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 2005. 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 2005 1 887 candidates passed Part I of the Qualifying Examination, compared to 1 783 in 2004.

<table>
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<th>Passed</th>
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<tr>
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Average marks per question:

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<th>Question 3</th>
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**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 by constantly improving 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 Senior Executive responsible for the examination; 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 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, which authorises the final suggested solutions and the mark plans that will be 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 English and Afrikaans scripts.

Each script is marked independently by two different persons who record their marks on separate mark sheets. 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 on 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 after the marking process has been completed.

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:
- Whether the candidates encountered any time constraints;
- The level of difficulty of each question;
- 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.

In order to ensure that the whole marking and adjudication process remains anonymous, the instructions to candidates clearly state that their 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.
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 Overall comments on the papers

Overall comments received from universities indicated that the papers were challenging but of an appropriate standard for Part I of the Qualifying Examination.

The accounting questions were both answered reasonably well. Several candidates scored full marks for Paper 2, Question 1 which indicates that it was a very manageable question.

The tax questions were both of a moderate to easy standard as evidenced by the number of candidates who obtained full marks for Paper 1, Question 2. Despite this, both questions were not answered well and markers specifically commented on candidates’ lack of basic tax knowledge. Candidates often became confused when performing the tax calculation, particularly when adding or subtracting different items, so that they treated similar items in an inconsistent manner.

The standard of the managerial accounting questions was challenging but appropriate for Part I of the Qualifying Examination. Both questions were answered reasonably well by most candidates.

The standard of the audit question was challenging. Candidates did not fare well in this question mainly because were unable to apply their theoretical knowledge. Candidates who simply provided “shopping lists” of information did not score marks.
3 Specific comments

From a review of candidates’ answers to the seven examination questions for the March 2005 examination, the following specific deficiencies were identified:

3.1 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. Many responses by candidates were a “shopping list” of items – namely mere repetition of theoretical knowledge gained about a subject at university, but not applied, and therefore of no real relevance, to the question in hand. This is a major concern, because by the time candidates qualify for taking these examinations, one would expect them to have assimilated the knowledge, at least to the extent of being able to apply it to the simplified scenarios given in an examination question.

3.2 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. In many instances workings were performed by candidates but not cross-referenced to the final solution. Once again, markers cannot award marks if they are unable to determine which working related to which part of the final solution. Candidates must ensure they show their workings and these must be properly and legibly cross-referenced to the final solution.

3.3 Communication

Candidates fared better in questions requiring calculations than in discursive questions. It is therefore important that candidates take note of the fact that written answers form a large component of the Qualifying Examination, as written communication is a key competency required in the workplace. Candidates should learn to answer discursive questions competently, by practicing answers to such questions under exam conditions in preparation for the examination.

In addition markers found that candidates used their own abbreviations in their answers. Marks were not awarded in such cases. It is candidates’ responsibility to ensure that their work is generally understandable. Markers cannot be expected to interpret idiosyncratic abbreviations.

3.4 Journal entries

A fundamental part of financial accounting is an understanding of the system of debits and credits. A means of assessing whether a candidate understands the fundamental principles is to require the candidate to prepare the relevant journal entries. Candidates increasingly do not understand what journal entries they have to process. In many instances basic journal entries were processed the wrong way around. This is inexcusable and candidates must ensure they understand the impact transactions would have on specific account balances, which means they should demonstrate that they know which accounts have to be debited or credited in the income statement or balance sheet. It is not sufficient for a candidate with Accounting IV to be a technocrat – understanding of the fundamental principles of accounting is critical to the success of a candidate at a Part I level.
3.5 Tax knowledge

On the whole candidate’s tax knowledge was found to be extremely poor. Both tax questions were relatively easy and candidates with up to date tax knowledge scored well. Repeat candidates must make this an area to focus on when preparing for next year’s examination.

4 General comments

From a review of candidates’ answers to the seven examination questions for the March 2005 examination the following general 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.

4.1 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, i.e. in the form of a letter, memorandum or a report. (Here candidates are again reminded that their names should not appear anywhere in the paper. Thus candidates should not use their own (or realistic) names when signing letters, reports, etc., but to use names like “Joe Bloggs”, “QE candidate”, “A Student”, etc.)

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

4.2 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.

4.3 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 question attempted and too little time on the last. They should never overrun on time on any question, but rather return to it after attempting all other questions.
4.4 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.

4.5 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, answered questions in words where calculations were required or presented financial statements where a discussion of the appropriate disclosure was required.

4.6 Open-book examination

A particular problem relating to the open-book examination 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 show from which perspective the question is answered and to enable markers to follow the argument. It should be noted that marks are awarded for stating detailed definitions, as this indicates that candidates could identify the applicable issue. 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 and attract the most marks.

Candidates should also bear in mind 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 – or search for information – in the texts. Time constraints mean that candidates should be able to provide an immediate response based on embedded knowledge. Complex information needs to be fully understood before the examination. Candidates who enter the examination hoping to look up data that they have not processed beforehand, will be at a disadvantage as they would be unlikely to finish the paper.

In conclusion, a message to those who were not successful in the examination:

*Please start preparing for next years’ examination in good time.* Don’t give up - sufficient preparation and a review of the basics will stand you in good stead next time around!

Best of luck!!
Paper 1 consisted of four questions that dealt with the impairment of an asset, option to purchase an additional interest in a subsidiary, tax consequences relating to Normal tax, Capital Gains tax (CGT), Donations tax and Secondary tax on companies (STC), commentary on whether a company can return to profitability, substantive audit procedures, control procedures, related party transactions and Corporate Governance and Companies Act requirements.
Question 1

Number of scripts marked: 4236

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<tr>
<td>65</td>
<td>28</td>
<td>1420 (33%)</td>
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Level of difficulty: Average

Part (a) – 26 marks

Candidates were required to prepare journal entries with workings and narrations to record the changes to the carrying value of an asset. Detailed comments on this are as follows:

- The impairment consideration was generally handled well by most candidates,
- However, incorrect principles were applied to determine the present value factor to be used and most candidates did not include the residual value of R7 050 in the net present value calculation.
- Many candidates viewed the change in the residual value as a change in accounting estimate and missed that it related to an impairment.
- While the impairment aspect was picked up by most candidates, the knowledge of how to calculate the impairment was poor. Many candidates only used the carrying amount of R27 million and the residual of R16 million to impair the train with an impairment value of R11 million. This resulted in candidates receiving between 12 and 15 of the available marks.
- Very few candidates used a discount rate adjusted for the average receipt of cash flows (i.e. to 7.2%). In addition, some candidates used annual rates of 15% or 10% as the discounting rate for the cash flows.
- Discounted cash flow was generally dealt with poorly by most candidates: Many candidates did not add back depreciation, while others accounted for the tax charge.
- The residual value journal entries for taxation were prepared on a reasonable basis.
- However, it was disappointing to see the number of candidates who do not understand deferred tax, as was evidenced by tax assets and liabilities being raised incorrectly.
- In addition, few candidates knew how to deal with the deferred tax aspect of the impairment.
- There is a disappointing lack of foundation accounting knowledge, with swapping the debits and credits (e.g. debit accumulated depreciation and credit depreciation to account for depreciation for the year)
- Candidates were unable to provide appropriate names for the ledger account debits or credits.
- Many candidates did not show their workings, thereby missing out on very crucial (and easy) marks.
- Many candidates included their workings either at the end of their scripts or at random places throughout the paper. It is very frustrating if a marker has to search for the workings!
- Workings were often not logically presented, headed or cross-referenced, either.

Part (b) – 3 marks

Here candidates were required to calculate the revised budgeted depreciation charge for an asset.
This section was generally answered well, although some candidates used the selling price as the residual value and some budgeted depreciation over incorrect periods (two or four years instead of three years).

Many candidates again did not show their workings and so lost valuable marks.

Several candidates answered part (b) in part (a) and then failed to answer part (b). While marks were carried over, this constitutes an inappropriate presentation of answers to the required.

**Part (c) – 13 marks**

This section was on auditing and candidates were asked to list the audit procedures relating to the recognition and measurement of an asset.

- Although this section was easy, it was poorly answered. Most candidates simply provided a mind dump of standard procedures, which did not earn marks. There was also evidence of poor examination preparation and technique. Further, the quality of the answers presented brought into question the general level of knowledge of candidates with regard to audit matters.
- Candidates also tended to make the same point in many different ways. Marks are NOT awarded for repetition.
- Most candidates wrote generic answers that showed they had not applied their knowledge to the facts.
- Candidates apparently did not read the question carefully and as a result discussed irrelevant topics such as disclosure.
- Candidates were not specific enough. Many candidates wrote general remarks such as “cast balances” or “agree to supporting documents”, without specifying which balances or supporting documents they referred to. Candidates should give complete answers, such as “cast the fixed asset register” or “agree the cost price per the fixed asset register to the original purchase invoice”.
- “Obtain a management representation letter” is not a valid audit procedure. To earn marks, candidates must have described what specific representation was being sought.

**Part (d) – 23 marks**

This was a good question on a topical matter: Candidates were required to prepare a report to the financial director in which they described the appropriate recognition and measurement of the investment and the option to purchase an additional interest in the investment.

- The answers of candidates were generally poorly structured:
  - Candidates either did not consider all technical matters, or provided insufficient information for the marks allocated to the section.
  - Many answers contained a lot of “waffle”, mind dumping (once again candidates felt it necessary to repeat the entire framework and its recognition criteria for assets) and repetition.
  - Many candidates wrote pages and pages of definitions and recognition criteria to prove that the option or the investment was an asset, but then did not address the treatment of the assets.
A large number of candidates also discussed the definitions of an asset or the classification of financial instruments into held for trading, held to maturity, loans and receivables and available for sale – none of which was relevant – in the process wasting a great deal of time.

Many candidates apparently did not understand the difference between available for sale financial instruments and IFRS 5. Many did not seem to understand non-current assets held for sale, either. It would seem that candidates were either spotting for IFRS5 or their understanding of both IFRS5 and IAS39 is weak.

The basic features of options – in particular that options are derivatives – were poorly understood by most candidates. As a consequence answers on option accounting were very poor.

Many candidates’ reasoning around the issues of significant influence and equity accounting were flimsy.

Most candidates provided poor discussions around the goodwill and fair value accounting for investments in associates.

Candidates displayed a very poor knowledge of the topic of withholding tax and they were apparently unable to relate this to the issue of whether there was deferred tax or not. Most answers discussed the section 6quat rebate, which is a tax rather than the required accounting issue.

Deferred tax on investment was not discussed at all, although almost every one discussed the withholding tax implication with regard to dividends.

Many candidates never reached any conclusions, but instead discussed a variety of possible options.

The advice given by most candidates was very vague and unstructured. Answers should follow some structure, for example:

- State any literature (e.g. definition of an associate);
- Apply the literature to the question (e.g. the options would effectively result in a 40% interest); and
- Come to a conclusion (e.g. therefore significant influence exists and the investment meets the definition of an associate and should accordingly be equity accounted).

The tone of many memos was completely unprofessional. Candidates were asked to write a memo to their client, not their best friend.

Many candidates used idiosyncratic abbreviations, with the result that their memos resembled sms messages which bordered on being unintelligible. It should be noted that the use of abbreviations was worse in the Afrikaans scripts.
Question 2

Number of scripts marked: 4136

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Level of difficulty: Average

Candidates were required to prepare a memorandum setting out with reasons and relevant provisions of the Income Tax Act and discuss the potential tax consequences arising from the proposed transaction set out in the question. Candidates had to address normal tax, CGT, donations tax and STC. The two companies in the scenario, RK (Pty) Ltd (“RK”) and ART (Pty) Ltd (“ART”), were subsidiaries of LEX Ltd (“LEX”).

General comments

- Candidates did not always answer the question in full. They were specifically asked to discuss the normal tax, CGT, donations tax and STC consequences for both RK and ART. They would for example leave out donation tax consequences for RK or neglect to specifically state that there were no STC consequences for RK.
- On the other hand, some candidates discussed the VAT consequences or the tax consequences for LEX, although this was not required.
- Candidates were sometimes vague in answering the question, stating for example “this might be seen as a dividend by SARS…”, or they would argue in the alternative, for example “should this be seen as a dividend then…, however should this not be regarded as a dividend, then…”.
- In some cases candidates would quote the Act without making it applicable to the facts provided in the question and without reaching any kind of conclusion.
- Not all candidates used the memorandum format, although this was specifically required.
- Many candidates incorrectly discussed section 31.
- A number of candidates discussed the provisions of section 45, namely intergroup transactions.

Implications for RK

- Most candidates addressed the tax avoidance issue and referred to either section 103(1) or 103(2) or both. Some candidates went into a lot of depth and discussed the requirements of these sections in detail.
- Only a few candidates applied section 20 (some of them incorrectly referred to the section 20A on ring fencing).
- Most candidates were aware of the section 8(4)(m) recoupment, but did not always explicitly state the requirements of the section.
- Quite a number of candidates (and surprisingly so) mentioned that the interest could not be deducted by RK as it was not actually incurred because it was not and will never be paid.
- Very few candidates addressed the issue of whether section 20 or 8(4)(m) has preference and whether they could be applied on the same amount.
CGT consequences for RK were answered fairly well. Many candidates knew the par. 12(5) provisions of the Eighth schedule and were aware of the exception for companies in the same group.

**Implications for ART**

- It was obvious that most candidates were confused by the fact that the loan was still shown on the balance sheet of RK, although it had already written off by the company. Very few candidates mentioned that ART has already claimed the bad debt in the 2004 financial year and therefore could not claim it again.
- Most candidates correctly discussed the requirements of section 11(i).
- Many candidates knew the section 56(1)(r) exemption for donations between group companies. They would however simply state that no donation would have taken place instead of stating that although it is a donation, it would be exempt under section 56(1)(r), resulting in no donations tax in the hands of ART.
- CGT consequences:
  - Most candidates applied paragraphs 56(1) and 39; only a few applied par 56(2).
  - Not many candidates actually calculated the capital loss.
  - Some candidates argued that money / currency is excluded from the definition of asset and therefore no CGT consequences would arise.
- STC consequences:
  - Many candidates did not realise that section 64C(2)(b) refers to a connected person in relation to the shareholder (being LEX).
  - They therefore did not realise that this would be a deemed dividend declared by ART to LEX.
  - Many candidates discussed the section 64B(5)(f) election.

**Income tax**

- Most candidates stated that a recoupment should take place, but did not indicate how it would take place since there is no receipt as required by section 8(4)(a).
- Candidates did not discuss how the proposed transaction would affect the assessed loss of RK.
- Candidates did not understand the information; the fact that RK did not write off the loan, did not influence the write-off of ART.
- Candidates did not refer to the general principles of gross income and general deduction when discussing the income tax implications.

**Capital gains tax**

- Candidates do not understand the working of disposal and deemed disposals.
- Candidates did not know how to apply capital gains with regard to writing off debt.
- Because they did not understand the rules, several candidates discussed the rules that applied to RK under ART and concluded that no rules were applicable to RK.
- Candidates did not apply the rules that are applicable to a group of companies.
**STC and donations tax**

Many candidates did not answer the required with regard to these aspects, namely that the STC and donations tax implications for both companies be explained. In addition, most candidates only discussed the rules that are applied to ART, and did not refer to RK at all.
Question 3

Number of scripts marked: 4216

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<td>50</td>
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Level of difficulty: Average to difficult

In question 3 candidates were required to analyse and discuss the budgeted income statement and costs, specifically commenting on whether the division was capable of returning to profitability. In addition they were required to calculate the contribution per unit, advise management whether they should supply the order and comment on the pricing strategy of the company.

General comments

On the whole candidates appeared to understand the question and used the information that was provided. Candidates fared better on the calculations than on the discussion.

Part (a) – 25 marks

Candidates were required to identify that the income statement had been drawn up on an absorption basis, which was inappropriate for management accounting purposes, and then to redraft the statement using variable costing. Candidates were also required to implement a relevant costing approach.

- Candidates generally did not understand the difference between absorption costing and variable costing. Few candidates identified that it would be inappropriate to base the decision on an absorption costing method.
- Most candidates did not apply a relevant costing approach, which included all costs.
- Candidates who implemented a variable costing approach scored well on the calculations, although very few calculated the shafts variable and fixed costs split correctly.
- Most candidates understood the concept and provided formulae for the break-even calculation. Few of the candidates identified the correct fixed costs.
- Commentary on the break-even calculation was generally well answered.
- Few candidates identified the capacity constraints.
- The theory section for actions leading to profitability had a generous mark allocation, and candidates generally scored well in this area.

Part (b) – 10 marks

Candidates were required to provide a variable costing analysis for accepting the order.

- Candidates scored well on the basic costing calculations, but few provided adequate calculations for the labour costing aspect.
- The split of the shafts cost into variable and fixed components was particularly badly answered.
Part (c) – 10 marks

Candidates were required to determine the contribution earned on an internal transfer of inventory, and to compare this alternative to the special order in part (b). Marks were awarded for calculations, and for a discussion of the transfer pricing and other issues.

- Although the mark plan for this section was generous, candidates generally performed poorly.
- Few candidates provided a narrative solution.
- Candidates applied relevant costing principles poorly, and did not demonstrate an understanding of the business issues relating to the comparison.
- Few candidates addressed the issue of transfer pricing.
- The stepped high low method for piping was particularly poorly answered, although the principles were relatively straightforward.
- Few candidates discussed other factors that had to be considered, or concluded with advice to the management.

Part (d) – 5 marks

Candidates were required to comment on the appropriateness of the set mark-up pricing strategy applied by the company.

- This section was particularly poorly answered by candidates.
- Candidates displayed little knowledge of pricing strategies in general.
- Few candidates raised the issues relating to standard costing.
- Candidates did not identify the use of product life cycle and target costing in setting prices.
Question 4

Number of scripts marked: 4219

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<td>60</td>
<td>30</td>
<td>2517 (59%)</td>
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Level of difficulty: Difficult

In question 4 candidates were required to draft substantive audit procedures and control procedures as well as outline steps for related party transactions and discuss corporate governance and Companies Act requirements.

Part (a) – 20 marks

Candidates were required to list substantive audit procedures (ignoring timing and extent) that test all aspects of a related party transaction on the issue of share capital, the purchase of inventory and the recognition of management fee income and a related receivable. Candidates also had to list the relevant financial statement assertion(s) addressed by each procedure.

The candidates generally answered the question appropriately, but lost marks for the following reasons:

- A number of candidates did not formulate proper audit procedures as required by the question (did not describe “how”) and instead wrote bullet-point objectives (e.g. “Perform cut-off tests”); and
- Some candidates listed generic procedures for the audit of inventory, share capital and accounts payable, rather than tailoring the procedures to address the terms of the related party transaction described in the scenario.

Part (b)(i) – 5 marks

Candidates were required, in the context of the scenario, to discuss the factors they would consider in determining whether to obtain audit evidence from manual controls and automated application controls, rather than solely from substantive audit procedures. Despite being relatively straightforward, this part was on the whole answered poorly.

Part (b)(ii) – 13 marks

Candidates were required, in the context of the scenario, to describe the nature of the manual controls and automated application controls that they would expect to find in place. In general, this part was answered poorly. Many candidates provided mind dumps of general computer controls (which earned no marks) and some provided audit procedures instead of controls.
Part (b)(iii) – 5 marks

Candidates were required, in the context of the scenario, to set out the additional substantive audit procedures that should be performed at year end to establish the completeness of sales revenue. In general, this part was answered poorly. Some candidates dealt with tests of control rather than substantive procedures.

Part (c) – 7 marks

Candidates were required, in the context of the scenario and work already covered by parts (a) to (b)(iii), to outline the additional steps they would take to address the risk of fraudulent financial reporting in respect of related party transactions. In general, this part was answered poorly with a number of candidates listing generic steps for the audit of related party transactions and balances.

Part (d) – 10 marks

Candidates were required, in the context of the scenario, to discuss the corporate governance and Companies Act requirements that the directors of Lion Ltd should have considered specifically in relation to the issues arising from the information about the business. In general, this part was answered poorly despite being relatively straightforward.
PROFESSIONAL PAPER 2

Paper 2 consisted of three questions, and dealt with a consolidation, intangible assets, equity accounting of associates, consolidated cash flow statements, calculating the tax liability for a company, calculating the STC liability from a dividend cycle and evaluation of a valuation.
Question 1

Number of scripts marked: 4234

<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>90</td>
<td>48</td>
<td>2474 (58%)</td>
<td>1766 (42%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Average

Question 1 required candidates to prepare a consolidation as well as deal with the recognition and measurement of intangible assets.

General comments

Generally poor exam technique is still a major problem for the majority of candidates. The following specific areas were noted:

- Most candidates did not apply the information in the question to their discussions. Often answers were vague and general and lacked evidence of candidates having committed to a certain conclusion.
- Many candidates still contradict themselves in theoretical discussions. This may because they attempt to obtain maximum marks in a question, but they then come across as illogical.
- Many candidates did not read the requirements of the question properly and spend a great deal of time discussing issues that are not relevant and preparing pro-forma journal entries for issues or companies that were not required to be addressed.
- The handwriting of some candidates was almost illegible and the layout of a number of answers was disappointing.
- Some candidates demonstrated a complete lack of knowledge regarding pro-forma journal entries. Entries were switched around, debits and credits were not indicated, journals were not narrated or did not balance and no attention was paid to detail. For example, minority interest was not indicated as pertaining to the balance sheet or income statement, which makes a substantial difference.
- Certain candidates struggled to perform the reconciliation of intangible assets in the note disclosure to the consolidated annual financial statements. Many calculations were done, but candidates mostly failed to structure them in a logical and orderly manner.
- Many candidates appeared to have difficulty in following through adjustments that had to be made at consolidated financial statements level. The recognition of an additional intangible asset at acquisition date led to additional amortisation/impairment, but many candidates completely overlooked these adjustments.

Part (a) – 11 marks

This section dealt with the recognition and measurement of intangible assets and was generally well addressed by most candidates. Candidates appeared to have grasped the issue surrounding the recognition criteria for intangible assets in a business combination. However, poor exam technique (as discussed above) cost many candidates marks in this section of the question.
**Part (b) – 39 marks**

In this section candidates were required to prepare consolidation journal entries. Most candidates seemed to understand the majority of these journal entries. However, journals regarding additional adjustments/corrections at group (consolidated) level were on the whole neglected by candidates in their answers.

**Part (c) – 14 marks**

Candidates were required to reconcile the intangibles note in the consolidated cash flow statement to the consolidated annual financial statements. This section was generally well done except for those areas listed above. The general layout of the final answer of most candidates was very disappointing.

**Part (d) – 8 marks**

Candidates were required to calculate the amount to be reflected on the group income statement for the equity accounting of an associate company. Most candidates had a sound knowledge of the principles underlying the equity accounting of the associated company’s financial results. However, many demonstrated a lack of understanding of how the intercompany dividend should be treated in the context of equity accounting. While most candidates appeared to have understood the adjustments that had to be made at group level, some only performed an analysis of shareholders’ interest, and did not indicate the relevant amounts that had to be included in the equity accounted earnings at group level.

**Part (e) – 18 marks**

Candidates were required to prepare extracts of the consolidated cash flow statement. As discussed above, this section of the question was well executed and most candidates achieved a good mark for this section. Certain candidates however performed calculations without indicating which of the calculated amounts had to be included in the consolidated cash flow statement – these calculations were unfortunately meaningless on their own.
Question 2

Number of scripts marked: 4237

<table>
<thead>
<tr>
<th>Maximum mark</th>
<th>Average mark</th>
<th>Marks &gt; 50%</th>
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</thead>
<tbody>
<tr>
<td>50</td>
<td>31</td>
<td>2513 (59%)</td>
<td>1727 (41%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Easy to average

Question 2 required candidates to calculate the tax liability for a company.

General comments

- The marking process revealed that candidates’ overall tax knowledge was indeed very poor. Given the number of very easy marks available, it was disappointing that candidates did not manage a pass average for this question.
- Candidates showed a lack of basic knowledge on how to approach a tax computation that is simply unacceptable at this level of examination. For example, candidates would start their computations with sales, but would then proceed to add back or deduct accounting entries not allowable for tax purposes!
- Some candidates also started their calculations with sales, but became confused halfway through and from then on applied the method used for the calculation starting with net profit before tax.
- A substantial number of candidates never updated their tax knowledge with recent changes in tax legislation. For example, many candidates still subtracted recoupments on the sale or loss of assets from the cost price of replacement assets, instead of taxing recoupments and capital gains in line with allowances granted on replacement assets.
- The lack of basic tax knowledge is perhaps best illustrated by the fairly large number of candidates who believed the rate of tax applicable to this company was 40%, 35%, 29% or even 15%!
- Many candidates were inconsistent with the use of brackets. In some cases, if they wanted to deduct an amount, they neither used the word “less”, nor put those amounts in brackets.
- Many candidates would write a great deal of information down, but then not include anything in the total column. Markers cannot be expected to guess whether a candidate wanted to deduct or add an amount. The candidate should indicate that himself/herself to gain any marks.
- One of the most critical exam technique issues still remains candidates’ poor handling of the CGT consequences of transactions. Many candidates did not aggregate capital gains and losses, despite the fact that the comments for the 2004 QE specifically noted that this had been a huge problem in the 2004 exam. Many candidates also calculated proceeds and base cost incorrectly.
- In accordance with the decision obtained at the initial umpire’s meeting, marks were not awarded where candidates simply included capital gains in taxable income as and when the capital items arose. The principle of the aggregation of capital gains and losses is crucial, and even more so in this question where there was a large capital loss.
- Some candidates did not recognise all of the CGT events, while others applied the annual exclusion for individuals against the CGT position of the company in question.
An unacceptably large number of candidates did their calculations in note or separate workings format. In other words, they did not show their calculations in their tax computations. This made the marking process very difficult, particularly as many candidates did not cross-reference their workings to the computations. Markers cannot be expected to guess what goes where.

Part (a) – 52 marks
- Many candidates would calculate the tax effect of aspects but then add instead of subtract (or vice versa) an amount.
- Some candidates would calculate the tax effect but then omit the effect from their calculations, as if unsure of how to deal with it.
- In calculating the cost of the imported raw materials, some of the candidates used the spot or forward rate instead of the average rate. This again indicates that candidates’ legislation knowledge is not up to date.
- The unrealised foreign exchange gain and loss were sometimes calculated incorrectly.
- A few of the candidates who started their calculations with net profit before tax forgot to add back the accounting profit of R80 000 on the sale of the shares. Some candidates set off the R55 000 capital gain, given in the question, against the R80 000 accounting profit and deducted the difference.
- A large number of candidates apportioned the section 12C allowance incorrectly. This shows extremely poor knowledge of legislation, as there is hardly a tax question that does not include some reference to it.
- Restraint of trade allowances were incorrectly apportioned.
- Almost all candidates knew that local dividends were exempt, but some candidates applied the interest exemption against the R1 000 interest received from the collective investment scheme.
- Section 11(e) wear and tear was not apportioned.
- The recoupment in respect of the deemed acquisition of the computer was not handled well, which could possibly be ascribed to a lack of knowledge about section 8(5).
- Many candidates set off the recoupment of machine A against the cost of machine B. There were also a number of candidates who included the full amount of the recoupment, again pointing to a lack of updated tax knowledge.
- Many candidates recognised the possibility of taking a section 12H learnership allowance. Of them, many candidates could not calculate the allowance accurately, mostly because they used the incorrect number of weeks.
- A large number of candidates were unable to correctly calculate the disallowed and excessive interest. When calculating the thin capitalisation, many candidates simply multiplied the share capital and retained income by three. Many candidates calculated the excessive interest on R650 000, instead of on R570 000.
- Many candidates provided for an allowance against the acquisition of the trade mark. This again highlights a lack of basic tax knowledge, as no allowance has been available on trade marks since October 1999.
- Some candidates performed VAT calculations which were not required and lost valuable time in the process.
- With regard to the VAT adjustment on the acquisition of goods in note 20, many candidates added the VAT amount, instead of deducting it.
Many candidates devised their own abbreviations, so that markers to try to determine what is meant by for example “PUT” (property unit trusts?). It should be noted that NO marks were awarded for abbreviations not officially recognised in English or Afrikaans.

**Part (b) – 5 marks**

- A large proportion of the candidates did not recognise that there were two separate dividend cycles.
- A number of candidates used 12,5%/112,5% in the STC calculation. This was not a liquidation dividend.
- Many candidates did not know that the thin capitalisation returns are a deemed dividend.
- Some candidates incorrectly deducted the property unit trust dividends in the STC calculation.

**Part (c) – 3 marks**

- This was generally answered poorly by most candidates and a large number did not even attempt this part of the question.
- Many candidates included incorrect amounts for interest and dividends.
Question 3

Number of scripts marked: 4201

<table>
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<th>Maximum mark</th>
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</thead>
<tbody>
<tr>
<td>50</td>
<td>23</td>
<td>1914 (45%)</td>
<td>2326 (55%)</td>
</tr>
</tbody>
</table>

Level of difficulty: Average

Question 3 covered income statement analysis and valuations.

**Part (a) – 15 marks**

Candidates were required to analyse historical and forecast income statements and discuss any issues arising from their analysis. Part (a) was not difficult given the available marks for performing basic ratio analysis and the limited interpretation of information required.

Candidates were asked to review income statements for six financial years and compute and comment on key ratios. Candidates were required to exercise judgement on which ratios to compute and had to assimilate a significant volume of information.

- The decline in turnover in 2004 was an obvious anomaly but many candidates failed to comment on this.
- Most candidates commented on ratios in isolation. For example, commentary on the planned capital expenditure and impact on turnover would have attracted additional marks for the insight displayed.
- Stating the obvious does result in marks in the QE. Turnover was forecast to increase by 4%, 12% and 7% respectively in 2005, 2006 and 2007. This erratic trend should have elicited some comment.
- Certain candidates calculated the gross profit percentage as cost of sales divided by turnover instead of using gross profit as the numerator.
- Some candidates commented on the positive trend in profitability over the period 2005 to 2007. The issue arising was whether these forecasts were realistic and not that prospects appeared to be positive.
- Very few candidates identified that dividends were being declared despite the company borrowing funds for planned capital expenditure.
Part (b) - 30 marks

This part tested valuations using a very different approach to prior examinations. Instead of requiring that candidates perform a valuation, they were required to review and comment on the earnings and free cash flow (FCF) valuations prepared by the financial manager. There were many obvious errors in the financial manager’s valuations.

- It was disappointing to note that many failed to identify the obvious errors in the presented earnings valuation. Depreciation and taxation were clearly ignored by the financial manager in determining “net profit”, and the deduction of dividends from the aforementioned was obviously erroneous.
- Exceptional items should not have been included in projected cash flows, not because they were exceptional in nature but due to the fact that they did not constitute cash flow items.
- Many candidates failed to identify that finance costs and investment income should not be included in forecast cash flows. The tax impact of adding back these items was also often ignored.
- Very few candidates compared the earnings and valuations, usually a basic reasonability check.
- The group operated in different countries. This caused complexities in valuations and the possibility of valuing individual territories should have been raised as an issue.

Part (c) – 5 marks

In this part candidates were required to discuss general shortcomings in earnings based valuations. The fundamental lack of understanding by the majority of candidates was astounding. Earnings and valuations adopt fundamentally different approaches to derive a fair value for an entity, but many candidates compared these two valuation approaches instead of focusing on shortcomings of the earnings based method.