P1 Performance Operations

Questions and answers from past ‘ask a tutor’ events – archived by syllabus area

[Please note that the responses given are the tutors’ own. They are not definitive nor do they necessarily reflect the views of CIMA.]

Syllabus area A - Cost Accounting Systems

Question (Nov 2011):

I really struggle with remembering formulas for variances and how they break down. Can you recommend a way to make this easier?

Response from tutor:

All of the cost variances can be calculated by comparing the ‘should’ figure with the ‘did’ figure, but ultimately the only way to properly crack variances is through question practice and this will also ingrain the formulae in your brain!

Question (Nov 2011):

Test Your Understanding question chapter 2 page 31 in the text book, asks for the under- or over-absorbed fixed production overheads for the year.

I do not follow the answer to this question on page 48, when actual units produced is multiplied by budgeted labour hours per unit and then apply the absorption rate.

Since the absorption rate (budgeted O/H rate) in this case is $0.5 per labour hour and 60,000 actual units takes 930,000 labour hours to produce, ($0.5 x 930,000) – 475,000 actual O/H incurred, seems to me to be the correct calculation.

I get O/H to be (10,000) under absorbed while textbook answer shows O/H as 65,000 over absorbed. Please advise where I am going wrong with my logic and why it is done as on page 48 and not as I have outlined?

Response from tutor:

You have fallen into a classic trap that the examiner also likes to set in the real exam. The question tells you that the fixed overhead absorption rate is based on labour hours. So you are quite correct that firstly you need to calculate absorption rate using the budgeted figures in terms of labour hours; in this case $0.50 per labour hour. However before this can be used as an absorption rate, you then need to calculate the rate per unit and as in this question the budgeted hours per unit is 18 hours, the overhead rate per unit is 18 x 0.50 = $9 per unit.

This means that the actual amount of overhead absorbed will be 60,000 units x $9 = $540,000 and as the actual overhead is $475,000, the over-absorption is $65,000.

Question (Nov 2009):

Could you please help me with some questions related to the ABC exercise starting page 61 in the P1 Performance Operations textbook (Operational Level) 2010 printing edition.

I am struggling with the last worked exercise of Chapter 2.

1) First in part 1, overheads are calculated according to the "Traditional Method"
I do not understand on which basis the cost services i.e. the Factory Management and ordering costs were split between machining and assembly cost centres.

How were the numbers K£600 and K£1,100 allocated to the machining and assembly cost centres?

2) In part 2, the ABC method is applied.

I do not understand how the figures for step 4 were obtained. That is to say how the factory management cost were allocated to the other cost centres such as the figure 230 for the machining cost centre.

Response from tutor:

Unfortunately, I cannot comment on specific workings in any of the Professional Course Textbooks as I do not have access to all such material.

For part 1
Service cost centres are often allocated to production centres based on stated proportions (from the question) or the usage of the service by the production centre (for example the ordering costs may be allocated on the basis of number of orders or requisitions.)

For part 2
Under ABC, the service cost centre will always be allocated based on their usage of the relevant cost driver. You should carefully check the question/solution to see what driver applies to Factory Management.

Question (Nov 2009):

What is the real difference between Budgeting and Standard, what comes first budget or standard?

Please give some examples.

Response from tutor:

This is an area where students frequently get confused. Budgets and standards are very similar in that both are an expression of what we expect to happen in the future.

Management accounting has been described as providing information to assist in planning, control and decision making in a commercial environment. To control costs and revenues effectively some plan must exist to help managers control and evaluate performance.

The Standard Cost is defined as: the “planned unit cost of a product, component or service.” (CIMA Official Terminology) Standard Costs may be determined on a number of bases and the main uses of standard costs are in performance measurement, control, stock valuation and as a starting point for establishing a selling price.

Standard Costing systems offer a very effective “control technique that reports variances by comparing actual costs to pre-set standards so facilitating action through management by exception” (CIMA Official Terminology) A budget has been defined as a “quantitative expression of a plan for a defined period of time. It may include sales volumes and revenues; resource quantities, costs and expenses; assets, liabilities and cash flows.” (CIMA Official Terminology) Or to put it more simply, a budget is “a plan expressed in terms of numbers and values”.

Standard Costing’s Relationship with Budgetary Control:
Standard costing concerns plans that relate specifically to single cost units, whereas the budgetary control system will be more concerned with overall company departmental performance. Both systems incorporate some analysis of variances.

While each system can operate independently, they are best used in conjunction with one another, for example the standards being used as a basis for budgeted figures.

To summarise:

**Standard Costing:**
- **Main Aim:** A product costing system.
- **Main Output:** A standard cost per unit.

**Budgeting:**
- **Main Aim:** An overall company-wide planning system.
- **Main Output:** A defined plan for a period in terms of values

**Question (Nov 2009):**

In relation to mix & yield variances, when is an average cost of raw materials used as opposed to individual cost?

**Response from tutor:**

Mix and Yield Variances – Individual V Average Valuation Methods:

There are two ways of valuing the mix variance: individual or average. Both methods give the same total answer for the mix variance but the individual basis method is usually considered the easier of the two. Therefore you should use this where you have a choice (therefore unless the question tells you otherwise!). However, both methods are examinable on the syllabus. As always, ensure you read the question carefully to ascertain which method is required.

There is some academic debate which argues that the average method provides more consistent control information for management and that the individual method can sometimes mask the impact of using different amounts of each material than those as per the standard mix.

For example using less of a (cheaper) material may be reported as a favourable variance using the individual method. The average valuation method would report this as an adverse variance based on the argument that using less of one material will cause more of a substitute material to be used in the mix. If the substitute is more expensive, then using this as an alternative to the cheaper material is actually bad news (adverse) overall.

**Question (May 2010):**

I believe there is an error in the answer for question 1.1 on page 167 in the Paper P1 official CIMA Learning System study text.

The answer should be (C) and not (B) as shown. Please correct me if I am wrong.

**Response from tutor:**

You are correct – the answer should be (C) - calculated as follows:
<table>
<thead>
<tr>
<th></th>
<th>Original Plan</th>
<th>Revised ex Post Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials</td>
<td>7kg x £4.10 x 1250</td>
<td>7kg x £4.50 x 1250</td>
</tr>
<tr>
<td></td>
<td>= £35875</td>
<td>= £39375</td>
</tr>
<tr>
<td>Planning Variance</td>
<td>£35875 – £39375</td>
<td>= £3500</td>
</tr>
</tbody>
</table>

The answer is therefore C.

**Question (Nov 2010):**

Paper P1

Dear Tutor,

I find it difficult to understand and describe optimised production technology (OPT), synchronous manufacturing, just-in-time (JIT) and total quality management (TQM). What is the relationship between them? How could synchronous manufacturing be applied together with JIT and TQM in an organisation? I appreciate your kind guidance. Thank you

**Response from tutor:**

I will start by defining each of these terms:

Optimised production technology (OPT) is a philosophy that focuses on inventory control and production processes and looks more carefully at optimising the use of bottleneck resources.

Synchronous manufacturing is an all-encompassing manufacturing management philosophy that includes a consistent set of principles, procedures and techniques where every action is evaluated in terms of the global goal of the organisation.

Just-in-time (JIT) is a system whose objective is to produce or procure products or components as they are required by a customer for use, rather than for stock.

Total quality management (TQM) is an integrated and comprehensive system of planning and controlling all business functions so that products or services are produced which meet or exceed customer expectations. TQM is a philosophy of business behaviour, embracing principles such as employee involvement, continuous improvement at all levels and customer focus, as well as being a collection of related techniques aimed at improving quality such as full documentation of activities, clear goal setting and performance measurement from the customer perspective.

The above represent different production management strategies and so as such are not necessarily interlinked; though many modern businesses will adopt more than one of these strategies.

The consistent set of principles, procedures and techniques used in synchronous manufacturing could, but don't have to, include JIT and TQM.

**Question (Oct 2010):**

Hi

I am struggling with Standard Costing and variance mixes. Will you please explain in a simplistic manner the easy way to remember formulae in this section, and what to look out for in questions (the 'red herring') that might steer one from the question asked? Is activity-based costing (ABC) examinable? Will you please give me an overview of what is it as compared to other classic costing methods?
Response from tutor:

**Mix variance** = difference between the standard mix of materials and the actual mix of materials, valued at the standard material cost.

**Yield variance** = difference between the actual output from the materials used and the standard output, valued at the standard material cost.

You may also find it helpful to think of the mix variance as the input variance and the yield variance as the output variance.

These calculations tend to be tested in Section A of the exam paper and so the questions don’t tend to include ‘red herrings’.

ABC is included in the syllabus (Paper P1 – A.1(c)) and the following diagram contrasts it with traditional absorption costing:

Put simply, ABC is a more detailed version of Absorption costing where overheads are broken down into different ‘pools’ of overheads and then an OAR is worked out for each pool separately based of what ‘drives’ that cost pool.
Question (Nov 2010):

Question Two (e) of May 2010

How do we see that production labour and overheads consists of fixed and variable costs and how are we going to calculate both the cost?

Response from tutor:

If you divide a cost by the number of units produced in incurring that cost, you can calculate the cost per unit. If you do this at two different production levels and the cost per unit is the same, you know that this cost is entirely variable. If however the cost per unit falls as the production volume increases, you know that the cost is mixed – partly variable and partly fixed. To split such a cost into its variable and fixed components you can then use the high-low method. If the cost at two different production levels is the same, you know that the cost is entirely fixed.

Here is an illustration of the above. I suggest that you work through it and once you are happy have another go at question 2(e) of May 2010 exam.

Illustration

ABC Ltd has produced the following budgets for 2 possible sales levels for the next budget period.

<table>
<thead>
<tr>
<th>Production &amp; sales (units)</th>
<th>5,000</th>
<th>7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Material</td>
<td>15,000</td>
<td>21,000</td>
</tr>
<tr>
<td>Labour</td>
<td>20,000</td>
<td>28,000</td>
</tr>
<tr>
<td>Production overheads</td>
<td>15,000</td>
<td>17,000</td>
</tr>
<tr>
<td>Admin overheads</td>
<td>11,000</td>
<td>11,000</td>
</tr>
<tr>
<td>Total costs</td>
<td>61,000</td>
<td>77,000</td>
</tr>
</tbody>
</table>

Estimate the individual and total costs for a budget that is based on sales volume of 6,500 units.

Solution

How do we tell what the cost behaviour is for each type of cost?

Fixed costs should be obvious as they will not change as output level changes.

For other costs if it is not obvious by just looking at the figures given then the first thing to do is work out the cost per unit at the different volume levels. If the cost/unit is constant then the cost must be a variable one whereas if the cost/unit changes then it must be a semi-variable cost.

From the above data it is clear that Admin overheads are a fixed cost. The following table looks at the other 3 costs.

<table>
<thead>
<tr>
<th>Cost</th>
<th>Cost per unit @ 5,000 units</th>
<th>Cost per unit @ 7,000 units</th>
<th>Cost category</th>
</tr>
</thead>
<tbody>
<tr>
<td>Material</td>
<td>$3</td>
<td>$3</td>
<td>Variable</td>
</tr>
<tr>
<td>Labour</td>
<td>$4</td>
<td>$4</td>
<td>Variable</td>
</tr>
<tr>
<td>Production overheads</td>
<td>$3</td>
<td>$2.43</td>
<td>Semi-variable</td>
</tr>
</tbody>
</table>
Before we produce our final answer we need to estimate the fixed and variable elements of the production overhead cost. This can be done using the hi-low method:

<table>
<thead>
<tr>
<th>Output</th>
<th>Total costs</th>
</tr>
</thead>
<tbody>
<tr>
<td>High</td>
<td>7,000</td>
</tr>
<tr>
<td></td>
<td>17,000</td>
</tr>
<tr>
<td>Low</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>15,000</td>
</tr>
<tr>
<td>Difference</td>
<td>2,000</td>
</tr>
</tbody>
</table>

The $2000 increase in costs must be a change in variable costs (since fixed costs do not vary as output changes). Therefore we can estimate the VC per unit as follows:

**VC per unit = change in total costs / change in output**

VC per unit = $2,000/2,000 = $1 per unit

We know that when output is 5,000 units, total costs are $15,000
We also know that

\[ TC = FC + Total VC \]

So we can say

$15,000 = FC + (5,000 \text{units} \times \$1 \text{ per unit})$

$15,000 = FC + \$5,000$

Therefore

FC = $10,000

The estimated total costs at a forecast volume of 6,500 units can now be calculated as follows:

<table>
<thead>
<tr>
<th>Production &amp; sales (units)</th>
<th>Type of cost</th>
<th>Workings</th>
<th>6500 $</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Material</td>
<td>Variable</td>
<td>@ $3 \times 6,500</td>
<td>19,500</td>
</tr>
<tr>
<td>Labour</td>
<td>Variable</td>
<td>@ $4 \times 6,500</td>
<td>26,000</td>
</tr>
<tr>
<td>Production overheads</td>
<td>Semi-variable</td>
<td>@ ($1 \times 6,500) + $10,000</td>
<td>16,500</td>
</tr>
<tr>
<td>Admin overheads</td>
<td>Fixed</td>
<td>No change</td>
<td>11,000</td>
</tr>
<tr>
<td>Total costs</td>
<td></td>
<td></td>
<td>73,000</td>
</tr>
</tbody>
</table>

**Question (Nov 2010):**

Q. P1 paper: Idle Time Variance

Idle time variance is a sub-variance of Direct Labour and Variable Overhead. Could you clarify how to calculate the Idle time variance, efficiency variance for direct labour and for Variable Overhead?

Thanks,
Regards,

Stefano
Response from tutor:

This is best answered through an illustration:

**Illustration**

Control plc manufactures tennis rackets. The standard cost of making a tennis racket is shown below.

<table>
<thead>
<tr>
<th>Standard cost for a tennis racket $</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct materials (0.3kg @ $30 per kg)</td>
<td>9</td>
</tr>
<tr>
<td>Direct Labour (2hrs @ $12 per hr)</td>
<td>24</td>
</tr>
<tr>
<td>Variable production overhead (2hrs @ $4 per hr)</td>
<td>8</td>
</tr>
<tr>
<td><strong>Variable (marginal) production cost</strong></td>
<td>41</td>
</tr>
<tr>
<td>Fixed production overheads (2hrs @ $8 per hr)</td>
<td>16</td>
</tr>
<tr>
<td><strong>Full (absorption) production Cost</strong></td>
<td>57</td>
</tr>
<tr>
<td>Profit per unit</td>
<td>13</td>
</tr>
<tr>
<td><strong>Selling Price</strong></td>
<td>70</td>
</tr>
</tbody>
</table>

The following information relates to the production and sales for month 2.

**Budget**

Sales/production volume 15,000 rackets

**Actual**

Sales/production volume 18,000 rackets
Materials cost $165,000 for 5,600kg
Labour cost $405,000 for 33,000 hours paid (only 32,500 hrs worked)
Variable overhead $135,000
Fixed overhead $260,000
Revenue $1,245,000

**Requirements**

Calculate the labour and variable overheads variances for month 2 in as much detail as the information will allow.

**TOTAL LABOUR VARIANCE**

Did making 18,000 rackets cost us more or less than we would have expected in terms of labour cost.

Based on **ACTUAL** production $ 

18,000 rackets
Should cost (18,000 x $24) 432,000
Did cost 405,000

**VARIANCE** 27,000 (F)
LABOUR EFFICIENCY

Based on HRS WORKED in ACTUAL PRODUCTION

18,000 rackets

Should use
(18,000 x 2 hrs) 36,000
Did use 32,500
VARIANCE in hrs 3,500 (F)
Valued at the standard cost per hr $12
VARIANCE in $ 42,000 (F)

LABOUR RATE

Based on hours PAID FOR

33,000 hrs paid for
Should cost (33,000 x $12) 396,000
Did cost 405,000
VARIANCE 9,000 (A)

IDLE TIME

33,000 hrs were paid for but only 32,500 hrs worked. Labour was therefore idle for 500 hrs
Variance = 500hrs (A) @ $12
= $6,000 (A)

TOTAL VARIABLE OVERHEAD VARIANCE

Did making 18,000 rackets cost us more or less than we would have expected in terms of variable o/h based on ACTUAL production $18,000 rackets
Should cost (18,000 x $8) 144,000
Did cost 135,000
VARIANCE 9,000 (F)

VARIABLE OVERHEAD EXPENDITURE

Based on hours WORKED $18,000 rackets
32,500 hrs worked
Should cost (32,500 x $4) 130,000
Did cost 135,000
VARIANCE 5,000 (A)

VARIABLE OVERHEAD EFFICIENCY

Based on HRS WORKED in ACTUAL PRODUCTION

18,000 rackets
Should use (18,000 x 2 hrs) 36,000
Did use 32,500
VARIANCE in hrs 3,500 (F)
Valued at the standard cost per hr $4
VARIANCE in $ 14,000 (F)
**Question (Nov 2009) – P2, now P1:**

Please could you kindly help me to elaborate on the definition and application of the following terms:

a) Could you please provide examples with the definition of over absorption rate. I do not understand what it means when one says that the actual overheads incurred differ from the overhead absorbed.

b) What is Traditional activity based cost and what is its main differences with ABC.

c) Can we say that ABC tries to explain the link between the product and level of overheads without focusing its analysis on volume related activities?

d) Could you please further elaborate on the methodology used for apportioning service cost to production cost centres.

**Response from tutor:**

a) Overhead absorption rate is calculated as budgeted overheads/budgeted basis. It is a predetermined cost of overheads that can be attributed to a product. If a product goes through a factory it needs to be costed at full manufacturing cost including material, labour and overheads. Calculating overhead absorption rates gives us the mechanism of calculating that overhead part. When actual overhead invoices are collecting the total of these is likely to be different to the budgeted rate applied to the product. This gives an under or over absorption and allows us to “correct” the P and I charge from the absorbed overheads to reflect the actual overhead figure instead.

b) The above describes the traditional overhead costing system where overheads rates are calculated based on a few departments. For ABC the rates are calculated for the individual overheads or cost pools. This means there would be many more specific rates that should be more accurately calculated on the basis that specifically drives those costs. In the long run it should also draw management attention to each activities use of the company's resources, although ABC would be administratively more expensive to operate.

c) If a company only produces a single product or low volume products then it is unlikely that the benefits of ABC would outweigh the benefits, so yes I think your sentence is correct.

d) The service department overhead costs are apportioned on a suitable basis to the other productive departments since the product does not enter the service departments and so these costs would never be recovered through the costing of the product. A maintenance department for example would have its costs shared out on say a machine hour basis, whereas a canteen could have its costs shared on number of employees. Any reciprocal servicing would lead to costs being shared back & forth until the service department overheads total zero (or become insignificant).

You should look on cimaglobal.com for articles on this topic that give a more detailed explanation. You should also practice past questions and review the model answers which are available by logging into My CIMA. This is a core topic that you should understand as is forms background to many other subjects in the syllabus.

**Syllabus area B - Forecasting and Budgeting Techniques**

**Question (Nov 2011):**

Can you explain the analysis of expenses by function with a standard numerical example?

**Response from tutor:**
The following examples will illustrate cost categorisation:

**Illustration – cost categorisation & forecasting**

ABC Ltd has produced the following budgets for 2 possible sales levels for the next budget period.

<table>
<thead>
<tr>
<th>Production &amp; sales (units)</th>
<th>5,000</th>
<th>7,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td>$</td>
<td>$</td>
</tr>
<tr>
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<td>21,000</td>
</tr>
<tr>
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<td>28,000</td>
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<td>11,000</td>
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</tr>
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**Total costs**

| 61,000 | 77,000 |

Estimate the individual and total costs for a budget that is based on sales volume of 6,500 units.

**Solution**

How do we tell what the cost behaviour is for each type of cost?

Fixed costs should be obvious as they will not change as output level changes.

For other costs if it is not obvious by just looking at the figures given then the first thing to do is work out the cost per unit at the different volume levels. If the cost/unit is constant then the cost must be a variable one whereas if the cost/unit changes then it must be a semi-variable cost.

From the above data it is clear that Admin overheads are a fixed cost. The following table looks at the other 3 costs.

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<tr>
<td>Labour</td>
<td>$4</td>
<td>$4</td>
<td>Variable</td>
</tr>
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<td>$3</td>
<td>$2.43</td>
<td>Semi-variable</td>
</tr>
</tbody>
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Before we produce our final answer we need to estimate the fixed and variable elements of the production overhead cost. This can be done using the hi-low method:
The $2000 increase in costs must be a change in variable costs (since fixed costs do not vary as output changes). Therefore we can estimate the VC per unit as follows:

\[
\text{VC per unit} = \frac{\text{change in total costs}}{\text{change in output}}
\]

\[
\text{VC per unit} = \frac{2,000}{2,000} = \$1 \text{ per unit}
\]

We know that when output is 5,000 units, total costs are $15,000.

We also know that

\[
\text{TC} = \text{FC} + \text{Total VC}
\]

So we can say

\[
$15,000 = \text{FC} + (5,000\text{units} \times \$1 \text{ per unit})
\]

\[
$15,000 = \text{FC} + $5,000
\]

Therefore

\[
\text{FC} = $10,000
\]

The estimated total costs at a forecast volume of 6,500 units can now be calculated as follows:

<table>
<thead>
<tr>
<th>Production &amp; sales (units)</th>
<th>Type of cost</th>
<th>Workings</th>
<th>6500</th>
</tr>
</thead>
<tbody>
<tr>
<td>Costs</td>
<td></td>
<td>$</td>
<td></td>
</tr>
<tr>
<td>Material</td>
<td>Variable</td>
<td>@ $3 x 6,500</td>
<td>19,500</td>
</tr>
<tr>
<td>Labour</td>
<td>Variable</td>
<td>@ $4 x 6,500</td>
<td>26,000</td>
</tr>
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</tr>
<tr>
<td>Total costs</td>
<td></td>
<td></td>
<td>73,000</td>
</tr>
</tbody>
</table>
**Question (Nov 2010):**

How much part of budgeting and break even covered in P1 paper? Can examiner test a full comprehensive question of each topic in paper?

**Response from tutor:**

Specific learning outcomes requiring an understanding of breakeven analysis appear in Paper C1 and Paper P2. Since Paper C1 is sequentially placed and studied before Paper P1, breakeven analysis is assumed knowledge brought forward when sitting Paper P1 exams. Therefore whilst it is possible that a part of a question may require breakeven knowledge in order to provide an answer, the probability is that this topic will be more extensively tested in Paper P2.

Note: In Paper P1, Forecasting and Budgeting Techniques have a 10% syllabus weighting. Consequently while the examiner could set a 25 mark Section C question on this area, it is very unlikely that you will get a full question, though this could form part of a Section C question.

**Syllabus area C - Project Appraisal**

**Question (Nov 2011):**

My NPV calculations always end up looking a mess. How can I keep them tidy?

**Response from tutor:**

Before you start writing out your answer read the whole question and in particular notice how long the project lasts for. Then leave a space down the right hand side of your page for descriptive narrative and have a column across the top of the page for each time point for the project. Then write headings in the first column for each relevant revenue and cost. You can then enter all of the easy figures and do separate workings for the harder figures. By following this approach you can obtain a pass mark even if you don’t have time (and you probably won't) to finish the question. I have produced an example pro-forma following this approach below.

<table>
<thead>
<tr>
<th>Time</th>
<th>0</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
<td>$000</td>
</tr>
<tr>
<td>Direct Materials</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Variable Production Costs</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Advertising</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Lost Contribution on Existing Production</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Operating Cash Flow</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
</tr>
<tr>
<td>Tax @ ??%</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>New Machine</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Tax saved on Capital Allowances (W1)</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
<td>$xxx</td>
</tr>
<tr>
<td>Working Capital</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Net Cash Flow</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Discount Factor @ ??%</td>
<td>1.000</td>
<td>0.xxx</td>
<td>0.xxx</td>
<td>0.xxx</td>
<td>0.xxx</td>
</tr>
<tr>
<td>Present Value</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
<td>$(xxx)</td>
</tr>
<tr>
<td>Net Present Value</td>
<td>$xxx</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Note: Fill in the blanks with the appropriate values.
Question (Nov 2011):

I refer to the NPV calculation for P1 for March 2011 (Question 4). I’m trying to understand how you deal with working capital in an NPV calculation. In this question it says that working capital of $1 million will be required. It is a 5 year project. How do I deal with working capital in this instance and in general in NPV calculations?

Response from tutor:

In NPV calculations what interests us about working capital is the cash flow it requires. We always assume that the investment in working capital is required at the start of each year. We also assume that within each year the units purchased and sold are identical and so if the total amount of working capital required changes, the cash flow only equals the change. Finally we always assume that at the end of the project the working capital outstanding is received as a cash inflow. This means if you add up all of the working capital cash flows (before discounting them) they should add up to nil i.e. you get back what you put in.

Question (Nov 2011):

I refer to the NPV calculation for P1 for March 2011 (Question 4). I’m trying to understand how you deal with depreciation. Not a real cash item. So just ignore? The questions says fixed costs, including straight line depreciation of the buses costing $5 million with a 5 year life (no residual value), are expected to increase by $3.5 million. Do I take off the depreciation of the buses from the $3.5 million?

Response from tutor:

Correct, depreciation is not a cash flow and so is not relevant and should thus be omitted from the calculation. Fixed costs are only relevant if, as in this question, they change as a result of the project being undertaken. So the relevant figure in the question is $3.5m – ($5m/5 years) = $2.5m.

Question (Nov 2011):

Can you explain the concept of sensitivity analysis in project appraisal with a standard numerical example?

Response from tutor:

Sensitivity analysis involves seeing how much the estimates used to make the original decision can change before the decision becomes incorrect. The less they can change, the more sensitive the decision.

\[
\text{Sensitivity(\%)} = \left( \frac{\text{Project NPV}}{\text{PV of variable finding sensitivity of}} \right) \times 100
\]

Care needs to be taken over the treatment of taxation.

Illustration 4 – Sensitivity analysis

B Ltd is considering a two year project with a capital cost of $1.5m with the following pre-tax operating cash flows:

<table>
<thead>
<tr>
<th></th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$6,300</td>
<td>$7,200</td>
</tr>
<tr>
<td>Costs</td>
<td>$(4,800)</td>
<td>$(5,500)</td>
</tr>
</tbody>
</table>
After 2 years there will be no residual value to the equipment. The company pays tax at a rate of 25% on its net pre tax operating cash flows. Based on the company’s existing cost of capital of 9% the NPV of the project has been established as $605k.

Estimate the sensitivity of the project to changes in:

1. Selling price
2. Cost of capital

Solution

1. We first need to calculate the PV of the sales revenue less tax (costs are not affected by the selling price) as follows:

<table>
<thead>
<tr>
<th>Time</th>
<th>1</th>
<th>2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$'000</td>
<td>$'000</td>
</tr>
<tr>
<td>Sales</td>
<td>6,300</td>
<td>7,200</td>
</tr>
<tr>
<td>Tax (25%)</td>
<td>(1,575)</td>
<td>(1,800)</td>
</tr>
<tr>
<td></td>
<td>4,725</td>
<td>5,400</td>
</tr>
<tr>
<td>Discount Factor @ 9%</td>
<td>0.917</td>
<td>0.842</td>
</tr>
<tr>
<td>Present Value</td>
<td>4,333</td>
<td>4,547</td>
</tr>
<tr>
<td>Total Present Value</td>
<td>8,880</td>
<td></td>
</tr>
</tbody>
</table>

This tells us that if the selling price fell by more than 6.8% then this project would show a negative NPV (assuming all other variables remain unchanged).

2. To find the sensitivity to the cost of capital we need to identify the cost of capital at which the NPV would be zero. That is we need to find the IRR of the project.

Using a discount rate of 40% gives an NPV for the project of ($46k)

The IRR is clearly much closer to 40% than 9%, an estimate can be made as follows;

\[
\text{IRR} \approx 9\% + \left( \frac{605k}{605k + 46k \times (40\% - 9\%)} \right) \approx 38\%
\]

The cost of capital would have to rise to 38% before the project ceased to give a positive NPV (all else remaining unchanged). This is a rise of 322% ((38%-9%)/9%).

Question (Nov 2010):

For P1 paper:

When calculating NPV the timing of tax payments is critical. If the question states that the tax is payable ‘at the end of the financial year’ does that mean tax for year 20X5 is paid in 20X5 or 20X6?
Response from tutor:

20X5.

If the question said the tax is paid one year in arrears, it would be paid in 20X6.

Question (May 2011):

What's the best approach to successfully understand and tackle questions in investment appraisal and the last part of the syllabus?

Response from tutor:

The best way of improving your understanding and technique is to practice as many past questions as you can. You can either download past papers, answers and post exam guides from CIMA’s website or buy one of the many books of both past and exam standard questions.

Question (May 2011):

Please elaborate about the preparation strategy of Parts C & D. Please recommend books for preparation which cover all topics of the mentioned parts especially as per the CIMA criteria because I appeared two times but the questions from these parts were so typical to solve. I have used CIMA study text and still do now.

Response from tutor:

I assume by Parts C & D you are referring to the Project Appraisal and Dealing with Uncertainty in Analysis parts of the syllabus. The best way to prepare for this exam is to practice past exam questions against the clock and review these against the answers and the post examination guide.

Question (May 2010):

P1 Performance Operations (Investment Appraisal)

In Internal Rate Return [IRR] you are required, to calculate IRR%, but you will find that only one (1) discount rate is given. e.g. 12%, Therefore, my question is how a student picks up another correct discount rate for discounting, because you must have higher and lower discount rate in order to solve IRR. Also, how do you become sure that the second discount rate I have picked is the right one to satisfy the cash flow.

Response from Tutor

The IRR technique is, in very simple language, a type of averaging or estimation (known formally as interpolation or sometimes extrapolation). It tries to find the actual return on a project by estimating between two points. These two points are the NPV at one discount rate and the NPV at another discount rate.

The things to remember about IRR are broadly as follows:

• It calculates the exact discounted cash flow rate of return for the project;
• It is the discount rate at which the NPV is exactly zero.

The Decision Rule is as follows:
If the IRR % > Target Rate => Accept the project And if IRR % < Target Rate => Reject the project.

Target Rate = Company’s Cost of Capital (as given in the question).

Ideally you get one discount rate to give a positive NPV and the other discount rate to give a negative NPV because the IRR is where the NPV is EXACTLY zero and will be at a discount rate in-between the rates that give a positive and negative NPV. This is known as interpolation.

However, it is possible to use two rates with NPVs of the same sign (i.e. both either positive or negative). This is known as extrapolation.

The steps in calculating the IRR are:
1. Pick a discount rate and calculate the NPV.
2. If first NPV is positive, pick a higher discount rate. This will give a lower (hopefully negative) NPV.
3. As a guideline for exams, the second discount rate should be between 3% and 5% different from the first one. Use this to recalculate and get a second NPV.
4. If the first NPV is negative (comes out negative), then recalculate for a second NPV using a lower discount rate. This will result in a higher (hopefully positive) NPV.
5. When you have your two rates and respective NPVs, apply the formula approach or prepare a graph to find the IRR.

Attached is a sample question using the formula approach which should help your understanding.

I hope that helps and best wishes for your exams.

Example:
Here is a sample question using the formula approach which should help your understanding.

Question:
Find the IRR of the project given below and state whether the project should be accepted if the company requires a minimum return of 17%.

<table>
<thead>
<tr>
<th>TIME</th>
<th>£</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>Investment (4,000)</td>
</tr>
<tr>
<td>1</td>
<td>Receipts 1,200</td>
</tr>
<tr>
<td>2</td>
<td>Receipts 1,410</td>
</tr>
<tr>
<td>3</td>
<td>Receipts 1,875</td>
</tr>
<tr>
<td>4</td>
<td>Receipts 1,150</td>
</tr>
</tbody>
</table>

Solution:
The total receipts are £5,635 giving a total profit of £1,635 and average profits of £409. The average investment is £2,000. The ARR is £409 + £2,000 = 20%. Two thirds of the ARR is approximately 14%. The initial estimate of the IRR that we shall try is therefore 14%

<table>
<thead>
<tr>
<th>Time</th>
<th>Cashflow</th>
<th>Discount Factor</th>
<th>PV</th>
<th>Discount Factor</th>
<th>PV</th>
</tr>
</thead>
<tbody>
<tr>
<td>0</td>
<td>(4,000)</td>
<td>0.877</td>
<td>3.503</td>
<td>0.862</td>
<td>3.378</td>
</tr>
<tr>
<td>1</td>
<td>1,200</td>
<td>1.052</td>
<td>1.266</td>
<td>1.048</td>
<td>1.084</td>
</tr>
<tr>
<td>2</td>
<td>1,410</td>
<td>0.743</td>
<td>1.048</td>
<td>0.793</td>
<td>1.048</td>
</tr>
<tr>
<td>3</td>
<td>1,875</td>
<td>0.641</td>
<td>1.048</td>
<td>0.543</td>
<td>1.048</td>
</tr>
<tr>
<td>4</td>
<td>1,150</td>
<td>0.552</td>
<td>1.048</td>
<td>0.525</td>
<td>1.048</td>
</tr>
<tr>
<td>NPV</td>
<td>83</td>
<td>NPV (81)</td>
<td>1.048</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The IRR must be less than 16%, but higher than 14%. The NPV’s at these two costs of capital will be used to estimate the IRR.
Using the interpolation formula:

\[
\frac{14 + 2}{83} = 15.01\% \\
\frac{83 + 81}{14 + 2} = 15.01\%
\]

The IRR is, in fact, exactly 15%.

Decision:
The project should be rejected as the IRR is less than the minimum return demanded.

**Syllabus area D - Dealing with Uncertainty in Analysis**

**Question (May 2011):**

Please elaborate about the preparation strategy of Parts C & D. Please recommend books for preparation which cover all topics of the mentioned parts especially as per the CIMA criteria because I appeared two times but the questions from these parts were so typical to solve. I have used CIMA study text and still do now.

**Response from tutor:**

I assume by Parts C & D you are referring to the Project Appraisal and Dealing with Uncertainty in Analysis parts of the syllabus. The best way to prepare for this exam is to practice past exam questions against the clock, and review these against the answers and the post examination guide.

**Question (May 2010):**

Hi! I am writing P1. I am having difficulty understanding:
(i) Minimax, Maximin, Maximax
(ii) Pay-off Tables.

How can I better understand this part of Risk and Uncertainty? Is there a better way?

**Response from tutor**

These are techniques that a manager may use to try to balance the risk and return aspects when making decisions where there are a number of possible outcomes. These concepts are particularly useful when projects and outcomes are mutually exclusive i.e. only one can occur (or be chosen) at any given time.

Firstly, a pay off table is merely a table put together based on the information provided in the question that illustrates the full range of possible profits and/or losses for each project under review.

The table will also factor in any probabilities of the various outcomes occurring for the project under review. Once the data is tabulated, you can consider which decision to go for depending on the manager’s attitude to taking or avoiding risk.

The main decision criteria are:

- Maximax
  This is where the manager seeks to get the best return possible. Look at each option and calculate the highest pay off in each case. Choose the highest of these to implement. i.e. “Choose the best of the best”.
This approach may be followed by someone who is a risk seeker. They will always go for the best possible outcome. You should remember though that the best possible return probably also has the highest possible risk involved.

- **Maximin**
  This is where the manager seeks to minimise the downside exposure. Look at each option and calculate the worst pay off in each case. Choose the highest of these to implement. i.e. “Choose the best of the worst”.

This approach may be followed by someone who is risk averse. They look at how bad things might get in each case and then go for the project which is the “best of a bad lot”.

- **Minimax Regret**
  This is where the manager seeks to avoid lost opportunities or have the smallest level of regret. In this method, construct a table calculating the opportunity cost of choosing each option for a project other than the best one. This will allow you to see the maximum regret (opportunity cost) for each project. Then select a strategy which seeks to minimise the maximum regret.

I hope the above helps and best wishes for your exams,

**Question (Nov 2010):**
Paper P1: Performance Operations I am not able to understand the concept of Value of Perfect Information in Decision Making when there is uncertainty. Please elaborate on this concept more for me. I have spent 3 days on it and not able to grab this concept.

Thanks!

**Response from tutor:**

An EV is just a weighted average calculation using the probabilities of each outcome as the basis of the weighting

\[
E(X) = \sum (\text{probability} \times \text{payoff}) \text{ GIVEN TO YOU IN THE EXAM}
\]

A risk neutral investor will generally make their decisions on the basis of maximising the EV.

**Illustration 1**

If we use the Alpha, Beta and Gamma example but now we have information about the probabilities of the 3 economic states as follows:

<table>
<thead>
<tr>
<th>Economic State</th>
<th>Probability</th>
<th>Alpha</th>
<th>Beta</th>
<th>Gamma</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>0.25</td>
<td>$140,000</td>
<td>$95,000</td>
<td>$30,000</td>
</tr>
<tr>
<td>Average</td>
<td>0.45</td>
<td>$90,000</td>
<td>$89,000</td>
<td>$50,000</td>
</tr>
<tr>
<td>Poor</td>
<td>0.30</td>
<td>($10,000)</td>
<td>$82,000</td>
<td>$78,000</td>
</tr>
</tbody>
</table>

We can work out the expected value of the profit for each of the 3 projects. The results are:

<table>
<thead>
<tr>
<th>Project</th>
<th>Alpha</th>
<th>Beta</th>
<th>Gamma</th>
</tr>
</thead>
<tbody>
<tr>
<td>EV</td>
<td>$72,500</td>
<td>$88,400</td>
<td>$53,400</td>
</tr>
</tbody>
</table>
If our decision had been based on EV and hence a long run average return project Beta would be chosen and the resulting EV would be $88,400.

**Value of perfect information (VOPI)**

The EV calculation above assumes that we do not have perfect information (i.e. we do not know what the economic state is going to be, all we can do is build the probabilities into the decision making).

The question is, how much would you pay someone if they were able to give you perfect information? In this instance somebody was able to tell us what the economic state was going to be before we had decided what project to choose. Presumably our decision making would be better in this situation and our overall return higher.

We work out the VOPI as \( EV \) (with perfect info) - \( EV \) (without perfect info)

**Illustration 2**

If we use the data from the previous illustration we can see that if someone told you the economic state was going to be good, you would choose Alpha and get a $140k return. If they indicated an average economic state, you would still choose Alpha and get a $90k return. Beta would be chosen if a poor economic state was indicated, thus giving an $82k return.

This can be summarised as

<table>
<thead>
<tr>
<th>Economic state</th>
<th>Probability (p)</th>
<th>Project Choice</th>
<th>Return (x)</th>
<th>(px)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Good</td>
<td>0.25</td>
<td>Alpha</td>
<td>140,000</td>
<td>35,000</td>
</tr>
<tr>
<td>Average</td>
<td>0.45</td>
<td>Alpha</td>
<td>90,000</td>
<td>40,500</td>
</tr>
<tr>
<td>Poor</td>
<td>0.30</td>
<td>Beta</td>
<td>82,000</td>
<td>24,600</td>
</tr>
</tbody>
</table>

**EV (with perfect info)**: 100,100  
**EV (without perfect info)**: 88,400

\( VOPI \) = 11,700

In theory we would be prepared to pay someone up to a maximum of $11,700 in order to obtain this perfect information.

**Question (Nov 2010):**

Can you please help me with the probabilities on decision tree. On May and September paper, can you please help me into getting the answer of the probability for the solution when the programme has been advertised? How do you get that 21000,58500,0 and 2500? I could get 69000 and 6000 because it is straight forward.

Thanks, much appreciated
Response from tutor:

To help people who are not familiar with the September exam, I have firstly reproduced the relevant question and solution:

A university is trying to decide whether or not to advertise a new post-graduate degree programme. The number of students starting the programme is dependent on economic conditions. If conditions are poor it is expected that the programme will attract 40 students without advertising. There is a 60% chance that economic conditions will be poor. If economic conditions are good it is expected that the programme will attract only 20 students without advertising. There is a 40% chance that economic conditions will be good.

If the programme is advertised and economic conditions are poor, there is a 65% chance that the advertising will stimulate further demand and student numbers will increase to 50. If economic conditions are good there is a 25% chance the advertising will stimulate further demand and numbers will increase to 25 students.

The profit expected, before deducting the cost of advertising, at different levels of student numbers are as follows:

<table>
<thead>
<tr>
<th>Number of students</th>
<th>Profit</th>
</tr>
</thead>
<tbody>
<tr>
<td>15</td>
<td>10,000</td>
</tr>
<tr>
<td>20</td>
<td>15,000</td>
</tr>
<tr>
<td>25</td>
<td>40,000</td>
</tr>
<tr>
<td>30</td>
<td>65,000</td>
</tr>
<tr>
<td>35</td>
<td>90,000</td>
</tr>
<tr>
<td>40</td>
<td>115,000</td>
</tr>
<tr>
<td>45</td>
<td>140,000</td>
</tr>
<tr>
<td>50</td>
<td>165,000</td>
</tr>
</tbody>
</table>

The cost of advertising the programme will be $15,000.

Required:

Demonstrate, using a decision tree, whether the programme should be advertised.

Decision tree: advertise programme or not
Therefore the programme should be advertised.

Following the advertising decision, there are two probabilities on each branch. So for example the probability of the outcome being poor is 60%, followed by no increase is 35%. So the joint probability is 0.60 x 0.35 = 0.21. The profit at the end of this branch is £100,000 and so the expected value is £100,000 x 0.21 = £21,000. The other three are all worked out in the same way.

Syllabus area E - Managing Short Term Finance

Question (May 2011):

What's the best approach to successfully understand and tackle questions in investment appraisal and the last part of the syllabus?

Response from tutor:

The best way of improving your understanding and technique is to practice as many past questions as you can. You can either download past papers, answers and post exam guides from CIMA’s website or buy one of the many books of both past and exam standard questions.
General questions – P1

Question (Nov 2011):
How much should I write for a 10 mark written question?

Response from tutor:
About a page, but break your answer down into short paragraphs each containing one point.

Question (Nov 2011):
I am taking P1 exams in Nov’11 and am looking for some advice around the preparation and study plan.
I got exemptions for the certificate level and E1 paper based on my MBA. I have studied accounting/finance as part of my bachelors and masters degree, but never really practised finance/accounts in the last 6 yrs period. I have been into Marketing/Sales and Business Development jobs.
As I have only 2 months left for the exam, I am planning to just brush up on my accounting basics and start with P1 study material. I am wondering as to whether it would be sufficient or should I look at the fundamentals of management accounting text in the certificate level, before I start with P1 study text. Please advise, as I am planning to do self study.

Response from tutor:
Given the limited time you have left to prepare I would start by attempting past real exam questions which can be downloaded from CIMA’s website. When you come across questions that you cannot do or understand, then refer to the relevant part of the study text. This will help you focus your exam preparation. You will find that you have already covered most of the P1 syllabus in your MBA.

Question (May 2011):
Performance operations: how do you understand and analyse the complicated question to answer. What is the fastest way to do the long 25 mark questions?

Response from tutor:
Ultimately your speed depends upon question practice; the more questions you have practiced, the more efficient you will be. However you will also be more efficient if you start by reading the requirement and work out exactly what the examiner wants you to do.

Make sure you are familiar with the verbs used in the question – this article (PDF format) is useful: http://www.cimaglobal.com/Documents/Student%20docs/feb2010verbsarticle.pdf

You can then read the question knowing precisely what you are looking for and so you don’t then waste time producing non-relevant information which won’t score any marks. When working on past exam questions, always compare your answers to the suggested answer and post exam guide, which includes a marking guide.

Question (May 2011):
P1 - Would it be wise to dedicate more time on the areas extensively examined in last year’s paper (May & Nov) and with so many formulae in the syllabus, which will be provided in the paper and which
will have to be learned?

Response from tutor:

Just because something was examined last year (or indeed March of this year) does not mean that it is more or less likely to come up in May. So your safest bet is to cover the whole syllabus. The formula sheet that will be provided in the exam is the same one that was provided for both of last year’s exams and so the best thing to do is to look on the website at one of these past papers.

Question (May 2011):

Hi... I am going to write E1, F1 and P1 this may.. I have seen many 'Write a report to...' questions in the revision question section of the textbook. Can you tell me the format of writing report? Can you also please give some guidelines on how to write a report?

Response from tutor:

If you are asked to write a report, you should put a heading in the middle of the page saying ‘Report’ and then underneath on the left hand side on separate lines you should say who the report is To: From: Subject: & Date. You should then put a sub-heading saying ‘Introduction’ and briefly outline what the report covers. You should then cover the issues asked for in the requirement using a separate paragraph for each point and leaving a blank line between each paragraph. Sub-headings for each issue are helpful for both you and the marker. Finally you should finish with a sub-heading saying ‘Conclusion’ and briefly summarise.

Question (May 2011):

What do u suggest to do with the little time at hand to improve my chances of passing the P1 exam?

Response from tutor:

The best way of improving your chances of passing P1 at your first attempt is to study the whole syllabus and practice as many past questions as you can. Attempting the written parts of this exam is critical to passing and these parts of your answer can be in your own words as long as they answer the question that you have been asked and clearly communicate to the marker.

Question (May 2011):

Re Operational & Managerial papers, what would you consider on average the number of hours for preparation per paper for both the operational & managerial levels?

Response from tutor:

This will vary from student to student, but for the P1 paper it will be in the region of 120 hours.

Question (May 2011):

E1, P1 and F1: I just want to ask u that how can I pass all these papers in my first attempt? And whether writing skills matter or not? And finally that can we give answers in our own wordings? Please answer my all queries....
Response from tutor:

The best way of improving your chances of passing P1 at your first attempt is to practice as many past questions as you can. Attempting the written parts of this exam is critical to passing and these parts of your answer can be in your own words as long as they answer the question that you have been asked.

Question (Nov 2010):

I am going to sit F1, P1 and E1 during this Nov 2010. Do we need to follow the same format/steps to answer our problem questions given in the CIMA study material or we can use some other format which we studied during our bachelors and masters. Thank you

Response from tutor:

The format/steps are not what matters; the critical factor is that the marker is able to follow your method. This is because if you make an arithmetic mistake (which is quite likely due to the time pressure) you can still earn a pass mark if the marker can see that you have used the correct method.