redemption rate. The estimated redemption rates are reviewed regularly. An adjustment to the contract liability is made by processing a journal entry to adjust for the difference in the balance according to the system and the estimate made.

IR's management expected that an estimated 80% of unredeemed points earned by customers would be redeemed and used this estimate to calculate the contract liability for FY2025.

Should the Group C stores be discontinued in FY2026, customers would still be able to redeem their loyalty points at existing IR stores. However IR has indicated that, under such a scenario, the redemption estimate would decrease from 80% to 65%.

4.2 Partnership with FabBank

IR partnered with FabBank during FY2025. This partnership was spurred by the opportunity to tap into the bank's customer base and consequently generate additional sales when the LC stores were opened. In terms of the partnership, FabBank's customers earn rewards on the bank's loyalty programme when shopping at the LC stores. To earn rewards, FabBank's customers simply swipe their debit or credit cards when making payments at any LC store. FabBank's customers can earn up to 18% in cash back. To determine how rewards can be earned or redeemed as well as what their rewards balances are, FabBank customers are required to log onto the bank's website or its banking app.

The partnership with FabBank does not extend to the existing IR stores and, should all LC stores be discontinued, the partnership with the bank will come to an end.

5 Inventory

Due to the impending decision to discontinue the Group C stores, the accountant determined the expected selling prices less costs to sell the inventory at year end. In addition, IR conducted inventory counts on 30 September 2025 at all 17 LC stores. The information can be summarised as follows:

	Selling price less costs to sell	Inventory count value	Total purchases
	R'000	R'000	R'000
Group A	98 000	96 100	300 000
Group B	96 500	132 150	250 000
Group C	26 500	36 725	100 000
Total	221 000	264 975	650 000

- 5.1 The accountant indicated that one of the suppliers delivered incorrect goods amounting to R120 000 to Group B stores. These are included in the inventory count value at year end but are excluded from the selling price less cost to sell value.
- 5.2 A service delivery unrest took place on 1 October 2025 during which inventory valued at R64 000 was stolen from some of the Group C stores.
- 5.3 The financial accountant stated that inventory was written down to its net realisable value at year end in line with the measurement requirements of IAS 2 *Inventories*. The following journal entry was processed at year end to meet these requirements.

Account descriptions and calculations	Dr.	Cr.
	R'000	R'000
Inventory write down (P/L)	43 975	
Inventory (SoFP)		43 975
<i>Calculation: R264 975 000 – R221 000 000</i>		
Write down of inventory to net realisable value		

INITIAL ASSESSMENT OF COMPETENCE, JANUARY 2026

PROFESSIONAL PAPER 3

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

PAPER 3 PART I – REQUIRED		Marks	
		Sub-total	Total
(a)	<p>Discuss the governance issues and ethical leadership concerns, with reference to the principles and recommended practices of the <i>King IV Report on Corporate Governance</i>, arising from the CEO’s actions and behaviour in connection with the opening of the new LC stores.</p> <ul style="list-style-type: none"> Do not discuss the SAICA Code of Professional Conduct. Do not discuss compliance with the Companies Act. 	12	12
(b)	<p>Critically evaluate the strategic considerations that influenced IR’s decision to invest in the LC stores.</p> <ul style="list-style-type: none"> Ignore the governance-related matters that may have affected the decision to invest in the LC stores. <p><i>Z1: Business internal environment</i> <i>Z2: Business external environment</i></p>	14	16
		1	1
		1	16

Continued on page 2

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PROFESSIONAL PAPER 3

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

PAPER 3 PART I – REQUIRED (cont.)		Marks	
		Sub-total	Total
(c)	Prepare a memorandum addressed to the board of directors. In the memorandum, incorporate insights across all LC stores but only include calculations for Group B stores. The memorandum should cover the following:		
	(i) An evaluation of why the actual net profit of the LC stores differs significantly from the budgeted profit. <ul style="list-style-type: none"> Focus only on the sales mix, market size and market share variances. (calculations: 9; discussion: 11) 	20	
	(ii) An assessment of the CEO’s theory that the store profitability could be improved by ‘right-sizing’ store formats to better align with local market conditions. <ul style="list-style-type: none"> Use break-even analysis, contribution margin and unit economics (revenue and cost per m²) to support your answer. (calculations: 5; discussion: 9) 	14	
	<i>X1: Communication skill – presentation and layout</i> <i>Y4: Judgement and decision making</i>	1 1	36
(d)	Evaluate the CEO’s proposal to close all stores in Group C by –		
	(i) using relevant costing principles to calculate the impact on the performance of IR in FY2026; and	12	
	(ii) critically discussing the impact on the company and its internal stakeholders. <ul style="list-style-type: none"> Assume that the FY2025 results are likely to be typical of the future performance in FY2026. 	5	17
Total for part I			81

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PROFESSIONAL PAPER 3

This paper consists of two parts. Answer each part in a separate answer book.

PAPER 3 PART II – REQUIRED		Marks	
		Sub-total	Total
(e)	(i) Discuss how the customer loyalty programme of IR (in section 4.1 only), should be accounted for in the financial statements of IR for FY2025. <ul style="list-style-type: none"> Do not discuss any disclosure requirements. Support your discussion with calculations. Round all calculations to the nearest rand. Ignore all forms of taxation. 	11	
	(ii) Discuss how the financial accounting implications in respect of IR’s customer loyalty programmes (in sections 4.1 and 4.2) would change if the Group C stores were closed by the end of FY2025. <ul style="list-style-type: none"> Address the implications for both programmes. Show calculations where applicable. Round all calculations to the nearest rand. Ignore all forms of taxation. <p><i>Y1: Critical thinking – logic and reasoning</i></p>	5	
		1	17
(f)	Critically evaluate, with reasons, the accuracy of the inventory journal entry processed by the financial accountant in respect of the inventory write-down for FY2025. <ul style="list-style-type: none"> Provide correcting journal entries where relevant. Do not provide dates of journal entries or journal narrations. Show calculations where applicable. Ignore all forms of taxation. Round all calculations to the nearest rand. 	10	
			10

Continued on page 2

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PROFESSIONAL PAPER 3

This paper consists of two parts. Answer each part in a separate answer book.

PAPER 3 PART II – REQUIRED (cont.)		Marks	
		Sub-total	Total
(g)	<p>Describe the additional substantive procedures that should be performed at year end by the AudSA audit team to obtain sufficient and appropriate audit evidence about the valuation, allocation, and accuracy of the contract liability resulting from the customer loyalty programme.</p> <ul style="list-style-type: none"> • Assume that an IT expert already verified all controls over the central IT systems, sales and loyalty integration systems. • You can rely on all reports produced by these systems. • Ignore all forms of taxation. • All audit procedures to place reliance on the systems and the work performed by the IT expert have already been performed by the audit team. 	12	12
Total for part II			39
TOTAL FOR PAPER 3			120