2003 QUALIFYING EXAMINATION
Part I

This report has been compiled from the analysis of examiners on candidates’ performance in Part I of the Qualifying Examination, which was written in March 2003. Its objectives are to assist –
• unsuccessful candidates in identifying those areas in which they lost marks and need to improve their knowledge and/or presentation;
• tutors in preparing candidates for the Qualifying Examination; and
• future candidates, by providing a commentary for them to use when working through past papers.

To accomplish these objectives, the report provides background information on how the examination questions are chosen, marked and adjudicated, comments on general shortcomings in answers and specific comments on each question of the two examination papers.

The purpose of Part I of the Qualifying Examination is to test the integrated application of cognitive knowledge, preferably as soon as possible after the prescribed academic requirements have been met.

STATISTICS FOR THE QUALIFYING EXAMINATION

In 2003 1 534 candidates passed Part I of the Qualifying Examination, compared to 1 608 in 2002.

<table>
<thead>
<tr>
<th></th>
<th>% Pass</th>
<th>Passed</th>
<th>Failed</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>First attempt</td>
<td>53%</td>
<td>1 124</td>
<td>1 015</td>
<td>2 139</td>
</tr>
<tr>
<td>All candidates</td>
<td>45%</td>
<td>1 534</td>
<td>1 850</td>
<td>3 384</td>
</tr>
</tbody>
</table>

Average marks per question:

<table>
<thead>
<tr>
<th></th>
<th>Question 1</th>
<th>Question 2</th>
<th>Question 3</th>
<th>Question 4</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Paper 1</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total marks</td>
<td>45</td>
<td>50</td>
<td>55</td>
<td>50</td>
<td>200</td>
</tr>
<tr>
<td>Average marks</td>
<td>19</td>
<td>18</td>
<td>19</td>
<td>22</td>
<td>78</td>
</tr>
<tr>
<td><strong>Paper 2</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total marks</td>
<td>120</td>
<td>50</td>
<td>30</td>
<td></td>
<td>200</td>
</tr>
<tr>
<td>Average marks</td>
<td>48</td>
<td>26</td>
<td>11</td>
<td></td>
<td>85</td>
</tr>
</tbody>
</table>
BACKGROUND

The Examinations Committee constantly strives to improve its ability to determine whether candidates demonstrate a readiness to continue with their accounting education and training. This is done by means of an ongoing process of evaluation and improvement in the way in which it selects questions for inclusion in the examination and decides on the final mark plans.

1 Source of the questions

The examination questions are drawn from three sources:

- Questions (the majority) are set specifically for a particular examination by the members of the Examinations Committee (a subcommittee of the Education Committee), who are all specialists in a particular subject area;
- Questions on a particular subject may be commissioned from persons in commerce and industry as well as in public practice by the Accountancy Development Director; and
- Questions submitted by practitioners, accountants in commerce and industry, and academics are added to a question pool that has been built up over the years and are also used in the examination papers.

2 Security and confidentiality of examination papers

The examination papers for each year are compiled, printed and sent to each examination centre under very stringent conditions of security. The only persons who know the contents of a particular paper are the members of the Examinations Committee. They are all selected with great care regarding their integrity and professional standing and are sworn to secrecy.

2.1 Marking of the scripts

The Education Committee devotes a great deal of time to the review and refinement of mark plans to ensure that the plans are consistent with its expectations for each question.

Before marking of the scripts commences, copies of the examination papers and suggested solutions are forwarded to all participating universities for comment. The markers and umpires decide on a suggested solution and mark plan after all these comments have been considered and a test batch of scripts has been marked. The suggested solutions, mark plans and test batch results are then reviewed by the Education Committee, who authorises the final suggested solutions and the mark plans that are used in the marking process.

All markers and umpires have to sign a declaration of secrecy regarding the handling of scripts, questions, solutions and mark plans. SAICA holds the copyright of the solutions and mark plans, and they are returned to SAICA together with the mark lists once the marking has been completed.

Each marking team consists of at least four individuals (comprising academics, practitioners and representatives from commerce and industry) and an umpire, who are on the whole fully bilingual and equally capable of marking both English and Afrikaans scripts.

Each script is marked by two different persons who record their marks on a mark list that they retain. Once the marking has been completed, the markers confer and jointly decide on the final mark to be awarded. Then each marker's mark, as well as the compromise mark, is noted down on the cover of the script. In the event of the markers being unable to agree upon the number of marks to be awarded for a particular answer, the script is referred to the umpire, who then awards the final mark.

In view of the above stringent marking process no request for re-marks will be entertained.
2.2 Adjudication

Adjudication is done by the full Education Committee as soon as possible after the Accountancy Development Director has received the mark list.

The members of the Committee receive lists of candidates – who are identified only by a ranking number based on marks obtained for the examination – together with the marks awarded to every candidate for every question. The members of the Education Committee base their decisions of which candidates passed with honours, which candidates passed, and which did not pass, on the marks as set out in these lists.

During the adjudication process, the Education Committee considers all relevant evidence, including the following:

- The Education Committee’s expectations for each question;
- The level of difficulty for each question;
- Comments from universities, markers and umpires with regard to any marking difficulties which were encountered or candidate time constraints which were noticed;
- Possible ambiguity in the wording or translation; and
- Any other problems that may have been encountered relating to the examination.

It is important to note that no person from the academe who is a member of SAICA’s Education Committee is allowed to serve on the Examinations Committee, and that candidates’ anonymity is preserved until the final adjudication has been completed.

However, it is disturbing that a number of candidates wrote their actual names on their answer sheets. This obviously compromises the integrity of the marking and adjudication process, and could lead to disqualification from the examination.

The instructions to candidates clearly state that names should not appear anywhere. This aspect also relates to questions where candidates are required to write a letter or a report to management. In these cases questions should be signed off using words like “Joe Bloggs”, “QE Candidate”, “A Student” etc.

Another area of concern relates to candidates leaving the examination room with their scripts. This particular issue is emphasised in the Candidates’ Guide to SAICA’s Examinations and announced by the Chief Invigilator before the start of the examination session each day. Such scripts could not be marked and candidates were disqualified. Please ensure that you have handed in your script before you leave the examination room!
GENERAL COMMENTS ON RESPONSES

1 Objective

In view of the primary objective of Part I of the Qualifying Examination, namely to test the integrated application of cognitive knowledge, candidates are tested on their ability to –

- apply the knowledge specified in the subject areas set out in the prescribed syllabus;
- identify, define and rank problems and issues;
- analyse information;
- address problems in an integrative manner;
- exercise professional judgement;
- evaluate alternatives and propose practical solutions that respond to the users’ needs; and
- communicate clearly and effectively.

2 Comments

From a review of candidates’ answers to the seven examination questions for the March 2003 examination the following basic deficiencies were identified. These problems affected the overall performance of candidates, and it is a matter of concern that candidates annually make the same mistakes. Although these aspects seem like common sense, candidates who pay attention to them are likely to obtain better marks, and it may even turn a low mark into a pass.

2.1 Layout and presentation

Candidates should allocate time to planning the layout and presentation of their answers before committing thought to paper. Very often, candidates start to write without having read the question properly, which invariably leads to, for example, parts of the same question being answered in several places or restatement of facts in different parts. Marks are awarded for appropriate presentation and candidates should answer questions in the required format, such as a letter, memorandum or report.

The quality of handwriting is also an ongoing problem and was of particular concern in this year’s examination. The onus is on the candidate to produce legible answers.

2.2 Irrelevancy

Marks are awarded for quality, not quantity. Verbosity is no substitute for clear, concise, logical thinking and good presentation. Candidates should bear in mind that a display of irrelevant knowledge, however sound, will gain no marks.

2.3 Time management

Candidates are advised to use their time wisely and budget time for each question. The marks allocated to each question are an indication of the relative importance the examiners attach to that question and thus the time that should be spent on it. Candidates should beware of the tendency to spend too much time on the first answer attempted and too little time on the last. They should never overruns on time on any question, but rather return to it after attempting all other questions.

2.4 Workings

It is essential that candidates show their workings and supply detailed computations to support the figures in their answers. Marks are reserved for methodology, but can only be awarded for what is shown.
2.5 **Recommendations / interpretations**

Responses to these requirements are generally poor, either because candidates are unable to explain principles that they can apply numerically or because they are reluctant to commit themselves to one course of action. It is essential to make a recommendation when a question calls for it, and to support it with reasons. Not only the direction of the recommendation (i.e. to do or not to do something) is important, but particularly the quality of the arguments – in other words, whether they are relevant to the actual case and whether the final recommendation is consistent with those arguments. Unnecessary time is wasted by stating all the alternatives.

A specific problem in this year’s examination was the fact that candidates did not support their arguments with reference to the relevant theory from accounting statements and exposure drafts. It is of utmost importance to apply definitions and requirements from statements to the scenarios presented in questions and to use the theory as a base for building logical arguments.

2.6 **Examination technique**

Examination technique remains the key distinguishing feature between candidates who pass and those that fail. Many candidates did not address what was required by the questions and, for example, provided answers in the form of statements while calculations were required or presented financial statements where a discussion of the appropriate disclosure was required.

3 **Taxation knowledge**

A specific concern to the examiners with regard to the 2003 Qualifying Examination was the apparent lack of basic taxation knowledge among the majority of candidates. Taxation is a practical and very technical subject, which means that apart from having a thorough grasp of the subject, candidates must be able to apply the knowledge to problems. Candidates would on the whole do far better in this examination should they present themselves with sufficient knowledge of taxation.

4 **Application of knowledge**

A serious problem experienced throughout the examination was that candidates were unable to apply their knowledge to the scenarios described in the questions. This is a major concern, because by the time candidates qualify for entrance to these examinations one would expect them to have assimilated the knowledge, at least to the extent of being able to apply it to simplified facts as set out in an examination question. After all, in a work situation no accountant can expect to deal with textbook type clients and situations, neatly set out in logical format!

5 **First open-book examination**

This was the first year that the examination was in open-book format and it did not appear to be well managed by candidates.

A particular problem was that candidates did not state the relevant theory and/or definitions in their answers. One cannot build a logical argument without using the theory as a base and starting point. Reference to theory and definitions is essential to create the perspective from which the question is answered and is essential to enable markers to follow the argument. However, since candidates have this information at hand, marks are not awarded for stating detailed definitions only. This type of examination does affect the answer that is expected and application and demonstration of insight into the use of the definition have gained in importance.
Candidates should also remember that one has to be very well prepared for an open-book examination. There is not enough time in the examination to look up all information from the texts. In certain aspects one would be expected to offer an immediate response based on embedded knowledge. Complex information needs to be fully understood before the examination. Candidates that enter the examination hoping to look up data that they have not processed before the examination will be disadvantaged, as they are unlikely to finish the paper.

We therefore recommend that the universities provide more opportunities, and that candidates practice, the exam techniques required for open book exams.

In conclusion, a message to those who were unfortunately not successful in the examination: Please start preparing for next years’ examination in good time.

Opera singer Beverly Sills once observed: “There are no shortcuts to any place worth going” and John C. Maxwell said: “A person who has a dream knows what he is willing to give up in order to go up.”

Best of luck!!
PROFESSIONAL PAPER 1

Paper 1 consisted of four questions, that dealt with consolidated financial statements, internal financial control weaknesses and potential risks in a disaster scenario, company income tax calculations (including capital gains tax), VAT considerations and a valuation of a business.

Question 1

Number of scripts marked: 3 384

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>45</td>
<td>19</td>
<td>996 (29.44%)</td>
<td>2 388 (70.56%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Average

In this question candidates had to prepare the abridged consolidated annual financial statements of a listed investment company, specifically dealing with the issue of new shares in one of the group companies in the consolidated cash flow statement (part (b)). In part (c) candidates had to discuss the tax implications of the repayment of a purchased loan.

On the whole the question was poorly answered, with a significant number of candidates consolidating assets and liabilities on a proportionate consolidation basis despite the fact that there was no joint venture. It was obvious that one of the investments was an associate and there was no ambiguity about this fact in the information provided in the question. The number of candidates who were not able to demonstrate that assets and liabilities of an associate must be equity accounted for, was astonishing.

Candidates had to provide a note to the cash flow statement (part (b)) for the disposal of the investment and these answers were generally disappointing, particularly in view of the fact that most of the information required was given in the question.

Many candidates did not answer part (c), which suggests that they did not understand what was required. In cases where answers were given it was not of adequate depth and only dealt with section 24J and not with the capital gains tax implications as well.
Question 2

Number of scripts marked: 3 384

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>18</td>
<td>536 (15,84%)</td>
<td>2 848 (84,16%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Difficult

This question dealt with a disaster simulation that had been performed by the management of a company offering consultancy services, and included information on the company’s disaster recovery plan. Candidates had to write a letter to the managing director on potential weaknesses in internal financial controls relevant to a disaster, and to recommend improvements to those controls. Then candidates had to discuss the potential financial risks that the company might have to deal with in the event of a disaster, as well as the potential implications for the business. Finally candidates had to make recommendations for improvements to the disaster recovery plan in respect of the financial accounting system.

Some candidates lost formatting marks for presenting answers in the form of memoranda rather than letters, or not bothering to format their answers at all.

Part (a) Potential weaknesses and recommendations for improvements in internal financial controls

Candidates were expected to identify a comprehensive list of control weaknesses and then to develop a tailored recommendation for each weakness in the context of the question. This section was answered poorly, as candidates tended to identify only a relatively small number of weaknesses. As a result, candidates earned neither the marks allocated for the unidentified control weaknesses nor the marks allocated for the control improvement suggestions that would have related to those weaknesses.

Furthermore, candidates tended to identify a small number of weaknesses and then listed a large number of generic internal controls and many candidates listed control weaknesses that were not relevant to the information in the question, and thus the scenario.

A number of candidates addressed internal controls that related to normal business activity prior to a disaster rather than financial controls that would be applicable after a disaster had occurred.

Part (b) Potential financial risks and the implications thereof

The section was generally poorly answered. Candidates lost marks for listing general risks rather than financial risks, and for providing recommendations instead of implications for the business.

Part (c) Improvements to the disaster recovery plan

The answers to this section, where attempted, were in general unsatisfactory, mostly because candidates provided generic recommendations for a disaster plan, rather than suggesting specific improvements to the ABC Ltd disaster recovery plan based on the information in the question.
Question 3

Number of scripts marked: 3 384

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>55</td>
<td>19</td>
<td>411 (12,15%)</td>
<td>2 973 (87,85%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Average

Part A of this question dealt with an income tax calculation for a company and specifically required capital gains tax (CGT) calculations. The scenario included details about a leasing arrangement, the purchase of a second-hand machine (which was financed by a loan from a financial institution), patents, trading stock, sales and other income as well as bad and doubtful debts and other expenses incurred. Details regarding the liquidation of a subsidiary and an investment in and dividend from a foreign company were also provided. In Part B the value-added tax (VAT) and capital gains tax (CGT) implications had to be discussed in terms of a scenario where the company has taken action to sue another company for compensation.

Candidates should take care when performing calculations to ensure accuracy. For example, instead of stating the sales as R20 million (as per the question), some candidates stated it as either R20 000 or R2 million in their calculations. Many candidates did not indicate clearly whether an amount should be included or deducted (by means of brackets or a negative sign), either.

It was disappointing that candidates lost a number of marks on basic principles being tested, such as trading stock, bad debts and patents.

A disappointing number of candidates could not deal with the CGT aspects of the question, and especially the implications regarding the liquidation of the subsidiary. Some candidates did not know that the declaration of a dividend in specie (machine) gave rise to CGT in the hands of the subsidiary (declaring the dividend), or that the distribution of the remainder of the assets as a liquidation dividend gave rise to CGT consequences in the hands of the holding company (receiving the dividend).

**PART A Calculation of the taxes payable**

Even though the question specifically required that candidates should “calculate the taxes payable in terms of the Income Tax Act”, almost all candidates also calculated the VAT payable or refundable, despite the fact that VAT is levied in terms of the Value Added Tax Act.

Quite a large number of candidates answered the question in the form of a discussion; they in other words did not calculate but discussed the normal tax payable.

- **Second-hand machine:** Many candidates incorrectly applied the accelerated allowance of 40% instead of 20% and candidates apportioned the section 12C capital allowance for part of the year. Candidates calculated their own rate to determine the interest incurred instead of using the rate of 15,96% provided in the question and some based apportionment on months instead of days.

- **Patents:** Candidates did not know over which period (20 years or a rate of 5%) the cost price of the new patent had to be written off and apportioned the allowance for part of the year. Many candidates did not apply the VAT rules for an imported service and worked with an amount of R3 million, as if excluding VAT.
Candidates did not apply section 23C of the Act and deducted R570 000 in terms of section 11(gB), instead of working with the amount exclusive of VAT.

- **Inventory (trading stock and spare parts):** It seemed as if candidates did not know that opening stock should be deducted and closing stock added to gross income! The 6,3% write-off confused candidates and many of the candidates who subtracted the 6,3% from closing stock added it in the tax calculation, resulting in a nil net effect.

- **Transfer of machines from trading stock:** Many candidates added a recoupment at the original cost (R3,6 million) instead of the market value of R3,3 million and did not calculate wear and tear at all.

- **Sales:** The statement in the scenario that only half of the sales had been to VAT vendors confused candidates and almost half the candidates only excluded VAT for 50% of the sales.

- **Income from contract work:** This part was answered well.

- **Doubtful debts provision:** Although the section 11(j) allowance was generally calculated correctly, candidates had difficulty calculating the actual bad debts of R6,5 million.

- **Interest received:** Quite a few candidates claimed the section 10(1)(i)(xv) exemption of R6 000 for individuals against the interest received!

- **Salaries and wages:** Almost half the candidates added back the salaries amount relating to moving of the machine, but then based the calculation of the capital allowance on the machine on an amount which included that same salaries amount.

- **Liquidation:** This section was answered very poorly. Candidates used the wrong proceeds (P) and par. 20 expenditure (B) in the time-apportioned base cost (TABC) calculation. Many candidates calculated T and N incorrectly because they did not count full years only. Quite a few candidates correctly calculated a taxable gain of R33 333, but then applied the annual CGT exclusion for individuals of R10 000. Apparently many candidates still do not understand that CGT is not a separate tax, but that a percentage of the taxable capital gain is included in taxable income in terms of section 26A.

In terms of the calculation of the dividend received by the holding company, candidates generally did not calculate the revenue reserves correctly, did not calculate the STC as a fraction (i.e. 12.5/112.5) or left out the current year’s results after tax. Most candidates correctly stated that the pre-1993 reserves were not subject to STC in the hands of the subsidiary and that the dividend received by the holding company would be exempt in terms of section 10(1)(k), as it was a local dividend received.

Very few candidates calculated the capital gain for the holding company on the liquidation of the subsidiary, being a disposal of an asset for CGT purposes.

Many candidates treated the lease rental as income and/or worked on an amount including VAT. Numerous candidates missed that the rental was only paid for six months and not the full year.

Many candidates did not apply the connected person limitation contained in section 11(e) with regard to the asset received as a dividend in specie and incorrectly used R3,4 million as the market value of the machine.

- **Foreign dividend:** This section was answered poorly. Some candidates applied both section 9D and 9E and some forgot to multiply by 11%. Some candidates applied the section 10(1)(i)(xv)(aa)
exemption of R1 000 for taxable foreign dividends, despite the fact that it is applicable to individuals only! Candidates did not calculate the maximum section 6quat rebate and some deducted the rebate above the line, i.e. from the section 9E inclusion.

**PART B** Discussion of the value-added tax (VAT) and capital gains tax implications if the company wins compensation in a legal case

This section was answered very poorly. Candidates did not apply or understand the “threshold test” for VAT, namely that it concerns a supply of goods or services by a vendor in the course or furtherance of an enterprise. Many candidates argued that this was an export, and should as such be zero-rated. Some candidates argued that VAT would be applicable, but then included VAT in the proceeds for CGT purposes. Similarly, candidates did not realise that, for CGT purposes, there must be a disposal of an asset.

Some candidates did not accept senior counsel’s opinion and discussed whether the amount would have a capital or revenue nature. In doing so they applied the section 11(a) test for capital nature, namely the enduring benefit test instead of the gross income definition “test” as stated in case law.

**Question 4**

**Number of scripts marked:** 3 384

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>22</td>
<td>1 469 (43.42%)</td>
<td>1 915 (56.58%)</td>
</tr>
</tbody>
</table>

**Level of difficulty:** Easy

Candidates were presented with information about a coffee shop and were required to advise a client on the purchase price he should offer for the business, considering various methods for determining a fair purchase price. Candidates then had to list and discuss issues to be clarified or resolved in concluding the purchase agreement and lastly they were required to advise the client of any apparent weaknesses in internal controls in the operation of the coffee shop and recommend procedures that would address these weaknesses.

The results for the question were disappointing. This was a relatively simple valuation question and many marks were available. Poor marks were often a result of poor exam technique.

**Part (a) Advice on a purchase price offer, considering various methods for determining a fair price**

The question essentially required candidates to identify the three methods for determining a purchase price for the business, namely earnings based valuation, free cash flow valuation and the net asset value of the business. Candidates had to calculate prices according to each valuation method and thereafter conclude what a fair purchase price would be.

Numerous candidates listed each possible valuation method and explained why it was relevant or not appropriate. This was clearly not required by the question and reflects poor exam technique. Outlining valuation approaches would have consumed valuable time without the gain of any marks.

The earnings based valuation was generally competently dealt with. The “operating profit multiple” flummoxed many candidates despite being clearly illustrated in the question.
Candidates generally did not fare well in deriving a free flow valuation. Many attempted to adjust the given discount rate of 40% for specific risk factors pertaining to the coffee shop. This is surprising in view of the absence of information about competitors.

Candidates were clearly confused by the description in the question of the hypothetical manner in which coffee shops are valued. Generally, a free cash flow involves discounting forecast cash flows, adding this to the terminal value derived and adjusting for cash/interest-bearing debt. The question stated that the net cash flow in a normal trading year is discounted by 40%. Candidates who reverted to projecting cash flows and discounting it would have received some marks (despite there being no information in the question for determining future cash flows!).

It was disappointing to note that most candidates did not add back depreciation and adjust for working capital changes in deriving cash generated by operating activities.

Part (b) Key issues in concluding the purchase arrangement

The issues candidates were expected to discuss would not be found in a textbook and required common sense. Most of the issues were apparent from the question.

Generally, answers were either very good or very poor.

Part (c) Weaknesses in internal controls and suggestions for improvement

This part was well answered and many candidates achieved full marks in this section.
PROFESSIONAL PAPER 2

Paper 2 consisted of three questions, and dealt with a sale and leaseback of property, a special purpose entity, revenue recognition, taxation and VAT implications for leases, contract fees and maintenance revenue, corporate governance and ethics, manufacturing considerations, the recognition and measurement of a share exchange transaction and an investment in a film.

Question 1

Number of scripts marked: 3 376

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>120</td>
<td>48</td>
<td>711 (21.06%)</td>
<td>2 673 (79.18%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Average

This question required candidates to discuss the appropriate recognition and measurement of a property sale and leaseback transaction. Secondly, candidates had to discuss the appropriate accounting treatment of an option held over the company who purchased the property in the sale and leaseback transaction. For part (c) candidates had to prepare an internal audit programme to audit the sale and leaseback transaction. In part (d) candidates were required to write a report to the group financial manager dealing with the revenue recognition of two types of leases and the treatment of maintenance revenue/costs and contract fees and in the next section the income tax and VAT implications of these transactions had to be discussed. Part (f) required journal entries on a transport contract denoted in foreign currency, including a foreign exchange contract on that transaction, and finally candidates had to list and explain corporate governance and ethics concerns apparent from the information provided in the question and make suggestions on how these concerns could be addressed.

The performance of candidates in this question was disappointing. Candidates failed to state the necessary theory to support arguments or to express a logical support for positions taken and did not provide acceptable essay style answers. Despite the fact that the topics dealt with elementary, basic knowledge, the answers were poor. Furthermore, the quality of the journal entries provided by candidates in part (f) indicates a lack of basic bookkeeping abilities.

Candidates were apparently unable to deal with an integrated question, even though it was limited to four themes. On the whole, candidates failed to demonstrate adequate knowledge of basic-level topics.

Given that candidates had three hours (as the question accounted for three fifths of the marks) to deal with the question and plan an appropriate response, and that most of the marks could have been earned very easily, it is clear that the candidates’ approach to this question was flawed. Candidates should have scored well in this question, especially as the time allowance was generous.
An analysis of the required sections (parts (a) to (g)) shows that this was a basic type of question and that a large portion of marks could thus have been attained by demonstrating the appropriate theoretical knowledge.

**Part (a) Appropriate recognition and measurement of sale and leaseback transactions of property**

Some candidates performed extremely well in this section with a number achieving 100%. However, the majority of candidates performed poorly, in view of the simplicity of the question.

A candidate would have earned 11 marks for the following theory:

- The definition of a finance lease;
- The principle of substance over legal form;
- The five indicators of a finance lease; and
- Treatment of the sale and leaseback profit if the transaction were an operating lease or of the asset and deferred profit if the transaction were a finance lease.

A further ten marks were set aside for application of the theory to the specific scenario of the question.

In most cases however, candidates not only did not state the theory, but in addition failed to apply what little theory they did provide to the facts given in the question. Candidates also failed to apply a logical exposition such as the above in their answers, which contributed to their poor performance.

Markers were not primarily interested in whether candidates correctly classified the lease as a finance or operating lease, but rather in whether they were able to consider and apply lease theory to their classification – thus to support their answer with logical arguments.

Candidates also did not follow through on their conclusions. Many candidates concluded the lease was a finance lease and then provided the accounting treatment for an operating lease.

**Part (b) Accounting treatment of an option to purchase all ordinary shares in another company**

This section of the question was most poorly answered of all. Most candidates ignored the requirements stated in part (b) and either described the consolidation process or discussed the treatment of an option as a financial instrument in general terms.

While many candidates provided valid descriptions of financial instruments (although this was not required), very few recognised the potential of a special purpose entity and its consolidation. Even those who recognised that there was a special purpose entity, did not properly address the theory or its application in terms of AC 412.

**Part (c) Providing an audit programme to audit the sale and leaseback transactions**

This section was answered well by most candidates. A moderate number of candidates gave generic audit steps without applying it to the question. Many candidates failed to respond as **internal** auditors and responded as external auditors.
Part (d)  A report to the group financial manager on the recognition and measurement of leases, maintenance contracts and contract fees, making appropriate recommendations where necessary.

The question called for a memorandum, written by the internal auditor and addressed to the group financial manager. The answers lacked structure and did not build robust and logical arguments.

- **Lease revenue accounting**: With regard to the lease revenue recognition, candidates did not adequately distinguish between lease A (a finance lease) and lease B (an operating lease). Candidates also did not support their lease classification with a meaningful discussion of the resultant revenue recognition. Candidates were often unable to state the appropriate accounting effect on the lessor that would flow from the finance vs. operating lease classification.

- **Maintenance revenue/costs**: Candidates did not consider separately the issue of a provision for maintenance costs and the up front recognition of prepaid maintenance revenue. Few candidates discussed the provision for maintenance costs. The quality of answers regarding the maintenance revenue was generally poor.

- **Contract fees**: Few candidates recognised contract fees as a service fee. Those candidates who did recognise this, failed to recognise that the provision of the lease arrangement constituted the service and that contract fees should therefore be spread over the lease term.

Part (e) A report on the income tax and VAT implications of the two lease alternatives, the maintenance option and the contract fees paid in respect of one of the leases

While many candidates performed well in this section, the layout of answers was generally poor. The discussion of the income tax and VAT treatment was generally mixed together in the same paragraph.

Answers did not always set out clearly the reason for the tax treatment pursued and the discussions often demonstrated a lack of basic tax knowledge, concerning aspects such as the following:

- The effect of transferring motor vehicles to fixed assets – the transfer being at market value for tax purposes;
- The VAT status of motor vehicles;
- The VAT status of finance leases versus instalment credit agreements; and
- The VAT levied on contract fees.

Many candidates did not follow through on their arguments, for instance concluding that the lease was an instalment sale agreement but then providing the tax treatment of an operating lease.

Part (f)  Journal entries for a transport contract receipt in foreign currency, related maintenance revenue and expenses, a forward exchange contract, and the taxation relating to these transactions

The marks achieved in the section were generally poor with few candidates scoring more than 50%.

If candidates ignored hedging completely and dealt purely with the cash transactions, revenue accrual, maintenance cost and tax effects of these items they could have earned 70% of the available marks. Further marks were available for assessing the hedge effectiveness and correctly recording the hedge transaction.

Many candidates were unable to provide the most basic of journal entries, such as an expense journal entry for maintenance expenses and a revenue journal entry for deferred revenue.
A large number of candidates were unable to translate the foreign exchange items in the transaction correctly. Candidates apparently become confused when faced with a currency other than USD/Euro/Pound. Many candidates both divided and multiplied the exchange rate in the same question.

The FEC hedge on the spot rate of the foreign exchange conversion rates – a fact which was given – was not properly assessed by any of the candidates.

Those few candidates who attempted to assess the effectiveness of the hedge did this incorrectly or were unable to deal appropriately with the effective portion and the ineffective portion. This indicates a lack of the most basic of applied knowledge regarding accounting for foreign exchange denominated transactions and foreign exchange contracts.

The journal entries for the current tax expense and deferred tax was either not done, or done poorly. Very few candidates were able to distinguish between accounting revenue and tax revenue. Most candidates deferred a part or all of the tax revenue, or recorded tax revenue on the contract incorrectly. A handful of candidates recognised the section 24C deduction for costs relating to the revenue contract. These tax journal entries indicate a lack of the most basic tax knowledge among the majority of candidates.

The layout and approach to the journal entries were poor, too. Not only did candidates fail to deal with journal entries for each of the three required dates, namely October, November and December, but the journal entries were often improperly narrated.

**Part (g) Corporate governance or ethics concerns, as well as suggestions for their resolution**

Despite the high ratio of available marks (35) to the marks allocated (15) candidates performed poorly in this section. Few candidates scored more than six marks, with many scoring less than three.

In general the poor performance was because candidates either

- failed to state each governance concern, the reason for the concern and proposed remedies; or
- failed to base concerns on facts relating to the question and rather gave generic answers on corporate governance best practice.

Almost no candidates used any form of tabular presentation, which would have lead to a better presentation of the required information. A number of candidates also pursued auditor independence issues and did not deal with any of the company’s governance issues. This was despite the fact that governance issues stemming from the question were numerous and easy to identify.
Question 2

Number of scripts marked: 3 376

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>50</td>
<td>26</td>
<td>2 068 (61.25%)</td>
<td>1 308 (38.75%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Easy

Candidates had to calculate the breakeven production and sales volumes based on certain budget assumptions and then had to discuss, with reasons, the apparent contradiction between these budgeted calculations and the preliminary results provided in the question. Candidates then had to calculate the budgeted profit for the next year. Candidates were also required to give advice, supported with calculations, to the managing director on steps that could be taken to enable the company to achieve its targeted profit. Candidates next had to discuss the factors to be considered in determining a selling price quote for a special order and finally to discuss the valuation of closing inventory in terms of South African Statements of Generally Accepted Accounting Practice (GAAP).

The question was not difficult and mark allocations were generous. The achieved average mark and pass rate of this question were therefore rather disappointing.

It was noticeable that candidates in many instances performed well in the calculation sections of the question (parts (a) and (c)) and less well in the discussion section or vice versa.

Part (a) Calculation of breakeven production and sales volumes

This part, which was easy, was comparatively well handled.

Part (b) Discussion of the apparent contradiction between budgeted breakeven sales and production volumes and the preliminary profit achieved

Many candidates failed to recognise the fundamental difference between cost volume profit analysis and absorption costing. Instead, many attempted to provide reasons for deviations from the budget relating to aspects such as actual performance costs and efficiencies; even though the question clearly stated that the actual costs equalled budget assumptions.

Part (c) Calculation of budgeted profit before tax

On the whole this part was handled well.

Part (d) Possible steps to enable the company to achieve a targeted profit before tax of 5% of turnover

Performance was disappointing with a minority of candidates approaching the question from a logical and structured perspective. Simple logic would have lead candidates to identify at least the basic drivers of profit (sales volumes, sales prices, cost levels, efficiencies). Merely identifying those drivers plus a brief example of possible action would have resulted in 8 out of 10 marks. However, many candidates limited their answer to a discussion of one element and as a consequence restricted the marks that could be awarded.

Part (e) Discussion of the factors to be considered in determining a selling price for a special order

On the whole this was handled fairly well, and many candidates achieved a pass mark for this section.
Part (f) Discussion of whether closing inventories have been appropriately valued in terms of GAAP

Candidates demonstrated a poor understanding of the GAAP principles applicable to inventory. A large number simply noted the requirements of the statement without applying them to the facts of the case. This is well below the required standard for an open book examination.

Question 3

Number of scripts marked: 3376

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
<th>Marks &lt; 50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>30</td>
<td>11</td>
<td>760 (22.52%)</td>
<td>2616 (77.48%)</td>
</tr>
</tbody>
</table>

Level of difficulty Average

The question dealt with a share exchange transaction as part of a listing process and an investment in a film, related financing of the acquisition and the subsequent licensing to a distributor. Candidates were required to prepare a report in which the appropriate recognition and measurement of the share exchange, the classification of the shares in terms of AC 133 as well as the related headline earnings treatment were discussed. Candidates were also required to discuss the recognition and measurement of the investment in the film as well as the appropriate disclosure of the licence fee arrangements.

The overall quality of answers to the question was lower than what was expected.

Some of the candidates did not complete the answer in report format – these are easy marks and all candidates should have received these marks. Candidates must read the required carefully and respond in the format that is specified.

Handwriting (probably because candidates were running out of time) was an issue and caused the markers some frustrations. It is the candidates’ responsibility to ensure that their handwriting is legible and that each section of a question is started on a new page. The fact that some candidates provided part answers, also point to time management problems. Efficient time management is one of the most basic tenets of good examination technique and one candidates ignore at their peril.

ISSUE 1 Change in shareholdings

This part of the question was not well answered on the whole and many candidates did not even attempt it. It would seem as if this was an unfamiliar scenario and type of transaction and that, because of the unfamiliarity, most candidates were unable to apply basic principles to it (see the examples below).

Part (a) The appropriate recognition and measurement with regard to the share exchange

Many of the candidates did not adopt the view that this was an "exchange" transaction, but considered it to be a sale and purchase transaction. Because they accordingly then referred to proceeds and cost – which were not applicable – they did not earn marks for their discussion. In addition, candidates’ answers lacked the necessary support or explanation for statements they made. Thus some candidates referred to "fair value" but did not state that this was the quoted price. Other candidates explained the difference in values but then did not take it a step further by explaining that there would be a profit/loss or how it should be calculated.
Part (b)  Classification of the shares exchanged

A significant number of candidates classified this as a "held to maturity" investment, which indicated that they do not understand AC 133 at all!

Part (c)  The headline earnings treatment of the share exchange

This part was dependent on an understanding of and correct treatment of part (a). Thus candidates who did not recognise a profit in (a) could not receive marks here. It would appear as if some candidates had no idea of what is meant by headline earnings, as they were unable to explain why the profit/loss should be excluded from headline earnings! This was again an issue of being able to apply theoretical knowledge to facts in the scenario provided in the question. While candidates were able to list the type of transactions (for example fixed assets) that should be excluded from headline earnings, they could not apply it to the facts stated in the question.

ISSUE 2  Investment in a film and related transactions

More candidates attempted to answer this issue of the question than did issue 1, and answers were generally better.

Part (a)  Recognition and measurement of an investment in a film in annual financial statements

It was disappointing that many candidates, even in an open-book examination, just wrote down the definition without applying it to the given situation.

Many candidates stated that the film was a "held to maturity" financial asset, which would again point to a lack of understanding of the tenets of AC 133. Of particular concern was the fact that many candidates classified the film as an "investment property". Neither of these classifications earned many marks in terms of recognition, amortisation and impairment. A number of candidates also referred to finance and/or operating leases and a few candidates classified the licensing arrangement (income portion) as an intangible asset.

Very few candidates received the mark available for stating that the licence fee (bullet payment) should be recognised over the ten-year period. Answers ranged from recognition after ten years to the present value of amount to be received over ten years, with adjustments over the period allocated to interest.

Very few candidates referred to the measurement of the impairment.

Part (b)  Disclosure of the licence fee arrangements for a film production

The answers to this part were disappointing, as this was the easiest section of the question. Candidates who could interpret the "disclosure" requirement and attempted this part generally scored well. However, many candidates did not refer to disclosure specifically or did not attempt this part of the question.

Again, a poor answer on part (a) was followed by a poor answer to part (b).