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RELEVANT TO PAPERS P1 TO P7



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# EDITOR'S CHOICE

## Welcome to the latest issue of *Student Accountant Essential Guide*

This issue is focused on exam-related information that you need to support your studies towards Papers P1 to P7.

We include examiner feedback from the Professional level exams taken in December 2013. This advice looks at overall performance in Papers P1 to P7 and outlines areas where candidates obtained both high and low marks. Reading the examiner feedback together with the past exam questions and answers from the latest exam session can help you identify where students have gone wrong in the past, and how to develop your answers to achieve the best

marks possible – it is one of the key resources to use in exam preparation.

As well as examiner feedback, this issue contains the examinable standards and information relevant to Papers P2, P6 (UK) and P7. Use this information to guide your exam preparation and take note of the areas that you could be examined on.

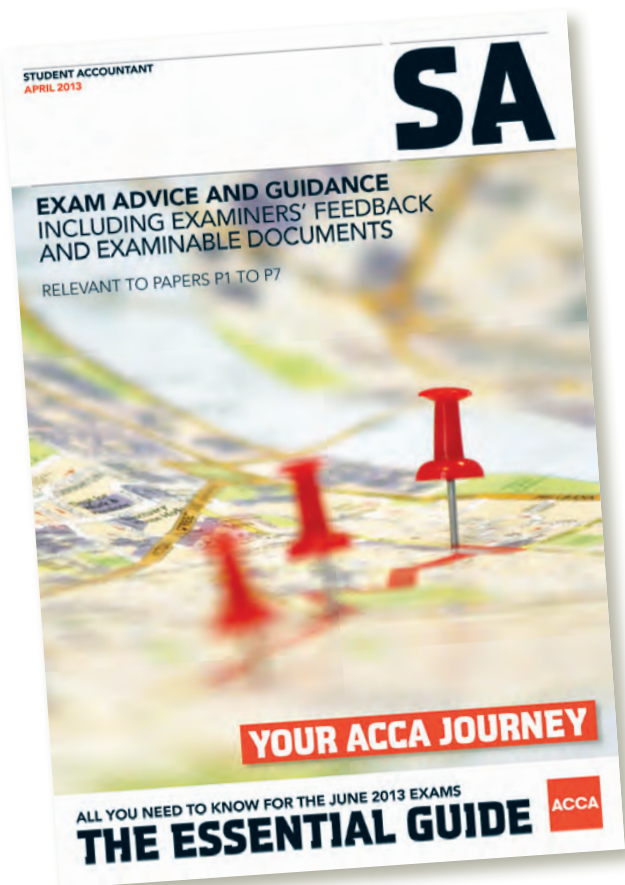
The Exam Toolkit section contains a range of useful advice and information to help you perfect your exam technique, including how to make best use of the reading and planning time and how to gain valuable professional marks.

In Noticeboard, you can view the exam timetable for June 2013, and access details on the exam rules and regulations that you need to be aware of, as well as information on entering for exams.

We've produced this magazine to be as helpful to you as possible for preparing for the June 2013 exams. We have also produced two other tailored magazines for students taking Fundamentals level exams and the Foundation level exams. These can be accessed at [www.accaglobal.com/studentaccountant](http://www.accaglobal.com/studentaccountant).

I hope that you find this magazine useful in your exam preparation. Email me at [studentaccountant@accaglobal.com](mailto:studentaccountant@accaglobal.com) with your feedback on this issue.

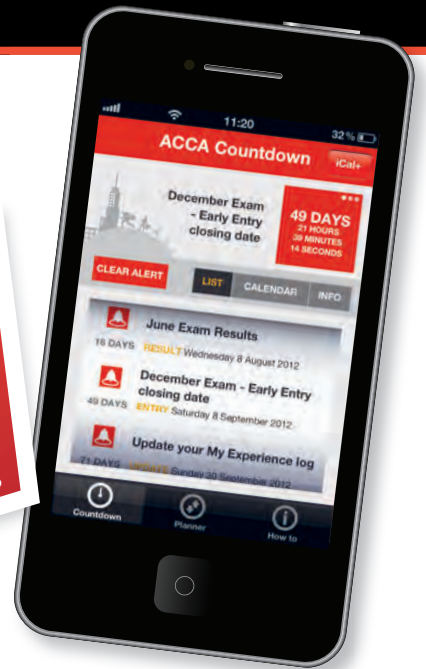
**Victoria Morgan**  
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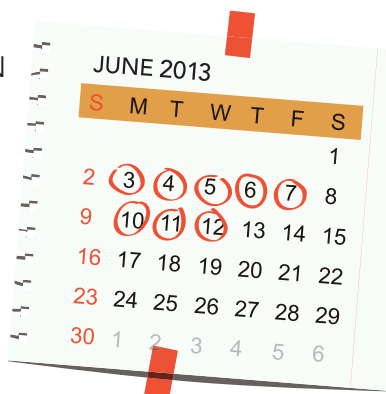
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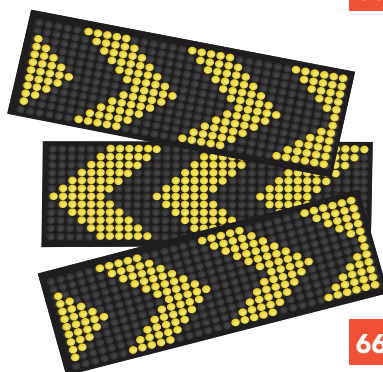
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# FEEDBACK

## EXAMINER FEEDBACK

FROM THE DECEMBER 2012 EXAM SESSION

Examiners' feedback provides guidance on past ACCA exam performance and suggests ways in which students can achieve higher exam results

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# EXAM FEEDBACK

## PAPER P1 PASS RATE: 50% GOVERNANCE, RISK AND ETHICS

The structure of the paper comprised one compulsory question in Section A and a choice of two from three in Section B. Question 1 was worth 50 marks overall and each Section B question was worth 25 marks.

The parts of questions done well by many candidates were Questions 1(a), 1(c), 2(a), 2(b), 3(a), 3(b) and 4(a). The parts that were often done poorly were 1(b), both parts of Questions 1(d) and also 4(b). I will discuss the reasons for the weaker performance in the question reports below.

### SPECIFIC COMMENTS QUESTION 1

The case in Section A, Question 1 was about a company called P&J that made a product (X32) that was discovered to be toxic and hazardous to health. With so much investment in the X32 supply chain, P&J had to face several strategic problems, not least of which was a likely long-term liability from litigation claims from employees and others that had been exposed to X32. The requirements examined a range of issues concerned with P&J and its difficult situation.

Part (a) asked about P&J's social footprint. Most candidates were able to define what it means (the first requirement) and the question then asked for four particular social implications of Professor Kroll's findings. The case described these and this showed the importance of carefully studying the case to gather this information. The emphasis here was on exploring how people and communities can be affected by business issues. In the case of X32, these issues concerned health, employment and the loss of company value.

Part (b) asked about the diversification of risk. Overall, this requirement was done poorly. A minority was able to describe well what the term means. The requirement was to explain why diversification of its risks would be very difficult for P&J. Again, it was necessary to study the case in some detail to answer this well as all the reasons for the difficulties were there. Weaker answers

attempted to fit the TARA framework into the answer, although this was an inappropriate and incorrect approach.

Part (c) was about the unethical and unprofessional behaviour of Hannah Yin, who was a qualified accountant and therefore subject to the fundamental principles of professionalism contained in the IFAC Code of Ethics. The case contained evidence that her behaviour breached three specific fundamental principles (integrity, objectivity and professional behaviour). Weak answers listed all of the IFAC principles with some attempting to show either their importance (which was not required) or to show how Hannah had somehow breached all of them. In understanding ethical behaviour for professionals, it is important to be able to criticise poor ethical behaviour and this was the main purpose of this question.

I was disappointed that neither requirement in Part (d) was done well by many candidates. Part (di) asked candidates to distinguish between strategic and operational risk and this was done quite well by many. It was the second requirement in Part (di) that was done less well: to show how the findings in the Kroll report are a strategic risk to P&J. This involved being able to apply the idea of strategic risk and to analyse the case to show why these risks are strategic (as opposed to operational). It is important, then, not only to know what terms like 'strategic risk' mean, but also to be able to apply them in the context of information from a case study.

I was surprised that Part (dii) was not so well done because five of the nine marks available were effectively testing theoretical knowledge (the board's responsibilities for internal control). A thorough and systematic revision schedule should have provided candidates with a full knowledge of the board's responsibilities in respect of internal controls and the COSO guidelines were a helpful framework around which to base a good answer.

The second task in Part (dii) was to criticise Mr Ho's decision to choose Plan B. This was poorly done overall even although there were clear criticisms

to be made of Plan B (in the case) from an ethical perspective: Plan B knowingly overlooked the health needs of some employees and acted based on how visible the changes would be, thereby ignoring the need to upgrade the facilities in the developing countries.

The four professional marks were awarded for writing the answer in the form of an article in a magazine called *Investors in Companies*. There were some excellent attempts from some candidates while others seem to have made no attempt at all to frame their answers according to this requirement. As in previous reports, I would remind candidates that making an attempt to gain the professional marks is very worthwhile and, in some cases, can be the difference between a pass and a fail.

### QUESTION 2

The case in Question 2 was about corporate governance in the country of Oland. All of the themes raised in the requirements had been in previous Paper P1 exams (some in more than one) and well-prepared candidates who had worked through the past papers would have seen similar requirements before.

Part (a) appeared to be straightforward at first glance but the emphasis here was on how sound corporate governance can make it more difficult for companies to fail. This, after all, is one of the most important purposes of corporate governance (protecting the value of shareholders' investment), and so the emphasis here was on showing how the measures in sound corporate governance make a company more robust and more able to cope with threats to its ongoing existence.

Weaker answers listed the key underpinning concepts from *Study Guide* Section A1(d). It wasn't clear how this approach was attempting to answer the requirement about making it more difficult for companies to fail, and therefore these answers were not well rewarded. Good answers reflected on the essential features of good governance and then, importantly, considered how each of these made a company more robust and less likely to get into financial difficulty.

Part (b) was quite well done overall. The distinction between rules and principles-based approaches to corporate governance was well understood by most candidates but the second task was less well done by some. In the case, Martin Mung had insisted that

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'comply or explain' was ineffective, thereby arguing for a more rules-based approach in Oland. The task was to argue against his position, thereby arguing in favour of 'comply or explain'. Some tagged this on to their discussion of the principles-based approach while others added it as a separate section after distinguishing between the two. Either was acceptable as long as the appropriate content was included in the answer.

Part (c) began by asking for an explanation of 'accountability', which most candidates could do successfully. The tasks asking about how shorter re-election periods and the provision of biographical detail might result in greater accountability were less well done by candidates. It was important to understand the link between accountability as a concept and the mechanisms of calling to account (such as those described in the case). Again, the ability to apply a piece of knowledge (knowing what accountability means) to a case was key to gaining good marks.

#### QUESTION 3

The case in Question 3 was about Yaya Company and a number of failures of internal control, mainly centred around the quality control laboratory. Part (a), on the typical reasons why internal control systems might be ineffective, was done quite well overall, partly because it was mainly bookwork. In a Paper P1 exam containing so much need to analyse the case and engage with higher level cognitive verbs, it is very important that bookwork marks are obtained where available. This underlines the importance of revising the main 'lists', themes and concepts in the *Study Guide* and in study texts.

Part (b) was a typical Paper P1 question and one that has been asked, in various forms, several times before. The task was to look carefully at the case and explain (not just list) the internal control deficiencies that led to the problems at Yaya. Well-prepared candidates were able to gain good marks on this requirement with the best approach being to carefully pick out the IC failures, one at a time, with a separate paragraph dedicated to each.

Part (c) was done less well. Weaker answers used a mnemonic to list the qualities of useful information (typically the 'ACCURATE' mnemonic) but the question specifically asked how they would be of benefit to Mr Janoon. Those that just listed the general qualities did not score highly as they failed to

engage with the value to Mr Janoon. A second task was to recommend specific measures that would improve information flow from the QC lab to the case. Many answers given were general or vague, whereas a good answer considered the specific information needs of Mr Janoon and was framed in that way.

#### QUESTION 4

This was a 'stakeholder' question in which a disputed route for a new railway set the scene. Both routes (A and B) had their pros and cons and, eventually, Route A was chosen which would protect Mr Krul's farm but destroy the feeding ground for the colony of endangered birds.

The Tucker 'five question' framework for assessing the decision to choose Route A (part (a)) was done well for the most part, but some candidates merely listed the five questions with little attempt to engage with the case. The point here was that while the decision to choose Route A was profitable and legal, there were questions over its fairness, its rightness and its sustainability. The better answers were able to engage with these issues and show that the selection of Route A was not without its complexities.

Part (b) was done poorly overall. A similar version of this question was on a previous paper so it was disappointing to see that many candidates performed poorly. A common, and incorrect, response was to frame the answer around the Mendelow matrix. Perhaps the word 'stakeholder' in the question triggered an assumption that the answer must involve the Mendelow matrix – but this was not so, except to highlight that some stakeholders are more influential than others. The question specifically asked about the importance of recognising all of the stakeholders in a decision and therefore concerned stakeholders as sources of risk, disruption, conflict and reputation loss. A careful reading of the wording of the question was necessary to get the actual meaning of what was required.

Finally, Part (c) asked about stakeholder 'claims' and then asked candidates to critically assess the claims of the three main stakeholders discussed in the case. *Student Accountant* published a technical article about this in early 2008 and it was pleasing to see that most could explain the notion of a 'claim'. The second task, to critically assess the three claims, was done less well, with weaker answers just repeating information from the case about each one.

## PAPER P2 PASS RATE: 49% CORPORATE REPORTING

The paper required candidates to answer the compulsory Question 1, which carried 50 marks and then to choose two questions out of the remaining three questions, which carried 25 marks each. Candidates performed quite well in this session.

As usual, the paper dealt with a wide range of issues and accounting standards. There are several key principles in each standard, which are the basis of most of the exam questions, and candidates should concentrate on understanding and interpreting these principles.

Candidates need to understand the standards, and not just learn their content. Understanding will lead to better application in the exam. Candidates should practise divergent thinking, which is the ability to think of several possible answers to a question before providing the solution. Seeing potentially different outcomes for a given set of circumstances will lead to candidates being able to apply the standards to different scenarios.

Every exam session produces scenarios that candidates may not be familiar with, so there is a need for this type of reasoning. Candidates often simply recite the standard, leaving the marker with the task of determining how applicable the answer actually is to the question. Candidates should adopt a model of learning that suits them and, by doing this, candidates will be better prepared for the exam.

#### SPECIFIC COMMENTS QUESTION 1

This question required candidates to prepare a consolidated statement of financial position for the Minny Group, as at 30 November 2012. The group structure was a complex group with a sub-subsidiary. Candidates also had to deal with an associate, which had originally been an investment within the group, impairment testing the holdings in the group companies, a disposal group and the capitalisation of development expenditure. Candidates dealt with the group structure quite well and the calculations of goodwill arising on acquisition were generally accurate. It is important to take time in the exam to determine the nature of the group structure as marks are allocated for this in the marking guide. Often, candidates calculate retained earnings and non-controlling interest inaccurately but the marking guide gives credit for





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candidates' own figures as long as the principle is correct. This latter point also enhances the importance of candidates showing full and clear workings. Some candidates condense their workings into a disproportionately small space in the answer book. Clarity is more important than conciseness. In this question, there were marks allocated for the presentation of the disposal group on the face of the statement of financial position. Many candidates did not show the disposal group separately. Another important consideration is the completion of the 'double entry' in the workings. Marks are allocated for the correct completion of the entries.

The main problems that arose were the treatment of the impairment of goodwill, the gain arising on the accounting for the associate, and the treatment of the disposal group. Additionally, candidates often find it difficult to deal with the volume of information in the question. This skill can be improved by exam practice and technique.

Part (b) of the question required candidates to discuss what is meant in IFRS 5 by 'available for immediate sale in its present condition' and 'the sale must be highly probable', while setting out why regulators may question entities on the application of the standard. It seems apparent from the nature of the question that there are two elements to the question. First, a discussion of IFRS 5 and, second, why questions may arise on the application of IFRS 5. Accordingly, marks were allocated on this basis. Many candidates simply repeated the information in the question, which did not gain marks. In the introduction to this report, the ability to think widely was discussed. This question required candidates to do just that. If candidates read widely and learn to formulate opinions, then this type of question would not pose problems.

Part (c) of the question set out a situation where a property with a carrying value of \$2m at the year end was being sold to a group company for \$1m shortly after the year end. Candidates had to discuss the ethical and accounting implications of the intended sale of assets. Again, there were two elements to the question. The ethical implications and the accounting implications. There were a surprising number of candidates who did not discuss the accounting implications and also many candidates did not see any ethical issues.

If candidates do not deal with every element of the question, then they are significantly restricting the number of marks that they are likely to achieve.

#### QUESTION 2

This question required candidates to discuss the accounting treatment of green certificates in financial statements. The green certificates were essentially income related government grants. However, there were a variety of IFRS that needed to be referred to besides IAS 20. These IFRS included IAS 18 and IAS 2. Many candidates discussed IAS 38, *Intangibles*, and some credit was given for a relevant discussion. The theme of this report is divergent thinking. Here, a candidate should not have simply discussed IAS 20 but widened the discussion to include the potential impact of other standards on the entity. This is a skill expected of an ACCA member.

The second part of the question dealt with an overseas subsidiary and required candidates to discuss amounts reported in the consolidated statement of cash flows. The surprising thing about this part of the question was the number of candidates who ignored the cash flow implications and simply discussed the accounting in the group statement of financial position. It is important for candidates to read the scenario the question. Marks will not be gained for irrelevant discussions. In fact, it is detrimental to a candidate's chance of being successful in the exam as such discussions use up valuable time for no credit.

The third element of the question dealt with the situation where there was some doubt as to whether an entity should treat the holding in another entity as a subsidiary in its consolidated financial statements. This question involved the discussion yet again of more than a single IFRS. There are a number of IFRS that deal with group accounting and candidates should look at these standards in conjunction with each other. In this question, control was determined by looking at IFRS 10 but, additionally, if an entity is not a subsidiary, then other standards should be consulted such as IFRS 11 for joint control implications and IAS 28 for equity accounting possibilities. A narrow answer dealing

with IFRS 10 would have restricted the marks. This part of the question was quite well answered.

The final part of the question required candidates to look at adjustments to current tax in respect of prior years and whether this expense should be treated as a prior year adjustment. These items related to adjustments arising from tax audits by the authorities in relation to previous reporting periods. In this and the above part of the question, the issues set out in the question were critical to a good answer. The information in the question was significant to a correct solution. An accountant cannot advise a client effectively, if the accountant ignores the facts that relate to that client. This part of the question was quite well answered. Marks were allocated for a reasoned discussion, even if the resulting recommendations were not in accordance with the model answer.

Professional marks were allocated in this question based upon the fullness of the attempt at the question and the degree of understanding and reasoning shown by candidates. This principle was applied throughout the paper.

#### QUESTION 3

This question dealt with a specialist type of organisation, a local government organisation, whose financial statements are prepared using International Financial Reporting Standards. The first part of the question dealt with investment property and property held as part of the organisation's housing inventory. Thus, the key standards were IAS 40 and IAS 16. Candidates needed a basic understanding of the two standards and the ability to apply their knowledge. The question was quite well answered but, again, several candidates did not use the information in the question such as the fact that the rent paid only covered the cost of the maintenance of the property. The rental revenue was incidental to the purpose for which the property was held, thus the property was not treated as an investment property.

The second part of the question dealt with the outsourcing of the waste collection to a private sector provider. The key standard here was IAS 17. Again, the skill required here was the application of knowledge.

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Many candidates discussed the risks and rewards arguments, but very few discussed who obtained the benefit from the asset. Generally, this part of the question was well answered.

The third part of the question dealt with IAS 37 and provisions. The scenario was one that many accountants face in practice. Many candidates felt that there was an obligating event but, because the legislation was not yet enacted, they felt that there should be disclosure of a contingent liability instead of correctly stating that a provision should be made. Marks are generally split between application and knowledge of the standard, which further shows the importance of not simply quoting an IFRS.

The final part of the question dealt with the impairment of an asset. There were three elements to the question. Knowledge of the standard, application of the standard and completion of the calculations. Candidates performed quite well on the knowledge aspect of the question. When applying the knowledge, reference to the question is essential and this is where candidates have problems, as they are not used to using information in this way. The knowledge should be second nature, it should not require very much thought, as it is the application in a question such as this that requires thought time. Very few candidates calculated the impairment loss correctly but, overall, the question was quite well answered.

#### QUESTION 4

This question required candidates to discuss the main principles of fair value measurement as set out in IFRS 13 and to describe the three-level hierarchy for fair value measurements used in IFRS 13. Surprisingly, this question was not as popular as was anticipated. Candidates who answered the question did well. Several candidates did not read the question carefully enough and answered Part (aii) in Part (ai). The marking guide allows some leeway in this regard.

Part (b) required candidates to apply the principles set out in Part (a) in two scenarios. The first was the fair valuation of an asset and the second was the fair valuation of a decommissioning liability. Both are common examples of fair valuation but candidates struggled to produce meaningful answers. It appears as though there was little understanding of the principles in the standard. For example, the nature of the principal and most advantageous markets for the asset was generally

poorly applied. Similarly, in the case of the decommissioning liability, the fair value of the liability assumes that it is transferred to a market participant at the measurement date. Often there will be no observable market in this case. These points were seldom raised.

#### PAPER P3 **PASS RATE: 48%** **BUSINESS ANALYSIS**

**The Paper P3 exam is in two sections. The first section contains one mandatory question, worth 50 marks, based around an extended case study. The second section contains three questions, each worth 25 marks. The candidate is required to answer two questions from this section.**

Performance in this exam was disappointing. This was despite good answers to the mandatory Question 1, where many candidates achieved high marks. However, there was even evidence in this question of candidates not being familiar with certain parts of the syllabus. A significant number of candidates did not answer the part of this question concerned with benchmarking.

In the optional questions, there was considerable evidence of candidates being unfamiliar with parts of the syllabus. Question 4, on decision trees, risk and software package evaluation was not answered by many candidates. However, even within their selected questions (Questions 2 and 3), it was clear that many candidates were unfamiliar with the principles of strategic alliances and, in particular, the sources of internal finance. This lack of knowledge meant that many candidates scored poorly in their selected optional questions.

Many candidates also spent too much time on Question 1(a), producing an answer that was far too long for the marks on offer. This meant that these candidates had less time to answer the optional questions. Time management is a common problem with this paper. The need for appropriate planning and time management in this exam can only be reiterated.

Overall, candidates are encouraged to write answers that are precise and focused. Obviously, the size of handwriting does vary, but in general most successful scripts were 12–15 sides long. They were easily contained in one exam booklet. Too many long scripts appear to be streams of consciousness with too much repetition, verbatim copying of facts and figures given in the scenario and text about models and frameworks that needed to be applied and not described.

#### **SPECIFIC COMMENTS** **QUESTION 1**

The scenario for this question described four companies in the EA Group. The first part of the question asked candidates to analyse the performance of each of the four companies described in the scenario and to assess each company's potential contribution to the EA Group portfolio of businesses. The key word here was portfolio. Most candidates recognised that this question was concerned with portfolio analysis and so used appropriate analysis models. The provision of market share and market growth data made the use of the BCG matrix (Boston Box) particularly appropriate. Some candidates did use alternative models (SWOT in particular) and still scored relatively well. However, there was insufficient data to undertake a SWOT analysis for each of the four firms in the scenario.

Many candidates scored very well in this part of the question. Indeed, in some respects, some answers were too comprehensive, with candidates making more points than the marks on offer. Sometimes this led to time problems later on in the paper. A few candidates scored very heavily on this part question (over 20 marks) and yet still failed overall, probably due to poor time management caused by spending too much time on this part question.

In contrast, the second part of Question 1 was poorly answered. This asked candidates to evaluate the potential influence of time, scope, capability and readiness for change at Steeltown Information Technology on any strategic change proposed by the EA Group. Too many answers did not concern themselves with strategic change but instead focused on changes in the type of systems developed at Steeltown, the fact that there was a backlog of applications and that user departments found it difficult to specify system requirements in advance. Furthermore, too few candidates commented on the competencies that the EA Group would bring to the problem, concluding that Steeltown would not have the ability to implement strategic change itself. This is probably true, but the scenario makes it clear that responsibility for strategic change lies with the EA Group. *'They (the EA Group) want to explore these (contextual) factors before they firm up their proposed strategy for the newly acquired company'.*

The final part of the first question concerned benchmarking. It was clear that many candidates had read the relatively recent *Student Accountant* article on this and so scored relatively well. It also appeared that some candidates were not prepared for this subject at all and omitted it completely. Overall, this part question was fairly well answered (five or six marks out of 10 was typical) by those who answered it.

#### QUESTION 2

The scenario for Question 2 concerned a large estate that was facing internal and external problems. A large part of the scenario consisted of quotes from a recent stakeholder survey.

The first part of this question (worth 15 marks) asked candidates to evaluate the strategic position of the estate with specific reference to:

- the expectations of stakeholders (both internal and external)
- the external environment of the estate
- strategic capabilities of the estate itself (internal strengths).

Candidates tended to produce unstructured answers to this part question, due to one, or more, of the following reasons.

- Too much use of the Mendelow power/interest grid; leading to a consideration of stakeholder management, rather than the conflict caused by the different stakeholder perspectives and expectations.
- Over-using PESTLE, in a case study scenario where there was very little on, for example; technology, economy and environment. Technology was usually considered in the perspective of the website, which of course is an internal resource. Indeed, it is an internal weakness.
- Attempting a SWOT analysis for which there was just insufficient information. This led to the consideration of weaknesses, which again resulted in an inappropriate in-depth analysis of the defects of the website.

Overall, this part question was not well answered, and despite some very lengthy

answers, relatively few candidates gained a pass mark on this part question.

The second part of the question asked candidates to discuss how the estate's website could be further developed to address some of the issues highlighted in the stakeholder survey. This should have been relatively straightforward, and indeed many candidates did score well in this part question, cross-referencing their points to the comments made in the stakeholder survey.

However, other candidates focused too much on the 6is (interactivity, etc), introducing general points that they could not back up with a relevant example because they were not appropriate in the context of the scenario.

Overall, although Question 2 was popular, it was not answered as well as it should have been.

#### QUESTION 3

This question concerned an industrial chemist who was looking for ways to take his company and ideas forward and exploit them before his patent expired. The first part of the question asked the candidate to evaluate the appropriateness of franchising, highlighting the advantages and disadvantages of this approach from the perspective of the chemist (the owner of Graffoff). This part question was relatively well answered, using a structure suggested by the question; description, advantages, disadvantages, evaluation. Some candidates did try to use the Johnson, Scholes, Whittington framework of suitability, acceptability and feasibility but this framework did not really suit the information given in the scenario. Some candidates were confused about franchising, restricting their discussion to a franchise just offered to one company – the Equipment Emporium.

The second part of the question asked the candidate to evaluate how other forms of strategic alliance might be appropriate to strategic development at Graffoff. Many candidates were aware of joint ventures and licensing but really failed to suggest why these

might be more appropriate or different to franchising. Candidates could have also made more of the potential link up with the Equipment Emporium. Some candidates suggested mergers, acquisitions and even selling the company. However, these are not strategic alliances.

Finally, candidates were asked to evaluate a claim that Graffoff could completely fund its organic expansion at a cost of \$500,000, through internally generated sources of finance. This part question was poorly answered on three counts:

- Many answers were too general (reduce creditor days) and included no calculation at all, so the consultant's claim could not be properly evaluated.
- Too many candidates turned the question into a general question on the advantages and disadvantages of organic growth. There were some good answers to a totally different question. In the context of this exam, most of these answers scored zero.
- Finally, too many answers focused on external finance (share issues, more loans) and this was specifically excluded from the question.

Although Question 3 was a popular question, many candidates scored poorly on Parts (b) and (c).


#### QUESTION 4

This question concerned a producer of aircraft and ship engines and the conduct and aftermath of a search for engine testing technology. The first part of the question asked candidates to construct a decision tree from information given in the question scenario. It also required candidates to discuss the implications and shortcomings of decision trees. Although this was an unpopular question, many candidates showed that they were very familiar with constructing and interpreting decision trees and so scored reasonably well on this part question. The most common error was to forget to subtract the cost of the investment. However, it also has to be said that some answers were very poor and it was unclear why some candidates chose to answer this optional question.

The second part of this question asked the candidate to discuss what other factors, not reflected in the decision tree analysis, should be also taken into consideration when choosing which option to select. Again, candidates who knew this topic well

UNFORTUNATELY, TOO MANY CANDIDATES ALSO TRIED TO APPLY PESTEL AND PORTER'S FIVE FORCES TO THE CASE STUDY SCENARIO. BOTH OF THESE FRAMEWORKS ARE MORE APPROPRIATE FOR DEFINING STRATEGIC POSITION, RATHER THAN STRATEGIC OPTIONS





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produced good answers, centred on risk, supplier viability and software functionality. In contrast, some answers were very poor and rambling, not answering the specific question at all.

Finally, candidates were asked to consider how two risks – supplier business failure and employee travel, might be avoided or mitigated. Again, there were some very good answers. However, there were also some very poor answers, lacking in content or generally describing risk management without any context at all.

Overall, this question was unpopular. Candidate performance tended to be good, with candidates confident in the application and limitations of decision tree analysis and able to properly discuss risk in context, or poor, with candidates unable to properly undertake decision tree analysis or discuss the concept of risk in the context of the scenario.

#### **PAPER P4 PASS RATE: 33%** **ADVANCED FINANCIAL MANAGEMENT**

**The structure of the paper was similar to past papers with two compulsory questions in Section A, consisting of 60 marks in total, and three 20-mark questions in Section B, of which candidates had to do two, for the remaining 40 marks.**

The overall performance of the candidates was satisfactory but the pass rate was a little lower than the previous sitting.

In Section A, Question 1 consisted of 33 marks and question two consisted of 27 marks. Four professional marks were allocated to Question 2. Both questions required candidates to undertake computations and discussion. In Section B, Question 5 was wholly discursive, while Questions 3 and 4 consisted of a mixture of computational and discursive elements.

Excellent answers were obtained from candidates who applied their knowledge to the scenario given in each of the questions. The presentation of such answers was good, with clear labelling and structure and workings. Successful candidates attempted all parts of the questions, and managed their time well between questions.

Like the previous sittings, there was evidence of some candidates employing poor time management techniques and not answering all the parts of a question. In a small number of cases some candidates did not answer a question at all. There was evidence that some candidates spent too long on one or some questions, then had to rush through the other questions. A number of such candidates failed marginally – even though the questions they had answered fully were of a pass standard – because they did not attempt all the questions. It is important to make a reasonable attempt at each question and each part of each question and good time management is essential. This can be done through candidates practicing past exam questions under timed conditions. It was also evident that well-structured answers enabled candidates to manage their time more effectively. For example, Questions 1 and 3 had parts that were long and complex, and good time management supported by clear presentation and structure to the answers resulted in high marks being achieved.

Some candidates were poorly prepared for the exam in terms of their knowledge, understanding and application. This was especially evident in Questions 1(b), 2(ii), 2(iii), 2(iv), 3(a), 3(b), 4(a) and 4(b). Candidates should be aware that they must have a good understanding and knowledge of the entire syllabus. Candidates need to know the syllabus well in order to apply knowledge to the question scenario. A consistent, sustained study approach, supported by question practice and reading around the subject, is much more likely to achieve success. It is highly unlikely that a strategy based on a last-minute intense study approach and attempting to question spot will be successful. This has been proved to be the case in every Paper P4 exam so far.

Poor performance was also evident where candidates did not read the content and requirements of the questions fully. Equally, answers need to be directed at the scenario in the question; general answers do not gain many marks.

In summary, a number of common issues arose in candidates' answers:

- ❑ A lack of knowledge and understanding of the entire syllabus. This can be put right for future exams through a strategy of sustained study, instead of last-minute intensive preparation and trying to spot questions and/or topic areas. A good knowledge of current issues is also essential.
- ❑ Failing to read the question requirement carefully and therefore providing irrelevant answers that score few, if any, marks. Question requirements and the information in the scenario need to be read with care.
- ❑ Poor time management. Some candidates spent far too long on some questions and this put them under time pressure to finish the remaining questions. Good time management between questions and in parts of questions is essential.
- ❑ Not learning lessons from earlier examiner reports and thus making the same mistakes. Many of the same comments are made repeatedly in the examiner reports.
- ❑ Illegible handwriting and poor layout of answers. It is very important to plan and structure answers properly. Good, clear handwriting is essential. Adopting these good practices will also enable candidates to get the majority of the professional marks available.

#### **SPECIFIC COMMENTS** **QUESTION 1**

Question 1 required candidates to calculate and comment on how the cost of capital of a company changes when it sells part of the business, to comment on the results and to explain any assumptions made (Part (a)); discuss whether the market value of equity would remain unchanged after a part of the business is sold (Part (b)); and to explain what a demerger was, and the possible benefits and drawbacks of a demerger as opposed to selling part of the company (Part (c)).

Overall, this question was done adequately. Many candidates made good attempts at all the parts and, aside from Part (b), gained reasonable marks. The presentation of the answers was varied, with some answers being presented well, but in others the information was in different places and not structured in a clear manner. In long questions, good presentation provides clarity of thought and indicates to the marker that the candidate understands the topic area well.

**IT IS VERY IMPORTANT TO PLAN AND STRUCTURE ANSWERS PROPERLY. GOOD, CLEAR HANDWRITING IS ESSENTIAL. ADOPTING THESE GOOD PRACTICES WILL ALSO ENABLE CANDIDATES TO GET THE MAJORITY OF THE PROFESSIONAL MARKS AVAILABLE**

Part (a) was generally done adequately. Most of the candidates calculated the initial cost of equity correctly, although a small minority confused the market risk premium with return on the market. Most candidates calculated the initial cost of debt correctly, but a few tried to estimate it using NPV and IRR, which was not correct. Although many candidates estimated the market values of equity and debt correctly, a significant number assumed that the book value of debt was the market value of debt, and that free cash flows were the market value of equity.

Most candidates were aware that they needed to estimate a revised beta, once a part of the company was sold. However, a significant number found it difficult to un-gear the beta, find the asset beta for the hotel services only, and thereby estimate an equity beta and cost of equity. Many candidates were unclear about the approach to be taken.

A sizeable minority of candidates did not comment on the results, nor explain the assumptions made in Part (a). Since about 25% of the marks were allocated for these, candidates who did not comment or explain were not gaining the maximum marks that were available.

Although the majority of candidates attempted Part (b), answers tended to focus on one to two points which were repeated. This resulted in limited depth and/or range of the answers provided and therefore few candidates gained more than half marks.

Many good answers were provided for Part (c) and it was pleasing to see that many candidates could apply their knowledge and understanding of demergers, and the benefit and drawbacks of demergers. However, a sizeable minority of candidates were of the opinion that once a company was demerged, it would remain part of the same group, which is not the case.

#### QUESTION 2

Question 2 was focused on transactions, translation and economic exposure related to foreign currency risk and its management. Part (i) asked candidates to explain the type of exposure the company faced in each situation. Part (ii) required candidates to apply two over-the-counter (OTC) derivative products to manage transactions exposure. Part (iii) required candidates to assess the translation gain/loss due to the devaluation of a currency. Part (iv) required candidates to discuss how economic exposure that the

company faced could be managed. Overall, this question was done less well compared to Question 1.

This question contained four professional marks available for well-structured answers presented in a report format. The presentation of the answers was varied, with some answers given in report style, but many candidates answered the question without paying due attention to what a report should contain. Answers that gave a report title but then did not structure the answer appropriately gained few professional marks. The same point has been made in all examiner reports – good presentation and structure is essential to gain a good pass, and professional marks are relatively easy to gain.

Part (i) was done well, with the majority of candidates able to explain the exposure the company faced in each case. Credit was given for explanation of the exposure faced even if it was not named. However, just stating the name of the exposure with no explanation gained few marks.

Part (ii) was done adequately but many candidates were not able to estimate the four-month forward rate correctly (many estimated the annual forward rate). Also, in the case of OTC options, many answers did not calculate the opportunity cost of the premium. Most candidates attempted to make reasonable recommendations and offer alternative hedging strategies. However, like Part (b) in Question 1, the range and depth of the advice was limited.

Part (iii) was generally done very poorly. Common mistakes were not converting the currency into euros, not getting the exposed percentages correct and not comparing the amounts before and after the devaluation in order to estimate the translation loss. Relatively few responses were able to discuss whether and how translation exposure should be managed. It seems that whereas many candidates knew what translation exposure was, few were able to apply measurement techniques to assess this in the question scenario.

Some reasonable responses were obtained for Part (iv), but again there was a lack of discursive depth to this part.

#### QUESTION 3

Part (a) of Question 3 required candidates to calculate the percentage gain on a target company's share price using three different acquisition methods and to comment on the results.

With the cash offer, a significant number of candidates failed to calculate the earnings per share of the acquiring or target companies correctly. With the share-for-share offer, many responses did not account for the synergies created. The majority of candidates were not able to calculate the value of the bond offer. A small minority of the candidates did not give the gains as percentages, but as amounts, although percentages were specifically asked for. It was surprising that many candidates failed to get many marks for this question, especially when a similar question had been set in a recent Paper P4 exam. It could be that candidates did not expect the same topic to be examined again so soon and decided not to study this area. Candidates should bear in mind that any topic area from the entire Paper P4 syllabus can be tested in an exam. Recent examination of a topic area does not preclude it from being tested again soon after.

Some reasonable responses were given in Part (b) of Question 3 but a sizeable number of candidates thought that minority share holders could never be forced to sell their shares, and a fewer but significant minority of candidates thought that offering a higher price to some shareholders was acceptable. Both of these assertions are incorrect within the EU Takeovers Directive. A significant minority of responses did not attempt to produce answers for either or both proposals and failed to gain any marks for Part (b). When selecting a question, candidates should ensure that they answer all parts of a question adequately in order to achieve a comfortable pass.

#### QUESTION 4

Part (a) required candidates to calculate the net present value (NPV) of a project and the sensitivity of the selling price. A sizeable number of candidates made basic errors in the NPV calculation with respect to timing of flows and not being able to calculate the present value of an annuity. Additionally, many candidates were unable to calculate the sensitivity of the selling price. Both these areas are part of the Paper F9 syllabus, as well as the Paper P4 syllabus. It was therefore surprising that few candidates got the majority of the marks available for this part.

Part (b) required candidates to formulate a multi-period capital rationing model. Very few candidates were able to do this successfully. Many responses



## ATTEMPTS TO PASS BY UNDERTAKING SHORT INTENSIVE STUDY AND TRYING TO SPOT QUESTIONS AND/OR TOPIC AREAS IS UNLIKELY TO RESULT IN SUCCESS

tried to calculate the acceptance of projects based on profitability index, which would be used for single-period capital rationing, rather than recognising that this was a multi-period capital rationing problem. There was also some evidence that suggested that candidates did not understand what the word 'formulate' meant, although it is used in the *Study Guide*.

Part (c) required candidates to explain the output results from a linear programming solution. The majority of candidates provided good answers for this part and gained the majority of the marks.

Part (d) required candidates to explain the need to apply capital rationing and the features of a capital investment monitoring system. Many candidates provided good answers for this part and gained the majority of the marks, although few responses distinguished between soft and hard capital rationing, and recognised that soft capital rationing may be as a result of hard capital rationing.

### QUESTION 5

Part (a) of the question asked candidates to explain the role and aims of the IMF, and the impact of IMF intervention, on the company. Generally, this part was done well by the majority of candidates who chose this question. There was clear evidence that many candidates had read the article about this in *Student Accountant*. The main weakness in responses to this part was that sometimes focus was put on either of the two requirements but a balanced narrative was not given. Overall, this part was answered well.

Part (b) asked candidates to explain why the company, as a mid-price retailer, was affected more than companies operating at the high price-end and the low price-end. Again, this part was done well.

Part (c) asked candidates to discuss the risks and how the reduction in quality control costs would impact the company. In the main, answers tended to focus on a few narrow points, rather than a broader range of possible risks and impact. As a result, relatively few responses obtained more than half to two-thirds of the marks.

### CONCLUSION

Overall, reasonable attempts were made at Questions 1 and 5, but Questions 2, 3 and 4 were done less well. Attempts to pass by undertaking short intensive study and trying to spot questions and/or topic areas is unlikely to result in success. Good presentation and structure of responses, good application of time management, answering all parts of a question, and knowledge and understanding of the entire Paper P4 *Syllabus* and *Study Guide* are the necessary requisites for success.

### PAPER P5 PASS RATE: 33% ADVANCED PERFORMANCE MANAGEMENT

**The exam paper comprised two sections, A and B. Section A consisted of two compulsory questions for 60 marks in total. Section B consisted of three optional questions for 20 marks each from which candidates were required to answer two questions.**

### GENERAL COMMENTS

I would offer similar broad comments to past reports, as these remain relevant to this paper. Most exams require a balance of memory work and evaluation/analysis. As one goes through the levels this balance changes, from pure memory to more analysis. Good candidates distinguish themselves by being aware that if they come to this exam expecting to repeat memorised material, they will probably score only between 20% and 30%.

The basis of this exam is analysis and application. Candidates will need a foundation in the techniques of the syllabus but should focus more on evaluation of these techniques and consideration of their usefulness to the given scenario. This is not difficult to revise as it is a mindset that can easily be encouraged by considering attempting past papers as an integral part of the revision process. Candidates need to be aware that performance management is an area which, at an advanced level, is dependent upon situation and environment. A good, professional-level answer will go beyond the mere repetition of how a technique works and focus on relating it to the entity's specific environment. It was

very clear to the marking team at this session that, typically, those candidates who had grasped the need for this went on to pass the paper with ease.

The vast majority of candidates attempted their allocation of four questions, and there was little evidence of time pressure, though much of poor time management. This was evident where about half of a candidate's script was taken up with the answer to Question 1, which was worth only 34% of the marks. Time problems were exacerbated by a failure to read the question requirement and produce an answer that was relevant to the question asked. Future candidates should use the mark allocation as a guide to how much to write on a particular topic and practise past paper questions under timed conditions in order to become familiar with this discipline.

The overall quality of the numerical working and the commentary on the results remains an area of concern, as noted in many previous reports. Disappointingly, there has not been significant improvement over the exam sessions in this aspect of candidates' performance. For example, in Question 1, where a commentary on numerical data was requested, there were numerous examples of scripts that limited themselves to basically putting into sentences the numbers calculated – for example, 'North's net income has fallen while East's and West's have risen.' This is inadequate on its own and gained no credit as a comment.

In advising those who will be taking this paper in the future, I must give some well-worn suggestions. First, some candidates are not spending sufficient time reading the question and understanding its requirements. There is a *Student Accountant* article on this that has been – and remains – accessible on the ACCA website, but the lessons still do not appear to have been learned. For example, markers frequently commented on answers to Question 4(a) which, instead of explaining why liquidity and gearing were important alongside profitability, offered a review of the performance of the company in the scenario, leaving the reader to draw conclusions.

Second, there was evidence that the syllabus is being only partially studied. I am afraid that I can offer no words of encouragement to those who insist on playing this risky game with the exams. There was evidence on Question 2 on budgeting methods, Question 3(b) on the impact



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of the regulatory environment on performance management, Question 4(b) on qualitative failure prediction models and Question 5(a) on Burns and Scapens report that these areas had been only superficially covered by candidates in their studies. However, there was good performance on the detailed calculation of EVA™ required in Question 3(a), which was the subject of a *Student Accountant* technical article published in July 2011.

Third, I would make a general criticism of the candidates' comments made on the issue of manipulation of performance measures. This is being used in a generic fashion without thought given to the implications of such criticism. Candidates need to be aware that all measures are, to a greater or lesser extent, subject to this problem and to demonstrate that gradation in their answer. They must support such comments with evidence from the scenario otherwise they are in danger of accusing their clients/colleagues/superiors of fraud without justification. Greater subtlety of understanding and communication is expected of a professional solution at the final level of the ACCA Qualification.

Finally, in the style of presentation of answers, candidates should avoid the unexplained use of jargon. It is possibly due to the candidates' lack of confidence in applying their knowledge that there is a tendency to simply put down lists of jargon phrases and hope for marks. As in previous exam sessions, better presented answers that demonstrate neat layout, logical structure and a readable style, offer an easier opportunity for markers to understand and so credit the points being made – this is something that will always remain an important point for Paper P5 candidates.

#### SPECIFIC COMMENTS SECTION A QUESTION 1

This 34-mark question was based on an advertising agency, Lincoln & Lincoln Advertising (LLA), and tested candidates' ability to analyse basic management accounting data to assess the performance of the business' three

regional offices, then to consider and improve the performance measures used at these offices and, finally, to evaluate and improve the current remuneration policy at LLA. There were four professional marks available for format, style, structure and clarity of discussion in the required report. Generally, this question was reasonably answered although many easy marks were omitted in Parts (i) and (ii) by candidates not addressing their advice to the individual circumstances of the three offices and, instead, only offering generic comments for the whole company. The scenario gave much detail on the three offices and it should have been obvious that they each faced their own challenges, which required a tailored response – indeed, the CEO in the scenario specifically advises candidates to avoid 'a one-size-fits-all policy'.

Part (i), for 10 marks, required candidates to assess the recent performance of the three regional offices of LLA by interpreting the data already prepared. For a standard Paper P5 question topic, the general performance on this part was poor. Most candidates understood that there were differences between the offices but failed to bring them out in their answers. The marks in this question were for analysis of the data, not its repetition. Therefore, those candidates who explained the implications of the data, or succeeded in connecting trends in one indicator with another, scored well (for example, falling revenue plus fixed costs leads to larger falls in profit). The best answers offered a general overview of the three offices' performance and then took each office in turn to bring out the commercial issues present there – for example, West's rapid growth but dangerous increase in receivables. Future candidates should consider the reader in writing their responses. In this situation, the board would have found an answer divided into sections by office much more helpful than split into sections based on the standard headings of an accountant's ratio analysis.

Part (ii) for 10 marks required an evaluation of the choice of net income as the performance measure for the regional offices and suggestions of other measures, and why they are appropriate

for each office. As in Part (i), candidates scored well if they appreciated the need to address the regional offices' specific requirements. Many candidates offered a reasonable set of generic suggestions for the company as a whole but missed out on the regional differences.

The first part of the requirement sought an evaluation of the existing performance measure (net income) and a recognition of two key facts – this measure contained uncontrollable costs and it was too general to cover the issues across the company. Other criticisms of the measure were credited as well – however, these were the main areas.

The second part required justified recommendations of alternative metrics. Most candidates realised that non-financial indicators would be useful and those that made suggestions appropriate to LLA scored well. Those who offered lists of metrics that could apply to any company scored significantly less well. There were many answers that provided lengthy (possibly rote-learned) proposals of ROCE, EVA™ and RI, although these were of limited use in this scenario, as they did not address the issues in the different offices nor did they address the fact that LLA would be likely to have a large intangible asset base. The better solutions made sure that their comments on these alternatives were consistent with their criticism of the existing measure.

Part (iii) for 10 marks required an evaluation of LLA's remuneration policy suggesting improvements. This part was typically well done. Most candidates addressed their comments to the five different grades of staff given in the scenario. However, as in Question 2(a), many candidates assumed that all of the existing policies must be wrong and so only made negative comments – future candidates need to be aware that evaluate means to give a balanced assessment (including both the positive and negative aspects of an issue). On the suggested improvements, most candidates provided practical suggestions addressing the weaknesses previously discussed. For example, the best candidates suggested that the account management staff should have part of their remuneration based on measures of client satisfaction, such as retention. However, many candidates seem to be under the misapprehension that share schemes solve all remuneration policy issues. These schemes can address alignment of interests of staff with shareholders

**GREATER SUBTLETY OF UNDERSTANDING AND COMMUNICATION IS EXPECTED OF A PROFESSIONAL SOLUTION AT THE FINAL LEVEL OF THE ACCA QUALIFICATION**



but do not necessarily address the shortsighted nature of many bonus schemes.

Future candidates should study the question and model solution for Parts (i) and (ii) as these give good examples of addressing the particulars of a scenario.

### QUESTION 2

This 26-mark question covered the core topic of budgeting methods requiring an evaluation of and improvements to the current budget method at the four divisions of Drinks Group (DG), a drinks manufacturer. This question was usually done reasonably well overall, with answers to Parts (a) and (b) being better than (c) and (d).

Part (a), for eight marks, required candidates to evaluate the current (incremental) budgeting method at each division.

This part was generally well done with candidates scoring well by identifying the circumstances at each division and then evaluating if these made incremental budgeting appropriate. A few candidates seemed to assume that as the method was being questioned it must be flawed for all divisions, and then sought reasons to justify this view. This is a poor approach to any question as it pre-judges the outcome without consideration of the evidence in the scenario. Incremental budgeting would be a strong candidate at the stable H and S divisions. Also, some candidates spent excessive time suggesting and justifying alternative budgeting methods when this was not asked for and, indeed, represented the bulk of the work in the remaining parts of the question.

Part (b), for eight marks, required a recalculation of the budget for Fizzy division (F) using rolling budgeting and an assessment of the use of rolling budgeting at this division. This part involved a simple application of the method and then a comment on its appropriateness for F. Candidates generally performed well in this part although many did not bother to prepare the new quarter's figures (Q1 of the next year), which keeps the budget rolling forward, and as a result missed out on some easy marks.

Part (c), for four marks, required a justified recommendation of the budgeting method at the Marketing division (M). This part was generally poorly done with candidates unable to identify the relevant circumstances at M that would suggest possible budgeting methods. Among these circumstances were the project-based

nature of marketing activity and the desire of the other divisions to control marketing spending.

Part (d), for six marks, required an analysis and recommendation of the appropriate level of participation in budgeting at Drinks Group (DG). Answers to this part were mixed. Most candidates identified the current level of participation, although a significant number just assumed that the current process was all top-down, ignoring the fact that divisional managers have input into the growth estimates (which are the important ones) in the existing incremental budget. The best candidates realised that, having suggested different budget methods for the four divisions, they should address their comments about level of participation to each division dependent on its budget method.

Future candidates should be aware that budgeting is a core topic and candidates will be expected to know the relative merits of the different methods and how to apply them in a scenario.

### QUESTION 3

This 20-mark question was based on Stillwater Services (SS), which provided water and sewage services to the public and businesses of a region in the imaginary country of Teeland. The question tested the areas of EVA™ and impact of regulatory control on performance management.

Part (a), for 13 marks, required an evaluation of the performance of SS using EVA™. The calculation of this metric was discussed in a recent *Student Accountant* article and had clearly been well prepared in advance by many candidates who scored most of those marks available. The calculations of NOPAT could be done by starting from PAT or Operating Profit and both approaches gained credit. The weakest area of the calculations was of the adjustments to capital employed. Most candidates realised the need to comment on the numbers and gave a summary sentence. However, many did not appreciate that there were three marks available for comments, and so did not provide any broader comment on the key assumptions in the method or its limitations. This could be seen as a failure to appreciate the need to 'evaluate' rather than simply 'calculate', which would be an approach more appropriate to a lower level paper such as Paper F5.

Part (b), for seven marks, required an assessment of whether SS meets its given, regulatory ROCE target and

comments on the impact of such a constraint on performance management at SS. This part was generally poorly done with many candidates not realising that the ROCE target was an upper limit on the company. The better candidates commented on the circumstances that could lead to generating a higher ROCE than allowed, the impact of the fines that would result and the management approach that should be taken as a result. Few candidates spotted that this constraint on the regulated side of the business would mean that the unregulated part of the business would be the engine of growth for SS, while the regulated side could act as a cash cow supplying capital. The impact on business performance of the regulatory environment is mentioned in Section B2 of the *Syllabus* and *Study Guide*, and future candidates would be advised that specific mention of an issue implies that question scenarios can be based around that area.

### QUESTION 4

This 20-mark question was based on the nursing home company Coal Creek Nursing Homes (CCNH) and tested candidates' knowledge on the importance of liquidity and gearing metrics and the use of qualitative models for prediction of corporate failure.

Part (a), for 11 marks, required a discussion of why indicators of liquidity and gearing need to be considered in conjunction with profitability at CCNH. Scores on this part were mixed with only the better candidates addressing the question requirement. Most candidates scored the incidental marks available for illustrative calculations from CCNH, although it was disappointing to see how many could not accurately calculate simple ratios. However, having done this work, they allowed it to lead them into believing that the question asked for a general assessment of the financial situation of CCNH when, in answering the question, this should be used as an illustration of why indicators of liquidity and gearing are needed alongside those of profitability. It was also notable that although many candidates successfully dealt with issues around financial gearing, only a few candidates addressed the operational gearing at the business. There appeared to be a lack of identification of the cost structures (variable/fixed) within CCNH, which ought to be a basic point in the financial assessment of a business by a management accountant.

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Part (b), for nine marks, required an explanation of one qualitative model for predicting corporate failure and comments on CCNH's position applying this model. Few candidates demonstrated a clear understanding of the issues in using a qualitative model and, in particular, in the Argenti model only a minority could explain defects, mistakes made and symptoms of failure. Many could quote the headings but few could explain what they referred to – the wiser candidates tried to cover this by illustrating each heading with an example from CCNH. However, given the above comments, it was pleasing to see that many candidates scored reasonably well by identifying the specific issues at CCNH.

Future candidates would be advised to learn the basic lesson in Part (a), which is to answer the question asked. They should also note the importance of grasping the cost structures of a business in a Paper P5 scenario.

#### QUESTION 5

This 20-mark question was based on Herman Swan & Co (HS), which makes fashionable clothes and leather goods and tested candidates' knowledge of the Burns and Scapens report on the future role of management accountants and performance issues surrounding brand loyalty and awareness. Although this was the least popular of the Section B questions, those candidates that tackled it clearly grasped the nature of the business and typically did well in their scenario-related comments and illustrations.

Part (a), for 12 marks, required a description of the changes in the role of the management accountant based on Burns and Scapens' work, explaining what is driving these changes and justifying why they are appropriate to HS. Most candidates had a broad grasp of the issues being dealt with by Burns and Scapens and did well trying to weave these in to the specific circumstances at HS. However, few candidates could remember the detail of the report, and so their analysis often missed out on one of the three factors mentioned (technology, management structure and competition).

Part (b), for eight marks, required a discussion of the impact of brand loyalty and an awareness of the business, both from the customer and the internal business process perspectives, and an evaluation of suitable measures for brand loyalty and awareness, illustrated by the information in the scenario. Most

candidates were able to discuss brand loyalty from the customer perspective and suggest suitable measures. Fewer were able to clearly distinguish the internal process perspective, although they had realised that quality was a key part of the product offering. The better candidates distinguished themselves by differentiating between loyalty and awareness, with awareness preceding loyalty and being about beginning to attract new customers. Loyalty was about retention of existing customers.

Future candidates are advised that the application of performance measurement concepts to specific scenarios will remain a core part of Paper P5. So, it should form part of your revision to practise taking the measures mentioned in the *Syllabus* and *Study Guide* and seeing how they apply to different businesses.

#### PAPER P6

##### ADVANCED TAXATION (UK)

**The overall standard in the December 2012 exam was satisfactory. Most of the scripts were concise and included attempts at virtually all of the parts of four questions.**

Poor exam technique was not a significant factor this session. However, there were two general failings as detailed below. In addition, there were, as always, various areas of technical weakness.

The exam was divided into Section A and Section B and was in its new standard format: Section A consisting of the compulsory Questions 1 and 2, worth 35 marks and 25 marks respectively, and Section B where candidates were required to answer two out of the three questions worth 20 marks each. In Section B, Question 4 was the most popular question and Question 3 was the least popular.

As noted above, there were two general failings in relation to exam technique.

The first concerned the inclusion of irrelevant content by weaker candidates who either did not know the answer to a question, and so wrote about something else, or who side-tracked themselves

away from the question and answered a different question. Irrelevant information does not score marks but does, of course, waste time. Candidates are advised to read the requirement carefully and to concentrate when writing their answers in order to ensure that they remain within the confines of the requirement.

The second failing concerned a small but noticeable minority of candidates who treated companies as individuals and/or treated individuals as companies. For example, such candidates wrote about entrepreneurs' relief, the annual exempt amount and tax rates of 18% and 28% when dealing with the chargeable gains of companies. Candidates should always begin a question more slowly than the final 'top speed' that they will eventually achieve. They must take the time to understand the facts of the question, the entities that they are dealing with and the particular taxes involved.

Candidates should pay particular attention to the following in order to maximise their chances of success in the exam in the future.

#### 1 Know your stuff.

- ▣ Successful candidates are able to demonstrate sufficient, precise knowledge of the UK tax system.
- ▣ This knowledge must be up to date. Candidates sitting the exam in 2013 must familiarise themselves with the changes introduced by the recent Finance Act as summarised in the Finance Act articles published in *Student Accountant* and on the ACCA website.

#### 2 Practise questions from past exams with the aim of adopting the style of the model answers.

#### 3 Address the requirement.

- ▣ Read the requirement carefully – in the Section A questions the detailed tasks that you are to perform will be set out in one of the documents. It may be helpful to tick off the tasks as you address them. Marks are awarded for satisfying the requirements and not for other information, even if it is technically correct.

**CANDIDATES SITTING THE EXAM IN 2013 MUST FAMILIARISE THEMSELVES WITH THE CHANGES INTRODUCED BY THE RECENT FINANCE ACT AS SUMMARISED IN THE FINANCE ACT ARTICLES PUBLISHED IN *STUDENT ACCOUNTANT* AND ON THE ACCA WEBSITE**



- ❑ The requirements of each question are carefully worded in order to provide you with guidance as regards the style and content of your answers. You should note the command words (calculate, explain, etc), any matters which are not to be covered, and the precise issues you have been asked to address.
  - ❑ You should also note any guidance given in the question or in any notes following the requirement regarding the approach you should take when answering the question.
  - ❑ Pay attention to the number of marks available – this provides you with a clear indication of the amount of time you should spend on each question part.
- 4** Don't provide general explanations or long introductions.
- ❑ If you are asked to calculate, there is no need to explain what you are going to do before you do it; just get on with it – only provide explanations when you are asked to.
  - ❑ Think before you write. Then write whatever is necessary to satisfy the requirement.
  - ❑ Apply your knowledge to the facts by reference to the requirement.
- 5** Think before you start and manage your time.
- ❑ Ensure that you allow the correct amount of time for each question.
  - ❑ Before you start writing, think about the issues and identify all of the points you intend to address and/or any strategy you intend to adopt to solve the problem set.

If you are preparing to resit the exam, think about the number of additional marks you need and identify a strategy to earn them. For example:

- ❑ Identify those areas of the syllabus where you are weakest and work to improve your knowledge in those areas.
- ❑ Ask yourself whether you could improve the way you manage your time in the exam and whether you address all of the parts of all four questions, or whether you waste time addressing issues that have not been asked for.
- ❑ Make sure that you earn the professional skills marks and that you are prepared to address the ethical issues that may be examined.

#### MARKS AVAILABLE IN RESPECT OF PROFESSIONAL SKILLS

Marks were available for professional

skills in Question 1. In order to earn these marks candidates had to use the information provided in the question correctly and then provide specific advice, clear explanations and coherent calculations in an appropriately formatted report. On the whole, the performance of candidates in this area was good, with the majority of them producing a report in a style that was easy to follow.

#### SPECIFIC COMMENTS QUESTION 1

Question 1 was in two parts. Part (a) required candidates to prepare a report with supporting calculations in relation to the proposed sale of a company. Part (b) required candidates to summarise the implications of an unexpected refund of tax.

Part (a) was in three parts. Part (i) required candidates to calculate the tax cost of two alternative transactions. The first involved a company, Flame plc, selling its subsidiary, Inferno Ltd, and the second, alternative transaction, involved Inferno Ltd selling its trade and assets. Answers to this part varied in quality quite considerably. There were many candidates who clearly understood the two alternatives and the related tax implications, while weaker candidates were unsure of the precise nature of the transactions and the related tax implications, such that they produced confused answers. This was also one of the questions referred to in the general comments above where a small minority of candidates treated the companies as individuals.

The sale of Inferno Ltd had two main implications – a chargeable gain on the sale of the shares and a degrouping charge. The chargeable gain was worth one mark. However, it took some candidates half a page or more to calculate and write about this gain in order to score that mark. This was most likely because it was the first thing they did in the exam and there were still almost three hours to go, such that the pressure was not yet on. Candidates must approach every mark in the exam in the same way and get on with it. There is no time to dither when there is so much to do.

Frustratingly, it was not uncommon for some candidates to only score half a mark for this gain because they based the indexation allowance on the unindexed gain rather than the cost. I suspect that this was a lack of concentration rather than a lack of knowledge, but the half mark was still lost.

It was stated in the question that the substantial shareholding exemption was not available. Many candidates simply included a statement to that effect in their report and earned a mark. However, a small minority of candidates wasted time writing at length about the exemption rather than getting on with the question.

The degrouping charge was done well on the whole. Those candidates who did not do so well were divided into two groups. The first group missed the degrouping charge altogether. This was perhaps due to a lack of knowledge but, in view of the fact that degrouping charges are examined regularly, was more likely due to a lack of thought. Candidates must give themselves time in the exam to think about issues before they start writing; it is difficult to successfully think of one issue while writing about a different one.

The second group of candidates knew that there would be a degrouping charge somewhere in the answer and earned most of the marks available for saying why and for calculating it. However, they did not know which of the two possible transactions would give rise to the charge, and either put it into the wrong section of the report or put it into both sections. This was not particularly costly, but would have been in a different question that was only concerned with one of these two transactions. Candidates must know their stuff; degrouping charges only occur on the sale of a company – ie on the sale of shares, and not on the sale of assets.

The sale by Inferno Ltd of its trade and assets was not done particularly well. A small minority of candidates treated the disposal as the disposal of a single asset by adding up all of the proceeds and then deducting the total cost. Even those candidates who knew that each asset had to be handled separately failed to apply basic rules concerning capital allowances and chargeable gains.

Capital allowances were handled particularly poorly with very few candidates identifying that where the tax written down value is zero, any sale of machinery must result in a balancing charge. In addition, most candidates calculated capital losses on the sale of the machinery, thus failing to recognise that, due to the claiming of capital allowances, no capital losses would be available. Finally, only a minority of candidates identified that the deferred gain of £8,500 would crystallise on the sale of the milling machine; most candidates thought, incorrectly, that the gain would be deducted from the asset's base cost.

A final thought on Part (i) relates to the narrative provided by candidates in their reports. The question required candidates to include concise explanations of matters where the calculations were not self-explanatory. On the whole this was done well. Most candidates kept their answers brief and very few fell into the trap of writing down everything they knew about the broad technical areas relating to the question.

Part (ii) concerned an approved company share option plan. This was a straightforward question that tested candidates' knowledge of a particular share scheme. In order to do well, candidates needed to slow down for a moment and make sure that they were about to write about the correct scheme. They then needed to ensure that they addressed all of the issues set out in the question. The majority of candidates did both of these things and, therefore, scored well.

Part (iii) concerned the VAT implications of the granting of a lease and was done reasonably well by most candidates.

Part (b) of Question 1 concerned a refund of corporation tax. Candidates needed to realise that this refund had been received some time ago and that, if it had been paid in error, it had to be returned to HM Revenue & Customs. Most candidates recognised this situation and were able to list the actions that the firm needed to take and the matters that needed to be drawn to the attention of Bon Ltd.

## QUESTION 2

Question 2 concerned an individual, Dana, and was in two parts. Part (a) involved the relief of losses in the opening years of an unincorporated business. Part (b) concerned capital gains tax and inheritance tax.

Part (a) required candidates to consider all of the ways in which Dana could realise her trading loss and to calculate the total tax relief obtained.

The first task was to determine the trading profit/loss for each of the tax years. This required candidates to deduct the pre-trading expenditure from the profit of the first trading period and then to apply the opening years rules. They also needed to know

that losses are only recognised once in the opening years. The treatment of the pre-trading expenditure was done well by only a minority of candidates. Other candidates either missed it out altogether or deducted it from the taxable profit for the tax year 2010/11 rather than the profit of the first trading period. The opening year rules and the treatment of the loss within those rules were done well by the majority of candidates. This was a significant improvement over the performance in recent exams.

Once the profits and losses had been determined, candidates needed to consider the reliefs available in respect of the loss. There were two aspects to this. First, candidates needed to know all of the available reliefs for the losses. This was done very well by the vast majority of candidates. Second, candidates needed to compare the different reliefs and then calculate the total tax relief obtained by the most efficient strategy. Performance of this second task was mixed with some candidates calmly and efficiently calculating the tax due before and after claiming relief in order to determine the tax saving, while others wrote about how to do it in general terms without actually doing it. This is perhaps a confidence issue; candidates should ensure that they have practised as many questions as possible prior to sitting the exam and, once in the exam, should have the self-belief to address the figures and come up with specific advice.

The second part of this question was in two parts.

Part (i) concerned the availability of gift relief on the transfer of a rental property to a trust and was not done particularly well. The issue here was that gift relief would be available because the transfer was immediately subject to inheritance tax. This is true, regardless of the nature of the asset, such that those candidates who focused on whether or not the property was a business asset had missed the point. This was not too great a problem as there were only two marks available. However, a minority of candidates made things worse by ignoring the fact that this question part needed to be

answered in approximately 3.5 minutes and wrote about gift relief at length, thus wasting time.

Part (ii) concerned Dana's inheritance tax position. Those candidates who made a genuine attempt to answer the question here did well. The technical issues in this question were:

- ▣ The transfer of the rental property in December 2007 was a chargeable lifetime transfer, such that we needed a value for the property in order to determine the nil band available for the transfer in September 2012.
- ▣ The gifts of cash to family members were potentially exempt transfers, such that they would not affect the nil band while Dana is alive.
- ▣ The cash gifts may be exempt depending on the amount given, the date of the gift and the reason for the gift. Exempt gifts would not use Dana's annual exemptions, such that they may be available for relief against the transfer to the trust.

This question was different from past inheritance tax questions and required some thought before it could be answered. It was not technically difficult but required candidates to address the specific question. The minority of candidates who wrote about inheritance tax in general terms and ignored the specifics of the question did poorly, as did those who tried to calculate inheritance tax liabilities. Some candidates let themselves down by writing that they needed 'the details of the gifts' without specifying what those details were and why they needed them.

## QUESTION 3

This question, in two parts, concerned two close companies: Banger Ltd and Candle Ltd.

Part (a), Banger Ltd, was in two parts. Part (i), for three marks, required candidates to explain the taxable income arising out of the use by a minority shareholder of a car owned by the company. Almost all candidates were able to calculate the benefit in respect of the use of the car but not all of them realised that this would be taxed as a distribution rather than employment income. Many of those who knew this point still failed to earn full marks because they did not state the reasons for this treatment; those reasons being that the company is a close company and that the individual is not an employee.

Part (ii) concerned the treatment of company distributions before and after the appointment of a liquidator.

**MOST CANDIDATES KEPT THEIR ANSWERS BRIEF AND VERY FEW FELL INTO THE TRAP OF WRITING DOWN EVERYTHING THEY KNEW ABOUT THE BROAD TECHNICAL AREAS RELATING TO THE QUESTION**

Performance in this part of the question was mixed. Those candidates who did not do well either did not know the rules or were not careful enough in addressing the requirements. A lack of knowledge of the rules was unfortunate and not something that could easily be rectified in the exam room. Failure to address the requirements carefully was a greater shame as potentially easy marks were lost. The requirement asked for the tax implications for 'Banger Ltd, the minority shareholders and Katherine'. Most candidates dealt with the minority shareholders and Katherine but many omitted the implications for Banger Ltd. Candidates should always read the requirement carefully and identify all of the tasks. It would have been helpful to use sub-headings for each of the three aspects of the requirement to ensure that all of the aspects of the requirement were addressed.

Part (b) required candidates to calculate the corporation tax liability of Candle Ltd. On the whole, this part was done quite well by many candidates.

The two more difficult areas of this part of the question concerned loan relationships and a share for share disposal. The loan relationships issue was not done well. The vast majority of candidates failed to apply the basic rules, such that they did not offset the amounts in order to arrive at a deficit on non-trading loan relationships. This was not a difficult or obscure matter – it simply felt as though candidates were not giving themselves the time to think before answering the question.

The share for share disposal was identified by the vast majority of candidates who went on to point out that no chargeable gain would arise in respect of the shares. There was then a further mark for recognising that there would also be no gain in respect of the cash received as it amounted to less than 5% of the total consideration received. This point was picked up by only a small number of candidates.

#### QUESTION 4

This question concerned various aspects of capital gains tax, VAT and income tax and was in three parts.

Part (a) was split into two parts. Part (i) required a statement of the conditions necessary for the disposal of an asset to be an associated disposal for the purposes of entrepreneurs' relief, and was not done well. This is not an area of the syllabus that one would expect to see examined regularly and many candidates will have known immediately on reading

the requirement that they did not know the answer. However, the sensible approach would then have been to write a very brief answer with some sensible comments on entrepreneurs' relief. It is likely that this would have scored one of the three marks available.

Part (ii) was more straightforward and required candidates to calculate a capital gains tax liability. In order to do so, candidates had to know how to calculate a gain on the assignment of a lease and on the disposal of a remaining piece of land following an earlier part disposal. Entrepreneurs' relief was available in respect of some of the gains, and there was also a capital loss and the annual exempt amount that needed to be offset correctly.

In general this question was done well by many candidates. There was no problem in deciding what needed to be done, so those candidates who did poorly simply did not have sufficient knowledge of the rules.

Part (b) concerned registration for the purposes of VAT. The majority of the question was done very well including, in particular, the advantages and disadvantages of registering for VAT. However, some candidates' answers lacked precision when it came to the circumstances where compulsory registration is required in that taxable supplies were not clearly defined and/or the 12-month period was not clearly stated. Other candidates wasted time by writing far too much on the recovery of input tax. One area where performance was not good was the exceptions to the need to register, which were referred to only by a very small number of candidates.

The final part of the question concerned the matters to consider when making a claim to reduce a payment on account of income tax. This was an area that candidates would have been familiar with but it approached it from a slightly unusual angle: it was not done well. Candidates needed to use their common sense, as much as anything else, and to recognise that the claim would need to be made before the end of the tax year. This in turn meant that the tax liability would need to be estimated and that interest would be payable if the final liability turned out to be more than the estimated liability. Making these two points would have scored two of the three marks available for this part of the question.

#### QUESTION 5

This question concerned various aspects of capital gains tax, income

tax and inheritance tax and was in three parts.

Part (a) required detailed knowledge of the payment of capital gains tax by instalments. It was the most difficult part of the question and was not done well. The fundamental problem here was that candidates simply did not know the rules, such that they had very little to say. The smart candidates kept their answers brief and moved on to the easier marks in Part (b) and, particularly, Part (c).

Part (b) concerned the penalty for making a careless error in a tax return. The question stated that the error was careless but many candidates described the full range of penalties available for all error types, and therefore wasted time. Having said that, candidates' performance in this part of the question was good, with the exception of the meaning of potentially lost revenue (PLR), the figure on which the penalty would be based. PLR is the additional tax due following the correction of the error and not the amount of the undeclared income.

Part (c) required calculations of inheritance tax and was done well. Almost all candidates understood the relevance of the taxpayer being UK domiciled rather than non-UK domiciled, and most candidates handled the chargeable lifetime transfer correctly.

There were two common areas where marks were lost. First, many candidates omitted to calculate the original inheritance tax liability that would have been paid before the additional information was discovered. This calculation was necessary in order to calculate the tax underpaid. Second, many candidates were not sure of the due date for inheritance tax or, if they knew the six-month rule, they did not know how to apply the rule to the facts.

A minority of candidates did not know the mechanics of inheritance tax particularly well. As a result, they did not deal with the nil rate band correctly, or they included the chargeable lifetime transfer in the death estate. Other errors involved applying capital gains tax exemptions to inheritance tax and failing to calculate an estate rate in order to justify the double tax relief available.

#### PAPER P7 PASS RATE: 32% ADVANCED AUDIT AND ASSURANCE

Candidates' overall performance in respect of the December 2012 paper was similar to previous sittings. The paper included requirements relating



# WHICH QUALIFICATION GIVES YOU MORE OPPORTUNITIES IN FINANCE?



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**to the planning and completion of audit engagements, as well as requirements involving ethical issues, audit evidence and audit reports.**

The exam consisted of two sections. There were two compulsory questions in Section A – Question 1 for 40 marks and Question 2 for 28 marks. Section B comprised three further questions of 16 marks each.

The vast majority of candidates attempted the required number of questions, and there was little evidence of time pressure. In Section B, Question 4 was marginally less popular than the other two optional questions.

Similar factors as detailed in previous examiner reports continue to contribute to the unsatisfactory pass rate:

- ❑ Failing to answer the actual question requirements.
- ❑ Lack of knowledge on certain syllabus areas, including core topics which are regularly examined.
- ❑ Discussing too few points and generally writing too little for the marks available.
- ❑ Identifying a number of relevant points but failing to expand on them.
- ❑ Lack of analytical skills.
- ❑ Illegible handwriting and inadequate presentation.

The rest of this report contains a discussion of each question, highlighting the requirements that were answered well, and the areas that need improvement.

**SPECIFIC COMMENTS**  
**QUESTION 1**

This question was for 40 marks, and was split into four question requirements. As is typical for Question 1, the scenario and requirements involved the planning of the audit, and information was given on the business background and recent developments of the client company, as well as some financial information. There were also ethical issues embedded in the scenario.

It was clear that the majority of candidates were familiar with audit planning questions and seemed comfortable with the style of the question and with the amount of information that had been given in the scenario. There was little evidence of time pressure despite the length of the question.

Requirement (ai) was for 12 marks, and asked candidates to evaluate the business risks faced by the company. This was by far the best answered requirement of the exam, with most candidates identifying and explaining a

range of relevant business risks, which on the whole were developed in enough detail. Most candidates tended to be able to discuss at least six different business risks, with foreign exchange issues, the loss of several executives, reliance on a single supplier and too few customers, and the problems of operating in a high technology industry being the most common risks discussed.

For candidates who achieved lower marks on this requirement, the problem was that they did not develop their discussion enough to achieve the maximum marks per point. Some of the answers just repeated the business issue as stated in the question without discussing any of the impact on the business at all. Most candidates discussed going concern, which was relevant, but instead of relating going concern to specific matters such as liquidity problems and the large loan, it was simply mentioned as a conclusion in relation to every business risk discussed, and therefore was not specific enough to earn credit.

Many answers could have been improved in relation to business risk evaluation by including some simple analysis of the financial information made available – for example, through the calculation of profit margins and trends. This would have been an easy way to develop the point that financial performance was suffering, as well as liquidity being poor.

Requirement (a(ii)) was for eight marks, and was less well answered. Candidates were asked to identify and explain four risks of material misstatement to be considered in planning the audit. (Note the UK and IRL adapted papers had a slightly different requirement with no specific number of risks of material misstatement required and a mark allocation for (ai) and (a(ii)) combined at 20 marks.) Answers were very mixed for this requirement. Some candidates clearly understood the meaning of a risk of material misstatement, and could apply their knowledge to the question requirement, resulting in sound explanations. However, despite this being a regularly examined topic and the cornerstone of audit planning under the Clarified ISAs, the majority of answers were unsatisfactory.

First, many candidates included a discussion about this being a first year audit that would result in a risk of material misstatement, but this was both incorrect and showed that the question had not been read carefully enough. Then, when attempting to explain a risk of

material misstatement, many candidates could do little more than state a financial reporting rule, and then say the risk was that 'this would be incorrectly accounted for'. It was not clear if this type of vague statement was down to candidates being reluctant to come to a decision about whether a balance would be over or understated, or if they thought that their answer was specific enough. Very few answers were specific enough on the actual risk of misstatement to earn credit.

The matters that tended to be better explained were the risks of misstatement to do with inventory obsolescence, impairment of property, plant and equipment, and the finance costs associated with the new loan.

On a general note, many candidates seemed confused between a business risk and a risk of material misstatement, and some answers mixed up the two. Candidates are reminded that it is an essential skill of an auditor to be able to identify both types of risk, and that they are related to each other, but they are not the same thing.

Requirement (a(iii)) was for eight marks, and focused on ethical issues. The requirement was to discuss the ethical issues raised in the scenario and to recommend actions to be taken by the audit firm. There were two ethical issues of relevance to planning the audit – the contingent fee that had been requested by the audit client, and the matter of the previous audit manager potentially gaining employment at the client. Answers here were mixed, and generally the answers in relation to the contingent fee were better than those in relation to employment at a client company. On the contingent fee most candidates seemed confident in their knowledge, and correctly identified that a contingent fee is not allowed for an audit engagement, and recommended sensible actions such as ensuring a discussion of the matter with those charged with governance. The majority of candidates had the correct knowledge here, and could apply appropriately to the question. As usual, candidates appear reasonably comfortable with the ethics part of the syllabus, but are reminded that to score well on ethical requirements in Paper P7, they must do more than just identify a threat.

On the matter of the previous audit manager going to work at the audit client, answers were unsatisfactory. Most could identify that it was an ethical threat, and could suggest which threat(s) arose, but were less competent at explaining why the threat arose in the first place. Most answers suggested at least one safeguard,

## ON A GENERAL NOTE, MANY CANDIDATES SEEMED CONFUSED BETWEEN A BUSINESS RISK AND A RISK OF MATERIAL MISSTATEMENT, AND SOME ANSWERS MIXED UP THE TWO

usually involving reviews of work performed and ensuring that the manager has no further involvement with the audit. Such answers were fine, but many also made inappropriate suggestions along the lines of ‘forbidding’ the manager to work at the client, ‘prohibiting’ the audit client from taking on the manager, and ‘disciplining’ the manager himself. Very few answers considered the key ethical issue of considering whether the audit manager retained any connection with the audit firm. Some answers had incorrectly assumed that the manager was being loaned to the client on a temporary basis, rather than taking up a permanent position, and some thought that he would be involved in both the audit and the preparation of financial statements. It is important to read the scenario carefully and to take time to think through the information that has been given before starting to write an answer.

The requirements discussed so far attracted a maximum of four professional marks. Generally, candidates presented their answer in a logical and appropriate manner, and a significant number of answers included both an introduction and an appropriate conclusion. Most answers used headings to separate their answer points and generally the presentation was improved from previous sittings.

Requirement (b) was for eight marks and asked candidates to recommend the audit procedures that should be carried out in respect of an insurance claim that had been submitted by the client just before the year end. The wording of the requirement should have been familiar to candidates as it has been used in many previous exam questions. The scenario contained a brief description, which should have made candidates sceptical of the claim being eligible to be recognised as a receivable – particularly the fact that the claim was highly material and, if recognised, would have turned the company’s loss into a profit, and also the fact that the amount being claimed seemed very unrealistic when compared to the annual revenue. Unfortunately, very few candidates picked up on these matters, and did not question the amount of the claim or the timing of it, and very few answers specified the impact that it

would have on the financial statements. Most answers included one materiality calculation but not the impact the adjustment would have on the reported loss for the year.

While some answers correctly discussed the accounting and disclosure requirements for a contingent asset, a number of answers incorrectly thought that the claim should result in some kind of provision or liability.

The audit procedures that were recommended were mixed in quality. Most candidates suggested a review of the terms and conditions of the insurance policy to see if the situation was covered, and most also recommended reviewing the actual claim and contacting the insurance provider. All of these are valid and appropriate procedures and generally were well described. Some answers tended to state that the matter should be ‘discussed with management’ with no further explanation, or that ‘an expert should be consulted’ but with no description of what evidence the expert should be asked to provide, or even who the expert should be. Too many candidates seemed to want to rely on representations and discussions about the possible outcome of the insurance claim when there were other stronger sources of audit evidence available.

### QUESTION 2

This question was for 28 marks, and was split into three requirements. The scenario was based on the completion of a group audit, and candidates were given draft consolidated financial statements and a selection of key audit findings, based on the audit work that had already been performed.

Requirement (ai) was for four marks and asked for an explanation of why auditors need to reassess materiality as the audit progresses. This was linked to a part of the scenario where it was explained that the materiality level applied to the audit of the group has been reduced. Answers were usually limited here to a definition of materiality and a suggestion of how an appropriate materiality figure is determined, and few answers actually answered the question requirement. Those that did tended to focus on risk assessment and

the auditor uncovering new information about the client as the audit progresses. These points are both valid, but very few answers discussed them, or any other relevant points, in sufficient detail.

Requirement (aii) was for 18 marks, and asked candidates to assess the implications of the key audit findings provided on the completion of the audit. Guidance was given on this requirement, instructing candidates that they needed to consider risk of material misstatement and the adequacy of the audit evidence obtained. Candidates were also specifically instructed not to recommend further audit procedures. The scenario provided nine key audit findings to be assessed.

This is a good example of a question requirement where candidates were expected to think on their feet and not rely on rote learnt facts. The candidates who did as the question instructed and took time to think about the information in the scenario scored well, and there were some sound answers. However, the majority of candidates could not apply their knowledge to this scenario, leading to unfocused answers that did not actually answer the question requirement. Answers were, on the whole, unsatisfactory. Candidates tended to approach the key audit findings in a logical way, working through them in the order presented in the question. However, for each key audit finding most answers simply stated that audit evidence was not adequate without explaining why, and then gave a list of audit procedures, which was specifically not asked for. As in Question 1(aii), answers were inadequate at explaining risks of material misstatement, and in fact were worse in this question, maybe because audit completion is less frequently examined than audit planning. Candidates made mistakes in calculating materiality, using the wrong basis for most calculations, and generally did not understand the part of the information provided that dealt with other comprehensive income and its components.

Some key audit findings were better answered, mainly because marks could be awarded for financial reporting issues which candidates seemed comfortable discussing, namely the property disposal that could have been a financing arrangement, and the potential impairment of goodwill. However, all other key audit findings were inadequately dealt with, in some cases not even warranting an attempt at an answer, even though the issues, when thought through, were not difficult. For



example, the key issue in relation to the actuarial loss that has been suffered was that a written representation is not sufficient evidence for such a material figure, and that no work had been done to consider the competence of the service organisation that had provided the figures. In relation to the associate, candidates did not seem sceptical of the fact that there was no movement on the statement of financial position, which in itself indicates a potential misstatement. A significant number of answers thought that the auditor need not obtain audit evidence for a material balance if it had not moved during the year.

Requirement (b) was for six marks, and asked for a discussion of the advantages and disadvantages of a joint audit being performed on a newly acquired subsidiary. Most candidates could identify at least two advantages and two disadvantages, though often they were not discussed at all and the answer amounted to little more than a list of bullet points, which would not have attracted many marks. Some answers seemed to confuse a joint audit with an audit involving component auditors, and some used the fact that the foreign audit firm was a small firm to argue that it could not possibly be competent enough to perform an audit or have a good ethical standing. Most answers identified the cost implications for the client, and the advantage of involving a local firm that would have knowledge of the local law and regulations.

#### QUESTION 3

This question was marginally the most popular of the optional questions. Requirement (a) focused on tendering, and provided information in relation to a potential new audit client – a multinational, newly listed group requiring a cost effective audit to a tight deadline. The requirement, for eight marks, was to identify and explain the matters to be included in the tender document.

This was generally well attempted, with a significant minority of answers achieving close to full marks. The best answers went through each of the typical contents of a tender document and related them specifically to the group in the question, resulting in focused and well-explained answer points. Interestingly, these answers were often relatively brief, but still managed to attract a high mark through application of knowledge to the question scenario. The more common areas discussed were the international

network, audit specialism, fees and deadline, and the introduction of key members of the potential audit team.

Some answers tended to either be much too brief – sometimes little more than a list of bullet points – or did not answer the question requirement, and instead of explaining matters to be included in a tender document, discussed the matters that may impact client acceptance, such as whether the audit firm has sufficient resources, and whether a fee dependency would be created. Candidates are advised to read question requirements carefully and not to make assumptions about what is being asked for.

Requirement (b) was also for eight marks, and focused on ethics. Two suggestions had been made to help an audit firm increase its revenue – one was to give managers and partners a financial reward for selling non-audit services to clients, and the other to provide an external audit service to clients. The requirement was to comment on the ethical and professional issues raised by the two suggestions. Answers tended to discuss one of the suggestions reasonably well, but then repeat almost identical points in relation to the second suggestion. There was some overlap given that both involved the provision of a non-audit service to an audit client, but there were enough separate points that could be made to avoid repetition. In relation to the financial incentives for partners and manager selling services to audit clients, hardly any candidates discussed the issue of the significance of the ethical threat depending on seniority and that partners couldn't have the arrangement. Many also discussed the self-interest threat in relation to the audit firm rather than its personnel.

In relation to the extended audit, most answers explained the self-review threat and suggested appropriate safeguards, usually that of separate teams. Fewer discussed the need for extended review procedures or for separate engagement letters, and billing arrangements were the internal audit service provided to an audit client. Fewer still knew the position of the ethical codes in relation to this matter, and there was very little in the way of discussion of the topic as a current issue.

The UK and IRL adapted papers were slightly different in this requirement, as they focused solely on the extended audit situation and asked for a discussion of how the Auditing Practices Board (APB) has responded to ethical issues raised. Answers on the whole

were satisfactory, with candidates appreciating the revision made to APB Ethical Standards in relation to the provision of non-audit services generally, and that robust safeguards are needed in the situations where a non-audit service is provided to an audited entity. Candidates seemed aware that this is a very topical issue and were largely ready to discuss the issue in some detail.

#### QUESTION 4

This question looked at revenue recognition from the auditor's point of view, beginning with a short discussion requirement, and moving on to two requirements based on short scenarios. This was marginally the least popular of the optional questions in Section B.

Requirement (a), for six marks, asked candidates to discuss the statement 'Revenue recognition should always be approached as a high risk area of the audit'. Answers here were mixed. There were some sound answers, which often used simple examples to illustrate the type of situation where revenue recognition is complex or subjective, with construction contracts, hotel deposits and the provision of services being common and pertinent examples. Many answers also referred to the problems of manipulation of revenue and, again, sound answers illustrated the point with a simple example, the most common being pressure on management to maximise revenue or profit. It was, however, unsatisfactory that so few answers referred to ISA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, specifically the fact that ISA 240 requires the auditor to use a presumption that there are risks of fraud in revenue recognition.

Most answers focused exclusively on the risk factors. Only a minority of answers tried to provide a counter argument that some companies with good controls and simple revenue generating streams were being low risk. It is important in a discussion question to consider both sides of an argument.

Requirement (b), for six marks, asked candidates to comment on the matters that should be considered and the evidence they should expect to find when reviewing the audit file in respect of a consignment stock arrangement, which was described in the scenario. This was generally well attempted, with most candidates discussing that the accounting treatment adopted for the

consignment stock arrangement was not compliant with IAS 18, *Revenue*, and correctly determining the impact on profit, and the overall materiality of the transactions to the financial statements. It is perhaps odd that while this requirement did not ask for risks of material misstatement, most answers were competent at explaining exactly what the risk of misstatement was and also quantifying its impact, in contrast with Question 1(aii) and Question 2(aii), when risks of material misstatement was asked for, but not answered well. Candidates were less competent at explaining the audit evidence they would expect to find, and the answers here were usually limited to a review of the terms of the consignment stock arrangement, and evidence of an inventory count.

Requirement (c) took a different slant on revenue, this time providing a brief scenario in which a fraud had been discovered, whereby a sales representative had been submitting false claims for commission earned on sales generated. The requirement, which was for four marks, asked for procedures that should be used to determine the amount of the fraud. Only a minority of candidates realised that procedures should focus on testing the validity of the sales that the sales representative had claimed to have generated – and these candidates then usually recommended some specific, valid procedures. Other answers were inadequate, and relied on evidence from ‘discussing with management’ or ‘interviewing the suspect’ – but without actually recommending the questions they would ask. Some candidates simply did not answer the question and, instead of providing procedures, gave an explanation of the steps involved in a forensic investigation, or focused on how they would ‘catch’ the culprit and punish them.

#### QUESTION 5

This question, as is typical for Question 5 in Paper P7, focused on reporting. The scenario for requirement (a) described the loss of accounting records that had occurred one month before the year end of a listed audit client. The records had been held by a service organisation, which had provided reconstructed records in respect of those that had been lost. Requirement (ai) was for seven marks, and asked candidates to comment on the actions that should be taken by

**SOME CANDIDATES SIMPLY DID NOT ANSWER THE QUESTION AND, INSTEAD OF PROVIDING PROCEDURES, GAVE AN EXPLANATION OF THE STEPS INVOLVED IN A FORENSIC INVESTIGATION, OR FOCUSED ON HOW THEY WOULD ‘CATCH’ THE CULPRIT AND PUNISH THEM**

the auditor, and the implication for the auditor’s report. Most candidates correctly discussed the fact that the auditor was unable to obtain sufficient, appropriate audit evidence based on the reconstructed records, leading them to explain that the audit opinion should be disclaimed. Fewer candidates suggested that alternative procedures could be used to obtain evidence, and fewer still recognised that as the accounting records were available for 11 months of the year, the audit report may not necessarily be subject to a disclaimer of opinion, or even qualified at all if alternative procedures could take place. A small minority of answers discussed the fact that due to the client being a listed entity, it would most likely have back-up records of its own and not be totally reliant on the service organisation in any case.

Some answers demonstrated a lack of knowledge on audit reports, stating incorrectly that an adverse opinion would be most appropriate, and few answers described the need for discussing the potential modification with those charged with governance, instead opting for resignation in the face of such ‘incompetent’ management.

Requirement (aii) for three marks asked for a discussion of quality control procedures that should be carried out by the audit firm prior to the audit report being issued. Sound answers appreciated that because the client in the scenario was listed, an Engagement Quality Control review would be required, and the answers that described what such a review would entail achieved the maximum marks. Most answers were too general, however, simply describing the quality control procedures that would be relevant to any audit. Many answers were extremely brief, with little more than a sentence or two provided.

Requirement (b), for six marks, was based on a scenario that described a review engagement that was taking place on the interim financial statements of another listed company. An accounting policy in relation to warranty provisions had been changed in the interim financial statements and,

based on the information provided, candidates should have appreciated that the accounting treatment was incorrect. Figures were provided to enable materiality to be calculated. The requirement was to assess the matters that should be considered in forming an opinion on the interim financial statements, and the implications for the review report. Most answers were good at discussing the accounting treatment for the warranty provision, that the non-recognition was not appropriate, and the majority correctly assessed the materiality of the issue. Answers were inadequate in discussing the impact of this on the review report, being mostly unable to say much more than the auditor would need to mention it in the review report. There seemed to be a lack of knowledge on anything other than the standard wording for a review report, with many answers stating that the wording should be ‘nothing has come to our attention’ followed by a discussion that there actually was something to bring to shareholders’ attention, but with no recommendation as to how this should be done.

#### CONCLUSION

This exam sitting showed that candidates must take time to think through not just the information they are given in a scenario, but also what they have been asked to do with that information. Many candidates failed to achieve a satisfactory mark at this sitting because they rushed to answer a question requirement without really understanding what the requirement actually instructed them to do. In some cases there is a definite lack of knowledge, which is compounded by inadequate analytical skills.

As stated in previous examiner reports, analytical skills do not just relate to numerical analysis – they also refer to the ability to understand and evaluate the narrative information provided in question scenarios to detect the key issues contained. As usual, candidates are encouraged to work through past questions and answers as an important part of preparation for this challenging exam.



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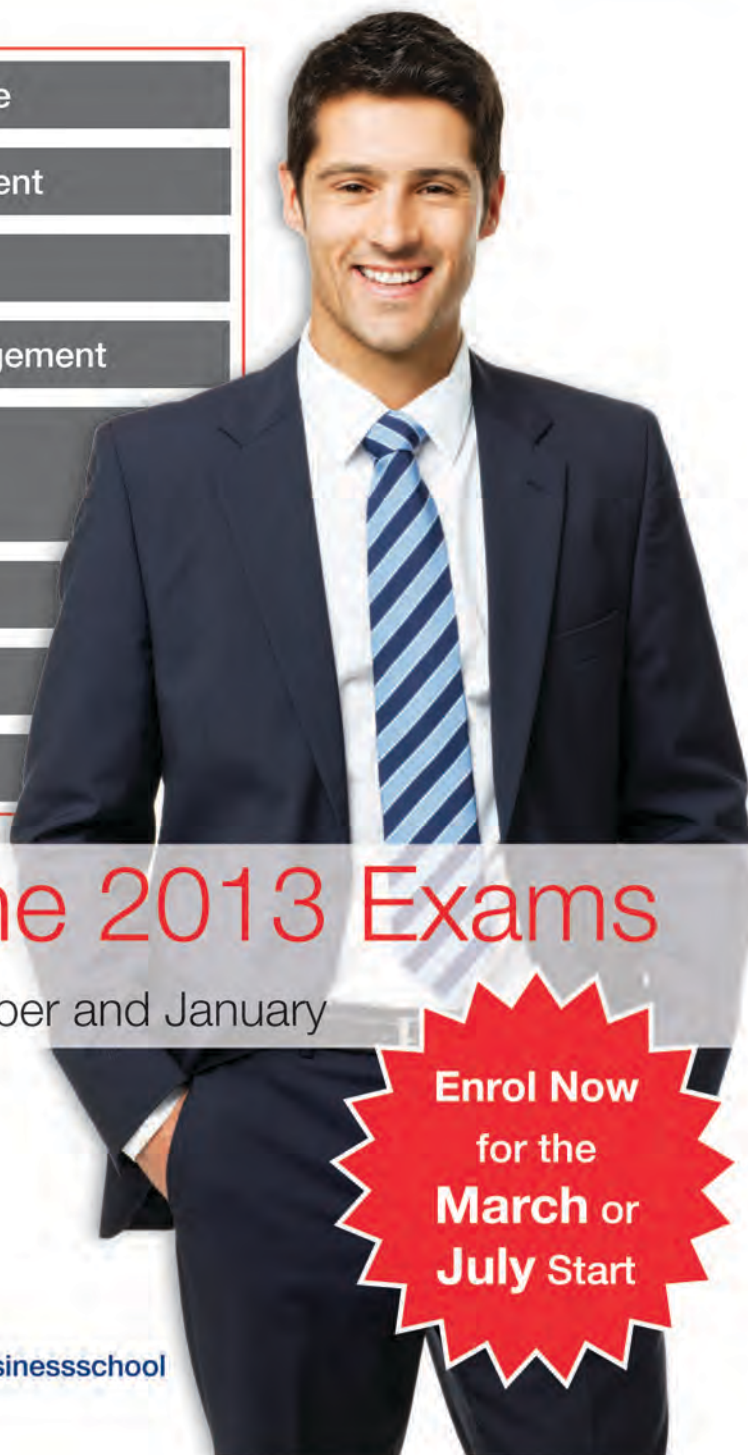


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