

CHANGES TO THE STUDY GUIDE

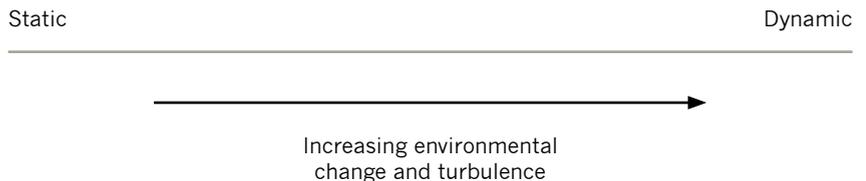
PART 1 RELEVANT TO ACCA QUALIFICATION PAPER P1

June 2011 sees a number of new additions to the Paper P1 *Study Guide*. I will explain these changes in two consecutive articles. In this issue, I discuss the dynamic nature of risk, management responses to changing risk assessments, risk appetite, and the concepts of business and financial risk. In the next issue of *Student Accountant*, I conclude my discussion of the *Study Guide* changes.

In seeking to maintain the currency and relevance of the P1 *Study Guide*, I have made a few changes which come into effect from the June 2011 exam onwards. All are in the risk sections of the syllabus and reflect some of the latest thinking in risk management as well as some issues that have arisen as a result of recent events in business. In this article I discuss each of the changes I have made.

I am also introducing the possibility of bringing in some simple arithmetic calculations into Paper P1 exam papers (again, from June 2011 onwards). This is to enable some aspects of risk to be examined that cannot be examined in a solely narrative-based answer. This is a change to the advice I gave when the Paper P1 *Study Guide* was first introduced. Students should not expect complicated calculations but should be prepared to manipulate numerical data and accordingly, a calculator may be helpful in future Paper P1 exams.

FIGURE 1: THE NATURE OF RISK ASSESSMENT



New C1(c): Explain the dynamic nature of risk assessment

This entry into the *Study Guide* was added to emphasise the fact that risks are not static: they change over time and between situations. One of the key features of any business environment is that the things that affect an organisation, either internal or external factors, are very changeable. In some situations, environmental factors change relatively little, but in other environments, risk factors can change a great deal. These are sometimes called 'turbulent' environments, shown in **Figure 1**.

As with environmental analyses in strategic analysis, it is important to recognise that the extent of environmental change can be understood as a continuum (see **Figure 1** above). Continua of any type describe two extremes and a variable state between the two extremes. At the left extreme is the situation in which nothing in the internal or external environment of an organisation ever changes.

This means that no risks ever change from year to year – no new risks materialise and no existing ones disappear or weaken. Of course this is only a theoretical situation and doesn't exist in practice. It's the same at the other extreme – a situation in which the environment changes so frequently that all risks are changing all the time. Again, this situation doesn't exist in reality, but situations close to it do exist. It is also the case that the risks that an organisation faces can change with changes in the internal activities as well as with external environmental changes. New product launches, changes in financial structure, changes in markets served, etc, can also change the risks faced by an organisation.

What matters is to appreciate that organisations differ in how exposed they are to changes in internal and external risks. Some are very changeable, perhaps in industries that are subject to a wide range of local and international influences (perhaps shipping, telecommunication and technology)

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while others are subject to fewer and less changeable risks. In other words, they occupy different positions along the static-dynamic continuum.

The result of this is that the assessment of any given risk can change and, thereby, the strategy for managing that risk.

The probability or impact of a risk can change over time and this change can move a risk on the likelihood/impact map which is often used in risk assessment (see **Figure 2**).

Suppose, for example, Risk A has a high potential impact and is assessed as having a 60% likelihood of materialising in a given period of time. Then a change in the environment or in the company's internal controls occurs which makes the likelihood much less, say down to 25%. The risk would then move on the graph, as shown on **Figure 2**, from position A to A'.

Similarly, suppose a risk is very unlikely but with a high potential

impact (position B). A change in the environment might decrease the potential impact of the risk, moving it on the map to position B'. In both cases, the risks have moved, as a result of the environmental change, to a new area of the map. In both cases, the strategy adopted for managing the risk will be likely to change.

New C1 (d): Explain the importance and nature of management responses to changing risk assessments

Following on from the discussion above about changing risks, it follows that management must tailor its risk management to match the nature of the risk threat. In terms of policy, those organisations in more changeable (or more dynamic) environments must make a greater investment in risk management strategies in order to manage the range and changeability of those risks. It follows that an organisation's

risk management must match the complexity of its risks. To fail to do this would be an incongruity between risk and response which could, in turn, be a failure in the strategy of the organisation. Some of the themes relevant to this entry are touched on in the other additions to the *Study Guide* which I have described in the remainder of this article and in the follow-on article in the next issue of *Student Accountant*.

New C1 (e): Explain risk appetite and how this affects risk policy (2)

This addition to the *Study Guide* introduces the notion of risk appetite which, as its name suggests, is a measure of the general attitude to accepting risk. Some individuals live their lives in a very careful way, seeking to avoid risks and withdrawing from situations in which a risk might be experienced. Other people, conversely, positively seek out and thrive on risk. They might enjoy gambling, parachuting, scuba diving and similar activities with very high potential hazards/impacts.

In the same way, some organisations are risk averse while others are risk seeking. Rather than doing this for the 'thrill' of it, however, risk-seeking organisations generally seek risk in the belief that higher risk is often associated with higher returns.

This range of possible attitudes to risk can be represented on a continuum (see **Figure 3** on **page 3**).

FIGURE 2: RISK ASSESSMENT PROBABILITY

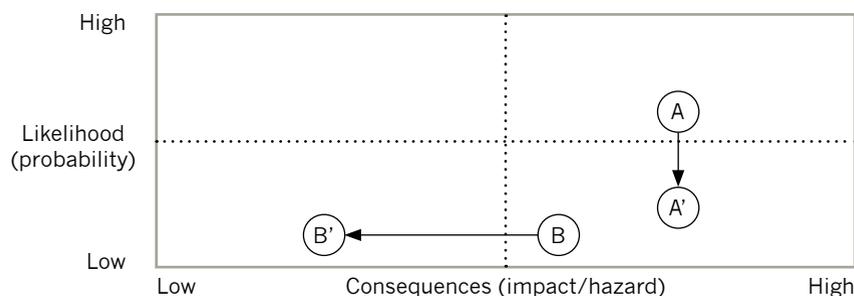
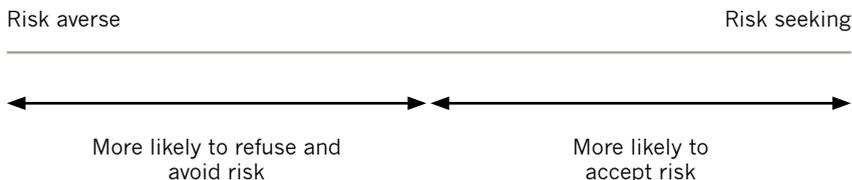


FIGURE 3: RISK ATTITUDE CONTINUUM



As with any other continuum, the two ends represent to two possible extremes while 'real life' takes place at various points along the continuum between the two extremes.

At the left-hand extreme is the situation of an organisation that always accepts risk and is actively risk seeking. At the other extreme are organisations (also mainly hypothetical rather than real) that never accept any risks and manage the strategy to always avoid situations in which risk may occur.

Risk appetite has an important influence on the risk controls that the organisation is likely to have in place. Organisations that actively seek to avoid risks, perhaps found more in the public sector, charitable sector and in some 'process'-oriented companies, do not need the elaborate and costly systems that a risk seeking company might have. Organisations such as those trading in financial derivatives, volatile share funds and venture capital companies will typically have complex systems in place to monitor and manage risk. In such companies, the management of risk is likely to be a strategic core competence of the business.

New C2 (c): Describe and evaluate the nature and importance of business and financial risks

In the original *Study Guide* for Paper P1, I listed a range of common risks encountered by organisations in section C2b. This list was far from comprehensive but did serve to illustrate some of the specific risks that are commonly faced. In adding this new entry to the *Study Guide*, I want to clarify the fact that there are other risks that can affect organisations.

Business risks are strategic risks that threaten the health and survival of a whole business. A number of factors can increase business risk and one of the purposes of the annual audit is to review the factors that might increase business risk such as the presence of any operational, financial or compliance failures that might affect the business as a 'going concern'. Business risk varies greatly between companies and sometimes over time, and is generally thought to be greatest for young businesses or those in cyclical industries such as tourism. The banking crisis in 2008 and 2009 taught us, however, that business risk can also apply to much older and more established companies.

A typical way of considering business risk is to examine the probability of a period of poor earnings and possible failure, and also to consider the potential impact of that failure. This brings us back to the notion of stakeholders because the issue is 'impact upon whom?'

The stakeholders most affected by business risk depend on the situation. If the business fails altogether, the employees will be greatly affected but the shareholder loss will depend on the individual exposure (the proportion of a portfolio invested in the failing company). If the business experiences a period of poor performance, the shareholders may be more adversely affected than the employees.

One of the major causes of business risk is financial risk. Large variability in cash flow and liquidity introduces instability to the financial health of the business. While these can be caused by trading fluctuations, the financial structure of a business can also be a strong contributory factor. High gearing, for example, can place pressure on cash flow because of the need to service debt in a way that would not be necessary with a higher proportion of equity capital. So while debt can be a favourable means of financing when interest rates are low or when equity capital is difficult to raise, it increases financial risk because of the increased likelihood of strained cash flow and defaulting on debt repayment.

Financial risks are typically of most concern to lenders and those that depend upon a company's cash flow such as suppliers who rely on prompt payment of payables.

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